The 'Brave New World' of pension scheme finances

How corporate Britain should respond to a world of volatile markets, high inflation and emerging scheme surpluses

November 2022

Helping corporate sponsors

A time of great opportunity

In the foreword to last year's LCP Corporate Report I suggested that pretty much every business decision needed to be seen 'through a pensions lens'. That may have seemed a bold claim at the time, but the events of the last year – and the last few weeks in particular – have shown just how important it is for corporate Britain to fully appreciate both the risks and opportunities relating to their Defined Benefit pension scheme.

Emerging surpluses

The issues on which this year's report focuses are dramatically different to those which schemes and their sponsors faced just a few years ago. Instead of focusing on how to plug pension scheme deficits, this year we start off with a major discussion of what to do if your scheme is in surplus or heading in that direction. This is very much in the category of 'a nice problem to have', but, as my colleagues point out in the opening section of this report, there are risks of 'trapped surplus' and sponsor capital being tied up in unproductive ways. But there are also opportunities to make sure that sponsors respond to this welcome change with a strategy that best meets their objectives, provided that they plan ahead.

Investment opportunities

We also devote a significant chunk of this report to the issue of investment strategy at a time of market turmoil. For example, some sponsors will have faced calls from their pension scheme for loans or cash contributions to tide them over a liquidity crunch caused by the surge in gilt yields, and a key question now is how far investment strategies need to change to avoid a repeat of this situation. In this report, our experts set out some key issues which schemes and their sponsors will need to tackle in the coming months as they review their investment strategy, and they are on hand to help you design the best strategy going forward in this new world.

Keeping perspective

The wide range of topics covered in the 'corporate developments' section of this report shows just how much there is for sponsors to keep on top of, whether it is responding to a new world of 'higher for longer' inflation and interest rates, the prospect of tougher new rules on pension scheme funding from the DWP or the potential to explore new 'endgames' for your scheme including DB 'superfunds'.

We also address the thorny issue of how the ups and downs of sponsor pension schemes show up in sponsor accounts, showing how actions that can look prudent from a pension scheme point of view (such as de-risking through a partial buy-in) can take some explaining when they are viewed through the lens of a sponsor balance sheet.

Much of the media discussion around pensions focuses, perhaps understandably on the negatives and the risks. And there is no doubt that there are plenty of these to manage. But I hope our report will also convince you that, for the sponsor who is on-the-ball with oversight of their pension scheme, this is also a time of great opportunity.

Sir Steve Webb

Partner at LCP and Pensions Minister 2010-15

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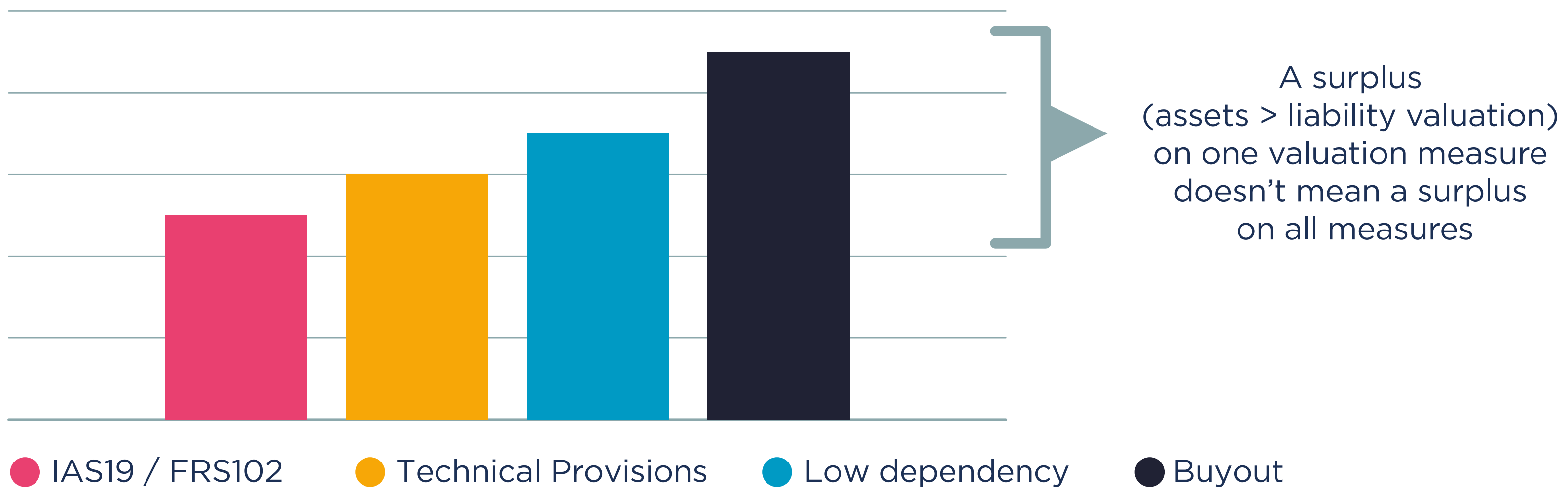
'Surplus' or over-funding risk – a nice problem that may have come out of the blue

Funding levels have greatly improved since last year, and surpluses are now here or much closer than they have ever been. This brings new and interesting considerations for sponsors when it comes to pensions strategy and, in some cases, a total shift in mindset. The unprecedented market movements seen at the end of September have, for most sponsors, made surplus management even more prominent than it was before given the impact on many schemes was, in the round, improved funding positions.

Pension liability valuations using different assumptions



Pension surpluses are a wonderful change compared to the deficits sponsors have been facing for over 20 years. I recommend all sponsors take action now and embrace the opportunities that the current economic environment brings for pensions management.

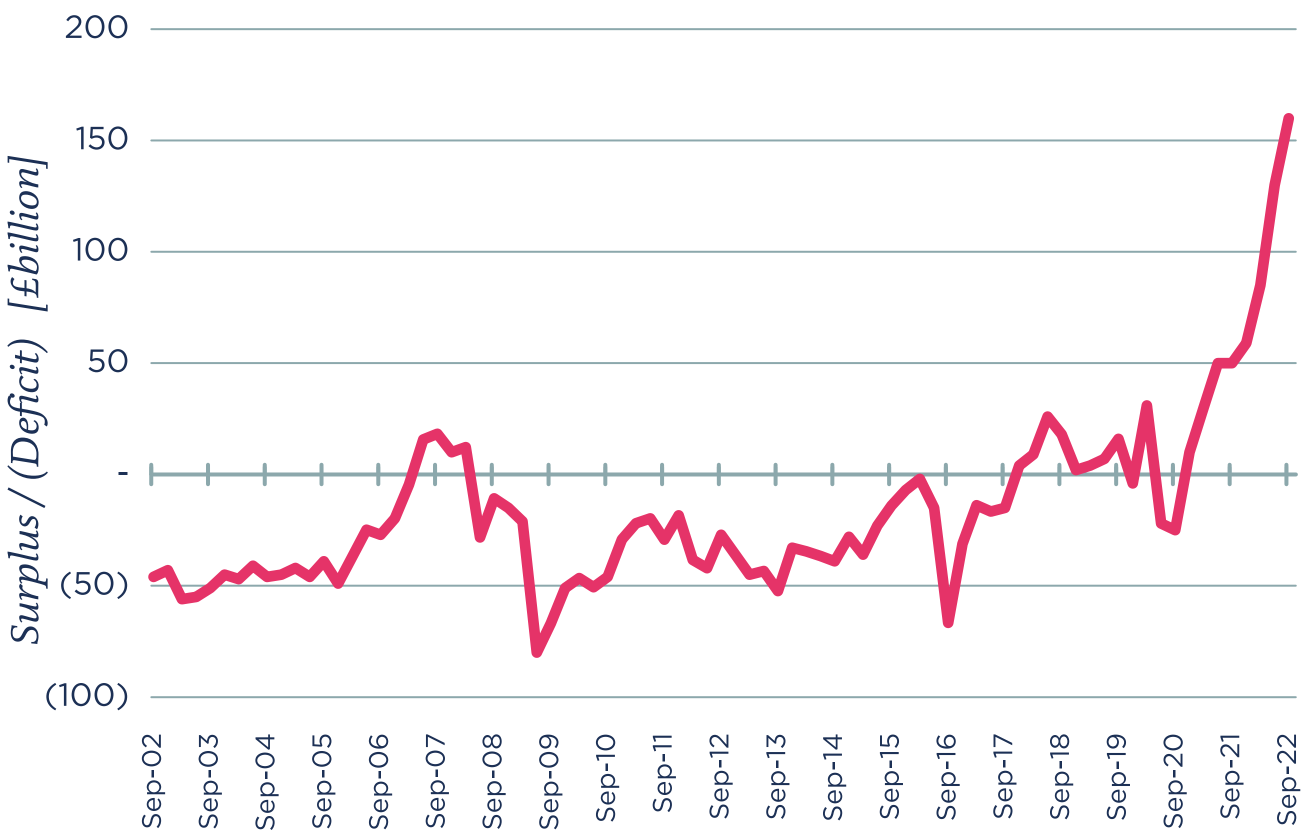
Alex Whitley Partner, LCP

What does a surplus mean?

A surplus can mean different things to different people. Pension schemes are subject to lots of valuation measures which all assume different things about the future: Looking at the IAS19 accounting measure, FTSE100 organisations have the potential to realise over £150bn of value if their schemes are run on and their assets achieve corporate bond yield returns.

This is important to think about as, if members can comfortably receive their full benefits under pension scheme rules, could DB pension schemes become a source of one-off revenue for sponsors at some point in the future, rather than a seemingly continuous cash call? See Section 4 for further commentary on accounting matters.

Change in estimated combined IAS19 position of FTSE100 sponsors at quarter ends over the last 20 years



FTSE100 now has an accounting surplus of >£150bn

Why does having a surplus matter?

Irrespective of which valuation measure you look at, having or approaching a surplus means that sponsors will have new issues calling for serious consideration.

