HYMANS ROBERTSON
The Spirit of Independence

briefing note

LOCAL GOVERNMENT FRS17 / IAS19 February 2013

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Local Government Pension Scheme: Accounting Assumptions for 31 March 2013

We receive a significant number of queries from employers and auditors about the assumptions underlying their FRS17/IAS19 results.

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 our approach to deriving these assumptions. We recommend that this paper is shared with all employers within the Fund which have 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.

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

At the middle of February 2012, the change to the net discount rate over the period from 31 March 2012 was a fall of around 0.3% p.a. This could increase balance sheet liabilities by around 5-10%. 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 and any market movements between now and 31 March 2013 could change this further.

For the avoidance of doubt, the approach to assumption setting outlined in this briefing note applies to both IAS19 and FRS17 disclosures (unless otherwise stated). We also propose that the same approach be adopted for unfunded liabilities.

Full adoption of the forthcoming changes to IAS19 will be put in place for March 2014 IAS19 reports. The projected pension expense for the 2013/14 year will incorporate the IAS19 changes (which will be shown in 31 March 2013 reports).

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.

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 all employers with the same year-end 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 2013. 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

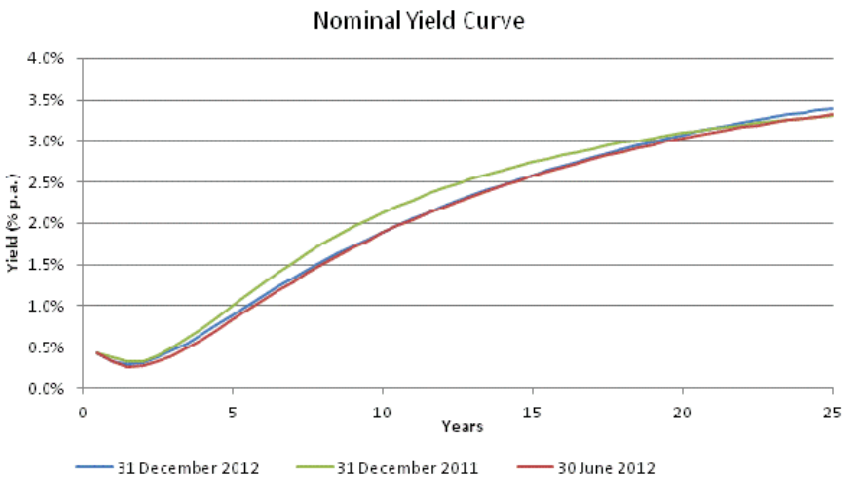
FRS17 (and in effect IAS19 also) state that liabilities should be discounted at a rate equivalent to the "current rate of return available on a high quality corporate bond of equivalent currency and term to the scheme liabilities". It further defines a high quality corporate bond as one that "has been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

To that end we have previously recommended a discount rate based on the yield available on a basket of AA-rated bonds (iBoxx Sterling Corporates AA over 15 year Index). Based on this, the discount rate as at 31 December 2012 was 4.1%.

We are aware, however, that the constituents of the iBoxx over 15 year index have terms that are somewhat shorter than those for the pension liabilities of a typical employer in the LGPS (which we estimate to be around 17 years from the most recent valuations, based on a discount rate of 6.1% p.a.). In 2012, we looked into alternative indices in order to determine if the iBoxx over 15 year index remained the most appropriate for use in FRS17/IAS19 calculations for LGPS funds. In particular, we looked at the yields available on UK Government bonds where longer maturity yields are available. As a result of this, we revised our approach to setting the discount rate as at 31 March 2012. Our approach is outlined in detail below.

Yield on UK Government bonds

The chart below shows the nominal spot yields for a Government - backed loan (i.e. the yield to maturity of a zero coupon bond) at various maturities at 31 December 2011, 30 June 2012 and 31 December 2012.



