Barnett Waddingham
a **true partnership** approach

RESEARCH

Accounting for pension costs

Survey of universities' disclosures as at 31 July 2013

Barnett Waddingham
a true partnership approach

This is our fifth annual survey of the assumptions adopted by UK universities for determining the value of their pension liabilities for accounting purposes.

As well as participating in the Universities Superannuation Scheme (USS) and local government schemes many universities operate their own occupational defined benefit schemes (which we will refer to as Self Administered Trusts) for non academic staff.

This survey focuses on universities which operate Self Administered Trusts (SATs) and looks at the significance of these schemes in the context of the overall finances of the university, as well as at the assumptions used in their FRS17 disclosures as at 31 July 2013.

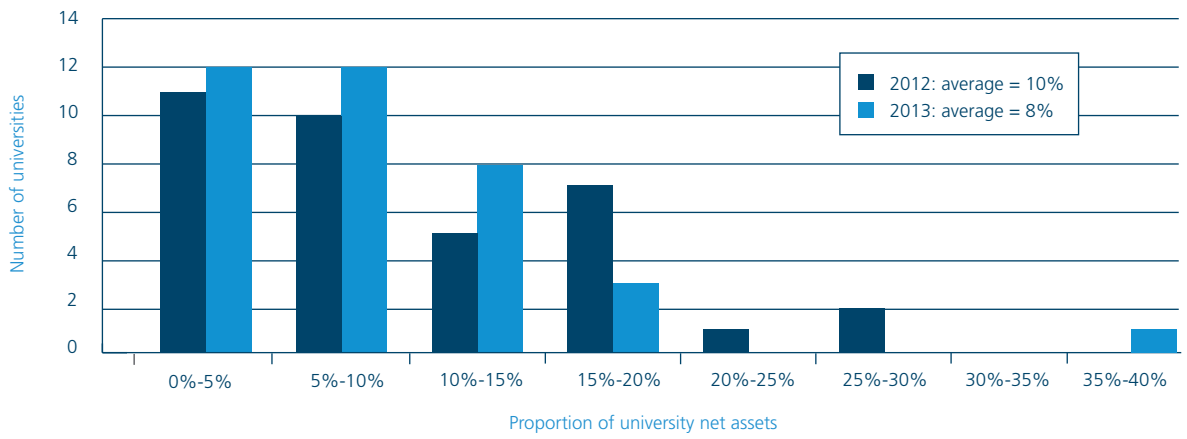
This survey is based on data in the published accounts of universities with financial years that ended on 31 July 2013. The figures in this survey are based on a sample of 36 universities whose accounts showed they operate SATs.

In some cases, data in the 31 July 2012 accounts has been restated since last year's survey. We have allowed for the updated data as at 31 July 2012 in this year's survey and therefore figures shown for 2012 may differ from those in last year's survey.

How much of a burden are these schemes?

For the universities in our survey the pension deficit represents an average of 8% of the net assets of the university (excluding the SAT pension deficit). This is lower than the average of 10% seen last year. Both falling deficits and rising net assets have contributed to this change. However, the chart below shows how this proportion can vary significantly between individual universities.

