



## US Companies Survey

Analysis of DB schemes in major US companies with UK subsidiaries



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This is our first annual survey of US companies which have a UK subsidiary with a defined benefit (DB) pension scheme. The survey covers 32 of some of the most influential companies in the US, with around £56 billion of UK DB pension liabilities between them.

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## Data source

Data has been taken from the latest available financial statements of the UK subsidiary companies, which are as at 31 December 2016 in most cases. Although the companies are not named directly within this survey, they are represented by the same number in each chart throughout. Note that some companies have been excluded from some of the analysis due to lack of available data, or due to data items being outliers.

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## Some highlights from the report include:

- Funding levels on the company accounting basis decreased by around 5% between 2015 and 2016, largely as a result of the volatility in markets following the EU referendum. However, relatively stable market conditions and positive performance on scheme assets over 2017 resulted in funding levels generally returning to pre-referendum levels by the end of 2017.
- Company contributions to the pension scheme represent a significant proportion of staff costs, with total DB contributions equal on average to 23% of staff costs reported in the accounts. With the Pensions Regulator paying increased attention to the level of dividends paid compared to the level of deficit contributions paid, there could be real implications on the return for shareholders.
- UK DB pensions may be making a disproportionately large impact on the performance of the US parent company. Indeed, although UK companies produce on average only 4% of the global revenue, they account for 29% of the global pension scheme liabilities and 31% of the global pension scheme contributions.
- The Freedom and Choice legislation has led to a large increase in the volume of DB to defined contribution (DC) transfer requests. Although it is probably too early to draw definitive conclusions about the level of benefits actually paid, the schemes in our survey saw an average increase in benefits paid of 23% over the period 2015 to 2016.

We also draw comparisons with the results of our FTSE350 survey, '[Impact of pension schemes on UK business](#)'.

The results should be considered in the context of recent publications, including The Pensions Regulator's 2018 Annual Funding Statement and the White Paper on 'Protecting Defined Benefit Pension Schemes'.

I hope you will find our report both interesting and useful as a benchmark of your UK pension exposure against other US-owned companies.

## White Paper

The recently released White Paper on 'Protecting Defined Benefit Pension Schemes' sets out possible legislative reforms that will impact DB pension schemes. In light of a number of recent high profile corporate failures, the Paper aims to maintain confidence in DB pensions by increasing the protection of members' benefits. There are three main policy areas:

- Strengthening the regulatory framework and the Pension Regulator's powers
- Introducing a new package of measures to optimise scheme funding
- Consulting on a legislative framework and authorisation regime to allow DB schemes to consolidate

We are unlikely to see any overnight changes as a result of the Paper, with reforms instead being introduced gradually over a number of years. It will be interesting to monitor the impact of these changes going forward on the asset and liability strategies of the companies in this survey, as well as on the wider market.



Please contact me for further information on the results of our research.

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# Funding levels

DB pension schemes can have a material impact on a company's accounts.

This can include the impact of the pension scheme deficit on the company's balance sheet position, and the ongoing cost of the scheme impacting the company's income statement. This in turn can affect the return on shareholder funds and the dividend payments made to shareholders.

In this section we look at pension scheme funding levels in more detail, before looking ahead to how companies may seek to improve their funding level.

## Funding levels

Figure 1 shows the funding levels of the UK DB schemes on the company accounting basis as at 31 December 2016. Funding levels ranged from 63% to 102%, with the average funding level being 86%. Two schemes showed a surplus on their accounting basis. The average is lower than the average funding level of FTSE 350 companies' DB schemes, which was 94% at the same date.

### 1. Funding level on the company accounting basis as at 31 December 2016



See data source note

## Changes in funding levels

Figure 2 shows the percentage change in the funding levels of the UK DB schemes between 2015 and 2016.

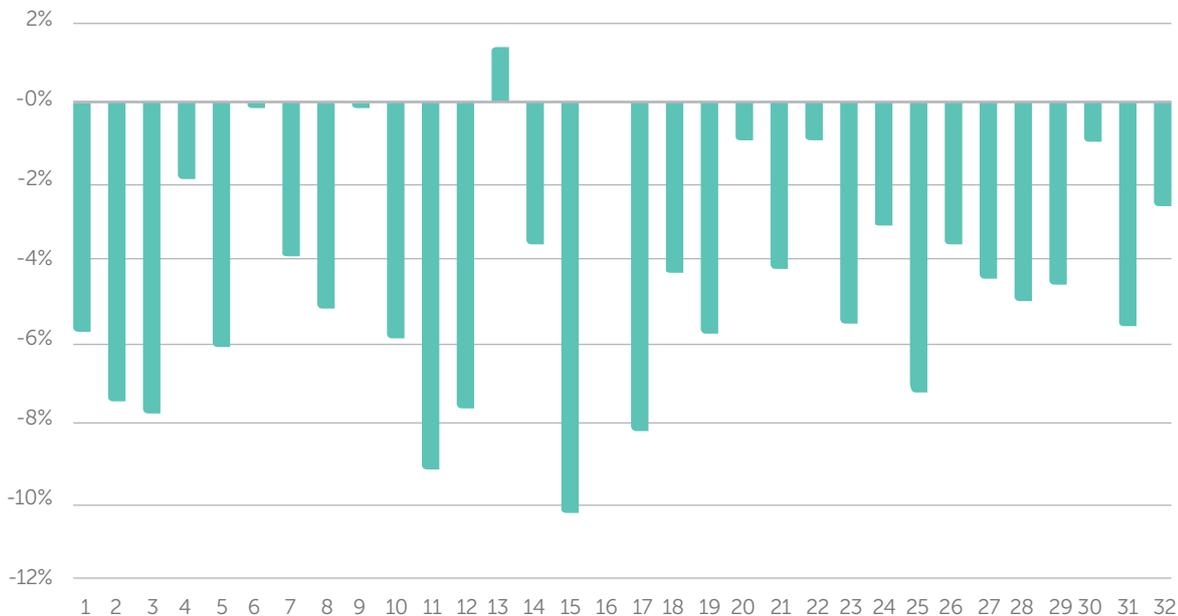
Most schemes experienced a decrease in their funding level, with the average decrease being 5%, although for some schemes the decrease was as high as 10%.

In general, most UK pension schemes experienced a decrease in their funding level during the latter part of 2016 and early 2017. This was caused by a significant fall in bond yields following the EU referendum, resulting in lower discount rates on the company accounting basis and a higher value placed on the scheme's liabilities.

In addition, many asset classes experienced volatile performance over this period.

However, during 2017, bond yields remained relatively stable, resulting in stable liability values, while asset values generally increased. As a result, funding levels for most schemes had generally returned to pre-referendum levels by the end of 2017.

### 2. Percentage change in funding level between 2015 and 2016



See data source note

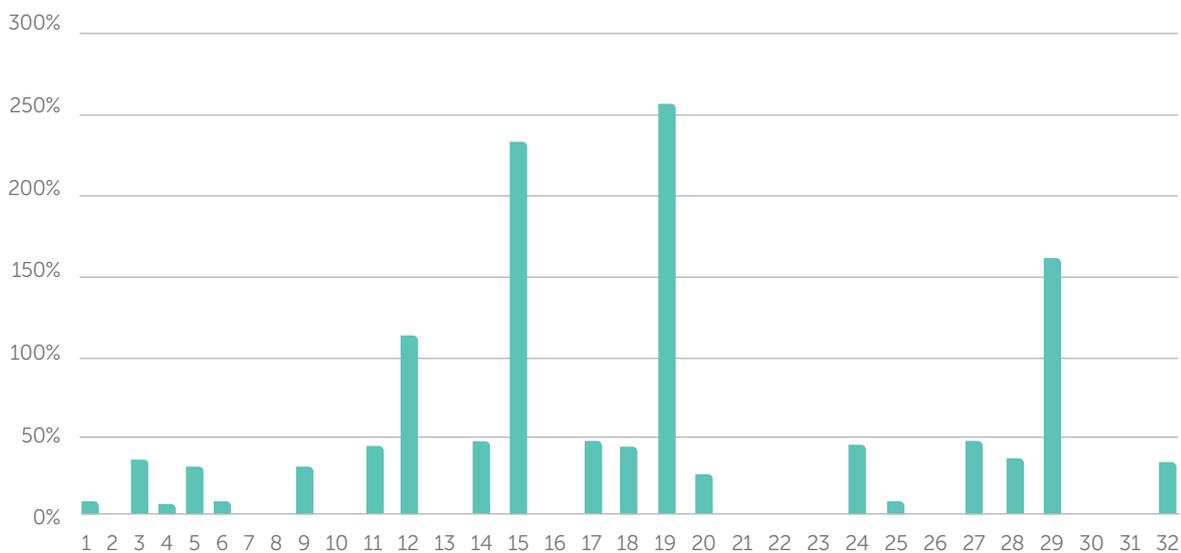
## Impact on shareholder funds

To illustrate the impact of pension scheme deficits on the company as a whole, figure 3 shows the UK DB scheme deficits as a proportion of UK shareholder funds.

