The future of defined benefit pension provision

An analysis of the FTSE100

June 2015

Headlines

Welcome to KPMG's 2015 survey of defined benefit (DB) pension provision in the FTSE100. There has been considerable activity since our survey last year, with another 5 companies announcing the closure of their schemes for all members. We expect that this pace of change will continue, if not accelerate, for the foreseeable future.

Our survey of the FTSE100 in 2014 revealed that only 59% of the FTSE100 had employees earning DB pensions. In the past year:

Five more companies have closed their DB pension schemes completely, leaving only 54 of the FTSE100 providing DB pensions to their employees. Several others have announced their intention to close in future.

Many factors, including the abolition of DB contracting-out from April 2016, continuing low gilt yields and the decrease in the Lifetime Allowance, mean that we expect this trend to continue.

Our view is that by 2018 less than 40% of FTSE100 companies will have DB schemes open for any employees.

There is a clear trend for companies to take more action even where they have previously made changes to their DB pension schemes.

Of the 42 FTSE 100 companies that have made prior attempts to reduce pension costs since 2005, just under half have either now closed, or made further changes, to their DB schemes.

Many companies are now favouring complete closure, or a simple pensionable salary cap, over tweaks to the benefit structure.

16 FTSE100 companies have implemented a cap to the salary that counts towards DB pension.

KPMG has helped over 140 companies through the process of making changes to their DB pension schemes over the past five years. In our experience, when DB schemes are closed, affected employees are now commonly provided with enhanced contributions to the replacement DC scheme, at least for a transitional period.

The average DC contribution across those FTSE100 companies that have closed their DB scheme in the last five years is higher than the average across the FTSE100 as a whole.

With the continued trend away from DB, companies will need to focus their efforts on the alternatives they offer their workforce as a whole, helping members to ensure that they have enough money to retire.

In a world with increased flexibility in the way people can build and access their pension savings, the provision of financial education and employee support are increasing important.

The following pages provide the details behind these headlines.

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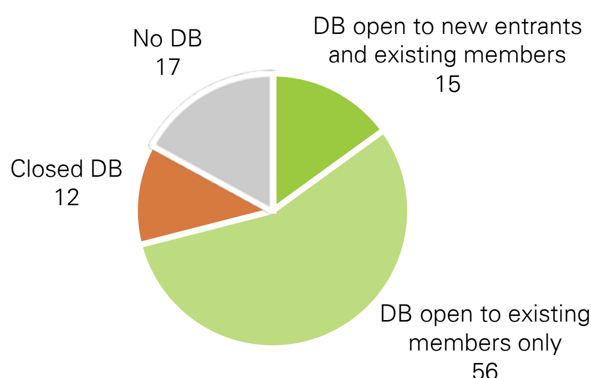
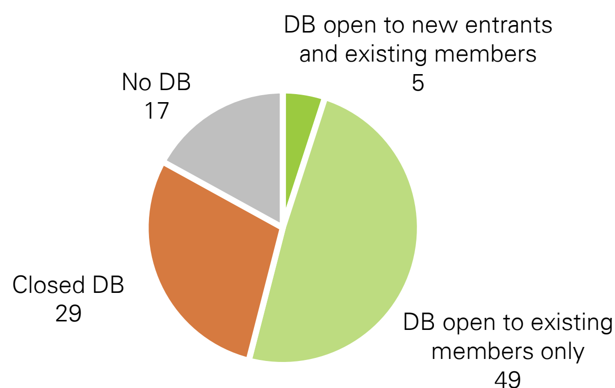
The FTSE100 continues to close its DB pension schemes

Since our last survey of the FTSE100 in 2014, some major household names have either closed their defined benefit schemes completely, or started on the road to closure.

FTSE100 in 2010



FTSE100 in 2015



Source: KPMG analysis.

Notes: Of the five schemes open to new members in 2015, two provide Career Average Revalued Earnings (CARE) benefits and three provide cash balance benefits. Results from 2010 refer to schemes of the current FTSE100 constituent companies at 31 December 2010.

Only five FTSE100 companies now have a DB scheme open to new entrants. Three of these schemes are cash balance schemes which do not provide a guaranteed income in retirement, and two are career average schemes. No schemes providing a guaranteed pension based on final salary remain open to new entrants.

In the last 12 months, 5 FTSE100 companies including HSBC and Standard Life have closed (or agreed to close) their defined benefit pension schemes for all employees.