SAT pension deficit as a proportion of university net assets

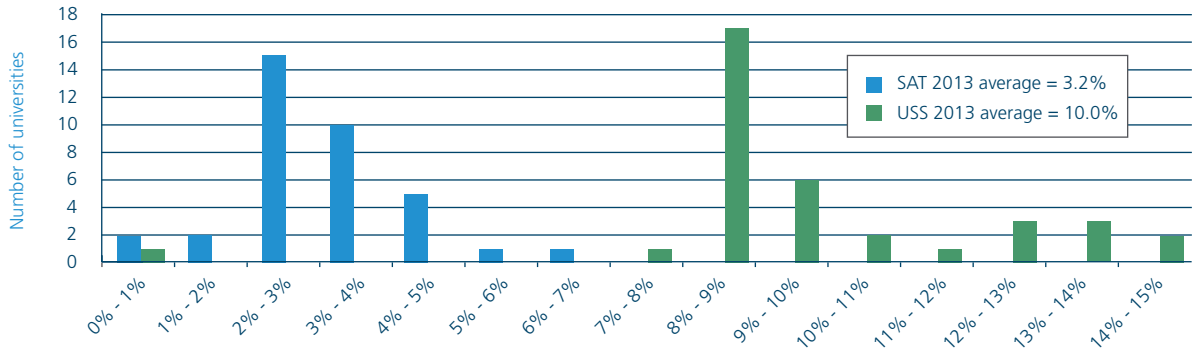


For the universities in our survey that contribute to both SATs and the USS, we found that the total contributions made by the universities to SATs largely remained unchanged as a proportion of total staff costs from 2012. The contributions in 2013 represent an average of 3.2% of total staff costs, whereas in 2012 the average was 3.3% of total staff costs.

The contributions made to USS, as a proportion of total staff costs, have remained unchanged since 2012 at 10%.

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

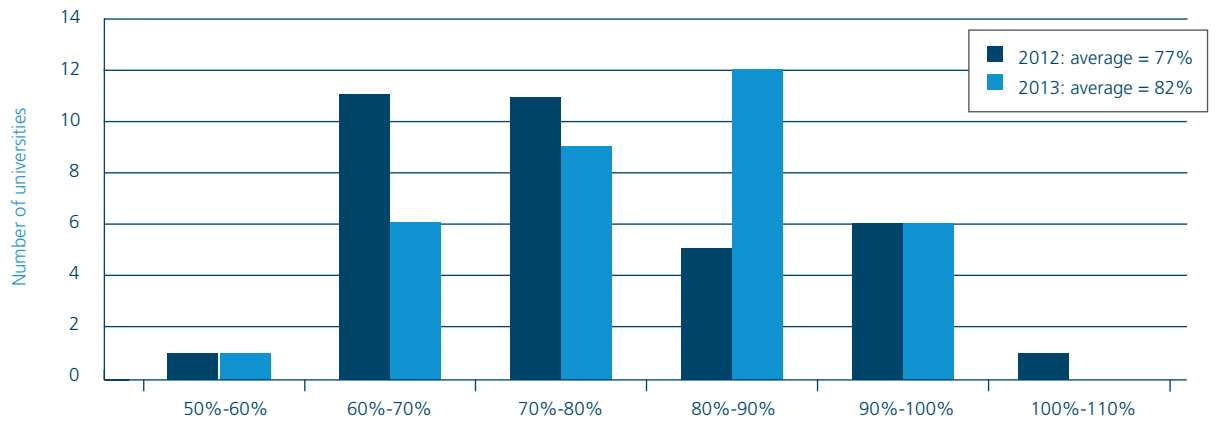
SAT and USS employer contributions as a proportion of total staff costs



Surplus / deficit

The average FRS17 funding level at 31 July 2013 for the universities in our survey was approximately 82%, up from an average funding level of 77% at 31 July 2012. The principal reasons for the improved funding levels over this period were strong asset performance and deficit contributions paid by the universities. The effect of this was offset to an extent by a large increase in expectations of future inflation levels.

