Pensions in FTSE 350 companies' accounts

Defined benefit pension schemes and their impact on company accounts at 31 December 2018

Willis Towers Watson

Introduction

Welcome to the eighth Willis Towers Watson report discussing the impact of defined benefit pension schemes on company accounts.

Defined Benefit (DB) Pension issues were seldom away from the headlines in 2018. Following the collapse of the construction and outsourcing firm Carillion, resulting in the biggest ever claim on the Pension Protection Fund, a joint inquiry by two House of Commons select committees concluded that trustees were "outgunned in negotiations with directors intent on paying as little as possible into the pension schemes" and criticised The Pensions Regulator (TPR) for its "feeble response", noting that the Regulator had never used its powers to impose funding targets or deficit reduction plans.[1] In March 2018, the Department for Work and Pensions (DWP) issued a White Paper entitled 'Protecting Defined Benefit Pension Schemes' that sought to enhance the powers of TPR. This represented a marked change of tone since 2013-14, when the emphasis was more on ensuring that DB schemes did not hold back the economy.

Whilst there were heightened concerns as to whether pension regulation was sufficiently robust, 2018 also saw the continuation of a number of trends that improve the security of DB pension schemes: 2018 was a record-breaking year in the bulk annuity market with nearly £21 billion of liabilities transferred to insurers. Higher discount rates and another year with very low mortality improvements have also reduced liabilities.

After 28 years of uncertainty, the Lloyds judgment on 26 October 2018 confirmed that schemes must equalise benefits between men and women where differences arise from the statutory calculation of Guaranteed Minimum Pensions (GMPs). For companies reporting their financial accounts at the end of 2018 we can see the first estimates of the impact of 'GMP equalisation' on pension liabilities.

This is the background against which companies prepared the pension numbers in their 2018 accounts. This report analyses what they disclosed.

About the Survey

This report is based on the published disclosures of 102 FTSE 350 companies with DB pension liabilities reporting at 31 December 2018 (comprising around 75% of all FTSE 350 DB pension obligations). Where we examine trends over time, we compare to companies reporting at 31 December in prior years.[2]

[1]Source: Report is at https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf

[2]The following sections provide more information on current issues and analysis of the underlying assumptions that affect DB pension scheme disclosures in company accounts. It is important to consider the impact of changes to assumptions together rather than in isolation.

Key findings

Funding positions have improved with **46%** of companies reporting an accounting surplus in 2018, more than double the figure in 2016.

On average discount rates increased by **35 basis points,** typically reducing defined benefit obligations by 7%.

30% of FTSE350 companies report pensions as a key risk in 2018, compared to half in 2015.

60% of companies expect 65 year-olds to live less long than they did a year ago. This is the fourth year in a row that life expectancy at 65 has fallen.

82% of companies with an accounting deficit could clear the deficit with less than two years of dividend payments.

'GMP equalisation' has on average added **0.6%** to liabilities – equivalent to £4bn for the FTSE350 as a whole.

60% of companies paying deficit reduction contributions (DRCs) paid out dividends that were at least ten times as large as their DRCs in 2018.

The trend in DB closures has accelerated, with over half of all closures occurring since 2014

The story of 2018
FTSE350 companies move into surplus

In 2018 aggregate funded status (on an accounting basis) improved by £11 billion for companies reporting at 31 December 2018. Indeed, 2018 marks the first year of our study where FTSE350 companies with a 31 December reporting date reported an aggregate accounting surplus. This £4 billion surplus compares to the £31 billion deficit recorded at the end of 2016 (Figure 1). Based on market movements alone, the position should be similar at the end of June 2019.

This improvement in funding positions reflects the fact that around three in four companies registered improvements in their funding levels on an accounting basis over the year. In 2018, almost half (46%) of companies reported an accounting surplus, more than double the figure of 2016 (22%).

By the end of 2018, three quarters of companies were 90% funded on an accounting basis and nearly one in ten on a buyout basis. This puts potentially over £140bn of buy-out liabilities within reach of transacting over the next few years, a figure which is likely to be in excess of the insurance market capacity in that time frame, based on current market participants.

The closure of DB plans to future accrual continues

The trend of companies closing their DB schemes to future accrual by existing members continued in 2018 (Figure 2). More than half of the companies analysed (56%) have DB schemes closed to future accrual (compared to 49% in 2017). In recent years this trend of closing DB schemes seems to have accelerated, with over half of all closures occurring since 2014 (where only 25% of companies had closed their DB plans to accrual).

Indeed, in 2017 FTSE350 companies with 31 December year-ends had paid more to defined contribution (DC) schemes than they had paid to finance new benefits in DB arrangements. This gap widened in 2018. Aggregate contributions to DC pension schemes increased from £5.0 billion in 2017 to £5.3 billion in 2018, while the cost of accrual of DB pension benefits fell from £4.9 billion in 2017 to £4.7 billion in 2018.

Looking at the average FTSE350 company in our study, three quarters of its spend on new pension benefits for employees is directed towards DC pension schemes, with one quarter directed towards financing DB benefits, accounting for those schemes still open to accrual.

"2018 marks the first year of our study where FTSE350 companies with a 31 December reporting date reported an aggregate accounting surplus"

