



2 December 2004

## **Pensions: Eurostat Communication to the AEG**

**Based on the proceedings of the *Task Force on the SNA review (financial accounts and government finance statistics)* and of the *Financial Accounts Working Party***

### **Contribution to the EDG on pensions**

#### **Introduction**

1. The Eurostat *Task Force on the SNA review (financial accounts and government finance statistics)* met on 15 September in Luxembourg and examined the progress made by the Electronic Discussion Group on pensions (retirement pensions) (EDG), which reports to the Advisory Expert Group (AEG).<sup>1</sup> On 21 September, the Task Force (TF) issued a contribution to the EDG signed by 30 participants indicating the unanimous opinion that the debate on a review of the SNA treatment of pensions could not come to closure at the end 2004 AEG meeting, as envisaged.
2. The TF met again on 17 November in Luxembourg to examine a draft Initial Report of the team (Richard Walton, Bank of England, Rapporteur) in charge of documenting the AEG item 2 for the TF consideration. The provisional results of the TF were then communicated to the Eurostat Financial Accounts Working Party (FAWP) who met on 18-19 November. There was widespread agreement amongst European Statisticians at these two meetings that alternative options significantly different to those presented by the Moderator of the EDG on pensions would need to be explored. In this context, the FAWP concluded that more time was needed to explore those alternatives.

#### **EDG proposals**

3. The EDG main proposals for changes of the SNA are (1) to treat unfunded employer pension schemes similarly to funded schemes, (2) to use actuarial valuation for flows and stocks and (3) to allocate the net assets of pension funds to the sponsor. Those proposals affect the measurement of households' assets, property income and labour costs. To the extent that employer schemes pension rights have the nature of deferred compensation of employees, the EDG proposal addresses convincingly the question of accounting for those.

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<sup>1</sup> Activities of the EDG on pensions are observable at: <http://www.imf.org/external/np/sta/ueps/index.htm>

4. The strength of the EDG main proposal (proposal 1) lays on the fundamental idea that the criteria for recognizing a liability are based on the characteristics of the obligations in question (i.e., whether the claim is sufficiently solid) irrespective of whether the obligation is backed by earmarked assets or not (funded or not). At the same time, it can be questioned whether unfunded or pay-as-you-go schemes are economically the same as funded schemes. Whereas many agree with the need to recognize such pension obligations as liabilities or at least to account for them separately in the system (satellite accounts), a specific treatment may be more appropriate in the light of the specific features of those obligations. This concerns the less solid nature of the claim—as its value can be unilaterally altered by the debtor. Moreover, it should be taken into account to what extent this value depends on all kinds of assumptions on uncertain future events and whether or not it can be estimated within narrow margins.
5. The EDG suggests that the criterion for liability recognition is when there is a legal or contractual obligation or a “constructive obligation”. Constructive obligations are, according to the International Accounting Standard Board (IASB), obligations that derive from an enterprise’s actions where: (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities; and (b) as a result, the enterprise has created a valid expectation on the part of those other parties that it will discharge those responsibilities. One consideration is whether the capacity of the debtor to unilaterally alter the value of the pension promises should be a main criterion for asset recognition. Another concern is whether the use of this concept of constructive obligations will be extended to other areas of SNA, and what would be the criteria against such extensions.
6. The TF also noted that the EDG current proposals would noticeably impact government accounts, as civil servants schemes are often unfunded. Government deficits and net worth would tend to noticeably deteriorate, up to 1 to 2% of GDP for the former and anywhere from 20% to 50% of GDP for the latter.
7. At the same time, the EDG proposal is to not recognize social security pension obligations as liabilities, with scope for creating serious difficulties in terms of borderline with employer schemes. The TF insisted that proper guidance be provided in this respect by the EDG.

