Pensions Accounting Update

As at 30 September 2022

SPENCE

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Overview

This guide is intended to be a useful reference for companies preparing their 30 September 2022 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 have increased by around 3.10% p.a. over the year to 30 September 2022. 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, long term expectations of future inflation have increased. Increases in inflation will increase inflation-linked liabilities, all other things being equal.

Almost all asset classes delivered negative returns over the quarter.

As there have been offsetting effects 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.

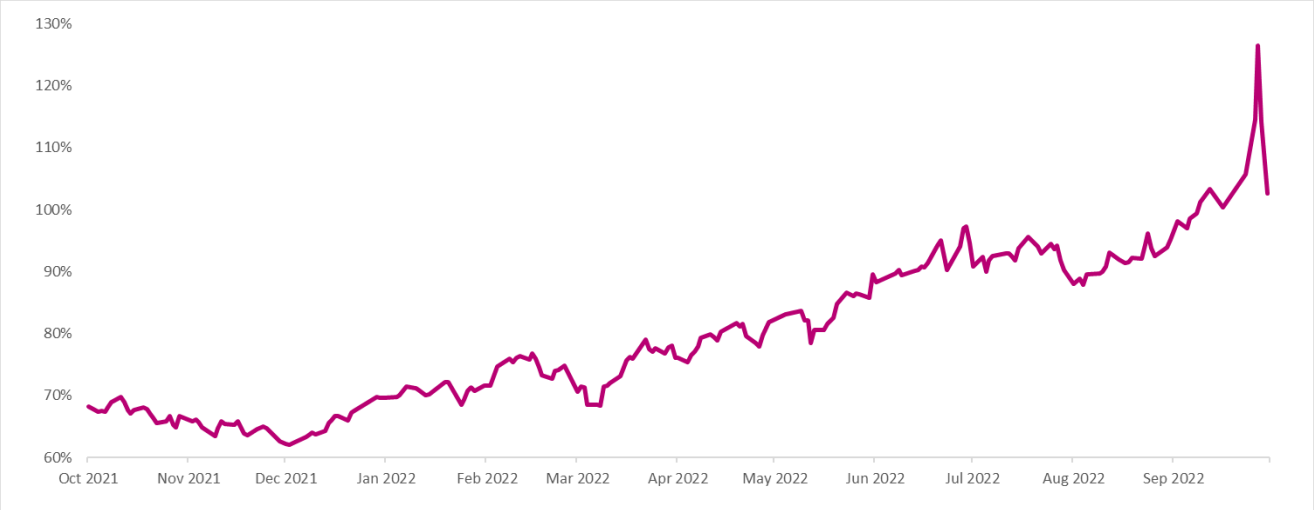


Chart 1 - Daily Movements in EPS funding level

EPS's funding level reduced until the start of December. Since then, the funding level improved steadily until mid-February when the conflict in Ukraine began, leading to a large and sudden drop in funding level. Since February, the funding level has been increasing consistently as interest rates increased. Towards the end of the year EPS's funding level spiked due to volatile market conditions following the Chancellor's mini budget, and fell again due to the Bank of England's intervention in the gilt market.

