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Big schemes survey: £1bn+

Keeping you on track with UK private sector defined benefit schemes with assets of over £1bn

Many pension innovations stem from big schemes and work their way through to smaller schemes as the strategies become more refined and accessible.

For example, asset backed contributions, pension increase exchanges and normal pension ages linked to longevity improvements. But what are the basic features of the big schemes in terms of scheme type, maturity and investment allocation; and how are they doing currently in terms of investment returns and funding position?

This is our second annual survey on private sector defined benefit (DB) schemes in the UK with assets of over £1bn. It is based on publicly available data up to 31 October 2013 and focuses on scheme type, asset allocation, investment performance, deficit contributions, and scheme expenses. The survey covers 166 schemes, but not all schemes are included within each section.

Some of the highlights from below include:

- About 50% of final salary schemes in our survey are closed to new members and a further 30% are also closed to future accrual, leaving just 20% open to new members. Career Average Revalued Earnings (CARE) schemes are not far behind, with 28% open to new members;
- 80% of schemes have a deficit on their company accounting basis, versus 66% last year;
- The average annual employer deficit contribution was £75m, but ranged from £5m to £2bn;
- A significant proportion (22%) of assets have been classed as ‘other’ i.e. hedge funds and derivatives, or funds where the allocation between equities, gilts, property etc. could not easily be determined. This has actually reduced slightly from last year, though, when it was 25%;
- The average 3-year investment return was close to 12% per year (for end dates ranging between March 2012 and March 2013), whereas the 5-year return was half this at about 6% per year;
- The average PPF levy paid was £2.2m; and
- The average annual investment management fee was around 0.2% of assets, which is unchanged from last year.

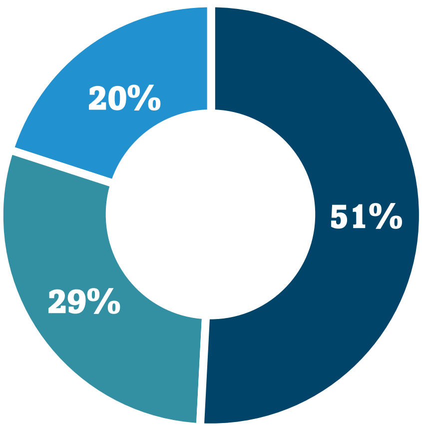
The decline of defined benefit

Not all final salary scheme closures result in a move to defined contribution (DC) – many of the big schemes have moved to CARE schemes. A number of those CARE schemes are closed to new members themselves, but generally remain open to accrual. We have analysed the status of final salary (118 schemes) and CARE (18 schemes) separately below.

The charts show that although only 29% of final salary schemes are frozen, the great majority (80%) are closed to members. CARE schemes are generally much younger than final salary schemes, so it is perhaps surprising that 72% of these are already closed to new members. However, quite a number would have been established as closed schemes from the outset, at the point of closing a final salary scheme to accrual and offering the CARE structure to existing members only, with a DC structure for new members.

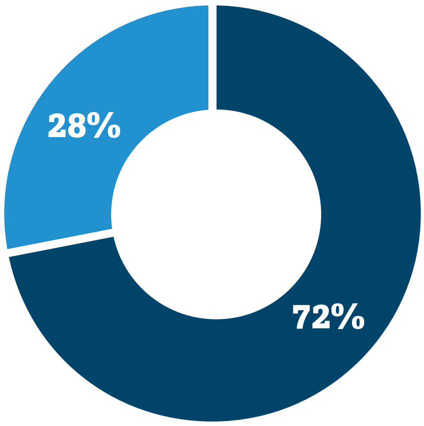
When moving from DB provision to DC, one of the key decisions is whether to establish the DC arrangement under the same trust as the existing DB scheme, or under a separate trust, or as a contract based scheme. For the companies included in this part of the survey, around 20% operate a DC section under the same trust as their closed or frozen DB schemes.

Final salary schemes status



Source: Scheme data downloaded from Pension Funds Online

CARE schemes status



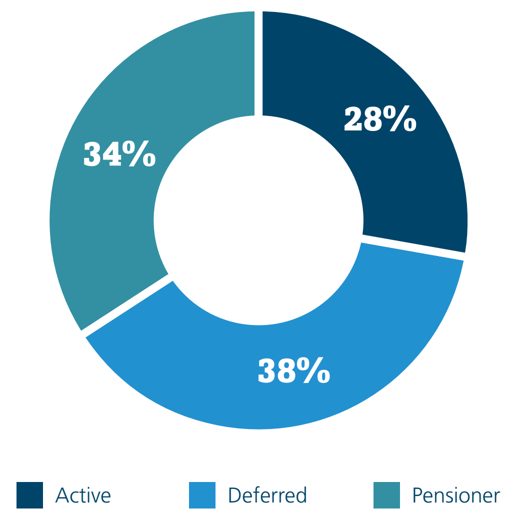
Source: Scheme data downloaded from Pension Funds Online

