BARNETT WADDINGHAM
beyond the expected

Current issues in pensions financial reporting

This note is for those involved in preparing and auditing pension disclosures under Accounting Standards FRS102 (UK non-listed), IAS19 (EU listed) and ASC715 (US listed) as at 31 March 2023. 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.

IAS19 liabilities in big fall, but balance sheet impact mixed

Since 31 March 2022, most schemes have likely seen a significant fall in the value of their IAS19 liabilities, with corporate bond yields generally rising by around 2% p.a.

Whilst the increase in discount rates and reduction in liabilities will be welcome to corporate sponsors, the outcome in terms of the net balance sheet position will be mixed, as most asset classes lost value over the year. The funding position will also depend on how much interest rate and inflation risk was hedged during the volatility seen in the gilt market in September and October 2022, how much leverage was used in the portfolio and whether schemes were able to source sufficient liquidity to meet collateral calls.

Generally, schemes with lower levels of hedging will have fared better over the year (but this is by no means universal, and such schemes may have been starting from a worse position). Figure 1 shows how the progression may have varied for three schemes with differing levels of interest rate and inflation hedging coverage.

Figure 1 +

Surpluses, IFRIC14 and asset ceilings

The improvements in funding levels mean many schemes may find themselves with accounting surplus at the next balance sheet date, possibly for the first time under the current versions of the accounting standards. Some schemes may also find that the accounting position is materially better than the scheme funding position used to determine the last recovery plan contributions, increasing the chances of additional liabilities being required under IAS19 (even if a deficit remains).

Companies will need make a judgement as to whether it is appropriate to recognise the surplus and whether IFRIC14 creates any additional liabilities due to commitments made under a recovery plan. The key points for each of the main standards are:

IAS19 - IFRIC14 applies: Where the company has an unconditional right to a refund of surplus this can be recognised in full. It is normally enough to be able to demonstrate the company would have this right in the scenario where the scheme is run on until a point where all benefits have been paid out (gradual settlement).

As long as the Company can (in theory at least) run the scheme on indefinitely and the rules allow them to receive a refund at the end of the life of the scheme, the surplus can be recognised.

Where the Company does not have an unconditional right to a future refund the surplus must be restricted to nil, and if there is a recovery plan in pace, the present value of these contributions should be recognised as an additional liability on the balance sheet. If there is future accrual, the additional liability can be reduced if the service cost exceeds the contributions agree for future accrual.

FRS102: IFRIC14 does not apply: The principles above are typically followed to determine whether to recognise a surplus or not, but there is no requirement under any circumstances to recognise an additional liability for recovery plan contributions. There is potentially more scope for management judgement to be applied when deciding on whether to recognise a surplus under UK GAAP.

US GAAP: No restrictions apply on the surplus that can be recognised (and no additional liability will arise from any recovery plan).

Establishing whether an unconditional right exists can be a subjective judgement and can, in some cases, require legal interpretation of the scheme's rules if there is doubt over how they would operate. Where companies have yet to consider the asset ceiling, they may wish to do so ahead of the next year-end as advice may be needed to establish the correct treatment.

Impact of Covid-19 on pension scheme demographics

When considering the impact of Covid-19, it is helpful to consider as two parts:

- The **historical** impact of the pandemic i.e. the increase in deaths over the historical period and the impact that this higher than expected experience has on pension scheme liabilities (typically reflected in updated membership data between valuations); and
- The **future** impact of the pandemic i.e. how will the consequences of the pandemic affect future numbers of deaths of pension scheme members.

The historical impact of the pandemic

The CMI has estimated that there have been approximately 171,100 excess deaths in the UK than would have been expected since the start of the pandemic 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.

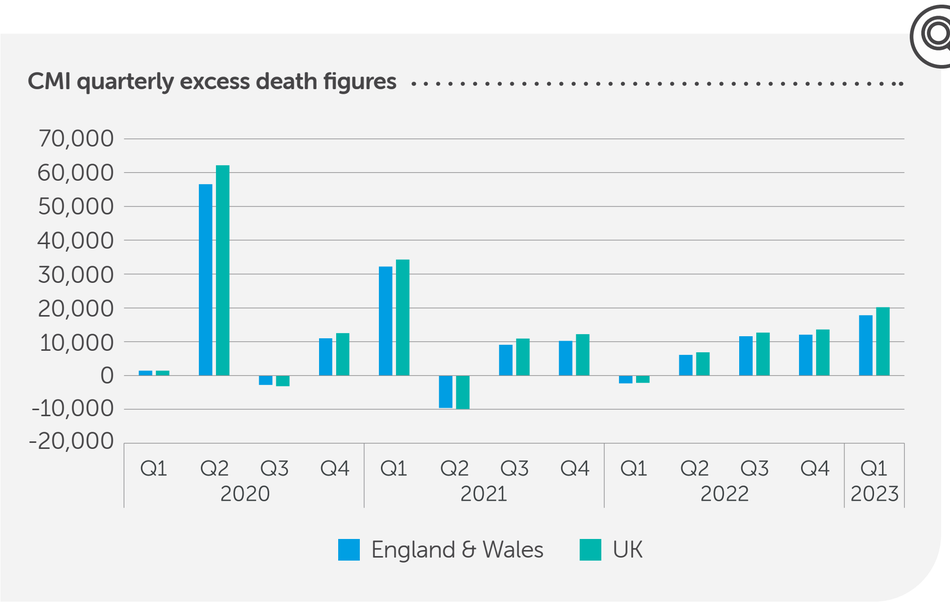
In general, we would expect the reduction in liabilities due to excess mortality to be negligible compared to the likely impact on the accounting position from financial markets. However, we would expect the impact to be more pronounced for more mature schemes.

