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French companies with UK defined benefit schemes

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French companies with UK defined benefit schemes

This survey looks at 16 UK defined benefit (DB) pension schemes that are linked to French companies, almost all of which are constituents of the CAC40 index.

It 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 within this survey, they are represented by the same number in each chart throughout.

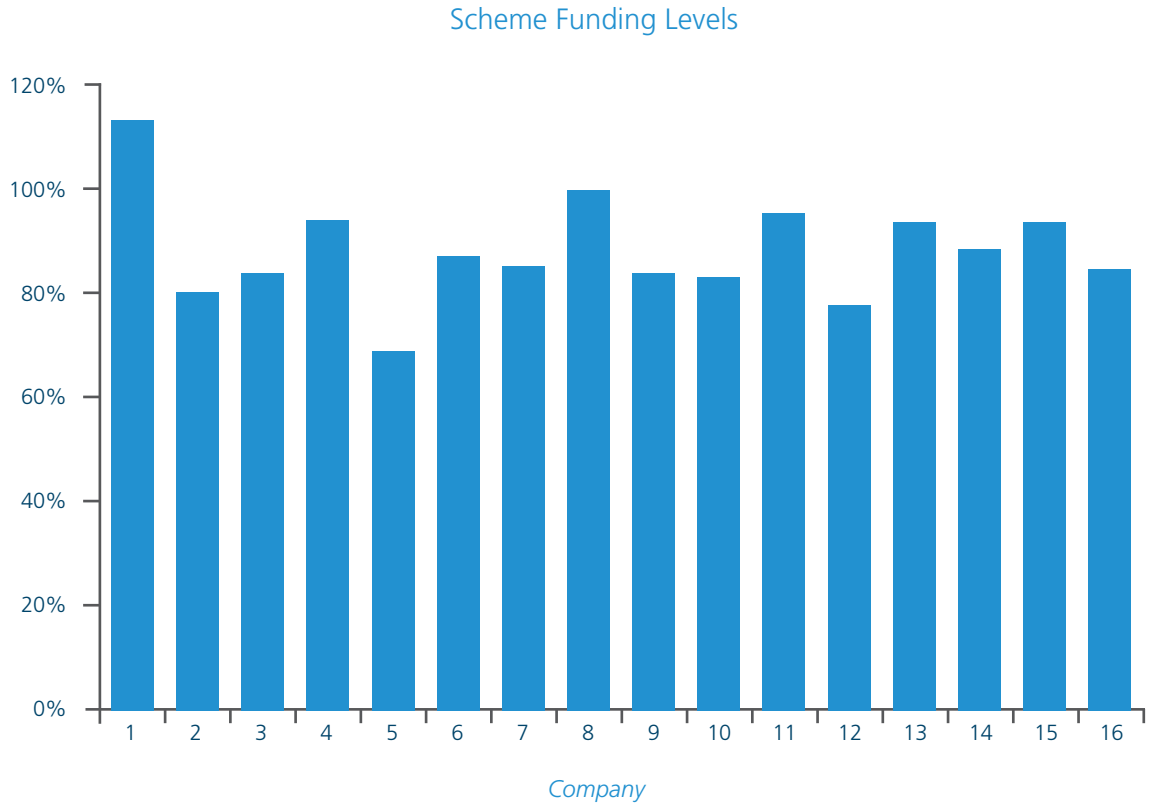
The costs and risks associated with DB pension schemes are well known. In most cases the French parent companies in our survey are leading players in their industries and are able to absorb reasonably substantial pension costs. However, the impact upon performance and return on investments of the UK 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 that some French parent companies are more exposed to the performance of the pension scheme’s equity holdings than they are to the performance of their own UK subsidiary company.

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.

