IASB® Speech

The pension liability: low interest rates are no free lunch

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Speaker: Hans Hoogervorst, Chairman, International Accounting Standards Board

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Introduction

When the Bank of England cut its Bank Rate to a record low as a response to Brexit, its Chief Economist Andy Haldane remarked that he would "rather run the risk of taking a sledgehammer to crack a nut than taking a miniature rock hammer to tunnel (his) way out of prison".[1] These words were clearly meant to be provocative. Yet, many people are indeed concerned if central banks aren't swinging a little bit too wildly with their monetary sledgehammers.

The Dutch pension system, probably the best capitalised in the world, is acutely aware of the collateral damage of low interest rates. Since 2007, the average coverage ratio of Dutch pension funds decreased by no less than 40 percentage points. This steep decline took place despite significant cuts in pension benefits, and more are in sight. These problems cannot be solely attributed to central bank policies; pension funds would have suffered from the financial crisis under any scenario. Yet the Dutch pension funds are acutely aware that low interest rates are no free lunch.

IFRS Standards and pension liabilities

With interest rates being so low for so long, some are reopening an old debate about the measurement of the pension liability. The approach in IFRS Standards has been in place for many years. Although generally supported, there are periodic challenges to our model, particularly at times when market conditions cause pension deficits to rise. Today is one such time, with several recent press reports[2] complaining about IFRS Standards causing deficits that are illusory.

Essentially, IFRS Standards require that pension liabilities be measured based on the characteristics of that liability, irrespective of how the obligation is funded. The liability in respect of a Defined Benefit pension is in effect a debt to employees where the payments are fixed or indexed. In a standard

[1] Speech in Port Talbot, Wales, 30 June 2016
[2] See for example Jonathan Ford: *Hard truths about the dismal cycles of pension calculations*, Financial Times, 24 October 2016

Defined Benefit scheme payments to employees are not affected by the actual returns on the assets used to fund those pensions. Accordingly, IFRS Standards require the liability to be measured using a discount rate that reflects a fixed interest return, and not the expected return on the actual assets held.

Of course I am not saying that the current IAS 19 on pensions is perfect. We recognise that our Standard is a bit out of date in that it does not cater for recent developments in pension scheme design. This is especially the case here in the Netherlands, where pure Defined Benefit schemes have largely made place for hybrid schemes in which the pension liability is defined more flexibly. I accept this and the International Accounting Standards Board is looking at whether improvements can be made. However, such problems are not related to the central tenet of the standard that liabilities that do not depend on asset returns should not be discounted at the expected asset return.

Interest rates

So why the controversy? As pension liabilities are measured based on bond yields, given the record lows for these rates, inevitably pension liabilities are at record highs. The argument is that if the future returns on pension assets can be expected to be higher than the liability 'discount rate' then fewer assets are actually required to pay those liabilities than is suggested by the accounting. Critics argue that if the fund is invested in, say, equities–with higher expected return –then meeting future pension payments requires fewer assets today and hence the liability is being overstated.

While these arguments have some intuitive appeal, the IASB believes them to be flawed. Here are some reasons for rejecting discounting pension liabilities at a higher rate:

- It fails to properly take account of risk–a central and key feature of finance. The objective of financial reporting is to provide relevant information for investors in companies. We would not serve that objective if risk were ignored.

- It would suggest that sponsors of pension schemes can reduce deficits by switching from low-risk, low-return bonds to higher-risk, higher-expected-return equities. The fact is that markets have already done so to a great extent and that equity prices are widely considered to be overpriced. Why are investors willing to pick up government bonds at negative rates if equities are so much more attractive? Equities and bonds compete for the same capital in many cases. If you exchange 100 worth of bonds for 100 of equities, clearly your wealth today remains 100.

