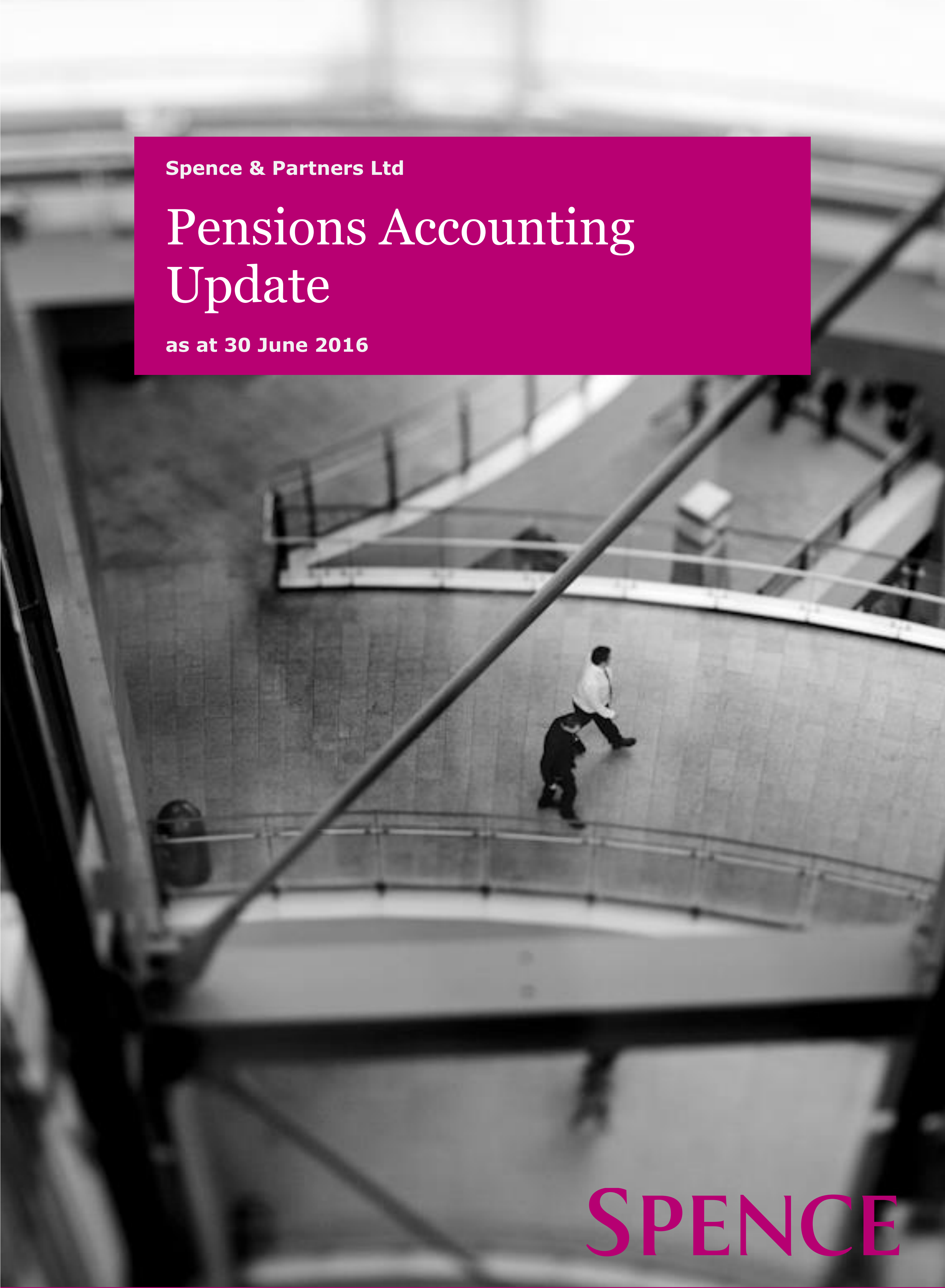
**Spence & Partners Ltd**

# Pensions Accounting Update

**as at 30 June 2016**



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This guide is intended to be a useful reference for companies preparing their 30 June 2016 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 3 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.

