Shifting sands

Enhancing shareholder value in challenging times for businesses and pensions

October 2020

Helping corporate sponsors

Welcome to LCP's third annual report into pensions issues for corporate sponsors.

In this report:

In section 1, we address the biggest topical challenge for corporate sponsors: how to ensure members get their benefits without compromising shareholder value. The effect so far from Covid-19, the challenging economic outlook, and the regulatory direction of travel are all putting more pressure on corporate sponsors. We discuss a wide range of actions that sponsors should consider depending on their particular circumstances.

In section 2, we discuss one of the most powerful levers to address these challenges: the pension investment strategy. We explain the importance of sponsors taking the initiative in this key area, with a number of actions to improve the efficiency, costs and balance of risks within the pension investment strategy. We focus on the practicalities of working in collaboration with the trustees to make progress that's acceptable to all parties.

In section 3, we summarise the wide range of current and upcoming legal, regulatory and market developments, and what sponsors should do about these. This includes the biggest changes to the funding rules in two decades, a significantly more powerful regulator, big developments in the area of member options, real signs at last of a market in DB consolidators, new solutions that focus on the use of third party capital, growing use of contingent funding solutions, pensions implications of the new Insolvency and Corporate Governance Bill, and ongoing reform to the RPI measure of inflation affecting all areas of pensions management.

And finally in section 4, we outline the key things you need to do to prepare for your 2020 year-end reporting. This includes what to do in the face of unprecedented balance sheet volatility, how to reflect the RPI reform in the assumptions underlying the balance sheet, how to factor in the effects of Covid-19 into those assumptions, managing two specific potential accounting risks to profits from any true-ups to the GMP equalisation reserve, and several other actions.

Gordon Watchorn
Head of Corporate Consulting

Many sponsors and schemes are in a hugely different place today to where they were at the start of 2020. Add in the raft of legislative changes and it is crucial that companies now revisit their pensions strategies and take a proactive approach to implementing a journey plan which considers their corporate objectives and risk tolerance.

Contents

www.lcp.uk.com/afp

LCP Accounting for Pensions 2020

A concise analysis of the key facts, figures and trends revealed by FTSE 100 companies reporting in 2019.

2019: trends and consensus emerging

60% of FTSE 100 pension schemes were in surplus on an IAS19 basis at their 2019 accounting date.

In 2019 we still saw diverse practice across FTSE 100 companies on life expectancy assumptions, but our research suggests that some market consensus was emerging on the core parts of how life expectancies are projected to improve.

2020: chaos and unpredictability

At 31 March 2020, in the midst of the Covid-19 crisis, the combined FTSE 100 IAS19 position was the best it has been for 20 years. This followed a rise of **1.5% pa in discount rates** over just eight days in March 2020. **Around 70%** of FTSE 100 pension schemes were projected to have an IAS19 surplus at this date.

However, 30 April 2020 was a then all-time record low for IAS19 month-end discount rates with **less than 60%** of FTSE 100 pension schemes projected to be in surplus by then.

Section 1:
Managing corporate pensions in the current environment

Section 1: Managing corporate pensions in the current environment

Meeting short-term challenges

Pensions may have been a low priority for many companies in recent months given the focus on business sustainability. But with some signs of companies viewing today's world as the new normal for some time, it's important to pick up pensions again. Before Covid-19, the direction of travel from The Pensions Regulator (TPR) and the Pension Schemes Bill (see section 3 of this report) all pointed to de-risking schemes more quickly and an acceleration of deficit contributions from the company.

As Covid-19 took hold, asset values fell and many employers sought to take advantage of easements announced by TPR, for example regarding payments of deficit contributions. The timetable for the new funding code was pushed back.

We are now in a world where the changes to funding are still paused, but asset values have recovered since the lowest point in mid March.

Our checklist remains relevant and is a starting point to make sure all risks are considered and all opportunities are investigated. We're expecting a busy year ahead ensuring corporate pension strategies are supportive of both the longer term aims for the pension plan but also the shorter term need for caution and fair treatment of all creditors including shareholders.

Reviewing the long-term pension strategy, prioritising projects, and proactive involvement on the scheme investment strategy are three key steps that every company should take to be on top of recent developments.

Phil Cuddeford
Partner

Sarah Lossin
Senior Consultant

I am very eager to see the first DB consolidator deals finally take place and to see how this exciting new market evolves over the coming months. It has been a tough year for many and the DB consolidators really do offer something new and innovative which is welcome in these uncertain times.

Longer term challenges – the end game

With most DB schemes closed to new members, the end game becomes increasingly important. Until recently, the only way to settle liabilities in full was by transfer to an insurer. However, we are seeing an emergence of innovative products alongside traditional solutions. These include: DB consolidators, 2 new products from L&G and other capital-backed solutions.

Solutions for the end game

	Interest rate risk	Inflation and other investment risks	Longevity and other demographic risks
L&G's Assured Payment Policy (APP)	Yes	Yes	No
L&G's Insured Self Sufficiency (ISS)	Partially	Partially	Partially
Capital-Backed Journey Plan (CBJP)	Partially	Partially	Partially
Longevity swap	No	No	Yes
Partial buy-in	Yes	Yes	Yes
DB Consolidator with connected covenant	Partially	Partially	Partially
DB Consolidator	Yes	Yes	Yes
Insured buy-out	Yes	Yes	Yes

Yes **Partially** **No**

L&G's "Assured Payment Policy" (APP): An insurance product that provides an income stream matching an agreed cash flow profile, which can be constructed to be a close match to the benefits owed to a group of members. This provides protection against asset default, interest and inflation risks but not longevity or other demographic risks. In this way it is essentially a buy-in without a longevity swap.

L&G's "Insured Self Sufficiency" (ISS): An investment product that provides an income stream matching an agreed cash flow profile, which can be constructed to be a close match to the benefits owed to a group of members. The "1-in-200" event protection against asset default and longevity risks is not replenished once consumed.

Capital backed journey plans do not remove the sponsor from its link to the pension scheme. They are designed to provide additional covenant support to the pension scheme, in exchange for retaining more risk in the investment strategy for longer. The intention is to use the investment returns, rather than cash from the sponsor, to plug the gap to buy-out over a reasonable timeframe.

What's interesting about capital-backed solutions is they follow similar investment strategies of full (and efficient) hedging, a lot of (but not full) cashflow matching, heavy investment in credit and secure income, targeting a net return of around gilts + 1.5% pa, with little de-risking over time. A key question for sponsors of larger schemes is why not do it yourself? If insured buy-out remains an appropriate long-term target, following this strategy is likely to get there sooner than accelerated de-risking, and reduce the need for top-ups from sponsors. Managing the down-side risks through the right combination of covenant and contingent funding approaches is key to the appropriateness of these solutions.

DB consolidators are cheaper than insured buy-out but achieve the same clean break to a sponsor, and so where the favoured buy-out is not achievable, and where there may be concerns over the ability to support a scheme over the longer term or the scheme is restricting a company's ability to turn around its fortunes, there may be a solution that offers both an exit for the sponsor and an improvement in security for members. Click here for details

Insured buy-out remains the gold standard for settling DB pension liabilities. Many schemes took advantage of opportunistic pricing as credit spreads spiked earlier this year. But with many factors in this report suggesting demand will increase from schemes for this solution, will supply be able to keep pace? Click here for details

The most appropriate end point and journey to reach that point will depend on many factors specific to each scheme and sponsor. So it's important to assess all options now and then tailor the journey, rather than assuming that a traditional de-risking route is the only solution.

