Pensions Accounting Update

As at 30 June 2023

SPENCE

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Overview

This guide is intended to be a useful reference for companies preparing their 30 June 2023 pensions accounting disclosures, whether under FRS 102 or IAS 19.

In this guide, we will review the changes in the investment markets over the last 12 months and consider the impact these will have had on a typical pension scheme. We will also review recent developments related to pensions accounting, highlighting issues that you should be aware of.

Executive Summary

Corporate bond yields have increased by around 1.32% over the year to 30 June 2023. As accounting discount rates are directly related to corporate bond yields, employers can expect higher bond yields to have a positive effect on pension scheme liabilities (i.e. a reduction in liabilities), all else being equal.

Over the year, expectations of short- and long- term inflation have decreased, with inflation over the medium term increasing. Whether or not Scheme's see an improvement in funding over the year as a result of changing inflation is therefore dependant on the average term of their liabilities, however we would expect that most Scheme's would see a slight improvement.

Over the year, equities generally performed well, with the exception of Pacific ex Japan and Emerging Market equities which both showed negative returns. Bonds continued to produce negative returns, with the return on UK Long-Dated Gilts reaching -24.9% over the quarter.

As there have been offsetting impacts over the last year, each individual scheme will experience different effects on their funding level, depending on the scheme benefits and investment strategy.

How might this affect a typical pension scheme?

Chart 1 below, captured from Mantle, Spence's award-winning integrated administration and actuarial system, illustrates the effect of market movements over the past 12 months on the balance sheet position of an example pension scheme "EPS" on an accounting basis.

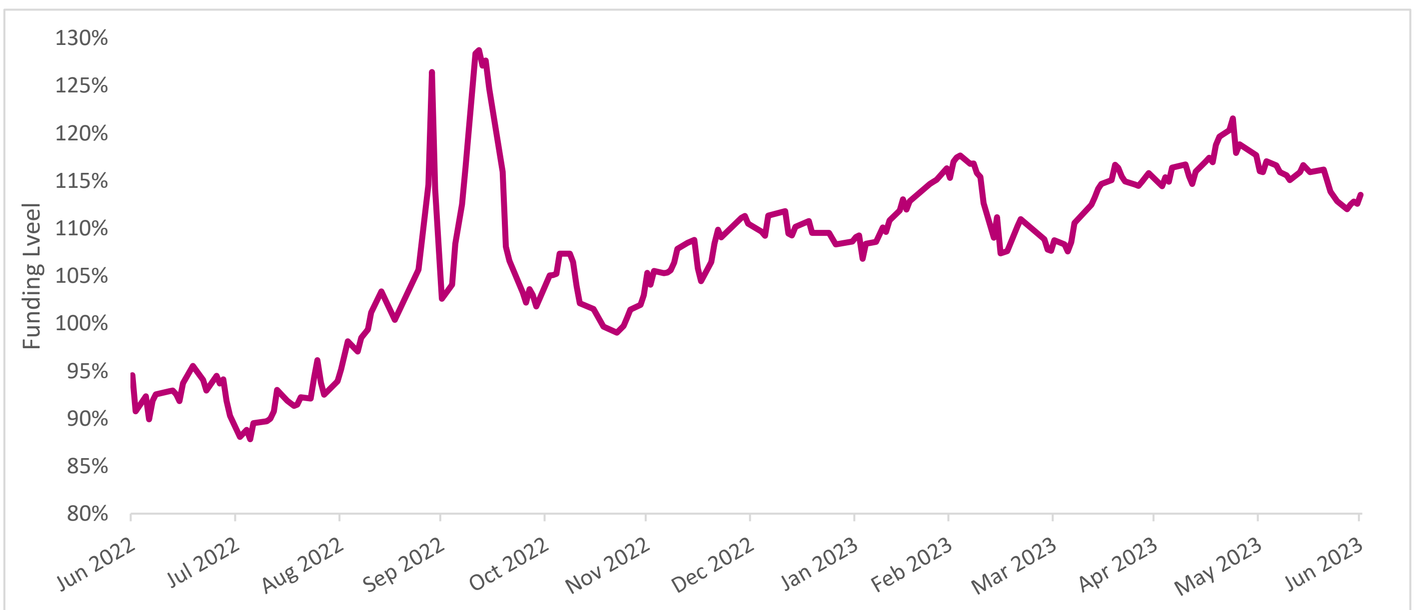

Chart 1 - Daily Movements in EPS funding level

At the beginning of the year EPS's funding level improved steadily as interest rates increased. The funding level over September and October was particularly volatile, due to rapid changes in bond yields following the ex-Chancellor's mini budget. Market conditions stabilised again at the end of October and the general trend of improvement in funding position over time continued until February. In February and March, EPS saw a small rise and fall in the funding level following volatility in equity markets. In April, the general trend of improvement in funding position continued in line with further increases to interest rates. However in May, the funding level experienced a small fall which stabilised at the beginning of June.