FRS17 funding level as at 31 July 2013

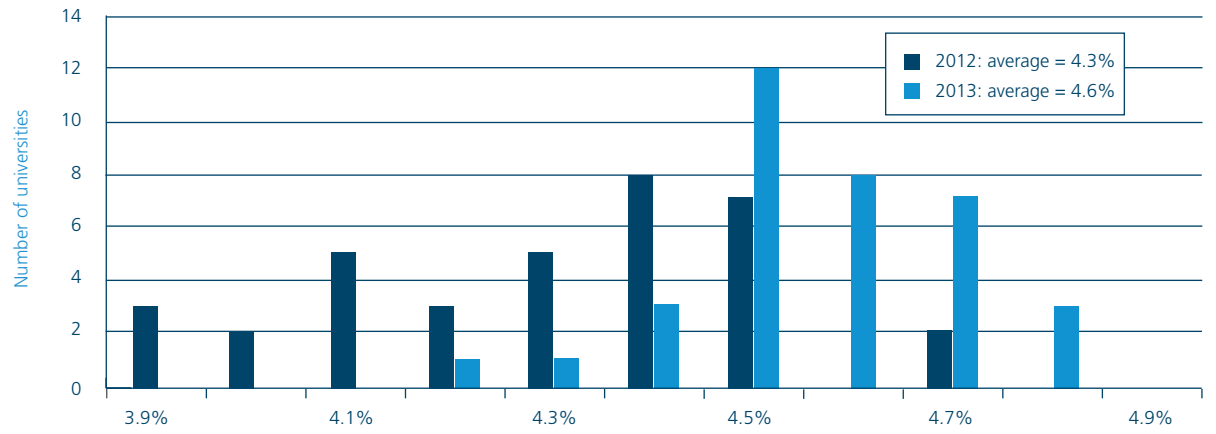


FRS17 assumptions

Discount rate

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

Discount rate (% p.a.) rounded to the nearest 0.1%



One university did not disclose the discount rate in 2012 & 2013

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

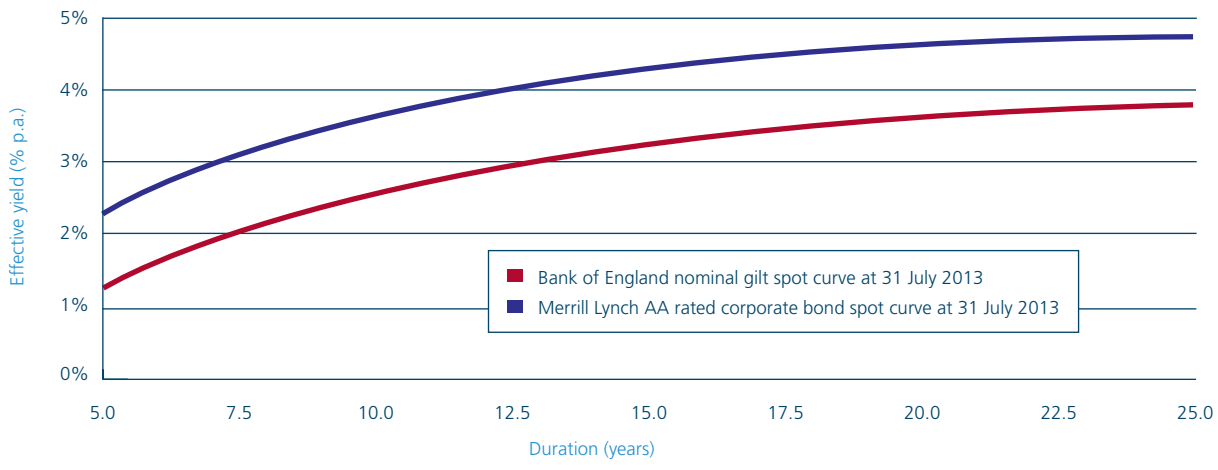
Year ending	iBoxx over 15 year AA-rated corporate bond index (% p.a.)	Average discount rate (% p.a.)
31 July 2010*	5.4	5.4
31 July 2011	5.3	5.3
31 July 2012	3.9	4.3
31 July 2013	4.3	4.6

* the 2010 average is based on 25 universities surveyed.

At 31 July 2013, the yield on the iBoxx over 15 year AA-rated corporate bond index was approximately 4.3% p.a. (2012: 3.9% p.a.).

It should be noted that the average discount rates used in both 2012 and 2013 were materially higher than the iBoxx index yield. This is most likely due to the fact that the yields on AA corporate bonds at the end of July 2012 and 2013 were higher at longer durations. As a result pension schemes (which will generally have liabilities with an average duration longer than the iBoxx index) may have been able to justify using a higher discount rate than the index yield. The graph below shows gilt and corporate bond yield curves at 31 July 2013, both steeply upward sloping.

Corporate bond and gilt yield curves as at 31 July 2013



Source: Merrill Lynch and Bank of England

As can be seen, the difference between yields at around 14 years (the approximate duration of the iBoxx index at 31 July 2013) and 20 years (an illustrative duration for a pension scheme's liabilities) was around 0.4% p.a.