### **Social security versus civil servants schemes**

8. The EDG proposals seem to fit well in countries where institutional arrangements comprise large occupational pension schemes operated privately, with social security pensions conceived as only providing some sort of safety net. The TF recognized that in many countries, notably of continental Europe, occupational pension schemes of the private sector are organized by government and, under the ESA/SNA, are classified as social security funds, even though they are largely substitutable to employer schemes observed in many other countries. The TF also wondered whether such institutional arrangements also exist in other countries in the world. In those circumstances, social security could be construed to be some kind of universal multi-employer scheme. In this context, it is a matter of concern that unfunded pension obligations of employer schemes would be recognized as liabilities whereas pension obligations of those social security schemes would not.
9. To put it another way, to what extent the households’ asset that exists in the case of employer schemes does not in the case of social security. Some TF members noted that households may commonly perceive to have accumulated rights in exchange for the contributions paid over the years to some security schemes, whereas such an impression may be less common for contributions paid to other types of social security schemes. One important consideration may

be whether accumulated rights can be converted into cash (and under what circumstances), or can be transferred in between schemes. In other schemes, pension rights cannot be transferred and can even be lost upon change in employment.

10. An important consideration is under what conditions the obligated party can change the pension entitlements it has promised. It is argued that similar to social security—where entitlement are deemed to be changed reasonably easily, by act of parliament, though generally a politically difficult exercise—so it seems often the case for civil servants in Europe. Others argue that civil servants schemes are noticeably better protected. It is also likely that accrued entitlements are, legally or de facto, much secure than entitlements due to accrue in future under an unchanged scheme.
11. Another important issue refers to the classification of schemes (and the recording of their transactions) that predominantly serve civil servants but also comprise contributors that are employed by corporations—often, by public corporations. De facto, such arrangements function like multi-employer schemes, but may be assimilated to social security. This again points to porosity in the borderline.

#### *Recording of switch in regimes*

12. Considering the proximity of some civil servants pension schemes and social security schemes, it has been suggested that it would not be implausible that the former to be merged with the latter at little transition costs in some countries. Guidance by the EDG on how such events would then be recorded in the system is necessary. Some argue that it would be a matter of concern if liabilities—and the impact on deficits—would disappear upon such events.

#### *Accounting standards*

13. There would seem to be an advantage to take time to try consolidating views of the statistical sphere with those of the accounting sphere, as the latter are prime source data provider to the former.
14. In this respect, it is worth noting that the Public Sector Committee (PSC) of the International Federation of Accountant (IFAC) has established a Sub-committee on Social Policy Obligations (SPO). An invitation to comment (by June 30, 2004) has been posted by the Sub-committee, including a chapter 8 dealing with old age (social security) pensions.<sup>2</sup> Whilst its paragraph 8.47 would seem to refer to a majority view<sup>3</sup> against extending widely liability recognition, the invitation to comment does not articulate the reasons whether and why civil servants unfunded employer pension schemes should be treated differently (i.e., treated as pension funds) from social security pensions.
15. It is noted that the International Public Sector Accounting Standards (IPSAS) of the PSC does not include guidance yet on the recording of civil servants pensions. It is sometimes assumed that the International Accounting Standards Board (IASB)'s standard on pensions (IAS 19) applies (see the EDG contribution by IFAC PSC staff)<sup>4</sup>. However this would need to be clarified. At the same time, the IASB is in process of reviewing IAS 19, with an exposure draft by end July 2004.<sup>5</sup>

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<sup>2</sup> <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0031>

<sup>3</sup> Majority for option 1, detailed in 8.12-8.13 notably, over option 3, detailed in 8.25-8.30

<sup>4</sup> <http://www.imf.org/forum/Message2.asp?forumid=10&messageid=355&threadid=355>

<sup>5</sup> [http://www.iasb.org/uploaded\\_files/documents/8\\_38\\_EDIAS19.pdf](http://www.iasb.org/uploaded_files/documents/8_38_EDIAS19.pdf)

16. All those questions were outlined during the June 4, 2004 OECD Workshop (see the EDG contribution of François Lequiller *Lessons from the OECD Workshop “Accounting for implicit liabilities”*<sup>6</sup>) and again discussed at the October 8, 2004 OECD National Accounts Experts Group. These questions are insufficiently taken into account at this stage in the EDG Moderator Report.
17. Another important consideration is the treatment of “funded defined contribution schemes” organized in the context of social security reform. Eurostat has ruled that under ESA 1995, such schemes needed to be classified in the insurance and pension fund sub-sector (S.125) instead of in the social security funds sub-sector (S.1314) (press release dated 2 March 2004).

