INVESTMENT & PENSIONS EUROPE

A few words of advice…

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As the International Accounting Standards Board and the International Financial Reporting Standards Interpretations Committee continue to deliberate the discount-rate objective in IAS 19, Stephen Bouvier invited Falco Valkenburg, one of Europe's leading consultant actuaries to set out the challenges facing the standard setters

Another month, another meeting, and the will-they, won't-they routine rumbles on. In short, there is still no clear sign that the International Accounting Standards Board (IASB) will ever take action to either clarify or change the discount rate objective in International Accounting Standard 19, employee benefits (IAS 19).

In the meantime, the blunt message from Falco Valkenburg, who chairs the Pensions Committee of the European Actuarial Consultative Group, is that – if they do – there is no one-size-fits-all approach when it comes to discounting a defined-benefit pension obligation. Speaking in an interview with IPE, Valkenburg says: "I think it depends on the pension promise that you are valuing. Pension promises differ enormously between countries and even within the same country. It is the promise that we need to put a value on and not the company.

"We should get back to the promise. If it is a hard promise, a guarantee or almost a guarantee, like an insurance promise, then we should use a risk-free rate. We can have a debate about how to define the risk-free rate, but the basic idea is that if it is a firm promise then that is the only rate that would be appropriate."

And the problem with opting for a risk-free rate, he explains, is that most pension promises are not fully guaranteed and, in reality, include an element of uncertainty. "There might be differences from scheme to scheme. In the Netherlands, we see a lot of schemes with an ambition or a goal, but it is not a full guarantee.

"With such schemes, you can reduce the annual indexation or even reduce accrued pensions. Similarly, in the UK, if a sponsor goes bankrupt you have a real-terms cut in the order of 30 to 40%. And where that is the case, a risk-free rate would lead to an over valuation of a pension promise. In such cases, I would say use a risk free-rate as a base rate, but adjust it for credit risk – in either direction – depending on the profile of the pension fund or the characteristics of the scheme.

At the other end of the spectrum are schemes were there is no guarantee whatsoever. “In the Netherlands we have, for example, collective-DC schemes where contributions are fixed and then distributed using a kind of DB formula. This leaves employees to bear the risk inherent in the scheme. In that case, you could argue for discounting with an expected return on assets,” says Valkenburg.

With a plan of this type, the discount rate would reflect the risk-free rate plus the full risk premium in your asset portfolio. In other words, if the risk-free rate is 2%, and the expected return on equities is 6%, the expected return on assets is the risk free rate plus a 4% risk premium. But away from these extremes, most pension promises fall somewhere in the middle.

“That is a challenge from an accounting perspective because although the accountants would like a single measure that is clear to everyone,” says Valkenburg. “It is unclear whether that single measure exists since there is no single pension promise. Using a AA-rated corporate bond is all well and good, but most of the time it fails to reflect the pension promise adequately. So what we need is a debate about the right discount rate. That clarity is often lacking in the debate.”

And setting aside the political obstacles to the use of a risk-free rate, what precisely is it? “That is difficult to answer,” Valkenburg agrees. “Recent experience has taught us that AAA does not always mean AAA. Ratings are not always in line with reality. But, in principle, that should be a starting point. So, you would identify an interest rate that is linked to a creditor that cannot go bankrupt: that would link with a pension that is a full guarantee.”

The same can also be said of a plan sponsor. As Valkenburg notes, this requires both sponsors and employees to hold an honest conversation about risk. “I would be against using any discount rate that would give a false impression of reality, and that comes back to being more transparent about what the pension promise is.

“I think employers, employees and politicians are talking about pensions as if they have a much higher guarantee than is really the case. This is what we need to debate using the facts in order to make informed decisions. There are many situations where we base our decision-making on figures that are not representing reality. And this is not about the last digit behind the decimal point. This is about large effects. A 1% lower discount rate could easily mean a 15–20% increase in the value of the pension liabilities.

“If at the end of that debate we conclude that it is not do-able to have a full guarantee, social partners need to discuss what is acceptable and where the risk goes. We need to go beyond the political debate that some politicians have come up with, advocating solutions that are said to be risk-free for the members, providing a full guarantee. Will it force a debate about cost? I’m sure it will, yes, but that is a separate issue.”

But central to any action by the IASB, Valkenburg warns, is the need to focus on the most appropriate discount rate to use and not on who, or what, might be doing the discounting. He explains: “I don’t see an immediate link between the creditworthiness of the company and the value of the pension promise. You can have the pension promise delivered by two different companies. Only if there is an element that is dependent on the company, like sponsor support in the UK, there would be a link with the credit worthiness of the company. It is the pension promise that we are trying to value. This value is independent of the sponsoring company or the assets in the plan.

“I hear suggestions that the discount rate might be different depending on assets, so pension funds that invest in infrastructure projects would be allowed to use a higher discount rate. Why? This is supposed to be about valuing the pension promise with the right discount rate.

“The pension promise is the pension promise. The fact that you might receive an allowance for taking a different investment decision is fine, but don’t treat the pension promise differently simply on that basis. So I would suggest that the asset strategy should in principle not influence the pension valuation framework, but that investments in infrastructure might result in a lighter regime in the supervisory framework.”

In other words, just because you have invested plan contributions in a bridge does not mean you have a free crossing from DB-land to DC-nirvana.

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