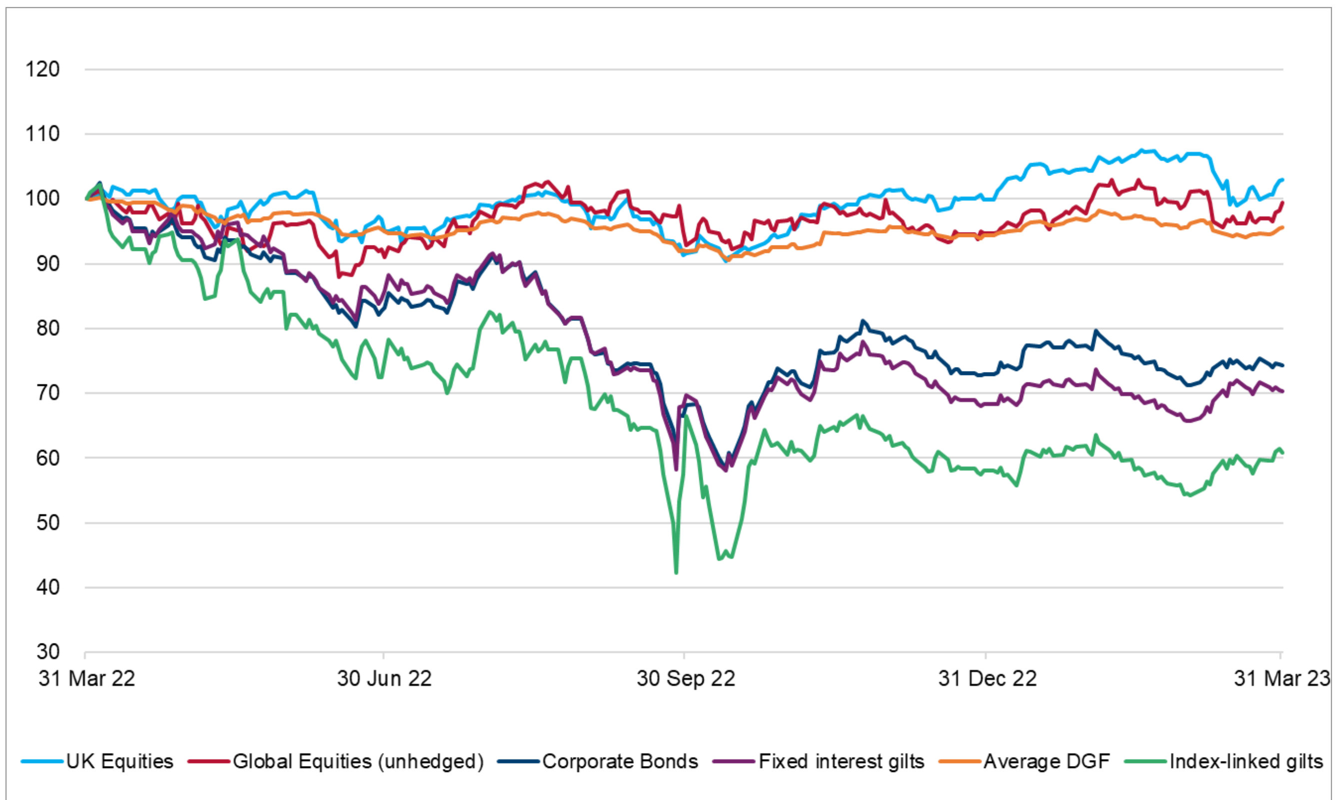
# Employer pension briefing, Quarter 2 2023

