BARNETT WADDINGHAM
beyond the expected

Briefing | 30 June 2021

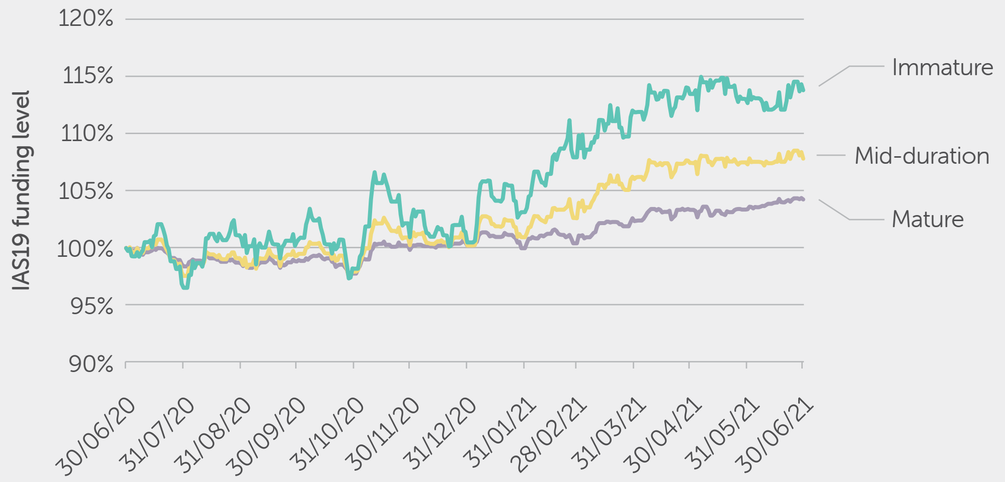
# Current issues in pensions financial reporting

This note is for those who will be involved in preparing and auditing pension disclosure under Accounting Standards FRS102 (UK non-listed), IAS19 (EU listed) and ASC715 (US listed) as at 30 June 2021. We look at the current topical issues as well as the considerations for company directors when setting assumptions, and for auditors in determining whether the assumptions are appropriate.

# Big improvement in IAS19 positions as markets rally

Since 30 June 2020 most schemes have likely seen a significant improvement in their IAS19 funding level, with immature schemes and those which have retained a high allocation to growth assets faring particularly well.

PROGRESSION OF IAS19 FUNDING LEVEL FOR TYPICAL SCHEMES




Whilst yields on corporate bonds have reduced slightly over the quarter, they continue to be higher than a year ago, which will have led to a fall in accounting liabilities under IAS19 since 30 June 2020.

Although any protection assets (such as government bonds or LDI holdings) will also have fallen in value, increases in the value of growth assets mean that the net position is likely to have improved for almost all schemes. Further, the lower the amount of interest rate hedging, the greater the improvement is likely to have been (although schemes with low amounts of hedging will likely have been starting from a lower funding level).

For those companies with 31 December 2020 currently looking at their mid-year figures, the changes will look very similar – the majority of the movement in corporate bond yields and gains on equities has occurred since the start of 2021.

# Impact of Covid-19 on pension scheme demographics

Illuminate - instant scenario testing

The CMI has estimated that there have been approximately 100,000 more deaths in the UK than would have been expected since the start of the pandemic, than if experience had been similar to that seen in 2019. Whilst this is an unprecedented number in recent times, it is unlikely to mean a significant reduction in pension scheme liabilities.

For example, 100,000 additional deaths equates to an approximate reduction of c. 0.8% in pensioner liabilities (based on a UK pensioner population of 12m), but the overall effect will be much lower for most pension schemes, as non-pensioner liabilities will not have been significantly impacted.

In general, we would expect the reduction in liabilities due to excess mortality to be negligible compared to the likely impact on the IAS19 position from financial markets. However, we would expect the impact to be more pronounced for more mature schemes.

The pandemic is also likely to have an impact on the selection of assumptions about future mortality. Experience analyses and models for future improvements will need to consider whether the experience in 2020 and early 2021 is a one-off, and whether future waves will lead to a material number of excess deaths during the remainder of 2021, noting that the vaccination programme appears to have limited deaths so far during the "third wave". The pandemic may also influence future mortality in other ways. For example, the pressure on health services may mean that progress against other causes of death such as cancer is slower than previously expected, meaning an assumption of a lower rate of mortality improvements might be appropriate. Alternatively, the surviving population may be in better health than those dying from Covid-19, meaning we might expect remaining members to live slightly longer.

