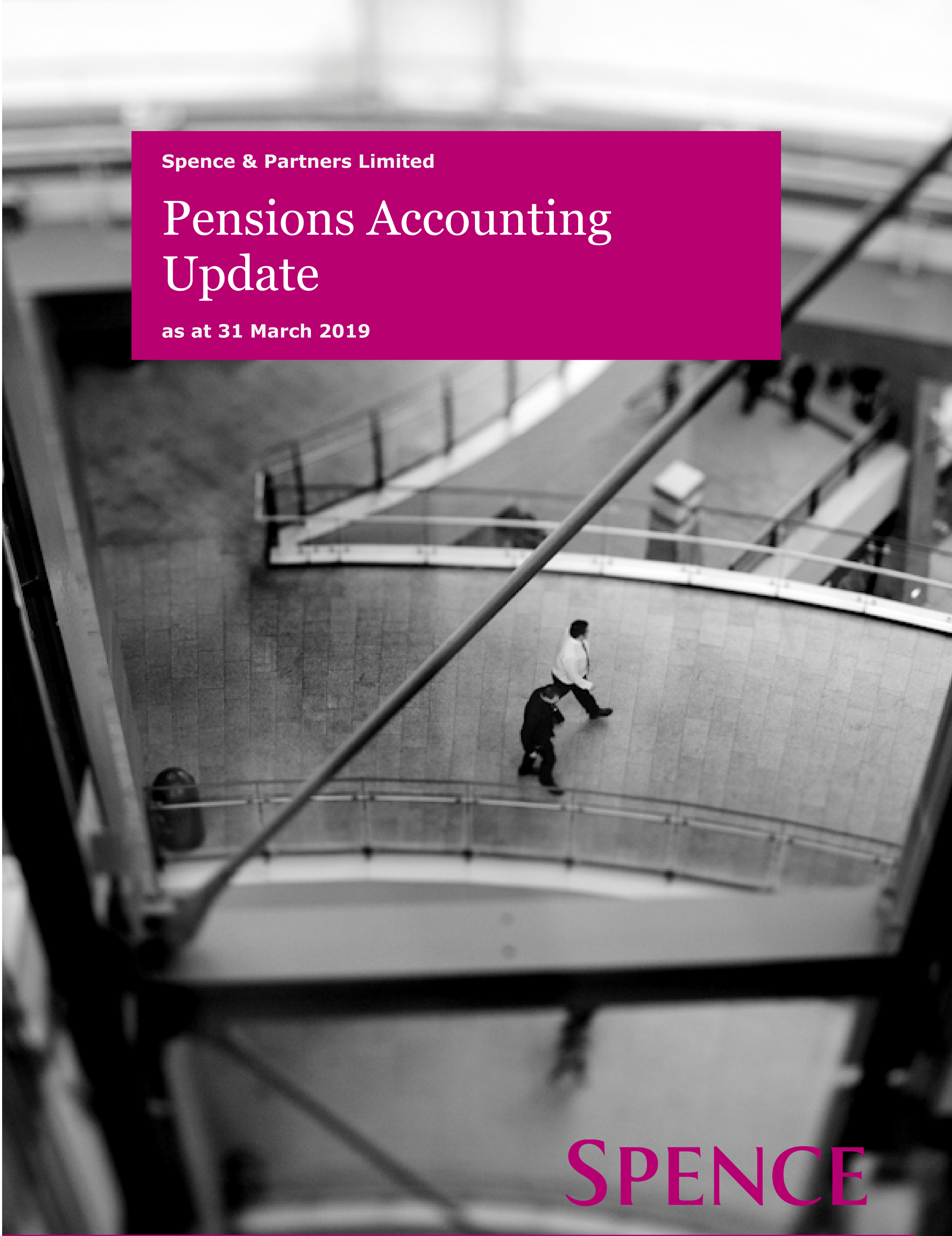
Spence & Partners Limited

Pensions Accounting Update

as at 31 March 2019



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This guide is intended to be a useful reference for companies preparing their 31 March 2019 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 in the area of pensions accounting, highlighting issues that you should be aware of.

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Executive Summary

Corporate bond yields fell over the last quarter and last year to 31 March 2019. As discount rates are directly related to corporate bond yields, Employers can expect lower bond yields to have a negative effect on their pension scheme's liabilities, all else being equal.

Inflation expectations have marginally increased at all durations over the last quarter and last year. The size of the effect that this will have on liabilities will depend on the proportion of inflation linked benefits in a scheme but overall, it will increase a scheme's liabilities.

There will, however, be a reduction in liabilities from moving to the latest version mortality projection models, which continue to show slowing improvements in life expectancy (see below for further details).

