Survey of universities' disclosures

Accounting for pension costs

We are pleased to present the results of our thirteenth survey of the assumptions adopted by UK universities for determining the value of their pension liabilities for accounting purposes.

The results of this survey show that the size of pensions deficits have reduced slightly over the year to 31 July 2023, driven largely by the increase in discount rates due to rising gilt yields. Unlike last year's disclosures, however, this increase has been partially offset by a reduction in the value of the assets.

While Self-Administered Trusts (SATs) remains the focus of this survey, in the wider sector it is the ongoing discussions around the Universities Superannuation Scheme (USS) - in terms of its 2023 valuation and benefit design - that is often the area of greatest focus. New valuations have also been completed for the Teachers' Pension Scheme (TPS) (in which costs have increased) and Local Government Pension Scheme (LGPS) (where costs have fallen). The survey looks at the significance of SATs and USS in the context of the overall finances of the university, as well as at the assumptions used in their FRS102 disclosures as at 31 July 2023.

This survey is based on data in the published accounts of universities with financial years that ended on 31 July 2023. The figures in this survey are based on a sample of 38 universities whose accounts showed they operate SATs. We have included the figures for 2021 and 2022 to compare with the 2023 data as part of our analysis.

We hope that this analysis continues to be helpful to universities formulating their own assumptions under FRS102 for future disclosures. Since 31 July 2023, gilt yields have been volatile but have generally fallen as markets price in reducing inflation and expectations of base rate cuts in 2024. These increased levels of uncertainty around financial markets, and within the sector as a whole shows no signs of disappearing in the short-term, meaning the impact of pensions on university finances remains a key concern.

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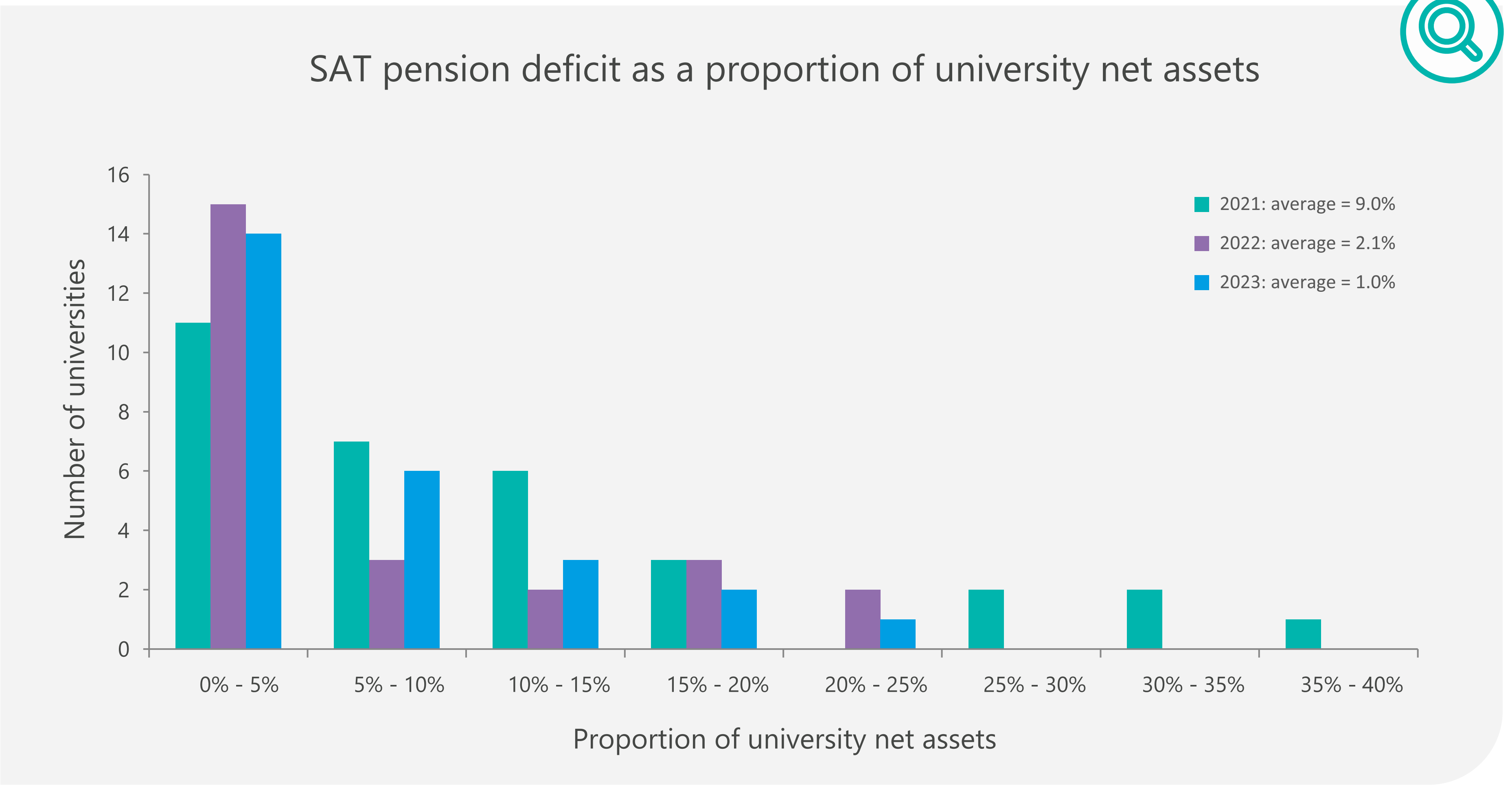
How much of a burden are these schemes

For the universities in our survey, the pension deficit represents an average of 1.0% of the net assets of the university (excluding the SAT pension deficit). This is a reduction from the average seen last year (2.1%) and the year before (9.0%), and reflects the fact that the general improvement in market conditions following the coronavirus pandemic has led to significantly reduced pension scheme deficits.

The chart below shows how this proportion can vary significantly between individual universities.

