# Pensions Accounting Update

As at 31 March 2021

SPENCE

# What's Inside?

**Page**

# Overview

## This guide is intended to be a useful reference for companies preparing their 31 March 2021 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 fallen by around 0.3% p.a. over the year to 31 March 2021. As discount rates are directly related to corporate bond yields, employers can expect lower bond yields to have a negative effect on pension scheme liabilities, all else being equal.

Over the year, inflation expectations have increased. The size of the effect that this will have on liabilities will depend on the proportion of inflation linked benefits in your scheme. An increase in inflation will increase a scheme's liabilities, all else being equal.

Some investment classes performed better than others over the year to 31 March 2021, Equities as a whole have performed well, largely recovering from the losses incurred during the height of COVID-19 related uncertainty in March and April 2020. Conversely, UK Long-dated Gilts and Cash both had a particularly bad year, posting negative returns in excess of minus 10% p.a.

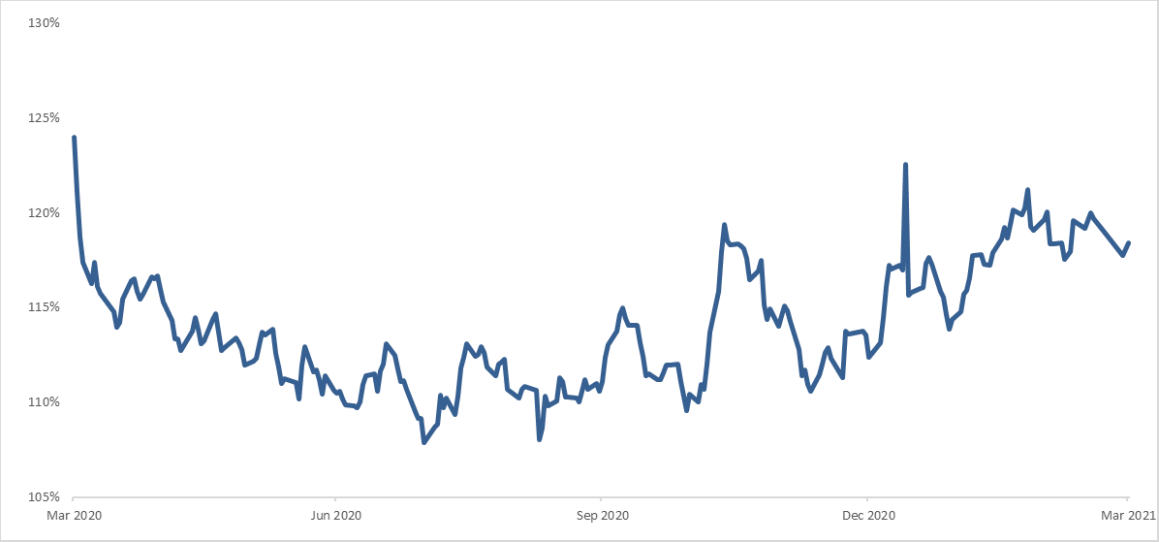
As there have been offsetting effects over the last year, each individual scheme will experience different effects on their funding level, depending on primarily the scheme benefits and investment strategy. However, we would expect that most schemes will see a deterioration in their funding position in comparison to last year.

Schemes with high levels of interest rate hedging are likely to be affected more, as increasing gilt yields resulted in a decrease in asset values. Schemes with a large level of inflation hedging will have seen the opposite effect, with increases in inflation expectations over the year resulting in an increase in asset values, matching liability increases.