Valuation measure	*Implications of surplus*
IAS19 / FRS102	• Communications with shareholders and investors need careful management. An accounting surplus doesn't mean an immediate cashflow windfall or that pensions are 'solved'. • 'IFRIC14': Auditor focus on this point has stepped up as accounting surpluses have grown – it's essential to understand your scheme rules to determine whether you can recognise your surplus. • The more an accounting surplus grows, the bigger the challenges become for future de-risking actions (e.g. bulk annuity insurance) which can act to reduce or remove the accounting surplus.
Triennial valuation ('technical provisions')	• If you have reached around 100% on the statutory funding requirement, then should you be paying in any more cash contributions to the scheme (e.g. to move towards any longer term targets), or stop contributions as soon as possible? • If you choose to pay in more / continue to pay in money to the scheme, might these contributions be more sensibly made into **escrow** or **'co-investment' vehicles**, which are then easier to 'get back' if not needed? • If you no longer have a deficit, should investment strategy be de-risked to reduce the risk of slipping back into deficit?
Low dependency / self-sufficiency	• If this position has been achieved, the pension scheme can in theory be run on indefinitely without the need for future cash support from the sponsor. Should cash contributions therefore cease immediately? • If this position has been achieved, should the governance model (trustee structure, investment advisory model etc.) be reviewed? • Do you understand what your scheme's future investment returns are expected to be, how these are projected to bridge the gap towards ultimate objectives (e.g. buy-out) and by when?
Insurance buyout	• If you are already (or nearly) 'there', how and when do you best engage insurers to obtain their senior time, resource, and best pricing? • Are any of your scheme assets in illiquid funds that need addressing / realising in order to ensure an insurance transaction is viable? • If some form of cash injection might be needed (even if only to fund future wind-up expenses), then the sponsor may have more influence in the insurance negotiations that have cost implications (for example, member option factors, wider insurances, and generosity of any discretionary benefits to be codified). • See also our recent insurance de-risking **report**.

Does a surplus mean sponsors can easily access it?

Not necessarily.

A sponsor's ability to access any pension surplus is heavily dependent on the lottery of what the scheme rules say.

This might affect your ultimate strategy, as the harder it is to access surplus, the less reason for a strategy that produces one.

Sponsors are used to thinking about whether they can access surplus in their pension schemes, but that's usually been focussed on technical questions about what gets shown on the balance sheet. It's really important right now, because it might affect your actual pension strategy, to get to the bottom of whether, when and how you can access surplus.

Phil Cuddeford Partner, LCP

What is your scheme's end-game objective / time horizon?

Natural run-off over time
(eg in low dependency)

Buy-out when affordable
(using investment growth, not cash)

Buy-out asap
(material funding available)

← **Longer time frame** — **Shorter time frame** →

Surplus can be paid to the sponsor
(ongoing, no significant conditions above over-arching legislation)

Surplus can be paid to the sponsor
(ongoing, but with material conditions and trustee discretions)

Surplus can be paid to the sponsor
(only on wind-up, potentially only after trustees have augmented benefits)

Surplus cannot be paid to the sponsor

← **More flexibility** — **Less flexibility** →

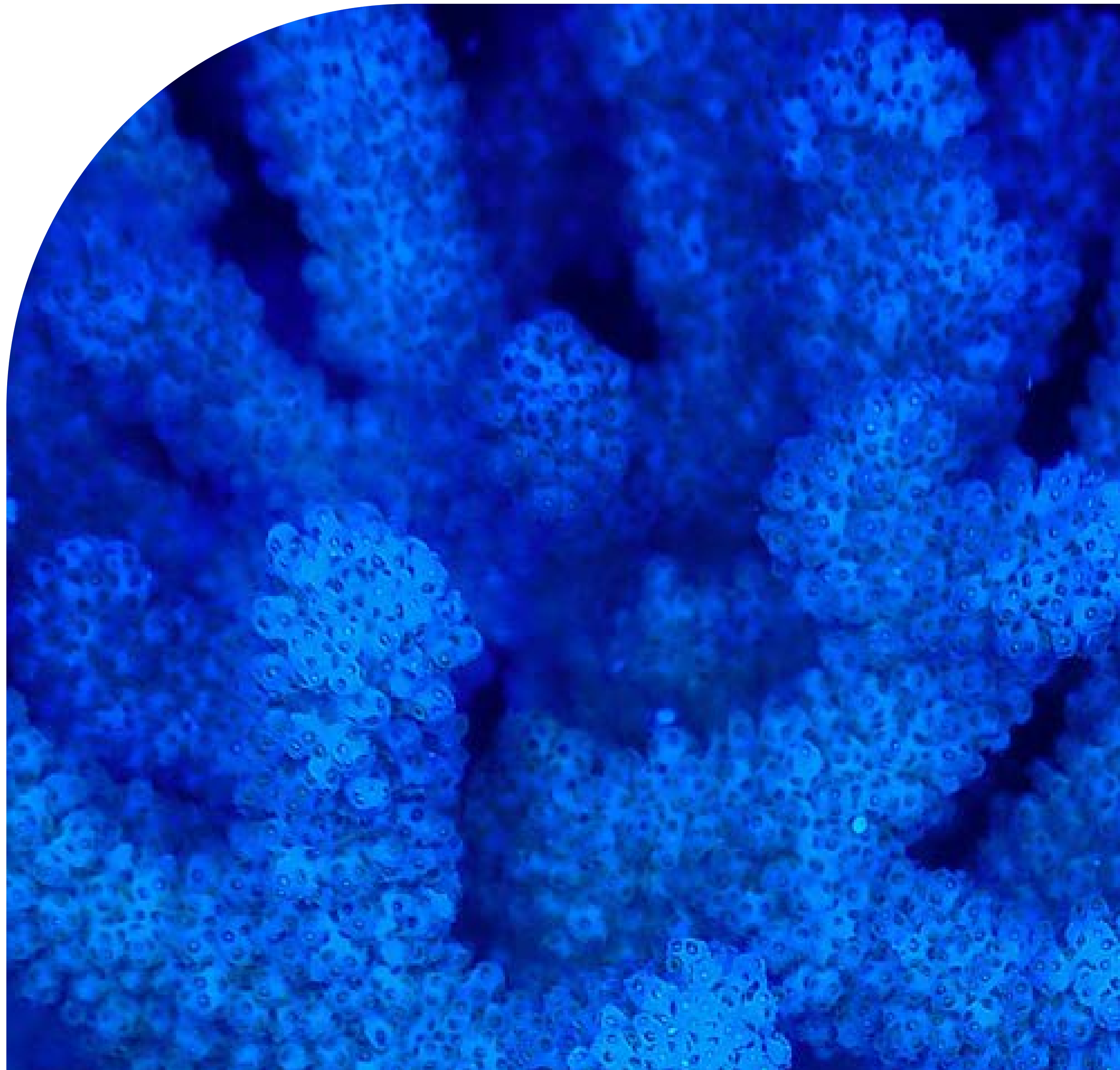
Does a surplus mean sponsors can easily access it? Continued

Over-arching legislation also imposes the following restrictions / considerations when it comes to refunds of surplus:

	General legal overlay for refunds of surplus
Ongoing	Where a scheme contains a power to make a payment to the employer, this power can only be exercised if the following conditions, under section 37 of the Pensions Act 1995, are satisfied: • the scheme has an estimated buyout surplus • the Scheme Actuary has certified the maximum amount payable to each participating sponsor • the trustees are satisfied that payment of the surplus refund is in members' interests • members have been given at least three months' notice • the trustees notify The Pensions Regulator within a week of the surplus payment.
Wind-up (when surplus refund is paid in connection with wind-up)	Under Section 76 of the Pensions Act 1995, the following conditions must be satisfied, and The Pensions Regulator can prevent payment if it does not consider these requirements to have been satisfied: • the Trust deed and rules must have a power that enables the payment of a surplus refund on wind-up • the scheme liabilities must be fully discharged • if on wind-up there is a power to pay a refund of surplus to somebody other than the participating sponsor, then this either needs to be exercised or there needs to be a clear decision not to have done so • members have been given at least three months' notice.

In both cases, a surplus can only be paid to a participating employer.

Finally, sponsors need to be aware that any refund of surplus from a pension scheme is typically taxed at 35%. For some, obtaining '65% of something' will be seen as a great outcome compared to '65% of nothing'. However, for others, a tax charge on any refund may not be seen as optimal.



What influence do the scheme trustees have when it comes to surpluses?

A lot!

In some cases, the powers within the scheme rules mean that the sponsor can only obtain a refund of surplus after the trustees have exercised certain powers (e.g. to augment member benefits).

In other cases, the scheme rules may only permit a refund to the sponsor once certain conditions have been met (e.g. all member benefits have been fully insured with a regulated bulk annuity insurer).

Sponsors should therefore work alongside their scheme trustees to articulate plans and objectives, rather than waiting for what might initially appear to be a great surplus position, only to find that it can't be accessed by the sponsor due to lack of up-front communication / strategy planning.

Are refunds the only way a surplus can be used?

In general, no.

The answer to this question will depend on your scheme and circumstances. Selected alternative examples for uses of surplus include:

- Using the surplus in one scheme to fund a deficit in another scheme sponsored by the same sponsor, or to facilitate a scheme merger.
- Using the surplus to fund future DB accrual or DC contributions.
- Using the surplus to pay for ongoing expenses.
- Funding partial buy-ins to remove risk, but retaining some non-insured assets and obligations to try and benefit from some of the surplus in future as the scheme matures.
- Augmenting member benefits if the sponsor believes this is appropriate.
- Sharing the surplus between sponsor and members (benefit augmentations then refund).
- For larger pension schemes with strong sponsors, combining a sponsor-owned captive reinsurer with a UK-regulated fronting insurer, could give access to future financial returns while providing the members with the benefits of insurance de-risking.

Could we have a surplus we don't know about or which is closer than we think?

Yes.

The 'buy-out' (or 'solvency') valuation is enormously dependent on the premium that insurers will charge at a given point in time. This in turn depends on how well prepared your scheme is for an approach to the insurance market, and how engaged you can get the insurers to be. Solvency estimates from scheme actuaries sometimes err on the side of caution, and they can be materially out of date if they were only produced as part of a previous triennial valuation exercise.