More than ever there is a challenge: how should a company deal with all the change in ensuring their pension scheme runs off in an optimal way, in terms of return to shareholders? Our view: focus on what matters most, take a step back and make a plan. What are your objectives around your DB scheme? For many these will be closed legacy schemes and most companies want to manage the costs and the risks of future costs, as well as the on-going impact on the balance sheet.

Here are 3 practical steps we think every company should be doing over the remainder of 2020:

1. Review and document your long-term strategy

For most (given high running costs, risks of running the scheme and a company being more attractive if it doesn't have a DB scheme) this should be to buy-out the scheme. For the very largest schemes it may instead be to run off given the costs of passing to someone else may outweigh the costs and risks of doing it yourself. Having a documented plan will help assess the relative merits of any project or product.

Given the market volatility so far during 2020, and the upcoming legislative changes, now is the right time to assess whether the strategy remains appropriate or needs adjustment – to improve the scheme's position ahead of the new funding regime.

2. Take a proactive involvement in the investment strategy

As well as some current market opportunities to improve expected returns or efficiency of current strategies, sponsors have more interest than ever on risk, expected return and cost reduction and need to be proactive to get traction. See section 2 for more on this.

3. Prioritise projects

Once a clear plan is in place, projects should be undertaken with a focus on improving the risk-adjusted outcome for the company and its shareholders against that plan. Focus on these projects to ensure you get most bang for your buck, aligned with clear objectives.

Section 2:
Investment – sponsors to take the initiative

Pension scheme investing is often considered to be a long-term exercise, with many decades to invest over. However, with new regulatory changes heading this way, many pension schemes will find themselves with shorter (and fixed) time horizons. As such, the importance of squeezing out extra returns and managing risks has never been greater, particularly in a low-yielding and Covid-19-troubled world.

In our view, now is the time to take action, or regret it later.

In this section we summarise our:

Managing costs - top 5 don'ts

- Don't tie up too much capital in hedging strategies
- Don't miss out on credit-linked LDI
- Don't over-pay on governance and manager costs
- Don't de-risk too quickly
- Don't buy too much long-dated credit

Managing risks - top 5 do's

- Get ahead of the pack on climate risks
- Take advantage of the full range of "real assets"
- Structure equities to better protect downside risks
- Get ahead of the pack on insurer transactions and third-party capital
- Use investment strategy to actively manage accounting position

Section 2: Investment – sponsors to take the initiative

Managing costs – top 5 don'ts

Don't tie up too much capital in hedging strategies

- LDI is now mainstream, with the majority of DB pension schemes now using some form of liability hedging strategy. However, two of the pitfalls we often see in LDI portfolios are (1) inefficient use of leverage, using up a lot of capital; and (2) a passive (rather than dynamic) approach that doesn't seek to actively hedge liabilities using the cheapest hedging instrument.
- Through efficient management of capital, funds can be freed up from LDI portfolios and used to earn higher returns.

For a typical £500m pension scheme, using a relatively low level of leverage (2x) and passive LDI, we think that over the next 10 years:

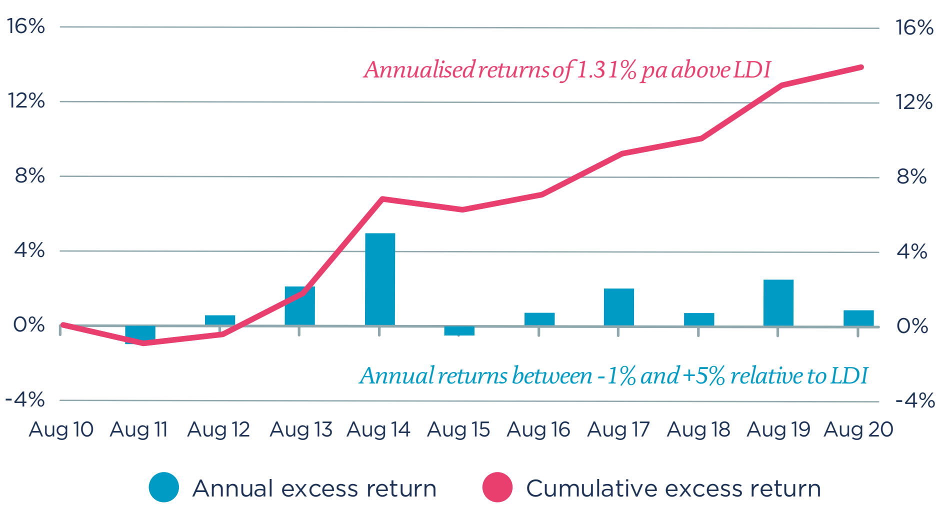
- *dynamic LDI may be worth around £10m - £20m more, while;*
- *modest collateral reinvestment may be worth around £10m - £15m*

David Govier
Consultant

Don't miss out on credit-linked LDI

- Most DB pension scheme investors would prefer to invest in investment grade corporate bonds than their fixed interest gilt counterparts. Investment grade credit very rarely defaults and the additional return compared to government bonds is often too good to turn down.
- Credit-linked LDI provides the flexibility to turn low-yielding LDI assets into a return more similar to investing in investment grade credit, with no additional capital requirements.
- In turn, this helps boost returns to help meet longer-term targets and / or facilitate de-risking elsewhere in the portfolio.

How much return credit-linked would have added to LDI over the last 10 years



Source: LCP analysis

Check out Laasya's blog on efficient LDI strategies, including credit-linked LDI

Laasya Shekaran
Associate Consultant

Don’t overpay on governance and manager costs

- Manager fees are usually the biggest cost to a pension scheme investment strategy. Frequent reviews and third-party opinions on manager fees are usually a very worthwhile exercise. The competitive landscape is always shifting and strategies that were previously expensive can often now be accessed more cheaply. Click here to read more.

Proportion of recovery plan payments used to pay manager fees

Funding	5 years	10 years	15 years
80% funded	9%	18%	27%
85% funded	12%	24%	36%
90% funded	18%	36%	54%

Recovery plan length

> *Fiduciary arrangements are often considered as all-or-nothing, but often a part-fiduciary solution can strike a better balance. Make sure you get independent advice from a third party on any fiduciary solutions and check out Joel’s views here.*

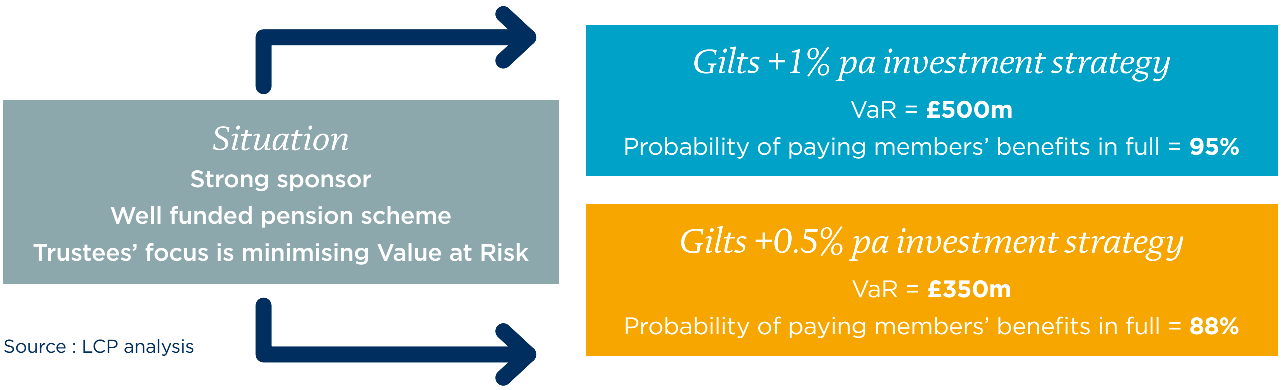
Joel Hartley
Partner

- It’s also important for the sponsor to have a seat at the table in regular discussions on investment strategy. In turn, this can save significant costs on letter writing ping-pong and help reduce opportunity costs by making faster, more joined-up decisions.