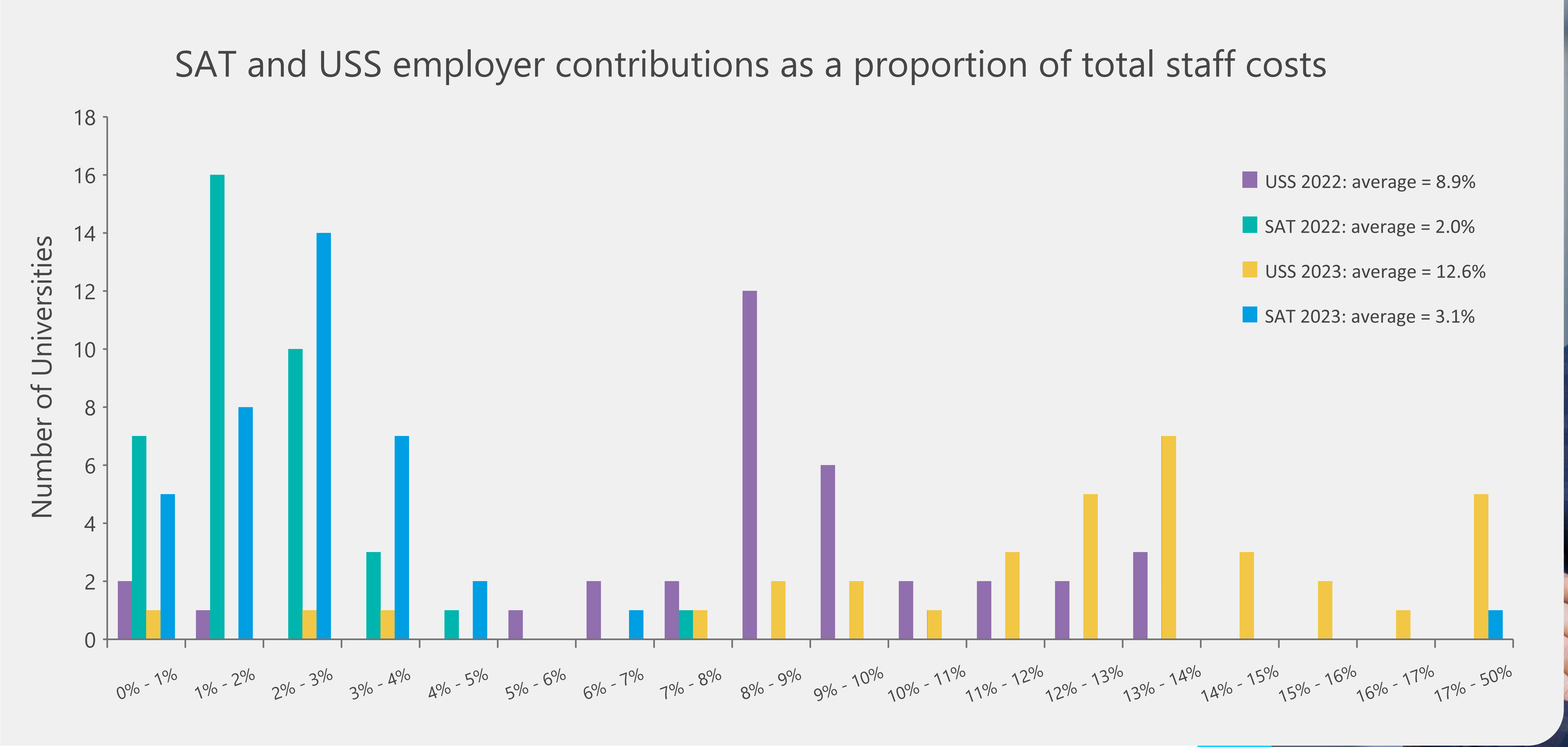


For the universities in our survey that contribute to both SATs and the USS, we found that the total contributions made by the universities to SATs as a proportion of total staff costs has increased from an average of 2.0% in 2022, to an average of 3.1% in 2023.

Total staff costs have typically risen in monetary terms between 2022 and 2023, perhaps reflecting the impact of the pandemic on working practices and support.

The contributions made to USS, as a proportion of total staff costs, have increased in the year to 31 July 2023 to 12.6%, compared to 8.9% in the previous year. Contributions to the USS remain substantially higher than the contributions made to SATs.

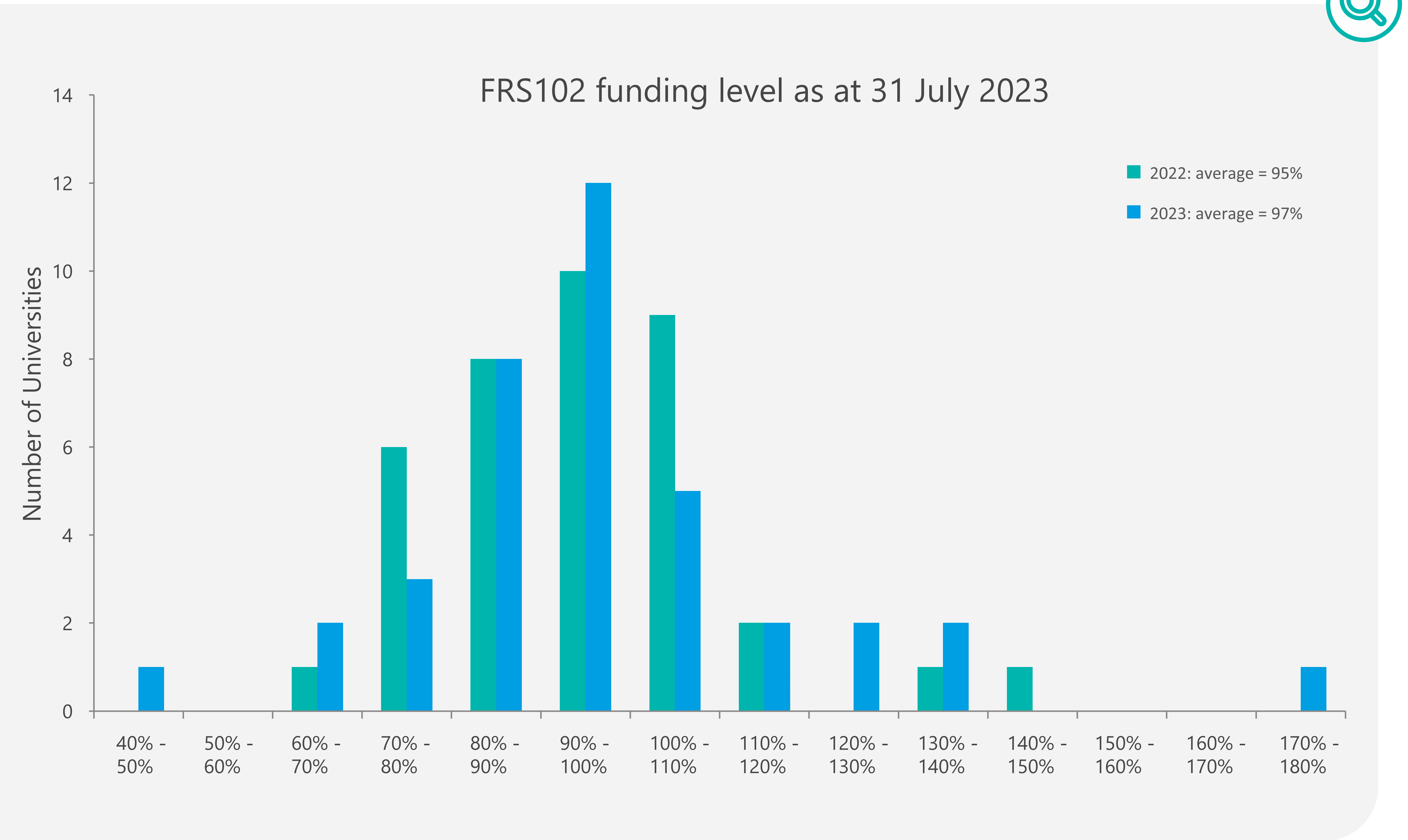
The chart below illustrates how the contributions to SATs compare with contributions made to the USS for these universities.



