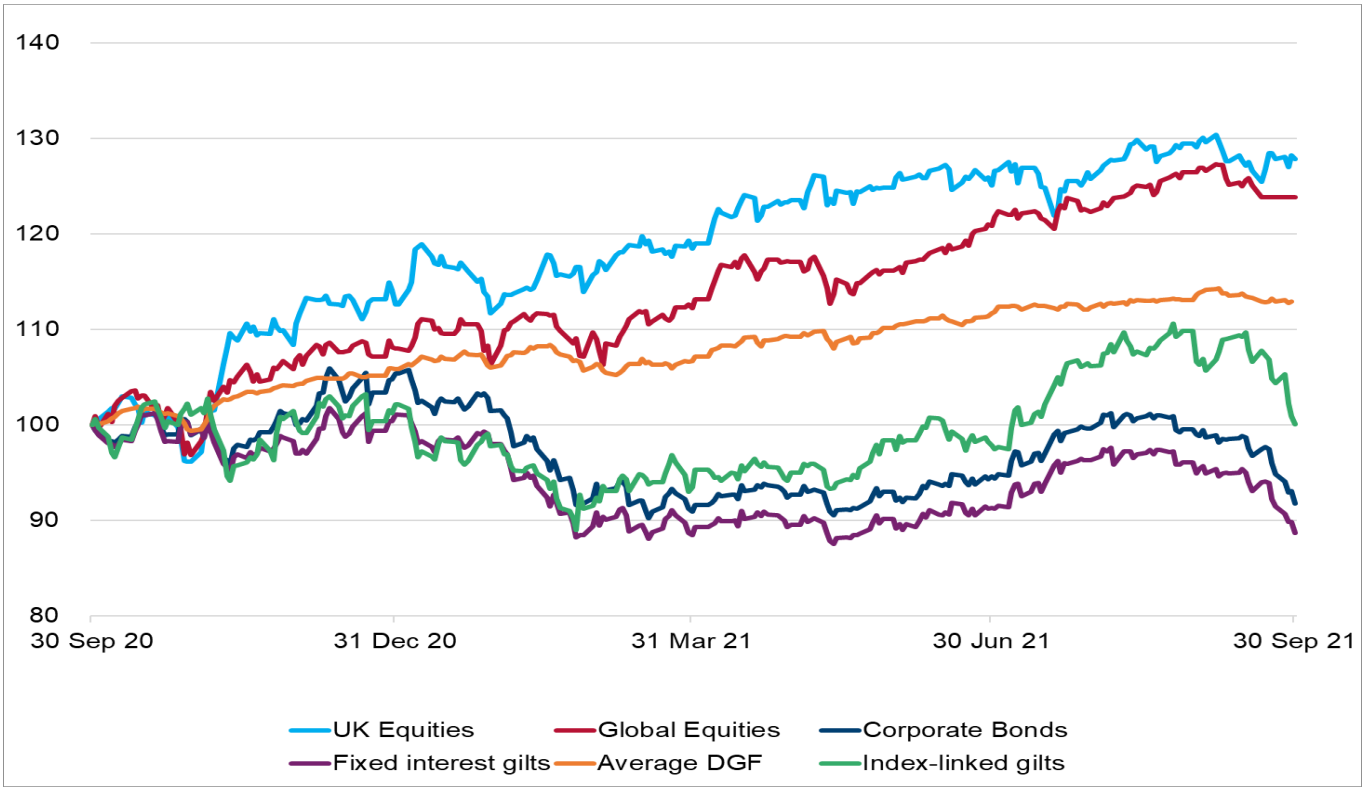
Employer pension briefing, Quarter 3 2021

In this briefing we highlight some of the key pension issues for employers from the third quarter of 2021, with a focus on some of the key pension cost accounting issues to consider for 30 September year-ends.

Changes in markets since 30 September 2020

Q3 2021 saw more muted returns in equity markets, with global equities up by around 2% over the quarter, contributing to a return of around 28% for the year to 30 September 2021.

Bond markets have been much more volatile over the last three months, although gains made over July and August were wiped out in September. Over the course of the year, returns on both corporate and fixed-interest government bonds fell by almost 10%. Index-linked bonds haven't fared as badly over the past 12 months, with returns flat over the year, having been boosted by expectations of higher inflation.



