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FUNDAMENTALS

Demographic dividends, corporate challenges

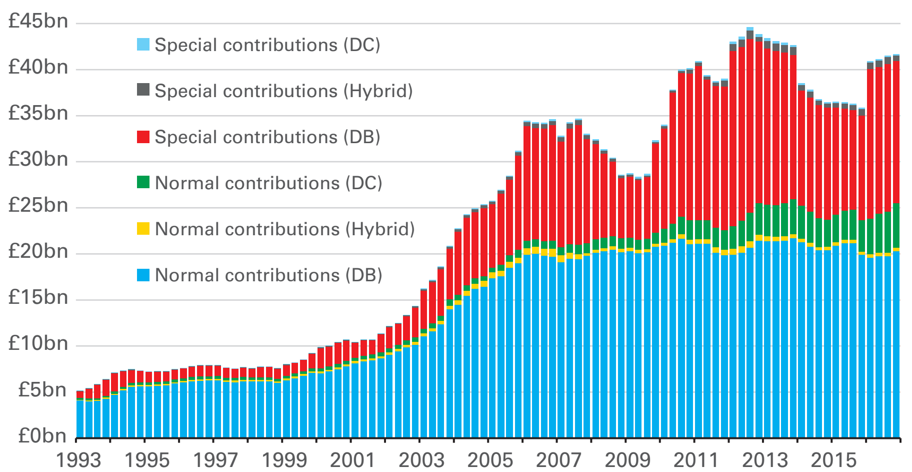
Is rising life expectancy creating difficulties for companies?

Olivia Treharne joined LGIM in July 2014 as a fund manager in the Inflation Plus team.

Increasing life expectancy is one of the most profound success stories of the post-war era. The pace and scale of this human success story has been remarkable, but it is creating its own challenges for corporates.

Arguably the most high profile challenge for companies is addressing rising pension deficits. Defined benefit (DB) schemes typically promised their members a proportion of their salary for the rest of their lives upon retirement – regardless of how long the member lived. The average boy born in the UK is now expected to live for 79 years – 8 years more than in 1980, equivalent to an increase in life expectancy of almost three months for every year that's passed (Source: ONS). Rising liabilities as a result of increased longevity, exacerbated by lower interest rates and weak asset returns have required corporates to pay more into schemes. According to the ONS, employer contributions for defined benefit schemes are currently around £37bn per annum, having been just under £10bn in 2000.

Figure 1: The rising cost of DB schemes for companies



Notes: 'Hybrid' schemes are part-DB, part-DC.
Source: Resolution Foundation Report. ONS Datasets

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For companies with DB schemes, there are also potential implications beyond the financial cost. These include challenges for their competitiveness, current employment opportunities, and their ability to invest for innovation.

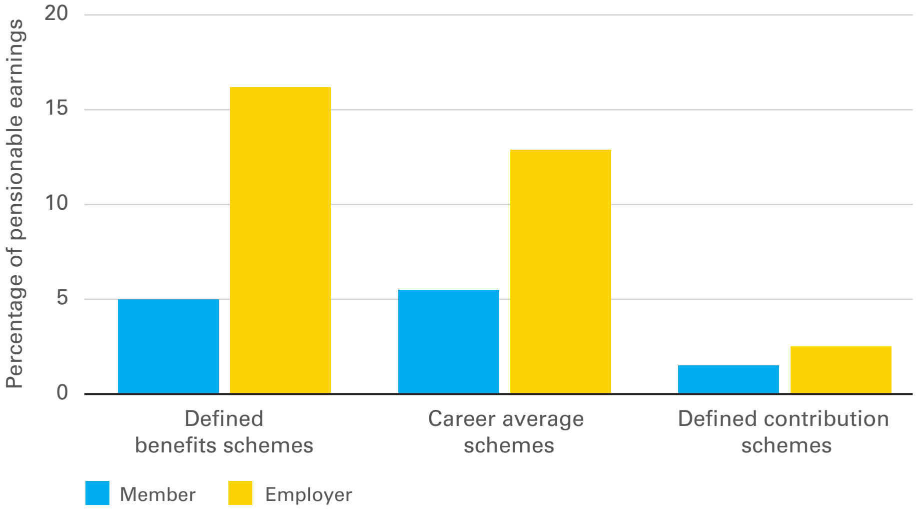
ARE RISING DEFICITS CROWDING OUT WAGE GROWTH?

For employers, pension liabilities represent a financial obligation given that these are contractual commitments. It could be argued that for corporates to maintain their cost competitiveness, they need to re-consider other variable costs within their control – pay, the number of employees and investment – to offset the rising cost of these obligations.