Surplus/deficit

The average FRS102 funding level at 31 July 2023 for the universities in our survey was approximately 97%, which is a further increase on the average funding level of 95% at 31 July 2022.

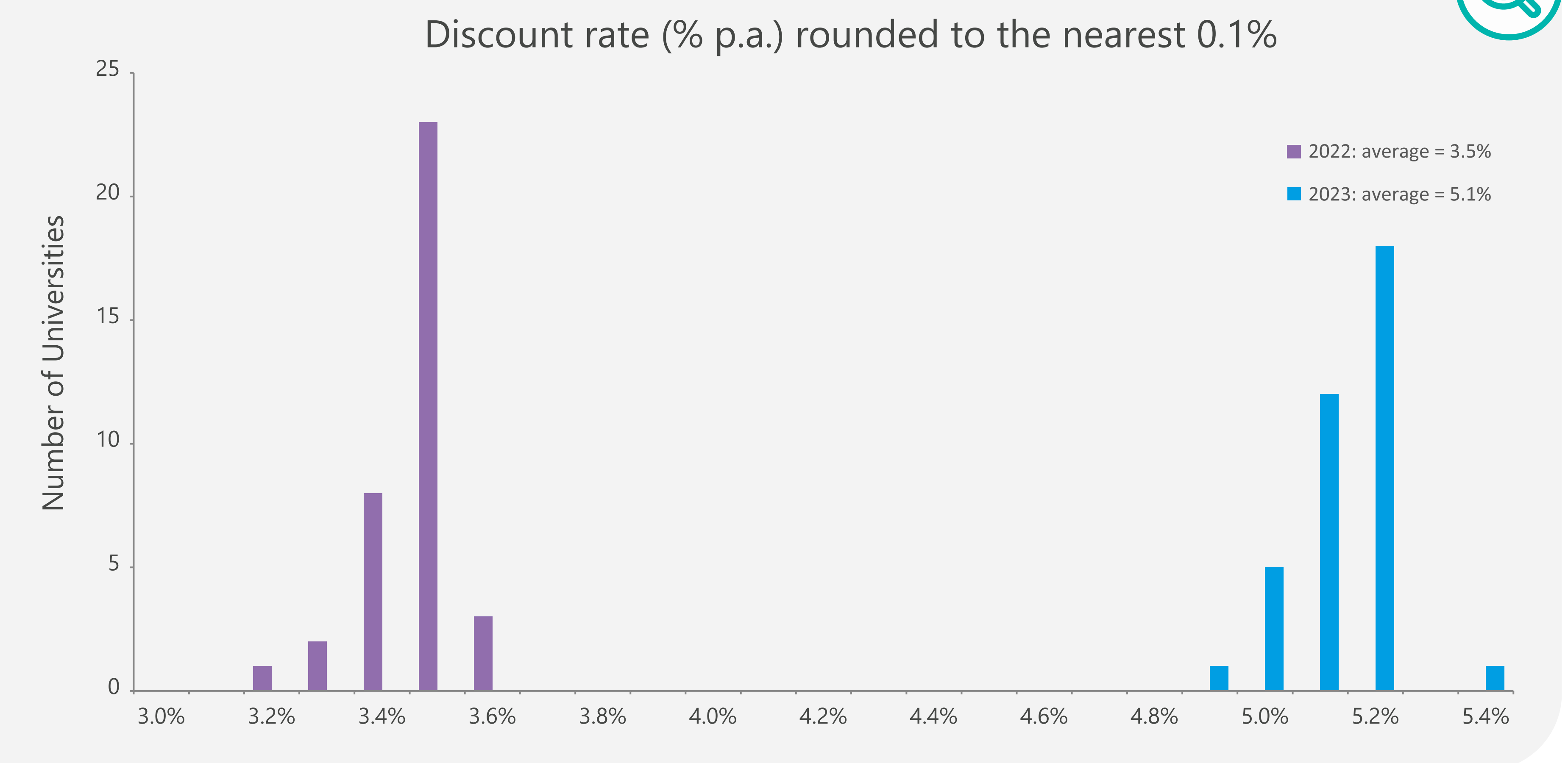
In the period, yields have risen meaning the present value of their liabilities have fallen, whilst the long-term inflation assumption has remained similar. This is combined with many universities revising their mortality assumption, which has acted to reduce expectations of long-term improvements in mortality, therefore reducing the value placed on liabilities. More details on this are provided below. This was partially offset by actual asset returns being lower than expected over the period. In addition, funding levels will have improved due to deficit contributions paid by the universities.



FRS102 assumptions

Discount rate

The discount rates used by the universities in our survey for their SATs are illustrated below.

