KPMG's Pensions Accounting Survey 2019

An insight into market trends at 31 December 2018

May 2019

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Introduction

KPMG's Pensions Accounting Survey 2019 looks at trends in best-estimate assumptions based on 212 of KPMG's clients with UK Defined Benefit (DB) pension schemes reporting under IFRS, UK GAAP or US GAAP at 31 December 2018. Our data sample spans the whole market, including clients who are advised by all the leading consultancies. This enables us to provide a detailed insight into market-wide practice, helping to inform discussions that go beyond accounting.

2018 was a turbulent year for the UK economy: GDP growth was the slowest it's been since 2012, at just 1.4% over the year; the Bank of England raised interest rates to 0.75%, a level not seen since the financial crisis; UK equities showed negative returns over the year; and salaries outpaced inflation. The key driver behind this mixed economic activity was the continuing uncertainty surrounding the outcome of the Brexit negotiations. This uncertainty has continued through to the first quarter of 2019, with the Bank of England forecasting that growth over 2019 will be the slowest since 2009, with a one-in-four chance that the economy will slip into recession in the second half of 2019.

Our publication deadline only allowed us to track Brexit events long enough to know that the UK didn't leave the EU on the planned date of 29 March 2019. The political uncertainty meant that market conditions were volatile over March 2019, with AA corporate bond yields falling by 0.3% and long-term inflation expectations increasing by around 0.1% over the month. Real AA yields fell to -1.3% at 31 March 2019, a significant drop from -0.9% seen at 31 December 2018.

In an effort to return inflation toward its 2% target, the Bank of England increased its benchmark interest rate during 2018 for the second time in a decade to 0.75% (an increase of 0.25%). This increase had already been largely priced into the market, and so this did not result in marked volatility. Amid the continuing Brexit uncertainty, the Monetary Policy Committee has recently voted not to increase interest rates further over 2019.

Over 2018, corporate bond yields rallied slightly from the lows seen over the past few years, finishing 0.3% higher than at the start of the year. These higher yields would generally have resulted in a reduction in pension scheme liabilities relative to 2017.

However, asset returns were generally poor over 2018. UK equities yielded a negative annual return of -9% which is a significant deterioration compared to positive returns of 13% over 2017. For many schemes the fall in corporate bond yields will have more than offset poor asset returns, but some schemes may have seen a deterioration in balance sheet position, depending on the types of assets held and the level of hedging in place.

Financial headlines

Median real or net AA discount rates (measured as the difference between the discount rate and RPI inflation) remained negative for the third consecutive year. However our analysis shows a shift from the downwards trend experienced in recent years, with the median net discount rate increasing by 0.4% from -0.8% in 2017 to -0.4% in 2018.

– The median discount rate assumption increased from 2.5% last year to 2.9% at 31 December 2018.

– The range of discount rate assumptions adopted has remained stable this year at 0.5%.

– However only 82% of companies surveyed had a discount rate assumption within 0.1% of the median, compared to 90% last year. This reflects the fact that although the yield curve has become flatter at very short durations, over medium to long durations the curve has become slightly more downward sloping.

– Long term inflation expectations have remained stable over the year with a median assumption of 3.3%.

– The range of RPI inflation assumptions adopted has decreased from 0.7% last year to 0.6% this year.

Demographic headlines

Life expectancy assumptions have continued to decrease for the fourth consecutive year.

– The median life expectancy assumption has fallen by 0.2 years for current pensioners, and 0.1 years for future pensioners.

– The Continuous Mortality Investigation Bureau (CMIB) continually updates its research and produces annual updates of the CMI projection model. For the past few years, these updates have projected a slowing rate of future mortality improvements. With 76% of the companies surveyed adopting the latest CMI projections at the time (CMI 2017), this has resulted in assumed life expectancies falling. As expected, this trend has continued as evidenced by the recent publication of the CMI 2018 projection model, which we expect to be adopted by the majority of companies by 31 December 2019.

– Despite the significant transfer value activity seen in 2018, only 4% of companies surveyed have included an explicit assumption in their accounts around future transfer expectations, a small increase from the 3% seen last year.

Looking ahead

The following key topical issues are likely to impact companies reporting in 2019:

– The changes to how the IAS 19 pension expense is calculated after the occurrence of a special event.
– The proposed amendments to FRS 102 in respect of multi-employer schemes.
– The ongoing review of IFRIC 14 by the International Accounting Standards Board (IASB) may lead to a further Exposure Draft sometime in 2019/20.

We explore these issues and more on pages 12 to 15.

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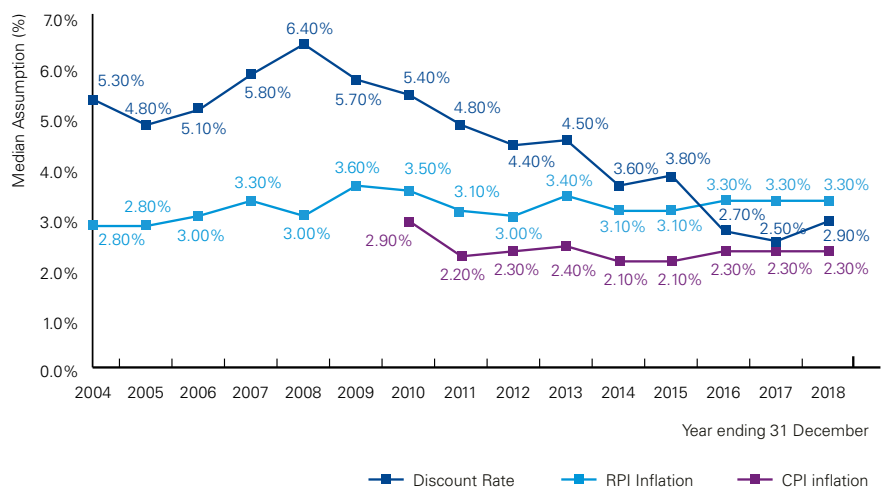# Key headlines

Financial assumptions

Real AA discount rates have increased from -0.8% last year to -0.4% this year.

Real yields have risen by 0.4% since the start of the year.

– The median discount rate at 31 December 2018 was 2.9%. This reflects an increase of 0.4% compared to the median last year.

– The median RPI inflation rate at 31 December 2018 was 3.3%, in line with the median last year.

– The median CPI inflation assumption adjustment and inflation risk premium have remained unchanged from the previous year at 1.0% and 0.2% respectively.

Movement in Median Assumptions

Year ending 31 December

■— Discount Rate ■— RPI Inflation ■— CPI inflation

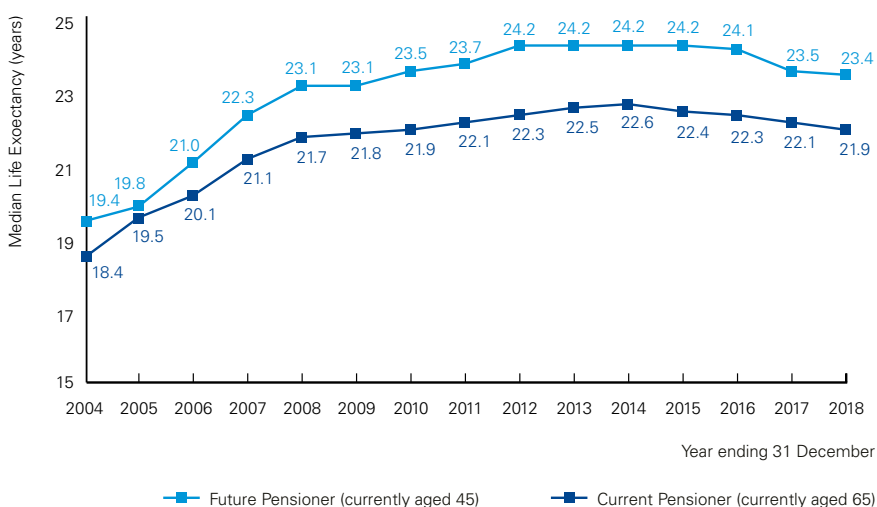Source: KPMG analysis

Demographic assumptions

> **Median assumed life expectancies have decreased by 0.2 years for current pensioners and by 0.1 years for future pensioners**

The trend of falling life expectancies has continued.

– The trend of falling life expectancies seen over the past few years has continued into 2018. This is largely due to the slowing rate of future mortality improvements projected by the Continuous Mortality Investigation Bureau (CMIB) over the past four years.

– With the publication of CMI 2018 in March 2019, we can now anticipate a 'lost decade' of life expectancy improvements between 2009 and 2019.

Movement in the Life Expectancies

Year ending 31 December

— ■ — Future Pensioner (currently aged 45)   — ■ — Current Pensioner (currently aged 65)

Source: KPMG analysis

Overall strength of financial assumptions adopted

The bubble chart below shows the discount rate assumption plotted against the corresponding RPI inflation assumption adopted by each scheme in our data sample. The size of the bubble indicates the number of schemes adopting those assumptions.

The axes cross at the median discount rate and RPI inflation assumptions. This means that the schemes who are in the bottom right section are adopting assumptions that are more optimistic than the median. Schemes located in the top left square are adopting assumptions that are more cautious than the median.

Although the corporate bond curve is still relatively flat in shape, it is slightly more downward sloping at the medium to long durations compared to last year. This has caused the discount rate assumptions adopted to be slightly less tightly packed around the median assumption.

The graphs shows that 57% of companies are within the central square that sits within 0.1% of both the median discount rate and RPI inflation assumptions, compared to 67% last year. Outside of this square there are slightly more companies towards the prudent end of the chart.

