

University Self Administered Trusts (SATs)

The key financial assumptions required for determining pension liabilities under the FRS17 Accounting Standards are the discount rate and the rate of future inflation. There are a number of considerations for university Finance Directors to take into account when setting these assumptions and for auditors in determining whether the assumptions are appropriate.

This newsletter is aimed specifically at those involved in the preparation of pension disclosures of University Self Administered Trusts (SATs) sets out some of the technical issues relevant to those involved in the preparation and the audit of pension disclosures.

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. Corporate bond indices are often used as a proxy to determine the discount rate.

The table below shows some of the key market indices that could be taken into account when deriving the discount rate. The yield on government bonds (gilts) is also shown for comparison:

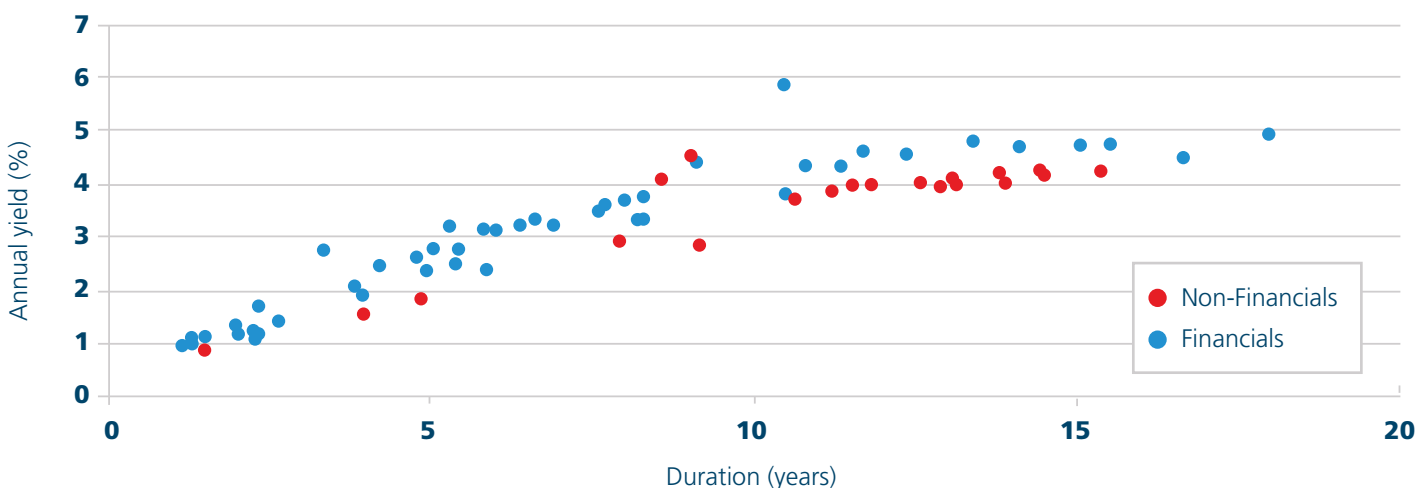
Index (annualised yield)	31/07/2013	31/07/2012
ML Sterling Non-Gilts AA over 15 years	4.19%	4.03%
ML Sterling Corporates AA over 15 years	4.31%	3.97%
iBoxx Sterling Corporates AA over 15 years	4.33%	3.89%
Over 15 Year Fixed Interest Gilts	3.43%	2.78%

At the end of July 2013, the yields on bonds of all types are significantly higher than those as at 31 July 2012. This is likely to result in higher discount rates being adopted for accounting purposes to those adopted last year which, all other things being equal, will lead to lower values being placed on pension scheme liabilities.

It is interesting to note that the yield on the over 15 year AA-rated non-gilts index is now lower than the yield on the over 15 year AA-rated corporates only index. The main reason for this has been the downgrade of lower yielding AAA-rated quasi and foreign government bonds, such as the Network Rail Infrastructure bond which is guaranteed by the government. In 2012, some 4% of the non-gilts index was made up of these quasi and foreign government bonds. This increased over the past 12 months such that around 27% of the index is now made up of quasi and foreign government bonds. Universities using this index to set their discount rate should now consider whether it remains appropriate given that the Accounting Standards require the discount rates to be based on high quality corporate bonds.