EPS holds no Liability Driven Investment and has limited interest rate hedging through corporate bond holdings. It also has dampened equity exposure via a Diversified Growth Fund

Market Summary

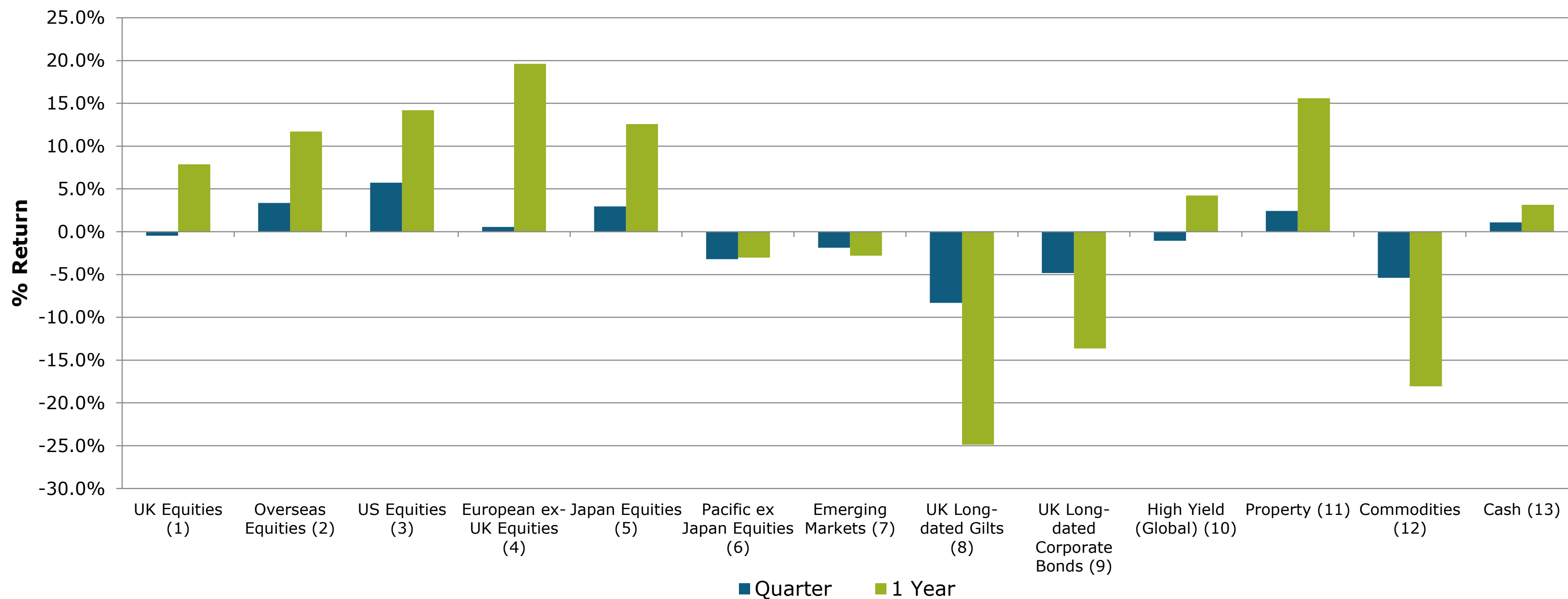

Chart 2 - Return on Major Asset Classes Source: Morningstar
Benchmarks:

1. *FTSE All-Share TR Index*
2. *FTSE UK All World TR GBP*
3. *FTSE USA TR Index GBP*
4. *FTSE AW Europe ex UK TR Index GBP*
5. *FTSE Japan Index TR GBP*
6. *FTSE AW AP Ex Japan TR Index GBP*
7. *MSCI Emerging Markets NR GBP*
8. *UK FTSE Actuaries Over 15 Years Gilt Price Index*
9. *Markit iBoxx £ Non-Gilts Over 15 Year Index*
10. *Bank of America Merrill Lynch Global High Yield & EM TR GBP*
11. *IS UK Property GBP*
12. *S&P GCSI Commodity TR Index GBP*
13. *SONIA TR GBP*

Market Movements in Detail

The key financial assumptions affecting a scheme's balance sheet position are the discount rate and the future rate of inflation.