On average the deficits amounted to 57% of shareholder funds, which is a significant proportion, although the proportions for individual companies varied greatly. Such high proportions could adversely impact the return on shareholder funds, which could affect a company's ability to transfer funds back to its parent company.



### 3. Scheme deficit as % of shareholder funds



*See data source note*

## Actuarial movements

Figure 4 shows the split of absolute actuarial movements between the liabilities (including both experience gains and losses and changes in assumptions) and the assets of the UK DB schemes.

In most cases, actuarial movements on the liabilities were more significant (on average 64% of the total movement) than those on the assets (on average 36% of the total movement).

However, it is likely that the majority of the movements in the liabilities relates to changes in assumptions, in particular, changes to the discount rate, expected inflation assumption and longevity assumptions.

In years where no formal valuation has been completed (usually two out of every three years), it is common for disclosures to be prepared using a roll-forward method where experience gains and losses on liabilities may automatically be reported as zero.

### 4. Split of actuarial movement between assets and liabilities



See data source note

## How can companies improve their funding level?

Having seen the significant impact that the pension scheme deficit can have on a company's accounts, companies are typically interested in ways they can improve their funding level. There are various measures companies can take in this respect, with some important considerations being:

- **Investment strategy** – a scheme's investment strategy is likely to be the largest long-term driver of funding position. Though the trustees of a scheme are generally responsible for decision making around investment, input from the company can drive improvements in investment decision making and this is likely to lead to improved funding level progression.
- **Actuarial assumptions** – a scheme's funding position depends on the actuarial assumptions used to value the liabilities. Companies can make significant changes to their reported funding position by optimising the assumptions used.
- **Contributions** – company contributions can form a significant proportion of staff costs. Companies should consider how they can best manage their contribution requirements.
- **Liability management** – there is a range of exercises that companies can undertake to remove risk from the pension scheme and help improve the funding level.



# Investment strategy

Generally, the investment strategy for a UK DB scheme is set by the trustees of the scheme, having taken professional advice and consulted with the company or sponsoring employer.

This is in contrast to DB plans in the US, where the company is responsible for setting the investment strategy.

Although the company is not responsible for setting the investment strategy in the UK, should the investment strategy fail to meet the appropriate performance target, then it is the company who will be required to make good any shortfall or deficit. It is therefore particularly important in the UK that the strategic views of the company (including risk appetite) are taken into account when the trustees set the investment strategy.

This requires proactive engagement from the company with the trustees. While this relationship can be made more complicated when the company is not based in the UK, this should not be a barrier to the company taking a more active role in the investment strategy decisions.

We have set out below three key areas where the involvement of the company can make a significant difference to the performance of a scheme's investment strategy, driving future improvements in funding level.

## Setting a strategy

### Risk versus reward

Companies' exposure to their pension schemes, and the associated cost, is driven by several risk factors. Some of these risks (such as equity market risk) are expected to provide schemes with long-term excess returns and therefore reduce the cost of providing benefits. Others (such as interest rate risk or longevity risk) offer no expectation of a long-term return, as the upsides and downsides are equally distributed – these are often referred to as unrewarded risks.

It is important for companies to have input not only into the size of risk being taken within their pension schemes, but also the distribution of these risks. Generally speaking, companies which have failed to mitigate risk in their schemes have seen funding positions deteriorate (despite a period of high asset returns and substantial company contributions).

Most companies still have significant amounts of unrewarded risk within their schemes and, with new tools available to pension schemes, there is likely to be significant scope to improve the efficiency of the investment strategy.

### Ultimate target

Trustees of pension schemes typically focus on the security of members' benefits and are somewhat agnostic to the funding of those benefits. Companies (particularly those with closed schemes) should be thinking about the funding of schemes over the long-term.

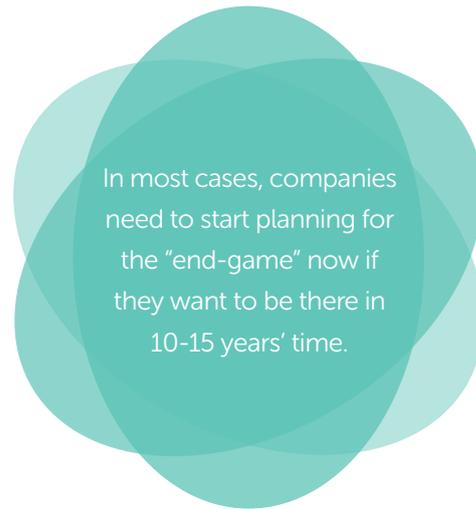
In most cases, companies need to start planning for the "end-game" now if they want to be there in 10-15 years' time. Setting an ultimate funding target, and investing and funding towards that target, is probably the most important input a company can make. There are several different models for this in the UK, which reduce the company risk exposure in the long-term.

### Investment governance

A well governed scheme does not guarantee better investment returns, but it should increase the chance of meeting the set funding targets.

Companies should encourage trustees to set realistic targets, and aim to maximise the certainty of those targets being achieved.

Companies also have the ability to influence trustees, particularly in the area of investment governance. There are several options for companies to improve governance, and trustees will generally be receptive to company interaction in this area and can help to improve overall engagement.



# Actuarial assumptions

A scheme's funding position depends on the actuarial assumptions used to value the liabilities.

Depending on the scheme's liability profile, relatively small adjustments to the assumptions can make a material difference to the pension scheme deficit.

The setting of actuarial assumptions should therefore be an important consideration for companies approaching their accounting year-end.

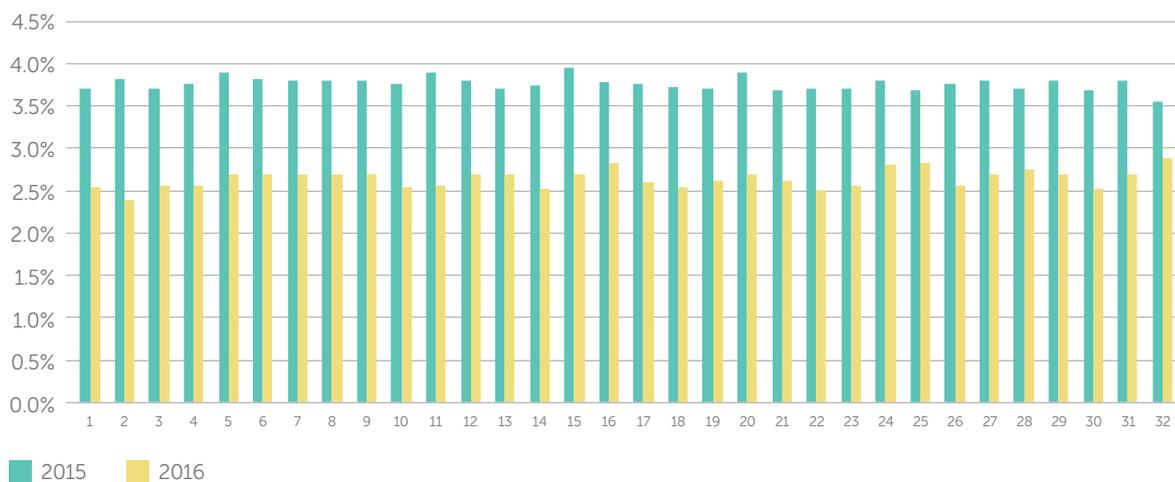
In this section we look at the actuarial assumptions used on the company accounting basis, together with possible adjustments that companies could make to their assumptions.

