



Sizing up Europe's corporate pension gap

Invesco Fixed Income analyses how Europe's pension funding gap could impact credit markets

Michael Booth
Credit Analyst
Invesco Fixed Income

Fabrice Pellous
Senior Credit Analyst
Invesco Fixed Income

David Todd
Head of Global Investment Grade
and Emerging Markets Research
Invesco Fixed Income

Executive Summary

The well documented decline in corporate bond yields driven by central bank monetary stimulus has led to a substantial rise in reported deficits among corporate Europe's defined benefit pension schemes. In the UK alone, pension deficits of FTSE 350 companies nearly doubled over the first half of 2016.¹ The pension funding gap is a regional problem, but is more acute for UK-based funded schemes due to the UK's regulatory oversight and its requirement to renew deficit funding plans every three years. This increases the risk of rising cash contributions, placing an additional burden on firms' free cash flow generation.

To date, credit rating agencies have taken a relatively passive position on rising pension deficits. At Invesco, we see potential for this to become an area of greater focus over the next year with credit risk materialising from UK schemes whose triennial reviews are due to be completed in 2017. In particular, we are monitoring 'low BBB' names with large gross pension asset and liability balances whose pension-adjusted leverage metrics are at, or close to, credit downgrade trigger levels.

Introduction to pension risk

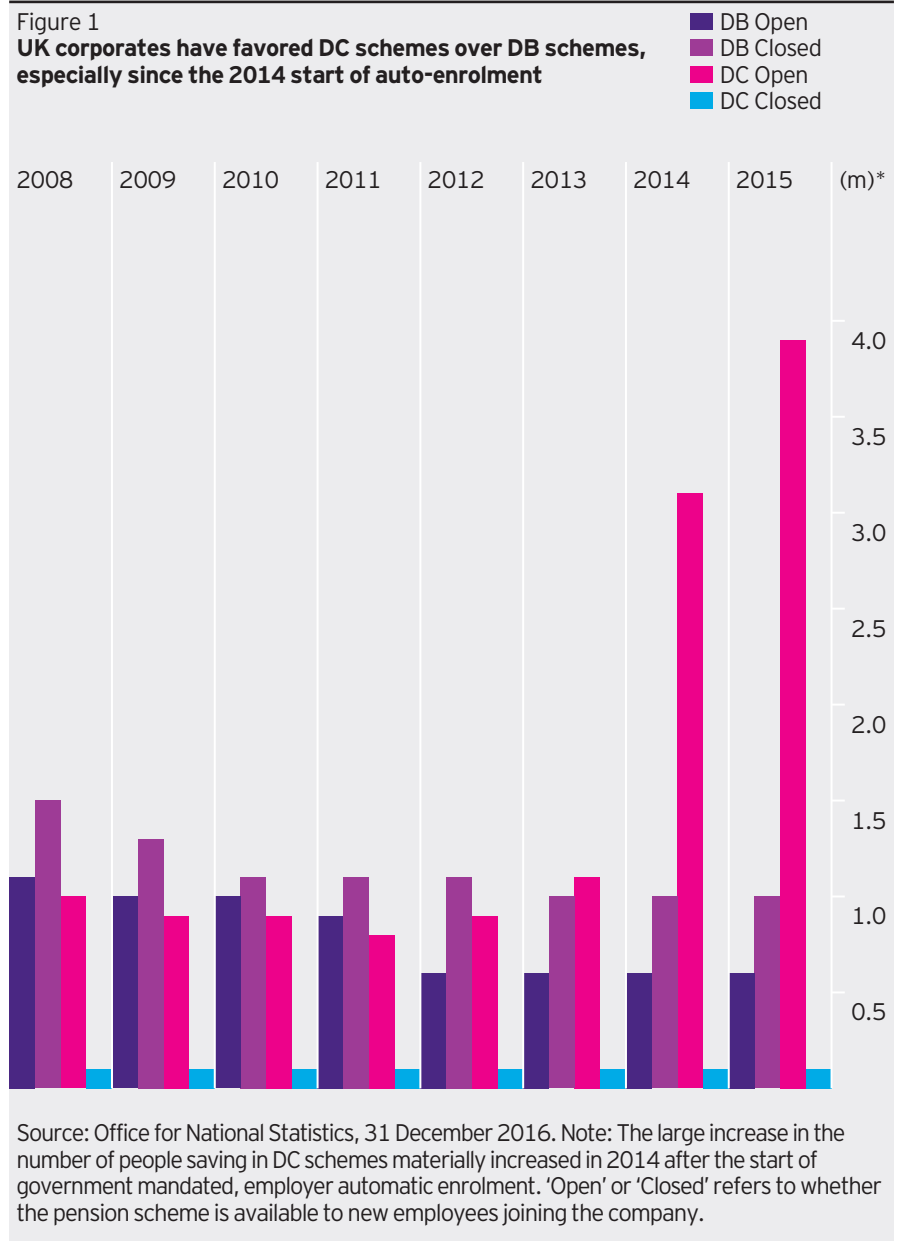
Because bond yields are used as the discount rate in the present value calculation of a company's gross pension liability, falling bond yields - and discount rates - cause a company's gross pension liability to rise. The reported pension deficit on a company's balance sheet will therefore also rise if the value of gross pension assets does not increase by an equivalent, offsetting amount. The past several years of extremely low bonds yields have strained the pension equation across Europe.

