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Industry Update

Post Brexit Actuarial Valuations

In our May Update we covered The Pensions Regulator's (TPR) latest Annual Funding Statement for defined benefit schemes, covering 2016 actuarial valuations. TPR expected that most schemes will have larger deficits than at their previous valuations. They anticipated that for the majority of schemes the increase in deficit reduction contributions required from the employer may be affordable, but acknowledged that some employers may be challenged.

Perhaps TPR knew something we didn't when they issued their Statement as little over a month later the UK voted to leave the European Union. The upshot is that gilt yields have fallen to all time lows and corporate bond yields have followed. Equity markets have been volatile to say the least. Uncertainty abounds and probably will continue to do so for several months to come (or years to come, for the more pessimistic), until the precise arrangements for Brexit are known.

For Trustees - Trustees' duties

Following the vote for Brexit, the outlook for the UK economy has become more uncertain. Trustees should monitor carefully the covenant of the sponsoring employer and have in place contingency plans should there be any signs of a weakening covenant if the economy turns downwards. They may wish to consider asking for more regular covenant updates if the industry in which the sponsor operates is particularly susceptible to a downturn. In addition, trustees should consider reviewing their investment strategy to ensure that it remains fit for purpose during this period of higher volatility, lower bond yields and a falling Pound. Trustees should also monitor more closely their scheme's funding position and consider whether any recovery plan remains on track to meet any previously disclosed deficiency.

For Trustees - Impact on Scheme Funding

Long term Gilt yields have fallen to their lowest ever levels; the redemption yield on 20 year gilts was only 1.7% p.a. at 30 June 2016. Three years earlier this yield was 3.3% p.a. Over the same period, the outlook for inflation has only fallen by around 0.4% p.a. For schemes with index-linked benefits this is a net fall in real yields of 1.2% p.a. and potentially increases the value placed on scheme liabilities by 25%-30%. For schemes with significant fixed pension increases the increase in liability values could be significantly higher.

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It is not all bad news; over the same three year period the return on the FTSE All Share Index has been 18%. In addition, trustees who hold gilts and bonds to match some of their pension liabilities will have seen the values of these holdings increase as a result of the fall in yields, offsetting part of the rise in liability values. A final plus is that the significant fall in the Pound over the week to 30 June has meant that the value of overseas equities has increased in sterling terms. Nevertheless, the net result will still be a decline in funding levels for most schemes.

If trustees already have a valuation in progress and are negotiating with the Employer on the outcome of the valuation, then this is classed as a post valuation date event. The trustees should consider whether it would be appropriate to take the impact of recent changes in financial conditions into account in their negotiations.

As highlighted in our May update, TPR continues to believe that there is sufficient flexibility within the funding regime to allow trustees and employers to find a suitable solution to the possibility of increased deficits in most cases.

For Employers – Impact on company accounting disclosures

Long term Corporate AA rated Bond yields have also fallen to lowest ever levels. The redemption yield on the Over 15 Year iBoxx Index was 2.75% p.a. at 30 June 2016, a fall of around 1.0% p.a. over the last 12 months. Since these bond yields form the basis of the discount rate applied in the pension scheme valuations used in company accounts, this is likely to lead to a significant increase in the value placed on scheme liabilities and hence a worsening in the accounting disclosure position for many companies.

We are still early in the reporting process for those companies with 30 June 2016 year ends. We have yet to see how much leeway auditors may allow in terms of using slightly higher yields for reporting purposes in these unusual circumstances. There is some evidence available to support proposing a 2.9% p.a. discount rate for those schemes with longer durations.

Similarly on inflation assumptions, we foresee some widening of the Retail Price Index (RPI)/ Consumer Prices Index (CPI) differential and more use of the inflation risk premium in the calculation of RPI and CPI assumptions for reporting purposes.

Companies should also consider discussing adopting the latest mortality assumptions for their disclosures. Recent heavier than expected mortality has fed through into both the latest base tables and the latest CMI Projection tables and this may help mitigate some, but unfortunately not all, of the pain caused by lower discount rates.

If you would like to discuss this further, please get in touch with your usual contact at Cartwright Group:

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