

A changing landscape

Protecting shareholder value in the
face of changing pensions regulation

October 2019



Written for corporate sponsors

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

In this report:



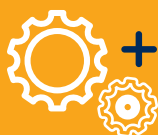
We address the key challenge for corporate sponsors: how do we ensure members get their benefits without compromising shareholder value? The regulatory direction of travel is putting more pressure on the use of corporate resources, and the Regulator has acknowledged this in its comments about the use of contingent assets. We expand on this with several case studies that show how a range of different contingent assets can be used to deliver this very outcome.



The evolving need to agree a "low-dependency on sponsor" long-term funding target and journey plan to get there really focuses the spotlight on the importance of investment strategy. We discuss the importance of sponsors taking the initiative in this area, and we focus here on the often neglected aspect of how the investment strategy affects the sponsor's balance sheet and income statement.



We provide a brief run-through of the wide range of current and upcoming legal and regulatory developments (including what's in the Pensions Bill released in October 2019), and what sponsors should do about these. In addition to funding changes, companies face beefed-up regulator powers, stricter rules around corporate governance, big developments in the area of member options, and a new market in DB consolidators. On top of these developments, we now have confirmation that the RPI measure of inflation may change. Even though this may not happen until 2030, this change to RPI has important consequences (potentially good news for some, bad news for others) which affect decisions being made now.



Finally, we outline the key things for you to do to prepare for 2019 year-end reporting. This includes what to do about all-time low corporate bond yields, how to reflect the RPI reform in balance sheet figures, what to assume about future longevity changes, how to avoid being tripped up by the new rules on special events, how to manage accounting risks from any true-ups to the GMP equalisation reserve, and several other actions.



Phil Cuddeford
Head of Corporate
Consulting

"Regulations are changing quickly. Corporate sponsors need to take advantage of the latest thinking to ensure they comply in a way that protects member benefits and shareholder value. Markets are also changing quickly and the recent announcements on RPI reform introduce big risks and opportunities. Sponsors who engage now will be best placed to deal with these."

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LCP Accounting for Pensions 2019

A concise analysis of the key facts, figures and trends revealed by FTSE 100 companies reporting in 2018.



www.lcp.uk.com/afp

Continued surplus for the FTSE 100

For the first time in two decades, 2018 saw the aggregate FTSE 100 pensions accounting surplus throughout the whole year.



Life expectancy

New life expectancy assumptions have decreased life expectancies and IAS19 liabilities. However, the increasing number of parameters now available has made setting this judgmental assumption even more difficult for company directors.

There's now over **£50bn** of subjectivity within this assumption for the FTSE 100 (around twice as much as within either the discount rate or inflation assumptions).



Executive pensions

FTSE 100 companies paid pension contributions to CEOs averaging 25% of their pay. Due to high profile pressure from regulators and investors, we predict this figure will be significantly reduced over 2019.



Contributions vs dividends

FTSE 100 companies paid on average

7 times more

in dividends than pension contributions. Whilst regulatory focus is increasing in this area, a simple dividend to contributions ratio is not adequate to assess whether a given company is behaving appropriately.





Section 1:

Journey planning from a sponsor perspective



Section 1: Journey planning from a sponsor perspective

Regulator ramping up its guidance

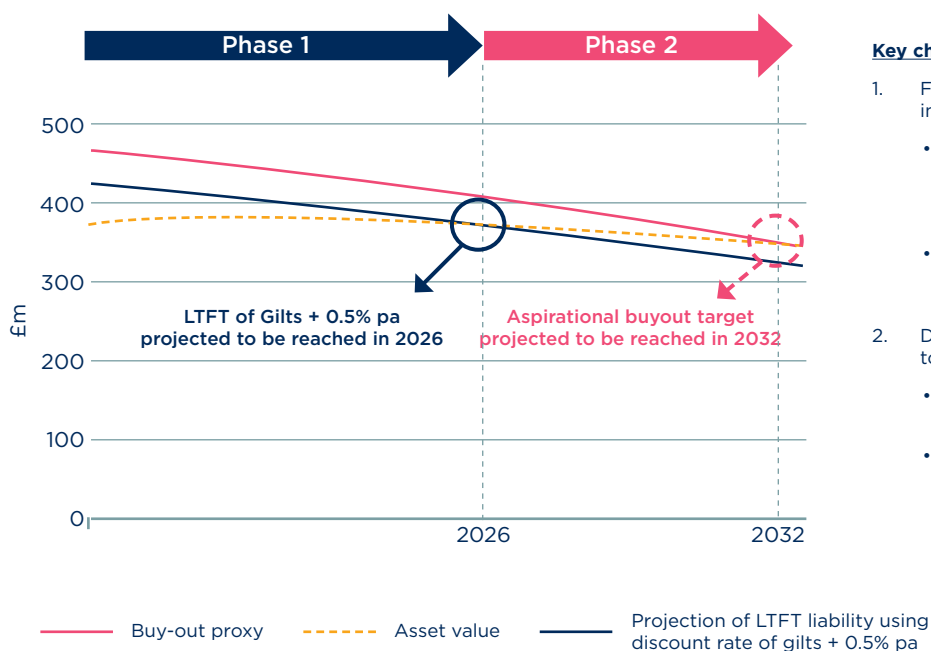
Following the Government's 2018 DB White Paper, the Pensions Regulator has been ramping up its guidance – its 2018 and 2019 annual funding statements and its more recent blogs all clearly signal a move towards a new world of DB pensions regulation. This is to be backed by new legislation, set out in the Pensions Bill released in October 2019, to make enforcement easier. Themes include:

1. A focus on deficit contributions vs dividends.
2. A focus on “mending the roof while the sun's shining” (or “pay now while you can still afford to”), along with new KPIs (set by the regulator in its own corporate plan) for the regulator to increase deficit contributions and reduce the length of recovery plans.
3. An expectation of a “long term funding target” (LTFT), to soon be enshrined in the upcoming revised funding code, with an agreed journey plan to get there.