Overall strength of financial assumptions adopted
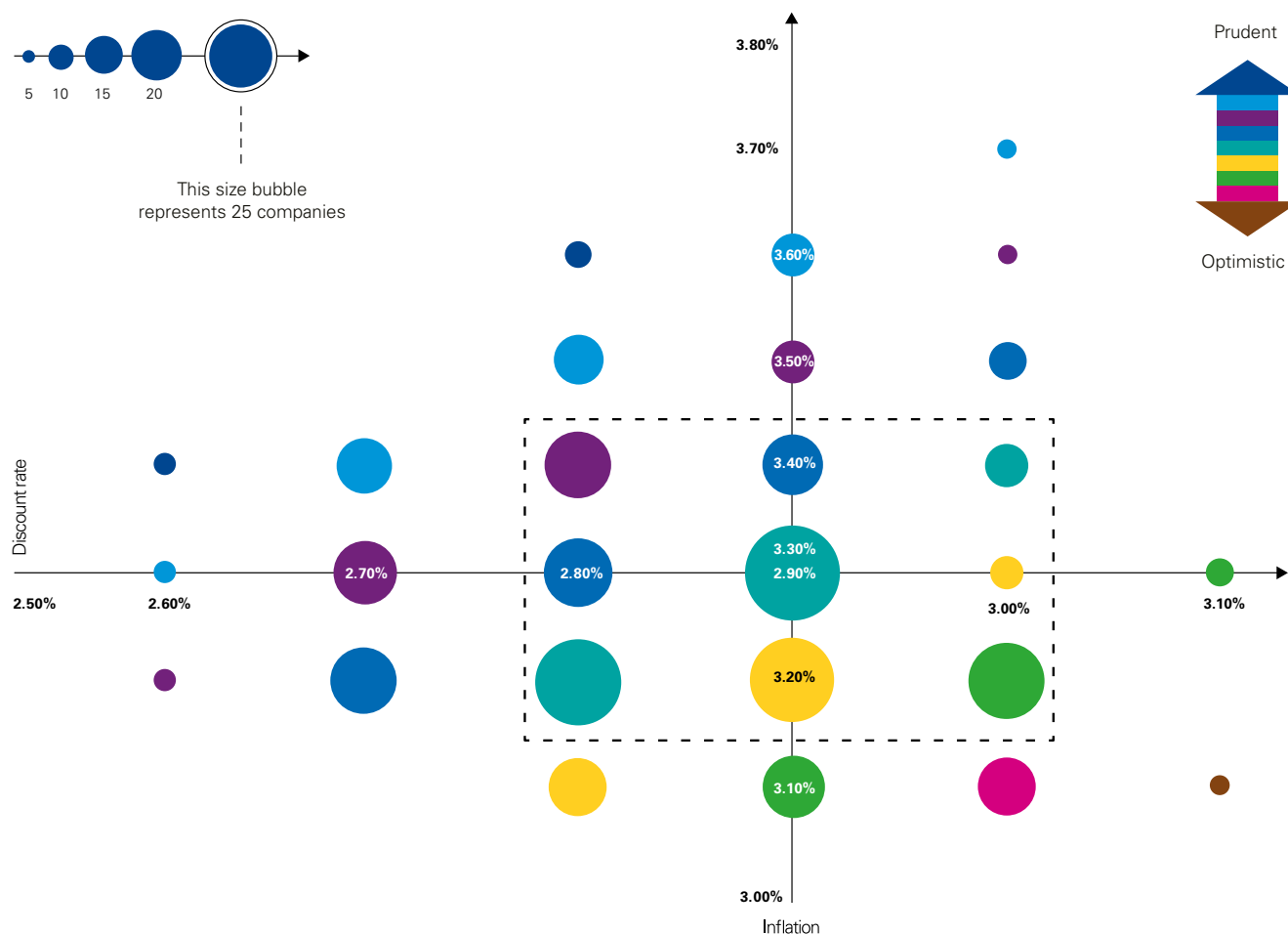
Source: KPMG analysis

"**57% of companies are adopting both discount rates and RPI inflation assumptions within 0.1% of the median.**"

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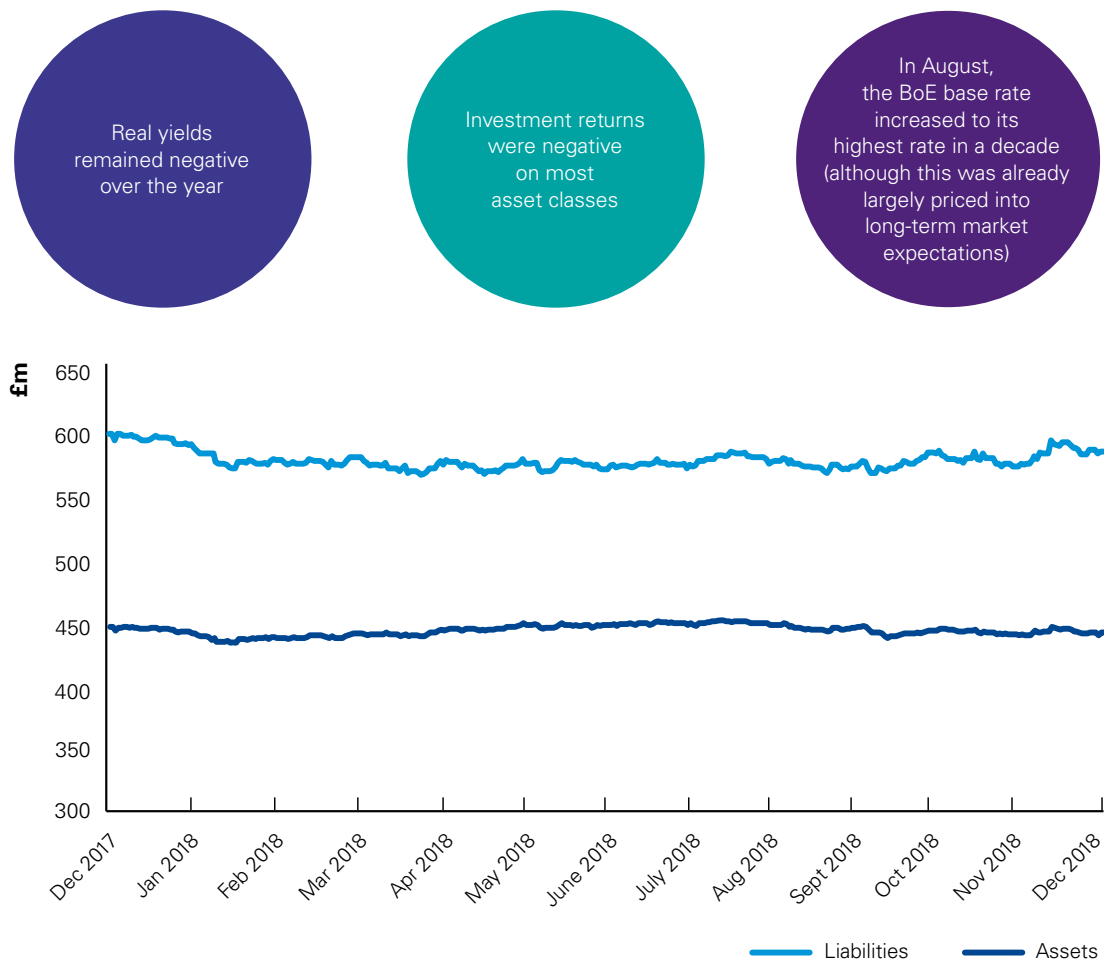07

Mortality

Section Two

A look back over 2018

2018 was a mixed year for pension schemes, as performance would have been heavily dependent on the types of asset held and the level of hedging in place. For a typical scheme, the reduction in liabilities due to the increase in corporate bond yields will have more than offset poor asset returns, resulting in an improved balance sheet position compared to the start of the year; however, this will vary depending on the asset mix held.

Fusion snapshot

The chart below is taken from KPMG's Fusion tool. It shows how assets and liabilities may have moved for a typical scheme over the year.

Real yields remained negative over the year

Investment returns were negative on most asset classes

In August, the BoE base rate increased to its highest rate in a decade (although this was already largely priced into long-term market expectations)

Source: KPMG Fusion analysis for a scheme with typical asset allocation and hedging levels

The balance sheet impact over the year would have varied between schemes depending on the asset mix held

The difference between assets and liabilities remained relatively stable over the year for schemes with a typical exposure to equity markets

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Liabilities

Both nominal and real discount rates (based on the difference between AA corporate bond yields and assumed RPI inflation) have increased relative to the beginning of the year (illustrated in the chart below).

Real discount rates have risen by around 0.3% since the start of 2018. For a typical scheme with a duration of 20 years, we estimate this will have resulted in a 6% reduction to defined benefit obligations.

> " **Real discount rates have risen by around 0.3% since the start of 2018.** "

Assets

In general assets performed poorly over the year.

A typical pension scheme invested in a combination of equities and bonds could have seen negative asset returns of around -3% over the year. This compares to positive annual returns of just under 10% in 2017. However, the decrease in liabilities as a result of increasing corporate bond yields meant that in general deficits would have improved slightly over the year.