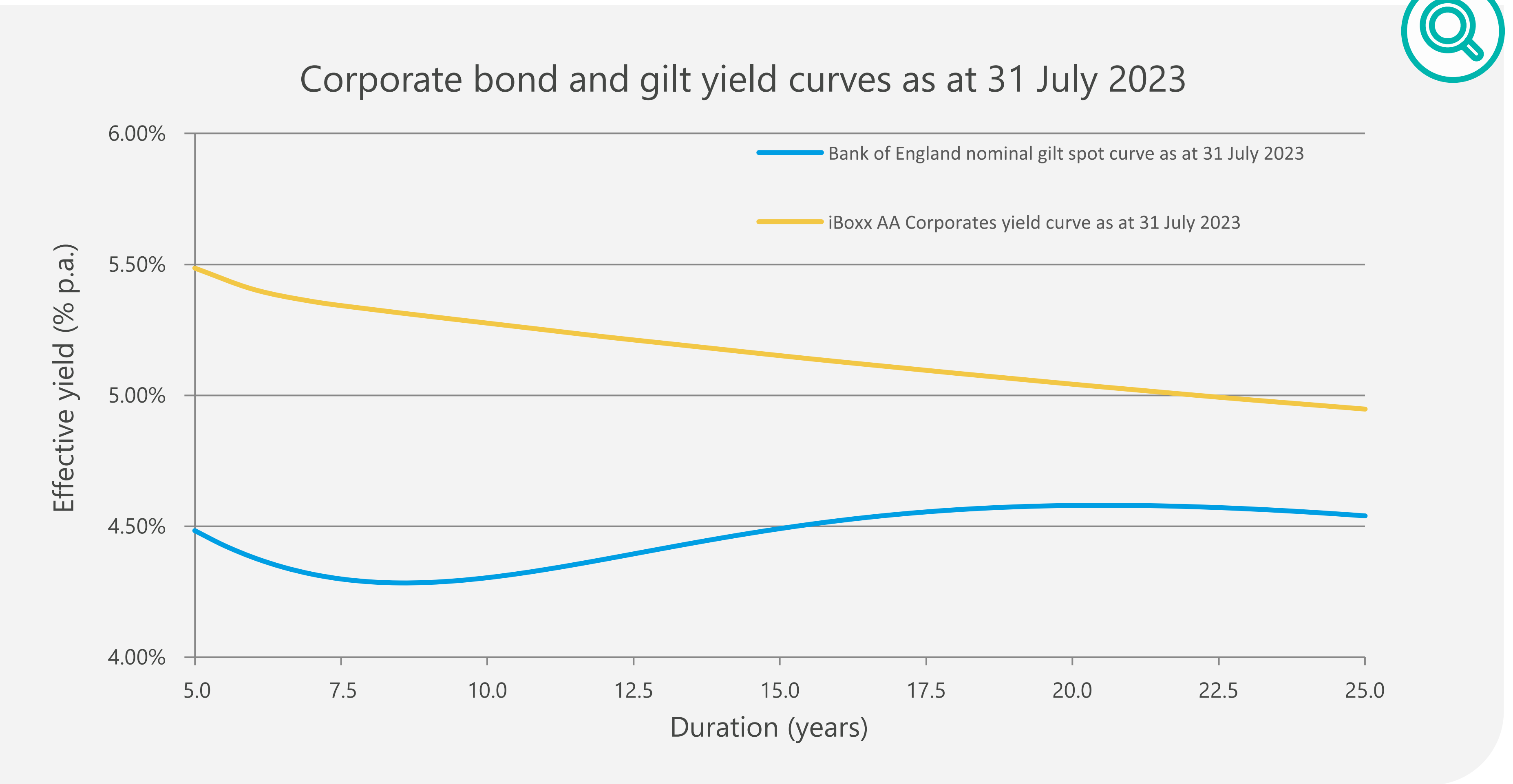


This reflects the large rise in corporate bond yields, on which the discount rates are based, over the year.

The following table compares the corporate bond yield and the average discount rate adopted at 31 July over the last five years.

Year ending	iBoxx over 15-year AA-rated corporate bond index (% p.a.)	Average discount rate (% p.a.)
31 July 2019	2.1	2.2
31 July 2020	1.4	1.4
31 July 2021	1.6	1.6
31 July 2022	3.5	3.5
31 July 2023	5.2	5.1

The discount rates adopted have, on average, been in line with the yield on the index shown over the past five years. In recent years the derivation of discount rates has tended to place specific reference on the term of the liabilities, for example through adopting the yield on a corporate bond yield curve at the relevant term, rather than making an approximate adjustment to an index value. There has also been a move to derive the discount rate using a full yield curve approach; i.e. finding the single discount rate equivalent to discounting each future cashflow using the yield curve at the relevant term. While there remain some outliers in the data set, in general discount rates have been close to the index yield.



37 out of 38 universities disclosed the discount rate assumptions in 2023.