We discussed (1), (2) and (3) in our Accounting for Pensions reports in [May 2018](#), [October 2018](#) and [May 2019](#). As regards (3):

- Proactive sponsor engagement and collaboration with the pension scheme trustees is likely to lead more quickly to a better solution (see [here](#) for the trustee perspective).
- The need to agree a journey plan gives the sponsor a good opportunity to proactively influence the pace and nature of de-risking in general and the investment strategy in particular.
- The “Funding” in LTFT doesn't mean the technical provisions (TPs) have to become the LTFT overnight, but it does mean there will need to be a clear demonstration of how the TPs will move to the LTFT over time.

Case study: Incorporating an aspirational target alongside a long-term funding commitment



Key characteristics of journey plan:

1. Funding target will move to gilts +0.5% pa in the longer-term
 - Provides downside protection to Trustees and a “back-up” plan to run-off with a low dependency on sponsor.
 - Doesn't overly commit the sponsor to fund buyout regardless of price/affordability.
2. Doesn't lose sight of longer-term aspiration to achieve buyout
 - Provided it can be achieved without significant additional contributions.
 - Ensures de-risking and investment decisions are taken with this context (e.g. avoids excessive de-risking once long-term funding target is met).

There are a number of things a sponsor can do to manage the impact of adopting a LTFT on its resources:

- If the LTFT is to reach a “self-sufficiency” measure with minimal calls on the sponsor and supported by a low-risk investment strategy, make sure that “prudence” is clearly quantified and **remove any hidden prudence** (which can sit across several non-key assumptions and can add up).
- Ensure the **agreed timeframe** for reaching the LTFT is appropriate – subject to covenant, there will often be no need to rush to the LTFT before members are predominantly retired (in the meantime, cash flows are uncertain, and the natural maturing of the scheme should tend to close the gap to the LTFT).
- Consider how the **investment strategy** develops, e.g. with a **flatter risk profile over time** – this can be a “win-win” as significant de-risking can be achieved sooner without being committed to de-risking too much or at inopportune times. Consider liability management and effective communication to members to reduce the size of the liabilities and **close the gap to the LTFT more quickly**.
- Consider the use of **contingent assets** to limit the sponsor’s immediate (and perhaps ultimate) cash commitment and reduce the risk of a trapped surplus in the scheme.

We expect that the regulatory direction of travel outlined above will lead to an increase in the use of contingent assets – indeed, the regulator has explicitly acknowledged this:

“We recognise that contingent assets or asset-backed funding might be appropriate more widely, for example, where cash flow is constrained but security is available, or if the employer has concerns over trapped surplus” – 2019 Annual Funding Statement.

The graphic below summarises the different contingent assets into their main category types. In practice, it often makes sense to combine different contingent assets to cover different eventualities such as funding and/or covenant downturns and perhaps also to address issues around the “fair” allocation of resources. See also the case study on page 10 showing how a flexible approach can improve use of resources for the sponsor in a volatile market.

We recognise that contingent assets or asset-backed funding might be appropriate more widely, for example, where cash flow is constrained but security is available, or if the employer has concerns over trapped surplus.

**2019 Annual
Funding Statement**

<i>Credit</i>	<i>Cash</i>	<i>Assets</i>	<i>Corporate actions</i>
Parent or bank guarantees	Escrow account	Charge over assets	Dividend or profit sharing
Surety bonds	Reservoir trust	Asset backed funding	Negative pledges

Contingent funding – bridging the gap

Below we consider the effectiveness of five of these eight contingent asset categories at managing different concerns. This table is simplified for illustration; the attractiveness of different solutions will be circumstance-specific, and there are other considerations (including sponsor costs and risks, legal, tax and accounting issues).

	Credit		Cash	Assets	
	Parent guarantee	Surety bond or letter of credit	Escrow account	Charge over assets	Asset backed funding
What is it?	Promise of support from the parent or other group company	Guarantee from insurers or banks to pay scheme on trigger events in return for a premium	Assets held on account by 3rd party which will release to scheme on trigger event	Sponsor provides security over cash account/specific asset – realised on trigger event	Future payments to scheme from assets held jointly by scheme and sponsor in partnership vehicle
Simple to set up	●	●	●	●	●
Flexibility	●	●	●	●	●
Excess funds/assets repayable to employer?	n/a	n/a	●	●	●
Recognised by PPF? (subject to conditions)	●	●	●	●	●
Upfront tax deduction for employer	n/a	n/a	●	n/a	●
IFRIC14 (balance sheet risk) mitigation	Depends	Depends	●	●	●

The following case studies focus on escrow type solutions, as we believe this is the type of contingent asset that is most likely to become more popular in the new funding world.



Gordon Watchorn
Partner

“Given improving funding levels and the direction of travel from tPR, we are helping corporates proactively approach valuations, proposing a range of contingent assets to support the scheme and reduce the need to pay excessive cash into the scheme.”

Case study – a simple escrow structure

This simplified case study shows that the use of an escrow can fully protect member benefits while providing the sponsor with the likelihood that some of the escrow funds are returned to the business to ensure shareholder value is protected.

Background

Scheme funding:

Assets £400m,
TP deficit c.£50m.

Recovery plan:

Annual deficit contributions
of c.£10m pa for 5 years.

Long-term objective:

To be fully funded on a buy-out proxy basis
("gilts-flat") in 10 years when most members are
pensioners. The current deficit on this measure
is c.£100m.

Investment strategy:

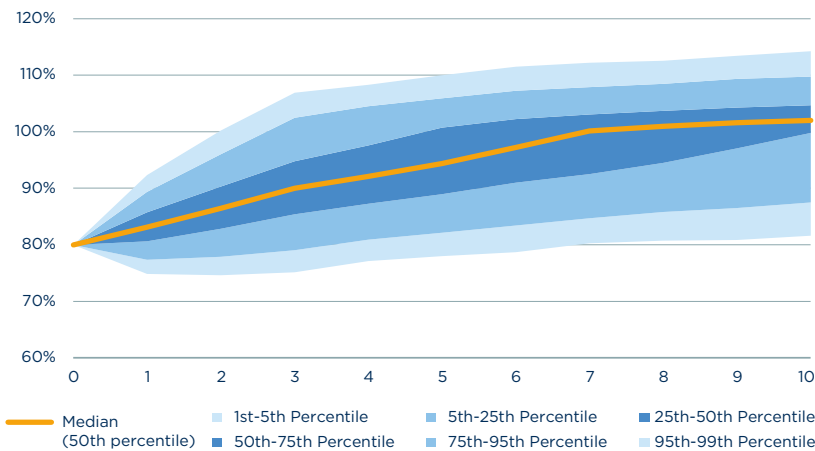
Target best estimate returns of gilts + 2% pa long-term,
and to de-risk this strategy if the long-term objective
is reached before the scheme is mature enough
to make a buy-out realistic without substantial cash.

