MERCER

COVID-19

Accounting implications for European pension plans

Update as at 31 March 2020

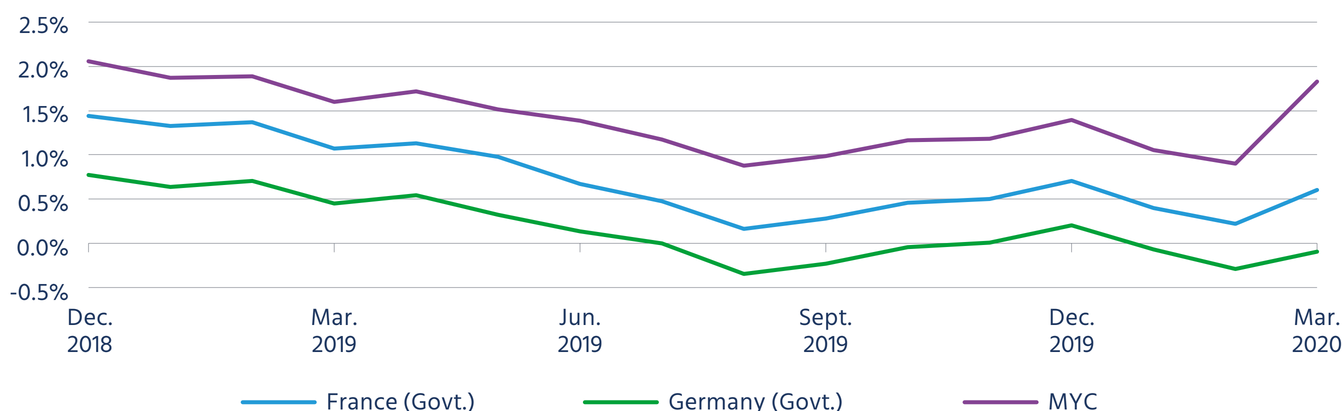
On the back of a turbulent quarter in which equity markets experienced their worst losses since the financial crisis and unprecedented central bank intervention announcements, sponsors of defined benefit plans are nonetheless likely to get some relief from the accounting standards. Market movements in both corporate bond yields and inflation expectations will likely result in lower obligations emerging at the 31 March 2020 measurement date.

Discount rates

Under standards such as IFRS and US GAAP, defined benefit liabilities are discounted using the yields on high quality corporate bonds, typically interpreted as that observed on AA-rated corporates with similar duration to that of the liabilities. These discount rates have increased over the quarter (reducing the calculated present value of liabilities) primarily driven by widening of corporate bond spreads since the emergence of the COVID-19 pandemic in Europe.

Many finance directors use corporate bond indices or purpose built yield curves to determine the appropriate discount for retirement plans. Methodology and approach is likely to differ from one organisation to the next, and engagement with auditors will be critical. The graph below sets out the movement in the Mercer's Eurozone yield curve ("MYC") over the last 15 months relative to Euro sovereign bonds.

