Don't look back

IAS19 surplus grows to record levels: learning from the pandemic and planning for tomorrow

LCP Accounting for Pensions
June 2022

Helping corporate sponsors

Welcome to LCP's annual report analysing the 2021 pension disclosures of FTSE100 companies

Our annual Accounting for Pensions report presents analysis of the pensions facts, figures and trends revealed by FTSE100 companies reporting in 2021.

Now in its 29th year, it will help those involved in preparing or interpreting accounts to understand and benchmark pensions arrangements. In addition, this report focuses on lessons learnt over 2021 and early 2022 and how these could influence future corporate actions and decisions in both the short and long term.

At first glance, the analysis suggests job done and pension schemes of FTSE100 companies are now an asset for UK Plc. However, with rising inflation, a potential recession and a new funding code on the horizon, whilst it's good news that the surplus is growing, companies need to understand how much of a surplus they really have, how to manage it, and make plans about how they best protect their schemes against the headwinds to come.

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IAS19 discount rates rose by 0.6% pa over 2021 reducing IAS19 liabilities by around 10% or £50bn.

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Most companies are yet to reflect the long-term impact of the Covid-19 pandemic in their life expectancy assumptions. Latest analysis suggests a reduction in pension liabilities of up to 2% or £10bn for the FTSE100 may be appropriate.

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All stakeholders need to consider the impact of high inflation – this has caused pension liabilities to grow by around £40bn for FTSE100 pension schemes.

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Average payments to FTSE100 CEOs in respect of pensions fell from 17% to 14% of pay, but remain above average contribution rates paid to the wider workforce.

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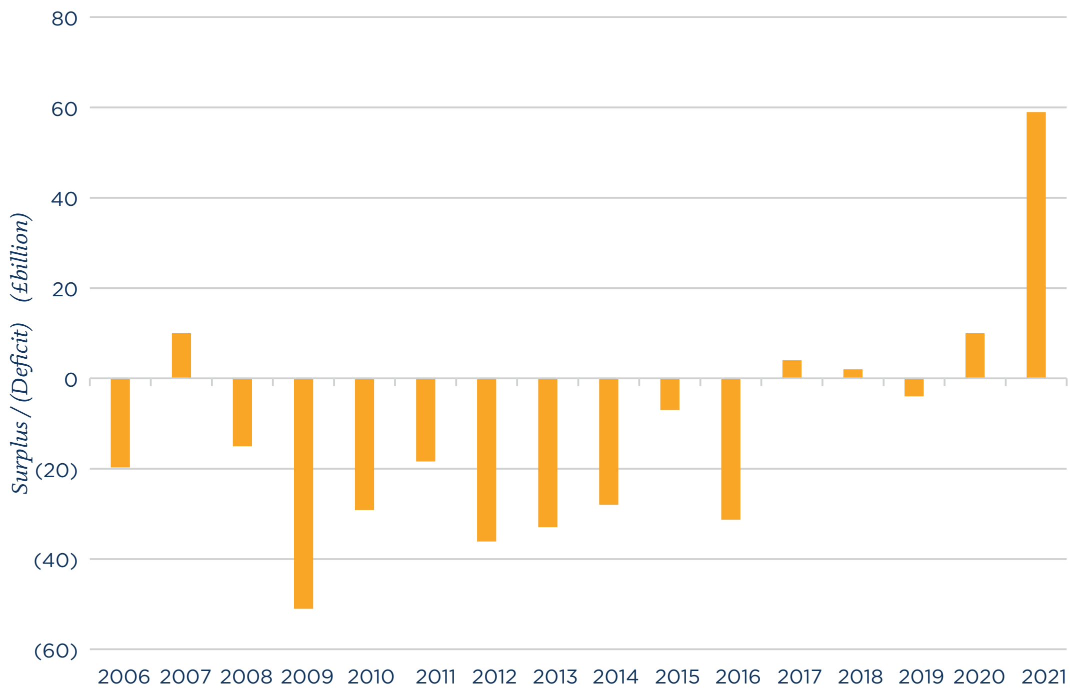
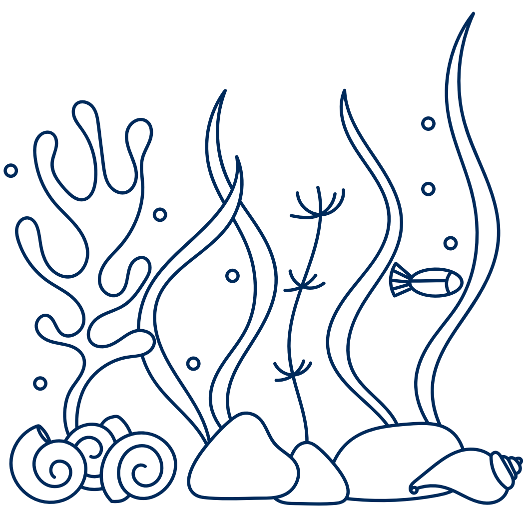
Section 1:
2021 IAS19 benchmarking

There was an element of deja-vu to the end of 2021, as once again scheme sponsors prepared to tackle a year-end against an economic backdrop dominated by Covid uncertainty. Thankfully, market conditions had improved from the record-breaking discount rate lows at the end of 2020. This improvement in market conditions for setting assumptions led to a much improved aggregate position for FTSE100 pension schemes. Surpluses increased from £10bn at the beginning of 2021 to £59bn at the year-end. However, scheme sponsors still have a lot to consider.

Estimated combined IAS19 position of FTSE100 companies at calendar year-ends



FTSE100 companies had a six fold increase in IAS19 surplus over 2021



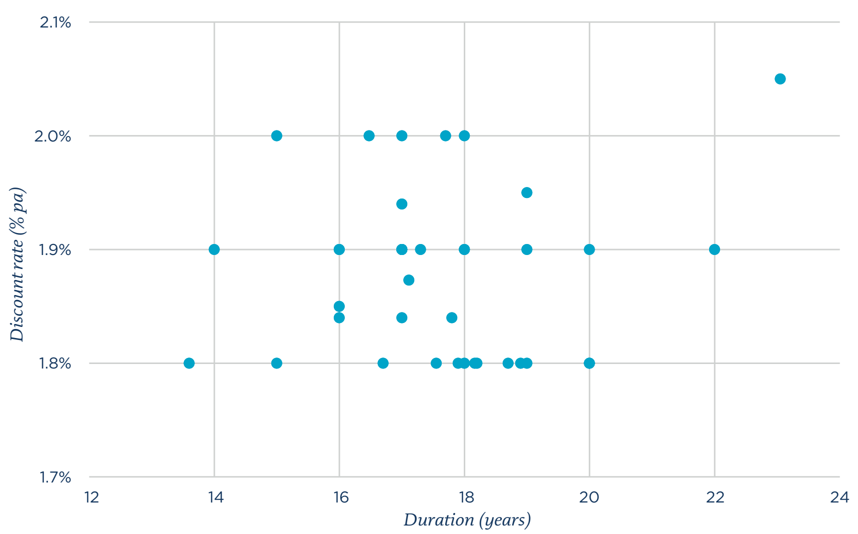
Discount rate

IAS19 discount rates are based on high quality corporate bond yields. Whilst 2021 lacked the high day-on-day volatility experienced at the onset of the Covid pandemic in March 2020, yields over the year still fluctuated. Corporate bond yields and IAS19 discount rates were up by c.0.6% pa over 2021, leading to a c.10% reduction in IAS19 liabilities. This equates to around a £50bn reduction in UK pension liabilities for the FTSE100.