Covenant:

Sponsor is assessed as "tending to strong."

What outcomes are expected (before escrow)?

Modelled range of funding levels over time on the buyout proxy measure



The chart shows that the long-term funding objective is expected to be achieved in 7 years, three years ahead of target. It also shows that in many scenarios, full funding can be achieved well before this time. The sponsor wanted to protect itself from having paid in more cash than needed in those upside scenarios whilst protecting member security in the downside.

Terms of escrow account

In this case, the escrow design was very simple:

All contributions agreed in the Recovery Plan were initially paid to the escrow account.

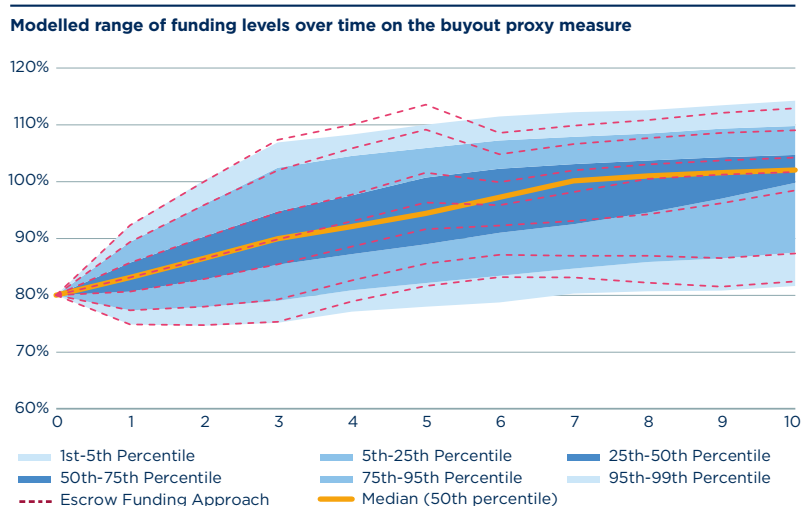
After five years, any deficit on the Technical Provisions measure up to the value of the escrow was paid from the escrow to the scheme, and any excess was repaid to the sponsor.

In the event of sponsor insolvency, the escrow funds are paid to the scheme.

The assets in the escrow were held in cash.

Journey planning from a sponsor perspective continued

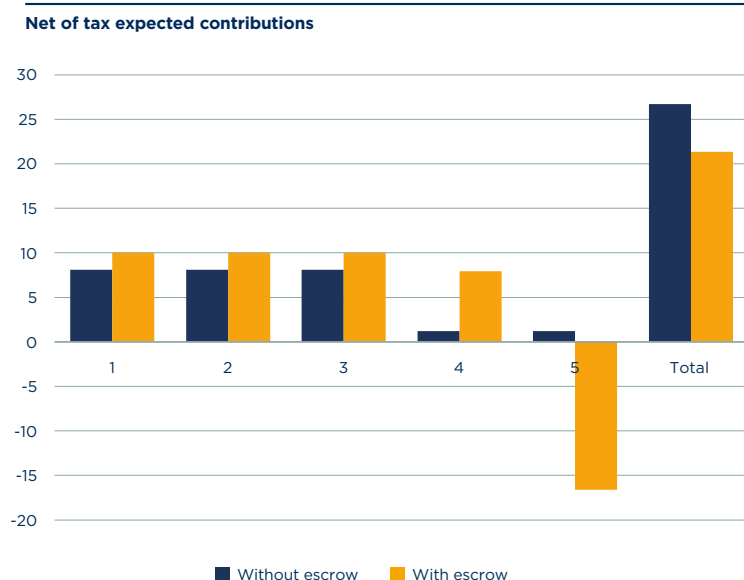
The chart below compares the outcomes from this approach (dotted lines) with the traditional approach (shaded areas).



company expects to get
c50%
of escrow back

The funding position in the chart above includes the value of funds in the escrow account and shows that the range of funding outcomes for the pension scheme is very similar under both scenarios.

In addition, c50% of the value of the escrow is expected to be returned to the company. The net of tax cash flow over the next five years for the escrow based approach is therefore likely to be more advantageous for the sponsor. However, there are some differences in individual years as payments to the escrow do not attract tax relief when they are paid - the chart below shows the net of tax expected payments into the scheme with escrow (orange bars) and without escrow (blue bars).



company expected
to pay
c£5m
less into scheme on
average having set up
an escrow account.

In upside scenarios most or all of the escrow is refunded to the sponsor, and in downside scenarios this is paid to the scheme.

There will also be – potentially substantial – advantages of funding to an escrow account for companies that might be impacted by any changes to the [IFRIC14](#) asset limit rules under IAS19 reporting, and therefore knock-on benefits for the corporate balance sheet.