The future impact of the pandemic

The pandemic is also likely to have an impact on the mortality projection assumptions. In particular, since the end of the second wave of the pandemic in Q2 of 2021 the number of deaths has been persistently and materially higher than expected (based on mortality in 2019), as shown in the following chart.

It is difficult to know what is driving these "excess" deaths, although reasons suggested include an increase in heart-related deaths (possibly caused by missed diagnoses during the pandemic or there being a higher risk of heart-related deaths following infection by Covid-19), other missed diagnoses and treatments during the pandemic, a bad influenza season accompanied by a cold snap in winter 2022/23 and pressures on the NHS (such as increased waiting lists and ambulance response times and strikes by medical staff).

It seems likely that these factors are likely to persist in the future, and therefore that mortality will be higher in the short and medium-term compared to pre-pandemic expectations.



Source: CMI week 13 mortality monitor

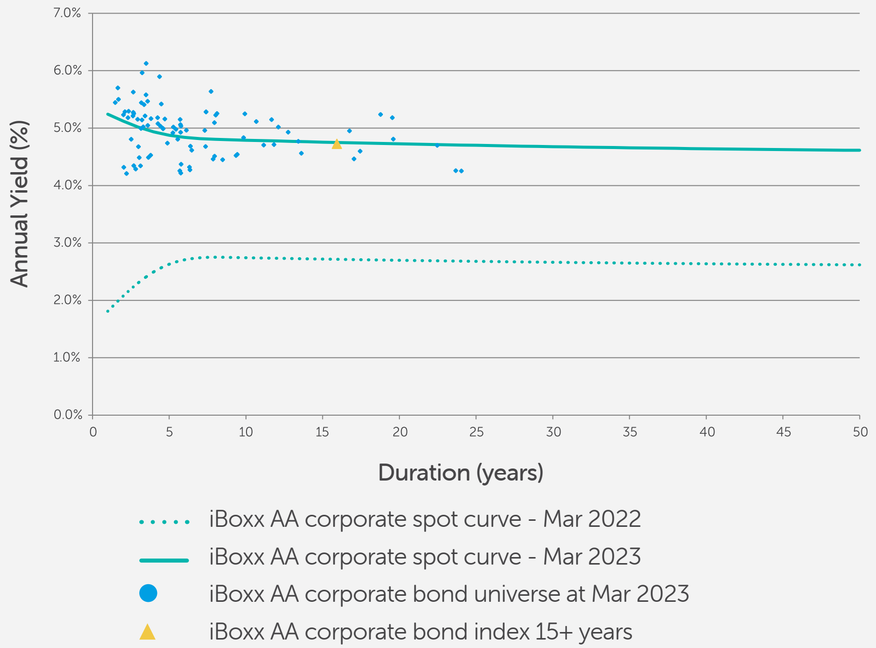
The latest version of the CMI model, CMI_2021, was published in March 2022. This model takes into consideration all the deaths which have occurred over 2020 and 2021, including those as a result of the current pandemic. When incorporating this model into the demographic assumptions, entities will need to decide on how much weight to place on the experience in 2020 and 2021.

It is likely to be difficult to justify placing a large weighting on the experience in 2020 and 2021, but some recognition that the pandemic may lead to a slowdown in life expectancy improvements compared to previous models would be considered reasonable. As the CMI have indicated that they are intending to incorporate a deterioration in life expectancy of around 2% due to the impact of the pandemic in the default setup of the next version of the CMI model (CMI_2022, expected to be released by the end of June), it is likely that the number of entities allowing for a deterioration in life expectancy as a result of the pandemic will increase (although a number of entities have already started to make a similar level of adjustment using CMI_2021).

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, considering the term of the relevant pension scheme's liabilities.

Figure 2: iBoxx AA Corporate bond universe at 31 March 2023



Source: Markit iBoxx

Figure 2 shows the individual yields on the bonds making up the iBoxx AA Corporate Bond universe as at 31 March 2023.

