The start of a recovery? Trends in pensions accounting over 2013

Our recent survey of over 140 of our clients with UK defined benefit pension schemes reporting under IFRS or UK GAAP looks at market trends in accounting assumptions over 2013. Companies' experience was varied, depending on both their asset and liability profiles.

Long awaited signs of recovery finally appeared during 2013 as equity markets improved considerably over the year. This meant that investment strategy has heavily shaped how IAS 19 funding levels have moved during 2013, with the emergence of surpluses for many, but not all, schemes. Yield curves flattened, leading to a narrower range of discount rate and inflation assumptions.

While market movements have favourably impacted schemes with high proportions of growth assets, both asset and liability values are at high levels, meaning companies which have not hedged pension risks should expect considerable volatility.

This could have been picked up in the new risk focused disclosures now required under IAS19 but companies have generally avoided this - a missed opportunity to inform and reassure. The recent surge in pensions analytics tools, such as Skyval, on the market will make risk analysis cheaper and easier and so maybe we can expect more meaningful disclosure in future.

The main trends

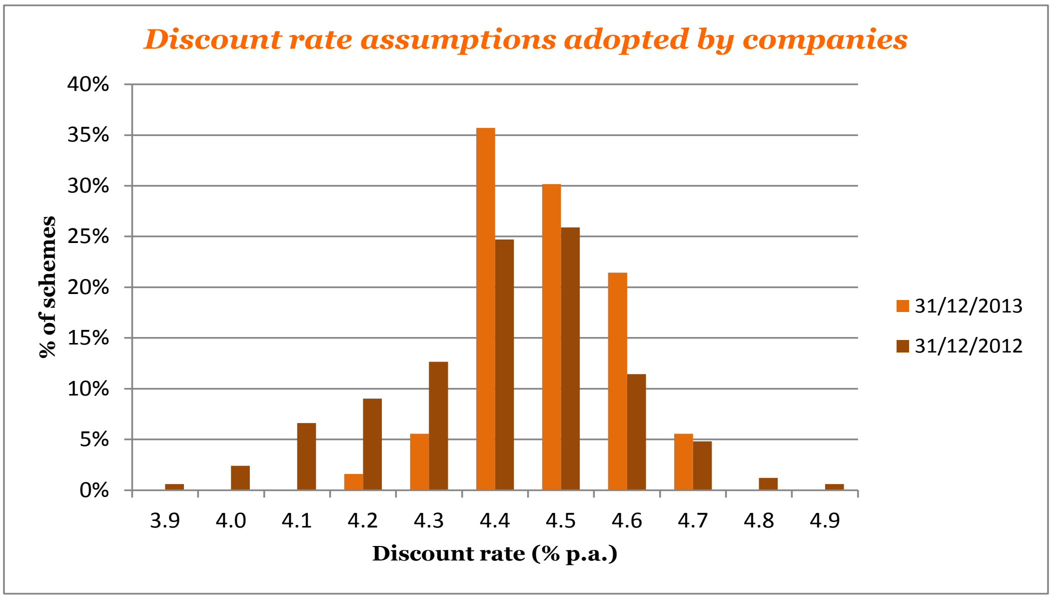
- Corporate bond yields have risen, particularly at short to medium terms, leading to a flattening of the yield curve. This has led to many mature schemes using a higher discount rate for 2013, but other schemes seeing little change.
- In January 2013, long-term retail price index (RPI) inflation expectations rose by over 0.3% p.a. when the Office for National Statistics (ONS) announced it would not be making widely expected changes to how RPI is measured. RPI then rose gradually for the rest of 2013 so schemes with mostly RPI-linked liabilities saw increases in their benefit obligations from 2012.
- Companies have increased the differential between their RPI and CPI inflation assumptions, largely to counteract the increase in RPI expectations. Schemes with mostly CPI-linked liabilities have used similar net financial assumptions as for 2012.
- Schemes with a high holding in growth assets have performed well over the year, whereas those with a matched investment strategy have tended to see little change or even a decrease in their IAS 19 funding level.

