HYMANS # ROBERTSON

Accounting Assumptions

Take control early, it's your call!

From listening to LGPS employers, we understand the importance of the pension figures disclosed in your accounts. The figures disclosed can have a material impact on your ability to carry out your normal business function.

The pension figures, in both the balance sheet and revenue account, are heavily dependent on the choice of assumptions. Crucially, as directors of the organisation, it is your responsibility to set assumptions that best reflect the characteristics of your organisation.

Your options

1 Enhanced Service

For employers who wish to take control of the figures disclosed in their pension accounts, using the enhanced service would allow your organisation to:

- Receive an employer specific assumptions paper covering the assumptions key to your organisation, what changes to assumptions could be made, and the estimated financial impact on your accounting disclosures. This would be based on information you provide about future expected pay growth and recruitment plans.
- Arrange a face-to-face meeting or a call with an Actuary to discuss the accounting assumptions and how these impact on your organisation's accounting figures.
- Receive provisional FRS102 / IAS19 figures in advance of the reporting date, giving an early indication of how your assets and obligations have developed and can also help inform the assumption setting exercise.

Engaging directly with the Actuary preparing your FRS102 / IAS19 report is typically more cost-effective than seeking third party advice.

For more information about our enhanced service, please click here or call one of our accounting specialists - Craig Alexander on 0141 566 7843, Tom Hoare on 0141 566 7991 or Adrian Loughlin on 0141 566 7591.

2 Basic Service

For employers who are happy to adopt the default assumptions, appropriate for an average LGPS employer with your liability profile, we will prepare the standard accounting report for the standard fee.

HYMANS ROBERTSON

Briefing note

Local Government FRS102 / IAS19 February 2020

> "You choose assumptions appropriate for your organisation"

As the actuary to the LGPS fund in which you participate, we provide a set of default accounting assumptions for a 'typical LGPS employer' which can be amended to be more appropriate for your organisation.

The accounting assumptions adopted are ultimately the responsibility of your organisation's directors (or equivalent) based on actuarial advice.

We therefore strongly recommend that you consider the suitability of the default assumptions to your specific organisation. It is up to you to determine how to proceed with the choice of assumptions given the relative importance of the LGPS accounting figures to your organisation's own circumstances.

The value placed on the liabilities for accounting purposes (the defined benefit obligation) is heavily dependent on the assumptions adopted. The assumptions you choose to adopt will drive:

1. your **accounting balance sheet at the year-end date**; and
2. your **profit and loss cost for the year following the year-end date.**

For example, adopting a lower salary increase assumption than our default assumption may better reflect your own organisation's forecasts. This change would lower the value placed on the defined benefit obligation (and improve the accounting balance sheet position).

If you wish to take control of your accounting disclosures, please get in touch with us as soon as possible.

The remainder of this briefing note sets out the rationale behind the setting of our default principal accounting assumptions. The approach to our default assumption setting applies to all accounting disclosures (unless otherwise stated) and is discussed in advance with the National Audit Office, Audit Scotland and Wales Audit Office.

Discount Rate

Both FRS102 and IAS19 state that the discount rate used to place a value on the liabilities should be determined by reference to market yields on high quality corporate bonds at the reporting date. In addition, the currency and term of the high quality corporate bonds used to set the discount rate should be consistent with the currency and term of the liabilities.

Corporate bond yield curve

Government bond yield curves are updated and available on a daily basis from the Bank of England. It is therefore relatively easy to identify a spot yield on Government bonds at any duration and at any date. Unfortunately, a similarly accessible corporate bond yield curve is not so readily available.

We have adopted an approach to setting the discount rate whereby a “Hymans Robertson” corporate bond yield curve is constructed based on the constituents of the iBoxx AA corporate bond index.

Weighted average duration

The discount rate should reflect the ‘term’ of the benefit obligation. We have interpreted ‘term’ to be the weighted average duration of the benefit obligation. This is broadly defined as ‘*the weighted average time until payment of all expected future discounted cashflows, determined based on membership and the financial and demographic assumptions at a particular time*’. The shorter the duration, the more ‘mature’ the employer.

With increased divergence of LGPS employers, the weighted average durations of individual employers can be materially different. It is therefore not appropriate for all employers to adopt the same financial assumptions for accounting purposes. Our default assumption approach sets out 3 separate discount rates (and corresponding RPI/CPI inflation assumptions) for employers who fall into each duration category below:

Weighted average duration at most recent actuarial valuation	Duration category
Less than 17 years	Short
Between 17 and 23 years	Medium
More than 23 years	Long

Retail Prices Inflation (RPI)

This assumption is typically derived from yields available on fixed interest and index linked government bonds, and should be consistent with the derivation of the discount rate.

We use a market implied inflation curve over a range of maturities. Cashflow weighted single RPI rates are derived from the market implied inflation curve that recognise the weighted average duration of each corresponding duration category defined above.

