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FTSE350 pensions

DB endgame back on course

Amid the chaos at the start of last year, the solvency of the UK's defined benefit (DB) pension schemes took a turn for the worse. The combination of an equity market crash and a drop in government bond yields put substantial downward pressure on DB scheme funding levels. At the same time, companies were put under significant stress by the actions taken to stem the spread of Covid-19, with a number of sectors relying on Government support to remain afloat.

On the whole, the picture looked extremely challenging for pension scheme funding. As funding levels worsened, a number of companies took steps to suspend deficit contributions, and the path to recovery looked long and difficult.

Fast forward a year, and the situation has changed dramatically. The vast majority of DB schemes are now on surer footing than this time last year, having comfortably weathered the storm of the initial economic disruption.

FTSE Topic 1 intro video - please see interactive link

In this analysis of the DB schemes of the FTSE350 companies we look at how the schemes have navigated back on course, and what this means for the future.

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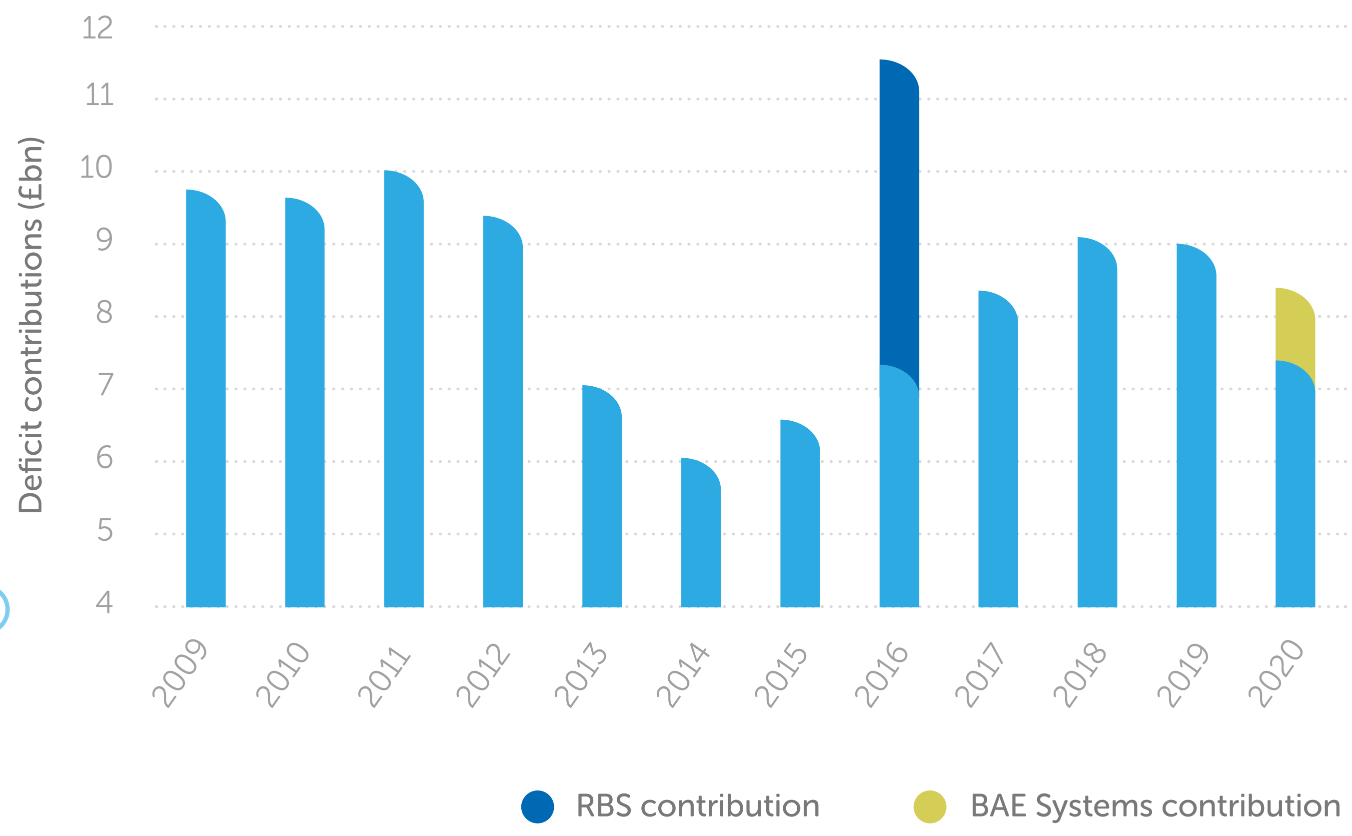
Cash conservation

The Pensions Regulator (TPR) reacted quickly to the announcement of the first UK lockdown, releasing guidance to help trustees react to the challenges brought about by Covid-19. A key issue was dealing with requests by companies to temporarily suspend DB pension scheme contributions, in a bid to manage liquidity pressures and preserve cash reserves.

