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Dear Sir

Comments on the ASB discussion paper *The Financial Reporting of Pensions.*

We have read with interest the ASB's discussion paper *The Financial Reporting of Pensions* and are pleased to set out below the views of the Railways Pension Trustee Company Limited ("RPTCL").

RPTCL is responsible for preparing and approving the financial statements of all the main pension schemes in the railway industry. In total these schemes have some 350,000 members, over 90,000 of whom are currently working in the industry. Well over 200 private sector employers and employer divisions are involved in these schemes, as are the Department for Transport and the British Transport Police Authority. The main scheme – The Railways Pension Scheme ("RPS") – is a centralised multi-employer scheme for non-associated employers, which is sectionalised into around 100 actuarially independent sections. The total assets for which RPTCL is responsible are around £20 billion, and during 2007 it paid over £880m of benefits and collected over £630m of contributions on behalf of the pension schemes of which it is trustee.

In preparing our response it has not been practical – nor would it have been appropriate – to canvass the views of individual employers participating in the schemes. The response has been prepared by RPTCL's in-house finance team and subject to comments from and review by RPTCL's Chairman and Audit Committee. In preparing the response, we have tried to consider the proposals from the perspective of members of the RPTCL schemes and, by extension, from the perspective of the members of any defined benefit scheme.

The members' perspective

We believe that the most important consideration from the members' perspective will be the impact, if any, the proposals have on the pension schemes of which they are members, the contributions they are asked to pay, and the benefits they will receive. In particular members will be concerned whether the proposals will have any impact on the behaviour of employers, which might include closing schemes to future members, changing future benefit accrual rates, or even closing schemes completely. Several of the proposals in the discussion paper are relevant to this question, including, inter alia:

1. The use of a risk-free rate rather than an AA corporate bond rate to discount liabilities to present value (we recognise that this could be offset to some extent by the exclusion of future discretionary salary increases, but the net effect would still be an apparent increase in reported liabilities).

2. The proposal that actual investment returns rather than expected investment returns should be reported in profit and loss.

3. The proposal that assets should be measured at fair value, and, in the case of liquid assets, that fair value means marked-to-market.

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4. The notion that all gains and losses should be recognised immediately rather than allowing any sort of deferral or corridor mechanisms (we note that in the UK, this is already the case, but it will still be relevant to UK companies reporting under IFRS).

The combined effect of these changes would be an immediate and large increase in the reported value of pension fund liabilities coupled with increased volatility of the profit and loss charge in all subsequent accounting periods.

There is now a considerable body of evidence concerning how changes such as this influence the behaviour of employers. According to the National Association of Pension Funds, the proportion of UK private sector DB schemes still open to new members was only 31% in 2007, down from 70% in 2002. The Association of Consulting Actuaries puts the current figure even lower, at 20%. The situation in the RPS is slightly better, but still only around 40% of sections are open to new members.

It would be unfair to put the blame for scheme closures entirely on accounting standards. Contribution rates are rising for demographic reasons, assets performed poorly during the first few years of the decade, and there may be other factors as well. Nevertheless, changes in accounting standards have undoubtedly been a major factor, as any survey of trade and/or general press articles on the topic quickly reveals.

Of course it is not possible to quantify the effect that changes (1) – (4) will actually have on the behaviour of employers. One view is that rational employers will not let accounting standards influence their decisions in this way, and will look to the level of required contribution rates or the regulatory funding position to determine whether schemes should be kept open or closed. Another view is that wiser analysts and investors will remove the effect of pensions from reported results altogether.

Such views, however, seem to be overly optimistic in the light of actual experience over the last decade. Anecdotally and as reported by elements of the press, previous changes in accounting standards and pensions regulations based partly on those standards have led to scheme closures. There has also been a huge increase in the amount of general press reporting of so-called pensions deficits (less reporting seems to happen in periods of estimated surplus), which has had a very significant impact on the confidence of members of schemes.

So we must conclude that, if implemented, the changes set out in the discussion paper would result in further closures of defined benefit schemes, and as a fiduciary trustee body considering how best to serve the interests of members, we regard this generally as a very backward step indeed.

