Railways Pension Trustee Company Limited

Accounting Standards Board
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27 April 2011

Dear Sirs

Comments on the Financial Reporting Exposure Draft ('FRED') 48, the draft Financial Reporting Standard applicable in the UK and Republic of Ireland

We have read with interest the ASB's draft Financial Reporting Standard applicable in the UK and Republic of Ireland ('FRED 48'), and are pleased to set out below the views of the Railways Pension Trustee Company Limited ('RPTCL'):

1. Background and introduction

RPTCL is responsible for preparing and approving the financial statements of all the main pension schemes in the UK railway industry. At the end of 2011 these schemes, of which the largest is the Railways Pension Scheme, had combined assets of almost £19bn and total membership of around 350,000. During 2011 RPTCL paid over £920m in benefits and collected over £780m in contributions on behalf of the pension schemes of which it is trustee. The pension schemes also accrued investment income during the year of over £270m.

We welcome the inclusion of a section in FRED 48 dealing directly with the financial statements of pension schemes. Under existing International Financial Reporting Standards ('IFRS') and UK Generally Accepted Accounting Practice, it has at times been difficult, even with the assistance of a pension scheme Statement of Recommended Practice ('SORP'), to adapt accounting standards designed with corporate reporting in mind to the demands of trustees and other users of scheme financial statements, which we feel are qualitatively different from the needs of the audience in the case of corporate accounts. With this in mind, we have set out below some specific suggestions where we think the relevant section of FRED 48, starting at paragraph 34.31, should be enhanced. With the wording as currently drafted, some uncertainties and ambiguities remain that will hinder application of the standard, and which will also make it more difficult for the industry to develop a new SORP.

However, before setting out our specific comments regarding the detailed application of the draft standard, we make some opening observations and express strong opposition to the most significant item, namely the proposed inclusion of risk disclosures and pricing hierarchies.

2. Risk disclosures and pricing hierarchies

In the view of RPTCL, there are two main objectives for pension scheme annual reports. First, they are designed to give members and their representatives (such as trades unions) a stewardship report of the most recent year of their scheme. This includes the accounting fair value of assets (which, incidentally, is not necessarily the same as their economic fair, or intrinsic, value) at the end of the year, a record of contributions and benefits in the period, and a report on how the benefits payable in the future are expected to be funded. This information is delivered by means of the financial statements, other disclosures to members and actuarial reports.

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Second, the audited asset value of the scheme is a key input into each triennial actuarial valuation and annual reports under the Pensions Act 2004, and as such has a direct bearing on the future management of the scheme and the setting of contribution rates.

The main impact of the proposed new accounting standard on pension scheme accounts will be a raft of new disclosures on credit, liquidity and market risk, and pricing hierarchies. There will also be some differences in the accounting treatment of interest and transaction costs. We feel the ASB has not taken into account whether the above changes will help pension scheme accounts meet their purpose. It does not automatically follow that what is good for corporate accounts is good for scheme accounts, and neither is it obvious that any alleged benefits will outweigh the disadvantages and additional costs.

Although investment risk and liquidity are highly relevant to investment decision making and the running of the scheme, it is almost inconceivable that fiduciary trustees and their advisors would ever, or should ever, use the annual report and accounts as the source of this information. The disclosures required by FRED 48, although long, will still not provide the type of information that might really be useful to trustees in making investment judgements. This is because in our experience, all real-world investment decisions, from the strategic down to the appointment and monitoring of individual managers, are taken by scheme trustees or investment committees on the basis of a detailed analysis that will include expected performance and risk (where appropriate), but which will be tailored to the specific requirements of not only the scheme, but of each individual decision. At best, and despite their inordinate length, the proposed risk disclosures in financial statements will only ever provide a standardised overview of the economic shape of investment portfolios, which will inevitably fall short of the bespoke analyses that are required to support actual decisions. While ratings agencies, as part of their expansion plans, may wish to report on pension schemes for sponsors and regulators, it seems inappropriate to expand upon the existing stewardship reports to members and their representatives, including trades unions, to support this.

Nor would it be sensible to attempt to address this deficiency through yet more increases in disclosure, for two reasons. First, the disclosures in FRED 48 will already unbalance annual reports by giving undue prominence to investment information, and further enhancement of disclosures would inflict even more damage. Second, and perhaps more importantly, the typical timescale for the production of reports and accounts means that while they are useful as a matter of audited historical record, by the time accounts are published, any risk and liquidity information they contain will be out of date and hence useless for informed decision-making.

