BARNETT WADDINGHAM
beyond the expected

Briefing | 31 March 2019

Current Issues in Pensions Financial Reporting

RISK | PENSIONS | INVESTMENT | INSURANCE

This note is for those who will be involved in preparing and auditing pensions disclosures under Accounting Standards FRS102 (UK non-listed), IAS19 (EU listed) and ASC715 (US listed) as at 31 March 2019.

We look at the current topical issues as well as the considerations for company directors to take into account when setting assumptions and for auditors in determining whether the assumptions are appropriate.

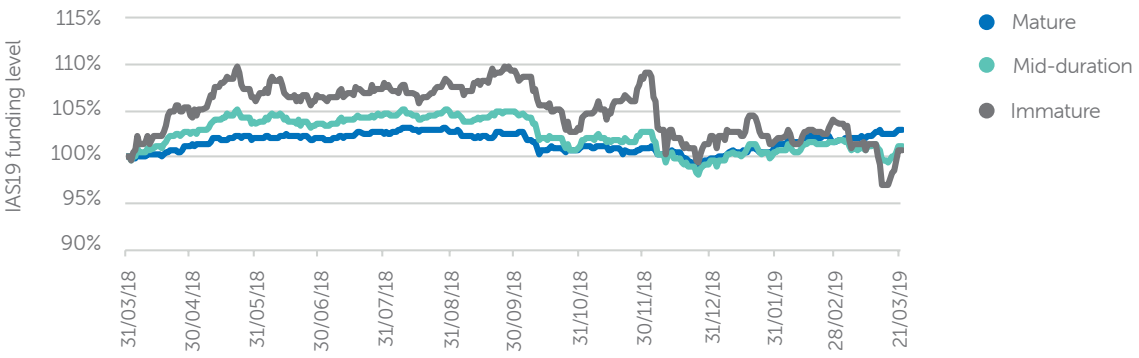
Funding levels have improved, but significant risks remain

The movement in funding level over the period will depend on the investment strategy adopted by the pension scheme and the chart below shows how this will have developed for three typical schemes.

For companies due to report at 31 March 2019 the position is likely to have remained broadly unchanged, with more mature schemes which are likely to have hedged interest rate exposure to a greater extent faring better than less mature arrangements.

There will, however, be a further small reduction in liabilities from moving to the latest version mortality projection models, which continue to show slowing improvements in life expectancy (see below for further details). Overall the current indications are the pensions accounting position for most companies reporting at 31 March 2019 is likely to be slightly better than at 31 March 2018.

PROGRESSION OF IAS19 FUNDING LEVEL FOR TYPICAL SCHEMES

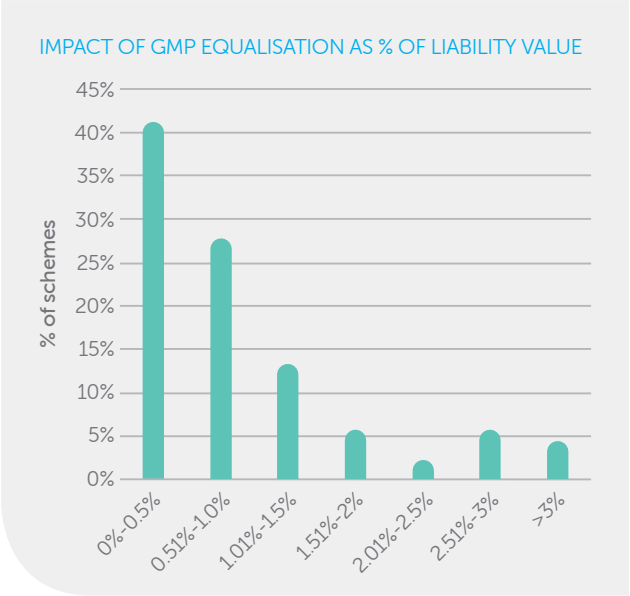


BARNETT WADDINGHAM
beyond the expected

GMP Equalisation

Guaranteed Minimum Pension (GMP) is a special tranche of pension for contracted-out service prior to 6 April 1997, intended to replace a sacrificed part of the state pension. In July 2018, Lloyds Bank went to court together with its pension scheme trustees and trade unions, seeking clarification as to whether its pension schemes are obligated to equalise GMP benefits between members of different sexes. The high court published its judgement in the case on 26 October 2018 and whilst some uncertainties remain it is expected that all schemes with GMPs accrued between 17 May 1990 and 5 April 1997 will need to equalise benefits for the effect of unequal GMPs.

