Perspectives

Boots and IAS19

Received (in revised form): 12 September, 2007

Guy Fraser-Sampson

is the author of various books and articles, including 'Multi Asset Class Investment Strategy', which looks at asset allocation for pension funds in the light of modern investment theory.

Abstract This paper looks at IAS19 in the light of the Boots pension scheme in the UK. The paper was originally written during the takeover of Boots by KKR, when the outcome of the situation in which the pension fund found itself was not known. The writer examines IAS19 and concludes that its scope and purpose is widely misunderstood and misused. In particular, it is inappropriate for use as a basis for investment strategy, or for regulatory purposes.

Pensions (2007) **12**, 207–211. doi:10.1057/palgrave.pm.5950055

Keywords: *IAS19, FRS17, pension regulation, pension regulators*

The takeover of Boots by KKR in the UK in June of this year looks set to become a landmark case in the ongoing story of pension fund deficits, the precise nature of a sponsor's responsibilities and the extent to which it may be relevant to take into account in advance possible future changes to the strength of the employer covenant. (At the time of writing this paper, no settlement had yet been agreed; subsequently KKR agreed to pay a considerable sum into the pension plan.) However, there is an aspect of the story that everyone seems to have overlooked, and it is this on which I would like to concentrate. Why should KKR actually have had to pay the pension plan anything at all?

Nobody would quarrel with the proposition that the trustees of a pension scheme that is in deficit have the right, nay the obligation, to ensure that on any change of control of the sponsoring employer, or transfer of its business undertaking, adequate measures are in place to take care of the deficit, either by way of a lump

sum payment, additional future contributions, asset security, etc. Indeed, should they not do so then they would be laying themselves open to possible legal action. The responsibilities of a trustee are heavy, and the standard of care high; after all, this is what the law calls a relationship *uberrimae fidei*, or of the utmost good faith.

It is therefore of paramount importance that we should have a tool available to calculate precisely when a pension fund is in deficit, and this is of course where IAS19 comes into the picture. Given effect under different names in different countries (in the UK it is FRS17), this is an accounting standard that arrives at a figure for insertion in the financial accounts of the sponsor that represents the net present value of the future liabilities of the scheme. If the current net asset value of the scheme at least matches this figure, then there is no deficit; if it doesn't, then there is. This figure, or at least the way in which it is arrived at, is universally accepted by auditors, finance directors, pensions consultants and trustees. It is blessed by the NAPF (the UK's pensions industry body), Parliament, the Pension Regulator and the Accounting Standards Board. It is quoted in newspapers and financial publications.

Correspondence: Guy Fraser-Sampson,
E-mail: guyfs@yahoo.co.uk

A whole investment industry (so-called Liability Driven Investment) has sprung up around it. Surely, then, the Boots trustees would be the last people to question it?

FRS17 apparently shows, however, that the Boots scheme was not in deficit but enjoyed a small surplus. One is therefore driven to wonder just what the trustees were objecting to, and why. Their scheme was fully funded on the basis of currently envisaged contribution levels. The assumptions on which the figures rest will presumably have been blessed by the scheme's actuaries. The current level of future contributions will presumably have been built into KKR's cashflow models. Thus, the only possible area of legitimate concern would be were the trustees to believe that the funding arrangements being proposed by KKR for the deal as a whole would make it significantly more likely that the sponsor might not after all be able to continue with the current level of contributions. Yet, this could logically only come about if the financial future of the company were to fall through the floor of the lowest case in the funding model, and even then the Pension Regulator would automatically be brought into play, behind whom would be the ultimate fall-back position of the Pension Protection Fund.

Yes, I am being deliberately provocative. Yes, the situation is decidedly more complex and less clear-cut than I am making it appear to be. Yet I am doing all of this for a purpose. I want to focus this discussion on one particular point, and I have deliberately simplified the argument thus far because I believe that the particular point in question is actually a very simple one, although consistently and dramatically misunderstood by pension trustees, with potentially tragic consequences for the members of occupational schemes.

