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Dutch companies with UK defined benefit schemes

November 2015

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> Our report analyses the contributions paid, levels of deficit and levels of risk within the schemes.

Introduction

This survey relates to constituent companies of the Dutch AEX share index that have UK subsidiary companies with defined benefit (DB) pension schemes. The survey covers 11 Dutch companies with around £12.8bn of UK pension liabilities between them.

Our report analyses the contributions paid, levels of deficit and levels of risk within the schemes. Data has been taken from the latest available financial statements of the UK subsidiary companies, which are as at 31 December 2014 in most cases. Although the companies are not named directly within this survey, they are represented by the same number in each chart throughout.

The costs and risks associated with DB pension schemes are well known within the industry. In most cases the parent companies in our survey are leading players in their industries and are able to absorb reasonably substantial pension costs. However, the impact upon performance and return on investments of the UK subsidiary companies can be more pronounced. Comparisons of these subsidiaries against other UK companies without legacy DB pension liabilities, especially on a cash basis, could be heavily influenced by the pension related costs and cash contributions.

There are also some interesting results, the average funding level of these schemes is only slightly lower than the FTSE350 average, the total contributions paid last year (for past service deficit and current service) represented 15% of total staff costs, versus a corresponding figure of 6% for the FTSE350.

I hope you will find our report both interesting and useful as a benchmark of your UK pension exposure against other Dutch-owned companies.

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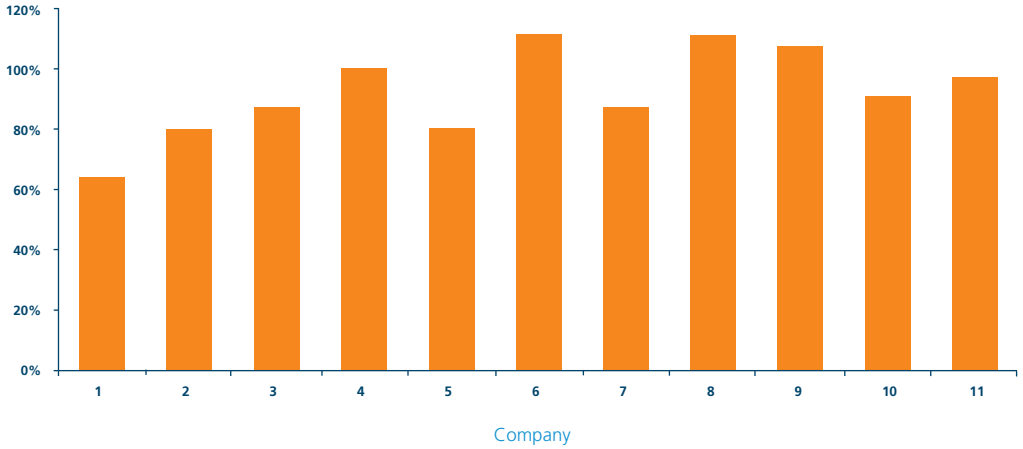
Note: Where figures are not available from a particular company's accounts, we have estimated them based on other information, if possible, or excluded them from the relevant section of analysis.

> The average funding level is 92%, which is slightly lower than the average funding level of FTSE350 companies' DB schemes at the same date of 93%.

Funding levels on the company accounting basis

The funding levels (as measured under IFRS) of these companies' schemes are similar to those seen across UK DB schemes as a whole. The average funding level is 92%, which is slightly lower than the average funding level of FTSE350 companies' DB schemes at the same date of 93%. There were three companies with funding surpluses, which are a rare sight within the FTSE350. The least well-funded scheme had a funding level of 64%.

Scheme funding levels 2014



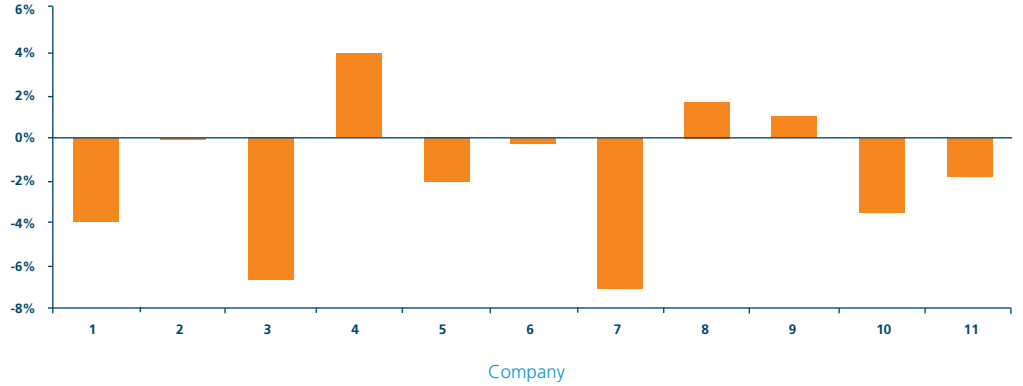
Source: Financial statements as at 31 December 2014

The funding level of course depends on the actuarial assumptions used to calculate scheme liabilities. The strength of assumptions adopted will vary from one employer to another, and from one year to the next but should comply with the international accounting standards at the relevant date.

