

# Accounting for pension costs

## Survey of assumptions used at 31 December 2008

### Introduction

This is our 8th annual survey of the assumptions adopted by FTSE100 companies for determining the value of their pension liabilities for accounting purposes.

This survey is based on data in the published accounts of FTSE100 companies with financial years that ended on 31 December 2008. At the time of writing, 52 companies had published results, 45 of which also appeared in last year's survey.

### Discount rate

The discount rates used by the companies in our survey are set out below.



At 31 December 2008, the yield on the iBoxx over 15 year, AA-rated corporate bond index was approximately 6.7% p.a. (2007: 5.8%). However, almost all the discount rates used at the end of 2008 were less than this index and with a much larger spread than for previous years. This is very different from 2007, when the majority of companies used a discount rate that was at, or very close to, the index yield of 5.8% p.a., as can be seen in the chart above.

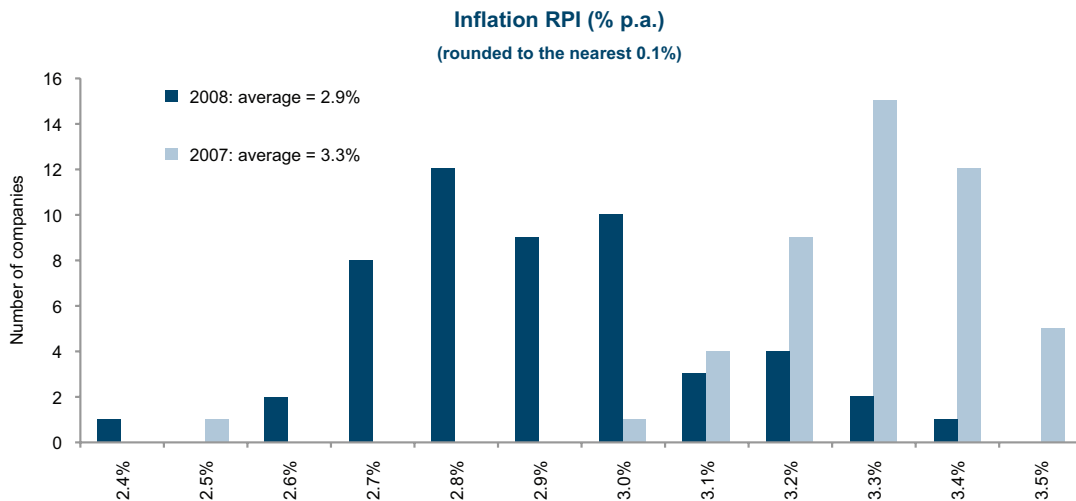
The iBoxx index dropped to 6.4% p.a. on 2 January 2009 due to changes in the constituents of the index. Some companies may have used this level as the starting point for arriving at the discount rate, particularly in view of the "credit crunch" having pushed up bond yields to relatively high levels.

It is also noticeable that different companies arrived at quite different conclusions for their choice of discount rate. One possible explanation is that yields at the end of 2008 were lower at longer durations and so companies with longer term pension liabilities may have used a lower discount rate to reflect duration. If so, it will be interesting to see whether these companies use discount rates above the index when the yield curve reverts to its more normal shape of having higher yields at longer durations.

The chart shows some overlap between discount rates used in 2007 and 2008. However only one company adopted a lower discount rate at the end of 2008, compared with 2007, and four companies left their discount rates unchanged; all the other companies adopted a higher discount rate for 2008.

