Written evidence from Professor Ian Tonks (PPF0025)

Evidence on the trade-off between dividends/investments and pension contributions

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Our research shows the following:

- **Motivation:** The latest PPF 7800 Index (June 2016) jointly produced by the UK’s Pension Protection Fund and Pension Regulator on the risks faced by occupational defined benefit pension (DB) schemes, reports that there were 4,864 DB pension schemes in deficit at the end of May 2016 (out of a universe of 5,945 schemes), and their aggregate funding deficit on a full buyout basis was £330billion. If companies fully fund these liabilities, what are the likely effects on company dividend policies and investments?

- Our research explores these issues by examining the effect of a company’s mandatory pension contributions on its dividend payments and investment spending, using a sample of FTSE350 UK listed firms from 2000 to 2007.

- Previous research has established a negative relation between pension contributions and dividends for UK listed companies. However this work and does not include information on pension funding status - defined as the percentage deficit of the pension scheme - since companies have only been required to reveal this information after the introduction of accounting standard FRS17 in 2001. In the absence of funding status details it is not possible to separate out firms with defined contribution (DC) schemes from DB schemes; yet it is only firms with DB schemes that are required to make mandatory pension contributions.

- A negative relationship between investments and pension contributions needs to be interpreted with caution since such a correlation would be consistent with limited investment opportunities and firms making voluntary pension contributions instead. To identify the effect of required pension contributions on investments one needs to condition on pension funding status - but funding status might in turn be correlated with investment opportunities. A firm might have funding problems because asset values are low due to low investment returns. Similarly, funding status might be correlated with dividends, through investors’ preferences. We argue that the function relating funding status to investment opportunities or dividend preferences is different from the function relating funding status to pension contributions, and consequently it is possible to identify the effect of contributions on investment and dividends.

- Minimum Funding Requirements (MFR) for DB pension plans in the UK were established after the Maxwell scandal of 1991, as a part of the Pensions Act 1995. The MFR established a baseline ratio of pension assets to scheme liabilities in order to cover the pensioner benefits in the event of the scheme being wound up.
• However the MFR was criticised for a number of reasons. First, in some cases, the level of assets required by the MFR proved insufficient to provide the benefits promised by the scheme. Second, it increased the regulatory costs for sponsoring firms without delivering the level of security as expected. Third, it made firms focus on meeting the requirements of the MFR, rather than on developing an appropriate funding strategy for addressing their specific pension commitments, and may have hampered firms from making efficient investment decisions.

• The Pensions Act 2004 replaced the MFR from September 2005 with a new scheme-specific ‘statutory funding objective’ (SFO), allowing more flexibly to individual schemes' circumstances whilst at the same time protecting members' benefits.

• Our sample focuses on a panel of 180 companies with at least one DB pension scheme over the period 2000-2007. Not only can we assess the impact of funding rules under the MFR over the period 2000-2004, but also our dataset allows us to examine whether the new funding requirements introduced under the Pensions Act 2004 have had any effects on firms’ pension contributions and accordingly their corporate expenditure decisions over the period 2005-2007.

• For our sample the mean ratio of pension deficits to assets is 8.6%, and 847 of the 935 firm-year observations over the period are underfunded, representing 90% of all sample firms. These figures illustrate the severe shortfall within UK occupational pension schemes after the introduction of FRS17 in 2001.

• We find there is a strong negative relationship between a firm’s dividend payments and its mandatory pension contributions even after controlling for the endogeneity of pension funding status on dividends and investments.

• We find that the effect of pension contributions on investments is weaker than the evidence for US companies, suggesting 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.

• Under the MFR, pension contributions for underfunded firms were smoothed over a number of years, but after 2005, the MFR was replaced with firm-specific funding requirements, allowing firms to focus on developing optimal funding plans that are appropriate to the circumstances of the scheme, and the Pensions Regulator with the powers to require companies to fund their pension liabilities. We found that the dividend and investment sensitivities to pension contributions are more pronounced in and after 2005, indicating that the regulations in Pensions Act 2004 have had a significant effect on corporate expenditures.

• Professor Ian Tonks says “What these results show is 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.”
Reference to the research:


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