LCP INSIGHT CLARITY ADVICE

New beginnings?

Uncertainty, volatility, and vast changes on the horizon – pensions for FTSE100s enter uncharted territory

LCP Accounting for Pensions
May 2020

Helping corporate sponsors

Welcome to LCP's 27th annual report analysing the pension disclosures for FTSE 100 companies.

Our annual Accounting for Pensions report presents a concise analysis of the pensions facts, figures and trends revealed by FTSE100 companies reporting in 2019, including pension provision for executives. It will help anyone involved in reading or preparing accounts to understand and benchmark these pensions arrangements.

Importantly, in the current climate of uncertainty, this report also focuses on what the future may hold. We look at the impact of recent market volatility on corporate balance sheets, reveal what the Covid-19 pandemic may mean for future assumptions, and set out what future regulatory changes may mean for you.

> *2019 was an eventful year in pensions, but this has been eclipsed by the start of 2020 and the disruption inflicted by Covid-19. As the dust begins to settle, companies must consider how to adjust their pensions objectives for a new beginning and to reflect the "new normal".*

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At a glance

2019: trends and consensus emerging

60% of FTSE100 pension schemes were in surplus on an IAS19 basis at their 2019 accounting date.

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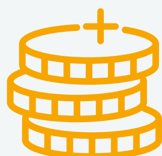
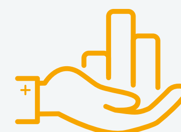


In 2019 we still saw diverse practice across FTSE100 companies on life expectancy assumptions, but our research suggests that some market consensus was emerging on the core parts of how life expectancies are projected to improve.



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Over 2019, the average pension contribution for FTSE100 CEOs **fell from 25% to 20%** of basic salary, and the ratio of CEO to average staff contributions fell from four times to three times.

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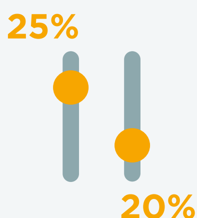

Companies are starting to adopt revised inflation assumptions in light of proposed RPI reform with observed changes in both the inflation risk premium and assumed gap between RPI and CPI inflation.

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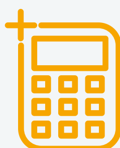
FTSE100 companies with DB pension schemes with an IAS19 deficit paid out **£30bn of dividends** in 2019. For these companies, this compares to £5bn of contributions and a combined IAS19 deficit of around £20bn.



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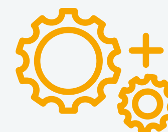
Companies continue to de-risk and make use of contingent assets or contingent contribution mechanisms to secure their pension schemes.



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2020: chaos and unpredictability

At 31 March 2020, in the midst of the Covid-19 crisis, the combined FTSE100 IAS19 position was the best it has been for 20 years. This followed a rise of **1.5% pa in discount rates** over just eight days in March 2020. **Around 70%** of FTSE100 pension schemes were projected to have an IAS19 surplus at this date.

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2020 has seen the highest number of UK deaths to 30 April for a decade, but it is still too soon to predict what the impact will be on both pension schemes and the IAS19 assumptions that companies make about future trends in life expectancies.

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However, 30 April 2020 was an all-time record low for IAS19 month-end discount rates with **less than 60%** of FTSE100 pension schemes projected to be in surplus by then.

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There have been delays in important consultations on pensions reform – in conjunction with planned legislative changes, these could have a major impact and represent the **biggest overhaul** of pension scheme governance for **at least 25 years**.

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Section 1: 2019 IAS19 benchmarking

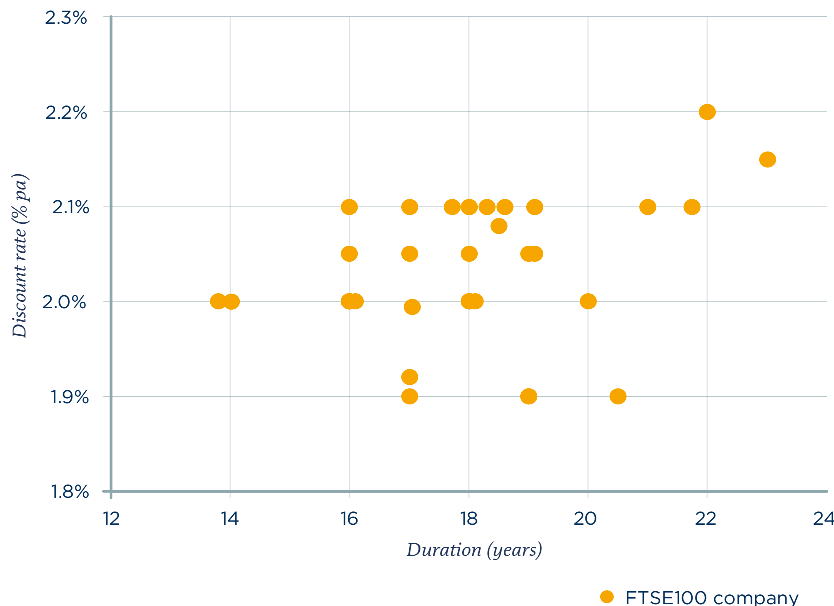
There have been unprecedented levels of volatility in 2020 with markets, IAS19 assumptions and asset values all seeing record movements over very short periods of time. These changes have caused significant shifts in accounting positions, and company pension balance sheets will be very dependent on the exact timing of their accounting date.

Companies reporting in 2019 took a wide variety of approaches to setting their IAS19 accounting assumptions. The differences in approaches used have a material impact on the IAS19 pension scheme liabilities (potentially the overall corporate balance sheet too) and will have been amplified in the subsequent market volatility.

Discount rate

The chart below shows the disclosed FTSE100 IAS19 discount rates as at 31 December 2019, with the majority of companies adopting an assumption of between 2.0% pa and 2.1% pa. The fall in discount rate from 31 December 2018, where discount rates were around 2.8% pa, will, in isolation, have caused a c15% increase in IAS19 liabilities for companies, corresponding to more than a £70bn increase for FTSE100 companies alone.

Disclosed IAS19 UK discount rates as at 31 December 2019



Falls in IAS19 discount rates over 2019 will have led to large increases in IAS19 liabilities for companies, and more than a £70bn rise for the FTSE100.

