Summary

- Headline accounting deficits are relatively benign.
- But experts warn investment risk and longevity still pose a risk.
- Alternative measures of DB deficits paint a much worse picture.
- The real deficit could lie between a buyout and a PPF calculation.
- Sponsors with a lower risk profile are well placed to face the challenge.

Too soon to celebrate

With pension deficits stabilising or even narrowing over the past year, Britain's DB sponsors could be forgiven for thinking the worst is behind them. But, discovers Stephen Bouvier, the twin challenges of investment risk and longevity are lurking in the shadows

A quick glance at the figures in the February JLT Employee Benefits monthly pension funding survey paints a picture of the new year kicking off to a relatively benign start for defined benefit (DB) schemes. The survey shows that based on the requirements of International Accounting Standard 19, Employee Benefits (IAS 19), the total DB deficit among FTSE 100 companies in January stood at £35 billion – a coverage ratio of 95 per cent, and up from 93 per cent this time last year.

Since then, however, the story has been one of how the FTSE 100 withstood the twin effect of a slide on equity markets and slightly better news from the bond markets. "For some schemes," says Lane Clark Peacock partner Tim Marklew, "those two opposing effects might broadly cancel out, but there will have been individual winners and losers."

Meanwhile, Hymans Robertson partner Alistair Russell-Smith broadly backs this analysis. "The one we most easily track is IAS 19 for the FTSE 350," he says. "It has been jumping around a bit recently, but we think it is around £100 billion deficit, compared with £85 billion at the start of the year. I agree that there are some bigger issues under the bonnet when looking at it at an individual company level."

Discerning the long-term trend

But whether this is a short-term improvement or a long-term trend is unclear, says Aon Hewitt principal consultant Simon Robinson. "I don't think we are going to see much of a change over the coming year. If you look at the past five years or so, the accounting ratio has probably gone from 93 to 97 per cent. Much of that change could be down to changes in the mortality assumption." According to his firm's data on the FTSE 100, total DB liabilities among Britain's top companies stood at £673 billion at the end of 2016 and nudged up slightly to £686 billion by the end of 2017.

Certainly, one feature of late is the apparent slowdown in the rate at which longevity is improving. However, Robinson urges caution: "Nonetheless, asset and interest rate volatility make it hard to break out those components. However, I think there is some evidence of an improvement of 3-4 per cent since 2013. The improvement in mortality assumption could be what is behind that improvement."

But as ever with pension deficit numbers, the devil is in the detail and Russell-Smith also cautions against celebrating too early: "Our Club Vita analysis of scheme mortality trends across more than 200 schemes shows that the improvement rates for more affluent members, who tend to be the ones with an occupational pension, have not slowed down as much as has been the case with less affluent members."

Marklew also notes that movements in the accounting numbers often reflect how sponsors have adapted to investment risk. He says: "Fifteen plus years ago, most schemes were invested in a broadly similar blend of equities and bonds, and reacted in a similar way to changes in markets. Now, however, schemes are using more sophisticated investment strategies with alternative investments and liability matching strategies, which means that recent movements in equity and bond markets have impacted different schemes very differently."

"The *[longevity]* improvement rates for more affluent members have not slowed down as much as less affluent members"

Which measure really counts?

Of course, the IAS 19 measure is simply a time point estimate for the purposes of reflecting in the accounts a snapshot of the total pension liability faced by a DB sponsor at the balance sheet date. Under EU law, companies with traded securities must report their results under IFRS. Within the IFRS reporting framework, the requirements for pensions accounting are set out in IAS 19. The standard requires a company to decide whether it has a DB or defined contribution (DC) plan.

DC accounting is simply a matter of expensing the annual payments to employees through the income statement. At the heart of DB accounting, however, lies the altogether more complex matter of the Projected Unit Credit method (PUC). At its simplest, IAS 19 requires you to project the benefit promise forward in line with assumptions about, for example, future salary growth, inflation and mortality and then discount back to reach a total net present value for the balance sheet liability.

But cautious though accountants are, sponsors are obliged to include an element of prudence in their approach. Typically, a scheme sponsor will agree a range of assumptions with the scheme's trustees on a range of factors such as salary growth and widow benefits. Essentially, the funding valuation is about estimating the cashflows in respect of liabilities over the life of the scheme on the one hand and taking account of plan assets on the other.

More cautious measures

Robinson is quick to point out the difference between a funding valuation and the superficially similar IAS 19 model: "Funding is different. Fundamentally, it is about what are you trying to achieve, and that is to smooth the cashflows that are payable from the company to the pension plan.

"You are saying, yes, we know we need to put money into the scheme, but it is almost like a cashflow smoothing exercise on an ongoing basis, with a little bit of prudence included, so it will more likely than not have enough money to pay the benefits as they fall due."

Yet more prudent then either of those models is the buyout rate. This approach is a market rate that adds up to the real-world figure that an insurer will accept to take over a DB sponsor's scheme risk. Ultimately, an insurer is in the business of making money, and so a buyout value will of necessity be less favourable to the sponsor than either the IAS 19 liability or the technical provision.

And whereas the funding approach assumes a sponsor will continue to meet its scheme's commitments, a buyout is about making sure that there will be sufficient resources to pay the scheme's liabilities. In fact, the apparently sudden leap in a firm's pension deficit when its sponsor collapses is really about the drop to a buyout basis, says Robinson: "Basically, it has appeared because you are measuring the liabilities in a different way for a different purpose."

Also in the news recently is the Pension Protection Fund's approach, or the s179 valuation. Although the starting point here is a buyout, the PPF deficit figure will vary. This is because the PPF only covers 90 per cent of the benefit promise for members who have not reached the scheme's normal retirement age when the scheme entered the PPF. This figure is also subject to an upper cap of just over £35,000.

Future cash calls on the cards?

Where sponsors go from here, says Russell-Smith, is largely down to how they have managed their investment strategy. "Companies that have already dialled down their investment risk are reasonably well placed. It is probably quite likely that they won't need to put more cash in, whereas companies that have taken more investment risk and not hedged as much are more likely to have to put more cash in.

"One of the issues with the regulatory focus on cash rather than risk is that it can sometimes lead to sub-optimal strategic decisions. So, for example, a push to fully fund schemes in a short time frame could lead to the taking of more investment risk than would otherwise be needed."

And, he warns: "There are still too many companies taking too much investment risk in their pension schemes. This is why we are seeing a lot of the volatility at the moment. Many schemes are taking significant levels of investment risk, sometimes to try and reach buyout in say 10 years.

"More often than not, we think a better approach is to take a lower level of investment risk and a longer period of time to reach full funding or buyout. This means taking less investment risk up front, which stabilises the funding position and improves the ability of the company to support the pension scheme."

Written by Stephen Bouvier, a freelance journalist