Retail Prices Index inflation

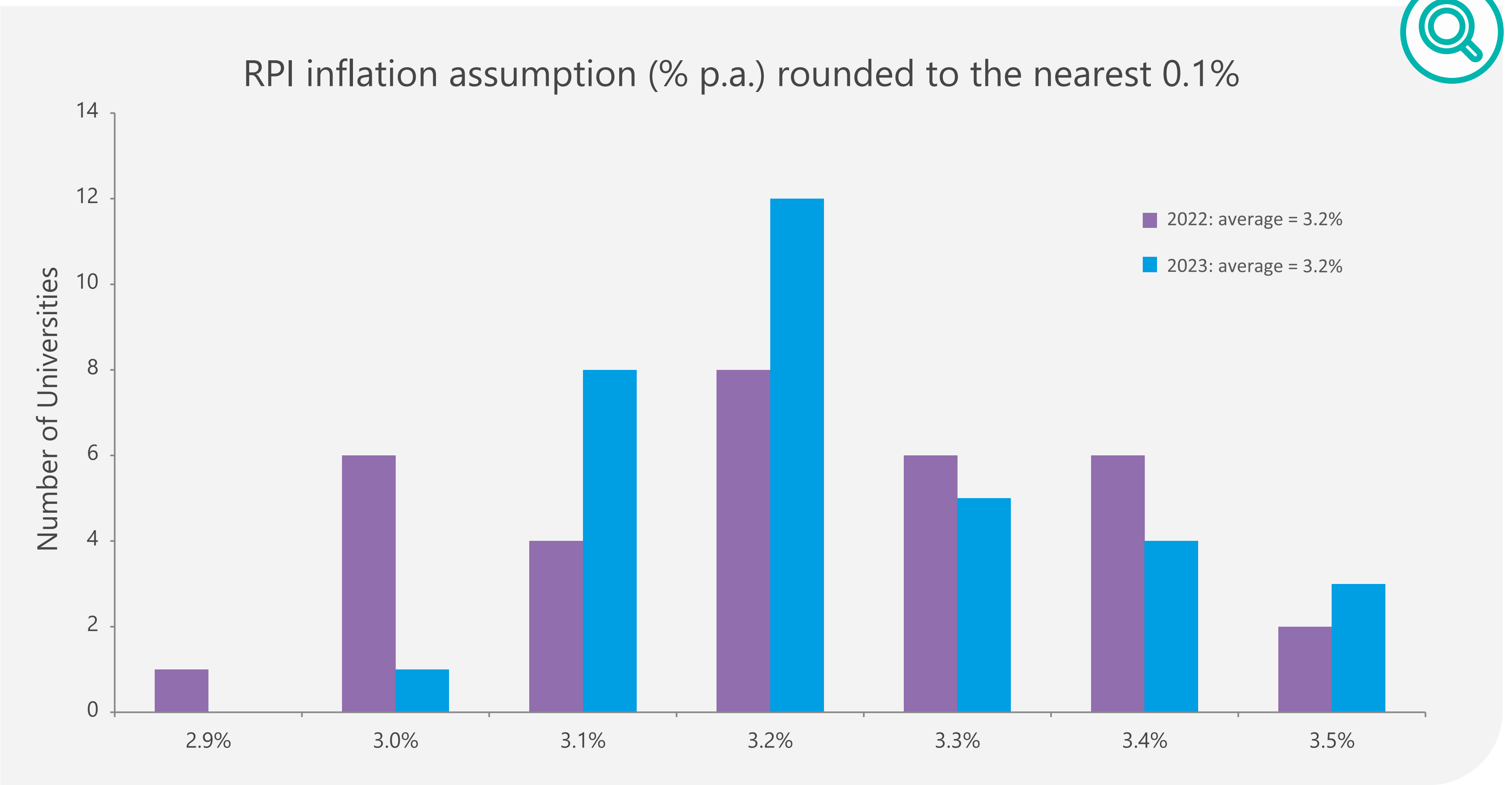
Market yields are generally used to set the future inflation assumption. The market's expectation of the Retail Prices Index (RPI) inflation rate calculated by the Bank of England at 20 years (based on the difference between fixed interest gilt yields and index linked gilt yields) was 3.5% p.a. as at 31 July 2023. Most universities in the survey assumed that inflation would be considerably lower, with the average at 3.2% p.a. It is likely that some allowance is being made for an 'inflation risk premium', which is based on a view that investors will pay more for index linked gilts because they provide inflation protection. This means that the break-even rate calculated by the Bank of England is higher than the market's best estimate assumption for future RPI inflation.

Year ending	Market implied future inflation rate* % p.a.	Average inflation assumption % p.a.
31 July 2019	3.6	3.3
31 July 2020	3.3	2.9
31 July 2021	3.6	3.2
31 July 2022	3.7	3.2
31 July 2023	3.5	3.2

The assumptions adopted are about the same as they were last year, which reflects the consistency in market-implied inflation over the year. This may be unexpected given the notably high levels of inflation the UK has been experiencing throughout 2023, however it must be emphasised that the inflation assumption reflects the long-term market expectations for inflation.

Market expectations for RPI are likely to have been influenced by the announcement that the way in which RPI is calculated from 2030 will change, moving instead to match the CPIH (Consumer Prices Index including owner occupiers' housing costs) formula.

A further factor that may be influencing the choice of inflation assumption is the reduction in duration that will have been caused by both the increase in bond yields and the gradual aging of these pension schemes, many of which are now closed to either new entrants or accrual (and consequently will be seeing the average age of their membership increasing over time). However, as at 31 July 2023, market-implied RPI at a duration of 15 years was 3.6%, only marginally higher than that at a 20-year duration.



33 out of 38 universities disclosed the RPI inflation rate assumptions in 2023.

We have continued to see that the 'single equivalent' approach to setting the discount rate is also being applied to the RPI inflation assumption.