Obtaining an up-to-date assessment of the insurance buy-out position, making appropriate allowance for the price reductions which a thorough and comprehensive competitive process should provide, and incorporating a realistic estimate of likely expenses, may show a pleasantly surprising position.

We've been seeing insurance pricing that is 5-10% better than some scheme actuary estimates once a comprehensive and competitive process had been performed and completed.

Ken Hardman Partner, LCP

Determining viable end-game contributions if over-funding is not acceptable

Case study

Due to extremely unfriendly refund of surplus rules in its scheme, the sponsor had an objective of looking to insure the pension scheme (with >£500m of obligations) prior to any surplus arising.

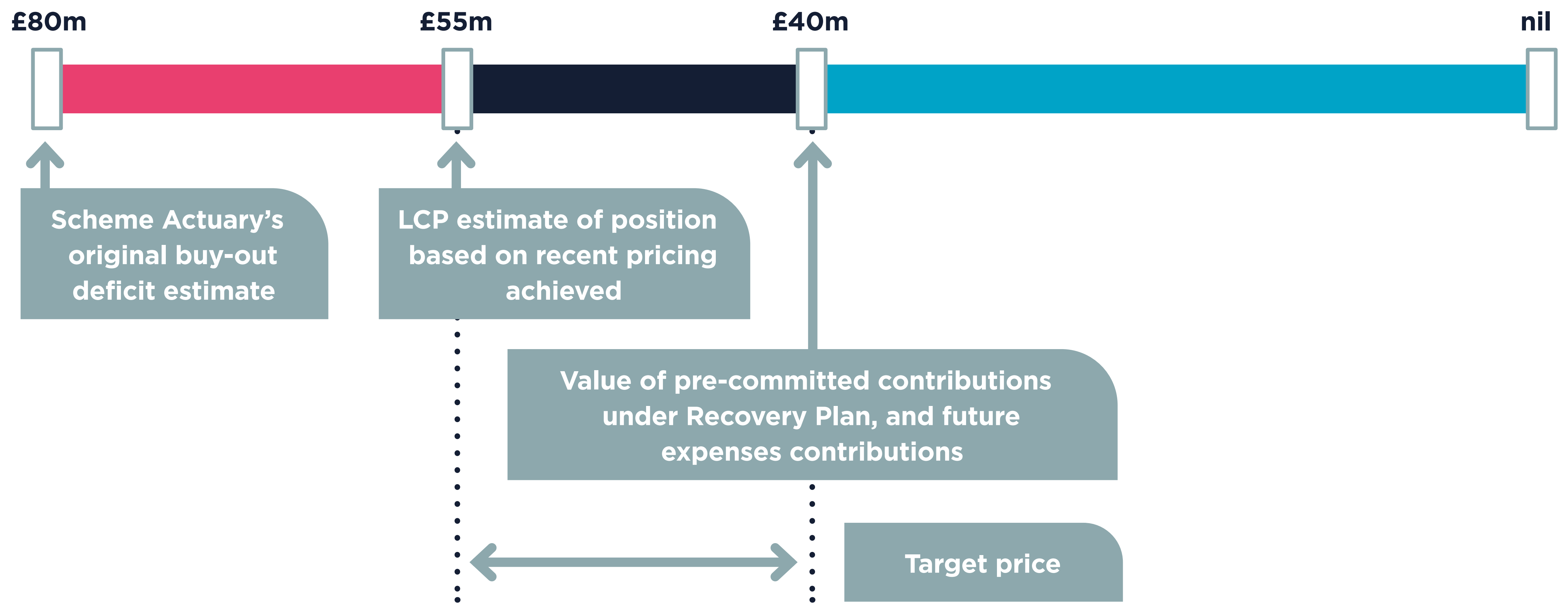
- a material cash injection was available to enable this at the right price, but the scheme actuary's estimate of £80m was not affordable.

On reviewing the estimated buy-out shortfall, LCP flagged that the actuary's most recent estimate was likely to have been excessively cautious.

Given our updated shortfall estimate of £55m, the sponsor reviewed the viability of insurance in light of the updated information and its wider circumstances.

- in particular, the sponsor already saw £40m of cash as being pre-committed given £30m of funding had been agreed as part of the latest recovery plan with the scheme trustees, and c.£10m of value was placed on the likely expenses and time costs over the next 5-10 years.

The sponsor therefore set an objective of looking to achieve full insurance with a cash injection of no more than £40m.



Put simply, more schemes are now expected to be at or near to full funding on an insurer basis than at any point in the last 20 years. Presenting your scheme attractively to obtain insurer engagement in a high-demand environment is now more critical than ever to take advantage of strong pricing.

Gordon Watchorn *Partner, LCP*

So what should sponsors do about it all?

LCP recommendation:

1. Work with your scheme trustees to agree a mutually acceptable end-game objective.
2. Get up to date estimates of your funding position on different valuation measures, and have a simple way to monitor these.
3. Take advice on precisely how / when your scheme rules permit refunds of surplus, and set your surplus strategy accordingly.
4. Take proactive actions to achieve the objective (1) within any opportunities, constraints and priorities identified by (2) and (3).

The emergence of surpluses and recent market turmoil are causing sponsors and trustees to take a fresh look at their pension strategies.

Phil Cuddeford *Partner, LCP*

Investment - key issues for corporate sponsors to act on

Overview

As already highlighted in the previous section, most schemes' positions will have substantially improved over 2022 – this creates an opportunity for scheme sponsors to grab the initiative and set the direction for the future of their scheme, perhaps years ahead of when they had been hoping to be ready to have these conversations.

These strategy discussions are also particularly relevant to be having soon given the significant impact of gilt market volatility and the step-change in approach many DB pension schemes will need to take in hedging liability measures.

In this investment section we highlight how practically you may want to guide the investments in your DB scheme depending on your high-level objectives, e.g. insuring and passing to a third party or running-off (possibly to access a growing surplus). The choice of 'end-game' has a big influence over how best to invest your assets. Of course, some trustees and sponsors will want the flexibility to head in either direction and elements of both strategies can be incorporated.

With inflation being so high and volatile, we then touch on practical steps trustees and sponsors can take to hedge inflation, but importantly how the cost of doing so can be reduced.

Finally, we provide a round-up of topical investment considerations caused by changing economic conditions, market levels, emerging risks or regulatory developments.

This includes the issue that hit the headlines recently with the Bank of England gilts intervention related to cash calls from 'LDI' investments, which has both short-term and longer term consequences for pensions investments and strategy.

Re-examining the long-term strategy

There has perhaps never been a more important time for sponsors to be investing in line with their long-term strategy. Rising gilt yields, capped inflation, and covid-19 impacts have reduced liability targets, and many pension schemes are now much closer to the 'end-game'.

The stakes also feel higher, with the recent turmoil in the gilt market demonstrating that risk management strategies need to be robust to unexpected market changes and hedging strategies can no longer be taken for granted.

For some sponsors, removing the DB pension scheme and its associated risks and costs from the corporate balance sheet will be the most appealing option - particularly if this can be done without additional contributions.

Others will recognise a value to running off their DB scheme, or waiting until their DB scheme is more mature (and hence cheaper to insure), perhaps with an ability to access the surplus, as discussed in Section 1 of this report.

The decision on which strategy to take has big consequences for how best to invest the pension scheme assets as highlighted in the two sections below.

As we emerge into a new world of higher bond yields, leaving many schemes closer than ever to full buyout, the industry should be challenging the "buy out as soon as you can" mentality. For some trustees and sponsors (in particular those that are small) this may be the right answer, but for many schemes there can be a significant loss of value compared to insuring when the scheme is predominantly pensioners and when illiquid assets have realised full value. Surpluses are often seen as a problem to manage, but really it's a nice problem to have!

David Wrigley Partner, LCP

Investment - key issues for corporate sponsors to act on Continued

Investing for a 3rd party transaction (e.g. buy-out with an insurer)

As we emerge from the gilt market turmoil, many pension schemes will likely find themselves closer to being able to pass their scheme across to a third party. For those schemes aiming for a 3rd party transaction such as a buy-in/buy-out with an insurer, the invested assets should transition from today's portfolio to one that broadly matches the insurer's pricing and that can be easily sold or transferred across as part of the transaction.

Where this is the end-game, the following decisions need to be made:

Decisions for sponsors	*Our views*
How or when to sell down **non-matching assets**	Pre-agreed de-risking triggers help identify good opportunities for when these assets are no longer required and when to crystallise returns.
How to manage down and roll-off the **illiquid assets**	Schemes should avoid allocations to new illiquid mandates and should be wary of the potential for a buy-out (or other end-games) being otherwise achievable sooner than expected.
How or when to move the hedging mandate away from scheme actuary figures to **hedging insurer pricing**	Insurer pricing of your liabilities and the scheme actuary's assessment will not move 1-for-1. How insurers price your liabilities and in particular your inflation linkages will become of greater importance. We have seen unintended over-hedges vs insurer pricing which can cause a scheme to move further away from buy-out and/or require a sponsor contribution when buyout would otherwise have been affordable.
How or when to capitalise on **insuring a subset** of members (i.e. a 'partial buy-in')	Phased buy-ins can reduce both investment and longevity risk along the journey towards full insurance, and importantly reduce exposure to insurer pricing at one end-point. In doing so, they provide an opportunity for accessing better pricing, and at worst they allow the scheme to 'average' insurer pricing over time. However, partial buy-ins are an illiquid investment and may reduce flexibility to allow efficient hedging of remaining liability risks, in particular as LDI funds are now expected to offer lower levels of leverage.
How or when to buy more **corporate bonds**	Whilst not the sole driver, insurer pricing is heavily influenced by market pricing for credit (or 'credit spreads') as insurers use predominantly credit-like assets to match benefit payments. Actively managing credit exposures will be important in optimising the journey towards buy-out. For example, increasing exposure when conditions are favourable and ensuring credit exposures are not too large (and result in an over-hedge) as you approach the end-game.

