Lincoln Pensions' FTSE 350 Pension Report

A study of the extent and distribution of defined benefit pension risk within the FTSE 350

Defined benefit pension schemes – "What lies beneath..."

Executive Summary

Lincoln Pensions has undertaken a new study of the defined benefit ("DB") Pension Schemes ("Pension Schemes") within the FTSE 350 to examine the extent of the investment risk that sits within them.

We have also assessed how the investment risk supported by FTSE 350 members is distributed across this population and how it varies according to the level of dependence a Pension Scheme places on the employer support that underwrites it ("Employer Dependence") and the strength of that employer support ("Employer Covenant").

Key conclusions of our research are:

The FTSE 350 carries considerable financial risk in DB Pension Schemes

- The FTSE 350 members, 225 of whom have Pension Schemes, disclose an aggregate accounting deficit of approximately £72bn as at their most recent accounting dates.
- Lincoln Pensions estimates that they are also underwriting almost £100bn of investment risk (being the aggregate Value at Risk of Pension Schemes of constituent companies in the FTSE 350) in their Pension Schemes.

This investment risk is supported by the "Employer Covenant" of the FTSE 350 members

- Lincoln Pensions believes Employer Dependence (being the aggregate of the funding deficit and the Value-at-Risk from time to time) is a key measure that Pension Schemes should assess when considering the financial capacity of the employer to underwrite the Pension Scheme (the "Employer Covenant").
- The stronger the Employer Covenant, the greater the capacity to support investment risk and higher the Employer Dependence.

Some of the Pension Schemes most reliant on their supporting companies are taking the greatest risks

- Across the FTSE 350 the average share of a Pension Scheme's assets invested in riskier Return Seeking Assets was a little over 44%.
- We found that the Pension Schemes that have the highest Employer Dependence relative to their Employer Covenant have among the highest allocations of riskier Return Seeking Assets.
- It appears such Pension Schemes may be trying to invest their way to full funding (and may be taking too much Investment Risk relative to the Employer Covenant) rather than increasing contributions from their employers.

Little evidence that the Pension Regulator's guidance is being reflected in practice

- Contrary to the expectation of the Pension Regulator ("TPR") in its Code published in July 2014, we have found limited evidence that the investment risk profile of Pension Schemes is being set in the context of the Employer Covenant standing behind it.
- This may reflect certain Pension Schemes supporting "sustainable growth" of the employer by leaving money with their sponsor rather than requiring funding for the Pension Scheme. But it is building up risk in the DB system by placing greater reliance on the employer to stand behind, sometimes disproportionate, investment risk.

“Pension trustees (and employers) should take proactive steps to ensure that a scheme’s sponsor has sufficient financial strength and flexibility to underwrite its investment risk.”

Francis Fernandes, Senior Advisor to Lincoln Pensions

“Building a clear picture of the risk and volatility in a scheme’s investment profile should be a key consideration for both pension trustees and employers as they assess its overall risk profile of the Pension Scheme and its reliance on employer support.”

Matthew Harrison, Managing Director at Lincoln Pensions

The accounting deficit is only a “snapshot”

