



# Changing Pension Framework



Fixed Income Forum  
Fall Roundtable  
November 5, 2003





# Changing Pension Framework

- Accounting
- Statutory (ERISA funding) - Norm Stein
- Investing (Asset Allocation) - Carl Hess





# Statutory Front

- 2003 defined future funding battle
  - strong vs. weak standards
- Hawks want full funding (ABO defeasance) at all times





# Investing Front

- Battle lines drawn here as well
  - equities for the long run (portfolio selection model) versus
  - bonds, bonds, bonds (corporate finance model)



# Accounting

- Convergence across borders
  - IASB
  - Continued importance of FASB
- Fair Value Paradigm
  - Replaces “historic cost”
  - Effort to mark everything to market
  - Start with financial instruments
  - Aimed at 2005, delayed by convergence



# Accounting

- Implications of fair value for defined benefit pension accounting
- Implications of pension accounting for pension investing



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# Fair Value - Pension Implications

- FAS 87
- Fair value

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# Fair Value - Pension Implications

- Assets

- Market related value (MRV) — trailing average — e.g., 5 years



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# Fair Value - Pension Implications

- Assets

- Market related value (MRV) — trailing average — e.g., 5 years

- Market value

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# Fair Value - Pension Implications

- Liabilities

- Discounted at Aa — should be yield curve — most use index

# Fair Value - Pension Implications

- Liabilities

- Discounted at Aa — should be yield curve — most use index

- Yield curve appropriate for collateralized debt of sponsor

# Fair Value - Pension Implications

- Expenses
  - New liabilities (service cost)
  - Time value increase in liability value
  - Minus return on assets
  - Plus/minus amortizations of prior deferrals

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# Fair Value - Pension Implications

- Expenses

- New liabilities (service cost)

- Same concept in fair value



# Fair Value - Expenses

- Time value increase in liability value
  - Discount rate times liability value



# Fair Value - Expenses

- Time value increase in liability value
  - Discount rate times liability value
  - Total liability return — including price change



# Fair Value - Expenses

- Minus return on assets
  - Expected return times market related value







# Fair Value - Expenses

- Minus return on assets
  - Expected return times market related value
  - Total asset return





# Fair Value - Expenses

- Plus/minus amortization of prior deferrals
  - Previously deferred items — e.g., liability price changes, actual less expected asset returns, benefit changes, etc.





# Fair Value - Expenses

- Plus/minus amortization of prior deferrals
  - Previously deferred items — e.g., liability price changes, actual less expected asset returns, benefit changes, etc.
  - None



# Fair Value - Expenses

- Categorization
  - Entire expense treated as “operating” (enters P/E multiple) — Coronado & Sharpe

# Fair Value - Expenses

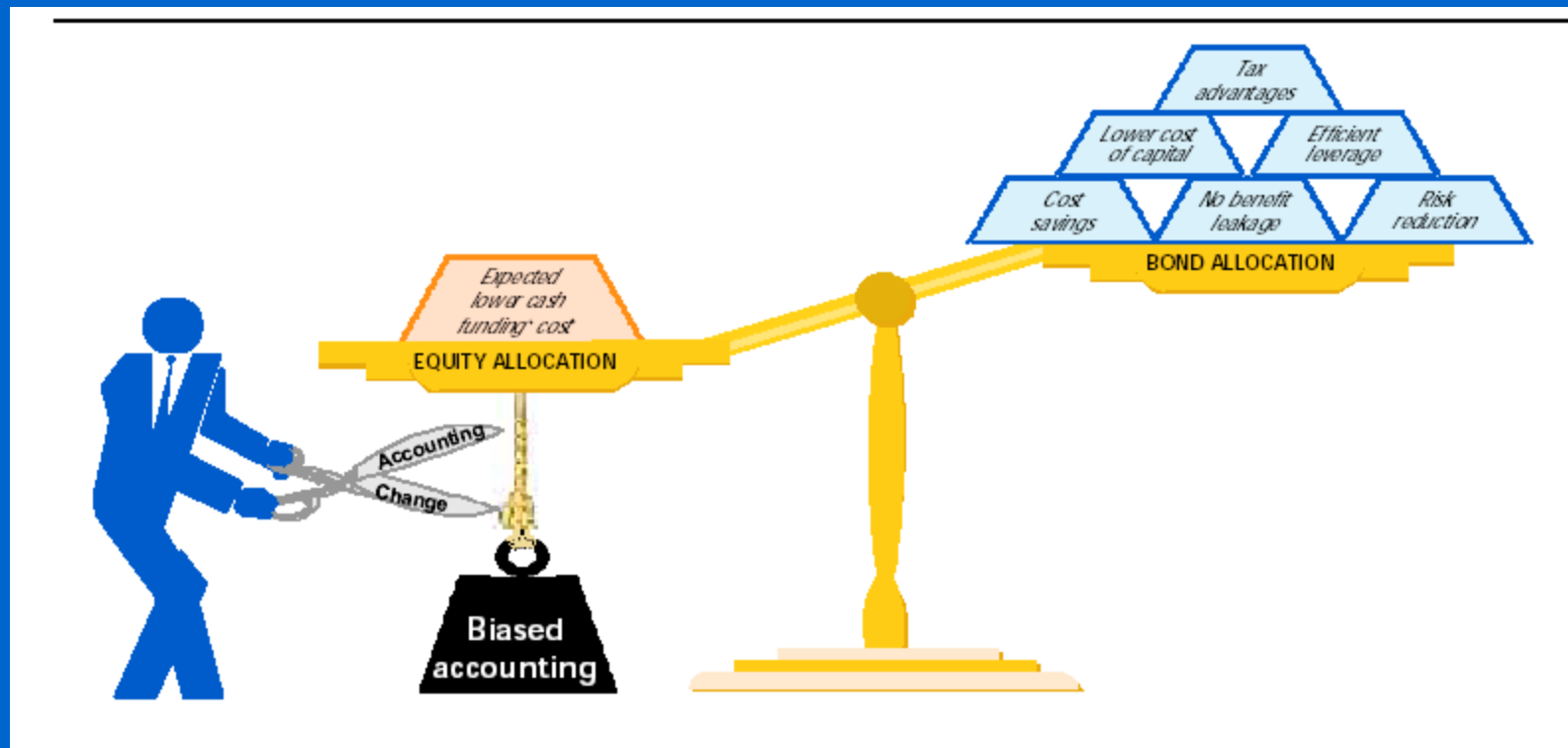
- Categorization
  - Entire expense treated as “operating” (enters P/E multiple) — Coronado & Sharpe
  - Service cost is operating (is multiplied)
  - Asset & liability returns are “financing” (non-operating)

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# Fair Value - Investment Implications

- First order — shareholder indifference
- Second order — taxes, risk management (distress costs)

# Fair Value - Investment Implications



# Fair Value - Investment Implications



UBS Investment Research

**Q-Series™: Pension Fund Asset Allocation**

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# Fair Value - Investment Implications

- Massive move to bonds before 2010
- First mover advantage



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