The new normal?

Making the most of multi-billion £ pension surpluses

LCP Accounting for Pensions

May 2024

Helping corporate sponsors

Welcome to LCP's 31st annual Accounting for Pensions report which analyses the 2023 disclosures of FTSE100 companies.

In recent years these reports have been filled with words like "turbulence", "fallout" and "unprecedented". Not so this year – from a financial perspective relatively benign conditions mean pensions surpluses that have emerged over recent years are beginning to look embedded.

This fact hasn't escaped the Government, and we're awaiting their response to a consultation that could make it easier for the surpluses identified in this report to be returned to companies where they are not required by the schemes themselves.

Making the most of the last few years may have been for the opportunists. But if pensions surpluses are indeed the "new normal", now is surely the time for the planners.

Contents

Section 1: Making the most of continued surpluses

Section 2: IAS19 assumptions benchmarking

Section 3: Hot topics for Finance Directors

Section 4: Executive pensions benchmarking

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AT A GLANCE

THE NEW NORMAL

aggregate FTSE100 surplus at 31 December 2023.

in a row showing an overall surplus.

of FTSE100 companies estimated to have had a pensions accounting surplus at 31 December 2023.

OLD HABITS

of FTSE100 UK pension scheme assets tied up in bonds and cash.

more invested in bonds than equities, with the ratio having increased seven-fold in a decade.

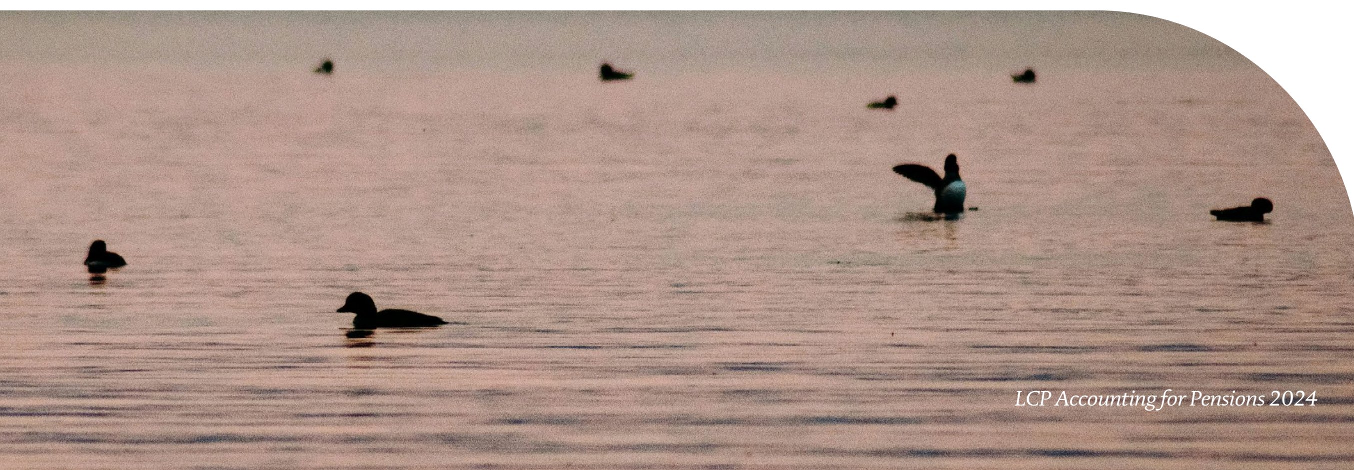
FTSE100 companies with UK DB pension schemes undertook an insurance transaction of some kind in 2023.

CHANGING TIMES

of FTSE100 companies using the CMI 2022 model of mortality projections allowed for recent mortality experience.

of basic pay is the average employer pension contribution rate for a FTSE100 CEO – down from 25% in 2018.

FTSE100 CEOs are now receiving pension contributions in line with their employees – this is up from around one in seven in 2018.

