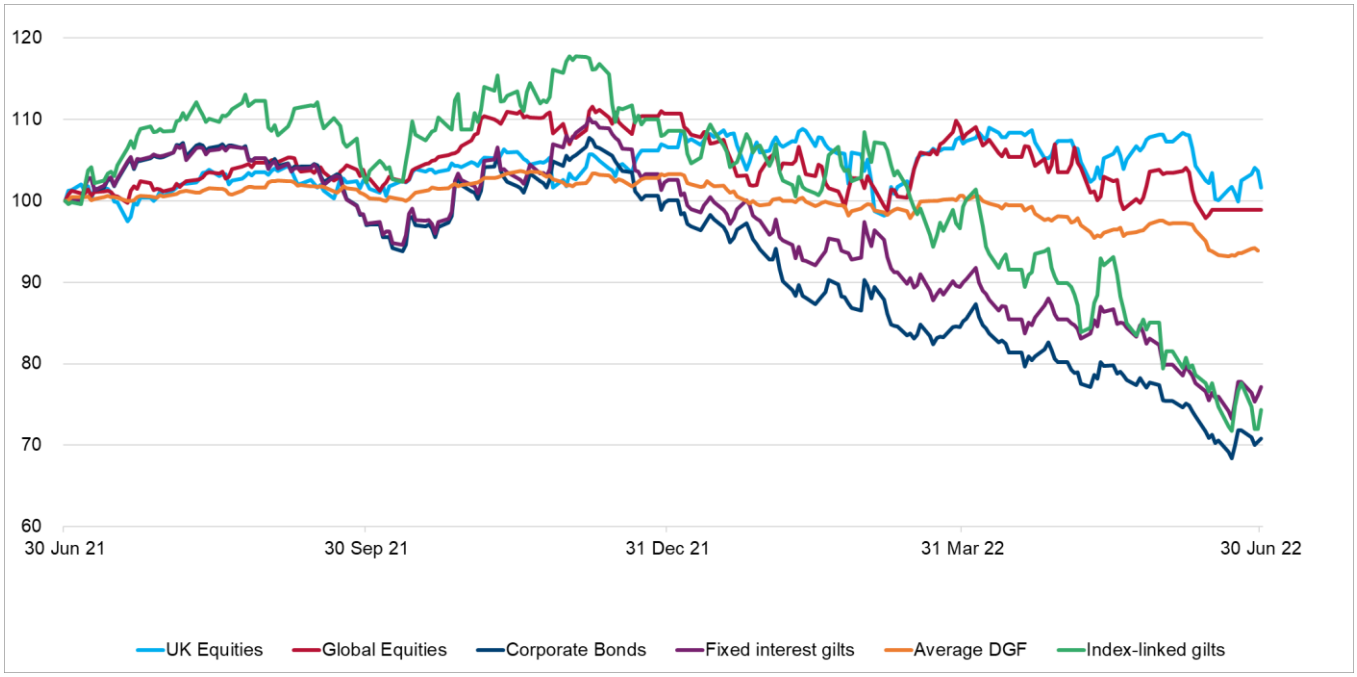
Employer pension briefing, Quarter 3 2022

In this briefing, we highlight key pension issues for employers from the second quarter of 2022, with a focus on important pension cost accounting issues to consider for 30 June year-ends.

Changes in markets since 30 June 2021

The first half of 2022 has seen significant losses in bond markets, contributing to negative returns over the year. Corporate bond values have fallen by nearly 30% since 30 June 2021, with government bonds not far behind. (However, this is not all bad news – see the next section.)

Equity markets saw another volatile quarter, with the value of global and UK equities falling by 5–10% since 31 March 2022. However, despite a turbulent period for equity markets, returns over the full year have been relatively flat.



UK equities: +2%

Global equities: -1%

Average DGF: -6%

Fixed-interest gilts: -23%

Index-linked gilts: -26%

Corporate bonds -29%

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. This will have reduced the value placed on scheme liabilities. Longer-term expectations of future inflation are at broadly the same level they were 12 months ago. However, the recent period of record inflation will have increased liability values – by exactly how much depends on the nature of your scheme's inflation linkage and inflation over the remainder of this year:

	30 June 2021	30 June 2022	Impact on the liabilities of an average[1] scheme
Corporate bond yield[2]	1.9% pa	3.8% pa	-32%
Gilt yield[3]	1.3% pa	2.8% pa	-25%
Market-implied inflation[4]	3.6% pa	3.6% pa	+c5%[5]

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
5 While forward looking inflation is broadly the same, actual inflation over the past 12 months will have increased liability values.

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 30 June 2022, we estimated that there was an aggregate surplus across all schemes, although it's clear that the position of individual schemes will vary significantly.

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

Mortality

The headline mortality news this quarter is that CMI has highlighted an issue with some of the data underlying the S3 series of mortality base tables. These are the latest tables available, and are widely used by the majority of DB schemes. We won't bore you with the details, but this issue has essentially led to the S3 tables overstating life expectancies by around one month for male members and around four months for female members.

