

International View

Employee Benefits Accounting

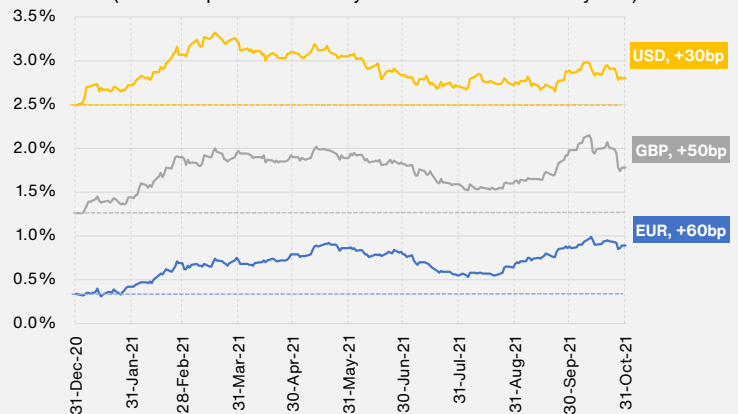
October 31, 2021 edition

Discount rates still up, while inflation increases, and strong equity returns

After a significant increase in September 2021, bond yields remained mostly stable or went further up during October. Almost all rates are significantly higher than on December 31, 2020. This seems to be a consequence of a slower than expected recovery of the economy and higher inflation expectations. Since YE20, bond yields increased 40bp in US and Eurozone, and 50bp in UK.

On average, **discount rates** are **up 40bp** from YE20 in the main currency zones, and **unfunded liabilities** could therefore be **6% lower** than YE20 but may suffer from increasing inflation-linked assumptions. **Funded liabilities** are further influenced by negative year-to-date bond performance, and strong equity returns.

Discount rate evolution 31-Dec-2020 until 31-Oct-2021 (in %) (Iboxx Corporate AA bond yields for duration of 10+ years)



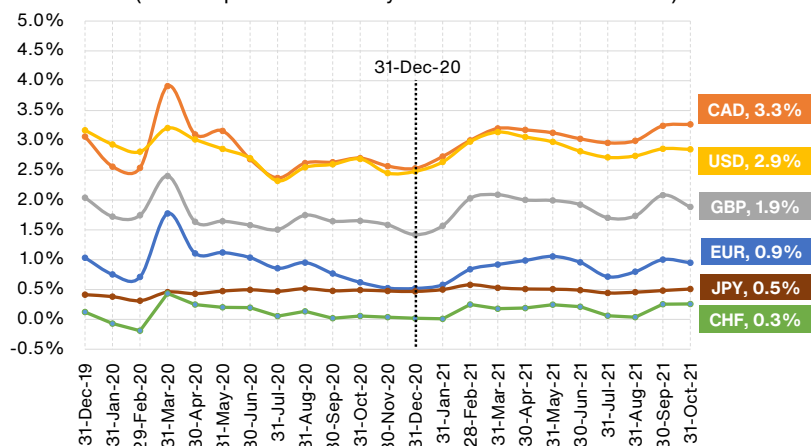
Most discount rates significantly up from YE20

Bond yields determine the discount rate of your company's pension liabilities under IFRS and US GAAP accounting.

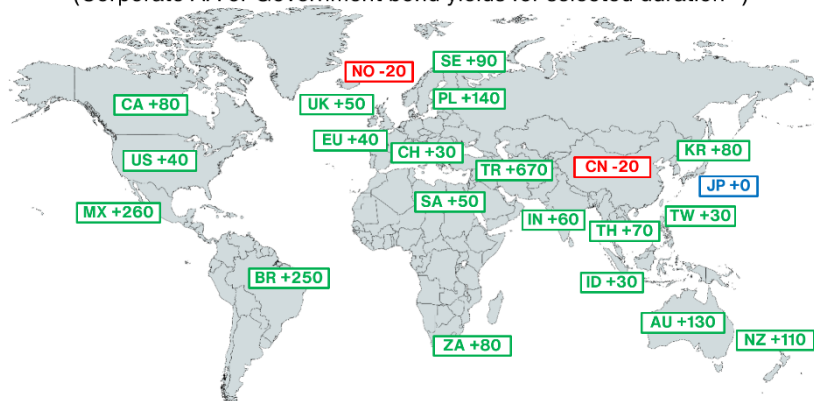
In Q1-2021 bond yields increased rapidly, driven by higher long-term inflation expectations and large stimuli packages. In Q2-2021 most yields remained stable or went slightly lower. After an initial decrease in July and August, most bond yields went up again in September.