Source: Bank of England (31 December 2012)

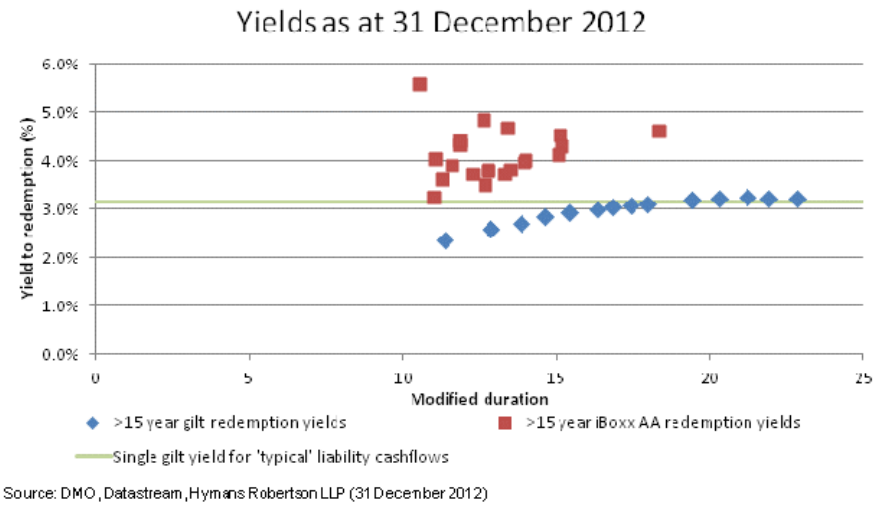
Applying the anticipated future cash flows for a typical LGPS employer, and deriving an equivalent single bond yield at a current date, suggests a yield of around 3.2% p.a. would be appropriate as at 31 December 2012. This differs from the Fixed Interest Gilt Yield Index (Over 15 years) of 3.0% p.a. as at 31 December 2012.

Credit spreads

Government bonds are more secure than AA corporate bonds. Thus, the yield on Government bonds is lower than on AA corporate bonds to reflect the lower default risk. In order to compare our Government bond yield of 3.2% p.a. with the yield derived from the iBoxx AA index, we have to determine a suitable addition (the 'credit spread') to the yield which will reflect the extra risk involved in using AA corporate bond yields.

In order to determine this addition to the Government yields, we considered the yield for each stock within the iBoxx AA over 15 year index and the corresponding over 15 year Government bond index.

The chart below shows these yields:



This chart indicates a range of 'credit spreads' of between 0.7% p.a. and 3.0% p.a. with a mean spread of around 1.3% p.a. This would suggest a credit spread of 1.3% p.a. would be appropriate as at 31 December 2012.

Discount Rate

This leads to a discount rate for IAS19/FRS17 purposes of 4.5% p.a. (being 3.2% gilt yield plus 1.3% credit spread) as at 31 December 2012, which is appreciably higher than the over 15 year iBoxx index yield of 4.1% at the same date.

We are comfortable adopting this approach despite the higher resulting discount rate than the iBoxx AA index. This is consistent with the approach taken last year, and we observed a similar difference between our discount rate and the iBoxx index yield during 2012. We believe that this approach (i.e. giving the 4.5% p.a. discount rate) remains appropriate for FRS17/IAS19 purposes.