Changes in funding level

The following chart shows the percentage change in the funding levels between 2013 and 2014. The funding level decreased by 2% on average between year-end 2013 and year-end 2014 for UK schemes in the survey.

Percentage change in funding level between 2013 and 2014

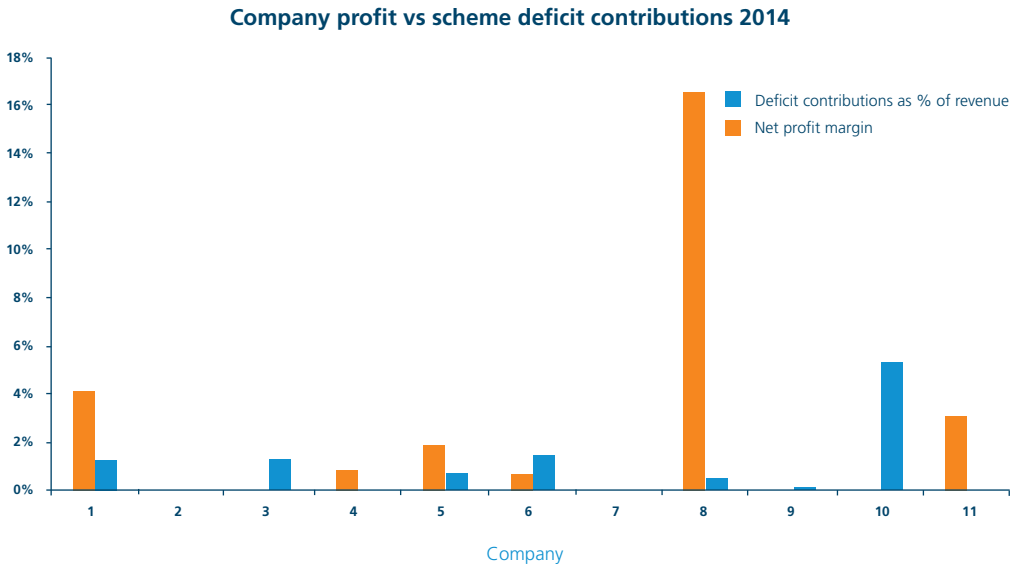


Source: Financial statements as at 31 December 2014

> At current contribution rates it will take an average of 11 years for the employers with scheme deficits to clear these, assuming that further deficits do not arise in the meantime.

Pension related cost and impact on financial performance

The following chart shows deficit contributions paid as a percentage of company revenues, against companies' net profit (losses are shown as zero). Companies 2 and 7 have been omitted as outliers.



Source: Financial statements as at 31 December 2014

For the purpose of this survey, deficit contributions have been derived as total DB contributions paid by the employer less the disclosed 'current service cost' for DB accrual.

The aggregate contribution paid into these DB schemes in 2014 was approximately £170m, with contributions relating to UK past service deficits amounting to £104m. This represents 3% of total UK revenues, which is greater than the 0.4% of total revenue contributed by FTSE350 companies on average in their 2014 accounts.

In most cases, the contribution requirements of the schemes are reasonably affordable for the employer and/or parent company, as they generate sufficient levels of profits. However it would appear that some will struggle to meet contribution requirements over the longer term without making changes to their funding strategy. For example, the use of formal guarantees to improve covenant and thereby enable a lower assessment of technical provisions; or asset backed contributions to bolster the assessed value of assets without immediate cash injections.

At a simpler level, the recovery plan could be extended in order to reduce the annual contribution requirement, although this will also depend upon the trustees' view of the company covenant.

At current contribution rates it will take an average of 11 years for the employers with scheme deficits to clear these, assuming that further deficits do not arise in the meantime.

