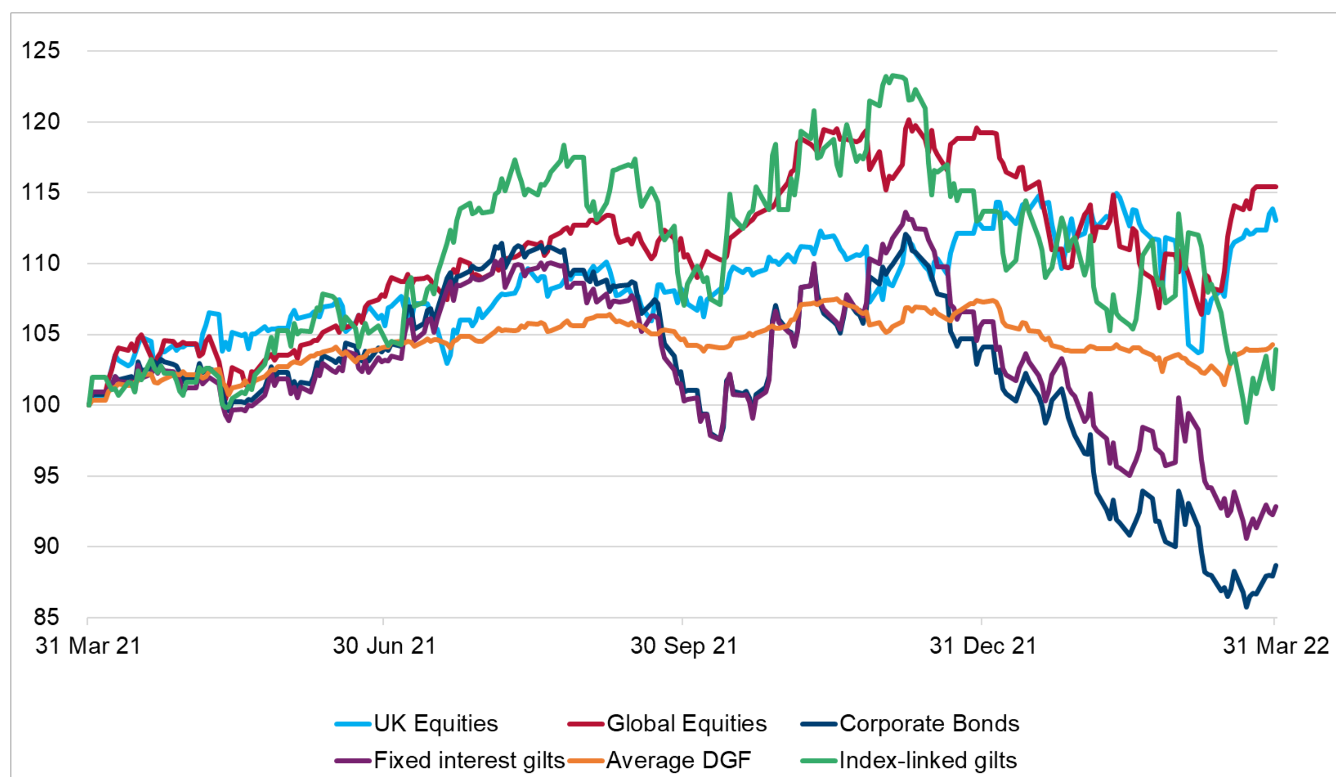
Employer pension briefing, Quarter 2 2022

In this briefing, we highlight some of the key pension issues for employers from the first quarter of 2022, with a focus on important pension cost accounting issues to consider for 31 March year-ends.

Changes in markets since 31 March 2021

The first quarter of 2022 saw significant falls in bond markets, contributing to negative returns over the year, with corporate bonds falling by more than 10% since 31 March 2021 (with government bonds not far behind). Index-linked bonds have fared better, driven by increases in expectations of future inflation, resulting in a positive return of around 4% for the year.

Equity markets saw a volatile quarter, although both global and UK equities had recovered from significant falls in February by the end of March. Over the course of the year, global equities were up by around 15%, with UK equities just slightly behind.



Global equities: +15%	UK equities: +13%	Average DGF: +4%	Index-linked gilts: +4%	Fixed-interest gilts: -7%	Corporate bonds -11%

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

Impact on 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:

	31 March 2021	31 March 2022	Impact on the liabilities of an average[1] scheme
Corporate bond yield[2]	2.0% pa	2.7% pa	-13%
Gilt yield[3]	1.4% pa	1.9% pa	-9%
Market-implied inflation[4]	3.7% pa	4.1% pa	+6%

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 over a duration of 20 years
4 Gilt market implied inflation at a term of 20 years from the Bank of England implied inflation curve

Overall, this means that we expect scheme liabilities to have fallen, but the extent to which this is the case will depend on the makeup of each scheme's liabilities.

Our Pension Cost Accounting (PCA) Index shows the financial position across all the UK's 5,000+ Defined Benefit (DB) pension funds on an accounting basis. At 31 March 2021, we estimated that there was an aggregate shortfall across all schemes of around £35 billion. This has varied significantly over the year, but strong growth asset returns and increased bond yields mean our estimate of the aggregate position at 31 March 2022 is a slight surplus.

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 31 March 2022 valuations* useful. Ask your usual First Actuarial contact for a copy if you don't already have one.

Mortality

The financial markets aren't the only factor to affect the value of your scheme liabilities, and it wouldn't be a pension briefing without mentioning mortality. The 'big' mortality news this quarter is the release of the 2021 version of the CMI model for mortality improvements.

