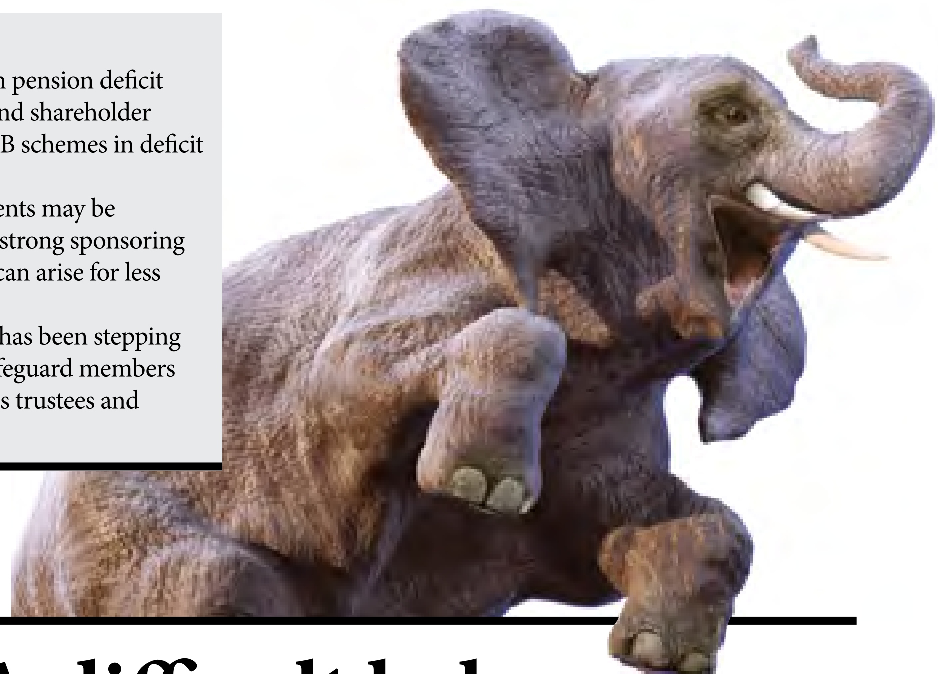
A difficult balance

Many schemes with pension deficits continue to pay shareholders dividends that vastly outweigh the amount they pay into their DB schemes to try to bring them out of deficit. Jack Gray investigates whether there should be stricter regulations to narrow the ratio between dividend payments and deficit contributions



Since 2012, the ratio between dividends paid to shareholders and deficit reduction contributions (DRC) for companies with pension schemes in deficit has been gradually, but significantly, increasing. The Pensions Regulator (TPR) has found that the median level of shareholder payments compared to DRCs for FTSE 350 defined benefit schemes in deficit has risen from 9.2:1 to 14.2:1. The widening gap was primarily driven by the increase in dividends since 2012, without there being a similar increase in DRCs.

For non-FTSE 350 firms that sponsor a DB scheme, the median ratio has increased at a slightly slower rate than companies in the FTSE, from 3.7:1 to 4.9:1 during the same period.

Summary

• The average gap between pension deficit reduction contributions and shareholder payments for FTSE 350 DB schemes in deficit has been steadily rising.

• High shareholder payments may be suitable for schemes with strong sponsoring employers, but problems can arise for less well-funded schemes.

• The Pensions Regulator has been stepping up engagement to help safeguard members from a minority of careless trustees and employers.

Although there have been significant increases in the discrepancies, companies, on average, do not seem to have been performing better enough to justify the rate at which the gap is widening.

TPR has been taking a more active role in ensuring members' benefits are protected, but do not currently have any legislation in place to stop companies paying the levels of DRCs and dividends they feel appropriate.

A TPR spokesperson comments: "We have not set any specific ratio which we consider acceptable, but where dividends are disproportionate to DRCs, we would consider affordability not to be an issue.

"In such circumstances trustees and employers should work together to give greater consideration to liabilities to the scheme."

Strong vs weak

Research from the University of Bath finds that FTSE 250 companies with DB schemes are paying out nearly five times more in dividends than in DRCs. The study reveals that the cumulative amount paid in DRCs in 2015/16 was £28.2 billion, while the amount paid in dividends was £142.5 billion, despite a cumulative deficit of £26.4 billion. Furthermore, 98 of the 250 companies were still in deficit. Could this indicate that there is a problem?

"I think that it's something we should think about," begins University of Bath professor of finance and director of the centre for governance, regulation and industrial strategy, Ania Zalewska. "It's hard to say whether this is definitely wrong, but it isn't particularly good."