Despite Europe's troubling pension deficit statistics, the good news is that defined benefit (DB) schemes have been superseded by defined contribution (DC) schemes as the accepted vehicle in Europe for delivering retirement benefits to employees. Still, DB schemes have received increased focus in global credit and equity markets recently due to the impact of historically low bond yields (a function of European and UK central bank monetary stimulus). Because DB schemes pose rising corporate credit risk, this is where we concentrate our analysis.

Defined Benefit versus Defined Contribution

A company sponsored defined benefit pension scheme guarantees a monthly payment based on the employee's earnings, tenure and age once the employee moves in to retirement, with the risk of any funding shortfall resting with the company.²

In contrast, a defined contribution scheme provides retirement income based on employees' and employers' contributions and their investment returns, with no guarantee of minimum monthly pension payments once retirement is reached - thus shifting the investment return risk from the employer to the employee.



From an accounting perspective defined benefit pension schemes are reported on the balance sheet of the sponsor company (under IAS 19 for companies using IFRS accounting).** In contrast, there is no balance sheet impact for defined contribution pension schemes, with the employer contribution payments simply treated as an additional expense and cash outflow as part of the salary cost line.

* Millions of people

** Note: IAS 19 is the International Accounting Standard covering the reporting of pensions under International Financial Reporting Standards (IFRS).

How do defined benefit pension schemes differ across Europe and what are the credit implications?

There are material differences between defined benefit pension schemes on a country-by-country basis. These variations can have a large impact on the credit implications for sponsor companies.

For example, whether schemes are 'funded' or 'un-funded' is a major differentiator. Figure 2 highlights the key characteristics of 'funded' and 'un-funded' defined benefit pension schemes. In the UK, schemes are 'funded' with regulatory oversight provided by the Pensions Regulator and administered by third party scheme trustees. In contrast, German schemes are typically 'un-funded', with no regulatory oversight.

In France, company sponsored defined benefit pension schemes are not commonplace. Instead, employers and employees are required to pay into a mandatory state pension on a monthly basis through a payroll tax (or social security contributions set as a percent of salary).

Figure 2

Comparison of common European pension schemes

Scheme type	Funded Defined Benefit	Un-funded Defined Benefit	Defined Contribution
i. Are assets set aside to cover the expected liability?	Yes, employer and employee contributions are invested in market assets out of which cash pension payments to retirees are ultimately made.	Typically no; companies instead meet monthly pension payments for retired employees out of on-going operating cash flow/cash reserves. Please see (iv) for further detail.	Cash contributions from both the employee and employer are invested in independently administered funds, although the employee bears the ultimate risk of the final value of the scheme at the designated retirement date.
ii. What is reported on balance sheet?	The gross pension assets and gross pension liability (essentially the present value of future expected pension payments) balances are reported as a net deficit under IAS 19.	There is only a gross pension liability for an un-funded scheme under IAS 19.	Nothing.
iii. Is there risk to the corporate of having to increase cash contributions to cover the deficit?	Yes; for example in the UK, the scheme trustees complete a triennial review with any under-funding typically expected to be covered by deficit funding cash contributions over a 10-15 year period.	No; typically in an unfunded scheme there is no obligation/regulatory oversight forcing a corporate to increase cash contributions to lower the deficit.	No.
iv. Can large one-off cash payments or asset transfers be made to the pension scheme?	Yes; companies will actively look to manage the deficit and 'one-off' transfers have been commonplace in recent years.	Yes; in response to some of the issues outlined in this report corporates with un-funded schemes (typically German companies) have sought to create consolidated special purpose vehicles in which ring-fenced assets are held for the benefit of funding pension liabilities. ³	No.

