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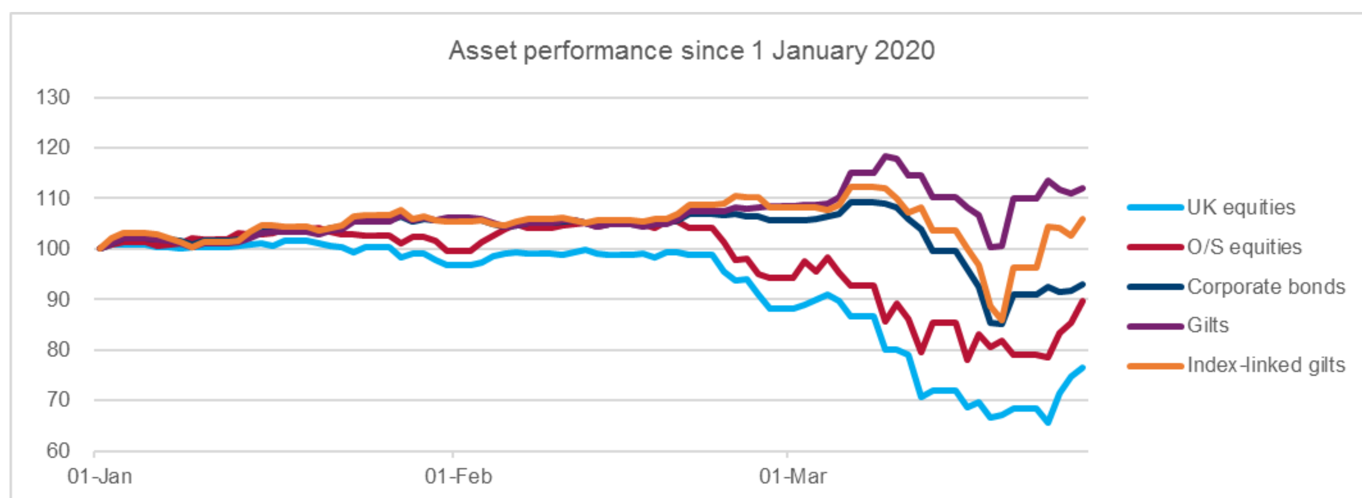
Employer pension briefing, Quarter 1 2020

The past month has seen unparalleled volatility in financial markets due to Coronavirus. In this briefing we explore the impact this may have had on your pension scheme's balance sheet position, as well as some other recent developments to be considered ahead of your next year-end.

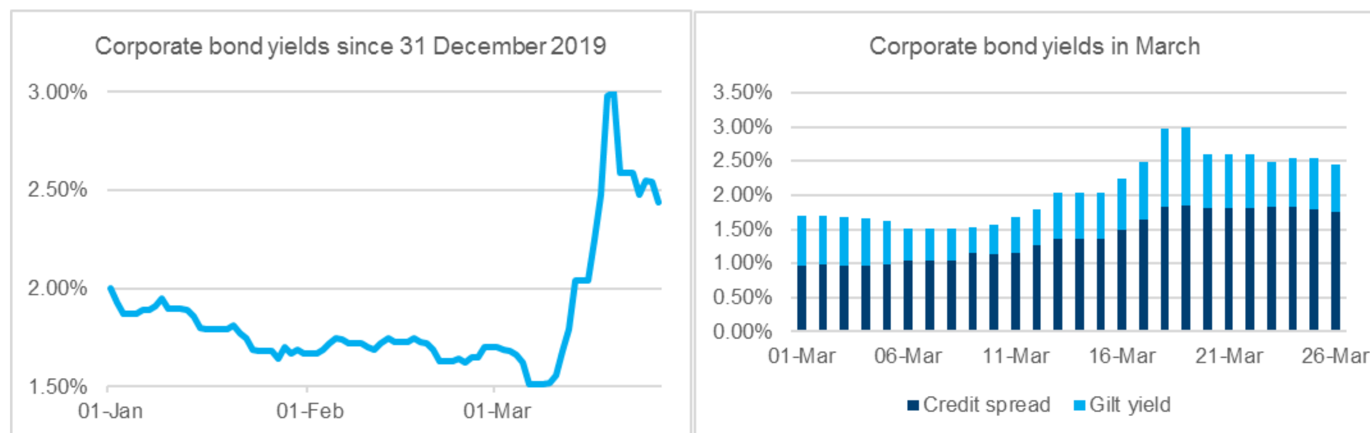
Market volatility



As well as the headline falls (and subsequent gains) in equity markets over the past month, we've also seen bond yields, credit spreads and future expectations of inflation move significantly over March.

