BARNETT WADDINGHAM
beyond the expected

Briefing | 30 September 2020

Current issues in pensions financial reporting

RISK | **PENSIONS** | INVESTMENT | INSURANCE

This note is for those who will be 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 2020.

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.

Accounting positions stabilise, but higher deficits projected for the year-end

Since 30 September last year most schemes have likely seen a deterioration in their IAS19 funding level, although well hedged mature schemes with limited exposure to UK equities were not impacted heavily. However, over the last quarter funding levels are likely to be broadly unchanged.

Last quarter we reported that corporate bond yields of all types have fallen significantly, which lead to an increase in accounting liabilities under IAS19. Since the last quarter-end corporate bond yields have risen slightly, leading to a modest reduction in liabilities.

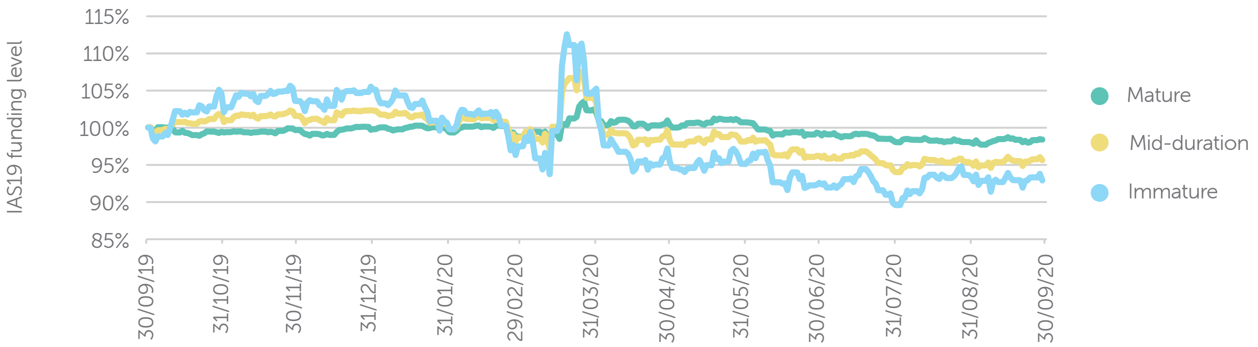
The majority of schemes will have asset strategies based around government bond holdings and other "growth" assets such as equities.

Over the last quarter government bond holdings have fallen in value slightly, whilst equity returns have varied depending on location. The net effect on the balance sheet position of movements in assets and liabilities will have been fairly modest for most schemes.

For those entities currently looking ahead to 31 December 2020 year-ends, the picture is mixed. Schemes which have hedged large proportions of their interest rate risk will not have seen much change in the position, but immature schemes with material exposure to falling yields are looking at significant reductions in funding level and higher IAS19 deficits.

PROGRESSION OF IAS19 FUNDING LEVEL FOR TYPICAL SCHEMES

Source: Barnett Waddingham model



For those companies with 31 March 2020 reporting interims at 30 September 2020, mature schemes may not have seen much change to their position, but schemes with a longer duration may be approximately 10% worse off in terms of funding level.

Impact of Covid-19 on pension scheme demographics

Last quarter we reported Covid-19 might have led to somewhere in the region of 60,000 more deaths in the UK than would have been expected at the start of the year. Assuming that there are no material excess deaths over the remainder of 2020 (as was the case over Q3 of 2020), this would equate to approximately 10% more deaths than expected. Whilst this is an unprecedented number in recent times, it is unlikely to mean a significant reduction in pension scheme liabilities. For example, if the pension scheme mortality assumption implies that 2% of the membership was expected to die over 2020, the impact of the pandemic means that 2.2% of the membership actually die over the year. This would lead to liabilities being reduced by only 0.2%, which is 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 in due course. As well as this, experience analyses and models for future improvements will need to consider whether the experience in 2020 is a one-off, and if the pandemic will influence future mortality in other ways. For example, the pressure on health services may mean that 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 that we might expect remaining members to live slightly longer.

Proposed changes from RPI to CPIH in 2030

The Government has proposed changing the Retail Price Index (RPI) inflation statistic to bring RPI in line with the "CPIH" index. If the changes set out in the consultation published on 11 March 2020 are adopted, this would significantly reduce the value of long-dated index-linked gilts, unless compensation is given to holders. RPI-linked pension liabilities would also fall in value, but CPI-linked pension liabilities would likely be largely unaffected. The government's response to the consultation is expected in the Autumn, although it had not been published at time of writing.

