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Scandinavian companies with UK defined benefit schemes

December 2014

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> The survey covers 18 Scandinavian companies with around £6.6bn of UK pension liabilities between them.

Introduction

This survey relates to constituent companies of the Scandinavian OMX share index that have UK subsidiary companies with defined benefit (DB) pension schemes. The survey covers 18 Scandinavian companies with around £6.6bn 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 2012 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 surprising results, for example although the average funding level of these schemes is a substantial 9% better than the FTSE350 average, the total contributions paid last year (for past service deficit and current service) represented 15.6% of total staff costs, versus a corresponding figure of just 7.7% for the FTSE350.

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

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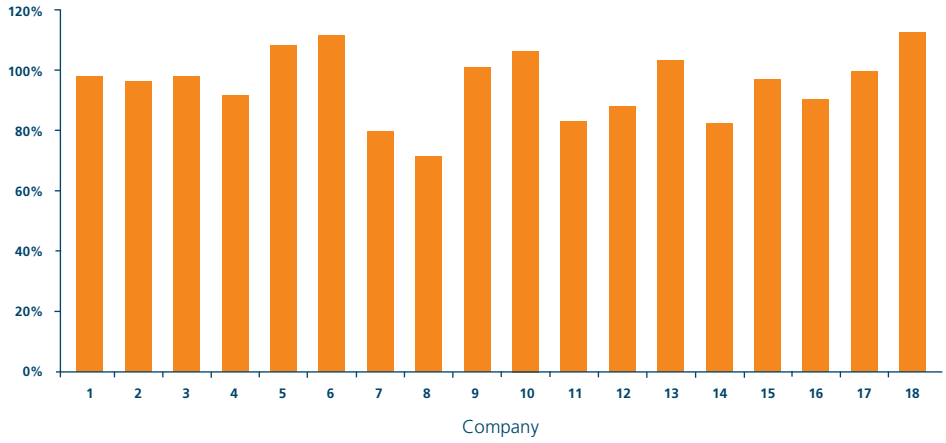
> The average funding level is 96%, which is a full 9% higher than the average funding level of FTSE350 companies' DB schemes at the same date of 87%.

Funding levels on the company accounting basis

The funding levels of these companies' schemes are generally in excess of those seen across UK DB schemes as a whole. The average funding level is 96%, which is a full 9% higher than the average funding level of FTSE350 companies' DB schemes at the same date of 87%. There were seven companies with funding surpluses, which are a rare sight within the FTSE350. Even the least funded scheme had a funding level of around 72%.

Scheme funding levels 2012



Source: financial statements as at 31 December 2012

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 (top of page 4) shows percentage change in the funding levels between 2011 and 2012. Both company 13 and company 17 have experienced sizeable increases in their funding position. These changes were a result of a significant acquisition of pension liabilities and a buy-in transaction respectively.

Company 8 has been excluded from the data, as we were not able to obtain complete data in respect of year end 2011. For the remaining cases, the funding level increases by 5% on average between year-end 2011 and year-end 2012. However, removing the sizeable gains of companies 13 and 17 shows signification distortion in the data, as the rest of the population has experienced a fairly insignificant average increase in funding of 1%.

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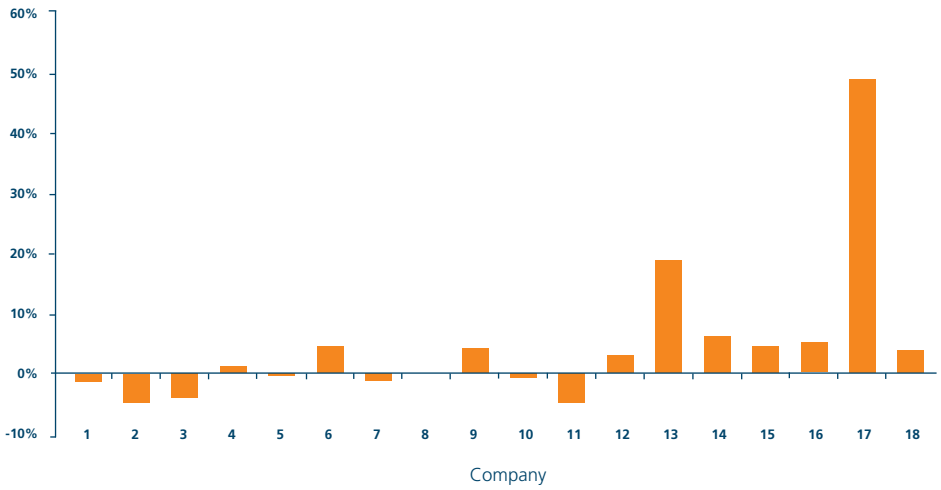
> Both company 13 and company 17 have experienced sizeable increases in their funding position. These changes were a result of a significant acquisition of pension liabilities and a buy-in transaction respectively.