Figure 1: **Aggregate funding position**

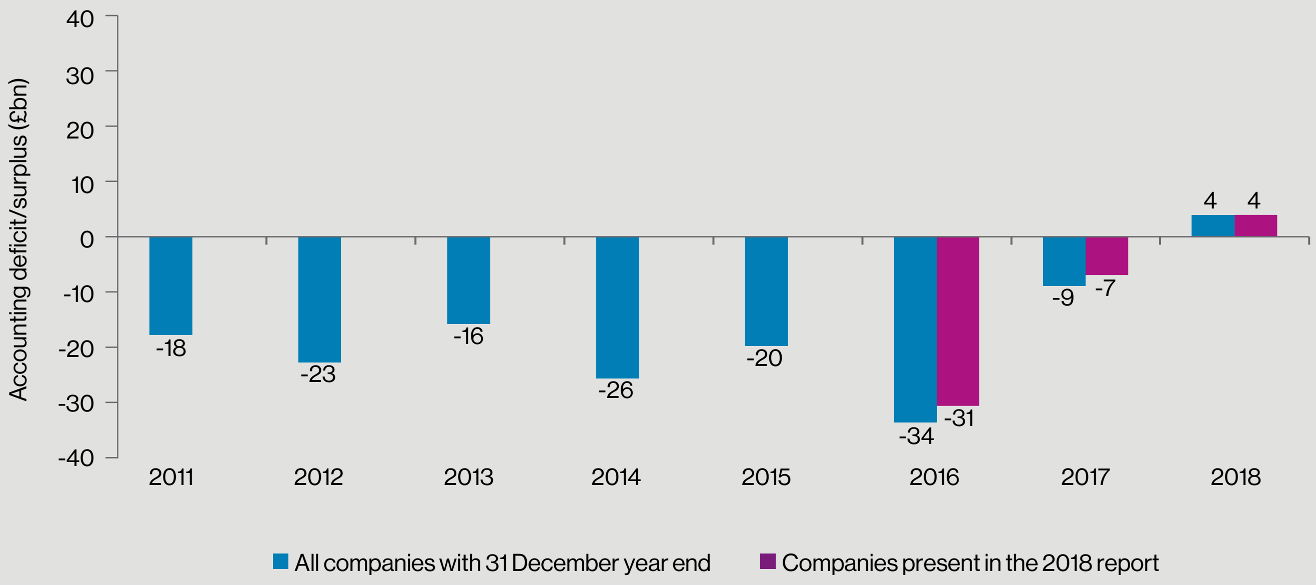
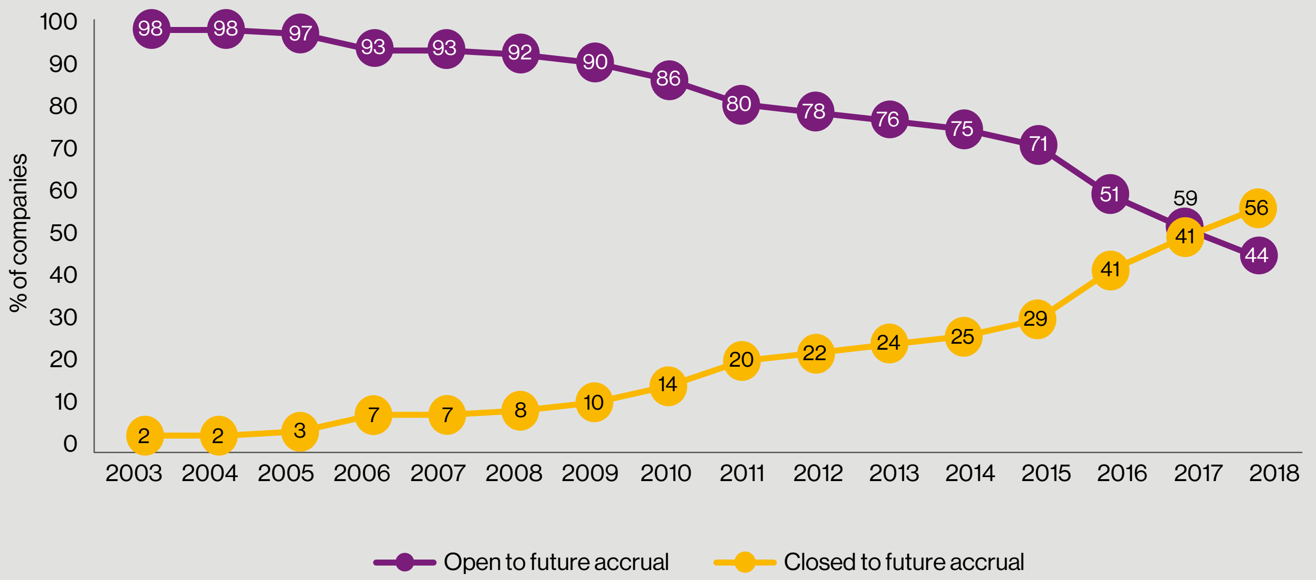


