FTSE 350

DB Pension Scheme Report 2023

Defined benefit pension schemes and
their impact on company accounts at 31 December 2022

May 2023

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Executive summary

Welcome to the twelfth WTW report discussing the impact of defined benefit (DB) pension schemes on FTSE 350 company accounts.

Accounting positions – 2 in 3 companies in the FTSE 350 are now in accounting surplus		
1	67% of companies have improved their accounting position	An improvement in funding positions was seen widely across the FTSE 350 in 2022, and the percentage of companies reporting a surplus on an accounting basis has increased from 38% in 2020 to 62% in 2021 to 65% in 2022.
2	From £5bn deficit at end of 2020 to £38 bn surplus at end of 2022	The end of 2021 saw the largest accounting surplus for a decade (£32bn). This increased further to £38 bn in 2022 (despite assets and liabilities falling). Aggregate funding levels increased from 107% to 111%.
Assumptions – Discount rates spike upwards, other assumptions stable		
1	+294 bps increase in discount rates	Discount rate assumptions fell sharply from 2018 to 2020. In 2021 we saw this trend reverse and in 2022 average discount rate assumptions spiked upwards, from 1.91% p.a. to 4.85% p.a., reducing liabilities by around a third.
2	-13 bps move in RPI	Whilst 2022 saw a sharp upward movement in inflation experienced over the year, for the most part this was felt to be a short-term phenomenon with little change in inflation assumptions over the mid- and long-term.
3	Life expectancy assumptions stable	Assumed life expectancies have been in decline since 2014. This trend paused in 2022, with little change to assumptions. Nevertheless, a more pessimistic evaluation of future prospects means 2023 could see further falls.
Key trends – DB closure continues, de-risking expected to grow, cost of pensions reach a turning point		
1	Only 3 in 10 companies reported DB plans open to future accrual	2022 saw further DB plan closure in the FTSE 350. However, the rate of closure may now slow, with many employers not seeing the current environment (pension surpluses and much lower DB costs) as one to make changes.
2	£40bn of de-risking transactions in 2022	After hitting a peak in 2019 the bulk annuity and longevity hedging market, have seen levels of activity decline somewhat since. 2022 was nevertheless one of the busiest years on record, with more activity expected in 2023.
3	Total pension contributions were £14bn	Significant one-off DB contributions and higher DC payments saw aggregate spend on pension rise by over 20% in 2022. However, the cost of DB pensions is expected to drop steeply in 2023.

Balance sheet positions continue to improve

The economic story of 2022 was headlined by steeply rising inflation and the end of the low-interest rate era.

Largely driven by the rising cost of energy, inflation grew sharply - ending 2022 in double digits - levels not previously seen since the early 1980s.

In response, we saw a rapid tightening of monetary policy around the world, exacerbated in the UK by the LDI crisis and the brief period of financial instability during September and October.

The rise in bond yields meant that the value of liabilities fell dramatically, but asset values also fell. How companies fared depended on the extent they were hedged against bond yield movements and how they came through the LDI crisis. Companies less closely hedged typically fared better.

In addition, companies continued to pay deficit reduction contributions in 2022, though this is expected to reduce sharply in the future.

As a result, in 2022, aggregate surplus rose from £32 billion (relative to £533 billion liabilities) to £38 billion (relative to £353 billion liabilities).

Hence, despite liabilities falling by about a third, aggregate surpluses still grew (i.e. asset values fell by less).

If assets and liabilities had moved in lockstep, then aggregate surplus would also have fallen (by around a third). However, aggregate funding rose from 107% to 111% and 67% of companies reported an improved accounting position over the year.

FTSE 350 companies reporting a surplus on an accounting basis has increased from 38% in 2020 to 62% in 2021 to 65% in 2022 and the focus of many companies is now shifting towards buyout, and some 20% of the FTSE 350 could be in a position to fully buy out their liabilities in the short-term.