Euro Sovereign Bond Yields Versus Mercer Yield Curve
20 Year Spot Rates



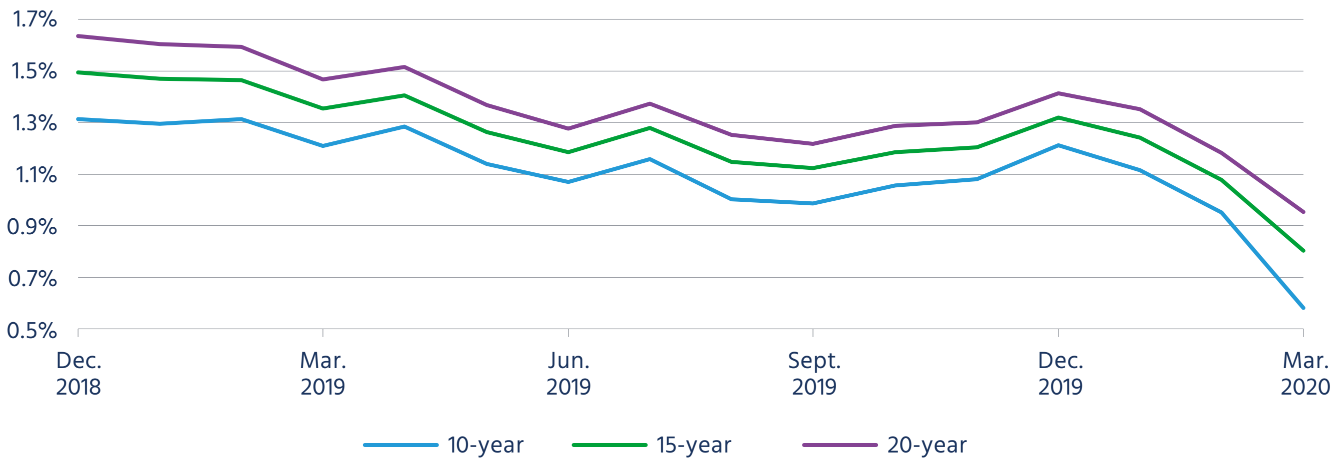
The MYC Euro spot rate for 20 year liabilities jumped from 1.39% to 1.83%, an increase of 44 basis points in the quarter to 31 March 2020 against a backdrop of falling core sovereign yields. Increases in corporate bond spreads of this magnitude over such a short period have not happened since the 2008 financial crisis.

Credit spreads will likely remain volatile for some time as fears remain elevated and individual corporates struggle to adjust their balance sheets. It is very difficult to predict a course for core Eurozone interest rates, as it will depend critically on central bank activity and the performance of the economy.

Inflation expectations

Over the same period, the market expectation of future Euro zone inflation has fallen dramatically with long-term expectations 50 basis points lower than they were at year-end. This will serve to further reduce the value of any plan liabilities that are inflation-linked and where the accounting assumptions are linked to market-based expectations.

The graph on the following page sets out the long term inflation expectations emerging from Euro HICP Swaps over the past 15 months.



Market-based inflation expectations have fallen significantly, and sponsors should carefully consider the implications for their plans, whether in terms of pension indexation on the liability side or opportunities to increase the levels of inflation hedging on the asset side. It is by no means inconceivable that policy-makers could contemplate potentially inflationary measures to kick-start economies after the COVID crisis abates.

Expected funding impact

The impact on accounting measures of funding at these dates will depend critically on the nature of the liabilities and the investment strategy pursued by individual plans.

Unfunded plans and plans that are heavily invested in Euro sovereign debt are likely to see improvements to their funding position. Where liabilities are also linked to market expectations of inflation, these improvements may be significant.

Plans with cash flow matching strategies that invest in corporate credit may see less of a gain in funding levels as discount rates increase, but those that were planning to take steps in this direction may indeed see attractive strategy entry opportunities with wider spreads.

Plans heavily invested in equity investments will have suffered significant losses on the asset side but this may well be offset to a significant extent by the improvements in discount rate and inflation assumptions.

Accounting versus solvency and funding

While accounting measures may provide some relief, it is important to emphasise a potential disconnect between accounting and other measures such as funding and solvency.

Solvency measures of pension liabilities are typically driven by the prevailing costs of securing obligations with an insurer. While insurance companies are making greater use of corporate and other credit in recent years, liquidity conditions and market volatility may challenge their ability to pass on the benefits of wider credit spreads in annuity pricing. As such, the full benefit of corporate bond spread widening may not be fully reflected in insurer pricing. Further, we expect that insurers and plan actuaries are likely to take some time before they price in any impact that the pandemic may have on long-term mortality rates. Based on Mercer's Global Buyout Index at year-end, European annuity costs were c12-16% higher than accounting liabilities for a typical pensioner population.

