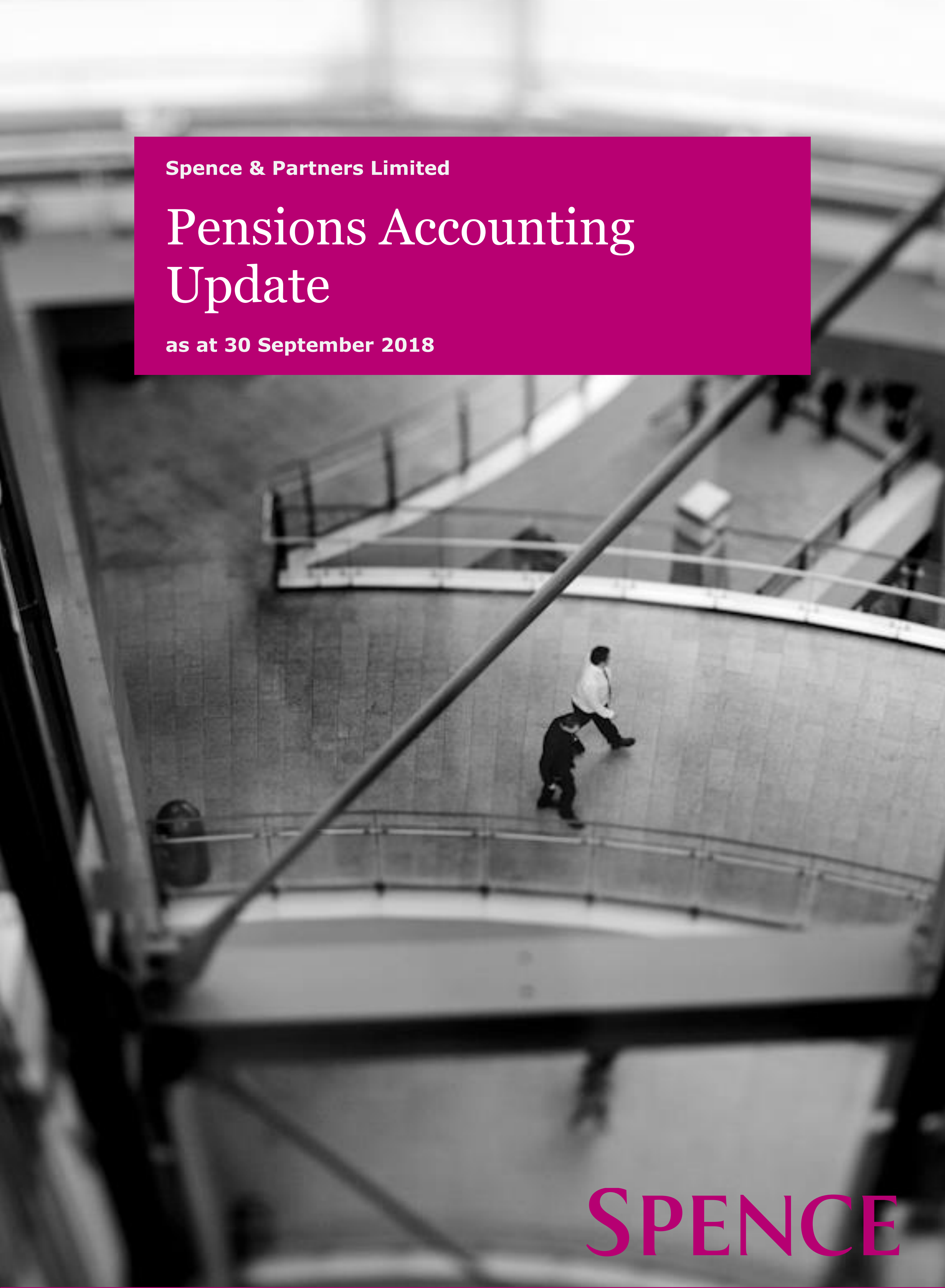
Spence & Partners Limited

Pensions Accounting Update

as at 30 September 2018



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This guide is intended to be a useful reference for companies preparing their 30 September 2018 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.

Executive Summary

Corporate bond yields increased over the last quarter and are higher than they were at 30 September 2017. Employers can expect higher bond yields to have a positive effect on their pension scheme's liabilities, all else being equal.

Inflation has increased over the past quarter but marginally decreased over the past year to 30 September 2018. The size of the effect that this will have on liabilities will depend on the proportion of inflation linked benefits in the scheme but overall, it will reduce the scheme's liabilities (all other things being equal).