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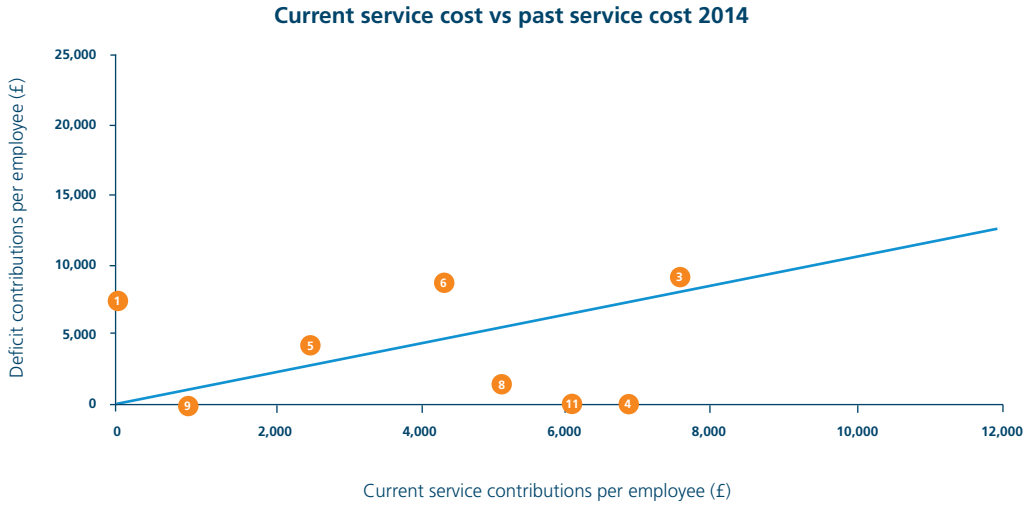
> In some cases, companies paid lower contributions towards current service benefits than towards past service deficits.

The following graph compares the future service cost of retirement benefits per employee against the annual contributions paid in relation to past service deficit, also on a per employee basis. Company 2 has been omitted due to insufficient data and companies 7 and 10 were deemed to be an outlier.



Source: Financial statements as at 31 December 2014

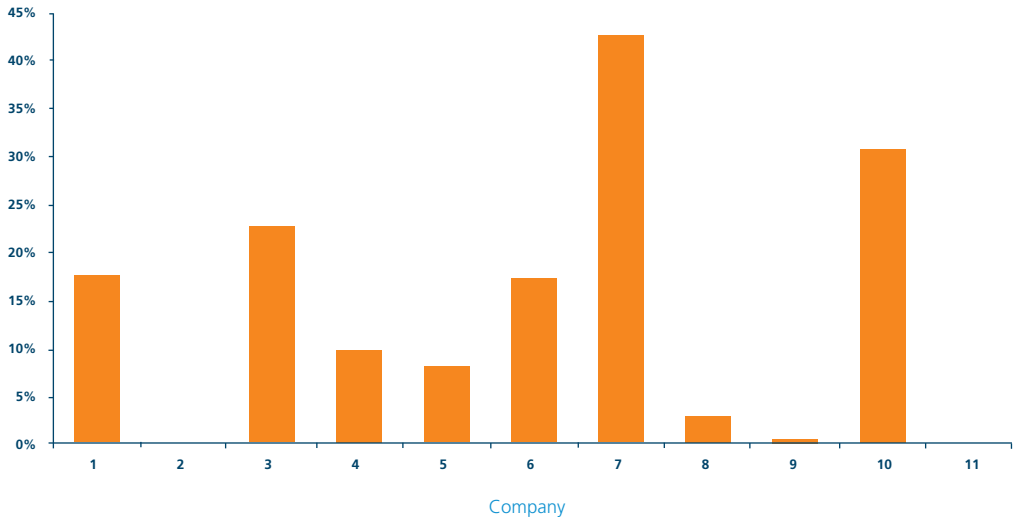
The average deficit contribution paid per employee in 2014 was around £5,300 and the average amount paid in relation to current service benefits was around £8,900 (this includes both DB and defined contribution (DC) arrangements). The average deficit contribution per employee is higher than the FTSE350 companies, which paid around £2,500 per employee in relation to past service deficits.

In some cases, companies paid lower contributions towards current service benefits than towards past service deficits (those above the blue line).

> The income statement may not provide a full breakdown of these costs, meaning that analysts' perceptions of companies' performance can be distorted.

The chart below demonstrates that pension contributions can represent a very significant proportion of total staff costs reported on the income statement. The impact of DB contribution requirements within these figures is diluted by employees who are not members of any pension arrangement and, to a lesser extent, those in DC arrangements. Nonetheless, in some cases, pension contributions are substantially increasing the cash outlay associated with employees' total remuneration. The income statement may not provide a full breakdown of these costs, meaning that analysts' perceptions of companies' performance can be distorted. Company 2 has been omitted due to insufficient data.