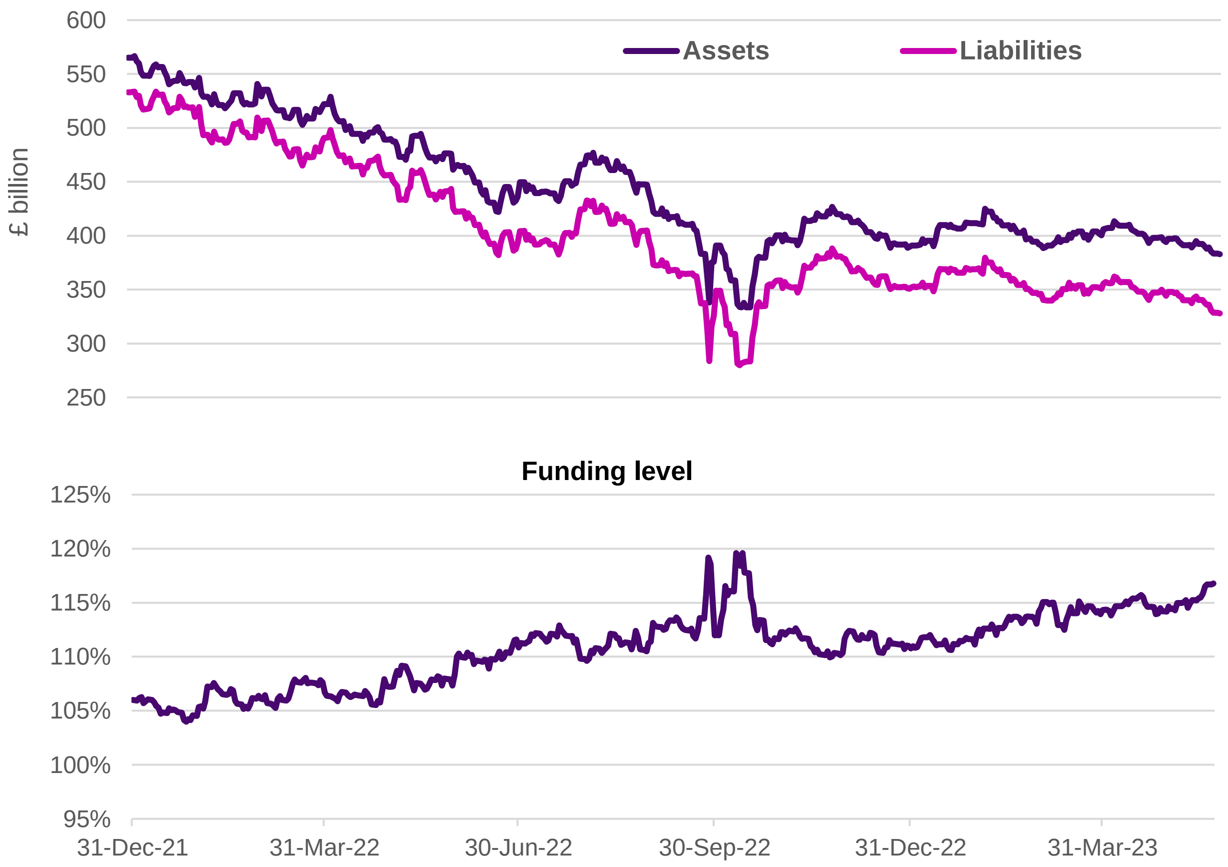
Accounting deficits/surplus (£bn)

Data represents FTSE 350 companies with a 31 December year end reporting in that year

Balance sheet positions

FTSE 350 – Estimated position over the year

Data represents FTSE 350 companies with a 31 December year end reporting in 2022



Against the backdrop of an almost inexorable rise in inflation during the first three quarters of 2022, central banks responded by increasing interest rates and bond yields rose.

From the end of 2021 corporate bond yields* rose from 1.9% to 2.7% in March 2022 and then to 3.8% in June 2022. Alongside this trend equity markets declined, with the expectation that rising interest rates would slow the economy.

During the first half of 2022 we thus saw both assets and liabilities in decline, but the latter to a greater extent and thus a gradual improvement in funding positions.

In quarter three of 2022 inflation peaked, as did bond yields in many countries. This was exacerbated in the UK, by the turmoil in response to market reaction to the ‘mini-budget’ and corporate bond yields reached 5.1%. Reducing both assets and liabilities sharply but again raising the aggregate funding level (up to nearly 120%).

In the last quarter, as economic policy stabilised and expectations for a softer landing for the economy over the medium term rose, bond yields fell a little (4.8% in December 2022) and equity markets recovered somewhat. But with the decline in bond yields, funding levels fell back.

Overall, across 2022, liabilities fell by 35%, whilst assets fell by 33%.

Looking into 2023, the direction of travel will be shaped by the path of bond yields and the global economy. Both remain highly uncertain. Will yields continue to rise as central banks fight inflation, or fall in reaction to economic weakness? How will the economy fare, and with it equity returns?