Most asset classes have had positive returns over the year to 31 March 2019, with the notable exception being hedge funds which have performed relatively poorly over the same period.

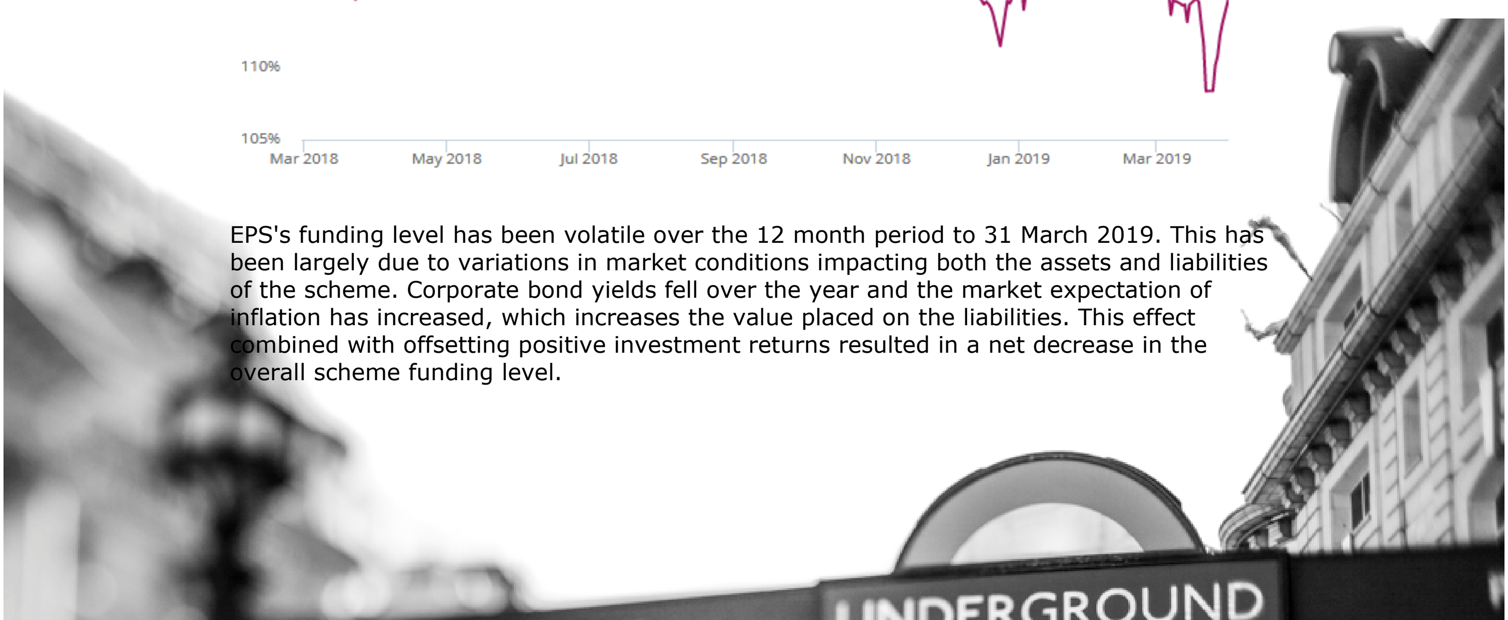
As there have been offsetting effects over the last year, each individual scheme will experience different effects on their funding level, depending on their scheme benefits, the maturity profile of the scheme and its investment strategy.

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".

Chart 1 - Daily Movements in EPS funding level

EPS's funding level has been volatile over the 12 month period to 31 March 2019. This has been largely due to variations in market conditions impacting both the assets and liabilities of the scheme. Corporate bond yields fell over the year and the market expectation of inflation has increased, which increases the value placed on the liabilities. This effect combined with offsetting positive investment returns resulted in a net decrease in the overall scheme funding level.



