HYMANS ROBERTSON

Putting pensions in context

FTSE 350 Pensions Analysis 2023

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Executive summary

Welcome to Hymans Robertson's annual FTSE 350 pension analysis report. In this publication we identify the key themes dominating the corporate DB agenda, backed up by our analysis of FTSE 350 pension schemes.

In our view, two key themes for 2024 are the favourable position of DB funding helping corporate activity, and the impact of the Mansion House reforms on DB endgame strategies.

1 — *Shrinking schemes no longer a block to corporate activity*

The Pension Schemes Act 2021 introduced stronger sanctions and new Contributions Notices for The Pensions Regulator ("TPR") to enforce proceedings against corporates. At the time there were concerns this would block corporate activity by requiring a commercially unattractive level of contributions or security to the pension scheme in a corporate transaction. However, rising yields mean schemes have now shrunk relative to covenants, and improved funding levels mean the £ amount of any deficit is now far smaller. The required level of mitigation for pension schemes in a corporate transaction is lower than it's been for years. 31% of FTSE 350 pension schemes are already fully funded on a buy-out basis. The average Section 75 debt is now only 0.2% of market cap and 2% of annual earnings, down from 2.5% and 27.2% 2 years ago.

2 — *Mansion House reforms could stimulate run-on endgame strategies*

With the government wanting to promote investment in the UK economy, it's looking like the existing asymmetric risk profile of funding a DB scheme will be tilted more favourably to employers. Currently an employer is on the hook for any deficits, but can only access a surplus if their scheme is fully funded on an insurance buy-out basis. Even then any surplus extraction is taxed at 35% (reducing shortly to 25%). Lowering the bar for accessing surplus and reducing the tax charge, alongside a capacity constrained insurance market, means more employers may choose to run-on rather than insure. If all FTSE 350 schemes run-on rather than insure, this would generate accessible surplus of £43bn over the next 10 years, equivalent to 36% of annual FTSE 350 dividend payments. Given the potential value generation here and likely development of more employer friendly regulations, some companies may consider running on for now to keep their options open rather than committing to an irreversible insurance buy-out transaction.

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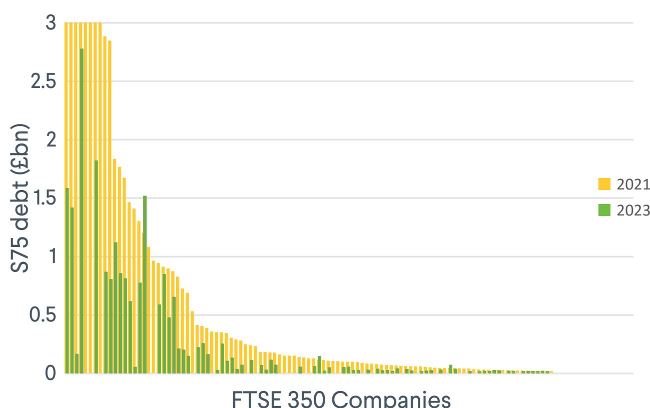
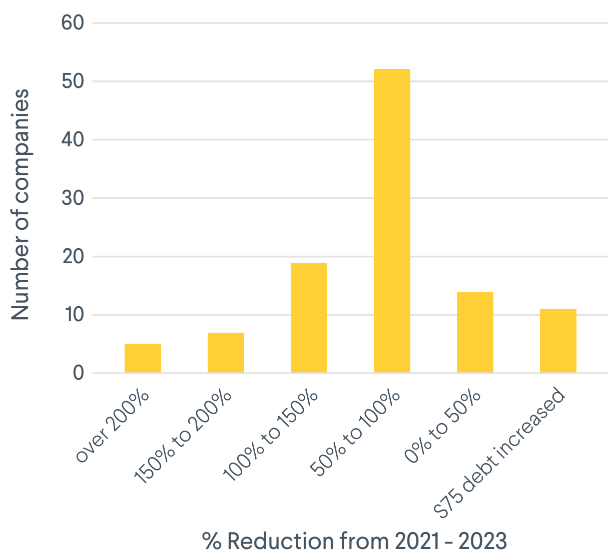
Shrinking schemes no longer a block to corporate activity?

Over the last two years, yields have risen by over 3% pa, shrinking DB schemes by 40-50%. In contrast corporate valuations and earnings have held up. Schemes are therefore now far smaller relative to their supporting covenants, making them less of a block to corporate activity.

