

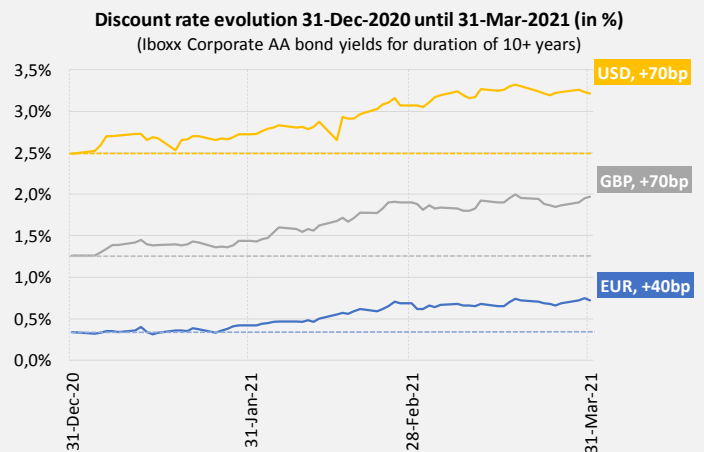
International View

Employee Benefits Accounting

March 31, 2021 edition

Discount rates jump up, while assets show mixed results

In Q1-2021, bond yields increased rapidly, driven by increased optimism on the global economic outlook in combination with a fear of higher inflation. The sentiment might change if growth would disappoint, central banks increase interest rates, new strains of Covid-19 are less amenable to vaccines, or if fiscal tightening happens too soon. In Q1-2021, bond yields increased 60bp in US, 70bp in UK and 40bp in Eurozone. On average, **discount rates are up 40bp** from last year-end in the main currency zones, and **unfunded liabilities could therefore be 6% lower** than last year-end. **Funded liabilities** are influenced by negative bond performance, and positive equity returns in Q1-2021.



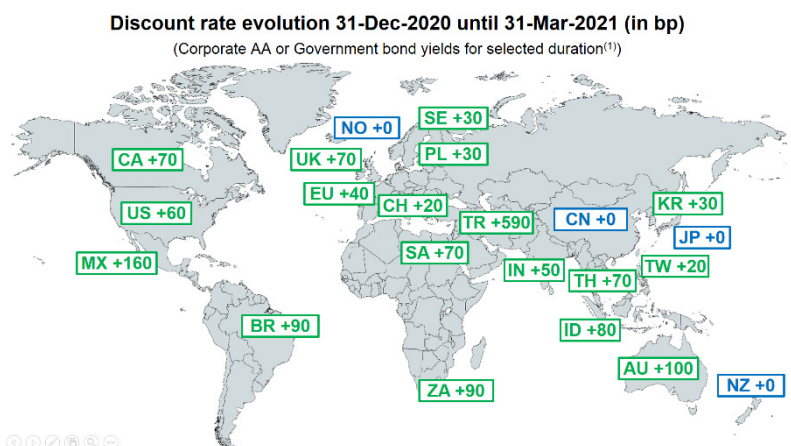
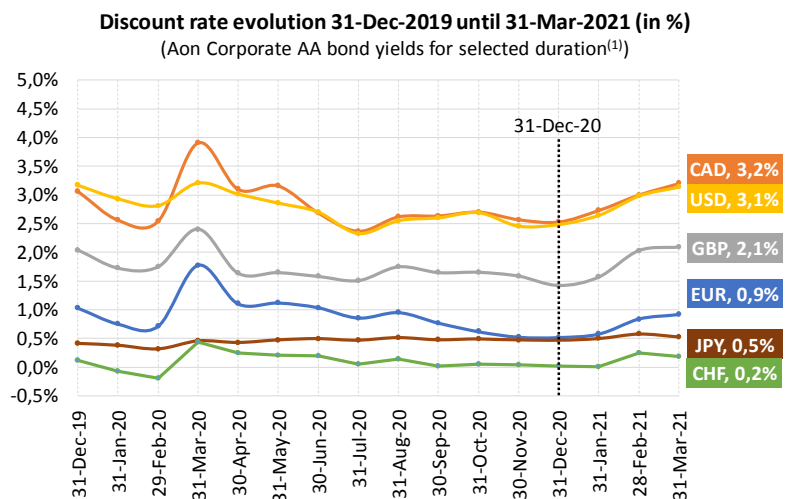
Breaking news: IAS19 Exposure Draft