Discount Rate

FRS 102 and IAS 19 require the discount rate to be based on yields of high quality (usually taken to mean 'AA-rated') corporate bonds, taking into account the term of the relevant pension scheme's liabilities.

The precise discount rate chosen will depend on a number of factors, including the duration of the scheme liabilities. For illustrative purposes, we show below how the yield has varied over the past 12 months on a suitable long-dated corporate bond index, the iBoxx over 15-year AA rated corporate bond index.

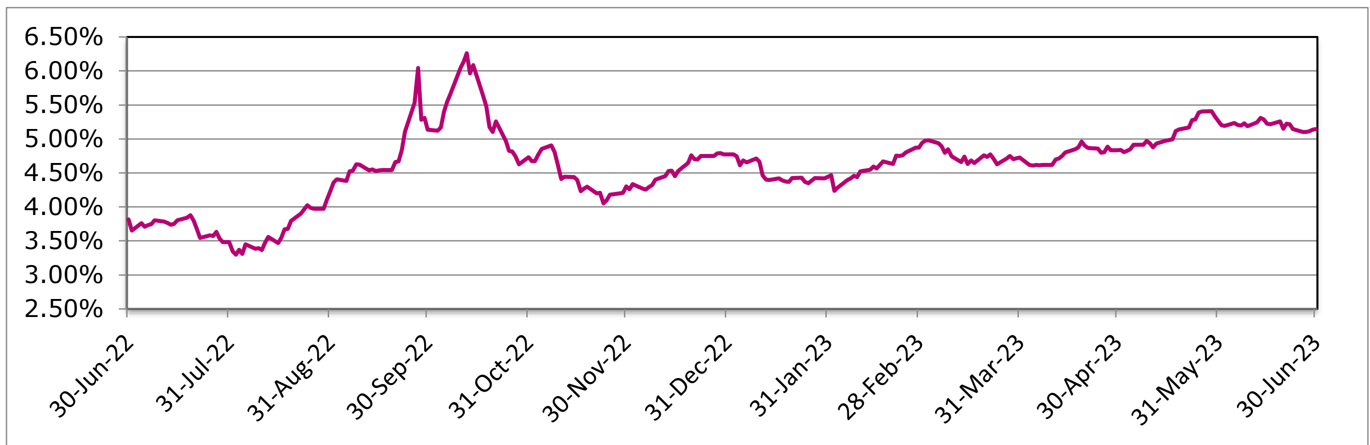

Chart 3 - Yield on iBoxx over 15-year AA rated Corporate Bond Index

We can see that yields have increased over the last year predominantly as a result of the Bank of England (BoE) further increasing base rates. The volatility in the market in September is also reflected in yields. Following the instability, a small decrease in the yields were seen in November. By December the yields had begun to increase again, a trend which has continued into May. The overall result of an increase in the yield will result in a higher discount rate and lower liabilities, all other things being equal.

The duration of the iBoxx over 15-year AA rated corporate bond index has decreased over the year from around 17 years as at 30 June 2022, to around 15 years as at 30 June 2023. As a result, schemes with durations greater than 15 will have more scope to make positive adjustments to the discount rate to reflect longer durations.

Inflation

The inflation assumption is important as this is generally used to determine future benefit increases, both before and after retirement. Again, there are a range of appropriate values that this assumption can take depending on each scheme's circumstances. Chart 4 shows the Bank of England implied future inflation curve.