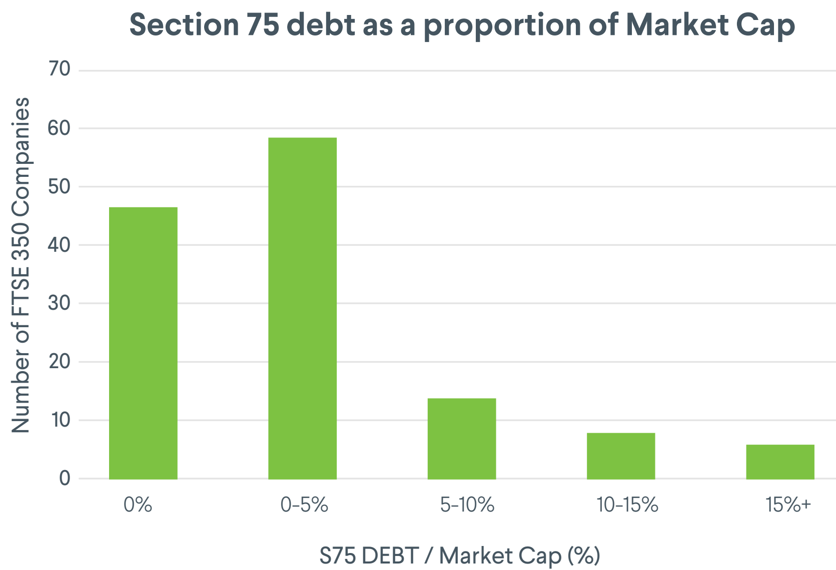
A key pension deficit for corporate transactions is the Section 75 debt – how much does it cost to fully insure the scheme and separate the scheme from the company? One of the covenant tests introduced by the Pensions Scheme Act 2021 is the employer insolvency test. This compares the Section 75 recovery on a hypothetical insolvency pre and post the transaction. Mitigation for the Scheme is usually required if this recovery drops, which could occur for example if debt is introduced that ranks ahead of the pension scheme. However, rising yields and improved funding levels mean Section 75 debts themselves are at historic lows, bringing down the cost of this mitigation.

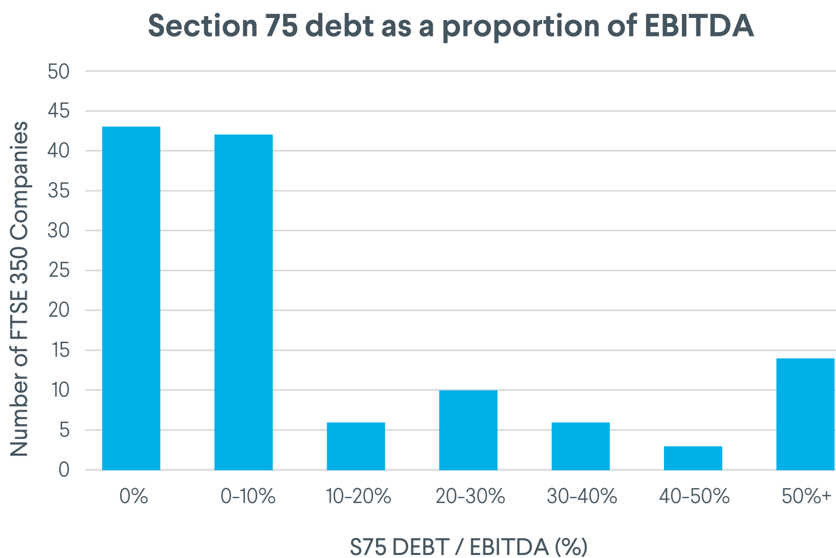
The charts below show the reduction in Section 75 debts over the last two years for each scheme in the FTSE 350. On average Section 75 debts have fallen by 76%. Note that the S75 debt for 2021 has been capped at £3bn





These charts show the Section 75 debt as a proportion of market cap and EBITDA. On average Section 75 debts are now only 0.2% of market cap and 2% of annual earnings.





