# Housing briefing, June 2020 – Social housing FRS 102 survey 2020

Our inaugural annual survey looks at FRS 102 assumptions and results for the social housing sector. The survey's 202 responses cover over £7bn of pension accounting liabilities. This makes it the biggest ever Defined Benefit (DB) pension survey of the sector, providing powerful insights into the funding of the sector's DB liabilities.

## Key trends at a glance

The aggregate FRS 102 funding level increased from **78%** as at 31 March 2019, to **86%** as at 31 March 2020.

Ex-SHPS schemes in the survey (created after a bulk transfer) have the highest aggregate funding level at **93%** as at 31 March 2020.

The aggregate asset value across our survey stayed at **£6.3bn,** with contributions offsetting the Covid-related fall in financial markets in 2020.

Accounting liabilities fell nearly **10%** (despite new benefit accrual) over the year. In 2020, the range of reasonable assumptions can change the value of the liabilities by up to **20%.**

Late March 2020 was a recent peak for FRS 102 funding levels, and by June 2020 some associations will have seen a **10%** fall in their FRS 102 funding level.

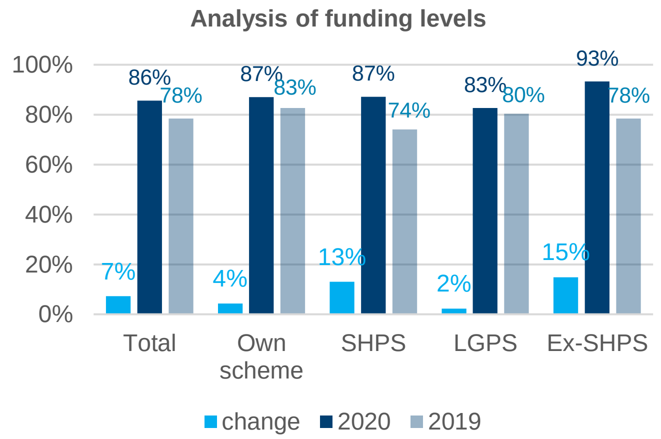
If investment returns of **3.2% pa** can be achieved for the lifetime of scheme members, there is enough money to pay benefits without any further employer deficit contributions.

## Funding Levels

FRS 102 funding levels improved over the year to 31 March 2020.

This was a surprise to many associations which were braced for a greater balance sheet deficit due to Covid-19. While in many cases asset values did fall, this was more than offset by a greater fall in the assessed value of the accounting liabilities.

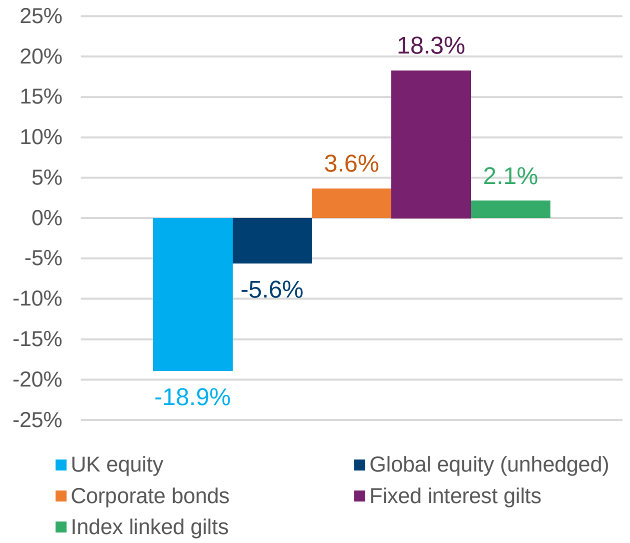
Despite very different investment strategies, each type of scheme in our survey saw an aggregate funding level improvement.



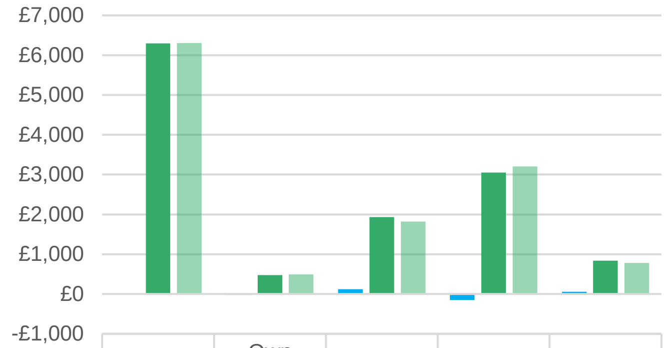
## Assets

The aggregate asset value of the 202 responses in our survey remained unchanged at £6.3bn – although this masks the significant levels of contributions paid by employers over the year.