Real – world economics

The above argument based on members' interests is hardly new, and a common counter-argument is that the downstream effect on pension schemes can not be allowed to drive accounting standards in any particular direction. Accounting standards should properly quantify the financial consequences of operating a pension scheme, and finance directors should take decisions based on the results.

We agree that accounting standards should be neutral. As far as possible they should form a basis for reporting reality irrespective of the social consequences, good or bad. What has gone wrong with accounting for pensions, however, is that reported results have already become divorced from the economic realities of running pension schemes, and proposals (1) – (4) would widen the "reality gap" even further. For example, consider the valuation of assets, point (3). In the discussion paper this gets very little attention. It is assumed almost without comment that fair value (meaning current, marked-to-market value wherever possible) is the only correct measurement basis for pension scheme assets.

Coupled with (2) and (4) this will mean recognising realised and unrealised gains and losses on pension scheme investments directly and immediately in the profit and loss account of the financial statements of sponsoring employers.

However we would argue that if one wishes to measure reality, it is a mistake to account for pension scheme investments as if they are held for immediate sale (unless the scheme is being wound up). The investments of a pension scheme are more akin to fixed assets. They are held for long-term growth, expected capital appreciation and, especially, for income generation.

For example, consider two of the pension schemes or sections run by RPTCL. Below they are referred to as "A" and "B," but they are real schemes and the figures below are extracted from the most recent audited financial statements.

Scheme A is a very large (assets in excess of £5bn) and very mature section of the RPS. It is closed to new members and has no active contributing members whatsoever. 71% of its members are pensioners in payment and the remainder are preserved pensioners with deferred benefits. Despite this, in 2007, 42% of its benefits were met from investment income (dividends and interest).

Scheme B is much smaller (assets of around £50m) but even more mature than scheme A – in fact it is about as mature as it is possible for a pension scheme to be – with 2,150 pensioners in payment, mostly of an advanced age, one deferred pensioner and no active members. Despite this unusually skewed membership profile, scheme B is able to meet 31% of its annual benefits out of investment income alone.

In each case, the remainder of benefits are met through the sale of assets, but even in the extreme case of scheme B this requires the sale of less than 8% of assets in any one year.

One would expect schemes less mature than A or B to be able to meet a much higher proportion of benefits out of investment income and contributions, and this is what we find in practice. Almost all the open RPS sections are cashflow positive and in order to pay their current level of benefits they do not need to realise assets at all. When they do trade assets, it is usually to make minor adjustments to their target asset allocations or to implement more significant structural changes in investment strategy.

In the light of all this, what is one to say about the practice of accounting for unrealised gains and losses on assets measured at fair value in the period they arise and taking them to straight to profit and loss in the accounts of sponsoring employers? It is not at all unusual for stock markets to move 1% or more in a single day, 10% or more in a month, and 20% or more in a single year, but this surely cannot be ascribed to changes in the intrinsic worth of companies or the income cashflows they will generate in the future. It is no more than a measurement of the sentiment of markets and the psychology of traders. The *long run* real return on investments is surely more relevant to running a pension scheme, but daily, monthly and yearly turbulence is surely not relevant in most cases.

Marked-to-market gains and losses are for all practical purposes random, or at least chaotic, numbers. Booking such numbers in company accounts is not decision-useful, and more importantly it does not say anything about the actual costs of running a scheme, which is what we believe profit and loss accounts should be designed to do.

A neutral accounting standard, which properly reflects the real cost of operating a scheme should not present such figures as if they are true and fair costs, when they are so unrepresentative of what is actually involved in sponsoring a scheme over time. Whilst accounting standards should not be re-drafted just to keep schemes open, they *should* be re-drafted to present fairly the economic impact of a scheme upon its sponsoring employer.

Existing standards are already poor in this regard, and proposals (1) to (4) would make the situation much worse. If such accounting rules had been in place a hundred or even fifty years ago, many of the most successful pension schemes of the 20th century might never have been started.