Discount rates in this year's survey were slightly less varied than in the previous year. The range in 2013 was from 4.2% p.a. to 4.8% p.a., compared with the range in 2012 from 3.9% p.a. to 4.7% p.a.

Inflation rate

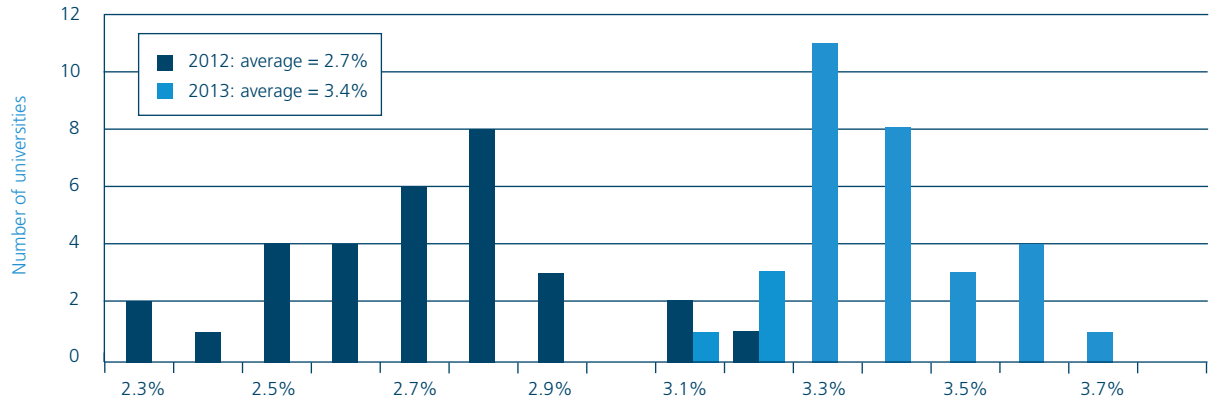
Market indices are generally used to set the future inflation assumption. The market's expectation of Retail Prices Index (RPI) inflation rate calculated by the Bank of England at 20 years (based on the difference between fixed interest gilt yields and index linked gilt yields) was 3.5% p.a. as at 31 July 2013. Most universities in the survey assumed that inflation would be slightly lower, with the average at 3.4% 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 breakeven 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 2010	3.5	3.2
31 July 2011	3.8	3.5
31 July 2012	2.9	2.7
31 July 2013	3.5	3.4

*Bank of England implied 'inflation rate' at 20 years.

The assumptions adopted are higher than they were last year, when the average was 2.7% p.a., reflecting the higher market expectations for future long term inflation. The average deduction made from the 20 year breakeven inflation rate fell from 0.2% p.a. to 0.1% p.a.

RPI inflation assumption (% p.a.) rounded to the nearest 0.1%



31 out of 36 universities disclosed the RPI inflation rate assumptions (31 in 2012).

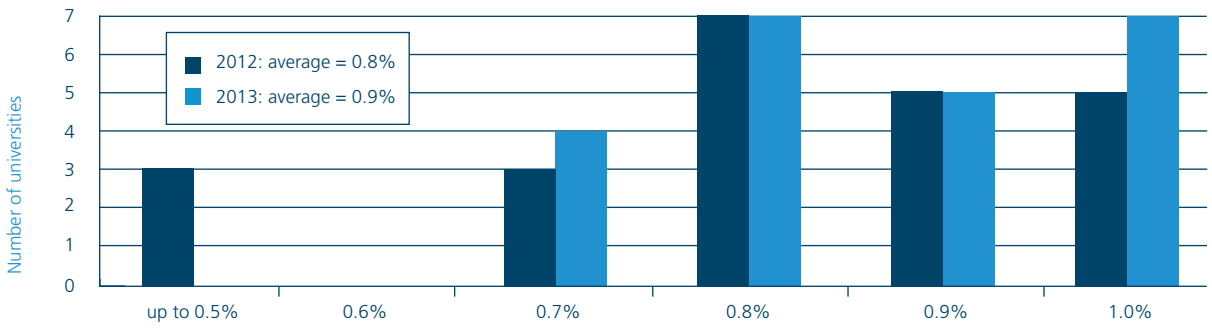
Some 27 out of the 36 universities in our survey explicitly disclosed a Consumer Price Index (CPI) inflation rate assumption, implying that three quarters of the universities in our survey use CPI as a measure of future inflation for at least some of the increases applied to benefits.