Total DB contributions as % of staff costs



Source: Financial statements as at 31 December 2014

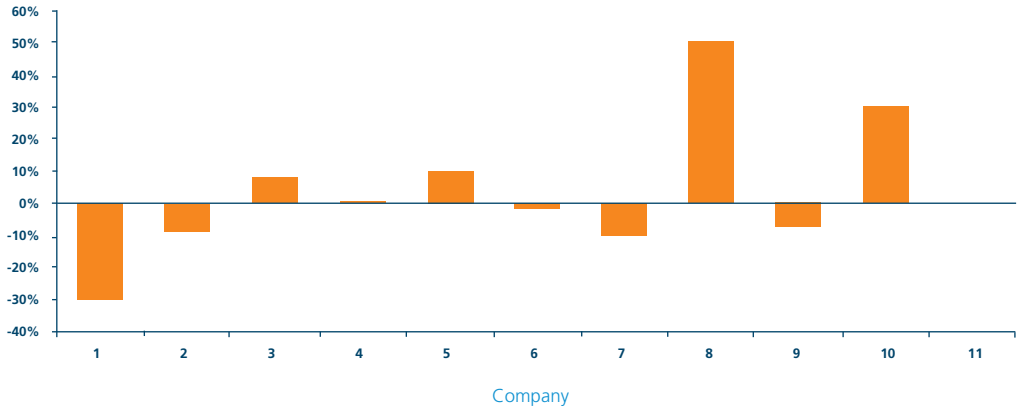
On average, pension contributions paid to DB schemes only (in relation to both past service deficit and current service) represented 15% of the total staff cost reported in the financial statements. However, the figure for individual companies varied greatly. The average contribution is much higher than for FTSE350 companies, where the equivalent figure is 6%.

> The contribution level decreased by 4% on average between year-end 2013 and year end 2014.

Changes in employer contributions

The chart below shows the percentage change in employer contributions to their defined benefit schemes between 2013 and 2014. The contribution level decreased by 4% on average between year-end 2013 and year end 2014.

Percentage change in DB contributions between 2013 and 2014



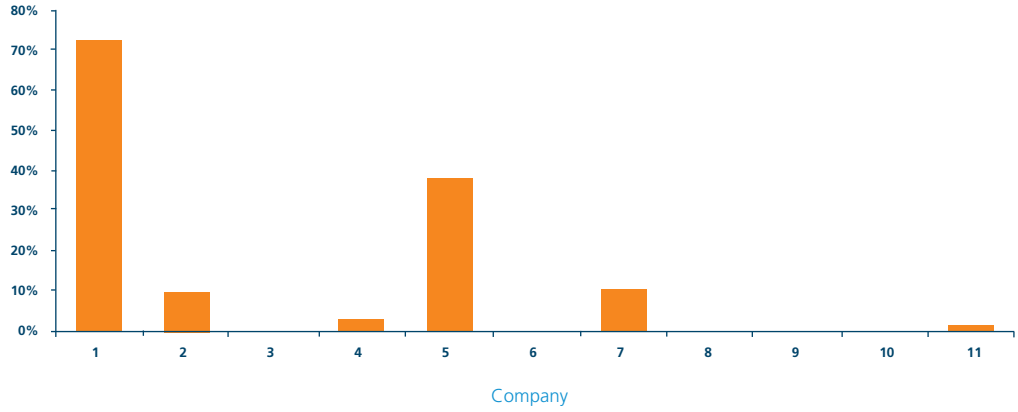
Source: Financial statements as at 31 December 2014

The average contribution paid into these DB schemes in 2014 was approximately £15.4m, which is higher than the 2013 average contribution of £12.8m.

Impact on shareholder funds

The following chart shows past service deficits as a percentage of shareholder funds. Those cases with no scheme funding deficit, including the schemes in surplus, and companies which have disclosed negative shareholder funds have been excluded.

Scheme deficit as % of shareholder funds 2014



Source: Financial statements as at 31 December 2014

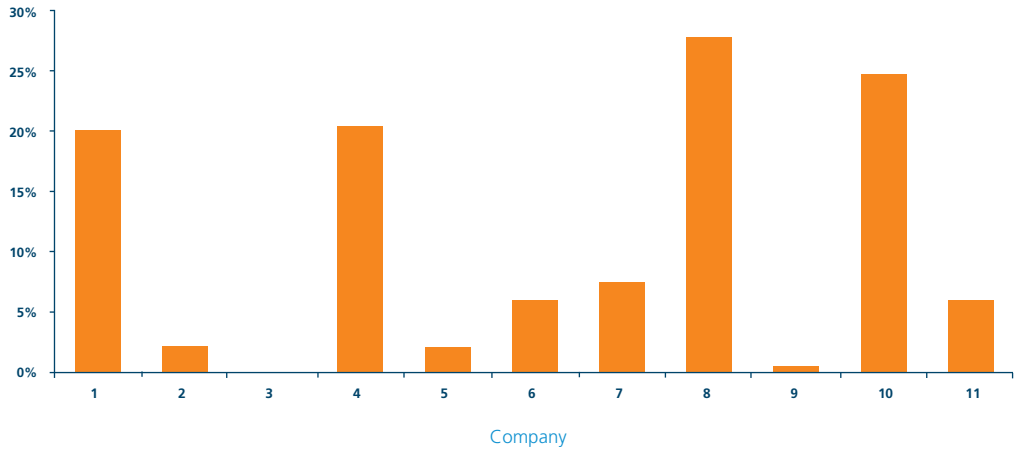
> On average, actuarial movement was about 12% of shareholder funds.

