Shareholders paying the price for pension deficits

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Companies are prioritising their pension fund deficits and shareholders are paying the price, shows new research from our University.

Professor Ian Tonks, from the University of Bath's School of Management, has been examining the effect of a company's mandatory pension contributions on its dividend payments and investment spending.

Professor Tonks, who conducted his research with Dr Weixi Liu from the University of Exeter, studied a sample of 180 FTSE350 UK listed firms from 2000 to 2007.

More than 90% of companies in this sample had a pension deficit over this period, meaning their pension schemes were underfunded, and the value of their pension liabilities were greater than the value of assets held to pay these pensions. The typical extent of this underfunding was a ratio of pension deficits to pension assets of 8.6%.The research investigated the impact of companies being required to fully fund their pension scheme liabilities on their dividend policies and investments.

The study made use of information on corporate pension deficits which became available after accounting changes to FRS17 in 2001 and legislative changes due to the Pensions Acts 1995 and 2004.

Professor Tonks said: "Results show that the channel through which companies with large pension deficits make up their funding shortfalls is by paying lower dividends to shareholders, rather than cutting back on

investments.

“The implication is that shareholders in a company with a pension deficit should anticipate that future dividends are likely to be reduced.”

The research has implications for future stock prices of companies with Defined Benefit pension schemes deficits. The latest Purple Book – published by the UK’s Pension Protection Fund and Pension Regulator documents the risks faced by occupational defined pension schemes. This latest report found that there were 5,450 pension schemes in deficit in 2011 and their overall deficit, based on a full buy-out basis, was £470.7 billion.

On 27 April 2012 The Pensions Regulator announced that it recognised that the current economic conditions impacts on companies funding their pension schemes but warned “If there is substantial risk to the likelihood of the pension scheme delivering the benefit entitlements promised within it, then dividend payments need to be re-assessed in light of the obligations to the pension scheme, and other creditors” (TPR, 2012; para. 26).

Professor Tonks’ study established that the effect of pension contributions on investments in the UK is weaker than the evidence for US companies. This suggests that pension regulations in the UK allow firms sufficient discretion to maintain investment spending, and that in the UK the response of balance sheet adjustments to financial pressures takes place through dividends rather than real investments.

Professor Tonks added: “We found that the dividend and investment sensitivities to pension contributions are more pronounced in and after 2005, indicating that the regulations in the Pensions Act 2004 have had a significant effect on corporate expenditures.”

More information: people.bath.ac.uk/it237/Resear … ment_Sensitivity.pdf

Provided by University of Bath

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