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Employer pension briefing, Quarter 1 2023

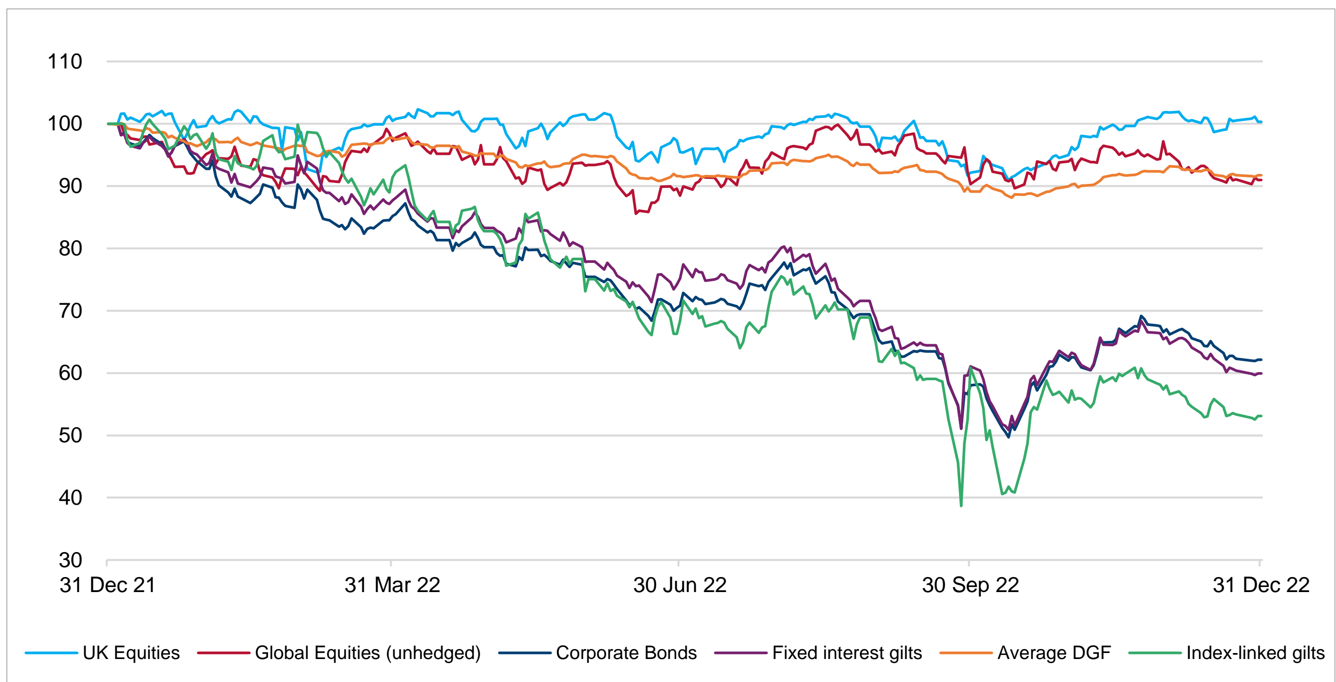
In this briefing, we highlight key pension issues for employers from the final quarter of 2022. We focus on areas of pension cost accounting to consider for 31 December year-ends, including the impact of gilt market volatility.

Changes in financial markets in 2022

The final quarter of 2022 began with significant volatility in bond markets, which continued throughout much of October. This volatility followed the Government's 'mini-Budget' in September. The first few weeks of October saw daily movements of up to 15% in the value of some bonds, although this volatility subsided as the quarter progressed.

Corporate bonds actually generated a positive return over the quarter. Gilts performed less well, however, with the value of index-linked gilts falling by around 13% over the period. Over the year, bond values fell by as much as 47%.

UK equity returns have essentially been flat during 2022. Global equities have fared worse, with losses on currency-hedged holdings close to 10% over the year. The fall in the value of the pound over 2022 meant that losses on unhedged global equities were closer to 20% over the year.



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Inflation

Increases to Defined Benefit pensions are often linked to inflation. High inflation therefore has a direct impact on the level of pension payments, and hence the size of scheme liabilities.

Most private sector schemes apply some form of cap on inflationary increases. For pensions in payment, these caps are usually applied annually, so they will have mitigated much of the impact of high inflation. However, increases in for pensions in deferment are typically capped over the entire period to retirement (in line with statutory requirements). Many deferred members will therefore see their pensions increase by around 10% this year as a result of the high inflation of 2022.

The extent of any increase in your scheme's liabilities will depend on the profile of the scheme and the specific caps that apply.

Changes to pension scheme liabilities

While asset returns over 2022 are clearly not good news in isolation, it's important to remember that changes in scheme funding levels will reflect movements in both assets and liabilities. Falling corporate bond prices mean rising corporate bond yields, and since these yields drive IAS 19 and FRS 102 discount rates, this translates to falls in the value of scheme liabilities.