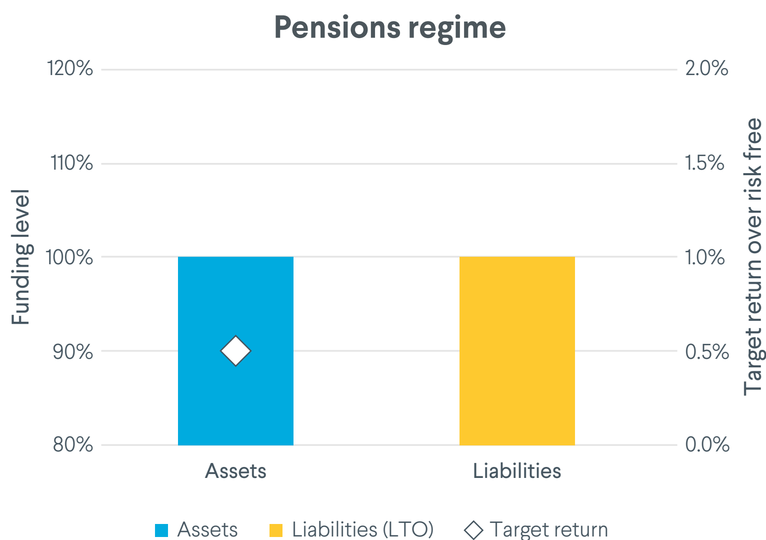
Our view:

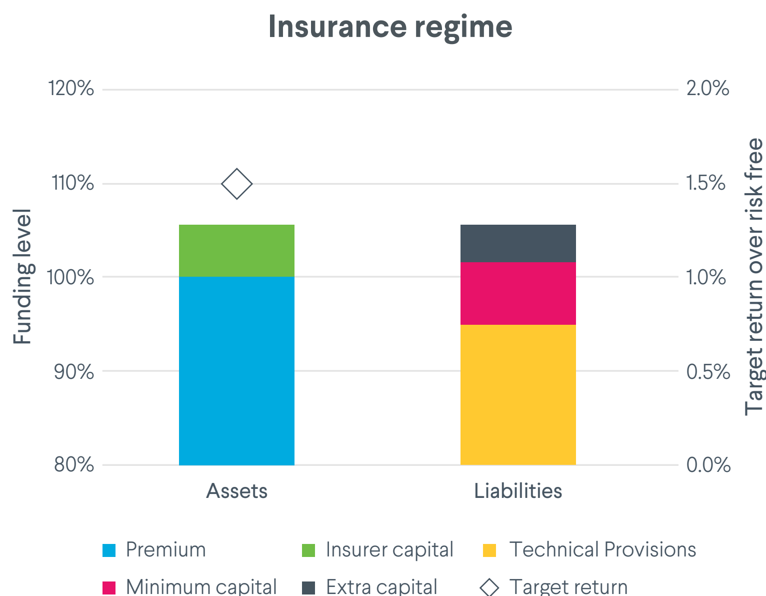
Pension schemes are now less of a block to corporate transactions. The cost of mitigation for the pension scheme for companies considering re-financing, re-structuring or M&A is at historic lows, and in some cases is nil cost. This, combined with valuations for UK corporates arguably looking low from an overseas perspective, means we can expect more transactions to proceed where previously the pension scheme may have been too much of a barrier.

Mansion House reforms to stimulate run-on strategies

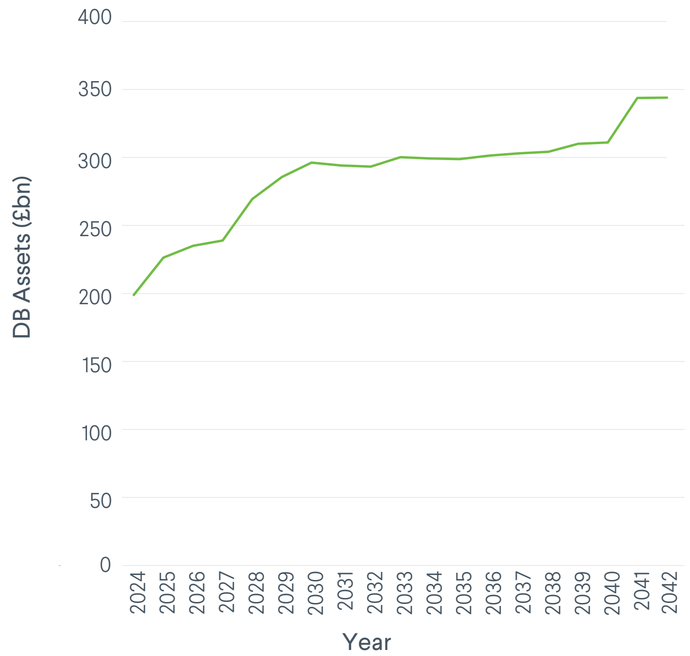
For many years, insurance buy-out has been considered the 'gold standard' endgame for DB schemes and member security. Certainly from an employer perspective, having the scheme off balance sheet with no further cost or risk is attractive. But how much does it really improve member security and how much value is being passed to insurers?