* iBoxx UK Corporate Bonds AA Over 15 Years

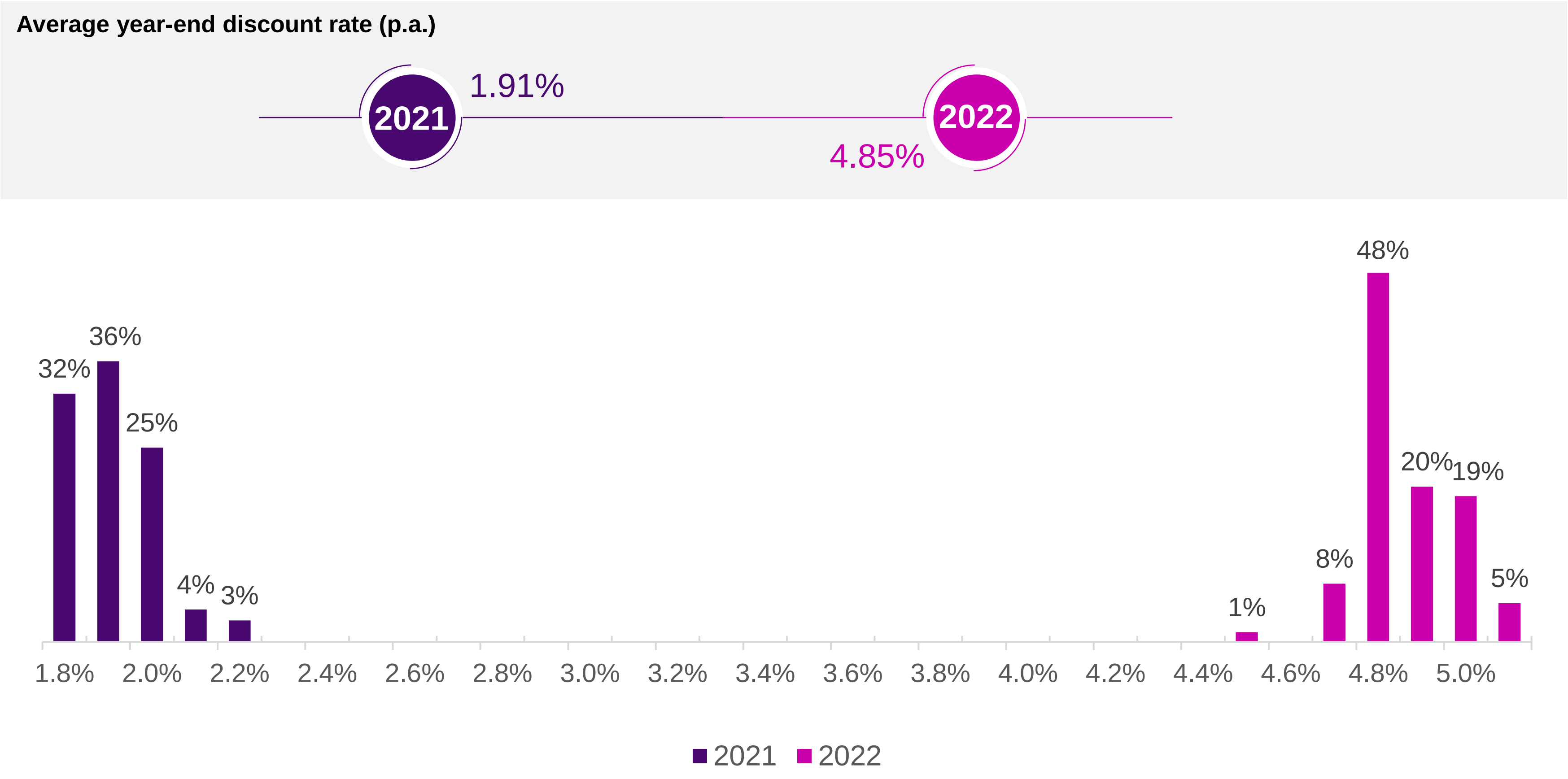
“2022 saw a small improvement in the aggregate surplus of pension schemes in the FTSE 350. But this was against a backdrop of sharply falling asset and liability values, and two thirds of companies in our sample saw funding ratios improve.

Companies reporting a surplus on an accounting basis are now the norm and 20% may be in a position to fully buy out in the near future. But even this subset of the FTSE 350 reporting at the end of 2022 would represent three years’ worth of recent activity in the transactions market if they all sought to buy out now.”

Charles Rodgers, Senior Director, Retirement

Discount rates increase sharply

Discount rate



Discount rate assumptions had fallen gradually from 2018 to 2020 (from an average of 2.81% in 2018, to 2.03% in 2019, to 1.37% in 2020). 2021 saw the start of a reversal of this trend and the average discount rate assumptions rose to 1.91%.

By contrast 2022, marked the sudden end of the prior five years of low rates and a return to figures last seen over a decade ago, with the average discount rate assumption more than doubling to 4.85%.

This would typically reduce pension liabilities by around 35% and largely drove the improved accounting positions of FTSE 350 companies.

Inflation assumptions

Average assumptions

RPI

2022

3.23%

↓ 13 bps

CPI

2022

2.61%

↓ 14 bps

RPI/CPI differential

0.63%

= 0 bps

Note: Data from December 2022 is compared to the data of December 2021. The RPI/CPI differential is based on companies reporting both figures.

2021 marked the return of significantly above-target inflation to the UK. In December 2021 annual CPI inflation was recorded at 5.4%, the highest figure since early 1992. By October 2022 this had peaked at 11.1%, a figure hitherto unseen in the published history of the CPI, but estimated by the ONS to be the highest since the early 1980s. The RPI stood even higher at 13.9%.