The IAS Board published a draft amendment to IAS19, open for comments until 21 October 2021. Its goal is to make disclosures on defined benefit plans more relevant. Fewer items would be mandatory, while more items are recommended when they have a material impact. The changes are not expected to be in place before 2023. Aon will shortly share a detailed analysis.

Discount rates jump 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 inflation and large stimulus packages.

In the first quarter we see that discount rates have increased in almost every country. The increase for continental Europe has been smaller than for Canada, USA and UK. Part of this worldwide increase in bond yields is linked to the higher long-term inflation expectations.



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 year-end 2020. In the other currency zones, the picture is broadly similar, except for Turkey where the increase is big due to increased inflation.

Selected duration ⁽¹⁾	Discount rate			Year-to-date increase/(decrease)		
	31-Dec-19	31-Dec-20	31-Mar-21	Discount rate	Unfunded liability	
Main currency zones						
USA	12	3,2%	2,5%	3,1%	0,6%	(6,8%)
Eurozone	15	1,0%	0,5%	0,9%	0,4%	(5,8%)
UK	20	2,0%	1,4%	2,1%	0,7%	(12,9%)
Canada	15	3,1%	2,5%	3,2%	0,7%	(9,7%)
Japan	10	0,4%	0,5%	0,5%	0,0%	0,0%
Switzerland	15	0,1%	0,0%	0,2%	0,2%	(3,0%)
Average main currency zones					0,4%	(6,3%)
Other currency zones						
Australia	10	2,5%	2,0%	3,0%	1,0%	(9,3%)
Brazil	10	6,7%	6,7%	7,6%	0,9%	(8,1%)
China	10	3,2%	3,2%	3,2%	0,0%	0,0%
Indonesia	10	7,5%	6,4%	7,2%	0,8%	(7,2%)
India	10	6,9%	6,2%	6,7%	0,5%	(4,6%)
Mexico	10	6,9%	5,3%	6,9%	1,6%	(14,0%)
New Zealand	10	1,8%	1,0%	1,0%	0,0%	0,0%
Norway	10	2,3%	1,7%	1,7%	0,0%	0,0%
Poland	10	2,1%	1,3%	1,6%	0,3%	(2,9%)
Saudi Arabia	10	2,7%	1,7%	2,4%	0,7%	(6,6%)
South Africa	10	9,6%	10,0%	10,9%	0,9%	(7,8%)
South Korea	10	2,3%	2,3%	2,6%	0,3%	(2,9%)
Sweden	15	1,1%	0,6%	0,9%	0,3%	(4,4%)
Taiwan	10	0,7%	0,3%	0,5%	0,2%	(2,0%)
Thailand	10	1,5%	1,4%	2,1%	0,7%	(6,6%)
Turkey	10	11,7%	12,4%	18,3%	5,9%	(40,0%)
Average other currency zones					0,9%	(7,3%)
Overall average					0,8%	(7,0%)

Inflation expectations significantly higher

Long-term inflation rate expectations increased significantly since year-end 2020. In the Eurozone, consumer price-based inflation increased by 30bp in Q1-2021, while the retail price index in the UK has increased by 40bp. A higher inflation rate generally increases inflation-dependent liabilities. Although the actual impact will be subject to the benefit plans valued.

