HYMANS ROBERTSON

IAS19 Assumptions Report

August 2020

Welcome

FTSE 350 companies support £830bn of defined benefit pension liabilities. These same companies have a combined market capitalisation of £1,200bn, so the way these liabilities are measured in company accounts is critical for assessing the financial wellbeing of UK plc.

The materiality of IAS19 pension assumptions is not lost on auditors, who continue to assess and challenge pension assumptions more than ever before. Setting appropriate evidence based IAS19 assumptions is therefore crucial for companies going through their year-end process.

This survey analyses the key assumptions adopted by the FTSE 350 for their defined benefit pensions disclosures as at 31 December 2019. We consider the key financial assumptions (primarily the discount rate and inflation) and life expectancy.

Clearly, the world is in a very different place now compared to 31 December 2019. The COVID-19 pandemic, and its economic implications, have had significant impact on some of the key metrics used to derive IAS19 assumptions. Published accounts with year ends during the pandemic are starting to emerge and we have had extensive experience of assumption setting within our own client base and through regular consultation with the "big four" audit firms. We've used this to set out some of the implications of COVID-19 on IAS19 assumptions based on our experiences to date.

We also have some commentary on RPI reforms and how this is currently influencing IAS19 assumptions for RPI and CPI (which is typically derived from RPI for assumption setting purposes).

I hope you find this report interesting and informative. Please contact me if you would like to discuss any aspect of our analysis.

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Key findings

Discount rates

Discount rates varied from 1.8% to 2.2% with an average assumption of 2.0%. 94% of companies used a discount rate within 10bps of the 2.0% average.

RPI inflation

RPI assumptions varied from 2.6% to 3.4%, with an average assumption of 3.0%. 77% of companies used a lower assumption than market implied RPI, showing the continuing widespread use of the "inflation risk premium" argument to use a lower assumption than market implied. Of those applying an inflation risk premium, the typical deduction is around 0.2% p.a.

CPI inflation

CPI assumptions varied from 1.8% to 2.4%, with an average assumption of 2.1%. This implies the average "wedge" assumed between RPI and CPI was 0.9%. This is lower than the 1.0% observed in previous years and perhaps reflects some of the market reactions around potential RPI reforms (more later). This year only 12% of companies used a wedge of 1.1%. The assumed wedge ranged from 0.5% to 1.1%.

Salary growth

Salary growth assumptions varied from 1.5% to 5.2%, with an average assumption of 3.1% (broadly consistent with the average RPI assumption).

Longevity

The average pensioner life expectancy was 87.2 years for a male and 89.0 years for a female. The average non-pensioner life expectancy was 88.6 years for a male and 90.5 years for a female. These averages are lower than last year, illustrating that a significant number of companies are reporting falls in disclosed future life expectancy. This reflects adoption of the latest projections model available at the end of 2019, which continued to show a lower rate of improvement than had been previously estimated.

There is around a 6-year spread in both pensioner and non-pensioner life expectancy assumed across the FTSE 350, which is broadly consistent with previous years.

Allowance for member options

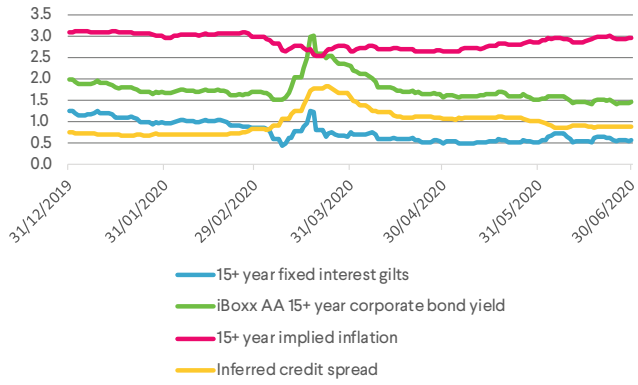
Allowance for transfer values remains very rare. Similarly, no companies surveyed disclosed an explicit allowance for future uptake of a pension increase exchange option at retirement.

