

Pensions Accounting Update

As at 31 December 2023

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Overview

This guide is intended to be a useful reference for companies preparing their 31 December 2023 pension 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 decreased by around 0.27% over the year to 31 December 2023. As accounting discount rates are directly related to corporate bond yields, employers can expect lower bond yields to have a negative effect on pension scheme liabilities (i.e. an increase in liabilities), all else being equal.

Over the year, expectations of future inflation have decreased for durations over 12 years. Decreases in inflation will reduce inflation-linked liabilities, all other things being equal.

Equities generally performed well over the year, with most markets again posting returns in excess of 10% p.a. Bonds performed well over the year after a strong performance in the final quarter of 2023 making up for poor returns earlier in the year. The return on UK Long-Dated Gilts rose to 1.7% p.a. from -12.8% p.a., and the return on UK Long-Dated Corporate Bonds rose to 10.6% p.a. from 2.8% p.a. Property also performed well over the year due to improvements over the quarter, reflecting rising house prices with a 7.1% p.a. return. Commodities, however, experienced poor performance over the quarter leading to a negative return over the year of -9.7% p.a.

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.

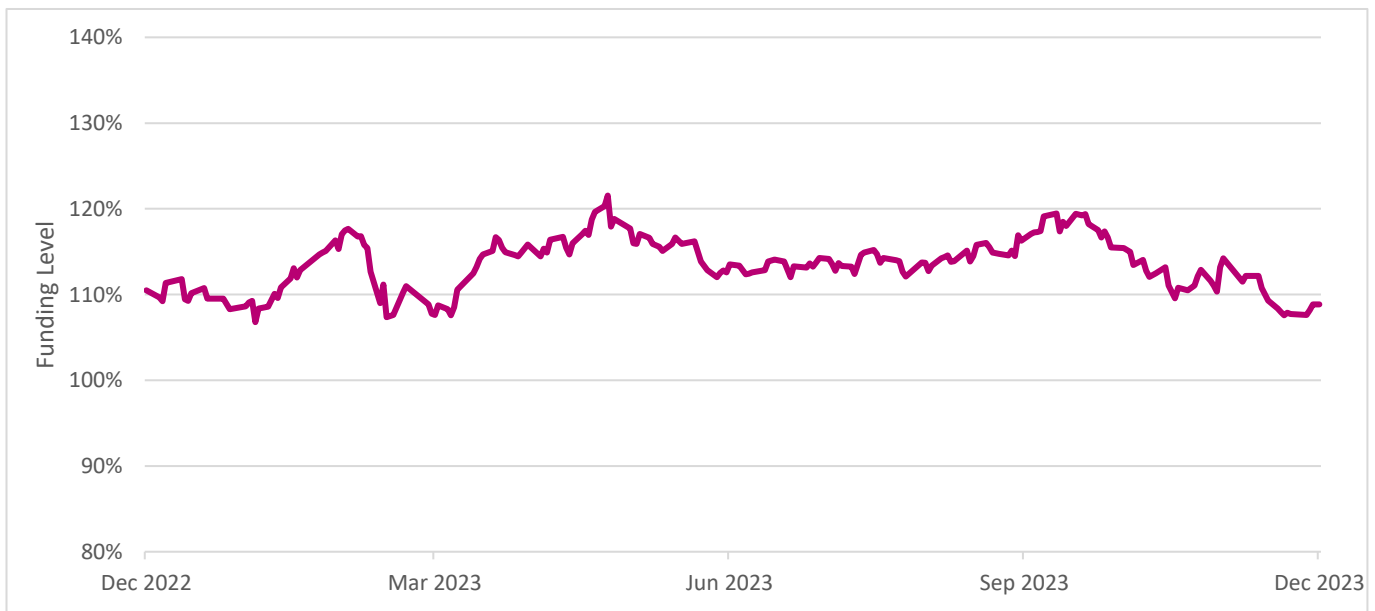


Chart 1 - Daily Movements in EPS funding level

In the first quarter of the year, EPS saw a 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. The funding level was largely flat between June and September before decreasing in the final quarter of the year in line with reducing bond yields in light of reducing expectations of future increases to the base rate by the Bank of England.