Rises in corporate bond yields over 2021 reduced IAS19 liabilities by 10%...

The chart opposite shows the disclosed IAS19 discount rates for FTSE100 companies reporting at 31 December 2021. The majority of companies reported in the range 1.8% pa to 2.0% pa (compared to 1.3% pa to 1.4% pa as at 31 December 2020), with the core range in rates being slightly wider in 2021 than at the 2020 year-end.

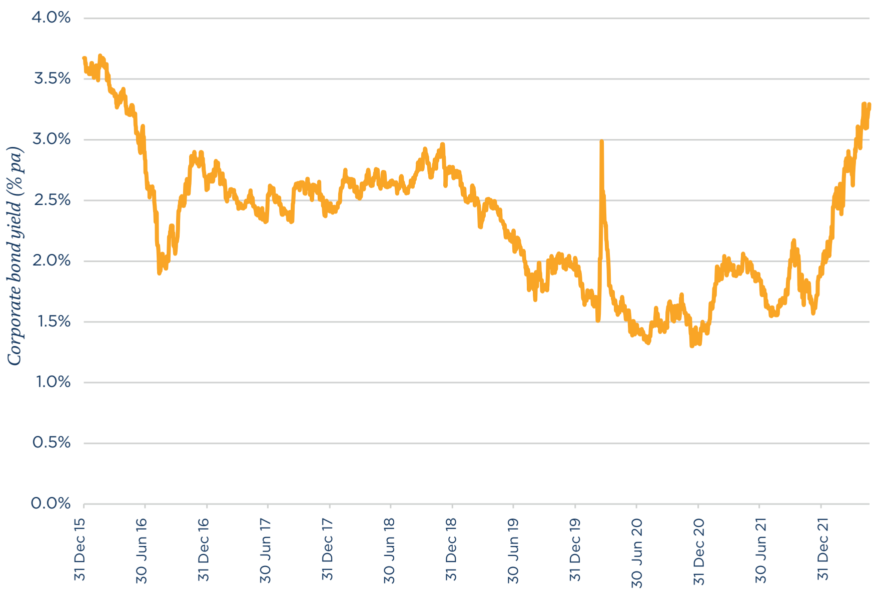
Disclosed UK IAS19 discount rates as at 31 December 2021



Since the 2021 year-end, there has been a sustained increase in corporate bond yields as shown in the chart opposite. Yields have risen to over 3.0% pa, a landmark not seen since before the EU referendum in mid-2016. This rise since the year-end, in isolation, will have reduced IAS19 liabilities by a further 20% - broadly a £100bn reduction in pension liabilities for the FTSE100.

... and rises since the start of 2022 have reduced liabilities by another 20%

Movement in corporate bond yields since 31 December 2015



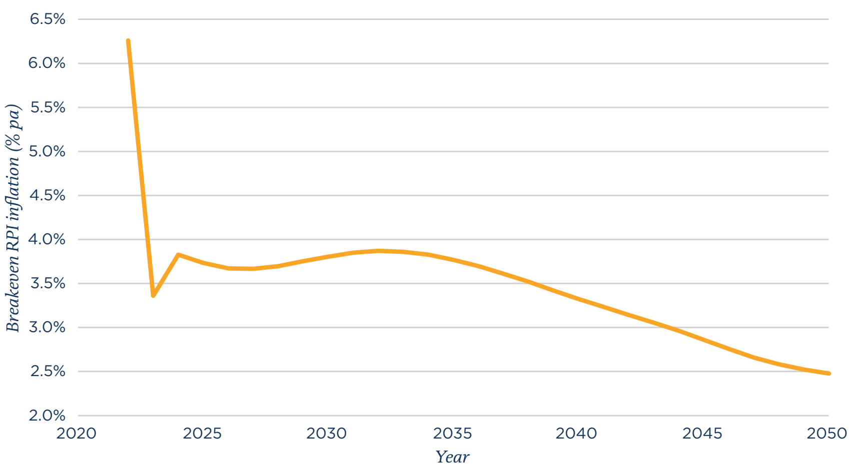
Source: ICE GBP AA Corporates 15+ yield

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. The assumption is an average over the long-term, and the high levels of inflation expected in the short-term feed into this average. We also describe some specific knock-on impacts and actions for companies to consider in section 2 of this report.

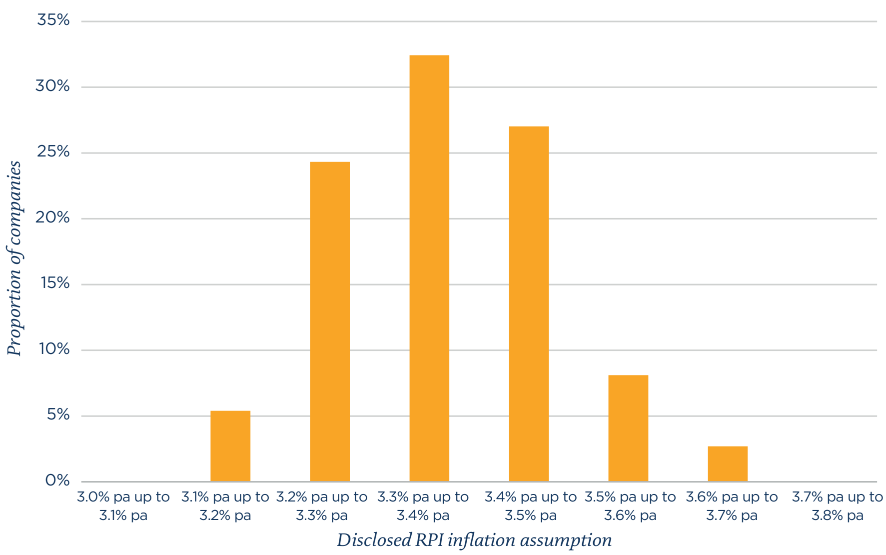
The chart opposite shows the projected year on year rate of RPI inflation implied by breakeven rates. There are significant variations between projected inflation in the short-term and in the long-term. This presents challenges for pension schemes when deriving their inflation assumptions, as companies will need to consider the specifics of their pension scheme (for example, the scheme maturity, whether benefit increases are fixed or linked to inflation, as well as any caps on annual pension increases) as the resulting inflation assumption could vary significantly. This means that, in some circumstances, simple average rates may not accurately represent the scheme, and more sophisticated assumption derivations will now be appropriate.

Breakeven RPI in each calendar year (31 December 2021 market conditions)



Source: LCP calculations based on observed differences in nominal and real gilt yields

Disclosed UK RPI inflation assumption as at 31 December 2021

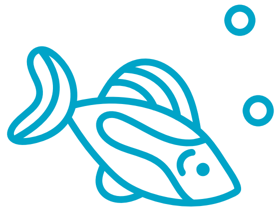


The chart opposite shows disclosed long-term RPI inflation assumptions for companies reporting at 31 December 2021. These are average assumptions over the lifetime of the pension scheme. The breakeven inflation assumption at this date varied depending on each scheme's duration, with longer duration schemes having lower inflation assumptions as they are assumed to benefit more from the future fall in inflation rates (as the chart above showing year on year inflation rates demonstrates). The breakeven inflation rate varied between 3.7% pa (for a short duration) to 3.4% pa (for longer durations). The majority of companies continue to use an inflation risk premium or "IRP" of around 0.3% pa.

