



Spence & Partners

Pensions Accounting Update

as at 30 September 2016

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This guide is intended to be a useful reference for companies preparing their 30 September 2016 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 3 months and consider the impact these will have had on a typical pension scheme. We will also review recent developments in the area of pensions accounting, highlighting issues that you should be aware of.

Market Summary

The uncertainty created by the United Kingdom's decision to leave the European Union continues to have a significant impact on the value of the major asset classes. Despite an initial sharp fall, UK equities rallied to finish up over the quarter. Due to investors' "flight to safety", excess demand for government and corporate bonds have led to prices increasing, and hence yields falling (due to the inverse relationship between prices and yields). As the discount rate assumptions are set with reference to the yield on corporate bonds under the accounting standards, pension schemes will see increased values being placed on their liabilities.

Depending on a scheme's investment strategy and its weightings in the major asset classes, any gains from investment returns may well have been more than offset by these increased balance sheet liabilities. Schemes with investment strategies which hedged interest rate risks, or those with overseas equity exposure (without a currency hedge in place) will have fared better than others.

How might this affect a typical pension scheme?

Chart 1 below, captured from [Mantle](#), Spence & Partners' award winning integrated administration and actuarial system, illustrates the effect of market movements over the past 3 months on the balance sheet funding level of an example scheme, "Example Pension Scheme" ("EPS"), all else being equal.

Chart 1 - Daily Movements in EPS funding level



From Chart 1 it can be seen that EPS's funding level has been very volatile over the 3 month period to 30 September 2016. This has been largely due to variations in market conditions impacting both the assets and liabilities of the scheme. In particular, the EPS has witnessed a significant fall in its funding position from the end of July into early August due to a further fall in yields and, to a lesser extent, an increase in expected inflation.

Market Movements in Detail

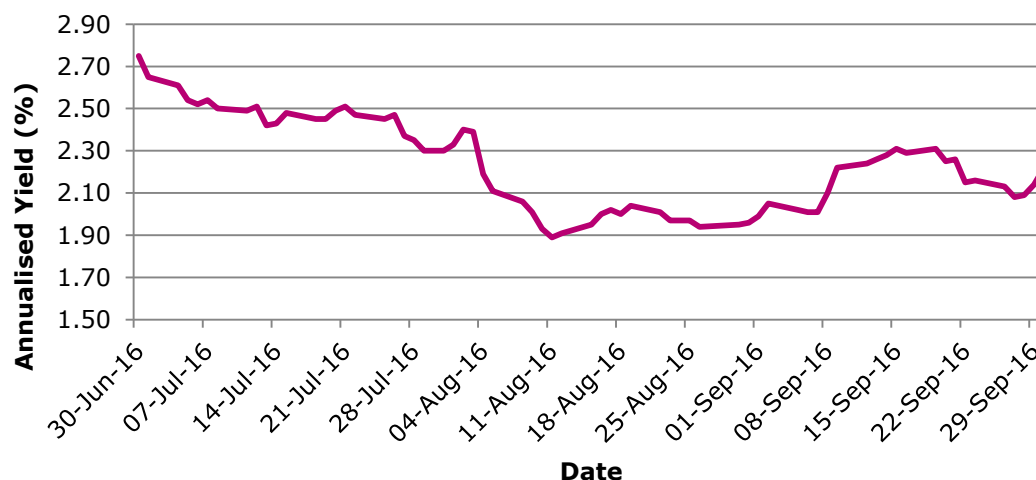
The key financial assumptions affecting a scheme’s balance sheet position are the discount rate and the future rate of inflation.

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, but for illustrative purposes we show below how the yield has varied over the past 3 months on a suitable long-dated corporate bond index, the iBoxx over 15 years AA rated corporate bond index.

