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Exploring Southern Europe

Analysing the impact of UK Defined Benefit Plans on Southern European companies

January 2019

After the turmoil of 2016, following the UK's decision to leave the EU, 2017 was a much more positive year for DB plan funding levels.

Executive summary

In our analysis of IBEX 35 and FTSE MIB companies, funding levels reported for accounting purposes improved over the year, with the aggregate IAS19 funding level reaching 99% at 31 December 2017. Further improvements may come through in 2018, given the increase in bond yields since the start of the year.

Achieving 100% IAS19 funding is a positive milestone, but not the ultimate goal. Companies should be thinking about the longer-term objectives for their pension plans, whether gradual run-off, buy-out or even transferring them into a consolidation vehicle, and how these objectives can best be achieved.

The gradual move away from growth assets to protection assets continues in 2017, though there are exceptions and significant investment risks remain. In view of the recent improvements in funding levels, companies may wish to consider working with trustees to accelerate their investment de-risking to help lock in the current funding levels and protect against future falls in investment markets.

Most companies in our survey saw an increase in benefit payments in 2017 over 2016: a 24% increase at the aggregate level, reflecting increased member interest in accessing their pension benefits more flexibly. Companies should be considering whether now could be an appropriate time to run liability management exercises to remove further risk from their pension plans.

Cash contribution requirements remain significant. For many of the companies in our survey these relate mainly to past service deficits. The Pensions Regulator (TPR) is also paying increased attention to the level of dividends paid to shareholders (including payments from UK subsidiaries to their overseas parent companies) compared to the level of deficit contributions paid to the pension plan. As a result, as part of pension plan funding negotiations, companies may see their UK pension trustees asking for additional deficit contributions if dividend payments rise above certain levels.

We hope you will find our report both interesting and useful as a benchmark of your UK pension exposure against other Southern European listed companies.

Isabel Coles
HEAD OF INTERNATIONAL CONSULTING

isabel.coles@mbwinternational.com

+44 20 3949 5710

Andrew Vaughan
DIRECTOR

andrew.vaughan@mbwinternational.com

+44 20 7776 2275

Introduction

> Our research considers the impact UK DB pension plans are having on the companies that make up the Spanish IBEX 35 and Italian FTSE MIB indices, and highlights how these companies are addressing the challenges posed by their DB pension obligations.

The analysis covers *20 multinational companies*, with around £51.7 billion of UK DB pension liabilities between them.

Private sector DB plans are relatively uncommon in Spain and Italy, and so DB pensions may not attract the same attention as they do in the UK. However, DB pensions remain an important issue for companies in the UK. As well as the obvious impact on the company's performance through the balance sheet and income statement, the level of contributions required and payments to the parent company are receiving a lot of attention.

In this report, we look at how funding levels have changed and consider developments three important areas:

- Assets and investment risk
- Benefit payments
- Cash contributions

See also...

A TURNING POINT FOR FTSE350 PENSIONS?

A broader indication of what UK companies are doing to better manage their DB pension obligations.

READ OUR REPORT >

FINANCE DIRECTORS' GUIDE TO PENSIONS

To find out more about UK pensions issues discussed in this report.

FIND OUT MORE >

UK DB pension plans can have a disproportionate impact within multinational companies' global pension arrangements, potentially affecting dividends to shareholders. Looking at the IBEX 35 and FTSE MIB companies in our survey:

7%

of their global revenue is produced by UK subsidiaries with DB plans

42%

of their global pension plan liabilities are for UK companies

74%

of their global DB pension plan contributions are for UK companies

Funding levels

2017 was a more positive year for UK DB plans. IAS19 funding levels for the IBEX 35 and FTSE MIB companies in our analysis improved over the year, and improvements could continue in 2018 if bond yields remain at 30 November 2018 levels until the end of the year.

