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RESEARCH

German companies with UK defined benefit schemes

April 2014

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The average funding level of these schemes is a substantial 11% better than the FTSE350 average

This survey relates to constituent companies of the German DAX30 share index that have UK subsidiary companies with defined benefit (DB) pension schemes. The survey covers 19 companies with around £22bn of UK pension liabilities between them.

The survey 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. 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.

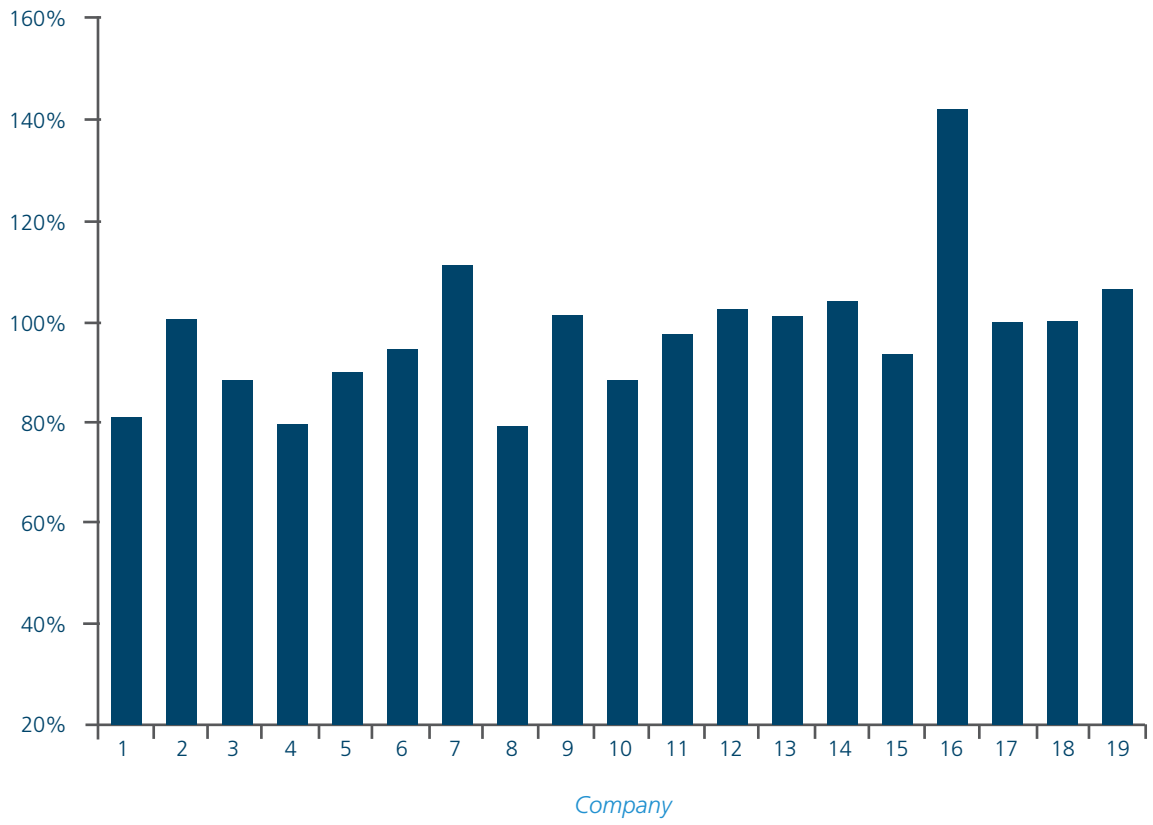
There are also some surprising results, for example that although the average funding level of these schemes is a substantial 11% better than the FTSE350 average, the total contributions paid last year (for past service deficit and current service) represented 13% of total staff costs, versus a corresponding figure of just 7.7% for the FTSE350.

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 level on the company accounting basis

The funding levels of these companies' schemes are generally better than seen across UK DB schemes as a whole. The average funding level is 98%, which is a full 11% higher than the average funding level of FTSE350 companies' DB schemes at the same date of 87%. There were nine companies with funding surpluses, which are a rare sight within the FTSE350. Even the worst funded scheme had a funding level of around 79%.

