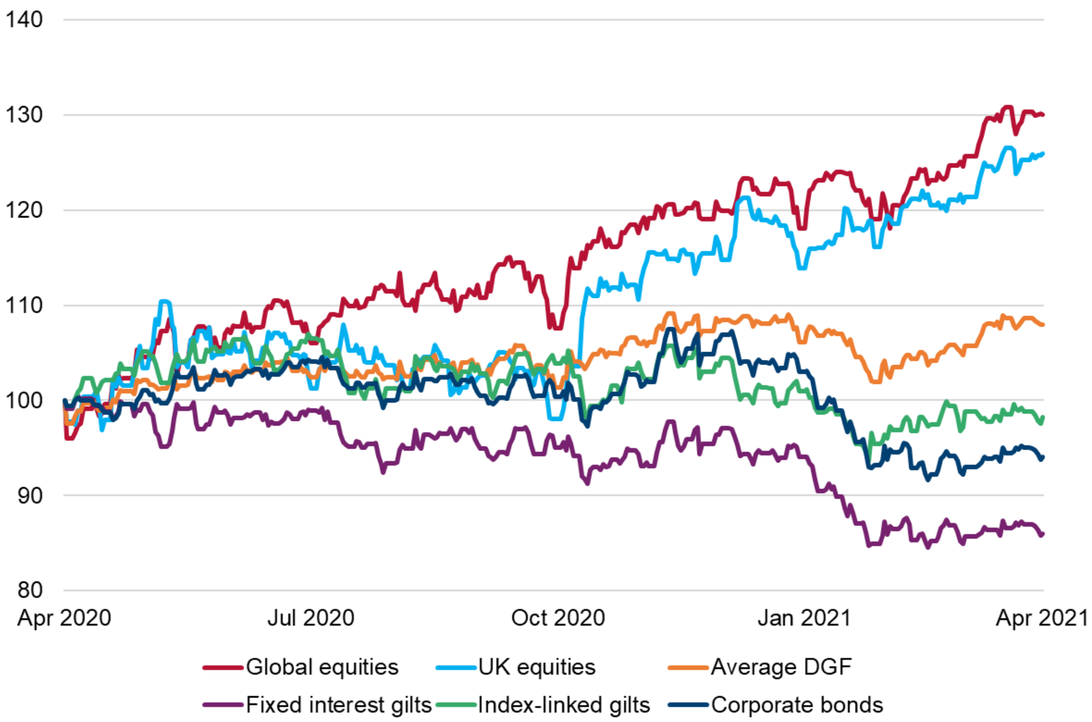
First Briefing, May 2021 – Scheme funding in the legal sector

Many legal firms prepare their statutory accounts as at 30 April. This briefing looks at some of the issues these firms face when preparing this year's FRS 102 pension disclosures. It includes analysis of the majority of legal firms with a Defined Benefit pension scheme (33 schemes across 30 firms). Contact us for a free benchmarking report to find out how the funding of your scheme compares to others in the sector.

Change in assets since 30 April 2020

Financial conditions over the year have been mixed as markets looked to recover from the pandemic-induced volatility we saw in the first quarter of 2020. Equities have performed well, with positive returns over the year averaging from 25% to 30%. Bond yields have risen significantly so far in 2021, meaning that the values of government and corporate bond holdings are generally lower than they were at the start of the year.

Overall, the impact on individual schemes will vary according to the investment strategy adopted. Schemes with higher allocations to equities will have seen their assets increase, whereas schemes with high bond allocations may have seen a reduction in assets over the year (although as we discuss in the next section, this may have been offset by a reduction in liabilities).1



Global equities: +30%

UK equities: +25%

Average DGF: +10%

Index-linked gilts: 0%

Corporate bonds -5%

Fixed-interest gilts: -15%

Changes in liabilities since 30 April 2020

Asset experience is only half of the story. Changes to assumptions over the year can have a significant impact on the value of liabilities.

Corporate bond yields (which are used to calculate FRS 102 discount rates) have increased over the year. This will have reduced the value placed on liabilities. By contrast, market expectations of future inflation have also increased over the year, which will have increased the value of liabilities.

Overall, schemes may expect to see a modest increase or decrease in the value of their liabilities as at 30 April 2021, depending on their membership profile and benefit design.

