# Does IAS 19 (Accounting for pension costs) meet the criteria for its adoption and retention including the legal requirement of being conducive to the public good?

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## Introduction

In this note, we will consider the role and influence of a particular international accounting standard, IAS 19 for pension schemes, on capital markets and aspects of the national economy. The linkage we examine is between financial statement information, the corporate response to this and the subsequent economic consequences.

The investment management behaviour of pension funds is collectively performative, meaning that it influences the subsequent investment performance of the asset classes in which it invests. To a greater or lesser degree, depending on the significance of pension funds as owners of an asset class, it influences both relative and absolute performance. Of course, the absolute performance of an asset class is also a function of its structure, for example the total returns available from a conventional bond are limited to and by the gross redemption yield on which it was bought. At the same time, we should remember that pension funds are only one of many possible investor classes present in markets and as owners at any point in time.

## The Standards and their legal framework

Compliance with international accounting standards was first imposed on certain companies in the EU by *Regulation (EC) No 1606/2002 of the European Parliament and of the Council* of 19 July 2002. Article 4 of this Regulation required companies listed on any regulated market (eg a stock exchange) in a member state to publish consolidated accounts prepared in "*conformity with the international accounting standards …*"

Article 3 introduced a hurdle for adopting an international accounting standard for the purpose of this Regulation:

"*Article 3: Adoption and use of international accounting standards*

*2. The international accounting standards* ***can only be adopted if****:*

*— **they** are not contrary to the principle set out in Article 2(3) [requirement for company accounts to show a true and fair view] of Directive 78/660/EEC and in Article 16(3) [requirement for consolidated accounts to show a true and fair view] of Directive 83/349/EEC and* ***are conducive to the European public good***[1] *and,*

[1] We have not been able to find a legal definition of "public good" but there is an interesting discussion in "A European Common Good? Hartmut Marhold" (in l'Europe en formation 2015/2(No 376), pages 9-24 available at this link: https://www.cairn.info/revue-l-europe-en-formation-2015-2-page-9.htm).

***— they meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.*"** (Emphasis added)

**UK regulations associated with Brexit**

To deal with the effect of Brexit and the UK no longer being a member state, a statutory instrument, *The International Accounting Standards and European Public Limited-Liability Company (Amendment etc.) (EU Exit) Regulations 2019,* made the consequential amendments to UK law.

Regulation 4 of those Regulations incorporated into UK law the international accounting standards which were in force within the EU on 31 December 2020 at 11pm.

As to the adoption of international accounting standards after 31 December 2020, this is to be done in accordance with Regulation 7 which corresponds to Article 3:

*"**Basis for adoption of international accounting standards***

***7.**—(1) The Secretary of State **may only adopt** an international accounting standard under regulation 6 **if** the Secretary of State is of the view that, in relation to the form of the standard the Secretary of State intends to adopt—*

*(a) the standard is not contrary to either of the following principles—*

*(i) **an undertaking's accounts must give a true and fair view** of the undertaking's assets, liabilities, financial position and profit or loss;*

*(ii) **consolidated accounts must give a true and fair view** of the assets, liabilities, financial position and profit or loss of the undertakings included in the accounts taken as a whole, so far as concerns members of the undertaking;*

*(b) the use of the standard **is likely to be conducive to the long term public good** in the United Kingdom; and*

*(c) **the standard meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management."*** (Emphasis added)

This is a minor modification to the text of the European criteria, whereby the requirement to be conducive to the European public good becomes the softer "likely to be conducive" and specifies the "long-term" public good in the United Kingdom. However, these differences are not material for the substance of this note. The criteria of paragraph (c) are word for word the same as previously under the European regulation.

