12/2022

XPS Express for Employers

Bringing you the latest pensions news for employers

Managing an unprecedented pensions accounting year-end

At a glance

Corporate balance sheets are projected to show material improvements due to large rises in corporate bond yields, with an estimated aggregate accounting surplus across UK DB schemes of £58bn

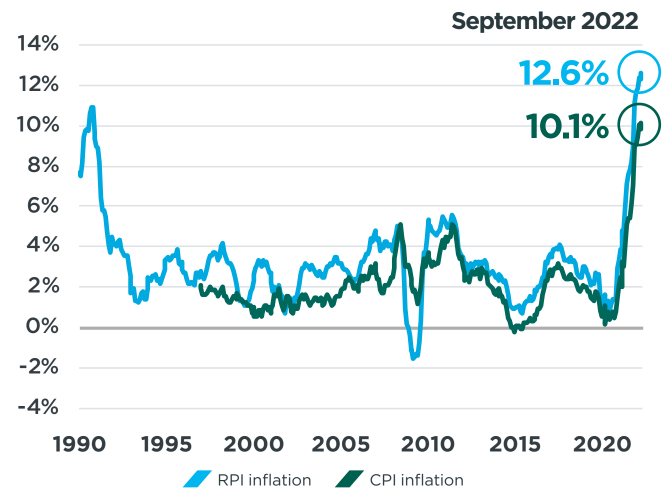
Whilst surpluses will be welcome by most employers, this positive accounting position requires consideration of how a surplus could be accessed by the sponsor and if it can be recognised in financial reporting

In addition The Pensions Regulator's draft new funding regulations could lead to increased cash contributions despite improving balance sheets and therefore increased scrutiny from stakeholders

Many schemes will be a lot closer buyout. This is a positive development but the accounting treatment of this can lead to significant P&L charges if the process is not carefully considered from an early stage

Cost of living crisis

With inflation at its highest level for 40 years, it is important for employers to reflect the one-off impact of significantly higher than expected inflation this year to avoid understating pension obligations on the balance sheet.



Source: Office for National Statistics

Change in corporate bond yields

Source: XPS Pensions Group

Actions employers can take

1. **Plan for the year-end with your advisers and engage early with your auditors to understand their views.**
2. **Consider the treatment of surpluses and understand your auditor's expectations.**
3. **Assess the likelihood of buy-in/buyout in the short to medium term and consider how best to structure the process to mitigate unpleasant accounting treatments.**
4. **Understand where your assumptions sit in the market.**

Year-end reporting

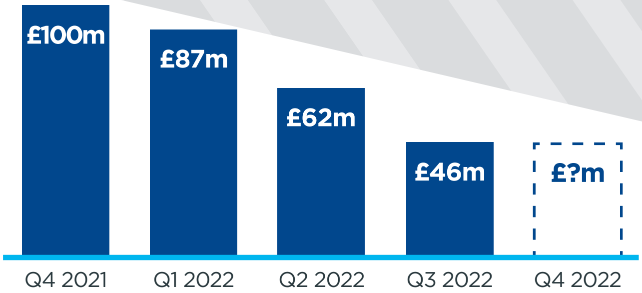
The recent, significant rise in corporate bond yields has cut balance sheet liabilities. We estimate an aggregate accounting **surplus** of **£58bn** at 31 October 2022 (compared to a **£59m deficit** at 31 December 2021) across all UK DB schemes.

Short-term inflation is at its highest level for nearly 40 years and it is important for employers to consider the one-off impact of significantly higher-than-expected inflation this year.

Asset values across most major asset classes have fallen since December 2021. In particular, schemes with high levels of interest rate and inflation hedging will have seen a significant decrease in the value of matching portfolios, but this will have been matched by similar falls in liabilities unless hedging was lost during the extreme gilt price volatility following the mini budget. Financial reporting of illiquid assets is a common difficulty due to subjective valuations that often take time to complete. The recent market volatility has exacerbated this with many schemes looking to sell illiquid assets to support LDI strategies meaning that fair value pricing is becoming more difficult.

There is an increasing need to establish mortality assumptions which are specific to the characteristic of your scheme and to understand how the excess deaths we are continuing to see since the COVID-19 pandemic affect your scheme. Auditors will expect to see evidence of how mortality assumptions have been set.

Accounting liabilities for an example scheme of medium to young maturity



Source: XPS Pensions Group

Returns on key asset classes

	Dec 21 –Jun 22	Jun 22 –Sept 22	Year to Sept 22
Global equities	-10.5%	1.4%	-9.2%
UK equities	-4.6%	-3.4%	-7.9%
Property	-19.1%	-19.4%	-34.8%
Index-linked gilts	-22.1%	-9.3%	-29.3%
Corporate bonds	-13.9%	-11.5%	-23.8%

Source: Refinitiv

Additional considerations for employers

New funding regulations

- Expected to come into force in late 2023.
- Likely to drive schemes to target higher funding levels resulting in continued balance sheet improvements.
- Directors may be under greater scrutiny as to why cash is being paid into schemes with a balance sheet surplus.

Treatment of surplus

- The majority of employers reporting under UK or International accounting standards will be able to recognise any surplus.
- We expect auditors to have a stronger focus on this area given market developments.
- This can be addressed in advance of the year-end.

Risk transactions

- Expecting buyout volumes of c.£50bn next year.
- Can result in a significant P&L charge, depending on the structure of the transaction.
- Important to work together with trustees to try and structure the transaction to mitigate the possible impact on accounting.

Understanding where your assumptions lie

- XPS have released a free-to-access interactive web-based benchmarking tool that enables employers to compare their key assumptions to those adopted by other employers.

To access the **XPS Accounting Tracker** click here

For further information, please get in touch with Jim Heal or Emma McAteer or speak to your usual XPS Pensions contact.

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