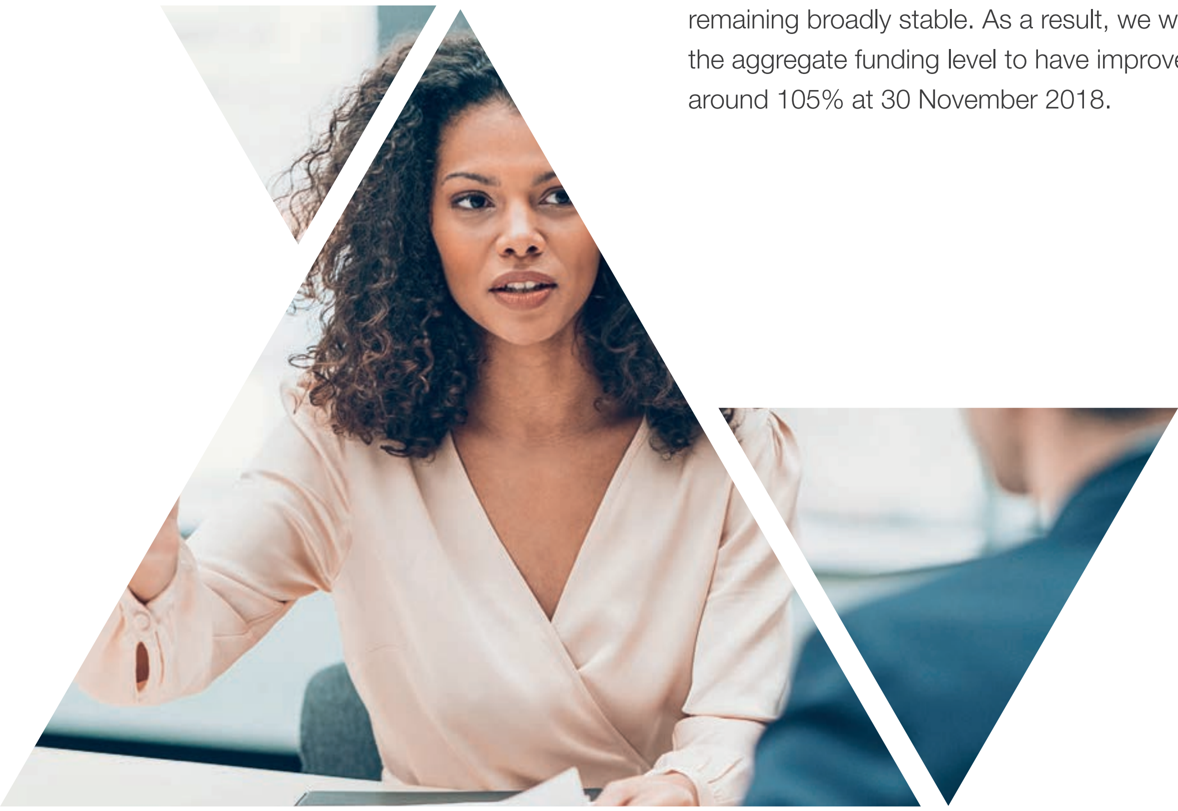
FUNDING LEVELS IMPROVE

Figure 1 shows the funding levels on the company accounting basis at 31 December 2017, compared to the 31 December 2016 figures. In general, funding levels improved over the year, with the aggregate deficit reducing from £2.2 billion to £670 million, and the aggregate funding level increasing from 96% to 99% over the year.

We saw a similar trend in the FTSE350, where the aggregate deficit of their DB plans globally reduced from £62 billion to £55 billion over the same period.

Market conditions remained relatively stable over the year, and the aggregate value of liabilities increased only by around 2% over the year (albeit that on an individual company level the change in liability values over 2017 ranged from a reduction of 10% to an increase of 9%, depending on individual plan circumstances). Meanwhile, positive investment performance and the employer contributions paid saw aggregate asset values increase by around 5% over the year, leading to an improvement in funding levels overall.

Looking ahead to the 2018 year end, market conditions have been favourable up to 30 November 2018, with corporate bond yields rising and inflation expectations remaining broadly stable. As a result, we would expect the aggregate funding level to have improved further to around 105% at 30 November 2018.