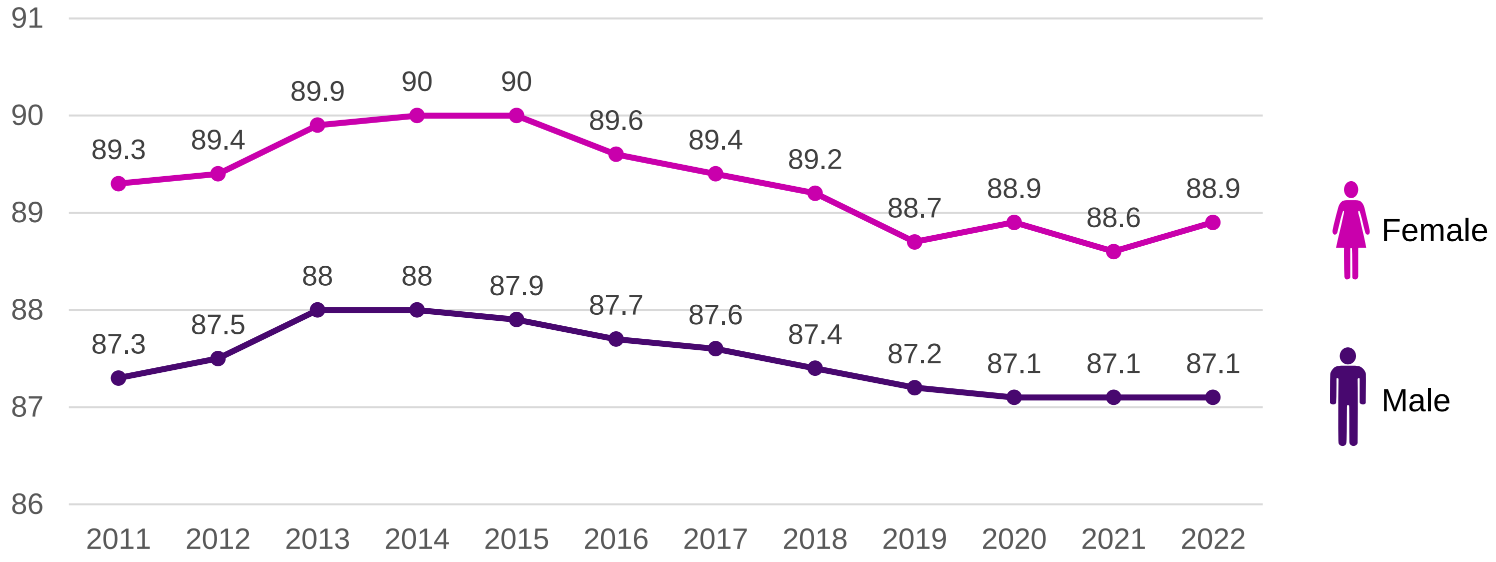
But much of this impact was assumed to be a short-term phenomenon, with many forecasters expecting rates to fall relatively quickly from 2023 onwards due to the impact of higher interest rates and a slowing global economy.

With the very high rates of inflation seen in 2022 no longer feeding into forward looking assumptions and with few forecasters expecting a sustained period of very high inflation in the medium- and long-term, average inflation assumptions fell slightly. The average RPI assumptions declined by 0.13% to 3.23%, while CPI assumptions fell by 0.14% to 2.61%.

The average wedge between RPI and CPI assumptions stayed constant at 0.63% in 2021 and 2022.

A pause in the downward trend in assumed life expectancy

Average life expectancy for members aged 65 (years)



Life expectancies disclosed for scheme members peaked in 2014 (88.0 for men reaching the age of 65, 90.0 for women) and since that time have trended steadily downwards.

2022 saw a pause in this trend, with little change in life expectancy assumptions. This runs contrary to expectations: many expected a more pessimistic view of the future would lead to 2022 showing a more negative view of life expectancy.

However, it may be that companies made only minor adjustments this year, whilst waiting on the dust to settle post COVID-19.

The impact on pension liabilities since 2014 will have been even bigger than the trend above suggests, as previously it would have been assumed that life expectancy would continue to grow.

But further decline expected in 2023

In March 2023 the CMI confirmed how they intend to reflect recent mortality experience in longer term projections, which will be reflected by most pension schemes when setting member mortality and life expectancy assumptions over the coming year.

Whilst 2020 and 2021 were previously ignored as being exceptional within the core version of the model, the key change is to recognise that the heavy population mortality (excess deaths) experienced in 2022 may be indicative of future mortality "to some extent".