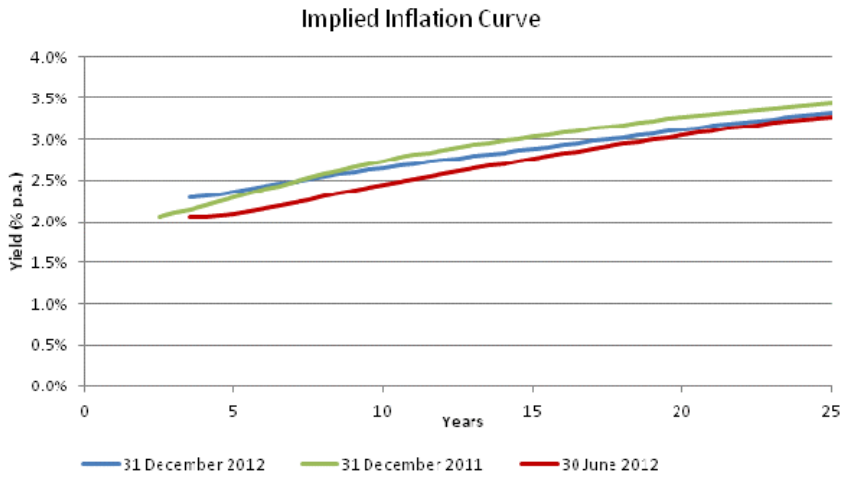
We will of course keep this position under review with particular attention to the position as at 31 March 2013.

We have discussed the above approach with the Audit Commission and their advisors and they have not raised any concerns with this.

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 December 2012, 30 June 2012 and 31 December 2011. The rate appropriate for the typical LGPS future cash flows is 3.2% p.a. as at 31 December 2012. The implied inflation curve is derived from the yields on both fixed and index linked gilt yields, and so is consistent with the average gilt yield underpinning the discount rate.



Source: Bank of England (31 December 2012)

Pension Increases

In the June 2010 Emergency Budget, the Chancellor announced that public sector pension increases will from now on be linked to the Consumer Prices Index (CPI) rather than the RPI. The Government has since formally implemented this proposal, and a legal challenge to this was rejected.

Therefore, as in previous FRS17/IAS19 exercises, the assumption regarding future pension increases for the March 2013 FRS17/IAS19 will be linked to CPI.

We have in the past estimated that CPI would be approximately 0.8% below RPI. Taking account of how this gap is expected to change in the future, our current best estimate of the gap (taking into account differences in the way CPI and RPI are calculated) remains a reduction of 0.8%. This would give an assumption at 31 December 2012 of 2.4% p.a.

Longevity Assumptions

The assumptions that we recommend for the FRS17/IAS19 2013 exercise for Funds are unchanged from last year. Therefore this year's longevity assumptions will continue to be based on the last formal funding valuation (please refer to the valuation report for your own fund for further information).

Other Assumptions

These are summarised on the next two pages, covering the main assumptions not already covered above.

Assumptions	FRS17/IAS19 Requirements	Scope for Judgement	Our Recommendation
Salary Growth (a higher assumption gives a higher liability value)	*The rate of increase in salaries and the discount rate must reflect the same rate of general inflation.*	The expected rate of growth in real pensionable pay (i.e. in excess of inflation) should be consistent with employer's long-term remuneration policy or objectives. Subject to being able to justify the assumption used, there is scope for judgement here. Taking a margin out of the inflation assumption could also help to reduce the allowance for earnings growth.	We have taken into account the Government's public sector pay restraints (originally announced in June 2010 and extended as per the November 2011 announcement). This will vary from Fund to Fund, but our recommended salary increase assumption is 1% p.a. for the next 2 years until 31 March 2015, reverting to RPI plus 1% p.a. or 1.5% p.a. thereafter, plus an allowance for promotional salary increases. Based on market conditions as at 31 December 2012, the rate beyond 2015 would be 4.2% p.a. or 4.7% p.a. plus an allowance for promotional salary increases.
Expected Return on Assets (affects only the net interest charge/ credit in 2012/13)	*The average rate of return, including both income and changes in fair value, expected over the remaining life of the related obligation on the actual assets held by the scheme.*	The return on bonds is assumed to be in line with redemption yields so the scope for judgement here is limited. However, nearly all LGPS employers have an equity-biased investment strategy, and there is no corresponding measure for the return on equities, or other growth assets such as property. There is thus scope for judgement in FRS17 cases. **Due to IAS19 changes taking place in 2013/14, this assumption no longer applies after 2012/13. However, it still applies for FRS17**.	Our recommended expected return on assets is taken from our proprietary asset model, further details of which are available on request. The model parameters are calibrated to market conditions on a monthly basis. We are happy to discuss the assumptions further with employers. At 31 December 2012 the expected return on UK equities was 6.2% p.a. **In line with the forthcoming changes to IAS19, the Expected Return on Assets assumption for 2013/14 will be based on the discount rate. For the avoidance of doubt this only affects the projected pension expense in 2013/14 and not the pension expense for 2012/13.**