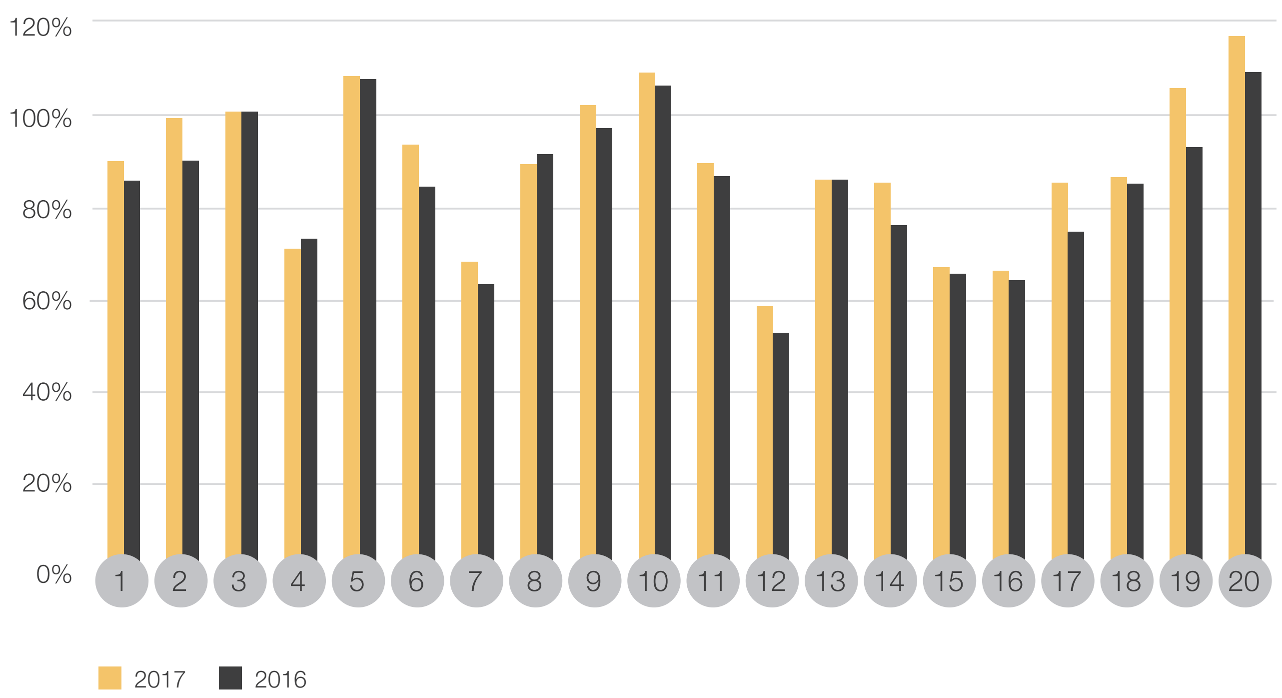
LONGER TERM STRATEGIES

Although funding levels appear to be on the increase, companies should not sit back and relax. After all, funding levels can go down as well as up. It is therefore important to think about the longer-term future of the company's DB plan. This could mean:

- **Gradual run-off** – the plan is closed to future accrual, and is supported by the company until all members have either left the plan or died. The trustees are likely to want to see a gradual de-risking of the plan's investment strategy over time. This is likely to be a lower-cost option relative to a full buy-out solution, but the company still retains the risks of the pension plan.
- **Buy-out** – the plan's liabilities are secured with an insurance company through the purchase of annuities. This is likely to be the most expensive option, but it allows the company to completely remove its pension plan liability. The bulk annuity market is currently very strong, with over £12 billion of buy-out and buy-in transactions completed in 2017, and 2018 set to be an even stronger year.
- **Consolidation vehicle** – this new option may offer companies a third way of "settling" their DB liabilities. The UK Government is currently consulting on the legislative framework for authorisation and supervision of these arrangements. There are already two commercial consolidation vehicles in development, and we await the development of this market with interest.

In the shorter term, companies may wish to use liability management exercises to remove risk from the plan, and to align the plan's liability profile closer to the chosen long-term target.

Figure 1: Funding level on the company accounting basis (IAS19)



Assets – investment risk

Asset allocations for the UK DB plans of IBEX 35 and FTSE MIB companies are showing a similar trend to those seen by FTSE350 companies for their plans, with a gradual move away from growth assets into protection assets. However, many plans still carry significant risk, and could be vulnerable to sudden changes in market conditions that could occur over the next few years.