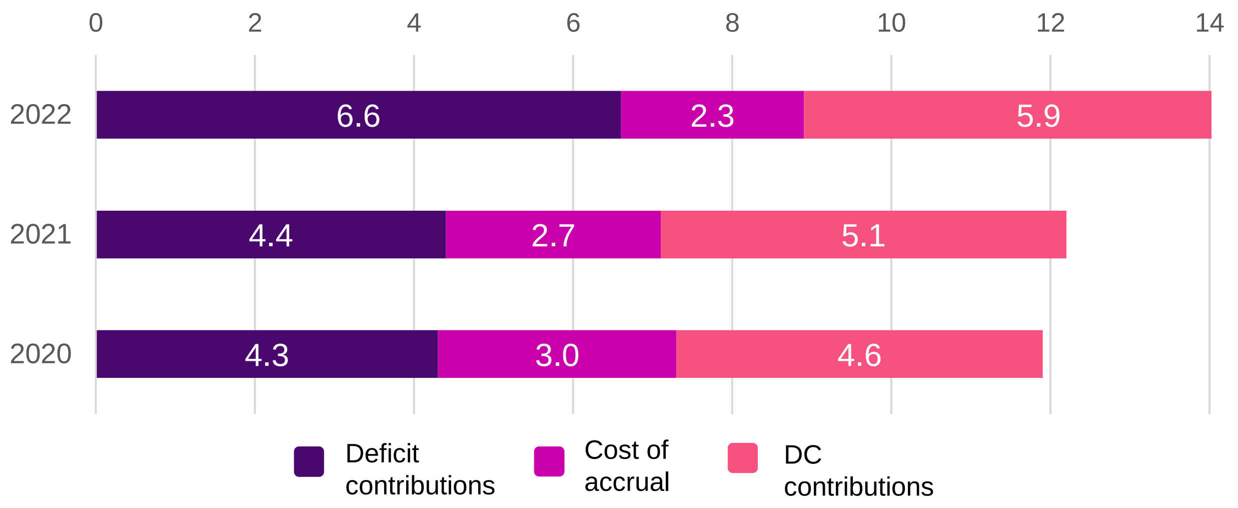
The headline impact of this could be to reduce life expectancy at age 65 by 1-2% (or around three to six months relative to last years' model) depending on the assumptions adopted to date, which could give rise to similar reductions in liabilities.

The CMI has only partially allowed for 2022 data (to allow for a pandemic effect) but in the coming years plan to increase the weight on observed mortality data. Hence, if the current high numbers of excess deaths continue (the first quarter of 2023 had the highest number of excess deaths since the pandemic's second wave in the first quarter of 2021) then further downward revisions to assumptions of future life expectancy may occur.

Significant increase in total company contributions

Aggregate company contributions (£bn)

Data represents FTSE 350 companies with a 31 December year end reporting in 2022



Change in 2022

- 71% of companies made deficit contributions in 2022, compared to 77% in 2021.
- Median deficit reduction contributions declined from £15 million to £14 million
- Median future accrual contributions increased by 13%
- Median DC contributions rose by 24%

Note:
* Cost of accrual has been estimated based on the service cost for companies that still have future accruals
* Not all companies disclose how much they pay in deficit contributions, but we derive an estimate by deducting service cost from total contributions to DB plans.

In recent years, most companies have sought to plug pension deficits by making reduction contributions (DRCs). However, with the improvement in funding seen in 2021 and in 2022, the number of companies paying deficit contributions has fallen (though there can be a lag between moving into surplus and ending deficit contributions).