Don’t de-risk too quickly

- While it can be compelling to de-risk investments, it is also worth considering the risk of not generating sufficient investment returns and the costs de-risking may ultimately place on the sponsor. All else remaining equal, lower investment returns mean higher contributions.
- Furthermore, a rigidly automated de-risking process may result in a scheme de-risking when it is expensive to do so – i.e. locking-in losses and buying expensive assets.
- But often what’s most expensive to sponsors is the pre-funding of future de-risking within actuarial valuations and journey plans. In our view, there should be clear investment rationale for de-risking rather than simply the passage of time.

Covenant affects risk measures based on member outcomes



Source : LCP analysis

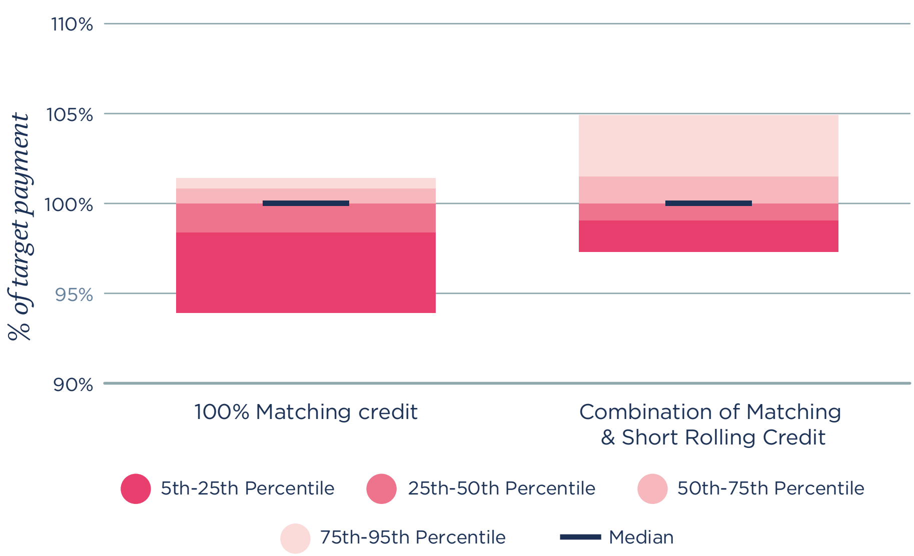
Don't buy too much long-dated credit

- It may seem appealing to match long-dated liabilities with long-dated corporate bonds – after all that's what the insurance industry has been doing for years. "Cashflow Driven Investment" or CDI is very much in fashion.
- However, we'd suggest caution. Ultimately the best that can happen when lending to someone for a long period of time is you get your money back. But what happens if members start living longer? Or don't retire when you expect them to? Or if you want to sell the bond before it matures? And what happens if you don't get all your money back?
- In general, it is safer to lend to people for a shorter rather than longer time period. It is better to have a more diversified portfolio and it is helpful to have investments generating higher returns in case required cashflows turn out to be higher than expected. For these reasons we prefer to combine shorter-dated credit, equities and a broader range of investments alongside long-dated cashflow matching corporate bonds.

Click here to read more on Andy Linz's analysis on the benefits of combining shorter-dated credit alongside long-term cashflow matching.

Andrew Linz
Consultant

Strategy outcomes for 10 year target strategy



Managing costs – top 5 do's

Get ahead of the pack on climate risks

- The risks related to climate change are multi-faceted. Not only should investors consider the long-term impacts of climate change, but also the transition risks of future regulation, public backlash and the risks of other investors being (strongly) encouraged to shy away from corporates with high emissions, and the list goes on.
- Click here to watch a recording of our webinar setting out the key issues and how you can better manage them.
- Two easy actions are to convert your investments in equities and corporate bonds into climate-tilted alternatives.

Check out Anais' blog on climate-tilting equities.

Anais Caldwell-Jones
Consultant

Take advantage of the full range of "real assets"

- Many pension schemes focus their "real asset" allocation on UK property. This is perfectly understandable given the Sterling nature of UK pension liabilities and the potential link to UK inflation.
- However, the UK property market is facing a number of headwinds, including Brexit, Covid-19-related issues, the longer-term trend away from the high street, and reduced demand as UK pension schemes de-risk. Add to this the potential for funds to suspend dealing ("gating"), the mismatch in liquidity terms offered to investors, and the underlying liquidity of a portfolio of buildings.
- Where standalone allocations to UK property are made, our preference is to use a fund of funds and diversify the fund-specific risks and the potential impacts of funds gating. Not being able to get your money out when you need it is a key risk when investing in property.

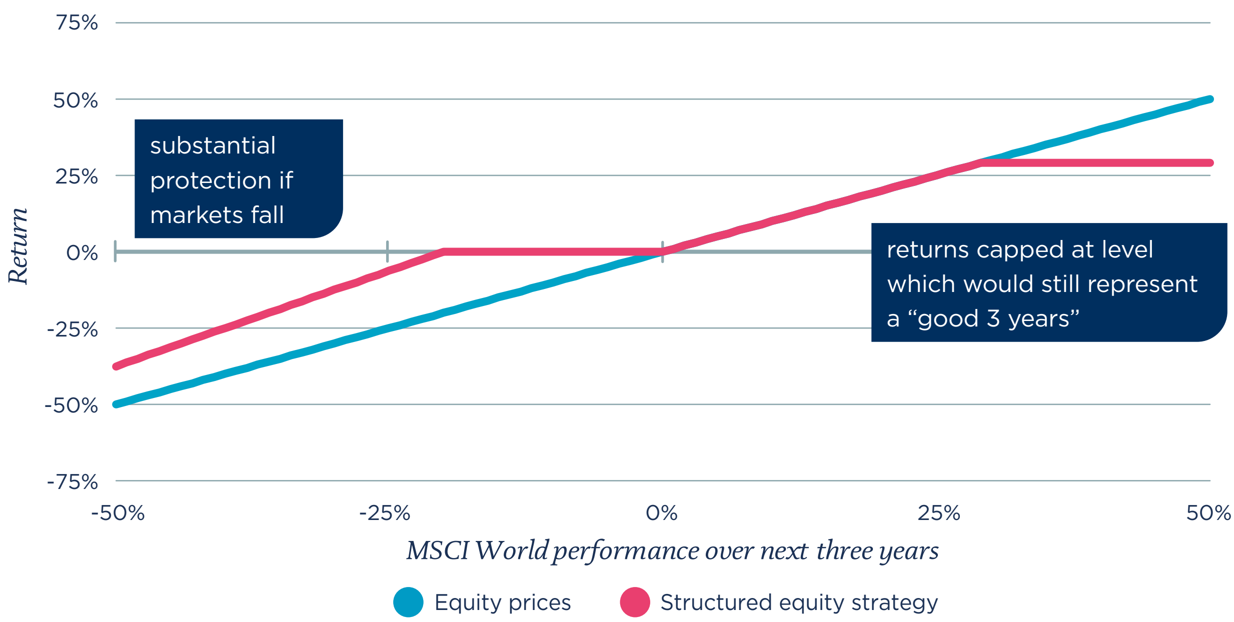
We recommend considering a more diversified approach to real assets, including global property, long lease property and global infrastructure, as set out in Lia's blog.