In light of the above remarks, it is our judgment that far from helping trustees with the management of the scheme, the new disclosures will in truth merely add cost and complexity to the production of accounts, and expense to the audit, without delivering any useful information or practical benefit. There also seems to be potential for regulatory capture here, as measures are added to disclosure and auditing standards which seem to benefit only those performing the relevant services, not those to whom the reports are addressed or for whom they are intended.

Regarding the role of audited accounts in actuarial valuations, since the new disclosures will not affect the accounting fair value of assets they are not directly relevant to valuations; and besides, if actuaries did require risk information it could be more cheaply provided outside of the accounting framework, and without the need for financial audit.

Turning from trustees to members, while the new disclosures might be interesting to a sophisticated reader, there is little, if anything, that the vast majority of members can do with

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such information, other than wonder how much the implementation of this latest round of changes has cost their scheme. The questionable benefit to a very tiny minority, if any, of the audience will in every case be outweighed by the fact that the changes will be positively confusing to the large majority, and ignored.

We note the objective of reducing complexity by having a single, simplified accounting standard for all entities that are not obliged to apply IFRS, but it then seems highly counterproductive to include the complex risk disclosure baggage of IFRS in the simplified standard. We suspect that it will not only be pension schemes that find these disclosures result in ever greater complexity while delivering no practical benefit, and think the ASB should consider removing them from the standard completely, thereby restricting them to only those entities required to apply full IFRS. As a minimum, they certainly should not apply to pension schemes.

The risk and pricing disclosures are part of a worrying trend of importing non-accounting information into reports and accounts – and hence bringing further information into the scope of the financial audit – when such information is much better dealt with through other channels. Investment risk and liquidity information is undoubtedly useful in the right context, but in the case of pension schemes it is best kept out of periodic, historical financial statements, in order that it can be produced more quickly, more cheaply, and be more effectively targeted at particular decisions which will tend to have a forward-looking dimension. In our view, the relentless year-on-year expansion of disclosures in accounts generally is misguided, and seems to us to be driven by some accountants' reflex belief that almost any difficulty can be solved by expanding the scope of financial statements. If all you have is a hammer, everything may look like a nail; but many problems are far better and much more cheaply solved without recourse to accounting standards and audit confirmation bias.

In the light of our observations above, and we'd be happy to expand on these views at a meeting, we sincerely believe that pension schemes should not be required to make risk and pricing hierarchy disclosures. Scheme accounts have a materially different audience and differing objectives from other financial statements, and moreover, such information would increase production costs significantly without delivering any practical benefit. The part of FRED 48 that deals with pension schemes should instead be used to make it clear that schemes are not required to produce these disclosures in their audited accounts. In our view, the current pension scheme reporting regime is fit for purpose and does not require adjustment. Holistic reporting and auditing is neither wanted, nor desirable.

If, however, the ASB chooses to press ahead with requiring pension schemes to implement FRED 48 on the basis of the way it is currently drafted, and we urge you not to do so, we still have some further observations on specific aspects of the proposed standard where we think changes should be made, or further clarity should be given, as set out below.

3. Effective interest accounting

Although FRED 48 does not explicitly state that effective interest accounting for bond instruments is required by pension schemes and other non-corporates, in the absence of a statement to the contrary our working assumption is that this is what is expected, in accordance with paragraph 11.14 *et seq.* It is current practice for pension schemes to price bonds 'clean' at accounting fair value, taking both interest and change in market value through the income and expenditure account, analysed separately. With effective interest accounting, schemes would report the same value of assets but would disclose different amounts for interest and unrealised gains and losses compared to the current treatment.

In theory, schemes should be interested in decomposing investment returns between yield, growth (positive or negative) and market re-rating (realised or unrealised changes in value) effects. Time series research shows the very important contribution of yield (income) to total returns for many asset classes (bonds, equities, property) in all types of market conditions. Sub-studies of equities over long time periods find that income determines the absolute level of total return, while market re-rating determines the volatility of total return. The same is true, if only to a lesser extent, with government fixed income securities and rental property, while with index-linked securities, the components of return include compensation for changes in purchasing power.

In practice, however, schemes are usually agnostic between income and changes in value, both in the calculation of performance and often also in asset selection.

Where schemes do have a preference it is normally the case that the cash income stream generated by an asset is the key consideration, since cash income can be used to pay benefits, whereas unrealised changes in value and accounting adjustments such as amortisation cannot. At best, therefore, effective interest accounting is an irrelevance to pension schemes, but one which will force schemes to incur the time and cost of adjusting systems to comply with the new treatment. Where schemes do have a preference between unrealised gains and interest, we think that the specific features of pension schemes mean that effective interest accounting will be counterproductive, since it will introduce confusion between cash income that can be used to pay benefits and other, non-cash, items.