# Market Summary

Major asset classes have had a relatively strong performance over the 3 month period to 30 June 2016. This strong performance follows on from the similar growth experienced in the Q1 of 2016. However, these asset classes have had their value distorted somewhat by 'Brexit' in the final week of the quarter.

The uncertainty created by the United Kingdom's decision to leave the European Union has had a significant impact on the value of the major assets classes. In general, it has adversely affected the value of 'risky' asset classes such as equities, particularly those denominated in Sterling, while causing a surge in demand for 'safer' assets like governments bonds.

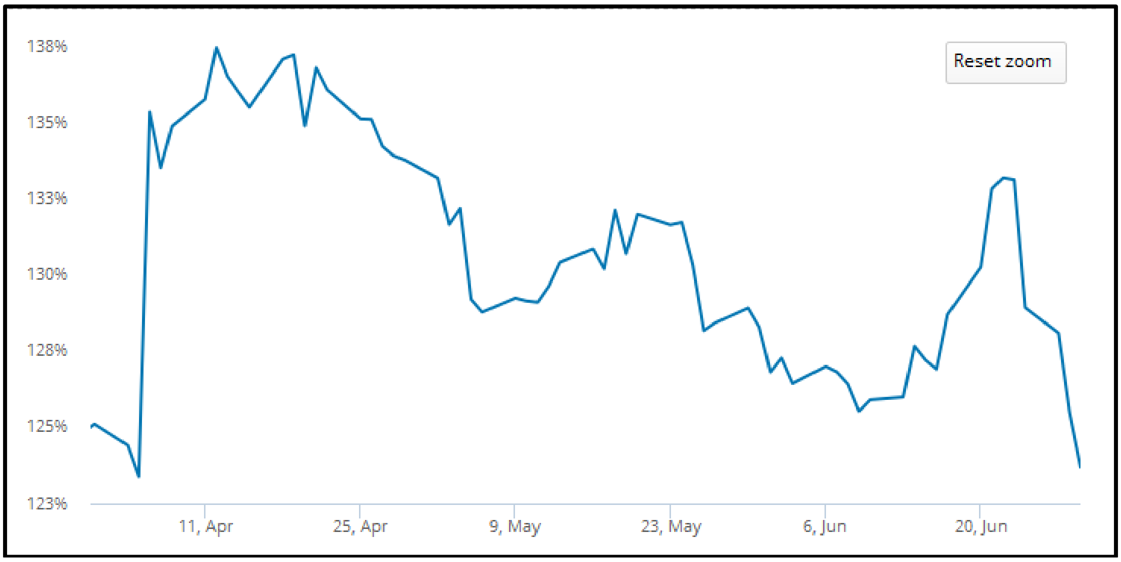
Given the inverse relationship between the price of a bond and the corresponding yield, the final week of the quarter has seen yields on governments bonds and, to a lesser extent corporate bonds, plumet. This will adversely affect the value placed on a scheme's liabilities, all other things being equal.

Depending on schemes' investment strategies and their weightings in the major asset classes, any gains from investment returns will likely have been more than offset by increase balance sheet liabilities, resulting from lower bond yields.

## How might this affect a typical pension scheme?

Chart 1 below, captured from [Mantle](), Spence & Partners' award winning integrated administration and actuarial system, illustrates the effect of market movements over the past 3 months on the balance sheet funding level of an example scheme, "Example Pension Scheme" ("EPS"), all else being equal.

**Chart 1 - Daily Movements in EPS funding level**




From Chart 1 it can be seen that EPS's funding level has been fairly volatile over the 3 month period to 30 June 2016. This has been largely due to variations in market conditions impacting both the assets and liabilities of the scheme. In particular, the EPS has witnessed a significant fall in its funding position in the final week of the quarter due to decline in corporate bond yields as a result of Brexit.

