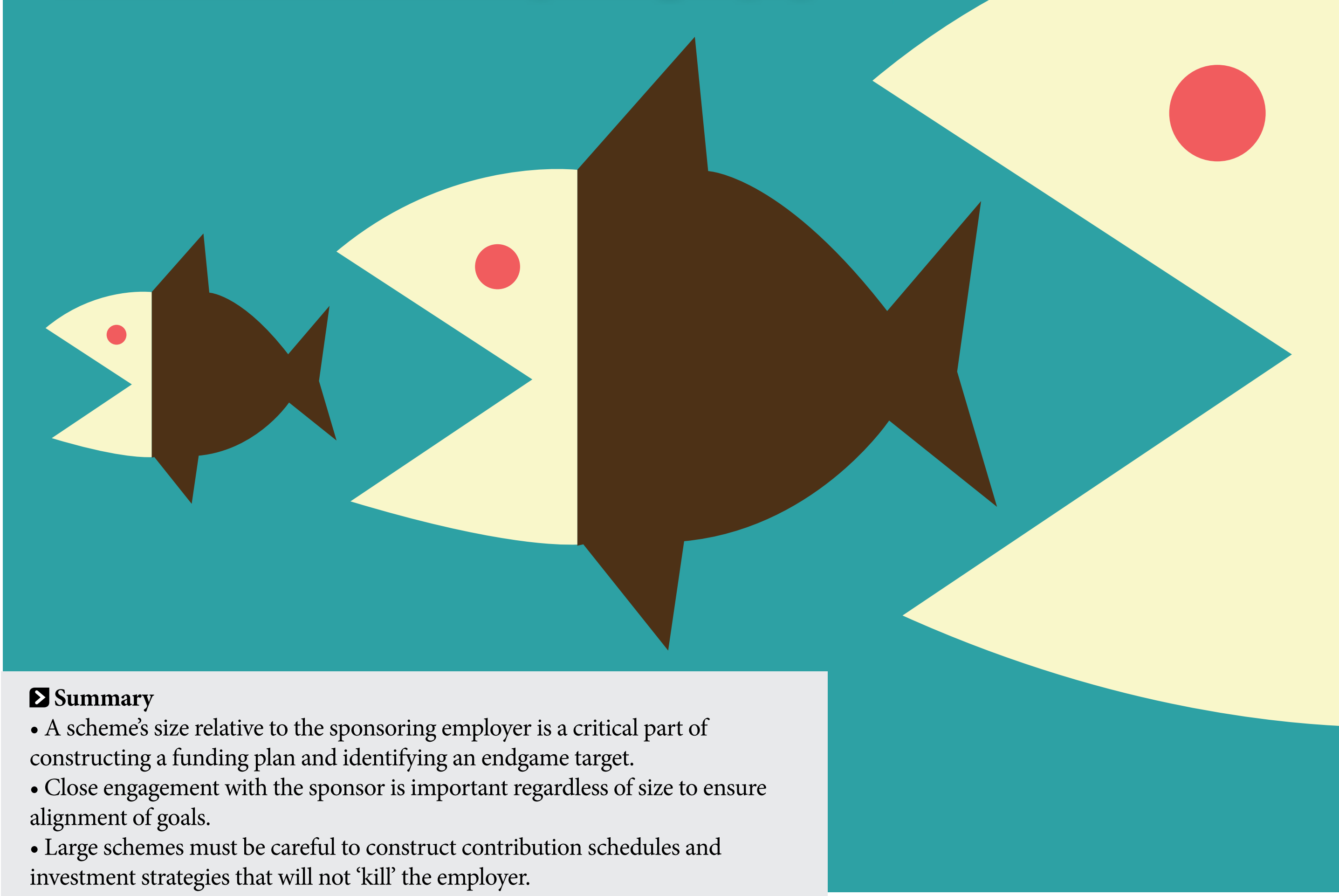
# Size matters

**Nick Reeve explores the relationship between the size of the DB scheme and the size of its sponsoring company**



**Summary**

- A scheme's size relative to the sponsoring employer is a critical part of constructing a funding plan and identifying an endgame target.
- Close engagement with the sponsor is important regardless of size to ensure alignment of goals.
- Large schemes must be careful to construct contribution schedules and investment strategies that will not 'kill' the employer.
- Small schemes should keep an eye on the long term and obtain written funding agreements to avoid falling off the sponsor's radar during good periods.
- TPR is developing a two-tier approval system for signing off recovery plans – but big schemes are unlikely to make the cut for its planned 'fast track' option.

Eight of the UK's 100 largest listed companies have DB schemes bigger than the organisations themselves. Across the FTSE 100 index, DB liabilities are valued at more than 20 per cent of the index's total market cap.

In some cases – such as BT Group, IAG, and Centrica – the DB schemes dwarf their parent companies, with liabilities valued at more than twice the sponsor's market capitalisation (three times, in the case of BT Group). British Airways – now part of IAG – was once commonly referred to as a pension fund with an airline attached.

But how does a scheme's size affect its sponsoring employer? Is having a relatively large scheme always a bad thing?

The size of a DB scheme relative to its sponsor is a "crucial part of the puzzle" when constructing a journey plan, according to Redington investment consultant Mette Hansen. While there

| *Sponsor* | *Assets (£bn)* | *Liabilities (£bn)* | *Market cap (£bn)* | *Liabilities as a % of market cap* |
|---|---|---|---|---|
| BT Group | 53 | 59.9 | 19.9 | 301% |
| IAG | 24.4 | 22.2 | 10.4 | 213% |
| Centrica | 8.5 | 8.6 | 4.2 | 205% |
| J Sainsbury | 10 | 9 | 4.6 | 196% |
| Royal Bank of Scotland | 48.8 | 39.6 | 26.4 | 150% |
| RSA Insurance | 7.8 | 7.5 | 5.4 | 139% |
| BAE Systems | 21.2 | 24.8 | 18.2 | 136% |
| Lloyds Banking Group | 42.2 | 41.1 | 40.9 | 100% |