Companies reporting at 31 December 2018 have generally included provisions for the cost of GMP equalisation and recognised this as an exceptional charge to profit and loss. The majority of FTSE100 companies have disclosed an impact of less than 1% of the liability value which is less than initially expected following the judgement. This is backed up by data from our own client base which is summarised below and shows that for almost 70% of schemes the impact is estimated at less than 1% of liability value on an accounting basis:



The final cost will not be known until schemes have taken legal advice and implemented adjustments to benefits although it is expected that any further impact will be recognised in OCI rather than hitting the P&L account.

New mortality tables and projections

The Continuous Mortality Investigation (CMI) Mortality Projections Model is widely used in the industry to model future improvements in mortality rates. The model is based on assumptions that current observed rates of mortality improvement will converge to a long-term rate over a period of time. The latest version of the model, CMI_2018, was published in March 2019. The core parameters for the updated model place more weight on recent experience, which has shown lower improvements and this results in lower life expectancies. As a result, adopting the CMI_2018 model will reduce liability values as at 31 March 2019 in comparison to previous years.

The CMI also recently produced an updated mortality rates table of members of defined benefit Self-administered Pension Schemes. The "S3" dataset provides the most recent mortality assumptions. The dataset is significant larger than used for the previous set of tables (the "S2" series), and the a greater proportion of the experience relate to members of public sector schemes. For this reason the S3 series is not directly comparable to the S2 series and any adjustments applied to S2 series tables to reflect scheme specific experience are unlikely to be appropriate for the S3 series. Most schemes will need to undertake an analysis of appropriate mortality assumptions at their next full actuarial valuation.

Survey of assumptions used by the FTSE100 as at 31 December 2017

Our seventeeth annual survey of FTSE100 pensions accounting assumptions revealed an increase in IAS19 funding levels over the year to 31 December 2017.

The full survey is available on our website

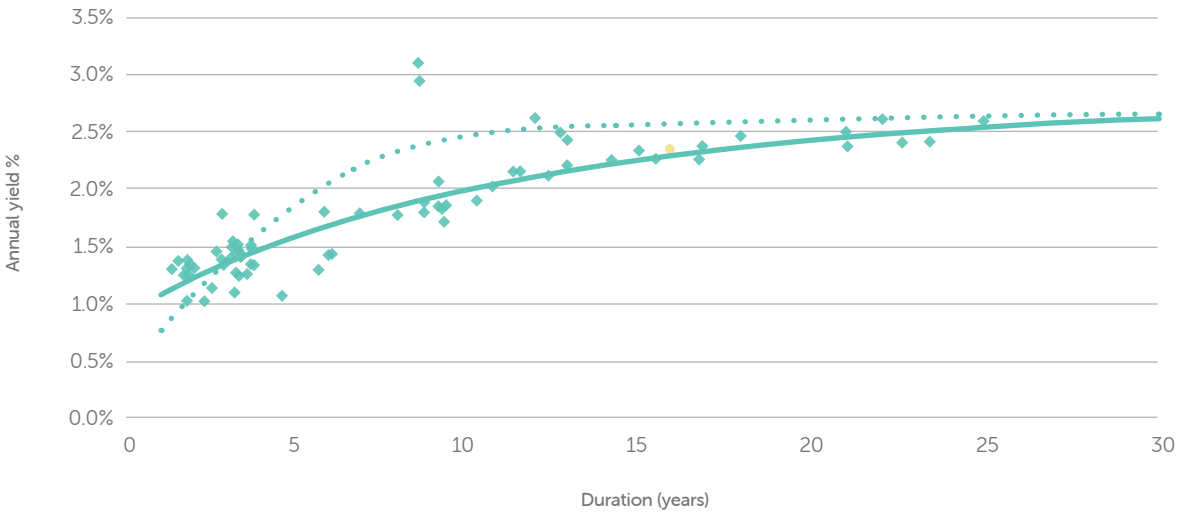
Discount rate

The Accounting Standards require the discount rate to be based on yields on high quality (usually AA-rated) corporate bonds of appropriate currency, taking into account the term of the relevant pension scheme's liabilities.

Figure 1 shows the individual yields on the bonds making up the iBoxx AA Corporate Bond universe as at 31 March 2019.