I would like to be able to say that people have lost sight of what FRS17 is, but I cannot. The sad truth is that most people have never properly understood it in the first place, and therefore have nothing of which to lose sight. Let me say at once, however, that by and large this is not their fault. Just as the true purpose of FRS17 has been hopelessly compromised by it being used

officially for purposes for which it was never intended, so the perception of it among pension trustees has been confused to the point of total incomprehension.

Once upon a time, companies were free to treat their pension arrangements for accounting purposes in any way to which they could get their audit partner to agree. How was one to treat a pension fund surplus, for example? Some sponsors took it onto their balance sheet as a company asset. How was one to account for the nonrepeatable element of company earnings to the extent that they were generated by pension contribution holidays? Some companies simply ignored this issue. This was bad enough in the days when pension fund surpluses were the norm, but once the funding deficit crisis became apparent then the problem rapidly assumed alarming proportions. Investors, analysts, suppliers, customers and bankers (not to mention pension regulators and trustees) all have a clear legitimate interest in being able to study a set of financial accounts that have been drawn up rigorously and transparently. Hence the need for an accounting standard.

This may surprise those who have not themselves trained as accountants, but accounting standards are not concerned with accuracy. They are concerned with fairness and consistency. The aim of IAS19 (of which FRS17 is the British implementation) was to establish a method for viewing pension liabilities that was logical and acceptable (ie fair) and would be implemented by every company in the same way (ie consistent). To do this, they came up with the idea of asking the actuaries to assess future funding obligations on the basis of pre-agreed assumptions, and then to discount these figures by the bond rate to arrive at a Net Present Value. The difference between this figure and the Net Asset Value of the pension plan gives the surplus or deficit as appropriate for the sponsor's balance sheet.

So far, so good. What is not properly understood is this. IAS19/FRS17 (it is called different things in different countries) does a great job for what it is designed to do. Indeed, it is difficult to see how a figure could be derived for accounting purposes without some form of

discounting taking place. Nobody pretends, certainly not the accounting or actuarial professions anyway, however, that the figure it produces is correct. It is in the belief that it can happily be adopted by trustees and used for their own purposes that the misunderstandings arise.

Even if it was correct (which it isn't), it does not purport to show the liabilities of the scheme to its members, but rather the liabilities of the sponsor to the scheme. Secondly, the liabilities that it discounts are not the real future liabilities, but rather have been arrived at as a result of some very contrived assumptions, including the fact that there will be no dramatic increase in longevity. In the UK, for example, many Local Authority schemes (all DB schemes open to new members, and among the very biggest schemes in the country) are still using 1992 actuarial projections, and many schemes, both corporate and public, assume that there will be no further marked lengthening in life expectancy after the next 20 years.¹

At the end of the 19th century, the average life expectancy for a British male was about 45. By the end of the following century, the corresponding figure was more than 80. Recently, average life expectancy increased by one year in the space of just one calendar year. It is entirely possible that within the next 20 years, people may expect routinely to live to one hundred. None of this is factored into IAS19 calculations. Yet just this one factor has the potential to blow apart all current pension fund liability workings.

Then there is the question of the discount factor. Why take the bond rate? If it is designed to mimic the effect of the investment return on the pension pot, then why not take a rate that is appropriate to the planned asset allocation of the pension fund, which will typically currently be about 70 per cent in quoted equities?

Hence, even a very cursory examination reveals that the IAS19/FRS17 approach ignores the real possible future liabilities of the scheme, the effect of inflation and the most likely impact of investment returns. It does what it sets out to do perfectly adequately, but, like any tool, if you try to use it for a purpose for which it was not designed then it will do a very bad job. If you try

to use a chainsaw to slice a loaf of bread then not only will it make a terrible mess but it may well kill someone, and unfortunately this is exactly what we see when we turn to the (mis)use of IAS19 by regulators.