Lia Licietis
Senior Consultant

Structure equities to better protect downside risks

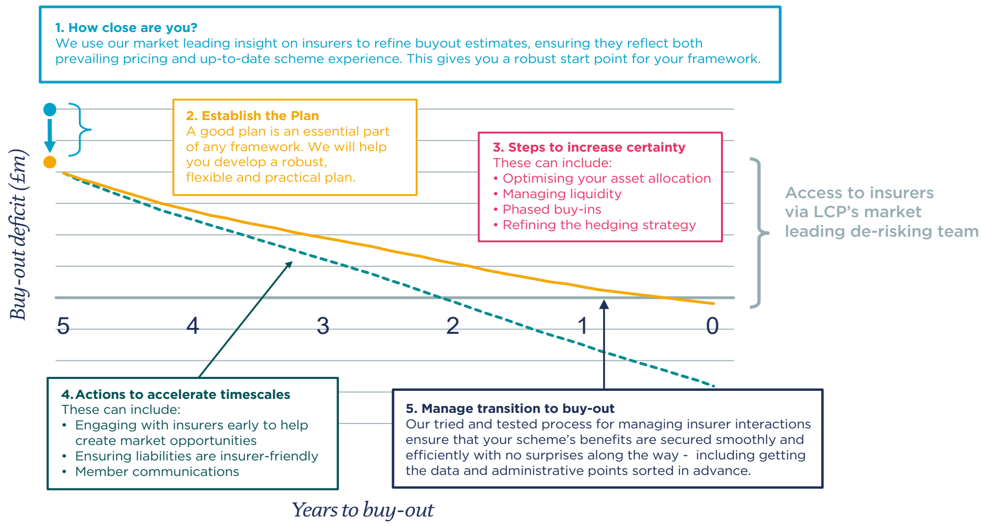
- Global equity markets, driven by the large US technology stocks, have surged since their Covid-19-lows in March 2020. Opinions are divided on whether this bounce-back is entirely merited or not. No doubt there is potential for both a continued rise or a large fall.
- In light of the above, it is attractive to have downside protection against falling equity prices. However, this comes at a cost. By "structuring" the equity exposure using equity options, it is possible to tailor the protection to be more cost effective and to better suit your circumstances.
- A popular strategy is to sell away the upside of markets rising above a certain level, on the basis the pension scheme would have likely de-risked and sold equities by this point anyway. In turn, the premium earned could be used to provide a layer of downside protection, on the basis that this is more cost effective than full protection. See the chart below for an example:

How a protected equity strategy could perform



Get ahead of the pack on insurer transactions and third-party capital

- In our leading the way report, we set out the potential supply issues of insuring the c£2 trillion of DB pension liabilities in the UK. Of course, not every scheme will buy-out but unless there are serious changes to the availability of insurance, the £25bn to £50bn of transactions per year might mean there is not enough capacity to meet future demand.
- Getting ahead of the pack and being “insurer-ready”, building relationships with insurers or transacting a small deal to insure a subset of members can help keep you at the front of the queue.
- The below infographic shows our 5-step planning framework for optimising the journey to buy-out. Click here to read more.



- As discussed in section 1, insurers are also getting creative with the solutions they're able to offer, in part to combat new and creative solutions offered by new entrants to the market. Sponsors are now able to access third-party capital to either consolidate their scheme in a “superfund” or provide a financial underpin in a journey to buy-out. These new kids on the block are hungry for deals and there will certainly be some first mover advantages.

Click here to read Sam's views on what lies ahead for superfunds.

Sam Jenkins
Partner

Use investment strategy to actively manage accounting position

- Interest rate and inflation hedging levels need to be considered carefully because the value placed on accounting liabilities is different to the reserve negotiated with the trustees for cash funding purposes. As a result, schemes with high hedge ratios can end up being over-hedged as far as the corporate balance sheet is concerned.
- Investment grade corporate bonds can have a positive impact on a sponsor's balance sheet as they offer some protection against falling credit spreads. Credit-linked LDI can be an easy way to get extra credit exposure within your portfolio.
- Sponsors should also carefully consider the effects of insurer buy-ins on the balance sheet. While these transactions can help to reduce risk, they can also weaken the balance sheet as the IAS19 asset value of the insurance policy is typically lower than the premium paid. Consider whether it would be more beneficial to reduce risk in other areas such as LDI, longevity hedging or accessing third-party capital.
- See section 4 for a wider discussion on accounting and preparing for the 2020 year end.

Click here to see a worked example where the accounting inflation hedge was 150%. At the very least sponsors should know what their hedge ratios are for their corporate balance sheet.

David Wrigley
Partner

Section 3:
Important changes in the pensions landscape for corporates

Phil Cuddeford
Partner

Understandably, pensions have been low on the corporate agenda as businesses have grappled with the immediate fallout and market volatility from Covid-19. The tsunami of change including greater personal responsibility for company directors, innovation in funding and end-game options, big shifts in the funding regime, and RPI reform coming down the track, means that pensions need to quickly zoom up the agenda.

Section 3: Important changes in the pensions landscape for corporates

Former pensions minister (and current LCP Partner) Sir Steve Webb writes:

"Most companies would prefer to concentrate on the day job and leave pensions to those who understand these things. This may be especially true where the pension scheme is closed and many or most of the members have little connection with the firm any more. But the tsunami of changes to pensions regulation and legislation that we discuss in this report can have multi-million pound impacts on sponsors and can be hugely significant to the financial position of your firm in both the short and long-term. For example:

- The Pensions Regulator is planning a big shake-up of DB pension scheme funding including things like how long you have got to clear any deficit in your DB scheme; this could have a massive impact on your corporate cashflow and your ability to invest in your business. Do you know what the changes could mean for your business and are you helping to shape them? Are you at risk of having money trapped in your pension scheme unnecessarily when it could be used productively for your business?
- For a large firm, PPF levies can vary by hundreds of thousands of pounds from one year to the next; engaging with the PPF as it decides how the total levy bill is to be carved up could be time well spent.
- Your pension scheme will at some point have to provide data for all members to the new 'pensions dashboard'; do you know what will be required and when? What might it cost your scheme to get its data ready for the dashboard?

Steve Webb
Partner

These are just a few examples of changes where legislation and regulation could feed through into direct costs for your business in the coming years. Are you happy to leave the shaping of these rules to politicians, trade bodies and technical experts?