Percentage change in funding level between 2011 and 2012

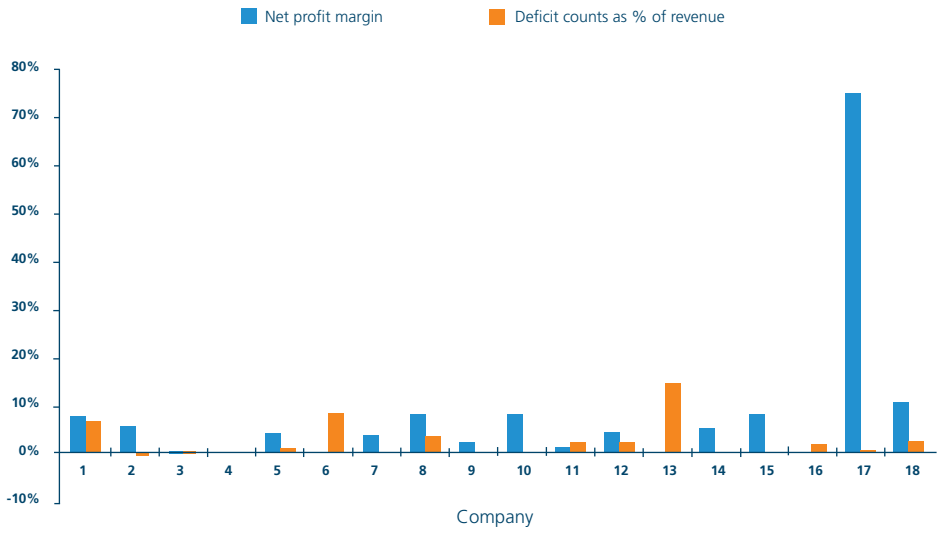


Source: financial statements as at 31 December 2012

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).

Company profit vs scheme deficit contributions 2012



Source: financial statements as at 31 December 2012

> At current contribution rates it will take an average of 8 years for the employers with scheme deficits to clear these, assuming that further deficits do not arise in the meantime.

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. Company 2 paid DB contributions at a rate slightly below their disclosed current service cost, which results in the disclosure of a negative deficit contribution.

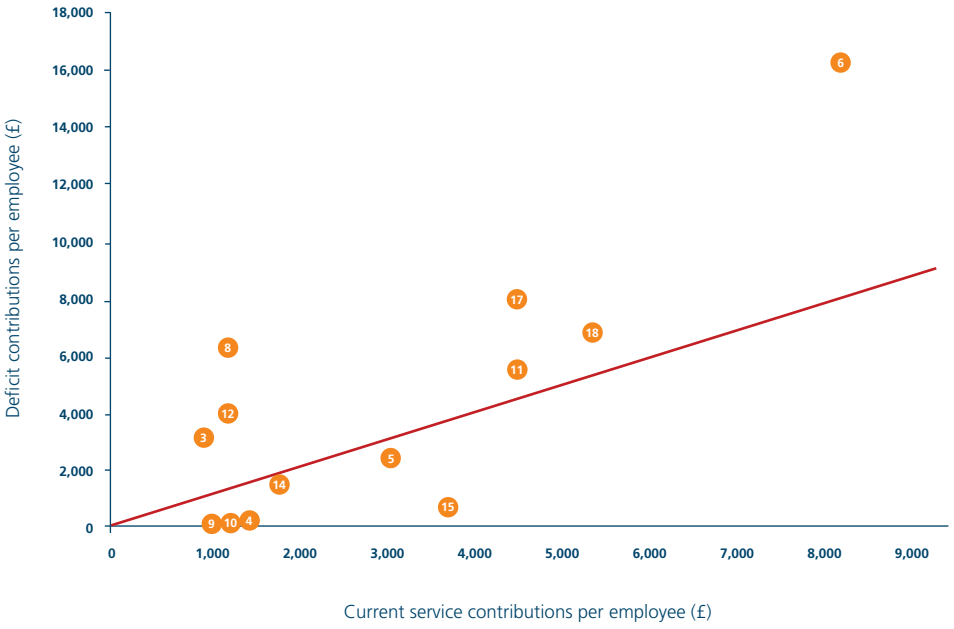
The aggregate contribution paid into these DB schemes in 2012 was approximately £324m, contributions relating to past service deficits amounted to £271m. This represents 2.5% of total revenues, which is over double the 1.1% of total revenue contributed by FTSE350 companies on average for the same period.