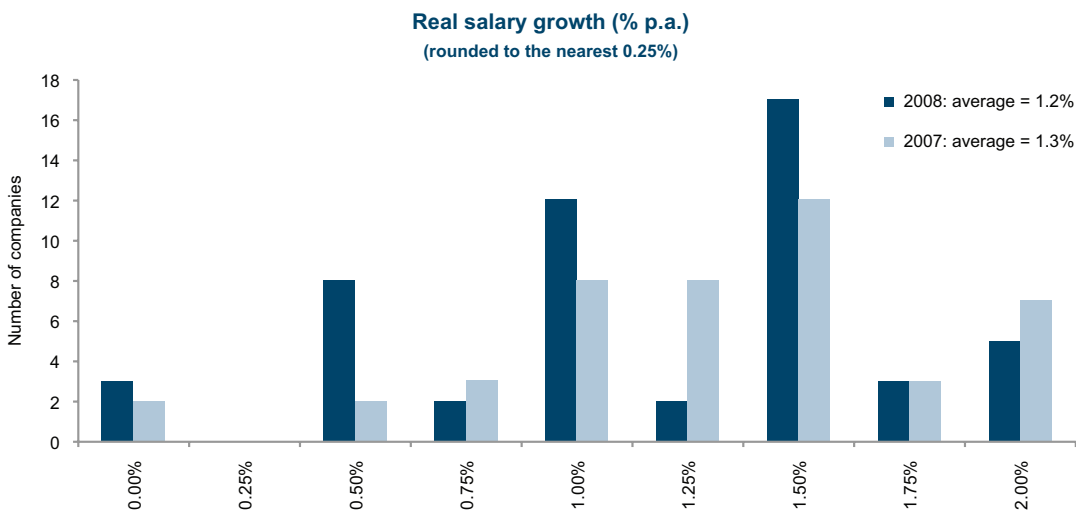
## Inflation rate

The Bank of England implied 'inflation spot rate' at 20 years (based on the difference between fixed interest gilts and index linked gilts) was 3.2% p.a. Most companies in the survey assumed that inflation would be somewhat lower, with the average at 2.9% p.a. There is a slightly wider spread of assumptions this year, which again may suggest that companies were taking into account the duration of their pension liabilities when setting the assumptions, as the inflation yield curve was lower at longer durations.



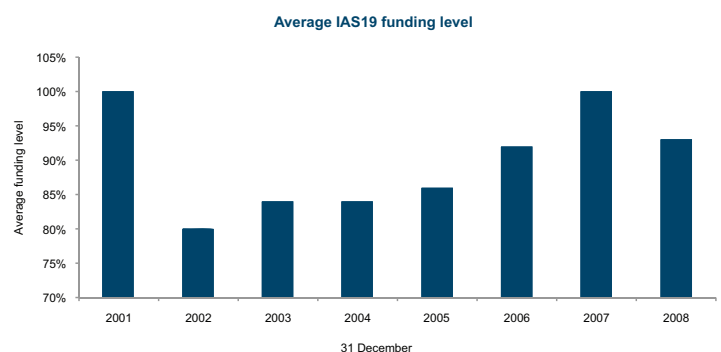
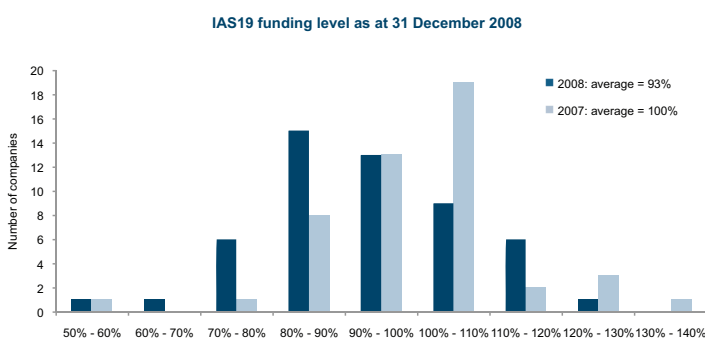
## Salary increases

Some companies may use a scale for promotional salary increases in addition to a general salary growth assumption and therefore a comparison of the disclosed salary increase rate assumptions may not be like-for-like in all cases. We have nevertheless shown below the disclosed salary increase assumptions used relative to the assumed rate of price inflation (i.e. real salary growth). The average real salary growth assumption was 1.3% p.a. in 2007 and remained broadly the same, at 1.2% p.a., in 2008.