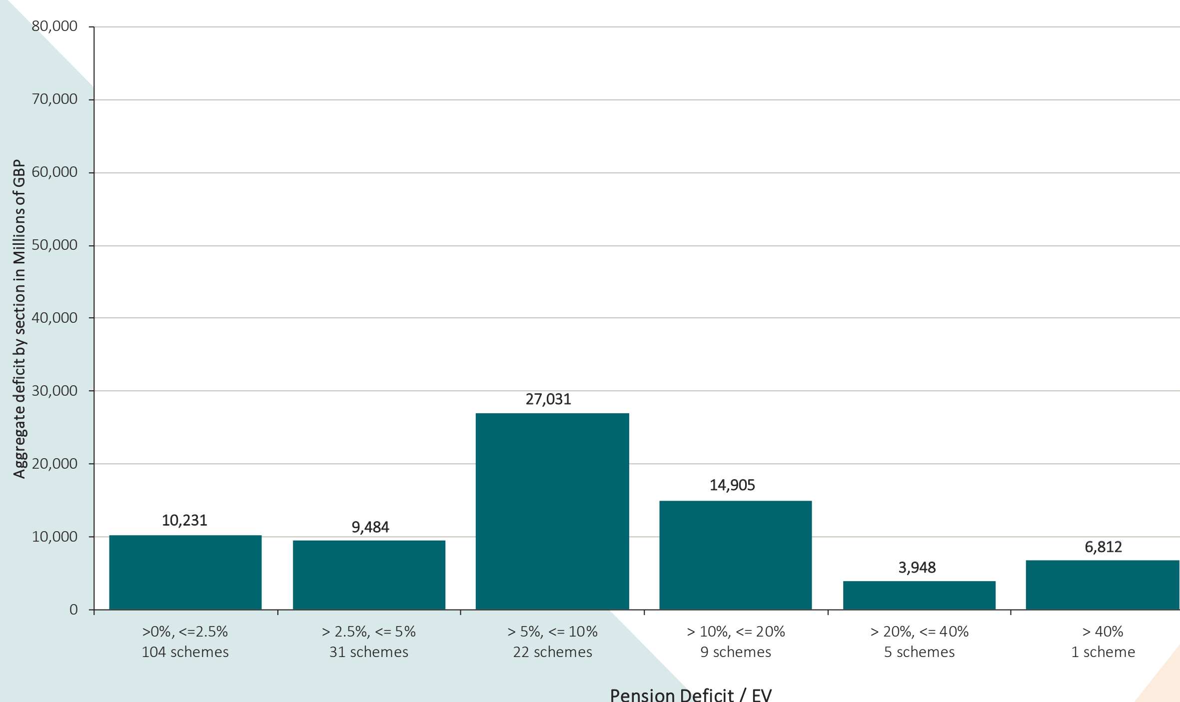
We have taken the accounting deficit as reported in the latest published annual report and accounts as at 10 June 2015 for each of the 225 employers within the FTSE 350 that have DB Pension Schemes. The total value of the liabilities across these schemes was £689bn (we note that these will be based on a range of measurement dates depending on each company’s accounting year-end). Only 172 reported an accounting deficit at the relevant balance sheet date. The aggregate reported pension deficit in the FTSE 350 was £72.4bn.

The accounting deficit distribution is concentrated, with 15 employers’ representing some 75.9% of the deficit. But the scale of the deficit is not the full picture; we need to consider this in the context of the employer which supports the Pension Scheme – the employer covenant.

The employer covenant is defined by TPR as “the [employer’s] legal obligation and financial ability to support the scheme **now** and **in the future.**”

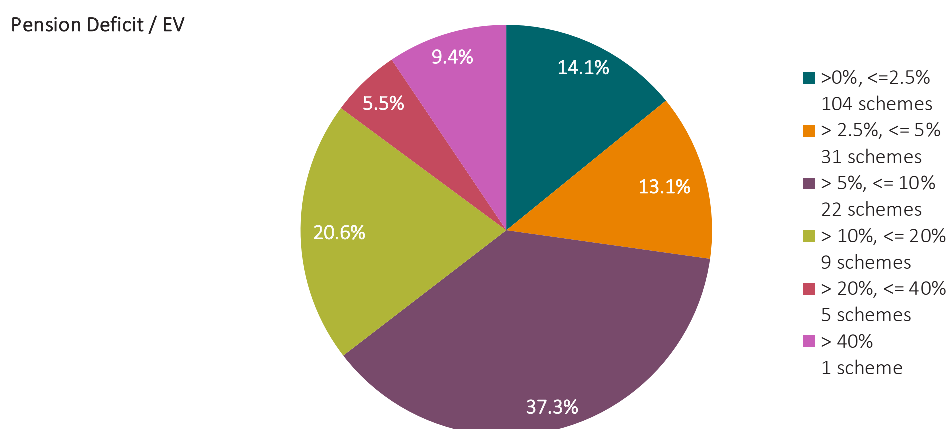
We have mapped the deficit for each employer against the value of the underlying business which supports the Pension Scheme, or the Enterprise Value (“EV”).