Based on a survey among professional forecasters, the European Central Bank (ECB) has kept in Q1-2021 its 5 years ahead inflation forecast at the same level as for Q4-2020. For the first time in several years ECB forecast and implied inflation expectations converged. The ECB Q2-2021 forecast will be published towards the end of April.

Selected duration ⁽¹⁾	Inflation rate			Year-to-date increase/(decrease)	
	31-Dec-19	31-Dec-20	31-Mar-21		
Eurozone CPI ⁽²⁾	15	1,4%	1,4%	1,7%	0,3%
UK RPI ⁽²⁾	20	3,2%	3,1%	3,5%	0,4%
<i>ECB longterm target for Eurozone</i>					
		1,7%	1,7%	1,7%	0,0%

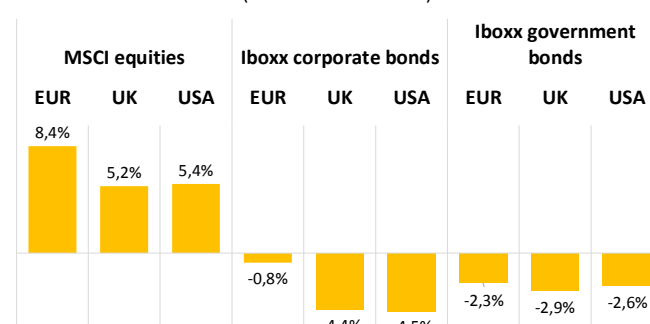
Equities up, but bonds down in 2021

For funded liabilities the situation can be different. The fear of inflation drove bond prices down in Q1-2021, while the faster than expected economic recovery gave rise to positive equity returns.

The year-to-date equity returns are very much positive in Europe, UK and USA. Corporate and government bonds show negative year-to-date returns in all three markets.

Depending on how their asset portfolios are weighted between equities and bonds, the change in funded liabilities will be different from that of unfunded liabilities.

Equity and bond returns 31-Dec-2020 until 31-Mar-2021
(Year-to-date returns)



Looking ahead

The global vaccine roll-outs, large stimulus packages, as well as some positive economic indicators, are supporting the hope of a quicker economic recovery. Markets believe however that this also increases inflation.

It's uncertain how this will progress in the short-term, with many countries still seeing new increases in Covid-19 cases in the wake of new virus strains, and with many regions dealing with slower vaccine roll-outs than hoped for.

In the longer-term uncertainty remains about the evolution of the virus, impact of vaccines, speed of economic recovery, inflation and central bank interest rates, and consequences of large government budget deficits that have been created while fighting the pandemic.

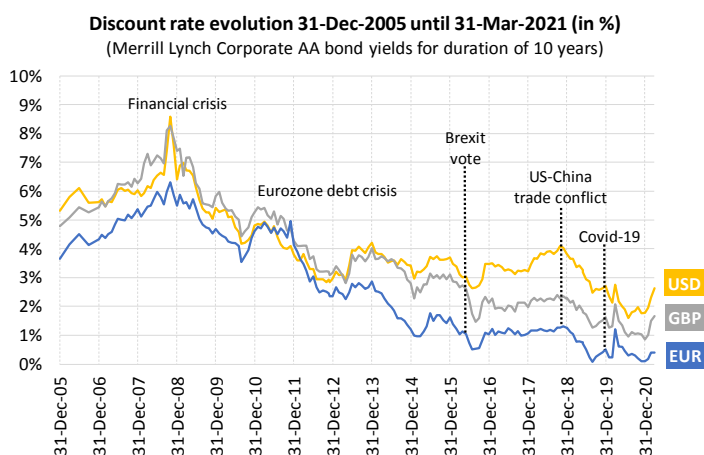
Companies should therefore closely monitor the evolution of discount rates and asset returns over the next months. Aon can help mitigate your company's exposure to balance sheet liabilities, for instance by giving advice on discount rates and other assumptions, investigating the possibility to settle 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 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, anbima.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	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.

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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.