Figure 2: **Closure of DB schemes to future accrual**



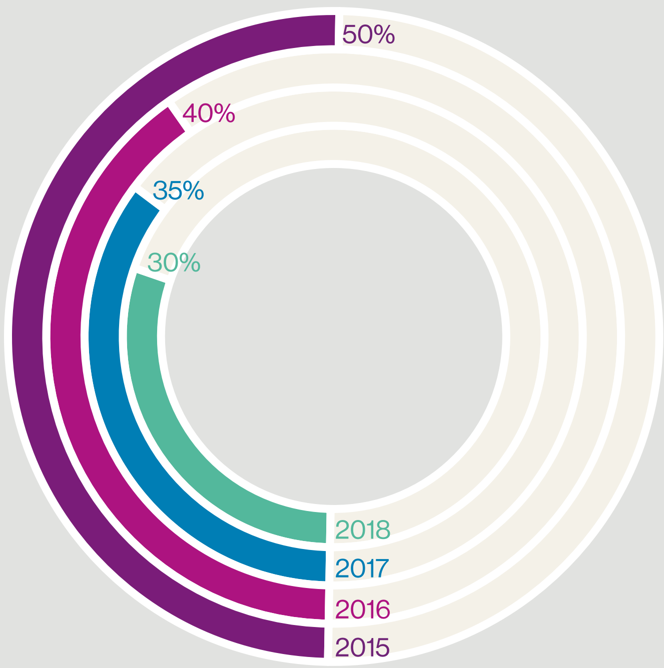
The story of 2018

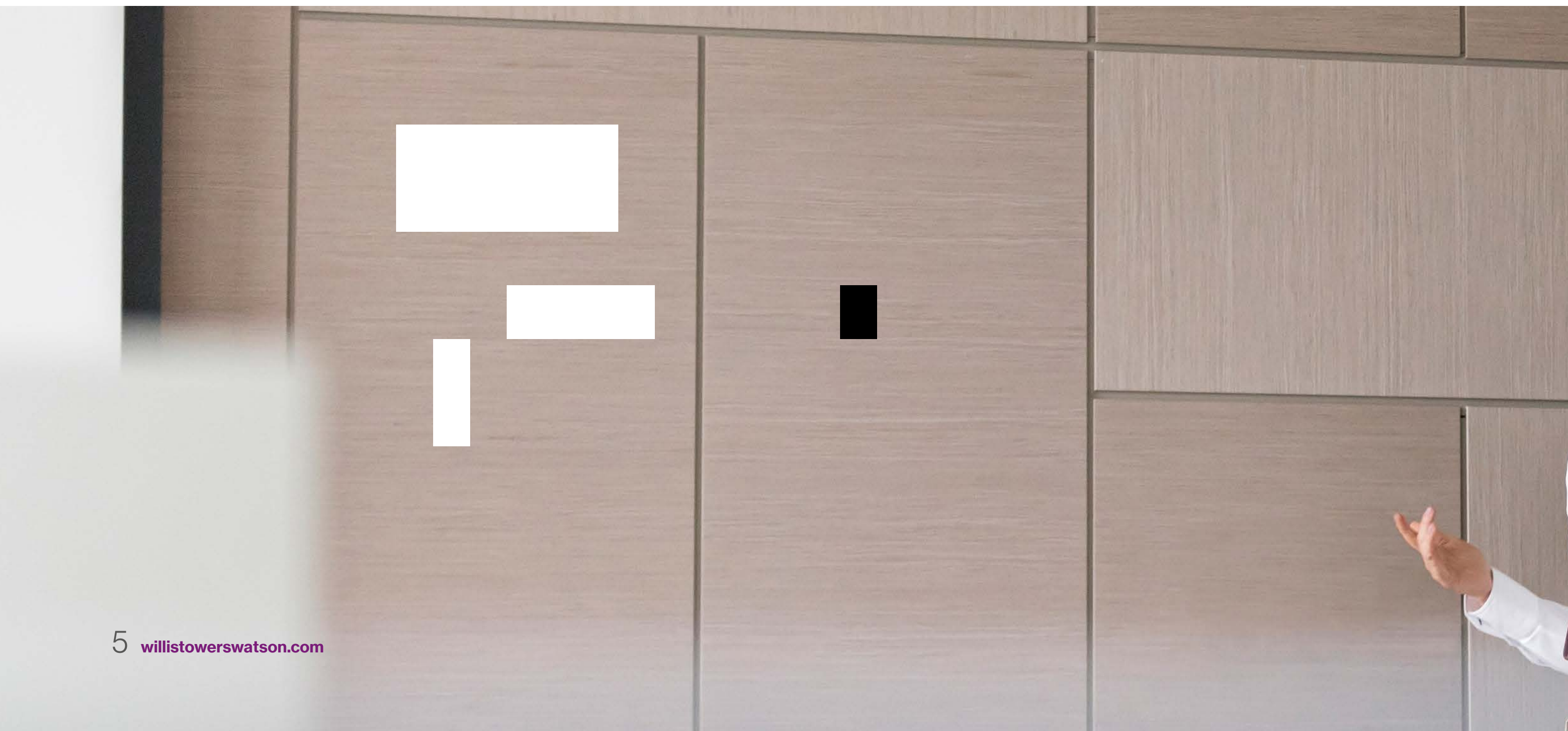
Declining pension risk

Alongside the improvement in funding levels seen since 2016, fewer companies report that pension scheme liabilities represent a key risk to the company. In 2018, less than one in three FTSE350 companies report pension as a key risk in 2018, compared to half in 2015 (Figure 3).

"In 2018, less than one in three FTSE350 companies report pension as a key risk in 2018, compared to half in 2015"

Figure 3: **Percentage of companies reporting pension as a key risk**



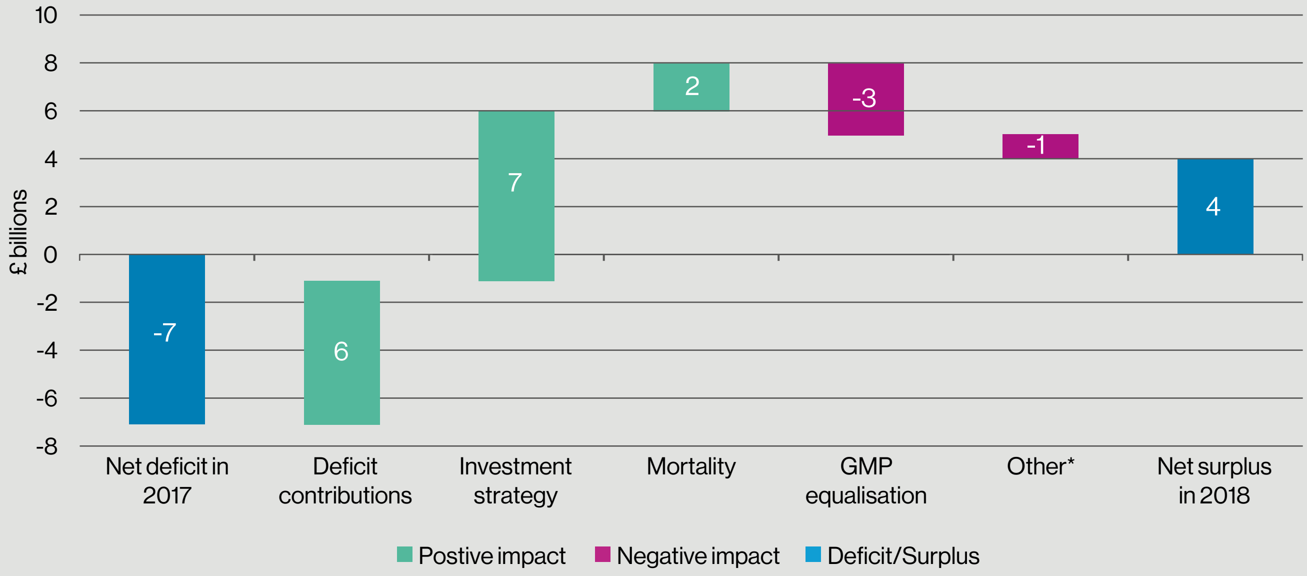


What is driving changes in funding levels?