For the remaining cases, scheme deficits amount to 23% of shareholder funds on average. The return on shareholder funds could be impacted by this percentage during the period over which the deficit is removed. This can significantly affect the companies' ability to transfer funds back to their parent companies.

Of course, cash contributions are not the only way to reduce deficits. For example, companies could consider re-risking the scheme's investment strategy (i.e. increasing the allocation to growth assets) or undertaking incentive exercises (providing scheme members with options to amend their benefits in ways they might find attractive, but which result in a saving to the scheme – e.g. pension increase exchange, or flexible early retirement).

The following chart shows 'actuarial movements' as a percentage of shareholder funds. The actuarial movement consists of the impact of changes in assumptions, experience gains/losses on liabilities, and experience gains/losses on assets.

Actuarial movement as % of shareholder funds



Source: Financial statements as at 31 December 2014

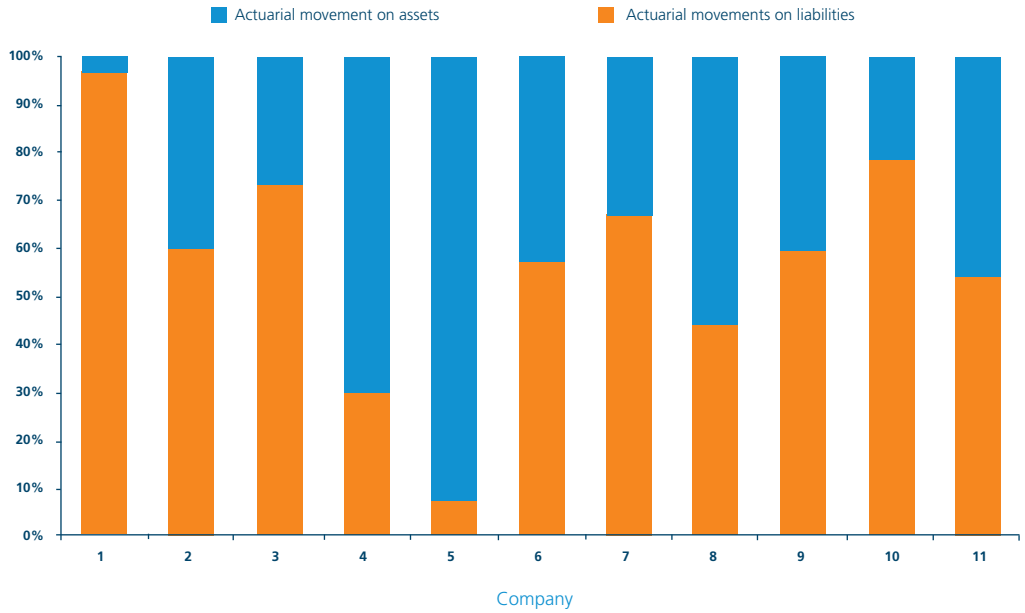
On average, actuarial movement was about 12% of shareholder funds. Company 3 has been excluded as an outlier. Movements at this level are fairly manageable, but in the case of Company 8, where the movement is over 25% of shareholder funds, this will have a significant impact on the parent companies' holdings in the UK subsidiary. Given the volatile nature of actuarial assumptions and investment returns, such movements are likely to reoccur on a regular basis.

> In 8 cases, actuarial movements on the liabilities were more significant than those on the assets.

The following chart shows the split of actuarial movements between liabilities (including both experience gains/losses and changes in assumptions) and assets in each case.

The chart shows that in 8 cases, actuarial movements on the liabilities were more significant than those on the assets.