Over the last 20 years to 2010, CPI has been 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 1.0% p.a.

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% p.a. and 1.5% p.a. However, this assumes that the constituent effect will continue unchanged, and there is no guarantee that this will be the case over the long term. The current government CPI inflation target is 2.0% p.a.

The following graph shows the gap implied by the assumptions chosen by the 23 universities who disclosed assumptions for both CPI and RPI. The average deduction from RPI was 0.9% p.a. in 2013 compared with 0.8% p.a. in 2012. All three of the universities with a deduction of 0.5% p.a. in 2012 adjusted their deduction upwards in 2013 to better reflect the expected increase due to the formula effect.

RPI and CPI difference (% p.a.) rounded to the nearest 0.1%



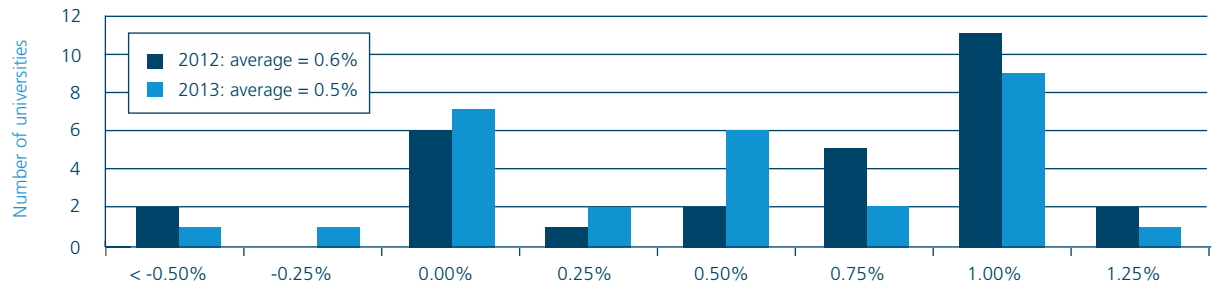
23 out of 36 universities disclosed both CPI and RPI inflation rate assumptions (23 in 2012)

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 RPI inflation assumption i.e. real salary growth.

The average real salary growth assumption fell by 0.1% p.a. in 2013 compared to the previous year. The chart below only considers universities which disclosed an assumption for RPI.

Real salary growth (% p.a.) rounded to the nearest 0.25%



29 out of 36 universities disclosed both the salary growth and RPI inflation rate assumptions

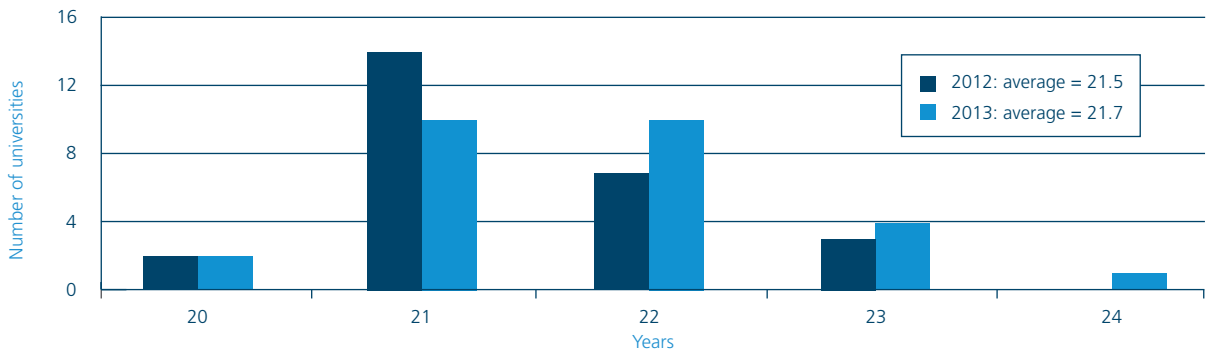
Life expectancy

30 out of 36 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 allowing 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 some of the mortality tables that were used.