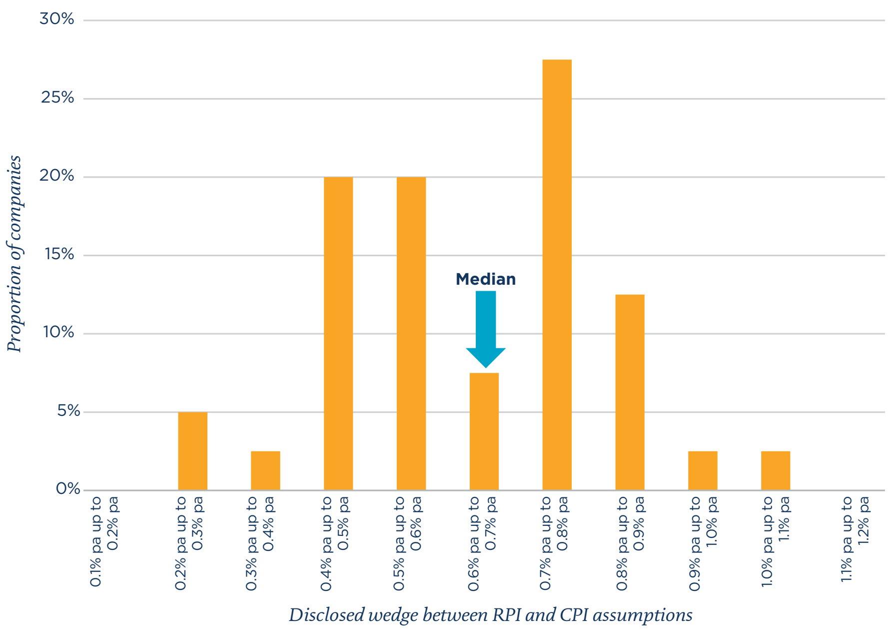
CPI inflation is then typically derived by taking a deduction from the RPI assumption to reflect structural differences between the two inflation measures – the "RPI-CPI wedge".

Last year's Accounting for Pensions Report highlighted changes that will reform the RPI inflation index to bring it in line with the CPIH index (a variant of CPI) from 2030. Inflation measured by CPIH is consistently lower than that measured by RPI by around 1% pa, and therefore these plans imply a significant step-change reduction in RPI inflation from 2030 onwards. The proposed inflation reforms would mean that the average RPI-CPI wedge will be around zero from 2030 leading to an expected gradual reduction in the wedge over this period to 2030. The exact impact on the average wedge will be very scheme specific and dependent on the proportion of post 2030 benefits that are linked to CPI.

This chart shows the wide range of RPI-CPI wedges disclosed for companies reporting in their 2021 year-end accounts. The range varied from a wedge of 0.25% pa to 1.00% pa, presumably reflecting the wide spread in the profile of benefits provided by FTSE100 companies. The median assumption of 0.6% pa is shown on the chart, although this single statistic masks the range of assumptions disclosed.

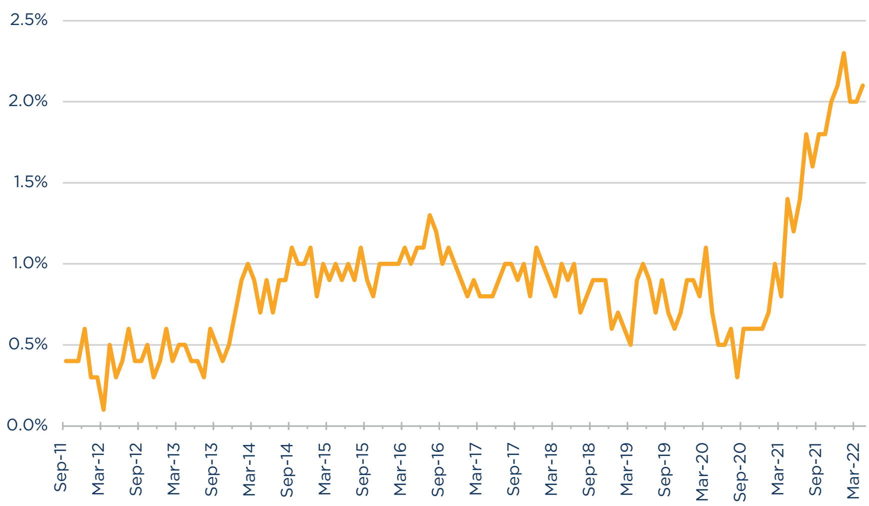


Wedge between disclosed RPI and CPI inflation assumptions



Over recent months, actual RPI and CPI have diverged significantly. As shown in the chart opposite, the gap is currently close to 2% - double the average over the past decade, and around three times the median wedge disclosed in FTSE100 companies' accounts. Companies will need to consider the extent to which the current wedge is expected to persist and whether to adjust assumptions as a result. Given the wedge only applies to any significant extent for the period up to 2030, even one or two years at this higher level could lead to lower CPI assumptions and material reductions in liabilities improving balance sheets and, for open schemes, potentially reducing service costs improving profit and loss.

Gap between published annual RPI and CPI inflation figures



Source: Office for National Statistics

Life expectancy

Setting an assumption for life expectancy is hard at the best of times. As we hopefully emerge from the Covid pandemic, companies need to carefully consider and understand the impact it has had and will continue to have on their pension scheme members. As we highlighted in our recent Longevity report, these impacts can be split into three different categories:

> *Setting a robust assumption for future life expectancy is challenging - particularly as we emerge from the Covid pandemic and its long-term impact is still not clear*

1. **Direct impacts:**
individuals contracting and dying from the virus;

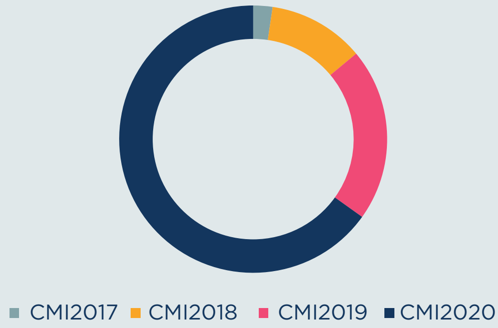
2. **Indirect impacts:**
deaths due to stresses on the health care system (e.g. increase in NHS waiting lists, disrupted or delayed treatments), or changes in the behaviour of individuals seeking health care;

3. **Economic and social impacts:**
wider economic, social and behavioural impacts of the pandemic on health and mortality in the future.

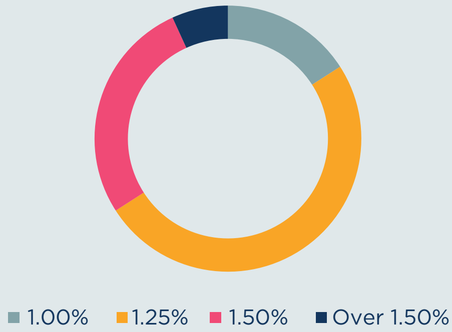
Whilst one can attempt to measure the first of these categories objectively, there is a large element of subjectivity in quantifying the impact of the other two. Like last year, given the level of uncertainty, we are yet to see a step change in the life expectancy assumptions used by the FTSE100. Companies generally appear to have retained the "wait and see" approach at the 2021 year-end - perhaps influenced by questions such as "what are my peers doing?" and "what does my auditor say?", the answers to which inevitably lead to a herding of assumptions.

The level of detail disclosed varies significantly between companies – with some disclosing just life expectancies and others providing full detail of the many component parts of the mortality assumption. The charts below show the information reported in 2021 where information on the underlying component assumptions is provided. Further information on what each of the components represents is available on page 10 of our previous Accounting for Pensions report.

