



PENSIONS

# Pensions Repayment Monitor

TAX

August 2010

## 2010 – Growing polarisation turns focus to profit recovery

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This is the fifth Pensions Repayment Monitor by KPMG in the UK. Over the last four years our survey has continued to show that many FTSE 100 companies would be able to repay their pension scheme deficits from discretionary cash flow (see methodology on page 7) within three years if they chose to, with a significant number able to do so in a single year.

The polarisation of FTSE 100 companies has become evident with companies falling into either one of two categories – those that can pay off pension deficits in a very short timeframe from discretionary cash flow and those that may never be able to pay off deficits at current levels of cash flow. Around 32% of FTSE 100 companies can now not pay off deficits in any realistic timeframe from discretionary cash flow compared to 22% last year. This change is not surprising and reflects primarily the consequences of the economic downturn on companies' profits and cash flow. For the pension schemes of these companies, the strengthening of the company is imperative to the future

of the schemes. Trustees of these schemes will need to play a long-term game and support business strengthening and growth.

### Key findings from our latest study are:

- The ability of FTSE 100 companies to repay deficits out of discretionary cash flow has decreased for a number of companies in the 2009 financial year but a majority still remain able to do so.
- 46% of the FTSE 100 would be able to pay off pension deficits from discretionary cash flow in one year and 63% are able to pay off deficits in three years. This compares to 62% and 75% respectively last year.
- However, the position has deteriorated significantly for some companies. The proportion of companies that cannot pay off their deficit in any realistic timeframe from discretionary cash flow has increased to 32% (the highest level since KPMG began this survey). This compares to 22% last year.

- If we add back dividends and capital expenditure to discretionary cash flow, 97% of the FTSE 100 could pay their pension deficits in three years. However, these are crucial to the supply of capital and growth of the business and can not simply cease - particularly in the current climate where businesses are seeking to attract or retain investment and contribute to an economic recovery.
- A realistic improvement in business' profits and equity markets of around 10% would have a dramatic impact. The percentage of the FSTE 100 being not able to pay off their deficits in any reasonable timeframe falls from 32% to 19% (in line with results in years prior to the economic downturn) and results in the majority of affected companies being able to repay deficits in three years. Supporting companies in achieving such a recovery therefore appears to be in the best interests of pension schemes.
- The easement provided by the Government announcement that CPI rather than RPI would be used to provide pension increases does decrease deficits in some cases but does not materially impact business' ability to pay off deficits. Of more importance is a strengthening of the profitability of companies themselves.
- Between end 2008 and end 2009 aggregate disclosed FTSE 100 deficits increased from around £40 billion to £50 billion. We estimate that at end June 2010 aggregate deficits increased by £15 billion to £65 billion.
- Only 3 companies now show an accounting surplus compared with 12 in 2008 and 21 in 2007.
- As we predicted last year, companies are now spending more on deficits than funding pensions for current staff. Nearly £2 out of every £3 spent in 2009 went on deficit reduction.

### **Pension schemes are still reliant on their sponsors**

While the 2010 survey shows that more businesses would not be able to fund their pension schemes in any reasonable timeframe from discretionary cash flow, this does not automatically put these schemes at risk. Rather it serves to highlight that trustees need to work with companies to improve the scheme's financial position over the long-term.

Our analysis shows that improving companies' profits and cash flow has a far greater impact on business' ability to finance deficits than moderate changes to benefits (for example from CPI to RPI). It will therefore be important for trustees to support the competitiveness of their employer and its ability to access finance. This might include recognising that capital providers (debt and equity) are essential to business success and any pension funding agreement should strike a fair balance.

## Economic conditions create a pension class divide

Pension deficits have increased over 2009 and the proportion of businesses that could pay off pension deficits in a single year from discretionary cash flow has decreased. At the same time, even more companies are not able to pay off pension deficits in any reasonable timeframe from discretionary cash flow. Economic conditions are driving a class divide between businesses. Improvements in company profitability and cash flow would reverse this trend and trustees will need to support companies in achieving this to secure pension benefits.

Changes from the 2009 survey have been impacted by increases in deficits disclosed by the FTSE 100 mainly due to reductions in bond yields used to value future pension payments (reflecting a return of credit spreads to more normal levels) and increases in long term inflation expectations increasing expected pension payments.