Funding levels

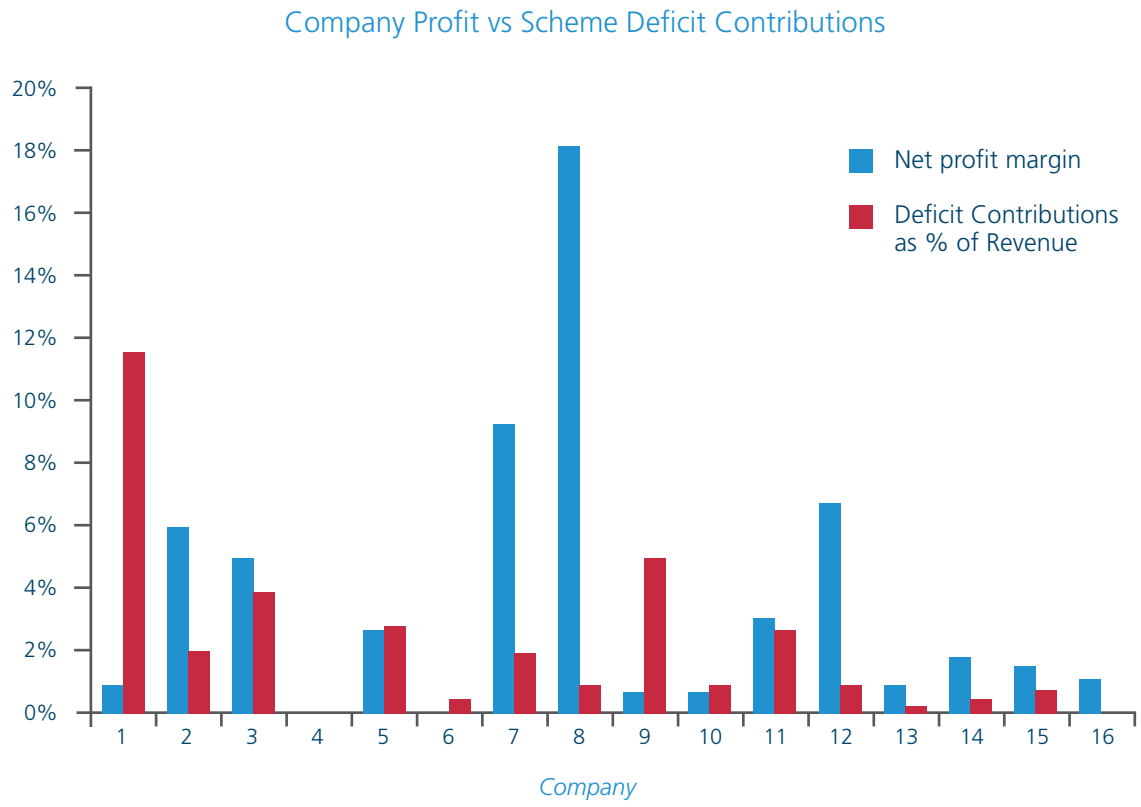
The range of scheme funding levels in our survey is fairly typical of UK DB schemes as a whole. The average funding level is 87%, which is precisely equal to the average funding level within the FTSE350. Six schemes have a funding level above 90%, of which one is actually in surplus. The worst funded scheme has a funding level of around 68%.



The disclosed 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, but should comply with the international accounting standards at the relevant date. The other major influences on scheme funding level are the investment returns achieved and contributions paid.

Pension related cost and impact on financial performance

The following chart shows deficit contributions paid as a percentage of company revenues, alongside companies' net profit margins (losses are shown as zero).