One might naively expect pension regulators to be concerned with the relationship of a pension plan with its members, and specifically the ability of a pension plan to pay its (real, actual) liabilities to its members as they arise. Instead, for reasons best known to themselves, they have chosen to seize upon the relationship between the pension plan and its sponsor and specifically the ability of the sponsor to pay its (unreal, artificial, discounted) liabilities to the pension plan today. This is in fact doubly illogical as you can only calculate the latter figure properly if you have first worked out the former.

Rather than follow any discernible logic, regulators across Europe have seized upon IAS19 as the panacea to all their concerns. In Scandinavia, a 'traffic light' system has been introduced, while the Netherlands have dreamed up the even more draconian FTK approach. There is no need to go into details, as these schemes will already be well known to pension practitioners, but not only are they based on a measure that cannot possibly be an accurate representation of scheme liabilities, not only do they attempt to match discounted net present values with actual market values, but worst of all they are a medicine aimed at the wrong disease, and whose side effects can make the real disease very much worse.

The European regulatory approach, of which the UK variant is more flexible but based on exactly the same principles, is essentially concerned with solvency. Why else would they be concerned with the theoretical position if the liabilities of the plan were to crystallise today? Yet there is not a pension plan in Europe, no matter how badly funded, that has a short-term solvency problem. What they have is a long-term investment returns problem. To solve the former, you will be required by the regulator to sell equities into a falling market in order to buy bonds. To solve the latter you need to be able to sell bonds to buy equities in a falling market. This

is a very simplistic example, but it will serve; the two are diametrically opposed. Solvency requires liquidity, but liquidity comes at a heavy cost in the shape of lower investment returns. Today's pension plans do not need liquidity; their liabilities must be met not today but as they fall due in the years to come. What they do need is the higher investment returns that they may legitimately expect to earn from investing in less liquid market segments.

Incidentally, these regulatory approaches may also be illegal, as the European Pensions Directive provides that no pension plan can be forced to reduce its exposure to equities below a certain amount, but this does not seem to concern anyone, not least the politicians who put these systems in place and who are of course expressly subject to European law.

It is when the IAS19 figure is seized upon by trustees, however, that the potential for even greater damage arises.

First, there is the danger that pension trustees who misunderstand what IAS19 is and how it operates (and why shouldn't they — it's not their job, after all) might seize upon the dangerously persuasive idea that as the bond rate is used to discount their 'liabilities' then all they have to do is match these against bonds and they will somehow have crystallised their financial position. In fact, of course, none of this is true, not least because it is not the most likely future liabilities that are being discounted, but only those that are the product of actuarial assumptions that are looking increasingly inadequate and out-dated, and that are not even applied consistently from one company to another anyway. In fact, the only thing that can be guaranteed to result from any of these so-called 'Liability Driven Investment' schemes is that the deficit figure will increase (if only as actuarial assumptions change), ironically the one result that such schemes are supposed to avert.

Secondly, there is the problem that thinking within an IAS19 environment blinds trustees to the wider picture, particularly as regards investment. There are one or two European pension plans that do attempt to model their cashflows and liabilities out into the future, and then try to extrapolate their target rate of

investment return. I know, because I have spoken to them, but they are very few and far between indeed, in contrast to North America where this practice (Liability Driven Investment properly so-called) is commonplace. As a result, instead of asset allocation taking place within a proper strategic framework, where specific objectives are defined and agreed and plans are then made to achieve them, it actually takes place within a vacuum. Instead of the target rate of return driving the choice of assets, an asset mix is chosen arbitrarily (and usually by reference to what other pension funds are doing) and whatever return that mix is likely to produce is adopted as the target rate of return. This is the tail wagging the dog with a vengeance.

Indeed, it seems so obviously illogical to use IAS19/FRS17 as a pension regulatory measure, when it was clearly designed to be nothing of the kind, that it calls into question government motivation for choosing it in the first place. Could it be that IAS19-based approaches are at the very least strongly persuasive of the 'need' to invest in government bonds, thus creating overwhelming demand for government bonds, which in turn has led to them trading at historically low prices? Not to mention the inverted yield curve that has been the result of the scramble for long-dated bonds in particular, which means that long-term government debt can now be issued more cheaply than short-term government debt? To boost demand artificially for a product of which one is the monopoly supplier may well seem an attractive model to politicians such as the new British Prime Minister, who, lest it be forgotten, was personally responsible for the ill-timed tax raid on British pension funds, which added very significantly to their problems.