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# Market Movements in Detail

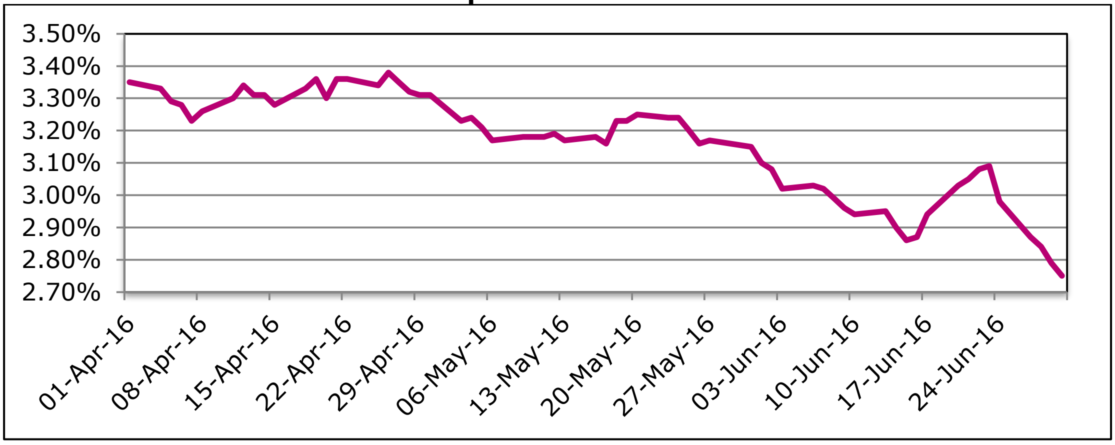
The key financial assumptions affecting a scheme's balance sheet position are the discount rate and the future rate of inflation.

## 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, but for illustrative purposes we show below how the yield has varied over the past 3 months on a suitable long-dated corporate bond index, the iBoxx over 15 year AA rated corporate bond index.

**Chart 2 - Yield on iBoxx £ Corporates AA 15+**

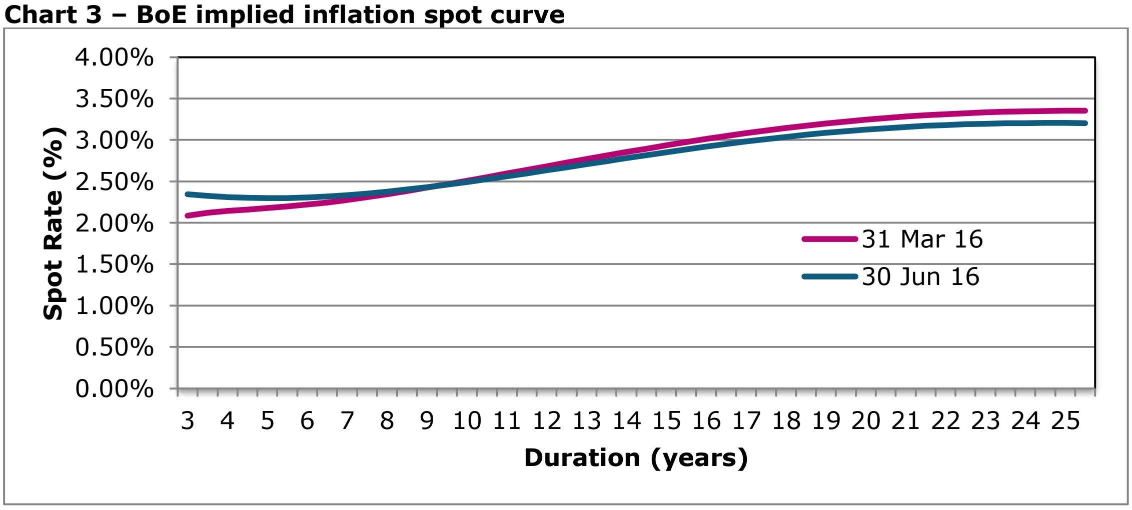



It can be seen that yields have fallen by around 0.6% since 31 March. As a result, discount rates will have decreased and therefore scheme's liabilities will have increased.