Regulation 7 continues with some guidance on interpretation:

*"(2) **In deciding whether** the use of a standard is **likely to be conducive to the long term public good** in the United Kingdom, the Secretary of State **must have regard**, in particular, **to** the following matters—*

*(a) whether the use of the standard **is likely to improve the quality of financial reporting**;*

*(b) **the costs and benefits that are likely to result from the use of the standard**; and*

*(c) whether the use of the standard **is likely to have an adverse effect on the economy of the United Kingdom, including on economic growth**."* ( Emphasis added)

The Statutory Instrument also sets out (in Regulation 5) the responsibilities of the Secretary of State as:

*"The Secretary of State is responsible for—*

*(a) the adoption of international accounting standards for use within the United Kingdom, with a view to harmonising the financial information presented by the companies required by section 403(1) of the Companies Act 2006 to prepare their accounts in accordance with UK-adopted international accounting standards, in order* ***to ensure****—*

*(i) a high degree of transparency and* ***international comparability*** *of financial statements; and*

*(ii)* ***the efficient allocation of capital, including the smooth functioning of capital markets in the United Kingdom****; and*

*(b) participating in and contributing to the development of a single set of international accounting standards."* (Emphasis added)

For completeness, we note that the Secretary of State has delegated the functions referred to in Regulation 5 above to the UK Endorsement Board in accordance with the International Accounting Standards Delegation Functions (EU Exit) Regulations 2021 with effect from 22 May 2021.

**IAS 19 and impacts on UK companies**

We will examine whether these tests have been met in relation to IAS 19 by looking at the specific impact of IAS 19 on UK listed companies. In this context, when it was within the EU, the UK had the largest amount of assets held in funded occupational pension schemes (also referred to as institutions for retirement provision or IORPs).

**Table 1: Top 5 countries in Europe that had IORPs operating within their country, ranked by asset size, plus additional information on type and total number of IORPs as at 31 December 2016 and 31 December 2018.**

| Country | Assets under management (approx. in EUR mil.) | | Main type of scheme as at 31 December 2016[2] | Size of the occupational pension fund sector | | |
|---|---|---|---|---|---|---|
| | Assets as at 31 December 2016 | Assets as at 31 December 2018 | | Total number of IORPs as at 31 December 2016 | Total number of IORPs as at 31 December 2018 (actual number in '000) | Total number of members of schemes as at 31 December 2018 (approx. in '000) |
| 1. United Kingdom | 1,800,000 | 1,778,323[3] | DC/DB | 40,000+ | n/a | 31,307 |
| 2. Netherlands | 1,300,000 | 1,362,290 | DC/DB | 289 | 221 | 19,181 |
| 3. Germany | 185,000 | 243,525 | DB | 170 | 169 | 10,460 |
| 4. Italy | 123,645 | 134,036 | DC | 267 | 247 | 4,981 |
| 5. Ireland | 92,364 | 103,600 | DC | 68,481[4] | 73 | 984 |

***Note 1:*** *there are later figures as at 2019 available for asset sizes for Member States (with the exception of the UK). However, the 2019 data is derived from EIOPA's database on occupational pensions information.*

[2] Definitions extracted from the EIOPA database on EU/EEA occupational pensions statistics. Defined Contributions schemes ('**DC**'): '*A pension plan where the only obligation of the plan sponsor is to pay a specified contribution (normally expressed as a percentage of the employee's salary) to the plan on the employee behalf. There are no further promises or 'guarantees' made by the sponsor*.' Defined Benefit schemes ('**DB**'): '*Retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to a formula usually based on employees' earnings and/or years of service*.'

[3] *The reduction in the number of assets for the UK between 31 December 2016 and 31 December 2018 appears to result from an exchange rate fluctuation. The ONS states that the 'Average Sterling exchange rate: Euro' for December 2016 is 1.1838 and for December 2018 is 1.1128 - https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/timeseries/thap/mret. The sterling has devalued over this period by 5.998%. In sterling (approx. in GBP mil.), the equivalent number of assets for the UK on 31 December 2016 was 1,520,527.116 and 31 December 2018 was 1,598,061.646.*

[4] There is a data anomaly here.

*Information on small IORPs (which are exempted from the full reporting requirements) are excluded, therefore for some Member States the 2019 data may not represent 100% of the total national IORPs sector.*

***Note 2:** Figures taken at 31 December 2016 are collected during the EIOPA peer review from national competent authorities, as referred to in: EIOPA, 'Results of the peer review on supervisory practices with respect to the application of the prudent person rule for IORPs' (EIOPA, 2019) 52 https://www.eiopa.europa.eu/sites/default/files/publications/eiopa_peer_review_iorps_prudent_person_rule_april_2019_0.pdf?source=search accessed 11 August 2021. The data is extracted from the EIOPA database on EU/EAA occupational pensions statistics (year 2016). These statistics are based on Pensions Data reports from IORPs in the EU and EEA.*[5]