Another feature is that there were fewer deaths than expected (based on mortality in 2019) during Q2 of 2021, so the "excess deaths" since the start of the pandemic noted above is actually slightly lower than shown in the last quarterly update.

The CMI published the CMI_2020 mortality improvement model earlier this year, and this model takes into consideration all the deaths which had occurred over 2020, including those as a result of the current pandemic. When incorporating this model into the demographic assumptions entities will need to decide on how much weight to place on the experience in 2020. It is likely to be difficult to justify placing a large weighting on the experience in 2020, but some recognition that the pandemic may lead to a slowdown in life expectancy improvements compared to previous models could be considered reasonable.

## Changes from RPI to CPIH in 2030

On 25 November 2020 the Government published its response to the RPI reform consultation.

> It is now widely expected that the change to the Retail Price Index (RPI) inflation statistic to bring it in line with the 'Consumer Prices Index including owner occupiers' housing costs' (CPIH) will take place in 2030.

No compensation is likely to be given to index linked gilt holders, and RPI-linked pension increases will also cost less to provide although CPI-linked pension liabilities will likely be largely unaffected.

CPIH became the UK's primary inflation measure in 2017 and essentially takes the Consumer Price Index (CPI) and includes a measure of owner occupied housing. It also means that from 2030, index-linked gilt payments will implicitly be linked to CPIH due to the change of the makeup of the RPI statistic.

> When RPI is aligned with CPIH, RPI would be expected to be lower in future and, all else being equal, this would be reflected in market valuations of index linked gilts.

Following the publication of the consultation response there was, in fact, a limited reaction from the market, whereas we might have expected a fall in long-dated index linked gilt prices, reflecting the expectation that pay-outs will be lower from 2030 onwards.

This suggests that either the market had already adjusted to expectations or supply and demand distortions means the holders of index linked gilts (such as pension funds or insurance companies) are more concerned with the hedging of liabilities than the price of the instruments.

The lack of market reaction may support the use of a higher Inflation Risk Premium than in previous years (see further comments below).

In relation to accounting assumptions, companies will need to review the methods used for setting both RPI and CPI assumptions going forward in light of the market's reaction to the proposed changes.

## GMP equalisation

On 26 October 2018, the High Court published its judgement to equalise benefit inequalities due to Guaranteed Minimum Pensions (GMP). On 20 November 2020 there was a further High Court judgement extending GMP equalisation calculations to members who have transferred out of schemes since 17 May 1990.

Companies will need to estimate the impact on each individual scheme's liabilities and agree the accounting treatment for any additional liabilities.

It is expected that in most cases the additional liability will need to be recognised as a charge to P&L, but the magnitude should be much lower than the cost recognised following the 2018 judgement.

## On the horizon

### IAS19 disclosure requirements

The International Accounting Standards Board (IASB) has released an exposure draft on 25 March 2021 which consults on amending the IAS 19 accounting disclosure requirements. The consultation runs until 12 January 2022, with the IASB due to provide feedback in the first half of 2022. Their changes are therefore unlikely to be effective until 2023 at the earliest, although no timeline has yet been given for implementation.

In releasing this draft, the board has stated that it is trying to address three main concerns regarding the information disclosed in financial statements: That is, there is not enough relevant information; too much irrelevant information; and ineffective communication of the information provided.

The board proposes to replace the existing set of disclosure requirements with a set of requirements focussing on a number of disclosure objectives..

Pensions market back on course

In addition there will be an increased focus and some new disclosure requirements on areas such as:

- disclosing how the pension scheme will impact on the company's future cash flows and the nature of those effects; and
- disclosing the period over which payments will continue to be made from the scheme to members of defined benefit plans.

The exposure draft provides examples of how to meet those new disclosure requirements, and it appears that a brief commentary will not be sufficient.

If the changes go ahead then it is likely that the amount of disclosure will increase for many entities, although improving the way existing information is presented also appears to be an objective of the review.

