RISK | PENSIONS | INVESTMENT | INSURANCE

A turning point for FTSE350 pensions?

Analysing the impact of DB pensions on UK business

After a number of difficult years, let's hope that 2017 is seen as the turning point for the defined benefit (DB) pension schemes of the UK's largest public companies. With equities performing strongly and bond yields having a quiet year, the funding position improved for many of the FTSE350 DB schemes. Overall, the aggregate IAS19 deficit for companies in the FTSE350 reduced from £62bn to £55bn.

Although contributions to pay down DB scheme deficits are on the increase, companies appear to be in a healthier position to deal with this based on the increase in free cashflow over the period.

While this is all good news, it would not take much to tip the balance the other way. Our analysis suggests that a 0.5% fall in bond yields in 2017 would have pushed the aggregate deficit of the FTSE350 DB schemes up to £85bn. With the current political and economic environment posing significant risks (not least the uncertainty relating to the outcome of the Brexit negotiations), companies should ensure that they are comfortable that the appropriate measures are in place to manage their DB pension scheme risks.

I would like to thank Michal Bobula from the University of the West of England, and Lewys Curteis and David Newgrosh from Barnett Waddingham for their work in helping to prepare this report.

Please contact me for further information on the results of this research. We would be very pleased to provide those covered by this analysis with a free bespoke report that will show how your company compares with your peers in the FTSE350.

NICK GRIGGS
Partner and Head of Corporate Consulting, Barnett Waddingham

REPORT HIGHLIGHTS

Transfer payments continue to rise

The benefits paid from the FTSE350 DB schemes totalled £42bn in 2017, with around £14bn of this being a result of transfers to defined contribution (DC) schemes. This means that the FTSE350 companies are now paying out to DB scheme members an amount close to half of the UK Government's State Pension budget.

Dividends vs. deficit contributions stable

With The Pensions Regulator's (TPR) focus becoming ever more concentrated on this issue, the average deficit contribution paid by FTSE350 companies as a proportion of dividends remained at 10% in 2017.

Intergenerational fairness

Contributions to DB schemes made up close to 70% of the FTSE350 companies' total pension cost. Given that the majority of current employees will be earning benefits in a DC scheme, are they paying the price for the generous promises made to the previous generation?

Affordability on the increase

Pension deficits as a proportion of market capitalisation reduced in 2017, while deficit contributions as a proportion of free cashflow remained steady, despite another increase in deficit contributions.

Overview

After a challenging few years, 2017 was a more positive year for the FTSE350 DB schemes. We provide an overview of 2017 in terms of the changes in funding levels and deficit contributions.

DB scheme deficits improve in 2017

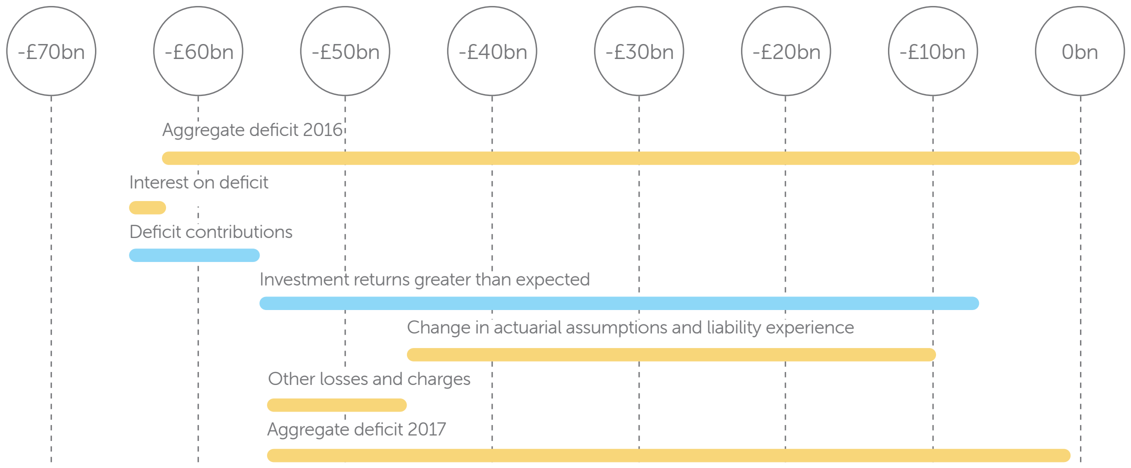
In 2017 the aggregate IAS19 deficit[1] for companies in the FTSE350 reduced from £62bn to £55bn. Relatively speaking, 2017 was a fairly benign year in terms of DB pension scheme funding. Corporate bond yields and inflation expectations both remained fairly static, while most DB pension schemes benefited from strong asset performance over the period. As a result, the majority of companies ended 2017 with their DB scheme in a healthier state than the previous year, and indeed this has continued into 2018, with the aggregate deficit standing at approximately £35bn at 30 June 2018.

A more detailed analysis of the decrease in the aggregate deficit over the last year is shown in the graph below.

It shows that while bond yields have fallen slightly over the year (discount rates at 31 December 2017 were around 0.2% p.a. lower than the previous year), this has been more than offset by positive asset performance over the period.

This is a very different picture from last year, when DB pension scheme assets struggled to keep pace with the large fall in bond yields following the EU referendum result.

ANALYSIS OF CHANGE IN AGGREGATE DEFICIT IN 2017



1 As published in the latest set of published accounts up to and including 31 December 2017 and ignoring 66 companies with an IAS19 surplus or neutral position

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Good year for the banks, energy companies and industrials

While almost all sectors had a positive year in terms of DB pension scheme funding, the biggest winners were undoubtedly the commercial banks, the energy companies and the industrial companies.

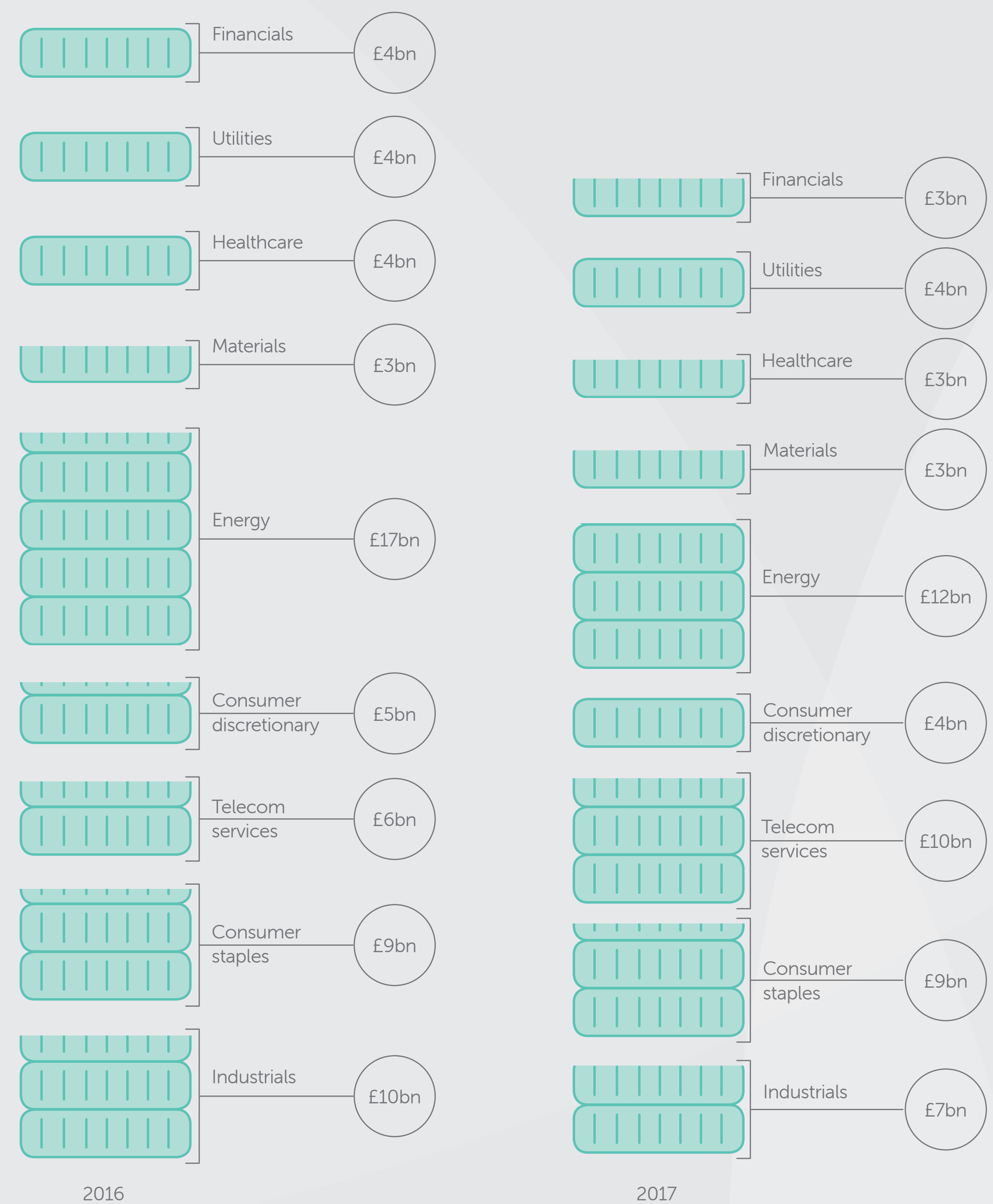
> As mentioned in our FTSE100 report, the four major high street banks all reported a surplus at the end of 2017, while companies such as BP, Royal Dutch Shell, BAE Systems and Rolls-Royce all saw material improvements in the funding position of their DB pension schemes.