Figure 1 shows the individual yields on the bonds making up the iBoxx AA Sterling Corporate Bond All Stocks Index as at 31 July 2013.

Figure 1: Individual yields as at 31 July 2013 on the bonds making up the iBoxx AA Sterling Corporate Bond All Stocks Index



Data Source: Markit Group

Other issues that should be noted when setting the discount rate include:

- The yields on individual AA bonds vary by duration, as shown on Figure 1. Taking into account the duration of a pension scheme’s liabilities when setting the discount rate may result in a different discount rate than if a single index figure is used. Figure 1 illustrates that longer dated stocks generally had a higher yield.

The duration of the iBoxx Sterling Corporates AA Over 15 years as at 31 July 2013 is approximately 13.5 years and this is generally shorter than the duration of most pension schemes’ liabilities. In years where the yields vary significantly by term, as continues to be the case now, the use of an index yield means that the discount rate will not normally be appropriate for the duration of the scheme’s liabilities. It is likely, therefore, to be appropriate to use a discount rate above the index yield if the duration of the scheme’s liabilities is longer than the index. Based on Figure 1 and extrapolating beyond the yield on the longest duration AA bonds it could be possible to justify discount rates of 4.5%-5% p.a. for immature schemes. As ever, consistency with the approach adopted in previous years should be considered.

Our [survey of assumptions adopted by university SATs](#) as at 31 July 2012 showed that the average discount rate used was 4.3% p.a. which was materially higher than the AA Corporate Bond index yield reflecting this consideration.

- It is possible to discount different tranches of liabilities at different rates, for example by using an AA bond yield curve rather than a single rate based on an index. Care should be taken, however, as AA bond yield curves can be derived in a variety of ways. The methodology chosen can lead to variations in individual rates and subsequently also in the liability figure derived.
- The yields on AA bonds issued by financial companies continue to be higher than comparable bonds issued by non-financials. Over the past year there has been a trend of narrowing credit spreads, arguably suggesting greater confidence in the corporate bond markets. During the year a number of financial companies were downgraded by the ratings agencies, which means that there is now less weight to that sector in the index.

Inflation

Retail Prices Index

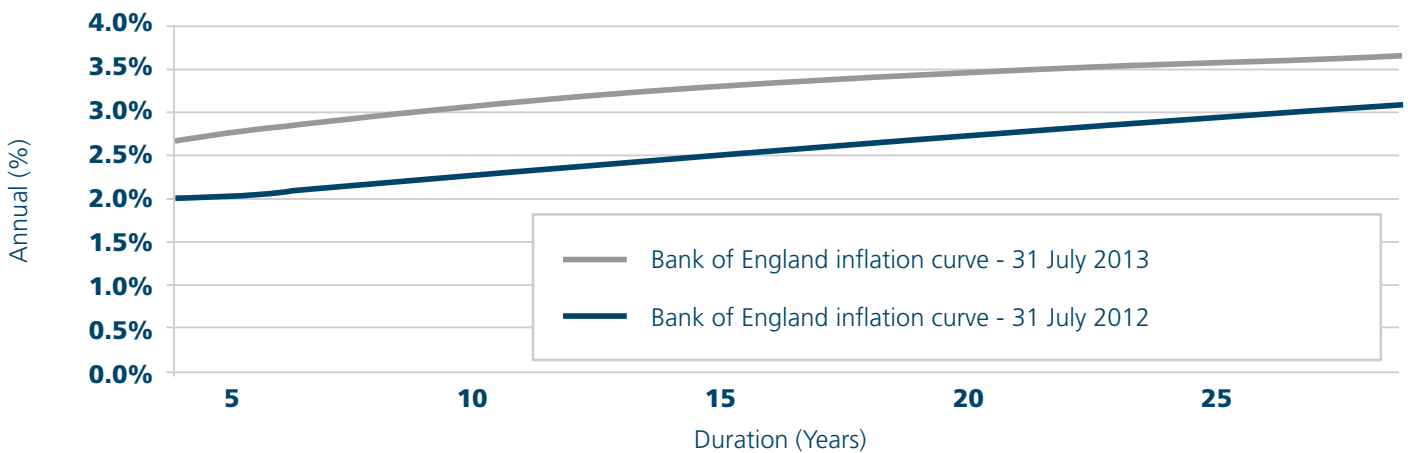
The table below shows a sample of market implied long-term inflation rates. As can be seen from the inflation yield curve in Figure 2, market implied inflation varies considerably depending on the term being considered. It may, therefore, be appropriate to adopt an inflation assumption appropriate to the characteristics of each specific scheme rather than merely adopting a proxy such as the Bank of England’s 20 year rate, particularly if the duration is significantly different to 20 years. Consistency with the approach adopted to derive the discount rate is important.