***Note 3:** Figures taken at 31 December 2018 and those referred to at **Note 1** (above) are extracted from the EIOPA occupational pension fund database, see: EIOPA, 'Occupational pensions statistics' (EIOPA, 2021) https://www.eiopa.europa.eu/tools-and-data/occupational-pensions-statistics_en accessed 17 August 2021. This database contains the statistical annexes submitted by national authorities to EIOPA from 2004-2019.*

**Conducive to the European public good or conducive to the long term public good in the United Kingdom: Preliminary**

Has IAS 19 been conducive to the European public good or conducive to the long term public good in the United Kingdom? We will examine whether the impact of IAS 19 can be said to satisfy either version of the public good test.

We acknowledge that:

- prior to IAS 19, accounting standards for pensions costs were initially regulated from 1986 first by SSAP 24, then FRS 17 and now by FRS 102 (as regards companies which were not required to prepare consolidated accounts in accordance with IAS 19 once IAS 19 applied to listed companies), and
- these standards also required the amount, as at a balance sheet preparation date, of defined benefit pension liabilities to be calculated using a discount rate which derives from AA corporate bonds.

However, the point to draw out is that these pension accounting standards have a direct impact on millions of employees and former employees and their survivors. But they have been adopted with minimal democratic accountability in pursuit of an objective of providing comparable but unreliable financial information as to pension costs in company accounts.

Perhaps unsurprisingly, if you are the finance director of a listed company which provides a defined benefit pension scheme for its employees and former employees, you have a concern if every year the value of your defined benefit pension liabilities fluctuates up and down as a function of the fluctuation in the yield of AA corporate bonds and the market value as at the balance sheet date of the pension fund's assets.

[5] For additional information about EIOPA's collection of occupational pensions statistics see: EIOPA, 'Occupational pensions statistics' (*EIOPA*, 2021) <https://www.eiopa.europa.eu/tools-and-data/occupational-pensions-statistics_en> accessed 12 August 2021; EIOPA, 'EIOPA Occupational Pensions Statistics: Frequently Asked Questions' (*EIOPA*, 1 June 2021) <https://register.eiopa.europa.eu/Publications/Pensions%20Statistics/FAQ_IORP_statistics.pdf> accessed 12 August 2021.

However, we should not forget that one of the objectives, where a defined benefit pension is part of the remuneration package, is to provide that benefit at the lowest possible cost commensurate with a sufficient level of security for payment of the pensions as and when they fall due.

The approach of determining discount rate from the yield on AA corporate bonds has, in turn, had an influence (as we will discuss later) on the way in which pension scheme assets are invested.

It may be helpful to make the following point expressly. There is no legal requirement either in the original IORP I Directive (Directive 20034/41/EC) or in its replacement consolidating directive (the IORP II Directive – Directive (EU)2016/2341) or in the UK domestic legislation transposing that directive (Part 3 of the Pensions Act 2004 and the Occupational Pension Schemes (Scheme Funding) Regulations 2005) that requires the discount rate for valuing pension liabilities to be that derived from AA corporate bonds.

It is permissible to use either a bond derived interest rate or a discount rate derived from the expected return on the investment of the scheme assets or a combination of both[6]. The only substantive requirement is that the assumptions used to value the scheme for funding purposes (as distinct from accounting purposes) are prudent.

We would also draw out that, insofar as IAS 19 specifies best estimate assumptions (eg for longevity), a prudent assumption would include a margin for prudence. If that margin is also added to the IAS 19 derived discount rate, there are outturns where there is an IAS 19 surplus and a valuation deficit leading to cash contributions by the employer to the pension fund (and a balance sheet prepayment).

**IAS 19: the principle of the discount rate**

In the discussion which follows we focus on the detail of IAS 19 and its specification of discount rates for pension liabilities.

The International Accounting Standards Board (IASB) statement of the principle that *"the discount rate reflects the time value of money but not the actuarial or investment risk"* is sound, if incomplete and ambiguous.

The pure time value is unobservable; it is a theoretical construct. The standard requires preparers to determine the discount rate for long-term pension liabilities as the prevailing yield on high grade corporate bonds at the time of valuation.