CPIH became the UK's primary inflation measure in 2017 and essentially takes Consumer Price Index (CPI) and adds a measure of owner occupied housing.

It was been proposed that, from 2030, index-linked gilt payments will implicitly be linked to CPIH due to the change of the makeup of the RPI statistic. If RPI is aligned with CPIH then RPI would be expected to be lower in future and, all else being equal, the value of index-linked gilts would fall and real yields would likely rise.

Following the initial news of the proposal in September 2019 appeared to be a c. 0.3% pa fall in the market's expectations, as measured by the difference in prices between fixed and index-linked gilts, for post 2030 RPI (this is the total combined fall on 4 September 2019 following the announcement, and on 17 January 2019 following the original House of Lords report on RPI that has led to this issue). There may have been a small further impact on publication of the consultation, but not more than 0.1% pa., although it is difficult to identify whether the change is priced in to a greater extent than this. The expected difference between RPI and CPIH over the long-term is around 1% pa so the market does not appear to be allowing for the full impact of the potential change at present.

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 and we comment further on this below.

Changes to IAS19

As noted in our previous update, for reporting periods beginning on or after 1 January 2019, there is a change to the requirements of IAS19 where either a plan amendment, curtailment or settlement event has occurred during the period.

The key change is that the current service cost and net interest cost will need to be recalculated for the remainder of the accounting period based on the re-measured position following a special event. This creates the possibility that relatively modest augmentations that are accounted for as a plan amendment will have a more significant effect on the P&L charge if, for example, the deficit has increased significantly since the previous year-end.

It is possible that audit firms will require a strict interpretation of whether the impact of this is "material", e.g. they may require companies to make these adjustments if the impact of the event and the recalculation of the other P&L items would have a material impact (rather than just the event itself being material). However, it may be possible for a more pragmatic approach to be taken and this is something that will be worth raising with auditors in the early stages, if this hasn't been done already.

In cases where these events happen on a regular basis, it may also be possible to agree trigger levels, meaning that more minor events can be ignored for this purpose.

On the Horizon

IAS 19 disclosure requirements

The IASB is planning to release a consultation and an exposure draft on proposed changes to the disclosure requirements under IAS19 in the first half of 2021. We will provide further updates in due course on how this may impact disclosures made by entities. It is not yet clear when any changes will come into force, but this is unlikely to be until 2023 at the earliest.

GMP equalisation

A further judgement on the long running issue of whether there is a requirement to equalise benefit inequalities due to Guaranteed Minimum Pensions (GMP). A previous judgement on 26 October 2018 clarified there was a requirement to do so, but it did not deal with whether the requirement extends to historic transfer value payments. A judgement on this is possible later this year. If this happens, entities will need to consider the accounting treatment for any additional liabilities.

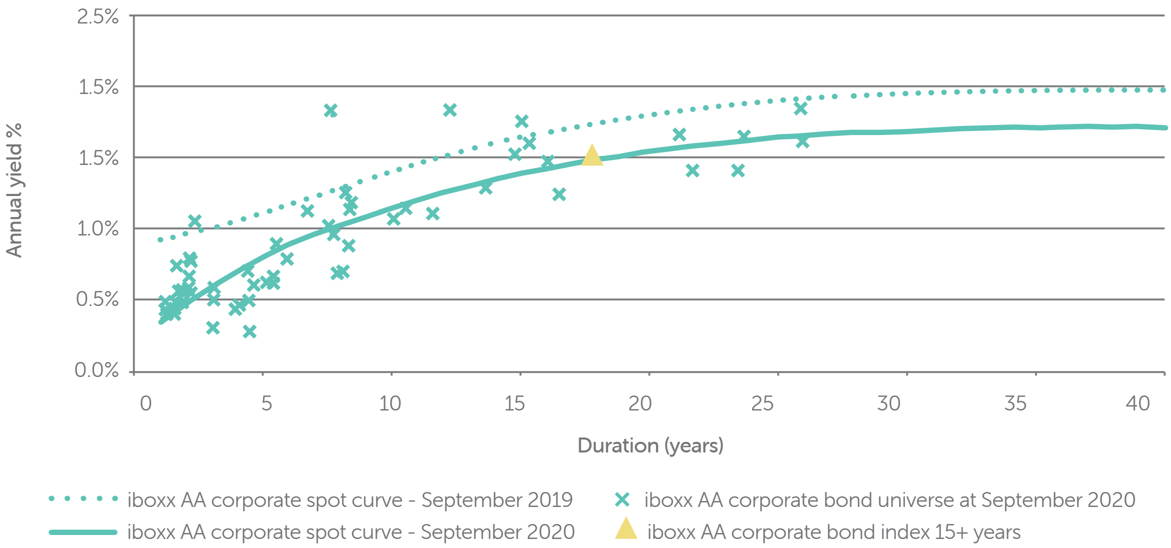
Discount rate

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.

