

International View

Employee Benefits Accounting

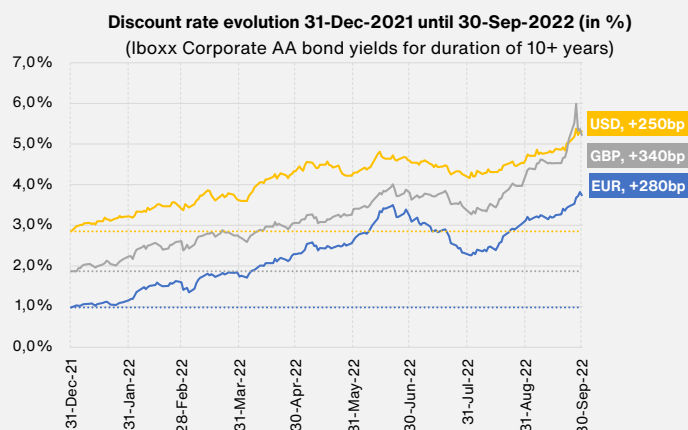
September 30, 2022 edition

Discount rate climb continues. Recession fear hits asset markets.

Geopolitical tensions keep pushing up inflation to levels unseen for more than forty years. In their attempt to slow down inflation, central banks are rapidly increasing rates. Bond yields and hence discount rates are moving up to reach post-financial crisis levels. Volatile equity markets are hit hard due to global recession fears which are fed by declining demand and increasing production cost.

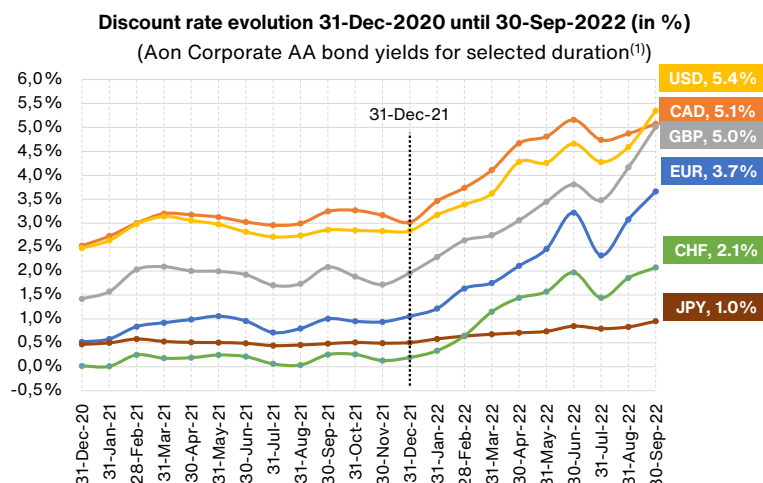
Bond yields showed an average increase of 300bp in UK, and 260bp in USA and Eurozone.

Discount rates are on average **210bp higher** from YE21 in the main currency zones, and **unfunded liabilities** could therefore be **26% lower** than at YE21 but may suffer from higher inflation-linked assumptions. **Funded liabilities** are influenced by negative equity and bond performance.



Discount rates much higher than at YE21

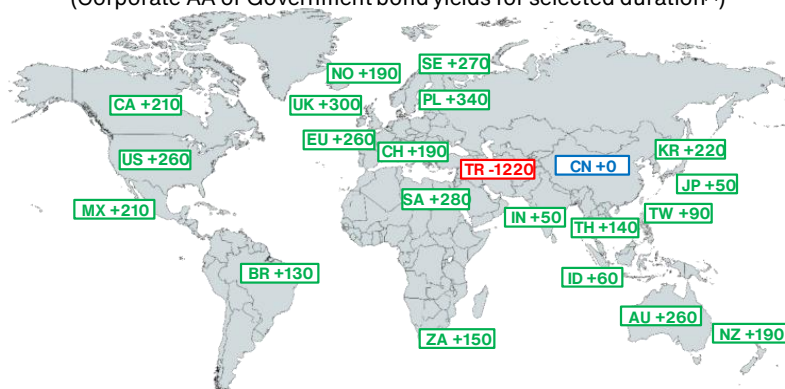
Bond yields determine the discount rate of your company's pension liabilities under IFRS and US GAAP accounting. After an initial drop in July, most bond yields increased rapidly in August and September, due to uncertainty caused by higher long-term inflation expectations, accelerated by the geopolitical situation, and by central bank interest rate increase programs as a reaction to rising inflation. The total average increase among all countries is on average 180bp. Notable increases from YE21 are observed in UK (300bp), Eurozone and US (260bp), Canada (210bp), and Switzerland (190bp).