## 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**



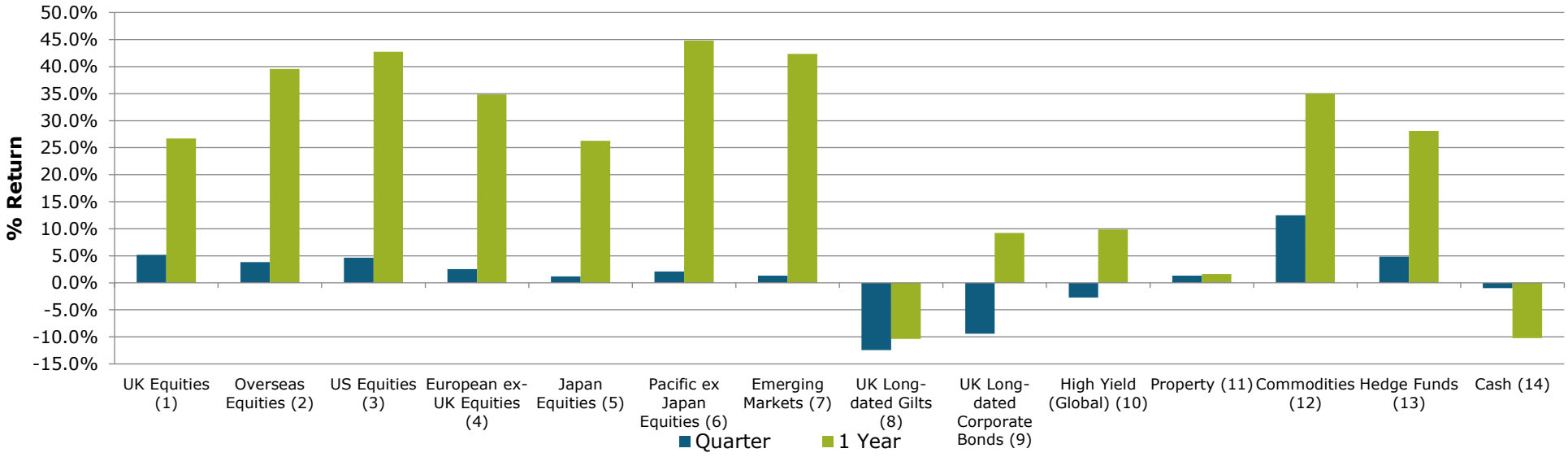

EPS's funding level has been volatile over the 12-month period to 31 March 2021. This has been mainly as a result of the COVID-19 outbreak affecting financial markets.

EPS holds no Liability Driven Investment and has limited hedging through corporate bond holdings. It also has dampened equity exposure via a Diversified Growth Fund.

# Market Summary

Chart 2 below details the performance of major asset classes over the 12-month period to 31 March 2021.

**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. *Eurekahedge Hedge Fund*
14. *LIBOR 3 Month Interbank Rate*

# Market Movements in Detail

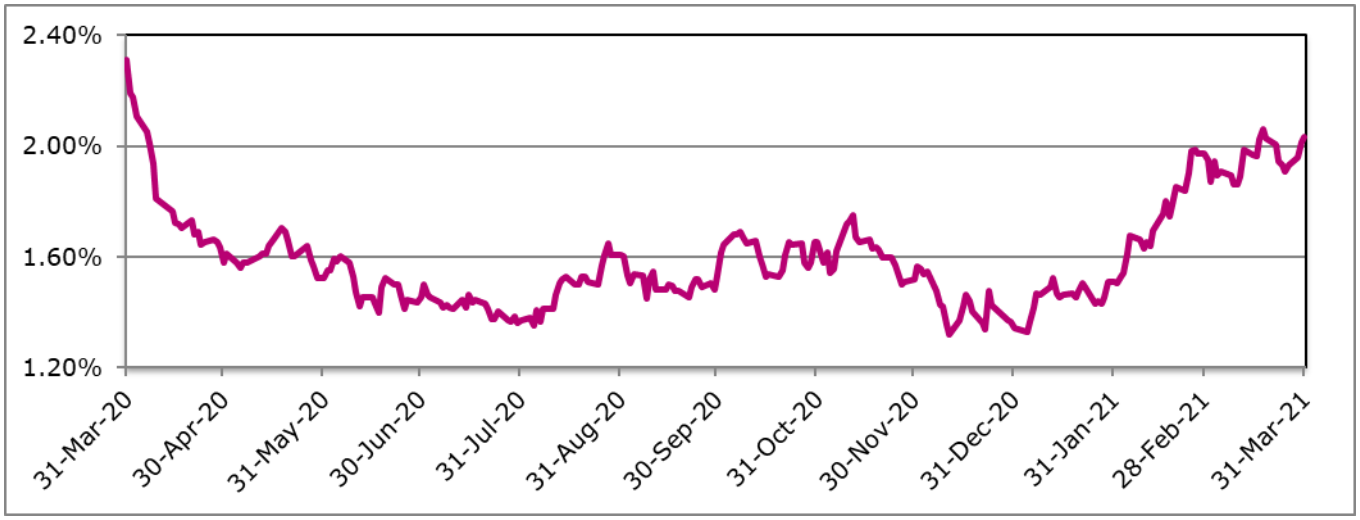
The key financial assumptions affecting a scheme's balance sheet position are the discount rate and the future rate of inflation.