On the funding side, liabilities in many geographies are valued by reference to the assets held, with risk premia added to core interest rates. As a result equity losses and reductions in sovereign bond yields may reduce the funding levels for many plans. Plans with significant levels of matching assets will fare better and the reduction in inflation expectations will help. Contribution requirements for funded plans may increase if actuarial valuations are due to take place and indeed existing plans may fall off-track and required remediation. The widening of corporate bond spreads may pose an opportunity for schemes to invest in wider credit instruments to improve the anticipated yields and reduce the calculated value of liabilities.

What can I expect and how should I plan?

A sustained period of shutdown or a worsening of the pandemic may cause corporate bond spreads to widen further. However, in the event that AA-rated issuers are downgraded or in default, discount rates may not rise in line. Alternatively, a shorter period of disruption or central bank intervention may result in spreads reverting to previous levels, which could push down discount rates and cause liability values to increase. Otherwise market conditions are likely to remain volatile, and subject to policy response.

It is important to plan for the future, and corporate sponsors could usefully consider how a set of plausible scenarios could impact their accounting positions, in particular for periods such as 30 June 2020 and 31 December 2020.

For example, scenarios could include:

- Further severe shock and widening in credit spreads
- Market conditions remain volatile but levels remain similar to 31 March 2020
- Further shock to growth assets, with intervention protecting fixed income assets
- Inflationary recovery in H2 of 2020

We would recommend that corporates consider how these potential scenarios could impact on their pension plan accounting and funding measures, and in particular understand whether any of the scenarios would have implications for member perception, debt covenants, credit ratings, shareholder perception or planned M&A.

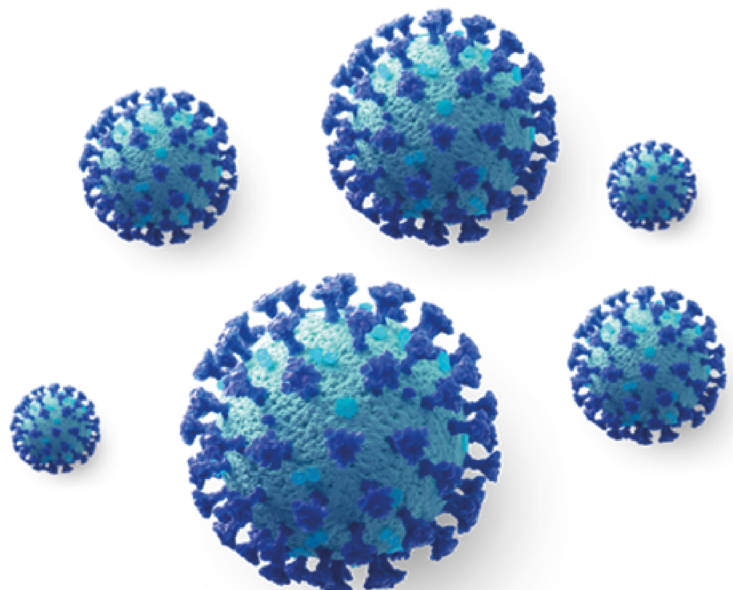
Summary

In summary, wider credit spreads are likely to provide some relief in the accounting for defined benefit plan liabilities at 31 March 2020 but funding concerns may remain or have increased. As uncertain market conditions are likely to persist for a number of months, it is not unreasonable to expect that wider corporate credit spreads could also help to lower accounting liabilities at 30 June 2020 and beyond. Where there are market consistent inflation expectations embedded in liability projections, falling breakeven inflation levels are also likely to provide relief. The impact on accounting measures of funding at these dates will depend critically on the investment strategy pursued in individual plans. Where funding valuations require additional cash flow, it may be possible to agree some deferral in contributions as regulators potentially contemplate short-term crisis relief.

While it is difficult to predict how the COVID pandemic will play out, corporates can usefully stress their accounting positions against plausible scenarios and plan accordingly. In doing so, it is important to expect a potential disconnect between accounting measures versus valuations for solvency and funding purposes.

Further information

If you would like to explore any of the issues in this note in greater detail, please contact your Mercer consultant or **john.obrien@mercer.com**.



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