Source: Invesco, 31 January 2017.

From this analysis we conclude that companies with German-based, un-funded pension schemes have greater cash flow flexibility versus UK-funded schemes since German schemes are under no regulatory obligation to increase cash contributions, although large 'one-off' payments cannot be ruled out.⁴

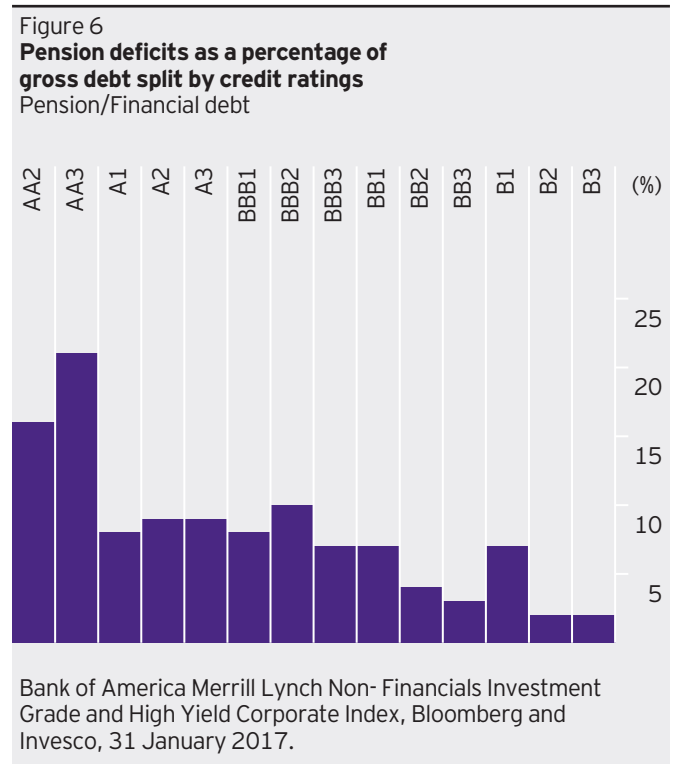
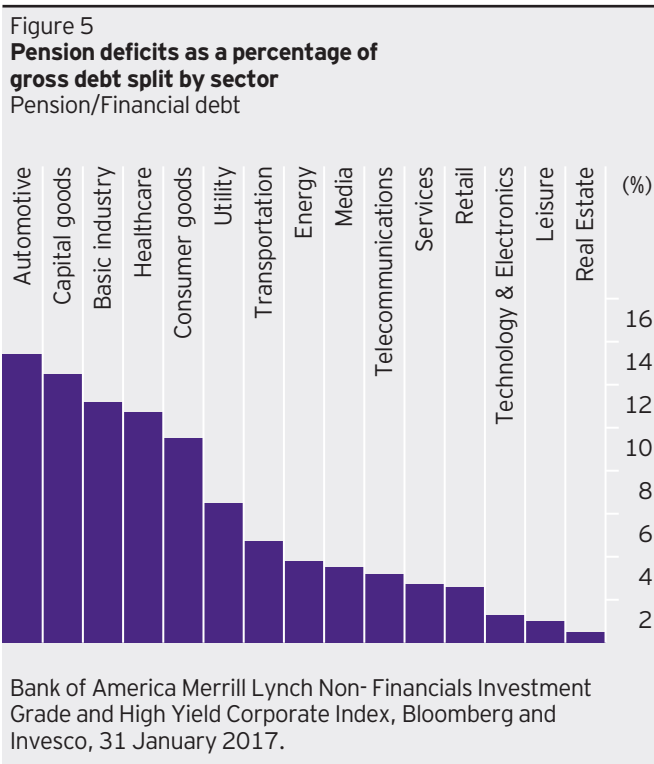
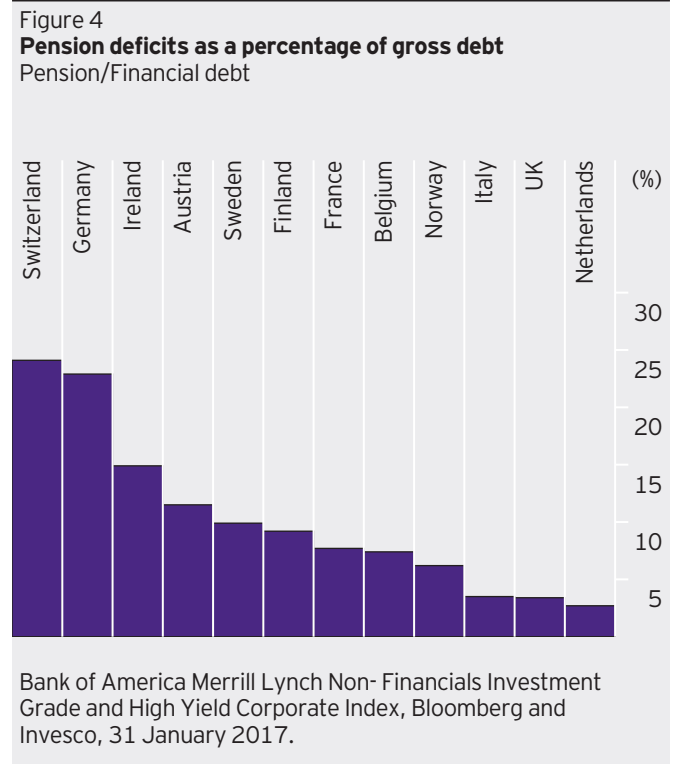
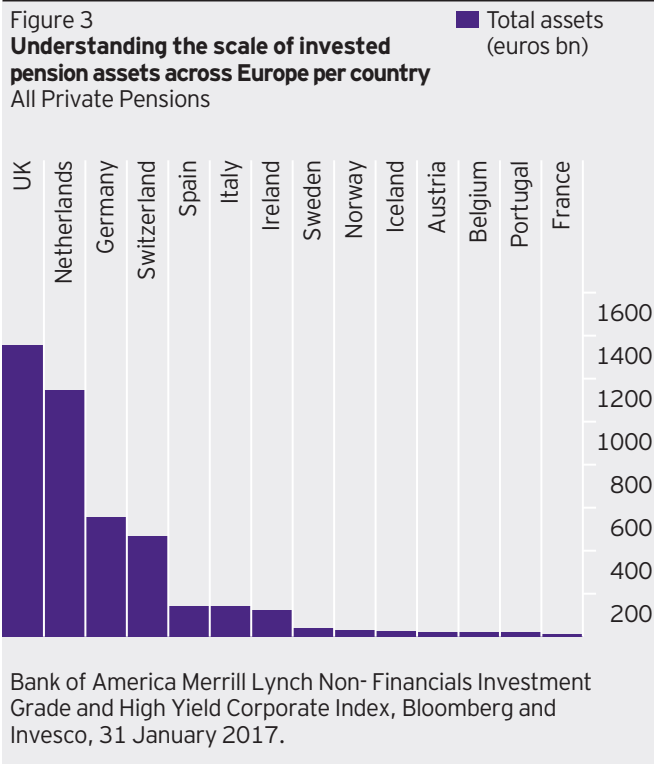
However, we see higher balance sheet risk in German based un-funded schemes as the reported gross pension liability balance is not offset with funded pension assets. Therefore any increase in the gross pension liability will be fully reflected on the balance sheet (in contrast with funded schemes, where some of the gross pension liability may be offset by an improvement in offsetting gross asset valuations). Consequently, understanding the jurisdiction in which pension schemes are located and whether schemes are 'funded' or 'un-funded' is fundamental in any corporate credit risk analysis.

How is pension scheme risk split between countries, corporate sectors and credit rating brackets?

We have analysed median pension liabilities across Europe as a percentage of gross financial debt, using the Bank of America Merrill Lynch Non-Financials Corporate index to ensure we obtained full coverage of capital market issuers. The largest private pension assets are in the UK, followed by the Netherlands, Germany and Switzerland (Figure 3).