Case study – flexible multi-approach solution

Background

Scheme funding:

TP deficit £300m,
assets £1.2bn

Accounting:

IAS19 surplus £50m

Sponsor objectives:

Provide robust financial support

Avoid inefficient use of sponsor resource and minimise risk of excessive funding

De-risk scheme over time as it progresses towards its Long-term Funding Target

Solution

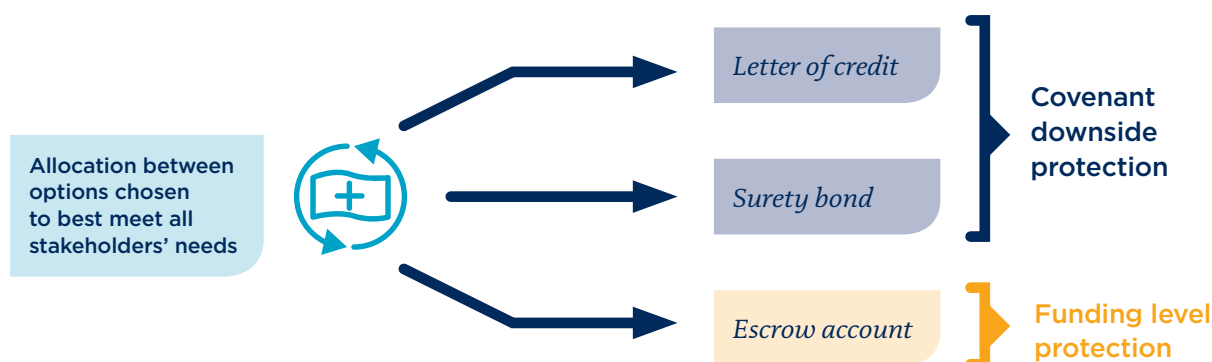
Around £150m of contributions was paid immediately into an escrow account.

The company supplemented the escrow with a surety bond and agreed an approach for maintaining protection going forward. The key point is the flexibility built into this approach: over time, the sponsor has some pre-agreed choices about how it provides the level of protection between escrow, surety bonds and letters of credit, and can make that choice in part depending on how the cost of capital of funding the escrow compares to the market pricing of each of the letter of credit and surety bond.

Conclusion

Sophisticated strategies that enhance capital efficiency are available – with different options being optimal for different sized schemes and sponsors.

Flexible approach to contingent assets



Aside – investing escrow funds and capital efficiency

The most common investment allocation within an escrow is for the funds to be held as cash. On the face of it, this looks like an inefficient use of capital. While other solutions can achieve the same outcomes, holding the escrow investments in cash provides the following benefits:

- Low fees and ease of governance
- Lower P&L volatility – the investment gains/losses within escrow are usually booked to corporate P&L
- Increased certainty to the trustees – reducing the need for any haircuts to be placed on the amount contributed.

If required, a scheme's investments can be adjusted to maintain the overall levels of expected risk and return.



Section 2:

*Investment –
sponsors to take
the initiative*



Section 2: Investment – sponsors to take the initiative

There are many reasons why sponsors should take the initiative in DB pensions investment:

1. **Journey planning:** the new requirement to agree a journey plan provides an opportunity for sponsors to take the initiative and proactively collaborate and seek agreement with their pension Trustees.
2. **Fees:** every extra £ of investment management fees worsens the funding position by a £ which is underwritten by the sponsor. Sponsors can take actions to save large amounts of money.
3. **Interaction with accounting:** Pension scheme trustees don't usually make investment decisions based on the impact on corporate accounting. Corporate sponsors should therefore be wary of potential adverse accounting impacts and “nudge” investment decisions accordingly.

In the rest of this section we focus on the interaction with accounting.

Investment – factors that impact balance sheet / P&L

Interest rate and inflation hedging

- High interest rate hedging levels can weaken balance sheets if interest rates rise. This can arise because accounting liabilities are usually lower than funding liabilities (due to the requirement to be prudent for funding). This can lead to an “over-hedging” of interest rates on the accounting measure whereby falls in asset values as interest rates rise are not fully offset by falls in the accounting liabilities. This effect is likely to get worse over time, as funding liabilities will now increase as they move towards a long-term funding target. The extent to which this is offset, if at all, by any “natural hedging” within the business more widely will be one of several factors affecting the sponsor's attitude to this risk.
- High inflation hedging levels cause a similar challenge - and the impact is often more severe eg due to an inflation risk premium and best estimate CPI assumptions: see case study overleaf.
- Testing your hedge ratios against the accounting measure and checking for any instances of “over-hedging” can be a very useful exercise. Trustees are usually open to accepting a range of hedge ratios and sponsors could “nudge” the hedge ratios to avoid surprising accounting impacts.

Corporate bond allocation

- All else equal, investment grade corporate bonds are attractive to sponsors as they offer some balance sheet protection against falling credit spreads and a high degree of investment security (due to the low chance of default).
- For companies with schemes in surplus, a higher allocation to corporate bonds could also better stabilise P&L. (Profit is weakened when corporate bond yields fall, so having assets that perform well in this environment and vice versa, such as corporate bonds, would dampen volatility).

Insurance transactions

- Insurance “buy-ins” usually result in a weaker balance sheet as the IAS19 asset value of the insurance policy is typically lower than the premium paid (there may be more flexibility here under US GAAP than IAS19).
- For many, this can be a good trade-off given the risk reduction, but for balance-sheet focussed corporates, it may be more palatable to reduce risk in other ways (e.g. LDI and longevity hedging) unless the scheme is in substantial IAS19 surplus.

Asset performance

- Good asset performance improves the balance sheets for both accounting and funding.
- However, if the corporate is sensitive to balance sheet volatility (e.g. if the scheme is very large compared to the corporate) then lower volatility strategies should be considered (e.g. higher levels of diversification or explicit equity protection strategies).
- Under US GAAP, expected return on assets can play a big role - all else equal, higher expected returns lead to better P&L (albeit for some, recent US GAAP changes mean this is no longer an Operating credit). It's therefore important for sponsors reporting under US GAAP to consider expected returns when consulting with their trustees on investment strategy and reflecting these within the accounting assumptions (such as dynamic LDI outperformance assumptions, and updating credit premium assumptions to correctly reflect the underlying credit rating/risk profile).

Case study – inflation hedging may not be what you think it is for your balance sheet

Scheme funding:

- £500m liabilities (i.e. 90% funding level and £50m deficit).
- 90% interest rate and inflation hedging.

Accounting:

- £400m liabilities (i.e. £50m surplus).
- The interest rate hedge ratio is 120% and inflation hedge ratio is 150%.