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

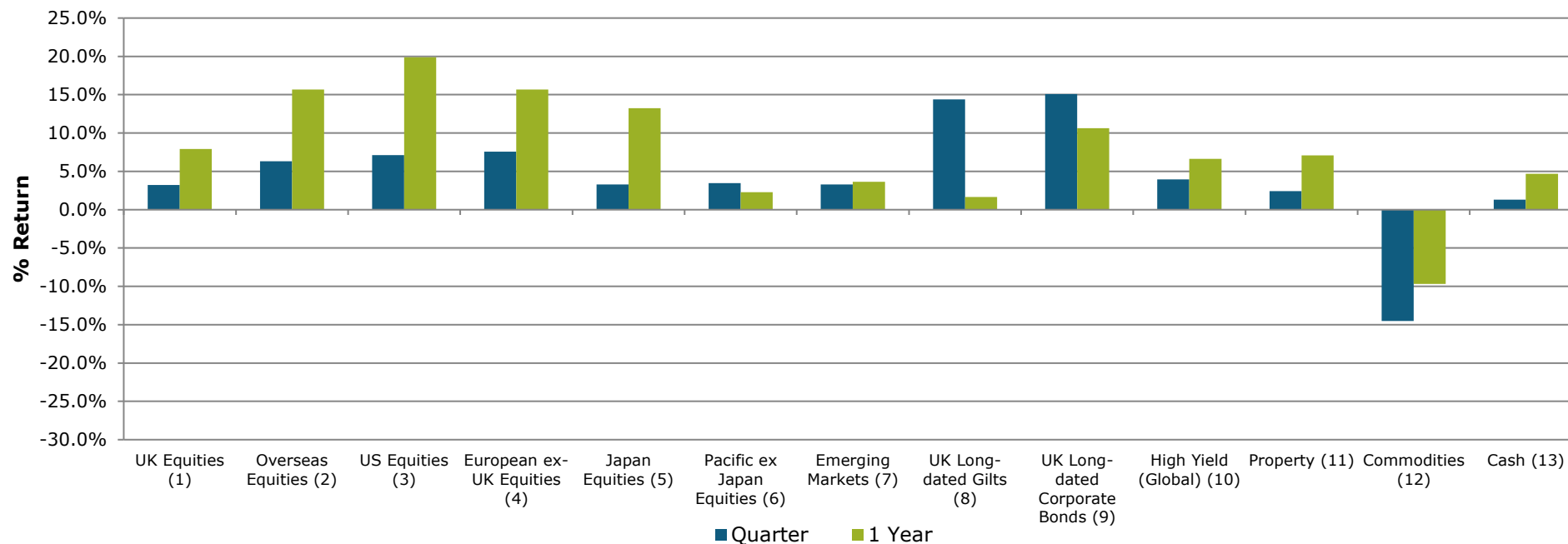


Chart 2 - Return on Major Asset Classes Source: Morningstar Benchmarks:

- | | |
|---|---|
| <ol style="list-style-type: none"> 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 | <ol style="list-style-type: none"> 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.

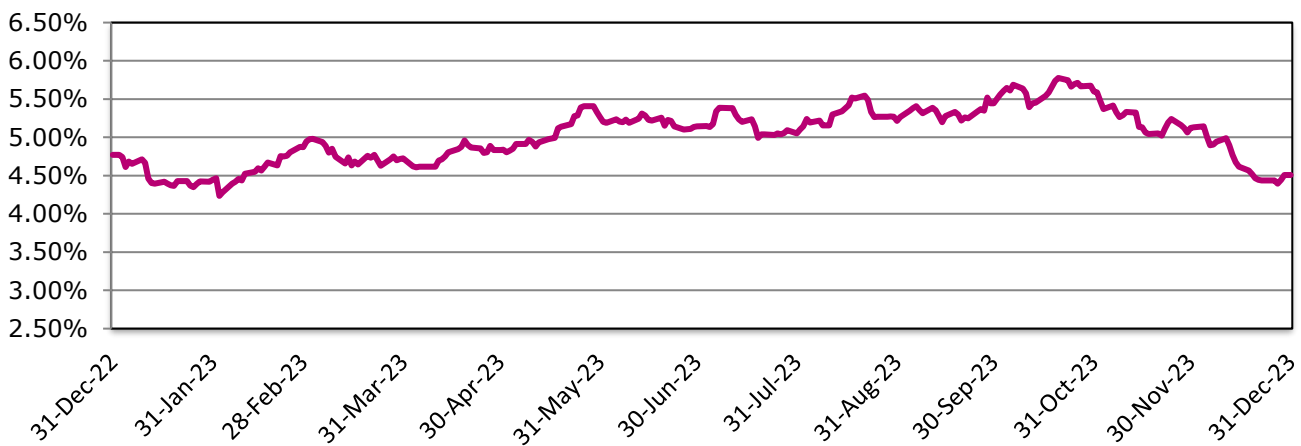


Chart 3 - Yield on iBoxx over 15-year AA rated Corporate Bond Index

Bond yields generally increased over the year up until September as a result of the Bank of England (BoE) further increasing base rates in order to tackle the high levels of inflation. The overall result of an increase in the yield will result in a higher discount rate and lower liabilities, all other things being equal. Since September, bond yields have generally decreased as expectations of further increases to the base rate set by the Bank of England decreased.

The duration of the iBoxx over 15-year AA rated corporate bond index was 15 years as at both 31 December 2022 and 31 December 2023.