Typical asset class returns over the year are set out below:

– Corporate bond yields returned a negative annual return of -0.4%, considerably lower than compared to positive returns of 2.8% over 2017 (iBoxx corporate AA index for all maturities)

– Gilt yields performed better, reflecting increasing credit spreads as a result of reduced investor confidence in corporate debt relative to government debt:

  - Conventional gilts returned +0.3%, compared to +3.3% in 2017 (FTSE fixed interest government bonds over 15 years index)

  - Index-linked gilts returned -1.4%, compared to +2.9% in 2017 (FTSE index linked government bonds, over 15 year index)

– The stock market performed relatively poorly this year:

  - UK equity returned -9.5%, compared to +13.1% in 2017 (FTSE all share index)

  - Global equity returned -3.1%, compared to +14.0% in 2017 (FTSE all world excluding UK index)

Yield trends over 2018
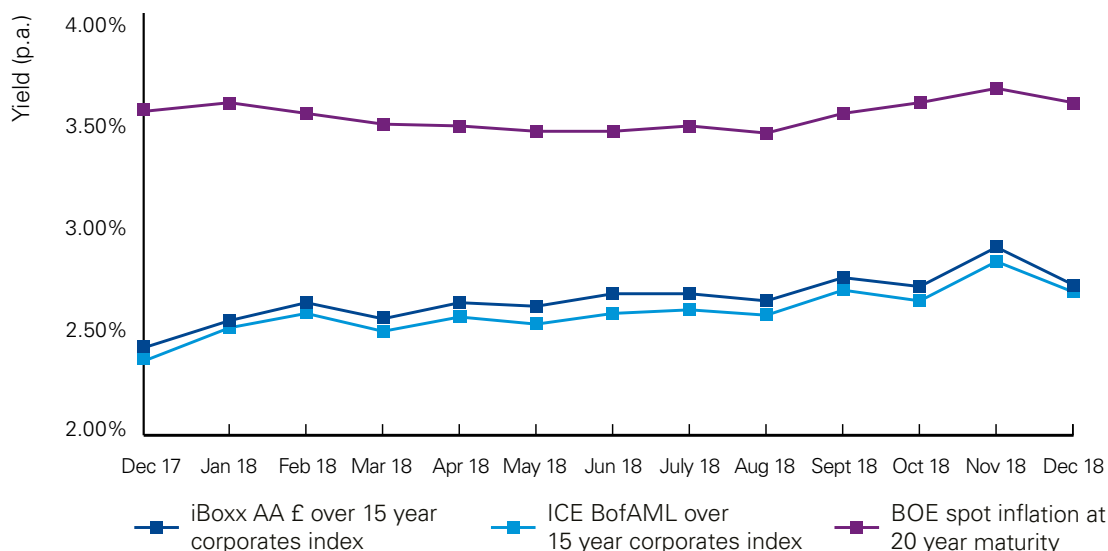
Source: KPMG analysis

Transfer activity

Over the last few years, there has been an increase in the number of members opting to transfer their benefits out of DB schemes. This is has been due to increased pensions freedom combined with low yields increasing the value of transfer values.

Despite this increase in transfer activity, only 4% of companies surveyed have adopted an explicit assumption about expectations for future transfers out of their schemes. This is only slightly higher than the 3% of companies experienced last year. Limited scheme experience data and uncertainty around whether the recent high transfer activity is likely to be a continued trend, has left most companies opting to hold off from making an explicit assumption within their accounts.

GMP Equalisation

A landmark judgement was reached in the High Court on 26 October 2018 in the Lloyds Banking Group Pension Trustees Limited v Lloyds Bank Plc Guaranteed Minimum Pension (GMP) Equalisation case. A key implication of this case is the need for pension schemes to equalise benefits for the effect of unequal GMPs built up between May 1990 and April 1997.

The judgement applies to all UK pension schemes who were contracted out of the State Earnings Related Pension Scheme (SERPS) during this period and whose members built up GMPs as a result. This has led to an increase to the IAS 19 Defined Benefit Obligation for many schemes as at 31 December 2018, with the increase recognised through P&L in the vast majority of cases.

More details are provided on pages 26 to 29.

Guaranteed Minimum Pension (GMP) that built up for contracted out service from 1990 to 1997 is inherently unequal for men and women in respect of areas such as payment age and accrual rate.

The High Court has ruled that schemes must adjust other scheme benefits in order to equalise for the effect of unequal GMPs. This is 'GMP Equalisation.'

Section Three

A look ahead to 2019 and beyond

IAS 19 amendments at a glance

– **With effect from 1 January 2019, components of the pension cost will be remeasured after a special event, based on assumptions at the date of the event.**

– **Remeasurement will apply if the combined effect of the special event and remeasurement is material.**

– **On a separate matter, the amended IAS 19 clarifies that if an asset ceiling restriction applies, any gain (or loss) from a settlement is recognised in P&L with a separate loss (or gain) in OCI for the change in effect of the asset ceiling restriction.**

– **Before carrying out benefit changes, member option exercises or insurance transactions, companies should consider the impact of the amended IAS 19 as this might influence the company's choice of timing of such exercises.**

Amendments to IAS 19

Remeasurement of pension expense following special events

The IASB published an amendment to IAS 19 in February 2018 which changes how the pension expense is calculated for the balance of the year immediately after a special event has occurred.

The changes to IAS 19 are effective for accounting periods beginning on or after 1 January 2019 and mean that the components of the pension cost after a special event will be remeasured based on assumptions at the date of the event (with net interest being calculated on the net asset/liability position at the date of the event). Previously, the pension cost for the whole year, both before and after a special event, was based on assumptions at the start of the year (with net interest calculated on the net asset/liability position at the start of the year).

The amended IAS 19 means that when accounting for a special event, an entity doesn't just need to consider if the impact of a plan amendment, curtailment or settlement itself is material, but also whether the impact of remeasuring interest cost and service cost for the remainder of the period has a material impact. So whilst the effect of the special event itself might not be material, if the combined effect of the special event and remeasurement of service cost and interest cost is material, the requirements of the amended IAS 19 should be applied.

Auditors are likely to expect entities to provide evidence to support the substance of plan amendments, curtailments or settlements in order to discourage any attempts to optimise the accounting result, for example by implementing a 'non-substantial' special event during the year to take advantage of favourable movements in market conditions in remeasuring service cost and interest cost for the remainder of the year.

Practical issues

For entities with a large number of plan amendments, curtailments or settlements during the year, pragmatic approaches to dealing with the remeasurement requirements may be necessary.

For example:

– Remeasuring pension cost from a single point in time for a group of special events;

and

– Only remeasuring where the impact of a special event (or group of special events) exceeds a specific threshold.

Any such approaches will need to be considered by auditors on a case by case basis and will be subject to materiality considerations.

Interaction of settlements and asset ceiling

Separately, the IAS 19 changes also remove any uncertainty on how the interaction of settlements and any asset ceiling should be accounted for. Previously, IAS 19 was unclear in this regard but the changes clarify that gains or losses on settlements go through P&L, regardless of any asset ceiling restriction. Any change in the effect of the asset ceiling will be considered separately and will be recognised in OCI. This is consistent with how the interaction of other special events (plan amendments and curtailments) and any asset ceiling is treated.

> **"Auditors are likely to expect entities to provide evidence to support the substance of plan amendments, curtailments or settlements in order to discourage any attempts to optimise the accounting result."**

Proposed amendments to FRS 102 – multi-employer schemes

When an entity participates in a multi-employer pension scheme and does not have sufficient information available to apply Defined Benefit (DB) accounting, it accounts for the scheme on a Defined Contribution (DC) basis.

The FRC recently published an Exposure Draft setting out proposed amendments to FRS 102 which, if implemented, will clarify how to deal with moving from DC to DB accounting for multi-employer schemes when sufficient information becomes available to apply DB accounting.

Employers in multi-employer schemes who apply DC accounting recognise a liability on balance sheet equal to the present value of any committed deficit funding contributions. On transitioning to DB accounting, the net defined liability (i.e. defined benefit obligation less fair value of plan assets) would be recognised on balance sheet. Currently, FRS 102 is silent on how any such change would be dealt with meaning potential inconsistency of accounting treatment between different entities. Under the draft amendments, the day 1 balance sheet impact of moving from DC to DB accounting would be recognised via OCI and the impact will be presented separately from other items recognised in OCI.

The proposed changes were driven by the Social Housing Pension Scheme carrying out an exercise to enable it to provide 'sufficient information' for the first time to participating employers to support DB accounting for the scheme.

Beyond the Housing sector the wider ramifications of the proposed changes are likely to be limited. But the proposals may be relevant in future to entities in other quasi-public sector multi-employer schemes if sufficient information becomes available to enable DB accounting for the first time.

If the proposed amendments go ahead, they will have effect for accounting periods beginning on or after 1 January 2020, with early application permitted.

IFRIC 14 remains under review

In September 2017 the International Accounting Standards Board (IASB) decided to revisit the proposed changes to IFRIC 14 which date back to the June 2015 Exposure Draft. This followed concerns that companies would be able to make changes to their scheme rules to avoid adverse outcomes from the changes proposed in the Exposure Draft.

Since then IFRIC staff have commenced a research project on developing a 'principles based' approach for entities to assess the extent to which pension scheme surpluses can be recognised on balance sheet.

Implications for companies

This has not yet led to any revised proposals for amendments to IFRIC 14 being put forward for consideration. At a June 2018 IASB meeting, IFRIC staff indicated that any such proposals are likely to be broader in scope than the 2015 Exposure Draft, meaning any proposed changes to IFRIC 14 following from the research project are likely to need to be re-exposed for industry comment. This means that it is likely to at least another two or three years, possibly longer, before any revised IFRIC 14 takes effect.

However, our view remains that the direction of travel appears to be towards greater restriction of balance sheet surpluses in future. Companies will need to revisit their IFRIC 14 position once any amendments are finalised. Further papers from the IFRIC staff should be available in 2019.

Given the Financial Reporting Council's focus on this area, it remains important for UK corporate reporters to disclose any significant accounting judgements made when assessing trustees' rights (e.g. to unilaterally wind up the scheme) in determining whether a surplus can be recognised on the balance sheet.

**"The ongoing
review of
IFRIC 14 may
lead to a further
Exposure Draft
sometime in
2019/20."**

Section Four

Discount rate

The discount rate is used to calculate the present value of future liabilities in a scheme.

The yield on the iBoxx Sterling AA Corporate Over 15 Year index, which has a duration of around 15 years, increased by 0.3% over the year.

The graph below illustrates how the yield curve has changed over the last 3 years.