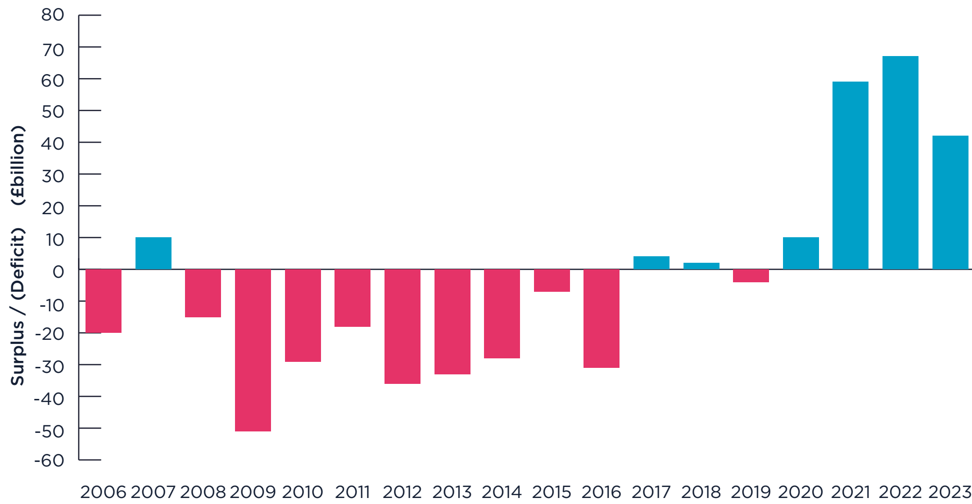


SECTION 1:
MAKING THE MOST OF CONTINUED SURPLUSES

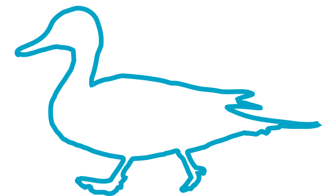
A reduction in surplus or not?

The estimated aggregate surplus for the FTSE100's UK DB pension schemes reduced from £67bn at the beginning of 2023 to £42bn at the year end, a reduction of £25bn.

Estimated combined IAS19 pensions position of FTSE100 companies at calendar year-ends



Accounting valuations for pension schemes are driven by corporate bond yields. Over 2023, we saw a significant reduction in the corporate bond spread – the gap between the yield on government bonds (gilts) and corporate bonds. This reduces the accounting discount rate and increases liabilities. The reduction in surplus can be almost entirely attributed to this reduction in corporate bond spread, which has persisted into early 2024 as shown in the following chart.



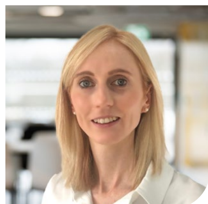
Long-dated AA rated corporate bond spread

Source: iBoxx GBP AA Corporates 15+ spread

Whilst a £25bn reduction in surplus may look like a sharp deterioration in the funding position, the accounting balance sheet is by no means the only measure of the financial health of a pension scheme.

In particular, the valuations for assessing the funding requirements of pension schemes and cash costs are typically driven by gilt yields. This valuation is also the one typically used by pension schemes to set their investment strategy. Trustees and sponsors will often target minimising volatility on this basis as it can impact cash requirements, but in doing so, can create artificial movements in valuations using other assumptions. This was covered further in last year's Accounting for Pensions report.

Importantly, the underlying funding position on a gilts-based measure has remained stable.



Whilst the headline IAS19 surplus reduced over the year, valuations for assessing the funding requirements of pension schemes have remained broadly stable. This relative stability presents an ideal platform for sponsors to review their pensions strategy, and in particular what "endgame" they are targeting for their pension scheme.

Laura Amin. Partner

What is your endgame?

For years, the direction of travel has been towards lower risk and ultimately getting the scheme off the corporate balance sheet by insuring it.

These tactics also played out over 2023 – across the FTSE100, bond allocations have reached almost 75% of scheme assets, and a quite remarkable 20% of FTSE100 companies with UK DB pension schemes undertook an insurance transaction of some kind.

At 31 December 2023, within the FTSE100 alone over £250bn of UK pension scheme assets were tied up in bonds and cash, over 9x the amount invested in equities. This ratio has increased seven-fold in a decade.

David Wrigley. Partner

However, an insurance "buy-out" is not the only option available to schemes and sponsors. What's more, we are awaiting the Government's response to its consultation on so called 'Mansion House' reforms, which could make it easier for sponsors and/or members to derive more value from their pension surpluses.

Accessing value from UK pension surpluses is not just a theoretical possibility – it is already happening and the outcome of the consultation on Mansion House reforms could make it easier in future.

Jonathan Griffith. Partner

So what?

1. Whilst insurance buy-out may be the right long-term strategy for many, it is not the only answer. Materially changed financial circumstances and an evolving set of available options mean reviewing previous made decisions is a must if you haven't already. More detail on this in our corporate report and this blog.
2. Don't forget the accounting impact of your long-term strategy when reviewing your options. More detail on this in Section 3.
3. Actively manage your messaging of an accounting surplus to the markets, rating agencies, and other users of your accounts. More detail on this in Section 3.

