

Accounting for pension costs

Survey of assumptions used at 31 December 2009

Introduction

This is our ninth 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 2009. At the time of writing, 46 companies had published results, 38 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 2009, the yield on the iBoxx over 15 year AA-rated corporate bond index was approximately 5.7% p.a. (2008: 6.7%) and this was by far the most popular discount rate used by the companies in our survey with 26 companies employing it in their pension liability calculations. All other companies in the survey used discount rates within the range 5.5% p.a. and 6.0% p.a. This range was much tighter than seen at the end of 2008, where the majority of companies used a discount rate that was at or somewhat below the index yield of 6.7% p.a., as can be seen in the chart above.

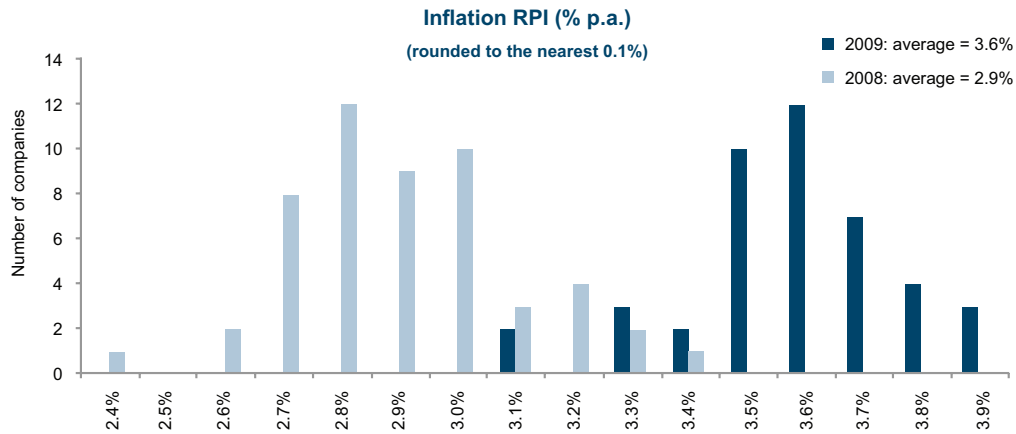
The wide range last year may have been because companies were reflecting the duration of the liabilities in the choice of discount rate. As the yields were lower at longer durations last year this may have led to lower discount rates being chosen. The yields at longer durations are not so markedly lower than the index this year which might explain the narrower range. Another explanation may be that some companies took the view that yields were artificially high at the end of 2008 due to the uncertainty in the markets at that time.

The chart shows some overlap between discount rates used in 2008 and 2009. Perhaps surprisingly given the drop in the corporate bond index yield two companies adopted a higher discount rate at the end of 2009, compared with 2008, and two companies left their discount rates unchanged; all the other companies adopted a lower discount rate for 2009.

Inflation rate

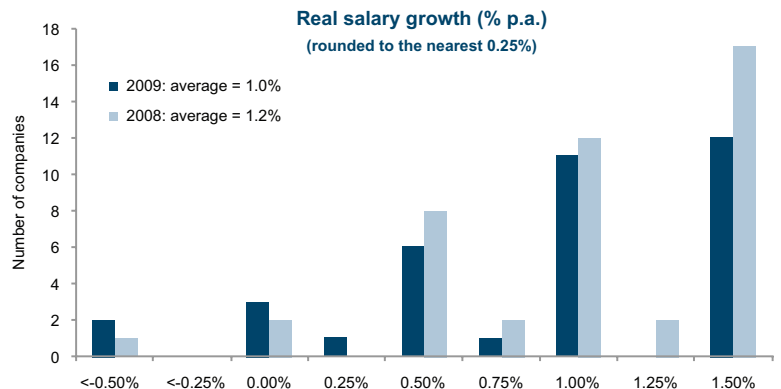
The Bank of England implied 'inflation spot rate' at 20 years (based on the difference between fixed interest gilts and index linked gilts) was 3.8% p.a. Most companies in the survey assumed that inflation would be slightly lower, with the average at 3.6% p.a. A possible explanation is that some allowance is being made for an "inflation risk premium" which is based on a view that demand for index linked gilts keeps the yield on these securities artificially low, and implied inflation artificially high.

The assumptions adopted are significantly higher than last year, when the average was 2.9% p.a. which reflects increased expectations for future inflation. However, there is a similar distribution of assumptions around the average this year as there was in 2008, which may suggest that companies were taking into account the duration of their pension liabilities when setting the assumptions.



