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APRIL 2020

NEWSALERT

IAS19 & FRS101/102 – 31 MARCH 2020

Employers for whom we have carried out IAS19 & FRS101/102 calculations in the past will be aware that we normally confirm our proposed actuarial assumptions shortly after the relevant year-end. However, for this particular year-end, as at March 2020, this note is somewhat more detailed than usual. This is in part due to the market turmoil as a result of the COVID19 pandemic. However, there have also been some fundamental changes in market-implied Retail Price Inflation (RPI), due at least in part to the UK Statistics Authority and HM Treasury launching a consultation on changing the RPI formula. Our proposed assumptions for Consumer Price Inflation (CPI) are significantly influenced by market–implied RPI, and as a result, we are proposing some changes to the setting of the CPI assumption for accounting purposes.

COVID19

In March 2020 there have been substantial falls in equity markets around the world in relation to the COVID-19 pandemic. This will have consequences for asset values, and these falls in equity markets will be reflected in the accounting figures as at 31 March 2020. Over the same month, the market falls have also extended to corporate bonds, and as a result we have seen the yields on AA-rated corporate bonds rise by something of the order of 0.5% p.a. As the discount rate for accounting purposes is based on corporate bond yields, this rise in yields will have caused a reduction in accounting liabilities over the month. Finally, market-implied RPI has fallen during the month, although this may be more due to the consultation on RPI reform rather than any fundamental shift in expectations. This is covered in more detail below.

DISCOUNT RATE

As set out in our proposal documents, the financial actuarial assumptions to be used for IAS19 & FRS101/102 calculations for 31 March year-ends, and in particular the discount rate, depend on market yields at that date. Those yields will vary from employer to employer depending on the duration of their pension liabilities. For accounting purposes, we assess the duration as at the date of the latest formal actuarial valuation of the Fund (or date of admission to the Fund if later). Overall, the discount rate is based on a yield on corporate bonds of 2.3%-2.4% p.a.

CONSUMER PRICE INFLATION (CPI)

Up until August 2019, our past practice had been to deduct a margin of 1.2% from market-implied RPI to arrive at our proposed assumption for CPI. This margin is partly to allow for supply/demand distortions in the investment markets and partly because CPI is currently a lower measure of inflation than RPI. However, the previous Chancellor announced on 4 September 2019 that he proposed to initiate a consultation on RPI reform. On 11 March 2020, the UK Statistics Authority and HM Treasury formally launched the consultation, with a view to changing the RPI formula to make it consistent with the calculation of CPIH inflation from a date between 2025 and 2030. Our own expectation is that RPI will be aligned with CPIH with effect from 2030 and that market pricing now largely reflects the forthcoming expected change. We are also of the view that long term average CPI and CPIH will be similar to one another.

Factoring in all the above, our view is that expected CPI can be derived by deducting a margin of between 0.8% p.a. (for the shorter duration buckets) and 0.6% p.a. (for the longer duration buckets) from market implied RPI, allowing for both the "inflation risk premium" (i.e. supply & demand characteristics in the index-linked gilts market) and the expected difference between RPI and CPI. This reflects the fact that at longer durations a greater proportion of the benefits will be payable after 2030, by which time RPI will most likely have been migrated to be in line with CPIH.

Increases in pensions and deferred pensions are in line with CPI but are subject to a minimum of zero. To allow for this we will use an increase rate that is currently approximately 0.1% higher than our base CPI assumption rate. There is no adjustment of this nature to our proposed active post 1 April 2014 CARE revaluation rate as there is no annual minimum of zero.

Our proposed salary growth assumption is consistent with the results of the latest formal actuarial valuation of the Fund (i.e. the same long-term "real" salary inflation assumption in excess of CPI inflation, and allowing for any short term pay assumptions). In practice, the assumptions to be used are determined by the employer, and we are happy to discuss the use of different assumptions in any particular case. The full set of proposed assumptions is set out below.

Duration Profile:	Young	Young-Intermediate	Non-pensioner	Intermediate	Mature	Very Mature	Retired
Approx. duration at latest actuarial valuation (yrs):	over 31	29-31	27.5-29	25-27.5	21-25	17-21	up to 17
Discount rate (% p.a.):	**2.3**	**2.3**	**2.3**	**2.3**	**2.3**	**2.4**	**2.4**
Market-implied RPI (% p.a.)	2.6	2.7	2.7	2.7	2.7	2.8	2.9
Adjust from market-implied RPI to assumed CPI (% p.a.)	0.6	0.6	0.6	0.6	0.6	0.7	0.8
Assumed Rate of CPI inflation (% p.a.):	**2.0**	**2.1**	**2.1**	**2.1**	**2.1**	**2.1**	**2.1**
Rate of increase in salaries:	Scheme and employer-specific						
Rate of increase in pensions/ deferred pensions (% p.a.):	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Active post 1 April 2014 CARE revaluation rate (% p.a.):	2.0	2.1	2.1	2.1	2.1	2.1	2.1

LIKELY EFFECT ON RESULTS FOR A STANDARD EMPLOYER

The year on year development of the IAS19 and FRS101/102 figures will reflect the following features:

- A reduction in the discount rate of around 0.2% p.a. during the year for employers with younger profiles (the more mature employers may see no change in discount rate), and a very small reduction in the CPI inflation assumption; the combined effect of this is to increase liabilities slightly for most employers, perhaps by 1%-2% on average.
- As explained above, equity markets over the year as a whole are showing significant falls, albeit fixed interest stocks have shown some increases. Overall, investment returns are likely to be negative (perhaps of the order of 10% negative), leading to a reduction in asset values for accounting purposes.
- For LGPS Funds in England and Wales, the incorporation of the 2019 actuarial valuation results into the figures. There are likely to be some small gains from life expectancy assumptions being shorter than previously, but other factors will come in to play, which can be positive or negative on an individual employer basis.

So in summary, while results for employers will vary according to their specific circumstances, for most employers using our proposed assumptions, compared to the figures calculated last year the general trends are:

- A reduction in assets, leading to an increase in accounting deficits over the year in most cases.
- An increase in projected "income & expenditure" figures for 2020/21 when compared to the 2019/20 year.

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If you have any queries on the content of this document please contact Mark Wilson (0151 242 7373 or mark.wilson@mercer.com).

We have prepared the above advice in connection with carrying out accounting calculations for employers which participate in our LGPS client funds. We do not accept any liability or responsibility to any third party in respect of this advice. It may not be used for any other purpose. This advice is confidential and may not be disclosed in whole or in part to any third party without Mercer's prior written consent, unless required by law or order of a court or regulatory body. Mercer retains all copyright and other intellectual property rights in the advice.

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