Accounting for pension costs - FTSE100

Survey of assumptions used at 31 December 2013
I am pleased to present the results of our thirteenth annual survey of the pensions accounting disclosures made by FTSE100 companies.

The survey shows that while 2013 saw the highest average funding level for five years, the position is some way off the peak in funding levels seen in 2007. This is despite record contributions being made by companies to close deficits over the same period.

The key financial assumptions required for determining pension liabilities under the Accounting Standards FRS17 (UK non-listed), IAS19 (EU listed) and FAS158 (US listed) are the discount rate and the rate of future inflation.

Our survey showed that the average discount rate had increased by 0.1% p.a. when compared to 2012, which is in contrast to what we've seen in recent years. The reversal of the trend of declining discount rates has helped to reduce pension scheme deficits this year.

Historically, companies have tended to make a deduction from market implied expectations for future inflation to allow for the view that this overstated true expectations due to high demand for index linked gilts – the ‘inflation risk premium’. In recent years, there has arguably been less justification for allowing for a significant inflation risk premium (IRP) due to the high level of demand for fixed interest gilts (created in part by quantitative easing) although many companies still appear to be allowing for an IRP in their inflation assumptions.

The most significant of the demographic assumptions used for accounting disclosures is the mortality assumption and this can have a significant impact on the accounting figures. We have seen a similar change in life expectancy this year as last year and again, it would seem companies are making more considered choices when choosing appropriate assumptions. This is reflected in the strengthening of their life expectancy assumption.

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

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Discount rate

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

At 31 December 2013, the yield on the iBoxx and Merrill Lynch over 15 year AA-rated corporate bond indices were both 4.4% p.a. (2012: both 4.1% p.a.).

46 out of the 51 companies that disclosed a discount rate assumption used a discount rate between 4.4% p.a. and 4.6% p.a. in their pension liability calculations. All discount rate assumptions included were within the range 4.0% p.a. to 4.7% p.a. This is a similar range to 2012, and is likely to reflect that companies are taking account of the duration of their scheme's liabilities into consideration when deciding the most appropriate yield to adopt.

Most of the companies in our survey adopted a very similar discount rate for 2013 when compared to 2012, with a good number of them keeping the rate unchanged. The average discount rate increased by 0.1% p.a., reflecting the small increase in corporate bond yields over the year and reversing the trend of declining discount rates in recent years.

This trend of declining discount rates over the last few years has been a major contributor to increasing pension deficits and so this trend reversal will surely be a welcome change. Companies should still carefully consider their approach in setting their discount rate, however, as those using an index yield approach may be overstating their accounting liabilities. Taking specific account of the duration of a scheme’s liabilities may lead to an alternative, more appropriate assumption being used, which may result in lower accounting liabilities. Setting the right duration is key.

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51 out of 55 companies stated a discount rate assumption in 2013.
Inflation rate

The Bank of England implied ‘Retail Price Index (RPI) inflation spot rate’ at 20 years (based on the difference between the yields on fixed interest gilts and index linked gilts) was 3.7% p.a. as at 31 December 2013 (2012: 3.1% p.a.). Most companies in the survey assumed that RPI inflation would be lower, with the average at 3.4% p.a.

It is likely that some allowance is being made for an ‘inflation risk premium’ which is based on a view that investors are willing to pay more for index linked gilts because of the inflation protection they receive. If this is true, it would mean that the difference between fixed interest and index linked gilts is artificially large. However, due to the high level of demand for fixed interest gilts (created in part by quantitative easing) there is arguably less of a justification for allowing for a significant inflation risk premium in deriving the inflation assumption at the present time.

The market implied expectation for long-term RPI inflation has increased from 3.1% p.a. in 2012 to 3.7% p.a. in 2013. The average RPI inflation assumption adopted by the companies in our survey has shown a smaller increase from 3.0% p.a. to 3.4% p.a.