Demographic assumptions

Assumptions	FRS17/IAS19 Requirements	Scope for Judgement	Our Recommendation
Commutation (a higher allowance for commutation will reduce the value of the liabilities)	*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.	We have gathered data on commutation over the period since this option became available to LGPS members. Although this data will inevitably be limited[1], we believe that it is essential for any assumptions to have an evidential base. For all funds, we expect to use the same commutation assumption as adopted for the last formal funding valuation. Further details of the assumptions made for the Fund/Employer will be detailed in the FRS17/IAS19 disclosures.
Other demographic assumptions, e.g. withdrawal, ill-health early retirements, proportions of deaths leaving a dependant, etc	As above	As Above	Our recommendations will be as for previous years, i.e. the same assumptions as adopted for the most recent formal funding valuation. Collectively, these are intended to be best estimate and are derived from specific past experience of LGPS funds.

[1] Commutation has only been an option since April 2006 (England, Wales and Northern Ireland) or October 2006 (Scotland)

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 / IFRIC14

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 (where IFRIC14 applies) 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 surplus exists at 31 March, 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.

IAS19 (Revised)

IAS19 is changing for accounting years starting on or after 1 January 2013 and this will affect the budgeted pension expense for the next financial year. The key change affecting LGPS employers relates to the expected return on assets. Advance credit for anticipated outperformance of return seeking assets (such as equities) will no longer be permitted. The expected return on assets is currently credited to profit and loss, however from 2013 this is effectively replaced with an equivalent figure calculated using the discount rate (as opposed to that calculated using the Expected Return on Assets assumption). There is no impact of this change on the accounts covering the 2012/13 financial year. The changes will be implemented in the 2013/14 financial year, so the projected 2013/14 pension expense shown will include this change.

The changes to IAS19 will be retrospectively applied for the 2012/13 financial year, at the time the 2013/14 accounts are prepared. This is in accordance with IAS 8. Essentially, this means that the 2012/13 income statement disclosed in the 2013/14 accounts will be rebased onto the IAS19 (Revised) reporting basis. Our 2012/13 IAS19 reports will state the impact of the IAS19 changes on the revenue account for the 2012/13 financial year, as a note to the disclosures.

Disclosure of whole fund liabilities

IAS26 relates to the Funds' own financial statements, as opposed to the accounts prepared by the participating employers in each Fund. Our recommendation to our Fund clients will be as

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stated in IAS26 para 17(b)(i), ie giving a note of the actuarial present value of benefits as at the accounting date (on FRS17/IAS19 assumptions, not the Fund's funding assumptions).

Where requested, we will provide a short IAS26 report to the Administering Authority.

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 agreed our approach with the Audit Commission.

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

Are our proposed assumptions suitable for all employers? We know that different employers have different maturity profiles, i.e. broadly younger or older membership than others. This could sometimes lead to a different view on the discount rate and inflation rate. We have discussed this point with the Audit Commission and they are satisfied that, for the great majority of CIPFA employers, our approach is perfectly reasonable. For the minority of employers with a younger membership profile, our approach still gives suitable "real discount rates", i.e. the gap between discount rate and inflation.

We recommend that each employer should discuss the proposed assumptions with their auditor. We would be delighted to tailor any of the assumptions to the needs of individual employers.

If the employer wishes to use different financial assumptions only we will be able to do so as part of the main batch of reports for a small extra fee if this is communicated to us prior to 31 March 2013.

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 2013. This will ensure that we are able to carry out the reports in the most cost effective manner.

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