Housing briefing, February 2020
Pensions cost accounting assumptions

For many housing associations, 31 March means the accounting year-end and the preparation of annual accounts. Whether you have LGPS liabilities, SHPS liabilities, or any other defined benefit pension scheme liabilities, you can control what assumptions are used.

The value placed on the liabilities for accounting purposes of the Local Government Pension Scheme (LGPS), the Social Housing Pension Scheme (SHPS), and other defined benefit pension schemes, is heavily dependent on what assumptions are used.

The assumptions used will affect your balance sheet at year-end and next year's profit and loss account.

Crucially, accounting assumptions are the responsibility of you, as the directors of the participating employer. Not the LGPS Fund Actuary, not TPT Retirement Solutions (who operate SHPS), and not your auditor. You.

In this briefing we explain how you can take control in setting the assumptions. But first we start by looking at what has happened since 31 March 2019.

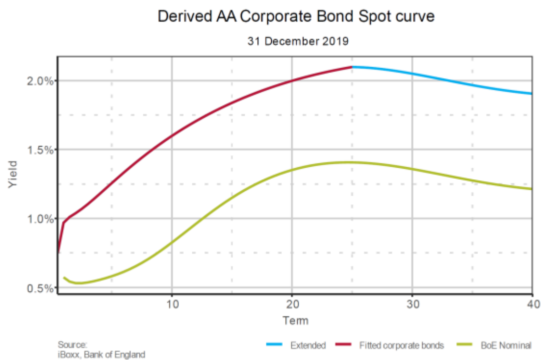
What's happened since 31 March 2019?

Recent equity market falls amid fears over the corona virus and falling corporate bond yields since 31 March 2019, mean your choice of assumptions will have a strong bearing on whether your accounting position has improved or worsened over the year.

Discount rate assumptions

The most important assumption is the discount rate assumption. Under FRS102 and IAS19, the discount rate used to place a value on the liabilities should be based on the yields on high quality corporate bonds. The bonds used should also be consistent with the currency and term (or duration) of the liabilities.

The chart below shows a spot yield curve fitted on bonds in the iBoxx AA rated sterling corporate bond index for all terms as at 31 December 2019, alongside a Bank of England gilts nominal curve.



The chart shows that the appropriate discount rate to use is different at different terms, e.g. around 1.6% at 10 years, compared to around 2.0% at 20 years.

Due to the relatively subjective nature of fitting a bond curve and determining the appropriate term for a scheme's liabilities, this can lead to different discount rate assumptions. And for every 0.1% pa increase in the discount rate assumption, the value of the defined benefit obligations may be reduced by around 2%.

Most LGPS Fund Actuaries and SHPS will provide a default duration-linked discount rate assumption, but you may wish to form your own view on whether a higher (or lower) discount rate could be justified.

Other assumptions

Another key assumption is inflation. A lower inflation assumption will reduce the scheme's liabilities.

It can be argued that the market implied rate of future RPI inflation is overstated if there is a greater demand for index-linked gilts than there is for fixed interest gilts (as is usually the case), or if an "inflation risk premium" exists to compensate for the risk of returns from fixed interest gilts being reduced by higher than expected inflation. A deduction of up to 0.3% pa to reflect this is not uncommon.

Also, the Government has announced that they will consult in early 2020 on changing RPI to effectively align it with CPIH (the Consumer Prices Index including some housing costs) by 2030, and possibly as early as 2025. A further deduction of up to 0.25% pa, say, could be argued to reflect this. Whilst the LGPS benefits are CPI-linked, and will therefore be relatively unaffected, SHPS does have RPI-linked benefits.

Again, for every 0.1% pa decrease in the RPI (and subsequently the CPI) inflation assumption, the value of the defined benefit obligations may be reduced by around 2%.

Other key assumptions include life expectancy, earnings growth and commutation. In a multi-employer scheme the default life expectancy assumption is unlikely to reflect your scheme membership.

Other considerations

LGPS employers may be asked how you wish to treat an adjustment to reflect the McCloud judgement that will ultimately impact the LGPS. This adjustment could be treated as a past service cost and pass through your and loss account, but this may depend on how it was treated last year (if at all).

For LGPS and SHPS, allowance for GMP equalisation will also need to be made. An appropriate allowance may increase your defined benefit obligations by between 0.1% and 1%.

SHPS launched an online DB accounting tool last year which allows you to change some of the assumptions and see the impact on your results. New features are expected to be launched for 31 March 2020 year-ends in mid-May 2020, which include a 5-year accounting projection.

Many housing associations have more than one LGPS fund, or have a combination of LGPS and SHPS. Auditors are becoming increasingly insistent that assumptions used (such as earnings growth and inflation) are consistent between funds (or differences justifiable). As these funds have different actuaries, the proposed assumptions may not necessarily be the same. We are also seeing a trend for housing associations to consolidate all their defined benefit schemes into one disclosure note.

How First Actuarial can help

First Actuarial helps lots of housing associations review and recommend accounting assumptions for their year-end accounts.

In giving our advice, we assess each of the default assumptions, giving our opinion on whether the proposed assumption is within what we consider to be a reasonable range, and quantifying the effect of changing the assumption.

Within a reasonable range
Within a reasonable range, but can be changed
Outside a reasonable range

This advice can be provided as part of our **firstwatch** service – First Actuarial's pension governance service which we provide for many of our housing association clients to help monitor and manage pension risks, and communicate these to Boards, management and colleagues.

Want more information?

First Actuarial provides independent pensions advice to more housing associations than any other firm.

If you would like to discuss any of the areas explored in this briefing, please contact your usual First Actuarial consultant or any of the First Actuarial Housing team below:

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