The charts below compare the capital position for a scheme fully funded on an insurance buy-out basis in the pensions regime and in the insurance regime. Whilst an insurer does commit capital to an incoming scheme, it also re-risks the investment strategy from perhaps Gilts + 0.5% pa to around Gilts + 1.5% pa. The additional capital is arguably supporting the additional risk. The level of risk adjusted capital is not changing significantly, but the ability to access the existing employer covenant disappears. Over time the gap widens, with the insurer removing capital as the liabilities mature, in contrast to the pension scheme generating more surplus and capital buffer. It is not clear that the insurance regime necessarily provides that much additional capital over a well-funded pension scheme.





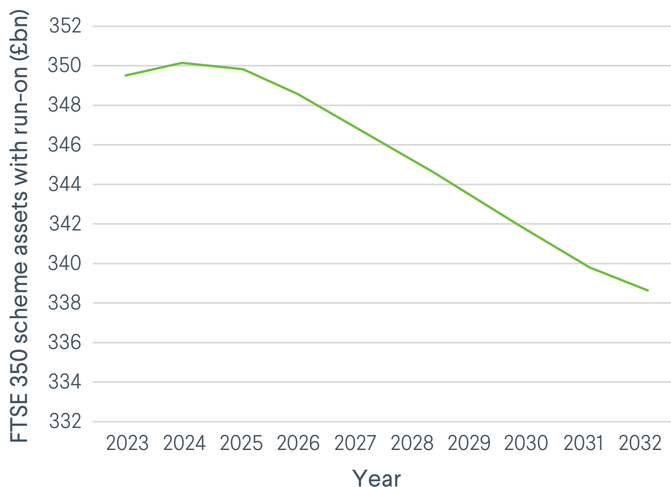
The chart on the right shows the weight of DB assets moving to insurers year-by-year if all FTSE 350 schemes buy-out when they can afford to. In aggregate this results in £299bn of assets moving to insurers over the next 10 years. Could these assets be better deployed to stimulate growth in the broader UK economy?

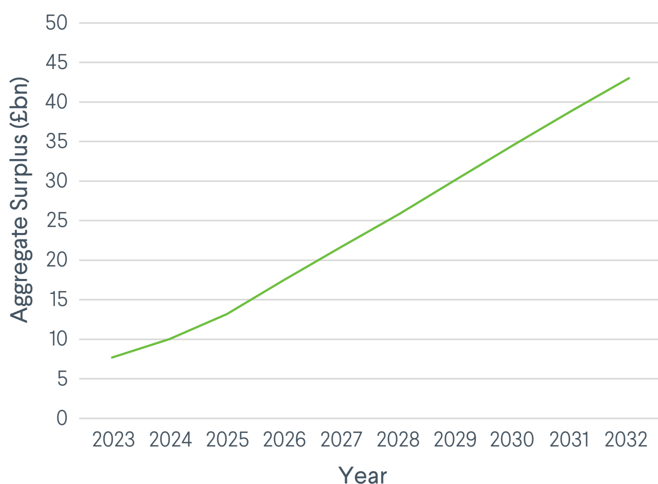


The first chart to the right shows the level of DB assets year-by-year if all FTSE 350 schemes run-on. The second chart then shows the surplus generated each year if schemes release surplus above an insurance buy-out basis. Over the next 10 years, this could result in £43bn of surplus generation, equivalent to 36% of current FTSE 350 dividend payments.

The other notable feature of the asset run-off is the shrinkage as more pension payments are made. The covenant / scheme size relationship becomes more comfortable over time. From an employer perspective, the risk from the DB scheme diminishes over time as it shrinks. From a scheme perspective the need for ongoing covenant support largely disappears when fully funded on an insurance buy-out basis. Layer on top of this a capacity constrained insurance market, the prospect of a lower cost consolidator market developing, and the possible relaxing of surplus release rules for employers, and this all points to employers running on in the short term to keep their options open, rather than committing to an insurance buy-out.