These companies were mainly helped by the performance of their DB scheme investment strategies – most of these companies have taken steps to hedge a significant proportion of their interest rate and inflation risk, which protected funding positions against the small fall in discount rates, while equities and other growth assets performed strongly to push funding positions higher.

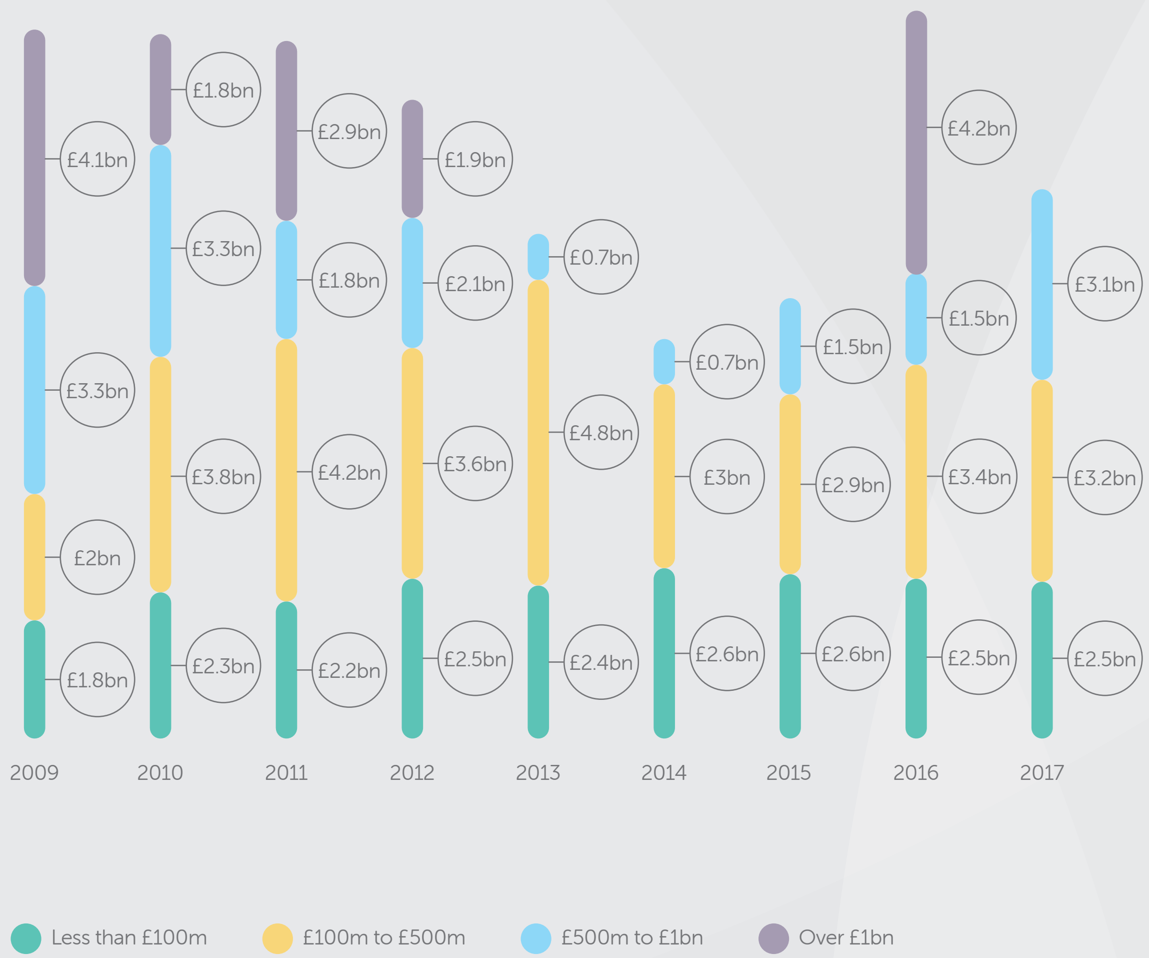
In contrast, the telecoms industry had a less positive year, with the pension scheme deficits of both BT and Vodafone increasing significantly over the year.

The chart on the right shows the share of the aggregate deficit by sector, and how this has changed since last year.

FTSE350 AGGREGATE DEFICIT BY SECTOR



DEFICIT CONTRIBUTIONS BY SIZE



Deficit contributions on the increase

After a slow decline in the amount of deficit contributions[2] paid in the years after the global financial crisis, this year's data suggests that the FTSE350 companies are slowly stepping up their commitment to paying down DB pension scheme deficits.

> If we ignore the one-off £4.2bn contribution paid by Royal Bank of Scotland last year, this is the third year in a row that we have seen an increase in deficit contributions.

The analysis later in this report suggests that in general affordability of deficit contributions is improving for the FTSE350 companies. Royal Bank of Scotland's DB scheme is now in a very strong position after the significant payment that it made in January 2016. It will be interesting to see if any of the other FTSE350 companies follow suit in making larger contributions if affordability is indeed improving.

2 Deficit contributions approximated by subtracting disclosed service costs (in respect of future pension provision) from the amount of contributions paid by companies into the DB scheme

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Impact on balance sheet

DB pension schemes can have a material impact on the balance sheet of a company. This can have tangible consequences for companies, particularly for regulated entities such as banks and insurance companies.

Market capitalisation

A straightforward way to compare the relative impact of DB deficits on the financial strength of sponsoring employers is to examine the size of the deficit against its market value.

> In general, pension deficits as a proportion of market capitalisation for FTSE350 firms reduced slightly, with the median proportion decreasing from 2.1% in 2016 to 1.4% in 2017.

The chart to the right shows a breakdown of the average deficit as a proportion of market capitalisation by sector, together with changes from the previous year. For most sectors, the proportions remained relatively stable over the year.

The sectors that saw the largest changes were:

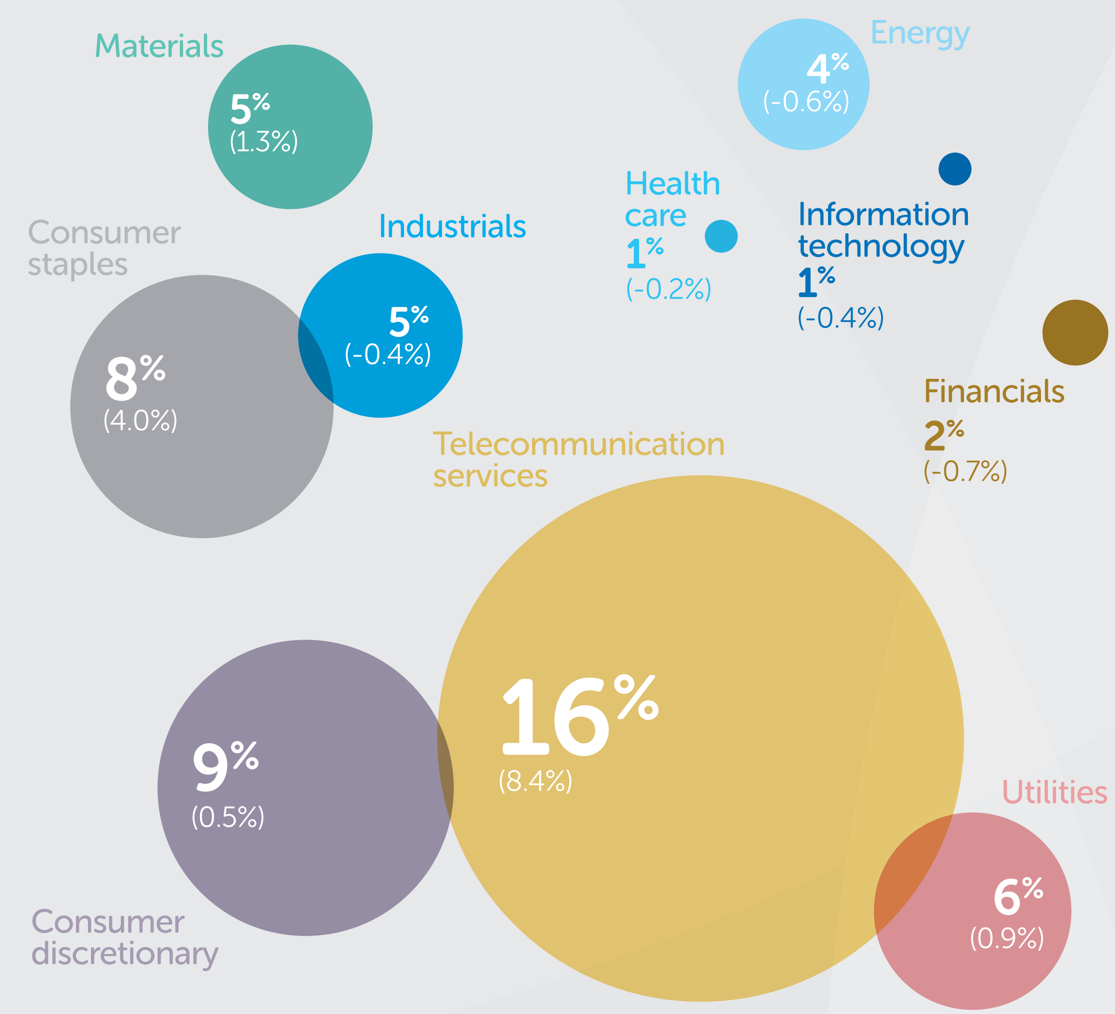
Telecommunication Services

This was mainly due to the large increase in the deficit for BT, together with a large decrease in its market capitalisation.

Consumer Staples

This was largely caused by a significant increase in the deficit for Tesco, with only a moderate increase in its market capitalisation. Tesco's deficit has since reduced primarily due to a change in the method used to calculate its discount rate, highlighting the importance of the choice of actuarial assumptions.

DEFICIT AS % OF MARKET CAPITALISATION BY SECTOR (AND % CHANGE FROM 2016)



INSIGHT FOR FINANCE DIRECTORS

Issues to consider when setting the actuarial assumptions

The funding position disclosed in the company accounts depends on the actuarial assumptions used to value the liabilities, especially the discount rate, inflation rate and mortality assumptions.

As the accounting assumptions are derived based on the relevant accounting standards, the assumptions can be quite different to those used for funding the DB scheme. This can result in a disconnect between the funding position disclosed in the company accounts and the funding position used for determining company contributions (the Scheme Funding basis). Where a company's DB scheme is better funded on the Scheme Funding basis than the accounting basis, it may be worth disclosing this in the notes to the company accounts to illustrate to investors that the DB scheme is in a stronger position than the (fairly arbitrary) accounting assumptions would imply.

Although the accounting standards are relatively prescribed in relation to pension disclosures, a range of assumptions are typically adopted by FTSE350 companies.

Relatively small differences in the assumptions can make a material difference to the pension scheme deficit disclosed, and therefore the setting of actuarial assumptions should be an important consideration for companies approaching their accounting year-end.

Discount rate

In the current environment of low bond yields, companies are paying increased attention to their discount rates. There are various approaches to setting discount rates that could result in an improved funding position being disclosed.

Based on our analysis, around 20% of the FTSE350 companies with a year-end of 31 December 2017 may have been able to increase their discount rate by 0.2% p.a. or more by adopting an approach used by other FTSE350 companies.

Inflation rate

As the majority of pensions in the UK increase in line with inflation, expectations for the level of future inflation are a key part of the calculation of a pension scheme's liabilities. Again, there are a variety of methods being adopted by FTSE350 companies which justify using a lower inflation assumption, for example making an allowance for an "inflation risk premium" where the quantum is extremely subjective.

Mortality

The life expectancy of pension scheme members is another key assumption when valuing a scheme's liabilities. Until recently we have seen life expectancies increase consistently above expectations, resulting in DB pension scheme liabilities increasing further. However, over the last few years, improvements in longevity have slowed. Companies should be alert to these changes and consider how they are being reflected in their mortality assumption.

CASE STUDY

Accounting consolidation for a FTSE350 company with global pension obligations

Our client is a large, multi-national company with significant pension and other post-retirement plans in the UK and the USA. We are appointed to provide consolidated IAS19 accounting figures in respect of these arrangements.

An efficient consolidation process involves good communication, both between the consolidating actuary and the local actuaries, and between the consolidation actuary and the client, to ensure that timescales are met. In our case, we required local currency figures to be provided on the 4th working day after the year-end and then provide the consolidated results to the client on the 6th working day. This meant providing assumptions advice for both the UK and the USA plans in good time to agree these with the client and their auditors prior to passing these to the local actuaries to undertake their year-end calculations.

Companies also need to be able to place a high degree of reliance on the figures provided. Through MBW International (our joint venture with Milliman) we were able to take advantage of an easy-to-use, web-based consolidation system to quickly and efficiently validate the local actuaries' figures and deal with any resulting queries.

We were then able to produce the consolidated results in a bespoke format designed to make it significantly easier for the client to find the key results than in previous years, reducing the internal time spent on the pension disclosures.

Without a robust process, the audit of pension disclosures can be a protracted process. The use of the consolidation system, early engagement with the auditors and reporting (which highlighted and explained the key issues) helped ensure that audit queries were kept to a minimum.

The process ran smoothly and figures were delivered on time, allowing the finance team to meet their internal deadlines.

Impact on Shareholders

For investors in a company with a large DB scheme, the financial health of that scheme and the risks associated with the scheme should be a key consideration.

DB schemes can hinder shareholders' long-term return by consuming large amounts of capital - capital that otherwise could have been used to invest in the future growth of the company, reduce non-pension related debt or returned to shareholders as dividend payments.

Shareholders vs. DB scheme

The allocation of capital is never a straightforward decision for companies, and it is even more complicated for companies with a large DB scheme. Following the recent high-profile failures of BHS and Carillion (amongst others), these decisions are coming under increased scrutiny, particularly the allocation of resources between shareholders and DB pension schemes.

Over the last eight years, the companies in this survey paid around £75bn into their DB schemes to reduce funding deficits. This is around one fifth of the £385bn paid out to shareholders as dividends over the same period.

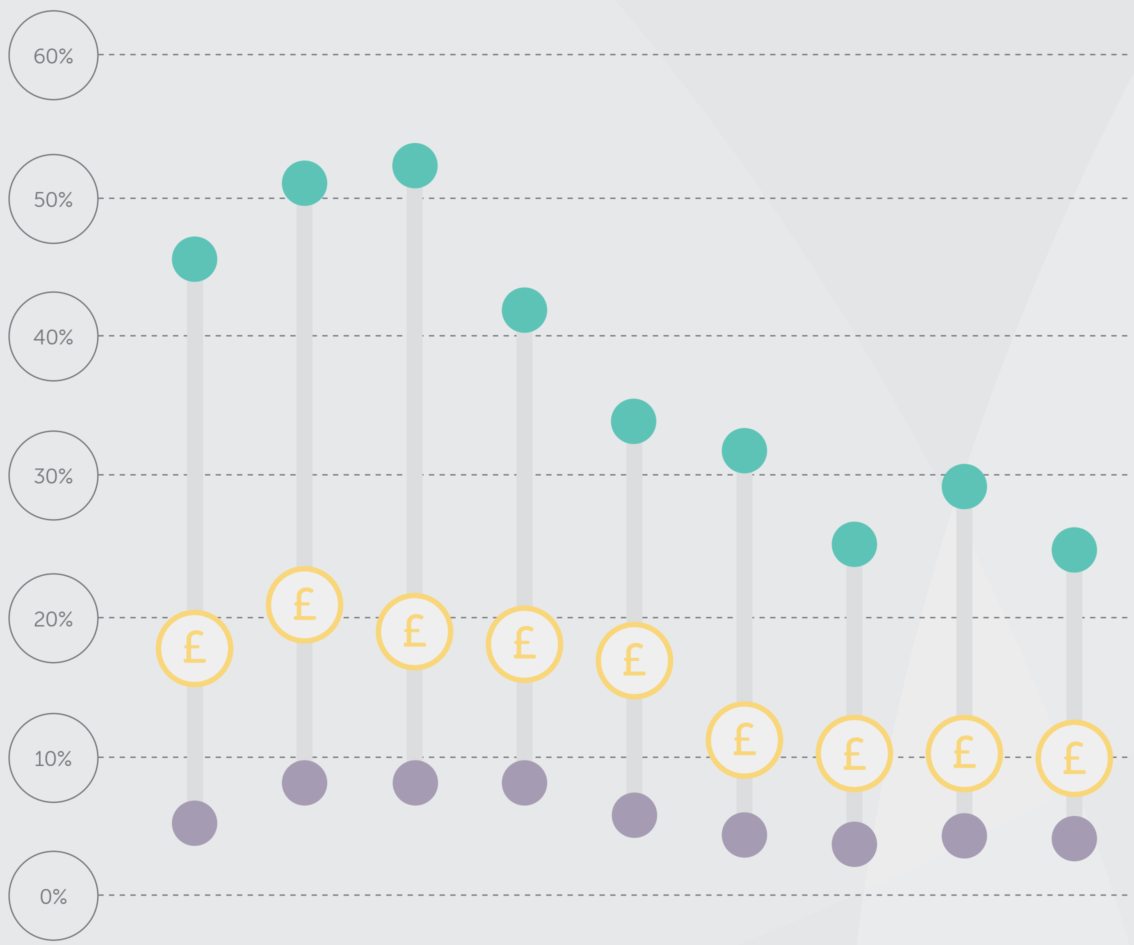
> In the last year, the FTSE350 companies in this survey paid £8.7bn in deficit contributions, while £66bn has been paid in dividends.