Global equities: +24%

UK equities: +28%

Average DGF: +14%

Index-linked gilts: 0%

Corporate bonds -8%

Fixed-interest gilts: -11%

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

Impact on pension scheme liabilities

Both corporate bond yields (which drive IAS 19 and FRS 102 discount rates) and gilt yields (which often drive funding discount rates) have increased over the year, which will have reduced the value placed on scheme liabilities. This has been offset, to some extent, by increased expectations of future inflation as shown below:

	30 September 2020	30 September 2021	Impact on the liabilities of an average[1] scheme
Corporate bond yield[2]	1.5% pa	2.0% pa	-9%
Gilt yield[3]	0.8% pa	1.4% pa	-12%
Market-implied inflation[4]	3.3% pa	3.8% pa	+8%

1 An average scheme is taken to have a duration of 20 years and around 75% of liabilities linked to inflation.
2 Yield on the iBoxx over 15-year AA-rated corporate bond index.
3 Bank of England nominal gilt curve for a duration of 20 years.
4 Gilt market implied inflation at a term of 20 years from the Bank of England implied inflation curve.

To find out more about the effect of changes in the financial markets on pension cost accounting and funding positions, take a look at our **PCA Index page**. You might also find our *Finance director's guide to 30 September 2021 valuations* useful. Ask your usual First Actuarial contact for a copy if you don't already have one.

Pension Protection Fund (PPF) levy

2021/22 PPF levies have been issued over the past month. We are aware of some cases where failure scores have deteriorated significantly over the year as a result of Covid-19 affected accounts being filed. Please do get in touch if your levy was higher than expected; while it may be too late to change the 2021/22 levy, there may be options available to reduce future levies. Please also remember that employers finding it difficult to pay their levy will once again be able to apply for an extension of up to 90 days interest-free to pay their 2021/22 bill.

Meanwhile, the PPF has recently launched its **consultation on the calculation of next year's levy**, which proposes that the methodology should remain unchanged. Due to improvements in the PPF funding position, this will mean a lower overall levy is collected and therefore a lower levy for the average scheme (although, as always, there will be trustees and sponsors for whom the opposite is true).

Increasing expectations of future inflation

Rising gas prices, petrol shortages and empty supermarket shelves all suggest that a period of higher inflation may be on the horizon. Investment markets seem to agree, with the market-implied expectation of future RPI inflation now standing at almost 4% pa over the next 20 years.

This is all happening alongside the spectre of RPI reform, which should, broadly speaking, align RPI inflation with CPI inflation (notwithstanding the result of the legal challenge mentioned in our last briefing). Some rudimentary analysis suggests that 'the market' is expecting the Bank of England to miss its CPI inflation target by an average of over 1.5% each year from 2030. Whether this is a true reflection of what investors expect inflation to be over this period or an indication that the market in inflation-linked gilts is broken, is a question we'll leave readers to ponder.

The long arm of the (pensions) law

The Pensions Regulator (TPR) has been granted new powers from 1 October 2021. These new powers allow TPR, among other things, to prosecute individuals who take action (or do not take action) that prevents scheme members receiving their benefits in full. Prosecution could see a prison sentence of up to seven years and an unlimited fine. If it makes you feel better, there is also scope for your humble actuarial advisers to be prosecuted too!

On the face of it, the scope of actions (or non-actions) that could be construed as "preventing members receiving benefits in full" is very wide – arguably choosing the wrong investment strategy, a sponsor pausing deficit contributions, or a sponsor becoming insolvent could all be seen to do this. However, TPR has said that the new powers are "not intended to achieve a fundamental change in commercial norms or accepted standards of corporate behaviour in the UK". More detail on how TPR might use these new powers is set out in its **policy document**.

Plugging your funding gap without emptying your bank account

Whether it's due to adverse market movements, increased prudence or moving funding targets, many sponsors are being asked to put more money into their pension scheme.