The Mansion House reforms could lead to a lower bar for accessing surplus than an insurance buy-out funding level, and they have already led to a reduction on the tax charged on surplus refunds to employers to 25%.





Our view:

The tide is turning on the treatment of DB schemes, with the government eager to use some of the £1.4trn of capital tied up in UK DB schemes to stimulate the economy for wider societal benefit. The case for run-on is becoming stronger. Buying out is an irreversible decision that passes value to insurers. Given the scale of the possible value generation and the likely development of more employer friendly regulation, some employers may consider running on in the short term to keep options open, rather than buying out.

FTSE 350 pensions analysis

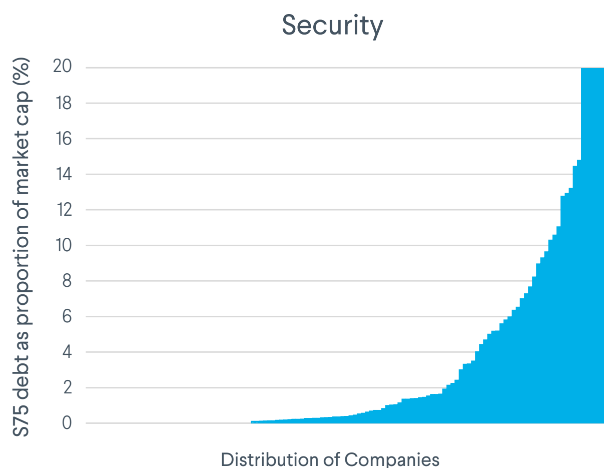
We consider four metrics that put pension schemes in the context of the businesses supporting them: security, affordability, fluctuation and expenditure. Given the improvement in scheme funding in recent years, we now consider the pension liabilities on an insurance buy-out basis rather than an IAS19 basis (as we have done in previous years). The insurance buy-out basis is far more relevant for corporate transactions and endgame planning than IAS19.

- Security – Section 75 pension deficit as a proportion of company market cap
- Affordability – Section 75 pension deficit as a proportion of company earnings
- Fluctuation – un-hedged pension buy-out liabilities as a proportion of company market cap
- Expenditure – pension contributions as a proportion of company earnings

The charts below show the spread of results on each metric across the FTSE 350.

Security

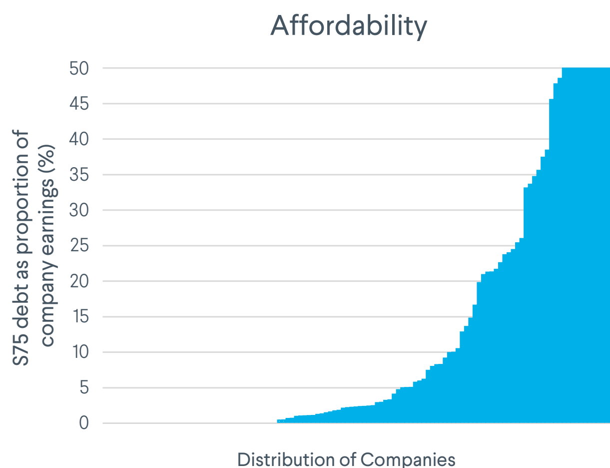
Section 75 pension deficit as a proportion of company market cap



- 1 company has a deficit greater than the market cap. Deficits remain manageable relative to market cap.
- 90% of companies have a pension deficit of less than 10% of market cap.
- 79% of companies have a pension deficit of less than 5% of market cap.

Affordability

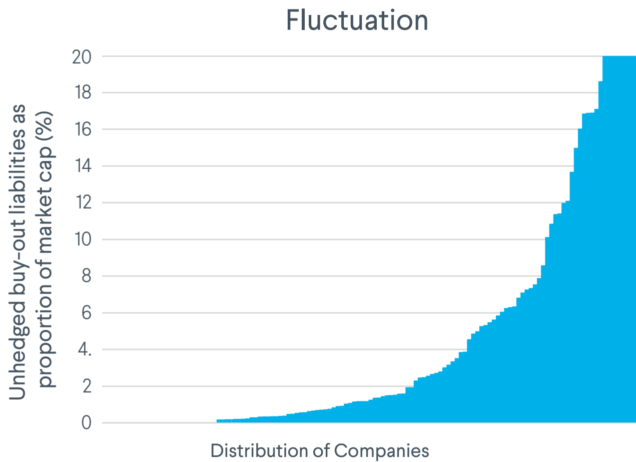
Section 75 pension deficit as a proportion of company earnings



- There are 5 companies that have a pension deficit greater than their earnings.
- 89% of companies have a deficit of less than 50% of earnings.
- 80% of companies have a deficit of less than 25% of earnings.

