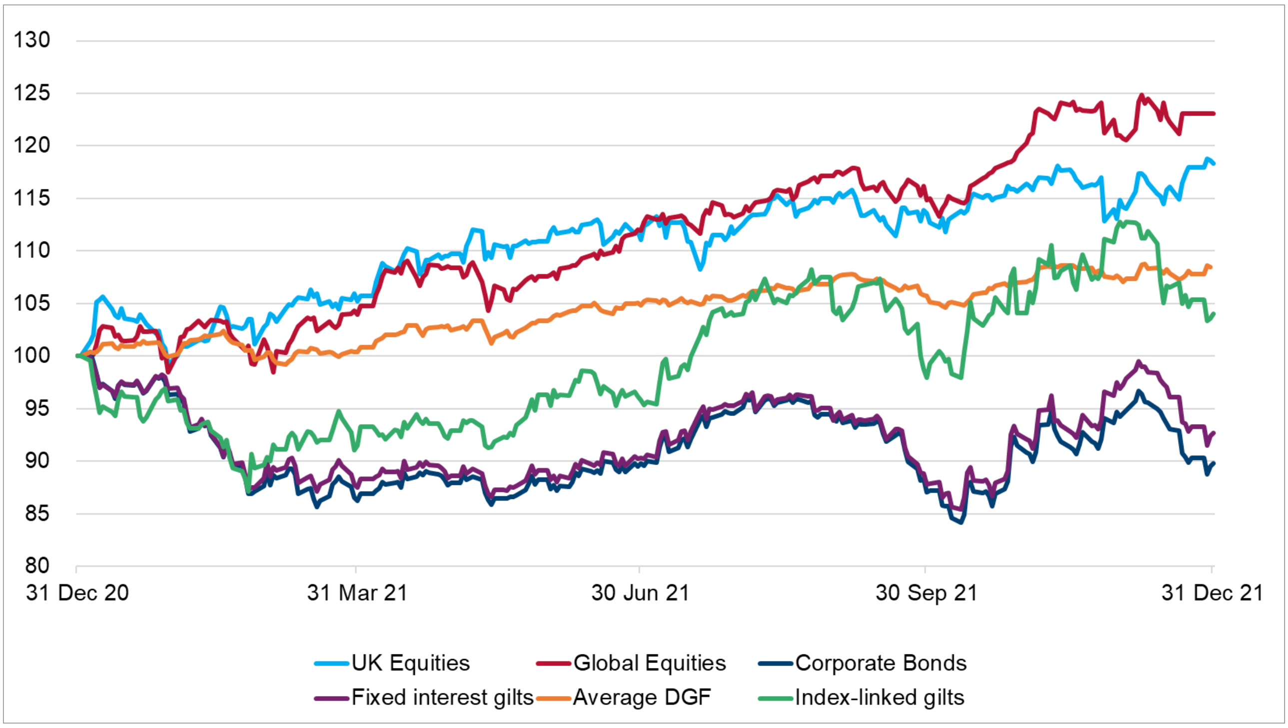
Employer pension briefing, Quarter 1 2022

In this briefing, we highlight some of the key pension issues for employers from the final quarter of 2021, with a focus on some of the key pension cost accounting issues to consider for 31 December year-ends.

Changes in markets since 31 December 2020

The final quarter of 2021 saw continued strong returns in equity markets, with global equities up by around 7% over the quarter, contributing to an overall return of over 20% during 2021.

The volatility in bond markets seen over the first nine months of the year continued into the final quarter, with gains made during October and November largely wiped out by December losses. Over the course of the year, fixed-interest bonds saw negative returns, with corporate bonds falling by around 10% (and government bonds not far behind). Index-linked bonds have fared better, driven by increases in expectations of future inflation, resulting in a positive return of around 4% for the year.



Global equities: +23%	UK equities: +18%	Average DGF: +9%	Index-linked gilts: +4%	Fixed-interest gilts: -7%	Corporate bonds -10%

Impact on 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 scheme liabilities. This has been offset, to some extent, by increased expectations of future inflation as shown below:

	31 December 2020	31 December 2021	Impact on the liabilities of an average[1] scheme
Corporate bond yield[2]	1.3% pa	1.9% pa	-10%
Gilt yield[3]	0.7% pa	1.2% pa	-9%
Market-implied inflation[4]	3.4% pa	3.8% pa	+6%

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 over a duration of 20 years
4 Gilt market implied inflation at a term of 20 years from the Bank of England implied inflation curve

Overall, this means that we expect scheme liabilities to have fallen, but the extent to which this is the case will depend on the makeup of each scheme's liabilities.

Our Pension Cost Accounting (PCA) Index shows the financial position across all of the UK's 5,000+ DB pension funds on an accounting basis. At the start of the year, we estimated that there was an aggregate shortfall across all schemes of around £115 billion. This has varied significantly over the year, but strong growth asset returns and increased bond yield mean our estimate of the aggregate shortfall at 31 December 2021 is under £40 billion.