But paying over cash isn't the only solution available. Many employers are now looking to fund their pension scheme deficits using alternative approaches. These can sometimes be positive for both sides: a lower level of cash contributions required from the sponsor, alongside an immediate increase in security for scheme members. The table below sets out a few of the options available:

Option	What is it?	Should you choose it?
Asset backed contributions (ABCs)	An arrangement which results in a stream of payments being made to the scheme, typically based on an underlying asset. ABCs are usually set up by transferring the underlying asset(s) to a Scottish Limited Partnership (SLP). The trustees and the sponsor both hold a specified interest in the SLP, which allows for income to be paid to the scheme and can also allow the trustees to take ownership of the underlying asset in certain scenarios.	ABCs are often structured so that they can be recognised as an asset of the scheme, resulting in an immediate improvement in the scheme's funding level. However, ABCs can be expensive to implement, with significant professional fees involved. It's also possible that an appropriate contingent asset, alongside a traditional recovery plan, can provide a similar outcome for the scheme.
Contingent assets	An agreement that, on a specified event, an underlying asset will pass to the scheme. Examples of such events include the insolvency of the employer, a merger with another company or failure to pay agreed contributions. The asset does not pass to the scheme unless the specified event occurs, nor do the trustees of the scheme have any control over the asset or receive any income from it. Popular examples are parental guarantees and charges over property.	Provides an immediate improvement in member security by improving the funding position on insolvency. Contingent assets can be set up to be PPF-compliant, helping reduce the annual PPF levy. Trustees must be comfortable that the contingent asset can be realised when it is needed (e.g. a parental guarantee may be worth very little if an insolvency scenario for the sponsor will almost certainly result in insolvency of the parent).
Contingent funding agreements	An agreement whereby the sponsor will pay a higher level of contributions under certain circumstances, typically due to improved business performance or adverse funding experience. Triggers used are typically based on an easily measurable financial metric, for example EBITDA or dividend payments, but there is no standard approach.	Upside sharing has become more prevalent as a result of Covid-19. With many sponsors temporarily pausing or reducing contributions over the course of the pandemic, upside sharing arrangements allow trustees to claw these back as and when opportunities arise.
Escrow accounts	An account held in the name of the sponsor, but over which the scheme has a charge (meaning that other creditors cannot access the account in the event of insolvency). Assets held in Escrow can be transferred to the scheme, or back to the sponsor, under certain specified 'trigger' events.	Typically used by schemes and sponsors that are relatively well funded and have concerns over over-funding/generating a trapped surplus. Can be structured so that funds can be 'passed back' to the sponsor at a lower funding level than would otherwise be the case.

Health and social care levy

The Government recently announced its intention to introduce a new health and social care (HSC) levy from April 2022, set at a rate of 1.25% for employers, employees and the self-employed.

In the 2022/23 tax year, it will be collected by a temporary rise in National Insurance (NI), increasing the employer rate to 15.05%, and employee rates to 13.25% below the Upper Earnings Limit and 3.25% above this level. From the 2023/24 tax year, it will become a standalone charge of 1.25% paid by employers and employees.

It will be largely based on current NI principles, so existing reliefs, bandings etc. will also apply to the levy. However, a key difference is that the levy will apply to individuals over State Pension age, unlike NI.

One way of mitigating the introduction of the levy is through salary exchange, and we expect many employers who do not currently offer it to (re)consider the viability of doing so. It is an arrangement which enables employees' pension contributions (and certain other employee benefits) to be paid more tax efficiently, generating National Insurance savings for both employees and employers, and giving employees full and immediate tax relief on their pension contributions.

It has become increasingly popular over the last few years, and importantly, it is not limited to Defined Contribution – many Defined Benefit schemes can benefit from its use too. Its introduction would generate not insignificant savings for employers and employees, while its ongoing use for pension contributions was expressly permitted by the government in 2017.

For more information about salary exchange, **read our salary exchange briefing note**. If you would like to discuss it further, our DC consulting team would be delighted to speak with you.

Get in touch with our experts

To discuss your scheme with us, contact your usual First Actuarial consultant or any of our **employer services team**.

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

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

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

Dale Walmsley
E: dale.walmsley@firstactuarial.co.uk
T: 0161 348 7464

Kapil Sheth
E: Kapil.sheth@firstactuarial.co.uk
T: 01256 297 727

Kirk Hinton
E: kirk.hinton@firstactuarial.co.uk
T: 01733 447 642