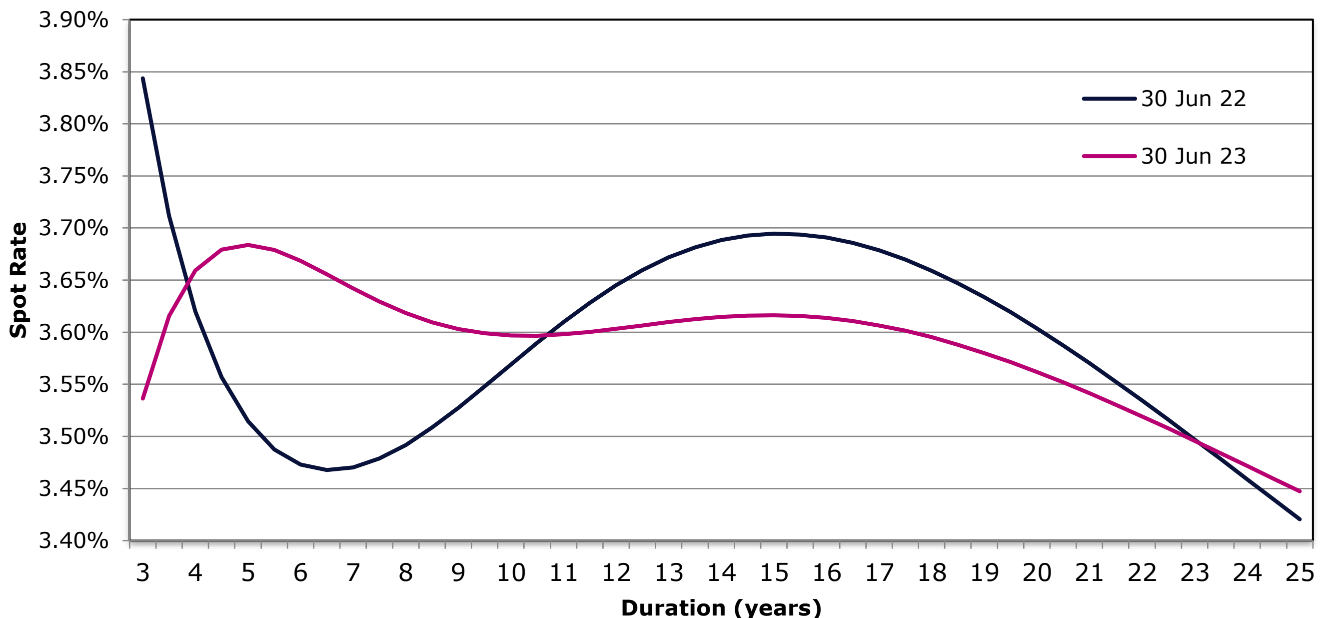

Chart 4 – BoE implied inflation spot curve

Inflation expectations have changed over the year. The short-term expectations of inflation have decreased along with longer term expectations of inflation also decreasing. Medium term inflation however has increased over the period. This is a result of further increases in the BoE base rate and also, in part, is reflective of the impact of energy price caps.

There may be other considerations to take into account when determining inflation assumptions, such as whether to adjust for a possible inflation risk premium ("IRP") that may be implicit in the Bank of England's implied inflation rates. This adjustment is typically used to reflect the supply and demand dynamics of inflation linked gilts, and adjustments in the region of 0.30% p.a. are typically seen within accounting assumptions.

Consideration should also be given to the fact that RPI will be moving into line with CPIH from 2030. Historically, the difference between RPI and CPI has typically ranged from 0.70% p.a. to 1.10% p.a. In November 2020, the UK Government published the outcome of its consultation on the intention to align RPI with CPIH, a variant of CPI that includes an estimate of housing costs. As CPIH is currently lower than RPI, RPI is expected to be lower from 2030 and it may be appropriate to adjust the RPI assumption to reflect this.

We are seeing a staged approach in many cases where a fixed gap is applied until 2030 (for example 1.00% p.a.), and then a smaller gap is adopted from 2030 onwards. The gap from 2030 may also reflect the differences between CPIH and CPI. For simplicity, this assumption is sometimes converted into a single gap at all terms, that will produce liabilities that are broadly equivalent to using a different gap pre and post 2030. The size of this single adjustment will typically be larger for schemes with short durations (who are more exposed to 'pre 2030' rates) and smaller for schemes with long durations. The nature of the benefits provided by the particular scheme also plays an important role here.

Market Effect on 'EPS' Liabilities

The main factors behind the movement in EPS liabilities over the 12-month period to 30 June 2023 are set out below.

Table 1 - Breakdown of Market Effect on EPS Liabilities

EPS Assumption	Effect of Market Movements	Change in Liabilities [1]
Discount Rate	+ 1.33% p.a.	- 17.36%
Inflation Assumption(s)	- 0.08% p.a.	- 0.53% [2]
TOTAL [3]		**-17.89%**

1. Assumes EPS liabilities have average duration of 15 years. Most Schemes will have seen a reduction to their duration over the year as a result of large increases to gilt yields. No allowance for cashflows has been made.
2. Assumes the effect on liabilities of the change in inflation is 50% of the effect of the equivalent discount rate change.
3. Note the approximate nature of this calculation. The above illustrates the approximate effect of changes to these assumptions only.

The balance sheet impact will depend on the asset classes held and the performance of the scheme investments.

Recent Developments

Market Conditions

On 23rd September 2022, the ex-Chancellor released his mini budget. The Government's plans required a large increase in borrowing. This borrowing along with reduced market confidence led to a fall in the value of government bonds and a rise in yields.