The wide range of life expectancy assumptions adopted by pension schemes generally can often be explained by differences in the underlying scheme membership, for example different average income levels or occupations. 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.

Life expectancy - male aged 65

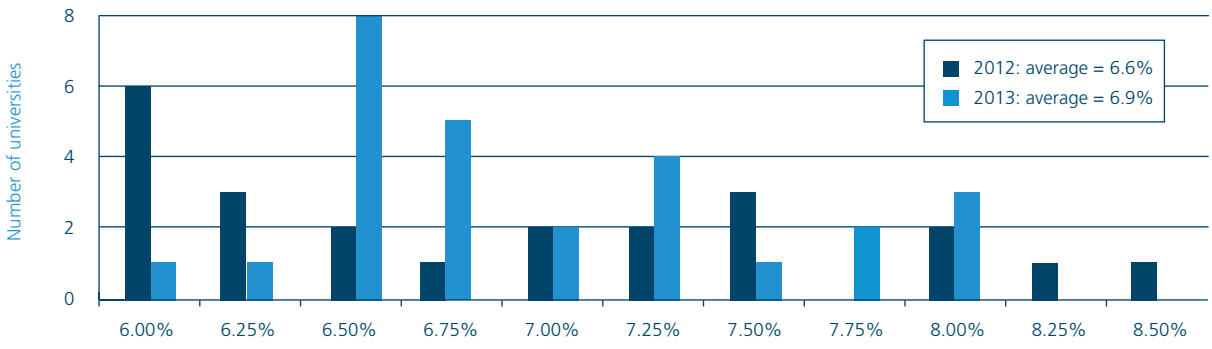


27 out of 36 universities disclosed the future mortality from age 65

Expected investment returns

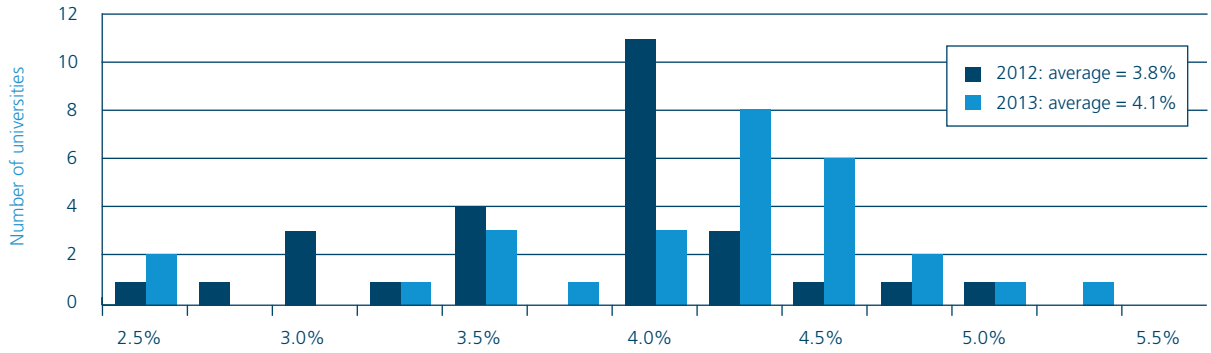
The expected returns on equities and bonds disclosed at 31 July 2013 are set out below.