Consequences

No-one can seriously argue that the average scheme member will not have to endure a much less comfortable retirement if her or his DB scheme closes. But it is also worth considering that there is more than one way to close a pension scheme, and not everyone stands to lose. Those with the most to gain are the pension buyout firms. The buyout market is still relatively small, but it is likely to expand rapidly if reported liabilities soar and earnings volatility increases.

New insurers and their private equity backers will be only too pleased to join the established players if their analysis reveals that they can solve companies' new accounting difficulties, by seeming to remove them altogether, and the insurers still make a profit. The truth about running a pension scheme will not have changed, but in the contrived arbitrage world of decision-making responsive to changes in accounting standards, buyout will suddenly look much more attractive when compared to the figures in financial statements. Wiser analysts on the other hand will not be so easily confused by step changes in accounting rules, and when the resulting buyouts still leave room for large margins, that will in itself prove that the accountants got it wrong, though by then of course, it will be too late to repair the damage for schemes stopped in their tracks and sold off.

Regulatory measures

The discussion paper acknowledges that regulatory measures may be the most relevant to understanding the cashflows involved in running a scheme, before going on to dismiss them as incompatible with fair value reporting and inappropriate because there is more than one regulatory measure.

However, it is our experience in dealing with employers during takeovers and mergers and phased closures that cashflows are in fact of paramount importance, both to the analysts working on corporate transactions and to the Pensions Regulator in considering the fairness of the impact on schemes. This is entirely consistent with RPTCL's view that the actual decision-useful information in deciding whether to open, maintain or close a scheme should in fact in most cases be a long-term measure. Putting the short-term fair value measure in the accounts does more than simply cloud the issue, it actually paints a false picture.

If companies choose to ignore the fair value measure by stripping these numbers from accounts in the interests of providing a true and fair view or using a regulatory measure instead, then that is to be applauded, but it does mean that the time and expense involved in creating the original figures is wasted. It is when companies choose not to ignore such figures that they may come to the wrong conclusion.

We feel that regulatory measures have been dismissed too quickly, and are more likely to be aligned with the real economic costs of running a scheme than returns on assets at so-called fair values. That several different regulatory measures may exist is undoubtedly a problem, but it seems poor reasoning to use the existence of more than one sensible measure as the justification for preferring one that is not sensible.

Possible alternative

The discussion paper is intended to be, "…a fundamental reconsideration, starting from first principles, of the accounting that should be required for pensions." Given our dissatisfaction with current standards, we certainly welcome this remark, but think that what is required is an even more fundamental re-evaluation than that suggested in the paper.

We believe that a regulatory measure of costs should not be dismissed out of hand, and an even better way of measuring the cost of running a scheme would be on an actuarial basis, and that this cost should be reported in profit and loss. The cost should be based on long term contribution rates, benefit rates, demographics, and prudent estimates of investment returns. This is the unbiased way to reflect the very long-term nature of the pension promise and the costs involved in making it and the investments made

to deliver it. For a value to be placed on assets it should be calculated on a discounted cashflow measure in the same way as liabilities, to reflect the intrinsic value of the assets in use.

Valuing assets on an actuarial basis has been criticised by some for being subjective and open to manipulation by unscrupulous finance directors and allegedly "supine" actuaries. There are several reasons why this criticism fails. Let us consider three of them.

Firstly, for liabilities there seems to be no alternative other than an expert actuarial calculation, so the opportunity for manipulation, if it exists, is already present. In theory, under current regulations, directors are able to use different actuarial assumptions (for the company accounts) than the scheme actuary (for the scheme valuation), but we cannot see a good reason why this situation should be allowed to persist. Directors may argue that handing over the calculations to the scheme actuary means they lose control over the company's financial statements, but this is also true under mark-to-market, except that an actuarial calculation is more relevant to the sustainable running of the scheme, and less volatile.

Secondly, we would argue that even a flawed estimate is more relevant than mark-to-market, since the latter is a random number whilst the former is at least constructed in a way consistent with the manner in which the real scheme actually operates.

Lastly, if we are not able to place reliance on expert actuaries and auditors to do their jobs properly, or trust them to make reasonable and prudent estimates, then accounting for pensions is likely to be the least of our problems. Any abuses should be tackled head-on by regulators.