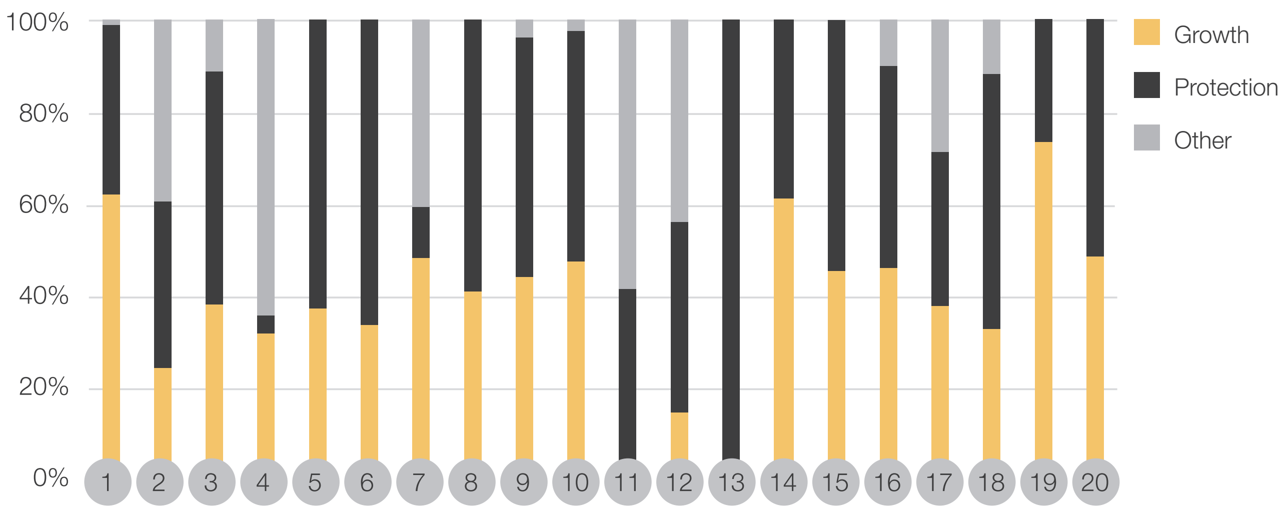
GRADUAL RISK REDUCTION

Figure 2 shows the broad asset allocations at 31 December 2017, split between growth assets (such as equities, property, and *diversified growth funds*) and protection assets (such as gilts, bonds, annuity contracts, and *liability driven investment* strategies). In some cases, the asset class descriptions provided in the company accounts are not sufficiently detailed to identify them as growth or protection assets; those assets are classed as "other" in figure 2.

During 2017 we continued to see a gradual move away from growth assets into protection assets. For example, Company 11 purchased an insurance contract (*buy-in*) to cover part of its pension liabilities, and Company 13 moved its remaining equity allocation into protection assets. Company 9 also adjusted its strategic investment benchmarks during 2017 with around 5% of the assets across its plans moving from growth to protection assets over the year. We observed a similar trend in our FTSE350 survey, where the percentage of growth assets has been decreasing over the last few years. This suggests that pension plans are gradually de-risking their investment strategies as the plans mature.

However, not everyone is de-risking: Company 10's allocation to growth assets increased by around 10% to 48% during 2017. We note that their plans remain open to new benefit accrual and the overall IAS19 funding level is over 100%, which may give the company and the plan trustees greater comfort in pursuing a more a growth oriented investment strategy.

Figure 2: Asset allocation at 31 December 2017



SIGNIFICANT RISK REMAINING

Despite the gradual move into less risky investments, there still remains significant risk within DB plans, as illustrated by the following scenario analysis (with each scenario considered independently). These scenarios are not implausible if you consider, for example, the effects on investment markets of the recession of 2008 or the UK's EU referendum of 2016.

If the global equity market fell by 15%, the aggregate deficit could increase from £0.7 billion to £2.7 billion, with the aggregate funding level reducing from 99% to 95%*

If bond yields fell by 0.5% pa, the aggregate deficit could increase from £0.7 billion to £4.5 billion, with the aggregate funding level reducing from 99% to 92%**

We saw similar results in our FTSE350 survey, suggesting IBEX 35 and FTSE MIB companies are carrying similar levels of risk to FTSE350 companies within their UK DB pension plans.

In view of the recent improvement in funding levels, companies may wish to consider working with trustees to accelerate their investment de-risking, to help lock in the current funding levels and protect against future falls in investment markets.

* Considers impact at 31 December 2017 based on equity allocation disclosed only. No allowance made for change in value of other assets, such as investment funds or diversified growth funds containing equity holdings affected by the fall.

** Considers impact at 31 December 2017 based on discount rate sensitivities and asset allocation to bond investments disclosed only. No allowance made for *LDI strategies*, which would lessen the impact.