*Sources: CapitalIQ, Bloomberg, Rhotic Media. Market cap as of 29/10/19*

are many elements to consider when assessing a scheme's covenant, relative size can be a guide to how likely a scheme is to "kill the sponsor", as Hansen puts it.

"If the company is weak, and the trustees asking for money would kill the company, they have to manage the scheme with that in mind," she says. "They need a close relationship with the sponsor and to know what it is trying to achieve."

**Big scheme, small sponsor**

An outsized DB scheme is an obvious problem for finance directors, especially if it is underfunded. It can be a drain on cash and place a limit on business expansion, as well as bringing unwanted attention from The Pensions Regulator (TPR) – and in some cases, politicians.

TPR's recent drive to ensure employers do not prioritise shareholder dividend payments over deficit reduction contributions has also posed a potential investment problem to companies.

Kempen Capital Management's head of UK investment strategy, Nikesh Patel, says: "That much attention usually lends itself to the sponsor pushing for a more professional trustee board, as the outcome of discussions can make or break the business plan for years – even decades – to come. The scheme's performance relative to its deficit could swamp the activity of the business itself."

For this reason, there is less room for a "misstep in the funding journey", according to River & Mercantile Solutions' co-head, Ajeet Manjrekar. This needs to form an explicit part of the scheme's investment strategy, he adds.

On the plus side, Hansen points out that the sensitivity of the situation may make it easier for trustees to engage with the sponsor's board to come up with practical solutions to funding problems, "especially if both sides understand each other and there is a shared goal".

In May 2018, the BT Pension Scheme (BTPS) agreed a deficit reduction plan with BT Group worth £13 billion to address what was an £11 billion shortfall in the DB scheme. This consisted of £2.1 billion in cash contributions paid by June this year, plus a further £2 billion raised through the bond markets and annual payments of £900 million, lasting until March 2030.