## Discount rate

The discount rate is the most significant assumption for valuing a scheme's liabilities. For a scheme of duration 20 years, a decrease in the discount rate of 0.1% pa would increase the value of the liabilities by around 2%.

Figure 5 compares the discount rates used to value UK DB schemes' liabilities in 2015 and 2016 on the company accounting basis.

### 5. Comparison of discount rates at 2015 and 2016



See data source note

Discount rates in 2016 were significantly lower than in 2015, with the average discount rate falling from 3.8% pa to 2.6% pa over the period.

Following the EU referendum in 2016, bond yields fell sharply, and then continued to fall more gradually for the remainder of the year. For companies with an accounting year-end in the latter part of 2016, this led to a large decrease in discount rates compared to the previous year-end, with a corresponding increase in the value of the liabilities.

Bond yields remained relatively stable over 2017, leading to relatively stable discount rates over the year, and stable liability values. However, discount rates are still low compared to historical levels.

### How can companies adjust their discount rate?

In the current environment of low bond yields, many companies are paying increased attention to their discount rates. There are various approaches to setting discount rates which may result in higher assumptions, including the following:

- Using different methods to extrapolate the corporate bond yield curve used to derive the discount rate, for example, keeping the last spot rate constant rather than the last forward rate
- Removing 'non-corporate' low-yielding bonds from the yield curve data, for example, University bonds or Transport for London bonds
- Using a 'single agency' approach to deriving the yield curve.



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## Inflation assumption

The impact on the value of a scheme's liabilities of changes in the assumption for future inflation depends on the level of inflation-linked benefits in the scheme.

UK DB pensions legislation requires that schemes provide increases to pension benefits both before and after retirement. This is in contrast to US schemes, which generally do not provide automatic increases to pensions before or after retirement. The minimum level of increase that must be provided is broadly in line with Consumer Price Index (CPI) inflation, although increases for some schemes will be based on Retail Price Index (RPI) inflation.

Our analysis is based on RPI inflation assumptions, although as the two assumptions are closely linked, we would expect analysis based on CPI inflation assumptions to show similar trends.

Figure 6 compares the RPI inflation assumptions used to value UK DB schemes' liabilities in 2015 and 2016 on the company accounting basis.

There was a slight increase in inflation expectations in 2016 compared to 2015, with the average RPI inflation assumption increasing from 3.1% pa to 3.3% pa over the period. However, inflation expectations remained relatively stable over 2017.

### 6. Comparison of RPI inflation assumptions at 2015 and 2016



See data source note

### How can companies adjust their inflation assumption?

Although inflation expectations have remained relatively stable, companies may still wish to consider whether they could make a downward adjustment to their inflation assumptions. Possible methods could include:

- The market-derived inflation assumption is usually calculated as the difference between the yields on fixed interest and index linked gilts. The market-derived inflation assumption could be reduced by deducting an 'inflation risk premium', which could be in the range 0.2% pa to 0.4% pa.
- The assumption for CPI inflation is usually derived as the RPI inflation assumption less a fixed amount – the 'RPI-CPI wedge'. Using a higher RPI-CPI wedge, which could be in the range 1.0% pa to 1.2% pa, would result in a lower CPI inflation assumption.
- Pension increases in the UK are often based on inflation with collars and caps, for example, RPI inflation with a minimum of 0% pa and a maximum of 5% pa. Increasing the standard deviation assumption in the model used to derive the inflation-linked pension increase assumptions would result in lower pension increase assumptions.

### Mortality assumption

The other key assumption for valuing a scheme's liabilities is the mortality assumption. Many companies use an assumption based on that used for scheme funding purposes, but with the margins for prudence removed. However, as scheme funding assumptions are generally only updated once every three years, companies may wish to consider updating the mortality assumption for company accounting purposes more frequently than this, to allow for more recent trends in life expectancy.

Up until a few years ago, life expectancy was generally increasing year on year, with each successive mortality model released showing higher life expectancies than the previous model. The result was that the value of schemes' liabilities was increasing over time as members were expected to live for longer.

However, recent research published by the Continuous Mortality Investigation (CMI) has shown that over the last few years, the trend of increasing life expectancy appears to have stopped, for the time being at least. Indeed, death rates have been higher over the last few years than would have been expected in 2011, and the recently released CMI 2017 mortality improvement model shows lower life expectancies than all previous versions of the CMI model.

⋮ In light of this recent research, companies may wish to review their mortality assumptions used for accounting purposes and consider moving to the latest CMI model.

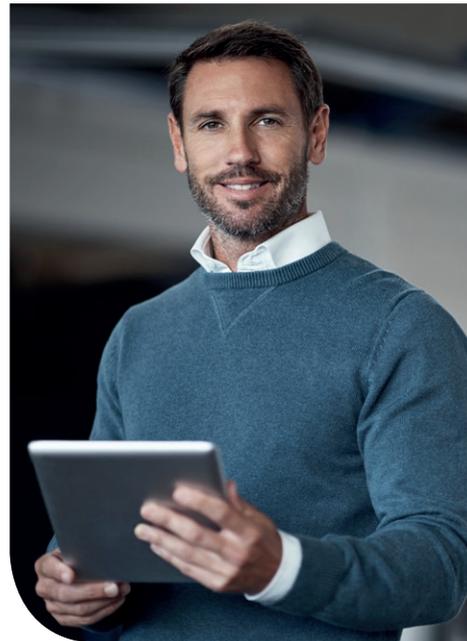
# Contributions

In order to fund the DB retirement benefits of their members, companies must pay contributions to their pension schemes, both in respect of benefits currently being earned in the scheme, and in respect of any past service deficit.

They must also pay for the ongoing expenses of running the scheme.

Most UK DB schemes are 'balance of cost' schemes, where members pay a fixed percentage of their salary as contributions, with the remaining cost being paid by the company. The danger is that this can represent an open ended liability to a company, with increasingly large scheme deficits leading to higher levels of contributions due, with seemingly no upper limit. In the worst cases, the pension scheme deficit could swallow up all of a company's profit and even force the company into insolvency.

In this section we look at the levels of both future service and past service company contributions, together with measures that companies may take to manage their contribution requirements.



## Analysis of contributions paid

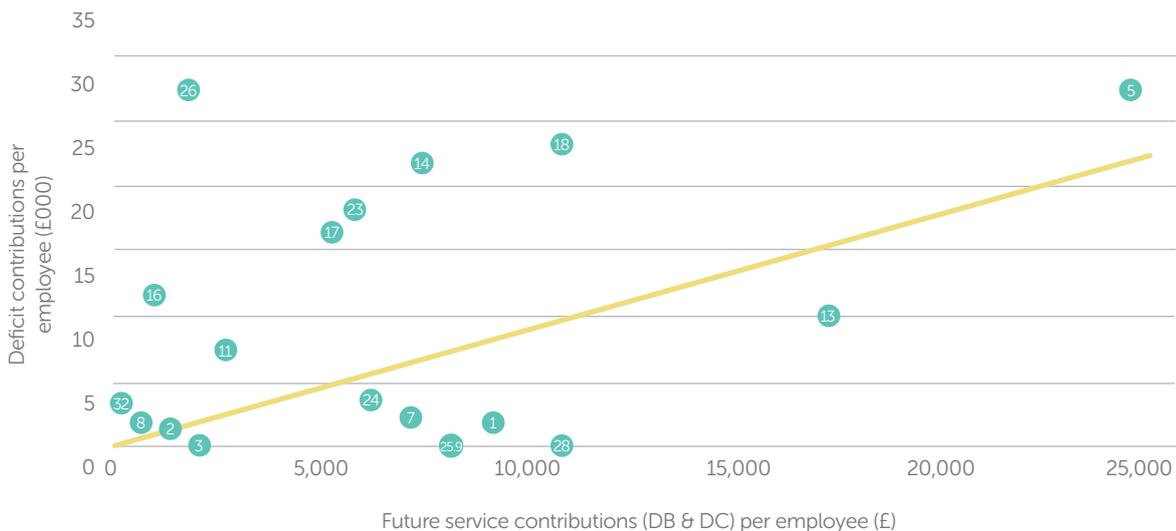
### Future service versus past service

Figure 7 compares the future service company contributions paid per employee (both DB and DC) against the annual past service deficit contributions per employee.