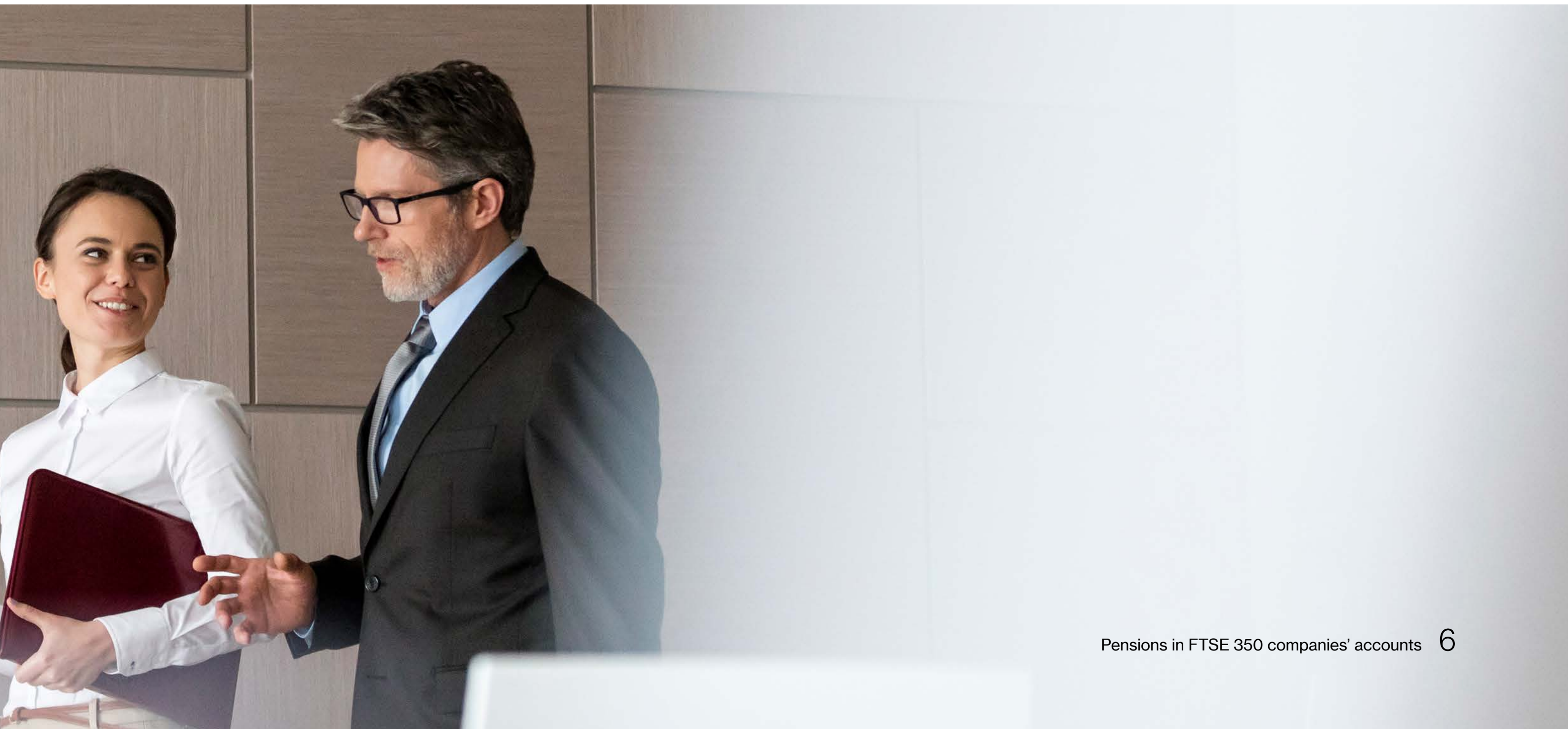
Key drivers of improvement in funding levels

Earlier we discussed how funding levels have improved for companies in this study from 2017 to 2018. Decomposing the change in aggregate funding level (on an accounting basis) for the FTSE350 with 31 December year ends between 2017 and 2018, we see that the main drivers for improved funded status are deficit reduction contributions (DRCs) paid (£6 billion) as well as an improvement attributed to rising interest rates (falling liabilities) outweighing relatively weak investment returns (falling assets) over the year (£7 billion) (Figure 4). Changes in mortality assumptions also improved funding levels by £2 billion. And the surplus could have been bigger were it not for the effect of 'GMP equalisation'. Disclosures estimate that this has added £3 billion to these companies' liabilities.

Figure 4: **Decomposing the change in aggregate funding**



*'Other' could include the effect of special events (e.g. buy-ins) and the incidence of transfers and retirements being different from that assumed



What is driving changes in funding levels?

Deficit reduction contributions

Whilst FTSE 350 companies are paying more into defined contribution plans than they are paying to finance new DB promises, the need to repair deficits means that the total amount paid to DB schemes was still double that going to DC in 2018 (Figure 5). Aggregate deficit reduction contributions[3] increased slightly over 2018, from £5.7 billion to £6 billion.