Chart 2 - Yield on iBoxx £ Corporates AA 15+

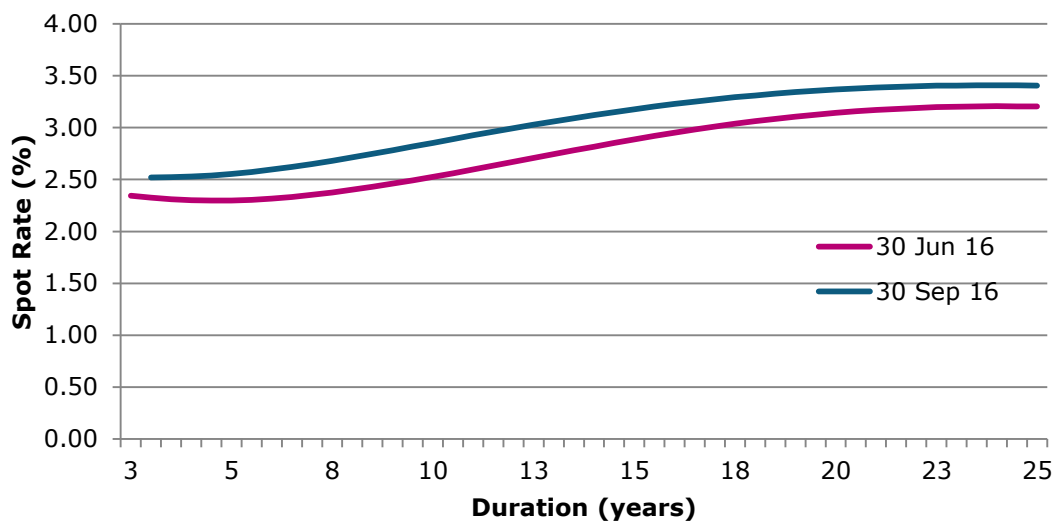


At the end of Q3 2016, the yields on AA corporate bonds were around 50 basis points lower than those at the start of Q3. This is likely to result in substantially lower discount rates being adopted for accounting purposes, although the extent of this will depend on how companies have allowed for the duration of their scheme’s liabilities when setting their discount rates. As an example, this reduction would translate into an increase of approximately 10% in liabilities for a typical scheme.

Inflation

The inflation assumption is important, as this is generally used to determine future benefit increases, both in deferment and on pensions in payment. Again, there is a range of appropriate values that this assumption can take depending on each scheme's circumstances. Chart 3 below shows the Bank of England expectations for the Retail Prices Index (RPI) over future durations. Similar considerations will apply for Consumer Prices Index (CPI) inflation.

Chart 3 – BoE implied inflation spot curve



As can be seen from the inflation yield curve in Chart 3, market implied expectations for the future vary considerably depending on the term being considered and so the assumption chosen will depend upon the characteristics of each specific scheme. Consistency with the approach adopted to derive the discount rate is important.

From Chart 3 we can see that the market's expectation of inflation since 30 June 2016 has increased at all durations. Consequently, for schemes with inflation linked liabilities, this will have the impact of increasing the scheme's liabilities. This will be emphasised further due to the increase in liabilities as a resulting from falls in discount rates.

Market Effect on 'EPS' Liabilities

It can be seen from Table 1 below that the main driving factor behind the movement in EPS liabilities over the 3 month period to 30 September 2016, has been a decrease in bond yields and the resulting decrease in discount rate.

Table 1 - Breakdown of Market Effect on EPS Liabilities

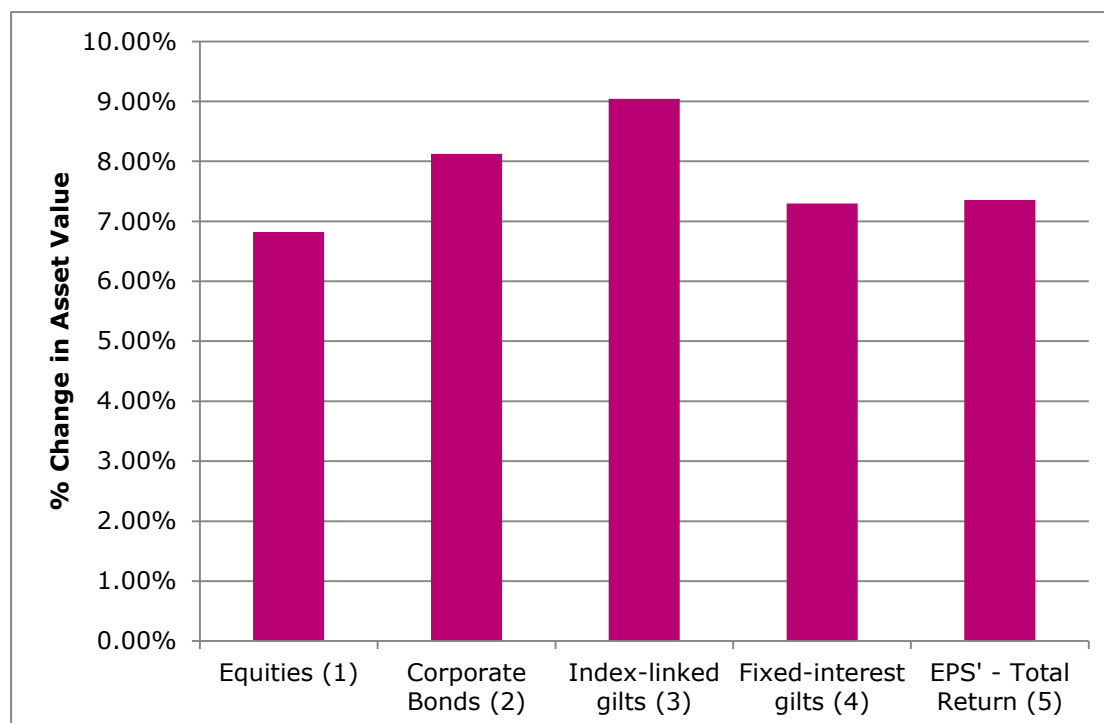
'EPS' Assumption	Effect of Market Movement	Approximate Change in Liabilities ¹
Discount Rate	-0.50%	+ 10.0%
Inflation Assumption(s)	0.25%	+ 2.5% ²
TOTAL³		+ 12.5%