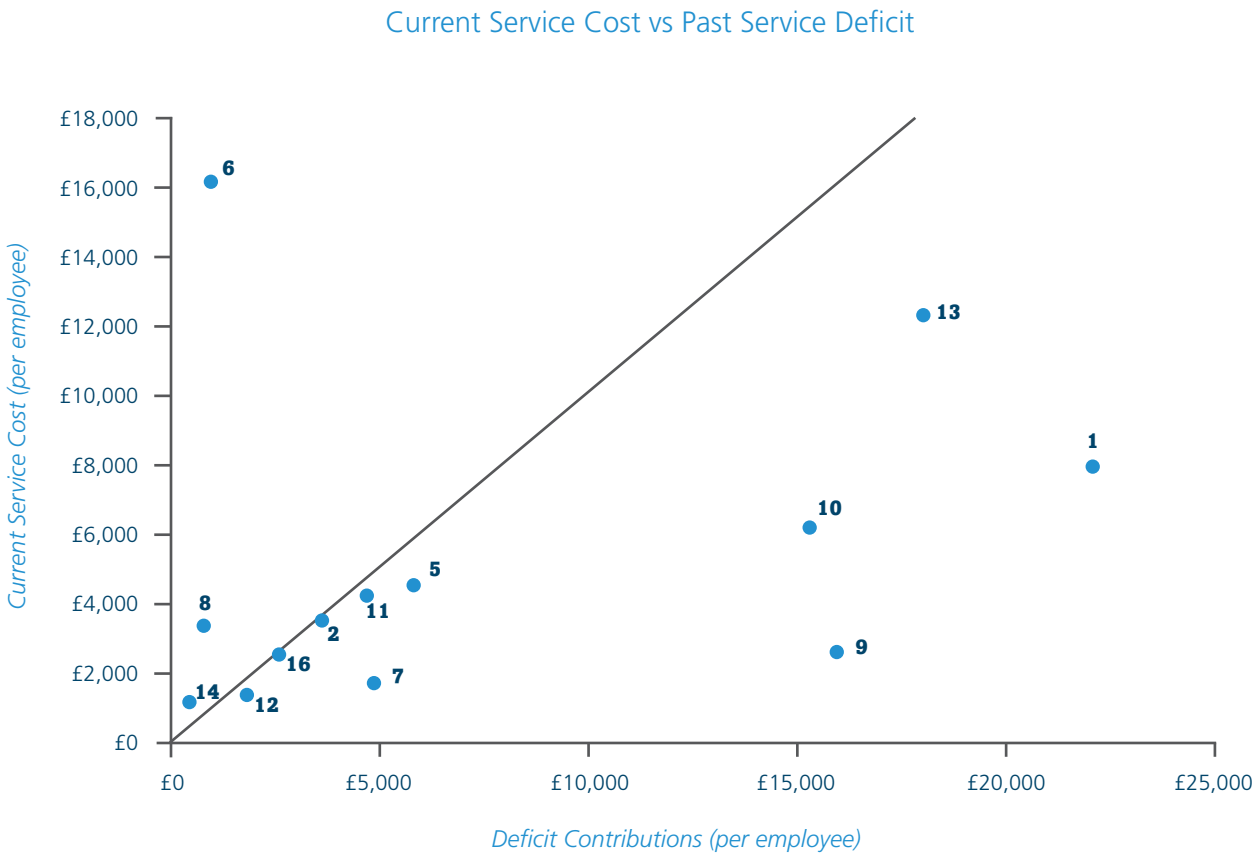


Note: company 4 disclosed a net loss for the year and also paid no deficit contributions

Due to the accounting treatment of pension related costs, contributions in relation to past service deficits are not stated explicitly within the income statement. These contributions often comprise mandatory and voluntary elements. The total DB contributions paid to the 15 schemes where this was reported in the accounts amounted to £527m, of which 69% (around £365m) were attributable to past service deficit. On average, this represents 2.25% of companies' revenues (although excluding the highest value, which might be regarded as an outlier, the average reduces to 1.6%), compared to an average of 1.1% for FTSE350 companies.

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, 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. Most of the companies' contribution rates are sufficient to remove the current deficits within ten years. However, in five cases contributions at the current rate wouldtake well over 10 years to remove the current deficits in full.