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. As 31 December 2023 and 31 December 2022 were both non-working days, inflation yields as at 29 December 2023 and 30 December 2022 have been used.

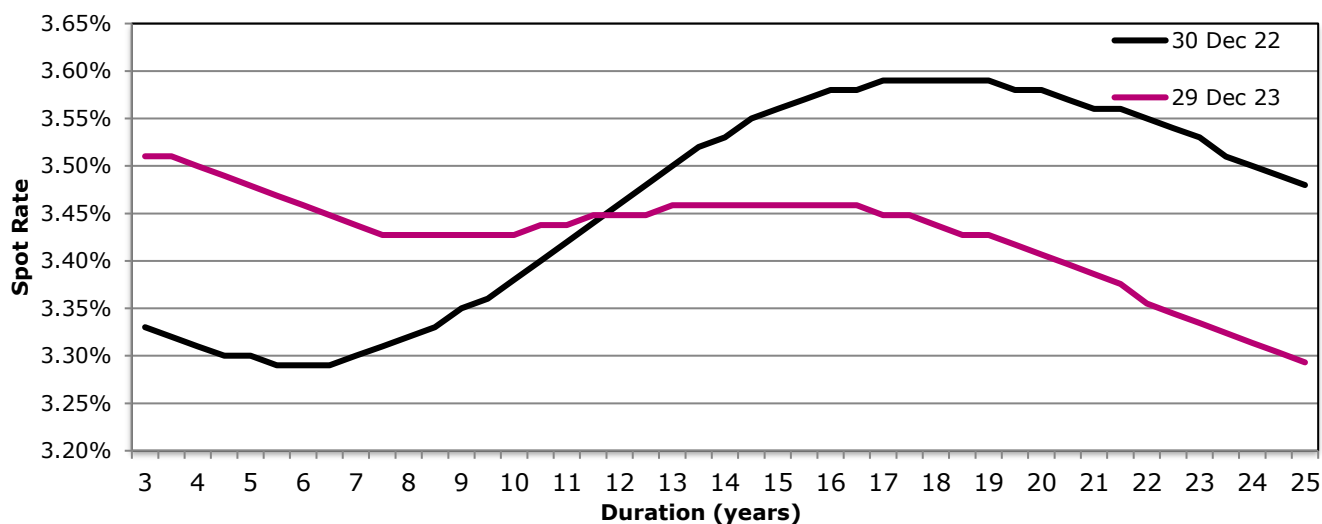


Chart 4 – BoE implied inflation spot curve

As can be seen, short term expectations of future inflation increased over the year while expectations of long term inflation instead decreased. Schemes with longer term liabilities may see a reduction to their liabilities as a result of inflation, all other things being equal, whereas schemes with shorter term liabilities may instead see an increase.

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 was lower than RPI, RPI was expected to be lower from 2030.

However in December 2023, the ONS published an update to their expectations for the impact that CPIH has on actual inflation statistics. They stated that CPI and current RPI are now expected to remain broadly similar, however CPIH might be expected to be approximately 0.2% p.a. higher in the long term than before. Therefore, RPI might be expected to be higher from 2030. The extent of this impact will depend on how private housing rental inflation progresses.

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 31 December 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	- 0.27% p.a.	3.62%
Inflation Assumption(s)	- 0.07% p.a.	- 0.48% ²
TOTAL³		3.14%

1. Assumes EPS liabilities have average duration of 14 years. Most Schemes will have seen an increase to their duration over the year as a result of decreasing 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

The Bank of England has increased the base rate substantially over the past year and continued to hold it over the quarter at 5.25% p.a. in December 2023. Overall, rates have increased by 1.75% since December 2022.

Updates from the FRC, Chancellor and the OBR

Amidst this economic uncertainty, the FRC has set out its expectations for the way that companies report results. They reference the increased need to include detailed user-friendly explanations of the positions taken related to impairments, and judgements and estimates.

The Chancellor delivered his Autumn statement on 22 November 2023. The statement supports recent government decisions to reduce borrowing, since inflation has fallen significantly. It also illustrates the stronger than expected recent economic growth, which is forecasted to continue.

Alongside this, the Office for Budget Responsibility (OBR) presented an economic and fiscal forecast to Parliament. They expect that government policies will continue to bring deflationary pressures over the next 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. The 2020 and 2021 mortality rates are therefore unlikely to be indicative of future experience. Use of them would impact actuarial calculations and as such, the CMI 2022 model places no weight on this data.

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 two years, 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 may offset any negative impacts as a

result of the conditions mentioned above. 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 were 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 2022, 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 expected 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.

Last quarter, the FRC published a Position Paper detailing their plan to reform the UK's audit and corporate governance framework.

The FRC is due to issue their new single UK Corporate Governance Code in the upcoming quarter.

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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