Split of actuarial movement between assets and liabilities



Source: Financial statements as at 31 December 2014

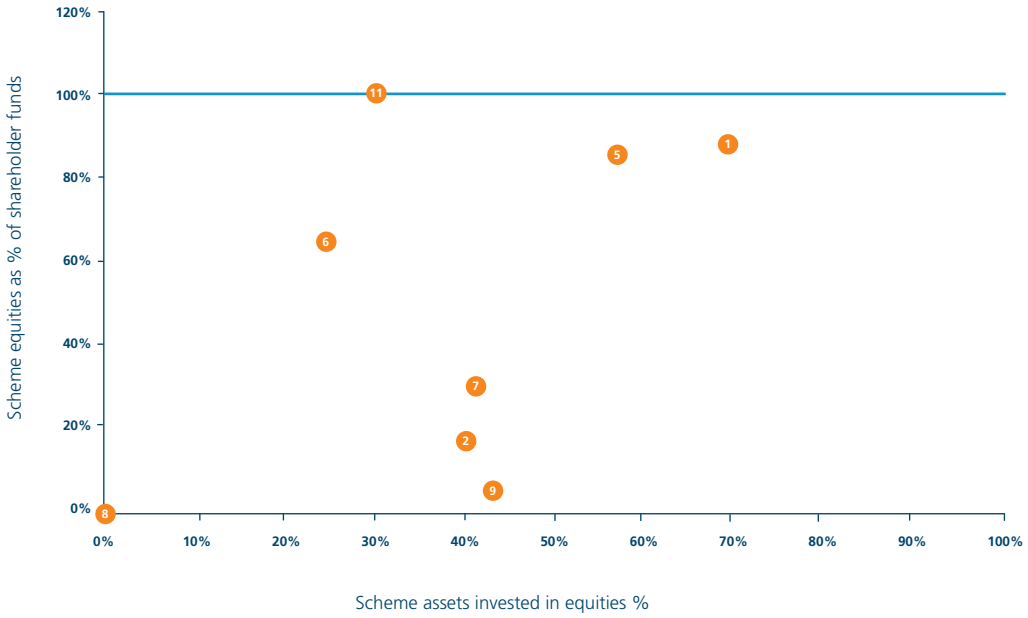
However, it is likely that the majority of the movements in liabilities seen relates to changes in assumptions. Specifically, changes to the discount rate, inflation assumption, and longevity assumptions. In years where no formal valuation has been completed (usually two out of every three years) it is common for disclosures to be prepared using a roll-forward method where experience gains/losses on liabilities may automatically be reported as zero.

> It would seem there is a case here to suggest that some of the parent companies are almost as exposed (or even more exposed) to the performance of their schemes' equity holdings as to the performance of their own subsidiary companies.

Indirect exposure to equity markets

A company's indirect exposure to equity markets via its pension scheme investments is sometimes overlooked. The chart below shows the level of equity investment both as a percentage of shareholder funds (vertical axis) and as a percentage of total scheme assets (horizontal axis). Companies 3, 4 and 10 have been omitted as they were outliers.

Indirect exposure to equities during 2014



Source: Financial statements as at 31 December 2014

The risk associated with investment in equities via the pension scheme could be deemed very significant in some cases. For example, in the case of Company 11 although the scheme's equity allocation is approximately 30%, this represents nearly 100% of the parent company's stake (measured by the value of shareholder funds) in the UK subsidiary.

The specific arrangements between subsidiary companies and their parents can sometimes lead to misleading results.

However, it would seem there is a case here to suggest that some of the parent companies are almost as exposed (or even more exposed) to the performance of their schemes' equity holdings as to the performance of their own subsidiary companies.

If this position is deemed undesirable then the schemes' holdings in equities could be reduced (in exchange for assets more closely aligned with the liabilities, such as bonds, property or liability driven investment funds). However, such a change could come with a significant increase in the expected cost of providing benefits under the scheme.

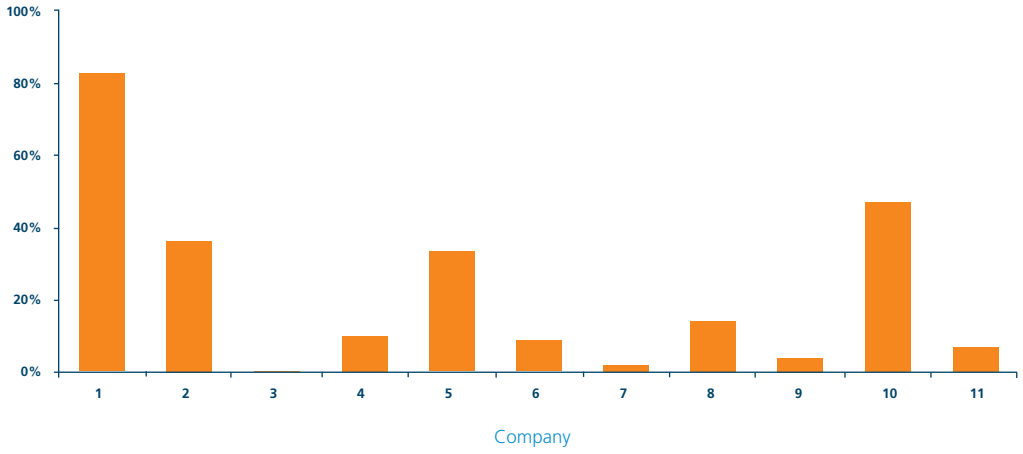
> On average, the UK liabilities account for 22% of the global liabilities related to DB schemes.