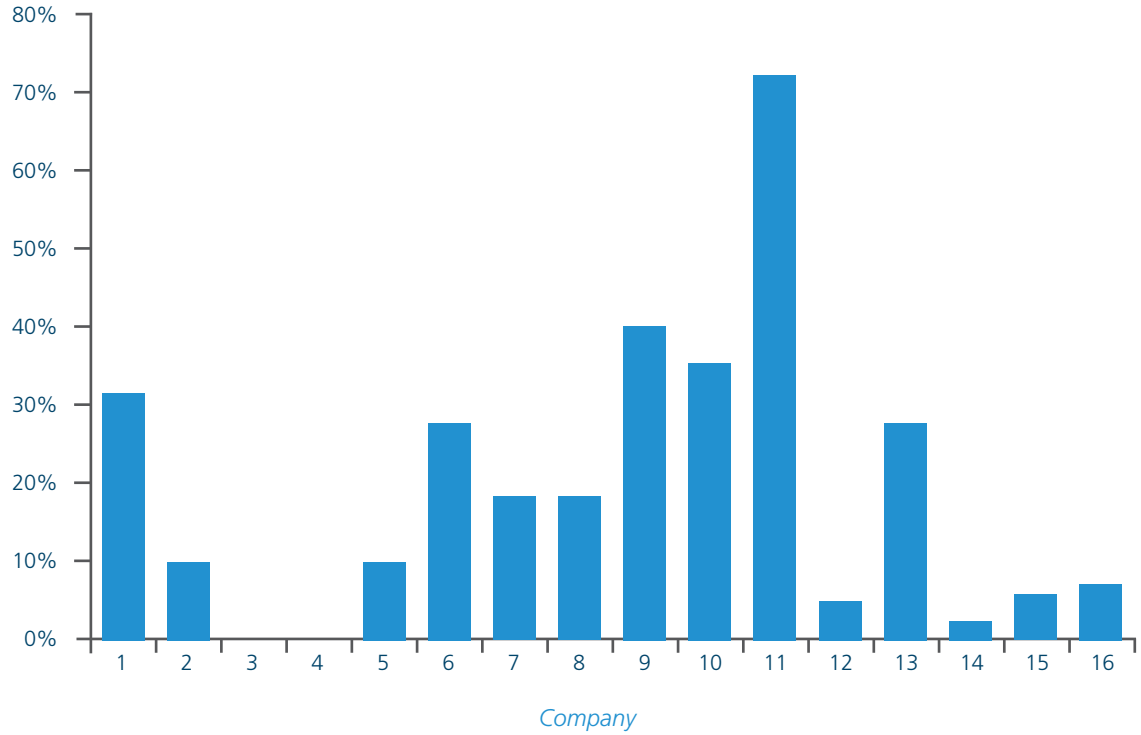
The following graph compares the future service cost of retirement benefits per employee against the annual contribution paid in relation to past service deficit, also on a per employee basis.



For the 14 companies where relevant information was disclosed, the average deficit contribution paid was around £7,100 per employee and the average amount paid in relation to current service benefits was around £5,000 per employee (this includes both DB and defined contribution (DC) arrangements). Both of these figures are higher than for FTSE350 companies, which paid around £3,970 per employee in relation to past service deficits and around £2,600 in relation to current service benefits. It can be seen from the chart that four companies in our survey paid substantially higher deficit contributions per employee than the other companies, which could be regarded as slightly distorting the average

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.

