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Briefing note

How to tackle your year-end pension problem

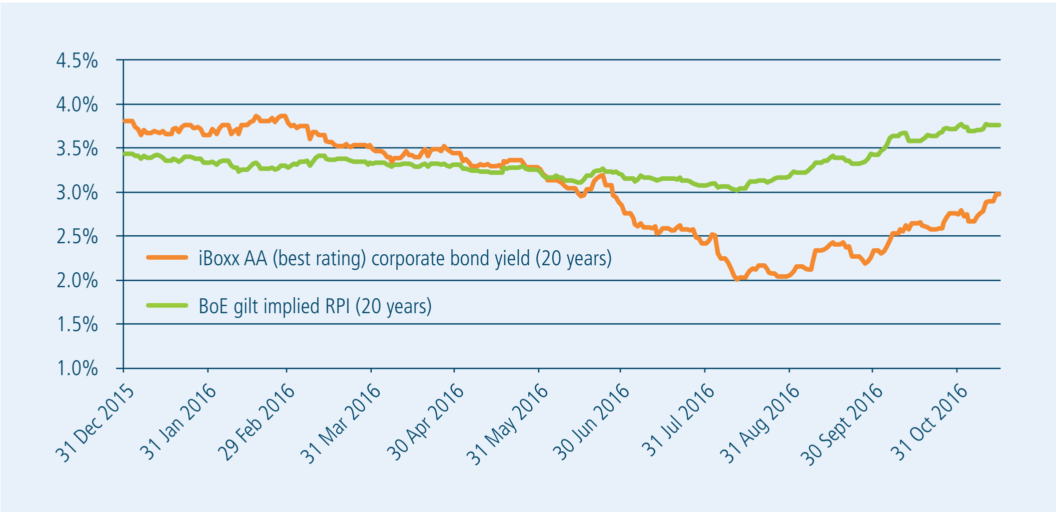
In October, Carclo plc announced that the rise in its accounting pension deficit (as measured by IAS19) meant that it was no longer able to pay its interim dividend. An extreme case maybe, but pension scheme deficits are expected to weigh heavy on corporate balance sheets come the calendar year end.

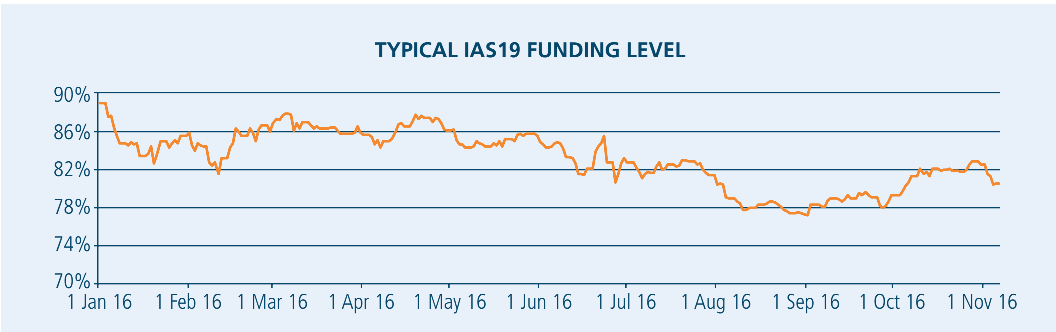
> We estimate that for a typical UK pension scheme the accounting position will have deteriorated from 90% funded to around 80% funded since 31 December 2015

The impact of Brexit on UK pension schemes has been a popular topic of discussion over the past few months. Much of this may have previously considered the balance sheet volatility that we might expect from a defined benefit pension scheme.

The difference this time is the sheer size of the swings and the real-world impact the accounting numbers can have.

We estimate that for a typical UK pension scheme the accounting position will have deteriorated from 90% funded to around 80% funded since 31 December 2015, driven by the double whammy of plunging corporate bond yields (which drive the discount rate for pensions accounting purposes) and rising inflation expectations.