Since the financial crisis, wage growth in the UK has been muted – according to the ONS real average weekly earnings have actually declined by 2.3% since December 2007; in stark contrast to rising employer spend on pensions. Does this mean that companies are paying for the past over the future?

Defined benefit scheme members are clearly more expensive to employ – employers contribute 16.2% of earnings for their defined benefit members, compared to just 2.5% for their defined contribution counterparts according to the ONS. Additional contributions are also required to fulfil historic deficits. However, the Resolution Foundation estimates that despite the increase in total contributions, pension deficits have only had the impact of lowering average employee pay by between 0.2 and 0.3%.

Figure 2: Weighted-average contributions to private sector schemes



Source: ONS

Significantly, the majority of defined benefit schemes have now been closed for a number of years, so scheme members are ageing on average. Of the 10.9 million members of DB schemes, 40% are already in retirement and just 1.6% are under 30 and actively contributing according to the Resolution Foundation.

Weak real wage growth may also not capture true trends in total remuneration. A hallmark policy of fiscal austerity since the financial crisis has been the public sector pay cap, set at 1%, which has resulted in real declines in public sector wages. However, as Former Pensions Minister Ros Altmann observes, the value of pension accrual for public sector workers is roughly five times that of average private sector workers, currently resulting in higher total remuneration. Such public final salary schemes are often funded on a 'pay as you go' basis (the Local Government Pension Scheme is an exception), where current tax revenue funds the historic commitment. One implication of the prevalence of such schemes and their rising cost may be a need for higher tax rates in the future to meet these ongoing liabilities.

Figure 3: Comparing private and public pay and pensions

	Public Sector	Private Sector
% full-time workers in final salary scheme	c.90%	c.15%
Gross weekly pay (full-time workers)	£500	£440
Value of average pension accrual (% of salary)	>30%	<7%
Value of pension accrual (£pw)	£150	£30
Total pay - earnings plus pension contribution	£650*	£470

* in addition, the public worker pays 1.6% lower national insurance each week.
Pay figures shown are median figures.

Source: http://www.rosaltmann.com/public_sector_pensions.htm

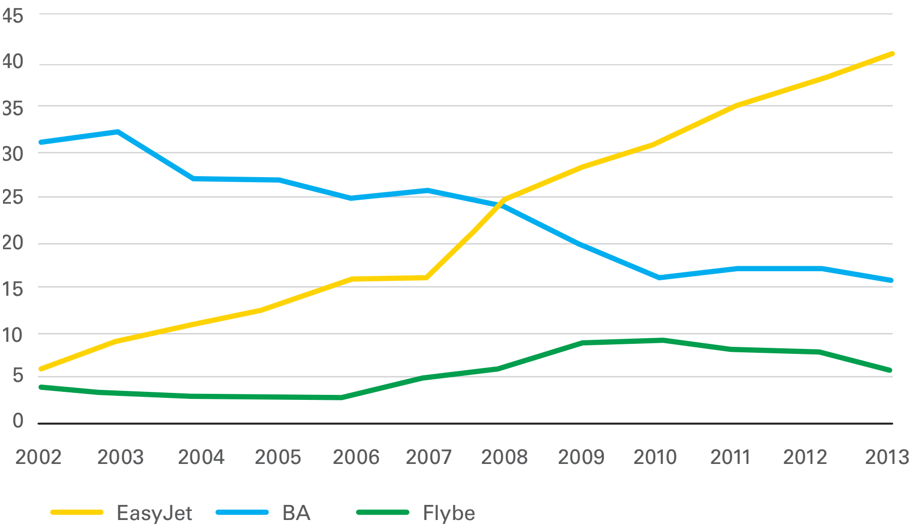
ARE COMPANIES RUNNING JUST TO STAND STILL?

For companies, the more significant impact of pension deficits may be on their relative competitiveness. Companies with large legacy liabilities may be vulnerable to new entrants, given structural differences in their cost bases.

This dynamic has played out in the airline industry in recent decades between national flag carriers and low cost carriers entering the market. One example would be British Airways, who have lost market share to the likes of EasyJet on short-haul flights (Source: Centre for Aviation). This can be partly attributed to structural differences in costs, due to their employee benefits. At the latest triennial valuation, the funding deficit for their New Airways Pension Scheme had reached £2.8bn, although the group's total deficit is actually higher given their Airways Pension Scheme is also in deficit. In contrast, EasyJet, founded 22 years ago, has no defined benefit scheme.