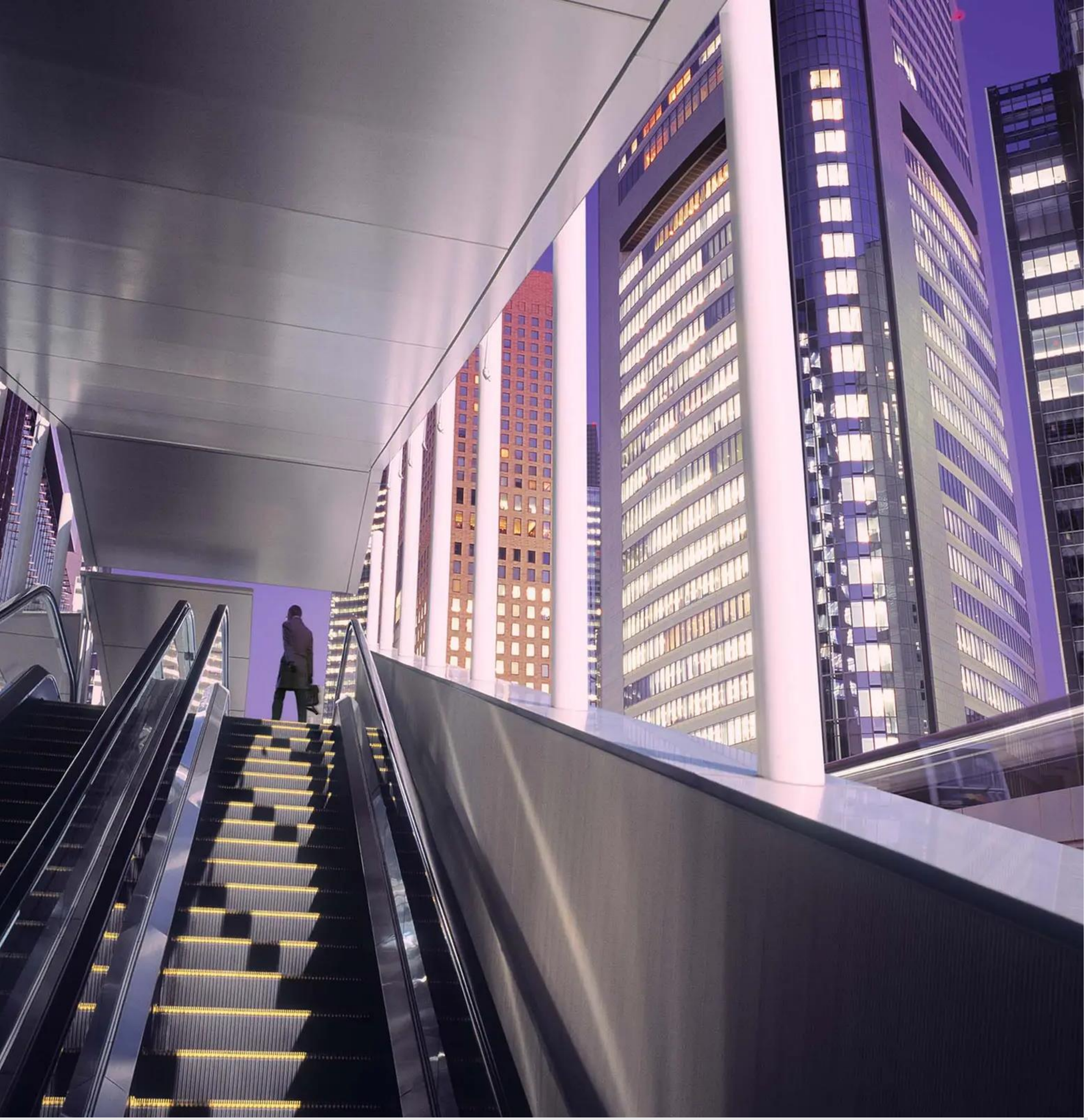
Whilst deficit contributions have typically declined, there have been substantial one-off contributions by a small number of companies in 2022 (c£4 billion), accounting for nearly a half of all DB pension contributions.

The cost of accrual fell from £2.7bn in 2021 to £2.3bn in 2022. This is explained by both the decline in the number of employees still accruing DB benefits and rising discount rates.

With the increases in discount rates and improvements in funding seen in 2022, contributions to defined benefit plans (both deficit contributions and cost of accrual) are expected to decline steeply in 2023, and may fall by between a half and two-thirds.

Contributions to defined contribution (DC) plans also continued their long-term trend upwards, driven by growth in wages and membership, totalling £5.9bn in 2022.

The prospect of DC contributions exceeding those paid into DB plans (where both are present) is likely to arise next year.



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2022 may mark a turning point, where the significant steps UK plc has had to take to repair pension deficits are no longer required and deficit recovery contributions start to become much more of a rarity.

In 2023 we expect contributions to DB pension plans to fall dramatically and it to become typical, for the first time, for corporate payments to DC plans to exceed those to DB, in those companies with DB obligations.