Benefit payments

Once again, benefit payments from UK pension plans have increased year on year, as members transfer their DB benefits to DC plans to take advantage of the new flexibilities. In light of this, companies should be considering whether now is a good time to run liability management exercises to further remove risk from their pension plans.

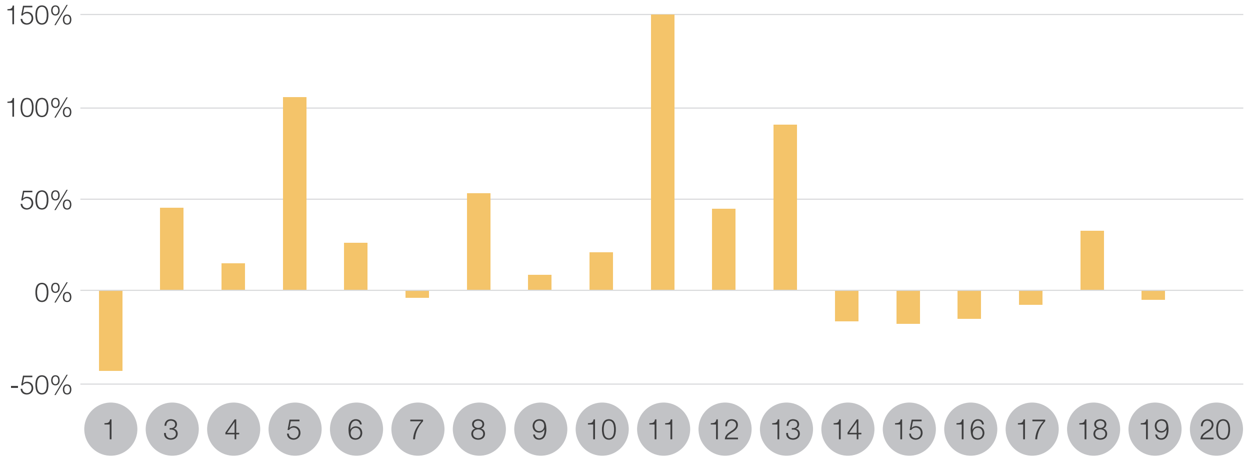
BENEFIT PAYMENTS ON THE INCREASE

Figure 3 shows the percentage change in benefit payments made from the IBEX 35 and FTSE MIB companies' UK pension plans, from 2016 to 2017. Most plans saw an increase in benefit payments over the period, with some plans seeing a significant increase. On an aggregate level, benefit payments of £2.3 billion were made in 2017, an increase of 24% from 2016. Around £600 million of these benefit payments are estimated to have come from DB to DC transfers.

A similar trend was seen in our FTSE350 survey, where aggregate benefit payments from their DB plans globally increased by 18% over the same period.

While we would expect benefit payments to increase each year, as the plan population matures and pensions increase, it is likely that the large increases seen in recent years are due to the increase in DB to DC transfers, following the introduction of the Freedom and Choice legislation for DC plans in 2015. This legislative change means DC plan members are no longer required to use their DC pension savings to buy an annuity at retirement and can instead take them as single lump sum or as regular withdrawals from the fund. DB plan members who wish to access their benefits more flexibly have been taking the option to transfer their benefits to a DC plan before retirement.

Figure 3: % change in benefit payments from 2016 to 2017



Company 2 did not disclose the amount of benefits paid from their UK DB plan in 2017, and therefore does not appear in this graph.

OPPORTUNITY FOR LIABILITY MANAGEMENT

These additional DC flexibilities are a key reason why liability management exercises are now likely to be more popular with members, with greater take-up rates. Companies should therefore be considering whether now might be the time to run such an exercise. For example, Company 11 carried out a transfer value exercise and a pension increase exchange during 2017. In brief:

- A transfer value exercise is where typically deferred members of the plan are quoted an up-to-date transfer value, and given access to independent financial advice. To encourage take-up, the transfer value could be enhanced above the 'standard' level, or a partial transfer option could be made available.
- A pension increase exchange is where pensioner members are given the option of exchanging their future non-statutory pension increases, typically for a higher non-increasing pension. This helps to reduce inflation and longevity risk in the plan.