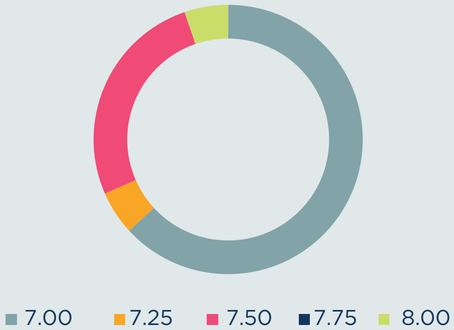
Projection tables disclosed by FTSE100 companies reporting in 2021 (43 companies)



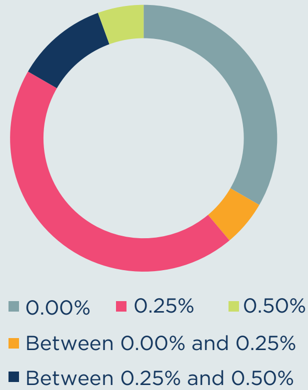
Long term mortality improvement rates disclosed by FTSE100 companies reporting in 2021 (44 companies)



Smoothing parameters disclosed by FTSE100 companies reporting in 2021 (19 companies)



Initial adjustment parameter disclosed by FTSE100 companies reporting in 2021 (18 companies)

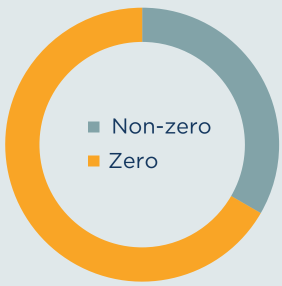


The CMI2020 projections contain a new parameter ("w2020") which determines how much weighting to place on the mortality data in 2020. More recently, the CMI2021 projections released in March 2022 have a further new parameter ("w2021"), which will need to be considered by companies reporting in 2022.

Whilst the default within the core projections is to ignore and place no weight on the data collected over 2020 and 2021, company directors will need to consider whether that will lead to a true best estimate of the long-term impact of the Covid pandemic on their pension scheme. The Pensions Regulator's Annual Funding Statement, released in May 2022, stated that they expect the reductions to liabilities for the impact of the pandemic within prudent triennial funding valuations to be no more than 2%, unless accompanied by strong supporting evidence. This indicates acceptance of an allowance for the longer-term impact of the pandemic in pension scheme valuations and suggests the "wait and see" approach is becoming less appropriate

Whilst there was no wholesale step change or change in approach, some companies we work with did make an explicit allowance for the longer-term impact of the pandemic within their disclosed accounting figures. Of the FTSE100 companies that stated the w2020 assumption, around a third made an explicit allowance for the impact of the pandemic, with the average impact being a reduction of around 1% in liabilities. Although this statistic only covers a subset of companies, we fully expect the number and proportion of companies making an allowance to grow over 2022.

w2020 parameter disclosed by FTSE100 companies reporting in 2021 (15 companies)

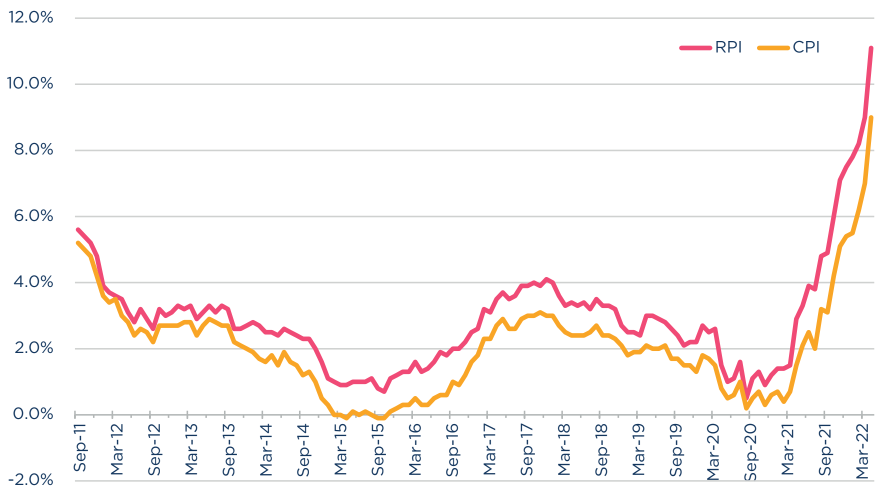


Section 2:
Current hot topics in pensions strategy

High inflation – what impact on your pension scheme and its members?

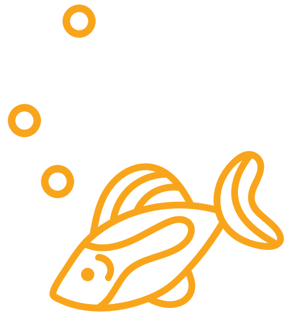
As has been widely reported in the media, RPI and CPI inflation have increased sharply and are currently (May 2022) running at 11% pa and 9% pa respectively.

Published annual inflation figures



Source: Office for National Statistics

This has a significant impact on pension schemes – increasing the pension increases granted both in payment and in the period to retirement. This in turn increases the liabilities and the ultimate cost of providing the benefits.



Hedging

Pension schemes typically hold investments, such as derivatives or index-linked gilts, that are intended to hedge (i.e. remove or reduce) inflation risks. This helps stabilise the funding position (on all measures) and avoids dramatic swings on the sponsor's balance sheet. Given the uncertain outlook for both short and long-term inflation, there has never been a more important time for companies and trustees to make sure that the right hedging is in place and that it is acting in line with intentions.

For example:

- Increases granted to pensions in payment are set out in each scheme's rules and are typically capped each year – with common caps being 5% pa or 2.5% pa.
- Current inflation levels are around 10% which is well above common caps.
- Movements in the current level of inflation that are above the cap will not impact the increases granted to members whose benefits are in payment in the short-term.
- There is therefore currently no short-term inflation linkage for these benefits.
- Companies and trustees should ensure that the assets used to hedge inflation risks reflect this. If they do not, there could be unnecessary and unwanted volatility in funding positions.

In the example above, schemes could have benefitted from being over-hedged for inflation and are likely to have seen their funding position improve as a result (as assets could have continued to rise in value to reflect the rise in inflation). Trustees and pension scheme sponsors should consider whether to maintain this unbalanced position, or whether to adjust their investment strategy to hedge the current position and lock-in these gains. On the other hand, schemes which are under-hedged are likely to have seen a drop in funding levels. Sponsors need to make sure they understand the position for their scheme and take action to avoid further potential surprises.

Impact on individual members

Pension scheme members who have not started taking their pension will typically benefit from some form of inflation linkage between the period they stopped earning benefits and the point of their retirement.

Typically the cap on increases is applied on a cumulative average basis, rather than on an annual basis. That is to say, if the cap is 5% pa before retirement, then the benefit receives full inflation protection irrespective of whether the level of inflation is over 5% in some of these years, as long as it didn't exceed 5% pa on average over the whole period. This means that the increase this year granted to pensions before retirement could be higher than the increase granted to pensions in payment.

There can be some oddities within scheme rules or the terms used to calculate pensions that can give rise to some unexpected cliff edges. Companies and trustees could come in for criticism or complaints if benefit quotations don't properly reflect these factors.

Companies and trustees will need to consider whether to communicate with their scheme members so that members can make informed decisions over how inflation impacts their scheme benefits.

Discretionary increases

As funding positions improve, and as inflation exceeds pension increase caps, many Trustees and sponsors need to consider whether to give discretionary increases over and above the increases set out within the scheme's rules. There are clearly many considerations to factor into the discussion, but from a corporate perspective, some of the key issues will include:

Powers:
Who has the power to make the decision? Is it the Trustees, the sponsor, or a joint power?