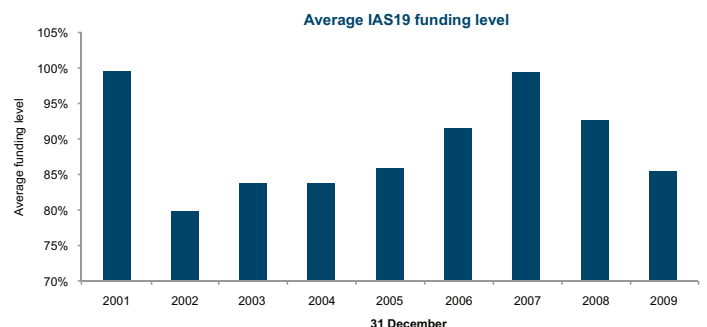
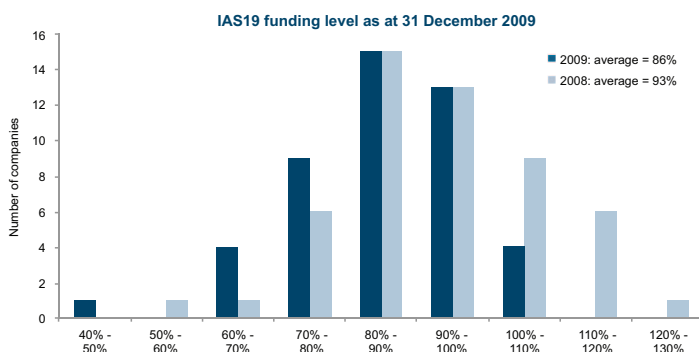
Salary increases

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 1.2% p.a. in 2008 and decreased slightly, at 1.0% p.a., in 2009. Two companies in the survey have salary growth assumptions of more than 0.5% p.a. below inflation but this is a reflection of their decisions to cap increases in pensionable salary at a level below the rate of inflation.



Surplus / deficit

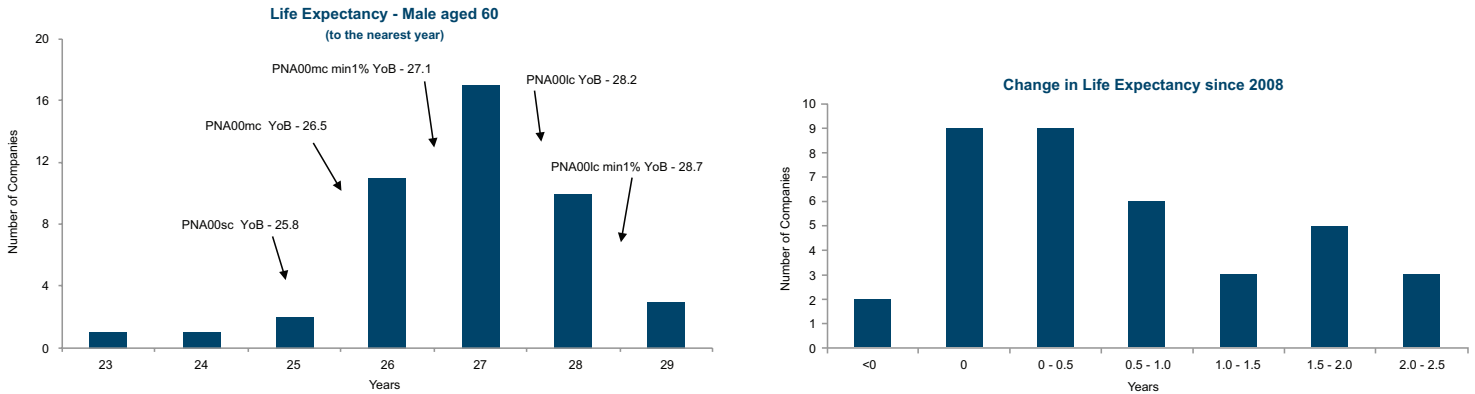
The average IAS19 funding level for the companies in our survey decreased to approximately 86% at 31 December 2009 compared with 93% at 31 December 2008. This is mainly due to a decrease in the discount rate and an increase to the inflation rate used by many companies in calculating their pension scheme liabilities. However, this may have been offset slightly by an increase in asset values as markets recovered over the second half of 2009. This is the second consecutive year in which the average funding level of companies in our survey has fallen.



Life expectancy

The majority of 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.

