A Balanced Perspective on Fair-Value Pension Accounting

CAPE's Analysis of the C.D. Howe Institute's Report on Public Service Pension Plans

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In a recent report, the CD Howe Institute, a conservative think tank, claimed that there was a significant deficit in the pension plans of Canada's public service, Canadian Forces and the Royal Canadian Mounted Police. The report, entitled *"Supersized Superannuation: The Startling Fair Value Cost Of Federal Government Pensions"* immediately caught the eye of the media and captured headlines across the nation. The report caught the attention of government officials, union leaders and employees alike. Moreover, it ignited a firestorm, and seemed to encourage a backlash against all public servants, by the Canadian population at large. Rarely has a report so acutely divided public opinion.

The most startling finding contained in the report was that by using something called alternative valuations and fair-value accounting, they calculated an accumulated deficit of nearly $522 billion at the end of fiscal year 2008/2009. This implies that the deficit of these plans is nearly $58 billion more than that reflected in the government's pension accounts for that fiscal period. If true, then taxpayers and plan participants will be exposed to underappreciated risks. The report concluded that reducing costs, and risks, should be a key element in restoring federal finances to a sustainable position. It follows from the report that the pension plans would probably be targeted to reduce these costs and risks.

Naturally, the response from union officials and public service employees was clearly defensive. "Well the government took $30 billion of surplus out of the plan a decade earlier, and they should be responsible for this state of affairs." "The Government should improve private plans before it attacks the Superannuation Plan." "How could the Chief Actuary, as well as the Auditor General, have missed these results? Aren't they responsible to protect this Plan, and the public purse?" Curiously there was little or no response from senior government officials, or Canada's elected representatives.

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What's in a Name?

These defensive reactions by union officials, and employees as well, should have been expected. At the outset, everyone assumed that the method employed by the C. D. Howe Institute – "fair-value accounting", had to be more appropriate, if not more accurate than historical accounting approaches. And if it was being used by such a prestigious organization, it carries an imprimatur as an authoritative document, whose conclusions must be above reproach. There is also the logical implication that if this method is "fair-value" then other traditionally accepted accounting methods are not "fair value". As Canadians, we love our country, our flag, and pride ourselves on the values of honesty, integrity, and fairness. So once this report was wrapped in the protective mantle of the words "fair value", no one bothered to ask the following natural questions:

1. What is fair-value accounting (FVA)?
2. Does it have any significant conceptual or practical problems?
3. Has there been any significant business/political objection to FVA?

By the way, the approach used by the CD Howe Institute has also been commonly called "mark to market"(MTM) accounting. Had this name been chosen, it is likely that the initial report would have been subjected to a more rigorous examination. There is no denying that the CD Howe Institute's report chose its name carefully, and its tabloid style title had sex appeal. Obviously missing from the report are the volumes of articles and criticisms of this method, which have been a part of a large public debate throughout financial markets these past several years. So now that the smoke has dissipated and the dust has settled, perhaps its time we examined these questions and see what well-reasoned judgement would have us believe.

1. What is "fair-value accounting"?

It is defined as the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties, in an arm's length transaction. Quoted prices in active markets must be used as fair values when available. In the absence of such prices, valuation techniques and all relevant market information should be used. It is allowed to make a significant adjustment to an observed price in order to arrive at a price at which an orderly transaction would take place.

In comparison, under historical cost accounting (HCA), assets and liabilities are recorded at their values when first acquired. They are not then generally restated for changes in values. Costs recorded in the income statement are based on the historical cost of items sold or used, rather than their replacement costs. Long term prices and rates are frequently averaged over extended periods of time, yielding less volatile results.

Consider, for example, natural gas reserves. The value of these reserves will fluctuate with the price of natural gas. How should the natural gas be valued? Using the current price will see the natural gas company report an increase in value as the price rises even for the gas which has not gone to market, and will report losses in value as the price declines – this is how the value of the reserves would be calculated using fair-value accounting. Using historical cost accounting, a long-term average price will dampen this effect and will mean no profit is reported until the natural gas is brought to market.

No one method is completely satisfactory. It can be reasonably argued that FVA appears to service the needs of investors in the short term, while HCA proponents may have a longer term perspective.

FVA, however, is known to show less reliable results, particularly as many elements of the balance

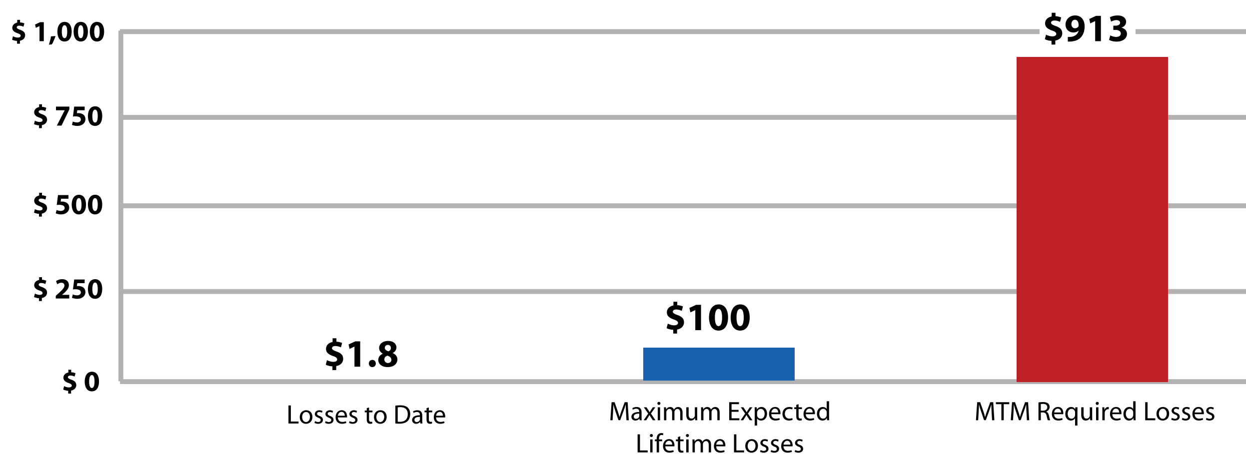
sheet may be rarely traded, and in application it produces widely fluctuating results, given its reliance on current transactions. When one considers the timeframe for the CD Howe Institute report (9 years, ending in 2008/9), it is clear, that the write down in values resulting from the world recession, may in and of itself be responsible for a major share of the increase in the restatement of the debt associated with Canada's public pension plans. Will not this short term "deficit" be erased once markets recover?