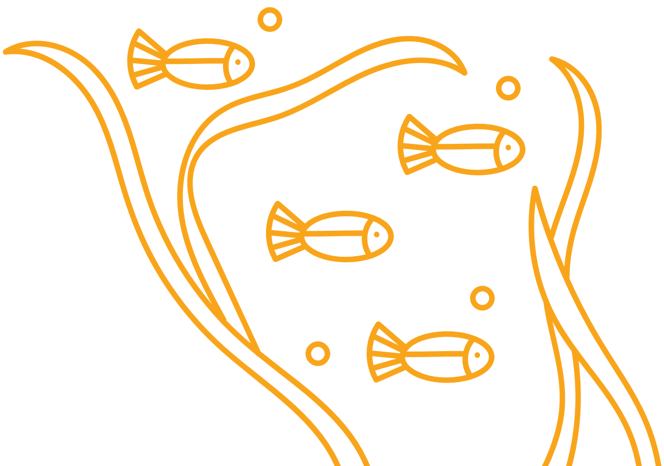
Precedents:
Does granting an increase now set a precedent or expectation for future increases?

Accounting treatment:
Unless there is a past practice and assumption within the liabilities already, the cost of the increase would typically be recognised through P&L. Is this acceptable?

Fairness:
How would any increase be applied fairly for different members who have different caps on pension increases? Is it fair to treat pensioners and non-pensioners differently? How is fairness assessed?

End-game:
How does granting an increase impact the end-game? Does it push back the target date?

Funding:
How is the increase going to be funded? Will the sponsor be required to pay any additional cash – now or at any point in the future – to pay for this increase? If using an existing surplus to fund an increase, what could the sponsor request in return?



Actuarial terms for member options

A pension scheme's existing actuarial terms used for member options such as cash equivalent transfer values, early or late retirement factors, or the factors used to convert pension into a tax-free cash lump sum at retirement may no longer be robust in the current high inflation environment. This could be particularly true where calculations are based on automated routines, where assumptions are fixed, if there are any underpins, or where factors inherently assume a particular level of future inflation increases.

Member option exercises

Many companies and trustees are currently undertaking member option exercises with a view to managing risks, reduce potential future costs, accelerate the position towards the long-term target, as well as providing flexibility for pension scheme members.

These exercises could be:

Offers to members to transfer their defined benefits either fully or partially out of the pension scheme. This includes "Enhanced Transfer Value" or "Flexible Retirement Option" exercises, as well as one-off trivial or winding-up lump sum exercises. In this situation, companies and trustees should confirm that the factors adopted for the exercise remain fit for purpose in the current environment.

Modification exercises such as GMP conversion or offers to members to surrender future pension increases in return for a higher initial pension (a "Pension Increase Exchange", which is typically offered either to pensioners in retirement or at the point of retirement). In addition to the terms and calculations, depending on the structure of the offer, companies should consider the timing of any exercise and reflect whether offering members the option to give up (some) inflationary protection in the current high inflation environment in return for fixed or no increases in future pension will lead to the desired engagement and/or take-up.

Covenant

The covenant is a company's legal obligation and financial ability to support their DB pension scheme both now and in the future. Trustees, as part of ongoing good governance, will monitor the covenant and assess whether there has been any change.

Different companies will be impacted by high inflation in different ways. Both the trading covenant (for example, impact on input costs, ability to pass on any increase to consumers) and the balance sheet covenant (for example, is there any impact on existing or future rate of borrowing?) could be impacted in either beneficial or adverse ways.

Trustees are likely to want to consider the impact over the short- and long-term and request information from the company. It will be important for companies to focus on what any changes in covenant mean in terms of support offered to the pension scheme. Many schemes will have contingent funding arrangements, and this should be monitored as well to ensure that the contingent assets continue to provide the level of support originally envisaged or to confirm whether a change in covenant triggers a requirement for additional contributions.

DC pensions

A key issue for DC pensions is whether the investments keep pace with high inflation. Companies should review their default investment strategy to ensure the strategy remains robust in the current environment. This could be particularly true for schemes that use investment funds targeting CPI inflation plus a margin – in these situations, companies and their advisers should consider how these funds are likely to perform if inflation remains high for, say, the next few years.

Member communications, such as benefit projections, may assume a lower level of future inflation, potentially giving members a misleading view of their retirement benefits. Companies should review their communications and consider whether changes are required.

Covid and long-term mortality – understanding the wider impact

The Covid-19 pandemic has placed more focus on public health and life expectancy, simultaneously generating significant uncertainty around both these topics. This uncertainty is compounded by the current surge in the cost of living, which is likely to have an adverse impact on life expectancies and widen the current health and life expectancy inequalities observed across the UK.

At the same time, mortality assumptions are becoming more important as pension scheme trustees and corporate sponsors de-risk their investment strategies and establish long-term journey plans. For many pension schemes this means longevity is now their largest outstanding individual risk, and for some it dominates the scheme's overall risk profile. Excessive prudence in this assumption may therefore lead to an increased risk of "over-funding" pension schemes.

As a direct consequence, it is important for pension scheme sponsors to understand the wider impacts of the pandemic on pension scheme members and liabilities. This is so that companies can objectively assess the value for money of insurance de-risking (such as buy-ins or longevity swaps), to inform valuation negotiations, provide input into terms for member options, as well as derive best estimate IAS19 accounting assumptions.

To address these challenges, and as set out on page 8, more judgement is required on the direct and indirect impacts of the pandemic. It is especially difficult to fully assess the impact given full data is not yet available or clear as patients are yet to present themselves for diagnosis and/or treatment. The following analysis highlighted by LCP's Health Analytics team and taken from our Longevity Report illustrates some of the issues at the current time.

NHS diagnostic tests[1]:

97% of patients were seen within 6 weeks before the pandemic hit in March 2020.

↓

56% during the first wave, and has subsequently recovered to around **71%**.

[1]Source: Fetzer and Rauh; arxiv, January 2022

This fall and delay in diagnosis will impact life expectancy over the medium term, and potentially longer if the current level persists.

With regard to treatment, for cancer, once diagnosed the target is to receive treatment within 62 days of diagnosis. 78% hit this target before the pandemic but this has gradually decreased since to around 66%, with 55,000 patients receiving treatment later than 62 days of diagnosis. Again, this could have medium to long-term impacts on mortality.

There is a similar picture when looking at other major health issues. For example the rate of Type 2 diabetes diagnosis fell by over 50% as the pandemic hit. This rate has yet to return to even close to pre-pandemic levels.

So what does this mean for companies and their pension schemes?

A typical best estimate assumption for the impact of Covid-19 for a scheme may be around a 1% fall in liabilities, but the impact will vary on the specifics of each scheme's membership – including the profile by age, sex, region, or deprivation. We have observed reductions in liabilities of up to 2% when looking at scheme specific data, and we are seeing reinsurers making up to 2% reductions in their longevity swap pricing (again, any reduction is scheme specific). This level of reduction translates to a c.£10bn reduction in liabilities for the FTSE100. As was shown on page 9, the majority of companies are currently not recognising this "gain" within their corporate accounts, and this will lead to a further improvement in overall position.

The same will be true for cash funding figures, meaning that pension schemes will be closer to their target end game, be that an insurance buy-out or a low-risk run-off strategy, than previously realised.

> *Allowing for the impact of the pandemic on longevity expectations leads to a 1% to 2% reduction in liabilities – broadly equivalent to a £5bn to £10bn "gain"*

Section 3:
IAS19 surplus – so now what?

