Accounting in Pensions

31 March 2024 Quarterly Update

isio.

Accounting benchmarks

What are the key financial indicators for accounting?

The table below summarises Isio UK financial indicators for 31 March 2024 for company accounting purposes, as well as changes since 31 December 2023 and 31 March 2023

	31 March 2024[1]	31 December 2023	*Change*	31 March 2023	*Change*
Discount rate[2]	4.81%	4.51%	***0.30%***	4.66%	***0.15%***
RPI inflation[2]	3.40%	3.26%	***0.14%***	3.46%	***-0.06%***
CPI inflation[2]	2.55%	2.41%	***0.14%***	2.61%	***-0.06%***
Gilt yield[2]	4.37%	4.06%	***0.31%***	3.77%	***0.60%***
FTSE All Share-TR	9,379.3	9,056.2	***3.57%***	8,650.3	***8.43%***

[1] Figures are based on high level analysis and for illustrative purposes only.
[2] Financial indicators based on an average pension scheme with a 20-year term.
[3] Assuming a typical investment strategy consists of 40% growth assets and 60% matching assets with 70% level of hedging

Movement over the last year

For an average scheme, with a funding level of 95% at 31 March 2023, the changes in discount rate and inflation above may have resulted in a c.4% decrease in the liabilities. Assuming a typical investment strategy[3], assets are anticipated to have reduced by c.2% over the year, resulting in an **overall c.2% improvement** in the funding position.

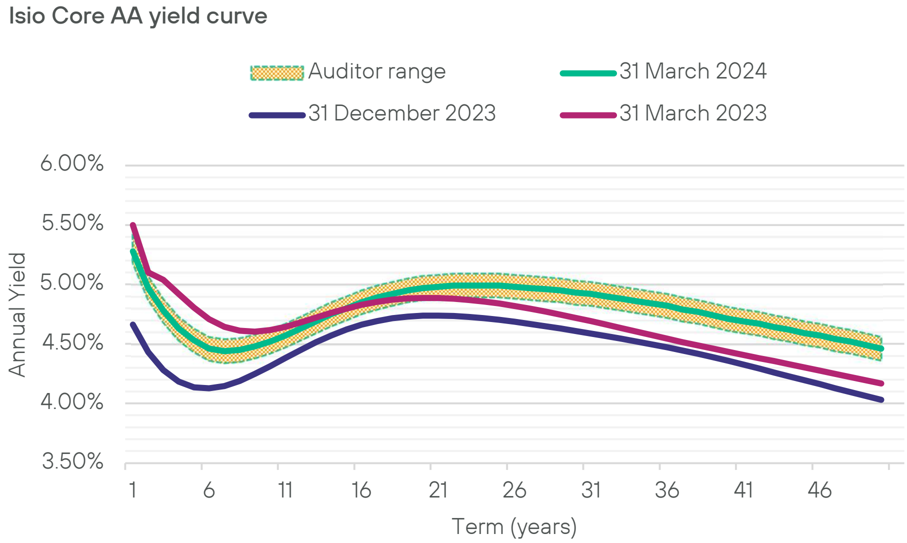
Movement over the last quarter and year

For an average scheme with a funding level of 95% at 31 December 2023, the changes in discount rate and inflation above may have resulted in a c.3% decrease in liabilities. Assuming a typical investment strategy[3], assets are anticipated to have remained broadly the same over the quarter, resulting in a **c.3% improvement** in the overall funding position.

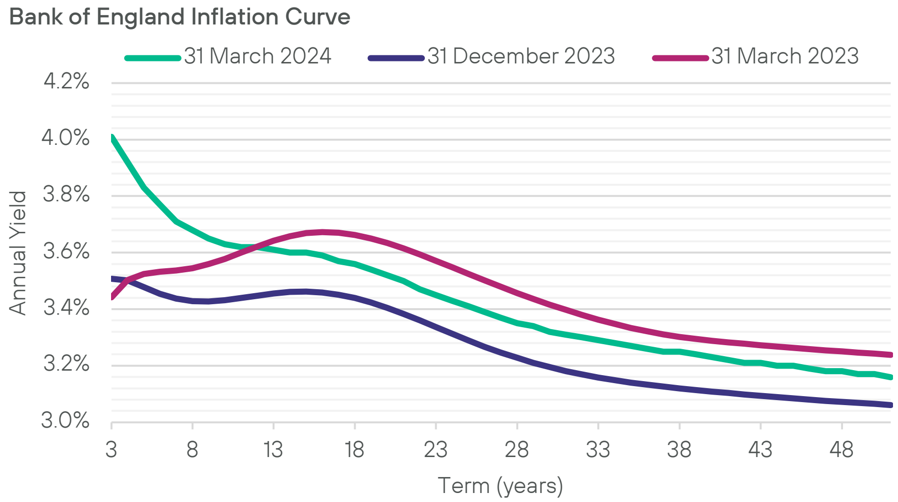
Schemes may not see a significant movement in their liabilities compared to a year ago; corporate bond yields and long-term inflation expectations have reduced by a similar, small amount, having a limited effect on liabilities. As these financial movements have not been significant, balance sheet positions will be heavily influenced by how assets have performed, which will vary from scheme to scheme based on their particular investment strategies.

What does this look like at different terms?

The chart below shows the expected discount rates for all terms at 31 March 2024, as well as at 31 December 2023 and 31 March 2023. This is based on Isio's Core approach and includes an indicative auditor acceptable range (further detail below).



