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De-Risking of Global Pension Liabilities

By Norman Dreger

The trend for employers to move from defined-benefit (DB) to defined-contribution (DC) pension plans is a global phenomenon. Many multinational companies now have pension guidelines that encourage or even require pension provision to be granted using a DC approach, and some emerging economies without long-standing pension systems have skipped DB benefit provision altogether.

Unfortunately for plan sponsors, moving to DC for new hires or for future services does not mean that the pension liabilities arising from historic DB pension arrangements will just disappear. Thanks to the long-term nature of pensions, many companies, even those who have closed their major DB pension plans long ago, still have material pension liabilities in their balance sheet. In such cases, the liabilities typically do not form part of an ongoing human resources (HR) or workforce planning strategy; they are in many respects simply historic financial obligations that need to be managed down.

In light of this, many companies are looking for ways to settle their pension obligations, or use other strategies in order to reduce balance sheet volatility and risk exposure to DB pensions.

The approaches to pension provision and the legal framework and regulatory requirements placed on pension plans will vary from country to country, often dramatically. As such, the solutions employed to deal with historic pension obligations will also generally need to be country-specific. There are, however, three basic strategies that can be used to reduce a company's risk exposure to DB pension plans:

1. **Transfer risk to a third party, such as an insurance company:** Examples of this are "buyouts" (transferring the full obligation for certain benefits from a pension plan to an insurance company) and "buy-ins" (purchasing insurance to fund the pension obligations, which is then held as an asset in the pension fund). Risk transfer typically comes with a price tag, however, and some companies that may like to remove their pension obligations in this manner might not be able to do so for financial reasons, at least not right away.
2. **Agreements with beneficiaries to cash out/alter benefits:** In some countries, it is possible to agree with certain beneficiaries to pay a lump-sum settlement amount in lieu of pension entitlements (pension cash-out). It is also possible that only a portion of the benefits be altered; as an example, it is sometimes possible to agree with pensioners that they will receive an increased pension immediately, in lieu of receiving future pension indexing, thereby reducing the company's exposure to inflation risk.
3. **Funding using liability-driven investment (LDI) techniques:** Simply put, assets can be purchased and held, which are expected to develop in a similar manner as the liabilities. For instance, if the liabilities are sensitive to inflation, inflation swaps could be purchased that would increase in value in a high-inflation environment, thereby negating the increase in liabilities. Longevity swaps are also available in some countries, which protect a company against unexpected and unreserved increases in life expectancy of the underlying beneficiary population.

In practice, often a combination of approaches is applied. As an example, a company that is interested in transferring its pension obligations to an insurance company, but does not currently have the money to do so, might initially choose to implement an LDI investment strategy, combined with a mid-term funding strategy, with the goal of buying out the liabilities after a certain number of years. As agreements with beneficiaries to cash out benefits are often

less expensive to implement than risk transfer to an insurance company, companies may want to start with a voluntary pension cash-out program first, before settling the remaining liabilities with an insurance company as a second step.

MANAGING HISTORICAL PENSION OBLIGATIONS IN MULTIPLE COUNTRIES

Pension law can vary dramatically from country to country, but despite these differences, pension laws around the world typically have one thing in common: They are complicated. As such, while the fundamental de-risking strategies to be employed are broadly consistent, these will need to be tailored to reflect the pension environment in a given country.

Below we look at several examples of approaches used to mitigate historical pension obligations in several countries: Germany, the United Kingdom and Canada.

GERMANY

There are a number of different options available for companies to de-risk their DB pension plans in Germany. One approach that is currently quite attractive to many companies is to offer lump-sum payments to pensioners in order to settle their pension benefits. The amounts offered to pensioners are typically oriented toward the German-GAAP (HGB) liability; as this liability is determined based on a seven-year moving average of market rates, under current market conditions, the HGB liability is typically 20 to 30 percent lower than the liability (DBO) under International Accounting Standard (IAS) 19 in respect of the same benefits. If cashed out in this manner, the difference between the German-GAAP liability and the IAS 19 liability is shown as a settlement gain under IAS 19; thus when such an approach is used, not only does it result in the removal of pension liabilities from a company's balance sheet, it also results in potentially substantial incremental earnings from operations due to the settlement gains.

As many de-risking and risk-transfer activities available around the world require companies to pay more than the amount they are showing in respect of the liabilities in their international balance sheet, many activities will typically lead to accounting losses and negative profit-and-loss (P&L) impacts for the company. As the opposite applies here, companies who have a global pension de-risking budget may often find that they get the biggest "bang for their buck" by starting with a pensioner settlement project in Germany.

