HYMANS ROBERTSON

briefing note

LOCAL GOVERNMENT FRS17 / IAS19

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Local Government Pension Scheme: Accounting Assumptions for 31 March 2015

This briefing note has been prepared by Steven Scott of Hymans Robertson's Public Sector Practice specifically for employers participating in the LGPS to outline the approach to deriving our recommended FRS17/IAS19 assumptions as at 31 March 2015. We recommend that this paper is shared with all employers in the Fund with March year ends. This will allow employers to discuss our approach with their auditors and identify any issues in advance of the FRS17/IAS19 exercise. We hope this will limit the number of queries and also minimise any rework required at a late stage in the process - both of which could incur additional costs. For the avoidance of doubt, the approach to assumption setting outlined in this briefing note applies to both FRS17 and IAS19 disclosures (unless otherwise stated). We also propose that the same approach be adopted for unfunded liabilities.

We have discussed the approach to set our recommended assumptions with the Audit Commission, who have not raised any significant concerns with this.

> "We recommend that each employer should discuss the proposed assumptions with their auditor."

Changes in market conditions since 31 March 2014

The change in market conditions since 31 March 2014 is expected to lead to a lower net discount rate as at 31 March 2015. This would increase the value placed on the FRS17/IAS19 liabilities.

At the end of January 2015, the change to the net discount rate for a typical LGPS employer over the period from 31 March 2014 was a fall of around 0.8%. Over the same period, asset returns have been greater than expected and this may go some way to offset any increase in liabilities.

Ultimately, the impact could vary significantly between individual employers although it is likely that most, based on current market conditions, will see a deterioration in their balance sheet over the 2014/15 year.

Any market movements between now and 31 March 2015 could change this further.

Background to FRS17/IAS19 assumptions

As for any actuarial calculation, the value of the liabilities for FRS17/IAS19 purposes is heavily dependent on the assumptions underpinning the calculations. If they are not already, employers should be aware that, ultimately, they are responsible for the assumptions used.

For example, FRS17 states:

The assumptions underlying the valuation should be mutually compatible and lead to the best estimate of the future cash flows that will arise under the scheme liabilities. The assumptions are ultimately the responsibility of the directors (or equivalent) but should be set upon advice given by an actuary.

Any assumptions that are affected by economic conditions (financial assumptions) should reflect market expectations at the balance sheet date.

For a number of reasons, principally cost and employer timescales, we have historically recommended a standard set of assumptions as at a given date for all employers within the LGPS. (This is subject to any specific guidelines for any group of employers, such as Government agencies who follow the Financial Reporting Manual guidance). However, FRS17/IAS19 has become increasingly important to employers and we understand that auditors' guidance now requires them to go beyond simply accepting the actuary's calculations as the work of an expert.

We welcome the greater interest in the assumptions being taken by employers and their auditors. However, in order to maintain service standards and contain costs, our default approach is that reports for employers with the same year-end and similar maturity profile are processed using the same assumptions. We believe that this approach remains appropriate for the majority of employers, particularly local authorities and other public sector bodies.

Corporate entities for whom FRS17/IAS19 affects decision-making may take a different view; the additional costs associated with adopting bespoke assumptions are possibly worthwhile for them. It should also be noted that Hymans Robertson fees for LGPS employers are a fraction of those for sponsoring employers of stand-alone private sector schemes; this is due to the efficiencies and economies of scale which Hymans Robertson has put in place for your benefit.

An employer in the Fund and its auditor may decide that they wish to use a different approach to setting just the **financial assumptions** (e.g. discount rate) for accounting purposes. In this case we will normally be able to accommodate this, although it will lead to an increase in costs. It will, however, still be possible to prepare the report as part of a batch and so will still be cheaper than a fully bespoke report.

If an employer wishes to use different financial assumptions, then it is essential that we are made aware of their desired approach to assumption setting prior to 31 March 2015. If we are informed after this date, we will have to process the report individually and the employer will not benefit from reduced fees from being part of a group.

Any different approach to **demographic assumptions** (e.g. life expectancy) will be more time-consuming to adopt, and so a further increase in fees will result.

To assist employers in assessing whether they wish to accept our recommended assumptions, we have set out below the rationale for our recommendations for each of the principal assumptions.

Discount Rate

FRS17 (and in effect IAS19 also) state that liabilities should be discounted at a rate equivalent to the "current rate of return available on a high quality corporate bond of equivalent currency and term to the scheme liabilities". It further defines a high quality corporate bond as one that "has been rated at the level of AA or equivalent status".

The principle behind our approach to setting the recommended discount rate as at 31 March 2015 has remained unchanged since 31 March 2014 i.e. the discount rate is still derived from a corporate bond yield curve whilst recognising the weighted average duration (or term) of the benefit obligation for each separate employer.