Or are these issues material enough to your business that you need a strategy for dealing with them and how best to engage in the most influential way? If the answer to this last question is yes, we'd suggest an audit of the changes that are coming down the track, which ones are most likely to affect you, and what you can do to shape them. Don't leave it to others – they may be leaving it to you!"

Here are some of the key developments that corporate pension sponsors need to be aware of and ready to react to.

Covid-19 and DB pensions

The regulator has been pragmatic to date in its guidance around giving companies breathing space, for example on deferring deficit contributions provided certain conditions are met. Its 2020 Annual Funding Statement contains useful information for sponsors on what is expected around this and for ongoing valuations.

So what?

Sponsors need a clear plan on how their DB pension fits into their wider short-term commercial strategy. This depends on company specifics and Brexit but will often involve the use of contingent funding. Read more here.

Biggest changes to the funding rules in two decades

The regulator is currently considering how to beef up the DB scheme funding rules following concerns over the likes of BHS and Carillion and is wrestling with how the new Covid-19 reality should also be factored in – a difficult balancing act. They are expected to launch a second consultation in Spring 2021 with more details on enforcement, fast track parameters and what linkage there is between fast track and bespoke.

So what?

Sponsors currently engaged in valuations need to have an eye on their subsequent valuation which will be the first one under the new regime, and remember that much could change before this new regime is finalised.

In the meantime, the focus will be on agreeing journey plans with trustees with a common sponsor objective being to ensure these are as flexible as possible. Find out more here.

Company directors must protect themselves against new criminal sanctions

The Pension Schemes Bill's provisions are expected to come into force during 2021. Other than the funding and climate risk changes which are covered separately here, the main changes relevant to sponsors include:

- Corporate transaction oversight: Corporates will need to produce a new detailed "declaration of intent" document in advance of M&A activity or granting security in priority to the scheme. This will bring timing, cost, confidentiality and commercial challenges.
- Two new Contribution Notice triggers: Corporates could be hit with these if they act broadly in a way that results in a lower amount being available to a pension scheme on insolvency or a materially lower ongoing level of support.
- New powers for the Pensions Regulator to gather information including interviewing corporate directors.
- New criminal offences and regulatory sanctions: Prison sentences of up to 7 years and fines of up to £1 million may apply to individual company directors (and others) broadly where an action or inaction is tantamount to employer debt avoidance or constitutes conduct that detrimentally affects in a material way the likelihood of accrued benefits being received.

So what?

Sponsors should put processes in place now to ensure in scope activity is identified and appropriate action taken, so as to protect themselves and others against these risks – this link describes how.

Inflation reforms affecting most areas of pensions management

We expect the Treasury to respond imminently to the consultations on (1) whether to bring forward the 2030 change from RPI to CPIH (to a date between 2025 and 2030) and (2) technical issues around the transition process.

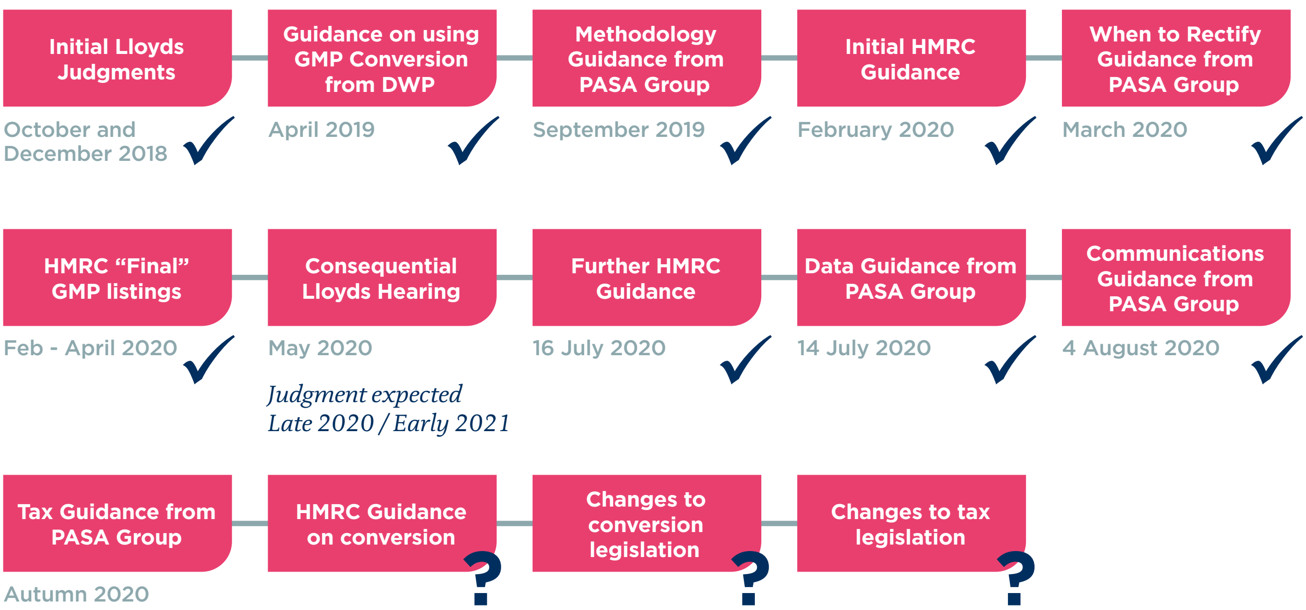
So what?

This affects almost everything. For example, actuarial valuations, company accounting, long-term funding targets, member option exercises or communications, investment strategy, buy-ins, buy-outs, GMP equalisation, changing the index used for pension increases, and long-term journey planning. Some sponsors will find their pension costs go down, others will go up.

GMP equalisation

The following graphic summarises nicely the logistical complexity and outstanding uncertainties on GMP equalisation. Click here for more details.

Industry wide developments



Broadly, the two main areas of uncertainty now are historical transfers (discussed in section 4 of this report, as they may impact sponsors' 2020 profits) and pensions tax.

So what?

These uncertainties should not stop sponsors from analysing their membership, understanding their options and engaging with their trustees on the best options to focus on. As well as managing the considerable risks involved, there are opportunities for those who consider this carefully, including the possibility of reshaping benefits and/or combining with certain member options.

Member options – more changes

From 1 October 2020 the ban on contingent charging on pension transfer advice came into force, along with several other changes including prioritising DC workplace schemes as the destination for any transfer values. These changes, along with increased professional indemnity insurance costs, are resulting in many financial advisers leaving this market and will make it harder for members to access affordable advice.

The FCA's views on whether the provision of illustrative figures that compare outcomes in member communications constitutes regulated advice is a hot topic currently under discussion with potential wide-ranging impacts on what sponsors and trustees can do to help their members.

So what?

These regulatory changes make it even more important for sponsors and trustees to consider offering IFA support to their members. This can be done well or badly, and involves significant reputational risk if done badly.

DB consolidators – ready to take off at last

In June 2020 the regulator published an interim regulatory regime for DB consolidators, with updated guidance for trustees in October, and for sponsors to follow. See section 1 for more details.

So what?

Transactions with consolidators can now take place as soon as the vehicle in question has had its business model approved. This is relevant not just to sponsors who are near the "sweet spot" to transact today, but also for a much wider range of sponsors in terms of considering an appropriate Long Term Objective under the new funding regime mentioned above.

Third party capital – a new development

This development is discussed in section 1 of this report.

So what?