- Initial indications are that few companies are taking full advantage of the opportunity given by the new IAS 19 disclosures requirements to reassure investors that their pension scheme risks are being well managed.
- As expected, companies generally saw an increase in pension costs in their financial statements as the changes to IAS 19 were adopted. This had been well trailed and there does not seem to have been an adverse effect in the market in response.

Discount rates

Over the year to 31 December 2013, average gilt and corporate bond yields rose due to expectations of higher interest rates, particularly over the medium term (5 to 15 years), as economic recovery emerges. The most commonly used AA corporate bond indices have risen 0.3% p.a. from 4.1% to 4.4%, although the impact on longer term yields has been lower. The result is a much flatter AA bond yield curve and, as pension scheme liabilities tend to have a longer term than the bond indices, there has been only a small change in median discount rates, which have risen by 0.1% p.a. (from 4.4% to 4.5%).

Mature schemes and those which do not use a cashflow-weighted approach have tended to see a more significant rise in the discount rate, with a corresponding fall in liabilities. The flattening of the curve has reduced the spread of discount rates, with far fewer discount rates below 4.4% p.a..



Pension scheme maturity	Range of discount rate assumptions at	
	31 December 2013	**31 December 2012**
Mature	4.2% p.a. – 4.7% p.a.	3.9% p.a. – 4.5% p.a.
Typical	4.3% p.a. – 4.7% p.a.	4.1% p.a. – 4.7% p.a.
Immature	4.35% p.a. – 4.7% p.a.	4.3% p.a. – 4.9% p.a.

In the table above, a mature scheme is taken to mean a scheme with an average 'duration' of less than 17.5 years, a typical scheme with term of 17.5 years to 22 years and an immature scheme with duration of greater than 22 years.

The trend towards the use of a cashflow-weighted approach to derive discount rates has slowed. Over half of listed companies in our survey did this at 31 December 2013, similar to 31 December 2012. Typically the same approach is used for setting both the discount rate and the inflation assumption.

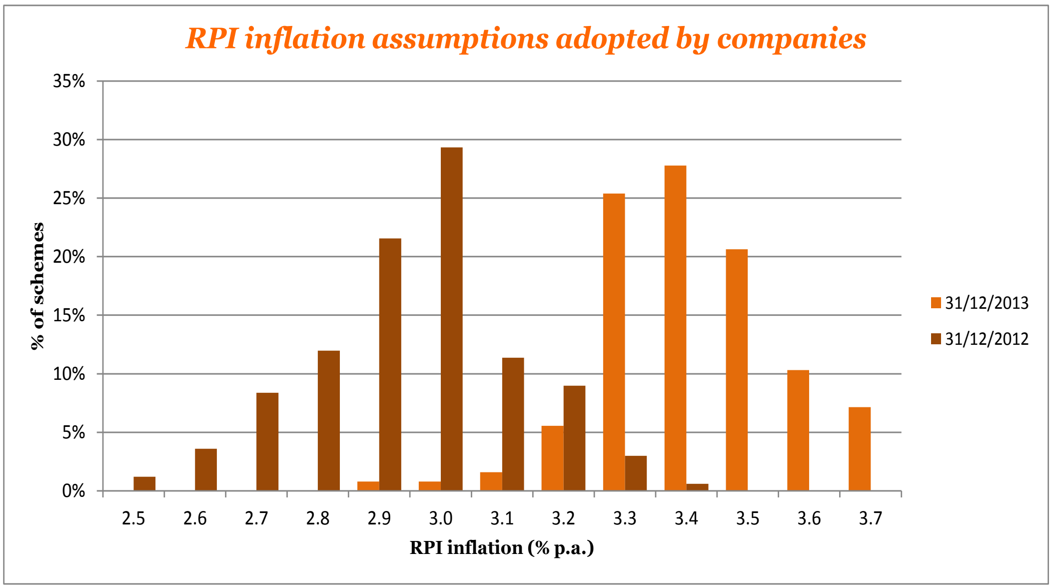
Increase in RPI expectations

Market-implied rates of long-term RPI inflation have risen over the year to 31 December 2013. The Bank of England's 20-year spot rate rose from 3.1% p.a. at 31 December 2012 to 3.6% p.a. at 31 December 2013.