The chart to the right shows the estimated aggregate deficit contributions paid into the FTSE350 DB schemes over the year (with previous years shown for comparison).



Deficit contribution levels fell slightly over the year (by around 7% in aggregate), suggesting the impact of Covid-19 on overall contribution levels was limited. However, the data is slightly skewed by the large one-off £1 billion contribution paid by BAE Systems plc over the period. Once this is excluded from the analysis, overall deficit contributions into the FTSE350 DB schemes fell by around £1.6 billion over the year (a fall of around 18% in aggregate), indicating a more substantial impact.

However, looking closer at the data, less than a third of this £1.6 billion reduction was a result of Covid-19 deferrals, with the main reason for contribution reductions being changes to recovery plans as scheme funding levels improved in the period prior to the pandemic.

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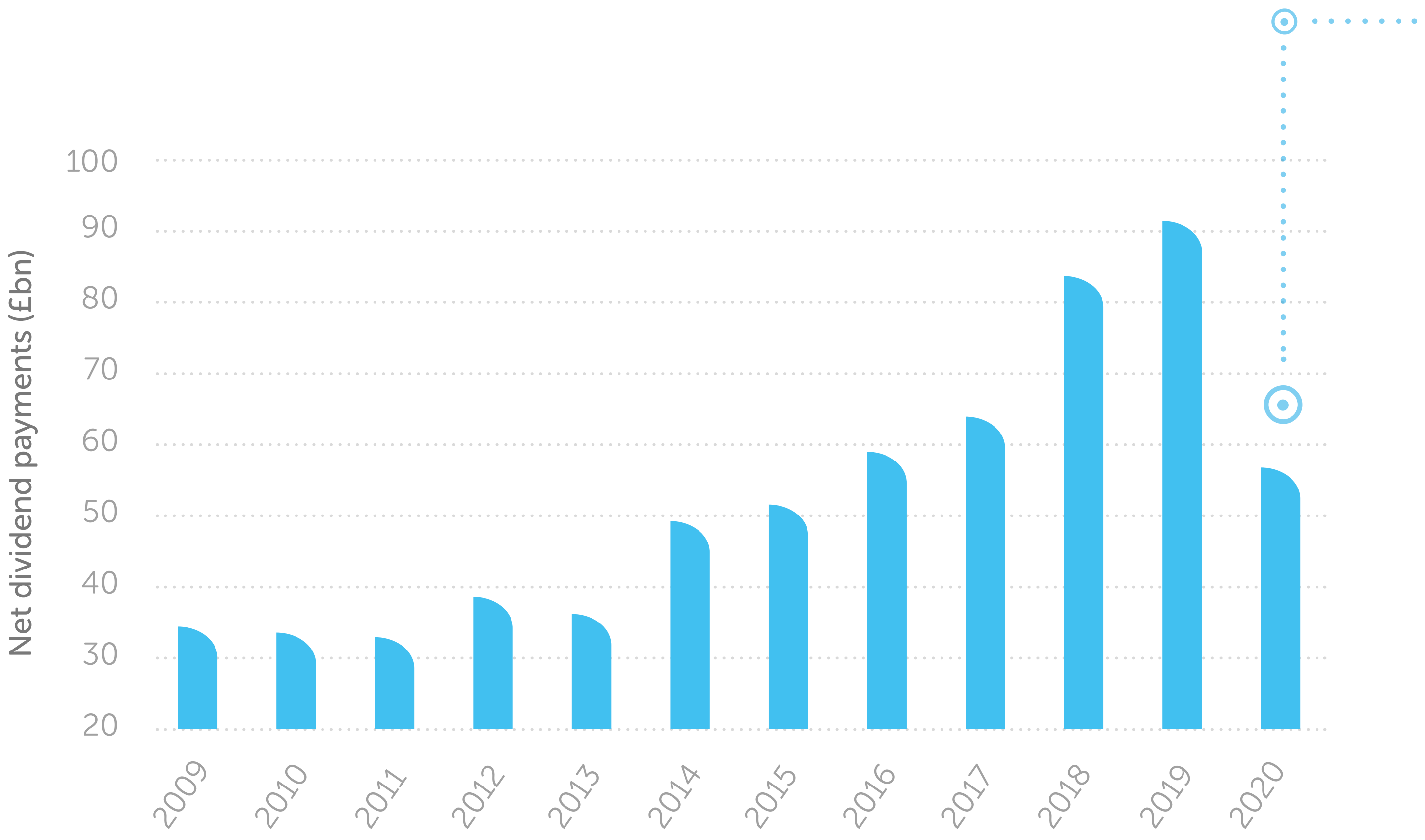
The treatment of DB pension schemes relative to company shareholders is an issue frequently raised by TPR, and is often illustrated by the level of deficit contributions versus the level of dividends paid. The chart below shows the estimated dividends paid to the FTSE350 DB scheme sponsors over the year (with previous years shown for comparison).