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 eight years for the employers with scheme deficits to clear these, assuming that further deficits do not arise in the meantime.

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.

Current service cost vs past service cost 2012



Source: financial statements as at 31 December 2012

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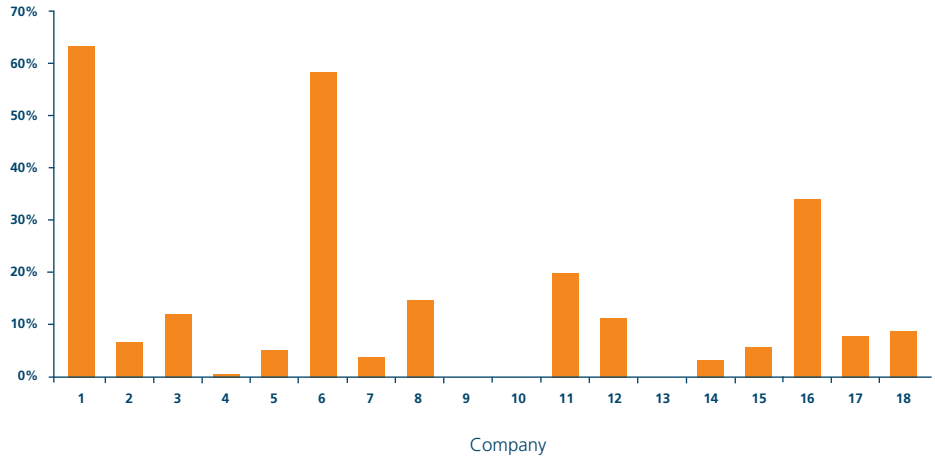
> The average deficit contribution per employee is in line with FTSE350 companies, which paid around £3,970 per employee in relation to past service deficits.

The average deficit contribution paid per employee in 2012 was around £3,980 and the average amount paid in relation to current service benefits was around £2,930 (this includes both DB and defined contribution (DC) arrangements). The average deficit contribution per employee is in line with FTSE350 companies, which paid around £3,970 per employee in relation to past service deficits.

In many cases, companies paid higher contributions towards current service benefits than towards past service deficits (those below the 45-degree line).

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.

Total DB contributions as % of staff costs 2012



Source: financial statements as at 31 December 2012

On average, pension contributions paid to DB schemes only (in relation to both past service deficit and current service) represented 15.6% of the total staff cost reported in the financial statements. However, the figure for individual companies varied greatly, from 0% up to 65%. The average contribution is higher than for FTSE350 companies, where the equivalent figure is 7.7%.

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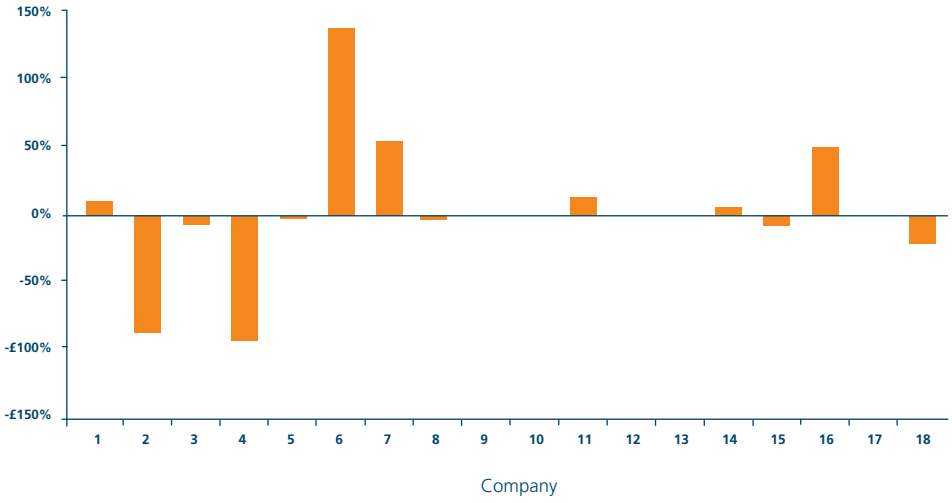
> The aggregate contribution paid into these DB schemes in 2012 was approximately £325m, over 70% higher than the 2011 aggregate contribution of £188m.