Chart 1 – Breakdown on the IAS19 accounting deficit by Enterprise Value of sponsor



Source: Company annual reports

Chart 2: Breakdown of aggregate Pension Deficit relative to the EV of the employer supporting it



Source: Company annual reports

The aggregate deficit represents 3.7% of the Enterprise Value of the relevant Pension Scheme employers.

The majority of Pension Schemes (by number) have a deficit which is less than 2.5% of the employer's Enterprise Value – i.e. the deficit is small in the context of the employer. However, 15 Pension Schemes (35.4% of the total deficit) represent more than 10% of the Enterprise Value of the employer.

There are a number of studies which track the movement in the FTSE 350 accounting deficit over time. However, the accounting deficit is only a "snapshot" at a point in time. This is simply an estimate of the level of reliance placed on the employer to fund the Pension Scheme "**now**", which can, and will, change "**in the future**"….

Investment risk and Employer Dependence

> *"The assessment of a scheme's reliance on employer should not simply take account of the deficit, but it must also consider the investment risk being run by the scheme – i.e. the potential for additional employer support to be required."*
>
> **Alex Hutton-Mills, Managing Director at Lincoln Pensions**

The level of investment risk being taken by a Pension Scheme will vary depending on the individual asset allocation and its hedging strategy. It is not possible to accurately model investment volatility based on public disclosures.

However, we have applied an illustrative estimate of investment risk to the deficit figures discussed above. For the purposes of this analysis we have used a 1-in-20 year "Value at Risk" estimate ("VaR95"). VaR95 estimates the impact of a negative financial event with 1-in-20 year likelihood on the accounting deficit position of a Pension Scheme.

Applying this measure of investment volatility to the deficit position of the Pension Scheme "**now**" provides an indication of the extent to which the employers also underwrite the investment risk "**in the future**".

Aggregating the deficit at a point in time with a measure of the investment risk in the Pension Scheme (VaR95) provides an approximate measure of the "**Employer Dependence**" of each scheme in the FTSE 350.

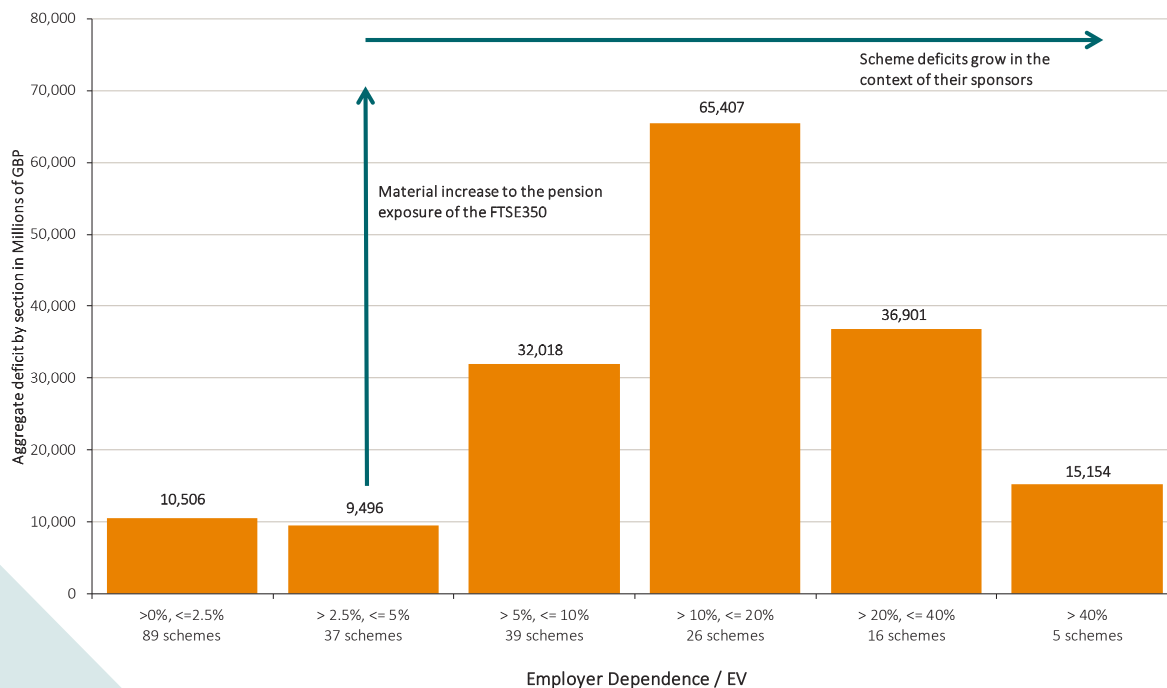
There remains a strong concentration of the overall Employer Dependence within the FTSE 350 with 15 employers shouldering 69.3% of the Employer Dependence. To see the full picture we must, again, consider this Employer Dependence in the context of the employer's ability to underwrite this exposure…