Scheme funding levels

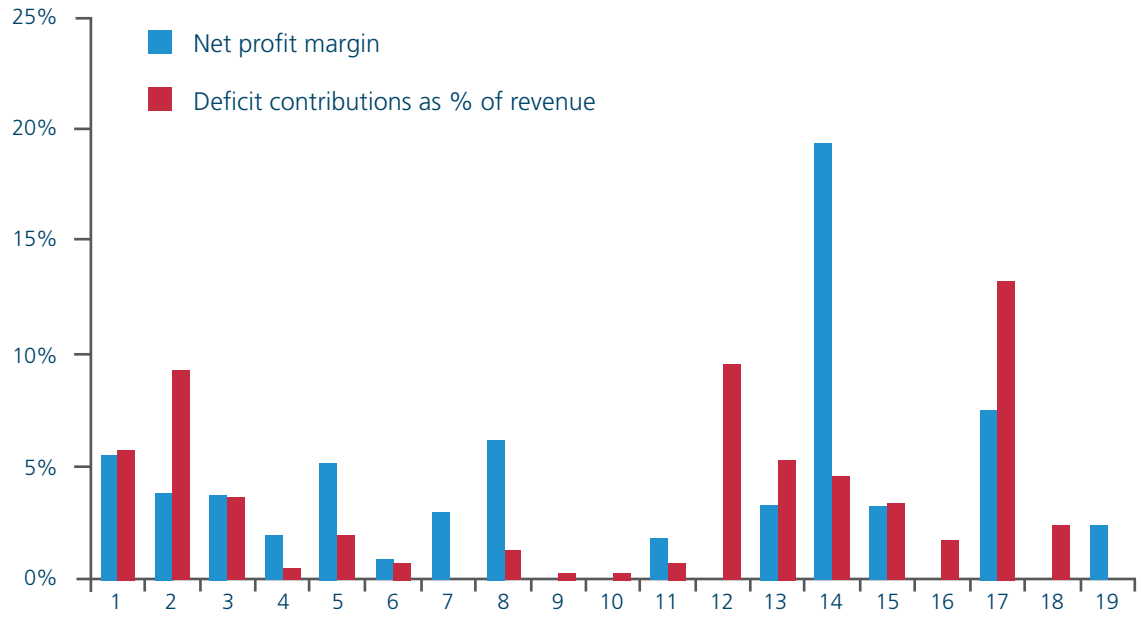


The disclosed funding level of course depends on the actuarial assumptions used to calculate scheme liabilities. The strength of assumptions adopted will vary from one employer to another, but should comply with the international accounting standards at the relevant date. The other major influences on 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, against companies' net profit (losses are shown as zero).

Company profit vs scheme deficit contributions



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.

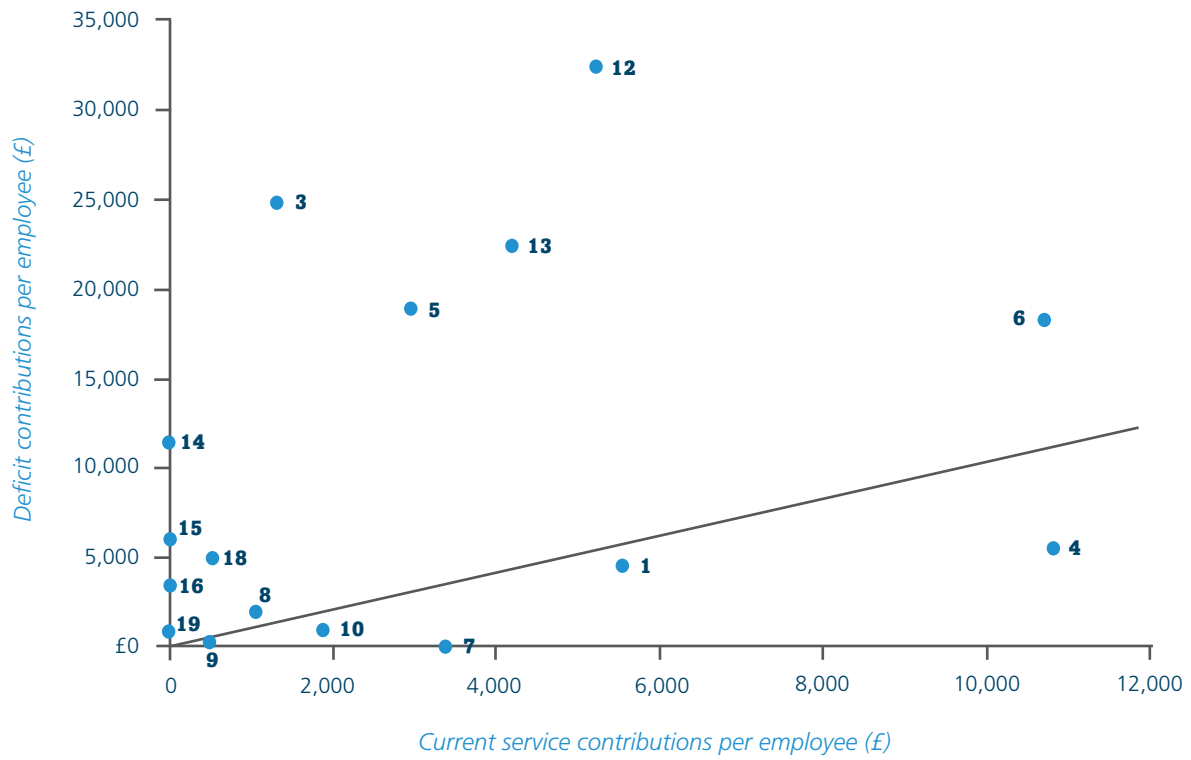
The aggregate contribution paid into these DB schemes in 2012 was approximately £650m. Contributions relating to past service deficits amounted to £539m, which represents 1.7% of total revenues. This is just slightly higher than the 1.1% of total revenue contributed by FTSE350 companies on average for 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, 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 5 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 contribution paid in relation to past service deficit, also on a per employee basis.