**The AA corporate bond rate**

The AA corporate bond rate does not satisfy this IASB principle. The yield of a corporate bond reflects both that time value of money **and** an investment risk - the likelihood of default within the term of the bonds. As this element results from subjective perceptions of the willingness and ability of the

[6] See the Occupational Pension Schemes (Scheme Funding) Regulations 2005, Regulation 5 available at this link https://www.legislation.gov.uk/uksi/2005/3377/regulation/5 correctly reflecting the IORP I Directive Article 15(4)(b) and the IORP II Directive, Article 13 (4)(b)

bond issuer to meet its contractual payments, it introduces an arbitrary and spurious volatility to the discount rate employed. This volatility also extends to the time dimension.

If, in the alternative, the yield on the sponsoring employer's own bonds were to be used, that would also introduce an arbitrary and spurious volatility to the discount rate. As the credit rating of the sponsoring employer worsened the discount rate would increase (and vice versa).

**Does using the gilt yield resolve this issue?**

While sovereign default on debts denominated in its domestic currency may always theoretically be avoided by the issuance of new money, it is far from uncommon[7].

Researchers have identified 132 default and restructuring events of domestic sovereign debt instruments, in 50 countries from 1980 to 2018, and they observe that, over time, they have become larger and more frequent than foreign law defaults. While the default likelihood for gilts may be extremely small, the market yields on gilts reflect the supply and demand for these securities as well as the time value of money.

**The exogenous variable**

Above all else, this IAS 19 discount rate is an exogenous variable; it will introduce its variability to the financial statements produced that use it.

Consequently, rather than helping with economic decision-making and the stewardship of management, it actually confounds the information used in those processes. For example, changes to the discount rate will be reflected in changes in the present value of liabilities and their apparent burden even when those liabilities are unchanged, or unchanged other than for their intrinsic amortisation arising from the passage of time. We refer to this intrinsic amortisation in other papers[8] as the (endogenous) contractual accrual rate.

**Does IAS 19 meet the specified criteria it is required to meet?**

This leads to questions over the requirement that *"the standard meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management."*

We will touch briefly on three of the specified criteria

**Understandability**

While the operation of the prescribed discount rate clear, it is not at all obvious that the resultant values produced are meaningful true and fair values.

[7] A Journey in the History of Sovereign Defaults on Domestic Law Public Debt, Aitor Erce, Enrico Mallucci and Mattia Picarelli, LUISS School of European Political Economy, Working Paper 14/2021 September 22, 2021

[8] See, "Discount Rates, Defined Benefit Pension Schemes, and their Sponsors" Philip Bennett, Iain Clacher, Alan Duboisée de Ricquebourg, Mark C. Freeman, Con Keating, May 2021

**Relevance**

The chosen discount rate is exogenous. There is no economic, financial, or business justification for its use. Discounting using the exogenous rate returns a value which would only apply if that reflected the underlying contractual arrangements of the fund. However, that is highly unlikely across all pension funds through time. As such it is unrelated to the cost to the reporting entity of the historic liabilities being valued.

The cost to the reporting entity is not what the liabilities may cost if issued today but rather is determined by the terms they were issued on – and that implies an endogenous discount rate for the liabilities.

**Reliability**

Market yields have an intrinsic volatility which renders their results over time inconsistent and in that sense, results derived in this manner and published in financial statements are unreliable.

As the rate specified is exogenous, rather than helping with economic decision-making and the stewardship of management, it actually confounds the information used in those processes. For example, changes to the discount rate will be reflected in changes in the present value of liabilities and their apparent burden even when those liabilities are unchanged, or unchanged other than for their intrinsic amortisation arising from the passage of time. We refer to this intrinsic amortisation in other papers as the (endogenous) contractual accrual rate.

**Cost of applying exogenous discount rates**

We now move to consideration of the effects of this standard on the behaviour of companies and their pension funds and in turn the consequences of this for financial markets. We would note that the direct costs of the use of this standard are substantial – deficit repair contributions total some £200 billion, and contributions have increased almost fivefold in the past 20 years[9].

This is far greater than the increases in projected benefits and the cost increases associated with closure to new members.

However, these are almost surely minor costs when compared to the effects on financial markets, the economy more broadly, and on individuals who are likely to be considerably poorer in retirement with the move to individual defined contribution pensions, and it is our sense that there is a feedback loop between all of these things that will only get worse through time as future consumption by pensioners tomorrow must be lower.