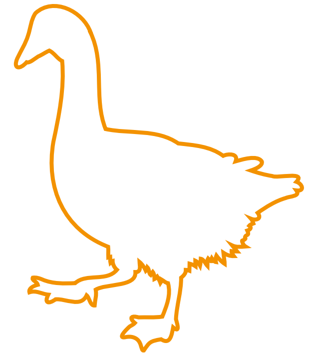
SECTION 2:
IAS19 ASSUMPTIONS BENCHMARKING

Discount rate

IAS19 discount rates are set with reference to high quality corporate bond yields. Over 2023, there was a reduction in these yields of around 0.3% pa, driven largely by a reduction in corporate bond spreads.

AA-rated corporate bond yields over 2023

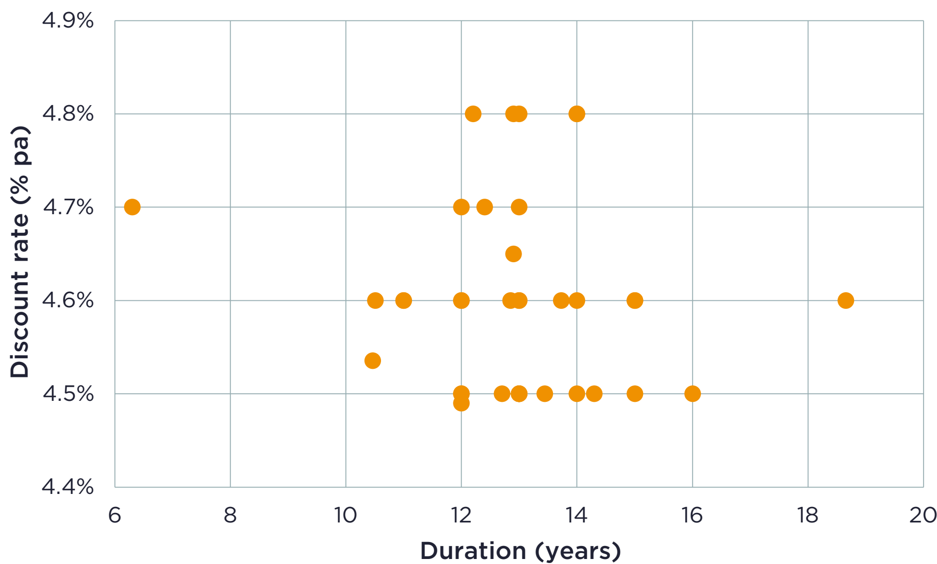
Source: iBoxx GBP AA Corporates 15+ spread

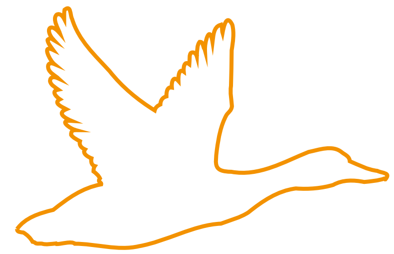


As described in Section 1, a fall in corporate bond spreads has reduced the aggregate surplus over 2023.

The chart below shows the disclosed IAS19 discount rates for FTSE100 companies reporting at 31 December 2023. The majority of companies reported in the range 4.5% pa to 4.8% pa, which compares with a typical range of 4.8% pa to 5.0% pa in 2022.

Disclosed UK IAS19 discount rates as at 31 December 2023



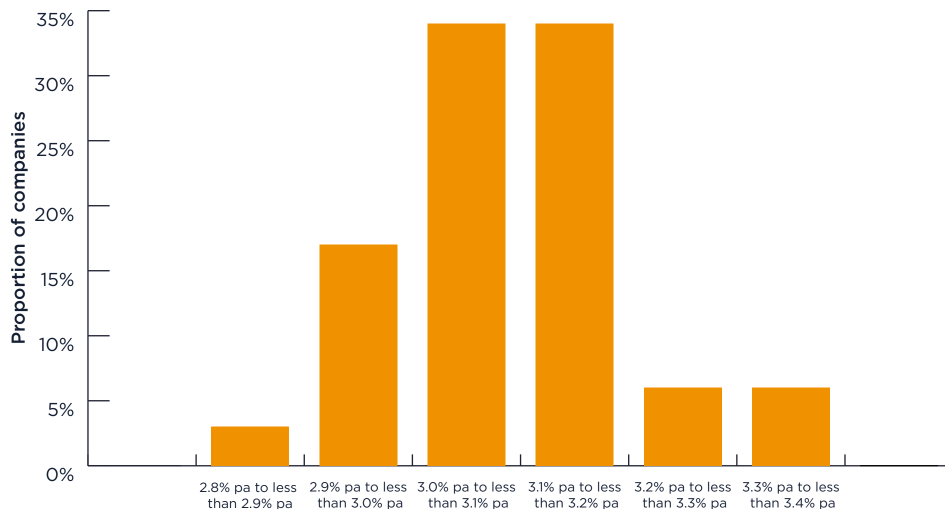


Inflation

Companies typically set their assumptions for future RPI inflation by comparing the market yields available on RPI-linked gilts with fixed-interest gilts. The assumption is an average over the lifetime of the pension scheme.