## 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+**



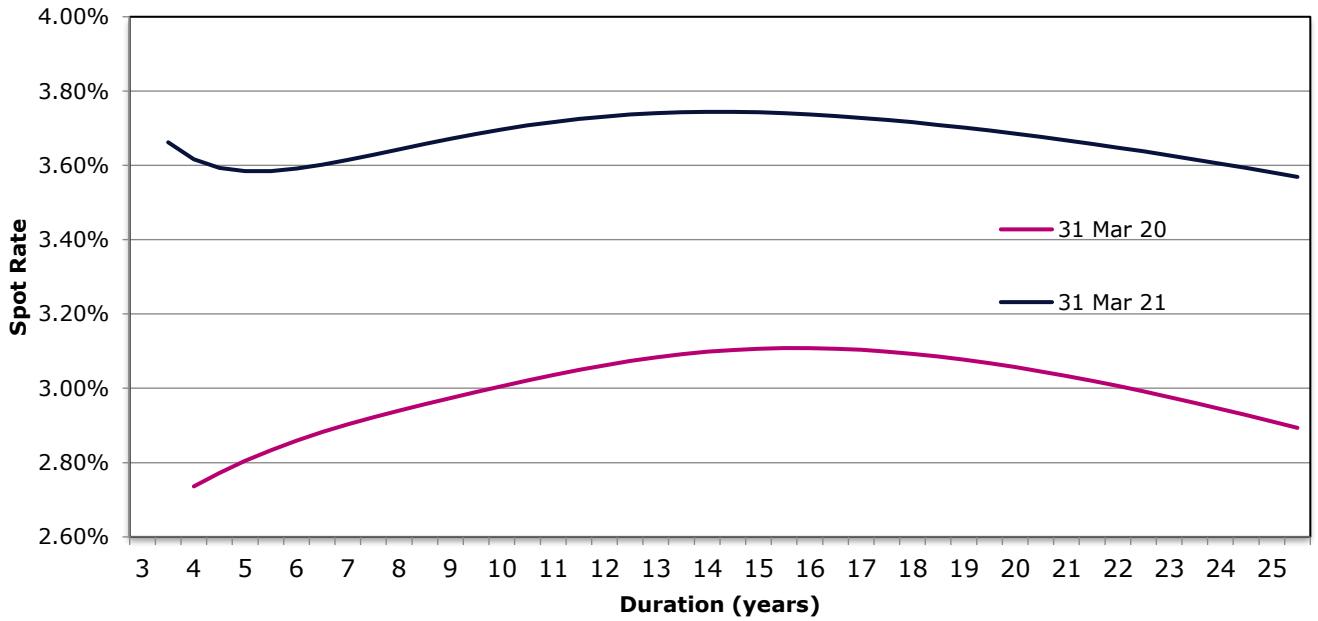

We can see that yields have decreased over the last year. This will result in a lower discount rate and so higher liabilities, all other things being equal, for most schemes.

The duration of the iBoxx £ Corporates AA over 15-year index has increased over the year from around 17 years as at 31 March 2020, to around 21 years as at 31 March 2021. As a result of this, many schemes will have less scope to make positive adjustments to the discount rate assumption to allow for duration.

## 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's expectations over future durations.

**Chart 4 – BoE implied inflation spot curve**




As can be seen, inflation expectations have increased over the last year.

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 to adjust for the consultation for moving RPI into line with CPIH from year 2030. Adjustments of up to 0.30% p.a. are typically used to reflect an IRP.