There may be other considerations to take into account when choosing inflation assumptions, such as whether to adjust for a possible inflation risk premium that may be implicit in the Bank of England’s figures or for any other external factors that the Finance Directors feel should be taken into account in determining this assumption. The justification for including an inflation risk premium is arguably less strong under current market conditions due to the high level of demand for fixed interest gilts.

Index (annualised rate)	31/07/2013	31/07/2012
Bank of England 20 year market implied inflation	3.54%	2.86%
Bank of England 15 year market implied inflation	3.37%	2.59%

Implied rates of future inflation are significantly higher than those of a year ago. Allowing for a higher implied inflation rate would in isolation result in higher pension scheme liabilities (to the extent that benefits are linked to inflation).

Figure 2: Spot Inflation Curves (annualised)



Data Source: Bank of England

Consumer Prices Index

The figures above relate to inflation as measured by the Retail Prices Index (RPI). Many schemes now have benefits increasing with reference to the Consumer Prices Index (CPI) and over the 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 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.

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. Barnett Waddingham’s [survey of assumptions used by university SATs](#) as at 31 July 2012 showed a difference of up to four years in the life expectancy assumptions adopted. Each additional year of life expectancy can add around 3% to the value of pension scheme liabilities and hence the chosen assumption can have a big impact on the results.

For simplicity, Finance Directors have often adopted the same mortality assumptions used by the scheme’s trustees for the funding valuation. As pension costs have increased there has been an increasing tendency to adopt different assumptions. Trustees are required to use prudent assumptions whereas the assumptions for accounting disclosures should be a best estimate. Entities should consider reviewing their mortality assumptions to ensure these are not overly prudent and that their pension liabilities are not being overstated.



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

FRC issues FRS102

On 5 March 2013, the Financial Reporting Council (FRC) 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.

Other Pension Accounting Issues

Recent Market Volatility

Equities are generally at a much higher level than they were at this time last year, although accounting liabilities are also likely to be higher for those schemes with a significant proportion of benefits linked to inflation.

The overall effect of market movements will differ for schemes depending on their asset allocation. Schemes with a significant proportion of their assets invested in equities are likely to see improvements in their accounting positions (over the 12 months to 31 July 2013), especially if a higher discount rate is adopted. However, ignoring deficit contributions and scheme experience, the improvement in the accounting position for many schemes (particularly those with a significant portion of benefits linked to inflation) are likely to be offset by higher inflation assumptions being adopted.

BW Pension Scheme Accounting Modeller – Instant Scenario Testing

Pension schemes can have a significant impact on a company's accounting position. Our interactive modelling tool can help university Finance Directors understand and quantify the factors influencing the financial position of the Scheme so that they can be linked into the university's own internal plans for its core business.

The software allows an instant assessment of the sensitivity of the accounts to the year end assumptions so that the Finance Director can make a fully informed decision on the optimal approach.

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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