The chart shows that dividends to shareholders reduced by around 38% over the year, a drop of around £34bn, with shareholders arguably bearing a greater portion of the pain than DB schemes during the initial economic crisis.

Given TPR's concerns regarding the equitable treatment of pension schemes relative to shareholder distributions, it may take some comfort that deficit contributions appear to have taken priority over dividends during the challenging months of lockdown.

With the outlook for the UK economy more upbeat than this time last year, TPR will be keen to see DB pension schemes share in the proceeds of improving company profitability. Having a robust long-term journey plan for the DB scheme will be the best strategy for convincing TPR that its attention is best served elsewhere.

Markets to the rescue

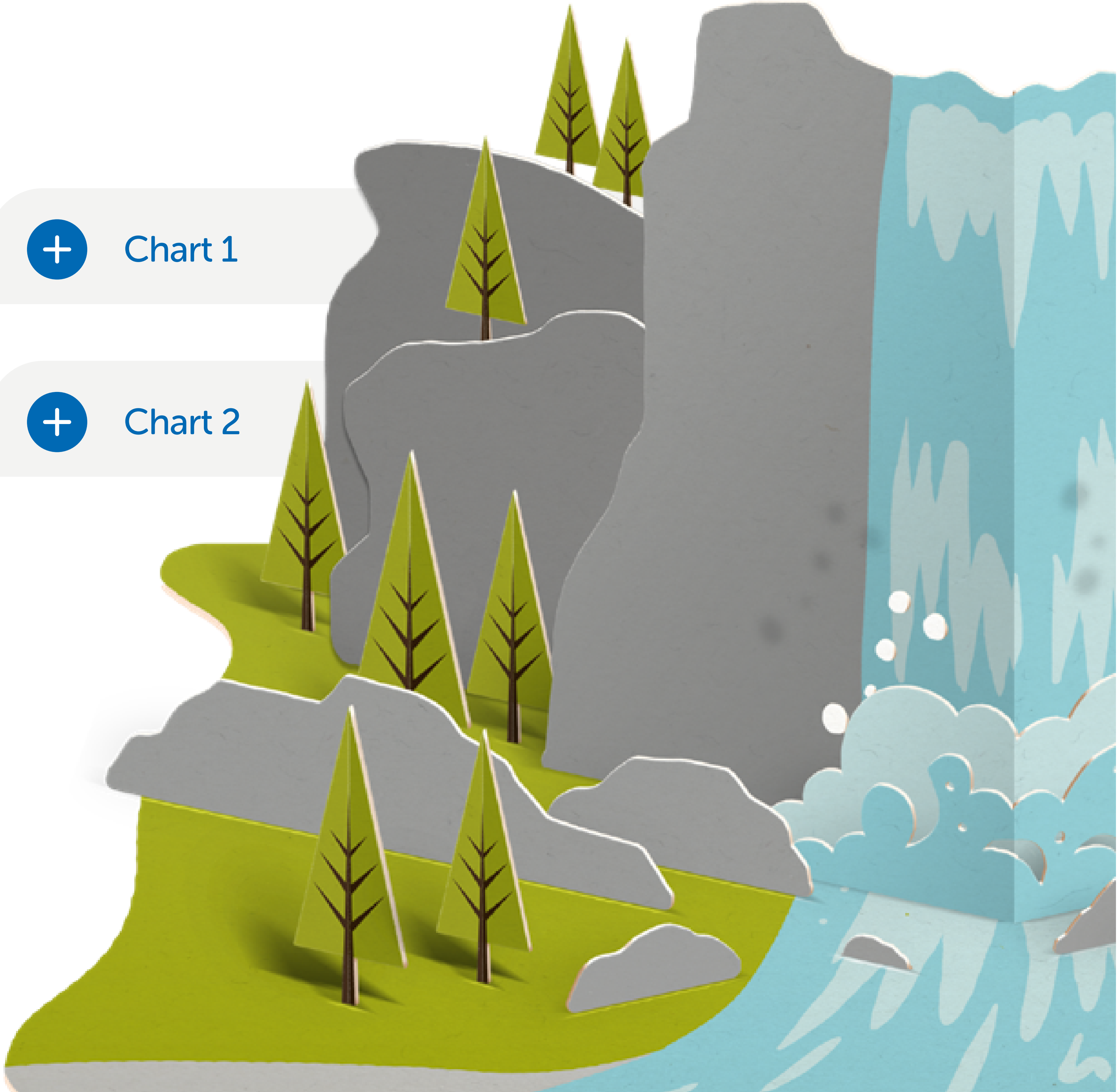
The tightening in company purse strings during the pandemic has fortunately had minimal impact on the solvency of the FTSE350 DB schemes, as the astonishing resurgence in financial markets resulted in a significant turnaround in funding levels.