AA corporate bond yield curves
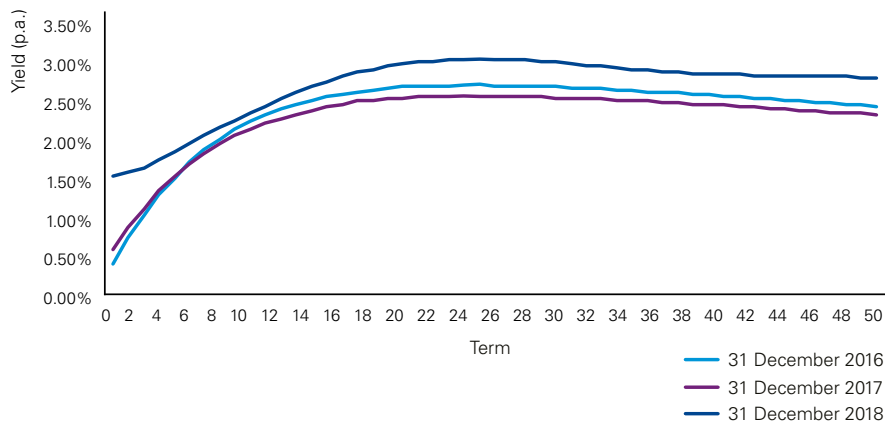
Source: ICE BofAML and KPMG analysis

AA corporate bond yields (and hence discount rates) have increased at all durations compared to last year. The shape of the curve has become flatter at very short durations, but has become slightly more downward sloping over medium to long durations.

> "**The iBoxx Sterling AA Corporate Bond yield index for bonds with a duration of over 15 years has increased by 0.3% over the year.**"

Variations in discount rate approaches

We are continuing to see further innovation and research in how companies derive their discount rate assumption to help mitigate some of the negative effects of the low corporate bond yields experienced in recent years.

IAS 19 states that the discount rate should be based on high-quality corporate bond yields of a term consistent with the underlying benefit obligations. In addition, the discount rate, like other assumptions, should be unbiased.

We have seen variations in three key areas which can lead to higher discount rate assumption:

– **Single agency approach**: The discount rate is set with reference to bonds that are rated at AA by one or more of the selected rating agencies. This approach provides a larger universe of bonds to be considered when setting the discount rate. The increase of 0.05% to 0.15% in the discount rate from this approach can lead to a 1.0% to 3.0% reduction in liabilities.

– **Removing quasi-government bonds**: This approach involves removing any corporate bonds that have at least a quasi-government aspect to them. Examples include university, housing association and Transport for London bonds. Using this approach can result in a discount rate increasing by up to 0.05% leading to a 1% reduction in liabilities.

– **Extrapolating the curve**: Since pension cash flows are long term in nature, there is a need to extrapolate the yield curve at the longer end as corporate bond data is limited here. This can be done in a number of ways, e.g. assuming a fixed forward rate over longer durations, or adopting more aggressive extrapolation methods (including variations of the approach adopted by the US Department of the Treasury). Alternative extrapolation approaches could increase the discount rate by up to 0.15% to 0.25% therefore reducing liabilities by 3% to 5%.

Our analysis shows only 10% of companies have adopted an alternative discount rate approach at 31 December 2018. This could be as a result of the increase in real yields over the year, making alternative methodologies relatively less attractive to companies, as pension liabilities begin to fall, and relieving pressure on company balance sheets.

> **Only 10% of companies have adopted an alternative discount rate approach.**

> **82% of companies adopted an assumption within 0.1% of the median discount rate compared to 91% last year.**

Distribution of discount rate assumptions
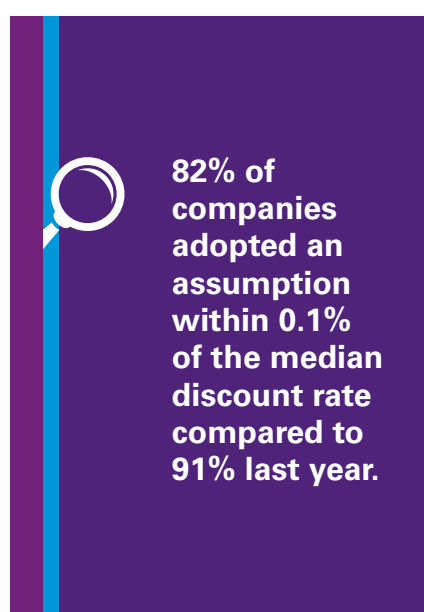
Source: KPMG analysis
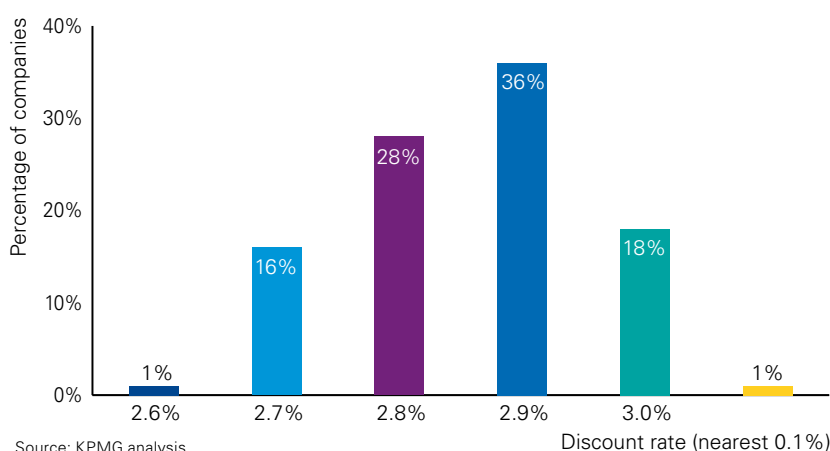
The graph shows the overall distribution of discount rates adopted by companies at 31 December 2018. The median discount rate has increased by 0.4% over the year to 2.9% at 31 December 2018.

Distribution of discount rate assumptions by duration
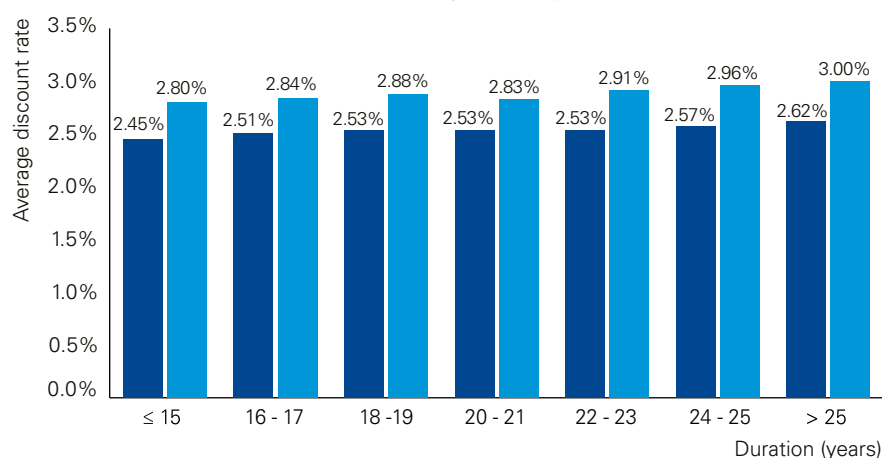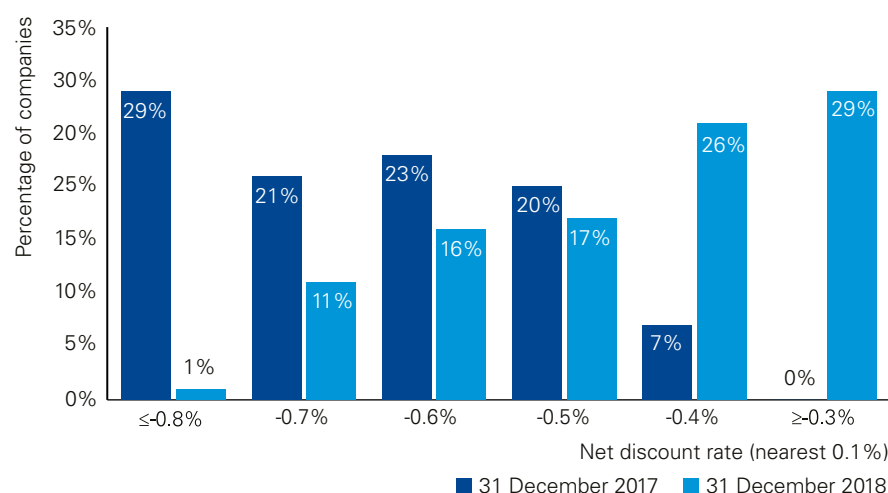

Source: KPMG analysis

■ 31 December 2017   ■ 31 December 2018

The graph shows the discount rates used by schemes grouped by the duration of their liabilities. This uses our survey sample at 31 December 2017 and 31 December 2018. Overall, discount rates for schemes have increased over the year. Despite more variation in the discount rate by duration compared to last year, there remains to be a tight range of average assumptions for schemes with a duration of around 16 to 23 years.

Distribution of net discount rate

Net discount rate assumptions are negative for the third consecutive year. However, net discount rates have increased over the year with the median net discount rate increasing from -0.8% to -0.4% at 31 December 2018.

Source: KPMG analysis

■ 31 December 2017   ■ 31 December 2018

The median net discount rate has risen by 0.4%. This would reduce liabilities by around 8% for a typical scheme with a duration of 20 years.