A 1-in-20 year downside financial event would push the aggregate accounting deficit of the FTSE 350 up by £97.1bn from £72.4bn to £169.5bn.

So, when we apply the measure of Employer Dependence, rather than just the accounting deficit, 212 employers would show a deficit position.

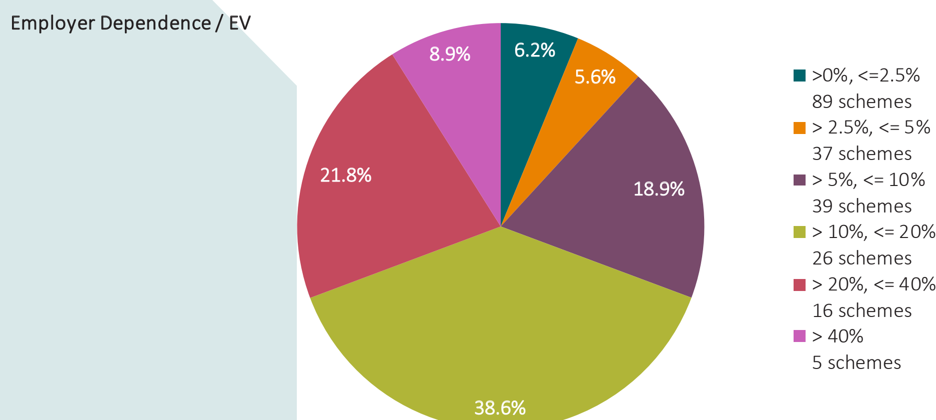
£169.5bn represents 7.2% of the total Enterprise Value of the relevant employers (up from 3.7% for the deficit alone), placing additional strain on these businesses.

Chart 3: Overall Employer Dependence compared to the Enterprise Value of the employer



Source: Company annual reports and Lincoln Pensions analysis

Chart 4: Breakdown of aggregate Employer Dependence relative to the EV of the employer supporting it



Source: Company annual reports and Lincoln Pensions analysis

Although this analysis is indicative, it clearly demonstrates there are material investment risks being run by the DB Pension Schemes in the FTSE 350.

While the majority of Pension Scheme deficits remain below 2.5% of the sponsor's Enterprise Value in this scenario, we observe a clear "shift to the right" in the bar chart overleaf (Chart 3).

An increasing proportion of the revised deficit (69.3%) now sits in employers where the overall Employer Dependence is more than 10% of the Enterprise Value supporting the Pension Scheme.

Looked at another way, the overall Employer Dependence represents 2.4 years' worth of the total dividend paid by these 212 employers in FY2014. Crystallisation of the Pension Schemes' investment risk, or a meaningful proportion of it, could put pressure on ongoing payment of dividends at this level.

How does this impact on asset allocation?

TPR's Code indicates that the level of investment risk being run by trustees should be commensurate with the employer's ability to underwrite that risk.