**Returns for the 12 months to 31 March 2020**




**Change in asset levels (£m)**




| | Total | Own scheme | SHPS | LGPS | Ex-SHPS |
|---|---|---|---|---|---|
| change | -£2 | -£21 | £120 | -£155 | £55 |
| 2020 | £6,299 | £473 | £1,936 | £3,051 | £839 |
| 2019 | £6,301 | £494 | £1,816 | £3,206 | £784 |

change 2020 2019

Covid-19 caused huge financial shocks in Q1 2020, with equity markets falling significantly from February 2020. In contrast, gilt and bond prices rose as investors moved money to safer asset classes. In this environment, pension schemes that hold a high proportion of equities (such as most LGPS funds) will have fared worse. However, even though pension schemes invest for the long term, most schemes will be happy with how diversified strategies reduced the short-term impact of the shock in Q1 2020.

## Liabilities

The key assumption used to value the liabilities is the discount rate. FRS 102 states that this must be derived from *"market yields at the reporting date on high quality corporate bonds"*. The higher the discount rate, the lower the assessed value of the liabilities. The graph below shows that, in terms of corporate bond yields, 31 March 2020 was a relatively favourable time to value FRS 102 pension liabilities compared to conditions before and after this date.

**Corporate bond yields since 31 March 2019**

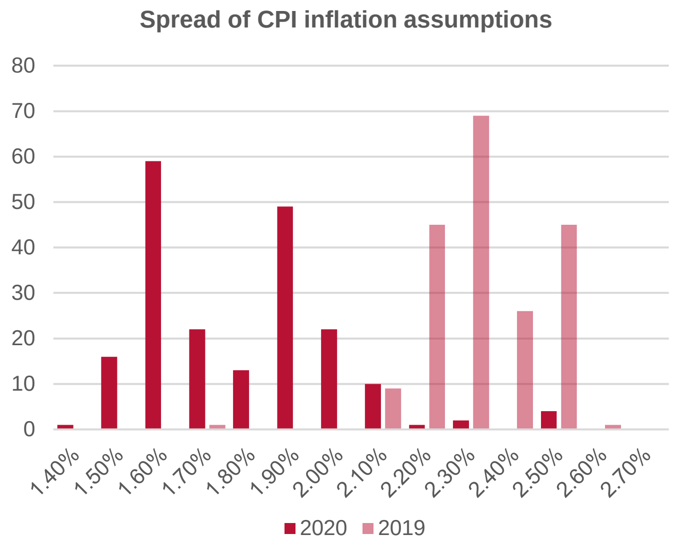
Although the discount rate is derived from the yield on high quality corporate bonds, there is a range of reasonable assumptions. The assumptions for FRS 102 are the responsibility of each association's board, and we are seeing an increasing trend towards receiving independent advice on assumptions, rather than accepting the default assumptions provided by each scheme.

Even though different assumptions can sometimes be justified, the vast majority of results in our survey used a discount rate between 2.30% pa and 2.45% pa. This is in contrast to CPI inflation, where the assumptions are spread over a wider range.

As there are no CPI market instruments, the CPI inflation assumption is derived by first setting a RPI inflation assumption based on the price of fixed and RPI index-linked gilts. A deduction is then made from the RPI inflation assumption to obtain a CPI assumption. However, there is now a range of views on:

- RPI – whether gilt-market implied RPI inflation is a good indication of future RPI or needs to be adjusted
- The medium and long-term gap between RPI and CPI.

CPI inflation assumptions in our survey typically ranged from 1.5% pa to 2.1% pa – a difference that could alter the value of the liabilities by 10% to 15%. The most common assumptions were 1.6% pa and 1.9% pa, showing a divergence in views on how close the Government will get to its CPI inflation target of 2% pa.