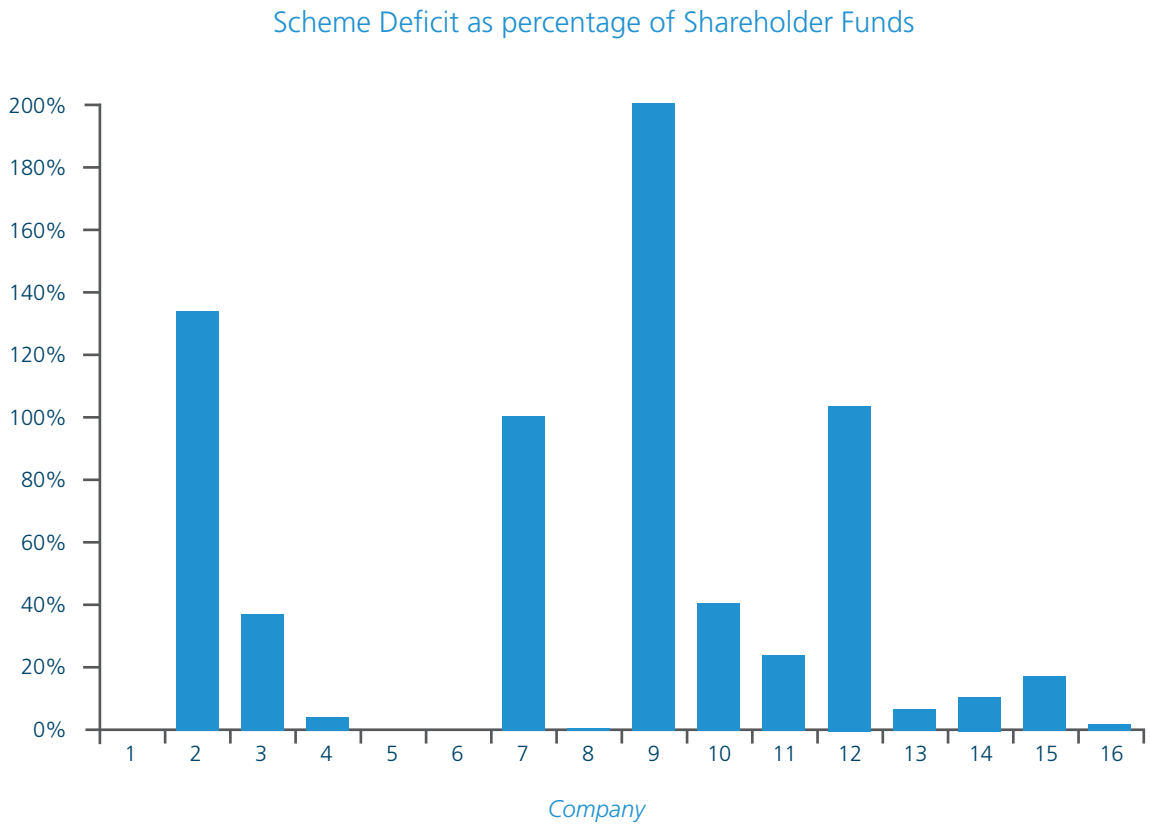
Total Pension Contributions as a percentage of Staff Costs



On average, pension contributions paid to DB schemes only (in relation to both past service deficit and current service) represented 22.6% of the total staff cost reported in the financial statements. However, the figure for individual companies varied greatly, from 2% up to 71%. The average contribution is higher than for FTSE350 companies, where the equivalent figure is 7.7%.