IAS19 developments

Recent changes to IAS19 mean that events that lead to changes in liabilities can lead to a remeasurement of P&L at the point any change is confirmed. Market volatility linked to COVID-19 creates a risk of significant changes in P&L if an event occurs.

COVID-19

Our analysis focuses on reporting based on conditions at the end of 2019. Whilst pensions accounting is unlikely to be top of anybody's risks related to COVID-19, substantive changes in reporting conditions have come through so far in 2020.



The chart above shows how volatile market conditions have been over the first half of 2020. This has tended to cause greater range of outputs from different assumption setting methods. It is therefore important to recognise that companies may see assumptions move away from a previous benchmark and this could act as a trigger to review methodology (particularly on the discount rate) to ensure it remains appropriate. We've outlined below some key implications for pensions accounting:

Discount rates

IAS19 references yields available on AA-rated corporate bonds. The yield can be split into two parts: government bond (i.e. gilt) yields and credit spreads (the premium over gilts). Gilt yields have fallen dramatically since 31 December 2019, driven in part by the Bank of England's monetary policy measures. Credit spreads increased substantially in mid-March, reflecting anticipated higher levels of default. These subsequently reduced substantially (though not back to December levels) over the next quarter. It is possible that changes to credit ratings could alter the constituents of AA-rated corporate bond indices and this could also impact IAS19 measurements.

Inflation

Reduced economic activity has resulted in a decrease in short-term inflation. There was a notable fall in longer term RPI expectations in March, with some reversion of this over the next quarter. As discussed later in this report, alongside the impact of COVID-19 there is also uncertainty from proposed RPI reform which will also be a factor in longer term market views on inflation.

Longevity

In the first half of 2020 around 60,000 more people died in the UK compared to average over the last five years. At the time of writing it appears too soon for pension schemes to form updated views on future longevity expectations as there remains huge uncertainty over the impact of COVID-19. In the first half of 2020, we expect most companies will stick with their current longevity assumption or update consistently with prior periods rather than try to build an explicit COVID-19 allowance into their assumptions. In early July the CMI announced that they planned to look at data out-of-cycle to try to help assist in the setting of future longevity projections.

Valuation of assets

Timely and accurate valuations of assets can be challenging, particularly if holdings are illiquid and/or do not perform in line with standard market indices. Asset prices have generally been more volatile than usual as reaction to the pandemic caused widespread disruption. There can therefore be some concern around using "approximate" values e.g. taking an earlier valuation. Auditors have a general preference to wait for final asset confirmations, which may take considerably longer than usual. Over time, we might expect these issues to subside, either because the current levels of volatility subside or because managers and auditors become more experienced in this environment.

Discount rate

£10bn
increase in FTSE 350 pension deficit

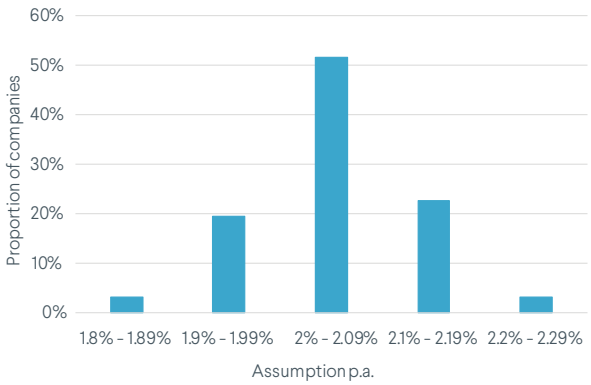
-7 bps
on discount rate

The discount rate is the most significant financial assumption for assessing pension obligations. A low discount rate leads to a high value being placed on the pension liabilities. The discount rate is set by reference to high quality corporate bonds of a suitable term. Long dated corporate bond yields fell by around 75 bps over the year.