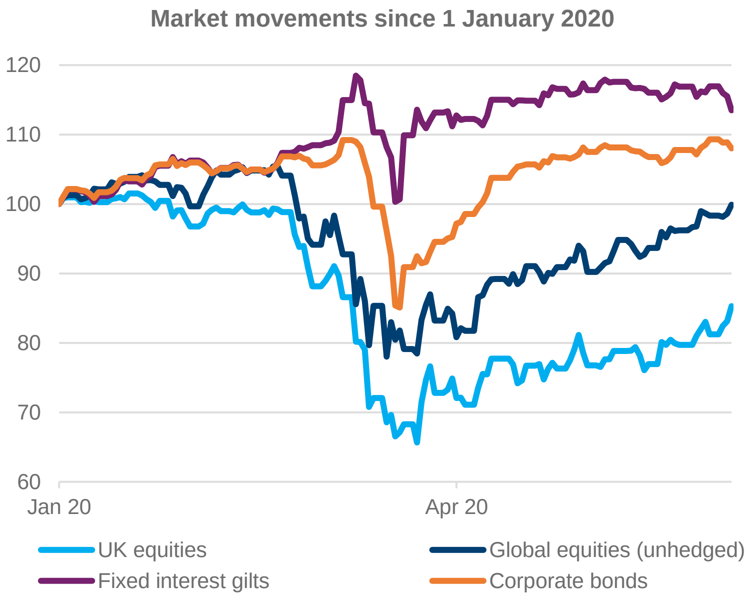




## Developments since 31 March 2020

At the time of writing, global equities are up 25% since 31 March 2020, and are almost unchanged in value since the start of the year. Other asset classes have also increased in value.

While the increase in asset prices is good news for pension scheme funding, there is bad news on the liability side. Corporate bond yields have fallen by around 90bps, increasing the accounting liabilities in some schemes by up to 25%. Combined, the changes in asset and liability values since 31 March 2020 to early June 2020, will have resulted in a fall in the FRS 102 funding levels for most schemes (with some schemes seeing a fall of as much as 10%).

Financial market conditions remain extremely volatile, and it is too early to make any predictions about funding levels in 2021.



## What does all this mean?

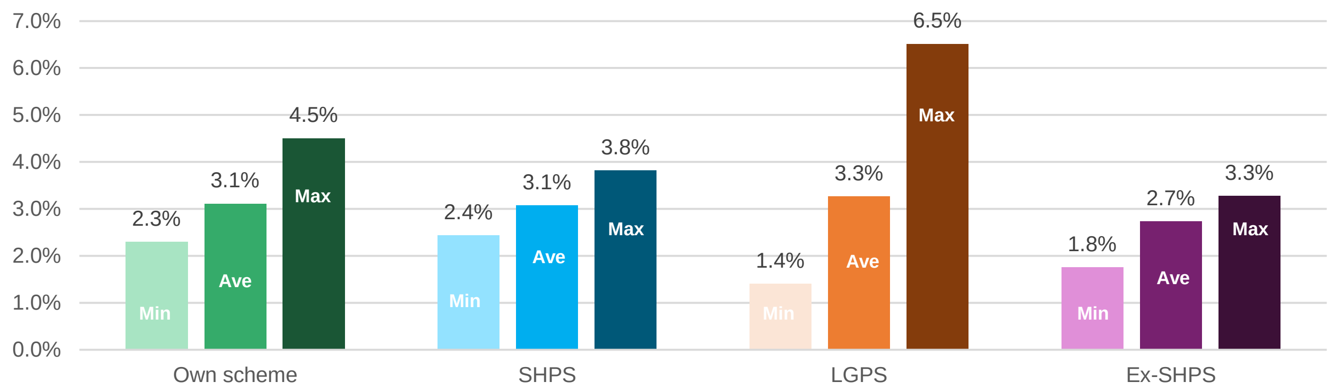
FRS 102 valuations provide an interesting insight into pension scheme funding. However, they are not used to determine cash funding. Instead, for cash funding the liabilities are valued on different (sometimes more prudent) assumptions, and there are different (even more prudent) assumptions for exit valuations.

All the different liability measures can get confusing. We often find it helpful to look at the issue the other way around – what investment returns do schemes need? – rather than what return is being assumed in the liability calculation.

We call the investment return needed for the lifetime of the scheme in order to pay members their benefits in full the Break-Even Investment Return (BEIR), ie if this return was assumed in the liability calculation, there would be no funding deficit / surplus and no deficit contributions required.

The aggregate BEIR in our survey showed the funding of the sector's Defined Benefit scheme liabilities is in a relatively healthy position – with a return of 3.2% pa needed over the schemes' lifetime to pay all accrued benefits. Arguably a return of 3.2% pa is challenging in the current low interest rate environment (particularly if the investment strategy is cautious), and we therefore expect many employers will be asked for deficit contributions at upcoming actuarial valuations.

**Comparison of break-even investment returns, 2020 (min, average and max)**




The graph above shows that the funding and investment return needs vary considerably between schemes. To better understand your obligations and benchmark your FRS 102 results against our survey please get in touch.

## Contact us to discuss further

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