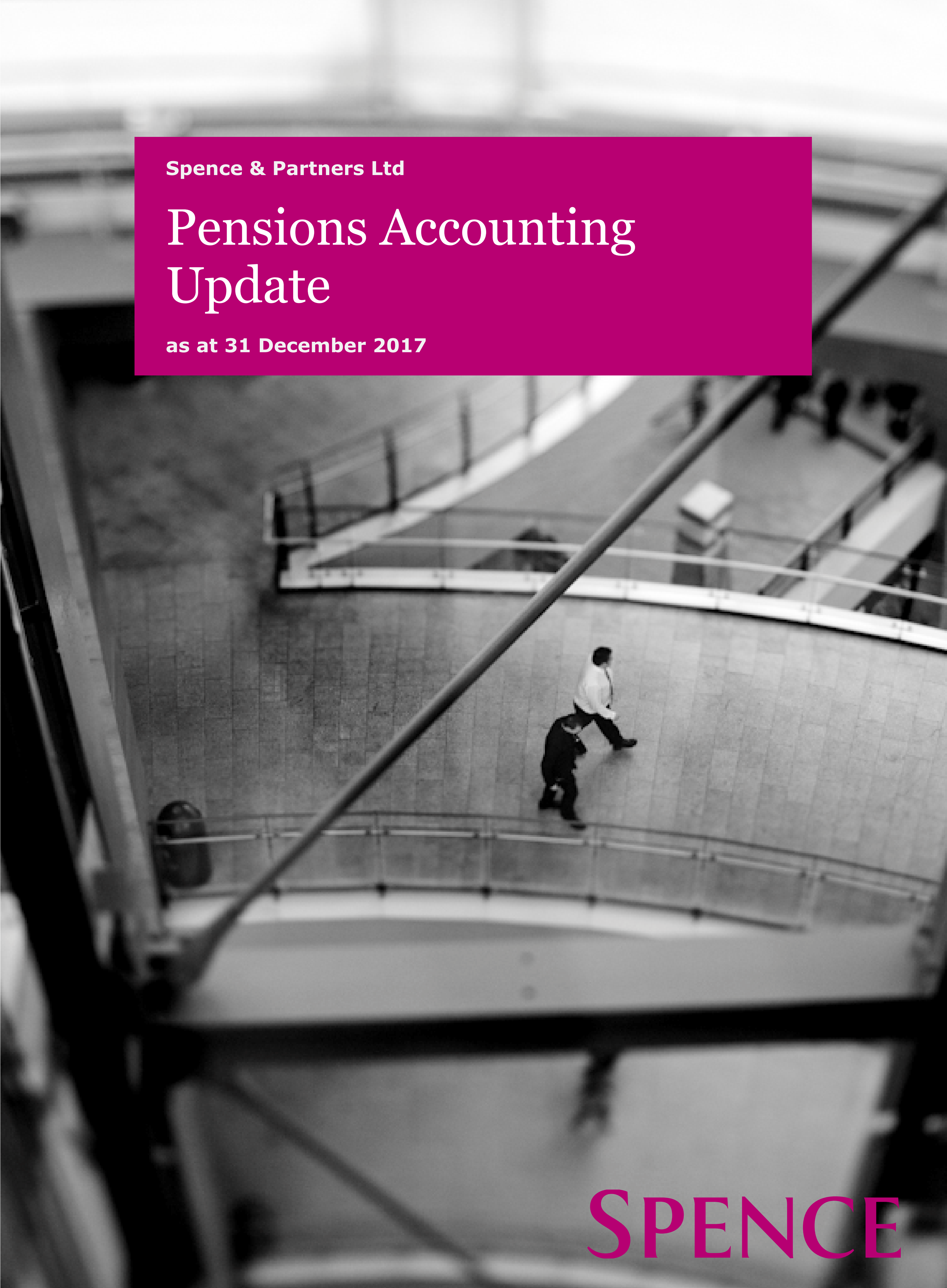
Spence & Partners Ltd

Pensions Accounting Update

as at 31 December 2017



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This guide is intended to be a useful reference for companies preparing their 31 December 2017 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.

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Executive Summary

Due to falls in corporate bond yields over the last year, most companies will be faced with higher values being placed on their pension scheme liabilities.

However, for companies sponsoring schemes that have a significant allocation to UK and overseas equities, the asset growth should have more than offset the increase in liabilities. Schemes which have a higher allocation to protection assets (e.g. government bonds) may not have fared quite so well.