Section Five

Inflation

The inflation assumption is typically used as a basis to set other assumptions used for pensions accounting such as pension increases in payment, deferred revaluation and long-term salary growth.
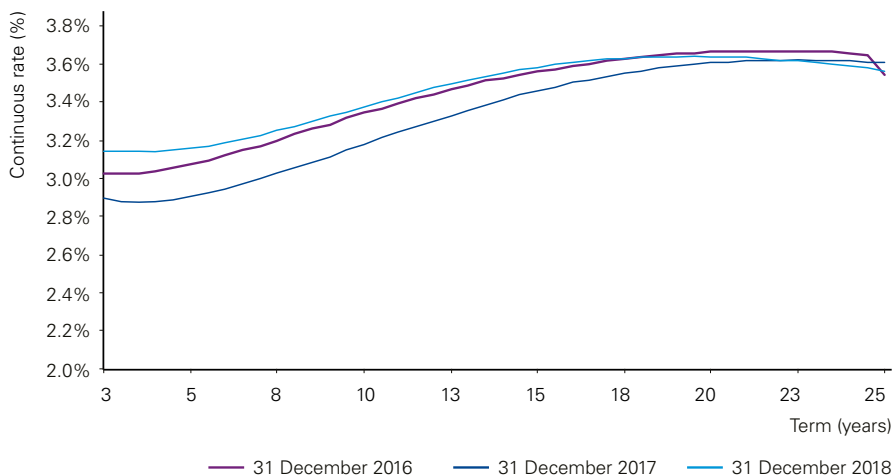
The median RPI inflation assumption of 3.3% at 31 December 2018 has remained unchanged compared to last year.
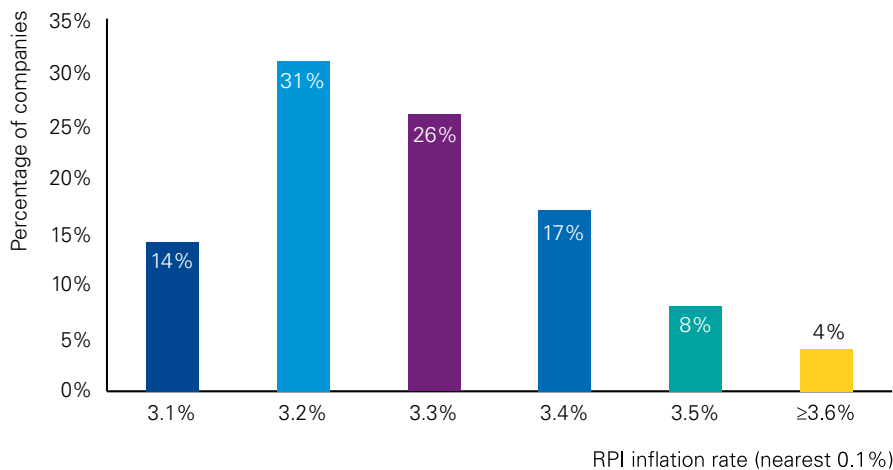
RPI inflation

The graph below shows long term RPI inflation expectations. The shape of the curve is largely unchanged from last year.

Movement in Inflation Spot Curve

Source: Bank of England

Distribution of RPI inflation assumptions

Source: KPMG analysis

The graph above shows the distribution of RPI inflation rates adopted by companies at 31 December 2018. The median RPI inflation is 3.3%. The range of RPI assumptions has remained the same compared with last year, and is partially explained by the use of different inflation risk premia (see page 23).

CPI inflation

CPI inflation is typically used for deferred revaluation and some pension increases. As there are no market indicators for CPI inflation, it is usually set using an offset to the RPI inflation assumption. The graph on the right shows the spread of the RPI-CPI 'wedge' used by companies as at 31 December 2018. There is a clear trend with the majority of companies adopting the median of 1.0%, which is unchanged from last year.

In January 2019, the House of Lords Economic Affairs Committee released a report on its recent inquiry into the problems with RPI as an inflation measure. The report included a number of recommendations for the possible way forward including correcting the RPI formula, issuing CPI-linked gilts and moving towards a single inflation measure.

Whilst there is some uncertainty on how this might all turn out, gilt markets have reacted to the Committee's report during Q1 2019 and appear to be pricing in RPI at 0.10% - 0.15% lower as a result. Although this does not affect future expectations of CPI inflations, with market implied expectations of RPI down, we have recently adjusted our house view of the best estimate RPI-CPI wedge down from 1.0% to 0.9%. We expect to see many companies adopting a smaller RPI-CPI wedge at 31 December 2019.

Distribution of CPI inflation assumptions

Source: KPMG analysis

RPI less CPI (nearest 0.1%

90% of companies are adopting a RPI-CPI wedge of within 0.1% of the median, compared with 85% last year.
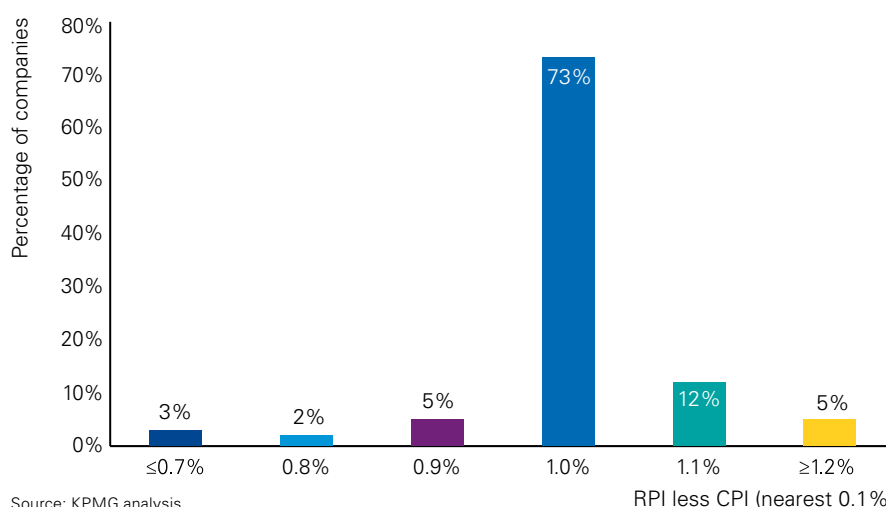
In recent years, the Retail Prices Index has been discredited as a measure of inflation and there have been a number of high profile court cases which ruled in favour of certain schemes being able to switch their pension increases from being linked to RPI inflation to be linked to CPI inflation.

The case against the RPI measure of inflation continues to build and in January 2019, the House of Lords Economic Affairs Committee published a report, 'Measuring Inflation', which recommended that the Consumer Prices Index be adopted where possible until a more suitable single measure of inflation is available.

Other recommendations in the report included a move towards a single inflation measure, with changes phased in gradually, and proposed changes to the RPI in the interim, which are generally expected to reduce RPI inflation by 0.3% or more, all else being equal.

The House of Lords review marks the most meaningful momentum there has been in the case for change to RPI inflation. Whilst nothing will happen quickly, we might expect to see a reduction in RPI inflation as the market begins to anticipate future changes. We also expect more schemes to question whether the RPI is the right inflation measure for their pension increases to be linked to.

Inflation risk premium

An inflation risk premium (IRP) is often applied to reflect certain supply and demand effects on the gilts market. These can be argued to keep break-even inflation rates artificially high.

Distribution of Inflation Risk Premium assumptions

At 31 December 2018, around 84% of companies used an IRP adjustment.

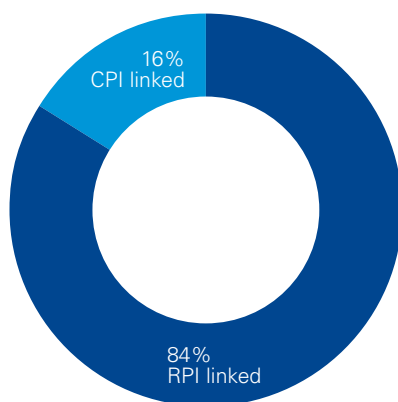The median IRP remains unchanged since 2012 at 0.2%.
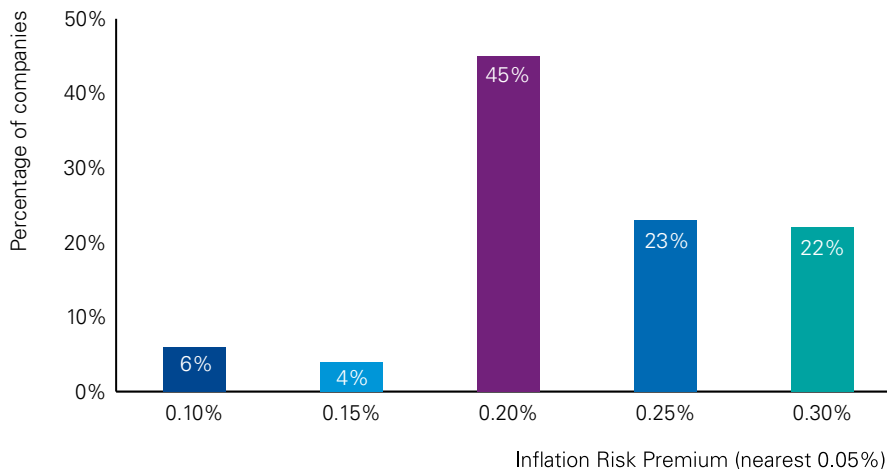
Source: KPMG analysis

Pension increases

The majority of companies have post retirement increases which are linked to RPI inflation. As the statutory index for future post retirement increases is CPI inflation, we expect to see this split shift going forwards.

Split of most significant pension increase assumptions

> **"The majority of companies have post retirement increases which are linked to RPI inflation."**
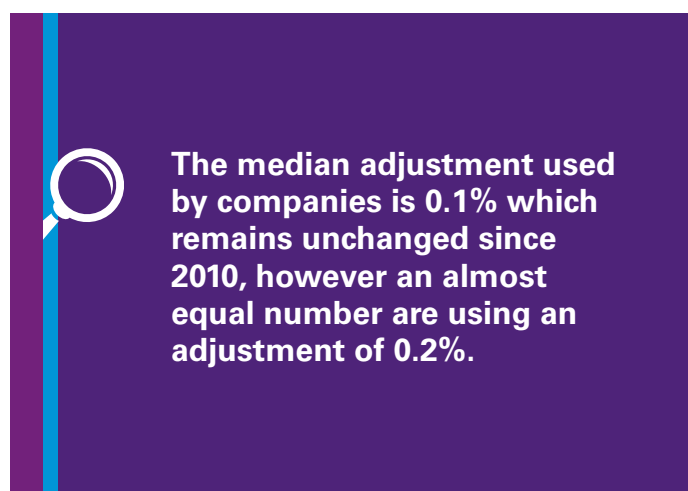
Source: KPMG analysis

The most common pension increase for past service is inflation capped at 5.0% each year which is known as Limited Price Inflation (LPI). This assumption is usually set by applying an adjustment to the RPI inflation assumption, based on the expected future volatility of inflation. As inflation rates remained stable over the year, we have seen similar offsets being applied to RPI inflation in order to derive the LPI assumption, compared to last year.