The most exposed sectors are the heirs of the industrial revolution, with automotive, capital goods, basic industry, healthcare and consumer goods showing the highest percentage of pension liabilities versus gross financial debt (Figure 5). At the same time, the risk appears to be concentrated in the higher rating spectrum, from double 'A' to 'BB1' (Figure 6).

While the median European pension deficit is moderate, accounting for only 8% of gross financial debt, we have identified 24 companies - mostly well-established blue-chip corporates - which are running very large pension liabilities at well in excess of 50% of gross financial debt.



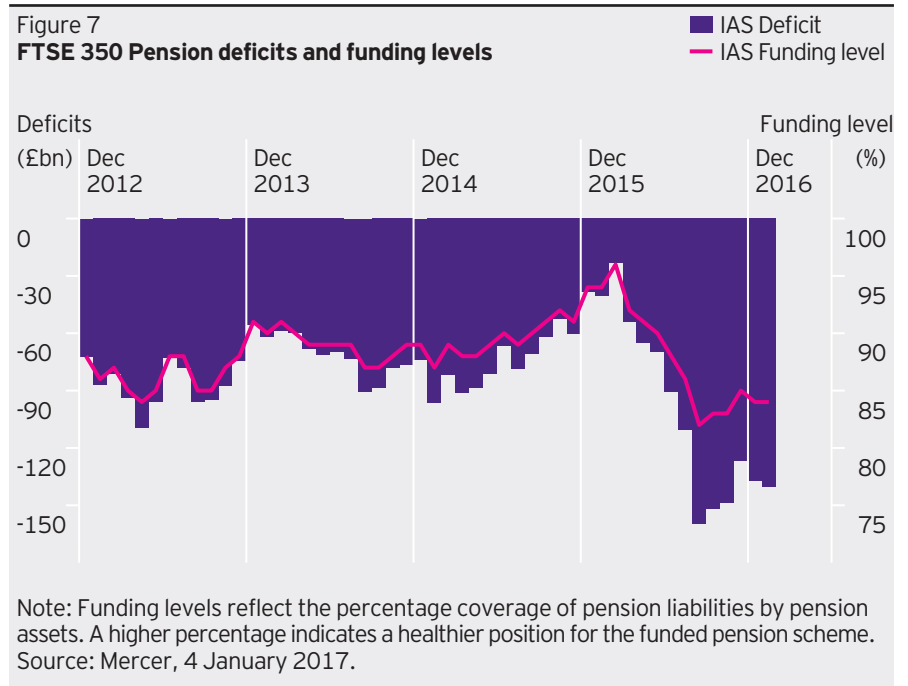
A closer look at the UK defined benefit pension scheme landscape

Figure 7 shows that UK DB pension deficits materially increased in 2016, which may have a number of negative credit implications:

- i) Higher pension-adjusted debt (whereby the net pension deficit is added to the reported debt amount) which could lead to weaker pension-adjusted balance sheet leverage metrics.
- ii) Companies with 'funded' schemes may be required to increase cash payments to fund their pension deficits.

Not surprisingly, UK regulators have increased their scrutiny of pensions - in part due to the high profile collapse of British Home Stores ('BHS') in 2016, which left behind a pension deficit of around £600 million (USD720 million/€690 million).⁵

A UK government inquiry is currently ongoing and a report is due to be published in early 2017. An extension of power for the the Pensions Regulator to have a greater say in corporate merger and acquisition activity is one of the major discussion points, illustrating the potential for increased regulatory oversight.⁶



Credit rating agency treatment of pensions and key implications

Both Moody's and Standard and Poor's add the net pension deficit to total outstanding debt as reported in the company's financial statements, thus ensuring that the impact of the pension deficit is reflected within key ratios for assessing credit risk, such as debt/EBITDA. In contrast, Fitch does not use pension-adjusted metrics in its credit rating methodology or downgrade triggers, but assesses pension risk separately on a case by case basis.