1. Assume EPS liabilities have average duration of c.20 years. No allowance for cashflows has been made.
2. Assume effect on liabilities of change in inflation is 50% of the effect of the equivalent discount rate change.
3. Note approximate nature. The above illustrates the approximate effect of changes to these assumptions only.

Market Effect on 'EPS' Assets

Chart 4 below details the performance of different asset classes over the 3 month period to 30 September 2016.

Chart 4 - Return on Major Asset Classes



1. FTSE All Share Capital Return index
2. iBoxx £ Corporates Total Return index
3. iBoxx UK Gilt Inflation-Linked Total Return index (Nominal)
4. iBoxx £ Gilts 15+ Total Return index
5. EPS asset allocation: 60% equities, 20% corporate bonds, 10% index-linked bonds and 10% fixed-interest gilts.

Although each scheme's investment strategy will differ, using Chart 4 above as a guide, we can see many schemes' assets will have increased materially over the 3 month period to 30 September 2016, with a weighted average return of just over 7% for our model scheme, EPS. This has been a result of a strong improvement in the four asset classes outlined in Chart 4. In particular, where a scheme has more exposure to Index-linked Gilts and Corporate Bonds than that assumed in Chart 4, average returns for the period may be higher still.

As a result of the inverse relationship between bond prices and bond yields (and hence discount rates), increases in funding levels achieved through positive asset returns are likely to be more than offset by increased balance sheet liabilities, although the extent of this will depend on schemes' investment strategies.

Whilst all schemes vary in their particular details and needs, the broad experience of our example scheme (a small scheme with a 20 year average term) may be taken to be similar to the average small to medium sized scheme. We hope it will serve as a useful guide as to what to expect from 30 September 2016 disclosures.

Other Considerations



Mortality

In addition to the main financial assumptions detailed in this newsletter, a scheme's demographic assumptions used for the accounting disclosures can have a significant impact on the results. The most significant of these assumptions is the mortality assumptions, which includes the base mortality tables and future improvements in mortality.

Company directors have often adopted the same mortality assumptions used by the scheme's trustees for the funding valuation. Trustees are required to use prudent assumptions whereas the assumptions for company accounting should be a best estimate. In light of current market conditions and newer mortality information being available, it may be appropriate to update the mortality assumptions to reflect a more up to date analysis of life expectancies.

As an example, the Continuous Mortality Investigation ("CMI") monitors mortality experience and issues tables setting out the probability of death, and trends for future improvements in mortality. Their publication of the CMI S2 Series of tables is based on data gathered from UK self-administered pension schemes between 2004 and 2011. These S2 series of tables are based on the actual experience of UK pension schemes, and therefore may reflect the Scheme's expected experience.

The base mortality tables are based on past experience and do not allow for future improvements in life expectancy. CMI mortality studies make allowance for the long-term nature of expected improvements. Furthermore, projections based on the most up to date information available from the CMI may be expected to result in more accurate life expectancies and so provide a truer picture of the Scheme's liabilities.

To illustrate this, table 2 below compares the life expectancy of members upon reaching age 65 based on the CMI base tables and future improvements in mortality, with those from other widely used mortality assumptions.

Table 2 - Life Expectancy at Age 65

	S2PxA, CMI2015 with a long term improvement of 1% p.a.	PCxA00, with medium cohort improvements with a 1%p.a. underpin
Male currently aged 45	23.2	24.8
Female currently aged 45	25.4	27.2
Male currently aged 65	21.9	22.9
Female currently aged 65	23.9	25.3

Broadly speaking, a reduction of 1 year in the life expectancy could reduce the value of the scheme's liabilities by around 3%, therefore it is clear why these are assumptions which should not go unnoticed when considering your accounting position.

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Next Steps

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

The implications of recent developments in Financial Reporting Standards should be assessed and considered to help you avoid any surprises. Spence can help guide companies through these complexities and 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.

At Spence we can even deliver daily funding valuations and user-friendly modelling for direct use through your browser or portable device.

To discuss these topics further, please contact Spence through your usual contact or connect with our Corporate Advisory practice head, Richard Smith, at richard_smith@spenceandpartners.co.uk or by telephone on 020 3691 2948.



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