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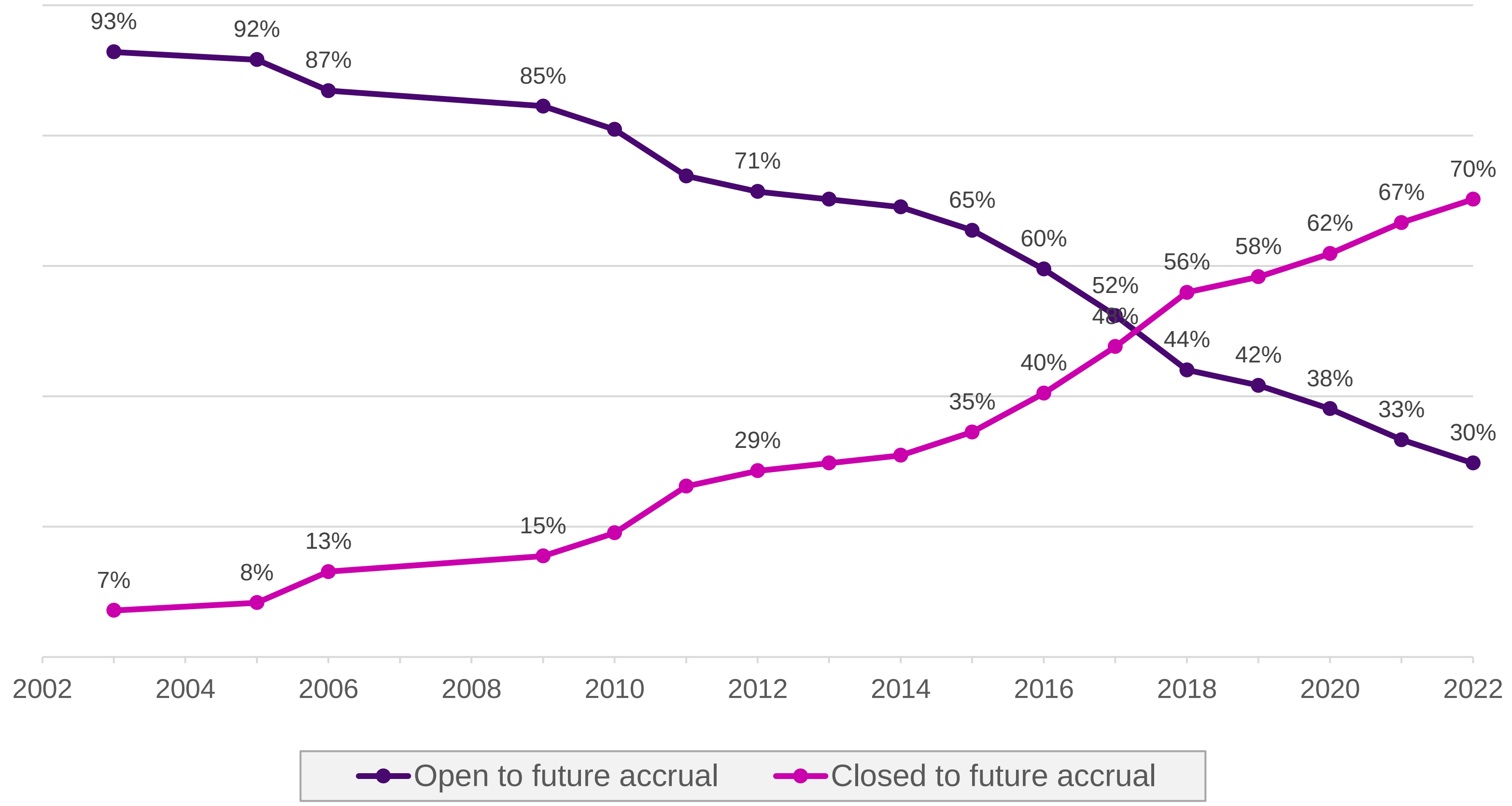
Bina Mistry, Managing Director, Retirement

Trend for DB closure continues in 2022

DB plan closure

Data represents FTSE 350 companies with a 31 December year end reporting in 2022.



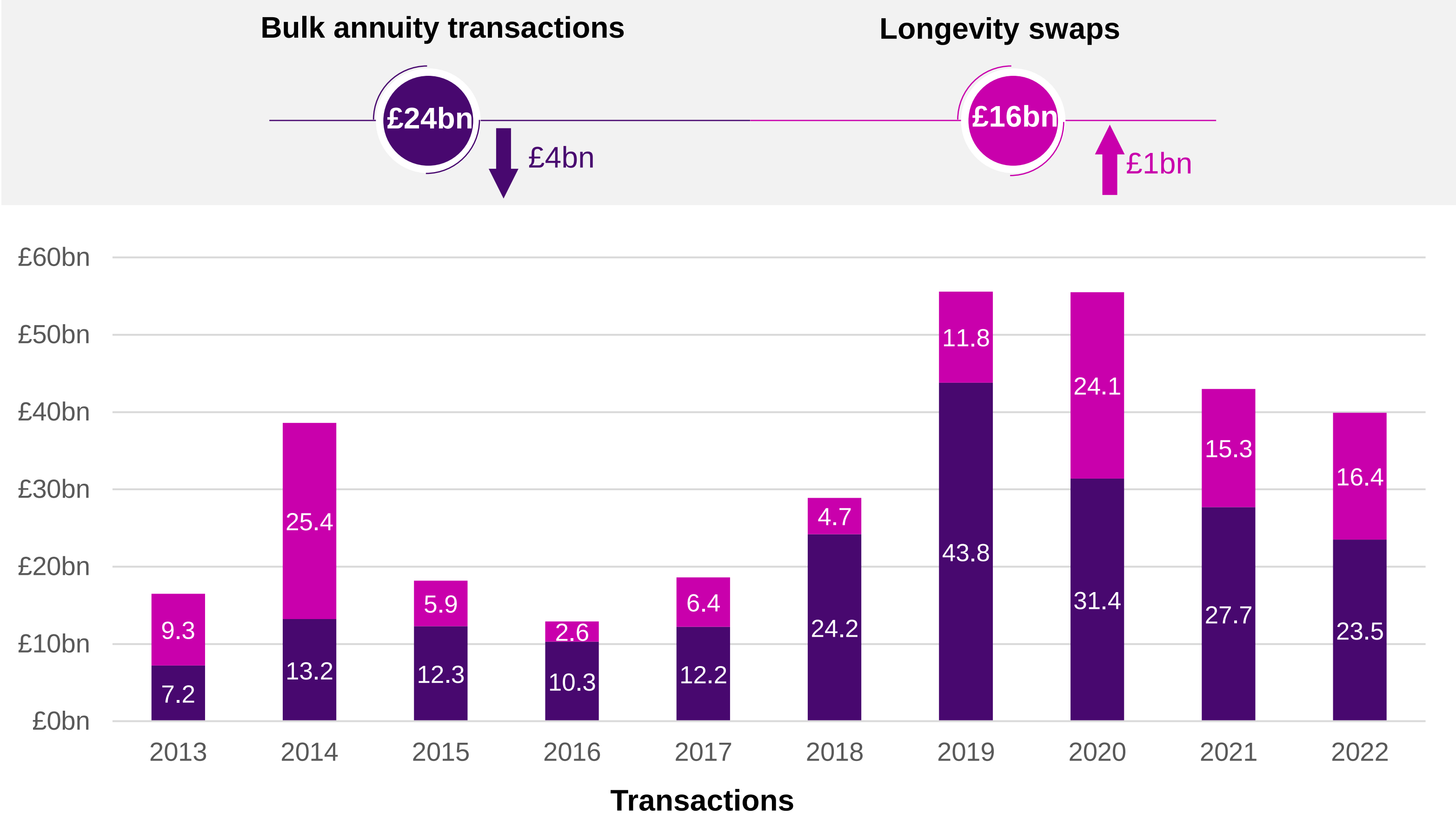
The proportion of defined benefit plans still open to future accrual declined further in 2022, falling from 33% to 30%. As recently as 2015, over two-thirds had (some) members still accruing DB pension benefits, today it stands at roughly one-third.