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 31 December 2021 valuations* useful. Ask your usual First Actuarial contact for a copy if you don't already have one.

Choosing your year-end accounting assumptions

It will come as no surprise to learn that actuaries are yet to perfect the art of predicting the future. As a result, there's no single 'correct' set of assumptions that should be used when determining the value of scheme liabilities for your company accounts. As is often the case, there is more uncertainty in some areas than others, and the two key areas that may require a little more thought this year are inflation and mortality.

Inflation

Inflation is currently sitting at its highest level for 30 years, with CPI inflation exceeding 5% over 2021 and expected to increase further. Many commentators are suggesting that the current high levels of inflation are temporary and that the Bank of England should be able to get CPI inflation heading back towards its 2% target over the longer term.

Throw RPI reform into the mix – which essentially means that RPI inflation will be broadly aligned with CPI inflation from 2030, and so should be 1% pa lower from that point – and you have all the indicators that market-implied RPI inflation should be trending downwards.

However, this sentiment doesn't seem to be shared by gilt-market investors, with average implied inflation over the next 20 years sitting close to 4% pa at the year-end. Whether this represents a lack of confidence from investors in the Bank of England's ability to control inflation or an indicator that gilt market-implied inflation is not a great estimate of future inflation is a debate that may still be running in 2042.

But for this year, there are some fairly strong arguments for making deductions to market-implied inflation to arrive at your year-end RPI and CPI inflation assumptions. This reflects the presence of an (increased?) inflation risk premium, supply and demand distortions and nervousness from investors around RPI reform.

An increase to the adjustment made for these factors of 0.2% pa might serve to reduce liabilities by up to 4%.

Mortality

Covid-19 has led to a marked increase in the number of deaths over the past two years. Mortality rates over 2020 were 12% higher than 2019, and while the position improved over 2021, mortality rates were still significantly higher than pre-pandemic levels. But while the short-term impact of Covid-19 is relatively clear (at least in terms of excess deaths), the longer-term impact is less so.

This is evidenced by the approach taken in the latest version of the CMI model (CMI 2020), used to project mortality improvements, which under its default parameters will ignore experience over 2020. The upcoming CMI 2021 model will do the same for both 2020 and 2021 experiences, reflecting the prevalent view that it's too early to understand the longer-term impact.

This does, however, raise a question as to whether such a view represents a 'best estimate' of the future. While this 'wait-and-see' approach is reasonable, and indeed may be appropriate for many schemes and employers, it is not the only view that can be taken.

The table below sets out some feasible alternative views, and what those views might mean in terms of the assumptions adopted and your liabilities.

View	Possible change to assumption	Reduction in liabilities
Covid has caused a short-term 'shock' to mortality rates	Increase base table loading by 5%	Up to 2%
Covid (and resulting economic actions) will see a slowdown in mortality improvements	Reduce long-term rate by 0.25%	Up to 2%
Covid is here to stay and will continue to result in increased mortality rates	Apply a 25% weighting for 2020 experience	Up to 2%

Health warning: This table does not reflect advice in respect of any individual scheme, and you should discuss this with your usual First Actuarial contact if you'd like to investigate your options in more detail. It's likely that auditors would want to see evidence and a robust rationale if you were to adopt any of the above.

Looking to the year ahead

2022 is likely to be a busy year for pension schemes. We look ahead to some of the key events that are coming up below

New funding code

The Pensions Regulator has delayed the second consultation on its draft Defined Benefit funding code until late summer 2022. This means that schemes with triennial actuarial valuation dates in early 2022 should not be subject to any additional requirements, with the new code becoming operational in late 2022 or early 2023.

GMP equalisation

Many schemes will now be making a start on equalising GMPs. Some (albeit more optimistic) industry estimates suggest that over half of schemes will be paying pensions on an equalised basis by the end of the year.

Those of you who also wear trustee hats will be pleased to hear that we're not going to cover any of the detail here (although there is plenty of this on our GMP equalisation hub if you're interested). While this is a process that is controlled by trustees, employers should be working closely with trustees to understand the approach being taken, any alternatives considered (or not considered), and whether GMP equalisation can be used as a tool to manage scheme liabilities and simplify benefit structures.

Insurance market transactions

Strong asset returns and rising bond yields over the year mean that many schemes are much closer to being able to buy-out scheme liabilities. Expectations are that risk transfer transactions may top £60bn for the first time in 2022.

These improved funding levels and increased levels of transactions mean that insurers' capacity for taking on new business is likely to limited.

This is most acute at the smaller end of the market (say for sub-£50m transactions), and as such, if your scheme is considering an insurance market transaction in the next 12 months, it's essential to make the scheme as attractive as possible to insurers. This means carrying out work to rectify benefits and data, adopting an appropriate investment strategy, resolving any outstanding issues (including GMP equalisation), and having in place a firm commitment from the employer to pay any additional contributions needed.

Our specialist buy-out team can help employers and trustees work through these steps and offer advice on actions that can be taken to reduce the overall cost of buy-out.

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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