Current service cost vs past service cost

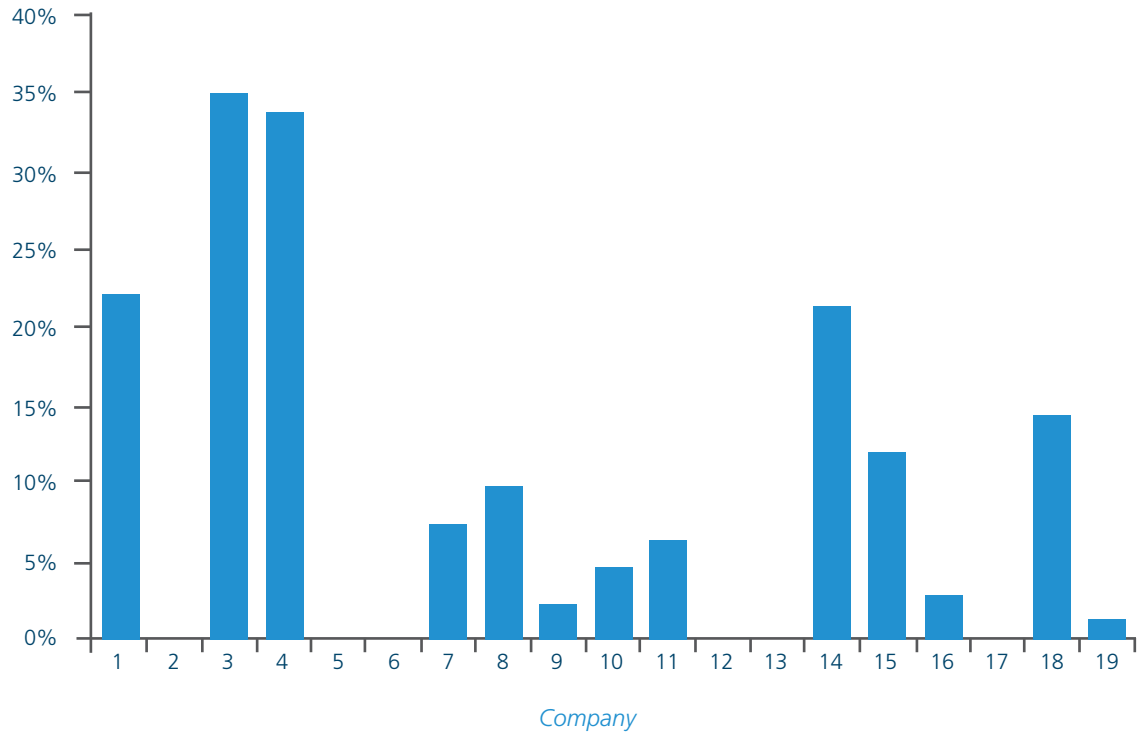


The average deficit contribution paid per employee was around £9,800 and the average amount paid in relation to current service benefits was around £3,000 (this includes both DB and defined contribution (DC) arrangements). The average deficit contribution per employee is materially higher than for FTSE350 companies, which paid around £3,970 per employee in relation to past service deficits.