In many cases, companies paid higher contributions for past service deficits than for future service benefits (those above the yellow line). Indeed, the average deficit contribution per employee was around £9,100, compared to an average future service contribution per employee of around £6,400. However, there were some significant variations around these amounts.

This illustrates the difficult balance companies need to find between providing a competitive pay and benefits package for their current employees, while ensuring that legacy DB liabilities (in many cases for staff who have long since left the company) remain appropriately funded.

### 7. Future service cost vs past service cost



See data source note

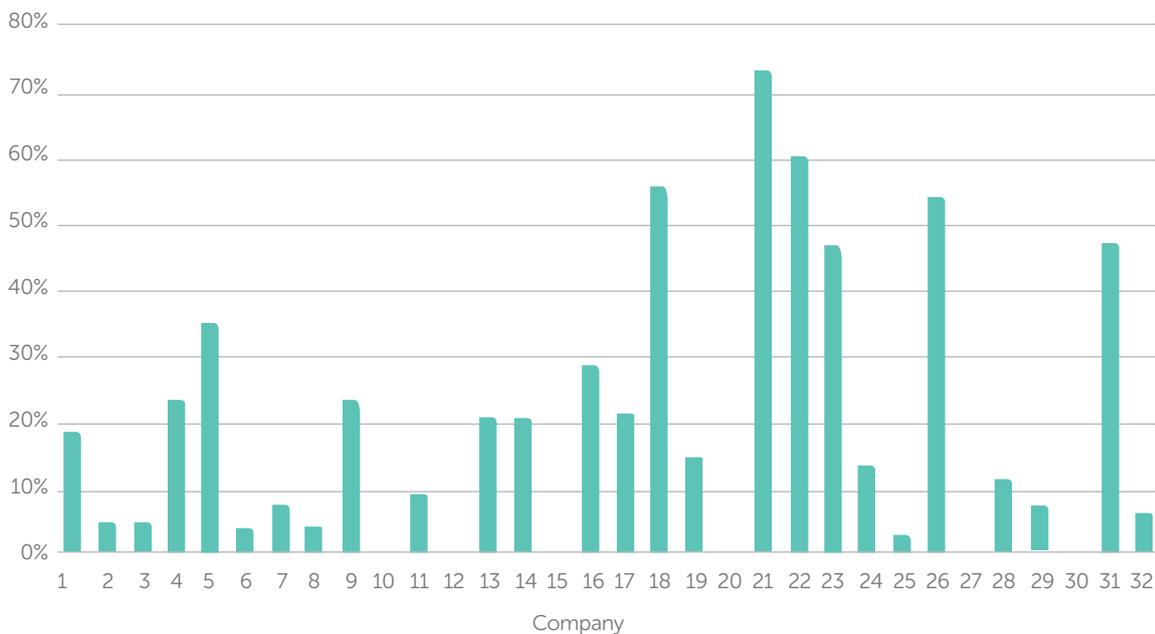
### Contributions as a percentage of staff costs

Figure 8 shows the total DB company contributions, in respect of both future service and past service deficits, expressed as a percentage of total staff costs.

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, as we have just seen.

On average, total DB contributions were equal to 23% of staff costs reported in the accounts. However, the figure for individual companies varied greatly, from less than 3% to over 73%. This variation is to be expected, as the level of deficit contributions is likely to vary greatly between companies.

#### 8. Total DB contributions as % of staff costs



See data source note

### Changes in contributions

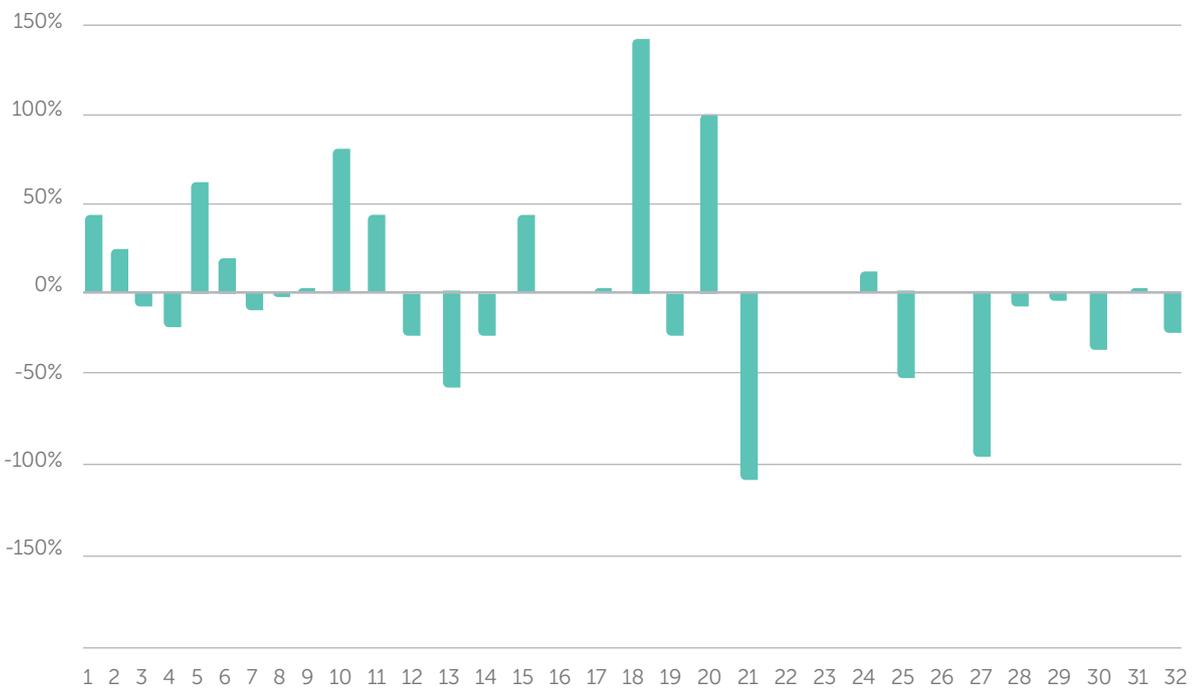
Figure 9 shows the percentage change in company DB contributions between 2015 and 2016.

Most companies experienced little or no change, with the average change being an increase of 3%, while a few experienced a large change in contributions. This is to be expected, as significant changes in contributions would normally only be expected once every three years, following a scheme's triennial funding valuation.



Most companies experienced little or no change, with the average change being an increase of 3%

9. Percentage change in DB contributions between 2015 and 2016



See data source note

## Company profit and dividends

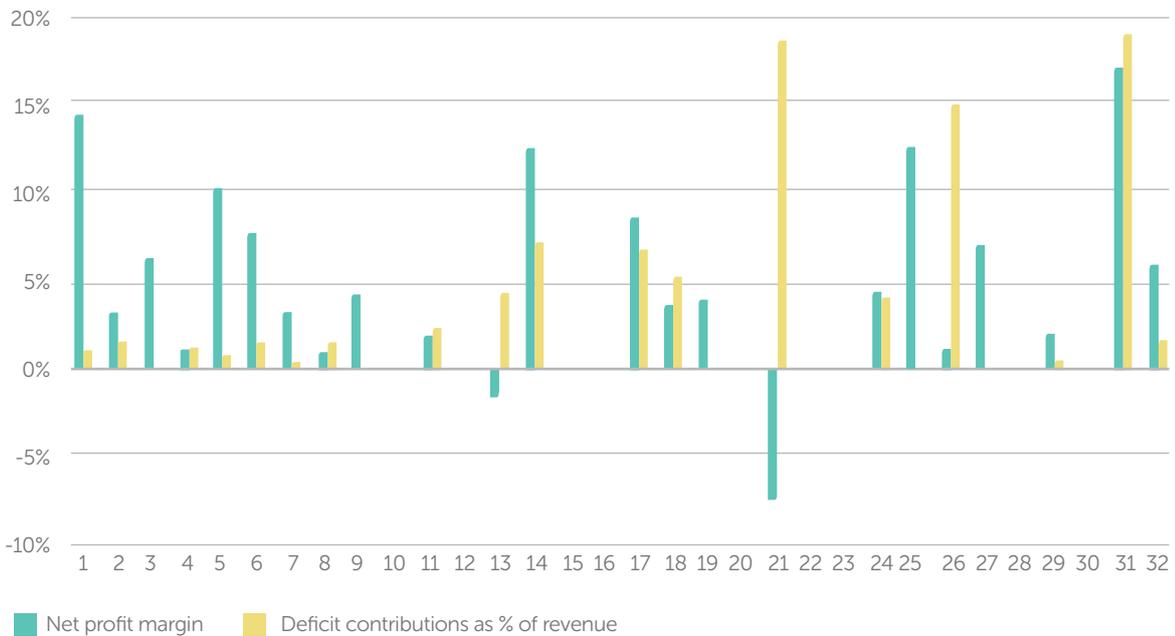
Figure 10 compares companies' profit margins with deficit contributions expressed as a proportion of revenue.