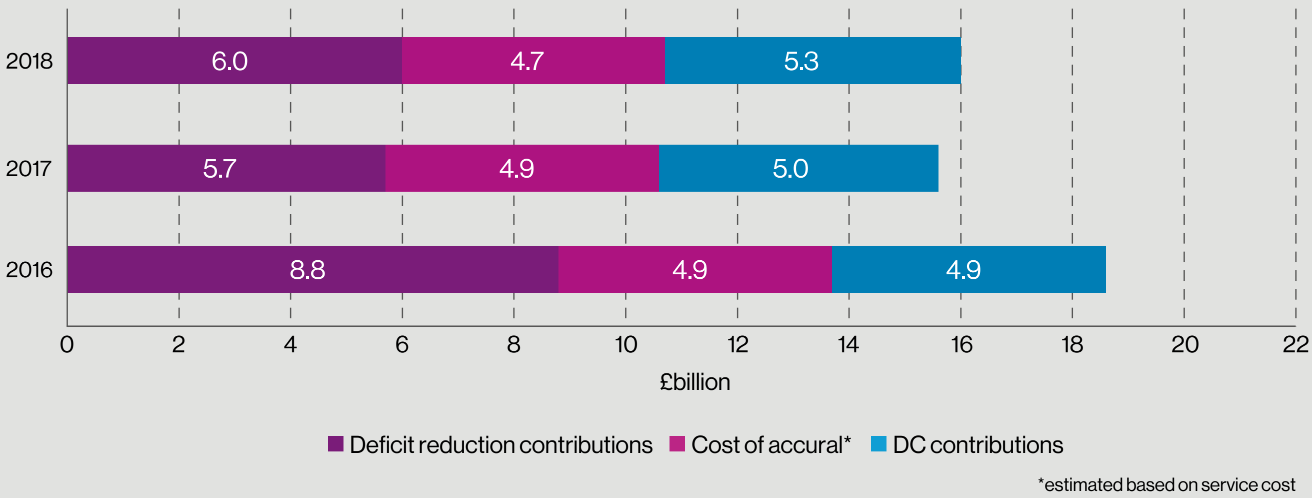
However, this comparison is affected by a small number of companies making sizeable deficit reduction contributions (DRCs).[4] For most companies DRCs saw little change in 2018 compared to 2017 – unsurprisingly, as they are typically reviewed following a triennial actuarial valuation.

There was a small movement away from paying sizeable DRCs, which is consistent with the improvement in funding levels seen since 2016. 11% of companies had deficit contributions of more than £100 million in 2018 (compared to 16% in 2017 and 12% in 2016).

For those that paid DRCs in 2018, the median contribution was £10.3 million (compared to £11.5 million and £11 million in 2017 and 2016 respectively).

20% of companies did not pay DRCs in 2018 (compared to the same figure in 2017 and 15% in 2016).

Figure 5: **Aggregate company contributions**



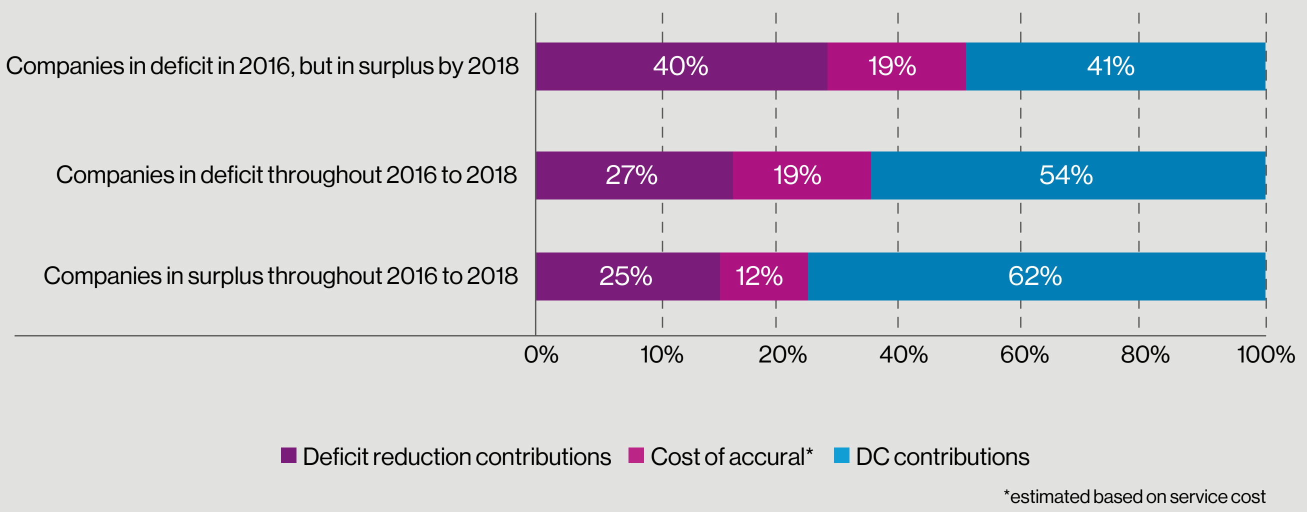
[3] We use total DB contributions minus service cost as a proxy for DRCs. The actual DRCs paid (usually in line with a deficit recovery plan agreed with the trustees) can be different and are not always disclosed.
[4] One company, Royal Bank of Scotland, paid over £4 billion in deficit contributions in 2016 and over £2 billion in 2018.

Companies that managed to move out of deficit since 2016 (around a quarter of FTSE350 companies with 31 December year-ends) have had a much larger share of company contributions directed as DRCs (Figure 6).

A typical company in this group devoted 40% of their pension spend to DRCs, compared to 27% for those that stayed either in deficit (over half of FTSE 350 companies) and 25% for those in surplus (under a quarter of all FTSE 350 companies).[5] As the funding targets negotiated with trustees will often be higher than the measurement of liabilities recorded in company accounts, some of the companies with accounting surpluses are still paying DRCs.

Companies that moved from deficit to surplus also paid a lower share in DC contributions, although it is not clear whether this represents 'crowding out' (with the cost of DRCs holding down DC contributions) as opposed to an explicit decision to divert resources from other uses (Figure 6).

Figure 6: **Average share of company pension contributions (2016 to 2018)**



Note: Percentages may not sum to 100% due to rounding

[5] Here, we categorise companies on the basis of an accounting surplus or deficit at 31st December. DRCs can still be due from companies with an accounting surplus; they are based on funding deficits, which will have been measured differently and at an earlier date.

What is driving changes in funding levels?