Inflation expectations fall by 0.5% pa:

- Funding liabilities fall by £50m, asset value falls by 90% of this amount, ie £45m. Funding level remains at 90% and deficit falls slightly from £50m to £45m.
- Accounting liabilities only fall by £30m, but assets still fall by £45m. The result is a fall in the accounting surplus from £50m to £35m and next year's pension P&L credit falls by 30% - **so the “good news” from lower inflation expectations worsens the sponsor's balance sheet and P&L.**

Why can the hedge ratio be higher for accounting than funding?

- The accounting liability is often a lower value.
- Due to the inclusion of an “inflation risk premium”, the inflation assumptions are typically lower for accounting – this can lead to lower long-term inflation sensitivity for the accounting measure.
- The longevity assumptions are required to be a sponsor's best estimate and not prudent, meaning the long-term impact of inflation-linkages over time is reduced, further reducing the inflation sensitivity of the accounting measure.
- The inflation sensitivity of the assets can therefore be considerably higher as a proportion of the accounting measure than the funding measure.



David Wrigley
Partner

“Trustees generally don’t assess the hedge ratios against the sponsor’s accounting measure, meaning this effect can often go unnoticed until it’s too late. The most appropriate action (if any) to address this will depend on many factors, but at the very least the sponsor should consider these effects as part of the investment strategy consultation discussions.”

Section 3:

Important changes in the pensions landscape for corporates



Section 3: Important changes in the pensions landscape for corporates

The pensions world is constantly changing. Here are some of the key developments that could have a major impact on corporate pension sponsors.

New funding requirements

The DWP's March 2018 White Paper on "Protecting DB Pension Schemes" stated that there will be a new DB funding Code of Practice along with associated legislation. This was confirmed in the government's Pensions Bill that was released in October 2019. We currently expect the first consultation (on the principles) early in 2020, with the second consultation (on the Code itself) around summer 2020.

There will be a "fast track" route to compliance, or an alternative "bespoke approach" attracting greater regulator scrutiny and engagement. While the regulator expects most (in particular smaller schemes) to go down the "fast track" route, we expect a significant number of complex or large schemes will use the "bespoke" approach.

As some of this thinking is already built in to the regulator's 2019 Annual Funding Statement, many sponsors and trustees are already working together with the LTFT mindset. Those sponsors that are on the front foot will be more likely to construct and agree an overall long term funding and investment strategy that satisfies the needs of all stakeholders – as described earlier the use of contingent funding is one way to help achieve this.

The Pensions Bill state that employer agreement will be required for the long term funding and investment target.

RPI reform will affect almost every pensions decision - now.

On 4 September 2019 it was confirmed that the UK Statistics Authority intends to reform RPI so that it essentially becomes CPIH from 2030 at the latest – this is not a government decision and should not be subject to political uncertainty.

There will be two consultations in January 2020, but only about (1) whether to bring forward this change to 2025 and (2) technical issues around the transition process.

CPIH is expected to be around 1% pa less than current RPI, a big difference. This means:

- DB scheme members with RPI-linked increases will expect to get lower pensions from 2030 than they otherwise would have had
- A net financial gain is expected if the scheme increases are mainly RPI-linked and this is only partially hedged (many schemes are in this situation)
- However, if the scheme increases are mainly CPI-linked and RPI instruments are in place to hedge this (e.g. index-linked gilts), then such schemes are likely to suffer a net financial loss.

This could impact actuarial valuations, company accounting, and long-term funding targets. We also expect buy-in and buy-out insurers and consolidators to charge less to take on RPI-linked benefits.

The response to date (October 2019) of index-linked gilt markets has been unexpectedly muted. Some of the potential reasons for this are that the market:

- had already priced this in
- believes that "compensation" will be paid to index-linked gilt holders (or other users of RPI)
- is primarily driven by supply and demand, which may not have changed
- is more driven by other factors including Brexit, uncertain political developments and recession risk.

RPI is changing from 2030.

Important changes in the pensions landscape for corporates

continued

In light of this response, there may still be opportunities for sponsors and trustees to re-position their inflation hedging strategies (particularly for CPI-linked liabilities) to better protect the scheme against any future market sell-off.

Sponsors should also consider this issue carefully if they are involved in any significant pensions action – for example, buying or selling of index-linked gilts or similar swaps, buy-ins and buy-outs, changing the index used for pension increases, transfer value or PIE exercises, and long-term journey planning.

Corporate governance and requirements for company directors

In April 2019 the House of Commons Business, Energy and Industrial Strategy (BEIS) Select Committee called for a tightening of the UK's dividend payment regime. It is unclear whether this will include consideration of pension deficit contributions but given the Pensions regulator's focus on this issue it seems likely – no further details are known at this time.

The BEIS have also announced proposals that company board directors should receive training on significant issues – for many this will include pensions.

Regulating DB consolidators

In December 2018 the DWP launched a consultation on the design of a legal framework and authorisation regime for commercial vehicles offering to consolidate DB schemes.

At the same time the Pensions regulator issued separate guidance: for trustees and sponsors looking to transfer to a DB consolidator before DWP's framework is in place; and for the vehicles themselves on the regulator's expectations.

The consultation closed on 1 February 2019, but the DWP has delayed its progress since then. We are expecting a number of clearance applications to be considered by The Pensions Regulator in the coming months when there is more clarity.

LCP's DB consolidator team has identified a set of "sweet spot" situations where [DB consolidators](#) may be the optimal end-game solution. Sponsors should ensure this is included in the long-list of their journey plan considerations.

Member options and transfer values – Significant developments

Sponsors are increasingly focussing on this area: with a view to helping their members make better decisions; and as an integral part of a holistic journey plan.

In the light of the clear risks and negative publicity in several high-profile cases, there are several regulatory and guidance developments including a proposed ban on contingent charging of IFAs (FCA consultation) and a new Pension Transfer Gold Standard.

In addition, some of the trends in market practice include:

- Providing ongoing access to chosen IFA(s) (sometimes subsidised).
- Online portals for members to see their options with illustrative figures in real time, plus general education materials and videos.
- [Partial transfers](#) being increasingly offered and clearly communicated, to manage risks for all parties.