Over the course of 2021, we estimate the combined IAS19 funding position of FTSE100 pension schemes improved from a surplus of £10bn to a surplus of £59bn. In early 2022 we have seen further improvements, to an estimated surplus of £100bn in mid-May. This is the first time the landmark £100bn barrier has been crossed with the improvement in position largely driven by rising IAS19 discount rates.

Does the large pension surplus on the IAS19 measure mean this is a case of "job done"? Are well-funded pension schemes really now an asset for UK Plc?

In short – probably not.

Although the large IAS19 surplus is good news and represents a stark improvement from the position over 10 years ago, this surplus is on the basis that the schemes are continued until the final pension payment is made to the final member. For many schemes this could be over 80 years in the future.

IAS19 liabilities represent a best estimate of the cost of providing all benefits due to pension scheme members (and their dependants) assuming investment returns in line with high quality corporate bond yields – broadly equivalent to 1% pa above gilts. This level of expected return can typically comfortably be achieved through a low-risk diversified investment strategy. However, at some point in the pension scheme's future it is likely that the ongoing expense, risk, and management time associated with running the scheme will outweigh the financial cost of passing the pension scheme to a third party such as an insurer or a consolidator.

So what's next for pension schemes with an IAS19 surplus? What should their sponsors, in collaboration with the scheme trustees, be targeting and when? What hurdles or barriers will they encounter on the way? The following sections set out some of the key areas for attention.

Recognising a surplus on the balance sheet

Whether or not a company can recognise an accounting surplus on their balance sheet is determined by the rules of their scheme, and an accounting interpretation, IFRIC14.

IFRIC14 limits recognition of surplus to cases where the company can derive economic value from the surplus, which requires it to have an unconditional right to the surplus. This is a slightly contrived concept. In the UK it typically comes down to the "run-off argument" within IFRIC14, which is based on it being within a company's control to run the pension scheme on until all benefits have been paid (whether the trustees have a unilateral power to wind-up the scheme or to augment benefits in the meantime may affect this, depending on how the sponsor and its auditor interpret IFRIC14).

If the company does have an unconditional right to the surplus, it should be shown on the balance sheet. If not, then no surplus can be shown, and IFRIC 14 requires the company to go one step further and recognise an additional liability on their balance sheet in respect of all deficit contributions promised to their pension plans that they cannot derive economic benefit from. This is one reason why the use of escrow accounts for future contributions may be attractive to sponsors.

IFRIC 14 reform?

IFRIC 14 had been considered for review by the International Accounting Standards Board (IASB) for some years. Companies were faced with the possibility that changes would result in them no longer being considered to have an unconditional right to their surplus. For impacted companies this could have materially increased their balance sheet liabilities.

However, in late February 2022, after eight years of announcements, exposure drafts and consultations the IASB called a halt to its project proposing reform. So, for the foreseeable future, companies can continue to calculate IAS19 figures in line with current rules and practice.

For those companies without the unconditional right to recognise a surplus, an improvement in the IAS19 funding position won't necessarily lead to an improved balance sheet. For these companies, not recognising an IAS19 surplus could be a positive due to:

- Return on equity metrics, whereby any increase in pension surplus worsens the metric as it is included within the equity measurement.
- Challenges with explaining the position to investors, and why, for example, there is an IAS19 surplus but the Company is still paying cash deficit contributions.
- The Company is not actually expecting to gain any future economic benefit from the surplus.

As IAS19 positions improve, and more individual companies have a surplus for the first time, more companies will be bitten by these rules and, for those already impacted, bitten harder. This is demonstrated looking at the position disclosed within 2020 and 2021 accounts, whereby around one in five FTSE100 companies now disclose some form of balance sheet restriction.

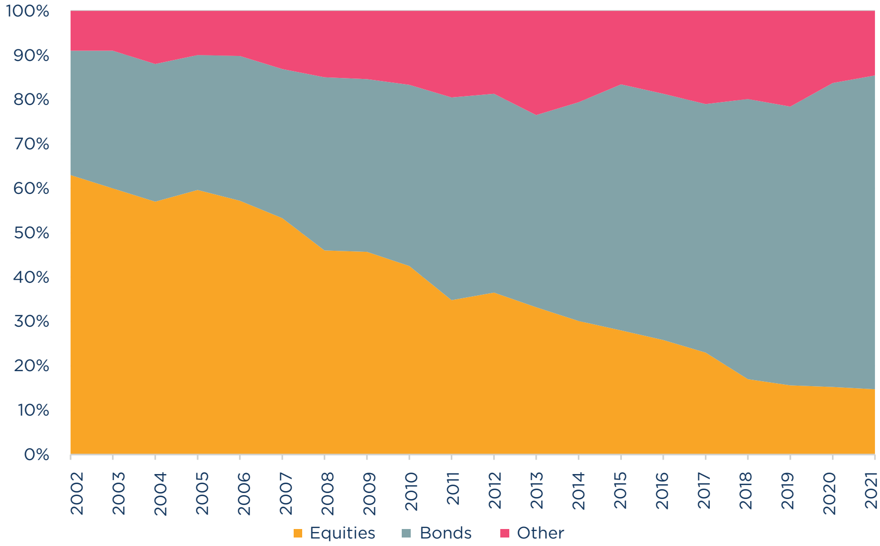
	2020	2021	Change
Aggregate surplus	£10bn	£59bn	Up £49bn
Number of companies disclosing an IAS19 surplus	47	59	Up 12
Number of companies disclosing an IFRIC14 adjustment	16	19	Up 3
Total IFRIC14 restriction	£10bn	£14bn	Up £4bn

IFRIC14 can be a bit of a marmite issue – for some companies it is irrelevant, whilst for others it has the potential to impact many future corporate pensions decisions particularly where a large balance sheet movement has knock-on effects to dividends, capital, budgets, credit ratings and investor perceptions. Whether or not a company is impacted depends on a legal lottery of the precise wording of a pension scheme's rules. Given growing IAS19 surpluses, companies should review previous advice received to confirm whether their current IFRIC14 treatment remains both appropriate and consistent with evolving practice.

Asset de-risking

The movement of assets away from return-seeking equities to bonds, that typically better match liability movements, continued. Now only 15% of FTSE100 pension scheme assets are invested in equities, down from around 60% 20 years ago. This reflects less need for high investment returns as schemes have become better funded, a move towards lower-risk or "self-sufficient" investment strategies, a stronger regulatory regime and schemes having shorter time horizons as many closed to the future accrual of benefits some time ago.

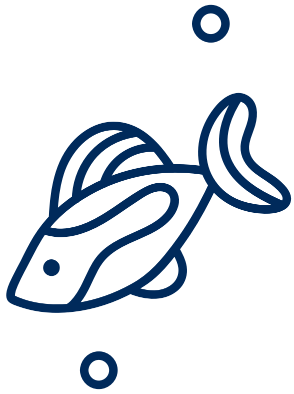
Estimated overall asset allocation for UK pension schemes sponsored by FTSE100 companies



Companies, in collaboration with pension scheme trustees, need to consider their long-term target and ensure they retain sufficient expected investment returns within their asset portfolio to bridge the gap between being fully funded and, for example, the cost of passing the scheme to an insurer without the need for additional contributions. Alternatively, companies may wish to continue to underwrite investment risk with the intention of extracting surplus from the pension scheme and potentially increasing shareholder value.