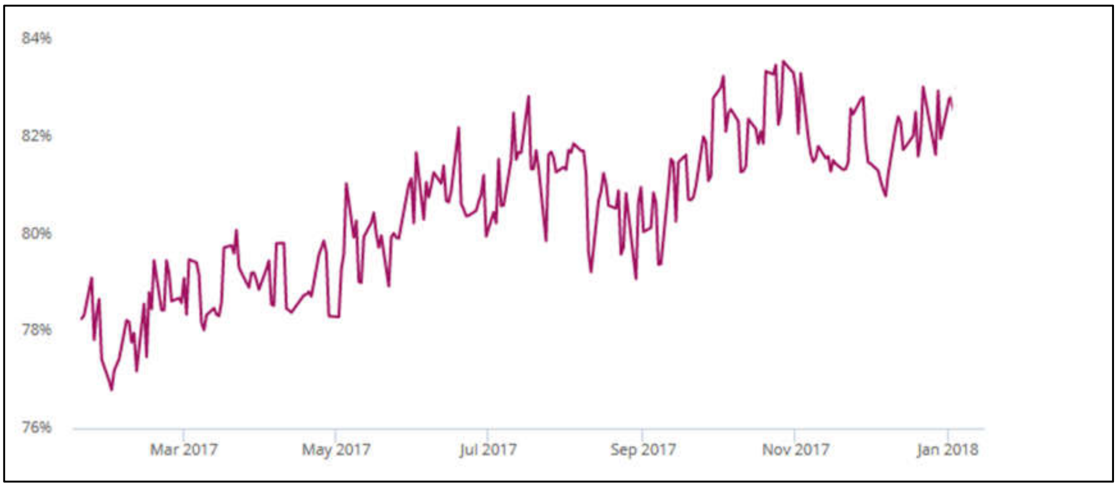
Schemes may find a small reduction in liabilities from using the latest version of the Continuous Mortality Investigation (CMI) mortality projection model.

Overall, the pensions accounting position for most companies reporting at 31 December 2017 may be better than at 31 December 2016 despite the significant fall in corporate 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 12 months on the balance sheet position of an example pension scheme “EPS”.

Chart 1 - Daily Movements in EPS funding level

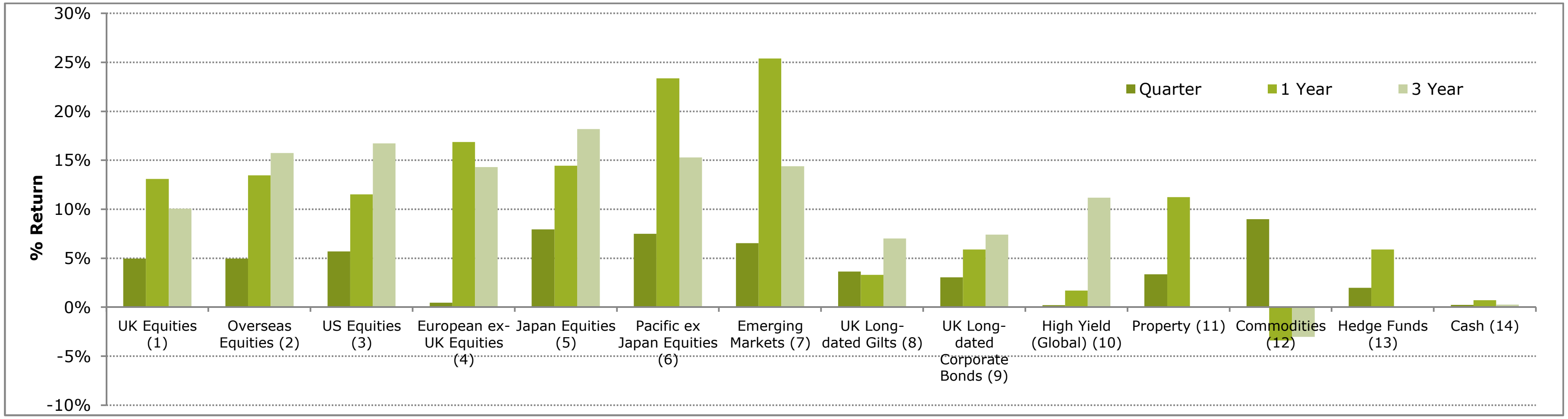


EPS's funding level has been relatively volatile over the 12 month period to 31 December 2017. This has been largely due to variations in market conditions impacting both the assets and liabilities of the scheme. Corporate bond yields reduced over the year, which increased the value placed on the liabilities. However, this was more than offset by strong investment returns which resulted in an increase in the overall scheme funding level.

Market Summary

Chart 2 below details the performance of major asset classes over the 12 month period to 31 December 2017.