GMP equalisation has come of age – but still lots to do

Following the judgment in the Lloyds Bank case in October 2018, sponsors are proactively engaging with trustees on GMP equalisation, often even where the estimated impact is small. This is because options such as GMP conversion offer opportunities to deliver a cleaner long-term solution with lower administration burden, costs and risks; conversion also simplifies the benefit structure which can improve both communications and insurer buyout pricing.

The Lloyds Bank Trustee recently confirmed that the only outstanding technical question to be explored with the courts (around April - May 2020) is whether there is a need to revisit past transfers out or other events where members have cashed in their benefits (other questions such as "anti-franking" will not be discussed). The court process is therefore no longer a reason to hold up addressing equalisation.

Beyond the court question, we still have three main areas of uncertainty:

- the pensions tax position
- whether conversion legislation will change
- what the recently formed Equalisation Working Group will continue to put forward as "good practice".

We hope that there will be significant progress in all three areas over the coming months. In the meantime sponsors can meaningfully get on with analysing their membership, understanding their options and engaging with the trustees on the likely options to focus on.

More Pensions Regulator powers

In February 2019, the government published its response to the DWP's June 2018 consultation on beefing up the powers of The Pensions Regulator.

Important changes in the pensions landscape for corporates

continued

The Pensions Bill released in October this year confirmed that The Pensions Regulator will gain significant new powers to tackle corporate misbehaviour. However, there has been a change to the wording of the key text from “*wilful and reckless*” behaviour, to any “*... act....or course of conduct that detrimentally affects in a material way the likelihood of ... benefits being received*”. Crucially this new power would apply whether an individual knew or “*ought to have known*” about the impact of the action.

This means that, going forwards, it will likely be important for companies to consider at full Board level the potential impact on pension benefits of any corporate refinancing or restructuring, the company’s dividend policy, and any other issues that individual directors might reasonably be expected to know that could impact their pension schemes. Failure to do so could lead to jail sentences for company directors of up to 7 years and very large personal fines.

The main proposal areas are:

- **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 would bring timing, cost, confidentiality and commercial challenges and more consultation is needed on content and timing.
- **Anti-avoidance powers:** Significant additions and adjustments to the current Contribution Notice (CN) powers, a lower bar for the regulator to impose a CN on employers, and various changes to the Financial Support Directions.
- **New criminal and civil penalties:** A host of new criminal and civil penalties for corporates and directors for a range of offences. These include conduct that detrimentally affects the likelihood of benefits being received or the avoidance of employer debt (undefined but up to 7 years in prison and unlimited fines), failure to comply with a “Contribution Notice” (unlimited fines), failure to comply with a Financial Support Direction, the Notifiable Events Framework, the Declaration of Intent requirements or providing false information to trustees or regulator (each attracting fines up to £1m).
- **Information gathering powers:** New regulator powers to interview corporate directors and inspect premises.

Responsible Investment (RI) – opportunity for sponsors

Many pension trustees are enhancing their RI approach, prompted by new legislative requirements and scrutiny from the regulator, politicians and members. RI can help companies manage pension costs, improve their employee satisfaction and protect against reputational risk. We recommend that employers have active input into their pension schemes’ RI policies and consider whether the pension scheme RI principles need to be more aligned with their corporate responsibility position. See [here](#) for further details.

Collective Defined Contribution (CDC)

The basic principle of the CDC approach is to share risks between members. One of the key characteristics of this particular approach being focussed on is the need to be able to reduce benefits (which will require new legislation).

In October 2019, the Pension Bill provided much awaited new insight around how CDC schemes will operate in the UK. The approach set out in the bill appears to be much broader than the original CDC model proposed by the Royal Mail by allowing two or more connected employers to set up new schemes. This will be good news for other companies and organisations minded to follow the Royal Mail example and enable employees to join a pension scheme that provides an income in retirement.

Important changes in the pensions landscape for corporates

continued

However, the implementation regime could yet prove difficult with The Pensions Regulator potentially taking a very significant role. For example, the regulator will need to be satisfied that schemes meet key requirements around financial sustainability and continuity, member communications and wider systems and controls, which could set new barriers. This emphasises the need for significant scale from the outset and for companies interested in the CDC route it will be important to watch how these detailed regulations take shape.

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

Executive pension changes

Following changes to the corporate governance code, strong statements by the BEIS, lobbying by the Investment Association (including [new guidelines](#) on 27 September 2019) and a significant amount of press coverage, some companies have recently begun to reduce the pensions and cash in lieu provided to their executives. More detail is in our [2019 Accounting for Pensions report](#) including benchmarking of the FTSE 100.

Companies should consider their options and potentially have a plan to act where:

- executives have a contribution tier with a pension/cash rate of 25% or higher;
- executive remuneration policy does not state that pension will be set in line with the majority of the workforce for future appointments; or
- executives are hired on a higher rate than the general workforce.