## Surplus / deficit

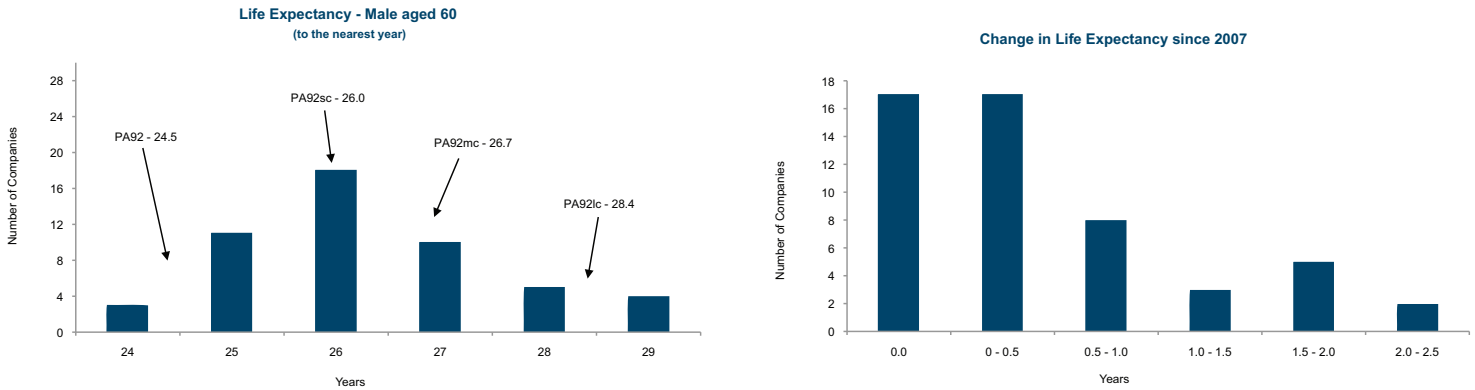
The average IAS19 funding level for the companies in our survey decreased to approximately 93% at 31 December 2008 compared with 100% at 31 December 2007. This was mainly due to large falls in asset values, which was only partly offset by the increase in discount rates and served to reduce the average funding level for the first time since 2002.



## Life expectancy

All 52 companies in this year's survey disclosed information on their life expectancy assumption, either by stating the assumed life expectancy or by referring to the mortality tables used for both this year and the previous year, allowing comparisons to be drawn.