In October 2021 discount rates remained mostly stable in the main currency zones, except in UK where rates decreased following the government's Autumn Budget announcement (-20bp). In other currency zones we often saw further increases in discount rates during October, especially in Australia (+80bp), Brazil (+60bp), Mexico (+60bp), and Turkey (+130bp). Most discount rates are still significantly higher compared to YE20.

Discount rate evolution 31-Dec-2019 until 31-Oct-2021 (in %) (Aon Corporate AA bond yields for selected duration⁽¹⁾)



Discount rate evolution 31-Dec-2020 until 31-Oct-2021 (in bp) (Corporate AA or Government bond yields for selected duration⁽¹⁾)



Unfunded liabilities around 6% lower in 2021

Unfunded employee benefit liabilities could decrease on average 6% in the main currency zones due to changes in discount rates since YE20.

In other currency zones, the picture is broadly similar, except for Turkey where the increase is largely due to accelerating inflation.

Selected duration ⁽¹⁾	Discount rate				Year-to-date increase/(decrease)	
	31-Dec-19	31-Dec-20	30-Sep-21	31-Oct-21	Discount rate	Unfunded liability
Main currency zones						
USA	12	3.2%	2.5%	2.9%	2.9%	0.4% (4.6%)
Eurozone	15	1.0%	0.5%	1.0%	0.9%	0.4% (5.8%)
UK	20	2.0%	1.4%	2.1%	1.9%	0.5% (9.4%)
Canada	15	3.1%	2.5%	3.2%	3.3%	0.8% (11.0%)
Japan	10	0.4%	0.5%	0.5%	0.5%	0.0% (0.0%)
Switzerland	15	0.1%	0.0%	0.3%	0.3%	0.3% (4.4%)
Average main currency zones					0.4%	(5.9%)
Other currency zones						
Australia	10	2.5%	2.0%	2.5%	3.3%	1.3% (11.9%)
Brazil	10	6.7%	6.7%	8.6%	9.2%	2.5% (20.7%)
China	10	3.2%	3.2%	2.9%	3.0%	(0.2%) 2.0%
Indonesia	10	7.5%	6.4%	6.7%	6.7%	0.3% (2.8%)
India	10	6.9%	6.2%	6.6%	6.8%	0.6% (5.5%)
Mexico	10	6.9%	5.3%	7.3%	7.9%	2.6% (21.6%)
New Zealand	10	1.8%	1.0%	2.1%	2.1%	1.1% (10.3%)
Norway	10	2.3%	1.7%	1.5%	1.5%	(0.2%) 2.0%
Poland	10	2.1%	1.3%	2.3%	2.7%	1.4% (12.8%)
Saudi Arabia	10	2.7%	1.7%	2.2%	2.2%	0.5% (4.8%)
South Africa	10	9.6%	10.0%	10.5%	10.8%	0.8% (7.0%)
South Korea	10	2.3%	2.3%	2.8%	3.1%	0.8% (7.5%)
Sweden	15	1.4%	0.9%	1.6%	1.8%	0.9% (12.5%)
Taiwan	10	0.7%	0.3%	0.5%	0.6%	0.3% (2.9%)
Thailand	10	1.5%	1.4%	2.0%	2.1%	0.7% (6.6%)
Turkey	10	11.7%	12.4%	17.8%	19.1%	6.7% (44.0%)
Average other currency zones					1.3%	(10.4%)
Overall average					1.0%	(9.2%)

Inflation expectations much higher than at YE20

Long-term inflation rate expectations increased significantly since YE20. In the Eurozone, consumer price-based inflation increased 20bp in October and 80bp since YE20. The retail price index in the UK has increased by 50bp as well since YE20.

A higher inflation rate generally increases inflation-dependent liabilities. Although the actual impact will be subject to the benefit plans valued.

The Q4-2021 outcome of the Survey of Professional Forecasters by the European Central Bank (ECB) shows a 20bp increase of the 5 years inflation forecast from Q4-2020, which is 10bp higher than the Q3-2020 forecast.