In many cases, companies paid higher contributions towards past service deficits than towards current service benefits (those above the 45-degree line). However, in at least four cases, information about current service benefits is incomplete meaning that the current service cost is understated.

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.

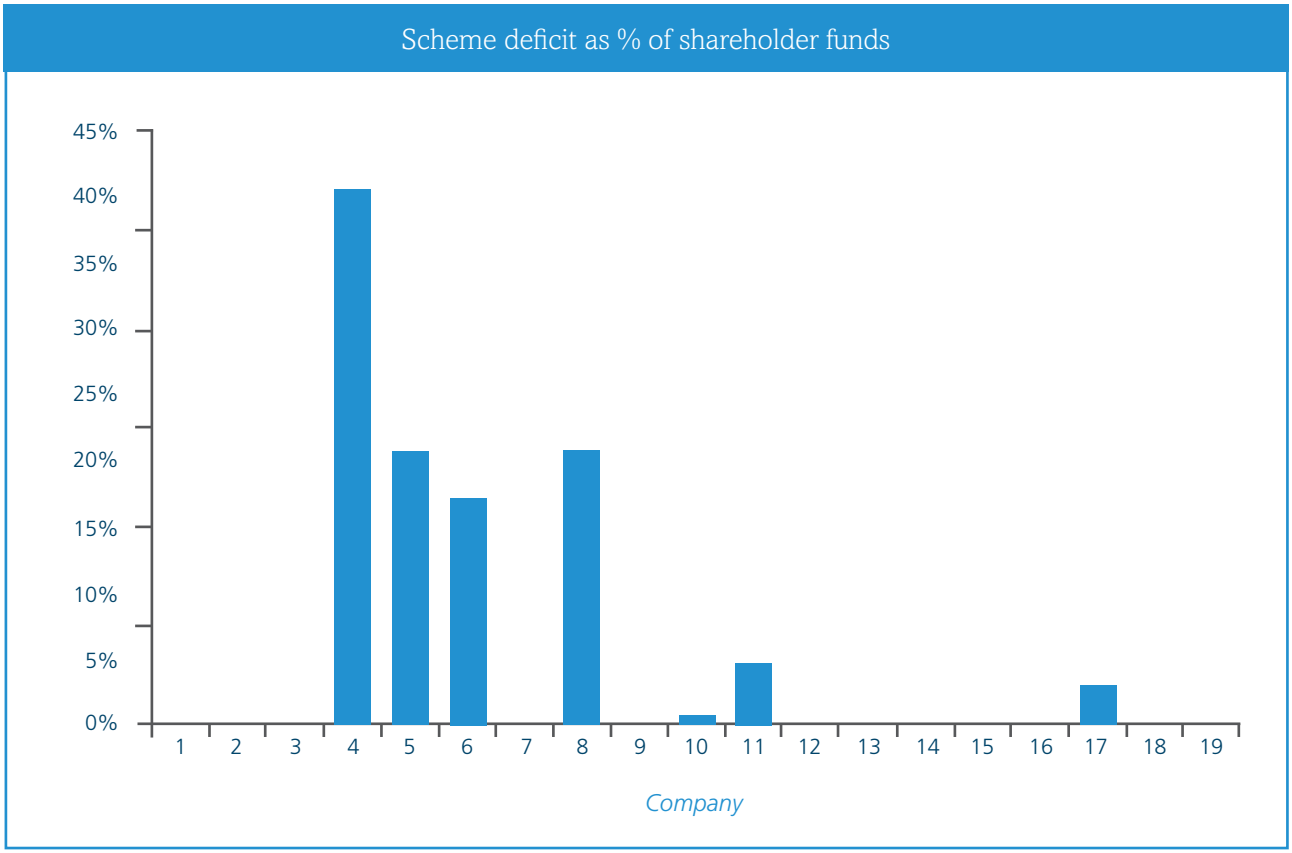
Total DB contributions as % of staff costs



On average, total contributions paid into DB schemes (i.e. both for past service deficit and current service) represented 13% of total staff costs reported in the financial statements. This is significantly higher than for FTSE350 companies, where the corresponding figure is 7.7%. It can be seen that this figures varies considerably between the companies, ranging from just a few percent up to about 35%.