Impact on shareholder funds

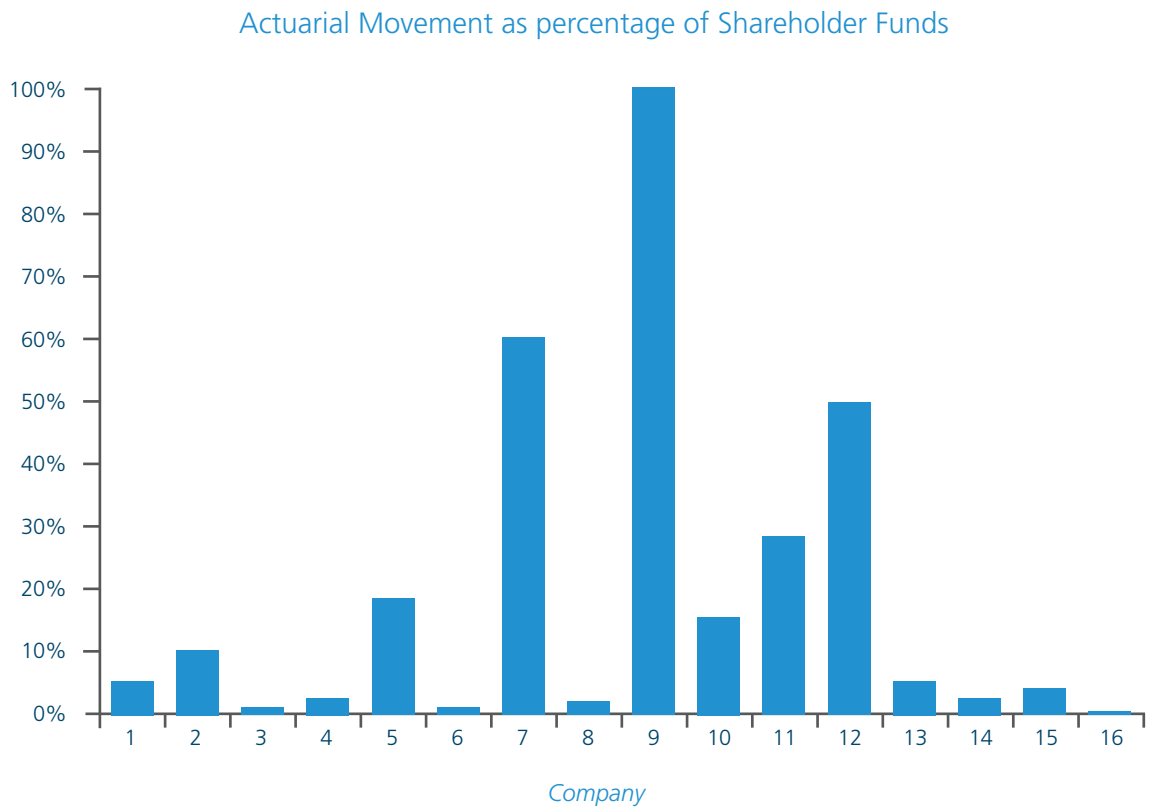
The following chart shows the past service deficit as a percentage of shareholder funds.



Five companies have deficits exceeding 40% of shareholder funds invested in the business. Hence, the return on shareholder funds in these cases will suffer more than a 40% reduction over the period for repayment of the deficit. This significantly affects these companies' ability to transfer funds back to the parent companies. Two companies disclosed a negative value for shareholders' equity and have been excluded from the chart. We have also excluded the company with a scheme in surplus.

