BARNETT WADDINGHAM
beyond the expected

31 December 2021

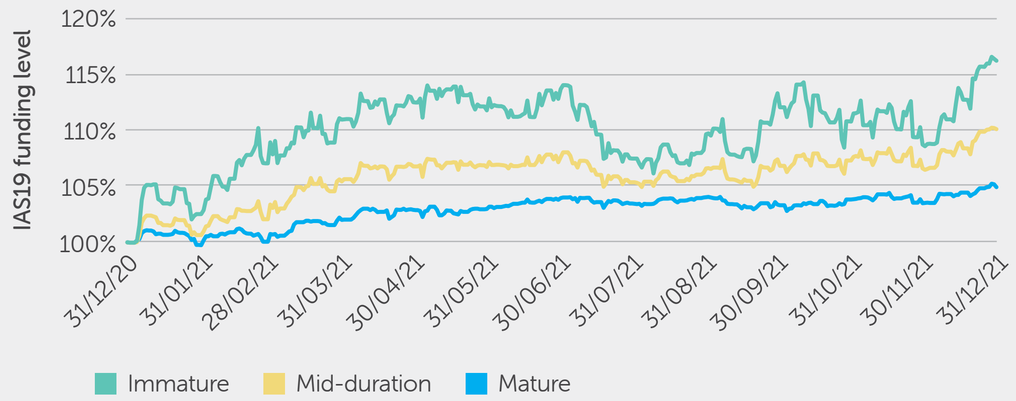
Current Issues in Pensions Financial Reporting

This note is for those who will be involved in preparing and auditing pension disclosure under Accounting Standards FRS102 (UK non-listed), IAS19 (EU listed) and ASC715 (US listed) as at 31 December 2021. 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.

Significant recovery in IAS19 positions as markets rally

Since 31 December 2020 most schemes will likely have seen a significant improvement in their IAS19 funding level, with immature schemes and those which have retained a high allocation to growth assets benefitting the most. While this is undoubtedly a welcome development, the improvement in 2021 followed a deterioration in 2020 and it may be that many schemes are now only back to where they started before the pandemic.

Progression of IAS19 funding level for typical schemes



Source: Barnett Waddingham model

Yields on corporate bonds rose significantly over the year, leading to an improvement in funding level as accounting liabilities under IAS19 decrease. Yields on protection assets (such as government bonds or LDI holdings) have risen correspondingly reflecting a general rise in interest rates reducing the value of these holdings. This fall in value will offset some of the reduction in liabilities, but continued increases in the value of growth assets mean that the net position is likely to have improved for almost all schemes. Furthermore, the lower the amount of interest rate hedging, the greater the improvement is likely to have been (although schemes with low amounts of hedging will likely have started from a lower funding level).
We have also seen a sharp rise in inflation levels this year, reaching its highest level since September 2008 in November 2021. This would lead to an increase in liabilities for schemes with inflation-linked benefits partially offsetting gains from other factors.

Impact of Covid-19 on pension scheme demographics

The CMI has estimated there have been approximately 120,000 more deaths in the UK than would have been expected since the start of the pandemic, than if experience had been similar to that seen in 2019. While 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 IAS19 position from financial markets. However, we would expect the impact to be more pronounced for more mature schemes.

The pandemic is also likely to have an impact on the selection of assumptions about future mortality. Experience analyses and models for future improvements will need to consider whether the experience in 2020 and early 2021 is a one-off, and whether future waves will lead to a material number of excess deaths during the remainder of 2021.

The vaccination programme appears to have limited deaths so far during the 'third wave', and although Q4 saw a return of excess mortality, this is at a much lower level than the previous peaks. The impact of the new 'Omicron' variant, along with other seasonal viral illnesses, may also have an impact.

The pandemic may also influence future mortality in other ways. For example, the pressure on health services may mean progress against other causes of death such as cancer is slower than previously expected, meaning an assumption of a lower rate of mortality improvements might be appropriate.

Alternatively, the surviving population may be in better health than those dying from Covid-19, meaning we might expect remaining members to live slightly longer.

Illuminate - instant scenario testing

The CMI published the CMI_2020 mortality improvement model earlier this year, and this model takes into consideration all the deaths which had occurred over 2020, 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. It is likely to be difficult to justify placing a large weighting on the experience in 2020, but some recognition that the pandemic may lead to a slowdown in life expectancy improvements compared to previous models could be considered reasonable.

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 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, and 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 means 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.

The lack of market reaction may support the use of a higher Inflation Risk Premium than in previous years (see further comments below).

In relation to accounting assumptions, companies will need to review the methods used for setting both RPI and CPI assumptions going forward in light of the market's reaction to the proposed changes.