However, the main driver affecting companies' ability to pay deficits from discretionary cash flow has been a fall in profitability as the effects of the economic downturn become apparent. Profits used in the survey to assess discretionary cash flow fell by an average of 19%. Restoring profitability will have the greatest impact on companies' ability to fund pension benefits and the security of pension scheme benefits.

### Results of the 2010 survey

The percentage of companies able to repay their deficits in a single year (at their last reported balance sheet date) has decreased from 62% last year to 46% this year.

Extending the repayment period to 3 years increases the percentage of companies able to repay their deficits using free cash flow to 63%. This compares to 75% last year.

The number of companies recording an accounting surplus in this year's sample has decreased to 3 compared with 12 last year.

### For just under a third of companies pension funding will now impact more significantly on business

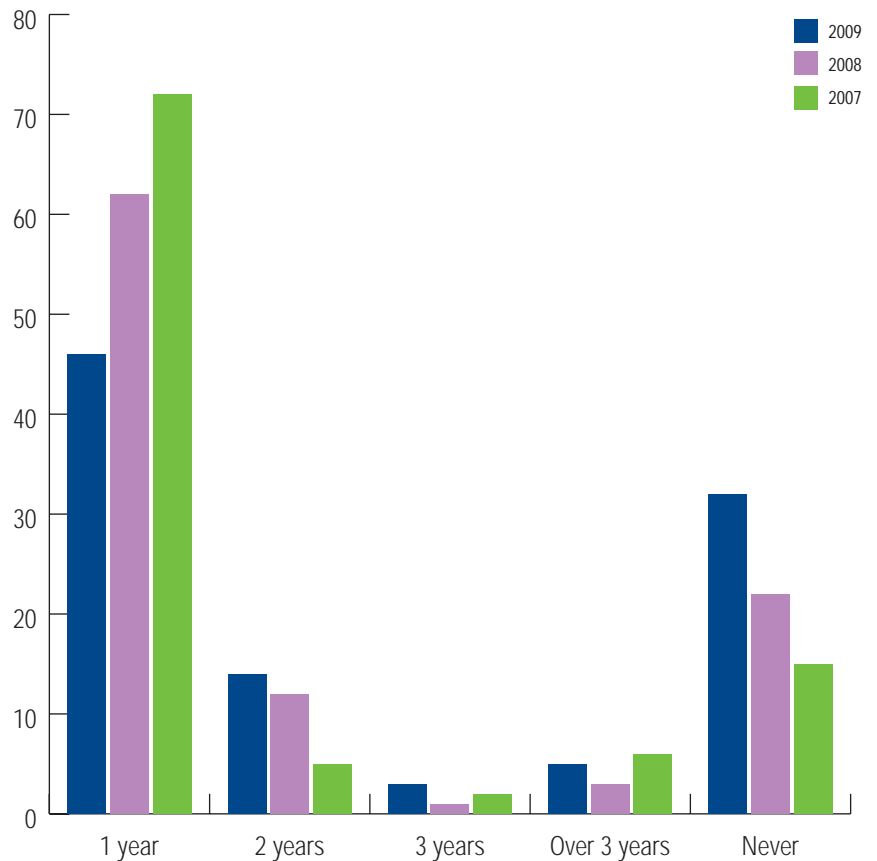
There is now a significant minority of companies who are not able to repay deficits from discretionary cash flow in a reasonable timeframe. The number of companies in this position has increased to 32% compared with 22% last year.

The overall position shows a marginal worsening in ability to fund pension deficits for a large proportion of the FTSE 100, but more businesses than before may still be facing calls to substantially increase pensions funding which can only be done by sacrificing other crucial payments. Trustees would clearly like to improve the Scheme's position, and may feel under pressure to be more prudent to reflect the perceived weakening of companies' covenants. This combination may put a further strain on business' ability to raise finance and invest to improve profitability and support a wider economic recovery. This will create challenges for trustees who will need to decide whether it is better to retain funds in the employer to ultimately strengthen the company's covenant or seek additional cash to be paid to the pension scheme – potentially weakening its long-term strength.

Such understanding will be key so that the pension scheme does not crystallise a class divide between companies, effectively handing a very real competitive advantage to companies that do not have to make sacrifices on investment to fund their pension schemes.

**Economic conditions create a pension class divide**

FTSE 100 pension deficit payback periods from pure discretionary cash flow.