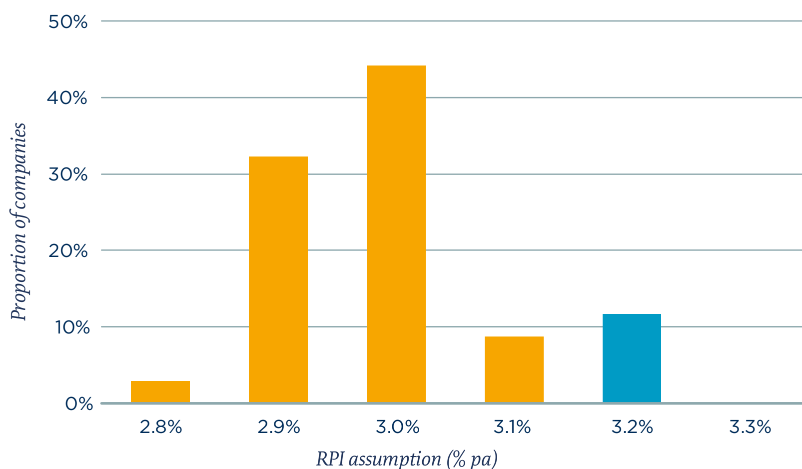
Inflation

Companies typically set their assumptions for future RPI inflation by comparing the market yields available on RPI linked government bonds with fixed interest government bonds (this is the "breakeven inflation" rate). Common market practice is to deduct an "inflation risk premium" to reflect the additional yield on fixed interest bonds that investors require given they are subject to inflation risks. CPI inflation is then typically derived by taking a deduction from the RPI assumption to reflect structural differences between the two inflation measures – the so called "RPI-CPI gap".

The UK Statistics Authority announced in September 2019 that they intend to reform RPI so that it essentially becomes CPIH (a variant of CPI) from 2030 at the latest. This change should not be subject to political uncertainty – it should happen. We provided more information on these proposed reforms on page 15 of our autumn corporate report.

The chart below shows disclosed long-term RPI inflation assumptions for companies reporting at 31 December 2019. The breakeven inflation assumption at this date was 3.2% pa (blue bar in the chart below). The majority of companies then deducted an implied inflation risk premium of between 0.2% pa and 0.3% pa – corresponding to RPI assumptions of 3.0% pa and 2.9% pa respectively. This premium is a marginal increase on previous years, where the average deduction was 0.2% pa. This change could be as a result of the increased uncertainty in the market and the perception that perhaps investors require additional returns if they were to hold inflationary risks in the current climate.

Disclosed IAS19 UK RPI inflation assumptions as at 31 December 2019



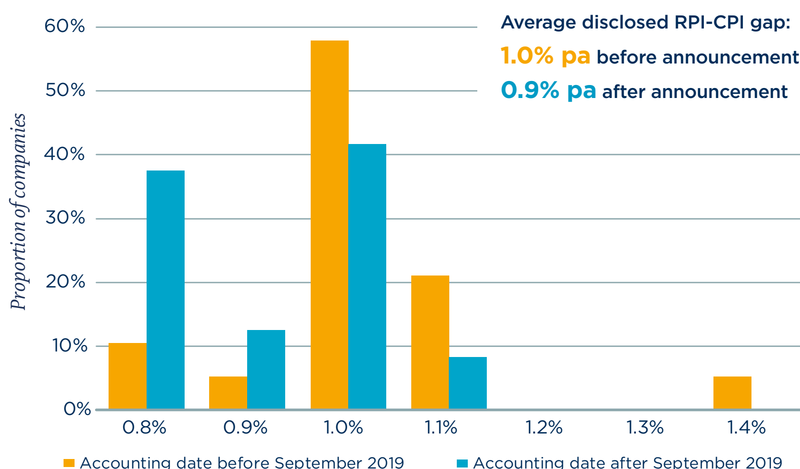
We saw a small rise in the implied inflation risk premium, perhaps as a result of the uncertainty around RPI reform.

The average RPI-CPI gap fell following the September 2019 announcement.

Prior to the September 2019 announcement, common and well-established market practice was to allow for an RPI-CPI gap of either 1.0% pa or 1.1% pa. The proposed inflation reforms would mean that the RPI-CPI gap will be close to zero from 2030 at the latest, leading to an expected reduction in the overall average RPI-CPI gap.

The next chart shows the range of assumptions for the RPI-CPI gap for companies reporting in their 2019 year-end accounts. We have split companies based on whether their accounting date was before the September announcement (orange bars) or after it (blue bars). The average RPI-CPI gap had been broadly constant for some time prior to the announcement, at 1.0% pa, but fell to 0.9% pa after the announcement suggesting not all companies were making full allowance for the proposed changes in RPI.

The average RPI-CPI gap fell following the September 2019 announcement



40% of companies assumed a gap of 0.8% pa after the announcement, compared to just 10% of companies before.

Life expectancy

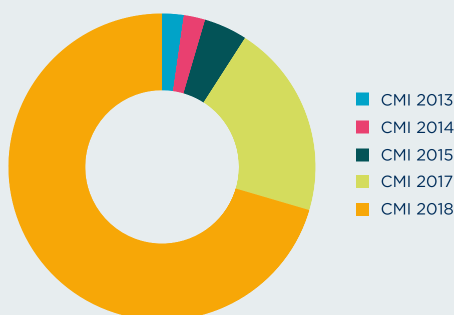
As we reported 12 months ago in our 2019 Accounting for Pensions report, there are now at least five different parameters to set when determining the assumptions to use for future life expectancy – resulting in more than £50bn of judgement and subjectivity within the FTSE100 accounts.

The level of information disclosed varies significantly between companies – with some disclosing just life expectancies and others providing full detail of all the various component parts of the assumption. The charts below show the information disclosed within accounts published in 2019 where information on the underlying component assumptions are provided.

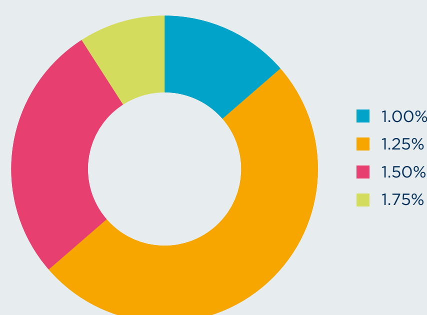
They show that:

- Most of these companies use the latest available projection tables (this approach is unchanged from recent years);
- Most of these companies use the default or "core" parameters (smoothing parameter of 7; and a nil initial adjustment parameter) within these projections; and
- Most of these companies adopt a long term annual assumed rate of improvement of 1.25%.

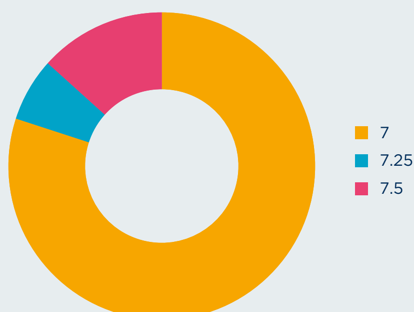
Disclosed projection tables by FTSE100 companies reporting in 2019 (45 companies)



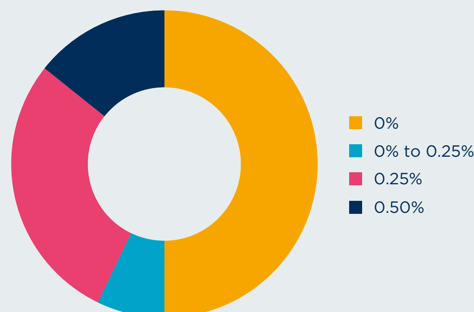
Long term mortality improvement rates disclosed by FTSE100 companies reporting in 2019 (45 companies)



Smoothing parameters disclosed by FTSE100 companies reporting in 2019 (15 companies)



Initial adjustment parameter disclosed by FTSE100 companies reporting in 2019 (14 companies)



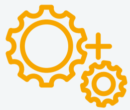
For the last three years, each new set of CMI projection tables has resulted in lower future life expectancies and therefore lower pension liabilities. A new projection table (the CMI 2019 projections) was released in March 2020. These tables generally predict slightly longer life expectancies than the previous tables. Given the current Covid-19 related uncertainties around future life expectancy trends, it remains to be seen whether this trend of adopting the latest projections continues at the 2020 year-end.