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).
On average, scheme deficits amount to just over £35,000 per employee, which is higher than the average annual wage of a full time worker in the UK. It is over twice as high as the average deficit per employee amongst FTSE350 companies, which is about £14,000

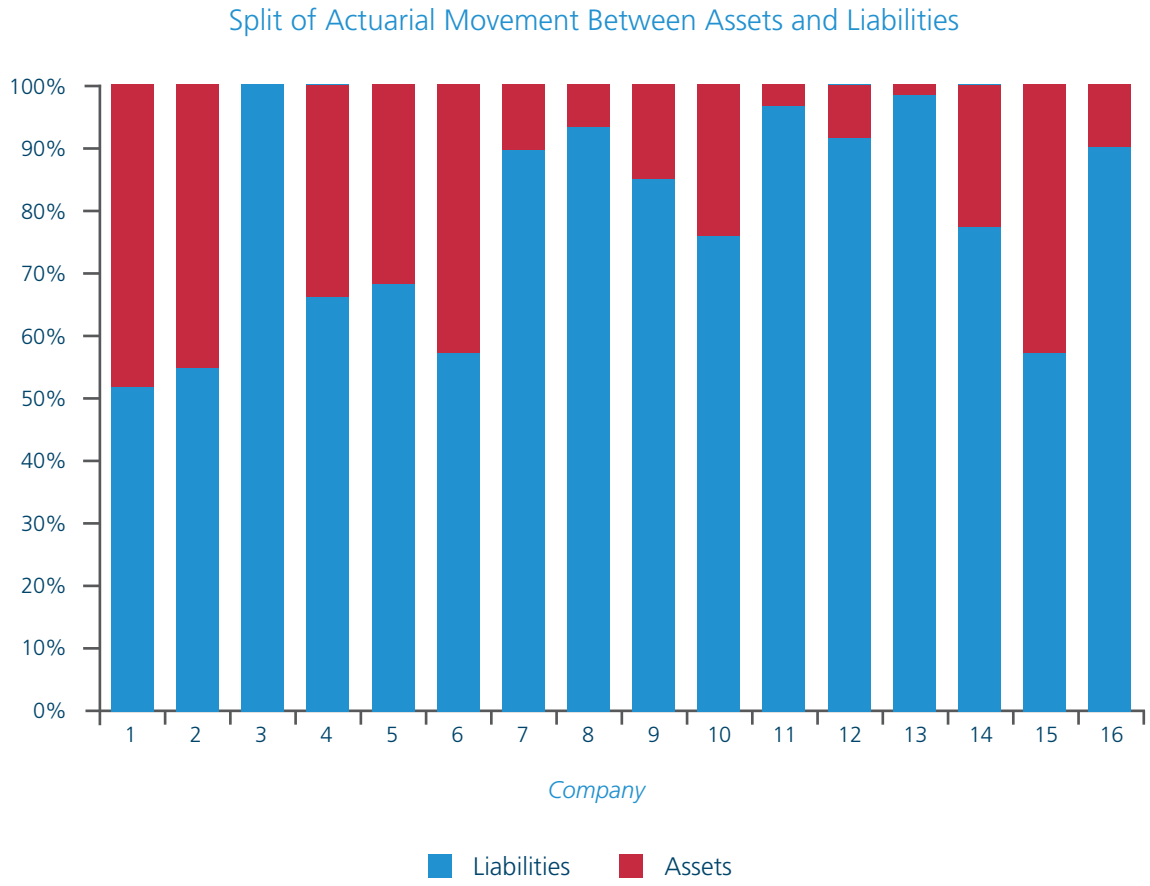
The following chart shows "actuarial movements" as a percentage of shareholder funds. The actuarial movement consists of the impact of changes in assumptions, experience gains/losses on liabilities, and experience gains/losses on assets.