Figure 1: iBoxx AA Corporate bond universe at 31 March 2019

Data Source: iBoxx



As can be seen in Figure 1, the yields vary significantly in the short to mid durations, but flatten out at the longer durations. A common method to reflect the shape of AA bond yield curve is to base the discount rate on a single equivalent rate rather than a single rate based on an index.

The table below shows single equivalent discount rates (SEDR) using the iBoxx AA-rated corporate bond curve based on sample cashflows for a range of durations:

Approximate duration (years)	SEDR 31 March 2019	SEDR 31 December 2018	SEDR 31 March 2018
10	2.20% pa	2.60% pa	2.45% pa
15	2.35% pa	2.80% pa	2.55% pa
20	2.50% pa	2.90% pa	2.60% pa
25	2.50% pa	2.95% pa	2.60% pa

At the end of Q1 2019, single equivalent discount rates on AA corporate bonds were lower compared to those at 31 March 2018. This will result in lower discount rates being adopted for accounting purposes compared to last year resulting in a higher value being placed on the liabilities. Each 0.1% decrease on the discount rate would translate to an increase of approximately 2% in liabilities for a scheme with a 20 year duration.

Where a single equivalent discount rate approach is used care should be taken, as AA bond yield curves can be derived in a variety of ways. The methodology chosen can lead to significant variations in individual rates and subsequently also in the liability figure derived. Even under this approach which, is argued by some to be the most accurate, a range of outcomes are possible depending on the dataset and method used to construct the curve and how this is extended to durations beyond the longest AA rated bond.

Generally it will be possible to justify a higher discount rate by adopting a 'single agency' approach where the discount rate is set by reference to bonds that are rated at AA by one or more of the three main rating agencies. This approach provides a larger universe of bonds (particularly at the longer durations) to be considered when setting the discount rate. Currently, an adjustment of 0.10% p.a. for shorter durations (up to around 15 years) and no more than 0.05% pa in excess of 15 years to a rate derived from the standard AA rated corporate bond data set is likely to be appropriate which is broadly the same as a quarter ago.

Inflation

Retail Prices Index (RPI)

As can be seen from the inflation yield curve in Figure 2, market implied expectations for the future vary considerably depending on the term being considered. Adopting a proxy such as the Bank of England's (BoE's) inflation spot rate at a duration equivalent to the scheme's liabilities does not reflect the variations in expected future inflation rate by term. In particular, the BoE curve indicates that implied rates peak at around 20 years but are lower at shorter and longer terms so it should be possible to justify assumptions below the spot rate at the given duration for most schemes. Consistency with the approach adopted to derive the discount rate is important.

There may be other considerations to take into account when choosing inflation assumptions, such as whether to adjust for a possible inflation risk premium (IRP) that may be implicit in the Bank of England's figures or for any other external factors that the company directors feel should be taken into account in determining this assumption. Adjustments of up to 0.3% pa are typically used to reflect an IRP although it may be possible to justify adjustments above this level.

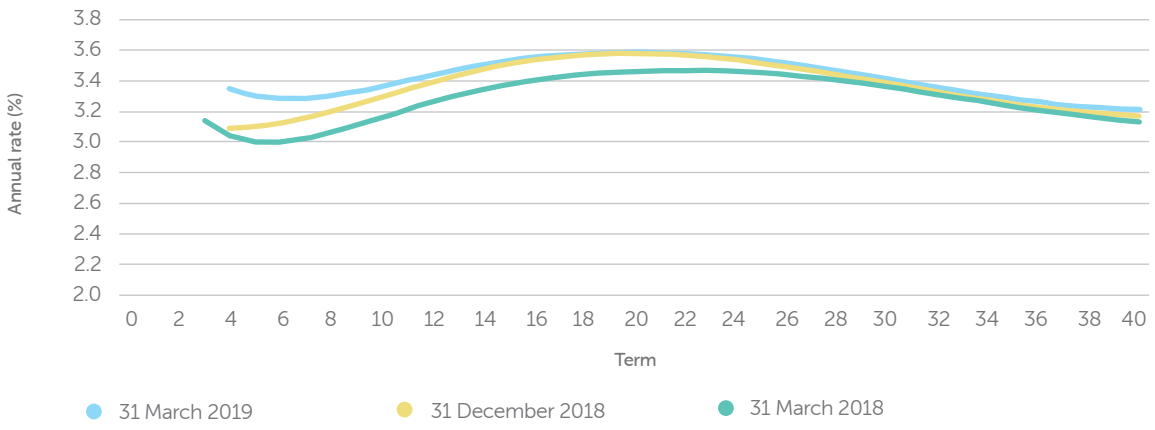
Impact of Pensions on UK Business

Our eighth annual report considers the impact that pension provision is having on UK business over the period to 31 December 2017.