In most cases, the contribution requirements seem reasonably affordable for the companies, as they generate sufficient levels of profit. Indeed, the average profit margin is just over 5%, whereas the average deficit contribution is only 4% of revenue.

However, in some cases it appears that companies may struggle to meet their contribution requirements over the longer term without making changes to their funding strategy.



### 10. Profit margin vs deficit contributions



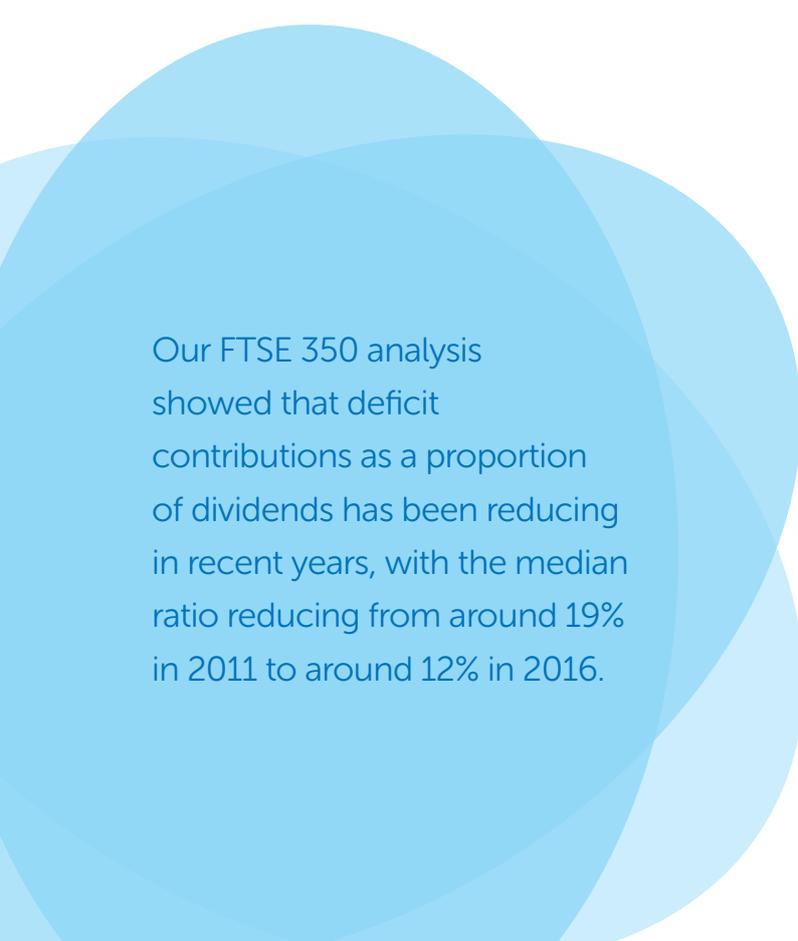
See data source note

### Impact on dividend payments

The level of deficit contributions can have implications on the payment of dividends to shareholders. Indeed, in light of a number of recent corporate failures, The Pensions Regulator (TPR) has been paying increased attention to the level of dividends paid to shareholders versus the level of deficit contributions paid to the pension scheme. This issue has been highlighted in its recently released 2018 Annual Funding Statement in which, among other things, TPR suggests that trustees perform an analysis of dividends paid relative to deficit contributions as part of their funding negotiations.

Our FTSE 350 analysis showed that deficit contributions as a proportion of dividends has been reducing in recent years, with the median ratio reducing from around 19% in 2011 to around 12% in 2016. The decrease was mainly driven by a significant increase in dividends over the period, without a corresponding increase in deficit contributions.

TPR has stated that it is 'concerned about the growing disparity between dividend growth and stable deficit reduction payments'. Companies should therefore expect greater scrutiny and challenge in their negotiations on recovery plans, as trustees and TPR will need to be satisfied that shareholders are not being prioritised over the pension scheme.



Our FTSE 350 analysis showed that deficit contributions as a proportion of dividends has been reducing in recent years, with the median ratio reducing from around 19% in 2011 to around 12% in 2016.

## Managing contribution requirements

With many companies paying significant levels of contributions to their pension schemes, companies will be interested in ways to manage their contribution requirements. Some possibilities include:

**Closure to future accrual / reduction to future accrual** – if a scheme is closed to the future accrual of benefits, this removes the requirement to pay contributions for future service benefits. By removing the salary link for past service benefits, it can also reduce the past service deficit and hence the level of deficit contributions required.

**Scheme funding negotiations** – unlike corporate plans in the US, funding assumptions and deficit contributions in the UK are subject to negotiation between the company and the trustees of the scheme, rather than being prescribed by legislation. Therefore in the UK, the company may be able to negotiate funding assumptions that result in a lower value for the scheme's liabilities and hence a lower level of contributions. Alternatively, the company may be able to negotiate a longer recovery plan, resulting in lower contributions on an annual basis.

**Parent company guarantee** – a parent company guarantee can improve the company covenant, which may in turn result in a lower value being placed on the technical provisions and a lower level of contributions.

**Asset backed contributions (ABCs)** – an asset owned by the company is transferred to a 'special purpose vehicle', in which both the trustees and the company have an interest. An ABC arrangement can thus increase the value of a scheme's assets without the need for immediate cash contributions from the company.

**Liability management exercises** – these can remove risk from the scheme and improve the funding level on the scheme funding basis. More detail on liability management exercises is included on pages 27-28.

**Pension Protection Fund (PPF) levies** – the PPF is the equivalent of the Pension Benefit Guaranty Corporation (PBGC) in the US, and was set up to protect members of schemes whose employer has become insolvent. The PPF is partly funded by a levy, which is based on both the risk of employer insolvency and the scheme deficit should insolvency occur and, like PBGC premiums in the US, can be substantial. There are a number of possible actions that companies can take to manage the size of their PPF levies, thereby making large savings on the expenses of running their pension scheme.

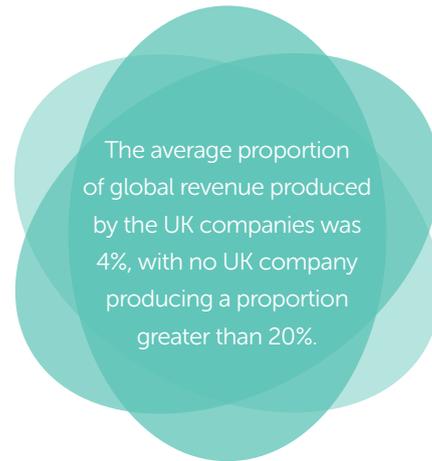
# Impact of the UK on the global company

So far we have looked at the impact of UK DB pensions on UK companies. However, there can also be significant implications on the performance of the parent company, as we will see in this section.