**Can it be said that the use of IAS 19 has been conducive to the public good whether of the European Union or of the United Kingdom?**

As noted in Table 1, within the European Union the UK had the largest amount of assets in funded defined benefit pension schemes. So, what follows will focus on whether IAS 19 was likely to be

[9] ONS MQ5

conducive to the long term public good in the United Kingdom (the post-Brexit test) as well as to the European public good.

For the avoidance of doubt, in this note we are not seeking to discuss whether IAS 19 contributed to Brexit and whether Brexit was or was not in the European public good.

We use the twenty-year period 1999 – 2018 in the analysis presented here as the ONS published reliable data for pension funds in its MQ5 publication until the end of that period. Though IAS 19 did not formally come into effect until 2002, and could, even then, be delayed, early adoption was encouraged and undertaken by many larger listed companies.

The experience since 2018 is actually more extreme than in the data period we consider and would further reinforce our argument. Liability driven investment strategies are reported to have produced returns of the order of 14% - 17% in 2019 and 12% – 15% in 2020[10].

This is principally the result of Bank of England interventions in bond and money markets in response to the Pandemic. The Bank of England now owns 32% of gilts outstanding and has bought 53% of all issuances since 2008[11].

**Asset allocation in UK pension funds**

In 1999 pension fund asset portfolios were relatively simple, mixes of listed equity, property and bonds. Equity was the dominant asset class accounting, on average, for over 70% of the asset allocation and in some cases was the only asset class held. Holdings of foreign equities were usually minor, less than 20% of the asset portfolio. Conventional gilts dominated the debt class. The asset allocation of UK pension funds reported by the ONS (MQ5) in 1999 was:

**Table 1**

| | 1999 |
|---|---|
| Equities | 73% |
| Gilts | 13% |
| Overseas Govt | 2% |
| Corp | 3% |
| Property etc | 10% |

ONS MQ5 Authors calculations

At this time, there was little difference in the asset allocation of public and private funded schemes. It is notable that there is no mention of derivatives or insurance contracts at this time. The allocation to gilts had risen in the wake of the 1995 MFR regulations. In 1994 it was 9.8% of assets.

This allocation strategy had served the industry well until that point in time. We show below the asset class real returns for the period 1983 – 1999. 1983 is chosen as this was the start of index linked gilt issuance.

[10] E Guppy, CIO Pension Protection Fund. Interview in "LDI New Challenges" Portfolio Institutional October 2021

[11] UK Debt Management Office

**Table 2**

| Real Returns 1983 - 1999 | | |
|---|---|---|
| UK Equity | Gilt | ILG |
| 12.9% | 8.4% | 3.7% |

J.E.Woods (2020) New exercises in decomposition analysis, Journal of Post Keynesian Economic 41:3

These were quite exceptional high returns; over the post-war period real returns for equity had been around 6.2% pa and for conventional gilts 4.5% pa.

At the end of 1998 gilt yields were around 4.4% and fell by the end 2018 to 1.2%, and high-grade corporate bond yields have also reflected this secular decline. This has had the effect of inflating the present value of liabilities twofold over the period.

The combination of interest rate declines and unprecedentedly large increases in life expectations in the early 2000s led to the widespread closure of schemes to new members and future accrual.

Interest rates came to be seen as the most important risk factor in scheme valuations. This spawned a new style of pension portfolio management, liability driven investment. The concept is simply the matching of liability sensitivities to interest rates to their asset equivalents seeking to have changes in asset and liability values move in tandem.

Its implementation involved the sale of equity and purchase of bonds as well as the widespread use of derivatives among larger funds. Less than 20% of portfolio allocations are now to equity and UK equity is a small part of that. UK pension funds now hold over 80% of index linked gilts outstanding – and ILG market prices have increased to levels of the order of CPI – 2%. UK pension funds hold just 2.9% of UK listed stocks. This shift involved disinvestment from equity of the order of £1 trillion.