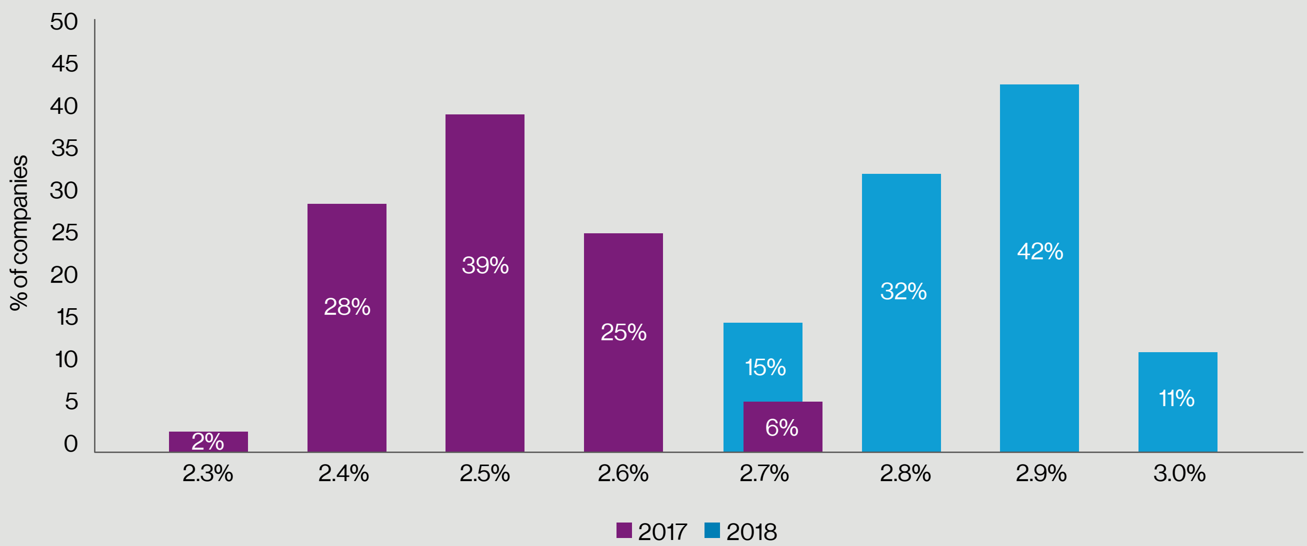
Discount rates

The average discount rate used by FTSE 350 companies moved from 2.49% at the end of 2017 to 2.84% at the end of 2018 (Figure 7). We estimate this increase in rates to have reduced Defined Benefit Obligation (DBO) by, on average, 7% over 2018.

This change is almost entirely explained (0.3% of the 0.35% increase) by rising corporate bond yields. Still, the fact that around one in ten companies had a material hike in their discount rate assumptions in 2018 suggests that some have changed the way that market yields observed at various durations are translated into a discount rate assumption, and this has reduced the liabilities disclosed. This continues a trend seen in previous years where material changes to discount rate assumptions have suggested that companies are changing the models employed.

In the first half of 2019, corporate bond yields have dropped back down, offsetting most of the reductions in liabilities seen at the end of 2018.

Figure 7: **Year-end discount rate assumptions**



"The average discount rate use by FTSE 350 companies moved from 2.49% at end of year 2017 to 2.84% at end of year 2018"

Longevity

For the England and Wales population, improvements in mortality rates averaged over five years were running at around 2% annually until 2011. They have since fallen to around 0.6% p.a. Improvements between 2017 and 2018 have been provisionally estimated at 0.7% for males and -0.3% for females.

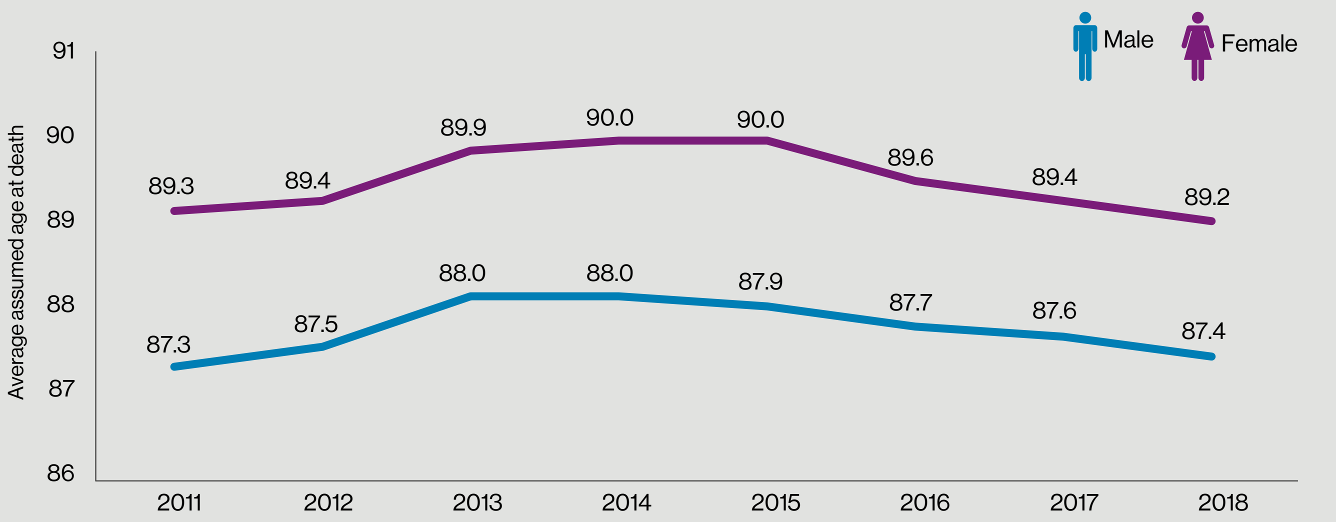
Most companies use the Continuous Mortality Investigation's projection model to derive the future mortality rates needed to calculate life expectancy. December 2017 accounts will often have been based on the CMI_16 model and December 2018 accounts on the CMI_17 model, which produces heavier mortality rates in the near future. The reduction in life expectancy at 65 shown in Figure 8 is broadly consistent with this change.