## UK versus global revenue

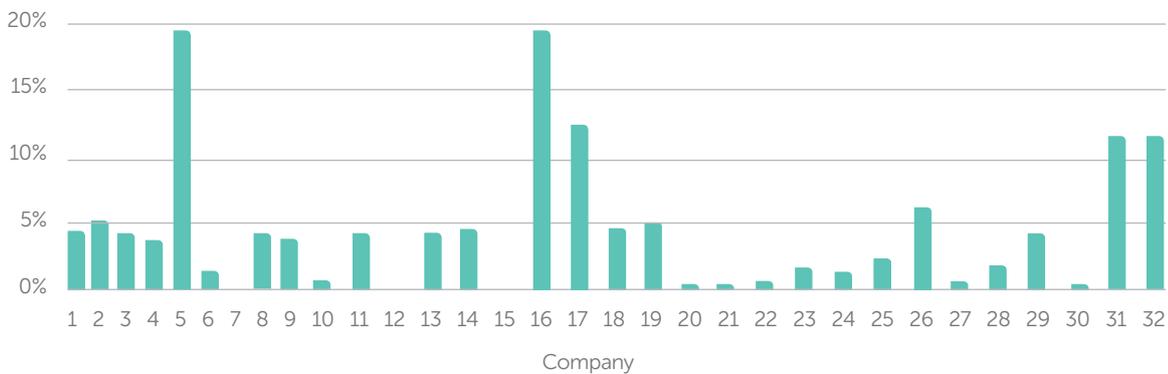
Figure 11 shows the UK companies' revenue as a proportion of the global companies' revenue.

The average proportion of global revenue produced by the UK companies was 4%, with no UK company producing a proportion greater than 20%. This suggests that UK revenue generally represents only a small proportion of global revenue, and as a result, a UK company may be seen as insignificant to the business as a whole by its US parent. However, this could be a dangerous assumption to make, as we will see in the remainder of this section.




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### 11. 2016 UK revenue as a proportion of global revenue



*See data source note*

## UK versus global pension scheme liabilities

Figure 12 shows the UK companies' DB pension scheme liabilities as a proportion of the global companies' DB pension scheme liabilities.

On average, the UK liabilities account for 29% of the global liabilities. However, the distribution is wide, with results ranging from less than 4% to over 96%. In general though, the UK liabilities account for a significant proportion of the global liabilities. In particular, they account for a higher proportion than would be expected based on revenue figures alone.

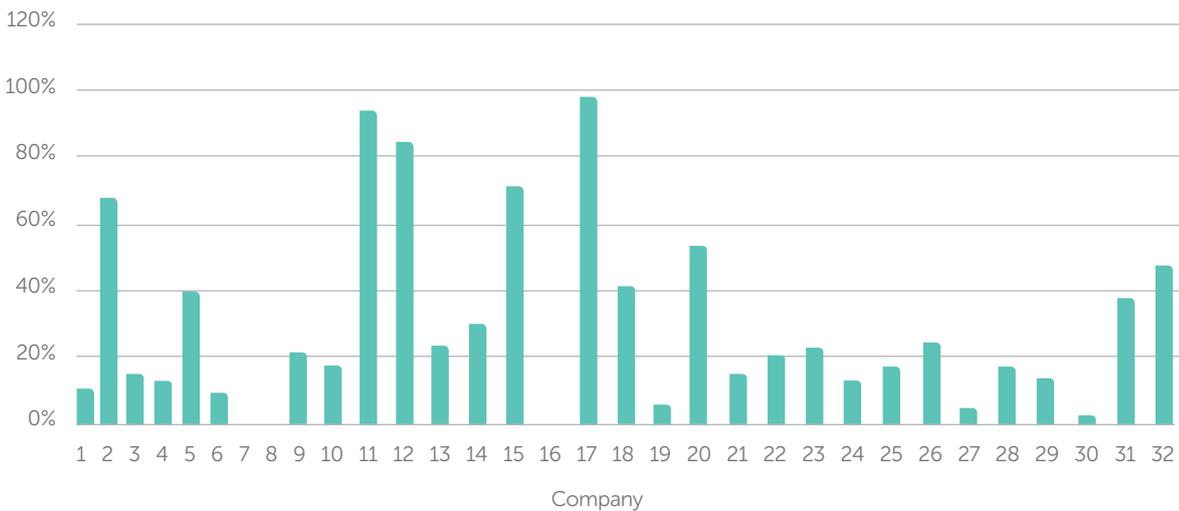
## UK versus global pension scheme contributions

Having looked at the UK versus global pension scheme liabilities, we now turn our attention to pension scheme contributions.

Figure 13 shows the UK companies' DB pension scheme contributions as a proportion of the global companies' DB pension scheme contributions.

On average, the UK contributions account for 31% of the global contributions. Once again though, the distribution is wide, ranging from 0% to 86%.

12. 2016 UK DB liability as a proportion of global DB liabilities



See data source note

Comparing these results with figure 12, a higher proportion of UK liabilities generally corresponds to a higher proportion of UK contributions. There are a few exceptions, but this may be due to contributions only changing significantly once every three years, following a scheme's triennial funding valuation.

Similar to the analysis on UK liabilities, the UK contributions also account for a significant proportion of the global contributions, and account for a higher proportion than would be expected based on revenue figures alone.

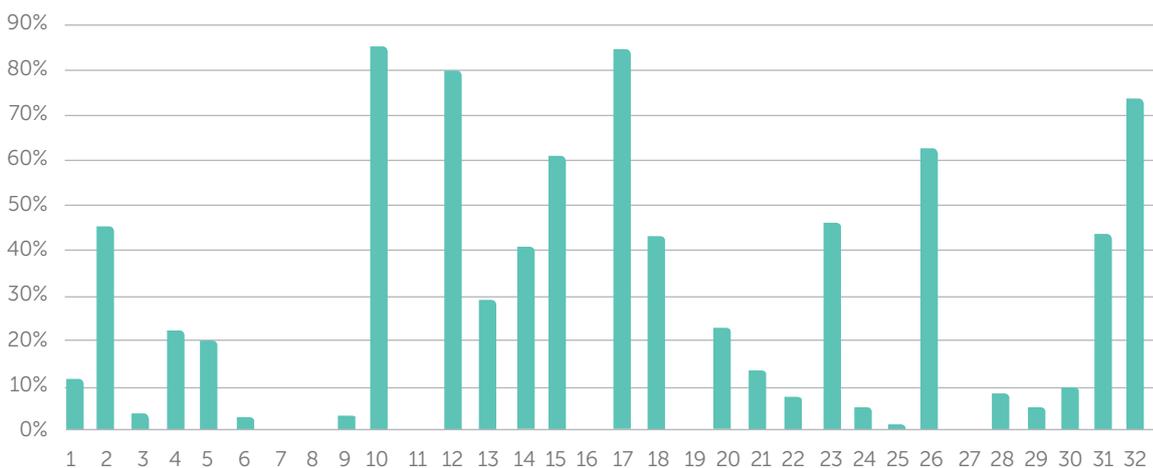
This suggests that UK DB pensions may be making a disproportionately large impact on the performance of the parent company.

In view of this, US company directors may wish to pay special attention to UK DB pensions, in particular, to ways they can mitigate their pension scheme liabilities and ways they can manage their contribution requirements.

## Summary

We have seen in this section that although UK companies produce on average only 4% of the global revenue, they account for 29% of the global pension scheme liabilities and 31% of the global pension scheme contributions.

### 13. 2016 UK DB contributions as a proportion of global DB contributions



*See data source note*

# Liability management

We have seen that DB pension liabilities represent a large risk to companies.

In view of this, liability management exercises are becoming an increasingly popular way for companies to manage the scale of their DB pension liabilities and to reduce the associated risks.

The ultimate goal may be to secure the scheme's liabilities with an insurance company via a bulk annuity transaction. With this end in mind, liability management exercises can significantly improve the affordability of an eventual bulk annuity deal, and even make the difference between such a transaction being feasible or not.

## Liability management exercises

Liability management exercises are seeing increased popularity with companies. From a company's point of view, common reasons for undertaking these types of exercise are:

- Removing risk from the scheme – all these exercises seek to remove liabilities from the scheme, together with the associated risks (relating to future investment returns, inflation and longevity)
- Improving the funding level on the scheme funding basis – as member options are often costed on a best estimate basis, this will generally improve the funding level on the scheme funding basis
- Reducing future administration costs – low value benefits in particular can have disproportionately high administration costs
- Making the scheme more attractive for an eventual buy-out – by aligning the scheme's liability profile to that preferred by insurance companies.