It also raises questions about the eagerness of pension regulators to implement such a system. Every person I have ever met who has worked for a pension regulator, both in the UK and overseas, has been an intelligent, well-educated professional. Why, then, should they be so ready to pursue a process that seems so fundamentally flawed? It used to be acceptable professional practice to challenge one's brief, but apparently no more.

I said earlier that what regulators are essentially doing is prescribing the right medicine for the wrong disease, and I have expanded on this theme elsewhere.² Briefly, even if IAS19 were a proper measure of pension plan funding (which it isn't), it could only possibly be relevant to short-term solvency. It is the equivalent of the accountant's 'quick ratio'. It measures, in so far as it measures anything at all, the ability of the combined resources of the plan and the sponsor to pay (albeit wrongly calculated) liabilities today. Not as they arise, but today. This central truth is both so fundamental and so overlooked that it bears repeating: there is not a pension plan in Europe, no matter how badly funded, that has a short-term solvency problem. Not one of them is in danger of not being able to meet their benefit obligations over the next 5–10 years, and yet this is the basis on which they are being assessed by regulators. Pension plans do not have a short-term solvency problem. They have a long-term investment returns problem.

Sadly, the medicine for the imagined disease makes the real disease very much worse. Focusing on liquidity denies pension funds the extra returns offered by less liquid market segments, such as those pursued so avidly by the likes of the Yale Endowment. Forcing pension plans to sell equities in falling markets can likewise only damage their long-term return prospects. Investing in bonds (at all) requires pension trustees effectively to drive along with the handbrake on. Regulators are killing the patient, not curing it.

Overall public policy towards occupational pension plans in the UK has been baffling, to say the least. Again, a naïve observer might imagine that it would be government policy to encourage employers to keep DB schemes open. In the Netherlands, for example, it is extremely difficult to close one, and even then usually conditional on pre-funding a DC scheme that is likely to offer a similar level of benefits. British government and regulatory policy, by contrast, was to hit plan sponsors repeatedly over the head with a baseball bat until they closed their DB scheme, at which point they wandered off with the satisfied air of a job well done. Pension policy

cannot be a hammer without an anvil. Nor can it be a stick without a carrot. If you simultaneously make it very onerous for an employer to continue a DB scheme and very easy for them to cease operating it, it does not take a genius to predict the likely outcome.

Whatever the case, we are apparently stuck with an IAS19 view of the world for the foreseeable future. It is therefore most important that trustees should be made aware by those to whom they have a right to look for advice (chiefly, the consultants) that from an investment point of view, it simply does not offer any valid starting point. This is not something that has been done nearly as well as it should have been, and consultants need to re-double their efforts, particularly with lay trustees who find these concepts understandably confusing. To understand that figures that have been drawn up for one purpose cannot properly be used for another, is not an easy thing to explain but hopefully consultants will rise to the challenge.

The ultimate irony, though, is exposed by the Boots situation, which, to a disinterested observer, seems suspiciously like a case of wanting to have your cake and eat it too. The one thing for which FRS17 is universally accepted in the UK is as a measure of the sponsor's obligations to the pension plan. Thus, if the Boots plan was fully funded according to this measure, what cause did they have for complaint? Were they saying that although FRS17 is supposed to be a proper measure of that liability, it isn't really after all? Was the pension regulator going to say that if and when he got involved? The possibilities are intriguing.

Either FRS17 is a proper measure of pension funding adequacy or it is not. If it is, then the Boots pension plan was already adequately funded and the trustees had no reasonable grounds for protest. If it is not, then why were they and the regulator using it in the first place? I do look forward to hearing the answer.

References

- 1 Professional Pensions, 21st June, 2007.
- 2 See, for example, 'Benefits and Compensation International' Volume 36, Number 5, December 2006.