### **Accuracy and reliability of data**

18. There is also a concern that the inclusion of data on pensions may put at risk the overall quality of statistics produced. It is argued that the usage of models and the multiplication of imputations should be limited to the extent possible, to avoid volatility in data and reduce scope for manipulations. The EDG should focus on this important question and provide guidance and reassurances, when giving recommendations.
19. In this respect, ESA 1995 already foresees an important role in actuarial compilations, but only when regulatory or professional arrangements provide reassurances in relation to the accuracy and reliability of estimates. In this respect, Eurostat draws the attention to ESA 5.101: “*Provisions or similar funds constituted by employers to provide employees with pensions (non-autonomous pension funds) are only included in category AF.6 if they are calculated according to actuarial criteria similar to those used by insurance corporations and autonomous pension funds. Otherwise these provisions are covered by the shares or other equity issued by the institutional units that set up the provisions*”. This paragraph can be construed to suggest that ESA 1995 recognizes a liability for social insurance employer pension schemes when a provision is expressly recognized and valued on the liability side by the unit in question (when using actuarial techniques),<sup>7</sup> which may perhaps provide some scope for bringing closer European views and those of the EDG Moderator Report.
20. In general, Eurostat would like to draw the attention of the AEG to the considerable implications for European government finance statistics that a change in the way pensions is accounted for in SNA would entail. European government finance statistics are fully integrated in the *ESA 1995* and are the basis for the Excessive Deficit Procedure (EDP), a process central to the multilateral fiscal surveillance in European Union (Stability and Growth Pact). For Europeans, major changes in national accounts have direct implications for fiscal policy assessment and policy making. European Statisticians still consider essential that the *ESA* be aligned with the *SNA*, and that care ought to be taken to prevent a situation of major departure. In this context, improvements in accounting standards, whilst welcome in general, have to follow “due process” that needs some time, and would require the meeting of some criteria: notably, improvement in comparability, reliability in estimates, and timeliness of data<sup>8</sup>.

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<sup>6</sup> See <http://www.imf.org/external/np/sta/ueps/2004/070704.pdf>.

<sup>7</sup> See the EDG Moderator Interim Report of September 2003 paragraph 127 at: <http://www.imf.org/external/np/sta/ueps/2003/092403.pdf>

<sup>8</sup> In the European Union, fiscal reporting to the Commission is required on general government accounts by 1<sup>st</sup> March of the next year in a summary form, and by 1<sup>st</sup> April in a more comprehensive form.

## Various reviewed other options

21. In order to reconcile the importance of providing information on pensions liabilities in the SNA—and perhaps in the accounts themselves—with the hesitation to give to such liabilities the same status to others, some innovative alternative accounting options have been explored by the TF (in addition to the use of memo items). Those options are applicable to all unfunded pension schemes: employer schemes as well as social security schemes.