There remains a small range of pension increase assumptions, with around 90% of companies adopting an adjustment within 0.1% of the median.

Distribution of RPI-LPI offset assumptions

The median adjustment used by companies is 0.1% which remains unchanged since 2010, however an almost equal number are using an adjustment of 0.2%.
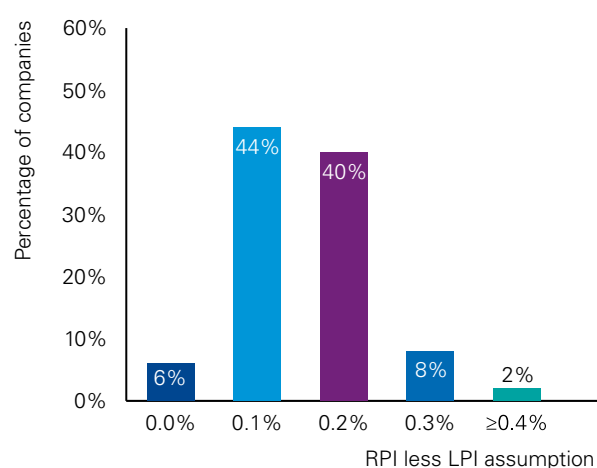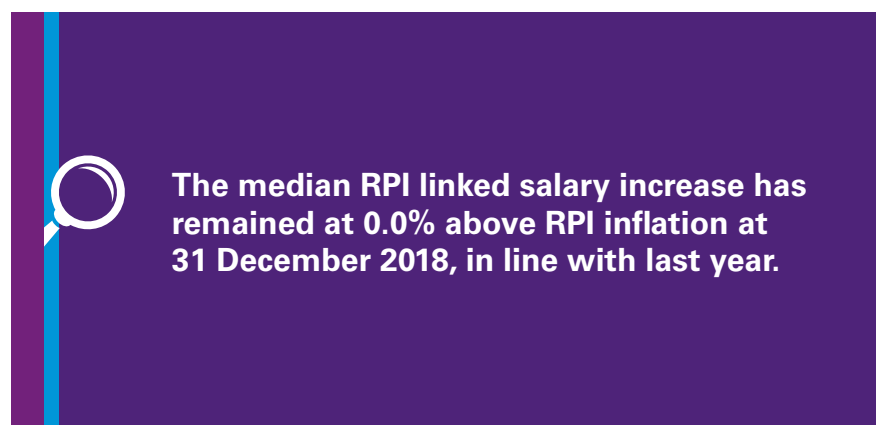

Source: KPMG analysis

Salary increases

Salary increases are generally linked to economic growth and inflation levels. The majority of companies are still referencing RPI inflation. Of the remainder 27% are referencing CPI inflation, and 17% are adopting a fixed salary increase assumption.

Split of salary increase assumptions

The median RPI linked salary increase has remained at 0.0% above RPI inflation at 31 December 2018, in line with last year.
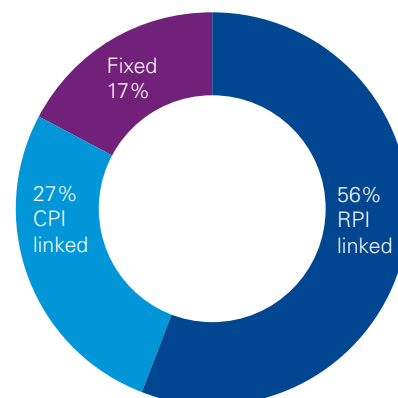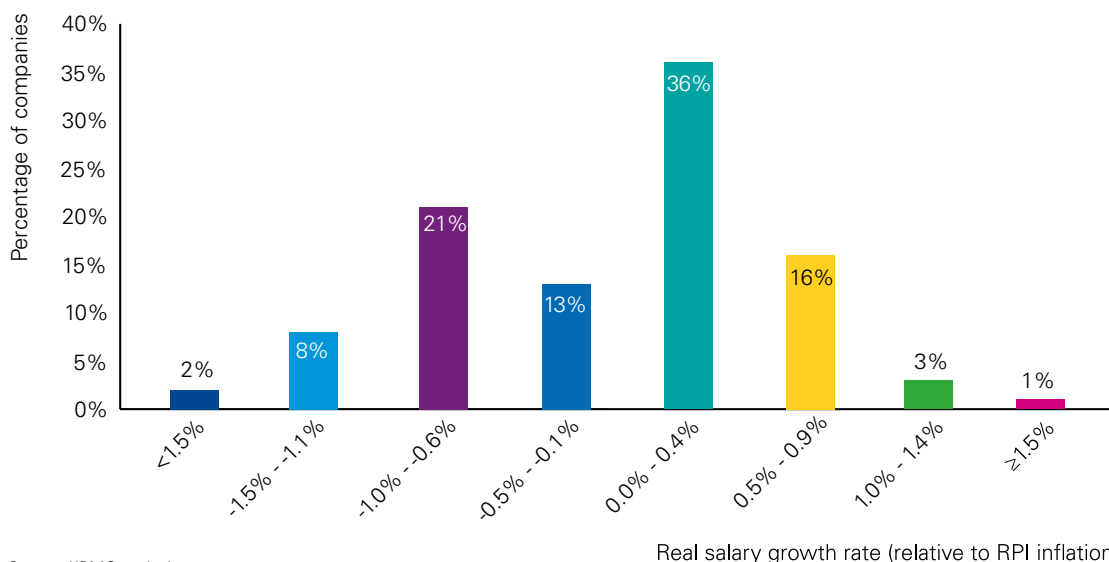

Source: KPMG analysis

As more companies close their pension schemes to future accrual and active member populations reduce in general, the salary increase assumption becomes less important. More than 60% of the companies in our sample are closed to future accrual, with more already closed to new entrants. This trend is only expected to continue as companies try to reduce uncertainty in relation to their future pension liabilities. Intermediate measures such as capping pensionable salary increases are also increasingly common.

> **The median CPI linked salary increase assumption adopted was 0.4% above CPI inflation at 31 December 2018. This is equivalent to an assumption of 0.6% below RPI assumption. Last year, the median CPI linked salary increase assumption was 0.2% above CPI inflation.**

Distribution of real salary growth assumption (relative to RPI inflation)

Percentage of companies

Real salary growth rate (relative to RPI inflation)	
<1.5%	2%
-1.5% - -1.1%	8%
-1.0% - -0.6%	21%
-0.5% - -0.1%	13%
0.0% - 0.4%	36%
0.5% - 0.9%	16%
1.0% - 1.4%	3%
≥1.5%	1%

Real salary growth rate (relative to RPI inflation)

Source: KPMG analysis

> **15% of companies who have disclosed a salary increase assumption have capped pensionable salary increases.**

Section Six

GMP Equalisation

Guaranteed Minimum Pension (GMP) is a pension benefit in lieu of part of the state pension for persons who were contracted out of the State Earnings Related Pension Scheme (SERPS)

On 26 October 2018 a landmark judgement was reached in the High Court on the Lloyds Banking Group Pensions Trustees Limited v Lloyds Bank Plc Guaranteed Minimum Pension (GMP) equalisation case. A key implication of this ruling was the need for pension schemes to equalise benefits for the effect of unequal GMPs accrued between May 1990 and April 1997, which will lead to an increase in liabilities for many schemes.

In order to determine the impact of GMP equalisation, detailed member-by-member calculations will be required based on data that may not be readily available. Therefore, approximations have been needed in order to estimate the liability impact of GMP equalisation for financial reporting purposes.

Method of Equalisation

A range of methodologies were described in the High Court ruling, with the understanding that the trustees should use the method which results in 'minimum interference' with the rights of any party. The different methodologies are summarised below:

– **Method A**
  Equalise each element of inequality separately

– **Method B**
  Provide the higher of the male benefit and the female benefit

– **Method C**
  As B, except allow for cumulative impact if the benefits cross over

– **Method D**
  One-off test to ensure the actuarial equivalence of benefits

87% of companies surveyed at 31 December 2018 have adopted Method C to estimate the impact of GMP equalisation.

Split of GMP Equalisation methods
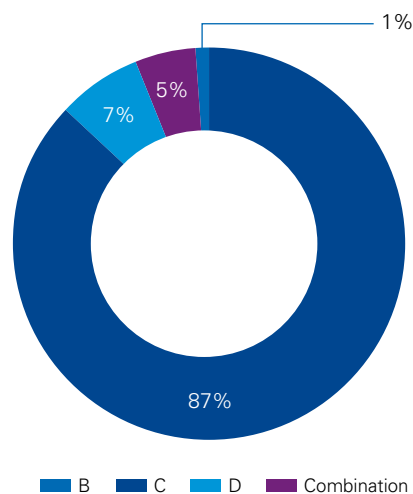
Back payments are also applicable subject to any limitations detailed within the scheme rules, with interest applied at 1% over the Bank of England base rate.