Expected return on equities (% p.a.) rounded to the nearest 0.25%



28 out of 36 universities disclosed the expected equity return assumption used

Expected return on bonds (% p.a.) rounded to the nearest 0.25%



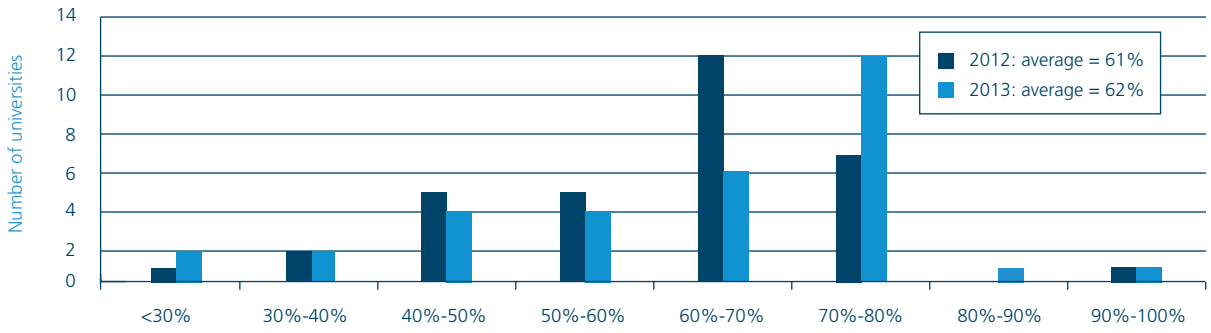
28 out of 36 universities disclosed the expected bond return assumption used

The average expected equity return was 6.9% p.a., compared with the average yield on long-dated gilts of 2.7% p.a., thereby implying an average 'Equity Risk Premium' of 4.2% p.a. (2012: 3.8% p.a.). The average expected bond return was 4.1% p.a., which is more reflective of the yield on long-dated corporate bonds rather than long dated gilts at the year end.

Asset allocation

The chart below shows the percentage of assets invested in equities for SATs in the 2013 survey, as at 31 July 2013 and 31 July 2012.

Equity weighting of total assets



33 out of 36 universities disclosed the equity allocation and asset amount figures

The average equity weighting of 62% is slightly higher than the 2012 average of 61%. This is perhaps as expected, with equities performing very strongly over the year to 31 July 2013. However, the average equity allocation of the SATs in our surveys remains substantially above the average equity allocation within private sector occupational defined benefit schemes in 2013, as reported by the Pensions Regulator. This suggests that universities are prepared to take a longer term view on investment returns and the SATs trustees believe a stronger covenant is being provided than that from many private sector scheme sponsors.

We hope that this analysis is helpful to universities in formulating assumptions for future disclosures under FRS17 for their respective SATs.

FRC issues FRS102

On 5 March 2013, the Financial Reporting Council Board formally approved the new UK accounting standard, FRS102. With regard to accounting for university SATs, this will replace the current FRS17 and will have implications for pensions accounting disclosures by bringing them broadly in line with the revised IAS19 standard for EU-listed entities, albeit with fewer disclosure requirements.

FRS102 will be compulsory for accounting periods beginning on or after 1 January 2015, and early adoption is permitted for periods ending on or after 31 December 2012.

The main change is that the 'expected return on assets' will cease to be used, and the finance cost will be replaced by a 'net interest' entry, calculated using the discount rate applying at the start of the period.

There are other changes affecting, for example, the way surpluses are restricted and how group and multi-employer plans must account for their pension arrangements.

It may also be more difficult to account for group plans (with more than one participating employer where these are under common control) as defined contribution schemes in future, and it is only possible to take this approach for multi-employer plans (with more than one participating employer where these are not under common control) if there is insufficient information to use defined benefit accounting methods.

It is likely that universities will need to make disclosures as to the impact of the changes during the transition.

Contracting-out to end in 2016

The reform of the State Pension system is planned to take place in April 2016 when the current structure will be replaced by a single flat-rate pension of around £144 per week (in today's prices) for everyone with a 35-year National Insurance Contributions (NICs) record.

As a consequence of this change, the ability to contract-out of the State Second Pension (S2P) via a salary-related scheme will cease. Rebates of NICs enjoyed by employers (3.4% of relevant earnings) and employees (1.4% of relevant earnings) by virtue of being contracted-out will be abolished – although increase in employers' National Insurance bills will be partially offset by a £2,000 'Employment Allowance' from April 2014.