Investment - key issues for corporate sponsors to act on *Continued*

Investing for run-off (e.g. to generate a surplus)

One alternative approach may be to simply pay benefits as they fall due over time without the need to pay for the cost of insurance. Or alternatively, waiting significant time until the scheme has a higher proportion of retired members before insuring. In this strategy matching insurer pricing is less of a concern (and in the purest form of this strategy, irrelevant). Instead, what really matters is having a high probability of meeting all the liability cashflows in full, with the intention of having money left over to either cope with downside risks or to be used at a later date (e.g. for increased benefits, to spend on DC or for funds to be refunded to the sponsor as discussed in Section 1).

For sponsors following this approach, the following investment considerations are key:

Questions for sponsors	*Our views*
How to **'match' liability cashflows**	We generally support a balanced approach between some long-dated matching bonds combined with rolling shorter-dated assets (read more **here**).
How to make best use of your **long-term investor** status	A long-term investor profile provides a wider asset base to choose from and an ability to accept illiquidity risk. Less liquid assets can provide attractive long-term returns, diversification benefits and stable, contractual income.
How to most **cost effectively match inflation-linked liabilities**	Ground rents and long lease property can be helpful investments in providing long-dated inflation linked cashflow with a higher yield than index-linked gilts.
How to best hedge **residual interest rate and inflation risk**	Consideration should be given to only hedging risks inherent in 'best estimate' cashflows to avoid over-hedging the true underlying interest risk and inflation exposures. This will often require a different lens than using cashflows relating to the scheme actuary's funding valuation. Consideration should also be given to best-value hedging and not being overly wedded to using gilts if, say, swaps offer a cheaper hedging price.
How to manage **climate risk**	As a long-term investor, the transition towards a greener economy is a key financial risk and steps should be taken to manage climate risks and opportunities. Solutions are now available with equities, corporate bonds and real assets, all of which should be considered.
How or when/if to hedge **longevity risk**	Hedging longevity risk has parallels with hedging inflation risks. Consideration should be given to treating both risks in a similar way. The illiquidity of partial buy-in assets in the new world of reduced LDI leverage means that all else equal longevity swaps may become more attractive for some. However, for smaller schemes, the relatively high cost of implementation needs to be considered.
How to reflect all of the above in **liability calculations**	The tail should not wag the dog. Investing to meet the cashflows is of greatest importance and liability valuations should follow suit. Assumptions for future investment returns should reflect the assets held ('asset-led discounting'). In turn this helps to reduce artificial volatility and leads to better decisions. Asset-led discounting can also help to reduce the amount of gilt-based sensitivity in scheme targets, and hence gilt hedging and leverage within your asset portfolio. The recent gilt market crisis has demonstrated the potential benefit this can bring.

Why might a DB scheme wait until more members are retired before looking to buy out?

- All else equal, retired members are cheaper to insure than non-retired members. There is a significant step-down in the cost of insuring a member the day after they retire, compared to the day before. As such, sponsors should (at least) consider whether to defer insurance transactions until a scheme is made up of predominantly retired members to get better value-for-money.
- Furthermore, the position may be improved should non-retired members decide to take up options available to them, eg transferring out of the scheme. Again, potentially providing better value in deferring an insurance transaction.
- By investing over a longer time period, schemes can continue to generate modest returns and further strengthen their positions. Illiquid assets can also be realised in an orderly way, rather than needing to be exited early and potentially incurring lost value.
- There is usually an IAS19 balance sheet impact of insuring members. This impact is usually smaller for insuring retired members than non-retired members, and is expected to reduce over time as members become older.
- The above considerations mean that it is likely that a scheme could generate a meaningful surplus by waiting until the pension scheme is predominantly made up of retired members, rather than insuring at the earliest opportunity. This can represent a significant opportunity for additional value for either members or the sponsor (and perhaps a balanced deal could be struck).

Investment - key issues for corporate sponsors to act on Continued

Retaining the flexibility for either approach

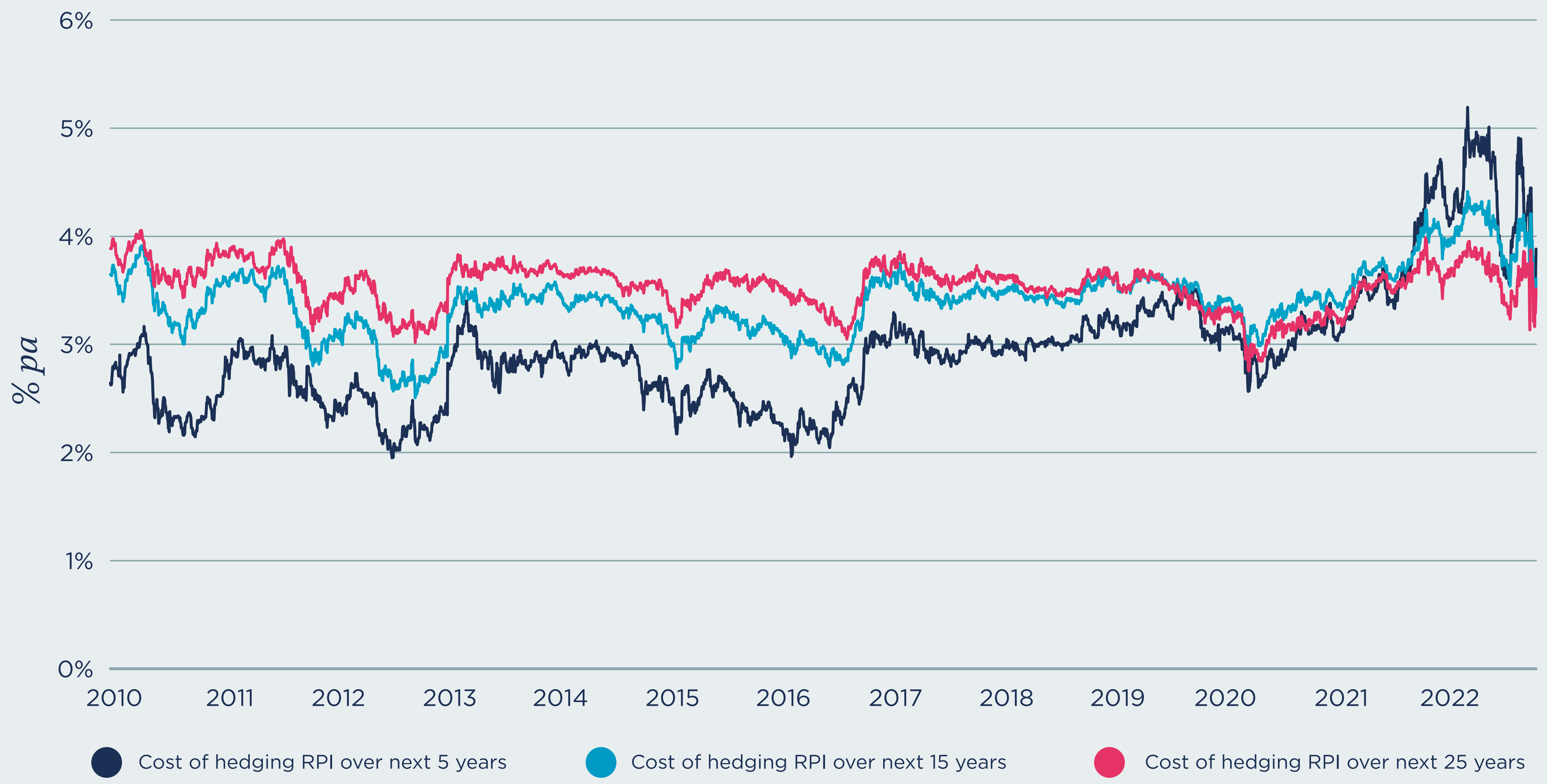
Of course, some sponsors may not yet be ready to commit to either approach and will want the flexibility to head towards either destination – or to be able to react quickly and move towards new options as they emerge.

For these schemes, avoiding investing in illiquid assets and retaining a reasonably high level of hedging will be key to managing risks and providing flexibility. However, sufficient return will also need to be earned to bridge any gap towards the cost of insurance (or other third party transactions), which presents its own challenges in a world in which liability hedges will require significant additional capital. As such, taking opportunities to boost return (such as using credit-linked LDI and/or maintaining a meaningful allocation to return-seeking assets will be important). Exploring equity protection strategies (particularly for well-funded and/or mature schemes) would be a worthwhile exercise.

Hedging inflation – what options are available to reduce costs?

Until the recent gilt market turmoil, inflation had been the major talking point when managing the risks of DB pension schemes. But with inflation relatively high, and projected to stay high over the next few years, how do pension schemes get best value?

The chart below shows the cost of hedging inflation over the next 5 (dark blue), 15 (light blue) and 25 (red) years using index-linked gilts. It is calculated based on the difference in yields on fixed interest and index-linked gilts. If, for example, the difference was 4% pa then index-linked gilt investors would be accepting a 4% pa lower return in exchange for receiving RPI. Put another way, the implied cost of hedging inflation would be 4% pa and index-linked gilt investors would win (lose) if RPI was higher (lower) than 4% pa.



Investment - key issues for corporate sponsors to act on Continued

Hedge using index-linked gilts

The most common way in which pension schemes hedge inflation is using index-linked gilts. The costs of doing so are highlighted in the previous chart, showing they are currently high by historical standards. It's unsurprising most schemes use this approach given its relative simplicity and consistency with the way in which actuaries typically set their inflation assumptions. It is quite typical to use the cashflows from the most recent actuarial valuation and hedge the inflation exposures using a portfolio of index-linked gilts – but is there a better way?

Providing greater flexibility to your hedging manager

Sometimes index-linked gilts will offer the cheapest way to hedge inflation, but sometimes they won't. Other investors, for example insurers, will commonly use inflation swaps and giving your manager the flexibility to use either gilts or swaps can significantly reduce the cost of hedging. Small differences, for example just a 0.1% pa change in the cost of hedging inflation, can add up to big numbers over long time periods (£15m over 30 years when hedging £500m of inflation-linked liabilities).

Refreshing your liability exposures

Inflation linkages in pension scheme liabilities are complex. Most pension increases have floors (e.g. the inflation increase can't be negative) and caps (e.g. the inflation increase is capped at 2.5% pa or 5% pa, with different caps applying for different tranches of benefit).