Short-term inflation impacts

When preparing yearend accounting figures, it is advisable for companies to consider to appropriately reflect potential effects of current high short-term inflation on their employee benefit liabilities, while also discussing this with their auditor. Your Aon consultant can help you in this respect.

Discount rate evolution 31-Dec-2021 until 30-Sep-2022 (in bp)
(Corporate AA or Government bond yields for selected duration⁽¹⁾)



Unfunded liabilities around 26% lower in 2022

Unfunded employee benefit liabilities could decrease on average 26% in the main currency zones due to changes in discount rates since YE21. In other currency zones, the picture is broadly similar with a few exceptions. Turkey's economy is in hyperinflation. Turkey's rates are therefore excluded from the averages.

Selected duration ⁽¹⁾	Discount rate				Year-to-date increase/(decrease)	
	31-Dec-20	31-Dec-21	30-Jun-22	30-Sep-22	Discount rate	Unfunded liability
	20	21	22	22		
Main currency zones						
USA	12	2.5%	2.8%	4.7%	5.4%	2.6% (25.9%)
Eurozone	15	0.5%	1.1%	3.2%	3.7%	2.6% (31.7%)
UK	20	1.4%	2.0%	3.8%	5.0%	3.0% (44.0%)
Canada	15	2.5%	3.0%	5.2%	5.1%	2.1% (26.1%)
Japan	10	0.5%	0.5%	0.9%	1.0%	0.5% (4.8%)
Switzerland	15	0.0%	0.2%	2.0%	2.1%	1.9% (24.6%)
Average main currency zones					2.1%	(26.2%)
Other currency zones						
Australia	10	2.0%	3.1%	5.3%	5.7%	2.6% (22.0%)
Brazil	10	6.7%	8.9%	9.6%	10.2%	1.3% (11.2%)
China	10	3.2%	2.8%	2.9%	2.8%	0.0% 0.0%
Indonesia	10	6.4%	6.9%	7.6%	7.5%	0.6% (5.4%)
India	10	6.2%	6.8%	7.4%	7.3%	0.5% (4.6%)
Mexico	10	5.3%	7.6%	9.1%	9.7%	2.1% (17.6%)
New Zealand	10	1.0%	2.5%	3.9%	4.4%	1.9% (16.8%)
Norway	15	1.6%	2.2%	3.9%	4.1%	1.9% (24.1%)
Poland	10	1.3%	3.7%	6.9%	7.1%	3.4% (27.6%)
Saudi Arabia	10	1.7%	2.3%	4.3%	5.1%	2.8% (23.7%)
South Africa	10	10.0%	10.5%	11.7%	12.0%	1.5% (12.6%)
South Korea	10	2.3%	2.9%	4.4%	5.1%	2.2% (19.1%)
Sweden	15	0.9%	1.6%	3.9%	4.3%	2.7% (32.5%)
Taiwan	10	0.3%	0.8%	1.4%	1.7%	0.9% (8.5%)
Thailand	10	1.4%	1.9%	3.0%	3.3%	1.4% (12.8%)
Average other currency zones					1.7%	(15.9%)
Overall average					1.8%	(18.7%)
Turkey	10	12.4%	23.2%	18.2%	11.0%	(12.2%) 183.7%

Inflation expectations higher than at YE21

Market-implied long-term inflation expectations increased with 20bp in the Eurozone since YE21. The Q3-2022 inflation survey performed by the ECB gives 2.20% as the longer term (5 years ahead) inflation forecast, continuing to increase from YE21 and remaining above the ECB target of "2% over the medium long term".