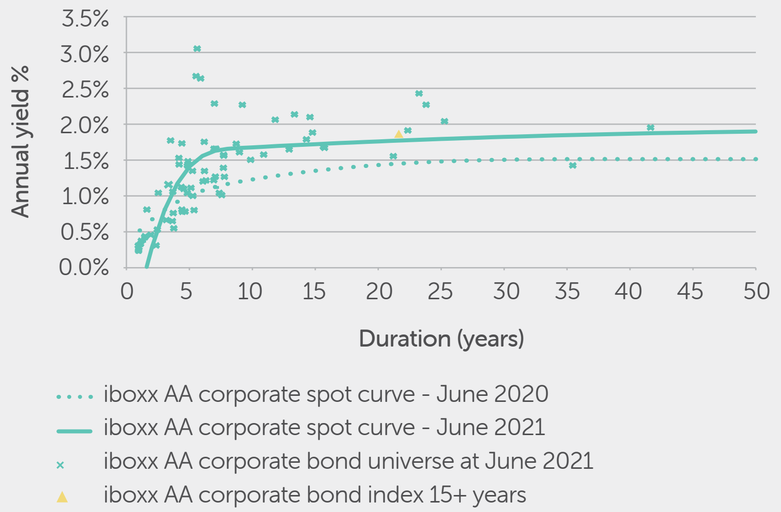
## Discount rate

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 30 June 2021.

**FIGURE 1** Source: iBoxx

AA RATED CORPORATE BOND DATA AS AT 30 JUNE 2021




As can be seen, yields on corporate bonds increase by term, and this effect should be reflected in the choice of discount rate.

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; our experience is that the audit firms prefer a cashflow weighted approach to be used.

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) | 30 June 2021 | 31 March 2021 | 30 June 2020 |
|---|---|---|---|
| 10 | 1.65% pa | 1.80% pa | 1.30% pa |
| 15 | 1.75% pa | 1.90% pa | 1.40% pa |
| 20 | 1.80% pa | 1.95% pa | 1.45% pa |
| 25 | 1.80% pa | 2.00% pa | 1.45% pa |

At the end of Q1 2021, single equivalent discount rates on AA corporate bonds were lower in contrast to 31 March 2021, although were up significantly on Q4 2020.

The table to the left shows discount rates derived from the iBoxx curve have fallen by approximately 0.2% p.a. since 31 March 2021, although were up significantly on Q4 2020, which will result in lower discount rates being adopted for accounting purposes compared to last year.

This will result 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 liability value 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.

How this is extended to durations beyond the longest AA rated bond, although the final point is perhaps less important at the moment due to the flattening of the curve.

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 increase of 0.10% p.a. to the rate implied by the standard AA rated corporate bond data set is likely to be appropriate, which is similar to last quarter.

# Inflation

## Retail Prices Index (RPI)

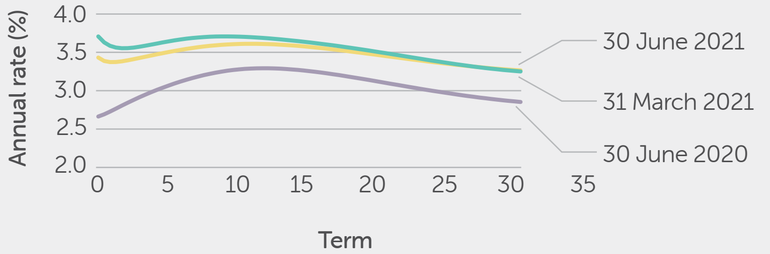
As can be seen from the inflation yield curve in Figure 2 below, market implied expectations for the future vary considerably depending on the term being considered. Adopting a proxy such as the Bank of England's inflation spot rate at a duration equivalent to the scheme's liabilities does not reflect the variations in expected future inflation rate by term.

In particular, this does not reflect the fact that the curve is downward sloping at the long end, and so using a single-equivalent approach it should be possible to justify assumptions below the spot rate at the given duration for most schemes.

In fact, our recent experience is that using a spot rate from the curve will generally be above the audit firms' usual range for RPI inflation assumptions. To this end we recommend adopting a single-equivalent approach, particularly where this is also being used to derive the discount rate.

**FIGURE 2** Source: Bank of England

FIGURE 2: BANK OF ENGLAND RPI INFLATION CURVE



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, particularly given the lack of market reaction to the expected reduction in RPI from 2030 onwards.

As shown in Figure 2, inflation expectations have risen since last year, but remain broadly unchanged over the quarter.