At the end of May equity markets were up by over 20% compared to the same point last year, with the news of the vaccine in November providing the key turning point. Over the same period, index-linked bond yields were up by around 25 basis points, reducing the value of DB scheme liabilities.

The impact of these financial market changes means that the aggregate buyout deficit of the FTSE350 DB schemes now stands at £130bn, a reduction of £80bn since the end of May last year.

Chart 1

Chart 2

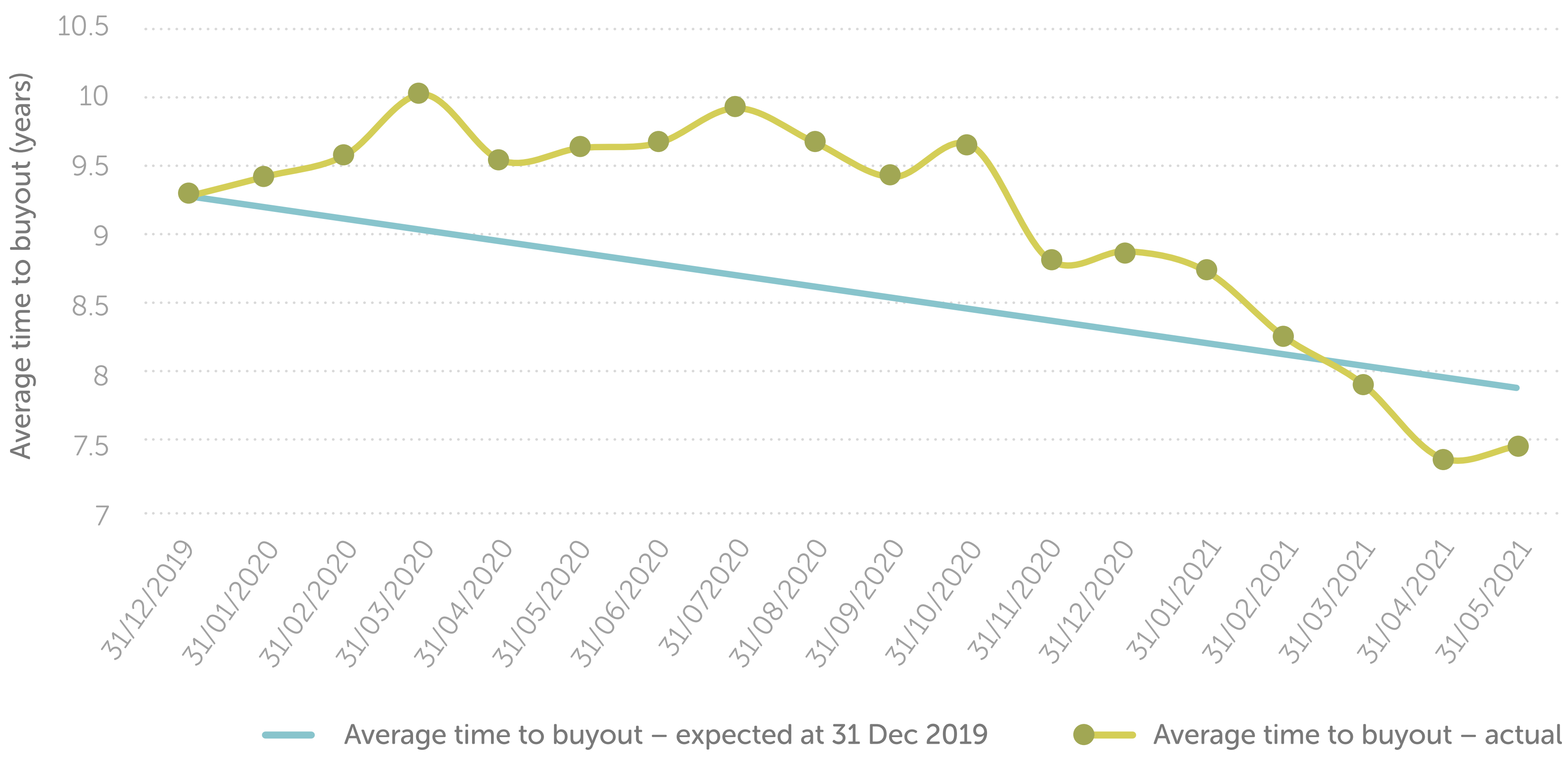


Endgame back on course

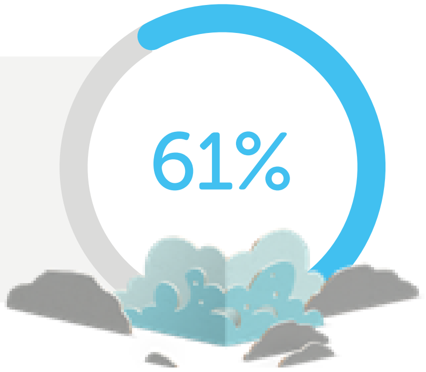
The upshot of the spectacular recovery in financial markets is that the FTSE350 DB schemes' journey to the endgame is now firmly back on course. The chart to the right shows the change in the average time to buyout[1] for the FTSE350 DB schemes since 31 December 2019.

At the end of December 2019, the average time to buyout for the FTSE350 DB schemes was around nine years and three months. Despite the significant volatility over the year, the chart shows that the FTSE350 DB schemes are now ahead of the expectations prior to the economic disruption of Covid-19, with the average time to buyout standing at around seven years and five months at the end of May 2021.

Whilst there will undoubtedly be more challenging times ahead for DB schemes, for now companies can breathe a sigh of relief that the Covid-19 funding gap appears to have been resolved without the need for a significant cash outlay.



Assuming the deficit contributions paid over 2020 continue, our calculations show that, currently, around 61% of the FTSE350 DB schemes can expect to be in a position to buyout within ten years.



1 The average time to buyout calculation excludes schemes where time to buyout exceeds 30 years

The value of a journey plan

The past year has clearly illustrated the value that a journey plan can bring for those with strategic responsibility for managing a DB scheme. Being clear what the objective is and agreeing a plan with clear risk parameters helps to put significant financial market changes into context. Having a clear decision-making framework also allows action to be taken quickly where necessary, and to capitalise on any opportunities that might arise.

The material improvement in funding positions over the last few months is a good example of how journey plans can add significant value. A robust real-time monitoring framework will have identified this step change in funding levels, allowing companies and trustees to take action to reduce risk and lock in the positive investment returns experienced over recent months.

DB Navigator video
please see interactive link

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The data used for this analysis has been collected from the accounts of FTSE350 companies for their 2020 year ends (i.e. up to and including the year ending 31 December 2020). Liability values on a buyout basis have been estimated by approximately updating these results and using Barnett Waddingham's view of average buyout pricing. Asset values have been estimated using index returns and the asset split disclosed in the pension disclosures. The current level of deficit contributions have been estimated based on information set out in the pension disclosures and for the purpose of this analysis these are assumed to continue until buyout funding is reached

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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