Section 2:
Developments since the 2019 year end and Covid-19

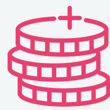
The Covid-19 pandemic has presented new, unexpected, and unprecedented challenges. Terms such as "lockdown" and "furlough" have now become commonplace, and companies have rightly changed their focus. The pandemic has caused and continues to cause a huge strain on people and on businesses.

From a pensions perspective, the pandemic and associated market volatility has caused huge movements in balance sheets, created even more uncertainty over future assumptions, and has also contributed to delays in key pieces of guidance and regulations.

We have set out an action plan for companies to help sponsors manage the impact and prioritise what needs to be done in relation to their pensions arrangements, and have also set up an insight hub to support companies with the pensions-related issues that accompany Covid-19.

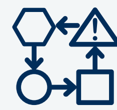


Ensuring business continuity



Quantifying financial impact

Take investment opportunities

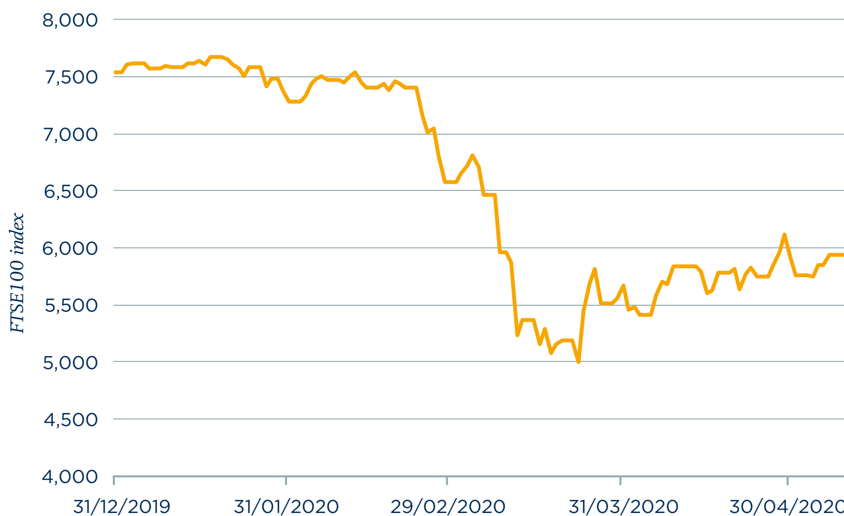


Help employees understand impacts

Market volatility

Since the beginning of the year, and as widely reported in the media, asset markets have been incredibly volatile with large falls in asset values. We saw the fastest bear market in history with over 20% being wiped off the value of the FTSE100 within a month (around twice as fast as for the 2008 financial crisis). Since the lowest trough, the index has picked up as shown in the chart below, but it is still sitting around 20% lower than the position at the start of the calendar year.

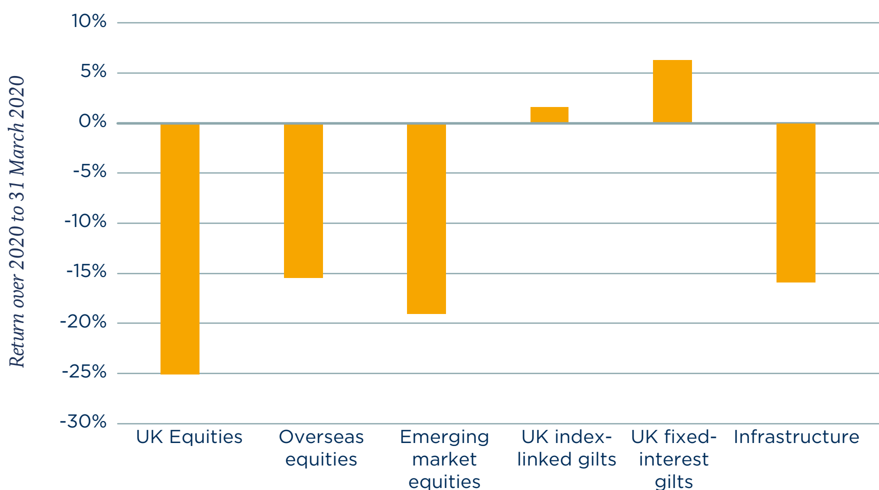
FTSE100 index over 2020 to date



Developments since the 2019 year end and Covid-19
continued

Over this period, pension scheme assets – almost across the board – saw large drops in value. Some of the returns on key asset classes used by pension schemes are shown in the chart below. The exception to the fall was government backed assets as investor demand for "safe" assets increased leading to an increase in value and fall in available yields.

Return on common pension scheme asset classes over 2020 up to 31 March 2020



The impact for individual pension schemes will be very dependent on where the assets are invested. There were large falls in assets for those schemes that were heavily invested in equities; whilst those schemes that already have low-risk strategies and higher levels of hedging are likely to be less impacted by the changes. On the whole, as the combined FTSE100 asset holding has less than 20% of its pension assets in equities and more than 60% in bonds, the overall impact on assets will be significantly more muted than the impact on the FTSE100 index itself.

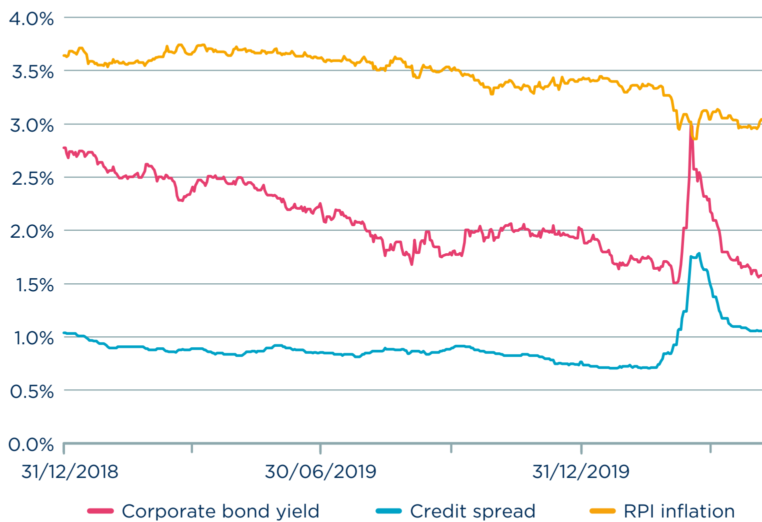
The key IAS19 accounting assumption is the discount rate and this too has seen unprecedented market movements since the start of 2020. Over eight days in March 2020, IAS19 discount rates increased by around 1.5% pa which, all else equal, corresponds to a c30% or £150bn drop in FTSE100 pension liabilities. This increase was driven by rising credit spreads (the difference between corporate and government bond yields) which, as shown in the chart below, spiked at c1.8% pa in mid-March.