In 2018, the asset allocation was:

**Table 3**

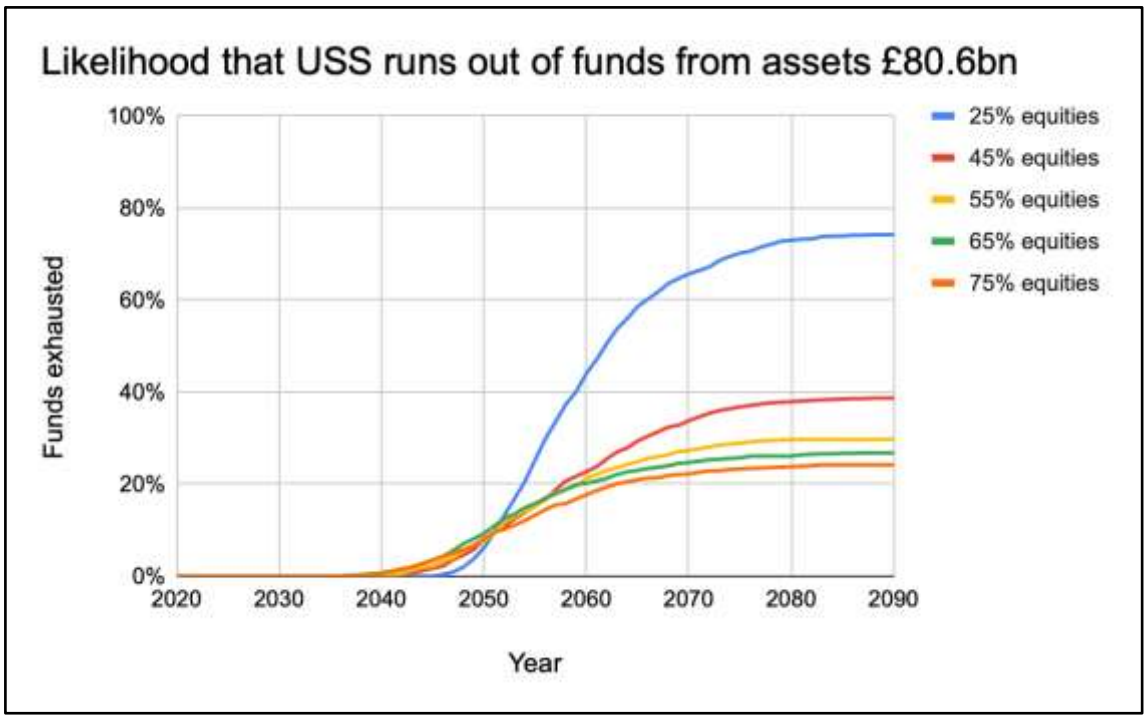
| | 1999 | 2018 |
|---|---|---|
| Equities | 73% | 12% |
| Gilts | 13% | 24% |
| Overseas Govt | 2% | 2% |
| Corp Bond | 3% | 10% |
| Property etc | 10% | 52% |

ONS MQ5 Authors calculations

The drop in equity is the most pronounced change. Only 3.5% of the overall funds remain invested in UK equities. The increase in the catch-all, Property etc., needs some expansion. Derivatives contracts account for 17.4% of the portfolio and Insurance contracts (buy-in) 9.8%.

It should also be borne in mind that the ONS data are for both local authority and private sector schemes and that local authorities have not followed the de-risking LDI strategies so common in the private sector, which means that these ONS figures understate the shift for private sector schemes.

There is little doubt that this has been a material contributor to the poor performance of the UK stock market internationally. In 1999, the UK market was over 8% of the total market capitalisation globally. It is now less than 3%. It has also contributed to poor investment performance of pension funds. In its most recent accounts for the year ended 31 March 2021, the Pensions Protection Fund reports a return of 3.2% but also states that the return on its growth assets was 17.6%. The liability hedging portfolio has been very costly indeed. A group of researchers looking at the risk of various asset allocations produced the following results for USS[12]:




The key take-away from this work is that there is a shift over time in the relative risk arising from the asset allocation, and over the long-term the de-risked bond heavy strategies are riskier than those with higher growth asset allocations.

Perversely, the liability hedging approach increases the cost to the sponsoring employer of providing the pensions. That increased cost means there is less money available for investment in the business, less money available for pay rises for employees and, for sponsoring employers with shareholders, less money to pay dividends to shareholders, and an overall weakening of the employer covenant available to support the scheme.