- It is inconsistent with prudent financial management. In effect, the suggested approach involves booking profit before it has actually been earned. For example, if a company purchases an equity investment, would it be prudent to report all of the expected future return

immediately at the time of purchase? This is, in effect, what is being advocated for pension accounting. It would facilitate imprudent distributions, excessive management bonuses and risky leverage in the entity's capital structure.

For these reasons the IASB rejects calls to fundamentally change pension accounting to eliminate or reduce pension deficits. Our approach to liability measurement in accounting is well accepted. The same or similar approaches are being used in other areas of accounting, such as insurance and environmental liability measurement. It is also the basis of prudential regulation and is consistent with how markets measure such liabilities and with the advice of the actuarial profession.

So if the accounting for the pension liability reflects economic reality, it is worthwhile taking a closer look at the forces that shape this economic reality. In the second part of my presentation I will examine the stated and unstated reasons given for current monetary policies, discuss their economic consequences and conclude with some observations on their sustainability.

Monetary policies

ECB President Mario Draghi recently defended his Bank's unconventional monetary policies in the German parliament.[3] He pointed out the need for pushing inflation towards a level of two per cent to "protect our economies from drifting into the dangerous territory of negative inflation". The danger of negative inflation would be a deflationary spiral: "Once expectations of falling prices become ingrained, consumers postpone purchases in anticipation of even lower prices, while firms hold off making investments because they do not know whether they will pay off. This downward spiral continues until the economy collapses". The Bank of Japan legitimises its even more unconventional monetary policies as an effort to break what it sees as the deflationary mind set in the Japanese economy.

Moreover, central bankers increasingly point out that they are forced to take extreme measures, because market forces already exert powerful downward pressure on interest rates. They cite a global savings glut, the ageing of many industrialised nations, slowing productivity gains and the post-crisis macro-economic slump as the main determinants of low interest rates.

To some extent these arguments are plausible. A Great Depression has been averted, at least until now, and the powerful monetary response to the financial crisis of 2008 has probably contributed to that.

But is the threat of deflation really as big as it is made out to be? Even if prices were dropping by one-two per cent per year (which we have not even come close to since 2008) it is extremely unlikely

[3] Introductory remarks made by Mario Draghi, president of the ECB at Deutscher Bundestag, Berlin, 28 September 2016

that this would have induced significant postponement of consumption or investment. Consumers have never stopped buying laptops when their prices dropped by 20-30 per cent per year. Mild deflation is just as unlikely to dampen consumption as mild inflation would be an incentive for consumers to bring purchases forward. So why go into ever more extreme monetary territory when prices are basically stable?

Some would also question the assertion that the low interest rate environment is basically a product of natural economic forces. While it is plausible that demographic and macro-economic developments exert downward pressure on the neutral level of interest rates, few central bankers can truly believe their own contribution has been modest.

Most market participants perceive the financial markets to be highly dominated by monetary policies. Former Bundesbank president Axel Weber summarised it thus: "I don't think a single trader can tell you what the appropriate price of an asset he buys is, if you take out all this central bank action".[4] But even if autonomous economic developments *were* the main cause of interest rates reaching historically unprecedented levels, the question is–again–why push them further to ever more extreme levels?

This question is being asked by more and more people since the negative side effects of unconventional monetary policies are becoming increasingly clear. The Bank for International Settlements (BIS) has warned on several occasions against the negative side effects of ultra-low interest rates[5]. Most visibly, unconventional monetary policies are starting to put pressure on the business models of banks, insurance companies and–of course–pension funds.

Inflation and debt

Secondly, current monetary policies lead to asset price inflation. This is partly an intended effect, but one may ask if it is sensible as in many jurisdictions prices of residential properties are now higher than just before 2008. In Amsterdam, house prices rose by 25 per cent in 2015 as people are able to borrow money for ten years fixed at two per cent interest. If retail prices rose that fast, it would set off all the alarms. Given the fact that housing markets are at the core of the economy and the banking system, shouldn't we be alarmed by this level of asset price inflation too? To be in bubble territory again so soon after one of the worst credit crunches in history defies common sense.

