30 June 2022

Current Issues in Pensions Financial Reporting

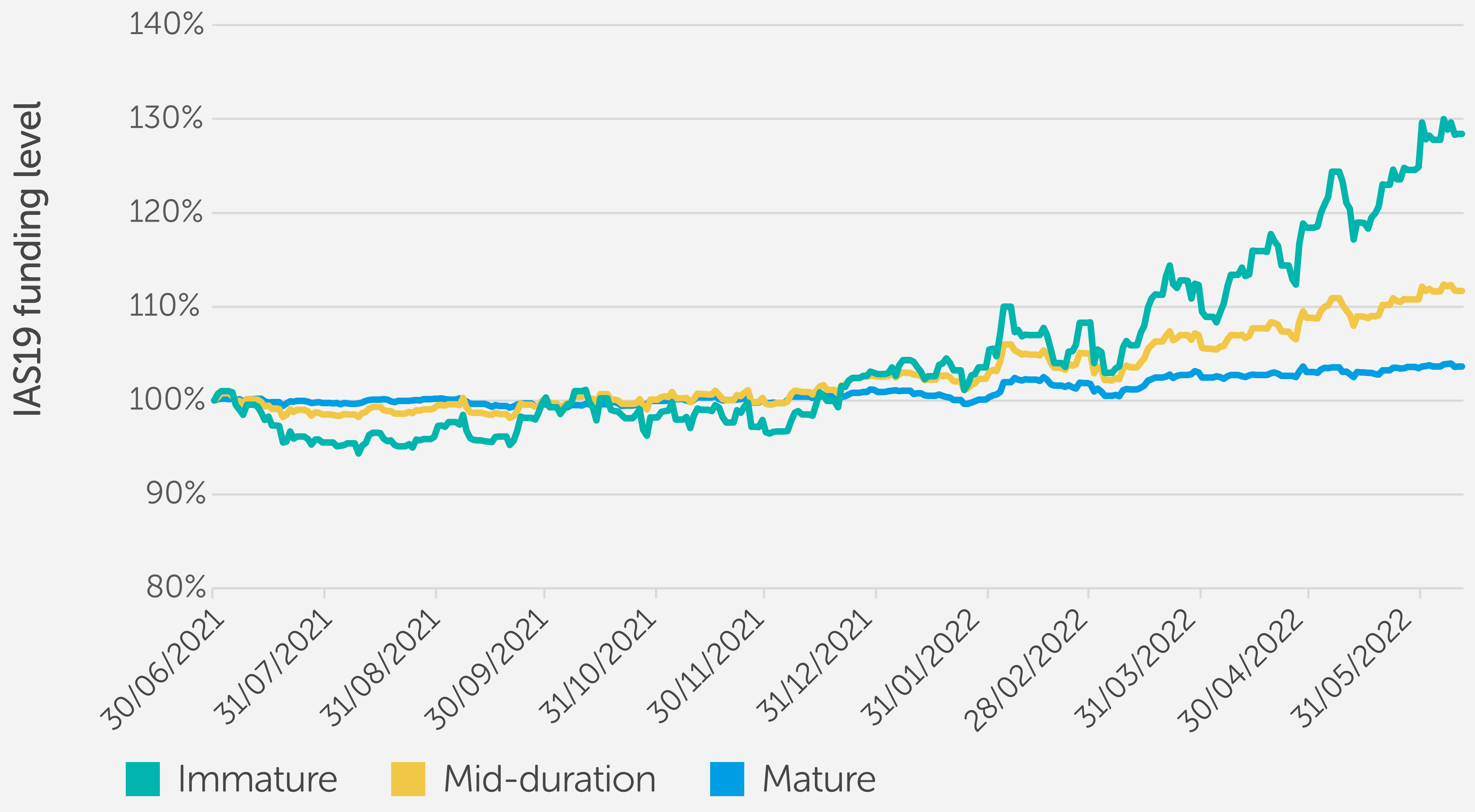
This note is for those involved in preparing and auditing pension disclosures under Accounting Standards FRS102 (UK non-listed), IAS19 (EU listed) and ASC715 (US listed) as at 30 June 2022. We look at the current topical issues as well as the considerations for company directors when setting assumptions, and for auditors in determining whether the assumptions are appropriate.

IAS19 positions improve as yields rise

Since 30 June 2022, most schemes have likely seen an increase in their IAS19 funding level, with immature schemes and those with lower levels of interest rate hedging having fared particularly well.