[12] Percentage of times USS funds are exhausted over a range of portfolios from 25% equities (75% bonds) to 75% equities (25% bonds). Here the fund is paying promises as they fall due from assets with no contributions. CPI basis, using Miles and Sefton assumptions with no mean reversion, initial assets of £80.6bn, USS cashflows to 2021, gilt yield from real spot rates at March 2020 and RPI adjustment 0.5%

The counter argument would be that, once the scheme is holding the right type of assets, using a liability driven investment strategy when the assets and liabilities are in balance should mean the scheme is self-sufficient with no need for further reliance on the employer covenant. But that does not allow for any unexpected improvement in longevity in the scheme or the default risk on the bonds held by the pension fund.

One reflection of this relative value issue has been the high recent levels of private equity purchases of UK listed companies. The effect of this growing segment of now highly leveraged companies on the performance and productivity of the UK economy is an open question. If we go back a decade or more, companies with DB schemes in deficit were considered highly unattractive targets by private equity – the scheme was effectively a 'poison pill'. While there are many contributing factors which may explain this shift, a large part has been the improvement in funding arising from the substantial contributions made by employer sponsors over this period.

The performance of the principal asset classes over the period 1999 – 2018 is shown below, along with their performance in the first and second decades.

**Table 4**

| Period | UK Equity | Gilt | ILG |
|---|---|---|---|
| 1999 - 2018 | 2.2% | 3.2% | 3.7% |
| 1999 – 2008 | -1.4% | 2.6% | 2.8% |
| 2008 - 2018 | 5.9% | 3.9% | 4.6% |

J.E. Woods, Op Cit

In theory, we should expect similar risk-adjusted real returns for conventional and index-linked gilts of similar maturity. Real returns to conventional gilts are expected to be higher than those for ILGs as compensation for the conventionals' exposure to inflation risk. To have index linked gilts outperforming conventional issues in an environment where inflation fell and was low and quiescent is most surprising. This is predominantly a revaluation (or speculative) effect. Following Woods[13], we show the returns due to revaluation or speculation, for the same periods and asset classes as in table 3, as table 4 below:

**Table 5: Revaluation**

| Period | UK Equity | Gilt | ILG |
|---|---|---|---|
| 1999 - 2018 | -2.4% | 3.9% | 7.3% |
| 1999 – 2008 | -5.7% | 3.3% | 1.7% |
| 2008 - 2018 | 1.0% | 4.6% | 13.3% |

J.E. Woods Op Cit

Some explanation of these returns is appropriate. The real return to UK equity over the period 1999 - 2018 would have been 4.6% p.a. but this was offset by a decline in the basis of valuation from the heights of the dot-com bubble almost all of which occurred in the first decade of the sample period.

[13] J.E. Woods (2020) New exercises in decomposition analysis, Journal of Post Keynesian Economics 41:3

Revaluation or declining market yields accounted for between 118% and 126% of the realised real returns from conventional bonds. By contrast, in the first period, 1999-2008, revaluation effects for index linked gilts accounted for 60% of the realised real return, but in the second decade accounted for 290% of the realised real return. Over the entire period, 1999-2018, revaluation returns accounted for 199% of the realised real return. To put this into context, index-linked gilts appear to be in a speculative bubble, the magnitude of which is about 2.5 times that seen in equity at the end of 1998.

The expected returns to an all-debt portfolio are lower than the expected returns to a balanced equity/debt portfolio, and this has empirical support in the historic record – as noted earlier equity has provided 6.2% real return and conventional gilts 4.5%. We would therefore have expected the liability driven portfolio to have produced less than the traditional equity heavy allocation in both absolute and relative terms. However, the good news is that the performative nature of the LDI allocation, by virtue of its overwhelming use of debt instruments, has delivered better relative returns than would be the case for those who maintained the traditional equity heavy allocation. However, it is important to recognise that these returns are almost surely lower than would have been the case without LDI being widely used – the range of returns for these two decades lie between 2.2% and 3.7% which compares poorly with the historic 4.5% – 6.2%.