The majority of this rise (0.3% p.a.) occurred in a matter of hours on 10 January 2013, when the ONS announced it would not be making changes to how RPI is measured. It had been widely expected (and priced in) that the changes would have reduced RPI and brought it more into line with CPI.

Over the rest of the year, market-implied inflation was much more stable, but drifted upwards over the course of the year by a further 0.2% p.a..

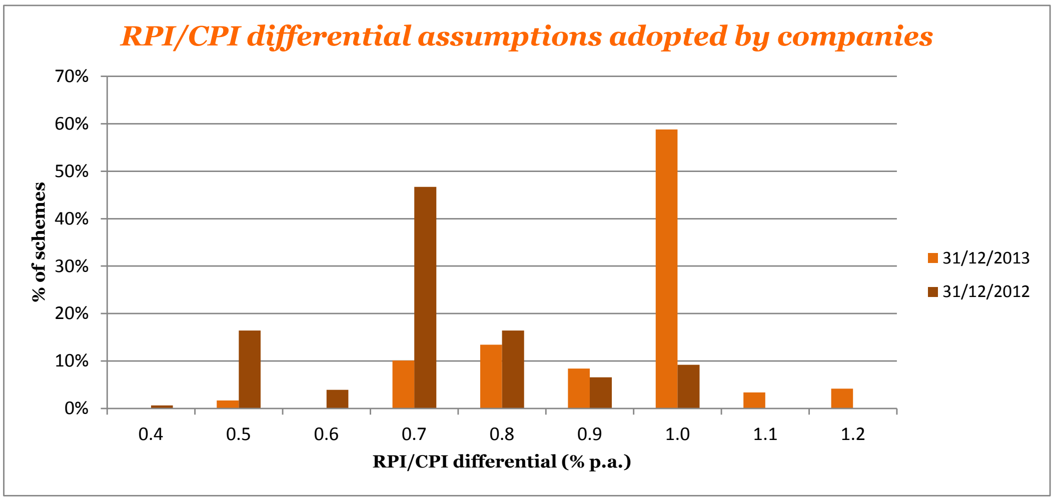
This rise has been reflected in the assumptions adopted by companies, with the median assumption increasing from 3.0% p.a. to 3.4% p.a..



Companies typically adjust market-implied inflation downwards to allow for an Inflation Risk Premium (IRP) which reflects the high market demand for index-linked gilts plus the compensation demanded by fixed interest gilt holders for bearing inflation risk. 80% of companies adopted an IRP of up to 0.3% p.a., with 0.2% p.a. being the most common.

Difference between RPI and CPI inflation

Over the prior year, most companies had decreased the differential between their RPI and CPI inflation assumptions, believing that the fall in market-implied RPI was a response to the review of RPI by the ONS and therefore did not impact CPI expectations. When the ONS chose not to change RPI and market-implied rates rebounded upwards in January 2013, most companies responded by reverting to differentials of at least those used in 2011 (and with some pushing even higher).



A differential between RPI and CPI assumptions of 1.0% p.a. at 31 December 2013 was by far the most popular. This is 0.3% above the dominant assumption for 2012.

Life expectancy continues to drift upwards, but for how long?

With no major developments in the world of mortality projections, there was a slow upwards drift in life expectancies as adoption rates of the Continuous Mortality Investigation's (CMI) latest model continued to rise. A version of the CMI model is now used by 87% of companies in our benchmarking, up from two thirds at 31 December 2012.