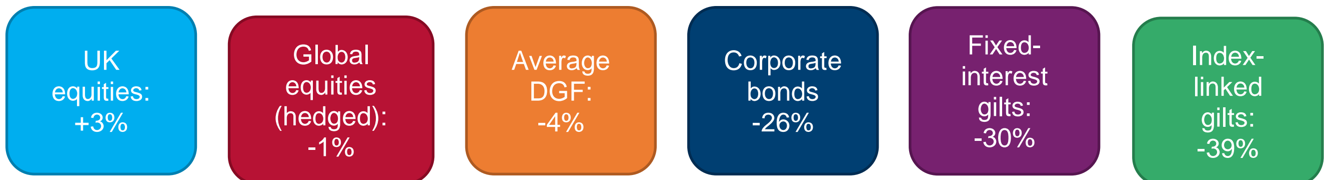
In this briefing, we highlight key pension issues for employers from the first quarter of 2023. We focus on the impact of market movements on pension cost accounting positions and upcoming funding valuations. We also highlight key developments in the pensions industry.

## Changes in financial markets

After a period of volatility following the Government's mini-Budget in September 2022, markets have stabilised. Returns on both corporate bonds and gilts were largely flat over the first quarter of 2023, although bond values remain materially lower than they were 12 months ago.

UK and global equity returns have been broadly flat over the last 12 months (with falls in the value of sterling meaning that UK equities have fared slightly better than their unhedged global counterparts).

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## Changes to pension scheme liabilities

### Bond yields

While asset returns over the last 12 months 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. Over the course of the last 12 months, the increase in corporate bond yields alone could have reduced accounting liabilities by over 30%. For employers with schemes that are open to accrual, next year's service cost will also be significantly lower.

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

### Inflation

Increases to Defined Benefit (DB) 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.

Many schemes apply some form of cap on inflationary increases. For pensions in payment, these caps are usually applied annually, so they will have limited the impact of recent record levels of inflation. However, increases in deferment are typically capped over the entire period to retirement. Many deferred members will therefore see their deferred pensions increase by around 10% this year.

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

As well as factoring in past inflation, scheme liabilities must also consider future expectations of inflation. Long-term expectations of future inflation are slightly lower than they were this time last year. This reduction is driven in part by the high inflation of the past 12 months (which has now effectively been unwound from the previous long-term assumption). This will, in isolation, result in a reduction in liabilities.

### Summary

Overall, this means that despite record levels of inflation, we expect scheme liabilities to have fallen significantly compared with the previous year-end.

| | 31 March 2022 | 31 March 2023 | Impact on the liabilities of an average[1] scheme |
|---|---|---|---|
| Corporate bond yield[2] | 2.7% pa | 4.7% pa | -32% |
| Gilt yield[3] | 1.9% pa | 4.0% pa | -34% |
| Market-implied inflation[4] | 4.1% pa | 3.6% pa | -6% |
| Actual inflation (year to Match 2023) | RPI: 13.5%<br>CPI: 10.1% | | Up to +10% |

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

### What does this mean for your scheme?

Many (although certainly not all) schemes will have seen their pension balance sheet positions improve over the year to 31 March 2023. 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).

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 March 2023 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.

### *A delay to life expectancy updates*

Each year, the Continuous Mortality Investigation Bureau (CMI) releases a new CMI model, which updates projected mortality improvements using the latest available information. These models are usually released in March of each year, but the release of CMI 2022 has been delayed until June, pending the outcome of a consultation on some of the underlying assumptions and data.

The expectation is that the newest model will see a reduction of projected life expectancies of around six months. This could knock 1% to 2% off liability values. For employers with a 31 March year-end, it may be possible to justify an adjustment to the mortality assumptions used last year to reflect this expectation. That said, making no change until the 2022 model is released is also likely to be considered acceptable by auditors.

### *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. This means that decisions 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.

## What to watch out for in upcoming actuarial valuations

### *Defined Benefit funding code*

The Pensions Regulator announced on 20 April that the new funding code will not be implemented until Q2 2024 at the earliest.

The Pensions Regulator (TPR) has been working to introduce a new code of practice for funding Defined Benefit schemes for some time. A first consultation took place in March 2020 and a second consultation closed on 24 March 2023. As noted above, it has now been announced that the new funding code will not be in place **until next year.** The earliest valuation date we expect to fall within scope of the new code is **1 April 2024.** It is, however, likely that the proposals will shape trustee views on funding valuations taking place before that date.