For an average scheme, this might mean liabilities are overstated by up to 1%. Given the inherent uncertainty around predicting changes in life expectancy, it would not be unreasonable to continue to use the current mortality assumptions in many cases. However, this issue is something to be aware of when setting assumptions for accounting or discussing assumptions for funding with trustees.

Surplus to (accounting standard) requirements?

If you are in the fortunate position to have moved to an accounting surplus, it may put a different spin on scheme funding and your future commitments.

From a balance sheet perspective, it's broadly neutral for contributions to be paid to an underfunded scheme (with the reduction in cash balance offset by a reduction in your pension shortfall). This might not be the case once you move into a position of being in surplus on an accounting basis, especially if the employer is unable to recognise the entire surplus due on the balance sheet because of the wording of the scheme rules. It's also likely that recognition of a surplus will become an area of greater auditor scrutiny as more employers find themselves in this position.

From a cash perspective, you might also be starting to think about the risk of your scheme becoming overfunded. In our **Q3 2021 briefing**, we looked at a number of non-cash funding options. These can also be helpful in mitigating the risk of a trapped surplus.

One example is an Escrow account. This is an account held in the name of the sponsor, but over which the scheme has a charge (so 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.

Paying new contributions into an Escrow account therefore means that those funds can be 'passed back' to the sponsor at a lower funding level than would otherwise be the case (actual payment from schemes back to sponsoring employers before wind-up is rare). As the Escrow account is held by the sponsor, it is usually recognised on the balance sheet.

New DB Funding Code and 2022 Annual Funding Statement

The Department for Work and Pensions (DWP) has launched a consultation on the draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023.

The consultation is also seeking views on plans to amend the Occupational Pension Schemes (Scheme Funding) Regulations 2005 to require that recovery plans are as short as employers can reasonably afford, and that DB schemes appoint a chair if they do not already have one.

Under the draft regulations, DB schemes will be required to have long-term plans set out in a funding and investment strategy, which they will also be required to submit to The Pensions Regulator (TPR).

A consultation on a new DB funding code will following in autumn. However, TPR has confirmed that the new DB funding code is expected to be operational from September 2023 and will not apply retrospectively.

TPR has also issued its **2022 Annual Funding Statement** for schemes with valuation between September 2021 and September 2022 (although it is relevant to all schemes). In line with recent annual funding statements from TPR, there is focus on setting a long-term funding target, assessing covenant and putting in place appropriate recovery plans, and ensuring fair treatment of schemes alongside other stakeholders.

New TPR Powers

It's a busy time for TPR. They have also recently finalised two policies on their new powers to issue fines of up to £1m – one for failing to comply with its **information-gathering powers** and the other targeting those who seek to **avoid an employer debt** or otherwise risk the security of scheme benefits.

If you're not familiar with the detail of the TPR's new powers, you can find out more in our **October 2021 briefing**. While the intention of the new powers is to protect scheme members from those with dubious intentions, there remains a risk that normal corporate activity could be caught by this. It's worth making sure you understand the powers and how TPR intends to use them. Do get in touch to discuss the potential implications in more detail.

Value for money in DC schemes

This spring, Government responded to a range of consultations relating to Defined Contribution (DC) scheme investments, as well as launching two further consultations.

Government responded to the charge cap reform consultation. The charge cap is a limit placed on management fees that can be charged to members in DC auto-enrolment schemes. It's currently set at 0.75% of a member's funds.

One issue identified following the implementation of the charge cap in 2015 was that performance-based investment fees – which are only paid to investment managers if they produce strong returns – were included within the cap. This meant that such investments were often not viable for DC funds, despite being occasionally useful in diversifying investment portfolios. Government therefore proposed bringing performance-based investment fees outside of the cap.

The response to the consultation was mixed, with the main concern being that members are still protected from paying excessive fees for poorly performing investments. Government concluded that they would not make any change to the inclusion of performance-based fees in the charge cap at present.

Over summer 2021, DWP issued a separate call for evidence of greater consolidation of the DC pension market, citing better member outcomes effectively through economies of scale. Government has now responded to this consultation, saying that they will "not be introducing any new regulatory requirements with the sole purpose of consolidating the market in 2022. However, we will work closely with TPR to monitor the impact of the value for members' assessment, which will start to be produced this year".

Government also said: "Our focus will continue to be on creating, with TPR and the FCA [Financial Conduct Authority], a value for money framework for occupational and workplace pension schemes… that brings about consistent, informative, member-focussed value metrics that will enable comparison and encourage competition on overall value."

The DWP held two further consultations in the spring. One concerns employer-related investments while the other includes a proposal that DC schemes with over £100m in assets must disclose their asset allocation publicly in the chair's statement each year. A key aim of the latter is to encourage value for money for members through diversification and illiquid investments, as well as promoting transparency. Both consultations have now closed and responses are expected later this year.

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 new code of practice for the authorisation and supervision of CDC pension schemes comes into force on 1 August 2022, making it possible to set up CDC schemes supported by a single employer or a group of connected employers.

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, contact your usual First Actuarial consultant or any of our **employer services** team.

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