Impact on shareholder funds

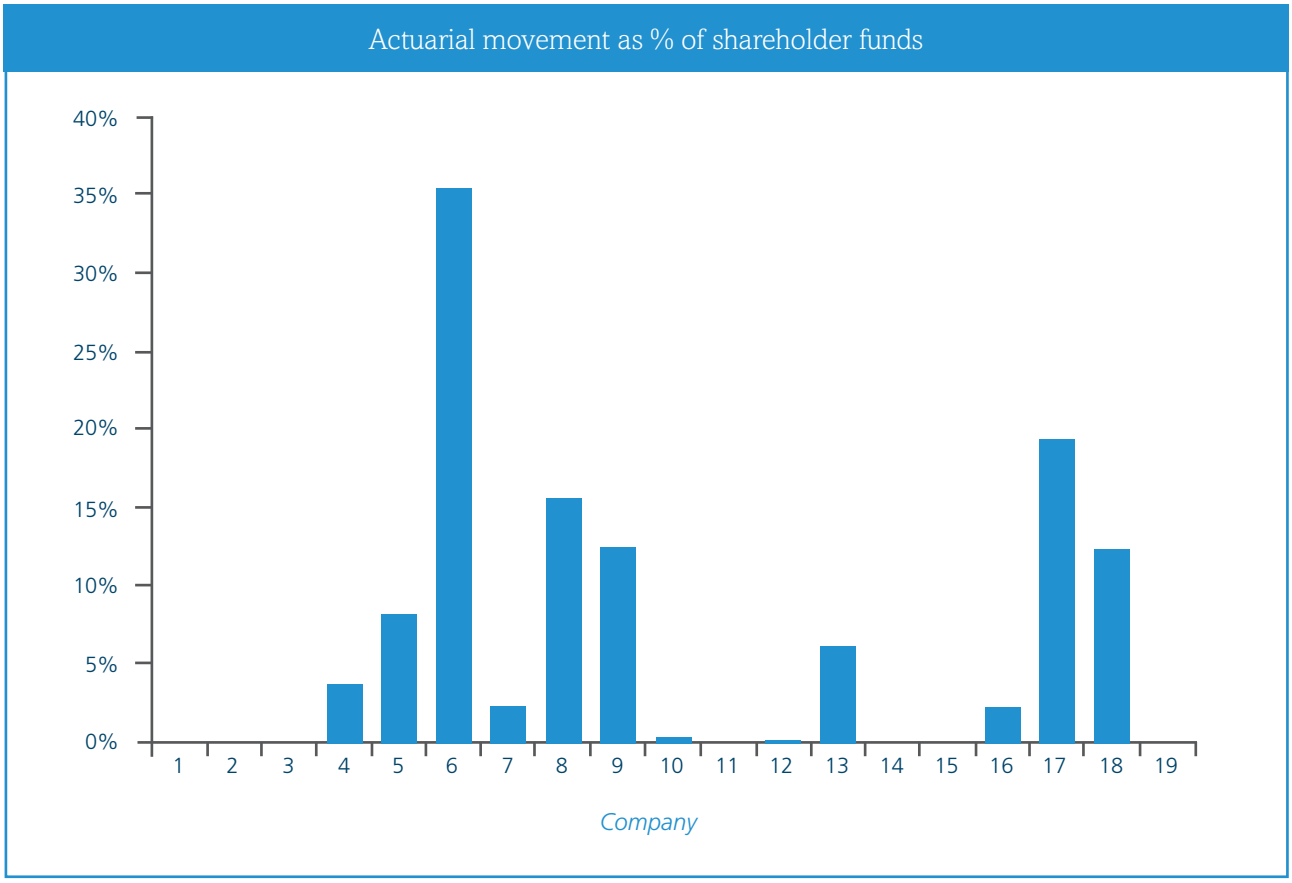
The following chart shows past service deficits as a percentage of shareholder funds, excluding some results that have been deemed outliers (companies number 1, 3, and 15) as well as those cases with no scheme funding deficit (companies number 2, 7, 9, 12, 13, 14, 16, 18, and 19).



For the remaining cases, scheme deficits amount to 13% 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).