Only by adopting an actuarial method ca n financial statements be made to fai rly reflect the real economic impact of running a scheme, and thereby allow companies to take the correct, rational decisions concerning the future. In contrast the ASB proposals will result in financial statements being swamped by irrelevant noise, which even the most sensible finance directors will find it difficult to ignore.

Whatever is reported will tend to come to be regarded as the truth, and open to media exaggeration. Accounting standards are meant to report reality, but the proposals in the discussion paper will take us further in the wrong direction, widening the gap between financial statements and what we regard as a fair measure of profit and loss based on the economic costs of operations. The apparent over-emphasis on the pensions balance sheet, and on mark-to-market valuations for the assets in particular, results in net asset volatility and a profit and loss charge that conveys little relevant information about the long-term costs of maintaining and sustaining long-term pensions arrangements.

The financial statements of pension schemes

Before closing we would like to make some remarks concerning the financial statements of pension schemes, which is dealt with in chapter 11 of the discussion paper. The main change from current practice suggested in chapter 11 is that liabilities to pay benefits in the future should be included in the annual financial statements of schemes.

We do not feel that this issue is as important to scheme members as the answers to the question of how their employers should report on pensions. Nevertheless we have considered it, and conclude that we agree with the results of the very recent consultations by the Pensions Research Accountants Group and the Pensions Regulator. Both these consultations concluded that a large majority of users of scheme financial statements and their representatives were opposed to the inclusion of liabilities.

The reasons for reaching this conclusion are that this information is already available elsewhere, and that pension scheme accounts are not general-purpose financial statements in the same way that company statutory accounts are. On cost / benefit grounds it is sensible to limit their content to matters relevant to the stewardship of assets and the governance of the scheme. Respondents to both of the two consultation exercises referred to above are of the view that pension scheme accounts are already fit for

purpose in this respect and that the inclusion of liabilities would require time and expense that would not be rewarded by any alleged utility to some of the users and will at best confuse members. RPTCL agrees with this view.

In particular, information on the actuarial position of the scheme is best communicated by means of the triennial actuarial valuation itself and the annual actuarial information that is required to be included in the scheme report and accounts, namely the summary funding statement, certificate of adequacy of contributions and certificate of the calculation of the technical provisions.

RPTCL has already witnessed a doubling of annual audit costs in having audited sectionalised accounts to support annual actuarial reports to the Pensions Protection Fund. We believe similar or greater annual cost increases would arise from any requirement to have actuarial valuations made annually rather than triennially, with concomitant increases in audit costs relating to auditors' review of the work carried out by experts.

Concluding remarks

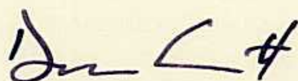
We hope you find our comments on the discussion paper useful. We applaud the ASB for initiating a fundamental review of accounting for pensions, since in common with many users of financial statements and even more so from the narrower perspective of pension scheme members and their representatives, we do not think FRS17 has been a great success and may with hindsight appear to be more of a failure, especially from the point of view of the members' whose schemes it has undoubtedly helped to close.

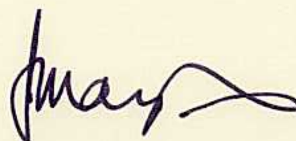
However we think that the proposals in the paper will amplify the faults and negative consequences of FRS17 rather than reduce them. The current review of pension scheme accounting should therefore be much more radical in its scope. However, for the avoidance of doubt, we are certainly not urging that accounting standards should be re-designed to keep schemes open at all costs.

What is needed is an accounting standard that results in a profit and loss charge more closely connected to the real world economics of running a scheme: the world of investment income and other returns, contribution rates and long term funding. This cost should be based on an expert actuarial calculation. Meanwhile the balance sheet position of any pensions deficit (or transitory surplus) should be one which properly reflects the intrinsic value of pension scheme assets as long-term investments designed to match long-term liabilities.

Members, and individuals who through scheme closures will be denied the opportunity to ever become members, will be the ones to suffer from standard setters taking fair value accounting to its next logical, but incorrect, conclusion.

Yours faithfully





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