Calculating the likelihood of whether these floors or caps will bite depends on whether inflation is expected to be high or low. When inflation expectations change, so does the likelihood of the caps or floors being breached, and by extension so does the inflation sensitivity of liability measures.

Dynamically managing your hedge in response to changing market conditions reduces the risk of being accidentally under-hedged or over-hedged. Furthermore, higher levels of inflation mean caps are more likely to be breached, which might cause you to reduce inflation hedging (and vice versa). This can result in a disciplined "buy low and sell high" hedging approach which adds significant value over time.

Take off the 'actuarial shackles'?

For those schemes with long time horizons, and in particular those who don't intend to fully insure their scheme, investors can look beyond those assets that match insurer pricing. These options can also be relatively more attractive in a new world of liability hedges absorbing significant capital - some schemes may find it very expensive to fully hedge inflation using gilts or LDI.

Ground rents, income strips and long lease property are examples of investments with strong underlying security (land/property) and provide inflation-linked rental income (often with a cap and floor that better match a pension scheme's liability payment).

The additional return on these investments over index-linked gilts can be multiple percentage points, but care needs to be taken on how best to reflect the cashflow matching characteristics of these investments within actuarial measures to avoid 'double-hedging' (which is even more important in a new world of more capital intensive liability hedging) – see example below.

Consider the following example

Property rented under a long-term lease to tenant with a strong credit rating. Rents increase contractually with RPI, floored at zero and capped at 5% each year.

Economic view	Actuarial view
Payments are a very good match for RPI pension increases capped at 5%	Asset value does not move in line with gilts
Can (broadly) expect rental payments to meet benefits as they come due	Add interest rate and inflation hedging overlays to remove "basis risk"
Security provided by underlying property	...and need to collateralise hedge overlay so best sell some of the property exposure and put in cash / gilts

Actuarial measures should not drive a sub-optimal investment strategy

Round-up of other topical investment developments

Whilst we've touched on some of these developments in the previous articles, below we provide a brief round-up of some of the topical investment considerations for sponsors of DB schemes.

Responding to the LDI collateral crisis, the Bank of England gilts interventions and lower LDI leverage levels going forwards

This LCP document provides a broad background summary of the LDI collateral crisis, across all aspects of pension scheme management.

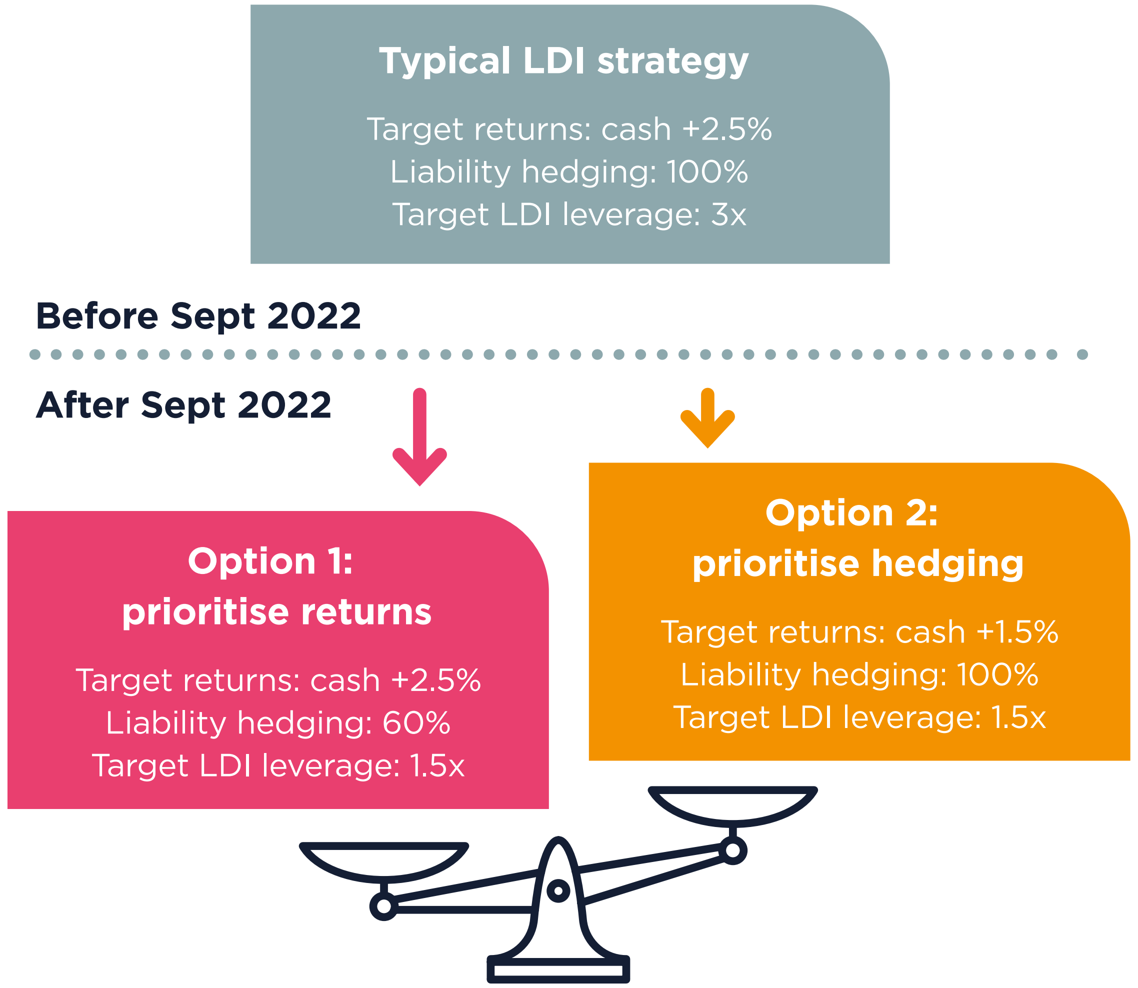
In a nutshell, rapidly rising gilt yields led to ever increasing collateral cash calls and rapid, unexpected liquidity difficulties for many pension schemes with LDI investments. For some this may even have caused unintended reductions in hedging levels, forced sales of growth or other assets, or even sponsor cash injections (possibly as a short term loan).

Whilst many schemes will have experienced operational difficulties, it is also worth taking a step-back and acknowledging the benefits many sponsors will have experienced in previous valuations through their hedging strategies and the £billions of contributions that sponsors may have had to contribute to pension schemes over recent years (when gilt yields were historically low) had liability hedging strategies not been in place.

Moving forwards, there are clearly some lessons to be learned and changes will be made to how pension schemes use LDI. The best approach is very dependent on the specifics of the scheme in question.

Going forwards, LDI managers have permanently imposed lower limits on leverage levels, typically around 1.5x to 2x (compared to 3x before late September 2022) as a "new normal".

This means schemes will either have lower hedge levels (not ideal for many as this will increase balance sheet and contribution volatility) or alternatively lower allocations to growth assets which will have to be sold to maintain high hedging levels at lower leverage (not ideal as a long term strategy shift for those wishing to have a journey plan with no expectation of additional contributions). This is illustrated in the graphic on the right.



LDI has helped stabilise scheme funding positions for many years, and likely kept some schemes afloat through periods of extremely low gilt yields. But the LDI we used to know is no more – efficiency of LDI mandates will now be reduced (to cope with substantially higher gilt market volatility). For some schemes this will be fine, as improved funding positions will allow them to reduce other growth assets. But others will have hard decisions to make – do they accept lower LDI hedging (and hence more volatility of cash demands), or lower growth assets (and hence higher expected cash demands to replace lost investment returns). We suggest sponsors are alive to this new decision and help ensure they work with trustees to reach an acceptable answer.

Steve Hodder Partner, LCP

Round-up of other topical investment developments *Continued*

Of course, this illustrates the extreme options – a balance exists in between, and wider changes such as prioritising hedging characteristics from shorter-bond investments may help balance the scales.

The good news is that recent improvements in funding positions will likely facilitate a reduction in expected future investment returns for many schemes.

All else equal (for a given funding level), lower available leverage levels may also mean that buy-in transactions can no longer be supported at the same sizing as had been previously planned. This might also mean that longevity swaps become relatively more attractive for some.

Sponsors need to work through these new challenges to their investment strategy, de-risking strategy and end-game with their trustees as soon as possible. Some of the key questions for sponsors to consider include:

- If your scheme position has improved, should you revisit your scheme's funding plan as soon as possible (e.g. pay contributions into **escrow** / coinvestment vehicle.
- If your scheme's growth assets were cut to support hedging, should this be accepted as a new long-term strategy, or should you work with trustees to reassess and perhaps re-establish a strategy with more growth?
- Would you benefit from your liabilities being measured in a way that is less sensitive to gilt yields (and hence reduce the focus in your assets on matching gilt movements)?

Capitalising on higher credit spreads

2022 has seen assets sell off almost universally. Credit markets have not been immune and the now lower prices mean higher future yields on offer. A typical additional return on a corporate bond compared to a government bond has gone from around 1% pa at the start of 2022 to 2% pa (i.e. broadly doubled). Investors should be considering what steps (if any) they take to capitalise on the higher returns and consider locking these in over longer periods. Some key questions include:

- How can we capitalise?
- What triggers have we set?
- Should we consider 'credit-linking' our liability hedging portfolio to lock-in the higher returns over government bonds, especially if our liability hedging mandate now needs to be a greater proportion of scheme assets?

Managing climate risk

Managing climate risk has been a priority agenda item for many pension schemes, with trustees and sponsors now far more alive to the financial risks and opportunities that can arise as a transition is made towards a greener economy. It has caused the industry to move from the theoretical to the practical. Climate-tilting investments and having net zero targets are quickly becoming mainstream for a broad range of asset classes. Some key questions include:

- How are climate risks managed within the equity, bond and real asset portfolios?
- How active are the managers in engaging in those sponsors without clear climate transition plans and how are the risks being managed?
- How do we best access opportunities, for example those in renewable infrastructure and greener technology?