Over eight days in March 2020, IAS19 discount rates increased by around 1.5% pa which, all else equal, reduced FTSE100 pension liabilities by £150bn.

Increasing credit spreads lead to higher IAS19 discount rates and lower liabilities. Some of this movement will be hedged by asset movements, through the use of gilts or liability driven investments ("LDI"). However, companies typically do not hedge movements in credit spreads, so the fall in liability values will not have been fully matched by a corresponding fall in asset values. Therefore, a large rise in credit spreads, will largely be good news for IAS19 balance sheet positions.

The change in corporate bond yields (pink line) and credit spreads (blue line) are illustrated in the chart below.

Movement in RPI breakeven inflation, corporate bond yields and credit spreads since 31 December 2018



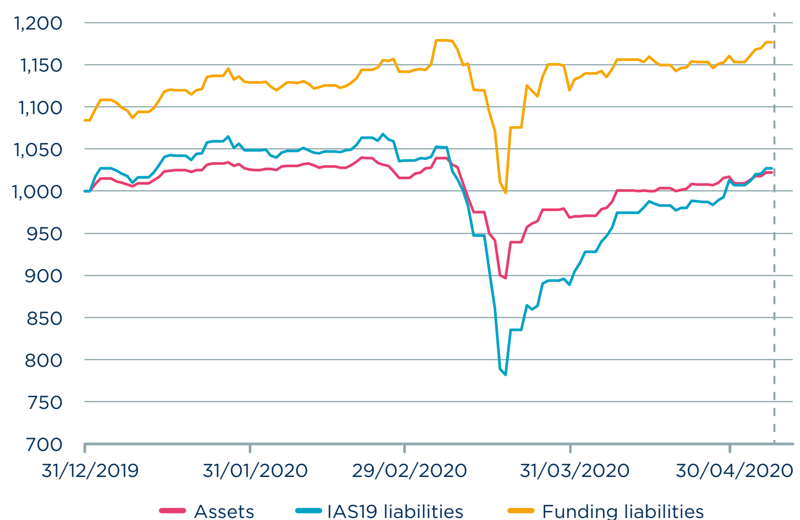
Source: ICE GBP AA Corporates 15+ yield and credit spread; Bank of England 20 year RPI breakeven inflation spot rate

> *Credit spreads spiked at c1.8% in mid-March, causing a very significant rise in IAS19 discount rates. Inflation expectations fell.*

The rise in credit spreads will, when combined with falls in long-term inflation expectations (orange line in the chart above), have more than offset the fall in asset values for the majority of schemes leading to an improvement in balance sheet position over the first three months of 2020.

For a £1bn sample scheme invested broadly in line with a typical FTSE100 pension scheme, the chart opposite shows the daily movement in IAS19 liabilities and approximate asset position, with the large fall in IAS19 liabilities (blue line) corresponding to the increase in IAS19 net discount rates. We have also illustrated the movement in a notional funding basis (orange line) – this is discussed further on the following page.

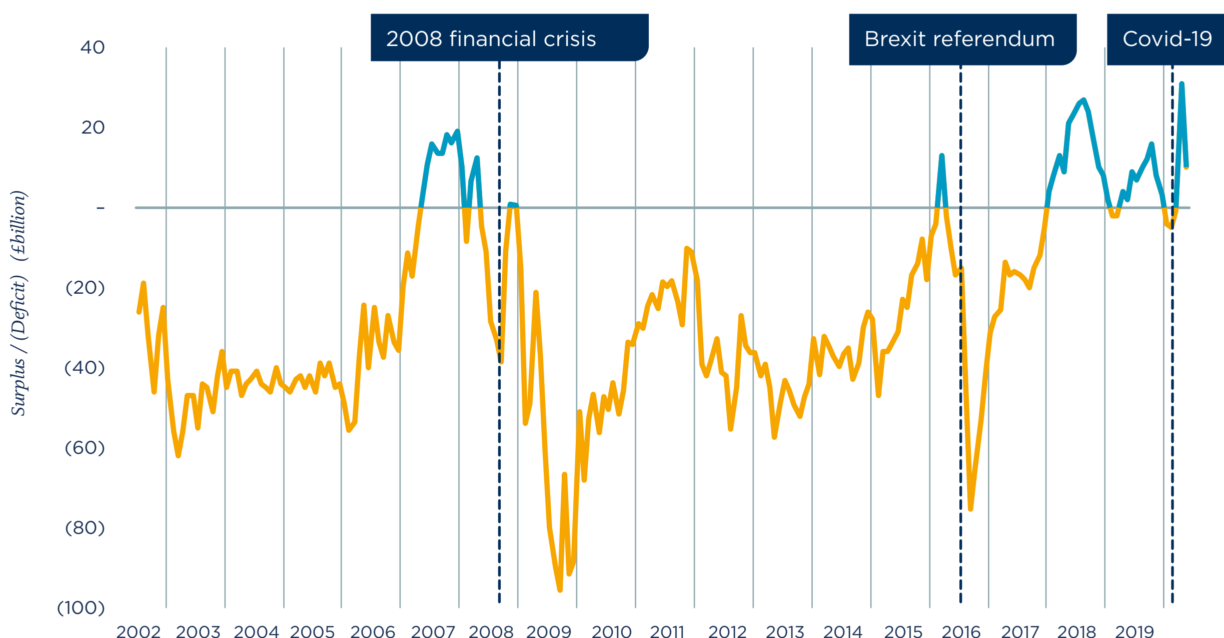
Estimated change in position since the beginning of 2020 for a sample pension scheme



Looking more closely at the combined FTSE100 position shown in the chart below, the change in position over March was the largest monthly move for a decade and the position at 31 March 2020 was the best month end position for twenty years. However, over the following month credit spreads and IAS19 discount rates fell leading to a dramatic increase in IAS19 pension liabilities. 30 April 2020 saw the lowest IAS19 discount rate at a month end on record (although credit spreads remained marginally above the pre Covid-19 level).

This serves to highlight the difficulties in measuring pension liabilities by reference to corporate bond yields when schemes are invested in a range of different asset classes.

Estimated combined IAS19 position of FTSE100 companies



Funding, however, is a different story.