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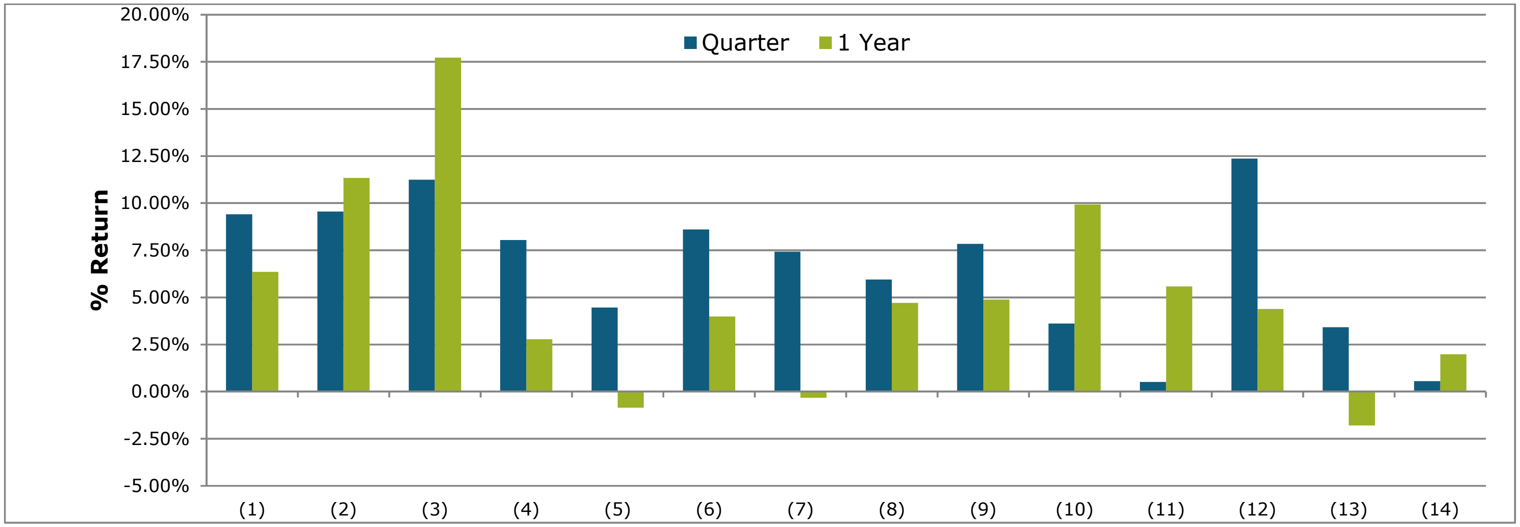
Market Summary

Chart 2 below details the performance of major asset classes over the 12 month period to 31 March 2019.

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. *Morningstar 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. *MSCI IPD UK All Property TR GBP*
12. *S&P GCSI Commodity TR Index GBP*
13. *Credit Suisse Hedge Fund GBP*
14. *LIBOR 3 Month Interbank Rate*

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Market Movements in Detail

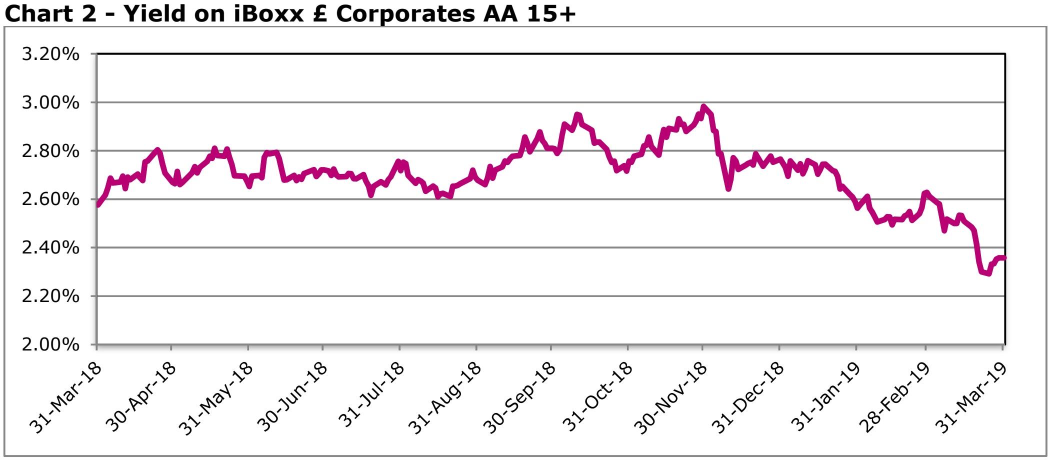
The key financial assumptions affecting a scheme's balance sheet position are the discount rate and the future rate of inflation.

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 12 months on a suitable long-dated corporate bond index, the iBoxx over 15 year AA rated corporate bond index.

Chart 2 - Yield on iBoxx £ Corporates AA 15+



It can be seen that yields have decreased over the last year, resulting in a lower discount rate and so higher liabilities, all other things being equal, for most schemes.