The market-implied UK retail price index expectation has increased 40bp above levels observed at YE21, seeing a steady increase over the summer after an initial drop observed in Q2-2022.

A higher inflation rate generally increases inflation-dependent liabilities.

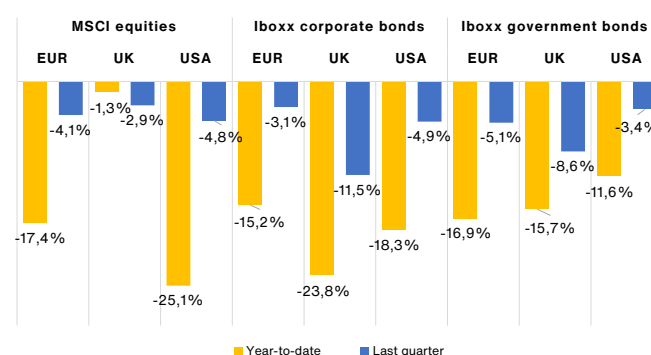
Selected duration ⁽¹⁾	Inflation rate				Year-to-date increase/ (decrease)	
	31-Dec-20	31-Dec-21	30-Jun-22	30-Sep-22		
Eurozone CPI ⁽²⁾	15	1,4%	2,2%	2,4%	2,4%	0,2%
UK RPI ⁽²⁾	20	3,1%	3,5%	3,2%	3,9%	0,4%
ECB longer term						
Eurozone forecast		1,7%	1,9%	2,1%	2,2%	0,3%

Equities and bonds are significantly down in 2022

The expectation of high inflation over a long period and the impact of unprecedented interest rate increases by central banks over the last months, drove both equity and bonds further down in Q3-2022. Markets are incorporating that some of the major world economies are or will fall in a recession. UK bonds have particularly suffered due to the mini-Budget turmoil.

All year-to-date returns are significantly negative in Europe, UK, and USA. The impact of the asset performance on funded liabilities depends on how asset portfolios are weighted between equities and bonds.

Equity and bond returns 31-Dec-2021 until 30-Sep-2022
(Year-to-date and Last quarter)



Looking ahead

Most central banks indicate they expect to keep raising interest rates in their combat of high inflation. However, the decision to increase rates needs to be thoughtfully made, as high rates will impact economic growth. The Ukrainian conflict is having a long-lasting impact on the geopolitical world map. Many key indicators are gloomy with negative growth prospects in the US and China and zero growth in Germany and the UK. Consumer and business confidence is down with receding demand, increasing production costs, and growing insecurity.

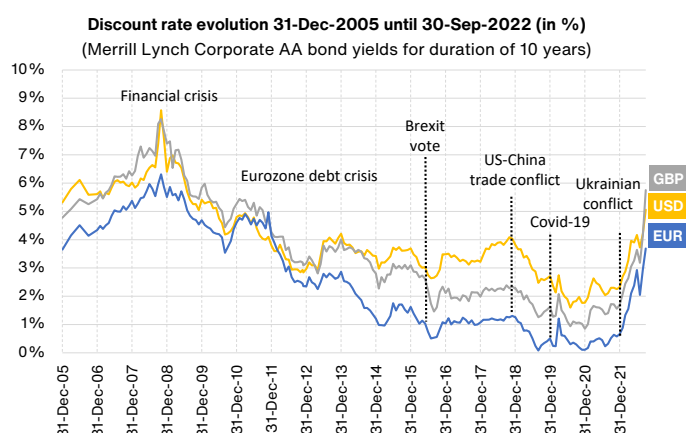
Companies should continue to closely monitor the evolution of discount rates and asset returns over the coming months. Aon can help mitigate your company's exposure to balance sheet liabilities, for instance by giving advice on discount rates and other assumptions, investigating the possibility to settle your company's liabilities (as this can become an increasingly favourable option in the current market environment), or reviewing funding options. If you would like help on this, feel free to contact your Aon consultant.