Chart 2 - Return on Major Asset Classes



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 Emergin 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. MSCI IPD UK All Property TR GBP
12. S&P GCSI Commodity TR Index GBP
13. Credit Suisse Hedge Fund GBP
14. LIBOR 3 Month Interbank Rate

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Market Movements in Detail

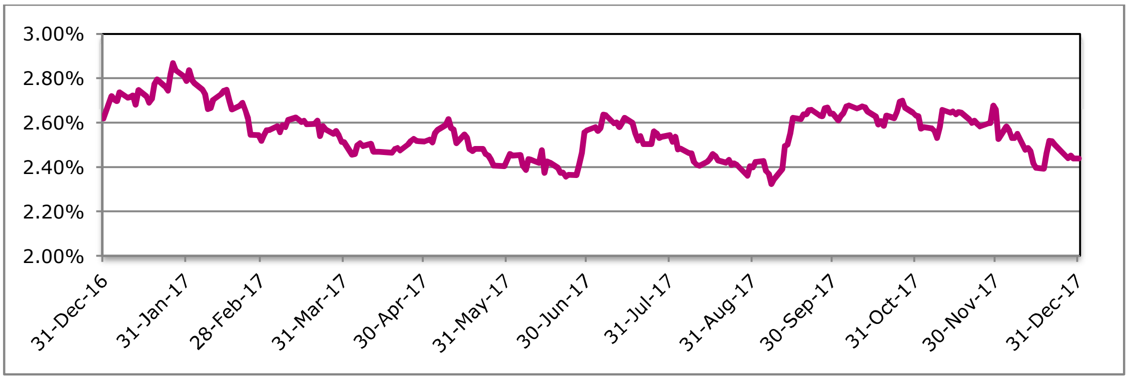
The key financial assumptions affecting a scheme's balance sheet position are the discount rate and the future rate of inflation.

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 12 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+



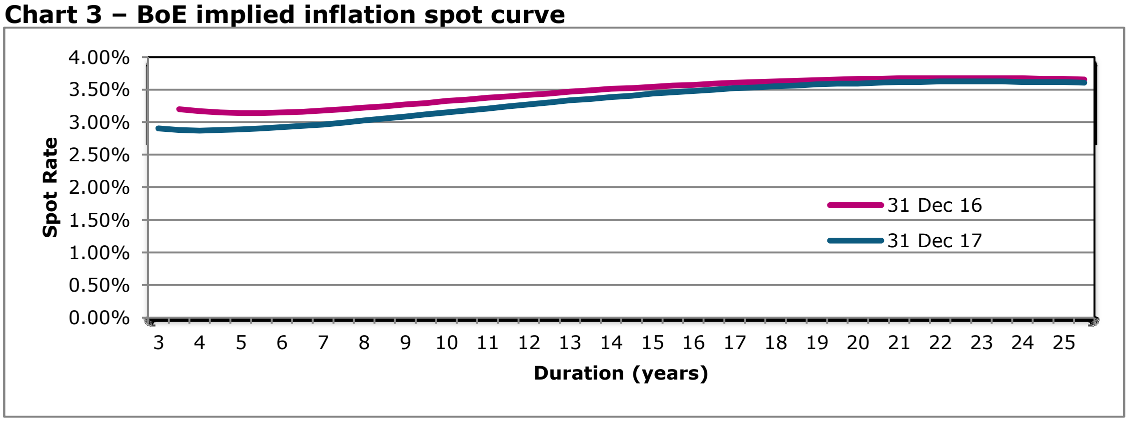
It can be seen that yields have fallen over the last year, resulting in a lower discount rate and so higher liabilities, all other things being equal, for most schemes.

The duration of the iBoxx £ Corporates AA over 15 years as at 31 December 2017 is 15.30 years but this is generally shorter than the duration of most pension schemes' liabilities. It may therefore be appropriate to use a discount rate above the index yield if the duration of the scheme's liabilities is longer than the index.

Inflation

The inflation assumption is 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's expectations over future durations.

Chart 3 – BoE implied inflation spot curve



Market movements in detail continued…

From Chart 3, the market's expectation of inflation since 31 December 2016 has marginally decreased for lower durations but remained broadly the same for higher durations. Decreasing bond yields will lead to a higher value being placed on Scheme liabilities but this will be partially offset by reduced inflation.

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 for any other external factors that the company directors feel should be taken into account in determining this assumption.

Market Effect on 'EPS' Liabilities

The main driving factor behind the movement in EPS liabilities over the 12 month period to 31 December 2017 has been a decrease in bond yields and the resulting decrease in discount rate.

Table 1 - Breakdown of Market Effect on EPS Liabilities

'EPS' Assumption	Effect of Market Movement (31/12/2016 to 31/12/2017)	Change in Liabilities [1]
Discount Rate	-0.18%	3.60%
Inflation Assumption(s)	-0.06%	-0.60% [2]
TOTAL [3]		**3.20%**

1. *Assume EPS liabilities have average duration of 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.*

The balance sheet impact will depend on the asset classes held and the performance of the Scheme investments.

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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.

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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