Moody's has taken a longer term 'through the cycle' view on discount rates and pension scheme deficits on the basis that "interest rates will rise again." Standard and Poor's appears to be taking a more proactive approach as reflected in several recent downgrades of UK and German companies, partially triggered by deepening DB deficits. Fitch's methodology is an outlier as it does not directly incorporate pension adjustments. We believe there is a risk of a hardening stance on the pension deficit issue from all three agencies especially if there is no medium-term respite in discount rates and/or if issuers' underlying business conditions deteriorate, which could place further pressure on rating metrics.

Figure 8⁷

	Moody's	Standard and Poor's	Fitch
Income Statement	EBIT/EBITDA includes current service cost (all other items removed) and interest is imputed on the amount added to debt with regards to the pension deficit.	EBIT/EBITDA includes current service cost (all other items removed) and net interest related to pension deficit as reported under IFRS is included as a finance cost.	No adjustment.
Cash Flow	Cash contributions in excess of the Profit and Loss account service cost are re-classified from an operating cash flow to a financing cash flow (i.e. debt re-payment), within the cash flow statement.	Excess cash contributions above the current service cost and net interest charge are added back to operating cash flow. S&P view these as a financing cash flow.	No adjustment.
Balance Sheet	Pension deficit added to gross debt.	Pension deficit added to gross debt.	No adjustment.

Adjustments have been summarised where possible to allow for ease of comparability and reader usefulness. Note: The 'service cost' relates to the present value of the incremental expected retirement benefits earned by active scheme members in that current year. EBIT is earnings before interest and tax, EBITDA is earnings before interest tax, depreciation and amortisation. Operating and financing cash flows are standardised headings within the cash flow statement as defined under IFRS accounting standards.

Invesco Fixed Income

At Invesco we believe in the contribution of both top down (market) and bottom up (company level) analysis to inform investment decisions. IFI Global Credit Research is a large team of credit analysts performing independent fundamental analysis within a common framework. The team is based in key Invesco offices around the globe specialising within markets and industry sectors and collaborating to drive effective information sharing. Our consistent and transparent approach promotes clarity of views across the platform. A performance based culture (through price-targeting of individual security recommendations) and team approach ensures that our analysts are a critical part of the investment process. We believe these key tenets enable us to deliver a superior investment experience to our clients.

Conclusion

The area of defined benefit pension schemes will likely remain in focus, especially if UK and EU interest rates remain 'lower for longer.'

In particular, companies in the automotive, capital goods, basic industry, healthcare and consumer goods sectors appear to be the most exposed to pension risk given the relatively high ratio of pension deficits relative to gross financial debt existing within these sub-sectors.

At Invesco, we see the greatest risk among large UK pension schemes for which triennial reviews are due to be finalised in 2017 and in 'low BBB' names with large gross asset/liability balances whose pension adjusted leverage metrics are at, or close to, credit downgrade trigger levels. The potential market impact could be significant, in our view.

An indication of the potential market impact of a credit downgrade from BBB to BB is illustrated by spread differentials between these ratings buckets. The spread on the Euro BBB Industrial index, for example, is currently 134 basis points, while the spread on the Euro BB index is 271 basis points.⁸ A downgrade from BBB to BB could, therefore, result in a potential price decline of around 8% for bonds with 5.7 years of duration (the average duration for the Euro BBB Industrial index).⁸

Invesco Fixed Income (IFI) is closely monitoring pension risk across Europe and especially in the UK. Having a well-resourced and experienced credit team is important for assessing the issues raised here and to inform our investment decisions. IFI seeks to ensure that credit spreads adequately reflect downside risk or, where this is not the case, that 'at-risk' names are avoided.

¹ Source: Office of National Statistics, January 2017.

² Source: GOV.UK, September 2016.

³ Source: Mayer Brown. Pension Scheme Funding in Germany, February 2015.

⁴ Source: Company reports, Daimler AG, the German automotive company, made optional contributions in to their un-funded schemes during both 2014 (€2.5 billion cash injection) and 2016 (€1.8 billion Renault equity stake transferred to the pension scheme).

⁵ Source: FT.com, May 2016.

⁶ Source: IPE. UK lawmakers to review powers given to Pensions Regulator, August 2016.

⁷ Source: Information obtained from credit rating agency websites, methodology papers and discussions with credit rating agency analysts.

⁸ Source: BofA Merrill Lynch BB Euro High Yield Index and BBB Industrials Index, February 28, 2017.

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