There are a number of different types of exercise, with some common examples being:

**Transfer value exercise:** these exercises are analogous to the 'lump sum windows' that have been very popular in the US over recent years. In a transfer value exercise, deferred members of a scheme are offered a transfer value – this could be a one-off exercise or part of a scheme's ongoing retirement process. To encourage take-up, the transfer value could be enhanced above the 'standard' level, or a partial transfer option could be made available.

**Pension increase exchange:** pensioner members are given the option of exchanging their future non-statutory pension increases, typically for a higher non-increasing pension. Such an exercise helps to reduce inflation risk and longevity risk in the scheme.

**Flexible retirement offer:** deferred members over the age of 55 are given the option of retiring early. Such an exercise can help reduce the number of deferred members in the scheme, and if the retiring members take cash lump sums, remove liabilities and the associated risks from the scheme.

**Trivial commutation exercise:** members with low value benefits are offered a cash lump sum in lieu of their pension. This can help to reduce the disproportionately large cost of administering low value benefits.

### How can companies maximise take-up rates?

For any such exercise, clear objectives, a well-designed proposition, detailed planning and effective member communications are essential in achieving a successful outcome. In particular, good quality member communications will help ensure a greater level of member engagement, which in turn increases the likelihood of high take-up rates.

These exercises offer additional choices to members that enable them to receive their benefits in a form which may better suit their own individual needs. If they are delivered well and with the appropriate level of support, they have the potential to be a mutual win for the members, trustees and the company.

## Pensions flexibilities

From April 2015, major new legislation ('Freedom and Choice') was introduced in the UK to give members of DC schemes greater flexibility in accessing their benefits. Prior to this, it was mandatory for retirees from DC schemes to annuitise their pension savings. Under the new legislation, which brings the UK more in line with DC plans in the US, members over the age of 55 are able to access their DC benefits in a variety of ways, including purchasing an annuity, accessing drawdown, or taking some or all of their pension pot as a cash lump sum.

The new flexibilities only apply to DC schemes. However, members of DB schemes can also access the new flexibilities, provided they first transfer to a suitable DC arrangement. The advent of Freedom and Choice could therefore have a substantial impact on DB to DC transfers and DB scheme liabilities.

From a member's point of view, the ability to transfer their DB benefits to a DC arrangement to access the new flexibilities could be an attractive proposition, and is a key reason why liability management exercises are now likely to enjoy greater member engagement and take-up rates.



The advent of Freedom and Choice could therefore have a substantial impact on DB to DC transfers and DB scheme liabilities.

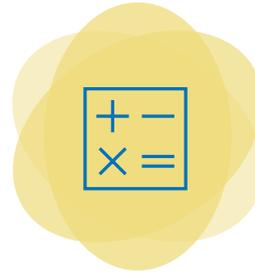
### Impact on transfer activity

It is therefore hardly surprising that many schemes have seen an increase in the volume of transfer value requests, as members explore their various options as they approach retirement. This is backed up by a recent survey by the Association of Consulting Actuaries, which found 47% of employers with a DB scheme reporting that the incidence of transfer value requests is greater than 5% of scheme members. However, the survey also found that completed transfers are at a lower level, with only 16% of employers reporting that completed transfers are greater than 5% of scheme members.

These findings may be a concern to companies, as the situation with many members requesting transfer values but relatively few actually transferring may place a large burden on scheme administration with little payoff. Indeed, the survey found that transfer value activity is adding between 10% and 20% to scheme administration costs compared to previous years.

One factor may be that many members are having difficulty finding IFAs who are prepared to advise on transfer values, and are therefore unable to obtain the financial advice needed for a transfer to proceed. Indeed, TPR expressed such concerns in its 2018 Annual Funding Statement. Companies might therefore consider the following:

- Appointing an IFA firm that could be highlighted to members, with a standardised approach to help save on administration costs
- Meeting the cost of financial advice in part or in full themselves
- Allowing partial transfers, enabling members to retain some guaranteed income within their DB scheme, whilst transferring some benefits to a DC scheme to enjoy greater flexibility



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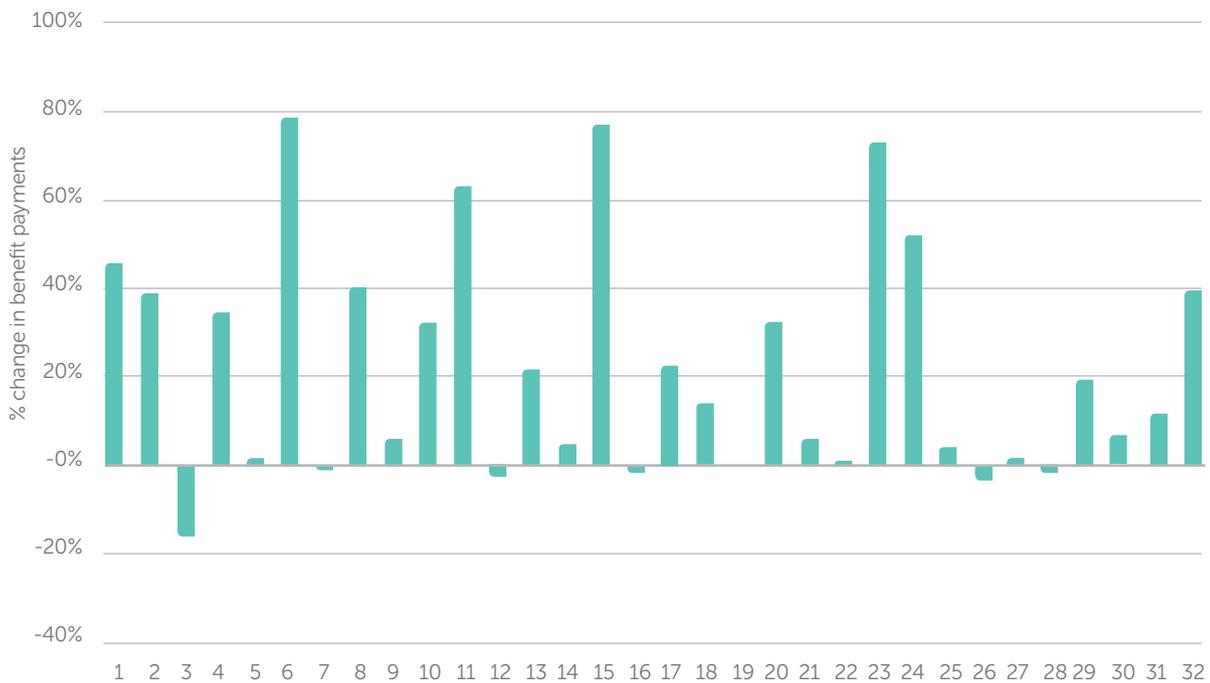
## Change in benefit payments

Figure 14 shows the percentage change in DB benefit payments made from UK schemes from 2015 to 2016.

Many schemes saw an increase in benefit payments over the period, with some schemes seeing a significant increase, and the average change being an increase of 23%.

It is still too early to say what the longer term effect will be, but it will be interesting to monitor the situation in future years.

14. Percentage change in DB benefit payments between 2015 and 2016



See data source note

## Bulk annuities

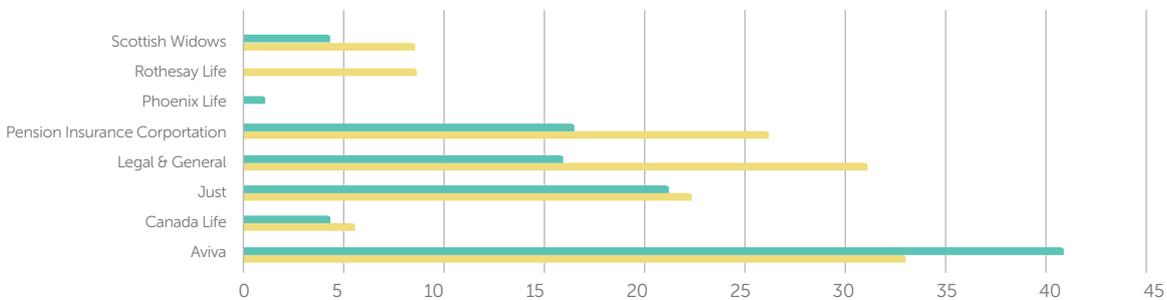
For many companies, the ultimate goal may be to secure the scheme's liabilities with an insurance company via a bulk annuity transaction. We now give a short summary of the UK bulk annuity market over 2017.