Other examples of liability management exercises include flexible retirement offers and trivial commutation exercises. The common advantage of all these exercises is to remove risk from the plan and make it more attractive for an eventual buy-out.

Cash contributions

Company contribution requirements have remained at a significant level, with most relating to past service deficits. With increased attention from The Pensions Regulator (TPR), this can affect the payment of dividends to shareholders or the parent company.

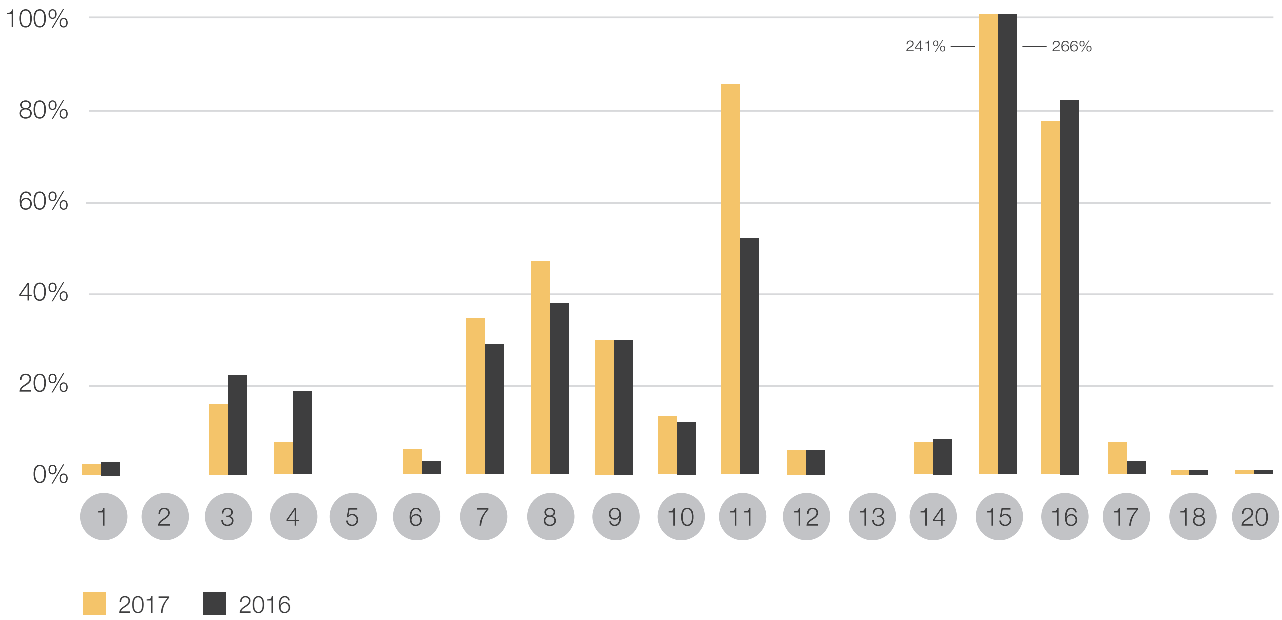
CONTRIBUTION REQUIREMENTS REMAIN SIGNIFICANT

Figure 4 shows the total UK DB company contributions for the IBEX 35 and FTSE MIB companies, for both future service accrual and past service deficits, expressed as a percentage of total UK staff costs for their subsidiaries with DB plans. On aggregate, contributions of £1.4 billion were paid over 2017 by 17 of the companies in our survey, equal to 23% of aggregate staff costs reported in the accounts of their UK subsidiaries with DB plans.

The majority of these contributions (73% of the aggregate employer contributions) relate to past service deficits, with only 27% relating to future service accrual. Of the 17 companies contributing to their UK DB plans in 2017, in five cases there is no future service accrual and the companies are solely contributing to fund the past service deficit in their UK DB plans. This highlights the continuing trend of DB plans being closed to future accrual, with staff moved into DC plans. It also highlights the significant level of deficit contributions still being paid, despite the improved funding levels.

Note that deficit contributions do not normally form part of the staff costs reported in the accounts. Instead, the pension cost reported is usually just the cost of benefits earned over the year. However, this could paint a misleading picture, as deficit contributions can cause the actual cash outlay to be far higher than this.

Figure 4: Contributions as % of staff costs of UK subsidiaries with DB plans



Companies 2, 5 and 13 did not contribute to their UK DB plans in 2017 or 2016. Company 19 did not separately disclose the staff costs for its UK subsidiary with the DB plan, and therefore does not appear in the above graph.