The chart below shows disclosed RPI inflation assumptions for FTSE100 companies reporting at 31 December 2023. Behind the headline assumptions below, and in line with previous years, the average assumption decreases with increases in duration (as they are assumed to benefit more from expected lower levels of future inflation). The median assumption for the 2023 year-end is down 0.2% pa from 2022, leading to a small reduction in IAS19 pension liabilities. The majority of companies continue to use an inflation risk premium (or 'IRP'), with the typical scale of these IRPs broadly unchanged from recent years at around 0.3% pa.

Disclosed UK RPI inflation assumption as at 31 December 2023

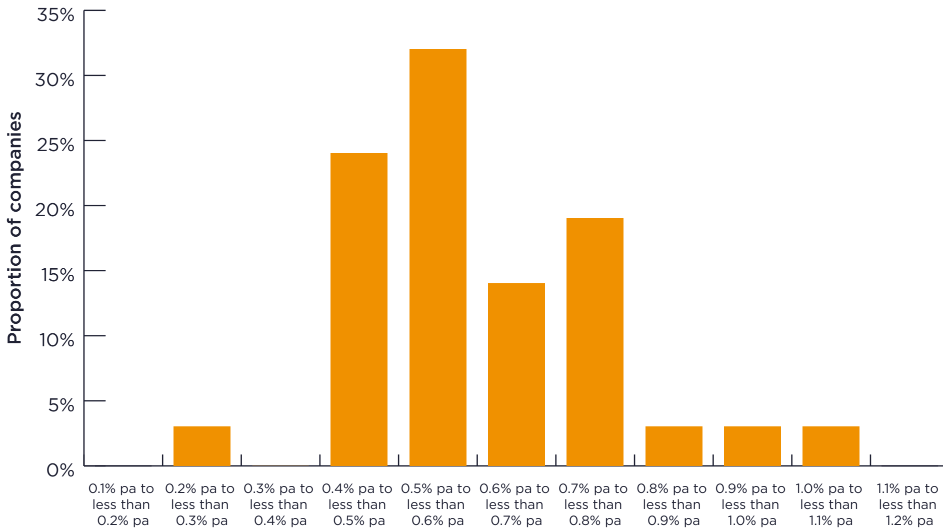


CPI inflation is then typically derived by making a deduction to the RPI assumption to reflect structural differences between the two inflation measures – the so called 'RPI-CPI wedge'. As previously reported, the RPI inflation index is being reformed to bring it in line with the CPIH index (a variant of CPI) from 2030. Inflation measured by CPIH is consistently lower than that measured by RPI, and therefore these plans imply a significant step-change reduction in RPI inflation from 2030, and therefore also a significant reduction in the RPI-CPI wedge from 2030.

On 1 December 2023, the Office for National Statistics published revisions affecting how the CPIH index is calculated. The revisions tend to increase CPIH relative to CPI, which may suggest an increase in the assumed wedge from 2030 onwards.

The impact of the planned changes will vary significantly by scheme and the nature of the scheme's benefits. The chart below shows the wide range of RPI-CPI wedges for FTSE100 companies reporting in 2023. The median assumption of 0.5% pa and range of assumptions are both 0.1% pa lower than last year.