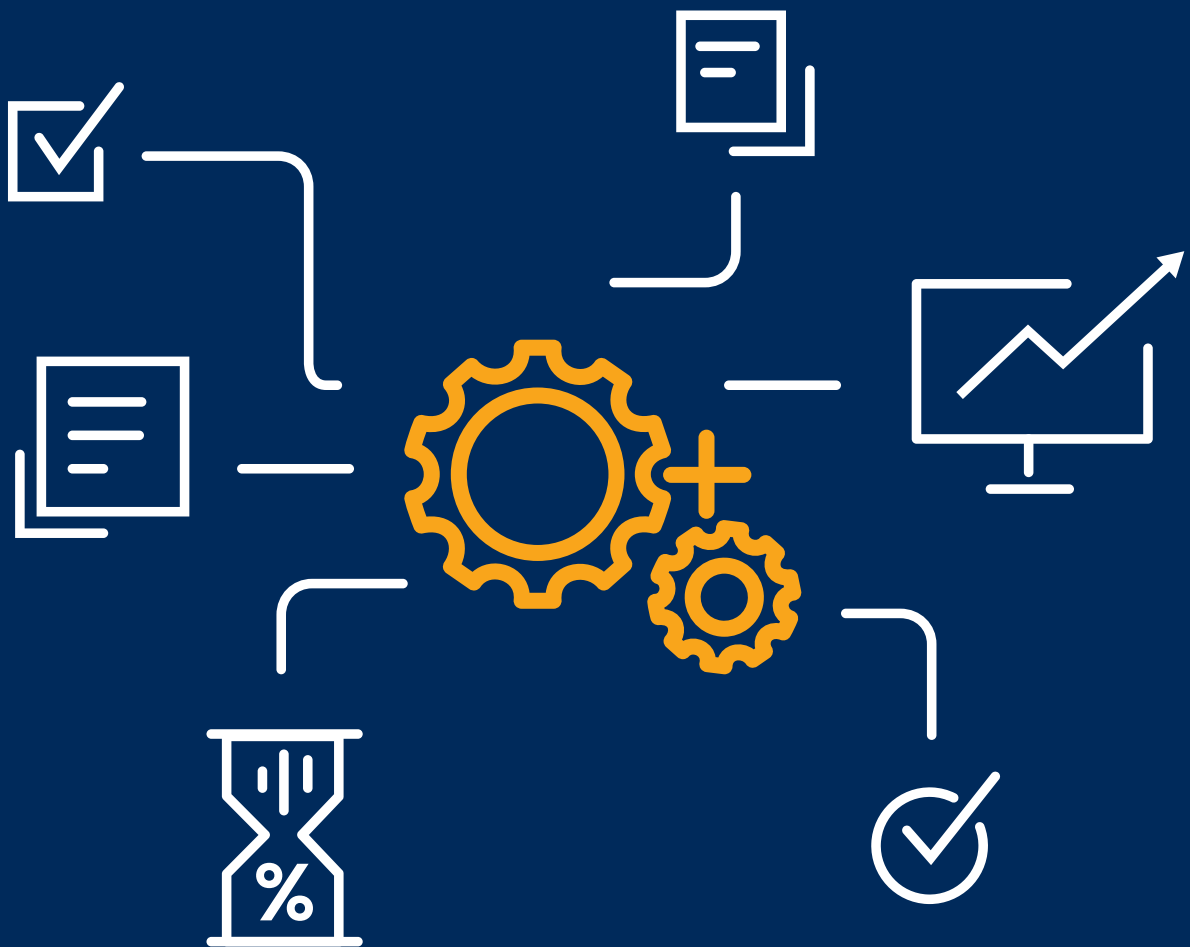
Phil Cuddeford
Head of Corporate Consulting

“The huge range of pensions legal, regulatory and market developments poses a real challenge to sponsors. Those who engage early will be best placed to protect their shareholder value by seizing opportunities and managing new and growing risks at an early stage.”



Section 4:

Preparing for the 2019 year-end



Section 4: Preparing for the 2019 year-end

Companies preparing for their 2019 accounting year-ends need to consider some or all of the following hot topics. See also our upcoming [webinar](#).

Corporate bond yields are at an all-time low

In September 2019 we have seen corporate bond yields hit a record low of well below 2% pa – even lower than the previous all-time record in the aftermath of the Brexit referendum in 2016.

The chart below shows that corporate bond yields have fallen by c.1% pa since 31 December 2018. For a company with a typical DB scheme this will cause a c.20% increase in the accounting liabilities. Unless their schemes are fully hedged against movements in corporate bond yields, companies are again faced with issues for balance sheets and P&L, which for some will bring knock-on implications for dividends, credit ratings, and the ability to raise capital.

For a company with a typical DB scheme this will cause a

c.20%

increase in the accounting liabilities.

Corporate bond yield (% pa)



Source: ICE / Merrill Lynch GBP Corporates AA 15+ index

So what can companies do about this fall in discount rate? There is some flexibility within the accounting standards as to how to set the discount rate and we continue to see a range of discount rates adopted by companies (as shown in our annual Accounting for Pensions report). We discuss this further in our recent blog post [here](#).

We have developed the LCP Treasury Model as a robust way to set accounting discount rates. This model addresses several issues with other common approaches and currently produces discount rates that are above typical audit benchmarks. You can find out more on the LCP Treasury Model in our 4 minute video- [watch it now](#).

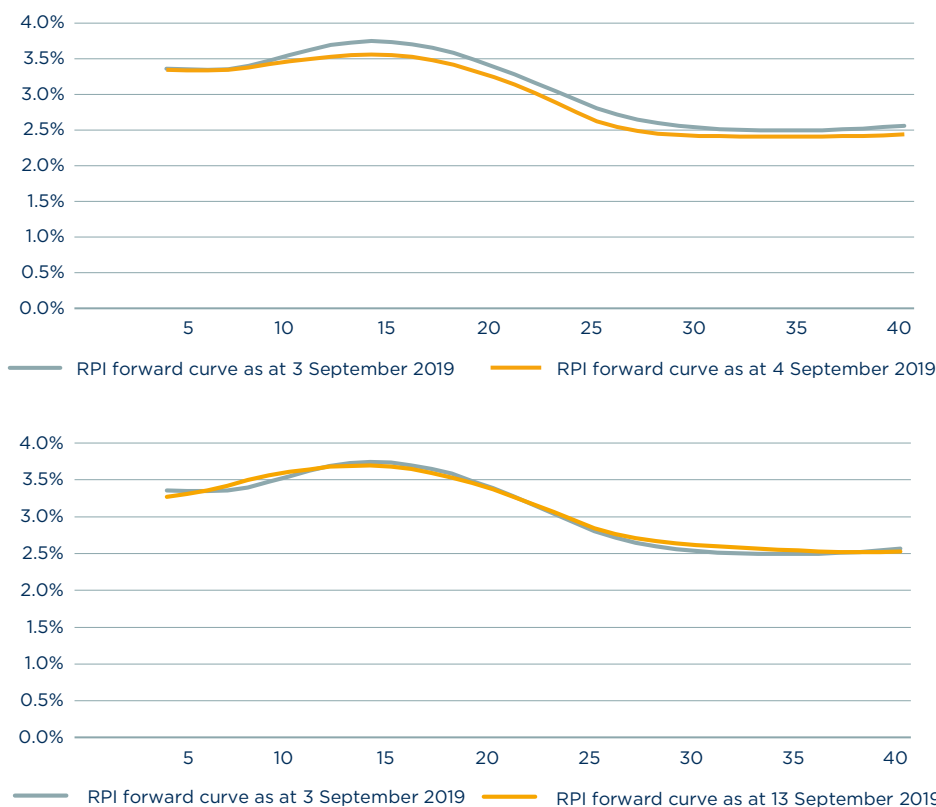
RPI reform – impact on accounting could be nil, or huge

This will bring huge good news for some, huge bad news for others, or somewhere in between.