Fluctuation

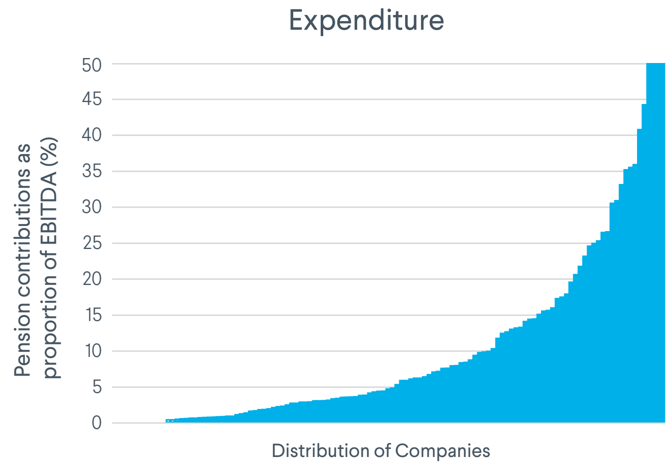
Un-hedged pension buy-out liabilities as a proportion of company market cap



- 1 company has un-hedged pension liabilities in excess of its market cap.
- 83% of companies have un-hedged pension liabilities of less than 10% of market cap.
- 71% of companies have un-hedged pension liabilities of less than 5% of market cap.

Expenditure

Pension contributions as a proportion of company earnings



- 1 company has paid contributions greater than their earnings.
- 97% of companies put less than 50% of earnings into their pension scheme.
- 88% of companies put less than 25% of earnings into their pension scheme.

Appendix

Methodology

We have analysed the 159 companies in the FTSE 350 that have defined benefit pension schemes sufficiently material to be disclosed under IAS19 in their annual reports. This excludes all investment funds and trusts, and is based on the FTSE Group listing at 31 May 2023. We have included UK and overseas funded and unfunded defined benefit schemes. Any figures or proportions quoted in this report in relation to the "FTSE 350" relate only to these 159 companies.

We have used market capitalisation in September 2023 to calculate our Security and Fluctuation metrics.

The following information has been taken from companies' most recently published annual reports. We have referenced annual reports with effective dates from 31 March 2022 to 31 March 2023, depending on when the relevant accounts were filed.

- **Pension data** - extracted from IAS19 disclosures.
- **Earnings data** - extracted from performance statements. We have referenced EBITDA, i.e. earnings before interest, tax, depreciation and amortisation.
- **Staff, pension and other costs** - extracted from the notes to accounts.

Where necessary, figures have been converted to sterling using appropriate exchange rates.

For company expenditure, we have taken the total expenditure on pensions covering contributions for both the accrual of benefits and the repayment of deficits. These figures are as reported in companies' annual reports and include both regular contributions and one-off contributions.

We have included both funded and unfunded defined benefit pension liabilities in our analysis.

To determine insurance buy-out liabilities, we have restated the disclosed IAS19 liabilities on to an insurance buy-out basis using approximate techniques. This takes account of the duration of the liabilities as inferred by the IAS19 sensitivities and Hymans Robertson's proxy insurance buy-out basis at the calculation date.

To determine un-hedged pension liabilities, we have taken the estimated buy-out liabilities less the value of bond or insurance type assets held by the pension scheme. Leverage is approximately allowed for in this calculation by taking twice the value of government bonds and LDI funds, with overall hedging capped at 100% of scheme assets.

When a company makes any pension deficit adjustment for IFRIC14, our analysis references the IAS19 pension surplus / deficit prior to the IFRIC14 adjustment.

Our analysis for companies that operate sections in the Railways Pension Scheme is after the liability / deficit reduction on account of franchise adjustments and employees' share of the deficit.