In addition, Tesco has announced its intention to close its career average pension scheme to both new entrants and all current members.

17 schemes have closed for all employees, including existing members, since 2010.

Only 54 of the FTSE100 are still providing some form of DB benefit.

17 of the FTSE100 have no UK DB provision – either as they have very few employees in the UK, or are younger companies without legacy DB schemes.

Common reasons given by companies for closing their DB pension schemes include:

- Falling gilt yields increasing costs at a time when every expenditure is subject to intense scrutiny:
  - Costs have commonly doubled in 10 years, to as much as 40% of salary.
- Disparity in reward between those with DC pensions and those who were able to join the DB scheme.
- Intolerable risks building up on the balance sheet due to the volatility of DB pension deficits.
- Years of regulatory change continuing to push up costs.
- A wish to view the pension benefits more holistically as part of the overall reward package.

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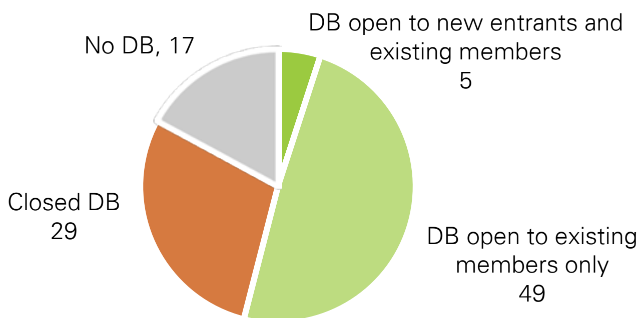
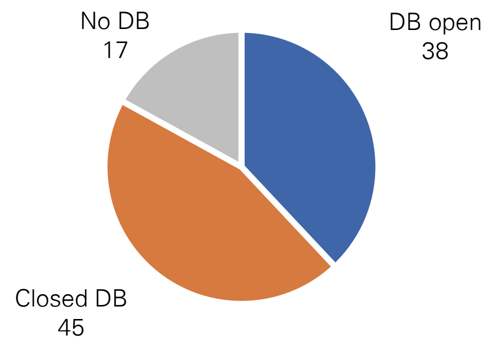
We believe that the trend for closure will continue and may increase

Based on the rate of closures over the last five years, by 2018 only 38 companies in the FTSE100 will have open DB schemes. If the pace of change increases, we could see less than a third of FTSE100 companies having any employees in a DB pension scheme within a relatively short period of time.

FTSE100 in 2015



FTSE100 in 2018



Source: KPMG analysis of position in 2015 and KPMG's assessment of potential changes over the period to 2018. It is likely that a number of organisations will cease providing DB pensions to new entrants (indeed Tesco has already announced its intention to do so), however there is not enough evidence from the last five years to predict precisely how many will do so by 2018.

With less than a year to go until the abolition of DB contracting-out from April 2016, as predicted, companies are using this as a trigger to take action. We expect that many of those who don't close will take other action to reduce pension costs.

"In a snapshot survey of over 60 companies, a fifth were planning to use the Statutory Override provision to recover the cash lost through the ending of contracting-out. However nearly 70% were planning to make more sweeping changes, potentially including closing their DB schemes."

Scott Kendrick
Director, Head of Pensions Benefit Change, KPMG

From April 2016, DB schemes will no longer be able to contract members out of the State Pension system. Both employers and employees face a rise in National Insurance Contributions (NICs). The Statutory Override will allow employers to offset their additional NICs by passing the cost to employees or reducing future benefits (without trustee consent). In addition, many pension schemes are integrated with the existing State Pension system and scheme rules will need to be amended.

Changes such as this, and other rumoured pension taxation changes, may act to increase the pace of closure from that seen in the last five years. This could reduce those FTSE100 providing open DB schemes to less than a third relatively quickly.