Changes in employer contributions

The chart below shows the percentage change in employer contributions to their DB schemes between 2011 and 2012. Companies 13 and 17 have been excluded in addition to those companies that have not disclosed contributions, due to transactions which have distorted these changes discussed above.

For the remaining cases, the contribution level increased by 5% on average between year-end 2011 and year end 2012.

Percentage change in DB contributions between 2011 and 2012



Source: financial statements as at 31 December 2012

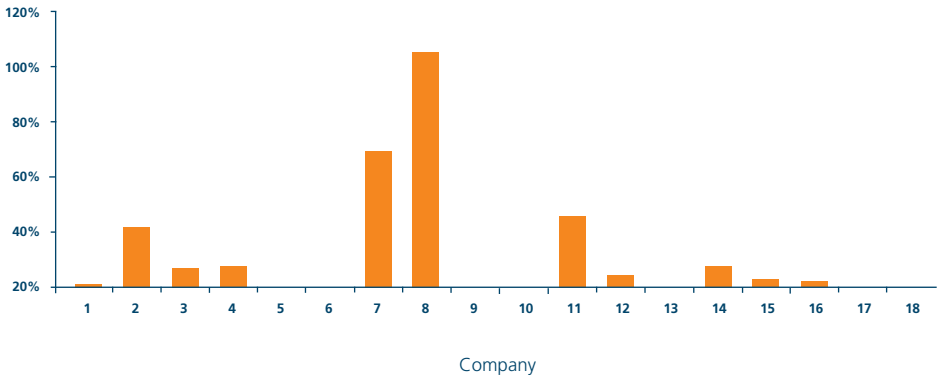
The aggregate contribution paid into these DB schemes in 2012 was approximately £325m, over 70% higher than the 2011 aggregate contribution of £188m.

> 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).

Impact on shareholder funds

The following chart shows past service deficits as a percentage of shareholder funds, excluding company 8, which has been deemed as an outlier as its deficit exceeds shareholder funds. Those cases with no scheme funding deficit, including the 6 schemes in surplus, have also been excluded.

Scheme deficit as % of shareholder funds 2012



Source: financial statements as at 31 December 2012

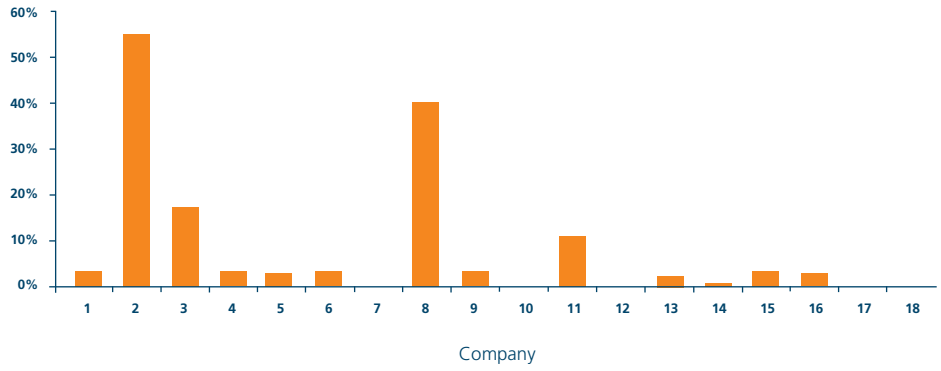
For the remaining cases, scheme deficits amount to 20.9% of shareholder funds on average. Hence, the return on shareholder funds will in theory be impacted by this percentage during the period over which the deficit is removed. This significantly affects the companies' ability to transfer funds back 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).

> For the companies that disclosed actuarial movement, on average it was about 9.9% of shareholder funds.