This has led to considerable volatility in the balance sheet position of UK pension schemes; assets could be down by up to 20% and liabilities may have moved by up to 30% over March as corporate bond yields bounced between 1.5% pa and 3.0% pa.

The chart on the left below shows the movement in corporate bond yields since the start of the year, whilst the chart on the right shows how the driving force for the increase in yields has been the widening of the credit spread over the period (an increase of around 0.8% pa over the period):



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Registered address: First Actuarial LLP, Mayesbrook House, Lawnswood Business Park, Leeds, LS16

Impact on balance sheet positions

Taking both sides of the equation into account (i.e. assets and liabilities), the balance sheet position is likely to have improved since 31 December 2019. The table below shows the change in corporate bond yields since 31 March 2019 and 31 December 2019:

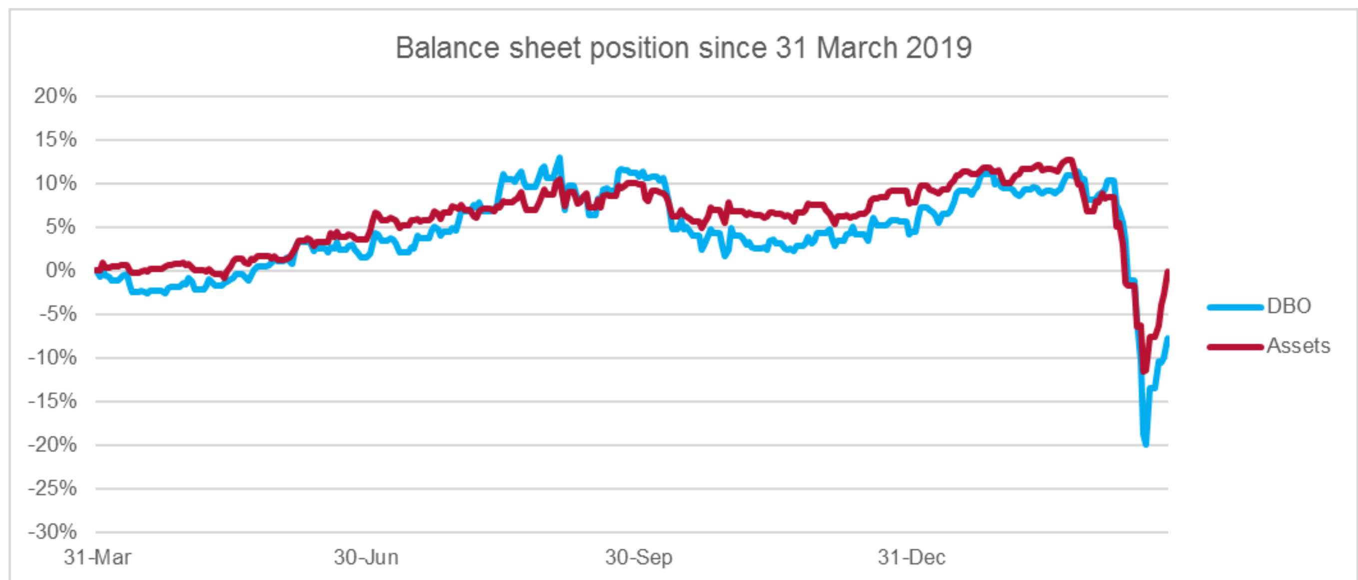
	31 March 2019	31 December 2019	26 March 2020
Corporate bond yield[1]	2.36% pa	2.00% pa	2.44% pa
Implied RPI inflation[2]	3.59% pa	3.41% pa	3.15% pa

1) iBoxx over 15 year £ AA corporate bond yield
2) Market implied RPI inflation for a duration of 15 years

Looking at the changes since 31 December 2019, corporate bond yields (and hence accounting discount rates) are up by around 0.4% pa, whilst future expectations of inflation are around 0.3% pa lower. It is worth noting that the change in implied RPI inflation might, in some part, reflect the proposed future changes to the calculation of RPI (and so you may already have allowed for some of this fall).