Generally, if given the choice, employers prefer to address the deficit through investment returns / risk in the Pension Scheme rather than through increased cash contributions. However, pension trustees would need to ensure that such an approach can be justified to Pension Scheme members…

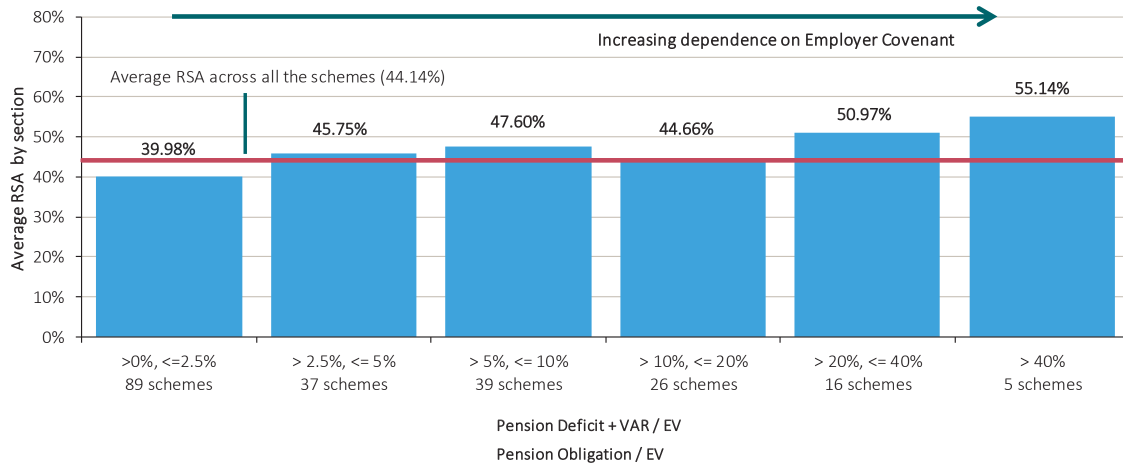
Trustees should perform sufficient analysis of the employer covenant to be comfortable that, if downside investment risk were to crystallise, the employer would still be in a position to fund the increased pension deficit. Where they do not have sufficient comfort, they should consider reducing the investment risk.

In light of this, one would expect the Pension Schemes which are largest in the context of the employer's Enterprise Value (to the right of the charts overleaf) to be invested in a lower proportion of Return Seeking Assets than other Pension Schemes.

The charts overleaf consider the proportion of Return Seeking Assets in a Pension Scheme depending on the scale of that Pension Scheme relative to the Enterprise Value of the employer. We look at this in two ways:

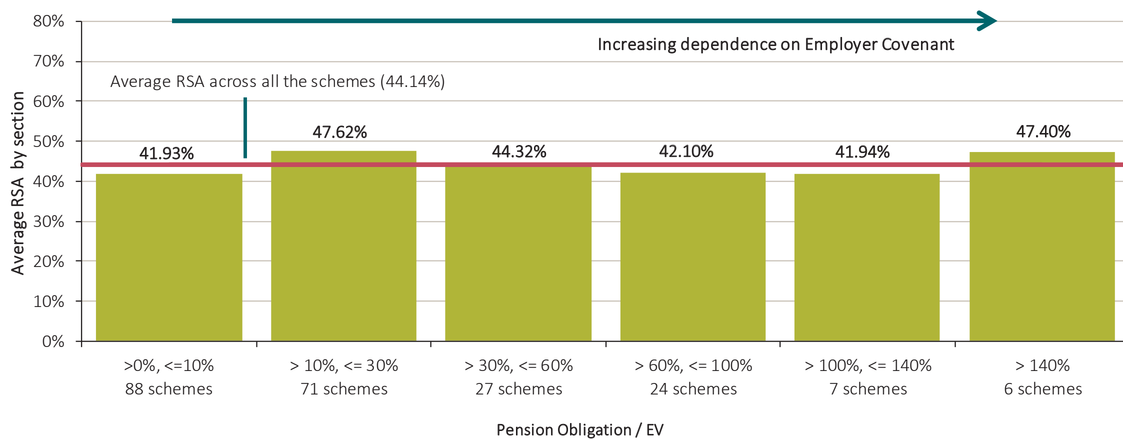
1. Employer Dependence versus Enterprise Value
2. Total pension obligations versus Enterprise Value