- Open: Open to new members (and to future accrual for all active members)
- Closed: Closed to new members, but still open to future accrual for exisitng members
- Frozen: Closed to new members and also closed to future accrual (sometimes referred to as paid-up schemes)

Scheme maturity

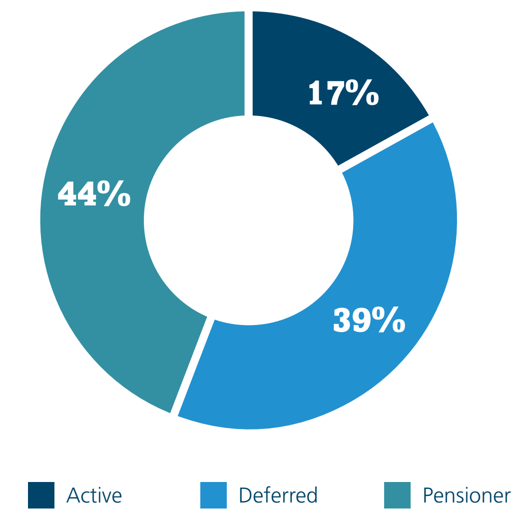
One key factor in identifying appropriate de-risking strategies is the maturity of the scheme, i.e. the proportion of pensions that are in payment and the age distribution of all members. For example, buy-ins and buy-outs are often most cost effective in relation to pensioners, whereas transfer and early retirement exercises are only appropriate in relation to deferred or active members. The following charts illustrate the membership profile of the schemes included in our survey, split between those with and without a CARE section.

Schemes with a CARE section



Source: Scheme data downloaded from Pension Funds Online

Schemes without a CARE section



Source: Scheme data downloaded from Pension Funds Online

As can be seen, the two sets of schemes have a similar level of deferred members, but the set with CARE sections have a substantially higher proportion of actives and a correspondingly lower proportion of pensioners.

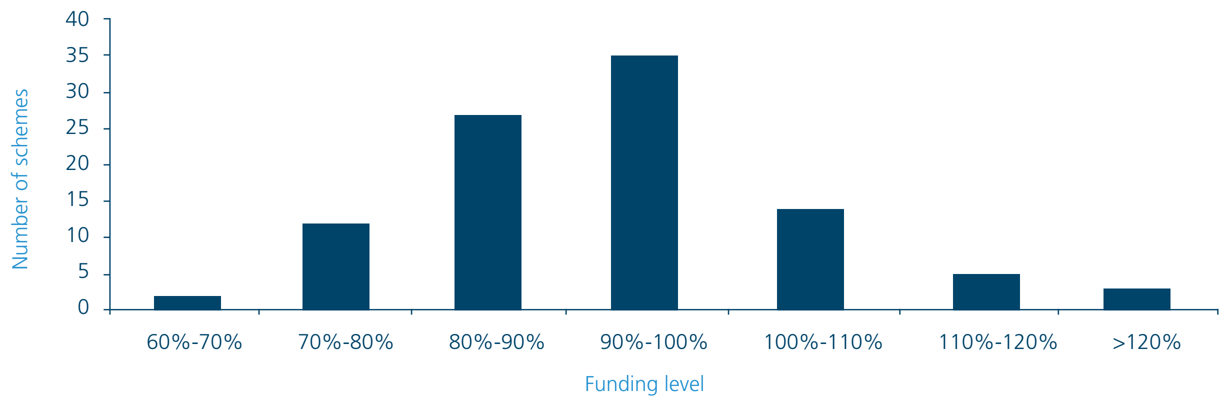
Assets and liabilities

All of the schemes analysed had total assets exceeding £1bn. In around 90% of schemes by number, total assets were below £5bn and the mean average across all schemes was £4.2bn. The largest scheme had assets of approximately £39bn.

The liability values were available for 98 schemes, of which 76 (around 80%) had a deficit on the company accounting basis, with the remainder showing a surplus or zero balance. The average funding level across these schemes was 93%. Anecdotally, the proportion of DB schemes across the UK as a whole with an accounting deficit at the relevant dates would have been much higher than 80%.

The following chart summarises the funding level information:

Scheme funding levels



Source: Scheme data downloaded from Pension Funds Online

The size of deficit is another key factor in determining the range of appropriate exercises for consideration. With a deficit of 20%, for example, a buy-in or buy-out is unlikely to be attractive and transfer exercises may require more cash from the employer than it has available. Leveraged interest rate or inflation hedges, on the other hand, might be appropriate, as could be a PPF-compliant guarantee (to help reduce the PPF levy) or an asset-backed contribution (to improve the disclosed funding position without requiring substantial cash contributions).