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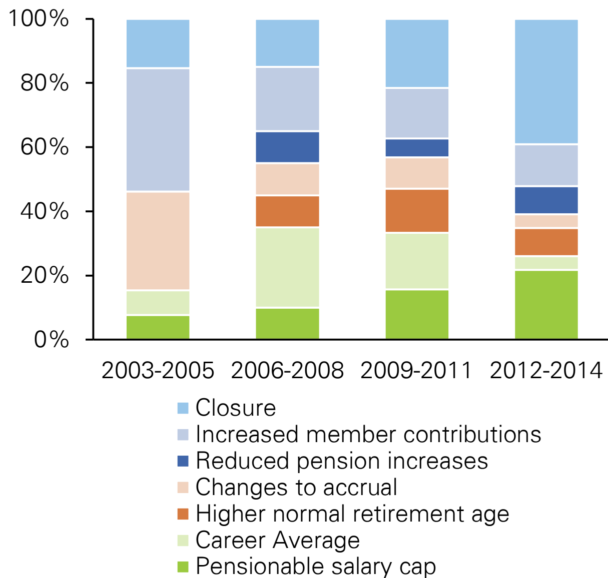
Companies are favouring simpler changes

Companies are choosing closure, or caps to the salary that counts towards pension, over changes to the benefit structure, such as changes to accrual rate.

DB scheme changes – 2003 to present



Company	Date of change	Limit to annual increases in pensionable salary
Anglo American	2005	RPI capped at 5%
Weir Group	2006	RPI capped at 5%
International Airlines Group	2007	RPI
RBS	2009	2%
L&G	2009	2.5%
AstraZeneca	2010	0%
ITV	2010	1%
M&S	2010	1%
United Utilities	2010	RPI
Travis Perkins	2010	3%
TUI Travel	2011	2.5%
Centrica	2012	2%
Next	2012	0%
GSK	2013	2%
LBG	2014	0% (previously 2%)
National Grid	2014	RPI capped at 3%

Source: KPMG analysis of the historic DB pension changes made by the current FTSE100 constituent companies.

Ten years ago, tweaks to the accrual rate (the amount of pension an employee builds up each year) or a move to a career average (CARE) structure rather than one based on final salary were the most popular changes.

Now, the most popular change other than closing the scheme is to introduce a cap to increases in pensionable salary.

There has been a steady flow of companies introducing pensionable salary caps each year and this trend appears likely to continue. They are often implemented via contractual agreements which don't require a change to the pension scheme rules.

Pensionable salary caps can be very effective but must be implemented carefully:

- Where caps are implemented contractually outside of the pension scheme rules, communication is key.
- As with any change – the business case must be robust, and must be explained to employees clearly.

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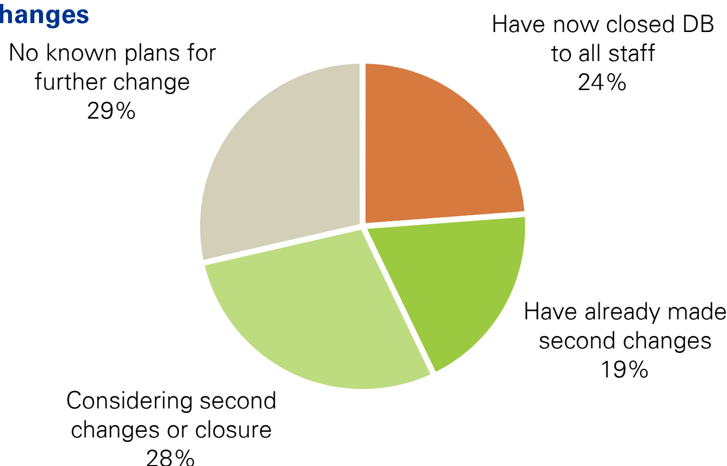
Many companies have made two separate changes in the last ten years

Of the 42 FTSE 100 companies that have made previous attempts to reduce pension costs since 2005, just under half have either now closed, or made further changes.

Second DB scheme changes



Source: KPMG analysis of actual changes made and KPMG's view of the number of companies currently actively considering further change.

KPMG is aware that another dozen companies are already considering making further changes

Many of the companies who have now closed had previously moved to career average schemes, perhaps in the hope that they would be able to continue to provide DB pensions for the medium to long term. However, in some cases, these measures have not been sufficient and a number of high-profile career average schemes, such as that provided by J Sainsbury, have now closed.

It is – so far – unusual to see companies with low pensionable salary caps subsequently closing their schemes, with only one example of this in the FTSE100. This may be because it generally costs companies to 'unwind' a salary cap.