The table below shows single equivalent inflation rate 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) | 30 June 2021 | 31 March 2021 | 30 June 2020 |
|---|---|---|---|
| 10 | 3.60% pa | 3.65% pa | 3.25% pa |
| 15 | 3.50% pa | 3.55% pa | 3.20% pa |
| 20 | 3.45% pa | 3.50% pa | 3.10% pa |
| 25 | 3.40% pa | 3.40% pa | 3.05% pa |

## Consumer Prices Index (CPI)

The figures above relate to inflation as measured by the RPI. Many schemes have benefits increasing with reference to the Consumer Prices Index (CPI) instead, and assumptions for CPI inflation are generally set with reference to the assumption for RPI inflation given the limited market for CPI-linked investments. The difference between RPI and CPI can be attributed to two things:

- the 'formula effect', resulting from technical differences in the way the two indices are calculated
- differences between the compositions of the two indices (i.e. the goods that are included in them).

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. Our experience is that deductions of up to 1.1% pa from the RPI inflation are typical although many entities have been using lower gaps for the period after 2030 to reflect the proposed changes to the RPI.

Following the response to the consultation there is now a much firmer expectation that RPI will be aligned with CPIH from 2030 onwards.

An appropriate CPI assumption at 31 March 2021 is likely to be based on the gap remaining at around 1% p.a. up to 2030, but then only a small (or no) difference after that date. It may be possible to justify a small difference between RPI and CPI after 2030 on the grounds there is still a remote possibility the changes will not go ahead and that there may be a difference between CPI and CPIH due to the differences in the make-up of these two indices.

## 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.

Whilst there is generally a wide range of assumptions adopted, we have seen reductions in mortality improvements over the past few years that have led to lower liability values for accounting purposes through the annual model released by the CMI.

For simplicity, company directors have in the past adopted the same mortality assumptions used by the scheme's Trustees for the funding valuation. However, the Trustees are required to use prudent assumptions, whereas the assumptions for company accounting should be a best estimate. We would therefore expect margins for prudence within the mortality assumptions to be removed before being used for accounting purposes, and we are increasingly seeing audit firms picking up on this as well.

There is likely to be more focus on mortality assumptions this year, as the CMI has released the CMI_2020 mortality improvements model which incorporates 2020 data involving COVID-19 related deaths.

## S3 tables

The S3 tables were released in December 2018. The S3 tables are based on a much larger dataset than the previous S2 tables, although the make-up of this dataset has changed; e.g. it now has much more exposure to public sector schemes. Because of this change, where tables are being adjusted to reflect a scheme's membership, it does not necessarily follow that the same adjustment should be applied to the new tables.

Most companies would have updated the mortality tables over the course of this period, either during their triennial valuation or when undertaking a comprehensive review of the scheme's mortality experience.

If companies move to S3 with the same loading as was previously used for the S2 tables then this will result in a small increase in liabilities.

## CMI_2019 model

The 2019 version of the model reflects death data collected during 2019. This data bucked the recent trend of falling mortality improvements. In general, moving to the CMI_2019 model would be expected to result in a slight increase in liabilities compared to CMI_2018, although this would still be below that produced using the 2017 version. There are no changes to any of the methodology in the model compared to the 2018 version.

The CMI has published a further paper around the initial addition to mortality improvements parameter, which will assist users in setting mortality assumptions. Companies may be required to justify their choice of the initial addition parameter, even if the core value of nil is used.

## CMI_2020 model

The CMI_2020 model was released on 4 March 2021. The model includes 2020 data, which accounts for the impact Covid-19 has on England's and Wales's population. A new "weight" parameter can be used to vary the weight placed on data for 2020; the core parameter will be set to place no weight on experience for that year. The CMI_2020 model without the weighted parameter could reduce the life expectancies by 5% for a typical scheme and therefore result in a decrease in the IAS19 liability. However, this is unlikely to be a realistic future scenario and would receive significant challenge from auditors if adopted as an assumption.

How appropriate are your mortality assumptions?

As discussed on pages 3 and 4, the choice of weight parameter in CMI_2020 will depend on companies' views of future mortality in light of the pandemic. We expect that a reasonable approach will be to either place no weight or a small weight on data for 2020.

The overall impact of the liability changing from CMI_2019 to CMI_2020 is likely to be very small if the default parameters are adopted, as these place a zero weighting on experience in 2020 for modelling future improvements.

However, it may be reasonable to reflect a view that the pandemic will have a negative effect on life expectancy improvements over the short to medium term by applying a modest weighting to the 2020 data in the model. This could result in a reduction of around 1-2% of liabilities under IAS19.

## 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.

Independent review of accounting disclosures +

BARNETT WADDINGHAM
beyond the expected

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