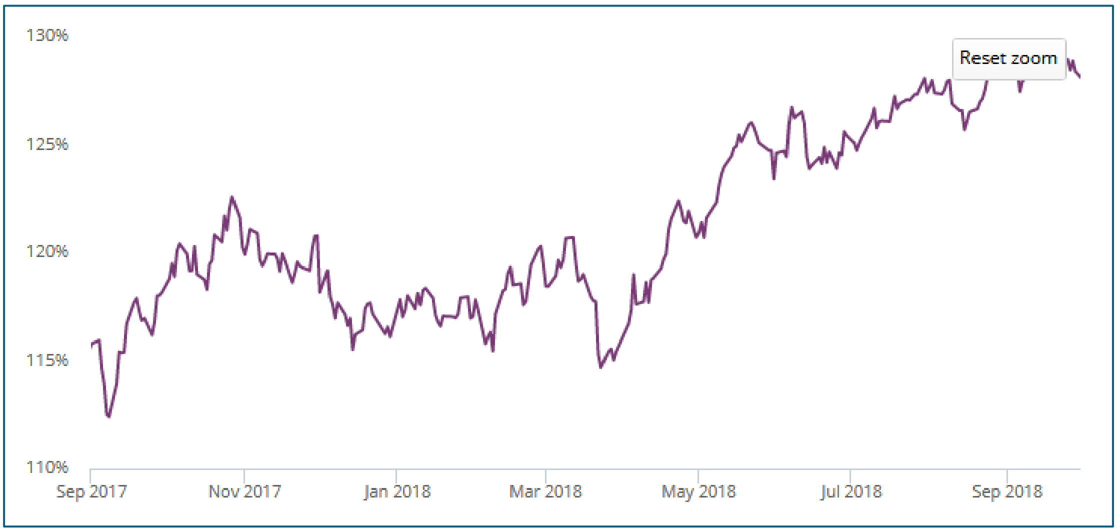
Looking to the investment markets, schemes that have a significant allocation to overseas equities and commodities will have enjoyed positive asset growth since 30 June 2018 (depending on the level of currency hedging in place), while most asset classes have generated positive returns over the year to 30 September 2018. On the whole, employers can expect good returns to improve the funding level of their schemes over the last year.

Overall, the pensions accounting position for most companies reporting at 30 September 2018 is likely to be better than at 30 September 2017 given the combined effect of slightly higher bond yields, lower inflation and positive asset returns.

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 relatively volatile over the 12 month period to 30 September 2018. This has been largely due to variations in market conditions impacting both the assets and liabilities of the scheme. Corporate bond yields increased over the year and the market expectation of inflation has reduced, which lowers the value placed on the liabilities. This effect combined with positive investment returns resulted in an increase in the overall scheme funding level.

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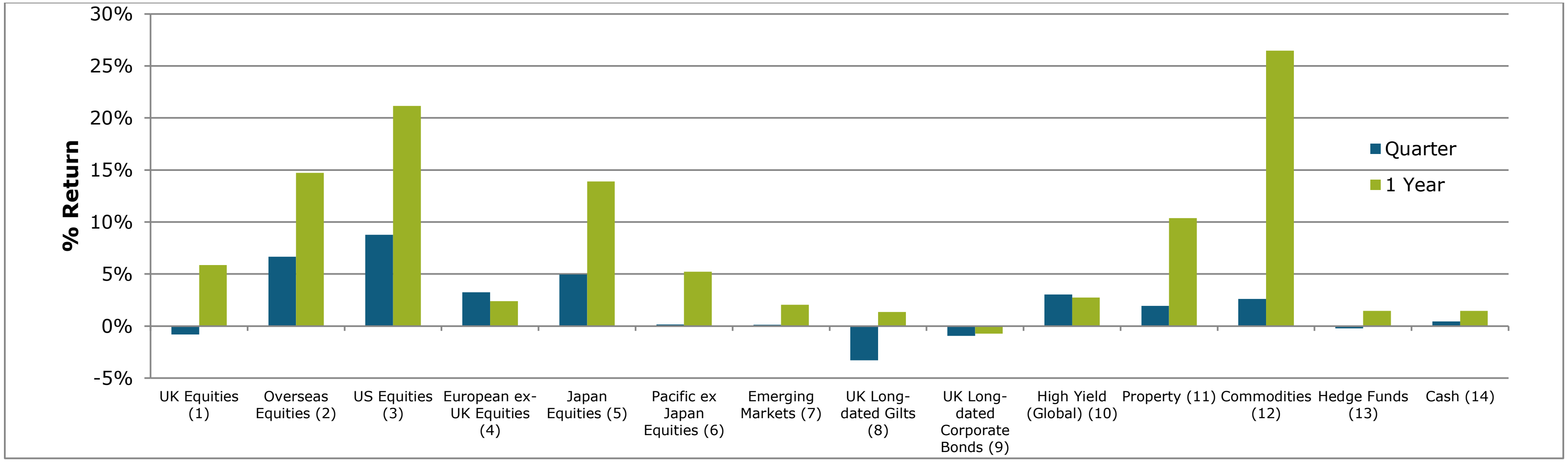
Market Summary

Chart 2 below details the performance of major asset classes over the 12 month period to 30 September 2018.