TPR has highlighted this as an area of particular interest, and has been steadily intensifying its rhetoric over recent years.

In its most recent funding statement, TPR said that it is "concerned about the growing disparity between dividend growth and stable deficit reduction payments" and "where distributions appear unreasonable relative to contributions, we expect trustees to negotiate robustly with the employer to secure a fair deal for the pension scheme".

The chart on the right shows deficit contributions as a proportion of dividends for the FTSE350 companies, including the median and the upper and lower quartiles.

DEFICIT CONTRIBUTIONS AS % OF DIVIDENDS



While the relative amounts paid vary significantly across the FTSE350, our research shows that, in 2017, the median of deficit contributions as a proportion of net dividend payments remained unchanged from the previous year, and has been relatively stable since 2014.

Therefore, in the relatively positive economic environment over recent years, it would appear that the FTSE350 companies have started to settle upon a favoured allocation of dividends and deficit contributions. Whether or not TPR is content with this balance between shareholders and DB schemes remains to be seen.

> With a lot of criticism about its lack of intervention in certain high-profile corporate failures, TPR is promising to take a tougher line with those companies deemed to be side-stepping their pension obligations.

To explore this in a bit more detail, we have analysed the changes to shareholder pay-outs (measured as net dividends plus share repurchases) and changes to deficit contributions over 2017. This is shown in the table below.

Number of companies		PAYOUT TO SHAREHOLDERS: Increase	PAYOUT TO SHAREHOLDERS: Decrease
DEFICIT CONTRIBUTIONS	Increase	42	26
	Decrease	43	28

> In 2017, 43 companies increased pay-outs to shareholders and at the same time reduced deficit contributions.

The equivalent number of companies for 2016 was 45 companies. While, on the face of it, it might appear that TPR should have cause for concern about the activities of these companies, there may be good reasons for this behaviour. For example, Smiths Group plc made a positive DB funding commitment by paying a significant one-off contribution to one of its UK DB schemes in December 2015, and has since continued paying the deficit contribution schedule agreed with the pension scheme trustees.

TPR is likely to be satisfied that 68 companies increased their deficit contributions in 2017, with 42 of those also increasing pay-outs to shareholders (suggesting a healthy financial position). For the 26 companies that increased their deficit contributions at the same time as reducing payments to shareholders, this shows a commitment to DB pension scheme funding.

INSIGHT FOR FINANCE DIRECTORS

Dividends vs. deficit contributions

Companies should expect greater scrutiny and challenge from TPR regarding the level of deficit contributions relative to the level of dividend payments. Finance Directors should therefore ensure that they are aware of TPR's guidance, particularly if any changes are being made to company dividend policy. Often the best defence against action from TPR is to agree an allocation between deficit contributions and dividends with the pension scheme trustees.

With the publication of the recent White Paper promising more powers for TPR, Finance Directors should ensure that they are kept up to date regarding any developments in this area.

Impact on Risk

DB pension schemes expose companies to a multitude of risks, including interest rate risk, inflation risk, investment risk and longevity risk.

In the face of this, companies essentially have two options: either setting an appropriate strategy to manage these risks over the long term, or removing these risks completely by transferring them to the insurance markets.

These choices are not mutually exclusive, however.

> A popular strategy is to have a long-term objective to transfer the pension scheme to an insurance company, but in the shorter term to find solutions to manage risk and, if possible, to settle liabilities at a cost below that of an insurance transaction.

In this section, we consider the risk exposure of the FTSE350 companies, and consider some of the ways that companies can deal with DB pension scheme risk.

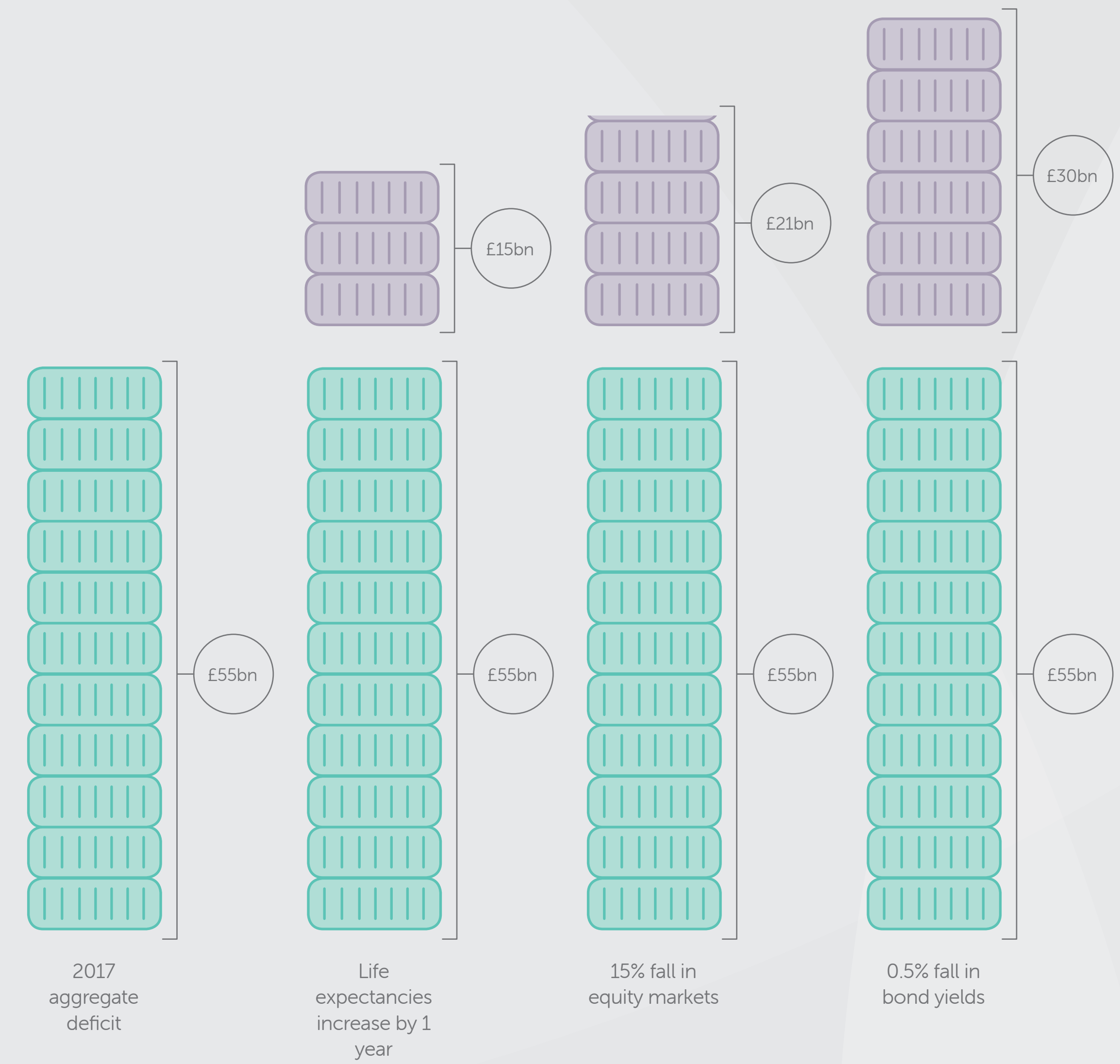
Risk exposure

To illustrate the level of risk that the FTSE350 companies are exposed to through their DB pension schemes, we have shown in the chart to the right the impact of various scenarios on the aggregate DB pension scheme deficit.