Similarly, Royal Mail has recently proposed the closure of its DB scheme on the basis that it cannot afford to increase its contributions from £400mn to £1bn per year (more than double their annual profit). Many of Royal Mail's competitors in delivery employ their workers on more flexible contracts which have no equivalent entitlements, preventing the company from increasing prices to offset these additional costs.

Figure 4: Share of slots at London Gatwick, summer schedule: 2002 to 2013

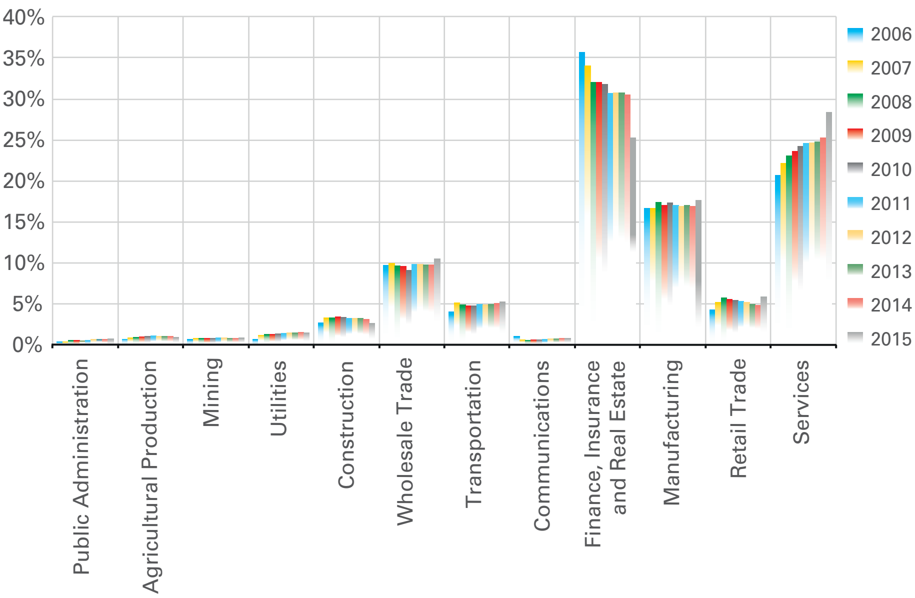


Source: CAPA- Centre for Aviation, Airport Coordination Limited

IS THERE A HIDDEN IMPACT ON JOB CREATION?

Another potentially hidden impact of competitive pressure may be declining employment in certain sectors. Traditionally labour-intensive sectors like manufacturing and services have the highest shares of DB schemes according to the Pensions Regulator.

Figure 5: Proportion of DB schemes by industry: a majority are in labour-intensive sectors



Source: Purple Book 2015

As a response to the cost pressure imposed by such liabilities and new competitors, technology can be deployed to increase productivity with the side-effect of reducing current employment. According to the ONS, manufacturing employment in the UK has declined by 60% since 1979, whilst labour productivity has tripled during the same period.

Similarly, automation in the face of cost pressure has impacted both branch and employee numbers in retail banking – a reflection of both cost pressure and changing preferences of consumers. According to the British Bankers Association between 2008 and 2012, retail banks shed over 32,000 staff – equivalent to around 10% of the total.

INVESTMENT AND INNOVATION

For companies, investment in research and development could also be considered a variable cost that is vulnerable to cost constraints. Interestingly, however, the Bank of England finds that the impact of corporate deficits on growth in corporate investment is minimal at around 0.1%. Their argument is that DB schemes are more typical of large corporates who have greater covenant strength.

Figure 6 highlights how deficit reduction contributions are estimated to have reduced aggregate investment growth only very slightly. Although large corporates have fared well so far, however, our own research suggests that risk remains.