Accounting assumptions (other than the discount rate which is prescribed) are intended to be "best estimate". They determine the figures disclosed in the company accounts, where they impact investors, dividends, capital, covenants and credit ratings. Funding assumptions on the other hand are required to be chosen prudently, and are determined for the specific scheme, in accordance with regulations. They drive the actual cash paid into the pension scheme.

The accounting discount rate is based on corporate bond yields, whereas the funding discount rate is linked to the scheme's investment strategy, and often expressed as a premium above gilt yields. For most, but not all, schemes, the liabilities on the funding basis are higher than those on an accounting measure – a gap that is only expected to increase given the regulatory direction of travel.

Importantly most funding discount rates have not increased due to the spike in the corporate bond spreads but have fallen with falling gilt yields.

As a result, many companies could be showing an IAS19 surplus on their corporate balance sheets whilst continuing to pay contributions to remove a deficit on funding assumptions. Covid-19 and recent market movements have exacerbated this situation.

We have illustrated this for the sample scheme in the chart on page 10 with the funding liabilities shown in orange. For this scheme, the funding liabilities were 8% higher than the IAS19 accounting liabilities at the start of 2020, but this gap grew to over 25% in March. Analysts and other stakeholders will need to understand this and more companies may wish to include additional disclosures (such as the results of the latest funding valuation) to illustrate this point.

Divergence of IAS19 accounting and cash funding liabilities due to increases in corporate bond yields relative to gilt yields.

Life expectancy

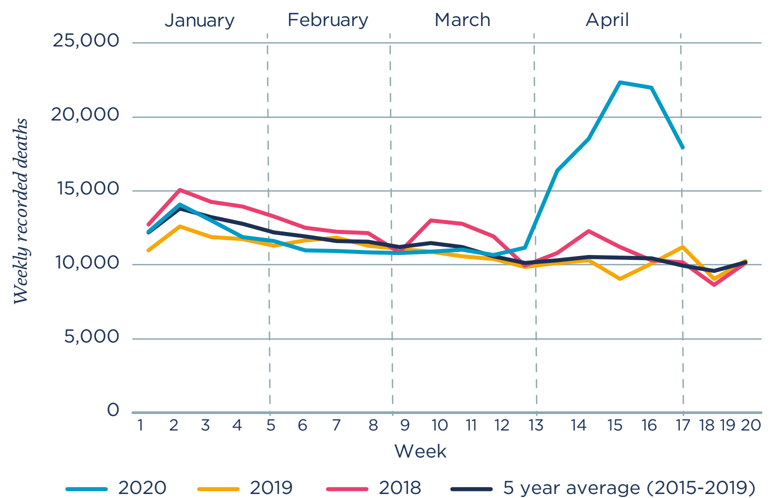
The daily and weekly statistics provided by government and the Office for National Statistics provide a very real reminder of the impact the pandemic is having. The two charts opposite show the total number of deaths across England and Wales split weekly and also on a cumulative basis over the year to date. To aid comparison, we have shown 2020 (blue line) against 2019 (orange line), 2018 (pink line), and an average of 2015 to 2019 (navy line).

The weekly chart shows the clear jump in number of deaths over April relative to previous years. The cumulative deaths chart shows that up to the end of March 2020 was marginally below the average of the last five years, but that it has since jumped. The increase is such that we have now seen more deaths up to this point than any year in the last decade.

It is much too early to say definitively what this will mean for a pension scheme's finances, but it is fair to note at this stage that the direct mortality impact of the pandemic will be observed in two ways.

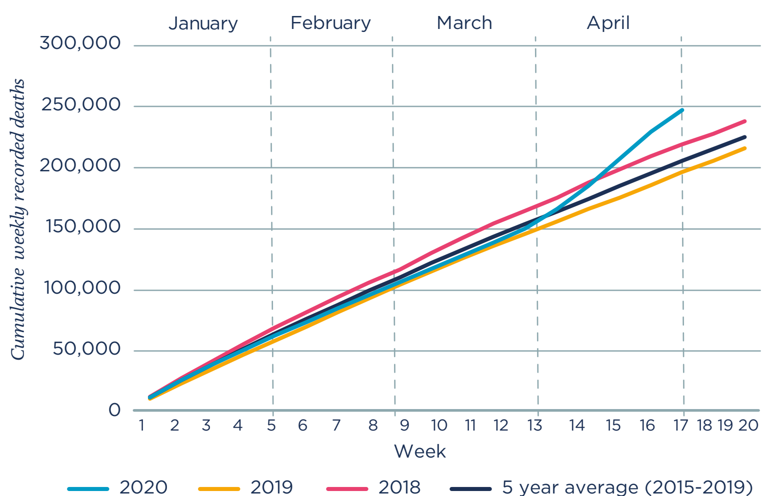
- First, and most directly, the impact on the liabilities will be crystallised when the membership data underpinning the IAS19 valuation is updated. This is typically done every three years at the time of the Trustees' triennial funding valuation. Although, depending on experience, we may see companies look to conduct a true up sooner than this.
- Secondly, the next set of mortality projections expected to be released in March 2021 will include observed mortality data collected over 2020.

Total weekly deaths in England & Wales over the year to date



Source: Office for National Statistics

Cumulative total number of deaths in England & Wales reported over the year to date



Source: Office for National Statistics

Looking more widely, factors such as any emergence of repeat waves of the virus, the impact on our health care system through diversion of resources to manage the current pandemic, and on peoples' health from economic factors could all have far bigger consequences than the headline statistics reported daily in the media.

Lastly, although as we write Covid-19 is the almost exclusive focus of the headlines, future changes in mortality over the long term will be largely driven by many other, perhaps more significant, factors including developments in medical treatment and prevention, technology, lifestyle and the environment.

Pensions reform temporarily stalls

There are currently three important pieces of pensions reform being progressed. In isolation, each could have a major impact on the way pension schemes are governed and managed going forwards. Combined, they have the potential to be the biggest overhaul of pensions governance since the 1995 Pensions Act (and potentially since the 1975 Social Security Act that introduced SERPS and contracting-out).

Pension Schemes Bill

Following criticism in cases like BHS and Carillion, the Pensions Regulator is set to get extensive new powers under the Pension Schemes Bill. These include powers to impose Contribution Notices on companies or individual directors more easily – requiring them to make one-off and substantial contributions to pension schemes.

When it receives Royal Assent (this was expected to be later in 2020, although the process has been delayed by Covid-19), the Pension Schemes Bill will further add to the obligations of companies that sponsor DB schemes. Directors will need to take legal and other specialist advice to ensure they don't fall foul of the new regime, as the penalties are severe in some cases, including unlimited fines and up to seven years in jail. This will require new governance to ensure "at risk" events are identified and appropriate action is taken – further detail can be found in our corporate checklist.