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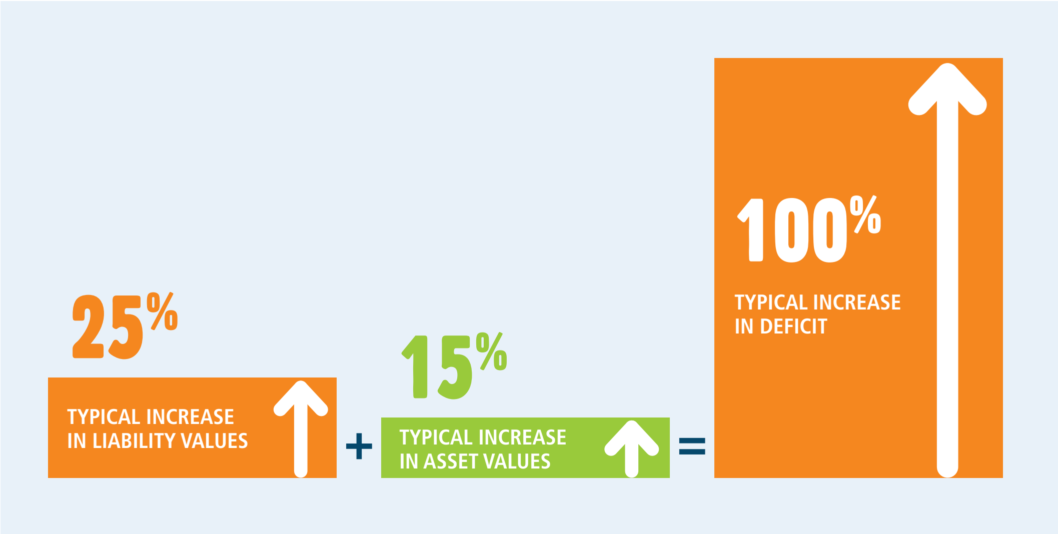
> In the short term there is a considerable amount of scope in the pension accounting standards to review the assumptions used this year end.

It is true that assets have also performed well over the period but they have not kept up with the increase in liability values.



So what can be done?

The only guaranteed way to influence asset values in the short term is to pay more in contributions, which is not very palatable, or indeed plausible for most business. Over the longer term the use of better matching asset strategies and making asset portfolios work harder, can reduce deficits and volatility.

What about the liability value - can something be done here?

The answer is yes, both in the short term and long term.

In the short term there is a considerable amount of scope in the pension accounting standards to review the assumptions used this year end. As a company you are not beholden to setting your assumptions in line with the approach adopted at the prior year end.

Small changes in assumptions can make a big difference.

For a typical scheme:

- a 0.1%pa increase in the discount rate will reduce the liability value by around 2%;
- a 0.1%pa reduction in the long term rate of inflation will reduce the liability by between 1% and 2%; and
- using best estimate assumptions for longevity and tax free cash take up can reduce the liability value by 3% to 6%.

These changes soon add up.

We are working with a number of companies in advance of the year end in order to mitigate the impact on their balance sheet position.

ACTION: review your year end assumptions now

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> The key to reducing the long term volatility of the pension scheme on the balance sheet is to shrink the liabilities.

A typical scenario for a £500m scheme is:

	Previous approach	New approach	Impact
Deficit on previous approach			(£100m)
Discount rate	2.7% pa based on the middle of the road approach	2.9% pa better matching of liability and detailed analysis of bond universe to set discount rate	£20m
Price inflation	3.7% pa standard Bank of England even yield approach	3.4% pa introduction of an inflation risk premium of 0.3% pa	£20m
Longevity assumption	In line with trustee cautious valuation assumptions	Revised best estimate assumption	£15m
Other demographic assumption	In line with out of date trustee valuation assumptions	Updated to take into account current best estimate views	£15m
Deficit value on new approach			(£30m)

Making changes to the assumptions to value your pension scheme liabilities can help with your year-end balance sheet, but does this address the underlying issue?

No. The underlying premise of a defined benefit scheme is that the company is on the hook for any shortfall in meeting benefits that have been promised.

Longer term you can tackle those liabilities directly by giving members the option to take benefits in a different format:

- take all as cash
- draw down benefits flexibility
- restructure the level of pension increases

Each of these are popular options for members - and will help reduce your pension liabilities. Securing benefits through an insurance contract will also reduce volatility. The key to reducing the long term volatility of the pension scheme on the balance sheet is to shrink the liabilities.

ACTION: understand how member option can reduce your liabilities

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

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