



Current issues in pensions financial reporting

30 September 2023

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 **30 September 2023**. It looks at topical issues, alongside considerations for company directors when setting assumptions, and for auditors in determining whether the assumptions are appropriate. Please note that this briefing should not be taken as a recommendation for a particular course of action – please seek advice appropriate for your circumstances.



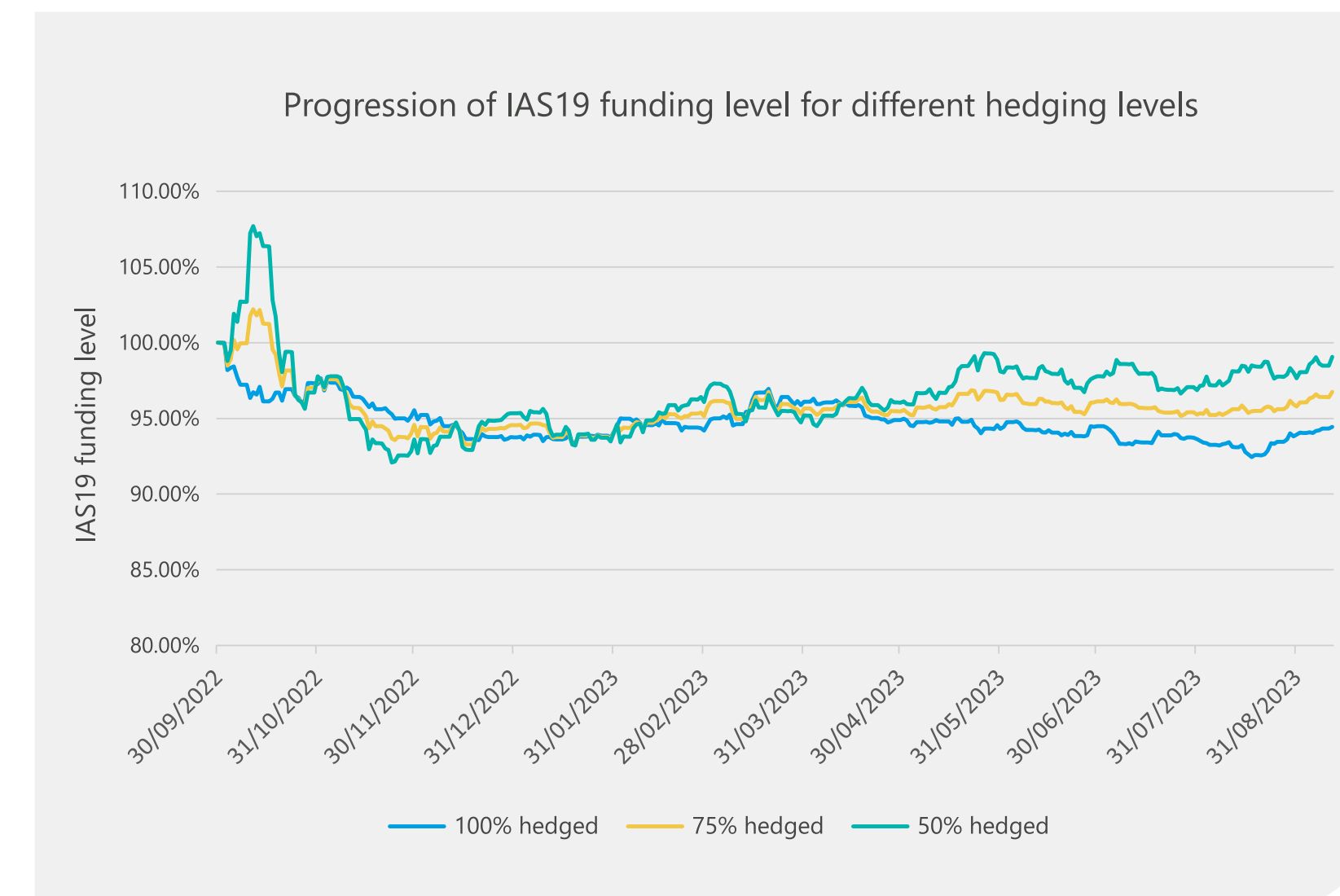
IAS19 liabilities fall, but balance sheet impact mixed

Since 30 September 2022, most schemes have likely seen a fall in the value of their IAS19 liabilities, with corporate bond yields generally rising between 0.1% p.a. and 0.7% p.a., depending on duration.