Broadly, the biggest change arising from the new funding code is the formal introduction of long-term objectives for schemes. Trustees will need to document what their 'long-term objective' (LTO) is and how they plan to get there over a defined period of time. This will be supported by a statement of strategy, which will comprise two parts.

Part 1 will consist of a funding and investment strategy' (FIS), which will document:

- How scheme benefits will be provided in the long term – such as running off the scheme indefinitely or buying out the liabilities with an insurer
- What investments the scheme will hold once it is 'significantly mature'
- How well funded the scheme should be at this point, assuming low dependency on the employer.

The FIS **must** be agreed with employers.

Part 2 will cover various supplementary matters, including how well the FIS is being implemented, along with the main risks to the FIS and how they are being managed. Trustees will need to consult with employers on Part 2 but employer agreement is **not** required.

The new DB funding code could materially change the process by which actuarial valuations are carried out and agreed, placing a greater governance burden on trustees and employers alike. For more information on the implications of the new funding code you might find our **In-depth look at TPR's draft DB funding code** useful.

### *TPR's Annual Funding Statement*

TPR has published its **2023 Annual Funding Statement** and accompanying **Press release: Trustees should ensure their long-term funding targets are still appropriate**.

The Statement is particularly relevant for trustees and sponsors of schemes who are undertaking valuations at the current time or are "*undergoing significant changes that require a review of their funding and risk strategies*".

Given changes in the financial markets over the past year, TPR is encouraging trustees and sponsors to reassess where their scheme has reached on its funding journey and take a fresh look at risks and opportunities.

## Other pensions news

### *Pensions dashboards*

Back in March, the Pensions Minister announced a *"reset of the pension dashboards programme"*. We are due an update in the next few months, which will hopefully set out a new timetable for delivery.

The first schemes were due to go live later this year and, while another delay to the programme is not good news for pension savers, extra time to prepare data will be welcomed by scheme trustees and sponsors.

### *Auto-enrolment*

The Department for Work and Pensions recently confirmed its support for proposals to expand auto-enrolment, encouraging millions of people to save more and start saving earlier.

The proposals would give ministers powers to include lower paid and younger workers within the scope of auto-enrolment. At the time of writing, the proposals are being considered by the House of Lords. Given the delays to the new funding code and pensions dashboard, it might be wise not to get too excited about any changes happening quickly.

### *Spring Budget 2023*

On 15 March 2023, the Chancellor delivered the Spring Budget 2023. From a pensions point of view, the Budget included (genuinely) surprising announcements on the **Lifetime Allowance (LTA)** and the **Annual Allowance (AA)**.

The LTA is a limit on the amount of tax-relieved pension savings that an individual can make over their working life. Before the budget, the LTA was £1,073,100, allowing a DB scheme member to receive an annual pension of £53,655 without incurring an LTA tax charge. The budget moved to abolish this limit from April 2024. This will initially be achieved by setting the tax charge payable when the LTA is breached to nil.

The AA is a limit on the amount of tax-relieved pension savings that an individual can make over a single tax year, and was increased from £40,000 to £60,000 for 2023/24.

Our briefing looks in more depth at the Spring Budget, and includes other pension-related changes and how these may affect employees.

## Financial wellbeing

Much of the UK is struggling with the current cost of living crisis, and many employers are looking at ways of supporting staff during these difficult times. Our financial wellbeing team has developed a set of resources on our Cost of Living microsite that you can share with your workforce and include in newsletters and other internal communications. The resources include:

- A video with tips on how to cope in a world of rising costs, focusing on areas where employees can save money
- A list of supportive organisations and useful websites
- An action plan to put employees in control of their money.

We can also provide more tailored support for your employees, including presentations, webinars and individual financial education sessions. Please get in touch with our financial wellbeing team for more information.

## 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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