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The Impact of Fair Value Accounting on the “Normal” Rate Curve—A Speculation

by Jeremy Gold

The “normal” shape of the rate curve is upward sloping. Not only do we all “know” this, we all know why it is so—because holding long duration bonds is “riskier” than holding short duration. From time to time the observed curve flattens or inverts (long rates below short rates). We “know” this reflects such things as short-term supply/demand imbalance (frequently attributable to Federal Reserve tightening) and changes in inflationary and business cycle expectations.

The International Accounting Standards Board (IASB) hopes to promulgate a new accounting paradigm known as “fair value.” Fair value, which may loosely be described as an effort to reflect current market value, is intended to replace “historical cost” for financial instruments circa 2005¹. Those seeking background information on fair value accounting may wish to read Statement of Financial Accounting Concepts #7 adopted by the U.S.-based Financial Accounting Standards Board in February, 2000.

I speculate that the worldwide promulgation of fair value accounting standards will make the normal shape of the rate curve downward sloping. Upward sloping curves will be the occasional exception rather than the rule.

Why do I so speculate? I hypothesize that fair value accounting will alter perceived risk, which, in turn, will alter both supply and demand along the duration dimension.

The Long and Short of Bond Supply

Presently outstanding bonds are carried at book on the corporate books of account. Corporate profit and loss reflects the coupon cash flow as an expense. Corporations that borrow at fixed rates for extended periods lock in this component of expense. Corporations that borrow short, or at floating rates, experience greater expense volatility. Corporate management views long fixed debt as less risky although somewhat more expensive in an upsloping rate environment².

Fair value encourages shareholders to look at corporate assets and liabilities as a portfolio where changes in asset and liability market values directly impact shareholder value. With financial instruments being marked-to-market at each reporting date, long fixed debt (unless matched to very interest sensitive assets³) will be a substantial source of volatility in earnings and shareholder value. Short or floating-rate debt tends to experience much smaller market movements.

Thus the supply of low-risk, floating-rate debt (which management will prefer to issue even at some expected cost) will increase while the supply of long fixed-rate debt is likely to decline. *Ceteris paribus*, higher short rates, lower long rates.

The Short and Long of Bond Demand

Among the primary consumers of long fixed-rate debt are life insurance companies and defined benefit plans. Although most life insurers manage their asset durations to approximate their liability durations, almost every defined benefit plan maintains an asset duration that is far shorter than its liability duration, relying in part on actuarial techniques to understate the volatility attributable to duration mismatches.

The eventual shift to more transparent, more market-oriented accounting for pension plans is quite likely to increase their appetite for longer fixed-rate securities. *Ceteris paribus*, lower long rates, higher short rates.

Or so I speculate. ☺



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1) Pension and post-retirement medical plans are currently excepted from this target date and are likely to be subject to fair value standards somewhat later. Similarly, fair value for balance sheet items that are not financial instruments will require separate, and later, study by the accounting authorities.

2) With inflationary expectations factored in it is possible to argue that the expected cost of long fixed-rate debt exceeds that of floating rate even when the curve is inverted at issue.

3) A factory or real property may be economically sensitive to rates, but ordinarily will not be marked-to-market unless it is replaced by a financial instrument (e.g., a sale/leaseback).