This analysis highlights the significant risk exposure of the FTSE350 companies, all of which play a crucial role in the UK economy. The scenarios that we have considered are not implausible – there are a number of potential events that could emerge over the next few years and result in these scenarios taking place (e.g. a Hard Brexit, a global trade war, advances in medical care).

Companies are not completely powerless in the face of these risks, and there a number of strategies available for managing or removing DB pension scheme risk.

SCENARIO ANALYSIS OF THE 2017 AGGREGATE DEFICIT



Risk management

Liability management exercises

While liability management exercises have always been a useful tool for companies looking to reduce DB pension scheme risk and cost, the Government's 2014 Budget significantly increased the scope for companies to do this successfully.

The introduction of pension flexibilities for DC schemes has made transferring from DB to DC a considerably more attractive proposition for DB scheme members.

> From a company's perspective, if a member transfers from DB to DC, this can result in an improvement in the DB scheme's funding position, and the risk relating to the provision of the member's DB benefit is entirely removed.

It is therefore becoming increasingly popular to communicate transfer values to non-retired DB scheme members, either as a one-off exercise, or as part of the scheme's ongoing retirement process. These exercises can be a genuine "win-win" for all DB pension scheme stakeholders if managed correctly.

To illustrate the popularity of DB to DC transfers, the chart on the right shows the change in benefit payments each year from the DB schemes of the FTSE350 companies.

While we would expect benefit payments to increase each year as the DB scheme population matures and pensions increase in line with inflation, as shown in the chart, the large increases seen since 2015 are due to the surge in DB to DC transfers following the Government's decision to introduce the Pension Freedoms for DC schemes in 2015.

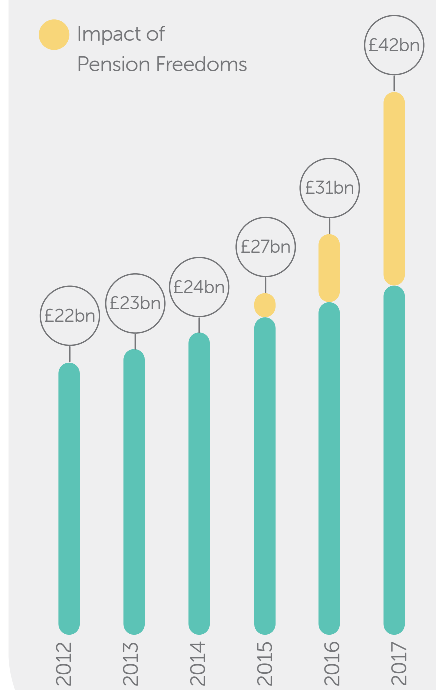
In total, around £42bn of benefits were paid out of the FTSE350 companies' DB schemes in 2017. This is an astonishing amount and is close to half of the £94bn paid by the UK Government in respect of the State Pension over the year to April 2018[3].

Barclays led the way in terms of transfer volumes, with £4.2bn being paid out as transfer values from its DB pension scheme. Aviva, Lloyds Banking Group and Royal Bank of Scotland also saw a large increase in benefit payments.

> The median increase in benefit payments of over 18% in 2017 is the highest on record, and indicates that the demand for DB transfers continues to increase.

While this undoubtedly gives companies a good opportunity to reduce risk and cost, they should be mindful of the impact that this increase in payments has on pension scheme cashflow, and should ensure that the investment strategy remains appropriate.

TOTAL BENEFIT PAYMENTS MADE BY FTSE350 COMPANIES OVER THE LAST SIX YEARS



3 http://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/welfare-spending-state-pension/

INSIGHT FOR FINANCE DIRECTORS

How to maximise take-up rates

Member engagement is crucial for the success of liability management exercises. Companies can improve the chances of a running a successful exercise by ensuring that the proposition is well-designed and communicated effectively with members. Where a company is simply looking to promote the options available to scheme members at the point of retirement, the take-up rate can be influenced significantly by the company agreeing to pay for independent financial advice.

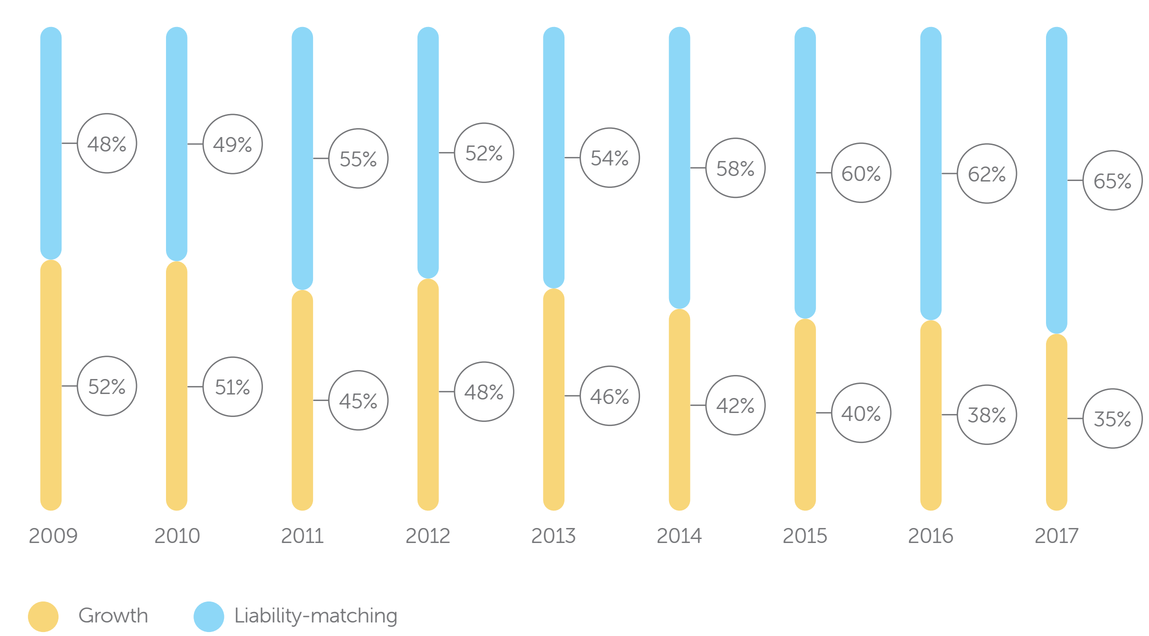
Where a scheme has a transfer value included as a standard retirement option, it is worth considering partnering with a trusted independent financial adviser (IFA). This will give the trustees comfort that members are getting access to the best possible advice, and the IFA firm is likely to offer preferential rates for members wanting to discuss their retirement options.

Investment risk management

The investment strategy of DB pension schemes is another area where companies can take positive action. Although pension scheme trustees are responsible for setting the DB scheme investment strategy, companies are becoming increasingly proactive in collaborating with the trustees to agree a mutually acceptable investment strategy. This is no surprise given the level of risk that companies are exposed to via their DB pension scheme investments.

The chart below shows the change in the percentage of DB pension scheme assets invested in growth assets (i.e. equities, property and diversified growth funds) and liability-matching assets (i.e. bonds, liability-driven investments and insurance contracts) for the FTSE350 companies.

CHANGE IN THE FTSE350 DB SCHEME ASSET ALLOCATION OVER TIME



Managing investment risks through liability-driven investments (LDI) continues to be an important strategic decision and, as shown by the chart, most schemes are well down this journey. However, managing the uncertain cashflow requirements created by the increased incidence of transfer values and the general maturing of schemes, whilst generating a positive real return on assets, is harder than ever given current yields and market conditions.

Schemes are increasingly looking to put in place strategies that capture upside returns with capital preservation during volatile markets, as well as strategies that help to tackle cashflow shortfall (i.e. preventing the need to sell assets during market downturns and crystallising losses).

Despite the trend towards liability-matching assets, there are still a number of companies taking significant risk in their DB pension scheme investment strategy. This is particularly true for the twelve FTSE350 companies with an equity holding in their DB scheme that was more than a third of the market capitalisation of the company.