However, the way we have constructed the corporate bond yield curve has been revised.

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.

At 31 March 2014, our corporate bond yield curve was based on the constituents of the iBoxx £ Corporates AA index using the UBS delta curve fitting methodology. Currently, the UBS curve produces a discount rate that, at longer durations, is lower than what we understand auditors would typically expect. Our understanding is based on recent discussions we have had with auditors.

For this reason, we have adopted an approach whereby a corporate bond yield curve is now constructed in the following manner:

- Use the UBS corporate bond curve (derived by applying the UBS delta curve fitting methodology to the constituents of the iBoxx £ Corporates AA index) for durations up to 8 years
- From 12 years onwards use a gilts curve plus a long term average credit spread of 1.0% p.a. (based on my judgement of market conditions as at 31 January 2015)
- Interpolate between the two approaches for durations between 8 and 12 years.

The UBS fitting approach is complex and specific details on this can be provided if required. This approach gives a smooth curve of locally averaged yields along the term structure. The chart below shows a representative yield curve as at 31 January 2015.

Weighted average duration

As mentioned above, 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.

Historically, the weighted average duration of the benefit obligation for each LGPS employer was similar. With increased divergence of LGPS employers, in particular the introduction of Academies in England and the increased number of outsourcings, it is now the case that the weighted average durations of individual employers are likely to be materially different. The use of a single discount rate appropriate for a typical employer in the fund is no longer appropriate for all employers.

In accordance with the approach adopted at 31 March 2014, we recommend separate discount rates (and corresponding RPI/CPI inflation assumptions – see below) for individual employers, dependent on their own weighted average duration. The first step in this is to allocate each employer to a duration category as defined below:

Weighted average duration	Discount rate category
Less than 17 years	Short
Between 17 and 23 years	Medium
More than 23 years	Long

The weighted average duration used to identify the appropriate category for each employer is that determined at the most recent actuarial valuation. For English and Welsh LGPS Funds this will be the duration determined at the 2013 valuation and will be identical to that used at 31 March 2014. For Scottish LGPS Funds, employers may see themselves being allocated to a different duration category with the duration calculated at the 2014 formal valuation being applied as opposed to the duration at the 2011valuation that was used to set the FRS17/IAS19 assumptions as at 31 March 2014.

Retail Prices Inflation

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.

The chart below show the Bank of England implied inflation curve over a range of maturities at 31 January 2015, 31 July 2014 and 31 January 2014. The recommended RPI inflation assumption for each discount rate category defined above will be identified at appropriate durations from this curve as at 31 March 2015.

Source: Bank of England (31 January 2015)

Pension Increases

In the LGPS pension increases are linked to the rate of CPI as opposed to RPI. As a market in CPI linked bonds does not exist, we need to estimate the long term gap between RPI and CPI in order to derive a CPI assumption for FRS17/IAS19 purposes.

In the past we have estimated that CPI would be approximately 0.8% below RPI. This was based on our estimate of the 'formula effect'. The Office for National Statistics (ONS) publish the size of the actual formula effect on a monthly basis and over the last four years it has varied between 0.8% and 1.0%. Based on this evidence and as a result of discussions we have had with auditors, we are increasing our assumed RPI-CPI gap to 0.9% p.a. at 31 March 2015. This will lead to a reduction in the assumed rate of CPI (all else being equal).

Indicative financial assumptions based on market conditions as at 31 January 2015

The following table shows the indicative financial assumptions based on this methodology and **market conditions as at 31 January 2015**. It is unlikely that market conditions as at 31 March 2015 will be identical to those as at 31 January 2015 therefore the actual 31 March 2015 assumptions are likely to differ to those shown below.

Weighted average duration	Discount rate	RPI inflation (CPI)
Less than 17 years (Short)	2.9%	2.8% (1.9%)
Between 17 and 23 years (Medium)	3.0%	3.1% (2.2%)
More than 23 years (Long)	3.1%	3.2% (2.3%)

Salary growth

Our recommended assumption will generally be consistent with the most recent actuarial valuation. In particular, recognition of short term pay restraints is made implicitly in determining a long term pay growth assumption linked to the assumed rate of RPI.

An additional allowance for promotional salary increases is also made

Longevity Assumptions

Our recommended longevity assumptions for the FRS17/IAS19 2015 exercise are in line with those adopted by funds for the most recent actuarial valuation (please refer to the valuation report for your own fund for further information).