Chart 5: Level of Return Seeking Assets by Employer Dependence versus Enterprise Value



Source: Company annual accounts and Lincoln Pensions analysis

Chart 6: Level of Return Seeking Assets by Total Pension Obligation versus Enterprise Value



Source: Company annual accounts and Lincoln Pensions analysis

Both of these charts demonstrate that, across the whole population, there is a fairly uniform level of Return Seeking Assets regardless of the Pension Scheme's scale in comparison to its employer. Indeed, there is some evidence that the larger Pension Schemes (relative to their employers) take more investment risk than others.

"In light of the Code, it is surprising to observe that in many cases that the share of Return Seeking Assets does not decrease as the schemes get larger in the context of their employer."

Matthew Harrison, Managing Director at Lincoln Pensions

This picture does not, as yet, appear to indicate investment risk being proportionate to the strength of the employer support provided to the Pension Scheme, which suggests that:

1. Pension Schemes which are relatively small in the context of the employer (to the left of the charts) could potentially take more investment risk, underwritten by their employer, and seek to make good a higher proportion of the deficit through investment returns

2. Pension Schemes which are relatively larger in the context of the employer (to the right of the charts) may be seeking to address deficits disproportionately through investment returns and / or be layering disproportionate investment risk on to the employer covenant risk which is already present in such scenarios.

Over time we expect the provisions of the Code to impact more widely. We also expect investment risk decisions to increasingly reflect trustees' views on the employer covenant which underwrites this risk.

Increasing reliance on the employer covenant?

TPR's May 2015 annual funding statement demonstrated that deficit recovery plans were extended by around three years for Pension Schemes with valuation dates between September 2012 and September 2013.

This may partly be the effect of TPR's new statutory objective to "minimise any adverse impact on the sustainable growth of an employer", which was introduced following the recession. Pension trustees may also be more relaxed about improving corporate performance. The combined effect appears to be that trustees are willing to provide flexibility to the sponsor around the time taken to repay the deficit. However, this builds up risk in the system and places greater reliance on the employer covenant to underwrite investment risks, for a longer period.

This is not necessarily a "bad outcome" for trustees, but decisions to prolong their reliance on the employer should be taken knowingly, having made an informed assessment of the other risks inherent in the Pension Scheme.

Conclusions and recommendations

The extent of the "hidden" Employer Dependence inherent within the FTSE 350's Pension Schemes is material. Applying an illustration of VaR95 increases the deficit by £97.1bn to £169.5bn, much of which (69.3%) relates to employers where this Employer Dependence is more than 10% of the sponsor's Enterprise Value.

Despite Employer Dependence and employer support varying considerably across the FTSE 350, there is relative uniformity of the asset allocation among Pension Schemes.

This suggests that the principles underpinning the Code have not yet been adopted widely within the FTSE 350.

We recommend that both trustees and employers take proactive steps to ensure their overall Pension Scheme risk profile is in balance. On a practical basis this should include:

- Understanding and quantifying downside investment risk volatility of the Pension Scheme
- Analysis of the financial capacity / flexibility of the employer to stand behind this volatility
- Assessing correlation between the investment risk in a Pension Scheme and the performance of the business which supports it.

> *"This kind of analysis may lead to scheme funding discussions which move away from the historic focus on funding today's deficit, towards understanding investment risk volatility and seeking a balance in the Pension Scheme's overall risk profile."*
>
> **Matthew Harrison, Managing Director at Lincoln Pensions**

Appendix

Methodology and definitions

The Code or TPR's Code
TPR's code of practice on Funding Defined Benefits ("the Code"), issued in July 2014.

The Employer Covenant
"The [employer's] legal obligation and financial ability to support the scheme now and in the future."

It is integral to the analysis that we are able to form an indicative view on the relative strength of the "employer covenant" provided to Pension Schemes by their sponsoring employer.

This is, by definition, a relative measure. Business metrics must to be set against the backdrop of the funding and risk profile of the Pension Scheme which it supports in order to form a reliable assessment.