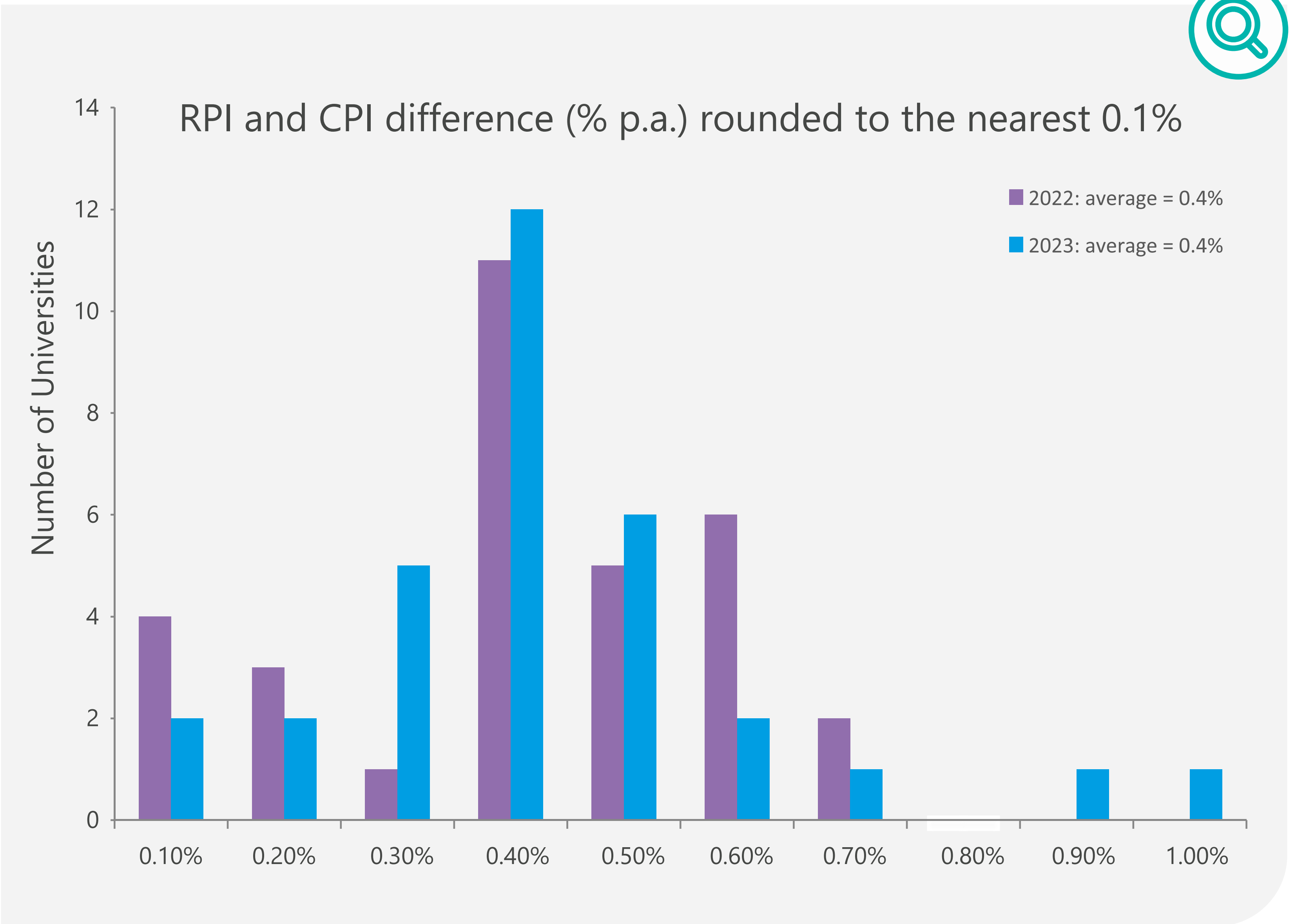
Consumer Prices Index inflation

37 out of the 38 universities in our survey explicitly disclosed a Consumer Price Index (CPI) inflation rate assumption, implying that most of the universities in our survey use CPI as a measure of future inflation for at least some of the increases applied to benefits.

Over the 20 years to 2010, CPI was on average around 0.7% p.a. lower than RPI. Of this, 0.5% p.a. could be attributed to the 'formula effect' resulting from technical differences in the way the two indices are calculated, and the remaining 0.2% p.a. could be attributed to differences between the compositions of the two indices. In 2010, a change was made to the way the indices were calculated and at the time this was expected to increase the difference between CPI and RPI going forward. The 'formula effect' since 2010 has been observed to be between 0.8% p.a. and 1.1% p.a.

In March 2015, the Office for Budget Responsibility (OBR) published a paper which included an analysis on the gap between RPI and CPI, which suggested that the other factors mean the gap could be around 1.0% p.a. Additionally, the Bank of England's latest estimate, from its 2014 Q1 inflation report, is that the gap will be around 1.3% p.a. over the long-term. However, these estimates assume that the constituent effect will continue unchanged, and there is no guarantee that this will be the case over the long-term. Indeed, the omission of housing costs from the calculation of CPI continues to provoke debate. The current Government CPI inflation target is 2.0% p.a.

The following graph shows the gap implied by the assumptions chosen by the 32 universities who disclosed assumptions for both CPI and RPI. The average deduction from RPI was 0.4% p.a. in 2023 which is the same as the 2022 difference, and likely reflects the anticipated changes to RPI from 2030 being factored into assumptions as at 31 July 2023.

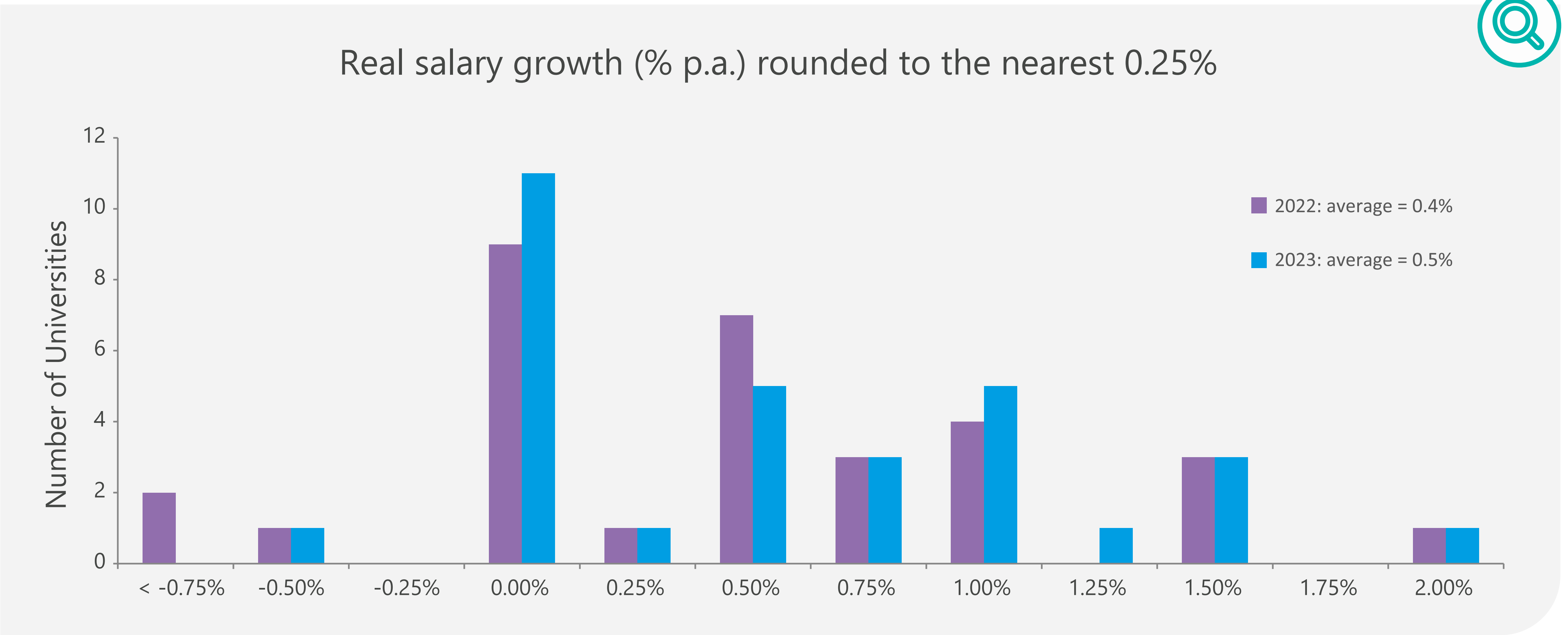


32 out of 38 universities disclosed both CPI and RPI inflation rate assumptions in 2023.

Salary increases

Some universities may use a scale for promotional salary increases in addition to a general salary growth assumption, and therefore a comparison of the disclosed salary increase rate assumptions may not be like-for-like in all cases. We have nevertheless shown below the disclosed salary increase assumptions used relative to the CPI inflation assumption i.e. real salary growth. Some universities also made different assumptions for short and long-term salary growth, perhaps in response to high short-term price inflation. We have concentrated on the long-term assumptions in our analysis.