Covid-19 has led to a marked increase in the number of deaths over the past two years. Mortality rates over 2020 were 12% higher than 2019, and while the position improved over 2021, mortality rates were still significantly higher than pre-pandemic levels. But although the short-term impact of Covid-19 is relatively clear (at least in terms of excess deaths), the longer-term impact is less so.

This is evidenced by the approach taken in the latest version of the CMI model (CMI 2021, released in March 2022), used to project mortality improvements which, under its default parameters, will ignore experience over both 2020 and 2021.

Cost of living increases, again

Bills, food, petrol, National Insurance… it won't come as a surprise to any reader that the cost of living is on the rise. In the 12 months to March 2022, prices increased by 6.2% on average, up from 5.5% in the year to February 2022, which means they are now going up at their fastest rate for 30 years (as measured by CPI).

At an individual level, many will be concerned about the value of their pension. The vast majority of schemes provide pensions which increase only once in payment, and these increases are usually linked to inflation with a cap. It has been confirmed that the State Pension will only go up by 3.1% in April, exactly half of the expected increase in the cost of living. At a scheme level, the increase in inflation may mean a worrying increase in a scheme's liabilities. More on this below.

The war in Ukraine

At the time of writing this briefing, we are two months into the crisis in Ukraine and our thoughts are with those suffering from the humanitarian consequences of the war.

Looking at the financial side of the war, the list of Russian sanctions grows as time passes, with some of the headline financial restrictions being the sanctions on government officials, business leaders, imports and exports (including a 35% tax on vodka), and the removal of some larger banks from the SWIFT, effectively freezing their foreign currency reserves.

A typical UK DB scheme will have a trivial exposure to Russian markets, and so the immediate impact on the value of assets held by the scheme will be limited. However, a far more concerning impact for pension schemes will be the knock-on effect on inflation, already a growing issue following the pandemic, and further exacerbated by the crisis in Ukraine.

Many schemes' liabilities are linked to inflation, and so as inflation rises, so does the corresponding value of the liabilities. Fortunately, however, the majority of benefit structures include 'caps', which means the impact of rising inflation will reduce as increases in inflation become more material. Any assets held by schemes to hedge inflation do not operate with 'caps' and so increases in these assets will overtake increases in the corresponding liabilities, resulting in a net surplus for the scheme.

Our recent investment briefing examines the impact of the Ukraine invasion on scheme assets but in this rapidly changing environment, analysis can quickly become out of date. Further briefings will be published on our website as appropriate.

Pension scams: new restrictions on transfers

Those of you who wear a trustee hat may well be aware of the new transfer regulations that give trustees the power to refuse a transfer where there is a risk that it's part of a pension scam. The aim of the new regulations is to empower trustees to halt suspicious transfers.

The regulations require trustees and scheme managers to carry out checks before processing a member's statutory request to make a transfer. One of two conditions must be met before the transfer can go ahead.

1. The receiving scheme is of a type listed in the transfer regulations
2. Checks for an employment link and overseas residency have not uncovered any red or amber flags.

But what is a red or amber flag?

Some of the red flags especially are common sense, and the vast majority of schemes would already be stopping a transfer value from progressing if one of these flags were present. Some examples include: if the member has failed to provide the required information, if the member requested a transfer following unsolicited contact, if the member has been offered an incentive to make the transfer, or if the member has been pressurised to make the transfer.

Some of the amber flags are a little less obvious and require administrators to be on top of their game. Examples include: high-risk or unregulated investments are included in the scheme, the scheme charges or investment structure are unclear or high, or there has been a sharp, unusual rise in transfers involving the same scheme or adviser.

Please **consult our First Briefing** for further details on these new regulations.

New notifiable events framework delayed

The introduction of new notifiable event regulations, which were expected to come into force on 6 April 2022, has been delayed.

It is proposed that the new notifiable event regulations will oblige employers with DB schemes to notify the Pensions Regulator of a broader range of corporate events and activities and to do so at an earlier stage than is currently the case. The proposals contained the introduction of two new employer-related notifiable events:

1. Sale of a material proportion of the business or assets of a scheme employer
2. Granting of security on a debt to give it priority over debt to the scheme.

The materiality threshold for both these events is proposed to be 25% of assets / gross revenues as appropriate, and needs to be considered cumulatively on a rolling 12-month basis.

However, following a consultation on the draft regulations in September 2021, many commentators in the industry raised concerns about difficulties interpreting certain provisions.

The latest indications are that the DWP's response to the consultation and final regulations will be delayed for some weeks. The expectation is that the new regulations will now be effective from October 2022. We hope that this delay will mean a revised set of regulations which address some of the practical concerns raised by the industry in the consultation responses.

In the meantime, we suggest that DB sponsors should be considering the implications of the Pension Schemes Act 2021 in its entirety on corporate activity and establishing the appropriate governance framework to comply.

Collective Defined Contribution (CDC) pension schemes get closer

Introduced in the Pension Schemes Act 2021, CDC pensions are set to become a reality for millions of people in the UK. The Government continues to work towards a 'go-live' date of August 2022 for CDC schemes supported by a single employer or a group of connected employers.

The consultation on a new code of practice for the authorisation and supervision of CDC pension schemes ended on 22 March 2022. First Actuarial responded to the consultation.

Derek Benstead – who has played an instrumental role in the introduction of CDC in the UK – has **written a blog post** on where we are with CDC and where we're heading.

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