In the light of the 4 September 2019 announcement on RPI reform (see page 15), there appears to be a general consensus that market-implied “breakeven” inflation is a less reliable guide to setting an RPI assumption than previously.

The charts below show the initial market reaction over one and ten days.

RPI forward curves fell on 4 September but had bounced back by 13 September



Source: Bank of England



Jonathan Griffith
Partner

“2019 has seen unprecedented market volatility and announcements on the future of inflation, as well as complex new mortality projections. In the face of a more robust audit regime, these developments bring new risks and challenges, but also opportunities for pension scheme sponsors.”

So where does that leave us for setting the year-end accounting assumption for RPI and CPI?

- There are strong arguments for the RPI assumption to be significantly lower from 2030 – perhaps even by as much as 1% pa. This would make allowance in the balance sheet an expectation of RPI reducing significantly from 2030 beyond what has been factored to date into market pricing of bonds. Given the expectation (in the absence of compensation) that RPI linked assets would fall in future, such a change now to the liability assumption could result in a large positive balance sheet movement now that is then offset by a negative balance sheet movement at some point in the future – an element of volatility that won't be attractive for all.
- RPI – CPI wedge: similar arguments to the above could lead to a zero or very small wedge assumption from 2030.

It will be important to set these assumptions consistently and to avoid unintended (and illogical) consequences; for example, reducing the wedge assumption without adjusting RPI inflation would simply increase the expectation for CPI – the one thing that we do not expect to change!

We expect that over the next few weeks the audit firms will develop specific audit guidance. We also expect pressure for clear disclosure of the significant judgements needed to derive these inflation assumptions, along with the sensitivities.

Setting longevity assumptions – keeps getting harder

Our [spring report](#) described the challenges for company directors in setting an appropriate set of longevity assumptions in the light of the judgements required and the large number of separate longevity parameters that have to be decided upon.

The most challenging aspect is the new “initial addition parameter” (“A”) designed to reflect different expected improvements for the pension scheme members compared to the general population of England and Wales. Recent analysis from the CMI suggests that between 2008 and 2015 more affluent groups (potentially such as members of DB pension schemes) have experienced higher longevity improvements than the general population. Further information is available within LCP's report on charting trends in longevity.

It's a significant assumption, which can increase the value placed on the liabilities by up to c5% and therefore very material for some balance sheets. This needs company directors (who are responsible for the accounting assumptions) to have a very clear view on questions such as:

- How, if at all, do we factor in the fact that there have been previous periods where more affluent groups experienced lower improvements than average rather than higher?
- Should we wait until a clear market consensus emerges on this assumption (this has not yet happened)?
- Should we place much emphasis on the affluence level of our scheme membership compared to the general population, and how robust is our data to back this up?
- Should we be consistent and keep the same level of prudence as in previous IAS19 valuations (which have all had A = 0 implicitly baked in)?

Whilst our experience over recent months is that some auditors have accepted A=0, they may start pushing companies to demonstrate a clearer justification for their chosen value at the upcoming year-end.



Accounting for GMP equalisation – it's not over yet

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 [Spring report](#)).

Depending on progress made to date and the scheme's specific circumstances, auditors could expect a possible recalibration of the balance sheet reserve at this year end (for example if there is new data, or significant new analysis). In addition, for some there is still a risk that any recalibration will cause a new hit to profits. Possible actions that could trigger such P&L charges include decisions to extend compensation beyond 7 years or to apply conversion of the GMP benefits. Companies need to manage these accounting risks proactively to avoid yet more surprises.

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

Full scheme buy-ins and buy-outs are now becoming much more common than in the past.

Opinions and practice to date are mixed on how to account for this. Some expect the initial full scheme buy-in to be booked to Other Comprehensive Income (outside P&L) as it is just an investment decision - even if it is more than likely to be followed by a full buy-out. Others argue for immediate P&L recognition of the buy-in with the underlying reason and rationale for the intended buy-out being the determining factor. Unless and until a clear market consensus emerges, this is an issue for companies to consider in advance and manage.

IFRIC14 continues to be high risk

As highlighted in our [Spring report](#), the International Accounting Standards Board is still considering changes to IFRIC14 which could bring significant extra liabilities onto the balance sheets of UK companies (£100bn or so for the FTSE 100).

Uncertainty remains over the timing of developments but our best guess based on industry discussions we're involved in at the moment is that proposed new rules might be put out for consultation in late 2019 or early 2020. Contingent funding approaches as detailed in this report can help mitigate the risk to some extent.

*Potential one-off
balance sheet hit
of over £100bn
to the FTSE 100*



New rules on special events – companies need a clear policy

As highlighted in our [Spring 2018 report](#), recent IAS19 changes affect how companies account for special events (such as a change in benefits, redundancy exercise or M&A activity). These new rules can make the cost of events such as benefit changes more complex to calculate and harder to predict.

A literal interpretation of the wording of these rules could lead to situations where very small events have a material impact on P&L. The best way to avoid this is to have a clear policy on how to apply these new rules.

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.

The IASB's work plan currently states: "The Board will continue its discussions throughout 2019 with a view to publishing an Exposure of amendments to the disclosure sections of IAS 19 and IFRS 13." Many details remain to be decided, and we await these proposals with interest.

Contact us

For further information, please contact one of us or the partner who normally advises you.



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