Equity protection strategies allow investors to change the 'shape' of their equity return to better suit their needs. A common approach is to pay away upside above a particular level (e.g. 10% pa) on the basis that is more than is needed / may have been de-risked anyway. In return for foregoing the upside, investors can protect on the downside (e.g. the first 20% of all losses) to protect against equity market falls.

New pensions regulations

Under new proposed legislation (see next page for more details), it would become the law for mature schemes to invest in a low-risk largely cashflow-matched investment strategy. Hence the move towards a low-risk asset allocation may come quicker than previously thought. This is another driver (in addition to reducing LDI leverage levels) for some schemes being forced to sell non-matching assets such as equities. Some key questions include:

- How will the proposed regulations impact our investment strategy?
- How do we protect ourselves against forced selling coinciding with depressed prices?
- Might equity protection strategies be worth considering if our investment horizon could be curtailed?

Important changes in the pensions landscape for corporates

High inflation and the LDI collateral crisis have dominated headlines, but there has been no shortage of other pensions legal, regulatory and market developments in recent months. The new funding regime draws closer, and this is just one of many reasons why sponsors should be keeping an eye on their pension schemes – as ever there are lots of opportunities to make the most of, as well as risks to understand and mitigate.

Jon Forsyth Partner, LCP

In addition to the surplus and investment issues covered in the first two chapters of this report, here are some of the key developments that corporate pension sponsors need to be aware of and ready to react to.

The new funding code – regulations could have big impact

The new funding regime promises to be the biggest shake up in DB funding in two decades. DWP has recently consulted on draft regulations, which provide the legal framework for the new regime.

As drafted, all schemes will be required – by law – to target a low-risk investment and funding strategy by the time they reach a certain level of maturity, and trustees must follow the principle that deficits should be paid off as soon as the sponsor can "reasonably afford".

These changes could have a big impact for lots of schemes and sponsors, though just how big depends on the detail of TPR's funding Code itself – we expect sight of that later in the year.

The regulations also bring covenant into legislation for the first time, setting out the matters to be considered in its assessment – including cash flow, sponsor prospects and likelihood of insolvency. And we expect much more detailed covenant guidance to be issued by TPR later this year, alongside the draft Code.

Looking further ahead, the best guess of when the new regime comes into force is for valuations post 1 October 2023.

More on the new regime, including our concerns with the draft regulations, can be found in our **On Point paper**.

So what?

Sponsors need to understand the possible impact on their valuations under the new regime. There is still uncertainty, but higher funding targets and shorter recovery plans are likely outcomes for many.

We believe the draft funding regulations need significant rethinking, mainly because they force a one size fits all approach that will worsen pension and employment outcomes for some members.

Jonathan Camfield Partner, LCP

Important changes in the pensions landscape for corporates *Continued*

High inflation

The latest annual figures for September 2022 are 10.1% for CPI and 12.6% for RPI – the highest levels for 40 years. And it seems high inflation could be here to stay for a while longer. This is also discussed in **Section 4 (accounting)**.

As well as the impacts on many businesses' covenants, there are lots of other implications for pension schemes and sponsors:

- Understand the funding impact – Given many pension increases in payment are capped, but these caps cannot be perfectly hedged, some schemes have seen significant gains in funding from high inflation as assets rose faster than liabilities. It's important to know where your scheme stands – and what any actuarial models are making allowance for (e.g. do they allow for monthly inflation as it is published, how do they join up past and future inflation).
- Rebalance hedging positions – For schemes that have not revisited their hedging profile for some time, now could be a good opportunity to more accurately hedge the impact of caps and bank any gains that have arisen.
- Understand the impact on members – this doesn't just mean pension increases in the Rules (though that is of course important) but also impacts on actuarial factors, in particular those used when members early retire. There are issues around giving members "fair value" – and how high inflation is factored into increases before versus after a member retires may mean some factors needing adjustment.

So what?

There are lots of implications of high inflation for sponsors to stay on top of and actions to consider – more detail can be found **here**.

Discretionary increases

Related to high inflation, many trustees and members are requesting sponsors consider discretionary increases, in light of inflation outstripping the caps on pension increases so significantly (not to mention some benefits having no automatic inflationary increases).

For sponsors there are of course many issues to consider here, including (this is not a full list):

- Accounting impact;
- How the treatment of DB pensioners compares with salary increases offered to current employees and to DC members;
- Treatment across schemes;
- How any increase is communicated, including managing future expectations;
- Past practice and/or seeking to avoid establishing a practice of increases;
- Potential reputational impact.

So what?

We expect there will be strong public and/or member pressure to grant higher pension increases in some cases. It will be important to consider the various issues and demonstrate that due process has been followed.

Important changes in the pensions landscape for corporates *Continued*

New TPR powers under Pension Schemes Act 2021

Most of the Pension Schemes Act 2021 provisions – including new criminal sanctions, civil penalties and contribution demands – have been in place for over a year, and so should now be embedded in processes. But if not sponsors should ensure they understand the new regulatory boundaries and have robust governance processes including records of decision-making.

Sponsors should also keep an eye out for the new Notifiable events regime and make any updates to processes swiftly.

So what?

We suggest sponsors consider the five steps we outline on page 6 in section 1 of **last year's report**, to ensure in scope activity is identified and appropriate action taken, so as to protect themselves and others against these risks.

Contingent funding solutions

Contingent funding solutions remain a great way to achieve a win-win for trustees and sponsors. Our recent **Chart your own course** survey showed around two thirds of schemes now benefit from one of these options – including almost half of schemes under £500m.

The Pension Schemes Act 2021, the upcoming new funding regime, an increasing risk of overfunding, and a need for escrow type solutions to manage deferred premium structures for full buy-ins are amongst the reasons why. **Click here** for details of the options available and how they can be used in practice.

So what?

These approaches are very much not just for valuations – they can provide a great outcome for all parties in many situations and help you achieve a wide range of objectives. It's worth ensuring you understand all the options.

Important changes in the pensions landscape for corporates Continued

Long term targets and journey planning

Various drivers including the new funding code are nudging more and more schemes and sponsors to put in place long term targets and more coherent journey plans to get there. The advantages are clear – knowing the steps you will take on the way to achieving your objectives, and ensuring you're able to capture opportunities and mitigate risks along the way, means a smoother and more cost-efficient journey overall.

See section 2 for some examples on the investment side depending on what end-game you are targeting. For broader journey planning considerations and our LCP GEARS framework, see our **journey planning hub**.

So what?

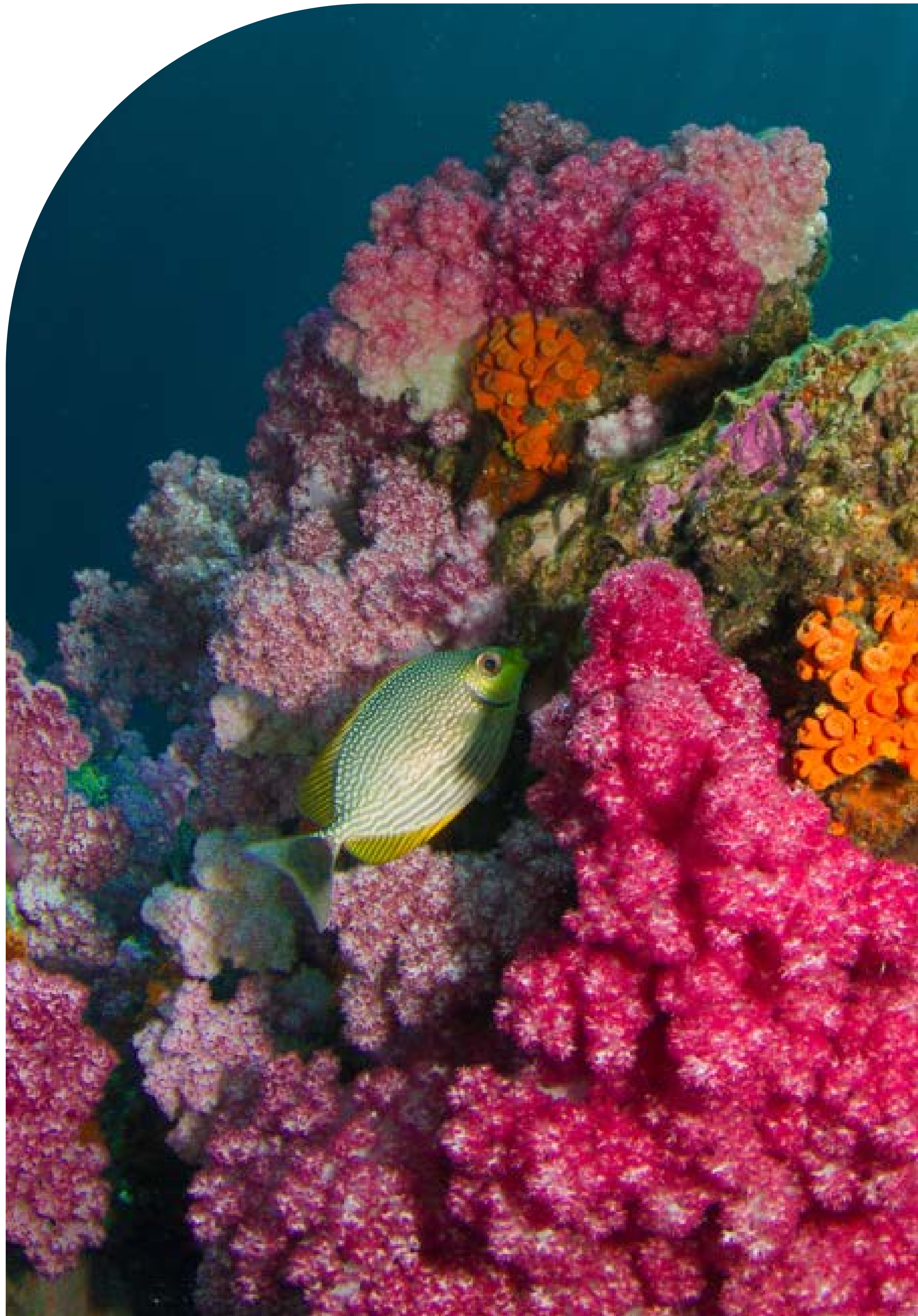
Sponsors should make sure they are at the very least involved in these conversations and there is no reason to not be driving them. Indeed, in many cases sponsors will need to agree long-term funding and investment strategies under the new funding regime. Ensuring sponsor objectives are taken into account and that plans are as efficient as possible are common objectives.