IMPACT ON DIVIDEND PAYMENTS

There can also be implications for the payment of dividends to shareholders or the parent company. Following a number of recent corporate failures, TPR has been paying increased attention to the level of dividends paid to shareholders, compared to the level of deficit contributions paid to the pension plan. It will have similar concerns where cash is being paid from the UK subsidiary to an overseas parent company. This issue was highlighted in its 2018 Annual Funding Statement, and more recently, TPR has been encouraging plans undergoing triennial valuations to put in place a guarantee of additional payments into the plan, where dividends grow above a certain threshold. Companies should be aware of this increased scrutiny, as well as any changes in legislation or powers introduced following the 2018 Government White Paper "Protecting defined benefit pension schemes". They can explore a number of options to manage this issue, including parent company guarantees and asset-backed contributions.

Companies in this survey

The following 20 companies are included in this survey:

- Aena S.A.
- Amadeus IT Group S.A.
- Banco Santander S.A.
- Brembo S.p.A.
- CNH Industrial N.V.
- Eni N.V.
- Exor N.V.
- Ferrovial S.A.
- Fiat Chrysler Automobiles N.V.
- Fomento de Construcciones y Contratas S.A.
- Iberdrola S.A.
- International Consolidated Airlines Group S.A.
- Leonardo S.p.A.
- Pirelli & C. S.p.A.
- Prysmian Group
- Repsol S.A.
- Saipem S.p.A.
- TIM S.p.A. (Telecom Italia Group)
- Telefonica, S.A.
- Tenaris S.A.

For this survey we have analysed publicly available data from these companies' group accounts and from the annual accounts of their UK subsidiaries disclosing DB plans. All these companies have a 31 December financial year end.

Some of these companies have been excluded from certain charts and analysis where the necessary data was not available. Although we do not name the companies in each of the charts, each company is represented by the same number throughout this report.

Other companies in the IBEX 35 and FTSE MIB indices do not appear in this survey either because they do not disclose any UK DB pension plans in their accounts or because some of their UK subsidiary accounts containing information on their UK DB plans for the financial year ending 31 December 2017 were not yet available at 15 November 2018.

Glossary

ASSET BACKED CONTRIBUTIONS (ABCS)

ABCs involve an employer transferring an asset to a special purchase vehicle for a fixed term. A contractual funding arrangement is created under which an income stream is provided to a plan via the a special purpose vehicle. That income stream is usually given a net present value by the trustees and is treated as an asset, thereby reducing or eliminating the plan's deficit.

BULK ANNUITY POLICY

A policy offered by UK insurers whereby pension plans pay a lump sum in exchange for an annuity that pays the retirement income in respect of some or all of the plan's members.

BUY-IN / BUY-OUT

A "de-risking" investment decision taken by the trustees of a defined benefit pension plan to match the pension benefits promised to a group of members by purchasing bulk annuity policies with an insurance company. If the policies are held in the trustees' name then it is a "buy-in"; in this scenario the insurer makes regular payments to the pension plan for the pension amounts covered by the bulk annuity policy, but the liability for paying the members' benefits remains with the trustees and the pension plan. Such a buy-in policy is an asset of the pension plan. If the policies are assigned to the individual members (effectively severing the link with the plan), then it is a "buy-out": the liability for these members' benefits is transferred from the pension plan to the insurer, and the insurer makes the annuity payments directly to the members.

CONSOLIDATION VEHICLE

Pension consolidation vehicles (sometimes referred to as "consolidators" or "superfunds") for DB plans are a new type of arrangement in the UK that could in due course provide an alternative to a buy-out for companies seeking to settle their UK pension liabilities. Pension plan trustees would be able to transfer part or all of the DB pension plan liabilities to a consolidation vehicle, which would take on full responsibility for those liabilities. The UK Government is currently consulting on the legislative framework for authorisation and supervision of these arrangements.

DEFICIT CONTRIBUTIONS

Additional contributions from employers, above the ongoing future service contributions, required in order to fund the deficit in respect of a plan's past service liabilities.

DIVERSIFIED GROWTH FUND

Diversified growth funds invest in a wide range of asset classes in order to provide investors with real returns over the medium to long term, whilst limiting the fund's exposure to market fluctuations (i.e. lower volatility). Investment performance targets are often set as a margin over LIBOR, a benchmark interest rate or an inflation index.