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, to reduce the value of these holdings. This fall in value will offset some of the reduction in liabilities, as will the falls in the value of growth assets, but the net position is still likely to have improved for almost all schemes.

Figure 1: Progression of IAS19 funding level for typical schemes at 30 June 2022



Source: Barnett Waddingham model

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 been starting from a lower funding level). Long term market expectations have now returned to similar level to a year ago, having spiked around the turn of the year, although higher short-term inflation will have increased liabilities for schemes with inflation-linked benefits.

The market movements noted above have mostly occurred over the six months to 30 June 2022, so companies with 31 December year ends currently preparing interim statements will have seen similar improvements since 31 December 2021.

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 to 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

The Continuous Mortality Investigation (CMI) has estimated that there have been approximately 120,000 more 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 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 2021 are one-offs - it is worth noting that mortality rates in Q2 2022 appear to have returned to broadly pre-pandemic levels.

The pandemic may also 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 we might expect remaining members to live slightly longer.

The CMI published the CMI_2021 mortality improvement model in March this year. 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 could be considered reasonable.

On the horizon

IAS 19 disclosure requirements

The International Accounting Standards Board (IASB) released an exposure draft on 25 March 2021 which consults on amending the IAS19 accounting disclosure requirements. The consultation ran up until 12 January 2022, with the IASB due to provide feedback in September 2022. The papers published for the next meeting of the IASB in July 2022 indicate a decision will be required as to whether to move forward towards finalising the new requirements, or not to proceed and retain the current approach with no changes to the standard. Given the timescales, it appears that any changes would now be unlikely to be in-force before 2024, if not later.

In releasing this draft, the Board have stated that they are trying to address three main concerns regarding the information disclosed in financial statements: there is not enough relevant information; there is too much irrelevant information; and the information that is provided is communicated ineffectively.

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

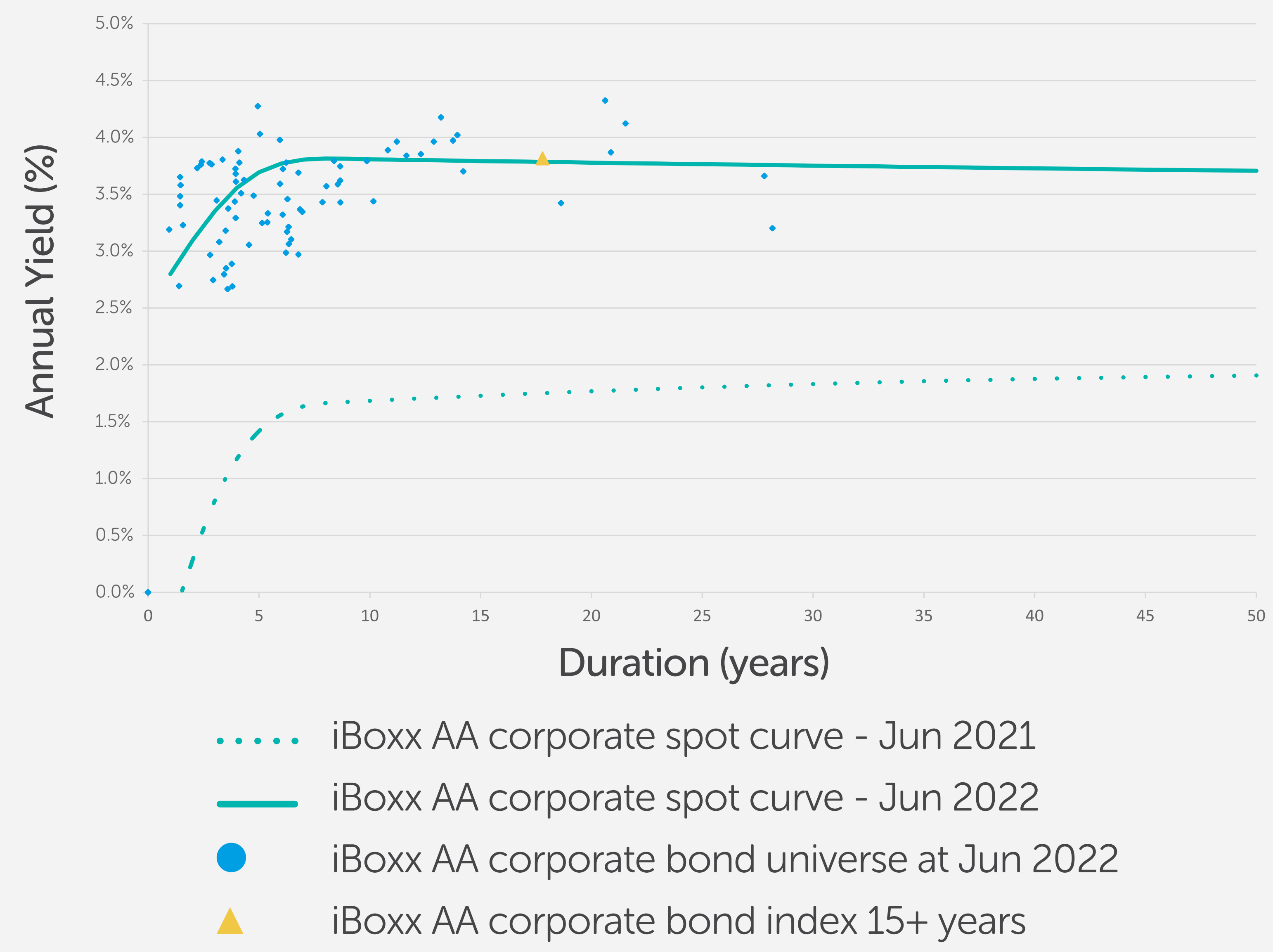
The Accounting Standards require the discount rate to be based on yields on high quality (usually AA-rated) corporate bonds of appropriate currency, taking into account the term of the relevant pension scheme's liabilities.