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

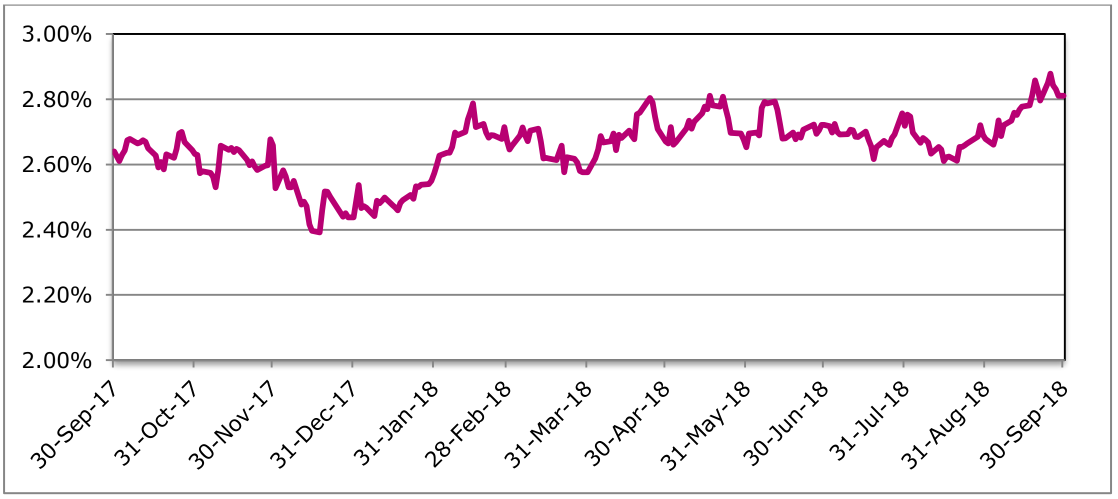
The key financial assumptions affecting a scheme's balance sheet position are the discount rate and the future rate of inflation.

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 yield on the iBoxx £ Corporates AA over 15 years index has risen over the last year, resulting in a higher discount rate and so lower liabilities, all other things being equal, for most schemes.

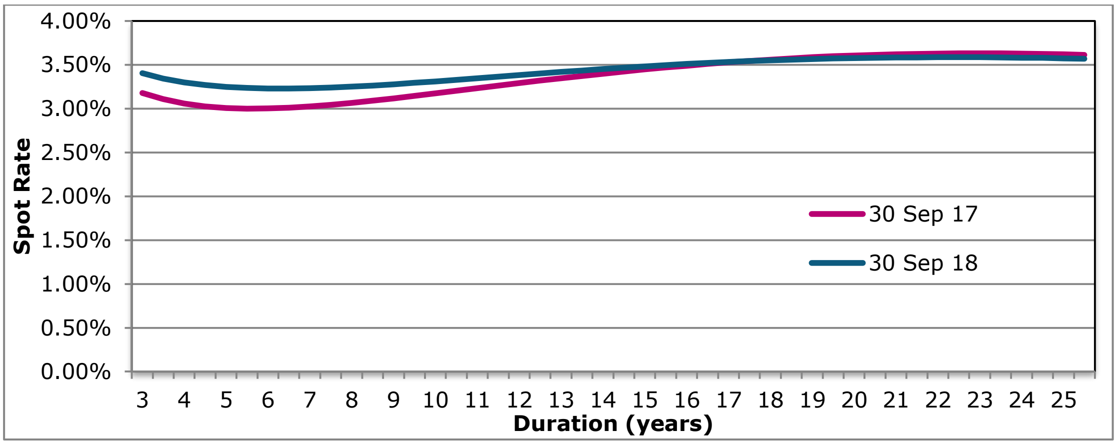
The duration of the iBoxx £ Corporates AA over 15 years as at 30 September 2018 was approximately 15.3 years but this is generally shorter than the duration of most pension schemes' liabilities. It may therefore be appropriate to use a discount rate above the index yield if the duration of the scheme's 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 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 overleaf shows the Bank of England's expectations over future durations at 30 September 2017 and 30 September 2018.

Market movements in detail continued…

Chart 3 – BoE implied inflation spot curve



From Chart 3, the market's expectation of inflation since 30 September 2017 has increased at shorter durations and fallen at longer durations. Increasing bond yields coupled with lower expectations of inflation at higher durations (as would be typical for most pension schemes) will lead to a lower 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 0.30% 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 30 September 2018 has been an increase in bond yields and the resulting increase in the discount rate, as well as a marginal reduction in inflation.

Table 1 - Breakdown of Market Effect on EPS Liabilities

'EPS' Assumption	Effect of Market Movement	Change in Liabilities [1]
Discount Rate	0.17%	-3.26%
Inflation Assumption(s)	-0.03%	-0.32%
TOTAL [3]		**-3.58%**

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.

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.

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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