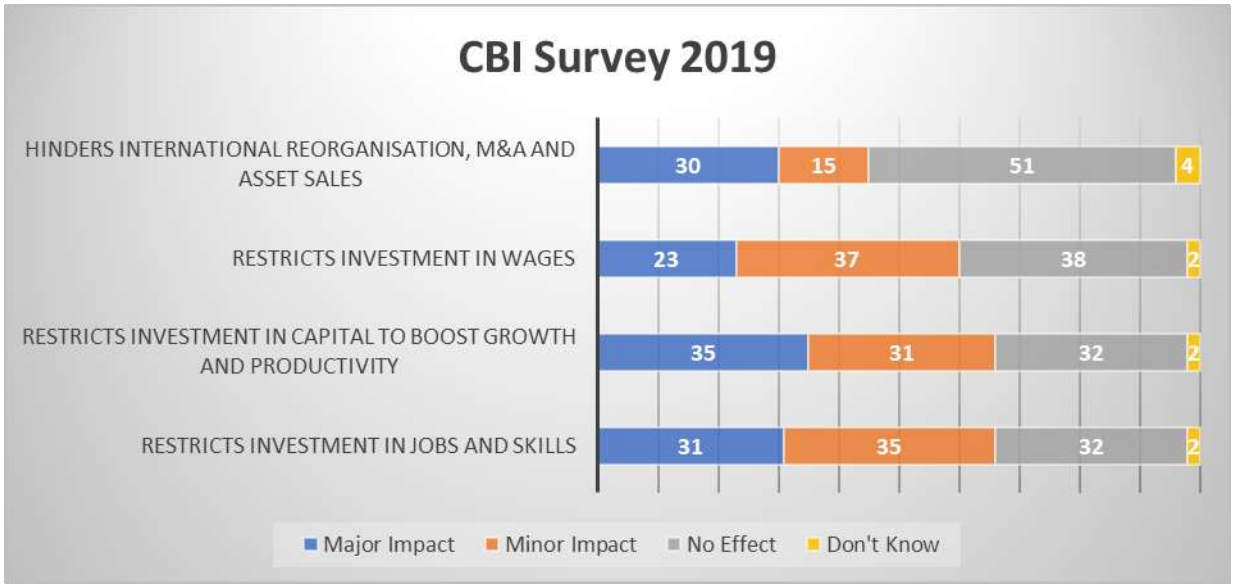
The effect of all of this has been to raise costs for sponsor employers. It appears that the £200 billion of deficit repair contributions would not have been needed had the traditional allocation been maintained, though poorly funded schemes would have had some difficulty in the 2002 – 2004 period when equity returns were extremely weak.

It should be emphasised that, although the funding position would have been stronger, the cost of new awards and future service contributions would have risen as bond yields have fallen. We should also not forget that, for tax paying employers, deficit to repair contributions are tax deductible. So, there is a significant loss of tax revenue and cost to the taxpayer flowing from IAS 19[14]; we calculate this to be a loss of receipts of the order of £40 billion.

[14] HMRC estimates of the tax cost of pension contributions use a counterfactual, which we believe overstates their cost.

**Corporate Finances and the Economy**

Scottish Widows conducted a survey for the CBI of 240 of its members. In response to a question on strict approaches to scheme funding the survey returned the following results:




Scheme funding requirements have affected, that is lowered, corporate investment in numerous dimensions.

It would appear the use of the IAS 19 is having an adverse effect on the economy of the United Kingdom, including on economic growth. Moreover, it has had deleterious effects on the efficient allocation of capital, as highlighted as far back in 2010 by Robin Greenwood and Dimitri Vayanos.[15]

**Conclusion**

Taken together, all of this has impacted on the smooth functioning of capital markets in the United Kingdom (as well as reducing tax receipts for HM Treasury), raising important questions on whether IAS 19 can be seen to meet the required criteria, including, in particular, of being "…conducive to the long term public good in the United Kingdom ".

The counter argument is that the use of the common measurement yardstick to compare pension costs has been beneficial to the users of accounts of listed companies in the UK and, in particular, investors in those companies. It is a price worth paying that should properly be borne by the employees and former employees (through the move to defined contribution arrangements), of those companies with defined benefit pension schemes, (who have paid out hundreds of billions of pounds in corporate capital), and by the UK taxpayer (who has, and will continue to, pay billions out to support this system).

[15] Price Pressure in the Government Bond Market, The American Economic Review, May 2010, Vol. 100, No. 2, pp. 585-590