## Inflation

The inflation assumption is also important, as this is generally used to determine future benefit increases, both in deferment and on pensions in payment. Again, there is a range of appropriate values that this assumption can take depending on each scheme's circumstances. Chart 3 shows the Bank of England expectations over future durations.

**Chart 3 – BoE implied inflation spot curve**



## *Market movements in detail continued...*

From Chart 3, we can see that the market's expectation of inflation since 31 March has decreased slightly at longer durations while increasing at shorter durations. Again, this is likely due to the short-term uncertainty created by Brexit. Given the long term nature of pension scheme liabilities, the implied inflation spot rate at longer durations is likely to be more applicable. Consequently, this small decrease in inflation expectations, which if viewed in isolation would decrease liabilities. However, when combined with the larger decrease in bond yields, it will have the net effect of increasing the liabilities over the period.

## Market Effect on 'EPS' Liabilities

It may be seen from Table 1 below that the main driving factor behind the movement in EPS liabilities over the 3 month period to 30 June 2016, as illustrated in Table 1, has been the fall in bond yields and the resulting decrease in the discount rate.

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

| 'EPS' Assumption | Effect of Market Movement (31 March to 30 June ) | Change in Liabilities [1] |
|---|---|---|
| Discount Rate | -0.6% | +12% |
| Inflation Assumption(s) | -0.05% | -0.5%[2] |
| **TOTAL [3]** | | **+11.5%** |

1. *Assume EPS liabilities have average duration of c.20 years. No allowance for cashflows has been made.*

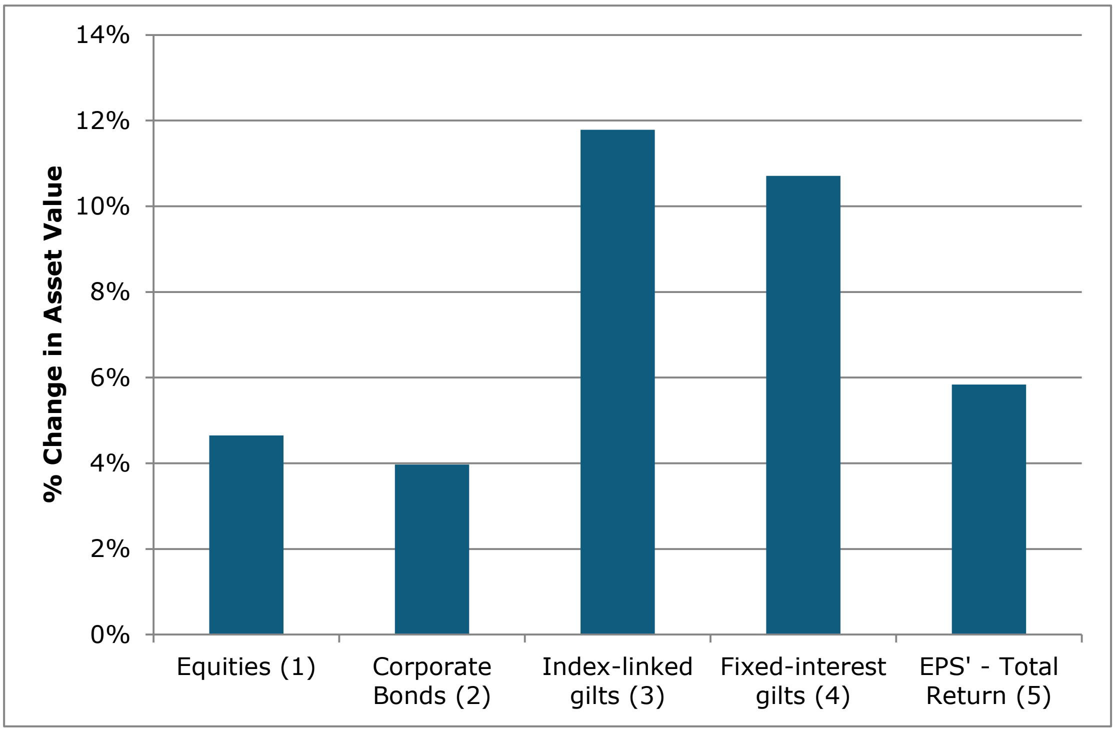
2. *Assume effect on liabilities of change in inflation is 50% of the effect of the equivalent discount rate change.*