Figure 1 shows the individual yields on the bonds making up the iBoxx AA Corporate Bond universe as at 30 September 2020.

FIGURE 1: IBOXX AA CORPORATE BOND UNIVERSE AT 30 SEPTEMBER 2020

Data Source: iBoxx



As can be seen in Figure 1, yields on corporate bond increase by term, and 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 prefer a cashflow 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 cashflows for a range of durations:

Approximate duration (years)	30 September 2020	30 June 2020	30 September 2019
10	1.35% pa	1.35% pa	1.60% pa
15	1.50% pa	1.45% pa	1.75% pa
20	1.55% pa	1.50% pa	1.85% pa
25	1.60% pa	1.50% pa	1.90% pa

At the end of Q3 2020, single equivalent discount rates on AA corporate bonds were slightly higher in contrast to last quarter and but lower than 30 September 2019. The table above shows that corporate bond yields have fallen by 0.2-0.3% p.a. since 30 September 2019, which will result in lower discount rates being adopted for accounting purposes compared to last year. This will result in a higher 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 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 and how this is extended to durations beyond the longest AA rated bond.

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% p.a. to the rate implied by the standard AA rated corporate bond data set is likely to be appropriate, which is similar to last quarter.

Inflation

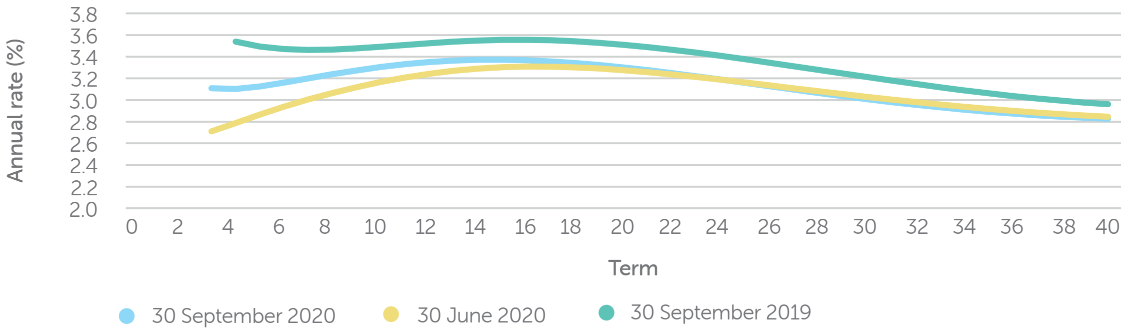
Retail Prices Index (RPI)

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 (BoE'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, and so 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 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.

FIGURE 2: SPOT INFLATION CURVES (ANNUALISED)

Data Source: Bank of England



As shown in figure 2, inflation expectations have fallen at all terms since last year, although are up over the quarter at the shorter terms.

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 2020	30 June 2020	30 September 2019
10	3.25% pa	3.15% pa	3.45% pa
15	3.15% pa	3.10% pa	3.35% pa
20	3.10% pa	3.05% pa	3.25% pa
25	3.00% pa	3.00% pa	3.15% 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 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).

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% 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 typically used, although recently many entities have adopted lower gaps to reflect the market's reaction to the proposed changes to the RPI.

Implications of the proposed changes to RPI

The proposed consultation mentioned above has implications for both the derivation of market-implied RPI and for the assumed gap between RPI and CPI.

As noted above, the market does not appear to be allowing for the full impact of the potential change to RPI at present. There may therefore be scope to make adjustments to market-implied RPI inflation post 2030, i.e. to allow for an additional deduction on top of what may already be priced in to the market rates.

This could mean a lower RPI inflation assumptions could be justified using the single-equivalent approach; the impact of this will depend on what level of deduction is made and the term of a scheme's liabilities, but could be up to 40 basis points in certain circumstances.