For around half of the companies, the actuarial movement is between 0% and 10% of shareholder funds. However, in three cases it is over 40%. These are highly significant movements in relation to the parent companies' holdings in their UK subsidiaries. Given the volatile nature of actuarial assumptions and investment returns, such movements are likely to reoccur on a regular basis.

The aggregate investment return generated by the 16 schemes' assets was £850m, compared against aggregate actuarial losses on liabilities of £814m and aggregate interest on liabilities of £615m. Together these amount to a worsening of the aggregate deficit of £580m. This was only partially offset by the deficit contributions of £365m paid during the year. The aggregate pension deficit across the 16 companies' most recently published accounts stands at £2.6bn.

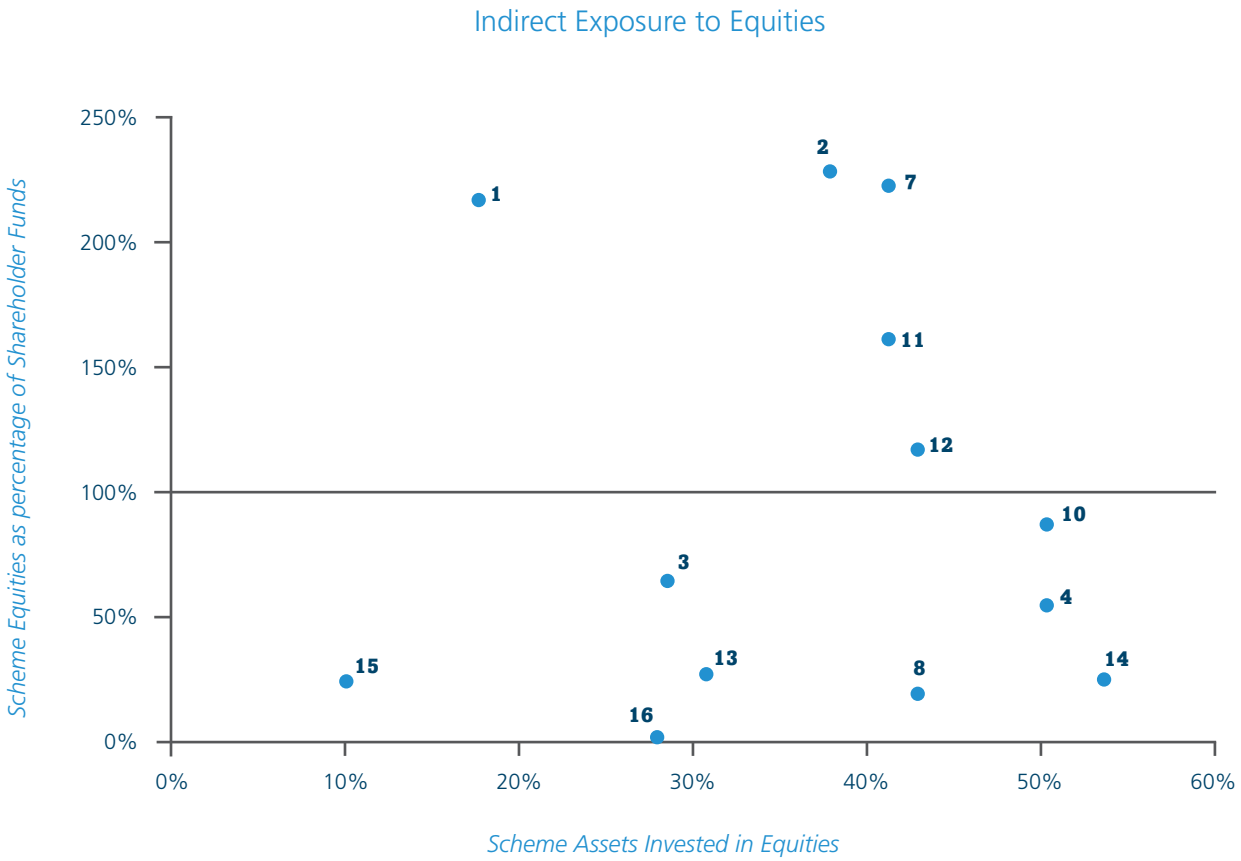
The following chart shows the split of actuarial movements between liabilities (including both experience gains/losses and changes in assumptions) and assets in each case.



The chart shows that in all cases, actuarial movements on the liabilities were more significant than those on the assets. Although the experience gains/losses on liabilities are not generally disclosed separately from the impact of changes in assumptions, it is likely that the majority of the impact seen is in relation 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).



The risk associated with investment in equities via the pension scheme is very significant in some cases. For example, in five cases the schemes' equity allocations are below 50% and yet this represents above 100% of the parent company's stake (measured by the value of shareholder funds) in the UK based subsidiary. In the most extreme case, the indirect equity exposure is more than ten times the value of the parent company's shareholding. These French parent companies are more exposed to the performance of the scheme's equity holdings than they are 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.

Summary of data

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

Company	DB Scheme Assets (£m)	DB Scheme Liabilities (£m)	Surplus/ (Deficit) (£m)	Deficit Contributions (£m)	Current Service Cost (£m)	UK Subsidiary Company Revenue (£m)
1	475	418	57	31	11	271
2	1,724	2,106	(382)	20	20	1,049
3	3,282	3,844	(562)	90	25	2,392
4	50	52	(2)	0	2	51
5	1,327	1,948	(621)	47	36	1,649
6	413	467	(54)	2	37	611
7	266	316	(50)	15	5	792
8	1,424	1,443	(19)	3	12	348
9	1,192	1,470	(278)	44	9	896
10	81	101	(20)	8	3	957
11	1,526	1,614	(88)	19	16	727
12	238	330	(92)	5	4	587
13	2,123	2,275	(152)	36	25	24,180
14	376	458	(82)	7	14	1,311
15	225	240	(15)	9	9	1,107
16	793	1,010	(217)	30	28	127,102

Contact information

If you would like to discuss any of the matters raised in this survey then please contact Malcolm Rochowski FIA, who is a corporate actuary based in our London office, on +44 (0)20 7776 2200.

Alternatively, you can email us at corporateconsulting@barnett-waddingham.co.uk

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