Wedge between disclosed RPI and CPI inflation assumptions

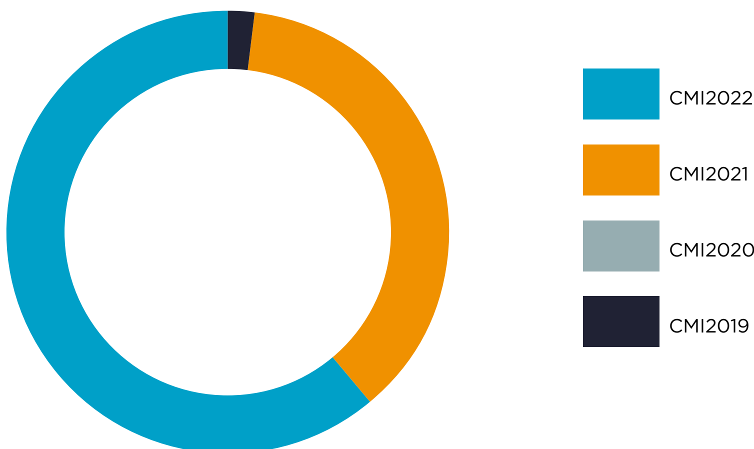


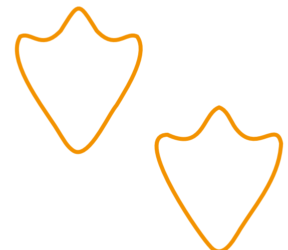
Life expectancy

The assumptions for life expectancy are the most challenging of the accounting assumptions to set objectively.

The level of detail disclosed varies significantly between companies, with some disclosing just life expectancies and others providing full detail of the many component parts of the mortality assumption. The charts below show the information reported in 2023 where information on the underlying component assumptions is provided. Where relevant, we have also provided commentary on how the position has changed since last year.

Projection tables disclosed by FTSE100 companies reporting in 2023 (46 companies)





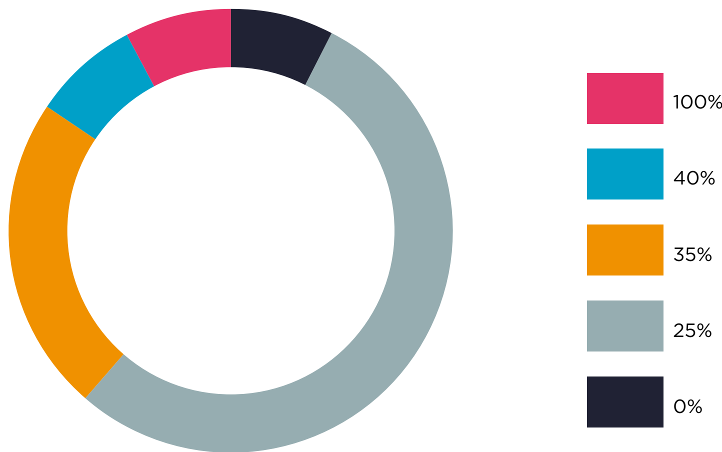
Only 4 of the 46 companies who disclosed the tables used did not use the latest available projections.

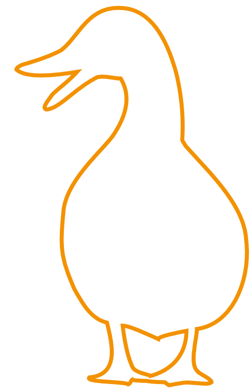
The projection tables estimate how life expectancies are expected to change in the future. New projection tables are released each year to include the latest available information. The latest such tables at 31 December 2023 were the CMI 2022 projections, which were released in June 2023. Of the companies that disclose which projection data table they use, the majority continue to use the latest available table at the balance sheet date. Given the range of accounting dates over the year, although companies may have used the latest projections, this may not have been the CMI2022 projections.

Long-term mortality improvement rates disclosed by FTSE100 companies reporting in 2023 (40 companies)

The long-term rate of improvement is an estimate of the rate of life expectancy improvement in the very long term. Of the companies that disclose this, the median assumption is a long-term annual improvement rate of 1.25%.

Allowance for mortality experience over 2022 in CMI 2022 model disclosed by FTSE100 companies reporting in 2023 (13 companies)





All but one company using the CMI2022 model made some allowance for mortality experience over 2022.

The CMI 2022 projections contain parameters to determine how much weighting is placed on mortality data collected over 2020, 2021, and 2022 (the w2020, w2021, and w2022 parameters respectively). This data covered the main Covid outbreaks, and the default core approach is to place no weight on the data collected in 2020 and 2021, and 25% weighting on the data collected in 2022.

Emerging market data, as well as analysis by LCP's Health Analytics team, suggests that there is likely to be an adverse long-term impact of the pandemic on life expectancy. 13 companies disclosed the w2022 assumption used in their accounts, with all but one making some allowance for data collected over 2022.

SECTION 3
HOT TOPICS FOR FINANCE DIRECTORS

3.1 Accounting impact of your long-term strategy

As discussed in Section 1 of this report, a growing number of sponsoring employers are beginning to consider and put in place alternatives to the classical endgame strategy of insuring the pension scheme as soon as it's affordable to do so.