When setting a long term objective, sponsors have more options to consider than just buy-out, consolidator or low dependency, thanks to several different emerging new solutions that include the use of third party capital.

Corporate Insolvency and Governance Act (CIGA) – big for pensions

In an attempt to give breathing space to companies in light of Covid-19, the 2020 CIGA radically changes the UK insolvency regime. The upshot for DB pensions is that in some circumstances the protection for trustees may be diluted.

So what?

Sponsors near this territory may have a better chance of survival from these new arrangements, but they will need to factor in the pension implications carefully. Other sponsors may need to engage on contingent security – either because an existing source of security is now worth less or because trustees are asking for new security to mitigate CIGA.

Contingent funding solutions – from niche to mainstream

There are many reasons for the growing use of contingent funding approaches as described here, including the regulatory direction on funding requirements, the effects of Covid-19 on cashflow and business outlook, the increasing risk of overfunding for some, the need for escrow type solutions to manage deferred premium structures for full buy-ins, the impact of CIGA, and the likely greater PPF levy benefits for some, among others.
Click here for details

So what?

These approaches can balance the needs of sponsors and trustees across a wide range of objectives and situations (not just valuations) – there's real value in sponsors understanding the options available.

Brexit

It can be easy to forget that 31 December 2020 is the end of the transition period for the UK's departure from the EU. The terms of the future partnership with the EU are still unknown, with corresponding uncertainty for business outlook, markets, investments and currency.

So what?

As and when clarity on the terms of Brexit emerges, sponsors will need to factor in the knock-on effect of business outlook, covenant and investment on pensions. Corporate-facing covenant advice will add value for many.

Climate risk management and disclosures

Most people agree that climate risk is large, for businesses as well as scheme investments, and it's ultimately a risk that is underwritten by sponsors. It could dwarf the impacts we're currently seeing from Covid-19. Large schemes are likely to have to adopt a climate governance system and report annually on their climate risk management within the next couple of years. See our News Alert for details.

So what?

In this area of fast evolving disclosure requirements and associated reputational risks, it will be important for sponsor and trustee considerations to be joined up. Those schemes over £1bn will need to move first.

Executive pensions – ongoing HR and reputational challenges

Following changes to the corporate governance code, BEIS statements, Investment Association guidelines and much press coverage, more and more companies are reducing the pensions and cash in lieu provided to their executives. More detail is in our Spring report including benchmarking of the FTSE 100.

So what?

Companies (particularly public companies) should consider their options to act where executives have a contribution tier with a pension/cash rate of 25% or higher, or executive remuneration policy does not state that pension will be set in line with the majority of the workforce for future appointments, or current executives are not expected to have been brought into line with the general workforce by 2022.

Collective Defined Contribution (CDC)

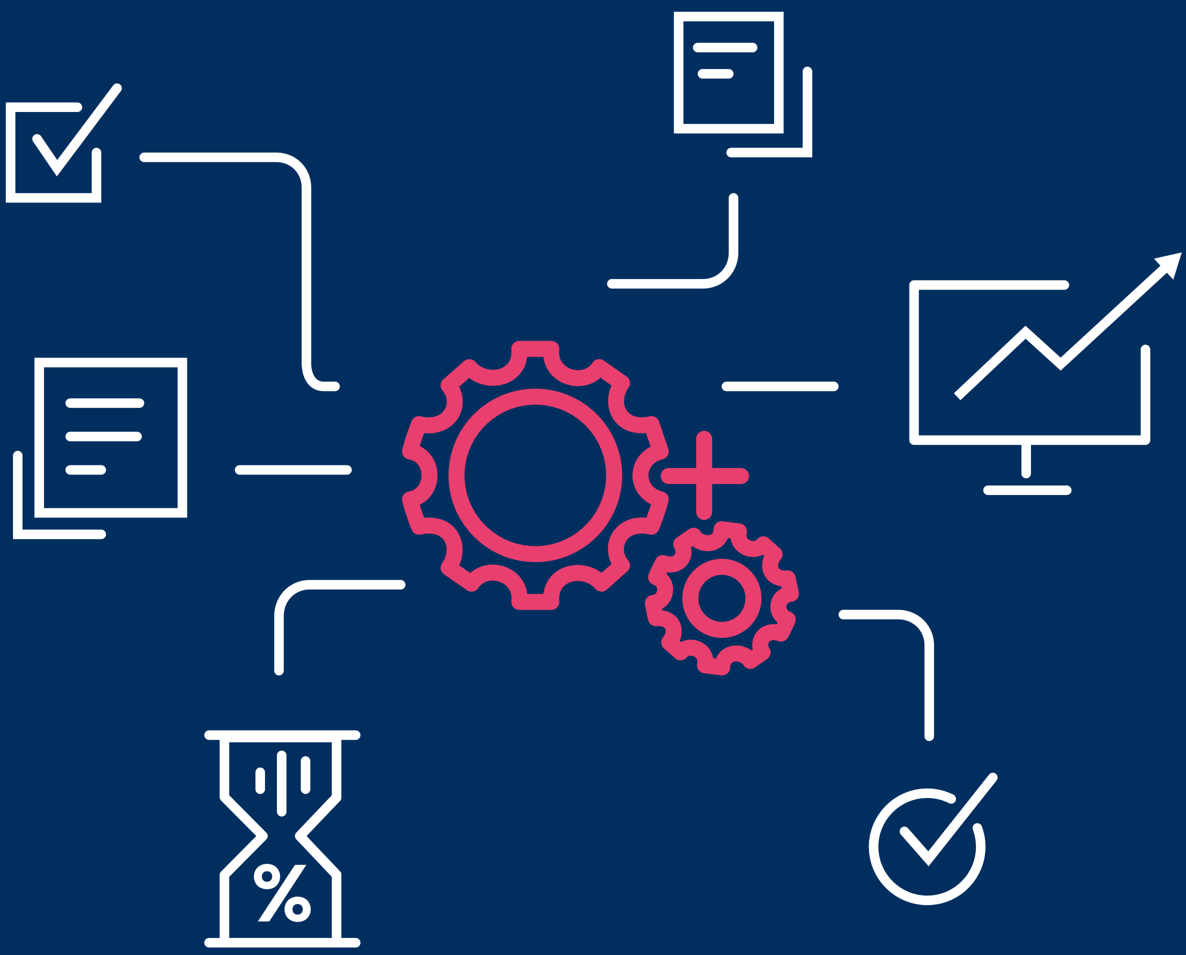
The basic principle of the CDC approach is to share risks between members. One of the key characteristics of the particular approach being focussed on is the need to be able to reduce benefits if required, and this will need new legislation.

The Royal Mail has stated that it will introduce a CDC scheme, but it is likely to be quite some time before it is up and running, and longer still for a wider CDC regulatory regime to come to fruition.

So what?

CDC schemes may be worth exploring for those organisations that are keen to offer a target benefit without the risks resulting from DB guarantees, are culturally comfortable with the concept of pooling risks amongst different members, and have the necessary scale (and expected longevity and patience) to implement such a solution.

Section 4:
Preparing for the 2020 year-end



Section 4: Preparing for the 2020 year-end

Companies preparing for their 2020 accounting year-ends need to consider some or all of the following hot topics. Whilst the focus is on corporate reporting, the impact goes beyond the Annual Report and Accounts with potential knock on effects for covenants, PPF levies, credit ratings and more.