The average real salary growth assumption has risen in 2023 compared to the previous year which could be a result of the economic recovery from the impact of the coronavirus pandemic. The chart below only considers universities which disclosed an assumption for CPI.



31 out of 38 universities disclosed both the salary growth and CPI inflation rate assumptions in 2023.

Life expectancy

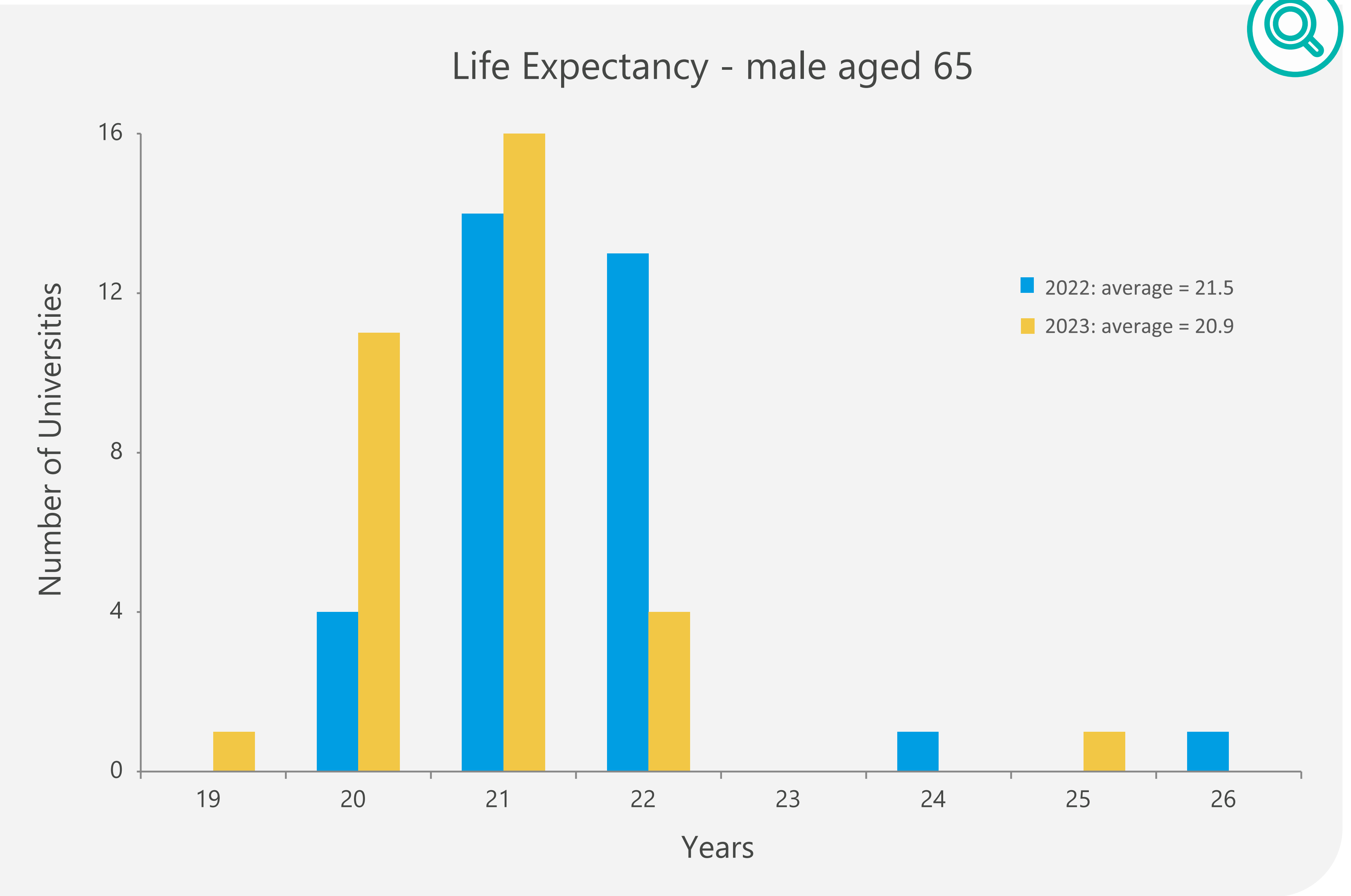
37 out of 38 universities in this year's survey disclosed information on their life expectancy assumption, either by stating the assumed life expectancy or by referring to the mortality tables used to allow comparisons to be drawn.

We have shown below the life expectancy assumptions for a man currently aged 65 at the year end, and also indicated the life expectancies implied by the mortality tables given.

The wide range of life expectancy assumptions adopted by pension schemes generally can often be explained by differences in the underlying scheme membership, e.g. different average income levels or occupations. However, as the profile of SATs members would be expected to be fairly similar from university to university, the wide range highlighted below is perhaps surprising, but may reflect that some universities carried out a more detailed scheme-specific mortality investigation.

On average, the mortality assumptions chosen led to a reduction in life expectancies as at 31 July 2023 when compared to last year. It's common practice to review mortality assumptions at each triennial valuation, but this would only be expected to affect around one in three schemes in any given year. Of the 37 universities who disclosed life expectancies at 65, 31 reduced their life expectancy assumption for males and 32 for females.