GMP equalisation

On 26 October 2018, the High Court published its judgement to equalise benefit inequalities due to Guaranteed Minimum Pensions (GMP). On 20 November 2020 there was a further High Court judgement extending GMP equalisation calculations to members who have transferred out of schemes since 17 May 1990. Most companies will have recognised P&L charges in previous periods reflecting the estimated cost of these judgments. The focus will now move to implementation. Where GMP equalisation is implemented using the same method as used previously to estimate the cost there should be no further P&L impact with any differences between the final and estimated cost passing through OCI. However, where a different method is used (for example B rather than C2 to simplify the administration), this can create additional P&L costs for the company.

On the horizon

IAS 19 disclosure requirements

The International Accounting Standards Board (IASB) has released an exposure draft on 25 March 2021 which consults on amending the IAS19 accounting disclosure requirements. The consultation ran until 12 January 2022, with the IASB due to provide feedback in the first half of 2022. The changes are therefore unlikely to be effective until 2023 at the earliest, although no timeline has yet been given for implementation.

In releasing this draft, the board has stated that it is trying to address three main concerns regarding the information disclosed in financial statements - that is, there is not enough relevant information; too much irrelevant information; and ineffective communication of the information provided.

The board proposes to replace the existing set of disclosure requirements with a more expansive set of requirements.

FTSE350 pensions back on course

In addition there will be an increased focus and some new disclosure requirements on areas such as:

- disclosing how the pension scheme will impact on the company's future cash flows and the nature of those effects; and
- disclosing the period over which payments will continue to be made from the scheme to members of defined benefit plans.

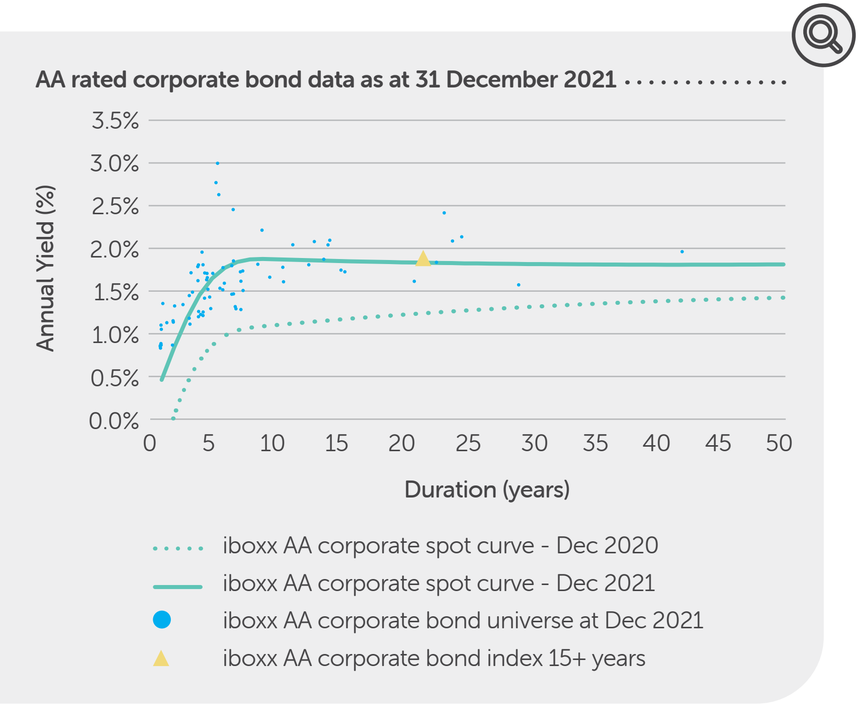
The exposure draft provides examples of how to meet those new disclosure requirements, and it appears that a brief commentary will not be sufficient.

> If the changes go ahead then it is likely that the amount of disclosure will increase for many entities, although improving the way existing information is presented also appears to be an objective of the review.

Discount rate

The accounting standards require the discount rate to be based on yields of high quality (usually AA rated) corporate bonds of appropriate currency, taking into account the term of the relevant pension scheme's liabilities.

Figure 1 shows the individual yields on the bonds making up the iBoxx AA Corporate Bond universe as at 31 December 2021. As can be seen in Figure 1, yields on corporate bond rise steeply at short durations but plateau at the medium to long-term, and this effect should be reflected in the choice of discount rate.



Source: Markit iBoxx

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 the audit firms prefer a cash flow weighted approach to be used.

The table below shows single equivalent discount rates (SEDR) using the iBoxx AA rated corporate bond curve based on sample cash flows for a range of durations. In most cases discount rates of 20bps higher or lower than the rates in the table will be acceptable for accounting purposes.

Approximate duration (years)	31 December 2021	30 September 2021	31 December 2020
10	1.80% pa	1.85% pa	1.10% pa
15	1.80% pa	1.90% pa	1.15% pa
20	1.80% pa	1.95% pa	1.20% pa
25	1.80% pa	2.00% pa	1.30% pa

At the end of Q4 2021, single equivalent discount rates on AA corporate bonds were lower in contrast to last quarter but higher compared to the previous year as at 31 December 2020.