On paper, it seems hard to argue against this being unfair on scheme members and beneficial to company shareholders. However, schemes that have a strong employer may be able to reward shareholders with high payments without it impacting scheme members.

"High dividend payments in comparison with pension contributions may weaken the covenant," says Dalriada Trustees senior trustee representative, Vassos Vassou. "This can be a particular concern for schemes supported by a weaker employer.

"By contrast, you may have a strong covenant supported by a well-run profitable company. If this company pays a relatively high dividend there may not be a material weakening of the covenant, which means no impact on the scheme or its members."

AJ Bell senior analyst, Tom Selby, agrees that "the most important thing" for a DB scheme in deficit that has low DRCs compared to dividends is to have a financially strong employer "standing behind the pension promises made to members".

"Although a dividend payment five times larger than the money committed to plugging a firm's deficit might seem hard to justify, the reality is shareholder rewards are the lifeblood of the stock market, with investors demanding a decent, reliable income in return for their investment and firms needing outside investment to drive innovation and growth," he adds. "If a company with a DB deficit were to lower or even scrap dividends and use the cash for the pension scheme instead, investors could pull their money and potentially put the firm's long-term future in jeopardy."

Striking a balance

Although a scheme having a strong employer covenant helps justify the gap, the discrepancy can be too wide, and companies have been tasked with finding a middle ground that will balance DRCs and dividends. This year saw multiple examples of company scheme deficits increasing significantly, without the losses being reflected in the ratio between contributions and shareholder payments.

Retail group Dixons Carphone's DB scheme deficit increased by £109 million year on year, as of 27 April 2019, with the company paying £46 million in DRCs and £116 million in dividends, despite the actuarial losses.

Heathrow Airport Holding's DB scheme swung from a £28 million surplus to a £39 million deficit between December 2018 and June 2019, with the company paying its shareholders £200 million in dividends while paying £12 million in DRCs. Commenting on the discrepancy, a Heathrow spokesperson says: "Heathrow's pension scheme is 99.1 per cent funded. The deficit highlighted is due to fluctuations in interest rates and not an underlying underpayment into the scheme – the scheme was in surplus at the end of last year."

Selby adds: "Companies face a difficult balancing act between rewarding shareholders and paying off DB pension deficits. It's fair to say that, certainly historically, paying out dividends has been seen as a bigger priority by most firms.

"That's not to say the balance currently being struck between deficits and dividends is the right one, but we need to be cognisant of the fact the decisions being made here are rarely black and white."

Although striking the right balance can be difficult, especially when you have members and trustees prioritising one thing and shareholders prioritising another, TPR insists that it is doing more to ensure the right balance is struck.

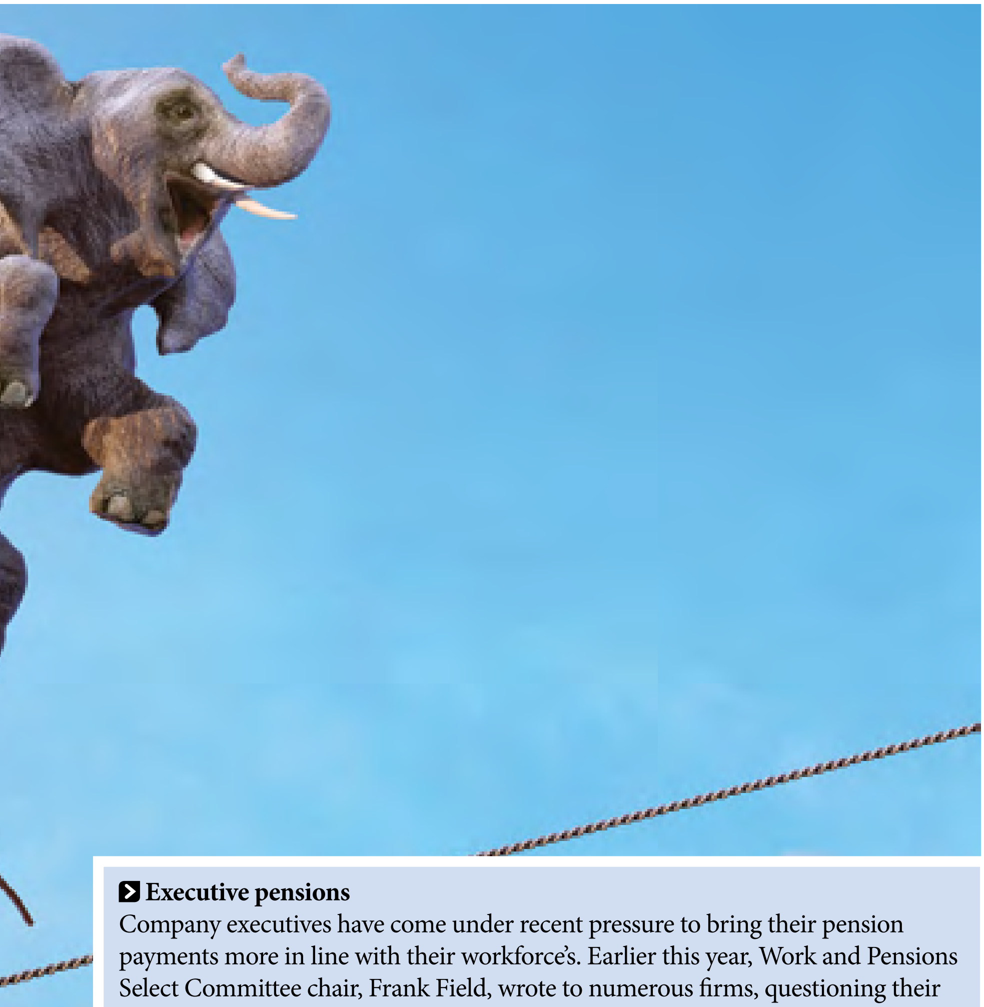
"We are also being tougher with companies that should be balancing their duties to pension savers with returns to shareholders," says a TPR spokesperson. "If a scheme could be better funded then we are checking whether the balance is right."