The bill also paves the way for the new funding code of practice as it will require trustees and sponsoring employers to agree a long-term "funding and investment strategy", and formally document how they intend to reach this long-term goal. Importantly, the bill also provides that regulations may prescribe the factors to be taken into account in preparing a recovery plan and in determining whether a recovery plan is appropriate for a particular scheme. That contrasts with the current legislative position where it is up to the Regulator to prove that a recovery plan is not appropriate before they can take regulatory action.

A new funding regime

In March 2020 the Pensions Regulator launched a major consultation into the future of the DB funding regime. This is set to be the biggest revolution to the requirements for scheme funding and investment for 25 years, and has been covered in various blogs and news alerts, and previewed in our corporate report last autumn.

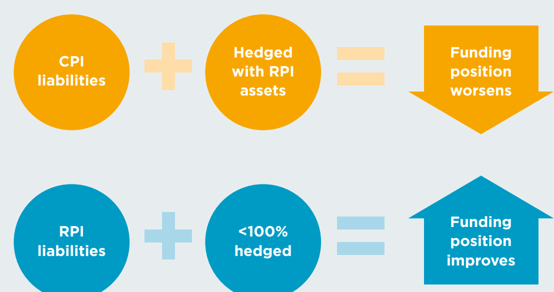
The legal basis of the new DB funding regime is not yet fully known, and we don't expect that all the law will be in place for some time – quite possibly not until the end of 2021. The regulator has stated in its 2020 annual funding statement that it will not be taking account of the consultation when assessing current valuations. Nevertheless, we expect the direction of travel indicated by the consultation to at least influence ongoing and upcoming DB scheme valuations. Should the legislation and funding code be introduced as drafted, the implications for some pension scheme valuations would include higher contributions payable by sponsors, deficits paid off more quickly by strong sponsors, and earlier de-risking of investments.

That said, even though the Regulator has indicated that it believes the principles of the consultation to be sound and it doesn't intend to depart from them in light of Covid-19, industry acceptance of those principles is waning and some prominent commentators have called for a major re-think of the concept, given how materially circumstances have changed since the consultation was launched.

RPI reform – a better measure of inflation?

Our corporate report (page 15) from October last year discussed future changes to RPI to bring it in line with CPIH inflation, from 2030 at the latest. CPIH, a measure of the annual rate of consumer price inflation, that includes owner occupied housing costs, is expected to be around 1% pa less than current RPI – this is a significant and potentially material difference.

If RPI changes to be equal to CPIH…



This means that DB scheme members with RPI-linked increases can expect to get lower pensions from no later than 2030 than they otherwise would have had and liability values will reduce as a result. RPI-linked assets will also fall in value. The impact on scheme funding positions will depend on how asset values are impacted which will reflect the strategy for hedging inflation. While a net financial gain is expected if the scheme increases are mainly RPI-linked and this is only partially hedged, schemes are likely to suffer a net financial loss if they are mainly CPI-linked and RPI instruments are in place to hedge this.

A consultation on the practicalities of when and how the change happens is currently under way. It was due to close on 22 April, but this has now been pushed back to 21 August 2020. This will be an important announcement with a big financial impact on pensioners, pension scheme finances, and their corporate sponsors.

Covid-19 insight in unprecedented times

For both trustees and sponsors, Covid-19 poses significant risks and challenges. With the regulatory focus being on long term planning, companies and trustees need to consider how they should adapt to this unanticipated event.

Deferring contributions

The Pensions Regulator has issued guidance around companies deferring or reducing pension scheme deficit contributions for up to three months. Any agreement would be subject to a number of conditions, including (but not limited to) that there should be no shareholder returns during the period and that banks and other creditors are being supportive.

The Regulator is keen to stress all the hoops that they expect trustees to go through before agreeing to a reduction or deferral in contributions. For example, this includes ensuring that there is a legally binding commitment not to pay dividends during any suspension of deficit contributions.

So, whilst this latest regulatory easement is to be very much welcomed during the next few months (very good news for some employers, investors, and possible also for pension scheme members), companies will need to proceed carefully and ensure that they do not set off any bear traps such as inadvertently triggering the wind-up of the scheme.

Deferral of pension contributions may offer some companies a lifeline, but companies will need to watch out for potential bear traps within their scheme rules.

Annual Funding Statement

Following publication of the Regulator's Annual Funding Statement in April 2020, it is clear that the Regulator is focussed on pension schemes getting a "fair share" of available cash or other sponsor resources - albeit recognising that this share may be from a smaller pot as a result of the current Covid-19 pandemic.

The statement is particularly relevant for schemes with valuation dates between 22 September 2019 and 21 September 2020. Those with triennial funding valuations over this period are understandably going to be concerned about the cash commitments trustees may be seeking at a time when Covid-19 has put a strain on liquidity. Where funding positions have deteriorated, and/or the company's covenant is assessed as having worsened, companies will need to be proactive with their scheme trustees to agree optimal and affordable funding arrangements, including use of alternative security packages where appropriate.

The impact will be different for each company depending on their specific circumstances. We have produced a corporate action plan intended to give a high level overview of the key areas companies should consider as part of a current or upcoming funding valuation.

PPF levies

The Pension Protection Fund (PPF) is the lifeboat fund for defined benefit pension scheme members and provides a level of benefit to members where the sponsoring employer becomes insolvent. The PPF receives annual levies from all pension schemes, although this is often financed direct by the employer. The overall levy to be collected by the PPF is not expected to change significantly as a result of Covid-19. However, the amount of money which an individual company has to pay into the PPF could rise threefold as a result of the current crisis with the worst-affected companies potentially facing annual levy increases of more than £1 million.

There are several things that companies can do if they think this could apply to them including making sure that the new method of measuring insolvency risk (introduced in April 2020) accurately captures the company's true financial position, reviewing whether to give the pension scheme some extra security (for example through parent company guarantees); or consider whether other more technical mitigation actions might help (such as certifying that deficit contributions have been paid, and that pension investment risk is being measured and managed appropriately).

The PPF levy for some pension schemes may treble, with the increase for some being in excess of £1 million.