As well as the contribution schedule, BTPS trustees also agreed to shut the DB section of the scheme and introduce a hybrid arrangement. They also amended the scheme's investment strategy, shifting 15 per cent from growth assets to lower-volatility investments.

At the time, BT chief financial officer Simon Lowth said the agreement would draw a line under "a key source of uncertainty for BT, the scheme members, and all our stakeholders, and allows us to move ahead with confidence as we deliver on our strategic initiatives such as investing in our network and improving customer experience".

The upfront contributions have already had an impact: in its annual report for the 12 months to 31 March 2019, BT reported a funding deficit of just under £6.9 billion.

**Small scheme, big sponsor**

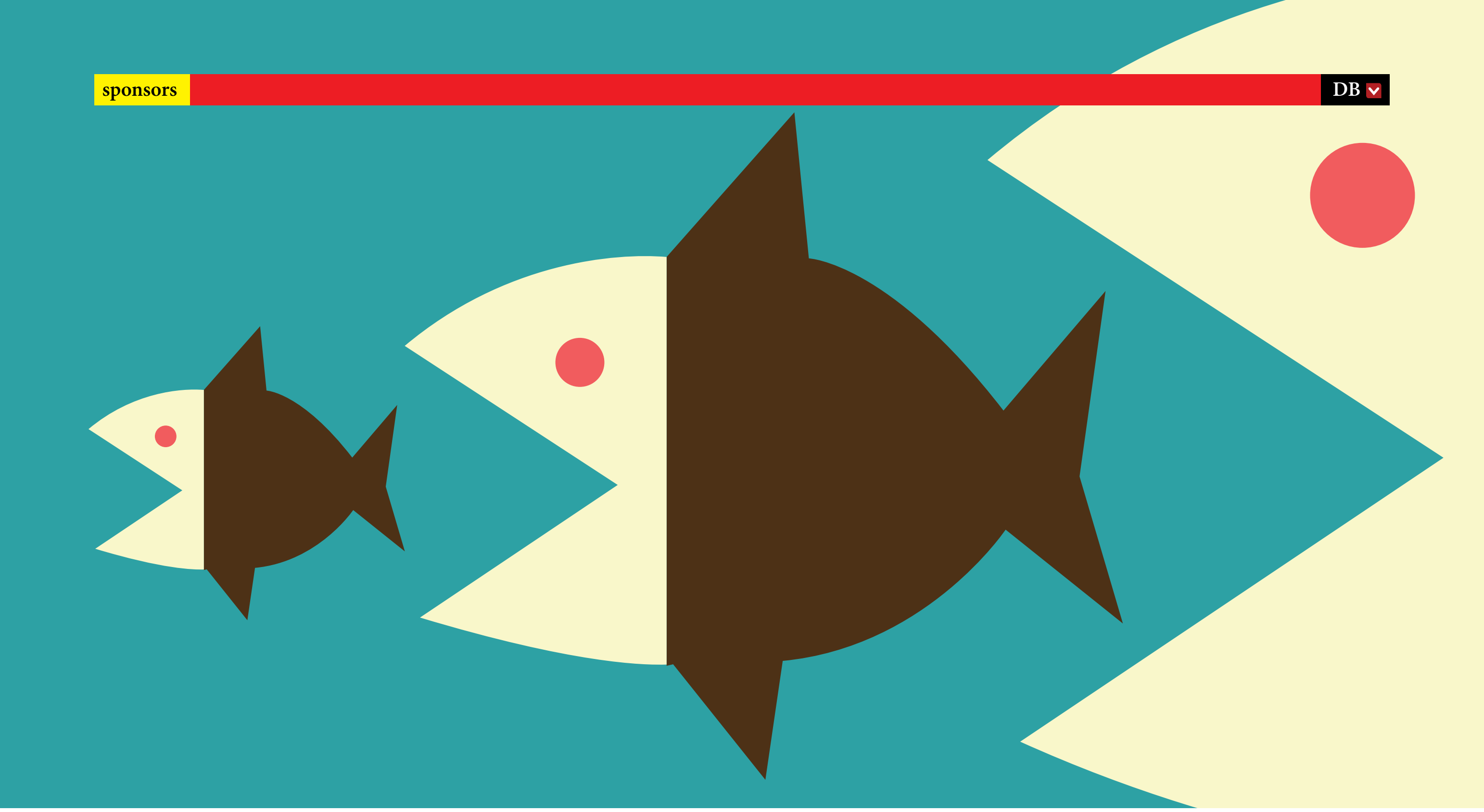
BT's position – and that of other companies whose DB liabilities outweigh their market capitalisation – is not the norm. There are many other companies with small schemes that do not cause their finance directors as many sleepless nights.