The table to the left shows discount rates derived from the iBoxx curve have increased since 31 December 2020 by approximately 0.70% pa for short duration schemes and by 0.50% pa for long duration schemes.

This will result in higher discount rates being adopted for accounting purposes compared to last year. This will result in a lower value being placed on the liabilities.

> Each 0.1% increase on the discount rate would translate to a decrease 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 this approach, 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. How this is extended to durations beyond the longest AA rated bond, although the final point is perhaps less important at the moment due to the flattening of the curve.

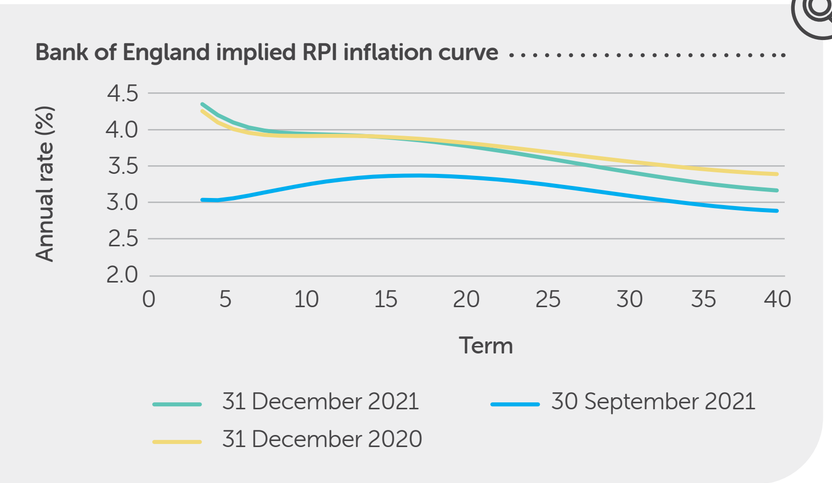
Generally, it will be possible to justify a higher discount rate by adopting a 'single agency' approach where the discount rate is set by reference to bonds that are rated at AA by one or more of the three main rating agencies. This approach provides a larger universe of bonds (particularly at the longer durations) to be considered when setting the discount rate. Currently, an increase of 0.05% p.a. to the rate implied by the standard AA rated corporate bond data set is likely to be appropriate, which is slightly lower than last quarter.

Inflation

Retail Price Index (RPI)

As can be seen from the inflation yield curve in Figure 2, market implied expectations for the future vary considerably 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.

Figure 2: Spot inflation curves (annualised)



Source: Bank of England

In particular, this does not reflect the fact 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 the company directors feel should be taken into account 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 2, inflation expectations are slightly lower than last quarter but are up significantly over the year. This will lead to higher liabilities for schemes with benefits linked to inflation.

The table below shows single equivalent inflation rate assumptions based on the Bank of England inflation curve and sample cash flows for a range of durations, before any deduction for an inflation risk premium.

Approximate duration (years)	31 December 2021	30 September 2021	31 December 2020
10	3.80% pa	3.85% pa	3.25% pa
15	3.65% pa	3.75% pa	3.20% pa
20	3.50% pa	3.65% pa	3.15% pa
25	3.40% pa	3.55% pa	3.05% 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 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).

Towards the end of 2011, the Office for Budget Responsibility (OBR) published a paper on the gap between RPI and CPI which suggested the other factors mean the gap could be between 1.3% pa and 1.5% pa.

A more recent paper published by the OBR in March 2015 suggests the median gap to be about 1.0% pa while the Bank of England central long-term estimate suggests 1.3% pa. Our experience is that deductions of up to 1.1% pa from the RPI inflation are typical although many entities have been using lower gaps for the period after 2030 to reflect the proposed changes to the RPI.

Following the response to the consultation there is now a much firmer expectation RPI will be aligned with CPIH from 2030 onwards.

An appropriate CPI assumption at 31 March 2021 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 there may be a difference between CPI and CPIH due to the differences in the make-up of these two indices.

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.

While 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.

There is likely to be more focus on mortality assumptions this year, as the CMI has released the CMI_2020 mortality improvements model which incorporates 2020 data involving Covid-19 related deaths.

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.

CMI_2020 model

The CMI_2020 model was released on 4 March 2021. The model includes 2020 data, which accounts for the impact Covid-19 has on England and Wales's populations. A new 'weight' parameter can be used to vary the weight placed on data for 2020; the core parameter will be set to place no weight on experience for that year.

The CMI_2020 model without the weighted parameter 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 parameter in CMI_2020 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.

The overall impact of the liability changing from CMI_2019 to CMI_2020 is likely to be very small if the default parameters are adopted, as these place a zero weighting on experience in 2020 for modelling future improvements.

However, 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 data in the model. This could result in a reduction of around 1-2% of liabilities under IAS19.

How appropriate are your mortality assumptions?

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.

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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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