Section 3: Trends in pensions strategy

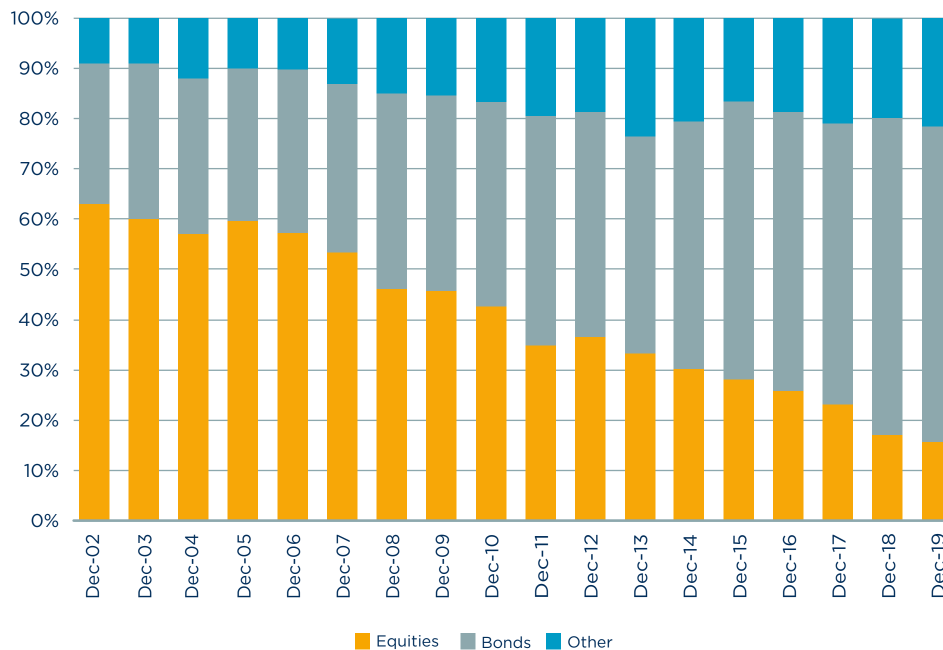
De-risking Pension Schemes

The move away from defined benefit pensions continues apace as many pension scheme trustees and companies take action to manage liabilities and risks. 2019 year-end accounts showed many examples of this including:

- Morrisons closed their pension scheme to new members and to future accrual in September 2018, with future pension provision now provided through a defined contribution scheme. This leaves just two FTSE100 companies (Croda and Johnson Matthey) offering DB pension in any form to new UK joiners.
- M&G introduced a salary cap for future pension accrual limiting future build-up of pension.
- Over 10% of FTSE100 companies (including Smiths Group, British American Tobacco, GlaxoSmithKline, Pearson and Rolls Royce) disclosed that they had transacted insurer buy-ins over the previous 12 months. More detail of this market is contained in our de-risking report.
- Lloyds Banking Group announced that they had transacted a £10bn longevity swap shortly after their 31 December 2019 year-end.
- Ferguson and Melrose Industries both disclosed that they had conducted an enhanced transfer value exercise.
- Sainsburys and Taylor Wimpey introduced a pension increase conversion option for members, whilst Diageo and TUI also ran pension increase conversion exercises for existing pensioners.

After last year saw equity holdings fall to a record low, the split of UK pension assets has remained broadly flat with the UK pension schemes of the FTSE100 continuing to hold less than 20% of their assets in equities and over 60% in bonds.

Estimated overall asset allocation for UK pension schemes sponsored by FTSE100 companies



Equitable treatment of pension scheme and shareholders – the dividend, contribution balance

Since 2017 the Pensions Regulator has been very clear on its view that pension schemes should be treated "fairly" relative to shareholders, with guidance broadly stating that where dividends exceed deficit contributions, they expect a strong funding target, and short deficit recovery plan. If the employer is unable to support the scheme dividend payments should have ceased.

Around 60% of companies analysed reported an IAS19 accounting surplus as at their accounting date in 2019. As many low-risk investment strategies are expected to deliver long-term returns in excess of the IAS19 assumed return (broadly 1% above gilts each year in the long run), it could be argued that, provided the covenant remains and is expected to remain strong, large pensions contributions are less likely to be required for this group. However, these companies still reported paying around £8bn of contributions into their DB pension schemes.

Companies reporting an IAS19 surplus paid total contributions of £8bn into their DB pension schemes.

A simple ratio of dividends to contributions can be misleading.

For the remaining 40% of FTSE100 companies, these companies paid around £5bn into their DB pension to schemes. For these companies, this compares to a total IAS19 deficit of c£20bn and total dividends to shareholders of around £30bn. However this comparison says nothing about whether the dividend vs contribution split is "fair" for a given company: it does not account for how well funded the pension scheme is, the investment strategy, the dividend policy, the sponsor covenant strength, the long term pension objective, or any contingent funding mechanisms that might be in place. In that way, the statistic in isolation and analysis of any movement from year to year, could potentially be misleading.

For 2020 we might expect to see deficit contributions increase relative to dividends. Many companies, particularly in the financial sector, have announced a suspension of dividends in response to the Covid-19 pandemic. At the time of writing, around a third of FTSE100 companies have announced a cancellation, cut, or deferral of planned dividend payments. Whilst it is possible that some severely impacted companies may also suspend or reduce deficit contributions, under guidance issued by the Pensions Regulator, this should only take place following a complete stop on dividend payments.

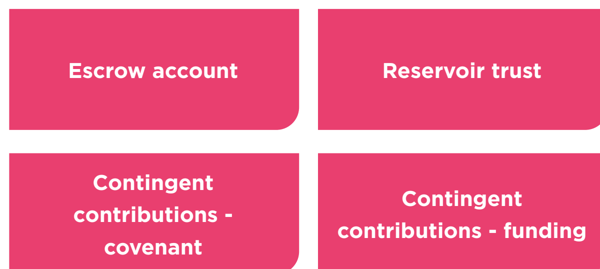
Is cash the only answer?

The general direction of regulatory travel is for reduced investment risk within pension schemes, increased contributions, and reduced ongoing reliance on the covenant of the sponsor (and as has been witnessed over recent months, there are no guarantees over the long-term covenant).

In order to provide a more appropriate use of company resources whilst still providing for the security of member benefits, a number of companies have put in place contingent mechanisms – some of which are shown below.

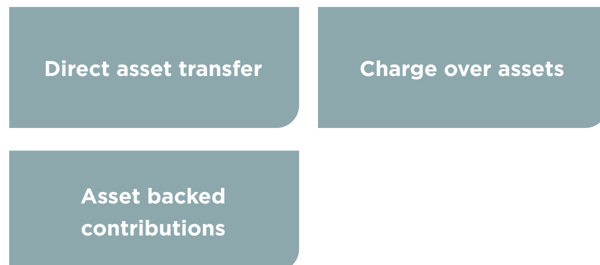
Categorising contingent funding options into four types

Cash

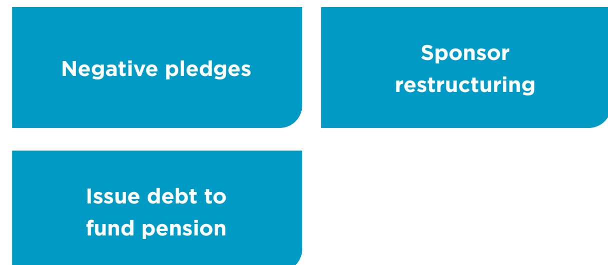


Credit

Assets



Corporate actions



A number of different examples are reported in FTSE100 2019 reports, including:

- Credit: Imperial Brands disclosed they have a surety guarantee in place until January 2023 which will pay out up to £600m under certain circumstances.
- Assets: Many companies, including Kingfisher, ITV, Diageo, Whitbread and Taylor Wimpey, disclose having asset backed funding arrangements in place. Such arrangements are typically structured as Scottish Limited Partnerships, backed by assets that support the projected contributions.