But the most important questionable side effect of low interest rates is probably that they are an incentive for leverage, which has been the core of the problem to begin with. Close-to-zero interest rates postpone adjustment in both the private and the public sectors. In the private sector, economic resources are misallocated by keeping zombie companies afloat, which is probably one of the reasons

[4] https://www.ft.com/content/8e5b9ac2-9126-11e6-a72e-b428cb934b78
[5] See for example the 82nd annual report of the BIS

why productivity growth is so low. In the public sector, adjustments to unsustainable public finances are easier to postpone as long as the monetary music keeps playing.

These incentives for leverage have contributed to the fact that the aftermath of the financial crisis has been very different from the normal unwinding of major credit crises. In the past, the bursting of credit bubbles would usually be followed by a period of sustained deleveraging. This time, things are different. Indeed, as a recent publication by McKinsey[6] shows, the build-up of leverage in the global economy has continued almost unabated.

In 2007, combined global debt of households, corporates, governments and the financial industry already stood at no less than 269 per cent of global GDP. While this staggering number was already historically unprecedented, it continued to grow after 2008. Some deleveraging took place in some categories in some jurisdictions, but on a global scale total public and private debt continued to rise to 286 per cent of global GDP at the end of 2014. Public debt grew especially fast; it ballooned from 33 per cent in 2007 to 58 per cent of global GDP in 2014.

These staggering debt levels also provide the (mostly unstated) explanation why it is so difficult for central banks to return to normality. A return to historically normal interest rates could bring some highly indebted sovereigns very close to the brink; it would wipe trillions of dollars off the bloated bond markets and zombie companies could be pushed into bankruptcy. It does not take much imagination to fathom what the consequences of such scenarios for the banking system would be…

The conclusion must be that we have basically dug ourselves into a hole.[7] The low interest rate environment has undoubtedly had a positive impact on economic activity in the short run. But it has facilitated an addiction to debt which suffocates the economy over the longer term. Ending this addiction will likely lead to short-term withdrawal symptoms, which explains the trepidation in a return to normality.

Does this mean that it is impossible to get out of this quandary? I don't think so. In many of the highly leveraged economies, there is ample scope for budgetary and structural reform which could bring economic growth to a sustainably higher level. A return to less accommodative policies would sharpen the sense of urgency that is needed to make such difficult measures happen.

We should also acknowledge that some problems simply take time to resolve. A historically unprecedented level of leverage that was built up over decades will take a long time to disappear.

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[6] McKinsey Global Institute: Debt and (not much) deleveraging, 2015. A recent study by the IMF gives comparable numbers.

[7] In a recent interview Lord Mervyn King, Former Governor of the Bank of England, said: "When you transfer spending from the future to the present, you dig a hole—time passes, and the future becomes today. So, now you cut interest rates again to bring even more spending forward, and that digs an even deeper hole". (The Trusted Professional, 8 August, 2016)

Sledgehammers cannot get us out of the deep hole that we have dug ourselves into. We need patience and persistence, instead of stacking distortion upon distortion.

Conclusion

Let me come to a conclusion. My analysis makes clear that I see no magic short-term solution for the problems of the Dutch pension system. If present policies continue, the pension schemes will continue to be plagued by the twin problem of low interest rates and excessive leverage.

A return to normality of macro-economic policies is the only healthy way forward. A return to more normal interest rates will reduce the pension liability and will be beneficial for the long-term health of the pension system. But even then, short-term pain seems inevitable, because a lot of damage has been done. While the pension liability will be reduced, there will probably be short-term harm to both your bond and stock portfolios. This is another reason why I do not believe that our accounting for the pension liability exaggerates the problem. It is simply not going to go away easily.

Fortunately, the Dutch pension system is among the strongest in the world. You have also shown willingness to be flexible and to adjust your schemes to economic reality. It is up to policymakers to make this economic reality better. It will take patience and perseverance, but it can be done.