	30 April 2020	30 April 2021	Impact on liabilities for an average[1] scheme
Corporate bond yield[2]	1.6%	2.0%	**-8%**
Market-implied inflation[3]	3.0%	3.6%	**+9%**

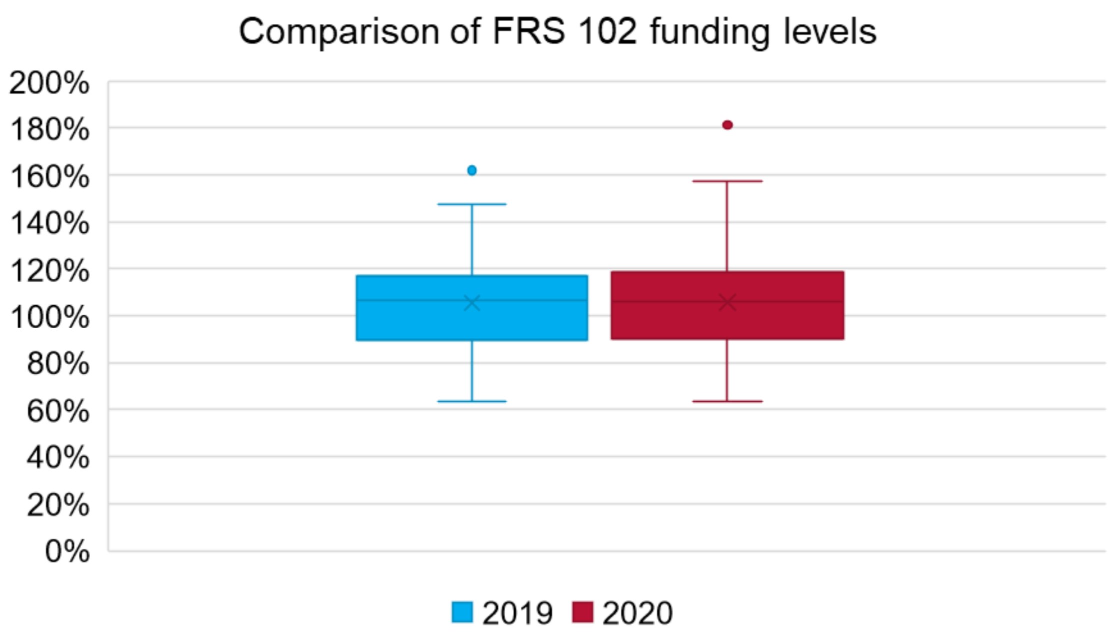
1 An average scheme is assumed to have a duration of 20 years and around 75% of liabilities linked to inflation.
2 Yield on the iBoxx over 15-year AA rated corporate bond index.
3 Implied inflation at a term of 20 years from the Bank of England implied inflation curve.

To find out more about the effect of changes in the financial markets on pension cost accounting positions, see our PCA index.

Comparison of 2019 and 2020 funding levels

Defined Benefit schemes in the legal sector have higher than average funding levels. Hedging strategies also mean that funding levels have been relatively stable in recent years. This is demonstrated clearly in our analyses of the sector's schemes in 2019 and 2020.

The average funding level, on FRS 102 assumptions, was above 100% in 2019 and 2020. The spread of funding levels between schemes increased slightly in 2020, reflecting the range of different funding and investment strategies. A number of schemes may be able to secure member benefits with an insurance company, without any additional contributions from the sponsor.



The impact of scheme-specific assumptions

The FRS 102 discount rate is set according to the yield available on *high quality corporate bonds* and, along with the other FRS 102 assumptions, is the responsibility of the directors.

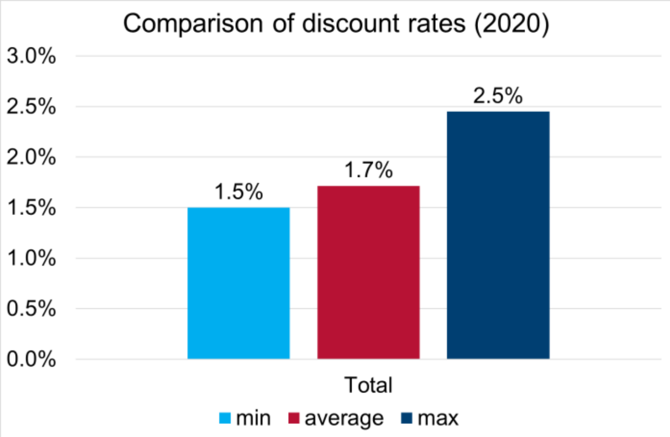
There is a wide range of reasonable assumptions to choose from. These will have a material impact on FRS 102 disclosures.