Within each of the headline endgame strategies available, there are many variations, all with different accounting implications. Whilst accounting implications should not determine corporate pensions strategy, understanding the potential impact of long-term strategic decisions on balance sheets should form part of the planning process. Incorporating these at an early stage can often enable potential unwelcome accounting outcomes to be managed or messaged appropriately.

Some simplified examples of unwelcome accounting outcomes include:

1. A full scheme buy-in could worsen the sponsor's debt measures or debt to EBITDA ratios, and in some cases reduce distributable reserves.
2. Long-term runoff could cause unwanted accounting volatility if it's not taken into account in the investment strategy.
3. Auditor interpretations of balance sheet surplus recognition may be less "company-friendly" if there is an agreement (or expectation) to share surplus with members.
4. There are many other situations where the accounting implications of a given pensions strategy might affect the attractiveness of that strategy. Those implications will sometimes be very different depending on the accounting standard – US GAAP in particular can bring a host of separate risks (and sometimes opportunities).

When exploring the range of endgame strategies, it's critical to understand what they mean in terms of balance sheet and key KPIs, as well as the best messaging to convey to the markets.

Phil Cuddeford
Partner

3.2 Messaging an accounting surplus to the markets, rating agencies, and other users of the accounts

Pensions accounting surpluses are now common and growing, and external messaging about what this means for investors is increasingly important. See also this LCP blog on how surpluses should be allowed for when valuing a business.

Market participants such as ratings agencies may give little or no credit to the company for this surplus. But Finance Directors may wish to convey to the markets the realities around this surplus, for example pointing out that:

1. An accounting surplus means that the scheme investments only need to provide AA corporate bond returns in future; if they achieve those returns, no further company contributions would be needed to pay all the benefits (in a long-term runoff scenario).
2. All else equal, the better funded a pension scheme the lower the risk to the sponsor of unexpected cash calls, and potentially the more likely the scheme can be an asset to the business through surpluses being used for the sponsor's benefit.
3. The company's position may be more favourable than that of peer companies that are competing for investors.

Finance Directors also need to be careful if they expect to buy-in any time soon. The focus of the messaging then needs to be around management of risks.

When Wincanton recently announced the results of their actuarial valuation to the markets, explaining the favourable impact on the company, their opening share price the following day jumped by over 13%.

Clear and effective messaging on a company's material pension plans to the markets can bring tangible benefits.

Alex Waite
Partner

3.3 Process and technical points that materially affect outcomes

3.3.1 Controls

Auditors assess the design and implementation of the controls applied by companies to reliably detect material misstatements. The outcome of the recent UK Corporate Governance Code consultation (including a requirement for boards to make a declaration in relation to the effectiveness of their material internal controls) also places increasing emphasis in this area.

Finance Directors will therefore be keen to ensure that the right controls are in place to minimise the risk of misstatement and the reputational consequences that could follow.

As an example, a company will often engage an actuary to advise on appropriate assumptions for pensions accounting purposes. Companies may be asked to demonstrate they have appropriately reviewed and challenged that advice. Some of the considerations include:

- Ensuring there is sufficient reliable and relevant data for the Company to critically question the assumptions set by the third-party actuary.
- Developing the Company's own independent expectations to compare against the proposed assumptions.
- Creating clear criteria or thresholds to identify, investigate and resolve differences.
- Demonstrating formal documentation that details the identification, investigation and resolution of significant differences from expectations, and the criteria for investigation and challenge.

Some examples of actions being taken by companies include:

1. Developing a formally documented controls process for pensions accounting.
2. Before key balance sheet dates, using the most recent survey information (e.g. auditor surveys, LCP's "Accounting for Pensions" report) combined with market indicators on yields, to produce an internal paper setting out expectations and ranges on the main assumptions.
3. Seeking relevant input where appropriate from Internal Audit.

Where applied proportionately, this is likely to add value to the controls, while easing the audit process and helping with Audit Committee interactions.

We have seen an increased focus on controls given audit and regulatory developments, and our clients are designing solutions that improve their risk management and processes in a proportionate way.