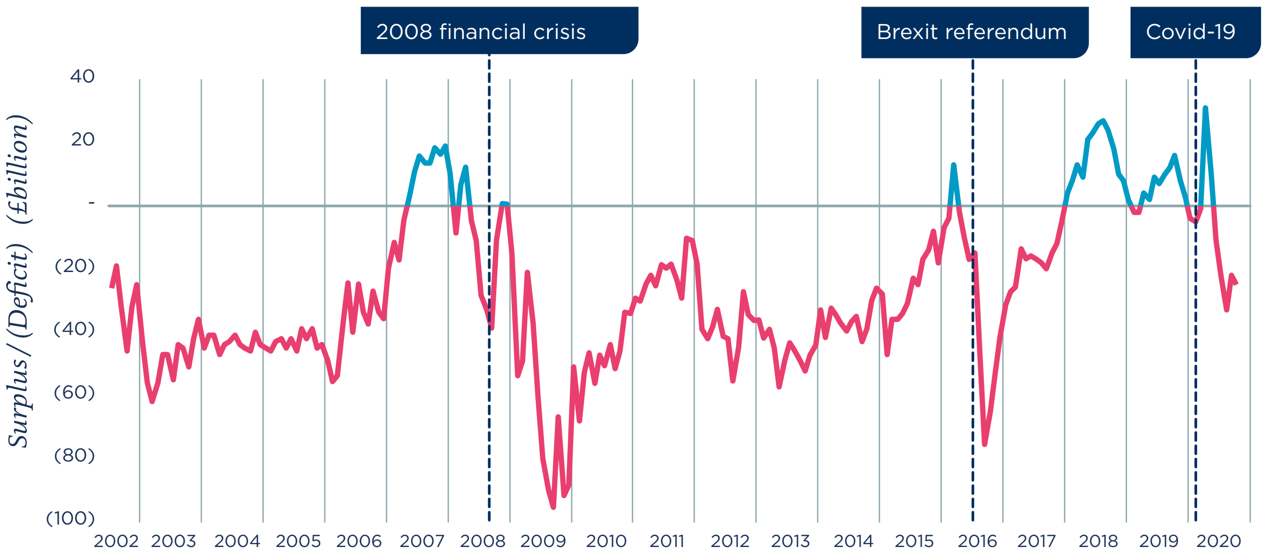
We are holding a webinar on 17 November 2020 covering key issues for sponsors ahead of the 2020 year-end.
Register your place here

Managing balance sheet volatility and the funding/accounting gap

Pensions accounting has never been easy. But now, Covid-19-driven market volatility, increasing audit pressures, and a fast-growing gap between the accounting and funding yardsticks have all made it much harder. It's particularly important for CFOs, Financial Controllers and Company Treasurers to have a clear plan.

We reported in our Accounting for Pensions report that the aggregate position of the FTSE 100 pension schemes was the best it had been for over 20 years in the run up to the beginning of the Covid-19 pandemic. As you might imagine, since then the position has not been so rosy and as at September 2020 there is a deficit - the worst aggregate position for three years.

Estimated combined IAS19 position for FTSE 100 companies



Pensions accounting liabilities are based on an AA-rated corporate bond yield discount rate, plus the "best estimate" for all the other assumptions (including inflation and life expectancy), and are updated at least once a year. On the other hand, cash funding liabilities are driven by the triennial actuarial valuation, which is a negotiation between the company and the scheme trustees within a regime that requires the assumptions to be "prudent". For most (but not all) this results in funding liabilities being higher than accounting, perhaps by around 10% to 20%. The current direction of travel of the Pensions Regulator is expected to further increase this gap.

Be aware of the differences between accounting and funding - schemes with a disclosed IAS19 surplus can still require deficit contributions.

Covid-19 and recent market movements have exacerbated this situation (mainly because corporate bond yields increased relative to gilt yields over March). The chart below shows the change in the gap between IAS19 accounting liabilities and a typical funding measure (used to determine cash contributions) for a £1bn pension scheme. At the height of the pandemic, the difference between these two measures had almost trebled compared to year-end 2019.

Difference between IAS19 and funding measures for a £1bn pension scheme

Source: LCP calculations for a sample scheme with £1bn of IAS19 liabilities at 31 December 2019

The funding – accounting gap is material and very volatile: So What?

For investors:

- It's important but difficult to compare like with like.
  - Different accounting dates give very different results – these are luck of the draw and not a measure of how well the pension scheme is managed.
  - In general insufficient information on funding plans is disclosed to enable a fair comparison.
- Large cash contributions can still be required for those pension schemes with an accounting surplus.

For pension scheme sponsors:

- Volatile market conditions mean the balance sheet and next year's P&L may move materially in a short space of time. Keep up to date and ensure there are no surprises come the year-end.
- Consider reviewing your disclosures to ensure the differences between the accounting and funding measures are explained – potentially not just in the pensions note, but in the wider key accounting issues or perhaps even in the strategic report.
- The overall position now may be worse than at the beginning of the year – consider a review of all assumptions, including those that are potentially seen as less material (for example, commutation or percentage married). Whilst the impact of an individual assumption in isolation may be small, a number of small changes combined can lead to a material overall impact.
- Engaging investors on these issues can help from both a reputational and an economic perspective.

RPI reform – impact on accounting remains uncertain

As we noted in last year's report, the accounting impact of RPI reform will vary considerably for each company based on the specifics of each pension scheme. It will bring huge good news for some, huge bad news for others, and somewhere in between for many.

Over the last 12 months, some companies have adjusted their approach to setting inflation assumptions with small average changes to both RPI and CPI inflation disclosed. The final results of the consultation are not currently clear and that leaves companies (once again) in a state of uncertainty where a range of different approaches can be justified.

Given this uncertainty, there is a wide range of different options companies could take to set their inflation assumptions - the key is to ensure that they are set based on a consistent rationale and avoid any unintended (and illogical) consequences.

Our experience to date is that audit firms require justification for the chosen approach – sometimes requiring market evidence to support this. Given what causes market movements and what the future may hold are both so subjective but also so material, we recommend tackling this issue and agreeing a course of action early in the corporate reporting process.

Setting life expectancy assumptions

Our 2020 Accounting for Pensions report described the challenges for company directors in setting appropriate life expectancy assumptions in the light of the material judgements required and the large number of separate parameters that have to be decided upon.

If companies use the latest life expectancy projections that were released in March 2020 (the CMI 2019 projections), this will, all else equal, lead to a small increase in life expectancy and a corresponding increase in accounting liabilities. In the current climate, companies will need to carefully consider whether this increase is appropriate.