Pension Increases (CPI)

The pension increase assumption is set in line with our default Consumer Prices Index (CPI) assumption. As a market in CPI linked bonds does not exist, we need to estimate the long-term gap between RPI and CPI to derive a CPI assumption for accounting purposes. Our estimate is based on analysis of past and emerging future trends in the gap between these indices. When setting a CPI assumption, we also take account of the Bank of England’s long-term rate of CPI inflation of 2% p.a.

Based on the above approach, our proposed default assumed RPI-CPI gap is 0.9% p.a. for 31 March 2020 (noting this is a slight reduction from the 2019 accounting exercise where 1.0% was used).

Salary growth

Our default assumption for salary growth is set relative to the derived RPI/CPI assumption at the reporting date using the same methodology as the 2019 actuarial funding valuation for the LGPS fund(s) in which you participate. Further details on the salary growth assumption can be found in the 2019 actuarial valuation reports, which will be publicly available on each LGPS fund's website from 1 April 2020.

Longevity assumptions

Our default longevity assumptions for the 2020 accounting exercise are in line with those adopted by your LGPS fund(s) for the 2019 funding actuarial valuation.

Other demographic assumptions

These include assumptions for commutation, withdrawal, ill-health early retirements, etc. We gathered data on recent experience of LGPS funds in order to set appropriate demographic assumptions for the 2019 actuarial valuation. Our default approach will be to use the same demographic assumptions for accounting purposes as at the 2019 funding actuarial valuation. Collectively, these demographic assumptions are intended to be best estimate.

Indicative default assumptions (based on market conditions as at 31 December 2019)

The following table shows our default financial assumptions at 31 December 2019, based on the above methodology. Our default assumptions used for the 31 March 2019 exercise are also shown for comparison purposes.

Please note that bond yields can be particularly volatile and it is the observed bond yields at the actual year-end date that will be used to set our default assumptions. Therefore, the actual default assumptions at 31 March 2020 could be significantly different from the indicative assumptions below which are based on *market conditions as at 31 December 2019*.

Duration category	31 March 2019		31 December 2019	
	Discount rate	RPI (CPI)	Discount rate	RPI (CPI)
Short	2.4%	3.5% (2.5%)	2.0%	3.3% (2.4%)
Medium	2.4%	3.5% (2.5%)	2.0%	3.2% (2.3%)
Long	2.5%	3.4% (2.4%)	2.1%	3.2% (2.3%)

* The indicative assumptions at 31 December 2019 allow for the proposed RPI-CPI gap of 0.9%.

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Appendix

Impact of the 31 March 2019 English and Welsh formal actuarial valuations

Formal actuarial valuations are carried out every three years, where each employer's assets and liabilities are calculated on a detailed basis, using individual member data, for cash contribution setting purposes. The formal valuations for English and Welsh LGPS Funds will be concluded by 31 March 2020.

The accounting balance sheet position as at 31 March 2020, and the projected charge to the P&L for 2020/21, are therefore based on this new roll forward from the 2019 formal valuation. This differs to the balance sheet position as at 31 March 2019 and the charge to the P&L for 2019/20, which were based on a roll forward from the 2016 formal valuation. **This 'step change' can lead to sizeable asset and liability 'remeasurement experience' items in the reconciliation of the balance sheet from 31 March 2019 to 31 March 2020.**

For accounting purposes, we project forward the results from the most recently completed formal valuation: we only allow for certain elements of experience since the formal valuation date, such as actual investment return, estimated contributions paid, estimated benefit outgo, actual early retirements and actual outsourcings/bulk transfers when advised to do so by the employer. As such, the accuracy of the accounting projection declines over time. We would normally expect our projection to be within +/-2% of the underlying position for each year of projection. However, greater differences are possible, particularly if there have been volatile financial market movements or significant membership changes.

The asset and liability 'remeasurement experience' items arise because in the accounting roll-forward we cannot recognise all possible elements of experience, and these are recognised in the formal valuation calculations. **In effect, our accounting figures are "re-calibrated" every three years following each formal valuation.** For example;

- Actual level of salary (or pension) increases – e.g. lower than expected salary growth over the previous inter-valuation period would lead to a positive liability 'experience' item (i.e. lower past service liabilities).
- Outsourcings / Bulk transfers – where the employer has chosen, due to materiality, not to recognise outsourcings and bulk transfers in their accounting position, the impact of these will be included in the asset and liability 'experience' items.
- Membership movements (new entrants, withdrawals, ill health retirements, transfers etc) – any movements different to those assumed within the previous formal valuation will contribute positively or negatively to the asset and liability 'experience' items.

In line with the accounting standards, the liability 'experience' item is identified separately in the reconciliation, however the asset 'experience' item is included in the re-measurement 'return on assets' item shown in Other Comprehensive Income (OCI). In non-valuation years, the 'return on assets' item reflects the difference between actual return over the year and the expected return (recognised in the P&L as the interest income on assets). At first glance, the 2019/20 'excess return on assets' item may appear unusual but this is likely to be due to the inclusion of any asset 'remeasurement experience' from the 2019 formal actuarial valuation 'step-change'.

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