UK and global comparison: Impact of UK DB liabilities

The chart below shows the companies DB liabilities as a proportion of their global DB liabilities.

On average, the UK liabilities account for 22% of the global liabilities related to DB schemes. However, the distribution is wide, as illustrated above, the results range from less than 1% to more than 80%.

2014 UK DB liability as a proportion of global DB liabilities



Source: Financial statements as at 31 December 2014

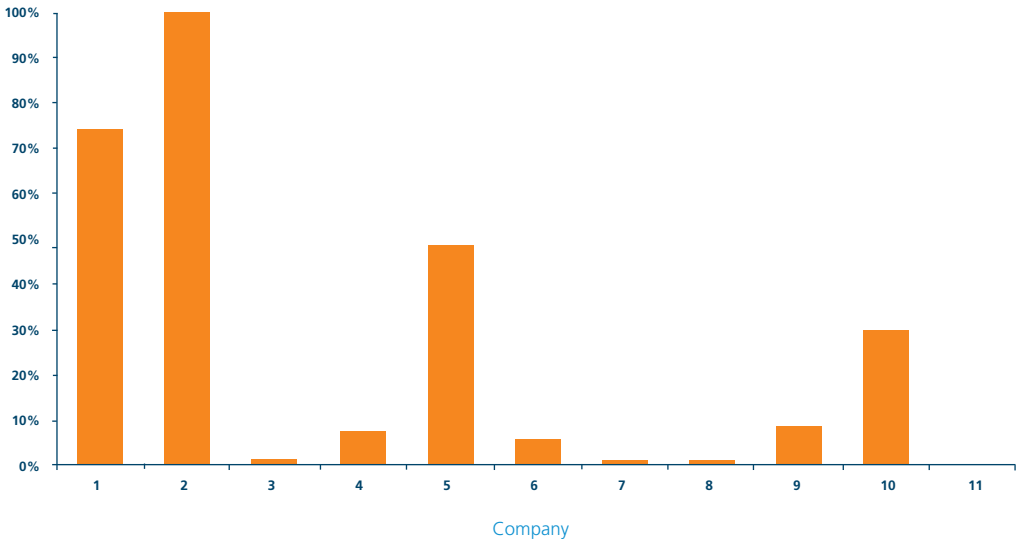
> While the remaining companies produce an average of 25% of global contributions being made by UK subsidiaries, the variation in the proportions across the companies is extensive from less than 1% to 100%.

Impact of UK DB contributions

The following chart displays the companies UK contributions as a proportion of the global contributions made to DB schemes.

While the remaining companies produce an average of 25% of global contributions being made by UK subsidiaries, the variation in the proportions across the companies is extensive from less than 1% to 100%.

2014 UK DB contributions as a proportion of global DB contributions



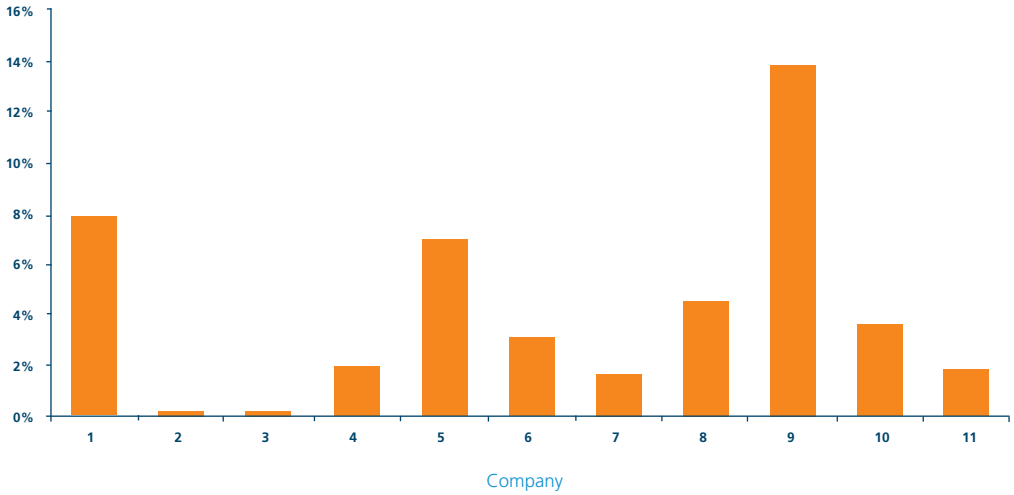
Source: Financial statements as at 31 December 2014

> Despite UK subsidiaries on average producing 4% of the global revenue, they account for on average 22% and 25% of the global DB liabilities and contributions respectively.