For the pension scheme projections, we have projected assets using long-term return assumptions for each major asset class and a continuation of current deficit contribution levels (where payable) for 5 years. Returns are assumed to reduce to Gilts + 0.8% p.a. over the next 10 years or to remain at current levels if already below Gilts + 0.8% p.a. The buy-out liability projection allows for Hymans' most recently available buy-out pricing estimates and a converging of the buy-out liabilities to a pensioner buy-out price as the schemes mature.

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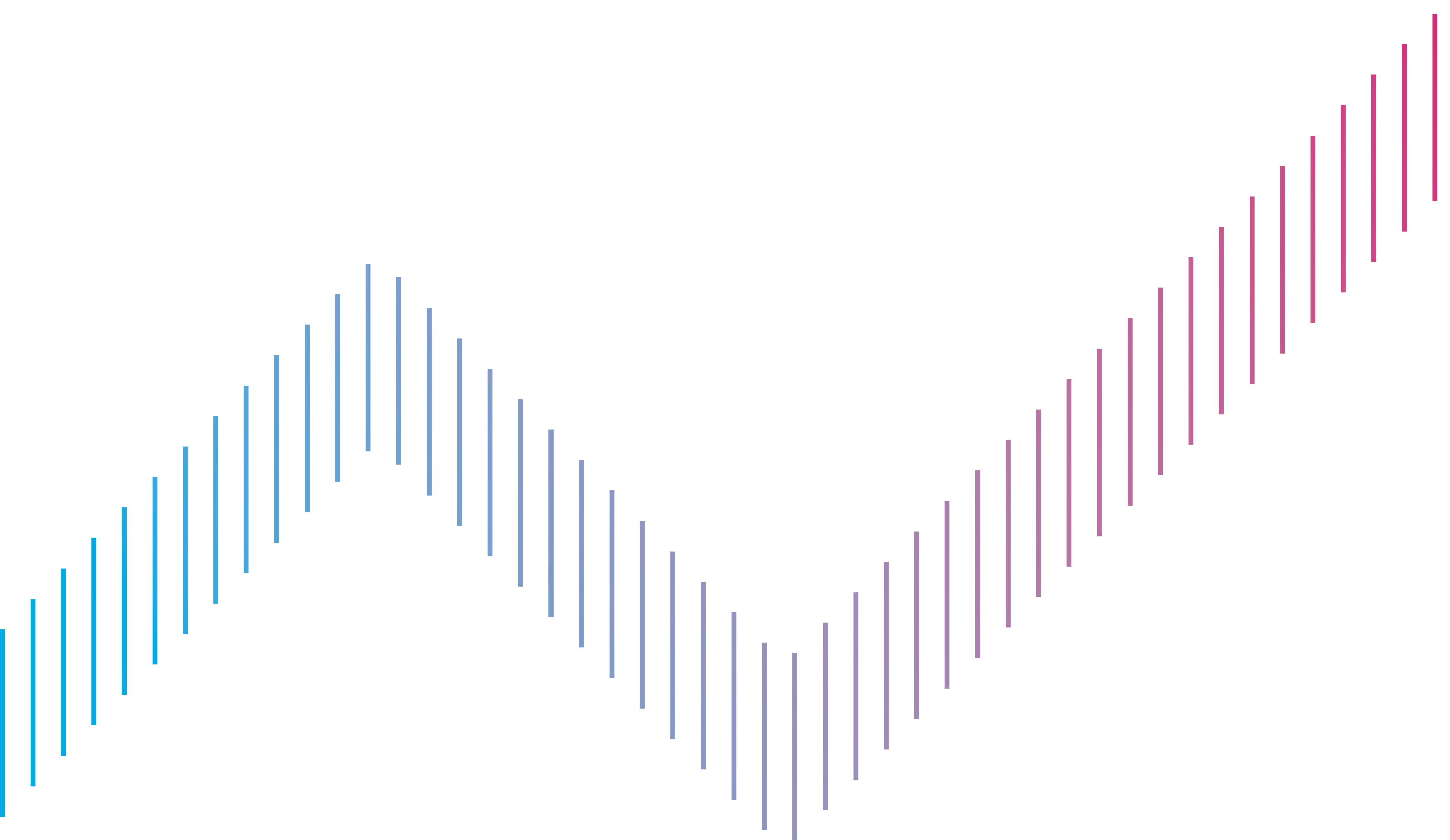

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