Taking into account the changes in both corporate bond yields and inflation, your Defined Benefit Obligation (DBO) may have fallen by as much as 20% since 31 December 2019, although the exact impact will vary by scheme.

The charts below show how the position has changed for an example scheme over the past 12 months (up to 26 March 2020):

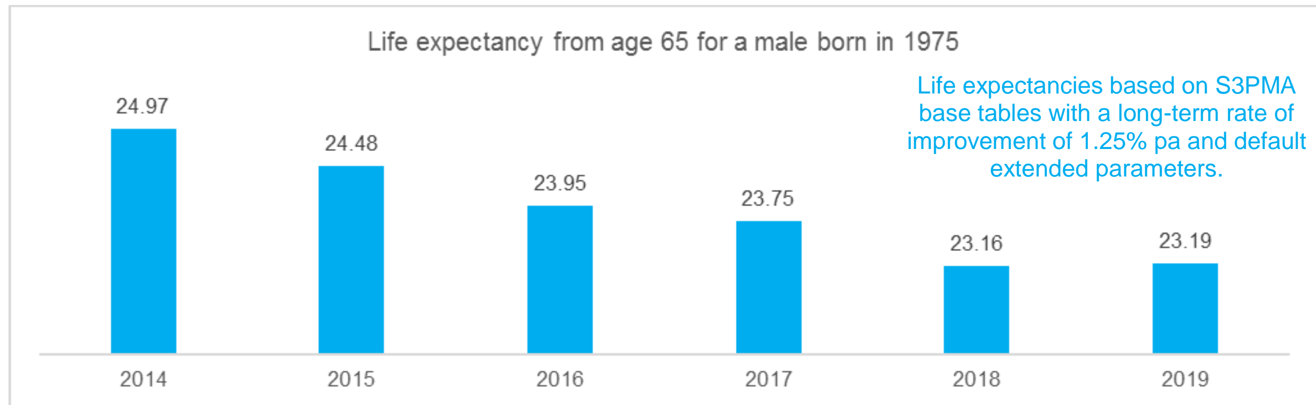


The impact for your scheme will depend on investment strategy, your scheme's duration, and how much of your scheme's liabilities are linked to inflation. The example scheme has an asset allocation of 50% equities and 50% bonds, a duration of 20 years, and around 75% of its liabilities are index-linked.

New CMI projections

Earlier this month, the Continuous Mortality Investigation (CMI) released the latest model for projecting improvements to life expectancies, CMI 2019.

CMI 2019 shows a slight increase in life expectancies against the previous model, CMI 2018, reflecting the lower number of deaths over 2019 than expected. This is the first such increase in life expectancy since the CMI 2014, as shown in the chart below:



On average, we'd expect moving to CMI 2019 from CMI 2018 to very slightly increase liabilities (by less than 0.5%), assuming you use the same parameters for both models. As a reminder, the key parameter in the CMI models is the long-term rate of improvement, but when CMI 2018 was released, two extended parameters were introduced: an initial addition to mortality, and the smoothing parameter.

This additional choice of parameters allows the model to be better tailored to suit your scheme membership, giving you more flexibility in choosing your mortality assumption, but also means your assumption choices are open to more scrutiny from auditors.

Our Demographic Assumptions Working Group are currently analysing the latest model and available information to determine the most appropriate parameters for use by our clients.

Scheme funding

The Coronavirus crisis represents an unprecedented challenge for many businesses, with the global economy all but grinding to a halt. For many employers, deficit reduction contributions (DRCs) represent a significant outlay. In circumstances where the employer is struggling, it may be possible to suspend or reduce DRCs for a temporary period.

The Pensions Regulator (TPR) has provided some guidance for employers, which sets out its pragmatic position on ceasing/ reducing DRCs where this can be justified, and a plan put in place to make these payments in the future. It is also worth looking at the trustee guidance, which sets out some of the areas that they will need to consider in light of any such requests.

If you would like to discuss what options may be available, or would like help discussing these options with your scheme's trustees, please get in touch with your usual First Actuarial contact, or a member of our Employer Services team below:

Rob Hammond
E: rob.hammond@firstactuarial.co.uk
T: 0161 348 7440

Sam Mullock
E: sam.mullock@firstactuarial.co.uk
T: 0161 348 7469

John Ingoe
E: john.ingoe@firstactuarial.co.uk
T: 0113 818 7365

Marcos Abreu
E: marcos.abreu@firstactuarial.co.uk
T: 01732 207 507