The variation in yield by term is different to a year ago, and the curve is now slightly downward sloping terms rise, compared to last year where rates increased at short terms before levelling off. 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, and our experience is that the audit firms this 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)	31 March 2023	31 December 2022	31 March 2022
10	4.80% pa	5.00% pa	2.65% pa
15	4.75% pa	4.90% pa	2.65% pa
20	4.75% pa	4.80% pa	2.65% pa
25	4.70% pa	4.70% pa	2.65% pa

At the end of Q1 2023, single equivalent discount rates on AA corporate bonds were lower when compared to the previous quarter at 31 December 2022 except for those of 25 year duration. However, when compared to last year at 31 March 2022, the single equivalent discount rates on AA corporate bonds were significantly higher. The table above shows that discount rates derived from the iBoxx curve have increased since 31 March 2022 by approximately slightly more than 2% pa. This will result in higher discount rates being adopted for accounting purposes compared to last year and therefore a lower 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 the full yield curve SEDR approach chosen in this analysis, 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. We extrapolate the curve beyond the duration of the longest AA rated bond through using the spot values predicted by the model up to 50 years and assuming a constant spot rate thereafter.

The increase in bond yields will have reduced durations significantly for most schemes. When selecting discount rates it is important that this change in duration is reflected in the methodology.

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% - 0.20% p.a. to the rate implied by the standard AA rated corporate bond data set is likely to be appropriate.

Inflation

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 "CPIH" index 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 mean 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.

A judicial review into the reform of RPI instigated by a number of large pension funds began in June 2022. This challenge failed in September 2022, making it more likely the change will go ahead as planned.

Retail Prices Index (RPI)

As can be seen from the inflation yield curve in Figure 3, market implied expectations for the future vary 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 3 +

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 considered 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 3, inflation expectations this quarter are slightly higher than last quarter but lower than those as at 31 March 2022. The fall relative to a year ago is partly attributable to expectations of high short term at this point last year having been realised over the period. This will lead to increased liabilities compared to the last quarter end for schemes with benefits linked to inflation, although this effect will have been more than offset by rising discount rates.

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)	31 March 2023	31 December 2022	31 March 2022
10	3.60% pa	3.40% pa	4.20% pa
15	3.65% pa	3.60% pa	4.00% pa
20	3.65% pa	3.60% pa	3.85% pa
25	3.50% pa	3.50% pa	3.70% pa

Consumer Price 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).

Following the response to the consultation on RPI reform there is now a much firmer expectation that RPI will be aligned with CPIH from 2030 onwards. An appropriate CPI assumption at 31 December 2022 is likely to be based on the gap remaining at around 1% pa 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.

Allowing for recent high levels of inflation

Since April 2021, inflation has been increasing with RPI and CPI respectively reaching as high as 14.2% and 11.1% in October 2022, although has eased slightly since then. As a result, recent pension increases in payment and deferment may have been higher than the long-term assumption used in previous accounting disclosures. Auditors will also expect known future increases to be considered – for example if the balance sheet date falls after the reference month for determining the increase, even if the increase will occur after the balance sheet date.

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 (often requesting evidence supporting the setting of the best estimate mortality assumptions, for example in a mortality analysis report).

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 makeup 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

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, please contact us using the details at the end of this note.

membership, it does not necessarily follow that the same adjustment should be applied to the new tables

Most companies will now have updated the mortality tables, either during their triennial valuation or when undertaking a comprehensive review of the scheme's mortality experience.

CMI_2021 model

The CMI_2021 model was released in March 2022. The model includes 2020 and 2021 data, the period in which there were the two primary waves of the Covid-19 pandemic in the UK. As with the CMI_2020 model, "weight" parameters can be used to vary the weight placed on data for 2020 and 2021; with the default parameters set to place no weight on experience for those years.

The CMI_2021 model full weighting 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.

As discussed on pages 3 and 4, the choice of weight parameters in CMI_2021 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 and 2021.

The overall liability impact changing from CMI_2020 to CMI_2021 is likely to be very small if the default parameters are adopted (as these place a zero weighting on experience in 2020 and 2021 for modelling future improvements), or the 2020 and 2021 weight parameters are chosen in CMI_2021 to reflect broadly the same liability impact as the 2020 weight parameter in CMI_2020.

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 and 2021 data in the model. This could result in a reduction of around 1-2% of accounting liabilities.

CMI_2022 model

In their Working Paper 173, published in March 2023, the CMI announced that they expect to release the lates version of their model, CMI_2022, in June 2023 i.e. available for companies with year ends falling after 30 June 2023.

The CMI_2022 model will be designed in a similar manner to the 2020 and 2021 models, with users able to vary the weight placed on 2020, 2021 and 2022 data through the use of "weight" parameters.

Due to the excess mortality experienced seen since the end of the second wave of the pandemic (discussed on page 3 and 4), the CMI's default position in CMI_2022 will allow for some weight on experience in 2022, which will reduce liabilities relative to pre-pandemic levels by around 2%.

Those companies who had previously made no allowance for life expectancy to fall following the pandemic could see an improvement in their balance sheet position following adoption of CMI_2022 (although the impact will likely be much less significant than movements due to volatility in the financial markets).

On the other hand, "early mover" companies that have already reflected the negative impact of the pandemic in liabilities may not see any change in their balance sheet position.

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.

Further information

- Illuminate - Instant Scenario Testing
- FTSE350 pensions: preparing for a transaction
- Independent review of accounting disclosures
- Training for those involved in Pensions Financial Reporting - FRS102, FRS101, IAS19 and ASC715
- Your global accounting consolidation provider

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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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