The chart below shows the Hymans Robertson Corporate Bond curve derived from the AA iBoxx index at 31 December 2018 and 31 December 2019. The table shows the index yields on over 15 year iBoxx bonds.

Date	31 Dec 2019
15+ year iBoxx AA yield	2.00% p.a.
15+ year UK gilt yield	1.25% p.a.
Average AA credit spread	0.75% p.a.

The chart below shows the distribution of discount rates adopted by the FTSE 350 at 31 December 2019, and the table shows the average discount rate.



Date	31 Dec 2019
Average discount rate	2.00% p.a.

Observations:

Discount rates continue to be bunched, and more so than last year (88% of companies were within +/-0.1% of the average last year compared to 94% this year).

Our view

A higher concentration around the average assumption this year may reflect a toughening stance taken by auditors when reviewing pension disclosures, following increased scrutiny of the profession in response to recent high profile corporate failures. Following 31 December 2019 and market developments stemming from COVID-19, there has been significant volatility. We expect that increased volatility will serve to increase the range of assumptions reported at subsequent dates in 2020.

Inflation

£10bn
increase in FTSE 350 pension deficit

+12 bps
on inflation

The inflation assumption is the second most significant financial assumption for assessing pension obligations, and typically drives the assumption for salary growth, deferred revaluation and pension increases (to the extent they are inflation linked). A high inflation assumption leads to a high value placed on the pension liabilities.

Most schemes consider a CPI assumption as well as an RPI assumption, with CPI typically being set equal to RPI less a margin.

RPI reforms

A consultation is under way on the future of RPI with the proposal for RPI to be aligned with CPIH (essentially CPI but including changes in owner-occupied housing costs) by 2030 at the latest. For IAS19 purposes, RPI is typically derived directly from the market with a small risk premium being deducted whereas CPI, in the absence of a suitably deep and liquid market, is set in line with RPI less a margin based on relevant historical differences between the two indices. Typical IAS19 RPI assumptions derivations will therefore naturally capture what the market is pricing in whereas, for CPI, historical differences between the two indices are likely to be a less useful guide to the future long-term gap going forward.

Market reaction to the reform announcements was somewhat muted, with market implied RPI reducing by 10 – 20bps immediately following the announcements. This compares with a recent historical difference of c100bps between RPI and CPI. We have seen many companies reduce their implied RPI-CPI gap by 10 – 20bps, whilst typically leaving the methodology for RPI unchanged.

Some practitioners favour a more detailed approach, by considering different gaps before and after 2030 (although this may still be translated back to a single equivalent gap for ease of reporting). Approaches can differ between auditors, with some being more strongly in favour of particular approaches than others.

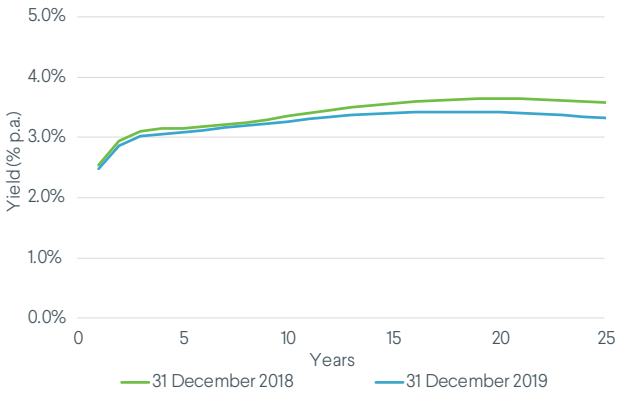
A key consideration is the materiality of the assumption i.e. the value of post-2030 CPI-linked obligations relative to the remainder of the scheme's liabilities.

The Bank of England's inflationary target of 2.0% p.a. can act as a sense check on any approach.