As not all pensions can be settled in this manner (only pensions with payment commencement before 2005 and "mini-pensions" may be paid out, and, for the pre-2005 benefits, the cash-out option has to be agreed between the company and the retiree), carrying out a pensioner settlement project will never result in all pension liabilities being settled. As a result, if a company is interested in fully removing the pension liabilities from its balance sheet, such a settlement project is often used as the first step in the de-risking journey, with alternative approaches (e.g., transfer of liabilities to an insurance company) being used in respect of the liabilities that cannot be cashed out.

UNITED KINGDOM

The budget announcement in 2014 was considered by many to have heralded in the greatest change in U.K. pensions in the last 50 years. One of the more dramatic changes made is that all employees with benefits under a DC plan must be given the option to receive their entire benefit entitlement as a lump sum. This change in legislation also impacts companies and employees with DB pension entitlements, as employees can be given the option of converting their DB benefits into a "DC pot," which could then be fully cashed out at retirement.

The press and travel industry responded immediately, with full-page advertising in major newspapers, encouraging new pensioners to "cash out their pensions and enjoy the vacation of a lifetime." While pensioners blowing their retirement savings on a cruise or some other exotic vacation might have broader long-term negative socioeconomic implications for the United Kingdom, at least from a company perspective there is a positive side to the story: Benefits that are cashed out will no longer need to be shown in the company's balance sheet, and, consequently, any financial risks inherent in the benefit schemes will be removed as well.

Assuming an employer would like to encourage employees to cash out their pension entitlements, this can be done by providing so-called "enhanced transfer values" or ETVs. In this case, the actuarial present value of the future pension entitlements is increased (enhanced) by a certain factor to "sweeten the pot" and encour-

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age beneficiaries to allow themselves to be cashed out.

Another interesting approach seen in the United Kingdom is the so-called "pension increase exchange." Pensions in the United Kingdom generally receive inflation adjustments after retirement; under a pension increase exchange exercise, pensioners receive an immediate increase to their monthly pensions, on the condition that they agree to waive all future pension adjustments. These activities can be structured in such a way that the expected costs to the company are somewhat reduced, but more importantly, a pension increase exchange exercise will serve to de-risk the pension obligations by removing the sensitivity of liabilities to future inflation levels.

There are also various options to settle pension liabilities with an insurance company. Obligations can either be transferred to an insurance company ("buy-out"), or the pension fund can purchase insurance and hold it as an asset ("buy-in").

CANADA

The pension environment in Canada is complicated, due in part to the way that pensions are regulated: Although Canada has by far the smallest population of any of the G7 countries, it is also the only country in the group that regulates pension plans on a provincial level. Thus while Germany, the United States, the United Kingdom and Japan all essentially have one set of national pension laws, Canada has 11 different sets of pension laws, one for each of the 10 provinces plus an

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11th set of rules for companies and industries that fall under federal supervision. Whether, for instance, the people living in the province of Saskatchewan really have such radically different pension needs versus those of the people of Manitoba, thus justifying a completely different set of pension rules, is perhaps a valid point of discussion. In any case, the law is how it is, which makes pension provision in Canada complicated.

The terms under which a pension plan can be terminated or "wound up," with liabilities transferred to an insurance company, will depend on the jurisdiction (province) of the participating members, which can make this process complex. However, the market for pension risk transfer to insurance companies in Canada is well-developed, and we have recently seen the first case where a longevity risk transfer vehicle was implemented.

CONCLUSIONS

In a world where pensions for new hires are predominantly provided with DC plans, DB plans have moved in many cases from being a strategic HR management tool to being a source of volatile historic liabilities and costs that need to be managed downward. While the approaches for dealing with these liabilities broadly consist of risk transfer, settlement or funding, the precise options available will vary by country depending on the local pension framework and legal requirements. Any company with material global pension liabilities would be well-advised to monitor these closely, in order to be able to take advantage of opportunities to de-risk, and to ensure that a global pension de-risking budget is allocated to the activities that are expected to yield the best returns for the group. ■

Norman Dreger, FSA, FCA, FCIA, is a partner at Mercer and the leader of Mercer's International Consulting Group in Central Europe (Austria, Germany and Switzerland). He is a member of the Mercer's Swiss and German Management Teams and the EMEA International Consulting Group Leadership Team. Dreger can be reached at *norman.dreger@mercer.com.*