Employer contributions

The average annual contribution made by sponsoring employers to fund their scheme deficits was £75m. By comparison, the average total operating profits declared by the employers was around £520m. As would be expected, the variation in deficit contributions was substantial, ranging from around £5m to around £2bn.

Employer contribution rates in respect of ongoing accrual are becoming increasingly complex, as multiple benefit tiers (with differing associated contribution rates) are common-place among the largest schemes and contributions may also be split at different rates between employers within a group. Ongoing DB contribution rates typically vary from around 10% to as much as 55% of pensionable salaries.

What is an asset backed contribution?

This is where the expected proceeds from an income-generating asset owned by the sponsoring employer are formally assigned to the scheme, so that the scheme's balance sheet benefits immediately from the capitalised value of the future income.

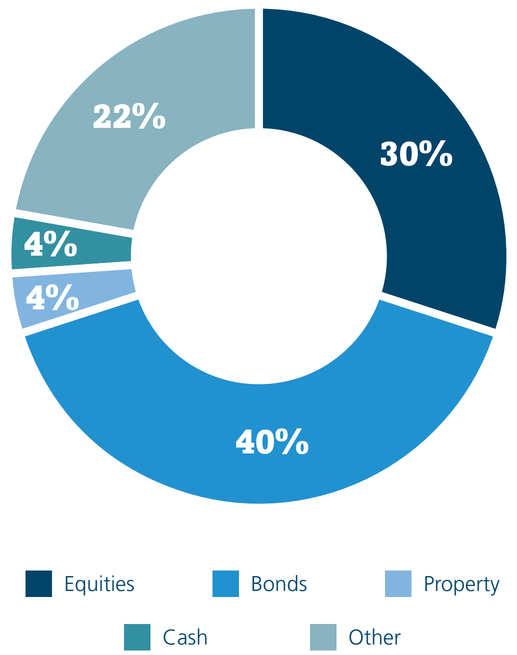
Asset allocation

The chart (right) summarises the asset allocations of the schemes within our survey. The split between growth assets (e.g. equities) and matching assets (e.g. gilts) is a fundamental decision and traditionally a typical growth/matching split has been 60/40. However, the allocation has swung the other way during the last few years (i.e. to around 40/60) and our analysis shows that the big schemes are in line with this trend. The average allocation to equities was about 31%, with about 44% allocated to bonds, property, and cash.

The observed move towards matching assets is partly a consequence of maturing schemes – as more schemes are closed to new members the average age increases and so matching assets become more appropriate.

It should be noted, though, that the 'other' category is substantial at 22% and it is likely to include more growth assets than matching. A large proportion of the 'other' category is accounted for by pooled investment vehicles. The asset allocations in these pooled funds vary, but often contain a higher proportion of growth assets than matching assets. The 'other' category also includes alternative asset types such as derivatives, emerging market currencies and hedge funds.

Average asset allocation

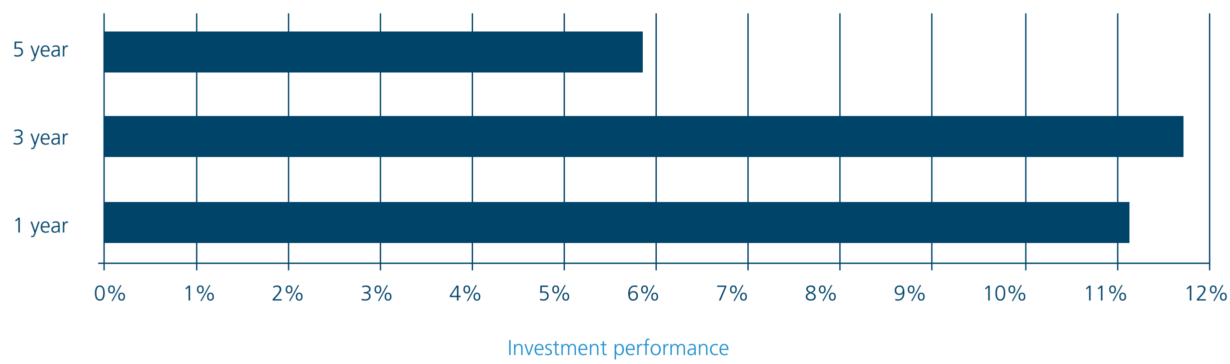


Source: Scheme data downloaded from Pension Funds Online

Investment performance

The following chart summarises the investment performance of schemes included in our survey over 1-year, 3-year and 5-year periods ending between March 2012 and March 2013:

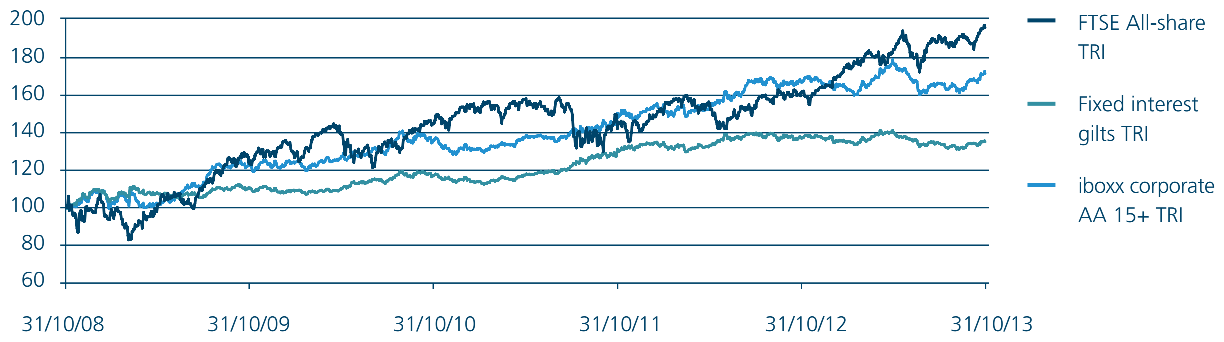
Average annualised investment performance



Source: Individual schemes' accounts and member newsletters

The 5-year performance (just below 6% per year) is significantly lower than for the 3-year and 1-year periods (at 11% to 12% per year). This reflects a large dip in equity values towards the beginning of the 5-year periods (between March 2008 and March 2009, the last part of which is captured in the graph below). Since then, good levels of return have been seen across all of these asset categories, despite some other substantial dips along the way. The graph below shows equity, gilt, and corporate bond total return indices over the 5-year period from 31 October 2008 to 31 October 2013.

Market returns

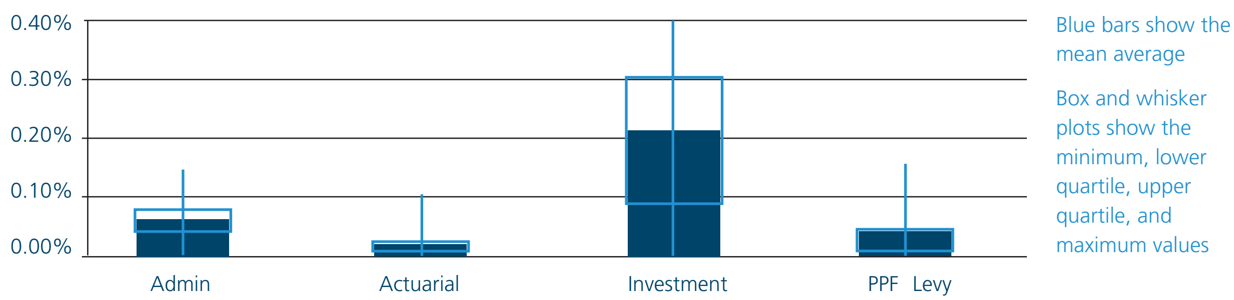


Source: FTSE and iBoxx market statistics

Scheme expenses

The rising cost of running DB pension schemes (due to regulatory complexity and the PPF levy) is often quoted as a contributory factor in the demise of such schemes. Careful monitoring and governance is required to keep costs under control. For large schemes, economies of scale should help to keep costs down, but in practice even tighter control is required to prevent costs from escalating. The following chart shows the spread of annual fees, as a percentage of scheme assets, paid by schemes included in our survey:

Scheme expenses



Source: Individual schemes' accounts and member newsletters

The average PPF levy was approximately £2.2m, corresponding to 0.04% of scheme assets. For these big schemes it is clearly worth paying for professional advice to ensure that the levy is kept as low as possible. Smaller schemes should take steps to avoid picking up an undue share of the total levy after the big schemes have optimised their position. Investment fees are the largest outlay by a substantial margin, at around 0.2% of the average total scheme assets. The big schemes are more inclined to hold segregated assets and employ complex investment structures in the hope of achieving out-performance. As such, their spend on investment fees may be higher than for a typical smaller scheme. Between the schemes included in our survey, though, weighting the average investment fees by scheme assets has no impact, so beyond £1bn of assets there is no evidence that extra scale reduces investment fees as a percentage of assets.

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For further information

Please contact your usual Barnett Waddingham consultant if you would like to discuss any of the matters raised within this survey in more detail. Alternatively, please email:

corporateconsulting@barnett-waddingham.co.uk

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