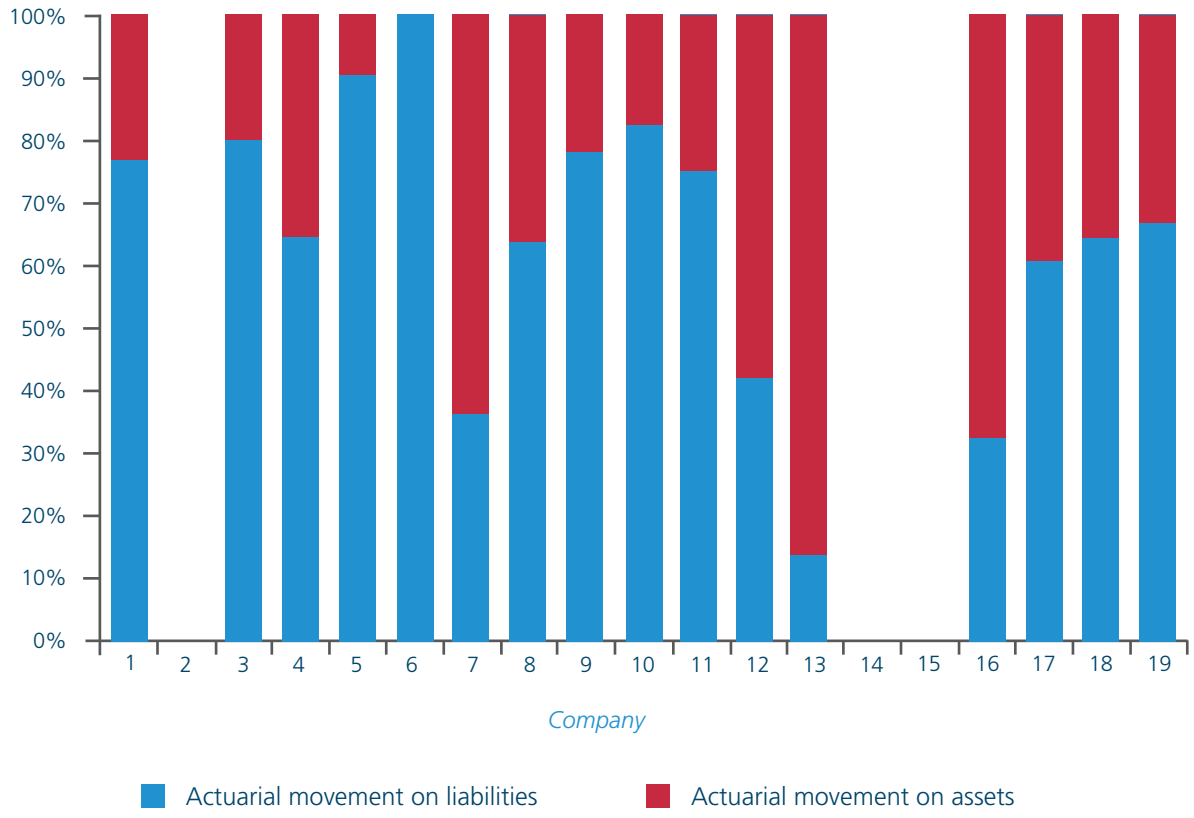
The following chart shows 'actuarial movements' as a percentage of shareholder funds. The actuarial movement consists of the impact of changes in assumptions, experience gains/losses on liabilities, and experience gains/losses on assets.



Companies number 1 and 3 have been excluded as outliers, whilst companies number 22, 10, 11, 12, 14, 15, and 19 have results of approximately zero, and so do not appear on the chart. The average actuarial movement was about 7% of shareholder funds. Movements at this level are fairly manageable, but in the case of company number 6 where the movement is over 35% 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.