Figure 2 shows the individual yields on the bonds making up the iBoxx AA Corporate Bond universe as at 30 June 2022. The yields on corporate bonds increase with term initially but then plateau as term increases. 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.

Approximate duration (years)	30 June 2022	31 March 2022	30 June 2021
10	3.70% pa	2.65% pa	1.65% pa
15	3.70% pa	2.65% pa	1.75% pa
20	3.70% pa	2.65% pa	1.80% pa
25	3.70% pa	2.65% pa	1.80% pa

Figure 2: iBoxx AA Corporate bond universe at 30 June 2022



Source: Markit iBoxx

The table opposite shows single equivalent discount rates (SEDR) using the iBoxx AA-rated corporate bond curve based on sample cashflows for a range of durations.

At the end of Q2 2022, single equivalent discount rates on AA corporate bonds were higher in contrast to both the previous quarter at 31 March 2022 and to the previous year as at 31 June 2021. The table above shows that discount rates derived from the iBoxx curve have increased since 31 June 2021 by approximately 2.10% pa for low duration corporate bonds, and by 2.00% pa for high duration bonds. 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, the method used to construct the curve and how it 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

Changes from RPI to CPIH in 2030

On 25 November 2020 the Government published its response to the Retail Price Index (RPI) reform consultation. It is now widely expected that the change to the RPI inflation statistic, to bring it in line with the "Consumer Prices Index with Housing (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 Consumer Prices Index (CPI) - linked pension liabilities will likely be largely unaffected.

CPIH became the UK's primary inflation measure in 2017 and essentially takes the 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 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.