Demographic assumptions

These include assumptions for commutation (a higher allowance for commutation will reduce the value of the liabilities), withdrawal, ill-health early retirements, proportions of deaths leaving a dependant, etc. The assumptions underlying the valuation should be mutually compatible and lead to the best estimate of the future cash flows that will arise under the scheme liabilities. Best estimate is not defined in FRS17/IAS19 so there is scope for actuarial judgement in setting these assumptions.

We gathered data on recent experience of LGPS funds in order to set appropriate demographic assumptions for the most recent formal funding valuation. For all funds, our recommendation will be to use the same demographic assumptions for FRS17/IAS19 purposes as at the most recent valuation. Collectively, these are intended to be best estimate.

Putting them all together

FRS17 and IAS19 do not require that every individual assumption is a *best estimate.* The Directors (or equivalent) of the organisation should be satisfied that the combined effect of the assumptions is reasonable as a whole.

Surplus limits

It may seem unusual to talk of surpluses in current market conditions, but we do expect to see a few employers whose IAS19/FRS17 balance sheet shows a surplus (net asset) position. These employers are often contractors who were set up fully funded in the midst of adverse market conditions.

For such employers, please note that:

- both IAS19 and FRS17 currently contain provisions to limit the amount of surplus recognised in the balance sheet;
- this limit will depend on various factors such as whether the employer is closed to new entrants or not, how the surplus compares to the service cost, and what contributions the employer is duty bound to pay to the Fund;
- if there is a surplus then further checks are required to see if the limit applies; if so, then changes are needed to the calculations and disclosures. These tasks are outside our standard pricing approach. Therefore, where a material surplus exists at 31 March 2015, we will simply flag this to the employer in the first place and await further instructions: any subsequent work would require separate agreement on timescales and fees.

FRS17 or IAS19?

Many larger employers, such as local authorities, are required to account for pension costs under IAS19 instead of FRS17. Many other bodies will also report on an IAS basis, and so it is important we are instructed whether to adopt IAS19 or FRS17 for each employer.

FRS102

FRS102 comes into effect for accounting years starting on or after 1 January 2015, (i.e. the first year of adoption for employers with a 31 March year-end will be 1 April 2015 to 31 March 2016). The changes to the FRS102 standard are broadly in line with the IAS19 changes i.e. the most significant change is to the Expected Return on Assets assumption, which should lead to a higher charge to the Profit and Loss account.

In order to help employers understand the implementation of FRS102, the FRS17 reports as at 31 March 2015 will include an appendix showing the 2014/15 figures on the FRS102 basis i.e. the impact on the profit and loss figures of setting the Expected Return on Assets assumption equal to the discount rate. This is what the 31 March 2016 FRS102 reports will show as the 2014/15 position.

LGPS employers are individually responsible for ensuring their accounts are prepared in line with their own specific statutory requirements. We will be able to provide FRS17 reports in the future for any LGPS employer who still requires this information to comply with their statutory accounting requirements.

Valuation approach

For Scottish LGPS Funds the FRS17/IAS19 balance sheet position disclosed as at 31 March 2014 was typically based on a roll forward from the 2011 valuation position. The FRS17/IAS19 balance sheet position as at 31 March 2015 will be based on a roll-forward of each employer's assets and liabilities determined at the 2014 valuation. The change in the accounting balance sheet position from 31 March 2014 to 31 March 2015 will likely be affected by this 'step change', with the impact differing for each employer. This will not be the case for English and Welsh LGPS Funds where the balance sheet at both 31 March 2014 and 31 March 2015, will typically be based on a roll-forward from the 2013 valuation position.

Next steps

Unless otherwise advised, any FRS17/IAS19 reports commissioned by employers through the Administering Authority will be based on our default recommended assumptions.

Our recommended assumptions are intended to fully comply with FRS17 and IAS19. As prescribed we have aimed for best estimate assumptions and have not tried to be prudent.

We have discussed the approach to set our recommended assumptions with the Audit Commission, who have not raised any significant concerns with this.

The Administering Authority should issue this Briefing Note to all employers in the Fund with a March year end.

We recommend that each employer should discuss the proposed assumptions with their auditor. We would be happy to tailor any of the assumptions to the needs of individual employers. If the employer wishes to use different financial assumptions we will be able to process as part of the main batch of reports for a small extra fee provided this is communicated to us prior to 31 March 2015.

However, if the employer wishes to commission a fully bespoke report with changes to non-financial assumptions or if changes are requested after the accounting date, this will require preparation outside of the main bulk of the reports. This will fall outside of our standard fee scale and timetable.

If an employer wishes to use an assumption setting approach which differs from those specified in this Briefing Note, then it is essential that they advise us through the Administering Authority as soon as possible and no later than 31 March 2015. This will ensure that we are able to carry out the reports in the most cost effective manner.

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