However, small schemes can have their own problems related to their size.

"A very small scheme in the context of a large employer is not usually given much priority, as it is not viewed as a significant business risk," says Patel. "They may struggle to get any serious attention or focus and be at risk of being pushed around in negotiations."

As Hansen explains, a small, well-run scheme can encounter engagement problems of a different nature.

"Sometimes trustees haven't thought about what happens when you're fully funded on a technical provisions basis," she says. Companies are not legally obliged to continue deficit reduction contributions once schemes are fully funded on a technical provisions basis,



even if it is not ready for buyout.

"It's a good problem to have, if engagement becomes harder because the scheme stops being a problem," Hansen says, "but it might be difficult to pinpoint an end target. Should you buy out or run off? Often trustees will want to do a buyout to wind up their fiduciary obligations. For very small schemes it's often not efficient to run off on your own."

Trustees should certainly not rest on their laurels in this situation, according to Manjrekar. While the employer may seem strong now, the picture could change dramatically over the life of the scheme – and trustees should factor this into their long-term thinking even when the funding position looks positive. For relatively small schemes, getting this in writing is vital.

"We believe that trustees need to work in partnership with the sponsoring employer to define and frame the long-term funding objective and endgame," Manjrekar says. "This should be coupled with a pre-agreement on financial support should the scheme get into difficulty.

"In doing so, trustees can therefore have greater confidence in the strength of covenant and may even target a higher level of return from the investment strategy accordingly."

**New funding code**

TPR is currently working on a new funding regime for schemes. Subject to legislation passing through parliament, it plans to set up a new two-tier approval system for DB recovery plans.

Speaking at the Pensions and Lifetime Savings Association (PLSA) conference in Manchester in October, TPR's executive director of regulatory policy, analysis and advice, David Fairs, told delegates that the regulator would introduce a 'fast track' process to reduce the regulatory burden on schemes and focus oversight efforts on more complex areas. He explained that TPR wanted schemes to reach a low level of dependency on their sponsoring employers by the time they reach maturity, or a cashflow-negative position.

Details of the new regime are still subject to consultation, but discussions of TPR's plans at the PLSA conference touched on how much of a factor size would be in ascertaining a scheme's eligibility for the fast-track route.

Hansen says: "We are supportive of the new regime, but fast track is meant to be for simple schemes. If you're not in the fast track it doesn't mean you're bad – it might just be that your situation is more complex and the right choices might be harder to figure out."

Over time, TPR will want more and more schemes to move to the fast track, Hansen adds, to help it identify where it needs to focus its efforts.

For Patel, the fast-track option will likely not apply to DB schemes larger than their sponsors. While small schemes may get the fast track, he warns that there will likely be more pressure on sponsors to close any funding gaps "faster and more aggressively".

Manjrekar concludes: "Ultimately, it is essential that the scheme and sponsoring employer are aligned on the long-term funding objectives of the scheme and its endgame. This reflects the balance in 'affordable and sustainable' contributions with targeting an appropriate investment return from the assets."

**Written by Nick Reeve, a freelance journalist**