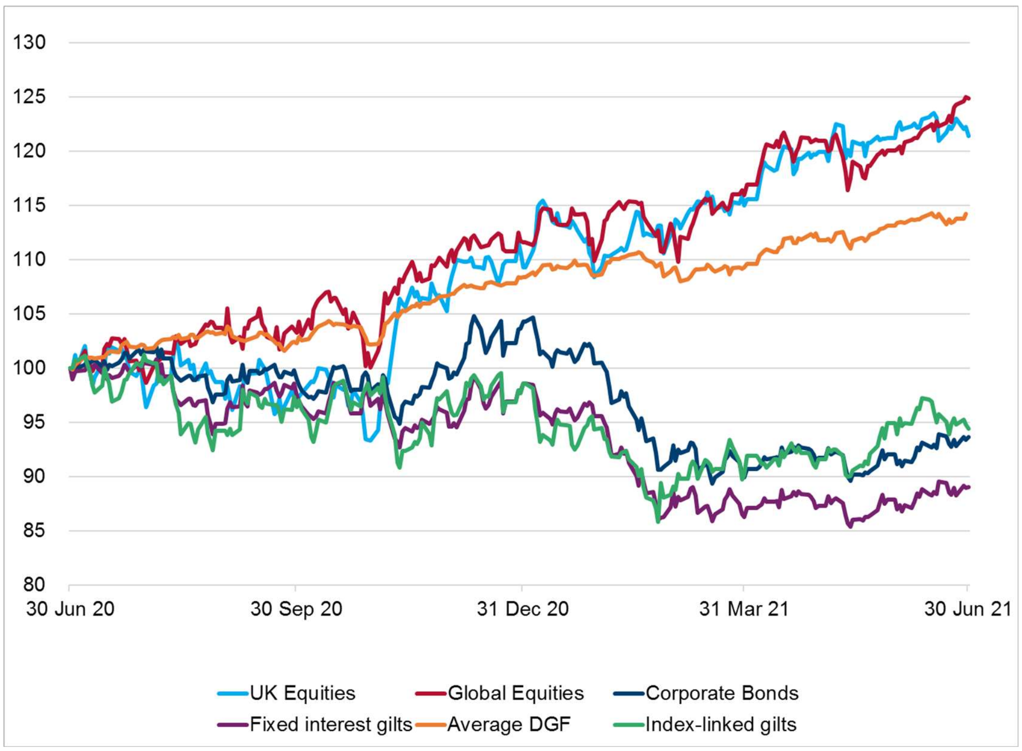
Employer pension briefing, Quarter 2 2021

In this briefing we highlight some of the key pension issues for employers from the second quarter of 2021, with a focus on some of the key pension cost accounting issues to consider for 30 June year-ends.

Changes in markets since 30 June 2020

Q2 2021 saw further strong returns in equity markets, with global equities up by more than 6% over the quarter, contributing to a return of around 25% for the year to 30 June 2021. Bond markets haven't fared anywhere near as well over the year. Their small positive returns over the quarter were not enough to offset significant losses over the first nine months of the year.



Global equities: +25%

UK equities: +21%

Average DGF: +14%

Corporate bonds -6%

Index-linked gilts: -6%

Fixed-interest gilts: -11%

Impact on pension scheme liabilities

Both corporate bond yields (which drive IAS 19 and FRS 102 discount rates) and gilt yields (which often drive funding discount rates) have increased over the year, which will have reduced the value placed on pension scheme liabilities. This has been offset, to some extent, by increased expectations of future inflation. The table below shows the impact of these changes in isolation for an average scheme:

	30 June 2020	30 June 2021	Impact on the liabilities of an average[1] scheme
Corporate bond yield[2]	1.5% pa	1.9% pa	-8%
Gilt yield[3]	0.7% pa	1.3% pa	-11%
Market-implied inflation[4]	3.3% pa	3.6% pa	+4%

1 An average scheme is taken 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 Bank of England nominal gilt curve for a duration of 20 years.
4 Gilt market 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 and funding positions, take a look at our PCA Index page. You might also find our *Finance Director's guide to 30 June 2021 valuations* useful. Ask your usual First Actuarial contact for a copy if you don't already have one.

RPI reform

The saga that is RPI reform rumbles on, the latest development being a legal challenge by the Trustees of the BT, Ford and M&S pension schemes.

The Trustees have joined forces to request a judicial review of the decision to align RPI with CPIH. They allege that the full impact on users of the RPI was not properly accounted for by Treasury and that the Chancellor of the Exchequer has breached his contract with RPI-linked gilt holders by agreeing to the reform.

While it is not for us to comment on the validity of the legal challenge, it does highlight that there remains significant uncertainty around the future of RPI, which makes choosing the 'correct' inflation assumption for funding and accounting more difficult than ever.

2021 Annual Funding Statement

The Pensions Regulator (TPR) published its 2021 Annual Funding Statement (AFS) in May, covering schemes with a valuation between September 2020 and September 2021 ('Tranche 16' valuations), although it will be interest to trustees and sponsors of all pension schemes.

Unsurprisingly, the statement focuses on the impact of Covid-19 on funding positions, sponsor covenant and affordability of deficit reduction contributions (DRCs). It sets out some of the key actions trustees should be taking, including stress testing and scenario planning, especially where there's significant uncertainty over future trading.

The statement provides guidance to those trustees thinking about making an allowance for post-valuation experience in their calculations. It also notes that TPR would like such positive funding experience to be used to reduce the term of recovery plans, rather than the level of contributions. As always, trustees should have a credible justification for the approach chosen, and be satisfied that any recovery plan is appropriate for the covenant and scheme risks.

Rising inflation – should you be worried?

Regardless of changes to the methods used to calculate inflation, there is increasing concern about the threat of rising inflation. Some level of inflation is to be expected as economies re-open following Covid lockdowns, and pent-up consumer demand collides with slow recovery in supply. However, experts are divided as to whether this will prove transitory (a view shared by major central banks) or whether it will persist in the medium term.

Employers (and trustees) will rightly be concerned about the impact of higher inflation on both assets and liabilities. The potential impact can be broken down into two key areas:

- Inflation could increase the value of your liabilities (and matching assets). The impact will depend on the level of inflation linkage in scheme benefits (including any caps in place), and the extent to which these are hedged using matching assets.

- Inflation could cause your growth assets to fall in value in the short term. This is likely to be the case if higher inflation leads to the expectation that interest rates will increase more quickly than previously thought. Schemes with a high proportion of growth assets, particularly those with pure equity allocations, are more likely to be adversely affected by such an impact.

If you'd like to explore whether your investment portfolio can be better protected against rising inflation, our investment team would be happy to discuss this with you.

Get in touch with our experts

To discuss your scheme with us, contact your usual First Actuarial consultant or any of our **employer services team**.

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