2. Does FVA have any conceptual or practical flaws?

Clearly we have already alluded to some difficulty with the inherent volatility of FVA. In addition there are a number of technical problems which have concerned numerous industries. The insurance industry has noted that FVA does not recognize prepaid acquisition costs as an asset. In addition, there is no market for insurance liabilities, or for that matter "other liabilities", which adds an element of uncertainty to the valuation of liabilities. As well, liabilities held at fair value may show greater volatility, due to changing yield curves and risk adjustments, as compared to undiscounted or conservatively discounted liabilities under HCA.[1]

The banking industry as well has been critical concerning the application of FVA.

Consider the example of a bank that made loans and securitized them as a mortgage backed security (MBS). The bank is required to record mark to market losses of $913 million, (even though there is no transaction) as opposed to the maximum expected lifetime losses of $100 million (all of which is absorbed by collateral), resulting in a significant overstatement of losses and having a negative impact on tangible common equity. The write down, it should be noted, is permanent and there is no subsequent reversal of loss. And of course going forward, reported yields on these investments are disproportionately high. [2]



Not just in North America but throughout Europe and even as far as the Middle East there has been a critical ongoing discussion about the shortfalls of FVA. Some have suggested that the method itself actually contributed to the spiraling recession in these economies.

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[1] *Casualty Actuarial Society.* February 2, 2010. CAS Task Force on Fair Value Liabilities White Paper on Fair Valuing Property/Casualty Insurance Liabilities, January 3, 2008 <www.casact.org/>

[2] *American Banker's Association.* February 2, 2010. Fair Value and Mark to Market Accounting, <http://www.aba.com/Issues/Issues_FairValue.htm>

3. Has there been any significant business/political objection to FVA?

In reading the CD Howe Institute Report no one would have ever guessed that there has been, particularly in recent times, strong objection to the application of FVA by business and political leaders. The reaction has been strongest where the economic recession has been strong, perhaps less so in Canada owing to the relative strength of it banking sector. Nonetheless, "..in April 2008 Steve Forbes, (President and Chief Executive Officer, Forbes Magazine) urged the Bush administration to temporarily suspend FVA. Blackstone Group Chairman, Stephen Schwartzman, vigorously campaigned against FVA, calling it pro-cyclical. Former Federal Deposit Insurance Corporation Chairman William Isaac, along with former House Speaker Newt Gingrich, joined this chorus of voices calling for changes to, or suspension of, fair value. Trade associations, including the American Bankers Association (ABA), the Independent Community Bankers Association (ICBA), and others stepped into the fray, arguing that fair value is not the most relevant measurement for financial instruments." [3]

Some Lessons to be Drawn

Some have suggested that the rapid rise and downward spiral of equity markets was to some extent influenced by the application of FVA throughout various world economies. Given the volume and intensity of debate on the application of FVA, it is appalling that the CD Howe Institute never mentioned these critical objections and shortcomings in its study. One would have thought that scholarly high values, the desire for well reasoned discourse, and the desire to inform the public in a dispassionate manner would have necessitated a balanced and even-handed treatment of the subject. But rather than a balanced discussion, it presented a one-sided analysis, devoid of any real critical evaluation. It is disappointing to see such a prestigious organization fall short of its own high standards.

Fortunately for Canadians, we can take a deep breath and relax. The results produced by the CD Howe Institute are subject to the same professional criticisms inherent in the FVA approach. Apply it during a recession and it will drive equity values down and raise plan debt. Use the same method in a period of rapid economic expansion and it will drive surpluses to unrealistically high levels. No wonder Canada's Chief Actuary has chosen the more traditional HCA in analyzing plan performance and position. It is also reassuring that our Auditor General, charged with protecting the public purse, has never found the public to be subject to any unreasonable or underappreciated risk in its public service pension plans. For employees and their representatives, they should have seen this coming.

The lack of response from senior government officials provides the best indication of their involvement in the study. You may expect the government to use this report to attack the public service pension plan. After all, every time the government has been faced with difficult financial decisions it has consistently chosen to secure an improvement on the backs of its own employees.

CAPE would like to thank past President Bill Krause for his contribution to this analysis. Mr. Krause served as a long time member of the Public Service Pension Advisory Committee, and is considered an expert in this field.

The ***Canadian Association of Professional Employees*** represents approximately 13,000 federal professional employees across Canada.

100 Queen Street, 4th Floor
Ottawa, Ontario K1P 1J9
(6130 236-9181 * 1-800-265-9181 * Fax: (613) 236-6017

[3] *National Association of Corporate Directors Directorship*, Cindy Fornelli, "The Great Fair-Value Debate", August 18, 2009. <https://www.directorship.com/the-great-fair-value-debate/>