The survey offers a unique assessment of the financial impact of DB pension schemes within the context of the wider finances of FTSE350 companies. Some of the key highlights of our research are the £7 billion reduction of pension deficit of UK plc companies in 2017, and the £14 billion value of transfer payments to DC schemes in 2017.

The full report is available on our website

Figure 2: Spot inflation Curves (annualised)



Data Source: Bank of England

As shown in figure 2, the implied rates of future inflation are higher compared to rates observed at the previous year end. For those schemes reporting at 31 March 2019 with inflation-linked liabilities, this is likely to mean a slight increase in liability value although this impact will depend on the maturity of the liabilities.

The table below shows single equivalent inflation (SEIR) assumptions based on the Bank of England inflation curve and sample cashflows for a range of durations, before any deduction for an inflation risk premium:

Approximate duration (years)	31 March 2019	31 December 2018	31 March 2018
10	3.50 pa	3.45 pa	3.35 pa
15	3.50 pa	3.45 pa	3.35 pa
20	3.45 pa	3.40 pa	3.35 pa
25	3.40 pa	3.35 pa	3.30 pa

Consumer Prices Index (CPI)

The figures above relate to inflation as measured by the RPI. Many schemes now have benefits increasing with reference to the Consumer Prices Index (CPI) instead, and over 20 years to 2010 CPI was on average around 0.7% pa lower than RPI. Of this, 0.5% pa could be attributed to the 'formula effect' resulting from technical differences in the way the two indices are calculated, and the remaining 0.2% pa 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% pa and 1.0% pa.

Towards the end of 2011, the Office for Budget Responsibility (OBR) published a paper on the gap between RPI and CPI which suggested that the other factors mean the gap could be between 1.3% pa and 1.5% pa. A more recent paper published by the OBR in March 2015 suggests the median gap to be about 1.0% pa while the Bank of England central long-term estimate suggests 1.3% pa.

The current Government CPI inflation target is 2.0% pa.

Mortality

Demographic assumptions used for accounting disclosures can have a significant impact on the accounting figures. The most significant of these is the mortality assumption. Barnett Waddingham's survey of assumptions used by FTSE 100 companies showed a difference of up to six years in the life expectancy assumptions adopted. The analysis showed a fall in average assumed life expectancy of 0.3 years between 2016 and 2017 which equates to a fall of 1.2% in the value of liabilities. This is likely to have been driven by recent evidence indicating life expectancy may not be rising as fast as previously predicted.

For simplicity, company directors have often adopted the same mortality assumptions used by the scheme's trustees for the funding valuation. As pension costs have increased there has been an increasing tendency to adopt different assumptions. Trustees are required to use prudent assumptions whereas the assumptions for company accounting should be a best estimate. Entities should consider reviewing their mortality assumptions to ensure these are not overly prudent and that their pension liabilities are not being overstated. As noted above, most schemes are likely to need to carry out an analysis of how their own population compares to the S3 series tables to derive an appropriate adjustment to the standard table.

Barnett Waddingham has developed a tool to help companies analyse the appropriateness of their mortality assumptions by looking at scheme-specific factors such as the socio-economic make-up of the membership. To find out more about this please contact us using the details at the bottom of this note.

Other assumptions

In the past, assumptions such as amounts commuted for cash at retirement and the proportion of cases where a pension is payable on death may have been set to align with the scheme funding valuation and may therefore contain an element of prudence. Individually such assumptions may not have a material effect on the liabilities but collectively can mean liabilities are overstated relative to a true best estimate. Any such overstatement will be exacerbated in low discount rate environments.

Companies should therefore review other assumptions from time to time to ensure they reflect a best estimate of future experience.

Illuminate - Instant scenario testing

Pension schemes can have a significant impact on a company's accounting position. We have added an interactive modelling tool to Illuminate to help Finance Directors understand and quantify the factors influencing the financial position of the scheme so that they can be linked into the company's own internal plans for its core business.

The tool allows an instant assessment of the sensitivity of the accounting results to the year-end assumptions so that the Finance Director can make a fully informed decision on the optimal approach.

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:

employers@barnett-waddingham.co.uk

0333 11 11 222

www.barnett-waddingham.co.uk