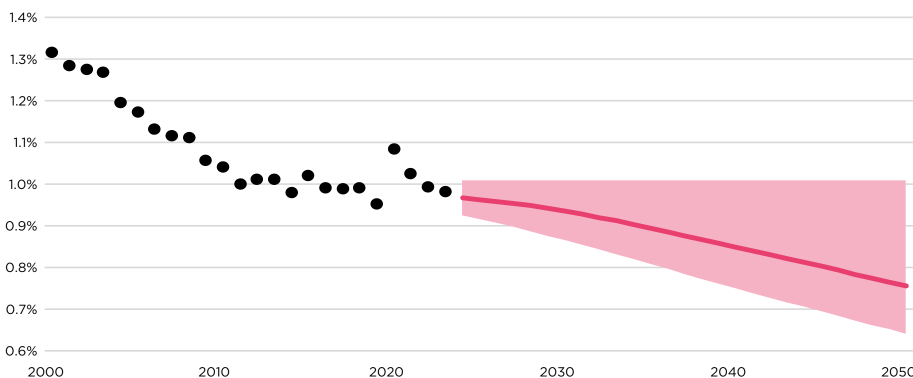
Helen Draper
Partner

3.3.2 Mortality developments

LCP's 2024 longevity report provides the latest insights into mortality expectations in light of the uncertainties post pandemic.

The chart below, taken from that report, shows mortality rates since 2000, with lower mortality rates implying fewer deaths and higher life expectancies. It shows a range of possible future trajectories, illustrating potential uncertainty. Mortality rates fell rapidly until 2010 but then stagnated for a decade, before increasing during the pandemic. So far in 2024, mortality rates are in line with the best years on record (i.e. lowest mortality rates), despite the ongoing pressures on the healthcare system. This highlights the uncertainty in the trajectory following the disruption caused by the pandemic.

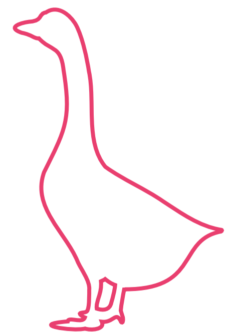
Average mortality for typical DB pension scheme membership since 2000, and projected scenarios



Source: CMI data, LCP analysis

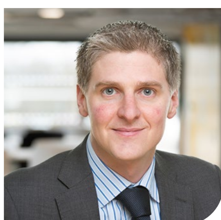
The upper range reflects a scenario where there are no more mortality improvements for the foreseeable future (continuing the stagnation in improvements since 2010 in the UK).

The lower range reflects a scenario where mortality improvements get back on track, and material reductions in mortality rates are seen again (akin to pre-2010).



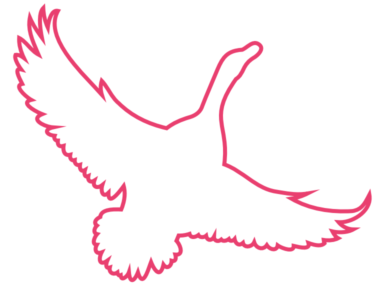
For accounting purposes, companies have to choose appropriate best-estimate mortality assumptions. When using the new "CMI 2023" model, this includes choosing how much weight to place on the years since 2020. This in turn will depend on having informed views on many uncertainties including:

- Will the NHS recover from its current strains, and what impact will this have?
- How will the future look for different subsets of the population, tailored to your membership?
- How will the incidence, detection, and treatment of diseases such as cardiovascular disease and cancer progress into the future?



The pandemic and the ongoing pressures on the healthcare system have significantly disrupted mortality trends. This disruption presents a challenge to traditional actuarial models used for forecasting mortality. We have helped clients understand how these issues will affect their schemes, which leads to better-informed decisions and can reduce liabilities through reduced life expectancies.

Stuart McDonald, Partner



3.3.3 Accounting for full scheme buy-ins

Under UK and International GAAP, a full scheme buy-in will normally result in a reduction in the reported funded status.

The biggest and best-known accounting question is whether this reduction is booked to P&L or not. The answer to this question will be specific to the circumstances as well as the views of the auditor. We have discussed this point in previous reports, for example here. US GAAP reporters should be aware that the rules, criteria, and options are quite different to UK and International GAAP.

There are several other points to consider, including where to book the expenses of the buy-in, any requirements for post balance sheet disclosures where a transaction is agreed shortly after the balance sheet date, and the optimal messaging of the benefits of the derisking transaction to the markets.

It's important to consider the accounting impact of a full buy-in transaction from the outset to avoid unpleasant surprises. This includes ensuring that the post transaction accounting is addressed in detail.

Nikki Ayriss
Partner

3.3.4 Accounting for discretionary increases

Discretionary pension increases have become a more common issue for companies to consider in the last couple of years due to (1) high inflation; (2) more pension scheme wind-ups with surplus; and (3) new endgame journeys that lead to a commitment or expectation of sharing surplus with members. Significant amounts can be involved, and this can be a material consideration both financially and reputationally.