As a result, between 2017 and 2018, 60% of companies reduced their life expectancy assumptions for a 65 year old male. The average assumption for life expectancy for a male age 65 has declined from 88 years in 2015 to 87.4 years in 2018. For female life expectancy the decline is from 90 years to 89.2 years (Figure 8).

The decline in life expectancy assumptions in 2018 trimmed around 0.5% off pension liabilities, marking the fourth consecutive year in which companies have reported lower life expectancies for 65 year-olds than they had done a year earlier.

The CMI's 2018 model, published in March 2019, again produces lower life expectancies – partly because of the heavy mortality rates observed in 2018 and partly because the core setting now puts more weight on recent experience when projecting the future.[6] Switching to CMI_18 for 31 December 2019 disclosures could reduce life expectancy at 65 by around six months, though this effect will be softened if companies use a new feature allowing them to assume that their members will enjoy faster improvements than the population as a whole, or if the fast improvements seen so far in 2019 continue and companies make some allowance for this.

Figure 8: **Life expectancy assumptions (age 65)**



[6] CMI Working Paper 119 (see https://www.actuaries.org.uk/learn-and-develop/continuous-mortality-investigation/cmi-working-papers/mortality-projections/cmi-working-paper-119)

What is driving changes in funding levels?

The impact of 'GMP equalisation'

On 26 October 2018 the High Court handed down its judgment in the Lloyds case relating to equalisation of member benefits for the gender effects of Guaranteed Minimum Pensions ("GMP equalisation"). This addressed a long-standing legal uncertainty and set a precedent for other UK schemes with GMPs.

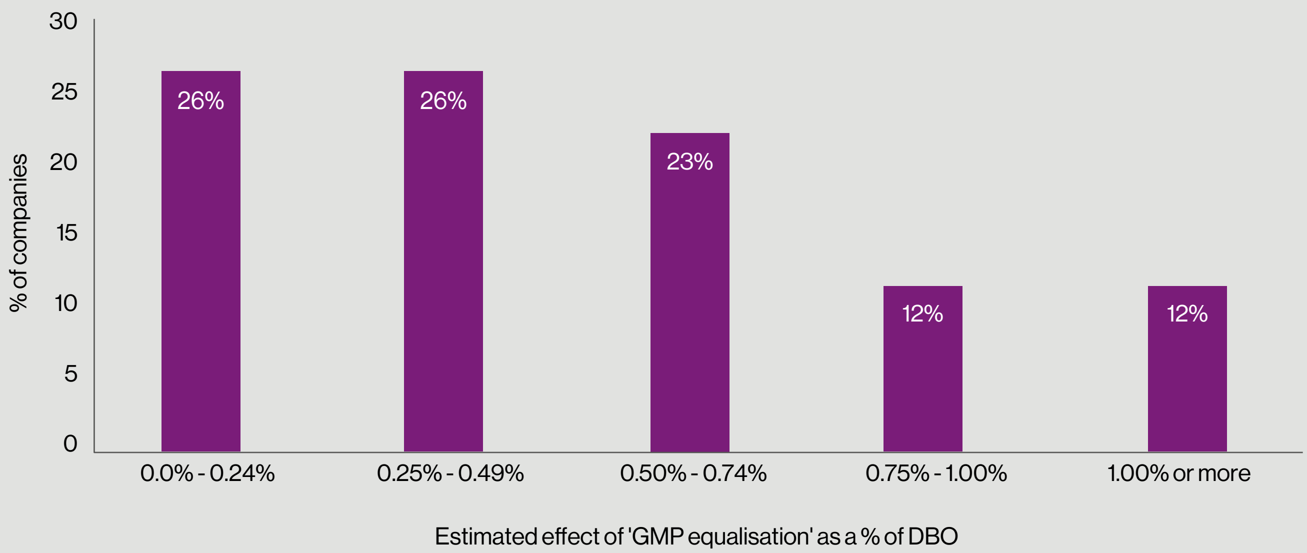
GMPs replace part of the State Pension for people who were contracted out through DB schemes between 6 April 1978 and 5 April 1997 and form part of the occupational pension they receive. By law, GMPs are calculated differently for men and women, which this means that the total benefit can also be different; whether the male or female benefit is higher can depend on the members' circumstances and the scheme design, and the answer can change as people get older. The High Court ruled that benefits accrued from 17 May 1990 must be equalised to counteract the effect of unequal GMPs.

In Figure 9, we report the estimated impact of 'GMP equalisation' as stated in the 31 December 2018 company accounts. For the majority of companies (52%), the increase in Defined Benefit Obligation (DBO) was less than 0.5%, with the average increase around 0.6%. This equates to some 2.4% of operating income. However, one in eight companies reported an increase in obligations of 1% or more. This represents an initial best estimate – the final number could change as employers and trustees agree equalisation methods and review their data in more detail.

We estimate that allowing for 'GMP equalisation' increased the DBO (on an accounting basis) of FTSE350 companies with 31 December year ends by around £3 billion (and circa £4 billion across the entire FTSE350).

"For the majority of companies (52%), the increase in Defined Benefit Obligation was less than 0.5%"