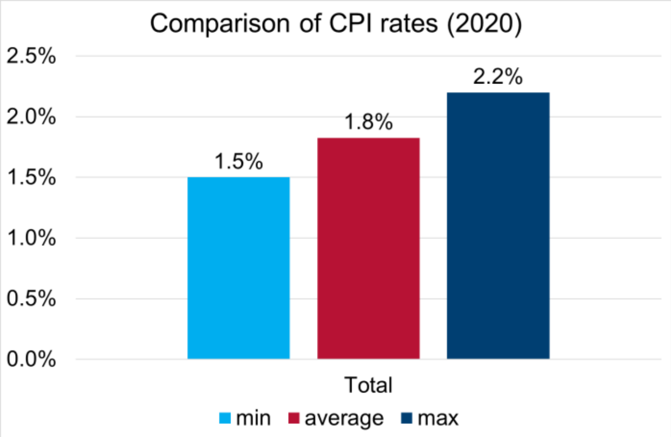
In 2020, the vast majority of results in our survey used a discount rate of around 1.7% pa (although some used a significantly higher figure of over 2%).

A similar spread was seen in the CPI inflation assumptions. Setting a CPI inflation assumption is not straightforward, and depends on the view of:

- Whether gilt-market implied RPI inflation is a good indication of future RPI or needs to be adjusted
- The medium- and long-term gap between RPI and CPI.

The range of assumptions shown below could impact the value of the liabilities by over 25%.





What does all this mean?

FRS 102 valuations provide interesting insights into pension scheme funding. However, they are not used to determine cash funding. Instead, for cash funding the liabilities are valued on different (sometimes more prudent) assumptions, and there are different (even more prudent) assumptions again for exit valuations.

All the different liability measures can get confusing. We often find it helpful to look at the issue the other way around – what investment returns do schemes need?

We call the investment return needed for the lifetime of the scheme in order to pay members their benefits in full the *Break-Even Investment Return* (BEIR), i.e. if this return was assumed in the liability calculation, there would be no funding deficit/surplus and no deficit contributions required.

The average BEIR in our survey showed the funding of the sector's Defined Benefit scheme liabilities is in a healthy position. On average, schemes required an average return of 1.6%.

Some schemes in our survey were so well funded they could achieve negative return and still expect to be in a position to pay full benefits to members. These schemes should be investigating an insurance company buyout.

Benchmark your scheme

Firms will now be starting to prepare their accounts as at 30 April 2021. Get in touch if you'd like a clear understanding of your obligations and a free benchmarking report of your scheme funding and FRS 102 results against our survey.

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Firms included in our survey

Our survey includes data from the following 30 firms. Firms with multiple schemes are indicated by (2).

Addleshaw Goddard LLP	Linklaters LLP
Allen & Overy LLP	MacFarlanes LLP
BDB Pitmans LLP	MacRoberts LLP
Blake Morgan LLP	Marks & Clerk LLP
Brodies LLP	Mayer Brown International LLP
Clifford Chance LLP	Napthens LLP
Clyde & Co LLP (2)	Norton Rose Fulbright LLP
CMS Cameron McKenna Nabarro Olswang LLP (2)	Simmons & Simmons LLP
DAC Beachcroft LLP	Stephenson Harwood LLP
Eversheds Sutherland (International) LLP	The General Council of the Bar
Farrer & Co LLP	Thompsons Solicitors LLP (2)
Freshfields Bruckhaus Deringer LLP	Trowers & Hamlins LLP
Gowling WLG (UK) LLP	Weightmans LLP
Haseltine Lake Kempner LLP	Withers LLP
Holman Fenwick Willan International LLP	Womble Bond Dickinson (UK) LLP

Information sourced from publicly-available information on Companies House.