1%
5%
7%
87%

■ B   ■ C   ■ D   ■ Combination

Source: KPMG analysis

Accounting Impact

The additional liabilities that are created as a result of GMP equalisation will need to be reflected in the financial accounts of the sponsoring employer.
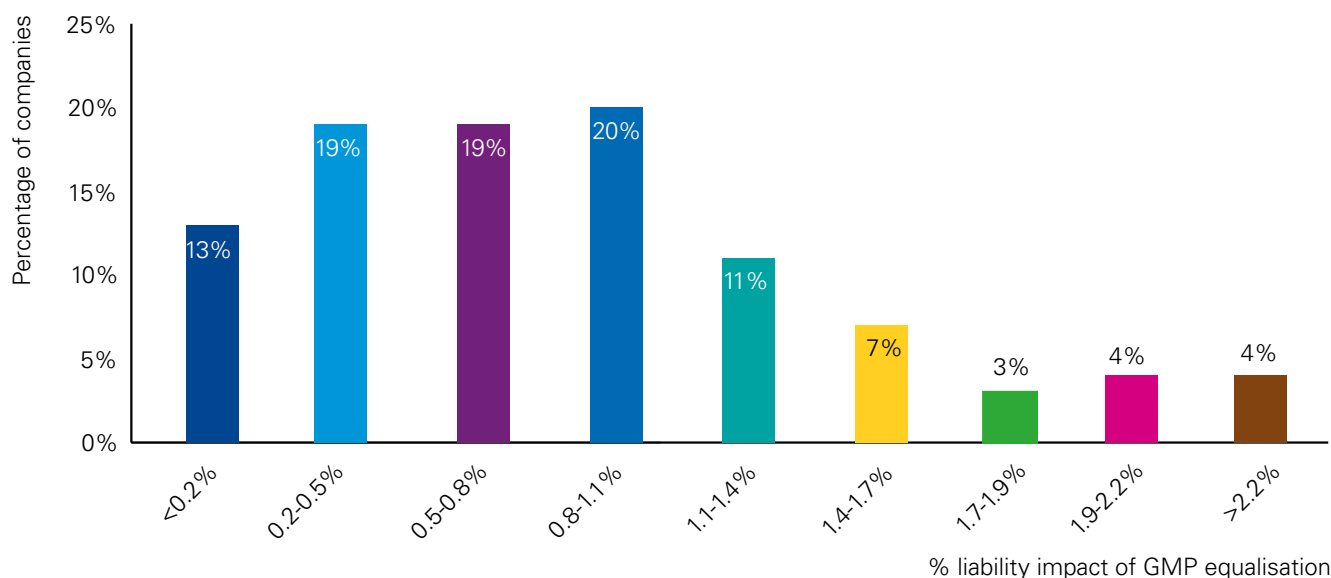
There are two accounting treatments which can be applied for recognising the impact of GMP equalisation:

– In the vast majority of cases, where companies have not previously allowed for the impact of equalisation in their financial reporting, a plan amendment must be recognised as there is now a confirmed obligation to change the benefits. Plan amendments are treated as past service costs within the Profit and Loss account. Generally amendments should be recognised at the date that they occur: in this instance the date of the judgement, 26 October 2018.

– However, in the rare cases that a company has previously made an explicit allowance for the impact of GMP equalisation in prior years' financial reporting (and can clearly evidence this), or has made previous attempts to equalise for the effect of GMPs, then it may be possible to recognise the judgement as a change in assumptions. This would then be reflected in OCI.

> **At the time of publication, over 90% of companies in our survey had concluded on allowing for GMP equalisation as a past service cost within the Profit and Loss account.**

Distribution of GMP impact

Percentage of companies (y-axis)

% liability impact of GMP equalisation (x-axis)

% liability impact	Percentage of companies
<0.2%	13%
0.2-0.5%	19%
0.5-0.8%	19%
0.8-1.1%	20%
1.1-1.4%	11%
1.4-1.7%	7%
1.7-1.9%	3%
1.9-2.2%	4%
>2.2%	4%

Source: KPMG analysis

> **The median impact of GMP equalisation at 31 December 2018 was 0.7% of total liabilities, with estimated impacts ranging between 0.0% and 4.1%, and being highly dependent on the specific scheme characteristics, in particular retirement age, pension increase rights, earnings histories and male/female splits.**

" **If a company has made an explicit allowance for the impact of GMP equalisation before, or has made previous attempts to equalise GMPs then it may be possible to recognise as a change of assumptions within the OCI.** "

Section Seven

Mortality

Mortality assumptions remain key for pension schemes, with continuing research and new approaches to scheme-specific mortality studies allowing companies to better quantify their longevity risk.

Median assumed life expectancies for current pensioners have reduced by 0.2 years whilst life expectancies for future pensioners have reduced by 0.1 years compared to last year, marking the fourth reduction in recent years for current pensioners, and the third for future pensioners.

Life expectancies

The graphs below show the spread of life expectancy assumptions used by companies for their current and future pensioners.

A current pensioner aged 65 is expected to survive a further 21.9 years on average, whereas a future pensioner currently aged 45 would be expected to live a further 23.4 years from the age of 65.

Distribution of current pensioner life expectancies
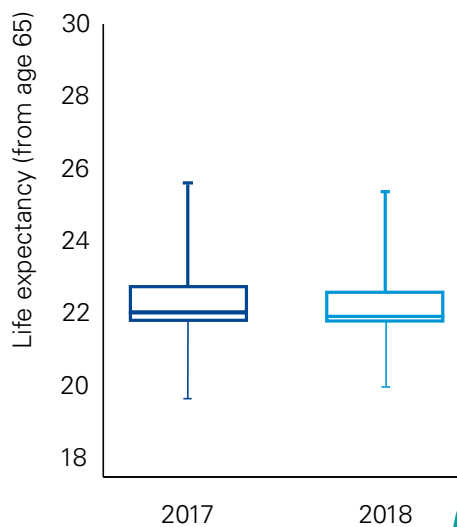
Source: KPMG analysis

Distribution of future pensioner life expectancies
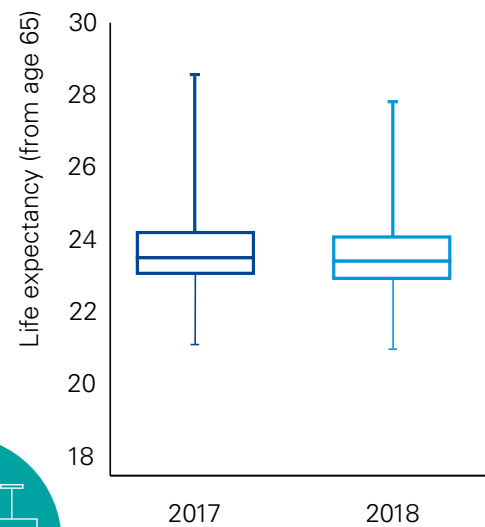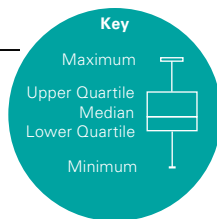
Source: KPMG analysis

Key
Maximum
Upper Quartile
Median
Lower Quartile
Minimum

Median life expectancies for current pensioners have continued to fall for the fourth year in a row.

Median life expectancies for future pensioners have continued to fall for the third year in a row, reflecting a decrease in the expected rates of future improvements in mortality.

Over the past few years, we have seen the median life expectancies for current and future pensioners decrease. This trend has continued in 2018 and is largely due to 76% of companies adopting the latest CMI 2017 series of projections published at the time, which reflected a decrease in the expected rates of future improvements in mortality.

Current pensioner life expectancy (male currently aged 65)

Source: KPMG analysis
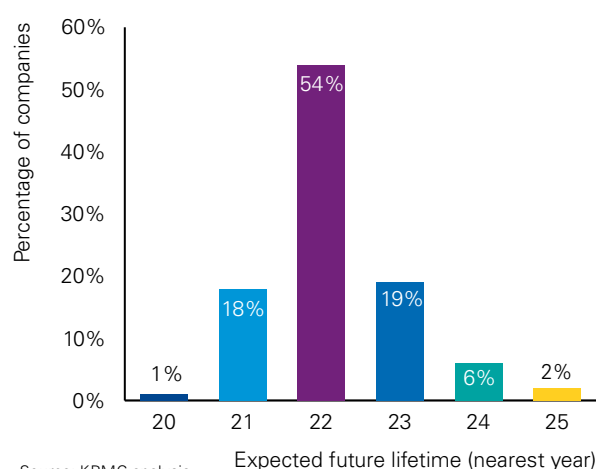
Future pensioner life expectancy (male currently aged 45 retiring at age 65)

Source: KPMG analysis
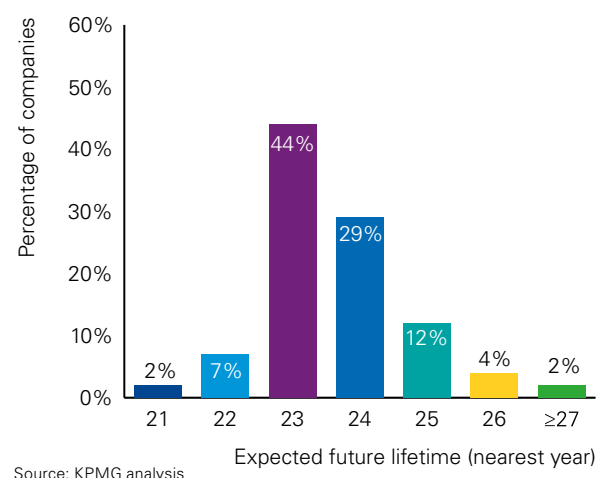
Around 90% of companies are using life expectancies within a 3 year range round the median.

Around 80% of companies are using life expectancies within a 3 year range round the median.

Base tables

The vast majority of companies have adopted the SAPS tables (97% at 31 December 2018). These mortality tables are based on actual pension scheme experience rather than life insurance tables such as PA92 and PA00.

Nearly all of these companies have adopted the S2 series published in February 2014 (95% adopted S2 at 31 December 2018 compared to 92% last year).

Of the companies surveyed, around 54% have adopted a scheme-specific scaling factor.

With mortality being a key assumption, mortality studies including postcode analysis and medically underwritten studies can help schemes to more accurately allow for the longevity risk in their population.

The Continuous Mortality Investigation Bureau (CMIB) published the S3 series of mortality tables in December 2018, which reflects the latest available data on pension scheme member's mortality experience.