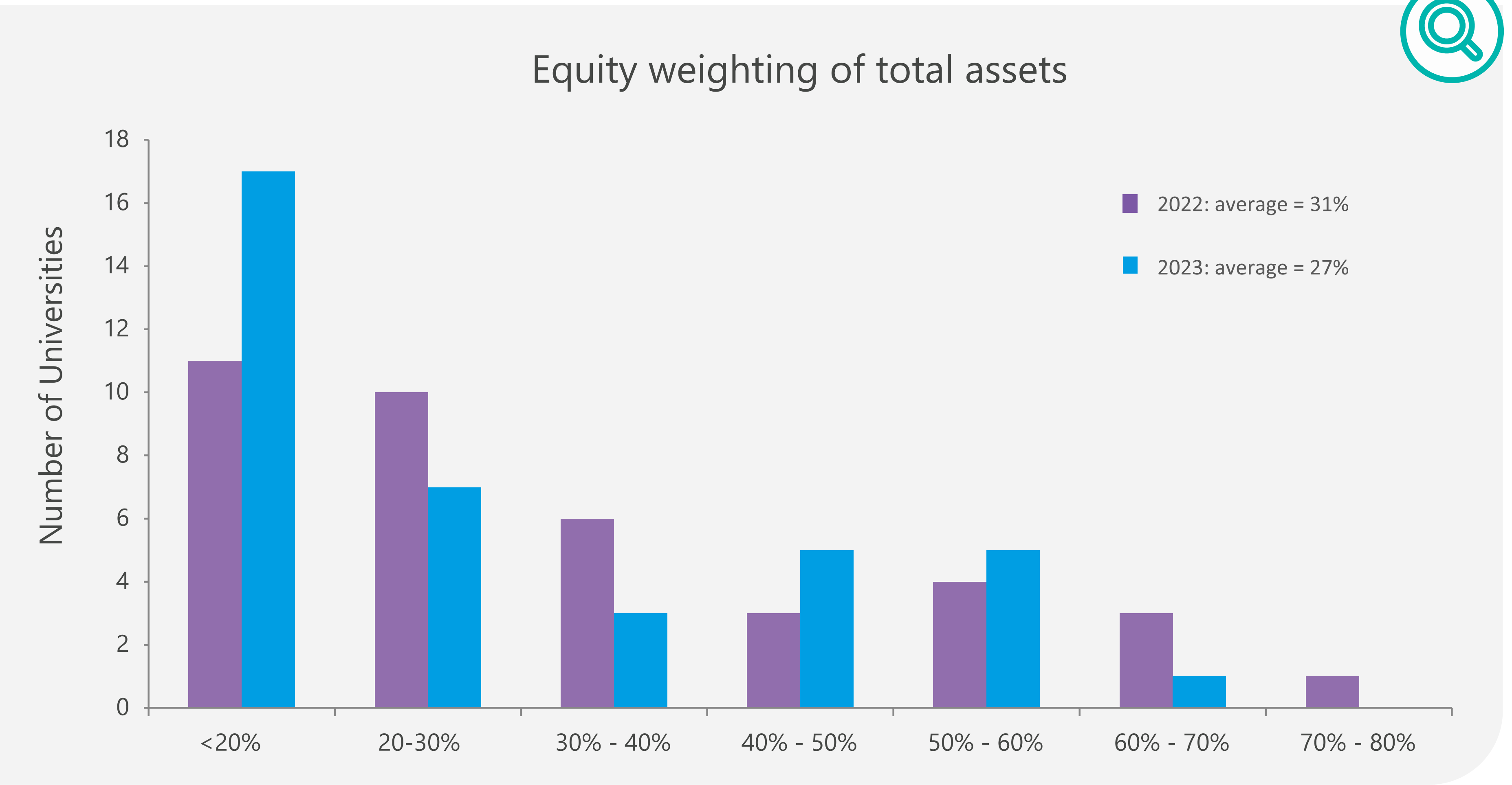
Lower life expectancies are likely to reflect the fact that the most recent large-scale analyses of mortality experience have shown that the rate of improvement in life expectancies has fallen. In other words, while life expectancies are continuing to increase, they are doing so at a slower rate. In addition, with the introduction of CMI 2022 in June 2023, mortality assumptions can now include the high death experience of the pandemic and post-pandemic years. These lower projected life expectancies will reduce the pension costs and deficits.



37 out of 38 universities disclosed the future mortality from age 65 in 2023.

Asset allocation

The chart below shows the percentage of SATs' assets invested in equities as at 31 July 2022 and 31 July 2023.



All 38 universities disclosed the equity allocation and asset amount figures.

The average equity weighting of 27% is lower than the 2022 average of 31%, reflecting both the maturing of schemes and perhaps a willingness to consider more varied asset classes such as LDI (Liability-Driven Investment) and infrastructure to reduce the impact volatile markets have on the funding position of the schemes. This is a continuous trend over the last five years, where equity allocations have reduced each year.

Current affairs

GMP equalisation

Accounting disclosures as at 31 July 2019 reflected the High Court decision in the case of the Lloyds Banking Group Pension Trustees Limited, with most accounts including an allowance for the expected increase in liabilities arising from it. A further court decision in November 2020 meant that further action was needed to address GMP equalisation in cash equivalent transfer values, which has led to a (generally minor) past service cost for some of the schemes surveyed this year.

GMP equalisation continues to be a live issue, with many schemes now moving from assessing the potential impacts to making the benefit changes necessary to implement equalised GMP.

Virgin Media vs NTL Trustees High Court Judgement

A potentially landmark judgement in the High Court case of Virgin Media vs NTL Trustees was handed down on 16 June 2023. The judge in this case ruled that, where benefit changes were made without a valid 'section 37' certificate from the Scheme Actuary, those changes could be considered void. The judgement could have material consequences for some DB (defined benefit) schemes which previously contracted-out of the state pension system. None of the figures in these accounting disclosures are likely to have allowed for it, but this could have an impact on these schemes in the near future.

Sustainability

An increasing focus for the trustees and sponsors of many pension schemes is the need to consider climate change as part of their long-term investment strategy, as well as the impact it may have on employer covenant and long-term funding. The immediate effects of this on accounting disclosures are likely to be investment-led – divestment vs engagement being just one of the more high-profile considerations – but the impacts are wide-ranging, and this may become one of the dominant themes over the coming years.

High Inflation and Cost of Living

Post-pandemic supply chain issues and the increased gas and electricity prices following the invasion of Ukraine have driven high inflation. This has exacerbated the pressures on the disposable income of families across the UK and further afield. Inflation peaked around the start of 2023, before falling to 4.0% by the end 2023. As a result, it is expected that central banks will reduce interest rates in over the next year. However, the impact of previous rate rises is yet to be fully seen, and there is potential for a technical recession here in the UK. These changing market conditions will influence the results of the accounting calculations as at 31 July 2024, as well as having economic, covenant and funding implications for the schemes.

Governance

There has been an increasing focus on pension scheme governance in recent years, and early 2024 saw the publication of The Pensions Regulator's 'General Code'. This consolidates previous guidance as well as setting out a revised framework under which it expects pension schemes to operate. The General Code came into effect on 27 March 2024 and we expect all pension schemes to be taking action to address this – many will have been doing so since the code was first published in draft form in 2021.

Coupled with this renewed focus on governance, there is an ongoing trend in the sector, and more widely to appoint independent trustees to assist 'lay' trustees in navigating the ever more complex pensions landscape.

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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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