Similarly, falling gilt prices mean rising gilt yields, which often drive cash funding discount rates (as well as buy-out pricing and low-dependency targets).

As a result of the significant increase in corporate bond yields over the year, the value placed on scheme liabilities for pension cost accounting will have fallen dramatically. For employers with schemes that are open to accrual, the 2023 service cost will also be significantly lower.

Despite the current levels of high inflation, long-term expectations of future inflation are slightly lower than they were on 31 December 2021. In general, we expect changes in the future inflation assumption to result in a small reduction in liabilities.

Overall, we expect most schemes to have seen their pension balance sheet positions improve over the year to 31 December 2022. Improvements will have been greatest for schemes that didn't have material levels of liability hedging in place (and so have not seen such substantial falls in asset values).

	31 December 2021	31 December 2022	Impact on the liabilities of an average[1] scheme
Corporate bond yield[2]	1.9% pa	4.8% pa	-43%
Gilt yield[3]	1.2% pa	4.2% pa	-44%
Market-implied inflation[4]	3.8% pa	3.6% pa	-3%

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 significantly (potentially by up to 40% compared with the previous year-end).

For more information on the implication on funding positions – especially if you have an upcoming actuarial valuation date – you might find our *Finance Director's guide to 31 December 2022 actuarial valuations* useful. Ask your First Actuarial contact for a copy if you don't already have one or request one here.

What to watch out for in year-end financial reporting

Choice of assumptions

There is no single 'correct' set of assumptions that should be used when determining the value of scheme liabilities for your company accounts. Instead, there is a range of values applicable to all key assumptions that could be considered reasonable (and therefore acceptable to your auditor). Appropriate values for each assumption will depend on the liability profile and benefit structure of your scheme, as well as the methodology used to set each assumption.

The table below gives an indication of the range within which we would expect each of the key assumptions to sit (for most schemes), and the financial impact that changing these key assumptions could have on your Defined Benefit obligation (DBO):

Assumption	'Reasonable' range	Impact on DBO
Discount rate	4.6% pa to 5.0% pa	0.1% pa change: up to 2%
RPI inflation	2.9% pa to 3.4% pa	0.1% pa change: up to 2%
Mortality (life expectancy at 65)	20.5 to 23.0 years	1 year: up to 3%

Recognising an accounting surplus as an asset

Many employers will find they have schemes that are now in surplus on an accounting basis for the first time in a while at least. This means that a decision may be needed on the accounting treatment of any surplus.

In most cases, a surplus can be recognised on the balance sheet under both FRS 102 and IAS 19, but this will depend on your scheme's rules (and your auditor's view). We recommend discussing the treatment of any surplus with your auditors as soon as possible. Your auditor may ask you to take legal advice for a definitive view, which could hold up the finalising of accounts.

One slightly technical point to note is that if you're unable to recognise an accounting surplus as an asset, then any future contributions to the scheme will effectively 'fall off' your balance sheet. This is something to consider if you're still paying contributions. You can take an alternative approach to cash funding to mitigate this impact.

Mitigating against trapped surpluses

Clearly, a scheme moving into surplus on an accounting (or any) basis is good news. However, this position brings problems of its own, namely the risk that the scheme will become 'overfunded'. If you find yourself in this position, it may be a good time to take stock and think about the future funding of the scheme. Employers should avoid 'overpaying' into a scheme, as it may well be the case that there is no way of recouping the surplus (or that any refund comes with a penal tax charge).

In our Q3 2021 briefing, we looked at a number of non-cash funding options, which can help mitigate the risk of a trapped surplus.

Discretionary pension increases

Many trustees – particularly those of schemes that have seen material improvements in funding levels – may be considering pension increases above the minimum required by scheme rules to help members cope with the rising cost of living. In most cases, trustees do not have a unilateral power to pay discretionary increases. Even where they do, we would expect this to be a joint decision between the sponsor and the trustees.

Paying discretionary increases is likely to result in a pension cost which needs to be recognised in your profit and loss account. And there could potentially be an additional liability in respect of future discretionary increases if it is felt that paying these results in a 'constructive obligation'. If your scheme's trustees are thinking about discretionary increases, make sure you take advice on the potential implications.

Insurance market update

Funding levels for many schemes will have improved over the year, and some schemes will now be much closer to being able to 'buy-out' their liabilities.

Expectations are that insurance transactions will reach record highs in 2023. Limited insurer capacity means that schemes will need to make themselves as attractive as possible to insurers by showing that they're 'transaction-ready'. If your scheme is considering an insurance market transaction in the next 12 months, you will need to carry out preparatory work to enhance its appeal to insurers. Such work includes rectifying benefits and data, adopting an appropriate investment strategy, and having in place a firm commitment from the employer to pay any additional contributions needed.

Our **specialist buy-out service** can help you and the 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, contact your usual First Actuarial consultant or any of our **employer services team**.

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