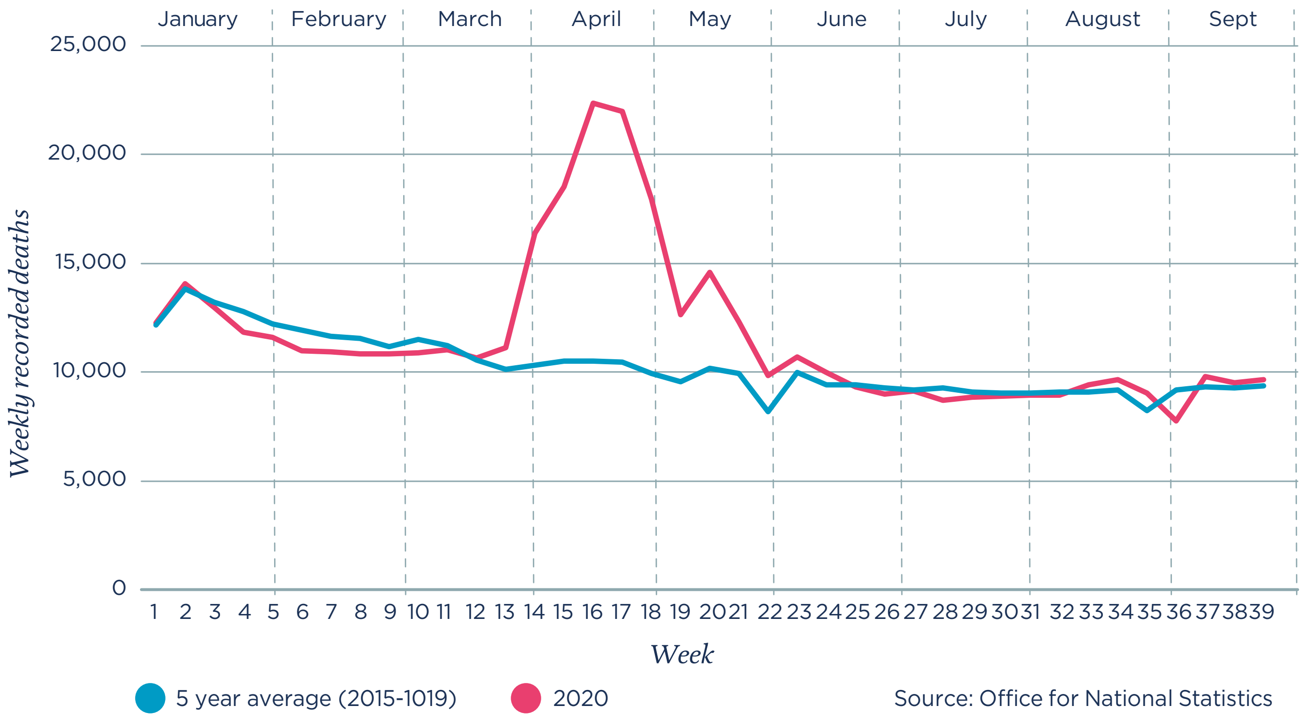
Looking ahead, and whilst not an issue for those reporting as at December 2020, the experience and increased number of deaths observed over 2020 would typically be reflected in the next set of life expectancy projections to be released in March 2021 (the CMI 2020 projections). However, the body that sets these projections recently announced a consultation on how the data from 2020 should be included. The consultation closes on 1 November 2020, with the outcome expected mid-December. Based on the number of deaths over the year to September, if no changes are made to how data is allowed for, the CMI 2020 projections could see a 4% reduction in assumed life expectancy – equivalent to a £20bn swing in balance sheet position for the FTSE 100.

The chart on the following page shows the number of deaths recorded weekly over 2020 to date (pink line) and how this compares with the last five years (blue line). The large potential decrease in life expectancy is driven by the number of deaths observed over spring. It does not allow for any potential uptick or second wave over the later months of 2020.

The new CMI 2020 life expectancy projections could reduce FTSE100 liabilities by over

£20bn

Total weekly deaths reported in England and Wales



Accounting for GMP equalisation – it's not over yet (and we said the same last year)

Company directors could be forgiven for thinking that accounting for GMP equalisation is done and dusted, given that virtually all affected companies reported a reserve for this at the first accounting date following the Lloyds Bank judgment in October 2018 (see the analysis of these disclosures for the FTSE 100 in our 2019 Accounting for Pensions report).

As we said in our report last year, auditors might expect sponsors to recalibrate their balance sheet reserve at the year-end (for example if there is new data, changes in assumed approach to GMP equalisation, or significant new analysis by the pension scheme trustees). For some there is still a risk that any recalibration will cause a new hit to profits. Companies need to manage these accounting risks proactively to avoid yet more surprises.

Perhaps of more universal relevance is that there is now a risk that you may need to recognise a further liability this year-end. Lloyds went back to court in May 2020 to seek clarification on whether there is also a liability in respect of members that have transferred out of their scheme. We understand the judge has recently asked for further submissions on the case at the end of October and it is possible we may receive a judgment some time between late November and January.

For many schemes the number of past transfers out, particularly prior to the freedom and choice reforms in 2015, was not very high, so any additional liability might be small and immaterial. However, for some it will be higher and the impact could be much more material particularly if, for example, the judgment covers bulk transfers or if schemes have conducted liability management exercises.

We have yet another twist in the GMP saga - hopefully immaterial for most but it could be potentially very significant for others. It must be covered off early in the year end process.

Jonathan Griffith
Partner

Seven issues to consider as a result of the upcoming judgment:

Lookback period -
Is it 6 years or 30 years?

Is it just individual transfers or also bulk transfers (much bigger issue)?

Is the data readily available to identify the level of transfers over the relevant period?

How high was transfer activity before Freedom and Choice was introduced in 2016?

If material, how should the extra liability be recognised? P&L or OCI?

Will the scheme receive any money in respect of transferred in benefits?

For bulk transfers, was anything covered in the sale and purchase agreements? This will likely require specialist legal advice as the impact could be very material if there is a liability.

From a practical perspective, there is a risk that the timing of the judgment will leave little time to react, answer these questions, and consider the impact ahead of the year-end. If the judgment comes in the new year, a worst-case scenario could be that the impact is material enough to trigger a requirement to adjust year-end accounts for a post-balance sheet event.

Accounting for full scheme buy-in / out – nobody can agree

Full scheme buy-ins and buy-outs have become much more common than in the past - the pensions bulk annuity insurance market is busy with over £80bn of transactions over the last three years. Further information is in our de-risking report.

Opinions and past practice are mixed on how to account for this and could be:

- **Other Comprehensive Income:** the initial full scheme buy-in is just an investment decision - even if it is more than likely to be followed by a full buy-out.
- **P&L:** there is a clear intention to convert a full buy-in to a buy-out, and as such this should be the determining factor.

Unless and until a clear market consensus emerges, this is an issue for companies to consider and manage carefully in advance at the early planning stage. This could involve proactive discussions with the pension scheme trustees to ensure the corporate view is recorded.

IFRIC14: gone but not forgotten

At its meeting in February 2020, the IASB decided not to finalise the proposed amendments to IFRIC14. This, at last, drew a line through the changes that were first proposed back in 2015 and could have brought a hit to corporate balance sheets of tens of billions of pounds.

The risk of future changes to IFRIC14 has not gone altogether, and the Board will consider the project's direction at a future meeting and whether to develop new proposals.

Possible IAS19 disclosure changes

The IASB is using IAS19 as an early test of its wider Disclosure Initiative (as well as IFRS13 which deals with fair value of assets). This may lead in time to additional disclosure requirements further increasing the length of a typical pensions disclosure.

Whilst the IASB have completed their technical decisions on the proposed changes, in order to assist stakeholders affected by the coronavirus pandemic the publication of an Exposure Draft of the amendments has been postponed (expected March 2021). Once published, there will be a 180 day period for comments on the Draft, so it is likely that any potential changes will not be in place for some time yet.

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