RPI

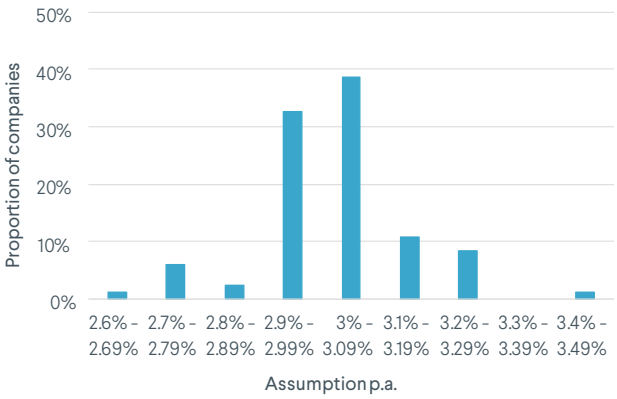
Over the year to 31 December 2019, long term RPI inflation expectations reduced slightly, with the reduction being more significant at the end of the curve. Given many schemes have durations of 15 – 20 years, RPI assumptions have generally been c20bps lower than those used at the last year-end. However, there is still quite a range in this assumption, reflecting the shape of the inflation curve and the maturity of different schemes, and the "inflation risk premium" argument often used to justify a reduction to market implied inflation.

The chart below shows the government bond implied RPI curve at 31 December 2019 and 31 December 2018, with the table showing RPI implied by over 15 year gilt yields at 31 December 2019.



Date	31 Dec 2019
15+ gilt implied RPI	3.1% p.a.

The chart below shows the distribution of RPI assumptions adopted by the FTSE 350 at 31 December 2019 and the table shows the average assumption.



Date	31 Dec 2019
Average RPI assumption	3.0% p.a.

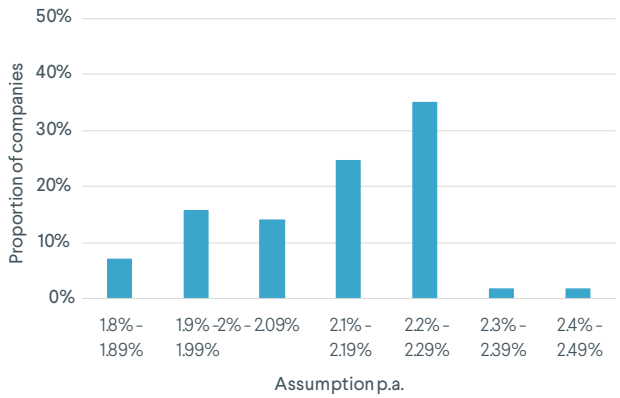
Observations:

- The average RPI assumption of 3.0% was used by 39% of companies, compared with 53% last year.
- Market implied RPI at a duration appropriate to most pension schemes is c3.1%. 77% of companies used a lower assumption than this, implying that most companies are deducting an "inflation risk premium" from market implied RPI. Of those that are applying a deduction, the typical size is around 0.2%.
- In recent years, we've tended to see a wider range of assumptions adopted for RPI than for the discount rate, a trend which has been repeated this year.

CPI

Some pension increases are linked to CPI rather than RPI. This switch to CPI typically occurred for deferred increases as opposed to pension increases after retirement.

The chart below shows the distribution of CPI assumptions adopted by the FTSE 350 at 31 December 2019.



Date	31 Dec 2019
Average CPI assumption	2.1% p.a.

Observations:

- The CPI assumption is dispersed with companies adopting assumptions between 1.8% and 2.4%. This is a bigger range than last year, when companies adopted assumptions between 2.0% and 2.4%.
- The average CPI assumption of 2.1% p.a. is 0.9% lower than the average RPI assumption, which gives an indication of the average differential assumed between RPI and CPI. This is 0.1% narrower than reported last year, which appears to be a consequence of the proposed RPI reforms, some of which may be presumed to have been reflected in RPI markets.
- Only 12% of companies used a wedge between RPI and CPI of 1.1% p.a. this year (down from 35% last year). This supports the view that the proposed RPI reforms were serving to reduce the assumed long-term gap between the indices.