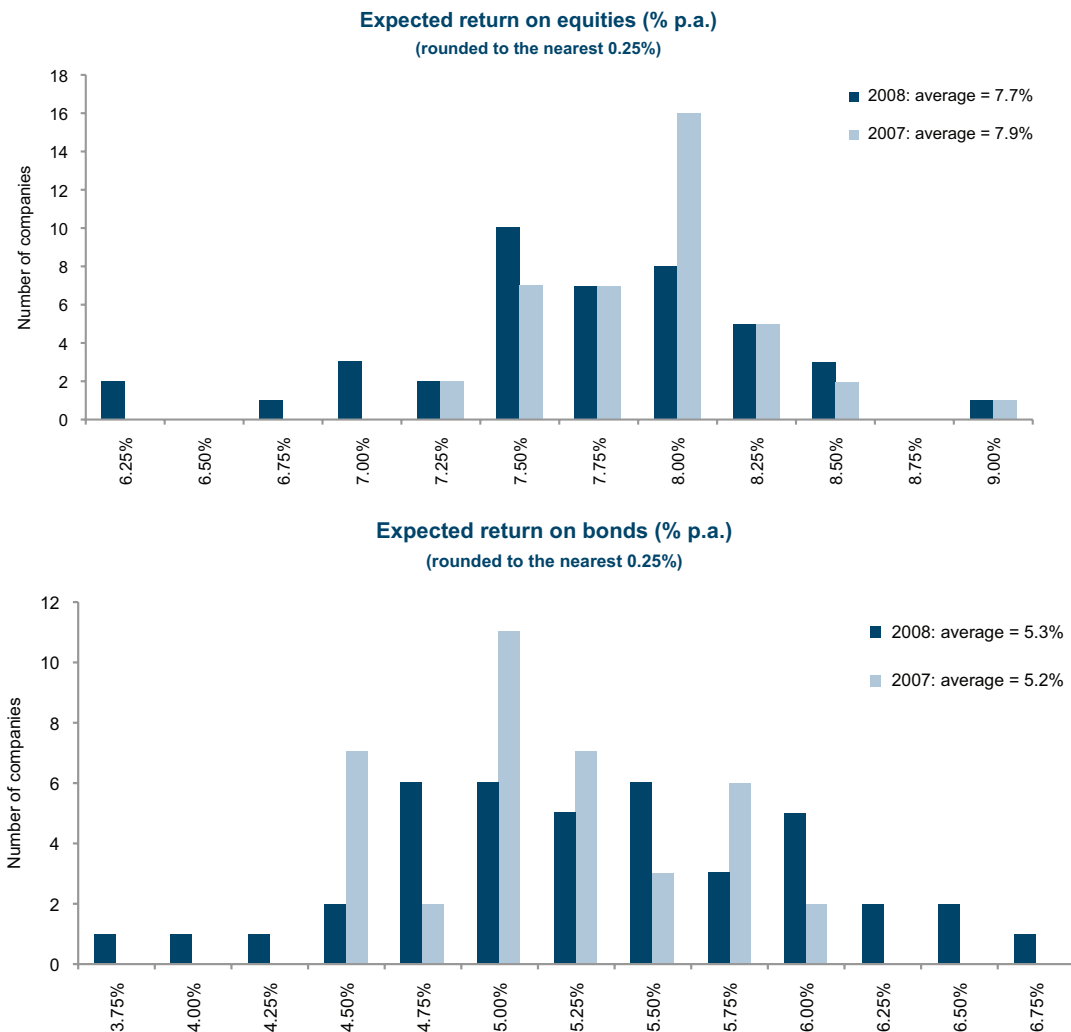
We have shown below the life expectancy assumptions for a man aged 60 at the year end and also indicated the life expectancies implied by some of the mortality tables that were used. The chart on the right hand side shows the number of companies that have increased their life expectancy assumption compared with the 2007 assumption (presented as the effect on the life expectancy for a man aged 60 at the year end).



The majority of companies in the survey left their mortality assumptions broadly unchanged from 2007. Some companies changed the base table used, in particular adopting the more recent "00-series" table instead of the "92-series" table, and also increased the allowance for future improvements in mortality. A number of companies also applied scheme specific adjustments to their mortality base tables and introduced underpins to the minimum level of future mortality improvement.

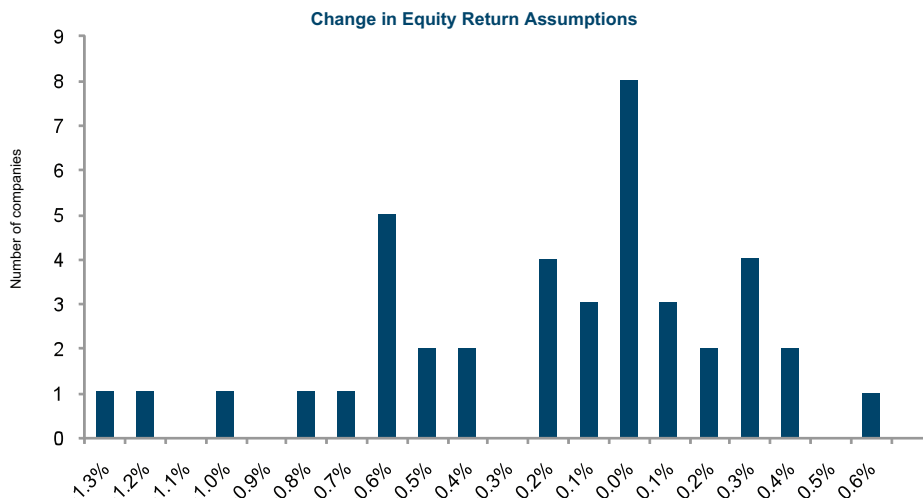
## Expected investment returns

The expected returns on equities and bonds disclosed at 31 December 2008 are set out below.