GMP equalisation

The industry wheels have very much started turning on equalising GMPs. There is often considerable logistical complexity, but there is plenty of helpful guidance from PASA, and plenty of growing industry expertise. Visit our **GMP insights hub** for more details.

So what?

Sponsors should be understanding the impact of different options and engaging with their trustees on the best options to focus on. As well as managing the considerable risks involved, there are opportunities for those who consider this carefully, including the possibility of reshaping benefits and/or combining with certain member options (see page 22).



Important changes in the pensions landscape for corporates Continued

Member options

More and more sponsors and trustees are taking action to enhance member options. The reason is the genuine win-win this can offer – members get greater flexibility and make the most of their benefits, whilst the trustees and sponsor benefit from the funding gains which typically apply whenever these options are taken.

Examples of actions in this area include putting in place IFAs to assist members in making important decisions in relation to transferring their DB pension, or adding options like bridging pensions where benefits are re-shaped to give a smoother total income when combined with the state pension. Watch our recent **webinar** to learn more.

So what?

A good and well implemented member options strategy can reduce reputational risk, improve engagement and accelerate your journey to achieving your objectives. High inflation and rising yields are a good reason to look again at what is on offer and the terms – noting some factors like commutation may now be overly generous after years of pressure to increase them.

DB Superfunds

In December 2021 TPR gave Clara Pensions the green light to move forward with its first superfund transactions. Whilst there has been much activity behind the scenes, no transactions have completed at the time of issuing this report. The other DB Superfund currently marketing itself – the Pension SuperFund – is still awaiting TPR's confirmation.

So what?

In the **right circumstances**, pension scheme trustees and corporate sponsors have a new option that could provide improved member outcomes compared with existing options.

Capital-backed options and other insurance solutions

We continue to see more innovative solutions involving the use of third-party capital to support a scheme's objectives. Whist there have only been a handful of transactions announced to date, we have seen new providers launch new solutions in this area over the last year.

We're seeing increasing interest in the use of captive solutions which provide a way for a sponsor to share in any profit that can be earned by an insurer in providing a buy-in or buy-out. However, these are complex solutions that introduce their own risks and operational challenges. To date they have been the preserve of very large schemes with strong sponsors willing to put in place the complex structures needed to support them.

So what?

These emerging solutions complement or replace existing de-risking solutions and it is important to be aware of the **spectrum of options** and which, if any, may be appropriate for your scheme.

Improvements in funding levels mean different things for different sponsors, including new or bigger surpluses, and some finding themselves much closer to end-game options than they had imagined just a few months ago. This is a time to embrace innovation to get better outcomes for all parties, and we will soon see transactions with superfunds and other emerging vehicles.

Gordon Watchorn Partner, LCP

Important changes in the pensions landscape for corporates Continued

Collective Defined Contribution (CDC)

The Royal Mail scheme is continuing at pace, and is expected to commence soon. DWP will consult on a "package of prospective design principles" later this year, to enable a much wider range of CDC schemes, including unconnected multi-sponsor schemes.

So what?

CDC schemes may be worth exploring for those organisations that are keen to offer a target benefit without the risks resulting from DB guarantees, are culturally comfortable with the concept of pooling risks amongst different members, and have the necessary scale (and expected longevity and patience) to implement such a solution. The target outcomes are typically better than in DC schemes with the same contribution levels due to pooling effects.

Pension scheme governance

The market for professional trustees continues to grow, as does the number and size of schemes moving to a Professional Corporate Sole Trustee (PCST). Drivers include the growing regulatory requirements that trustees must be familiar with, and the desire to streamline governance. **Our report** showcases the latest in the Sole Trustee market.

So what?

A PCST model will not be right for all schemes, but can offer streamlined decision making and access to the professional trustee's experience of a wide range of schemes and circumstances.

Multi-sponsor CDC could be a game changer. Sponsors will need to understand if it could work for them, given its growth and ESG focus, while targeting full inflation protection for members.

Steven Taylor Partner, LCP

Climate risk management and disclosures, and net zero

All pension schemes over £1bn are now having to produce disclosures in line with TCFD (Task Force on Climate-Related Financial Disclosures) requirements, and this could be extended to smaller schemes in due course. A large number of schemes have already announced net zero targets, with more likely to follow suit.

Climate risks should be factored into pension scheme decision making – whilst the worst physical impacts of climate change may still be many years away, the transition to a green economy is likely to mean many emerging risks and opportunities for investors.

So what?

This will remain an area of fast evolving disclosure requirements and associated reputational risks, and it is important for sponsor and trustee actions and messaging to be joined up.

Important changes in the pensions landscape for corporates *Continued*

And much more...

This table gives a quick summary of some other pension developments that sponsors shouldn't lose sight of:

Development	So what
Pensions tax – the number of members being caught by the Annual Allowance and Lifetime Allowance continues to grow, and large salary increases in light of high inflation will exacerbate this.	This could mean increased costs where sponsors are providing alternative compensation for members who opt out of the pension scheme to avoid incurring a tax charge.
Mortality assumptions – we are perhaps starting to see some of the longer term impacts of Covid-19 emerging, with noticeable excess deaths over the last few months. It's also been announced that the census results will likely lead to heavier mortality tables.	Sponsors are likely to see good news come through for funding and accounting due to mortality assumptions over the coming year. Market consensus seems to be settling on a 1-2% liability reduction allowance for the long-term impact of Covid-19 (**see also section 4**).
Corporation tax rate increasing – though briefly scrapped, this is now going ahead with the headline rate increasing from 19% to 25% from 2023, and there is also the eye-catching "super deduction" which allows businesses to claim tax relief of up to 130% on investment spending until 2023.	Finance directors may justifiably ask whether deficit contributions can wait until 2023 (or more precisely, the sponsors accounting year that contains 6 April 2023 – for example, that could affect contributions paid from 1 May 2022 for a sponsor with a 30 April year-end).
PPF levies – the latest PPF Annual Report showed it is now in **very good financial health**, with a funding reserve (surplus) of £11.7bn as of 31 March 2022. The PPF has therefore signalled it expects to collect significantly less PPF levy in future, starting with an almost halving of the PPF levy it expects to collect in 2023/24 (£200m, down from £390m in 2022/23). And the good news is expected to continue in future years, as the PPF has also published its Long-Term Funding Strategy review outlining how it intends to move to a simpler, lower-level PPF levy in future.	Good news for sponsors that aggregate levies are likely to be lower in future, but where insolvency scores worsen the levy for an individual scheme can still increase. Where the PPF levy is material, sponsors should seek estimates for budgeting purposes, and make sure any mitigating actions are being explored – including in relation to optimising insolvency scores.
Executive pensions – the overall level of remuneration paid to sponsor executives, and how this compares to their employees, remains a focus of attention. You can read more about this in our **2022 Accounting for Pensions report**.	To avoid the risk of a 'red-top', and for wider reputational reasons, sponsors who have not already made progress in this area should look to do so soon.

Important changes in the pensions landscape for corporates *Continued*

Development	*So what*
RPI reform - on 1 September 2022, a legal ruling from the High Court of Justice rejected an application to overturn the planned reform of RPI inflation, and subsequently the claimants have decided to not pursue an application from the Court of Appeal. So RPI reform will go ahead as planned from 2030, with no compensation for index-linked gilt holders.	This was the expected outcome so in most cases no further action is warranted, but the fact we now have more certainty is good news. There will be winners and losers from RPI reform but this should have all been factored in already. See page 17 of **last year's report** for more detail.
ARGA draws closer – the Audit, Reporting and Governance Authority is expected to replace the FRC in 2023.	The new regulator is expected to drive more audit market competition and mean more accountability for directors on bonuses and dividends. This may also affect IAS19 audit processes.
ESG – **social issues** continue to get more focus, including the idea of a "just transition" to net zero.	Sponsors should be engaging with trustees to make sure the investment strategy of the pension scheme is aligned with the sponsor's values, and that risks are being managed and opportunities explored in this area.
Diversity, Equity & Inclusion – this remains an area of focus.	Sponsors should be considering if the make-up of their trustee boards is promoting or limiting effective decision making. See our **Trustee guide to DEI** which includes tips for sponsors on this.
Pensions Dashboard – things are moving at pace, staging dates have been set out, and it is clear this is a government priority. It can however be a very big undertaking for schemes to get 'dashboard ready'.	Make sure you know your staging date and that trustees and administrators are on top of this big project – there can be reputational issues if it goes wrong.
DC and financial wellbeing – Given the cost of living crisis, the delicate and difficult balance of both providing for now and providing in retirement is an issue that many employees are grappling with. Good financial health can be a win-win – a good financial wellbeing strategy will pay for itself many times over.	Corporates should keep up to date on the latest trends and ensure that their offering remains competitive and valued by employees. Check out our latest **report on financial wellbeing including our survey**.

Key accounting issues ahead of the year end

As covered earlier in this report, changes in market conditions have driven big improvements in IAS19 balance sheet positions, with **LCP's Pensions Explorer** estimating the aggregate IAS19 surplus for the FTSE100 is around £160bn at the end of September 2022.

This section looks at what has driven the improvement in balance sheet positions since the start of 2022, what uncertainty remains, and what actions sponsors should be taking to ensure a smooth and hassle-free year-end.

Large increases in IAS19 discount rates

Since the turn of the year, corporate bond yields (used to set the IAS19 discount rate assumption) have risen materially. The chart on the right shows the yield available on corporate bonds since 1997. IAS19 discount rates have nearly trebled over 2022 from around 1.8-1.9% pa at the start of the year to over 5% pa at the end of September. All else equal, this will lead to a reduction in IAS19 liabilities of around 40%.

Join our webinar

We're holding a webinar on 15 November 2022 at 11am covering the key issues for sponsors to consider ahead of their next year-end and examples of how we have helped clients find solutions to these issues. Book your place **here**.