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

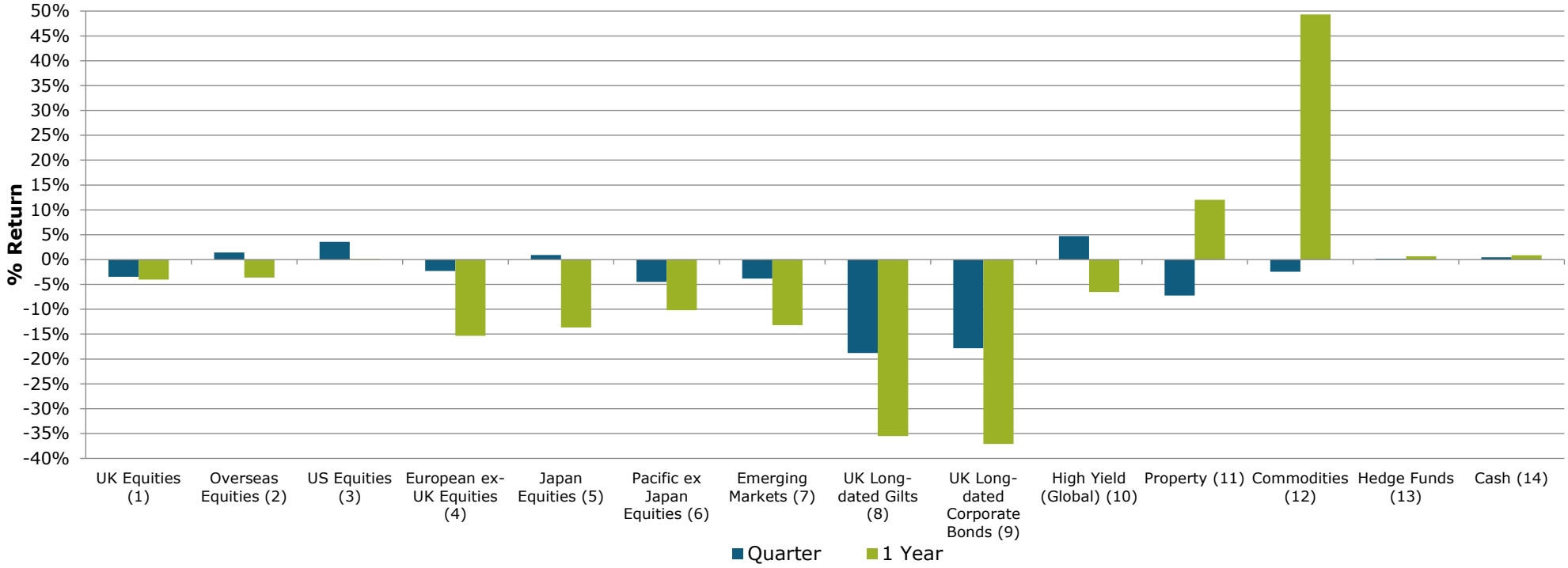


Chart 2 - Return on Major Asset Classes Source: Morningstar
Benchmarks:

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. *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. *IS UK Property GBP*
12. *S&P GCSI Commodity TR Index GBP*
13. *Credit Suisse Hedge Fund*
14. *LIBOR 1 Month GBP TR*

Market Movements in Detail

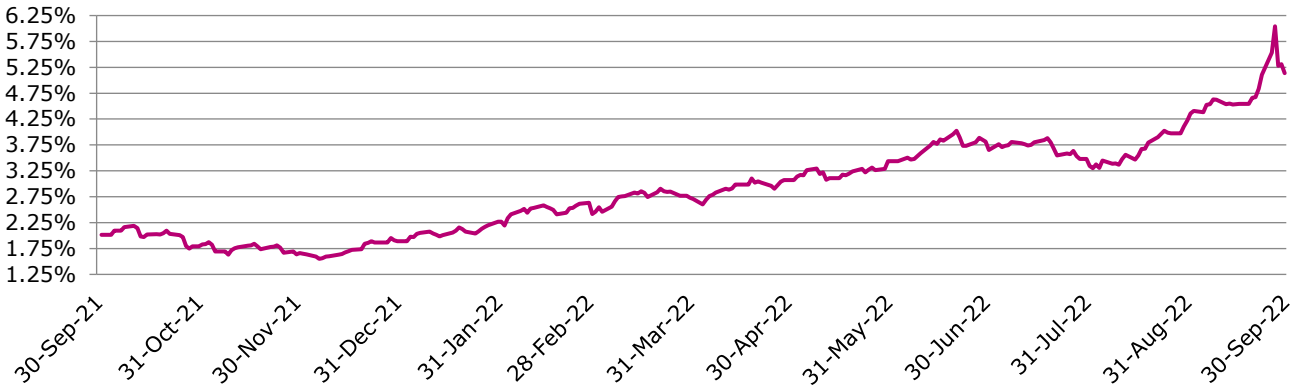
The key financial assumptions affecting a scheme's balance sheet position are the discount rate and the future rate of inflation.

