Pensions Accounting Update

As at 31 December 2021

SPENCE

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Overview

This guide is intended to be a useful reference for companies preparing their 31 December 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 increased by around 0.6% p.a. over the year to 31 December 2021. As discount rates are directly related to corporate bond yields, employers can expect higher bond yields to have a positive 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.

The majority of asset classes posted positive returns for the year to 31 December 2021. Equities as a whole have performed well returning c20% over the year, while commodities were the best performers with an annual return in excess of 40%. UK Long-dated Gilts and UK Long-dated Corporate Bonds both had a particularly bad year, posting negative returns of around minus 5% 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.

Schemes with large levels of growth assets and limited inflation linked benefits (and hedging) are likely to have seen a significant improvement in their accounting position. Schemes with high levels hedging are likely to have experienced less of an improvement as increasing gilt yields resulted in a decrease in asset values.

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 had largely been on an upward trend until mid-2021 which was mainly as a result of positive returns on most asset classes over the period and increases in corporate bond yields, reducing the value placed on liabilities. Since then, movements in market conditions have led to greater volatility in the funding level.

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 December 2021.

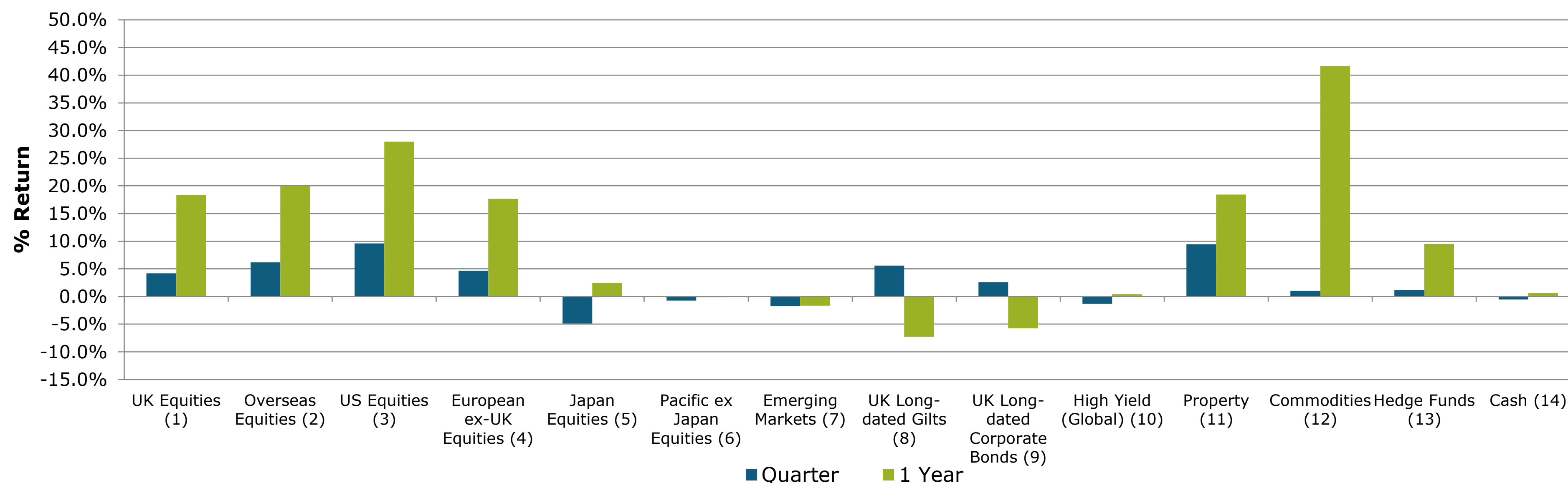


Chart 2 - Return on Major Asset Classes Source: Morningstar

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. *Credit Suisse Hedge Fund*
14. *LIBOR 3 Month Interbank Rate*

Market Movements in Detail

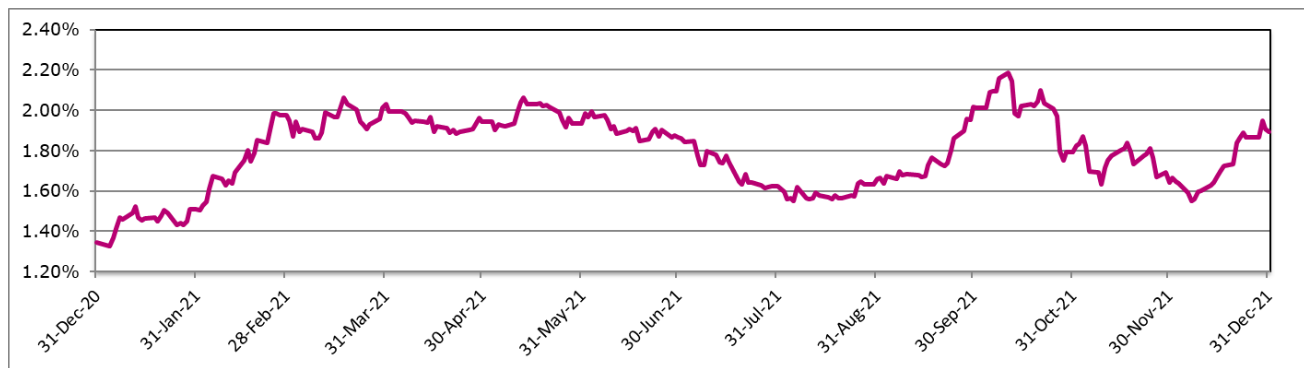
The key financial assumptions affecting a scheme's balance sheet position are the discount rate and the future rate of inflation.