The relevant business metrics used in a full employer covenant assessment will be bespoke to each situation. A "scheme specific" assessment will rely on forward looking financial information and understanding the Pension Scheme's position as a creditor - this cannot be derived from public information.

For the purposes of this analysis we have used Enterprise Value as an illustrative proxy for the value of the business which underwrites the Pension Scheme risk (the employer covenant). This approach does not capture the nuances of each business and is a simplified means of looking at the employer covenant available to each Pension Scheme. But when used across a sample of 225 businesses it is a useful indicator of employer's financial strength.

For a small number (12) of employers in the sample, primarily those in the financial services sector, Enterprise Value is not an applicable or available measure. In these circumstances we have taken market capitalisation as an illustrative measure of the value of the business supporting the Pension Scheme.

Employer Dependence
The aggregate of the deficit (in this report we have used the accounting deficit) of the Pension Scheme and the Value at Risk associated with that deficit from time to time. This provides a proxy for the extent to which the employer underwrites the funding shortfall and risk in its Pension Scheme.

Enterprise Value (EV)
The Enterprise Value of the sponsor is defined as the market capitalisation of the sponsoring group as at the relevant accounting year-end date plus the net debt held by the business. In theory, this should be equal to the present value of expected cash flows discounted at the Weighted Average Cost of Capital (WACC).

Return Seeking Assets
For the purposes of this analysis we have defined Return Seeking assets as the following (as defined in the employer's annual report and accounts:

Equity; Hedge Funds; Private Equity; Property; Other Return Seeking (if clearly stated as such).

Value at Risk (VaR95)
The Pension Scheme deficit/surplus is the difference between the value placed on the Pensino Scheme assets and that placed on its liabilities. The deficit will vary over time over time even and not just because pension benefits are paid out and contribution paid in.

The value placed on a Pension Scheme's liabilities at any given time will also depend upon how they are measured which will reflect market factors including future rates of inflation and yields on investments such as bonds.

The future market value of the pension assets will depend upon how the assets held perform.

Under a Value at Risk (VaR) model, the value of the deficit is projected forward one year using an actuarial probability model (allowing for benefits expected to be paid out and contributions expected to be received) thousands of times and the resulting deficit figures are placed in order and compared with the initial deficit to show a likely range for the increases/decreases in deficit over the next year.

The 95% VaR (VaR95) represents the increase in deficit figure for which 5% of all the projected deficits (in one year's time based on the model) are larger and 95% are smaller.

In simple terms, the VaR95 figure can be thought of as there being a 5% or 1-in-20 chance that the pension deficit will increase by at least this amount over the next year.

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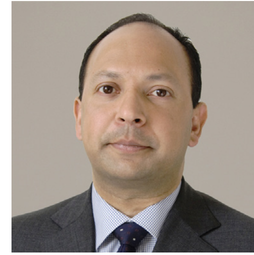

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About Us

Lincoln Pensions is the leading UK provider of employer covenant analysis and related independent financial advice to schemes and sponsoring employers. Our senior team possesses a breadth of experience unrivalled by any of our competitors including credit analysis, corporate finance, regulatory, legal and actuarial expertise. By providing advice to either trustees or companies, our clients can benefit from both perspectives in funding negotiations. We strive to provide independent, thoughtful and helpful covenant advice which can be used to support negotiations relating to scheme specific funding, M&A, or other corporate events.

Lincoln Pensions has a differentiated corporate finance-based (rather than accounting or actuarial) approach to sponsor covenant assessment which provides clear advice complementing the actuarial, investment consulting and legal advice already received by schemes, sponsors or other key stakeholders. As part of Lincoln International, a globally integrated platform, many of our clients have multinational businesses or sponsoring employers. We offer our clients access to our international resources which include sector knowledge, local market expertise and an understanding of global trends. More information about Lincoln Pensions can be obtained at www.lincolnpensions.com.

We were pleased to be shortlisted for both the Pensions Age Awards and Professional Pensions UK Pensions Awards in 2015

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