Given the recent huge rises in bond yields and corresponding falls in pension assets and liabilities, many pension schemes will have become less "material" within the context of the corporate accounts.

Jonathan Griffith Partner, LCP

Movement in UK AA corporate bond yields over the last 25 years

Source: MLX / ICE GBP AA Corporates 15+ yield

Given the large movement in yields, it is possible that different models used to set IAS19 discount rates behave differently, and as a result, a wider spread of discount rates could be expected at the upcoming year end. This could pose more of a challenge for sponsors that want to position themselves in a particular way relative to their peers and/or wider market.

Key accounting issues ahead of the year end Continued

The increase in corporate bond yield to 30 September is broadly split as a 2.7% pa increase in yields on government bonds (gilts) and 0.6% pa increase in credit spreads (the additional yield investors receive for investing in corporate bonds to reflect the perceived additional risk relative to government bonds) albeit both gilt yields and credit spreads have reduced slightly since this date.

Pension schemes are typically hedged to an extent against these gilt yield movements, although given the size of the movement, small differences in hedging levels or hedging targets could have a big difference on the resulting movement in balance sheet. The rise in credit spreads is not typically hedged to the same extent and so the resulting decrease in IAS19 liabilities will largely flow through to an improvement in corporate balance sheets.

Key action

The key action for sponsors ahead of the year-end is to get an estimate of their current position to ensure they understand the current position and that there are no surprises when final figures are produced.

Inflation: implications for pensions accounting

The impact of the current period of high inflation on both liabilities and investments has been covered throughout this report. From an accounting perspective, it gives rise to the additional issues below that sponsors will need to consider in more detail.

- **Experience item in OCI:** the gap between the actual increases granted to members over the year and the assumed increases at the beginning of the year, could in some cases be as much as 10% (for example, for members with uncapped increases in payment or for increases before retirement). This could lead to large (potentially material) experience losses which could lead to more attention, queries and analysis from auditors.
- **RPI-CPI wedge:** The CPI inflation assumption is usually set equal to the RPI inflation assumption less a 'wedge'. Given the announcement to reform RPI to be in line with CPIH (a variant of CPI) from 2030, this assumption has become a short-term assumption. Typically, a wedge assumption of around 1% pa has been used. September's inflation figures showed annual inflation running at 12.6% according to RPI and 10.1% according to CPI. The difference between these two indices is now unusually large. To the extent that this gap continues, sponsors will need to decide whether to adjust their wedge assumption – it will be particularly important where CPI inflation over the short term is a material assumption.
- **Discretionary increases:** for a majority of schemes, inflation will be above the maximum pension increase granted under the normal rules (common caps on annual increases are 5% or 2.5%). As a result, trustees may consider granting one-off discretionary increases, which may require consent from the sponsor. Unless there is an explicit IAS19 assumption already, these increases would typically be treated as a past service cost within P&L. Granting discretionary pension increases also introduces a risk of setting a precedent for future increases, and if deemed a change in constructive obligation, could materially increase the pension liabilities (and P&L charge) further. Sponsors will need to consider the accounting impact and whether it is possible to mitigate the risk of future P&L costs and uncertainty from discretionary increases.
- **Pension increases:** given the differences between short and long-term inflation expectations, sponsors will need to ensure that the models used to derive assumptions and figures remain fit for purpose. In particular: (1) what future inflation volatility to use and should this be reviewed given the current period of high inflation; and (2) how do the liability calculations allow for future pension increases that are either known but not yet granted or based on a reference month shortly after the accounting date (whereby the majority of the annual increase will be known).

Separately, sponsors may need to factor in the recent confirmation of RPI reform (see page 25) when setting RPI or CPI assumptions, especially if they had previously allowed for uncertainty.

Key accounting issues ahead of the year end *Continued*

Life expectancy and the Covid legacy

The life expectancy assumption is made up of two parts: an assessment of current life expectancy (the base table) and an estimate of how this is projected to change in the future. Over the past year, there have been announcements that could impact how some sponsors set both of these assumptions.

Base table – corrections to official data

In June 2022, it was identified that a large submission of data that underpins the industry standard mortality base tables was incorrect. For sponsors that calibrate the standard base tables to the specifics of their scheme using a mortality study, the expected impact of this data update will be small or zero as the base table multipliers will change to offset the base table update. On the other hand, for schemes that use unadjusted tables, mortality rates may on average have been understated by around 1%/3% for males/females respectively, thus overstating liabilities, which will now be reversed.

Projections – updates to official data

The model used to project mortality rates is built around data obtained from the Office for National Statistics (which records death registrations) and an estimate of the population based on projections from the latest census results (currently the 2011 census). High level analysis published in July 2022 suggests that updating the data to be based on the 2021 census could reduce life expectancies by around 0.5% on average. This change will be allowed for within the CMI2022 projections that are due to be released in 2023, and sponsors will typically update at that time. However, in some instances, it may be appropriate for sponsors to make an approximate update earlier than this.

The Covid legacy

On top of these changes, sponsors will need to consider whether, and how, to allow for the long-term impact of the covid pandemic within their assumptions.

There is a large element of subjectivity when attempting to quantify the indirect impact of covid (e.g. increase in NHS waiting lists, disrupted or delayed treatments) as well as the wider economic and social impacts. That said, we are now seeing an increasing number of sponsors make allowance for this within their life expectancy assumptions, with typical allowances being a reduction of up to 2% of liabilities.

The pandemic will leave a lasting legacy on health and life expectancy, with indirect impacts felt for years to come. But these impacts will not be evenly felt across society, or by pension schemes. With updated census data suggesting slower mortality improvements even pre-pandemic, now may be the time to carefully review the suitability of life expectancy assumptions.

Stuart McDonald MBE, Partner, LCP

Case study

LCP advise the sponsor of a large pension scheme where no allowance was being made for the long-term impact of the covid pandemic. Ahead of the annual IAS19 exercise and in preparation for the triennial valuation, we analysed the demographic profiles of the membership, as well as recent mortality experience, with a view to a more objective best estimate mortality assumption.

By comparison with the wider UK population and analysis of the different socio-economic groups, we were able to objectively demonstrate the direct and indirect impacts of the pandemic on members of the scheme. As well as adjustments to the base table, we identified that it would be appropriate to also reflect the impact within the mortality improvement assumptions.

Overall, our analysis supported a 3-4% reduction in liabilities through objective updates to the life expectancy assumptions. This analysis was provided to the sponsor's auditors to support the change in assumption for IAS19 purposes. It was also provided to the scheme's trustees and used as the best estimate assumption from which a prudent funding valuation assumption was developed.

Key accounting issues ahead of the year end *Continued*

IAS19 surplus: good news?

As reported in our **Accounting for Pensions report** earlier in 2022, the IASB called a halt to potential IFRIC14 reforms. This had the potential to change how sponsors would recognise their pension schemes on their balance sheet and so the project cessation means sponsors can, for the foreseeable future, plan and calculate IAS19 figures in line with current rules and practice.

- **Asset limit:** For a number, perhaps a majority, of sponsors this could mean reporting a balance sheet asset. Whilst the improvement in IAS19 position is generally good news, it can also lead to a number of consequences that will need careful messaging both internally within sponsors and externally within corporate accounts.
- **Funding vs accounting:** The cash contributions paid to a scheme will typically be based on a different and more prudent set of assumptions. To the extent that sponsors are paying cash contributions when there is a large accounting surplus, this could require careful messaging, depending on the size of the contribution and/or the surplus.
- **Reporting metrics:** Some metrics, for example 'return on equity', can worsen as the balance sheet surplus increases. Given the size of some pension schemes relative to their sponsors, a large increase in surplus could materially worsen some metrics despite increasing surplus being a positive. Sponsors may need to look at redefining the metric to ensure it remains fit for purpose.
- **Tax treatment:** Sponsors should seek clarity of the tax treatment of any IAS19 surplus. Our experience of market practice to date has been varied, with different auditors taking different views over whether the correct approach is to apply deferred tax at the relevant rate of corporation tax or to apply a deduction equivalent to the 35% tax that is deducted on refund of surplus. This comes down to an assessment of whether the 35% pension refund tax is deemed to be an 'income tax' of the reporting entity.
- **Insurance annuity transactions:** Coupled with improvements in insurer pricing, improving funding positions have meant that many schemes and sponsors have pursued buy-in annuity transactions. These transactions will weaken a sponsor's disclosed balance sheet position (as the cost of the annuity will typically be more than the corresponding accounting liability). This shift in balance sheet can be material and, unless there is careful messaging within accounts, can be perceived to overshadow the positive reduction in risk. As highlighted previously, where the transaction is a full buy-in covering the whole scheme, there is a risk that the change in balance sheet position is recognised through P&L – this is an issue for sponsors to consider and manage carefully in advance at the early planning stage.

Planning

Auditors are facing increasing scrutiny from the FRC following a number of high-profile reports and fines documenting perceived audit failures. As a result, auditors are increasing demands with regard to IAS19/FRS102 audit, covering assumptions, calculation models, approach, controls, and underlying data. To assist, we recommend engaging with auditors early in the process and giving them an opportunity to request information and set out what data they will require before the year end when timescales are not as tight.

In addition, given the size of pension schemes relative to sponsors, it is not uncommon for the accounting implications of certain pension projects to be either a driver or a block for those projects. Examples include closing to future accrual, introducing a new member option (such as a levelling/bridging pension option at retirement), running a member option exercise, or purchasing a bulk annuity to insure member benefits.

Where the potential accounting treatment is central to the decision as to whether to proceed, it is important to consider this early to ensure no late surprises from the accounting that could threaten the project.

Disclosing a significant IAS19 surplus can need careful messaging, particularly if deficit contributions are ongoing.

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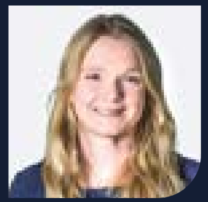

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At LCP, our experts provide clear, concise advice focused on your needs. We use innovative technology to give you real time insight & control. Our experts work in pensions, investment, insurance, energy, financial wellbeing and business analytics.

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