> *"Generally, companies that are considering a second change within ten years are choosing to make the final decision to close, or are implementing a pensionable salary cap to avoid having to debate a third change in the short term."*

Scott Kendrick
Director, Head of Pensions Benefit Change, KPMG

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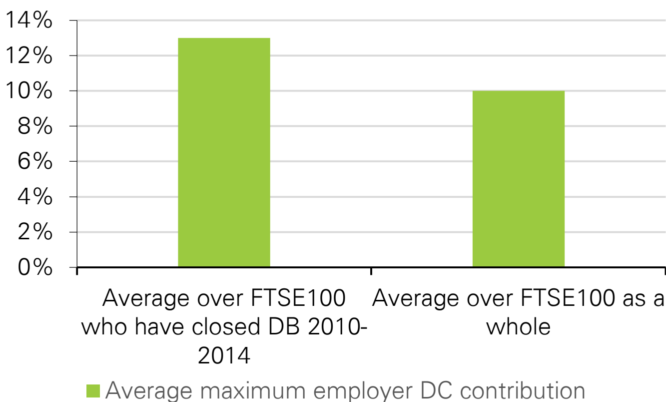
What next?

Could the continued closure of DB schemes lead to an increase in the contributions that employers offer under their defined contribution (DC) schemes? Recent evidence from the FTSE100 suggests that employers may pay higher DC rates where they have recently closed their DB scheme.

DC contribution rates following DB closure



Source: KPMG analysis of actual changes made

Our analysis suggests that the average maximum employer DC contribution rate across companies who have closed their DB schemes within the last five years is 13%. This compares to an average maximum DC contribution of 10% across the FTSE100 as a whole.

This may suggest that companies pay higher DC rates as mitigation for those who have had to leave DB schemes.

As DB schemes become increasingly rare, there is a shift in focus to providing reasonable alternatives such as DC schemes.

As companies continue to make changes to their DB pension schemes, they need to make sure that their members understand how the changes may affect the amount of pension they will have when they retire. Members should understand that a DC scheme is very different to the DB scheme they have always known, and that they will ultimately be responsible for how much money they will have at retirement. KPMG's dedicated pensions communication team have helped many companies support employees through this change.

The increased flexibilities offered from April 2015 allow members of DC schemes to choose how they'd like to take their benefits. DB scheme members can take advantage of these flexibilities by transferring their benefits; again, education and communication is key to ensuring that this group of members understands how they can make their retirement income work for them. Our exciting online tool, KPMG Pilot, enables members of DB schemes (including those who also have DC benefits) to think about whether the new flexibilities might be right for them.

“*The big focus in DC is on improving outcomes for employees. Companies have not gone through the pain of closing their DB scheme to reduce costs, just to throw money at their DC schemes. I am seeing a big increase in companies wanting to understand what they must do to provide a benefit that will be understood and valued by their employees.*”

Gurmukh Hayre
Partner, Head of DC Solutions, KPMG

“*As the end of contracting-out approaches, we are seeing more DB closures. Combined with the increasing complexity of pension taxation, this has resulted in more companies beginning to look at wider vehicles for retirement savings, such as ISAs, particularly after the most recent budget changes. Already, we are seeing companies combine ISAs and pensions to create a more flexible savings structure for employees.*”

David Fairs
Partner, People Powered Performance, KPMG

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KPMG Pensions

Our UK pensions practice consists of over 400 actuaries, consultants and investment specialists. We are able to combine the deep technical expertise of a "traditional" actuarial firm with the wider business expertise and commerciality of a "Big 4" firm.

Corporate pensions advisory:

- We support clients in managing changes to defined benefit (DB) or defined contribution (DC) pensions for current employees, which can reduce costs and/or risks, and can be tax efficient.
- We support companies in negotiating cash funding commitments with trustees, using approaches that could help to retain financial flexibility.
- We help reduce companies' risk exposure by reducing or reshaping the pension liabilities and using insurance and hedging to mitigate and remove risks.
- We help companies reduce the impact of pension schemes and trustees in corporate restructuring/refinancing, and M&A deals.
- We also support companies with accounting for pension arrangements.

Trustee services: We deliver a core actuarial and administration service to trustee clients backed by our investment in technology.

Investment advisory: We provide proactive advice and clear direction to pension trustees and sponsors on all aspects of their pensions investment arrangements.

DC advisory: Our national DC team is integrated within our pensions practice, and includes specialists in DC communications and investment.

Our advice is underpinned by **market leading technology** including **KPMG Pilot** and our award winning **FUSION®** modelling tool

400+
NUMBER OF KPMG PENSIONS PROFESSIONALS

25%
PROPORTION OF FTSE 100 ADVISED BY KPMG PENSIONS

£250bn
PENSION LIABILITIES THAT WE ADVISE ON

Source: KPMG data

Notes

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