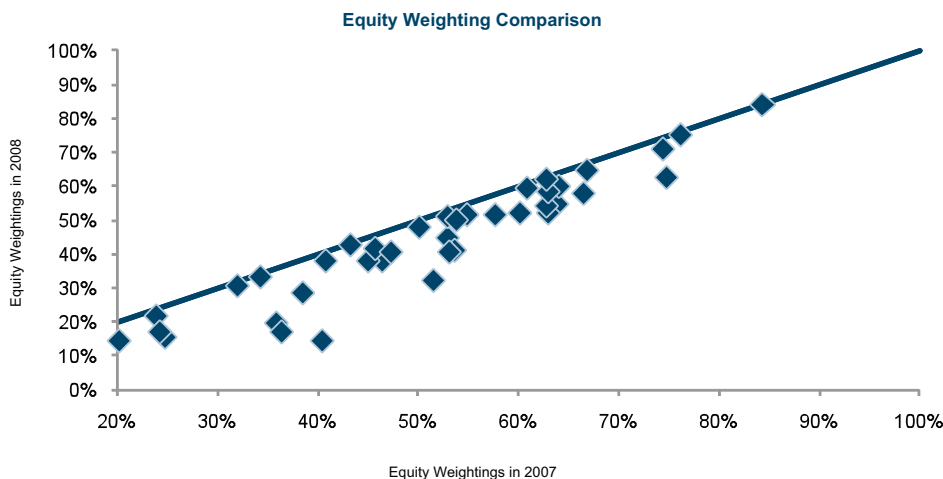
The average expected equity return was 7.7% p.a., compared with the average yield on long-dated gilts of 3.8% p.a. thereby implying an average "Equity Risk Premium" of 3.9% p.a. (2007: 3.4%). The average expected bond return was 5.3% p.a., which is broadly half way between the average yields on long-dated gilts and long-dated corporate bonds at the year end.

Of the 41 companies disclosing the necessary information, 21 have reduced their equity return assumption, 12 have increased it and 8 have left it unchanged from 2007. This is illustrated in the chart below.



## Asset allocation

The chart below shows the percentage of assets invested in equities for companies in the 2008 survey, compared with the percentage invested in equities by the same companies in the 2007 survey. The straight line represents an unchanged equity weighting from 2007 to 2008. Those companies that fall below the line have a lower equity weighting at the end of 2008, than at the end of 2007.



The significant falls in the value of equities over the year will have reduced the equity weighting for most of the companies. However, there are some companies with little or no reduction, which suggests they have taken steps to re-balance their asset allocations.

We hope that this analysis is helpful to companies in formulating their own assumptions under IAS19 (or FRS17).



Please contact your usual Barnett Waddingham consultant to discuss any of the above.

Barnett Waddingham - JUNE 2009

Chalfont Court  
Hill Avenue  
Amersham  
HP6 5BB  
Tel: 01494 788100  
Fax: 01494 788800

Rigby Hall  
Rigby Lane  
Bromsgrove  
B60 2EW  
Tel: 01527 559111  
Fax: 01527 559222

St James's House  
St James's Square  
Cheltenham  
GL50 3PR  
Tel: 01242 538500  
Fax: 01242 538501

163 West George Street  
Glasgow  
G2 2JJ  
Tel: 0141 243 4400  
Fax: 0141 243 4432

West Riding House  
67 Albion Street  
Leeds  
LS1 5AA  
Tel: 0113 394 3700  
Fax: 0113 394 3760

Port of Liverpool Building  
Pier Head  
Liverpool  
L3 1BW  
Tel: 0151 235 6600  
Fax: 0151 235 6640

Cheapside House  
138 Cheapside  
London  
EC2V 6BW  
Tel: 020 7776 2200  
Fax: 020 7776 3800

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