Employers should start thinking now about the effect of the end of contracting-out on their schemes and how to avoid an increase in costs. Our research indicates that almost 90% of SATs are still open to future accrual in some form and would be affected by these changes. The results of the 2014 USS valuation will shed some light on how it plans on dealing with these changes but things may be more complicated for the LGPS. While most private sector funds can amend their benefit provision to deal with the changes, LGPS funds are currently excluded from this provision and could face an increase in contributions unless further amendments are made.

How can Barnett Waddingham help?

We have experience in helping universities review benefit design and their options for future pensions provision. We have already seen changes in benefits following the move by USS to a CARE scheme in 2011. Will there be further benefit changes as a consequence of the end of contracting-out? Visit our website for our note entitled *'Single-Tier State Pension – Implications for defined benefit schemes'* (www.barnett-waddingham.co.uk/singletier) which gives more information on the changes, their impact on the costs associated with running DB schemes and the options available to mitigate these costs.

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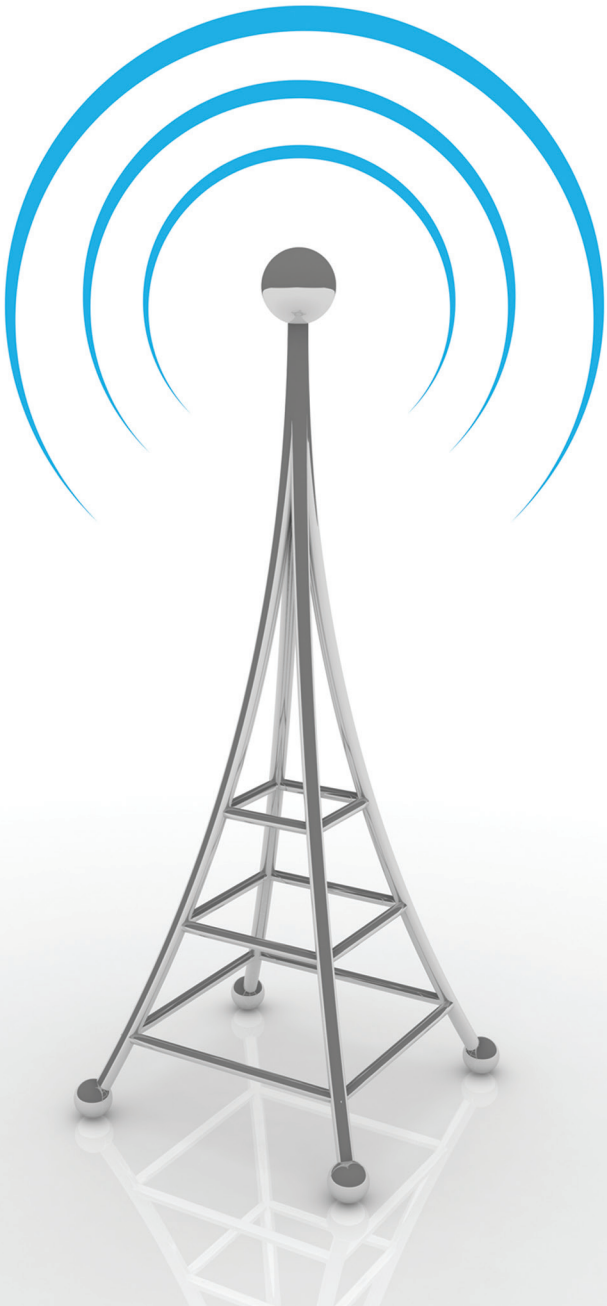

Pensions Training Videos For Employers

We have produced a series of short training videos covering issues that will be important to employers with a defined benefit pension scheme.

These can be viewed on our website http://bwllp.co.uk/gd, through our YouTube channel, or by searching for 'Barnett' in the podcast section of iTunes.

Corporate Consulting Blog

Looking for concise up to date commentary on the key pensions issues you face as an employer with a defined benefit scheme?

Use the following link to set up an RSS feed to our blog http://bwllp.co.uk/gU

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Further information

Please contact your usual Barnett Waddingham consultant to discuss any of these issues further or e-mail:

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