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 - for example, the value of bond and credit related assets will have fallen, but returns on equities were positive. The funding position will also depend on several other factors:

- 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
- Whether schemes were able to source sufficient liquidity to meet collateral calls.

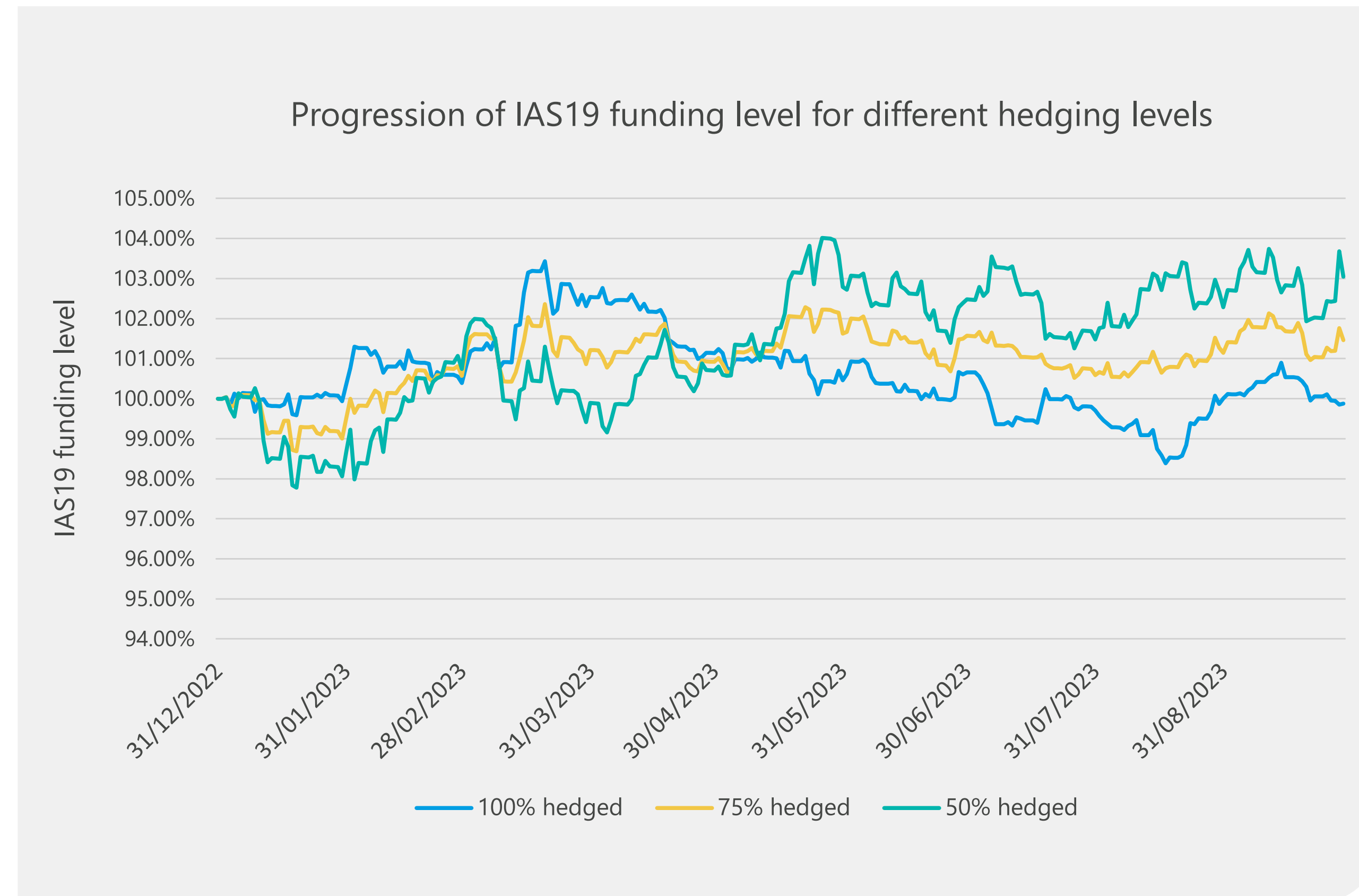
Generally, schemes with lower levels of hedging will have fared better over the year (but this is by no means universal, and such schemes may have been starting from a worse position). The chart below shows how the progression may have varied for three schemes with differing levels of interest rate and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



Conducting the same analysis over the nine months to 30 September 2023, we see that most schemes should have seen a fall in their liabilities from 31 December 2022. This is due to corporate bond yields rising by roughly 0.7% p.a. during the period.