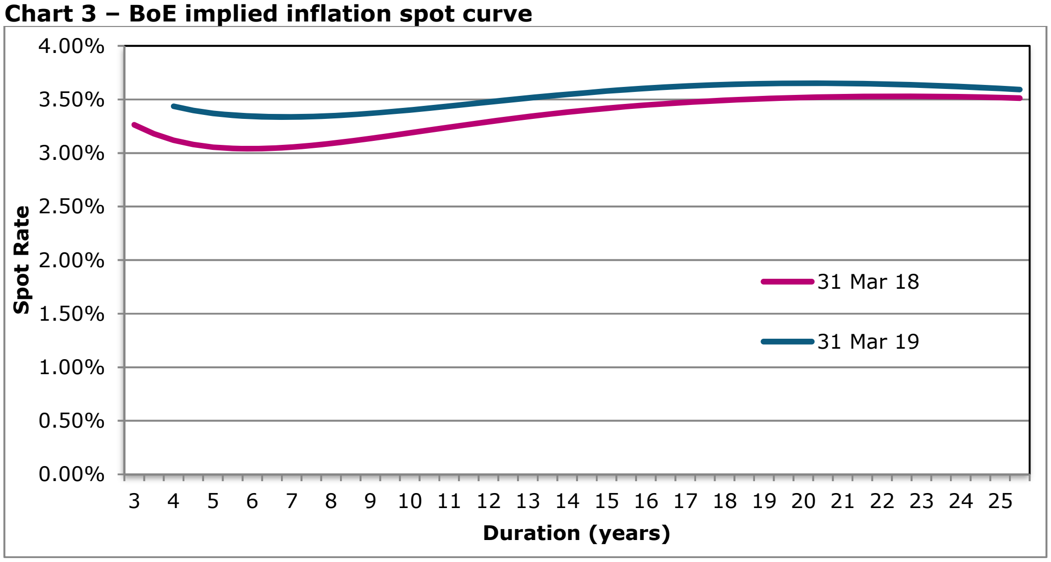
The duration of the iBoxx £ Corporates AA over 15 years as at 31 March 2019 was around 15 years but this is generally shorter than the duration of most pension schemes' liabilities. It may therefore be appropriate to use a discount rate above the index yield if the duration of the scheme's liabilities is longer than the index. Consistency with the approach adopted in previous years should be considered.

Inflation

The inflation assumption is important, as this is generally used to determine future benefit increases, both before retirement and after retirement. Again, there is a range of appropriate values that this assumption can take depending on each scheme's circumstances. Chart 3 shows the Bank of England's expectations over future durations.

Market movements in detail continued…

Chart 3 – BoE implied inflation spot curve



From Chart 3, the market's expectation of inflation since 31 March 2018 has increased for all durations. Decreasing bond yields coupled with higher expectations of inflation will lead to a higher value being placed on scheme liabilities overall.

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 rates, 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% p.a. are typically used to reflect an IRP.

Market Effect on 'EPS' Liabilities

The main driving factor behind the movement in EPS liabilities over the 12 month period to 31 March 2019 has been a decrease in bond yields and the resulting decrease in the discount rate, as well as an increase in inflation.

Table 1 - Breakdown of Market Effect on EPS Liabilities

'EPS' Assumption	Effect of Market Movement	Change in Liabilities [1]
Discount Rate	-0.22%	4.35%
Inflation Assumption(s)	0.13%	1.26%
TOTAL [3]		**5.61%**

1. Assume EPS liabilities have average duration of 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.

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

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Recent Developments

Updates from the Continuous Mortality Investigation

In March 2019 the Institute and Faculty of Actuaries released the latest figures from the continuous mortality investigation (CMI), which indicates that the life expectancy of Britons aged 65 has fallen by 5 months.

This new trend of deceasing life expectancies should ultimately reduce liabilities associated with pension schemes, as pensions will be expected to be paid for a shorter period of time.

Company directors should therefore consider adopting the newly released S3 mortality tables, along with the CMI 2018 model improvements when making assumptions about the mortality experience there scheme will face in the future.

GMP Equalisation

Guaranteed Minimum Pension (GMP) is a special tranche of pension for contracted out service prior to 6 April 1997, intended to replace a sacrificed part of the state pension. In July 2018, Lloyds Bank went to court together with its pension scheme trustees and trade unions, seeking clarification as to whether its pension schemes are obligated to equalise GMP benefits between members of different sexes. The high court published its judgement in the case on 26 October 2018, and whilst some uncertainties remain, it is expected that all schemes with GMPs accrued between 17 May 1990 and 5 April 1997 will need to equalise benefits for the effect of unequal GMPs.

The majority of audit firms are of the view that the impact should be included in any financial statements (whether full or part year) with an effective date after the year end. Unless an assumption had previously been included regarding the impact of GMP equalisation, the majority of audit firms are expecting the impact to be recognised in P&L rather than alternative of treating the impact as a change in assumption of experience item in OCI.

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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 the recent developments should be 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.

To discuss these topics further, please contact Spence through your usual contact or connect with our Corporate Advisory practice associate, Angela Burns, at angela_burns@spenceandpartners.co.uk or by telephone on 0141 331 9984.

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