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 2012



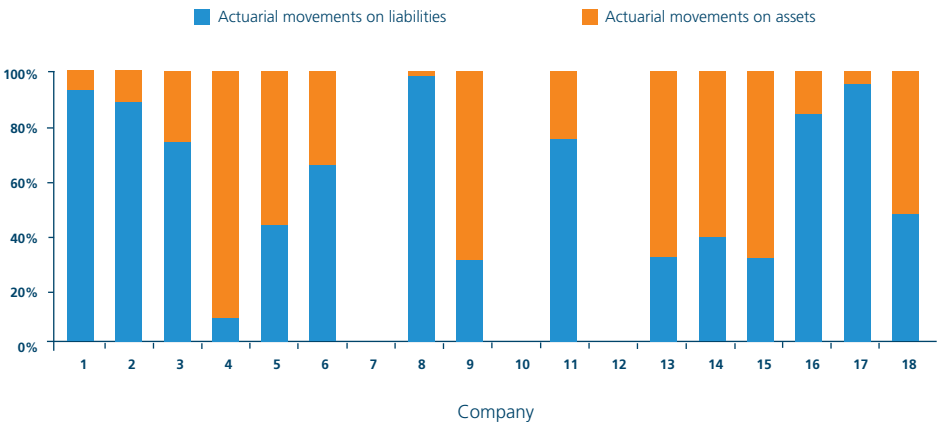
Source: financial statements as at 31 December 2012

For the companies that disclosed actuarial movement, on average it was about 9.9% of shareholder funds. Movements at this level are fairly manageable, but in the case of Companies 2 and 8, where the movement is over 40% 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.

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 eight cases, actuarial movements on the liabilities were more significant than those on the assets.

Split of actuarial movement between assets and liabilities as a % for 2012



Source: financial statements as at 31 December 2012

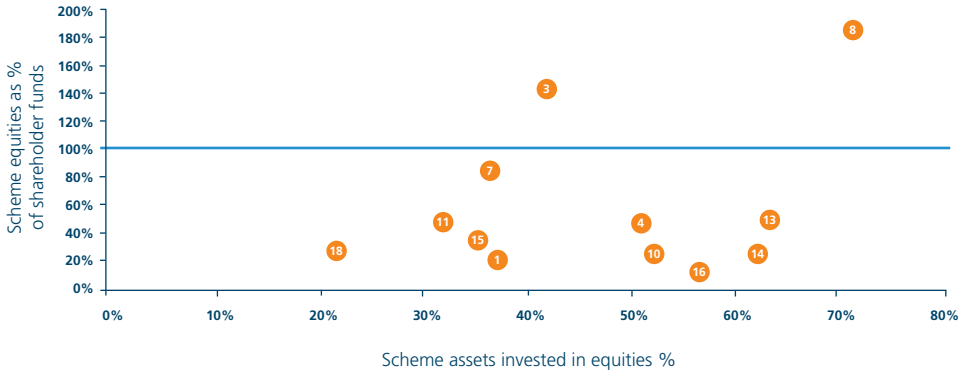
> The specific arrangements between subsidiary companies and their parents can sometimes lead to misleading results.

For accounting periods ending before 31 December 2013 it was not a requirement to disclose experience gains/losses on liabilities separately from the impact of changes in assumptions. 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.

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).

Indirect exposure to equities during 2012



Source: financial statements as at 31 December 2012

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 number 3, the scheme's equity allocation is approximately 40% and yet this represents over 140% 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.

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> On average, based on the remaining companies, the UK liabilities account for 39% of the global liabilities related to DB schemes.

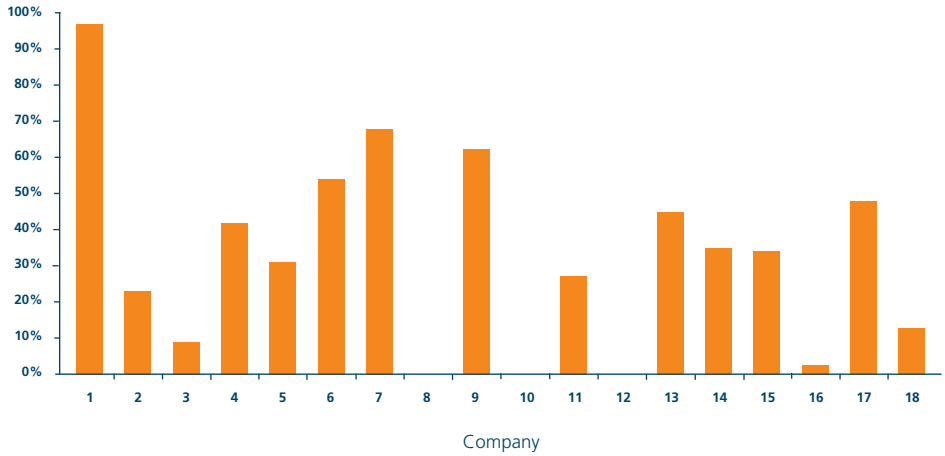
UK and global comparison:

Impact of UK DB liabilities

The chart below shows the companies UK DB liabilities as a proportion of their global DB liabilities. Results considered outliers and omitted correspond to companies 8 and 10. Company 12 was omitted, as they did not disclose global liabilities.

On average, based on the remaining companies, the UK liabilities account for 39% of the global liabilities related to DB schemes. However the distributions of proportions are wide, as illustrated below, the results range from 3% to 96%.

2012 UK DB liability as a proportion of global DB liabilities



Source: financial statements as at 31 December 2012

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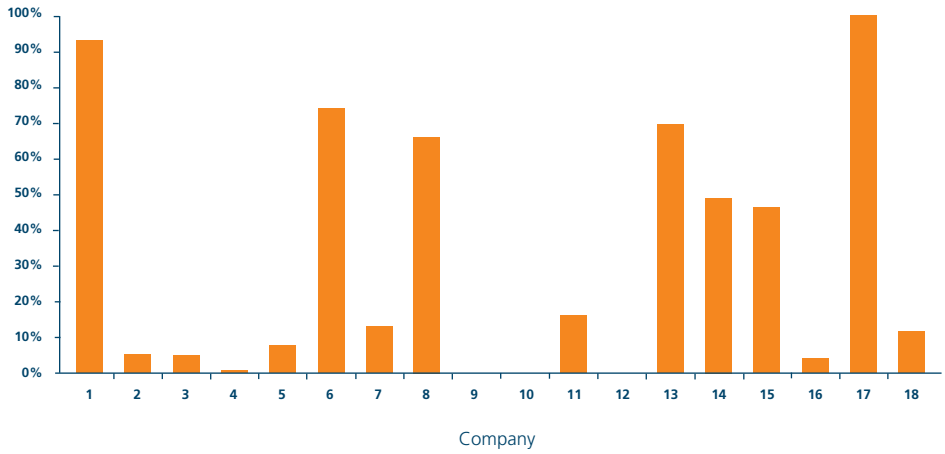
> While the remaining companies produce an average of 38% of global contributions being made by UK subsidiaries, the variation in the proportions across the companies is extensive.

Impact of UK DB contributions

The following chart displays the companies UK contributions as a proportion of the global contributions made to DB schemes. This excludes those cases where UK contributions are not disclosed (companies 9 and 10) as well as company 12, who did not disclose total global contributions.

2012 UK DB liability as a proportion of global DB liabilities



Source: financial statements as at 31 December 2012

While the remaining companies produce an average of 38% of global contributions being made by UK subsidiaries, the variation in the proportions across the companies is extensive.

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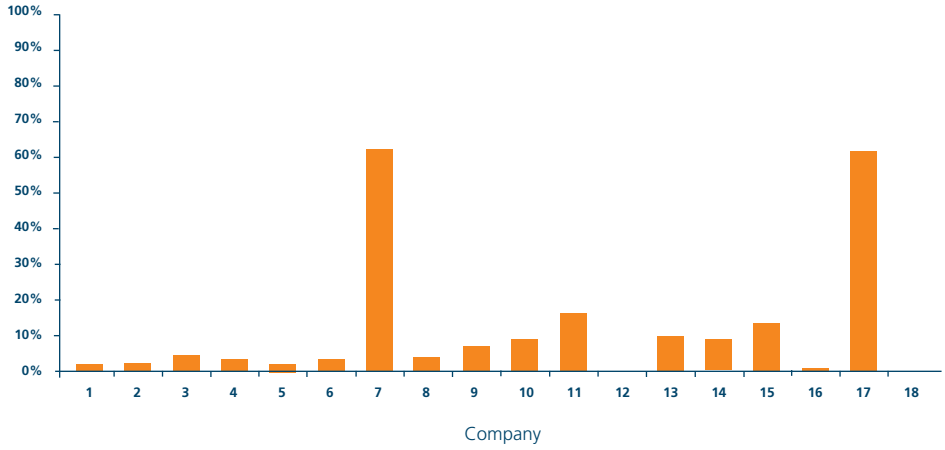
> The average proportion of global revenue produced by UK subsidiaries for the companies shown is 12%. Removing companies 9 and 22 from the average reduces it to 5%.