Our view

A wide dispersion of CPI assumptions compared to RPI this year is unsurprising given the proposed RPI reforms and the inherent uncertainty as to how much of this is being captured in RPI pricing. Different approaches can be taken pre/post-2030 (the point at which RPI will likely be aligned with CPIH) and so the term of a scheme's obligations can then become a significant factor. Many schemes may not have significant CPI exposure and so may take a different approach than those with substantial long dated CPI indexed liabilities. Auditor views on CPI assumption setting also vary with some placing more emphasis on the Bank of England's 2.0% target. Taken together, these amount to a considerable amount of variability in the approach a company might take. Over time, as details are confirmed, and markets price them in, we'd expect greater convergence. If RPI were to be aligned with CPIH in line with the proposals then the gap between RPI and CPI assumptions would be expected to materially shrink relative to gaps typically assumed at 31 December 2019.

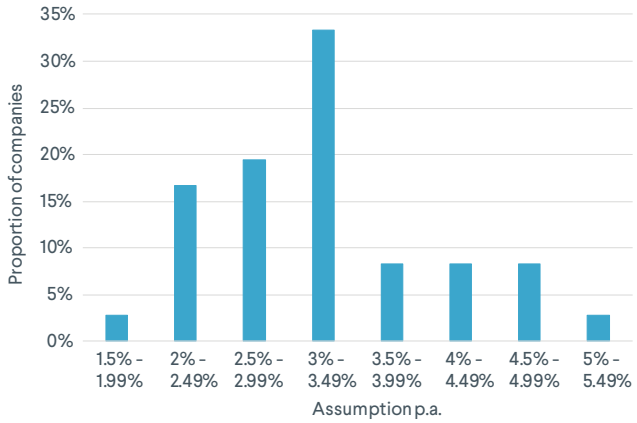
Salary growth

£10bn
increase in FTSE 350 pension deficit

+60 bps
on salary growth

Salary growth is a less significant assumption than the discount rate or inflation assumption as it only impacts on the liability for active members. This is becoming a smaller proportion of total liabilities as more schemes close to future accrual. However, it does still have a significant impact on the service cost, recognised in the income statement, for schemes that are open to future accrual.

The chart below shows the distribution of salary growth assumptions adopted by the FTSE 350 at 31 December 2019.



Date	31 Dec 2019
Average salary growth	3.1% p.a.

Observations:

- Unsurprisingly there is a wide range of salary growth assumptions reflecting differences in pay growth expectations.
- The average salary growth assumption of 3.1% is broadly consistent with the average RPI inflation assumption.
- 39% of companies use an assumption of less than 3.0% p.a. (the average RPI inflation assumption adopted), which we expect in part reflects the increased use of pensionable salary caps.