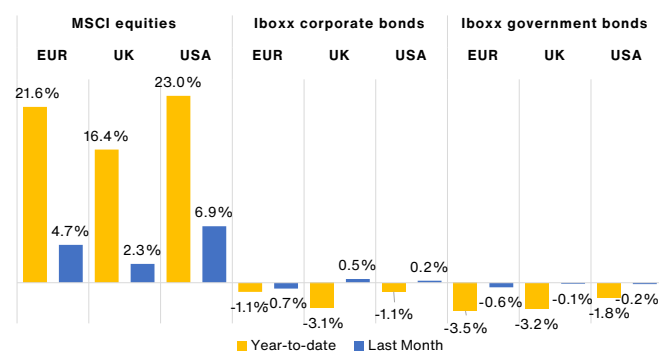
Selected duration ⁽¹⁾	Inflation rate				Year-to-date increase/(decrease)	
	31-Dec-19	31-Dec-20	30-Sep-21	31-Oct-21		
Eurozone CPI ⁽²⁾	15	1.4%	1.4%	2.0%	2.2%	0.8%
UK RPI ⁽²⁾	20	3.2%	3.1%	3.6%	3.6%	0.5%
ECB longterm						
Eurozone target		1.7%	1.7%	1.7%	1.9%	0.2%

Equities perform strong, but bonds down in 2021

The fear of inflation drove bond prices down in Q1-2021. They recuperated slightly in Q2-2021, while faster than expected economic recovery gave rise to positive equity returns. During Q3-2021, equity markets did not move that much, but they performed strong over October. The year-to-date equity returns remain very much positive in Europe, UK, and USA, while bonds still show negative year-to-date returns in all three markets.

The impact of the asset performance on funded liabilities will depend on how asset portfolios are weighted between equities and bonds.

Equity and bond returns 31-Dec-2020 until 31-Oct-2021
(Year-to-date and Last Month)



Looking ahead

Markets currently seem less optimistic about the speed of the economic recovery than earlier this year.

Combined with a fear of a higher inflation this may put some long-term pressure on bond rates and equity prices.

With many countries still battling the consequences of Covid-19, uncertainty remains about how the economic recovery and inflation will evolve, along with anticipated increase of central bank interest rates, large government budget deficits, labor shortage, and the impact of climate change.

Companies should continue to closely monitor the evolution of discount rates and asset returns over the next months.

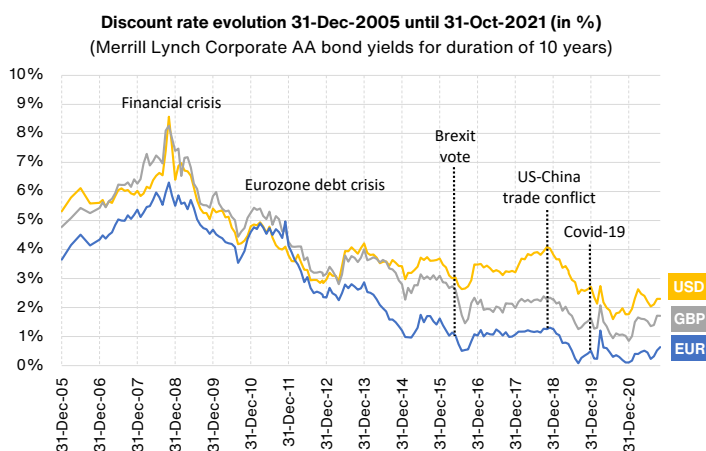
Aon can help mitigate your company's exposure to balance sheet liabilities, for instance by giving advice on discount rates and other assumptions, investigating the possibility to settle your company's liabilities, or reviewing funding options. If you would like help on this feel free to contact your 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.



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) ⁽²⁾
Norway	Discount rate for corporate bonds (regnskapsstiftelsen.no) ⁽³⁾
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 these countries is only published a few times per year. The most recent rate at the date of publication is reflected in this document.

Contact details

Aon International Retirement and Investment Team

EMEA

Stefaan Molders

Aon Brussels

+32 2 730 98 90

stefaan.molders@aon.com

Americas

Paul Garner

Aon Norwalk

+1 203 523 8467

paul.garner@aon.com

United Kingdom

James Nicholson

Aon Bristol

+44 117 900 4467

james.nicholson@aon.com

APAC

Ashley J Palmer

Aon Hong Kong

+ 852 2917 7963

ashley.j.palmer@aon.com

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.