The S3 series of tables are based on a larger dataset and also include an additional 12 tables compared to the

S2 tables. These additional tables include a 'Very Light' table for pensioners with incomes in excess of £40k p.a.

The life expectancies for the S3 Series tables are typically higher than would be obtained by projecting the equivalent S2 tables using CMI_2017. Life expectancy for males at age 65 is c.0.3 years higher for males when using the S3PMA table rather than S2PMA projected using CMI_2017. For females the equivalent difference is c.0.7 years. This would result in an increase in liabilities by around 1-1.5%.

The increase in life expectancies compared to the S2 tables is thought to be partly due to higher mortality improvements for pension scheme members than the general population, and partly due to the changes in the composition of the SAPS dataset. Therefore the CMI have advised that companies should consider the appropriateness of specific S3 series tables for their purposes and not simply apply the same scaling factors that were used with the S2 tables.

We expect to see many companies adopting the S3 tables by 31 December 2019.

Future improvements

The median gap between current pensioner and future pensioner life expectancies has remained the same at 1.4 years for a 20 year projection.

All of the companies surveyed adopted projections published by the Continuous Mortality Investigation Bureau (CMIB) for future improvements.
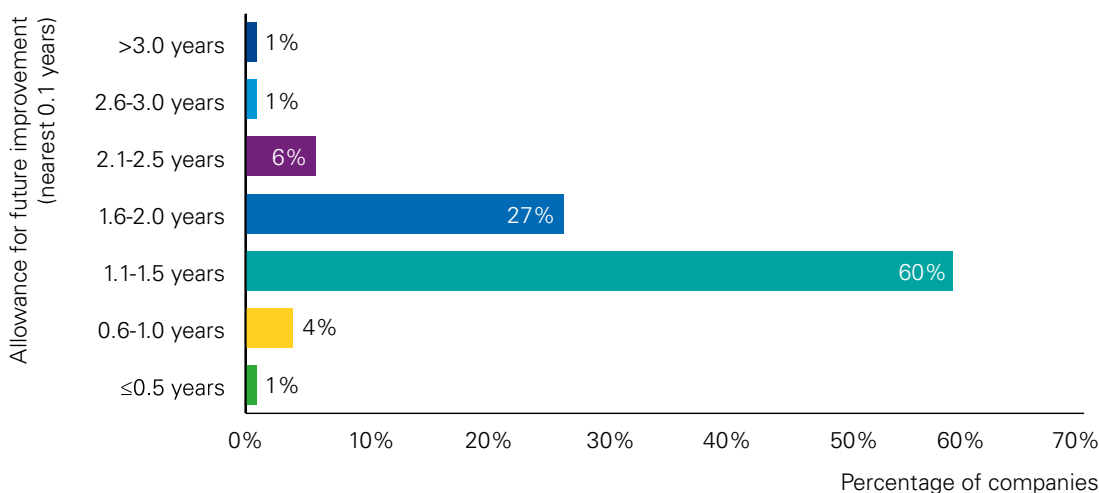
The CMIB is continually updating its research and produces annual updates of the CMI projection model. Companies are tending to use the most recent projections available. 76% of companies are using CMI 2017 for their 31 December 2018 accounting results.

Moving from CMI 2016 to CMI 2017 model would have reduced liabilities by around 0.6%, with a slightly greater impact for schemes with a younger membership.

The CMI 2018 projection model has recently been released, and we expect many companies to be using this model by 31 December 2019. Moving from the 2017 model to the 2018 model is likely to result in a reduction in liabilities of around 2% (of which around half of the impact relates to the update to the default smoothing parameter, as described on page 35), again with a slightly greater impact for schemes with a younger membership.
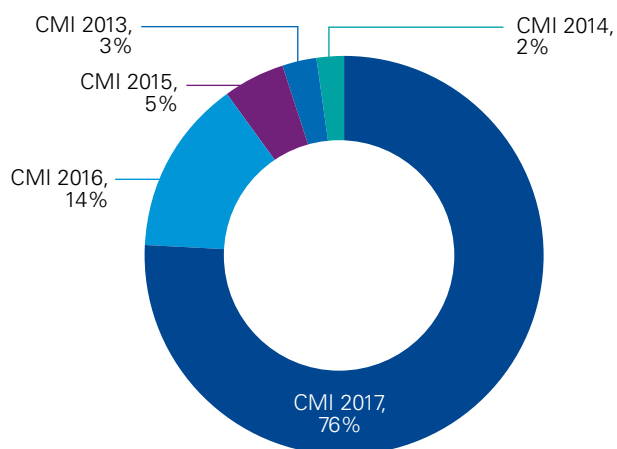
> **❝ The median gap between current pensioner and future pensioner life expectancies has remained unchanged from last year. ❞**
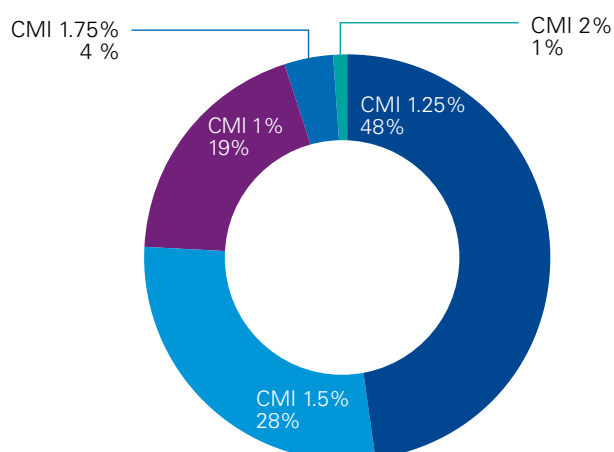
Distribution of future improvement allowances

Allowance for future improvement (nearest 0.1 years)

>3.0 years	1%
2.6-3.0 years	1%
2.1-2.5 years	6%
1.6-2.0 years	27%
1.1-1.5 years	60%
0.6-1.0 years	4%
≤0.5 years	1%

Percentage of companies

Source: KPMG analysis

Distribution of CMI projection models

CMI 2013, 3%
CMI 2015, 5%
CMI 2016, 14%
CMI 2014, 2%
CMI 2017, 76%

Source: KPMG analysis

Distribution of long term future improvements

CMI 1.75% 4 %
CMI 1% 19%
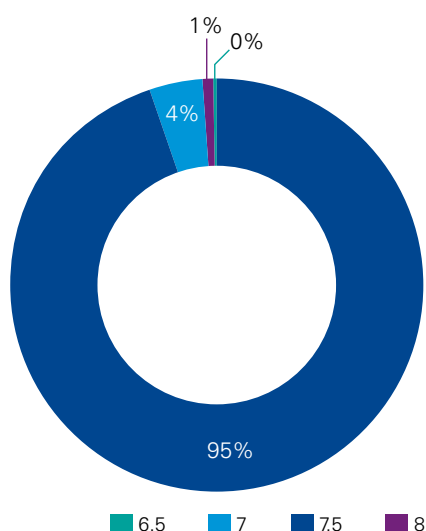CMI 2% 1%
CMI 1.25% 48%
CMI 1.5% 28%

Source: KPMG analysis

48% of schemes used the median long term future improvement of 1.25%, with the range from 1.00% to 2.00%.

KPMG

Smoothing parameter

Distribution of smoothing parameter adopted

1%   0%

4%

95%

■ 6.5   ■ 7   ■ 7.5   ■ 8

Source: KPMG analysis

> **In our data sample, 95% of companies have adopted the default smoothing parameter of 7.5 (applicable for CMI 2016 and CMI 2017).**

> **Next year, we expect to see many companies adopting the lower default smoothing parameter of 7.0 when updating to use the CMI 2018 model.**

A period smoothing parameter was introduced with the publication of the CMI 2016 model. This enabled companies to vary how much weight is placed on the most recent observed data on mortality improvements. In recent years, population data has shown the rate of mortality improvements slowing down.

The default smoothing parameter was initially set at 7.5 and was intended to be in line with the weightings used in the previous CMI models. A lower parameter than 7.5 smooths the most recent improvements to a lesser extent, and therefore makes the model more reactive to recent data.

There could be an argument that for setting best estimate accounting assumptions, it is appropriate to use a lower smoothing parameter to take more account of the most recent data. This would mean lower life expectancies and lower liabilities.

Following a consultation with the industry, for the latest CMI 2018 model that was released in March 2019, the default smoothing parameter has been updated from 7.5 to 7.0. This will place more weight on recent mortality experience and result in lower life expectancies and therefore lower liabilities. Moving from a smoothing factor of 7.5 to 7.0 would reduce liabilities by around 1% for a typical scheme.

Initial addition parameter

There has also been a new parameter added to the CMI 2018 model, called the initial addition parameter. This parameter is intended to allow users of the model to make adjustments to reflect differences in improvements in a particular sub-population (e.g. pension scheme members) relative to the general population data on which the model is calibrated. It remains to be seen how this parameter will be used when adopting the CMI 2018 model, and indeed whether companies will decide to move away from the core value (which could increase liabilities by several percentage points).

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Last year's survey
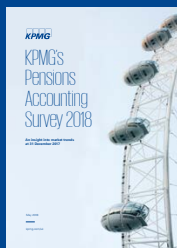
Click here
to view the 2018 survey

Visit Fusion
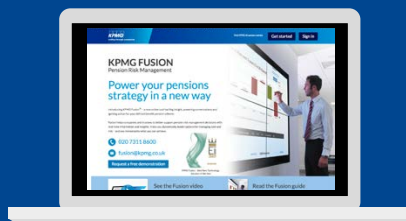
Click here
to visit the KPMG Fusion site

Visit Rethink Pensions
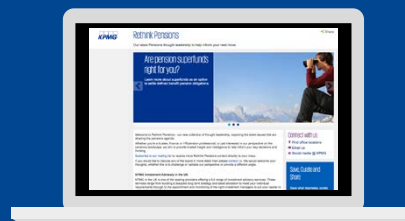
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to visit the KPMG Rethink Pensions site

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