The cost, complexity and flexibility of setting up each of these arrangements varies considerably depending on the type of structure and the extent to which it is bespoke. However, with the prospect of a new funding regime, improved funding levels and reduced levels of overall risk, we see the use of contingent funding as a positive way forward for trustees and companies to jointly provide security for members while helping companies better manage their resources.

We expect the incoming funding regime and focus on integrated risk management to drive an increase in contingent funding mechanisms- enhancing the security for members in a capital efficient manner for sponsors.

Section 4: Evolution of executive pension provision

The level of pensions provision to executives continues to be under the spotlight, as the issue of fairness between executives and staff has come to the fore. In the current environment many executives have been called upon to accept a pay cut, or significantly reduced bonus, as profits fall and, in some cases, employees are furloughed.

As reported in our Accounting for Pensions survey last year, the Investment Association (IA), which represents over 250 UK investment management firms who manage over £7 trillion of assets, pledged to challenge companies who pay executive pension contributions (or cash in lieu) of 25% of salary or more, or appoint new executives with pension contributions on different terms to those available to the majority of the workforce.

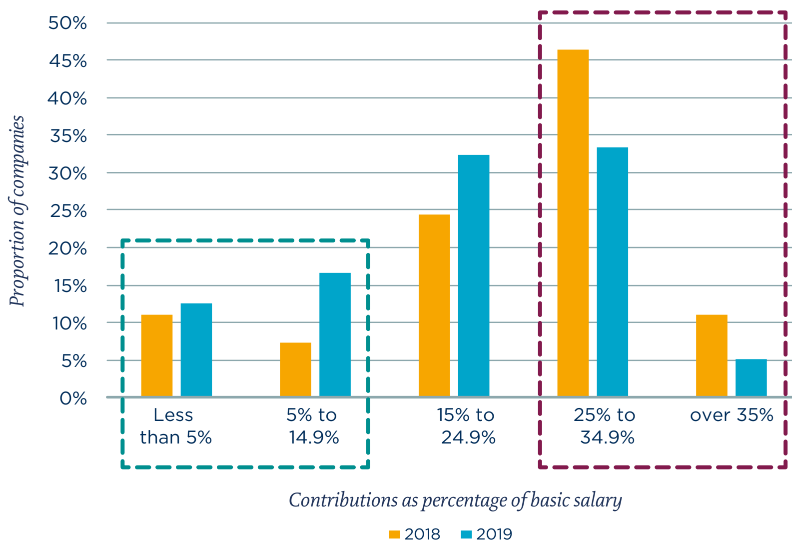
In September 2019, the IA went further. They announced a new set of guidelines whereby they will "red top" any company who pays a director a pension contribution of 25% of salary or more and has not set out a credible plan to reduce this contribution to the level of the majority of the workforce by the end of 2022. They will also "red top" any company that appoints a new director whose pension contribution rate exceeds that available for the majority of the workforce.

Our analysis of the FTSE 100 accounts disclosed in 2019 shows that the average CEO pension contributions (which is typically paid as a cash supplement) has fallen by a fifth over the past 12 months – from a rate of 25% in 2018 to a rate of 20% in 2019.

The chart below shows CEO pension contributions as a percentage of basic salary.

The median pension contribution for a FTSE100 CEO has fallen from 25% to 20% of basic salary.

Pension contributions to CEO as a percentage of basic salary

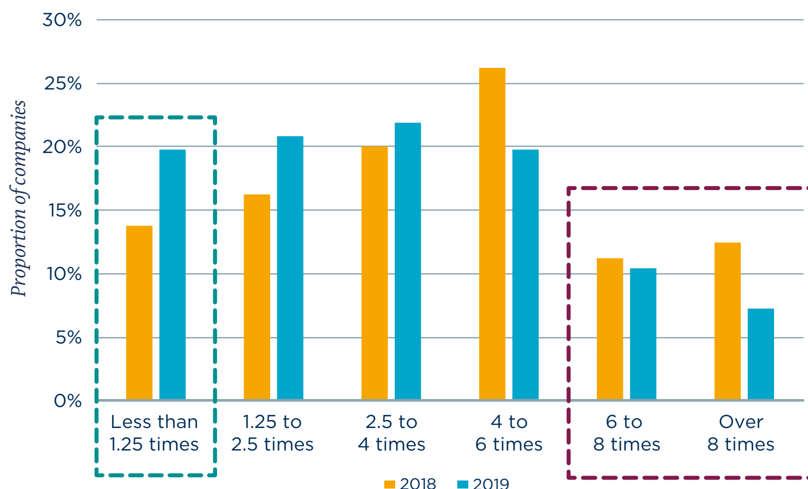


FTSE100 CEOs receiving 25% or more in pension has fallen from c.60% to less than 40%

The proportion receiving pension contributions of less than 15% of salary has increased to over a quarter

There has been similar movement over the past 12 months when comparing the level of CEO pension contributions with the average level paid to employees. The chart below shows how the contribution rate for the CEO compares with the average rate of the wider workforce.

Pension contribution rate for FTSE100 CEO relative to the average rate paid to employees (as disclosed in 2018 and 2019)



There has been a marginal fall in those paying more than 6 times the average employee contribution percentage rate to the CEO.

The number of CEOs receiving pension contributions broadly in line with employees has increased to nearly 20% of the FTSE100.

The median contribution rate has fallen from 4 times to 3 times.

There is significant movement from the position in 2018 but there is still some way to go on both measures.

- Although the proportion has fallen, c.40% of companies pay CEO pension contributions of 25% or more, and so are in danger of being "red topped" by the IA. However, around three quarters of these have either stated a specific plan to reduce this level or stated that the benefit is to be reviewed.
- The median contribution rate for CEOs relative to the rate for average employees has fallen, but at three times higher there is still some way to go if there is to be no difference by the end of 2022. In line with the guidance from the Investment Association, around a fifth of companies now pay CEO pension contributions that are broadly in line with the wider workforce – up from 15% last year.

With effect from 31 December 2019, the IA now requests that companies publish the contribution rates for both executives and their workforce. With this increase in transparency, it is perhaps little wonder that companies are changing their approach. As a result, we fully expect to see a lower average level of pension contributions paid to the CEO and a lower multiple difference between CEOs and their workforce when we review again in 12 months' time.

Companies will also need to consider corresponding changes to benefits for the next tier of executives, who, without adjustment, could receive higher pension contributions than either the general workforce or the CEO. These decisions around wider reward will often form part of a wider reaching review encompassing financial wellness and employee engagement.

Companies are changing their approach to pension provision for executives, and are moving towards a flatter structure for all – right from the CEO through to the newest recruit.

INSIGHT CLARITY ADVICE

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