Split of actuarial movement between assets and liabilities

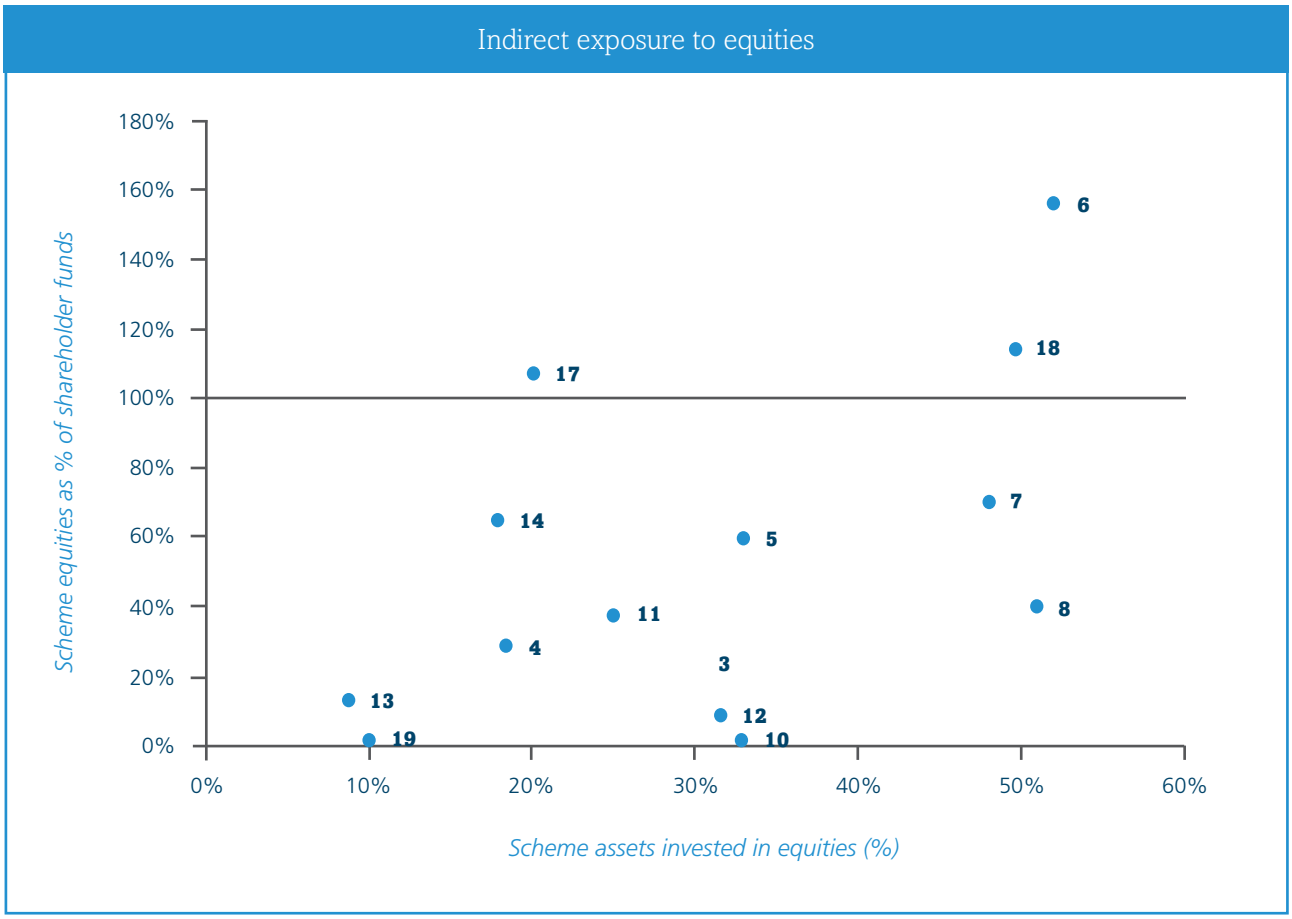


The chart shows that in 12 cases, actuarial movements on the liabilities were more significant than those on the assets.

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).



The risk associated with investment in equities via the pension scheme is very significant in some cases. For example, in the case of company number 6, the scheme's equity allocation is approximately 50% and yet this represents 160% 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.

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 revenue (£m)
1	740	910	-170	20	24	347
2	480	480	0	6	0	64
3	1,030	1,170	-140	26	1	719
4	4,700	5,920	-1,220	30	58	6,915
5	30	40	-10	3	0	164
6	90	90	0	3	2	403
7	340	310	30	0	8	4,785
8	20	20	0	1	1	92
9	90	90	0	0	0	139
10	290	320	-30	7	8	3,774
11	3,840	3,960	-120	14	0	2,347
12	1,850	1,810	40	22	4	231
13	240	230	10	15	3	292
14	2,650	2,550	100	34	0	761
15	230	250	-20	1	0	30
16	140	100	40	1	0	91
17	3,230	3,250	-20	350	1	2,665
18	80	80	0	5	0	208
19	180	170	10	1	0	7,178

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:

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