UK subsidiary revenue

To provide context for the UK proportions of the global liabilities and contributions previously shown, the following chart shows the UK revenue as a proportion of the global revenue.

2014 UK revenue as a proportion of global revenue



Source: Financial statements as at 31 December 2014

The result for all companies is 14% or under. The average proportion of global revenue produced by UK subsidiaries for the companies shown is 4%.

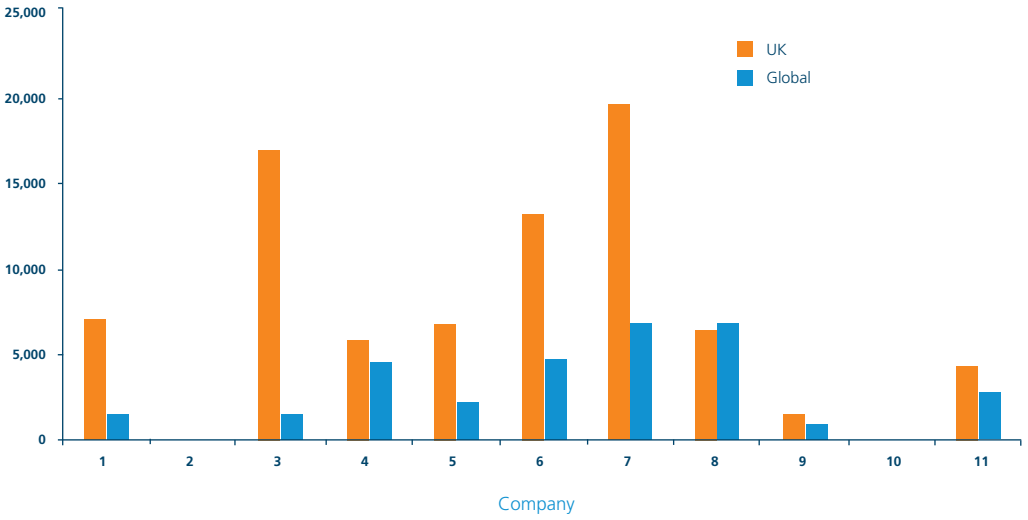
This is an interesting result, because despite UK subsidiaries on average producing 4% of the global revenue, they account for on average 22% and 25% of the global DB liabilities and contributions respectively.

> The average UK contribution in 2014 was over £9,000, whereas the average global contribution was around £3,500 per employee.

Global total pension contributions

The following chart puts into context the total contributions made globally into both DB and DC pension schemes per employee compared with the corresponding figure for the UK. Company 2 has been omitted due to a lack of data and company 10 is deemed to be an outlier.

2014 total contributions per employee (£)



Source: Financial statements as at 31 December 2014

Interestingly, for all of these schemes the contributions made to UK schemes per employee were significantly in excess of the equivalent global contribution. The average UK contribution in 2014 was over £9,000, whereas the average global contribution was around £3,500 per employee.

Summary of data

The following table provides a summary of some of the information used in this survey:

2014 year end	DB Scheme Assets (£m)	DB Scheme Liabilities (£m)	Surplus/(Deficit) (£m)	Deficit Contributions (£m)	Service Costs (£m)	UK Subsidiary Revenue (£m)
1	70	110	-40	2	0	142
2	1,000	1,260	-260	25	0	36
3	20	20	0	1	0	45
4	100	100	0	0	2	145
5	30	40	-10	1	0	133
6	60	60	0	1	0	79
7	20	20	0	0	0	16
8	3,340	3,000	340	3	0	763
9	20	20	0	1	0	725
10	7,370	8,090	-720	70	63	1,314
11	90	90	0	0	0	53

2013 year end	DB Scheme Assets (£m)	DB Scheme Liabilities (£m)	Surplus/(Deficit) (£m)	Deficit Contributions (£m)	Service Costs (£m)	UK Subsidiary Revenue (£m)
1	60	100	-40	2	0	150
2	830	1,050	-220	24	5	40
3	20	20	0	0	0	50
4	90	100	-10	0	2	160
5	30	40	-10	1	0	110
6	60	50	10	1	0	40
7	20	20	0	0	0	10
8	3,080	2,810	270	2	0	790
9	20	20	0	1	0	740
10	6,930	7,330	-400	37	65	950
11	80	80	0	0	0	80

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Contact information

If you would like to discuss any of the matters raised in this survey then please contact Andrew Vaughan FIA, who is a corporate actuary based in our London office, on:

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