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+



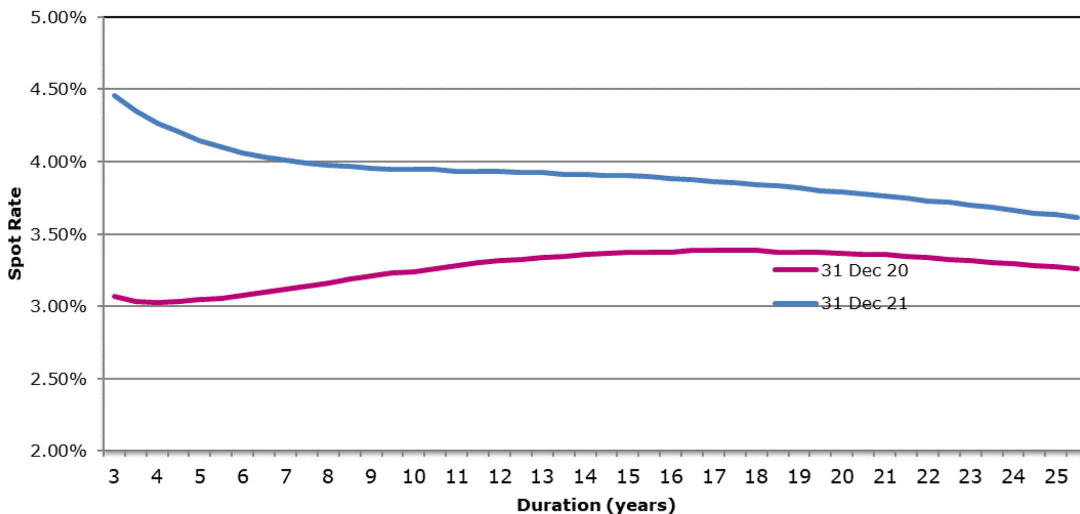
We can see that yields have increased over the last year. This will result in a higher discount rate and so lower liabilities, all other things being equal, for most schemes.

The duration of the iBoxx £ Corporates AA over 15-year index has decreased over the year from around 23 years as at 31 December 2020, to around 21 years as at 31 December 2021. For the majority of schemes there will likely be little scope to adjust the rate 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 significantly over the last year at all durations, but especially at shorter durations

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 rates. Adjustments of up to 0.3% p.a. are typically used to reflect an IRP.

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 0.7% p.a. to 1.1% 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 1.0% 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 table below sets out example adjustments that may be seen for schemes with short, medium, and long durations. The single rate will also depend on the nature of the benefits provided within the scheme.

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 factors behind the movement in EPS liabilities over the 12-month period to 31 December 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	+ 0.6%	- 10.3%
Inflation Assumption(s)	+ 0.4%	+ 4.3%[2]
TOTAL[3]		**- 6.0%**

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

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

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 audit.

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 audit, the report provides a range of examples of good practice identified by the FRC over recent audit quality inspections and supervision work.

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).

Amendments to Other Standards

Amendments to FRS 101, FRS 102, FRS 104 and FRS 105 have also recently been issued to reflect changes in company law following the UK's exit from the European Union that came into effect at the end of the Transition Period. These take effect for periods beginning on or after 1 January 2021.

FRC staff factsheet: Climate-related matters

The Financial Reporting Council (FRC) has published a staff factsheet to inform preparers of annual reports under FRS 102 of climate-related matters they may need to consider when preparing financial statements and associated narrative reporting.

In November 2020, the FRC issued a thematic review of climate-related considerations for a sample of financial statements for large groups prepared under IFRS. In the thematic review, the FRC stated that future work in this area may include 'highlighting areas of the financial statements of UK GAAP reporters where climate change could be a consideration'. The ESG Statement of Intent, published by the FRC in July 2021, stated that the FRC would 'develop guidance on the consideration by UK GAAP reporters of the impact of climate-related issues on the company's financial statements'. FRS 102 Factsheet 8: Climate-related matters ('the factsheet') is designed to address these public commitments.

The FRC emphasises that there is increasing legislation and guidance on the content of the narrative sections of the annual report; however, less attention has been paid to the financial statements themselves. The factsheet outlines the ways in which climate-related matters may impact a set of financial statements prepared under FRS 102, including:

- How the general requirements of FRS 102 should be applied in the context of climate-related matters – in particular, in the context of the risks, uncertainties, judgements and estimations that need to be considered when preparing financial statements.
- How climate-related matters could impact the recognition and measurement of items in the financial statements.
- How climate-related matters could impact the disclosures in the financial statements and what additional disclosures may be required.

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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