Regulator and regulation

Although the ratio between dividends and DRCs may appear to be spiralling out of control, each company is unique and any kind of regulation or legislation trying to apply absolute rules to a complex situation could have unintended consequences. For instance, companies with strong funding could be punished for being in a situation that would not suit a scheme with a weaker employer.

"Legislation on dividend payments – contribution ratios – should not be introduced as the issue is not that black and white," explains Vassou. "By far the majority of companies look after their pension schemes well alongside the trustees.

"Having set rules about dividend and contribution ratios may have the unintended consequence of changing behaviour of those well-run schemes



with companies targeting contributions at a level of minimum compliance instead."

Zalewska continues: "As much as I like regulation, I don't think that the regulatory regime can help much.

"It won't change the reality. Saying 'we mustn't do that' may backfire and companies will be even more keen to close down their DB schemes and this is not a route we should follow, in my opinion.

"I would be reluctant to say we have to have regulation, because we can't see exactly what's happening in those companies."

Despite the lack of legally binding regulation on DRC/dividend ratios, TPR has been stepping up its activity to ensure members benefits are protected. An anonymous DB scheme agreed to improve its scheme's funding by reducing its recovery plan length from 13 to seven years, pay annual DRCs of £3.7 million and a commitment to stop dividend payments for six years, following pressure from TPR.

A TPR spokesperson comments: "We will use the full range of powers available to us to ensure members are being treated fairly. We are working with the government on its strong white paper proposals and will be clarifying further our expectations on appropriate funding strategies in a new DB funding code."

Selby adds: "With TPR taking a much keener interest in companies' approach to DB deficits – particularly in light of the disaster that engulfed BHS – it would be no surprise to see more money poured into pension schemes in the coming years."

Although steps are being made to reduce the gap, Zalewska believes that we are some way off a perfect system: "I think the regulator has woken up in the past few years and they're introducing a lot of changes, but much more needs to be done."

Written by Jack Gray

Executive pensions

Company executives have come under recent pressure to bring their pension payments more in line with their workforce's. Earlier this year, Work and Pensions Select Committee chair, Frank Field, wrote to numerous firms, questioning their executive pension payment policy. For example, Lloyds Banking chief executive António Horta-Osório receives a contribution rate of 33 per cent, while its employees are restricted to a maximum contribution rate of 13 per cent. When questioned by Field, Lloyds defended its policy, saying it has reduced Horta-Osório's rate from 46 per cent. Field also queried Standard Chartered after it proposed policy includes executive pension contributions four times higher than the rest of its staff. Meanwhile banknote printer De La Rue was issued with an 'amber top' alert, after it was revealed that its chief executive received contributions equating to 30 per cent of salary.

Firms were queried after the Investment Association (IA) issued new guidance in February 2019, which stated that shareholders wanted executive directors to be paid pension contributions in line with the majority of the workforce. Commenting at the time, IA chief executive, Chris Cummings, said: "Companies that do not take on board shareholder concerns risk facing yet more shareholder rebellions next year."

The step up in regulatory activity seems to be taking effect, with three in 10 FTSE 100 companies pledging to cut executive pensions in August 2019. Thirty companies say that they have made significant changes, with 17 stating that any new director will be given a pension contribution in line with the majority of the workforce and four reducing contributions for incumbent directors immediately.