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| Spotlight: Single Agency Discount Rates | March 2018 |

UK GAAP (FRS 102) is fairly prescriptive on the assumptions which can be used however, even within this framework there is a range of suitable assumptions which could be selected when reporting pensions costs within your accounts. In this spotlight we look at how "Single Agency" discount rates can be used to help manage the impact of net pension's liabilities on the balance sheet.

# Accounting for Pensions Costs

# As you will be well aware, FRS 102 requires the costs of any post-retirement benefit schemes to be recorded on the balance sheet and included within the income statement.

# Given the size and cost of some of the pension schemes, and the emphasis of the accounting standard to show a fair picture of your financial position, it can be important to ensure that there is no unintended prudence included within the assumptions you select for valuing any pension schemes.

# What is required?

# Under the accounting standard, the economic and demographic assumptions are ultimately the responsibility of the directors. They are also required to be the best estimate *in aggregate*, which we typically assume means that there is an equal chance that the assumptions will under or overestimate long term future experience.

# In addition to these overall criteria, there are specific requirements placed on the discount rate chosen. FRS 102 requires the discount rate to be set equal to the current rate of return on a "high quality" corporate bond of equivalent term and currency to the scheme liabilities. Usually "high quality" is taken to mean that AA corporate bonds should be chosen.

Aon Hewitt use the constituents of the iBoxx index of AA rated corporate bonds to create a smooth yield curve (the Aon Hewitt GBP Select AA Curve), which is (broadly speaking) the aggregate yield available on AA rated bonds. However, in recent years, the market has developed its views on what bonds should be included within this yield curve.

# AA rating for corporate bonds

The quality of a corporate bond issue is usually determined by one or more of the three major credit rating agencies, Moody's, S&P and Fitch. There are a large number of ratings, but the one's given to the highest quality bonds are A, AA or AAA.

However, as determining the quality of a corporate bond issue is not an exact science, for some corporate bonds not all the ratings agencies agree on the rating to be given.

Traditionally, the market would usually only include a bond in a "high quality" yield curve, if it was rated AA by at least 2 of the agencies.

More recently, market practice has developed and many companies are now setting their discount rate with reference to corporate bonds which are rated AA by a single rating agency. The yield curves these produce contain a greater number of bonds than a traditional yield curve, and have become known as "Single Agency" yield curves.

# Impacts of moving to a single agency curve

There is a direct relationship between the yield on a corporate bond and its risk level. Those with lower ratings will have higher yields as investors need to be compensated for the additional risks they are taking (largely the underlying company's default risk).

Therefore including bonds which are not rated AA by all the ratings agencies will usually bring the overall yield curve up leading to higher discount rates. The chart overleaf shows the difference at 31 December 2017 between Aon Hewitt's Select AA curve and Single Agency Select curve.



The chart above shows the difference at [31 December 2017] between Aon Hewitt's Select AA curve and Single Agency Select curve.

A higher discount rate results in a lower present value being placed on future pension scheme cashflows, leading to reduced deficits and lower costs reported in the income statement.

At [31 December 2017] the impact of adding these additional bond's to the yield curve is to increase the discount rate by around [5bps], which would reduce the liabilities for a typical scheme by around [1%] and may reduce the service cost by [1.5%].

# Other approaches to producing the yield curve

There are also other developments to the production of yield curves used in the calculation of discount rates.

One option is to the removal of bond's issued by Universities. These bonds are not issued by "true" corporate entities (since universities are widely considered to be quasi-public organisations), and further these bonds are included in the Bank of England's bond purchase programme, which has resulted in these bonds having artificially inflated prices (i.e. depressed yields).

Excluding these bonds issued by UK universities is, in our opinion, reasonable and in line with the FRS 102 definition. By removing these bonds, the yield curve will shift upwards, leading to higher discount rates. At [31 December 2017] the impact of removing university bonds from the yield curve is to increase the discount rate by around [5bps].

There is also an unusual feature of discount rate curve that it is quite sharply downwards-sloping after around term 20. This is counter-intuitive, since one would expect investors to require compensation for holding bonds of a longer duration – known as a term premium – which would result in an increasing (or possibly flat) yield curve. Aon have, in recent years, started to use a method for producing the longer end of the yield curve which better fits with standard economic theory. This increases long term yields, generally leading to an increased discount rate overall

At [31 December 2017] the impact of adjusting the yield curve to create a flat long term yield curve is to increase the discount rate by around [5bps]

# Market and Auditor views

One of the reasonable concerns many companies have when looking to change their assumption setting process is around how their auditors will view these changes.

We have seen a large growth in the use of single agency curves, in the private sector, with around half of Aon's clients adopting a single agency discount rate at 31 December 2017. This growth has largely stemmed from the market gaining a greater understanding of single agency yield curves and greater recognition of their validity by auditors.

The numbers choosing to exclude university bonds is considerably lower at around 25% of Aon's clients reporting at 31 December. The use of flat extrapolation is not that common at around 5% of Aon's clients, and flat extrapolation was only used where university bonds were also excluded.

As noted above auditors are also becoming more understanding of the use of single agency discount rates, and are willing to accept changes in approach to adopt this method, so long as there is reasonable justification for doing so. We believe in many cases there are good justifications for a change of this sort and we would be happy to explore those reasons with you if required.

Finally, there are some important disclosure requirements when changing to a single agency discount rate. Whilst these requirements are not particularly onerous, it is important that all the requirements are met to give your auditors comfort around the process taken.

As with all major changes in accounting policy, we would recommend you discuss these changes with your auditor in advance of adopting the change, and we would again be more than happy to help with these discussions if needed.

# Other assumptions

It is also important to recognise that whilst the financial assumptions adopted for your year-end are very important, there are many demographic assumptions adopted by companies as part of their accounting processes which are not subject to the same level of scrutiny as the financial assumptions.

One key assumption when measuring the liabilities of a pension scheme is the assumption made about the mortality of members. It is common, particularly within the LGPS, for a higher and further education bodies to simply adopt the demographic assumptions used as part of the latest formal actuarial valuation of the Fund. However, formal actuarial valuations are required to adopt prudent assumptions, whereas the accounting requirements are for the assumptions to be best estimate. Therefore by adopting the valuation assumptions, these universities and colleges can be incorporating unintended prudence into the accounts.

In many cases in the private sector the directors of a company will reduce the long term trend in life expectancy growth when compared to the actuarial valuation, as well as adopting the latest base tables and future improvement models each year. This ensures that the company is gaining the most up to date assumptions each year-end and not accepting any of this "unintended prudence".

# Want to know more?

If you would like to incorporate the use of single agency discount rates in your accounting disclosures or would like to know more about how Aon can help you set appropriate assumptions for use at the year-end please get in touch.

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