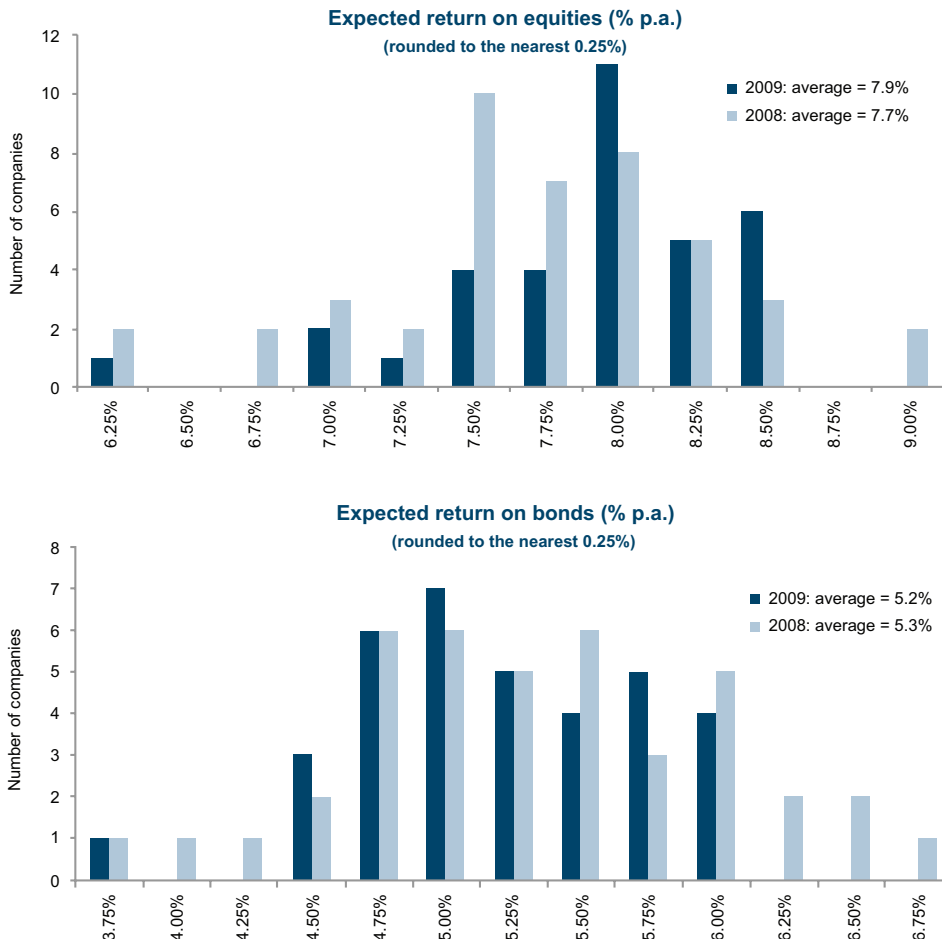
We have shown below the life expectancy assumptions for a man aged 60 at the year end and also indicated the life expectancies implied by some of the mortality tables that were used. The chart on the right hand side shows the number of companies that have increased their life expectancy assumption compared with the 2008 assumption (presented as the effect on the life expectancy for a man aged 60 at the year end).



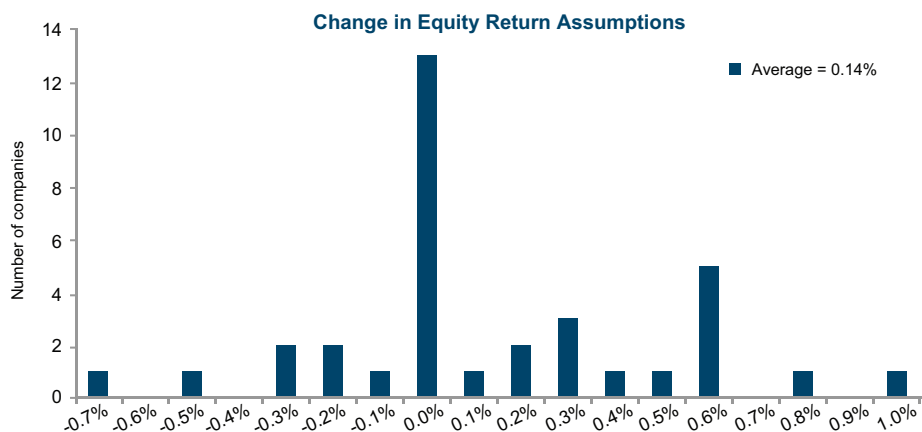
The majority of companies in the survey left their mortality assumptions broadly unchanged from 2008. Some companies changed the base table used, in particular adopting the more recent "SAPS" or "00-series" tables instead of the "92-series" table, and also increased the allowance for future improvements 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 2009 are set out below.



The average expected equity return was 7.9% p.a., compared with the average yield on long-dated gilts of 4.5% p.a. thereby implying an average "Equity Risk Premium" of 3.4% p.a. (2008: 3.9%). The average expected bond return was 5.2% 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 35 companies disclosing the necessary information, 7 have reduced their equity return assumption, 15 have increased it and 13 have left it unchanged from 2008. This is illustrated in the chart below.



Asset allocation

The chart below shows the percentage of assets invested in equities for companies in the 2009 survey, compared with the percentage invested in equities by the same companies in the 2008 survey. The straight line represents an unchanged equity weighting from 2008 to 2009. Those companies that fall below the line have a lower equity weighting at the end of 2009, than at the end of 2008.



The recovery in the value of equities over the year will have increased the equity weighting for a large number of the companies. However, there are some companies with little or no increase, and others with a decrease which suggests they may have taken steps to re-balance their asset allocations or "de-risk" their scheme. We hope that this analysis is helpful to companies in formulating their own assumptions under IAS19 (or FRS17).

For further information

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively, please email: CorporateConsulting@Barnett-Waddingham.co.uk.

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