INSIGHT FOR FINANCE DIRECTORS

DB scheme investment strategy

It is important for company directors to understand the level and type of risk being taken by the DB scheme assets, and ensure that this is in line with the company's risk tolerance. It is common for the Finance Director to consider taking independent investment advice and work collaboratively with the trustees to determine a suitable investment strategy, reflecting the company's objectives.

It is important to note that de-risking a DB scheme's investment strategy does not necessarily mean settling for a lower expected investment return. Schemes are increasingly using financial instruments that allow companies to reduce pension scheme investment risk while maintaining a rate of expected investment return that will keep contributions at an acceptable level.

With DB pension schemes becoming ever more mature, now is the time for companies to start thinking about the end game for their DB scheme. The investment strategy should be set with this ultimate objective in mind and should take into account any action being taken to reach that objective, e.g. liability management exercises.

Risk removal

The ultimate objective for most DB pension schemes is to transfer all or part of their DB pension scheme liabilities to the insurance market, completely extinguishing the risk of DB pension provision. As insurance companies are bound by stringent capital requirements, the cost of doing this can be prohibitive, and for most schemes this will be more of a long-term goal. For those schemes fortunate enough to be in a strong position, however, it is definitely worth investigating the feasibility of an insurance transaction.

The insurance market

2017 demonstrated that the demand for bulk annuities from UK pension schemes continues to remain strong, with over £12bn of transaction volumes being completed during the year. This was the fourth consecutive year where this figure exceeded £10bn.

> The insurers have reported a lot of demand for quotations meaning that they have to prioritise which cases they can quote on.

As a result, it can be difficult to obtain a range of quotations, especially for smaller schemes. Insurers are more likely to quote on cases where it is clear that a transaction is likely within a reasonable timescale.

There are eight UK insurers currently quoting in the market. Phoenix Life joined the market in 2017 and have recently completed their first transaction. The insurers have different preferences over their preferred types of transactions, with some only quoting for cases of a certain size or membership profile.

Pensioner pricing has continued to be attractive for schemes and many schemes have been able to complete pensioner buy-ins without worsening their funding level. This is often achieved by selling low-yielding assets such as gilts to fund the purchase. This option has been particularly attractive for larger schemes and some have insured a large part of their liabilities by carrying out several transactions as pricing for each tranche becomes affordable.

In our survey, 89 of the companies analysed would be able to achieve a full buy-out of their funded DB liabilities from their cash holdings alone, although for 21 of these companies it would have involved committing over 50% of their total cash holdings.

> Meanwhile, there were 29 companies in our survey that would have been able to fund a full pension scheme buy-out using the increase in their cash holdings between 2016 and 2017.

2017 was a more subdued year for the longevity transaction market, with fewer scheme-specific longevity transactions taking place. This was mainly due to the affordability of bulk annuities causing capacity constraints in the reinsurance market, but also due to the unexpected changes in life expectancies seen over the last couple of years.

A number of schemes will be waiting for these changes to stabilise and be fully reflected in insurers' pricing models before taking steps to enter into a longevity swap transaction.

INSIGHT FOR FINANCE DIRECTORS

Planning for an insurance transaction

Completing a buy-out or buy-in requires a lot of planning. The UK bulk annuity insurers are extremely busy at the moment and may decline to quote on cases where there is a lack of evidence that a transaction is likely in a reasonable timescale. In addition, any quotes will not be a fixed amount – they will move in line with market conditions and changes to the insurers' business strategies. Therefore, it is important that the trustees and sponsoring employer have a plan in place to transact once quotations arrive - affordable quotes may become unaffordable fairly quickly.

Before requesting quotes, it is important for the trustees and company to work together with their advisers to plan the process.

This includes obtaining a reasonable estimate of the likely premium, ensuring that the necessary funding is available, drafting the quotation request documentation, considering the scheme's asset strategy and resolving any potential issues. In particular, some schemes have incomplete membership data or problems with historical scheme documentation that would need to be reviewed. The preparation stage for obtaining quotes can be complicated, but is extremely important for companies looking to transfer their DB scheme to an insurer.

Impact on free cashflow

Free cashflow is cash generated by a company over and above that required to maintain or expand its asset base.

In this section, we consider the impact that DB schemes are having on financial flexibility for FTSE350 companies. Whether measured against the ability of companies to generate cash or, alternatively, against profit and loss measures, the contributions required to reduce DB scheme deficits must compete with many other financial commitments.

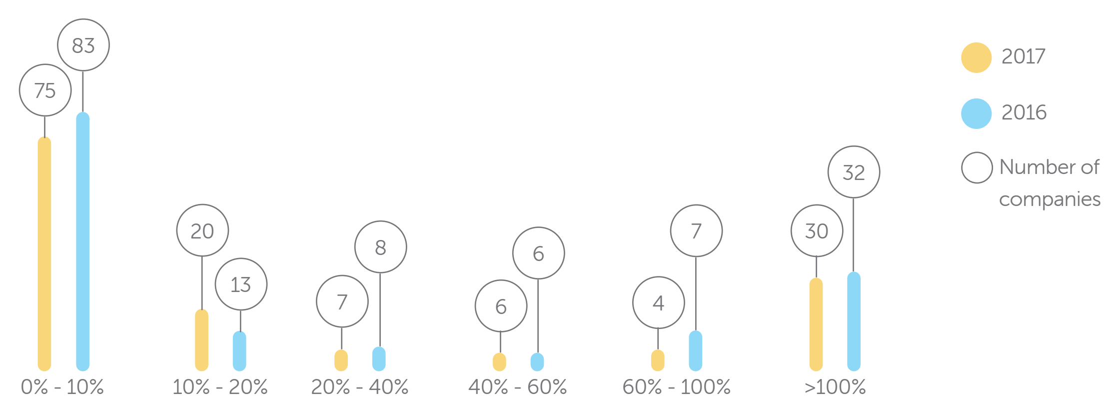
Ability to generate cash

One measure of a company's performance is its ability to generate cash, which may in turn be utilised to provide the financial resources to make additional investments, repay debt, build reserves or return cash to the shareholders (i.e. their free cashflow).

The chart below shows the distribution of deficit contributions as a proportion of free cashflow.

Total deficit contributions in 2017 represented 5% of total free cashflow for the FTSE350, which is unchanged from 2016. However, this should be considered in the context of an increase in deficit contributions of £1.4bn (if Royal Bank of Scotland's one-off contribution of £4.2bn in 2016 is ignored), suggesting companies are in a stronger position than they were last year.

DEFICIT CONTRIBUTIONS AS A PROPORTION OF FREE CASHFLOW



For the majority of companies, the proportion is in the range 0-10%, suggesting that deficit contributions should be reasonably affordable for these companies.

The chart below shows the number of companies whose deficit contributions exceeded free cashflow in 2017, compared with previous financial years.

The figure of 30 in 2017 is the smallest since our research began and is in contrast to the figure of 64 in 2015. Although DB pension schemes remain a challenge for a number of companies, this looks like positive news for the FTSE350 as a whole.

DEFICIT CONTRIBUTIONS GREATER THAN FREE CASHFLOW

INSIGHT FOR FINANCE DIRECTORS

Managing deficit contributions

With many companies paying significant levels of contributions to their pension schemes, companies will be interested in ways to manage their contribution requirements.

The company should ensure that the funding assumptions proposed by the trustees are reflective of the scheme's circumstances and, in particular, the proposed long-term investment strategy (which will not always be well defined).

The company may be able to negotiate a lower assessment of the scheme's liabilities or a longer recovery plan, resulting in lower contributions on an annual basis.

To facilitate this the company could offer a company guarantee. Such a guarantee (usually provided by a parent company) will extend the covenant provided to the scheme, which may make the trustees more comfortable in accepting a lower value being placed on the scheme's liabilities, a lower level of contributions or an acceptance to the company's proposals in relation to the investment strategy.

An alternative could be to use asset backed contributions (ABCs) – an asset owned by the company is transferred to a "special purpose vehicle", in which both the trustees and the company have an interest. An ABC arrangement can thus increase the value of a scheme's assets without the need for immediate cash contributions from the company.

It is important to note that reducing deficit contributions is not always the most sensible strategy, particularly if the company can afford to pay more. A common strategy is for companies to increase contributions, but on the understanding that the trustees provide something in return, for example agreement to a liability management exercise.

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Impact on profit and loss account

There are various ways in which the provision of pension benefits affects company profitability.

Pension provision can have a positive impact, for example when used as a tool to recruit and retain quality employees, but this is less true when, for example, funds are diverted from more profitable ventures to plug the gap in the funding of legacy benefits.