Many schemes now have benefits increasing with reference to the Consumer Prices Index (CPI), and over the last 20 years CPI has been on average around 0.7% p.a. lower than RPI. Of this, 0.5% p.a. could be attributed to the ‘formula effect’ resulting from technical differences in the way the two indices are calculated, and the remaining 0.2% p.a. could be attributed to differences between the compositions of the two indices. In 2010 a change was made to the way the indices were calculated and at the time this was expected to increase the difference between CPI and RPI going forward. The ‘formula effect’ since 2010 has been observed to be between 0.8% p.a. and 1.0% p.a.

Towards the end of 2011, the Office for Budget Responsibility (OBR) published a paper on the gap between RPI and CPI which suggested that the other factors mean the gap could be between 1.3% p.a. and 1.5% p.a.. However, this assumes that the constituent effect will continue unchanged, and there is no guarantee that this will be the case over the long-term.

Only a small number of companies in our survey disclosed both an RPI and CPI assumption. The average CPI assumption adopted as at 31 December 2013 was 2.5% p.a., around 0.9% p.a. lower than the RPI assumption used. This is a slightly higher difference than the 0.8% p.a. that was observed in 2012.

<table>
<thead>
<tr>
<th>Year ending</th>
<th>RPI inflation spot rate*</th>
<th>Average RPI inflation assumption % p.a.</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 December 2013</td>
<td>3.7</td>
<td>3.4</td>
</tr>
<tr>
<td>31 December 2012</td>
<td>3.1</td>
<td>3.0</td>
</tr>
</tbody>
</table>

* Bank of England implied ‘inflation spot rate’ at 20 years

44 out of 55 companies stated an RPI inflation assumption in 2013
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 RPI inflation (i.e. real salary growth). The average real salary growth assumption was 0.2% p.a. in 2013, a decrease from 0.6% p.a. in 2012.

Some companies in the survey have pensionable salary growth assumptions below inflation, reflecting 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 was approximately 91% in 2013 (2012: 88%). This result shows that the funding level for many companies has improved over the year.

Assumed future inflation was increased by more than the small increase in discount rates, which other things being equal would have increased the IAS19 deficit for most schemes. However, assets for many schemes performed better than expected, resulting in a net positive effect on the funding level in most cases.
Approximately 35% of companies in our survey were more than 95% funded in 2013. This compares to around 30% in 2012, just over 35% in 2011 and around 25% in 2010.

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 male aged 65 and also indicated the life expectancies implied by some of the mortality tables that were used.

66 FTSE100 companies who released accounts during 2013 stated a life expectancy assumption, this includes those with accounting dates other than 31 December.
The following chart shows the changes to life expectancy assumptions from 2012 to 2013 for the 66 companies that stated a life expectancy assumption in their 2013 accounts (presented as the effect on the life expectancy for a male aged 65 at the year-end).

The average life expectancy assumption increased by 0.3 years in 2013 i.e. the average life expectancy in 2013 of 22.8 years compared to 22.5 years in 2012. This is a similar change to last year and is a slightly higher increase in life expectancy than would be expected solely due to improvements over the year. This suggests that a number of companies have reviewed and again strengthened their life expectancy assumption.

Asset allocation

The chart below shows the percentage of assets invested in equities for companies in the 2013 survey, compared with the percentage invested in equities by the same companies in the 2012 survey. The straight line represents an unchanged equity weighting from 2012 to 2013. Those companies that fall below the line have a lower equity weighting at the end of 2013, than at the end of 2012.

Many companies fall below the line, which suggests that many schemes may have taken steps to reduce the risk in the scheme by moving to safer asset classes. Alternatively, it may be a natural consequence of reduced equity values for some schemes at the end of 2013.
We hope that this analysis is helpful to companies in formulating their own assumptions under IAS19 (or FRS17).

For further information, or to discuss any of these issues further, please contact your usual Barnett Waddingham consultant or the Corporate Consulting team on:

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