We expect that schemes adopting this approach will need to justify this to their auditors, and the change may also trigger additional reporting requirements in certain circumstances.

Separately, making such an adjustment would also impact on the CPI inflation assumption. CPI-linked benefits will not be affected by any changes, and therefore the gap between RPI and CPI inflation will need to be adjusted such that CPI inflation is unaffected. Even if no adjustment is made for the proposed changes, there could be an argument that the current gap should be revisited in light of the allowance that already appears to have been made for the proposed changes in market-implied RPI. Companies previously using a gap of 1% or above may now find this harder to justify going forward.

Impact of Pensions on UK Business

During 2020, we published a series of reports discussing the impact that pension provision is having on UK businesses, in particular looking at the sectoral differences in economic performance over recent months, as well as taking a look at how the economic turmoil of Covid-19 has impacted the path to the DB scheme endgame.

The full reports are available on our website.

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, and 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 sometimes 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 have released the new S3 series of tables during the year, as well as the CMI_2019 mortality improvements model.

S3 tables

The S3 tables are based on a much larger dataset than the previous S2 tables, though the make-up 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. As such, many companies may wait until the next triennial valuation takes place to update the mortality tables, where a more comprehensive review of the scheme's mortality experience may be carried out. However, others may want to pursue this sooner rather than later.

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 bottom of this note.

CMI_2019 model

The 2019 version of the model reflects death data collected during 2019. This data bucked the recent trend of falling mortality improvements. In general moving to the CMI 2019 model would be expected to result in a slight increase in liabilities compared to CMI 2018, although this would still be below that produced using the 2017 version.

There are no changes to any of the methodology in the model compared to the 2018 version. The CMI have published a further paper around the initial addition to mortality improvements parameter, which will assist users in setting mortality assumptions.

Companies may be required to justify their choice of the initial addition parameter, even if the core value of nil is used.

CMI_2020 model

CMI_2020 model is currently under consultation and one of the proposal is to introduce of a new "weight" parameter that can be used to vary the significance placed on data for 2020. The proposal addresses the abnormality in 2020 data caused by the pandemic. The 2020 model without the adjusted parameter could reduce the life expectancies by up to 9% and therefore result in a decrease in the overall schemes liability, which would not be realistic unless a view is taken that the excess mortality from the pandemic is likely to be a recurring event.

The CMI_2020 model is expected to include the 2020 data, which accounts for the impact Covid - 19 has on the population, but will only place a low (or even no) weight on experience for that year. The overall impact of the liability changing from CMI_2019 to CMI_2020 is likely to be very small if a low weighting for 2020 data is used. The consultation closes on the 1 November 2020, and the confirmation for CMI's plans on the model should be announced by the end of next quarter.

Independent review of accounting disclosures

The pension disclosures set out in a company's accounts need to be accepted by its auditors. We can support audit firms without the benefit of a specialist pension team to understand the assumptions and disclosures prepared by companies that they audit. The required scope of such a review varies and will provide auditors with the level of comfort they require to sign off the accounts.

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.

Illuminate - Instant scenario testing

Pension schemes can have a significant impact on a company's accounting position. We have added an interactive modelling tool Illuminate, to help finance directors understand and quantify the factors influencing the financial position of the scheme so that they can be linked into the company's own internal plans for its core business.

The tool allows an instant assessment of the sensitivity of the accounting results to the year-end assumptions so that the finance director can make a fully informed decision on the optimal approach. We can also benchmark your assumptions against those used by FTSE350 companies, including splitting by auditor if this would be useful.

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

There have been several recent and forthcoming changes to the pensions requirements under UK and International Accounting Standards. Our specialist consultants at Barnett Waddingham have extensive experience of advising on the assumptions and preparing the pensions disclosures for inclusion in company accounts under the different accounting standards (e.g. FRS102, FRS101, IAS19 and ASC715) as well as supporting audit firms without the benefit of a specialist pension team to understand the assumptions and disclosures prepared by companies that they audit.

Our specialist consultants can provide interactive workshops focussing on accounting for DB pension arrangements. We will provide background on the theory behind the main pension accounting standards – FRS102, FRS101, IAS19 and ASC715 – and will explore some of the current market factors influencing the disclosures and how these have changed over the last year or so.

For more information please email employers@barnett-waddingham.co.uk.

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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