### *New accumulation account option*

22. One option discussed has been to allow for a new SNA transaction item D.8X “*adjustment for the changes in net equity of households in **unfunded** pension schemes*” that would be located after the capital account but before the financial accounts, and to allow for incurrence and redemptions of *insurance technical reserves for unfunded pension schemes* (F.6X—new financial instrument).
23. This approach mainly builds on the OECD proposal made in the July 2004 EDG contribution.<sup>9</sup> It de facto creates a new accumulation account in the system below the capital accounts. This creates a situation, where a new balancing item appears after the net lending / net borrowing (B.9): *net lending / net borrowing adjusted for unfunded pension schemes* (B.9X). Under this new arrangement, the latter (rather than the former) would then also be equal to the balance of the financial accounts: net transactions in financial assets and in liabilities.
24. However, such an arrangement amounts to defining two measures of deficits<sup>10</sup>, which may be confusing to users. Alternatively this flexibility may allow policymakers to select the more relevant balancing item.
25. One advantage of this option is the way transfers of pension rights are being handled: when schemes transfer their unfunded obligations to other schemes against a lump sum, difficulties in recording arise in 1993 SNA. Although many argue that the event is financial in nature, other consider that to the extent that the pension obligations were not recognized as liabilities, the cash payment needs to be recorded as capital transfers (i.e., revenue of the “receiving” scheme). Following a majority of European Statisticians<sup>11</sup> Eurostat decided the latter interpretation for ESA 1995 (press releases of 21 October 2003 and 25 February 2004). In contrast, under the new arrangement, such an event would be without a doubt financial in nature: the counterpart transaction of the cash flows (F.2) is a transaction in *insurance technical reserves in unfunded pension schemes* (F.6X), with no impact on either measures of net lending (B.9 or B.9X).
26. One consideration would be whether, for consistency reasons, the existing item D.8 *adjustment for the change in net equity of households in pension funds reserves*, currently located in the *use of disposable income account* would also be moved into the new accumulation account, next to the proposed item D.8X.

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<sup>9</sup> See a report in the EDG contribution of François Lequiller *Lessons from the OECD Workshop “Accounting for implicit liabilities”* at <http://www.imf.org/external/np/sta/ueps/2004/070704.pdf>.

<sup>10</sup> In the European Union, government deficit is defined as the net lending net borrowing (B.9) of general government (S.13) as defined in national accounts (ESA 1995).

<sup>11</sup> CMFB — Committee on Monetary Financial and Balance of payment statistics.

### *Other economic flow option*

27. Another option considered by the TF is the possibility to record the incurrence and redemption in pension unfunded liabilities (AF.6X) via a new “other economic flow”, perhaps called K.13.
28. In such circumstance, the change in net worth (B.90) would reflect a fourth component in addition to the current three components existing in 1993 SNA:
- B.10.1 *Changes in net worth due to saving and capital transfers*
  - B.10.2 *Changes in net worth due to other changes in volume of assets*
  - B.10.3 *Changes in net worth due to holding gains/losses*
  - **New item:** B.10.4 *Changes in net worth due to unfunded pension obligations*

### *Memorandum items / satellite account*

29. Aside from those two options that seek to integrate pension obligations in the core of the system, a less demanding alternative would be to locate the relevant information as memorandum items. The fundamental difference would then be that the pension obligations would not be used for the measure of net worth of institutional sectors.
30. As a specific arrangement of this memorandum option, it would be useful to examine the possibility of having a compulsory memorandum item or alternatively of developing pension accounting grouped into a specific satellite accounts. The latter has the advantage of reporting comprehensively transactions, other flows and stocks of pension provisions, outside and in parallel the core system.

### **Six options**

31. So far, the FAWP and the TF have identified **6 relevant options worth studying**. The relative merits of neither have been insufficiently enquired by both groups. It is therefore much **too early to identify the likely preferences of European Statisticians**.
32. The six options are:
- **Option 1:** Leave SNA unchanged;
  - **Option 2:** Leave core SNA unchanged, but add the relevant information in a satellite account (or a memo item) inclusive of social security pension obligations;
  - **Option 3:** Recognize employer unfunded pension obligations as liabilities (i.e., EDG current proposal);
  - **Option 4:** Recognize all unfunded pension obligations as liabilities (i.e., extend the EDG current proposal to social security);
  - **Option 5:** Create a new accumulation account for all unfunded pension obligations (to be recorded as liabilities);
  - **Option 6:** Create a new other economic flow to capture the increase/decrease in all unfunded pension obligations (to be recorded as liabilities).
33. So far, the EDG has enquired in detail two options (Option 1 and Option 3). **It is strongly suggested the EDG needs to examine more in detail the other identified options, with the aim to indicate the pros and cons of each of those options also in view of the concerns and borderline issues mentioned above.** It is therefore recommended that the AEG be submitted with a new Report for the AEG meeting scheduled November 2005.