The trend towards the use of more prudent long-term rates to future longevity improvements also continues, albeit at a much reduced pace when compared to previous years. Nearly 60% of companies adopted an improvement of 1.25% p.a. or more, compared with just under half a year previously.

Long-term rate of improvement	Increase in life expectancy over 20 years	% of companies adopting at	
		31 Dec 2013	**31 Dec 2012**
< 1 % p.a.	< 1.0 years	6%	8%
1% p.a.	1.4 years	36%	43%
1.25% p.a.	1.8 years	37%	35%
1.5% p.a.	2.1 years	18%	13%
> 1.5% p.a.	> 2.5 years	3%	1%

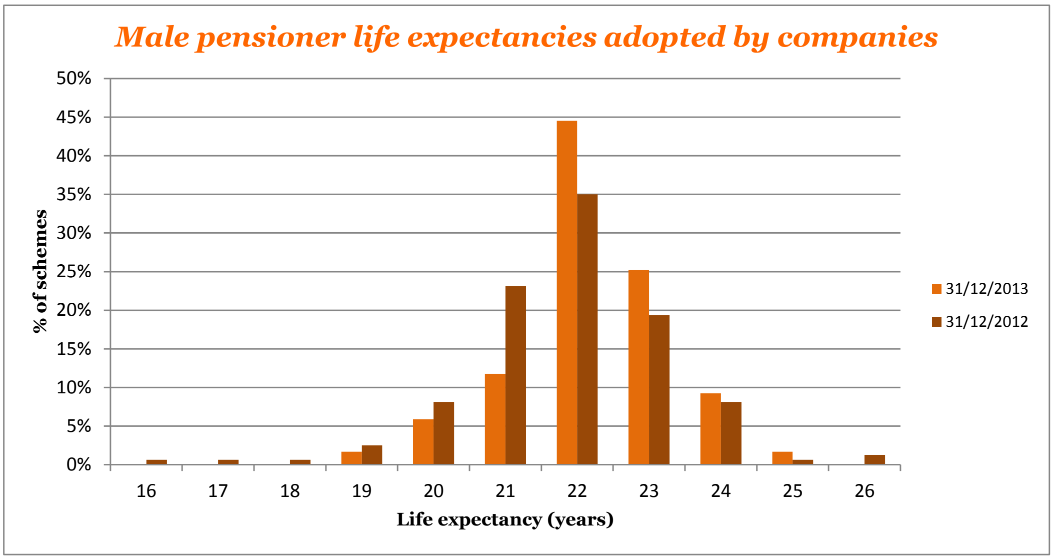
Notes:

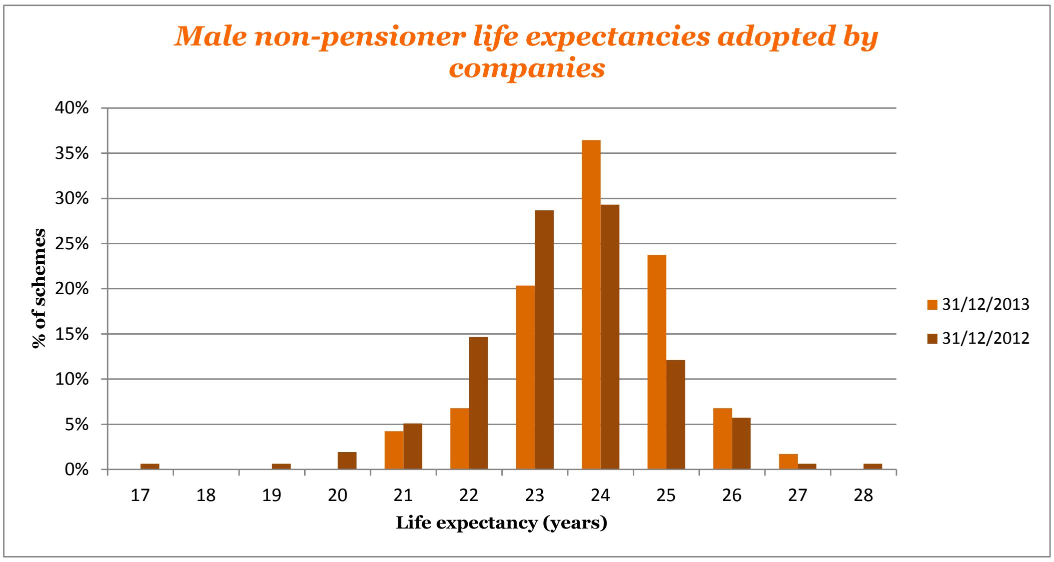
- *The use of a long-term rate of improvement increases life expectancy assumptions over time. This is illustrated in the table above which shows the increase in life expectancy for a man who will be 65 in 20 years' time compared to a man aged 65 now.*
- *The impact on a life expectancy assumption will depend on the base mortality assumption, gender profile and age of scheme membership so may vary slightly.*

