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REVENGE OF THE BEAN COUNTERS

Those bean counters are at it again. Not content with causing havoc a few years ago by recommending that pension fund liabilities should be valued by discounting future payments using the yield on AA-rated sterling corporate debt, it seems that they have changed their minds. They now seem to prefer a different method. To those investors that are not familiar with the *fascinating* world of pension fund finances, this may seem to be of little consequence.

Unfortunately, depending upon the reaction of pension fund trustees and their scheme advisors, the consequences could be very significant.

Let's begin with the accounting profession's first attempt at making their own lives easier. Via the set of rules known as FRS17, the accounting profession recommended that the value of a scheme's future pension promises should be calculated by discounting these liabilities using the prevailing AA-rated sterling corporate bond yield. This effectively meant that when corporate bond yields declined the value of these liabilities would rise, and vice versa – even though the pension promise itself and the nature of the underlying company's business was unchanged.

For scheme sponsor's (companies) seeking to reduce the volatility of this liability on their balance sheet, the best asset class to hold against it was AA-rated corporate bonds. Given these rules, sponsor's put pressure on trustees to increase the weight of these bonds in their asset portfolios. The increase in demand for these relatively scarce bonds naturally led to a rise in their price and a fall in their yield. This in turn increased the associated value of a typical scheme's liabilities, effectively creating a vicious cycle of rising bond prices, falling yields, further increases in bond demand and rising bond prices etc. It also helped to "crystallise" existing deficits.

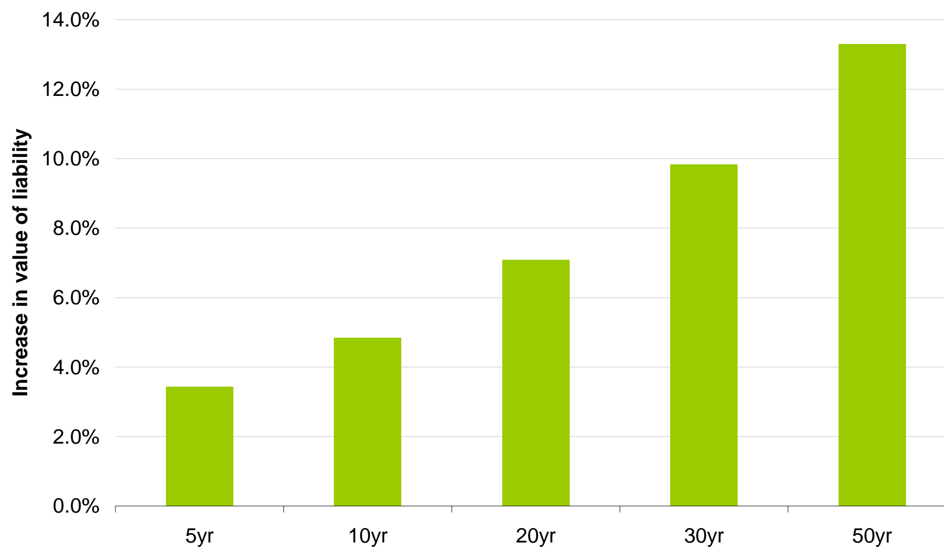
To some extent at least the industry has now come to terms with the new rules. Pension fund trustees also realise that buying an asset at a high price simply because it might keep the accountants happy is not an ideal investment strategy.

But just when pension fund trustees thought it was safe to conduct their investment strategies without further interference from the bean counters and their arbitrary rules – they have returned with a new proposal. The new proposal is that liabilities should be valued using gilt yields, rather than the yield on AA-rated corporate debt. Since gilt yields are lower than corporate bond yields the immediate impact will be to raise the current value of scheme liabilities.

In this week's chart we present the increase in the accounting value of a payment of £1 due in the future that would result if the present value of these payments were calculated using gilt yields instead of AA-rated corporate bond yields today. For every pound due in five year's time its value would rise by around 3.5%. For every pound due in 50 year's

time, its value would rise by just under 13.5%. Overall, based on today's gilt and AA-rated bond yields, for a typical scheme this change would imply a rise of around 7.5% in the total present value of a typical scheme's liabilities.

The potential increase in the present value of a £100 pension liability that could arise from a change in the way in which liabilities are calculated



Source: Fathom

Taken seriously, this change could have a number of consequences. First, it might affect the company's behaviour. It may invest less in its own future, if it sees this as a real increase in the value of its debt burden, putting at risk the company's ability to service its debt. Second, if trustees are forced to see it the same way then they may allocate more of their assets to gilts and less to asset classes that are more likely to help meet future liabilities. Given this, a third consequence might be a generalised increase in pension fund allocations to gilts, forcing up their prices, forcing their yields down, leading to an increase in liabilities and … etc, etc.

Valuing pension liabilities using gilts gives an indication of the cost of funding those liabilities that would arise were the assets of the scheme invested solely in UK government securities. However, if it is not their or their scheme's sponsor's intention to fund the liabilities in this way how relevant does the valuation become ? And is it right that it should have an impact on the investment strategy of the scheme ?

For example, suppose someone decides that I will need to buy a brand new Ferrari at some point in my life. They are expensive. Anyone assuming that this is my intention would naturally see my personal finances as being weaker than otherwise would have been the case. If my intention is to save up and to buy a Ferrari, less of my income would be available for servicing other debts such as my mortgage. As such any lender convinced that this is my aim, should be willing to extend less credit to me. This would affect my current consumption and spending habits etc. For the record, I have no intention of buying a Ferrari.

Valuing scheme liabilities using gilt yields implies a similar expectation, that is that the scheme has the intention of buying a very expensive asset, in this case a portfolio of gilts and index-linked gilts. If the scheme has no intention of buying this asset, then for all intents and purposes the valuation is nothing more than a simple spreadsheet exercise that any A level maths student could undertake.

We hope that the UK's pensions industry will see it this way too. If they do not then for investors betting on a pensions-related increase in the demand for gilts, the message is clear – despite the low yields available on UK government bonds, those yields could be forced lower by such activity, making what is effectively an unattractive asset class look good in the process.

In our view increasing allocations to gilts, beyond what might have been planned before these changes were proposed, would be a mistake and would, ironically, probably increase the likelihood that pension promises are not met in the future. We therefore hope that pension fund trustees and their advisors can look through these latest accounting proposals.

And besides, the bean counters have already changed their collective minds' once, they may do so again in another two or three years time. Investment planning for pensions should be driven by less fickle considerations.

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