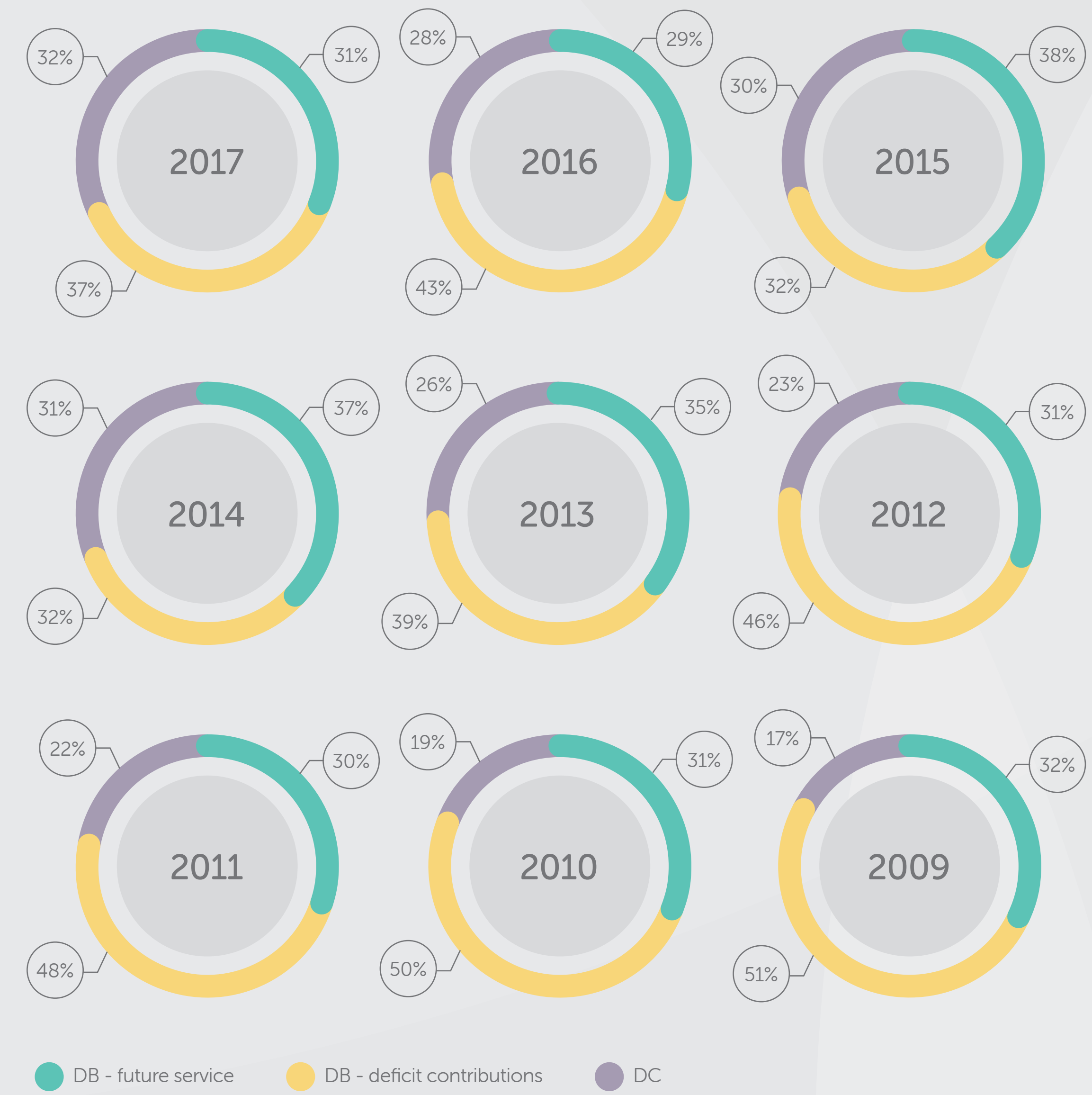
The most tangible measure of the impact of pensions on company profitability is the service cost, i.e. the amount paid by companies in respect of pension accrual for current employees.

> The average annual cost of pension benefits earned by employees was around £3,200 per employee in 2017.

The average annual cost of DC benefit accrual was around £2,200 per employee (i.e. around 70% of the total pension cost per employee), which is perhaps not surprising following the closure of a large number of DB schemes to future benefit accrual and the introduction of auto-enrolment in 2012.

However, as shown in the chart on the right, when deficit contributions are considered, DB benefits continue to be far more expensive for FTSE350 companies than DC benefits (making up nearly 68% of the FTSE350 companies' total pension cost). This is particularly shocking given that the vast majority of these deficit contributions relate to benefits earned by former employees.

TOTAL PENSION CONTRIBUTIONS FOR FTSE350 COMPANIES



Steps are being taken to redress the balance in pension costs between DB and DC. The median increase in DC contributions for the FTSE350 companies was 6% in the year to 2017. With the minimum employer DC contribution rate increasing from 1% to 2% in April 2018 and DB schemes continuing to close to future pension accrual, we expect this trend to continue in the next few years.

It will, however, be some time before DC costs exceed DB costs, as FTSE350 companies will be dealing with the burden of DB pension provision for many years to come. Whether or not DC is an appropriate replacement for DB is an ongoing debate.

> What is clear is that a vast number of UK employees are not contributing enough to their DC scheme to secure a decent retirement income.

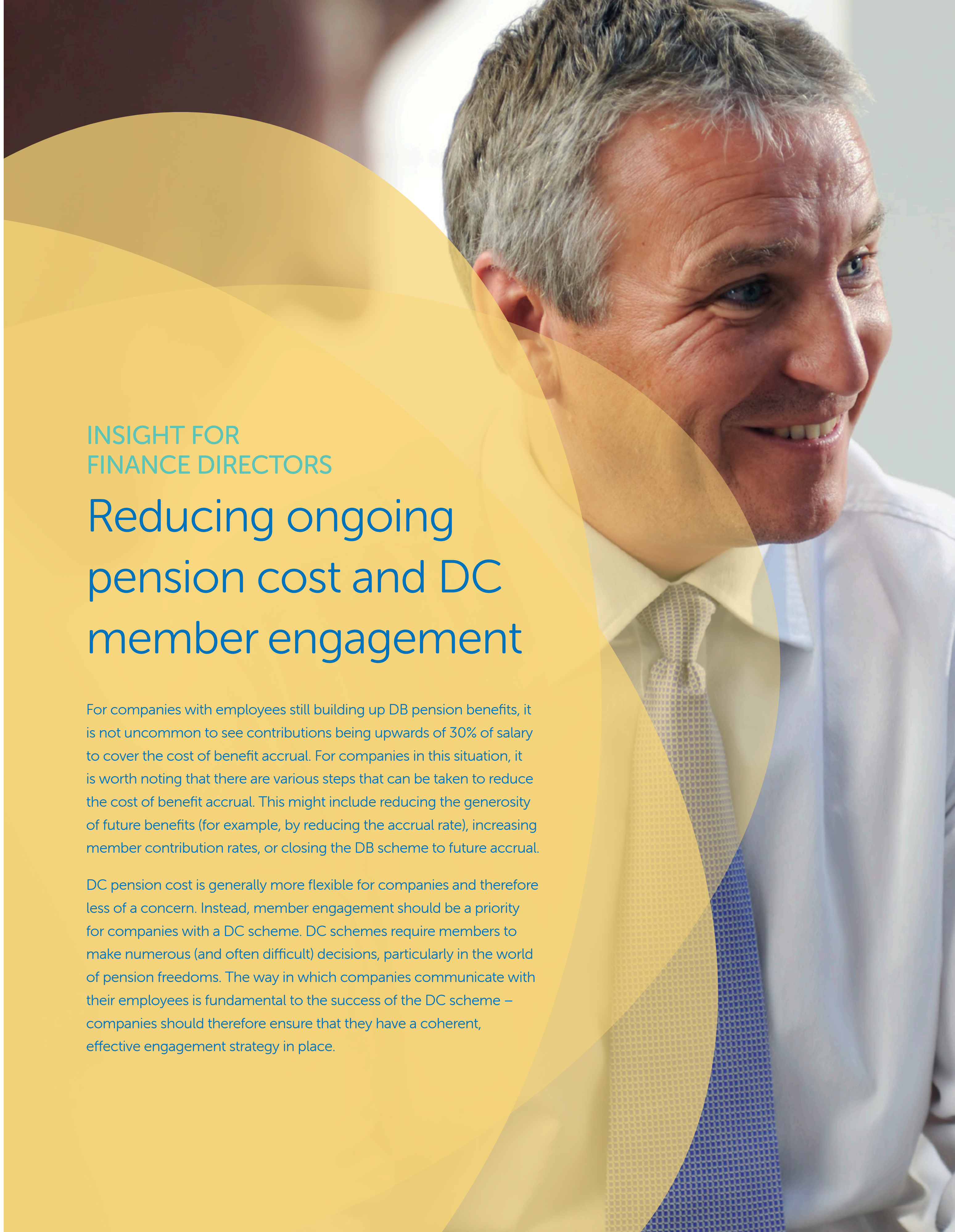
The Office for National Statistics has released data showing that the average total contribution rate for private sector DC schemes was 4.2% in 2016[4]. This compares to the minimum 12% contribution that the Pensions and Lifetime Savings Association believes is needed to provide an adequate income for retirees[5].