Background information

Employee benefit liabilities under IFRS and US GAAP accounting are calculated as the present value of your company's future pension obligations, adjusted for any available assets in an external funding vehicle. This present value is based on a discount rate derived from the yields on high quality corporate bonds with durations similar to that of these obligations, or on government bond yields if the corporate bond yield market is not deep enough.

What balance sheet impact your company can expect from a change in discount rate, depends on several factors. Important are the regional spread of your company, the duration profile of the liabilities and the size of the discount rate change. Also, other financial and demographic assumptions and the return on any available assets impact the liability.

Over the last decade discount rates showed a steady drop in most major currency zones, mainly caused by central banks' measures to avoid a global recession. This year that trend has reversed completely.



Data sources

Discount rate and inflation rate

For the main currency zones a single equivalent rate was derived from the yield curve using cash flows representative for employee benefits in these markets. For the other currency zones, the rate was selected from the yield curve for a duration of 10 or 15 years. All rates were rounded to the nearest 10bp.

Main currency zones – Yield curve source for the discount rate

USA	Aon US corporate AA bond universe curve
Eurozone	Aon Eurozone corporate AA curve
UK	Aon UK single agency corporate only AA curve
Canada	Aon Canadian new AA curve
Japan	Aon Japanese curve
Switzerland	Aon Swiss corporate AA bond curve

Other currency zones – Yield curve source for the discount rate

Australia	G100 discount rate curve (milliman.com)
Brazil	Government bond rates (NTN-B, anlima.com.br)
China	Government bond yield curve
India	Zero coupon sovereign rupee yield curve (ccilindia.com)
Indonesia	Zero coupon government bond yield curve (ibpa.co.id)
Mexico	10y government bond yield (scotiabank.com.mx)
New Zealand	Risk-free discount rate for accounting valuation (treasury.govt.nz) ⁽³⁾
Norway	DNB OMF curve (dnb.no)
Poland	Government bond rates (bondspot.pl)
Saudi Arabia	Aon US corporate AA bond universe curve
South Africa	Nominal zero coupon bond yield curve (iress.com)
South Korea	Corporate AA bond yields (kis-net.kr)
Sweden	Aon Swedish mortgage bond yield curve
Taiwan	Government bond index report (tpex.org)
Thailand	Zero coupon government bond yield curve (thaibma.or.th)
Turkey	Government bond rates (Bloomberg)

Main currency zones – Yield curve source for the inflation rate

Eurozone	Aon Eurozone inflation swap curve
UK	Aon UK market implied break-even rate curve

Asset return

Equity returns are based on MSCI net index evolution data published on investing.com. Corporate bond returns are based on total return index level data for the iBoxx investment grade corporate bonds as published on markit.com, and for government bond returns this is based on their investment grade sovereign and sub-sovereign bonds data. For USA, only the domestic bonds were considered. For UK, only non-gilts data was considered.

Notes

⁽¹⁾ Selected duration for major currency zones is based on the average observed duration of employee benefit liabilities in Aon's Global Survey of Retirement Plan Accounting Assumptions and is 10 years for most others.

⁽²⁾ CPI: consumer price index, RPI: retail price index.

⁽³⁾ The discount rate for New Zealand is only published a few times per year. The most recent rate at the date of publication is reflected in this document.

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The global retirement landscape is evolving at a rapid pace. Combinations of legislative, political and economic change pose both significant threats and create significant opportunities for DB and DC pension schemes. Setting and executing a successful global retirement strategy is therefore essential to managing potential risks; from effective benefits design and global mobility arrangements to the governance of financial and operational decision-making on a local, regional and multinational scale.

Aon's market-leading capabilities make us the perfect partner to help you through your unique multi-country pension challenges. Our international expertise across our broad portfolio enables us to provide integrated and comprehensive solutions, from the management of global retirement plans to the co-ordination of local retirement services. However large or small our clients' needs, we can help to empower results every step of the way.