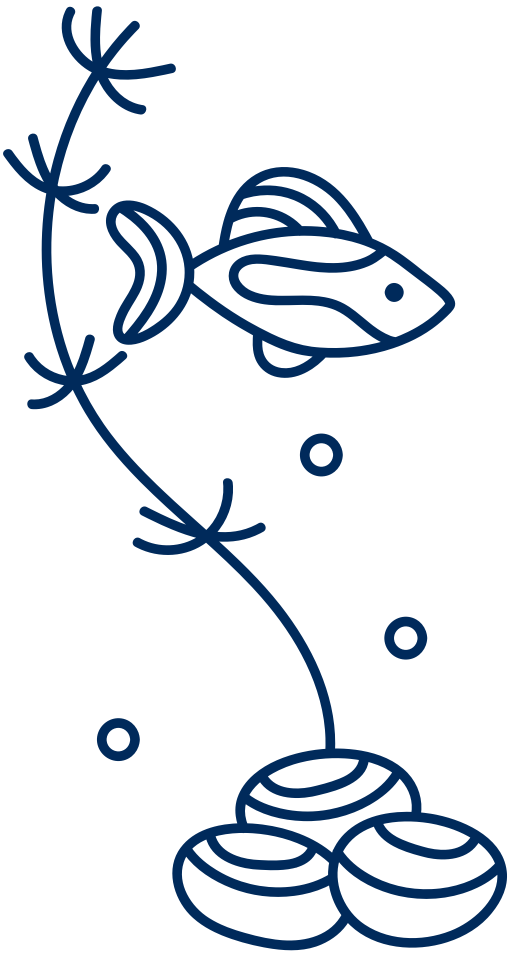
Annuity buy-ins and buy-outs

FTSE100 pension schemes have continued to use buy-in annuity transactions to de-risk and provide protection against investment and longevity risks. Nearly 40% of FTSE100 companies with DB pension schemes have insured some of their pension scheme through buy-ins, with 3i, National Grid, Smiths Group, Melrose Industries, Phoenix Group and Reckitt Benckiser all reporting new buy-ins within their 2021 accounts.



> *Nearly 40% of the FTSE100 have insured some or all of their DB pension liabilities*

In addition, Barratt Developments, Entain, Rentokil International and Segro all disclosed that they had converted existing buy-ins into buy-outs, completely removing the assets and liabilities in respect of these insured members from their corporate balance sheets.



Contingent funding

Contingent funding has become an integral part of many schemes' pension strategies and can help to protect both the sponsor and trustees over the long-term against both upside and downside risks, often providing a win-win solution for all parties. There are many different arrangements – further detail is available in our contingent funding handbook – and pension scheme sponsors may seek to adopt a strategy which means they still provide appropriate support to the scheme but do not over-commit resources now or pay contributions that are not ultimately needed.

As funding positions improve, an increased number of FTSE100 companies (around a quarter) have reported some form of contingent funding arrangement. Our experience is that companies are increasingly looking to contingent funding to mitigate the risk of a trapped surplus through the use of, for example, contribution triggers and escrow type solutions. We expect the use of contingent funding to grow, particularly in light of the new upcoming DB funding code which may require pension schemes to target more prudent funding measures requiring either additional contributions or downside protection.

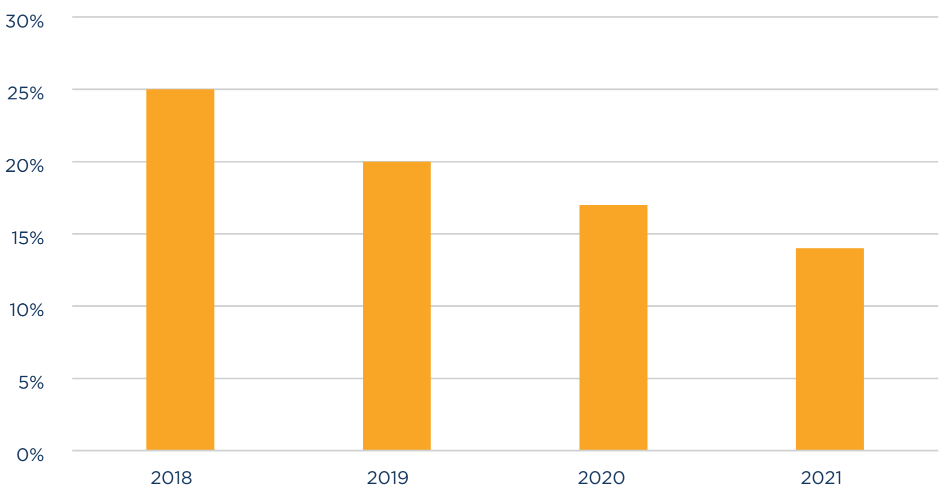
As with many pension solutions, getting the practicalities right is critical. Examples of this include futureproofing and flexibility. Avoiding trigger payments that are based on a single date can protect the sponsor against spurious effects of volatility. Upfront stress testing is imperative: the pandemic has shown that extreme events can and do happen and it's important to understand the impact of these on any contingent funding mechanisms before they are put in place.

Section 4: *Executive pensions*

The overall level of remuneration paid to company executives, and how this compares to their employees, remains a focus of attention.

We have previously reported on the pressure applied by the Investment Association to align the pension contributions (including cash in lieu) paid to company executives with those available to the majority of the workforce. Over successive years, the average FTSE100 pension contribution for CEOs has reduced, falling from 25% in 2018 to 14% in 2021.

Average pensions contribution to a FTSE100 CEO as a percentage of basic salary



As set out in last year's Accounting for Pensions Report, the Investment Association strengthened its guidance in 2020 stating that they will "red-top" any company who:

1. pays a director a pension contribution of 15% or more; and
2. 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.

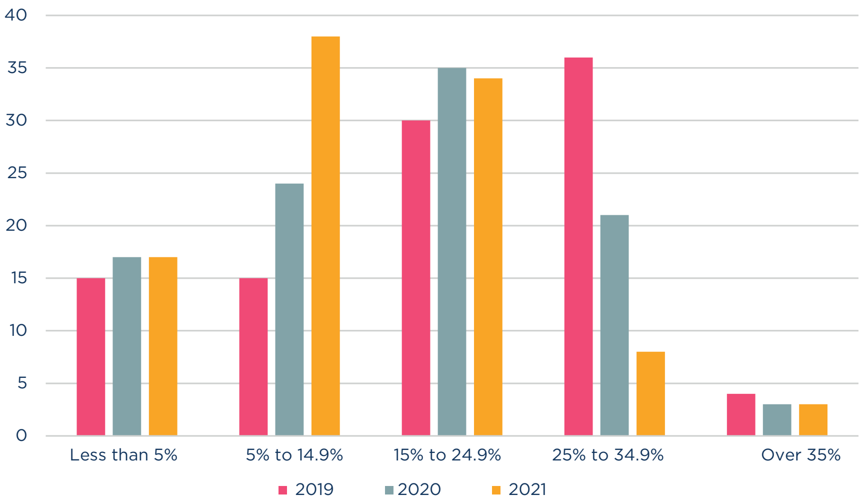
The chart above shows that the average CEO pension contribution rate is now in line with this guidance.

Average FTSE100 CEO pension contributions are now in line with latest Investment Association guidance

A more detailed breakdown of the pension contributions is shown in the chart below and shows there have been large changes across FTSE100 companies. The number of FTSE 100 CEOs receiving pension contributions of 25% or more of basic salary has fallen from 40 in 2019 to just 11 in 2021.