According to the Office for National Statistics, the average total contribution rate being paid to private sector DB schemes in respect of benefit accrual for current employees was 22.7% in 2016.

With the UK unemployment rate at around 4%, the labour market is tighter than it has been for decades. Could this be a stimulus for companies to start differentiating themselves by looking at alternative forms of pension provision? This could be a plausible outcome, particularly if a crisis emerges in future years as an increasing number of UK employees struggle to retire due to the inadequacy of DC pensions.

4 www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/pensionssavingsandinvestments/bulletins/occupationalpensionschemessurvey/uk2016

5 www.plsa.co.uk/Policy-and-Research/Defined-Contribution/Retirement-Income-Adequacy

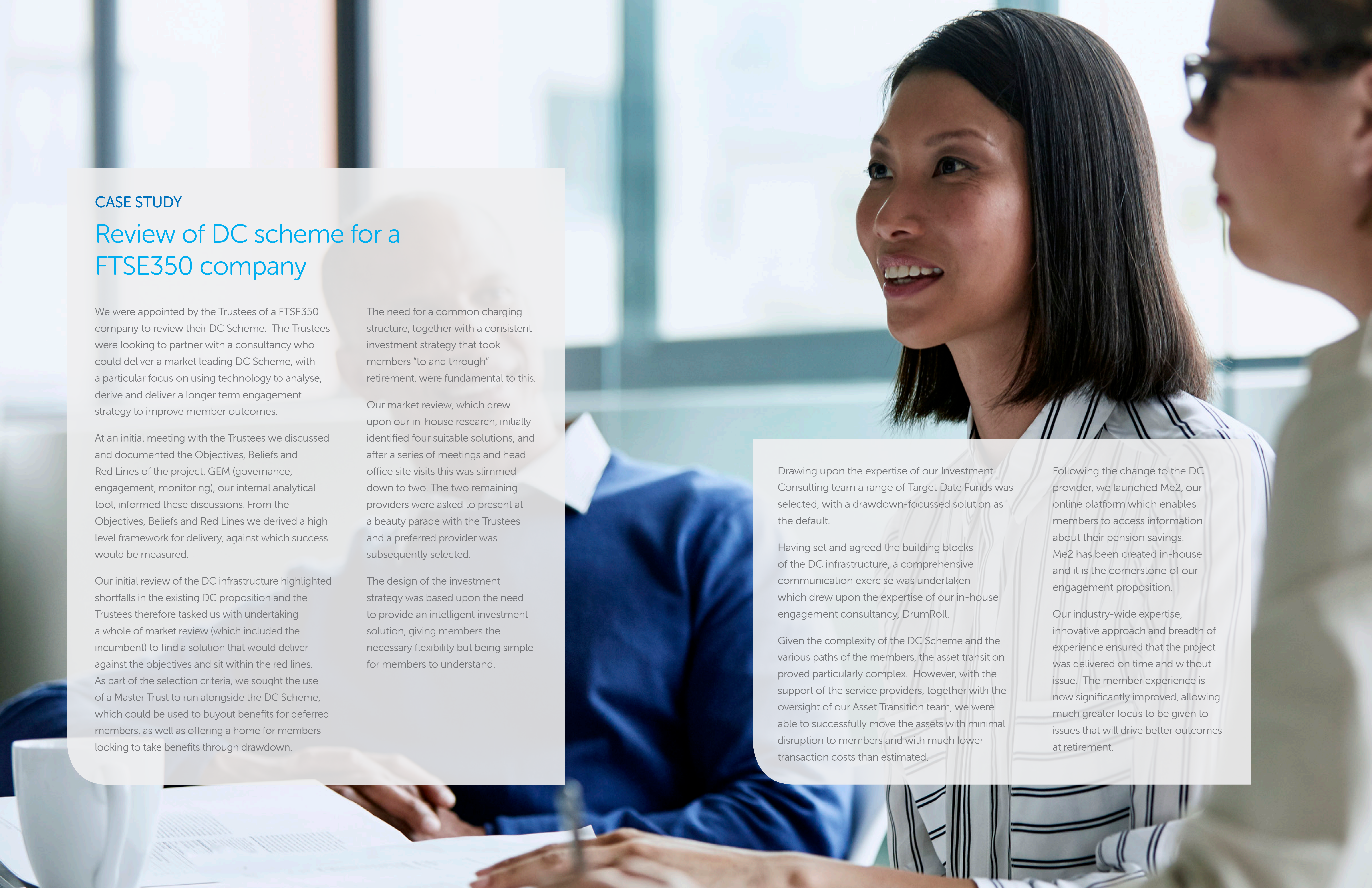


INSIGHT FOR FINANCE DIRECTORS

Reducing ongoing pension cost and DC member engagement

For companies with employees still building up DB pension benefits, it is not uncommon to see contributions being upwards of 30% of salary to cover the cost of benefit accrual. For companies in this situation, it is worth noting that there are various steps that can be taken to reduce the cost of benefit accrual. This might include reducing the generosity of future benefits (for example, by reducing the accrual rate), increasing member contribution rates, or closing the DB scheme to future accrual.

DC pension cost is generally more flexible for companies and therefore less of a concern. Instead, member engagement should be a priority for companies with a DC scheme. DC schemes require members to make numerous (and often difficult) decisions, particularly in the world of pension freedoms. The way in which companies communicate with their employees is fundamental to the success of the DC scheme – companies should therefore ensure that they have a coherent, effective engagement strategy in place.



CASE STUDY

Review of DC scheme for a FTSE350 company

We were appointed by the Trustees of a FTSE350 company to review their DC Scheme. The Trustees were looking to partner with a consultancy who could deliver a market leading DC Scheme, with a particular focus on using technology to analyse, derive and deliver a longer term engagement strategy to improve member outcomes.

At an initial meeting with the Trustees we discussed and documented the Objectives, Beliefs and Red Lines of the project. GEM (governance, engagement, monitoring), our internal analytical tool, informed these discussions. From the Objectives, Beliefs and Red Lines we derived a high level framework for delivery, against which success would be measured.

Our initial review of the DC infrastructure highlighted shortfalls in the existing DC proposition and the Trustees therefore tasked us with undertaking a whole of market review (which included the incumbent) to find a solution that would deliver against the objectives and sit within the red lines. As part of the selection criteria, we sought the use of a Master Trust to run alongside the DC Scheme, which could be used to buyout benefits for deferred members, as well as offering a home for members looking to take benefits through drawdown.

The need for a common charging structure, together with a consistent investment strategy that took members “to and through” retirement, were fundamental to this.

Our market review, which drew upon our in-house research, initially identified four suitable solutions, and after a series of meetings and head office site visits this was slimmed down to two. The two remaining providers were asked to present at a beauty parade with the Trustees and a preferred provider was subsequently selected.

The design of the investment strategy was based upon the need to provide an intelligent investment solution, giving members the necessary flexibility but being simple for members to understand.

Drawing upon the expertise of our Investment Consulting team a range of Target Date Funds was selected, with a drawdown-focussed solution as the default.

Having set and agreed the building blocks of the DC infrastructure, a comprehensive communication exercise was undertaken which drew upon the expertise of our in-house engagement consultancy, DrumRoll.

Given the complexity of the DC Scheme and the various paths of the members, the asset transition proved particularly complex. However, with the support of the service providers, together with the oversight of our Asset Transition team, we were able to successfully move the assets with minimal disruption to members and with much lower transaction costs than estimated.

Following the change to the DC provider, we launched Me2, our online platform which enables members to access information about their pension savings. Me2 has been created in-house and it is the cornerstone of our engagement proposition.

Our industry-wide expertise, innovative approach and breadth of experience ensured that the project was delivered on time and without issue. The member experience is now significantly improved, allowing much greater focus to be given to issues that will drive better outcomes at retirement.

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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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