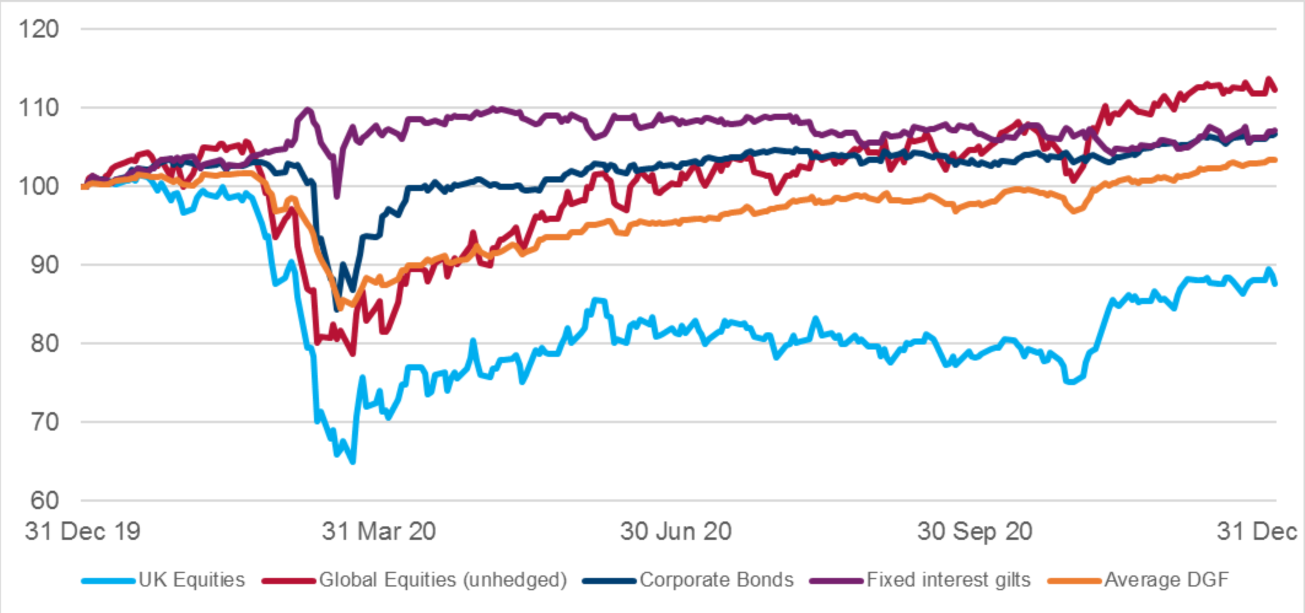
Employer pension briefing, Quarter 4 2020

In this briefing we highlight some of the key pension issues for employers for the final quarter of 2020, including analysis of the impact of Covid-19 and other tumultuous events on investment markets. The briefing focuses on key pension cost accounting issues to consider for 31 December 2020 year end.

UK equity returns continue to lag behind

The final quarter of 2020 saw further recovery in asset values, as investors reacted with relief to progress on Covid-19 vaccines and resolution of the US presidential election, with most major equity markets returning above 10%.

Most asset classes are showing a positive return over 2020. The clear exception is UK equities, where returns since 1 January 2020 remain negative (approximately -10% for the year). The main reason for this is the UK's relatively high allocation of oil and gas stocks, which have performed poorly over the year, especially compared with US tech stocks, which have driven global equity returns.



First Actuarial's Pension Cost Accounting Index

First Actuarial's Pension Cost Accounting Index shows the financial position of the UK's 5,318 DB pension funds on an accounting basis.

While the value of assets is up over the quarter, the same is true of the value of IAS1/ FRS102 liabilities. In particular, Q4 saw further falls in corporate bond yields, with the yield on the iBoxx Over 15 Year Corporate Bond Index hitting a low of 1.3% pa over December. This will mean lower discount rates, which in turn are likely to result in higher accounting liabilities.

The table below shows how corporate bond yields have moved over the year, and the impact that this change alone had on the Defined Benefit Obligation (DBO) of an example scheme:

Date	Yield on the iBoxx Over 15 Year Corporate Bond Index	Example DBO
31 December 2019	2.0% pa	£100m
31 March 2020	2.3% pa	£95m
30 June 2020	1.5% pa	£110m
30 September 2020	1.5% pa	£110m
31 December 2020	1.3% pa	£115m

The impact of changes in assets and DBOs will vary significantly by scheme, depending on liability profile, investment strategy, and whether any contributions have been paid over the period. Overall, across all UK pension schemes, we expect the aggregate balance sheet position to have deteriorated from a surplus of c£20bn at the start of the year, to a shortfall of c£115bn at the end.

More information of changes over 2020 can be found on our Pension Cost Accounting Index page.

Reform of the Retail Prices Index

The prospect of changes to the calculation of the RPI came to the fore in late 2019, when the UK Statistics Authority announced its intention of amending the index from 2030 and bringing it in line with CPIH. This change would in all likelihood reduce RPI inflation by an average of around 1% pa.

A consultation followed, with Government responding in November 2020. Broadly, the consultation response means that the proposed change to the calculation of RPI is almost certain to go ahead from February 2030, with no compensation being paid to holders of index-linked gilts.

The chart below shows the one-year market-implied expected rate of future RPI inflation (derived from the difference between the yields on fixed interest and index-linked gilts).

As you can see, there's virtually no difference between market-implied RPI inflation in 2029 and 2030 (i.e. before and after the change is due to come into effect). This suggests that either the market believes that RPI and CPIH will be broadly the same from 2030, or that supply and demand distortions mean that the market is not a perfect predictor of future RPI inflation.

There is also a knock-on impact on CPI inflation. While the calculation of the CPI will be unaffected by the change to the RPI, CPI inflation is generally derived as RPI inflation minus the expected difference between RPI and CPI inflation (known as the RPI-CPI wedge). Given the changes we expect from 2030, the RPI-CPI wedge will be lower. As RPI inflation has not fallen following the consultation response, CPI inflation assumptions are likely to be higher.

All of this means that setting your RPI and CPI inflation assumptions will be more difficult this year, but that auditors may be willing to accept alternative approaches and adjustments to market-implied rates given the lack of clarity.

GMP equalisation returns

Another issue that has made a return this year is GMP equalisation. Following initial judgment from the Lloyds Bank Case in 2018, employers were required to allow for the additional liability in respect of current scheme members on their balance sheet.

The most recent, and final, judgment concerns past transfers out, and confirms that pension schemes are required to top these up if they did not allow for GMP equalisation (which will be the case for the vast majority) and would have been higher had they done so.

The additional liability resulting from this final judgment should, in most cases, be much smaller than the additional liability from the original judgment. The difficulty with estimating the impact in the case of past transfers is the lack of data. Details of transfer payments and extinguished liabilities from up to 30 years ago are not always readily available.

Given the potential size of the additional liability and the costs involved in calculating an accurate estimate, we think that an approximate and pragmatic approach is likely to be appropriate for most company accounting purposes.

Get in touch with our experts

Our employer services team helps employers with all aspects of pension strategy. Please get in touch with one of our team if you would like to discuss your current situation.

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