Unlike the full-year scenario, corporate sponsors are likely to see a rise in balance sheet position over the nine months, particularly if less-well hedged, as reduction in liability values are likely to have been greater than reductions in asset values.

Similar to the full-year analysis, schemes with lower levels of hedging will have fared better over the nine months, although will have experienced more volatility. The chart on the right shows how the progression may have varied for three schemes with differing levels of interest rate and inflation hedging coverage.





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 place, 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 agreed 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 200,100 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 equate to an approximate reduction of c. 0.8% in pensioner liabilities (based on a UK pensioner population of 12 million), 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 shutdown of healthcare services in 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, as well as 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.

The latest version of the CMI model, CMI_2022, was published in June 2023. This model takes into consideration all the deaths which have occurred over 2020, 2021 and 2022, 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 joint experience in 2020 and 2021 as well as on the 2022 experience. It is likely to be difficult to justify placing a large weighting on the experience in 2020 and 2021 due to the exceptional circumstances in those years. However, a relatively large weighting placed on the 2022 mortality data, which had a mortality rate 6.2% higher than 2019, may be appropriate in recognising the fact that the pandemic may lead to a slowdown in life expectancy improvements compared to previous models.

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.

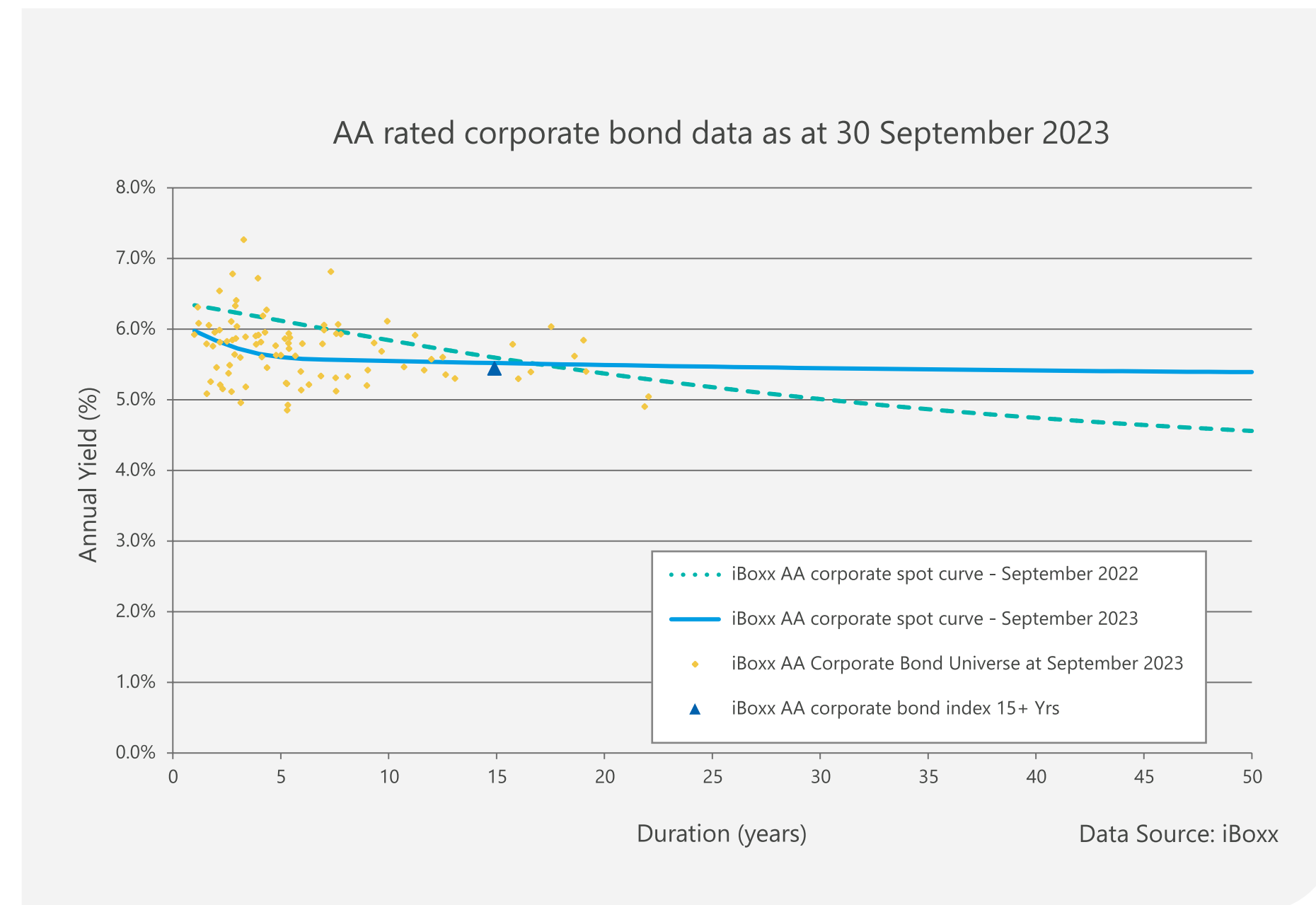


Figure 2: iBoxx AA Corporate bond universe at 30 September 2023

Figure 2 shows the individual yields on the bonds making up the iBoxx AA Corporate Bond universe as at 30 September 2023.

The variation in yield by term is different to a year ago, and the curve is now slightly downward sloping as terms rise and then levels off, compared to last year which exhibits a more linear downward relationship. This effect should be reflected in the choice of discount rate.

A common method to reflect the shape of the 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 prefer 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)	30 September 2023	30 June 2023	30 September 2022
10	5.45% pa	5.40% pa	5.40% pa
15	5.40% pa	5.10% pa	5.10% pa
20	5.40% pa	4.95% pa	4.90% pa
25	5.40% pa	4.85% pa	4.80% pa