Numbers of FTSE100 CEOs receiving pension contributions over 25% of pay has fallen by 70% since 2019

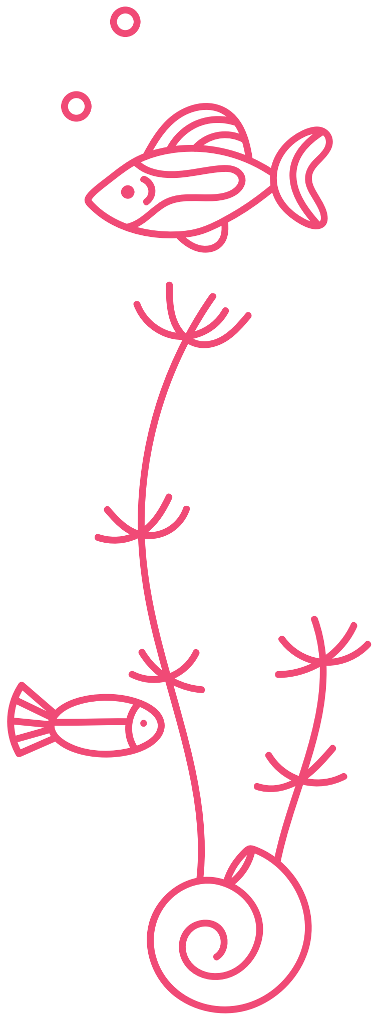
Pension contributions to CEO as a percentage of basic salary



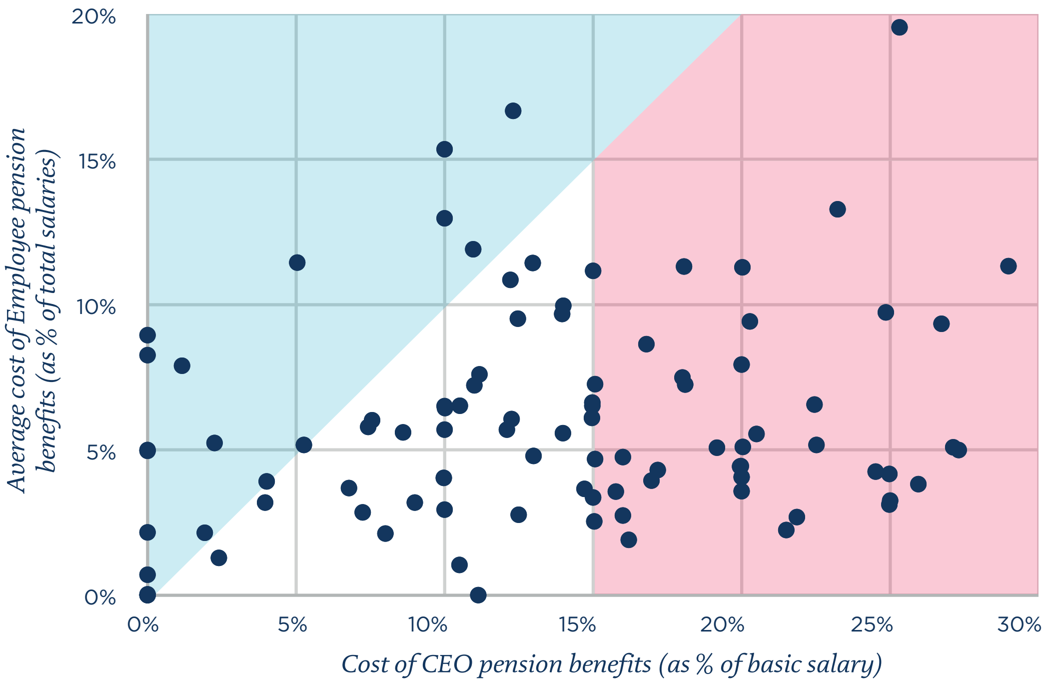
Given the firm guidance issued by the Investment Association, the majority of companies that are currently over the 15% threshold have plans to reduce the contributions further over the coming year or are already aligned with rates offered to employees. As such, we expect the observed trends to continue.

Comparing pension provision for CEOs to the average percentage pension cost paid for employees, it is clear there is still some way to go to meet the Investment Association's second objective. There remains a disparity between the percentage cost of pensions benefits for CEOs and the average percentage pension cost paid for employees. The chart on the following page compares the two. Currently around 1 in 5 FTSE100 companies are paying average pension contributions to employees that are either equal to or greater than those paid to the CEO.

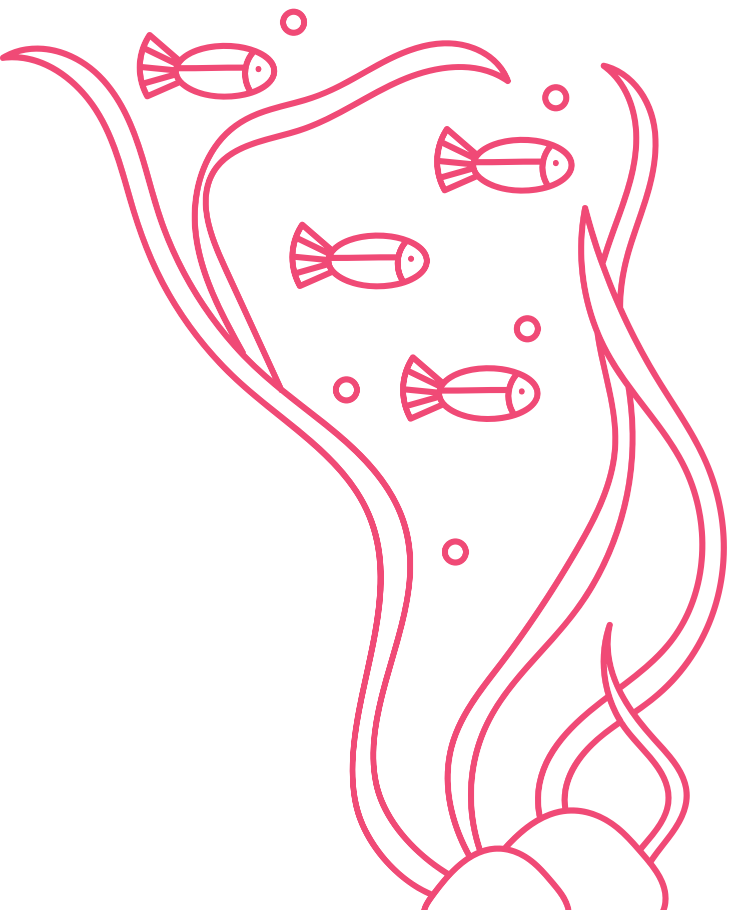
Whilst the average cost paid to employees is shown on the vertical axis, it is important to remember that this does not necessarily represent the maximum contribution offered by each company. The maximum level of contributions can be significantly higher – potentially more in line with that paid to the CEO and the Investment Association requirements.



Comparison of cost of pension benefits for CEO with average cost for employees



In light of the current cost of living crisis, some employees may seek to reduce their pension contributions with a view to maximising take home pay, potentially missing out on matching company pension contributions. This could result in a reduction in the average pension contribution paid of 5%. The delicate and difficult balance of both providing for now and providing in retirement is an issue that employees are grappling with. It will be important for companies to understand their employees. Our latest Financial Wellbeing report provides more insight.



The cost of living crisis may see some employees reducing their pension contributions and missing out on matching contributions from their employer

Contact us

For further information, please contact one of us or the partner who normally advises you.

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At LCP, our experts provide clear, concise advice focused on your needs. We use innovative technology to give you real time insight & control. Our experts work in insurance, pensions, investment, energy, financial wellbeing and business analytics.

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