As a result, liability-driven investment (LDI) markets have seen an increase in pressure. To maintain hedging levels within these funds cash was urgently needed. On 28th September, the bank of England stepped in with a £65bn bailout to prevent additional price falls and stabilise the market. This gave time to raise cash to meet these collateral needs.

The Bank of England has increased the base rate substantially over the past year and continued to do so over the quarter by increasing the base rate from 4.5% p.a. to 5.0% p.a. in June 2023. Overall, rates have increased by 3.75% since June 2022, with further rises expected by the end of the year.

CMI Model updates

The Continuous Mortality Investigation (CMI) has recently released an annual update to their Mortality Projections Model, "CMI 2022". The CMI model is used by UK pension schemes when making assumptions about future mortality rates.

2020 and 2021 saw significantly higher mortality due to the coronavirus pandemic, 14% higher than mortality in 2019. In 2022, England & Wales standardised mortality rates show a decrease, with mortality rates being 3% lower than in 2021. Although the 2020 and 2021 mortality rates will have an impact on actuarial calculations, it is unlikely to be indicative of future mortality and as such, the CMI 2022 model places no weight on the data from these years.

Mortality in 2022 has been less volatile, evident in the 3% decrease, albeit still higher than pre-pandemic levels. With this in mind, a consultation with CMI model users resulted in the CMI 2022 model placing a weight of 25% on 2022 data and 0% of 2020 and 2021 data.

Overall, the CMI 2022 model has lower mortality improvements than the 2021 model at most ages, decreasing life expectancies by around 5-6 months. In isolation, this translates to an approximate decrease of between 1% and 3% in liabilities for an average scheme.

Ongoing Russia/Ukraine Conflict

The ongoing Russia/Ukraine conflict has caused significant uncertainty for pension schemes and their sponsors over the past year, and the future consequences are still unclear. In addition to an increasingly challenging trading environment for many employers, the economic volatility arising from the conflict is likely to have a material impact on many pension schemes due to:

- Falls in the valuations of many asset classes due to a decline in the equity and credit markets
- Rising inflation expectations, which will place a higher value on pension scheme liabilities

The precise impact on a given scheme will depend on their individual circumstances, in particular their investment strategy and level of hedging. As mentioned previously in this note, increasing corporate bond yields are likely to reduce accounting liabilities which for many schemes will offset the negative impacts above for accounting disclosures. There is the scope for significant volatility to remain as the conflict endures, and pension schemes will need to continue to weather the storm of uncertainty.

Consultation on Changes to FRS 102

In December the Financial Reporting Council issued FRED 82 which proposes a number of changes to FRS 102 and other accounting standards following the second review of the standards. These updates include small clarifications and improvements as well as a new model for revenue recognition in FRS 102 and 105 and a new model for lease accounting in FRS 102. The proposed effective date of the amendments set out in the FRED is 1 January 2025. Comments on the suggested changes are requested by 30 April 2023.

In March 2023 the FRC published their 3-Year plan, within which they emphasised that one of their priorities for this year is completion of the periodic review of FRS 102.

Consultation on Changes to IAS 19

In March 2023, IASB published a review of IAS 19 disclosure standards. This review proposed no changes would be made.

ARGA

The government has announced plans to replace the FRC with ARGA (Audit, Reporting and Governance Authority), a new statutory regulator. At the end of July, the Financial Reporting council launched a consultation on its draft proposals on how the new regulator should be funded. ARGA will be funded through a mandatory levy on industry. Their new powers will include directing companies to restate their accounts without going to court.

Within their 3-Year plan the FRC confirmed that the expect date of transition from the FRC to ARGA has been pushed back from 2023 to 2024. There is still some uncertainty regarding when the ARGA Bill will receive time in Parliament.

Next Steps

With the wealth of corporate advisory experience available at Spence, we are well placed to provide you with guidance on how to best manage your pension scheme liabilities.

The implications of the recent developments should be considered to help you avoid any surprises. Spence can help guide companies through these complexities. We have a proven track record in navigating to the best outcomes for our clients.

We would be happy to discuss the options available to you in reaction to the market trends discussed above, including how to:

- Lock in asset gains.
- Decrease future risk.
- Reduce funding level volatility.

To discuss these topics further, please contact Spence through your usual contact or connect with our Corporate Advisory practice associate, Rachel Graham, at rachel_graham@spenceandpartners.co.uk or by telephone on 028 9041 2006.

NOTES

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