The chart below shows the Bank of England inflation rates for all terms at 31 March 2024, as well as at 31 December 2023 and 31 March 2023.



What are we seeing in the market?

We have summarised our findings from conversations with auditors, and information collected from accounting exercises to date, which may be useful when setting assumptions.

Discount rate

- Auditors' typical acceptable ranges are up to ±0.25% of the market median, but this range can be larger at longer durations.
- Isio's yield curve approaches are expected to be within audit firms' acceptable ranges. Whilst only our core approach is illustrated on Page 3, there are alternative approaches which result in slightly higher discount rates.

Inflation

- Current expectations are that RPI will continue to be calculated and published in the future, but from February 2030 these calculations will mirror those used for setting CPIH. Theoretically, this should mean published RPI should run 0.8%-1.1% lower from around 2031.
- The 2030 switch is now a highly likely outcome, following the High Court's dismissal of a judicial review of the switch launched by the trustees of a group of pension funds.
- Historically, a typical acceptable range for any Inflation Risk Premium ("IRP") was nil to 0.3%. The recent changes have seen some entities adopt higher IRPs, including applying post-2030 increases, reflecting views that market based RPI is being overstated.
- Most auditors default position will be to expect no RPI-CPI wedge post-2030, but a number of cases do make some modest allowance.
- Isio's break-even RPI inflation rates are expected to be close to the benchmark rates for each audit firm across terms.
- Auditors may expect RPI and CPI assumptions to be derived using separate durations, where they distinctly relate to benefits of different terms.

Mortality

- Auditors would normally look for the use of the latest long-term improvements data, with a preference for this to be updated annually rather than triennially.
- The CMI released the 2022 version of its projections model on 22 June 2023.
- The 2022 version of the CMI's projection model gives 25% weighting to 2022 mortality data (with 0% weightings for 2020 and 2021, 100% for all prior years). This compares to the CMI's approach for the 2020 and 2021 versions of the model, which gave no weighting to 2020 and 2021 data (and 100% for all prior years).
- Adopting the default version results in more material reductions in life expectancy compared to the CMI_2021 default position. When compared to CMI_2021, life expectancies at retirement typically reduce by c.6 months which could reduce liabilities by 1.5-2%.
- Users of CMI_2022 can choose to place more or less weight on data for all three post-pandemic years, 2020 to 2022.
- Isio has performed analysis based on its view of how it expects the pandemic, strained NHS, and other factors to affect future UK mortality. Based on this analysis, Isio's view is that an additional 10% weighting above the CMI's default w parameters is suitable to provide a best-estimate adjustment for these factors. However, any adjustment to mortality model parameters should be considered in

the context of the other mortality assumption parameters adopted for the scheme overall.

- Auditors are interested to understand the justification for the weighting parameters being proposed and are likely to look for more detail to support the use of higher values. Also, given recent experience, they may challenge the use of zero-value w parameters as best estimates.
- Most auditors will look at the resultant life expectancies from the proposed mortality assumptions with follow-up questions being raised if the life expectancies do not fit within the auditor's acceptable range – i.e. it's the combination of assumptions and parameters which is important, rather than specific individual parameters in isolation.
- Auditors may also query whether mortality base-tables adopted are best-estimate, following an announcement by the CMI that incorrect public sector data was used to determine their latest 'S3PA' tables. The result of this is that these tables understate mortality and therefore may produce slightly prudent, higher liabilities.

Other pensions accounting issues

- **Virgin Media vs NTL Pensions Trustees** – A challenge by the trustees of this pension scheme led to the High Court making a landmark judgement in June 2023. The judgement concluded that certain amendments made to schemes between April 1997 and April 2016 may be invalid if a confirmation known as a 'Section 37' certificate was not completed at the time. Whilst the ruling remains under appeal, the case is of significance as it could mean that the amendments of other schemes are considered invalid, resulting in additional unforeseen liabilities.

  The necessary work to understand the implications of this case for schemes will take time. However, most auditors will expect consideration to be given to the ruling, which may involve schemes identifying the key amendments to rules over the relevant period and whether their unwinding would result in a material impact on liabilities.
- **Inflation experience** – Over recent months inflation has reduced materially. RPI inflation for the year to Sep 2023 was 8.9%, but for the following five months to February 2024, RPI has been 0.7%. Many schemes may still experience large increases to pensions over 2024, as lags in indexation may mean schemes reference this higher period of inflation around September. However, more recently, actual inflation will typically be lower than schemes long-term assumptions, and therefore schemes may experience positive inflation experience at future reporting dates once this is allowed for.
- **Recognising experience** – Some auditors are focusing on ways that any roll forward methodology being used can be refined to reduce the size of experience items arising following the completion of the triennial funding valuations every three years (e.g. allowing for known historic and upcoming pension increases).
- **Surplus recognition** – With many schemes expecting to see material improvements in their balance sheet positions, some may need to consider their rights under the rules for the first time and therefore the extent to which this surplus can be recognised. Entities reporting under IFRS will also need to consider if any funding obligations would give rise to additional liabilities under IFRIC 14.
- **Onerous data requests** – Auditors are continuing to ask for more granular levels of data and information from companies, which in most cases will have to be requested from the trustees.

Note auditor ranges are indicative based on data from 31 March 2024 and ranges will vary between auditors. We can provide further insight on request.

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