We may be now be reaching a point where this trend slows, with a group of companies for whom DB schemes are difficult to close (due to the cost and difficulty of change) and there may be a weariness to attempt to close schemes in the face of a cost-of-living crisis and with the funding position of most DB schemes looking rosier. In addition, with rising interest rates having brought down the cost of ongoing DB accrual there is less incentive for companies to take this step.

Nevertheless, as the focus for many companies moves towards buyout some may bring forward the decision to close their DB scheme to future accrual, in preparation of settling their DB obligations.

Pension risk transfer transactions remain high

2022 Volume of business (£bn)



* These data include all scheme transactions, not just the FTSE 350

2019 was a record year for pension risk transfer transactions, with 2020 close behind. Since then, activity has dipped slightly, from c£55 bn in 2019 and 2020 to £43bn in 2021 and c£40bn in 2022 (including both bulk annuity transactions and longevity swaps).

However, one consequence of the significant rise in gilt yields seen in 2022 was the value of liabilities transferred by any transaction was significantly lower than it would have been a year or two before. Buy-ins that were around £1bn at the start of 2022, were closer to £600m several months later. After taking these market conditions into account, 2022 would be the second busiest year ever for bulk annuity transactions.

In 2022, the general increase in yields over the year, alongside the widening of credit spreads, was generally positive for buyout funding levels. In addition, the downward movement in deficits made it more palatable for sponsors to plug any gap in funding, required for buyout.

As a result, there was a significant increase in demand for risk transfer transactions, which looks set to continue and 2023 has the potential to be the biggest year ever in the de-risking markets.

Prospects for 2023 and beyond

Healthy funding positions and declining pension spend

- With the need to repair deficits receding, we would expect a notable drop in deficit reduction contributions and spending on DB

Investment strategy in focus

- With improved funding positions many schemes will seek to review their investment strategy
- Managing allocations to illiquid assets will be a priority for many given the instability seen during the LDI crisis

The Buyout question

- With buyout now on the horizon for many companies the focus on transaction readiness will accelerate
- But market capacity limitations and concerns around accounting implications may slow the trend to buyout
- For some schemes and their sponsors, retaining risk via managed run-off may generate better economic outcomes for stakeholders (e.g., use DB surplus to help fund DC contributions and / or uplift DB benefits)

About the survey

FTSE 350 DB Pension Scheme Survey

	FTSE 350	with December 31 2022 year ends
	157	**84**
	Companies with DB pension liabilities	Companies with DB pension liabilities
DB liabilities	**£541billon**	**£353 billion**

Further information

If you would like to discuss the content of the survey please contact your usual WTW consultant or:

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This report is based on the published disclosures of 84 FTSE 350 companies with defined benefit pension liabilities reporting at 31 December 2022.

These companies comprise around 65% of all FTSE 350 DB pension obligations.

Disclaimer

This report has been prepared for general purposes only and does not purport to be and is not a substitute for specific professional advice. While the matters identified are believed to be generally correct, before any specific action is taken, specific advice on the circumstances in question should be obtained.

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