Glossary

FLEXIBLE RETIREMENT OFFER

Flexible retirement offers can include:

- Retirement transfer options: at retirement plan members are offered a transfer to another pension arrangement instead of drawing a pension from the plan. The transfer would be subject to the member taking independent financial advice, which the company may pay for. This may be of interest to members who wish to take their benefits in a different from to the type of pension provided by the DB plan (e.g. seeking a higher initial pension by removing increases in payment or dependant's pension) or who wish to take advantage of the DC pension flexibilities.
- Early retirement exercises: encouraging members to begin drawing their pension early (subject to reduction – although possibly a smaller reduction than would normally apply) in order to accelerate payments out of the plan to reduce its overall size and duration.

FUNDING LEVEL

The relative value of a plan's assets and liabilities, usually expressed as a percentage (also known as the 'funding ratio').

GRADUAL RUN-OFF

In the context of a pension plan, in particular one that is closed to new benefit accrual, continuing to operate the plan and pay benefits from it until the last beneficiary dies.

LIABILITIES

The estimated value, using actuarial methods and assumptions, placed on the defined benefit obligations (that is, the benefits promised to members) of a pension plan. These defined benefit obligations include the present value of future pension instalments and contingent benefits (for example, benefits paid to family members on the plan member's death) and may include the expected value of future expenses.

LIABILITY DRIVEN INVESTMENT (LDI)

An investment management style in which a bond portfolio is built up to better match the plan's liability profile, either by investing in those bonds directly, or in synthetic bonds created using swaps. The use of swaps allows for the option of "gearing" so that the portfolio is more fully immunised against interest rate and inflation movements, but some of the assets are still available to invest in risk-seeking assets (which then adds risk back in to the portfolio).

LIABILITY MANAGEMENT EXERCISE

Liability management exercises are a well-established means of managing down the size of liabilities and risks associated with defined benefit pensions, whilst also offering increased choice to plan members. The main types of liability management exercises are: pension increase exchange (PIE), enhanced transfer values (ETV), retirement transfer offers, early retirement exercises and DB to DC enhanced opt-outs.

Glossary

PARENT COMPANY GUARANTEE

Where a company's subsidiary participates in a DB pension plan, the parent company can provide a guarantee to the pension plan that it will meet some or all of the subsidiary's financial responsibilities, if the subsidiary cannot meet them itself. Such a guarantee allows the plan trustees to rely on the resources of parent company, thereby improving the security of the plan and in funding negotiations for example, may give the trustees sufficient comfort to agree to lower deficit contributions paid over a longer period than they would otherwise be prepared to accept.

PENSION FLEXIBILITIES (OR DC FLEXIBILITIES)

Following the introduction of the Freedom and Choice legislation for defined contribution (DC) plans in 2015, DC plan members are no longer required to use their DC pension savings to buy an annuity at retirement. They now have the option to take their DC pension savings as single lump sum or as regular withdrawals from the fund.

PENSION INCREASE EXCHANGE (PIE)

An offer under which a member would give up future (non-statutory) pension increases in exchange for a one-off uplift to their pension.

TRANSFER VALUE EXERCISE

An offer under which deferred members of a defined benefit plan are reminded of their ability to transfer the value of their benefits into an alternative pension arrangement (such as a DC plan). Plan members are provided with an up-to-date quotation of the transfer value of their benefits in the plan and offered access to independent financial advice. The offer may include an enhancement to the standard transfer value level (known as enhanced transfer value or ETV exercises).

TRIVIAL COMMUTATION EXERCISE

Within DB pension plans it is possible to convert the whole of a small pension into a one-off cash lump sum payment to the plan member, subject to certain eligibility criteria. The offer can be made to pensioners and deferred members over the age of 55 years. From the company's point of view, these exercises can reduce the level of pension liabilities (and therefore risk) as well as reducing future administration costs.

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Get in touch

Please contact your MBW International consultant if you would like to discuss any of the above topics in more detail.

info@mbwinternational.com 0333 566 0340

MBW International Limited is a limited company incorporated in England with company number 10707996 whose registered office is at 2 London Wall Place, London, EC2Y 5AU, United Kingdom.

www.mbwinternational.com