The outlook for life expectancy assumptions over the next few years is less clear cut. The 2013 annual update of the CMI model was the first to show life expectancies lower than in the previous year.

Additionally, while life expectancies are generally still increasing, we have seen some companies weaken their base tables in response to actual scheme experience, which could be a sign that the seemingly inevitable increases of recent times may come to an end.

The graphs below showing male current and future pensioner life expectancies illustrate the continued gradual upwards drift in life expectancies, which is slightly more pronounced for future pensioners (driven by the more prudent assumptions made for future improvements in mortality).





Companies shy away from risk based disclosures

The year to 31 December 2013 is the first full reporting year under the revised IAS 19 standard. As expected, the changes resulted in higher pension costs for companies, as the ability to take advance account of high expected returns on assets was removed. This much analysed change ultimately resulted in few surprises when the new standard was adopted.

Another key change to IAS 19 was the replacement of a checklist approach to a more principles based approach to the disclosures, with an emphasis on providing information on pension plan risks which are material to the entity.

With some companies still to publish their full accounts, it is too early to state conclusively how companies have responded. However, indications are that few seem to have added much more information.

The new requirement that the asset class split should distinguish the nature and risks of those assets has resulted in more information on the breakdown of the assets held by the pension schemes. However, disclosures are generally light on detail about the asset-liability matching strategies, for example what risks the portfolio is aiming to hedge and the extent to which the portfolio achieves this. This was expected to be an area where companies could reassure investors and analysts that pension risk was being actively managed.

Other areas where we might have expected more detail are:

- description of the risks the plan exposes the company to - these have been provided, but are on the whole quite generic in nature;
- information on maturity profile - most companies have shown the average liability duration but few have shown more detail on future expected cashflows;
- indication of future funding cashflows - companies are disclosing the expected contribution to pension schemes over the next year, but it is less common to give details of the full agreed contribution schedule or information on the latest funding valuations for the most material schemes.

These first year trends are perhaps not surprising, as many companies are waiting to see how the market responds before rushing to produce detailed risk based disclosures. It remains to be seen whether companies will try to proactively improve and develop the qualitative aspects of their pensions disclosures.

Using analytics tools to streamline your accounting processes

The process of preparing consolidated pensions accounting figures within tight reporting deadlines can be hugely simplified by the use of high-powered analytics tools such as Skyval. The use of a single tool for all your pensions arrangements can take much of the pain out of the process as well as reducing costs. Skyval can produce the accounting figures required for your IAS 19 and UK GAAP disclosures within days of your year-end on both a consolidated and scheme by scheme basis.

Additionally, Skyval makes the analysis of pension risks much cheaper and easier and will allow simple improvements to the qualitative aspects of IAS 19 disclosures, as well as making risk management easier to understand and implement.

Skyval also allows you to access the type of benchmarking information included in this bulletin in real time on a live up-to-date basis.

http://skyval.com

Find out more

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Source of data

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For our commentary on market issues look at our blog:
pwc.blogs.com/pensions