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 £ Corporates AA 15+



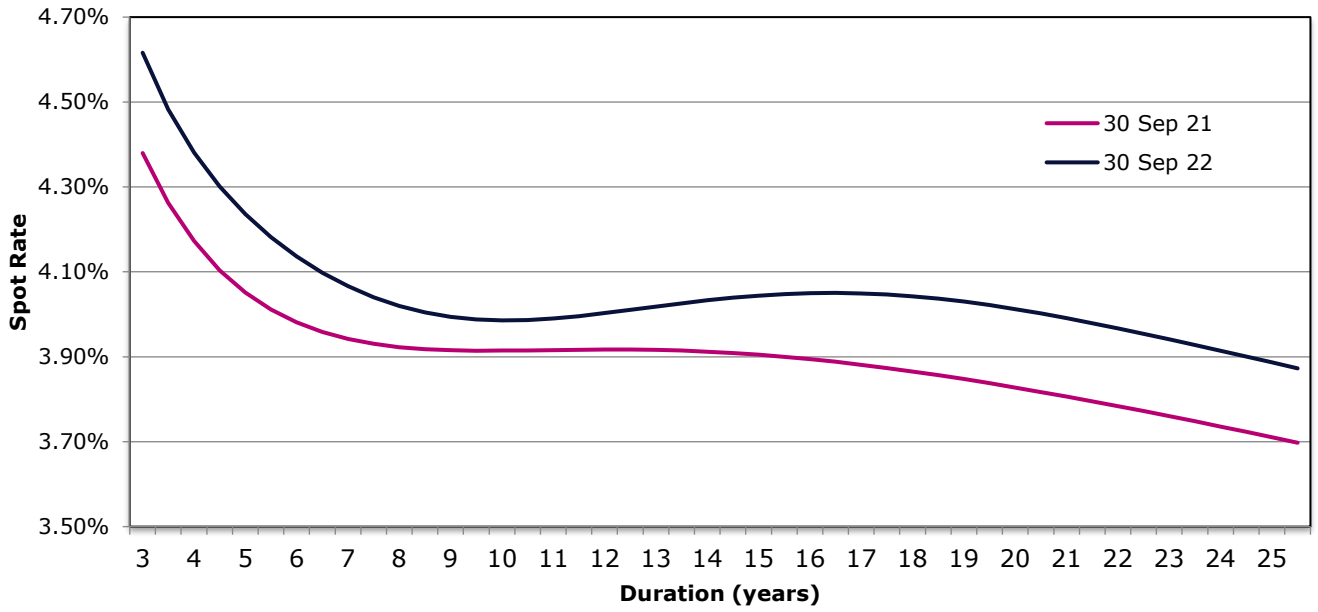
We can see that yields have increased over the last year, and increased materially over the last three quarters, predominantly as a result of the BoE further increasing base rates. This will result in a higher discount rate and so lower liabilities, all other things being equal.

The duration of the iBoxx £ Corporates AA over 15-year index has decreased over the year from around 21 years as at 30 September 2022, to around 15 years as at 30 September 2022. As a result, schemes with durations greater than 15 will have less 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



As can be seen, inflation expectations have increased over the last year, reflecting the current high levels of inflation being driven by factors such as increasing energy costs. It is important to note that inflation assumptions should not be driven by short term spikes in inflation as we are currently seeing in the market.

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 September 2022 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	+ 3.12% p.a.	- 45.22%
Inflation Assumption(s)	+ 0.18% p.a.	+ 1.81%[2]
TOTAL[3]		**-43.41%**

1. Assumes EPS liabilities have average duration of 20 years. 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 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.

Recent Developments

Market Conditions

At the end of the year, on 23rd September, the 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 (LLDI) markets have seen an increase in pressure. In order to maintain hedging levels within these funds cash was urgently needed. On 28th September, the bank of England stepped in with a £65bn bailout in order to prevent additional price falls and stabilise the market. This gave time to raise cash to meet these collateral needs.

Ongoing Russia/Ukraine Conflict

The ongoing Russia/Ukraine conflict has caused significant uncertainty for pension schemes and their sponsors, 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 are the conflict endures, and pension schemes will need to continue to weather the storm of uncertainty.

FRC report sets out what it expects from audit firms to deliver high quality audits

In January 2022 the Financial Reporting Council (FRC) issued a report setting out the key elements required by audit firms to ensure they are delivering high quality audits.

The FRC's report highlights the six key attributes that contribute to the running of high-quality audit practices such as the culture, governance and leadership of the firms, alongside their investment in well qualified people, training and processes. It also includes the key elements that contribute to high quality individual audits from the planning phase, through to the delivery and completion of audits.

To support the delivery of high-quality audits, the report provides a range of examples of good practice identified by the FRC over recent audit quality inspections and supervision work.

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.

Amendments to FRS102

Amendments to FRS 102 have recently been made in relation to the second phase of the interest rate benchmark reform and also in relation to accounting for temporary rent concessions for operating leases occurring as a direct consequence of the COVID-19 pandemic extending beyond 30 June 2021 (for which an amendment was also made to FRS 105).

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, Angela Burns, at angela_burns@spenceandpartners.co.uk or by telephone on 0141 331 9984.

NOTES

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