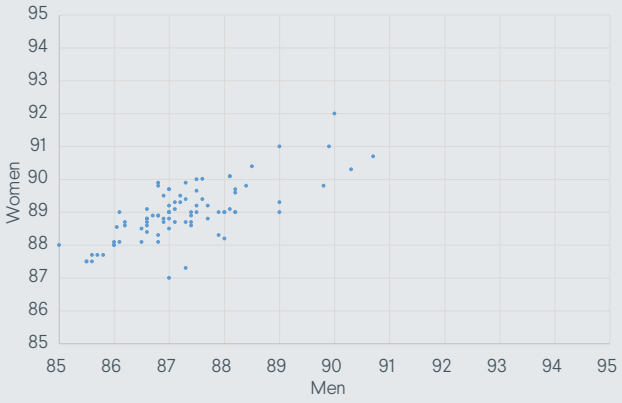
Longevity

£10bn
increase in FTSE 350 pension deficit

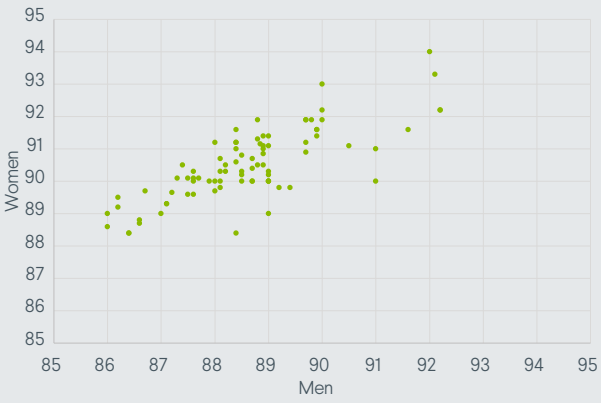
+4 months
on life expectancy

Longevity is the most significant non-financial assumption. The charts below show the distribution of male and female life expectancy assumptions for pensioners and non-pensioners used by the FTSE 350 at their most recent reporting date. These assumptions build in an allowance for how longevity is expected to change in the future. .

Life expectancy for pensioners



Life expectancy for non-pensioners



Average pensioner life expectancy

87.2 years

89.0 years

Average non-pensioner life expectancy

88.6 years

90.5 years

There continues to be a wide range of life expectancy assumptions for both men and women across the FTSE 350, with a spread of around 6 years for both pensioners and non-pensioners. These differences will reflect different views on the current longevity of scheme members (driven by industry, socio-demographics etc) and on how longevity is expected to change in the future for those members. Each additional year of life expectancy can add in the region of 4% to pension scheme liabilities, so a 6 year difference would equate to a difference in liabilities of around 24%.

Unsurprisingly, non-pensioners are expected to live longer than current pensioners, with life expectancy assumed to improve by around nine months per decade on average.

The average disclosed life expectancies have reduced by 0.2 years for pensioners and 0.3 years for non-pensioners over the last year.

Our view

In general, the 2010s have seen much slower improvements in longevity compared to the 2+ years per decade experienced during the late 90s and 2000s. These slower improvements (which equate to heavier mortality than would otherwise have been expected) continued to flow through to accounting assumptions last year, where we've been seeing a further tail-off in disclosed life expectancy improvements.

For disclosures at the end of 2019, the most recently available version of the CMI model for projecting mortality improvements was CMI_2018. Typically, a new version of the CMI model comes out around March each year. 2019 was a relatively light year for mortality in England & Wales. A switch from CMI_2018 to CMI_2019 would be expected to lead to a modest increase in life expectancies and accounting liabilities (assuming model parameters are not changed). However, COVID-19 means there is considerable uncertainty over mortality.

In early July 2020 the CMI announced plans to look at data out-of-cycle to try to help assist in the setting of future longevity projections due to COVID-19. In the first half of 2020 around 60,000 more people died in the UK compared to average over the last five years. At the time of writing it appears to soon for pension schemes to form updated views on future longevity expectations as there remains significant uncertainty. In the first half of 2020, we expect most companies will stick with their current longevity assumption or update consistently with prior periods rather than try to build an explicit COVID-19 allowance into their assumptions. However we may see more significant changes to longevity assumptions as new data and models become available.

A short-term impact from COVID-19 may be on pensioner payroll for schemes who have seen a noticeable increase in deaths (which will reduce liabilities). The extent of this will vary significantly across pension schemes, depending on factors such as the age, socio-economic and geographic profiles. We may see schemes taking extra cuts of member data to seek to allow for this more accurately in accounting disclosures.

Our view is that when setting future longevity assumptions consideration will need to be given both to the short-term effect of increased mortality rates in 2020 and the potential impact on longer-term trends. However, it will take time for evidence to emerge. For some schemes COVID-19 related deaths may have disproportionality affected those with significant health conditions meaning the remaining scheme membership may be healthier on average than before which may therefore see stronger mortality improvement rates. Alternatively COVID-19 may cause additional long term medical conditions which may act to suppress mortality improvements in future. Views on whether the pandemic will be a one-off shock, or potentially a recurring event like flu are also varied, and will depend on a number of factors such as development and availability of vaccines, rates of mutation of the virus, etc, many of which are currently very uncertain.