We ask that the ASB drop the requirement for pension schemes to apply effective interest accounting, and make it clear in the relevant section of the new standard that this is the case.

4. Transaction costs

Paragraph 11.13 of FRED 48 states that on initial recognition, financial assets shall be measured '…at the transaction price (including transaction costs except in the initial measurement of financial assets and liabilities that are measured at fair value through profit or loss)…'. Paragraph 11.14 requires that financial instruments should be measured '…without any deduction for transaction costs the entity may incur on sale…'

Elsewhere in FRED 48, such as in the part dealing with retirement benefit plans, there is no mention of transaction costs. Currently the SORP requires pension schemes to add transaction costs to purchase price and net them against sale proceeds, as appropriate, and to disclose total transaction costs in a note to the accounts.

In practice, pension schemes measure investment performance net of transaction costs, and so whether or not such costs are expensed directly or netted against investment transactions is yet another irrelevant consideration in the management of the scheme. In any case, such costs are an immaterial, if not trivial, component of scheme income and expenditure.

Particularly in view of the fact that transaction costs are already separately disclosed, this is another area where a change of treatment will consume time and resources but deliver no practical benefit. In addition, the wording of FRED 48 makes the matter somewhat unclear, since it only deals with transaction costs in passing rather than setting out the required treatment explicitly.

We ask that pension schemes should be allowed the option between either keeping the current treatment of transaction costs, or expensing them as separate items through profit and loss. In any event, a paragraph should be inserted into the section starting at paragraph 34.31 that removes the uncertainty by making the treatment, or choice of treatments, explicit.

5. Actuarial liabilities

We are pleased to note that paragraph 34.37 of FRED 48 allows information regarding the actuarial liabilities to be provided either within or alongside the financial statements. The view of a large majority of those in the pension scheme industry, as evidenced by several consultations undertaken separately over the years by the Pensions Research Accountants Group, the Pensions Regulator, the Department for Work & Pensions and others, is that the value of actuarial liabilities should be kept out of the primary financial statements. The National Association of Pension Funds is also opposed to the inclusion of an accounting measure of liabilities on the scheme balance sheet. However, the wording of FRED 48 leaves open the question of what form any actuarial information presented alongside the financial statements should take.

Actuarial information currently included in scheme reports typically includes extracts from some or all of: the summary funding statement, the certificate of the adequacy of the contribution rates, and the actuarial certificate of the calculation of the technical provisions. In the case of multi-section schemes such as the Railways Pension Scheme, the picture is complicated somewhat by there being separate calculations and certificates for each section, but only one report and accounts. RPTCL deals with this complication by including an Actuary's Report which summarises the various sources of actuarial information.

In the view of RPTCL, the information currently included by schemes in respect of actuarial information is good at providing members and employers with the information they require about the liabilities of their scheme and the security of their pensions. Depending on how one reads it, FRED 48 could potentially be consistent with current practice, although the wording of paragraphs 34.37 and 34.43 to 34.45 does not make this particularly clear and it is open to alternative interpretation. We feel it would be better if the eventual standard merely referred to a requirement for actuarial information to be presented, typically alongside the financial statements, or in the financial statements if schemes choose to do so, in a minority of cases. However, what this information should be is already dealt with by existing disclosure regulations. The new SORP should be left to provide the guidance, based on regulations, on what form the actuarial information should take, as does section 1.7 of the existing SORP.

6. Employer related investments

The Occupational Pension Schemes (Investment) Regulations 2005, as amended by the Occupational Pension Schemes (Investment) (Amendment) Regulations 2010 ('the regulations'), require that not more than five per cent of the market value of the resources of a scheme may at any time be invested in employer-related investments (the rules are slightly different for multi-employer schemes).

FRED 48 requires that the financial statements '…shall present … details of any investment in the employer' (paragraph 34.40d). Whether the wording of FRED 48 goes further than the regulations depends on the precise meaning of the word 'details' in this context. If the intention is for schemes to make a statement as to whether the level of employer related investment is more or less than five percent, then that would be consistent with the regulations. If, on the other hand, the intention is for schemes to make a statement as to what the percentage of employer-related investments is in percentage terms, then that would go further than regulations.