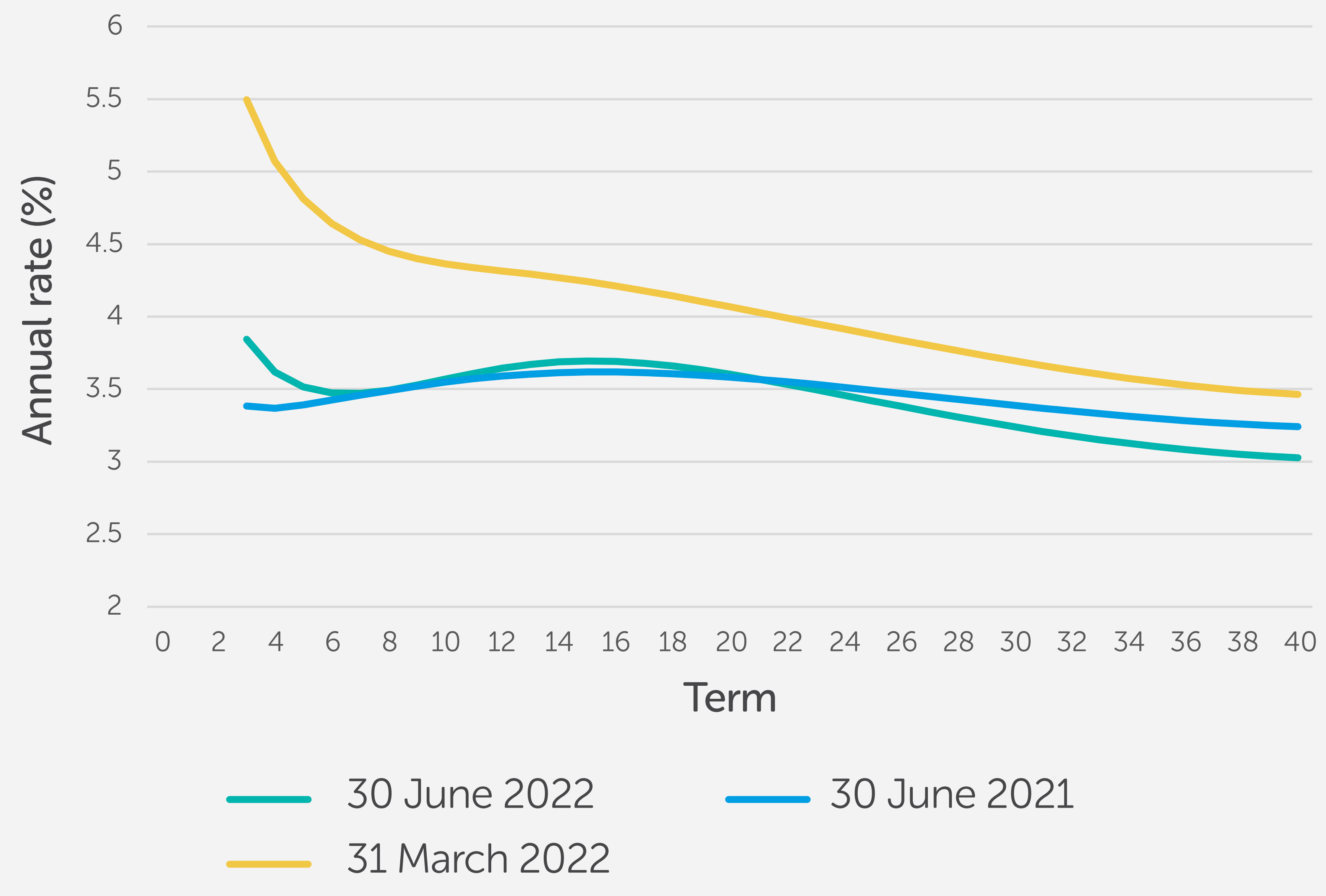
A judicial review into the reform of RPI instigated by a number of large pension funds began in June 2022. If this is successful it could mean the changes will either need to be reconsidered (although may still go ahead) or reversed, or compensation could be required for holders of RPI index linked gilts 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 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. 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

Figure 3: Spot inflation curves (annualised)



Source: Bank of England

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, 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 lower than last quarter and back to similar levels to 30 June 2021. This will lead to lower liabilities compared to the last quarter end 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 cashflows for a range of durations, before any deduction for an inflation risk premium:

Approximate duration (years)	30 June 2022	31 March 2022	30 June 2021
10	3.55% pa	4.20% pa	3.50% pa
15	3.40% pa	4.00% pa	3.45% pa
20	3.30% pa	3.85% pa	3.40% pa
25	3.25% pa	3.70% pa	3.35% 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
- Differences between the compositions of the two indices (i.e. the goods that are included in them).

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 30 June 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 reaching as high as 11.7% and 7.9% respectfully in May 2022. As a result, recent increases in pension 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 taken into account – 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. 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

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.

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_2021 model

The CMI_2021 model was released on 9 March 2022. The model includes 2020 and 2021 data, which accounts for the impact Covid-19 had on England's and Wales's population. As with the CMI_2020 model, "weight" parameters can be used to vary the weight placed on data for 2020 and 2021; the core parameters will be 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 impact of the liability 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. 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 2021 data in the model. This could result in a reduction of around 1-2% of liabilities under IAS19.

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 back on course
- Independent review of accounting disclosures
- Training for those involved in Pensions Financial Reporting - FRS102, FRS101, IAS19 and ASC715

BARNETT WADDINGHAM
beyond the expected

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:

employers@barnett-waddingham.co.uk

0333 11 11 222

www.barnett-waddingham.co.uk