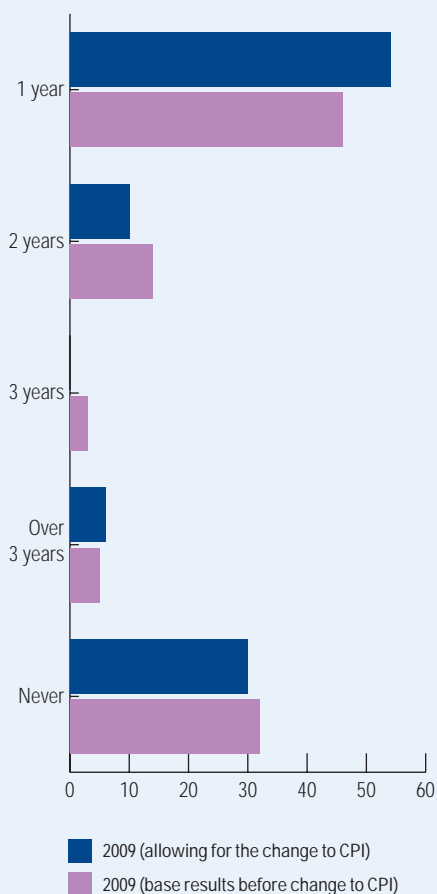
Source: KPMG's Pensions Repayment Monitor 2010

# Strengthening of companies' finances key to pension funding

Our analysis of pension scheme funding and company finances suggests that the only approach for improving pension scheme security is to support the recovery of the companies that fund defined benefit pension schemes.

## Strengthening of companies' finances key to pension funding

Deficit payback period from pure discretionary cashflow



Source: KPMG's Pensions Repayment Monitor 2010

## Companies are redirecting substantial cash contributions to pension schemes

Over 2009, the FTSE 100 paid an unprecedented £17.7 billion into defined benefit pension schemes (compared to £14 billion over 2008). Much of this was spent on seeking to reduce deficits as the cost of new defined benefits fell from around £9 billion over 2008 to £6.5 billion over 2009. As we predicted last year, companies are now spending more on deficits than funding pensions for current staff. Nearly £2 out of every £3 spent in 2009 went on deficit reduction. Nonetheless, given the size of pension liabilities, market movements still resulted in an increase of around £10 billion in pension deficits (increasing from £40 billion in 2008 to £50 billion in 2009).

Trustees are required to set appropriate funding targets and agree a plan with the company to fund the targets. Over the course of the lifetime of a pension scheme, deficits will increase or be removed by market changes. The company will need to be there to fund for any deficits that emerge. The long-term viability of companies is key to pension schemes ability to pay benefits.

## Changes in the cost of pensions have little impact on business' ability to fund deficits

Managing the cost of benefits is important and the recent Government announcement on linking increases in pension payments to CPI rather than RPI will provide welcome relief to a number of businesses. This change will impact companies in different ways and for some may even lead to an increase in costs. However, the effect of the change on affordability is marginal. The chart below shows that it has only a marginal impact on the 32% of businesses who cannot pay off

deficits over any reasonable period from discretionary cash flow (see methodology used to assess the CPI impact on page 7). This is because there is little to no scope for these companies to fund pension schemes without reducing investment in the business or reducing returns to providers of capital. The above takes account of the typical interaction of the change with scheme rules. Even if the change was applied by a legislative override to all pension scheme rules, then the percentage of FTSE 100 companies that could not pay deficits from discretionary cash flow would remain high at 27%.

## Reasonable recoveries in profitability have a significant impact

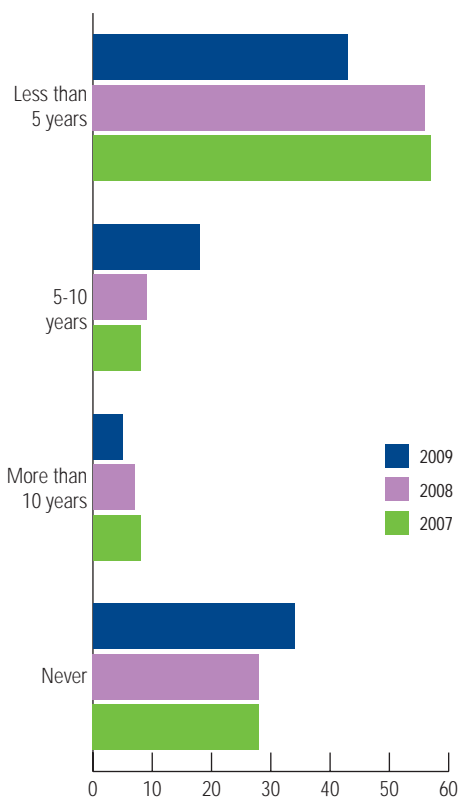
A 10% increase in the FTSE 100's profitability and in equity markets would have a significant impact on companies' ability to fund deficits. The proportion unable to do so over any reasonable period would reduce from 32% to 19% (in line with results from our survey before the economic downturn). The majority of affected companies would also then subsequently be able to fund their deficits over less than three years from discretionary cash flow.