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. (Omitted outliers include companies 12 and 18.)

2012 UK revenue as a proportion of Global Revenue



Source: financial statements as at 31 December 2012

Except for two companies with UK revenue contributing nearly 2/3 of global revenue (companies 7 and 17), for all other companies, the result is under 20%. The average proportion of global revenue produced by UK subsidiaries for the companies shown is 12%. Removing companies 7 and 17 from the average reduces it to 5%.

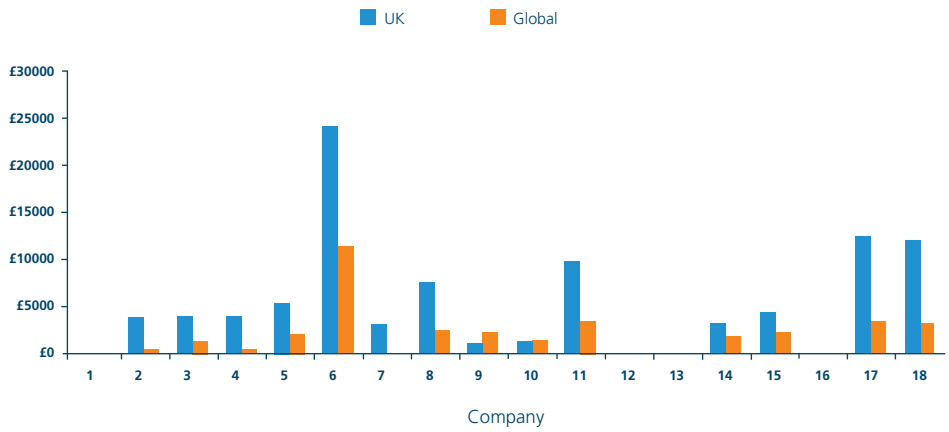
This is an interesting result, because despite UK subsidiaries on average producing 12% of the global revenue, they account for on average 39% and 38% of the global DB liabilities and contributions respectively.

> Interestingly, for all of these schemes the contributions made to UK schemes per employee were significantly in excess of the equivalent global contribution.

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. Companies 1, 13 and 16 have been omitted as outliers.

Total contributions per employee (£) 2012



Source: financial statements as at 31 December 2012

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 2012 was nearly £7,000, whereas the average global contribution was just short of £3,000 per employee.

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Summary of data

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

2012 year end	DB scheme contributions (£m)	DB scheme assets (£m)	Surplus/deficit (£m)	Deficit contributions (£m)	Current service costs (£m)
1	1,450	1,470	-20	55	4
2	450	460	-10	-2	3
3	350	350	0	5	2
4	150	160	-10	0	0
5	190	170	20	1	0
6	960	850	110	24	11
7	120	150	-30	1	0
8	90	130	-40	3	0
9	10	10	0	0	0
10	40	40	0	0	0
11	370	440	-70	8	5
12	70	80	-10	4	0
13	970	940	30	119	7
14	40	50	-10	2	0
15	490	500	-10	4	15
16	130	140	-10	15	4
17	20	20	0	14	0
18	670	590	80	18	2

2011 year end	DB scheme contributions (£m)	DB scheme assets (£m)	Surplus/deficit (£m)	Deficit contributions (£m)	Current service costs (£m)
1	1,390	1,390	0	48	6
2	440	430	10	10	3
3	330	320	10	6	2
4	140	150	-10	2	0
5	190	180	10	1	0
6	880	820	60	5	10
7	110	140	-30	1	0
8	50	60	-10	3	0
9	10	10	0	0	0
10	40	30	10	0	0
11	340	390	-50	8	3
12	60	70	-10	4	0
13	190	220	-30	9	5
14	40	50	-10	2	0
15	450	480	-30	6	15
16	100	120	-20	9	4
17	10	20	-10	1	0
18	610	570	40	15	10

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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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