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In practice, it is not always possible to derive a precise figure for employer-related investments, because the 2010 regulations removed the exemption that had previously allowed collective investment schemes to be excluded from the five per cent test. Managers of collective investment schemes are not obliged to disclose precise details of investments in their collectives unless required to do so by the terms of their agreements. In practice, and particularly in the case of hedge funds, the best that can often be done is to obtain 'upper limit' assurances from managers which enable the scheme as a whole to make a positive statement that employer related investments do no exceed five percent. Usually, and definitely in the case of the Railways Pension Scheme, it is not possible to determine an exact percentage, other than for directly held assets, which comprise only about two-thirds of the assets of the scheme. We have also seen the development of special purpose vehicles ('SPVs') to enable contingent assets to be used for security and funding purposes, which are not expected to count towards the percentage restrictions on employer-related investments. Such SPVs are positively encouraged by the (UK) Pensions Regulator as one of the ways in which trustees may agree additional, but contingent, security with scheme sponsors.

In order to keep accounting standards in line with what is reasonably possible and at reasonable cost, and also with what investment managers are obliged to disclose to their investors under the terms of contracts and investment management agreements, we ask that the provisions of 34.40 be amended to require schemes to make a statement as to whether the level of employer-related investments is less than five per cent, in accordance with the regulations.

7. Consolidation

It is common for pension schemes with a common trustee to organise their investments into common investment funds ('CIFs'), where each scheme's interest is represented by notional units. Although CIFs are not legal entities as such, they are regulated by, and operated under the approval of, HMRC. In the March budget, the government confirmed that legislation will be introduced to permit the authorisation of new tax transparent funds from summer 2012, which may also be of interest to pension schemes.

In accordance with the SORP, it is current practice for schemes investing via CIFs to disclose investment information on a limited 'look through' basis, and the RPTCL schemes achieve this by including the consolidated financial statements of the CIFs, which are themselves prepared in accordance with applicable sections of the SORP, in the scheme accounts.

As currently worded, there is a danger that section 9 of FRED 48 might be interpreted as requiring pension schemes to consolidate any CIF investments, either using full consolidation with other investors being disclosed as a minority interest, or on a proportional consolidation basis. However, we think it unlikely that this is what the ASB actually has in mind, since consolidation on either basis would be contrary to the point of common investment funds, extremely confusing to members, and in our view would not be compatible with the need for pension scheme accounts to show a true and fair view.

We therefore think it would be useful if either section 9 or section 34 could explicitly state that CIFs and other pooled investment funds of pension schemes are not expected to be consolidated into scheme accounts. As now, the SORP should be left to deal with the specific disclosure requirements for CIFs and similar arrangements.

8. Other disclosures

The part of FRED 48 entitled ‘Retirement Benefit Plans: Financial Statements’ also deals with the disclosure of non-financial information such as names of employers, and other information about the scheme. These requirements can be found in paragraphs 34.34, 34.45, 34.46 and some of 34.35. Paragraph 34.34 requires ‘a description of the funding policy’ to be included, and while we can think of several things that this might be, ‘funding policy’ is non-standard terminology that does not have any specific meaning of which we are aware.

Because information of this type is interesting and useful to members, we strongly support it being presented alongside scheme accounts (notwithstanding confusion over the meaning of ‘funding policy’). However, we feel that such disclosures are best dealt with by the SORP. Many of these disclosures have their origin in pensions legislation and regulations which change from time to time. Setting out these requirements in the SORP will allow changes to be made without alteration of the standard, and also allow a more expansive treatment that schemes will be able to use as a practical guide.

9. Format of FRS 102

We note the objective of replacing all existing standards with a single, simplified standard. However, we wonder how FRS 102 will be kept up to date with any subsequent developments, including changes in relevant international standards. Having a single standard divided up into sections may prove to be a problem as soon as changes are required. If it becomes necessary to change even a small part of FRS 102, either the whole standard will have to be re-issued, or separate documents will have to be published overriding certain provisions, which will result in confusion. On purely practical grounds we wonder whether it might be easier to adopt an appendix-based approach, in order that individual appendices can be replaced without affecting the whole.

10. Summary and conclusion

In summary, we think the ASB should rethink the inclusion of risk and pricing disclosures in the standard and exempt them from most, if not all, entities, since in our view such disclosures should only be required for entities applying full IFRS. If they remain in the standard, then they should simply not be applicable to pension scheme accounts.

We also hope you can take our comments on particular aspects of the detail in FRED 48 into your deliberations, and we repeat that we should be happy to expand on any aspect of this response or related issues at a meeting or by further correspondence.

Yours faithfully

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