If we add back dividends and capital expenditure to discretionary cash flow, 97% of the FTSE 100 could pay their pension deficits in three years. However, these are crucial to the supply of capital and growth of the business and can not simply cease - particularly in the current climate where businesses are seeking to attract or retain investment and contribute to an economic recovery. Rather investment in an economic recovery should be a priority to restoring companies' ability to fund pension deficits.

# Buyout

A large proportion of FTSE 100 companies' remain able to insure their pension liabilities from discretionary cash flows if they chose to. However, we are seeing a growing trend to insure liabilities along with implementing innovative funding and investment strategies to reduce pension risk without materially reducing business value.

Buyout



Source: KPMG's Pensions Repayment Monitor 2010

As highlighted in our previous surveys, we have used accounting deficits as a proxy for funding deficits. To completely settle the liabilities, companies would need to come up with the amount required by an insurer to take over the liabilities. As last year, KPMG has therefore considered how well UK plc could cope with fulfilling its pension liabilities by securing them with an insurance company.

As was the case in previous years, our analysis shows that a number of companies in the FTSE 100 could fund the buyout of their pension liabilities from discretionary cash flow. The position has worsened slightly since last year. Around 43% of companies in the FTSE 100 could still buy out benefits in 5 years or less from discretionary cash flow, compared to just over 50% last year. This increases to 62% of companies being able to achieve this position if the period is extended to ten years.

However, 34% of companies could not buy out their liabilities in any reasonable timeframe using pure discretionary cash flows, compared to 28% in 2008.

## Risk management with insurance becoming more innovative

We are seeing a number of companies increasingly review options for managing and reducing risk in pension schemes. A Buy-in of liabilities is viewed as one of the most cost effective ways to hedge both financial and longevity risks in light of current market conditions. A buy-in involves the pension scheme investing in an insurance policy for certain groups of pension members without transferring the individual liabilities to an insurer. However, businesses are critically assessing whether this adds to or decreases shareholder value.

As a consequence, a number of companies have reduced pension risk through buy-in while at the same time implementing innovative investment and funding strategies. A buy-in may create a funding strain for companies and as a result businesses are setting up special purpose vehicles to meet this funding strain from a wide range of business assets without losing the ability to generate profits from these assets. Also, investment strategies are becoming more sophisticated to ensure that return generating capabilities of the pension scheme assets remain the same even with the buy-in insurance asset.

We expect this area to grow as businesses seek to protection against pension volatility while maintaining the profitability of the company.

## Methodology

Only those FTSE 100 companies with UK defined benefit pension schemes were included in the analysis – a total of 88 companies. The latest accounts for each of these companies for years ending on or before 31 December 2009 were used.

To estimate pure discretionary cash flow, we started from the Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) disclosed in the latest accounts for that company. We then deducted profit and loss tax charges and interest paid to derive a 'tax and interest' adjusted EBITDA. To reach a figure which reasonably represents pure discretionary cash flow we then deducted ordinary dividends paid and a three year average of Capital Expenditure (CAPEX).

Our estimate of required buyout funding has been calculated as 130 percent of the corresponding accounting liabilities reflecting an average membership split across schemes and allowing for longevity and investment margins that may be reflected by insurers.

In calculating a deficit correction period, we divided the net pension deficit after taking into account a corresponding deferred tax asset by the pure discretionary cash flow.

We have made no allowance for the difference between expected return and interest cost being used as additional source of funding.

Companies with pension schemes in surplus are included within those that can pay off deficits in less than one year.

We have assumed that around 80% of pension schemes are impacted by the Government's announcement on linking increases in pension payments to CPI rather than RPI. We have further assumed that 60% of all schemes will be impacted for revaluation of deferred pensions up to retirement age and 20% will be impacted for both revaluation and also increases to pensions in payment. We have assumed that long term CPI will be 0.5% p.a. lower than RPI.



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