At the end of Q3 2023, single equivalent discount rates on AA corporate bonds were higher when compared to the previous quarter at 30 June 2023 and when compared to 30 September 2022 for all durations. The table above shows that discount rates for short durations derived from the iBoxx curve have increased since 30 September 2022 by approximately 0.1% and discount rates for longer durations have increased by approximately 0.5% (the variation by duration reflects the changes in the shape of the yield curve as outlined above). 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 over the last year 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 0.20% - 0.30% 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 “Consumer Prices Index including owner occupiers’ housing costs” (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. If this is successful it could mean the changes will need to be reconsidered (although may still go ahead), the changes could be reversed, or compensation could be required for holders of RPI index linked gilts adversely affect by the changes.

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.

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 compared to the previous quarter. Compared to inflation expectations as at 30 September 2022, expectations this quarter are significantly lower.

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 September 2023	30 June 2023	30 September 2022
10	3.60% pa	3.55% pa	4.00% pa
15	3.55% pa	3.45% pa	3.85% pa
20	3.50% pa	3.40% pa	3.75% pa
25	3.45% pa	3.35% pa	3.70% 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; and
- 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 30 September 2023 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 both have 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 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.



Barnett Waddingham has a specialist longevity tool (developed alongside our expert Longevity Consulting team) 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 or actual mortality experience over a historical period. To find out more about this please contact us using the details at the bottom of this note

CMI_2022 model

The CMI_2022 model was released in June 2023. 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. The model also includes 2022 data which the CMI believes can be relied on to an extent for the purposes of producing future mortality. As with the CMI_2021 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. In addition, there is an extended weight parameter for the 2022 data, independent of the 2020/2021 weighting; with the default parameter set to be 25%.

As discussed on pages 3 and 4, the choice of weight parameters in CMI_2022 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 and a small weighting for 2022 data.

The overall liability impact changing from CMI_2021 to CMI_2022 is likely to be fairly significant if the default parameters are adopted. This is because the CMI_2022 model projects a fall in life expectancies of between 2% and 3% (depending on age and gender) when compared to CMI_2021. For context, the CMI_2022 core parameters would be roughly equivalent to CMI_2021 with weights of 15% on 2020 and 2021 data.

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 2020/2021 and 2022 data in the model. This could result in a reduction of around 1-2% of accounting liabilities.





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

FTSE 350 pensions: preparing for a transaction

Independent review of accounting disclosures

Training for those involved in Pensions Financial Reporting - FRS102, FRS101, IAS19 and ASC715

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