Figure 9: **The impact of 'GMP equalisation'**



Note: Percentages may not sum to 100% due to rounding

Dividends, deficits and deficit contributions

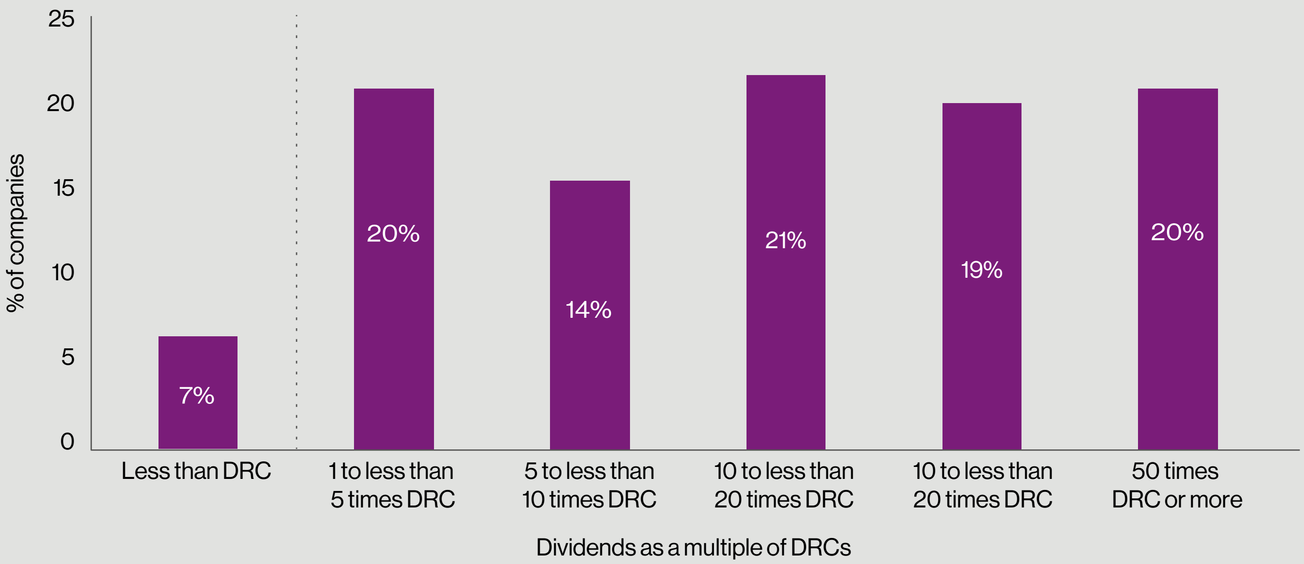
Following high profile corporate collapses in 2018, attention has focussed on the balance between resources paid out to shareholders (as dividends) and resources paid to pension schemes (via deficit reduction contributions).

TPR has repeatedly expressed concern about the treatment of schemes relative to shareholders. In March 2019, it set out its expectations are follows:

- "*Where dividends and other shareholder distributions exceed DRCs, we expect a strong funding target and recovery plans to be relatively short.* [However, the Regulator adds*: "In practice, TPR's response will be proportionate having taken into account the relative size of the sponsor and the scheme deficit."]*
- "*If the employer is tending to weak or weak, we expect DRCs to be larger than shareholder distributions unless the recovery plan is short and the funding target is strong.*
- "*If the employer is weak and unable to support the scheme, we expect the payment of shareholder distributions to have ceased.*"[7]

Following high profile corporate collapses in 2018, attention has focussed on the balance between resources paid out to shareholders (as dividends) and resources paid to pension schemes (via deficit reduction contributions)

Figure 10: **Dividends and DRCs**
Companies paying DRCs in 2018



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[7] See https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-annual-funding-statement-2019.ashx

Currently, it is typical for dividends to exceed DRCs many times over – though the comparisons that can be derived from global companies' annual reports may be distorted where the resources distributed come from employers within the corporate group which have no responsibility for the UK pension scheme; many FTSE350 companies have significant overseas operations. Amongst the FTSE350 companies we observed paying DRCs in 2018, less than one in ten report DRCs as large as dividend payments and six in ten companies paid out dividends at least ten times the size of their DRCs in 2018 (Figure 10).

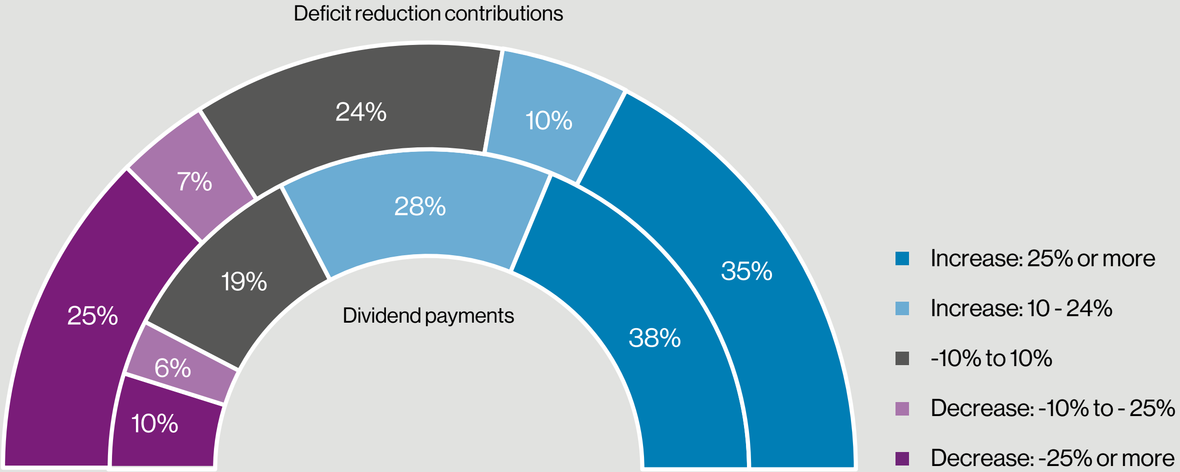
For companies making DRCs and dividend payments in 2018 and 2017, one in four reduced their DRC by more than 25% (Figure 11). However, those that made substantial reductions were in better funding positions, with an average funding level of 99% (on an accounting basis) at the end of 2017. Conversely, one in three companies increased their DRC payments by 25% or more. These companies had an average funding level on an accounting basis of 89% at the end of 2017.

Hence, companies' DRC payments are reacting to their funding position and those with weaker funding positions are more likely to be increasing contributions to their pension schemes.

Four in five companies are now either in surplus or could pay off deficit with one year of dividend payments. If we just consider companies whose schemes are currently underfunded (on an accounting basis) two in three could pay off deficit with less than a year of dividends payments and four fifths could pay off their deficit with less than two years of dividends payments.

"One in three companies increased their DRC payments by 25% or more"

Figure 11: **Change in DRCs and dividend payments between 2017 and 2018**
Companies paying DRCs and dividend payments in 2017 and 2018



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Further information

We hope you found this report informative. For further information, please contact Charles, Bina or Andrew, or your usual Willis Towers Watson consultant.

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