As well as the more direct effects on mortality, we could also see some indirect effects as the economy and society respond to the situation. For example, we may see a delay in the treatment of other diseases which could increase mortality rates. Conversely, increased awareness of hygiene standards, combined with social distancing restrictions, may help reduce fatalities from some causes like seasonal flu.

The effects of the pandemic appear to be being felt differently across socio-economic groups. Analysis from Club Vita shows that more affluent pensioners have been more resilient to the slowdown in longevity improvements over the last decade than less affluent pensioners and the wider England and Wales population. COVID-19 may exacerbate this trend. In general, liabilities are skewed towards these members who represent a significant proportion, and sometimes the majority, of liabilities for a typical DB pension scheme.

In the current circumstances it is even more important that, as well as taking account of recent experience at both the population and (where appropriate) scheme level, the socio-demographic profile of scheme members is considered for both the assumption for current longevity and the assumption for how longevity will change in the future.

Allowance for member options

The combination of pension freedoms and historically low gilt yields resulted in noticeably higher volumes of transfer values being paid out across the industry since 2015. More recently we've some increased regulatory oversight in this area leading to a reduction in IFA capacity which may lead to a reduction in transfer value uptake. Now that a number of years' experience exists, consideration should be given as to whether it is appropriate to allow for future transfers out in company accounting disclosures, particularly if this could lead to material changes in IAS19 liabilities for non-pensioners. Whilst transfers usually lead to a gain on longer term funding targets this is not always the case on an IAS19 measure – the change can depend on the age at which members are transferring and now the transfer terms are set.

Our analysis shows that at 31 December 2019, one company disclosed an explicit allowance for future transfers. Another company disclosed no allowance this year where they had made allowances in prior years, citing immaterial recent experience as the justification.

Pension Increase Exchange ('PIE') options are available in a number of FTSE 350 schemes. However, our analysis shows that none of the companies surveyed explicitly disclosed an assumption for future uptake of PIE within their financial statements.

| Our view

From our own data, we can see that transfer value requests are continuing to fluctuate around what are historically high levels of engagement albeit with a slowdown being observed more recently. It's challenging to predict whether high engagement rates will continue in the future as there are a range of factors which may impact members' decision making. These could include:

- COVID-19 increasing appetite for immediate access to pension savings, possibly to replace lost income.
- Economic uncertainty leading to members being more risk averse, or delaying a decision with their pension, similar to putting off selling or buying a house - for many individuals their pension will be one of their biggest assets.
- Stricter regulatory oversight on IFAs and an increased FCA spotlight, in light of high profile scandals such as British Steel, leading to fewer recommendations to transfer out.

However, we believe that future allowance may become more common, particularly within the financial services sector where volumes appear particularly high.

We expect that making an allowance for future uptake of a PIE option at retirement is likely to remain at lower levels. PIEs are more typically run as bulk exercises for current pensioners, in which case a gain is recognised at the point the offer is run, with less justification for a future uptake assumption.

IAS19 developments

Recent changes to IAS19 mean that events that lead to changes in liabilities can lead to a remeasurement of P&L at the point any change is confirmed. Market volatility linked to COVID-19 creates a risk of significant changes in P&L if an event occurs.

At the time of writing the pensions industry is awaiting a further High Court judgment in relation to GMP equalisation in respect of the Lloyds Bank and HBOS pension pensions. This judgment includes consideration of historical transfer values. The October 2018 equalisation judgment caused many sponsors to recognise additional liabilities, so sponsors should be aware of the potential for further changes to liabilities.

Economic pressures linked to COVID-19 may also cause companies to consider changes to pension schemes such as scheme closures. The accounting impact of any change could be material particularly with the possibility of P&L remeasurement.

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