3. *Note approximate nature. The above illustrates the approximate effect of changes to these assumptions only.*

# Market Effect on 'EPS' Assets

Chart 4 below details the performance of different asset classes over the 3 month period to 31 March 2016.

**Chart 4 - Return on Major Asset Classes**




1. *FTSE All Share Capital Return index*
2. *iBoxx £ Corporates Total Return index*
3. *iBoxx UK Gilt Inflation-Linked Total Return index (Nominal)*
4. *iBoxx £ Gilts 15+ Total Return index*
5. *EPS asset allocation: 60% equities, 20% corporate bonds, 10% index-linked bonds and 10% fixed-interest gilts.*

Although each scheme's investment strategy will differ, using Chart 4 above as a guide, we can see many schemes' assets will have increased over the 3 month period to 30 June 2016, with a weighted average return of just under 6% for our model scheme, EPS. This has been a result of a strong improvement in the four asset classes outlined in Chart 4. In particular, where a scheme has more exposure to Index-linked and Fixed Interest Gilts than that assumed in Chart 4, average returns for the period may be higher still.

As a result of the inverse relationship between bond prices and bond yields (and hence discount rates), increases in funding levels achieved through positive asset returns are likely to be offset by increased balance sheet liabilities, although the extent of which will depend on schemes' investment strategies.

Whilst all schemes vary in their particular details and needs, the broad experience of our example scheme (a small scheme with a 20 year average term) may be taken to be similar to the average small to medium sized scheme. We hope it will serve as a useful guide as to what to expect from 30 June 2016 disclosures.

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# Recent Developments

## EU Referendum

The Brexit vote has caused uncertainty in the global markets. After the leave vote was announced, investors flocked to what are regarded as 'safer' investments such as government bonds, and to a lesser extent corporate bonds.

This increase in demand pushes up the price of these bonds and therefore reduces the yield. As you will be aware, the lower the discount rate, the higher the value placed on Scheme liabilities. Post Brexit market movements will therefore be detrimental to schemes who are undertaking FRS102 or IAS19 valuations as discount rates are set according to the yield on high quality corporate bonds. Lower yields will mean lower discount rates and therefore a higher value will be placed on the scheme's liabilities. All other things being equal, this will worsen the balance sheet position.

# Next Steps

With the wealth of corporate advisory experience available at Spence, we are well placed to provide you with guidance in how to best manage your pension scheme liabilities.

The implications of recent developments in Financial Reporting Standards should be assessed and considered to help you avoid any surprises. Spence can help guide companies through these complexities and 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.

At Spence we can even deliver daily funding valuations and user-friendly modelling for direct use through your browser or portable device.

To discuss these topics further, please contact Spence through your usual contact or connect with our Corporate Advisory practice head, Richard Smith, at richard_smith@spenceandpartners.co.uk or by telephone on 020 3691 2948.

**Belfast**

Chamber of Commerce House
22 Great Victoria Street
Belfast
BT2 7BA

**t:** 028 9041 2000

**Glasgow**

The Culzean Building
36 Renfield Street
Glasgow
G2 1LU

**t:** 0141 331 1004

**London**

46 New Broad Street
London
EC2M 1JH

**t:** 020 7495 5505

**Manchester**

Pall Mall Court
61-67 King Street
Manchester
M2 4PD

**t:** 0161 641 6312

**Bristol**

Castlemead
Lower Castle Street
Bristol
BS1 3AG

**t:** 011 7959 5002

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