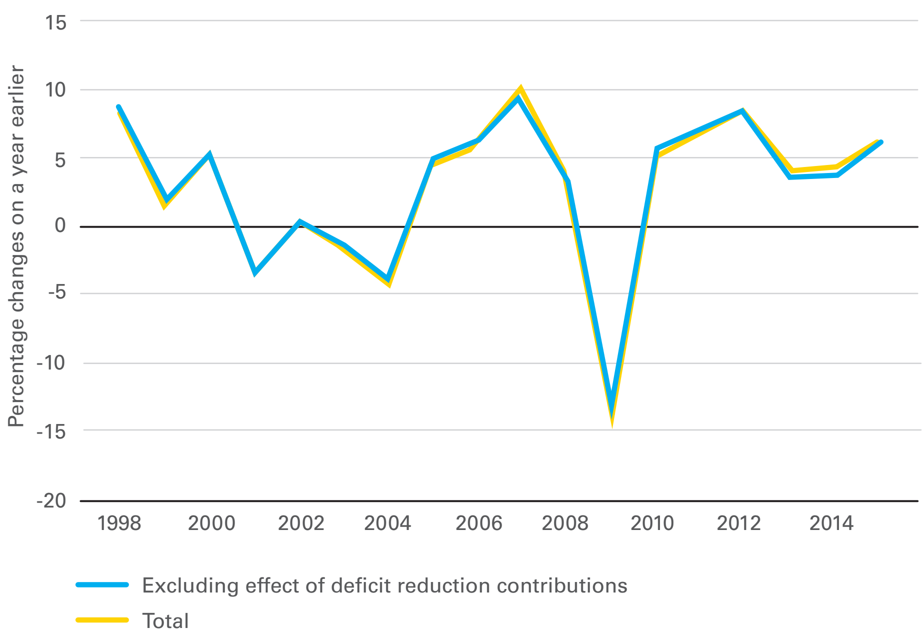
The average defined benefit scheme's sponsor has a BB credit rating – based on historic default rates, this would imply that one in three could default in the next twenty years, although this could be understated given accelerating technological disruption. The average duration of schemes are around 20 years and so less than half the benefits (undiscounted) would have been paid out by this point. Rising financial pressures on such corporates could lead to a greater impact on future investment spend.

INCREASING LONGEVITY HAS ONLY HAD A LIMITED IMPACT SO FAR

Overall, increasing longevity is clearly posing new challenges to corporates, although the empirical evidence suggests that companies are faring relatively well so far. The statistical evidence finds that the impact on both wages and investment is pretty small, owing to the nature of companies that have liabilities – typically larger listed companies.

However, quantifying the impacts on employment is more challenging as employers may have adopted technology to reduce labour intensity in response to such cost pressures. What impact there is seems likely to be concentrated in certain sectors where historic labour intensity (and hence liability) has been high, exposing such firms to competition from new cost-advantaged entrants.

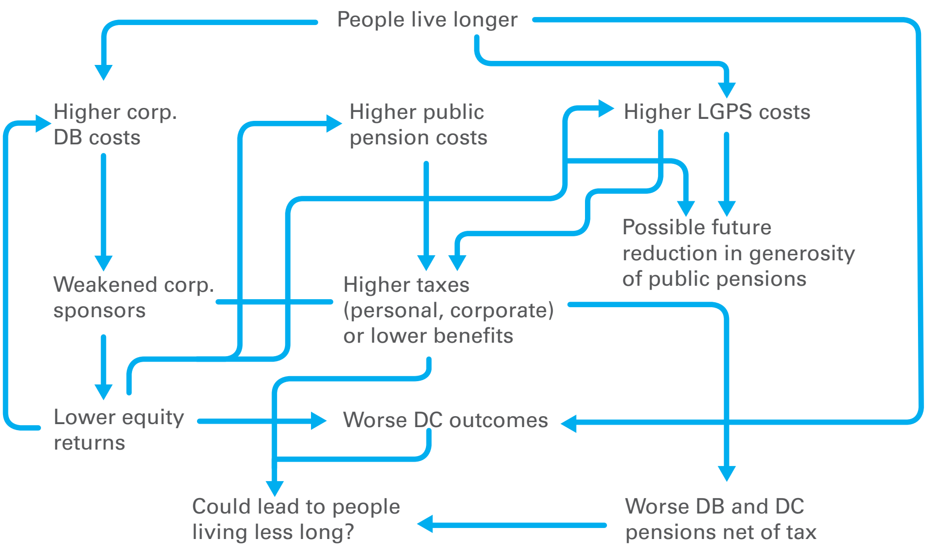
Figure 6: Business investment and the estimated effect of deficit reduction contribution



ASSESSING FUTURE RISKS

Looking to the future, DB schemes are forecast to reach their largest cash outflows in the next few years, suggesting declining liabilities for corporates. However, two clear risks remain. First, public sector pensions generally work on a 'pay as you go' basis – there is no fund – so the government is reliant on growing tax revenues to meet these liabilities. With a declining workforce, without productivity growth (which has been lacklustre in recent years), taxes are likely to rise to service these costs. For corporates, this would reduce their profitability, weakening covenant strength. Secondly, pension schemes are typically invested in the largest corporates – if a greater share of profits is required to fund pension schemes, the cash distributed to investors will be lower, reducing the investment return for pension funds. Lower investment returns could further increase scheme deficits.

Figure 7: Assessing future risks



For those with defined contribution schemes, therefore, rising deficits could represent a transfer of wealth to DB members through lower equity returns. Unless DC members can afford to save more, the primary solution to this appears to be to work for longer.

Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA www.lgim.com

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