Some of the direct accounting questions include:

- When does the granting of discretionary benefits become a company liability?
- When and how should that liability be booked?

When considering granting extra pension increases, it's important to consider the accounting implications, as the costs can have big implications for a company's bottom line.

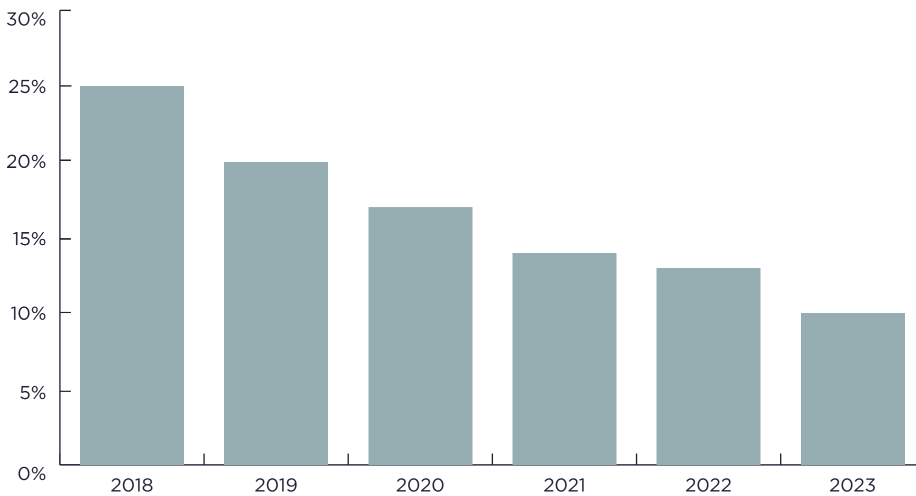
Tim Marklew
Partner

SECTION 4:

EXECUTIVE PENSIONS BENCHMARKING

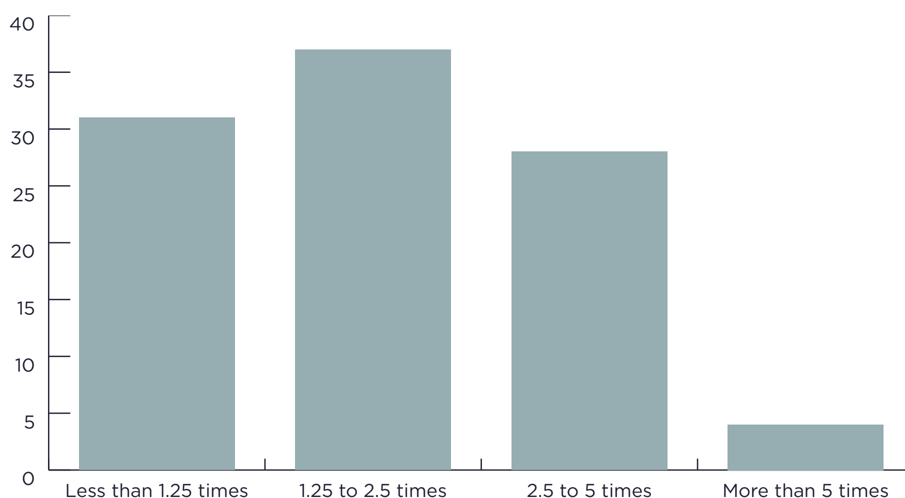
The Investment Association has been campaigning for companies to align pension contributions for executives with those available to the majority of the workforce. This has resulted in the average level of pension contributions (including cash in lieu of contributions) paid to a FTSE100 CEO more than halving over the six years from 2018.

Average pension contribution to a FTSE100 CEO as a percentage of basic salary



The chart below shows the rate paid to the CEO can be compared to the average rate paid to employees for each FTSE100 company. Around one in three FTSE100 CEOs are now receiving pension contributions in line with their employees – this is up from around one in seven in 2018. In addition, the number of FTSE100 CEOs receiving more than five times the average rate paid to employees has dropped by around 90% over the same period.

Pension contribution rate for FTSE100 CEO relative to the average rate paid to employees



Whilst this suggests that around 70% of CEOs are receiving pension contributions well in excess of those paid to employees, this does not necessarily mean that they are in breach of Investment Association guidelines. Companies may offer higher levels of pension benefits to employees, but some employees may elect not to access these benefits. In addition, pension contributions may vary from country to country.

The trend in average pension contributions for FTSE100 CEOs is quite remarkable, and the median hitting 10% of basic salary feels like an important milestone in the alignment of executive pensions with the wider workforce.

Luke Hothersall
Partner

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