Historically, the difference between RPI and CPI has typically ranged from 0.7% 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 lower than RPI, RPI will be lower from 2030. As a result of the difference, RPI and CPI will have to change from February 2030 onwards.

We are seeing a staged approach in many cases where a 1.00% gap is applied until 2030, and then an appropriate gap from 2030 onwards to reflect differences between CPIH and CPI. For ease, this assumption is sometimes converted into a single gap, that will produce liabilities that are broadly equivalent. The size of this gap will be larger for schemes with short durations and smaller for schemes with long durations.

The table below sets out example adjustments that may be seen for schemes with short, medium, and long durations.

| Duration | Gap |
|---|---|
| Short (17 years or less) | 0.75% |
| Medium (18 to 23 years) | 0.70% |
| Long (24 years or more) | 0.55% |

## Market Effect on 'EPS' Liabilities

The main driving factor behind the movement in EPS liabilities over the 12-month period to 31 March 2021 is set out below.

**Table 1 - Breakdown of Market Effect on EPS Liabilities**

| 'EPS' Assumption | Effect of Market Movements | Change in Liabilities [1] |
|---|---|---|
| Discount Rate | -0.28% | 5.57% |
| Inflation Assumption(s) | 0.63% | 6.50% [2] |
| **TOTAL [3]** | | **12.07%** |

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

## The Financial Reporting Impacts of Coronavirus

In September 2020, the ICAEW issued updated guidance in relation to coronavirus (or COVID-19). The guidance is primarily aimed at those preparing accounts in accordance with FRS 102. Similar guidance has also been produced for accounts being prepared in accordance with IAS 19, published in March 2020.

Due to the increased uncertainty in the economic and financial markets as a result of COVID-19, this has the potential to significantly impact entities with 2020 year ends approaching. The guidance provides an insight into the considerations that should be taken to highlight the potential scale and impact of COVID-19 on companies. As more information becomes available on the impacts of the virus, there may be a need for greater judgement surrounding the conditions at the year-end date.

Links to the guidance:

https://www.icaew.com/technical/financial-reporting/uk-gaap/uk-gaap-faqs/coronavirus-how-to-improve-disclosures-when-preparing-accounts-in-accordance-with-frs-102

The FCA has also a released statement offering companies the ability to delay submission of their accounts if needed.

https://www.fca.org.uk/news/statements/delaying-annual-company-accounts-coronavirus

## Amendments to FRS102

In December 2020, the FRC published amendments to UK and Republic of Ireland accounting standards following the end of the transition period for the UK leaving the EU. Changes were required to UK company law to ensure there was a smooth transition following Brexit, resulting in amendments being required to accounting standards to remain in line with the law. The effective date of these amendments is accounting period beginning on or after 1 January 2021.

Links to the amendments can be found at:

https://www.frc.org.uk/getattachment/8214be0e-d10e-440c-9406-5be7d049aefb/Amendments-to-UK-and-RoI-accounting-standards-UK-exit-from-the-EU-(Dec-2020).pdf

## Amendments to IAS19

CIPFA have updated their guidance for 31 March 2021 accounting in line with amendments issued by the International Accounting Standards Board in February 2018. The updated guidance is in relation to IAS19 standards for plan amendments, curtailments and settlements and will affect employers with events such as bulk transfers and redundancies over the accounting year.

This requires restating the profit and loss items from the date of the event, by remeasuring assets and liabilities using assumptions set at the event date. This would alter the amounts between the Profit and Loss and Other Comprehensive Income. Regardless of whether any remeasuring takes place, the IAS19 balance sheet position at 31 March 2021 remains unchanged.

## 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 average industry impact is expected to be 1% of the liabilities. The impact for each scheme will depend on the number of affected members, their service in the equalisation window, and the scheme benefit structure.

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 judgement. Unless an assumption had previously been included in the liabilities regarding the impact of GMP equalisation, the majority of audit firms are expecting the impact to be recognised in the P&L account.

In November 2020, the High Court gave its second ruling on the Lloyds GMP Equalisation case. It concluded that schemes will also need to take into consideration previously paid transfer values and whether or not a top up is required. Auditors will expect this to be considered as part of annual accounting work.

# 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.

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