2017 was another strong year for bulk annuity providers, with the total value of transactions increasing from just over £10 billion in 2016 to over £12 billion in 2017. This represents a return to the level of transactions seen in 2014 and 2015, which were both over £12 billion.

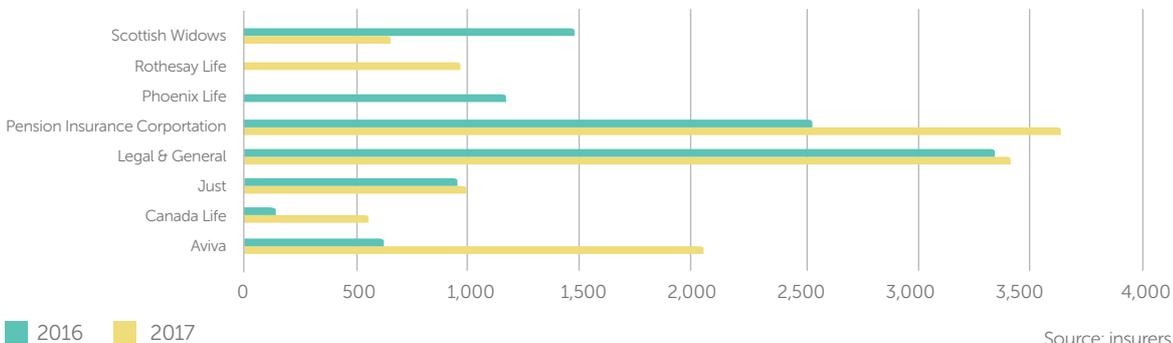
The slight dip in transactions in 2016 may have been due to Solvency II, the new regulatory regime for insurers, becoming effective at the start of that year. This led to an increase in transactions at the end of 2015, and consequently a slower start to 2016. It also may have taken time for insurers to adjust to the new regime and for the level of pricing to find its naturally competitive position.

The following charts compare both the number of transactions and the value of transactions in 2016 and 2017.

### Number of transactions



### Value of transactions



Source: insurers

See data source note

## The future of UK pensions

The future of pensions in the UK looks uncertain. Volatile investment returns, increasing life expectancy, increasing levels of ongoing expenses and increasing amounts of government legislation have all contributed to the increasing cost of DB schemes in the UK. It is therefore hardly surprising that many companies have closed their DB schemes and enrolled their employees into DC schemes.

However, there is a general concern that due to insufficient rates of contributions, poor investment returns and high levels of management expenses, many members will not receive adequate retirement income from their DC benefits. Such members may be forced to postpone their retirement and may end up relying on the State for support in later life.

So what does the future hold for pensions in the UK? Is there a third way between DB pensions, which are becoming increasingly unaffordable for companies, and DC pensions, which are unlikely to deliver adequate retirement income for members?

The concept of 'defined ambition' has been around for a few years now, but has yet to gain any real traction. Indeed, the Pension Schemes Act 2015 recognised defined ambition schemes as a distinct pension category, but regulations to bring them into force have not yet been introduced.

It is possible that in the future, the insufficiency of DC provision and a possible 'pensions crisis' may push companies to once again start offering some sort of pensions guarantee.

There are various forms that a defined ambition scheme could take in practice, but the common theme is one of sharing risks between the company and the members. The idea is to find a middle ground between the two extremes of DB (with the company bearing all the risk) and DC (with the member bearing all the risk). Indeed, earlier this year Royal Mail and the Communication Workers' Union agreed in principle to work towards introducing a form of defined ambition scheme for all employees called a Collective Defined Contribution (CDC) scheme. CDC schemes differ from DC schemes in that contributions are invested in a single collective pot, rather than individual pots for each member, thus sharing risks between members.

It remains to be seen whether defined ambition will materialise in practice. It is possible that in the future, the insufficiency of DC provision and a possible 'pensions crisis' may push companies to once again start offering some sort of pensions guarantee. We will monitor the situation with interest over the coming years.



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## Appendix - Summary of data

The following table provides a summary of some of the information used in this survey. All figures are on an accounting basis with a 31 December 2016 year-end.

### 2016 year end summary

	DB scheme assets (£m)	DB scheme liabilities (£m)	Surplus/ (deficit) (£m)	Deficit contributions (£m)	Current Service costs (£m)	UK subsidiary revenue (£m)	
1	1,830	1,850	(20)		9	20	810
2	740	1,070	(330)		11	3	730
3	200	250	(50)		0	3	380
4	1,850	1,860	(10)		9	19	690
5	1,700	1,930	(230)		31	23	3,810
6	260	260	0		2	0	140
7	3,500	4,710	(1,210)		9	31	1,950
8	210	250	(40)		4	0	240
9	6,370	6,620	(250)		0	92	5,530
10	8,290	9,720	(1,430)	280	104		790
11	670	760	(90)		11	0	480
12	560	720	(160)		13	0	0
13	3,420	3,380	40		59	17	1,360
14	930	1,010	(80)		21	0	300
15	280	350	(70)		10	1	0
16	1,950	2,330	(380)		206	8	1,600
17	1,190	1,590	(400)		28	0	410
18	1,260	1,310	(50)		29	9	560
19	1,670	2,290	(620)		0	52	1,250
20	3,990	4,560	(570)	112	37		50
21	160	190	(30)		3	0	20
22	150	230	(80)		4	0	10
23	480	540	(60)		15	0	90
24	320	400	(80)		5	5	130
25	3,150	3,200	(50)		0	20	1,100
26	330	420	(90)		26	0	170
27	80	90	(10)		0	1	40
28	2,010	2,180	(170)		0	26	580
29	60	70	(10)		1	0	260
30	250	240	10		3	0	0
31	1,320	1,730	(410)		47	0	240
32	120	140	(20)		4	0	260

## 2015 year end summary

	DB scheme assets (£m)	DB scheme liabilities (£m)	Surplus/ (deficit) (£m)	Deficit contributions (£m)	Current Service costs (£m)	UK subsidiary revenue (£m)
1	1,580	1,510	70	0	26	520
2	510	670	(160)	10	2	590
3	170	200	(30)	1	3	360
4	1,580	1,560	20	16	19	940
5	1,450	1,540	(90)	4	32	6,790
6	220	220	0	2	0	110
7	2,940	3,750	(810)	5	38	2,160
8	180	200	(20)	4	0	250
9	5,260	5,470	(210)	0	93	6,270
10	6,480	7,100	(620)	114	108	500
11	550	570	(20)	9	0	620
12	490	570	(80)	17	0	0
13	2,800	2,810	(10)	207	21	2,290
14	760	800	(40)	29	0	260
15	240	270	(30)	6	2	0
16	1,510	2,190	(680)	46	12	1,530
17	1,040	1,250	(210)	28	0	460
18	1,050	1,040	10	7	9	560
19	1,340	1,700	(360)	0	67	1,220
20	2,610	2,960	(350)	33	39	60
21	150	170	(20)	9	0	20
22	120	190	(70)	4	0	20
23	410	430	(20)	0	0	90
24	300	360	(60)	3	6	130
25	2,810	2,650	160	0	23	1,220
26	270	330	(60)	5	0	160
27	70	70	0	1	1	40
28	1,790	1,840	(50)	0	29	580
29	50	60	(10)	1	0	190
30	210	200	10	4	0	0
31	1,150	1,410	(260)	46	0	230
32	110	120	(10)	4	1	250



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

✉ [andrew.vaughan@barnett-waddingham.co.uk](mailto:andrew.vaughan@barnett-waddingham.co.uk) ☎ (+44) 0333 11 11 222 | 0333 11 11 222

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