



# Mastering pension risks globally

*Defined benefit (DB) pension plans continue to cause financial volatility, which is not yet at a comfortable level for many multinational companies, despite widespread moves toward defined contribution (DC) plans.*

The financial risks of DB plans can be reduced by headquarters (HQ) adopting a systematic multi-local approach with central guidance and oversight, to identify de-risking opportunities, lay the groundwork up front and stay on top of volatile financial markets – changing practices, legislation and trends.

DB obligations are a complex form of debt. This debt is the underlying cause of financial volatility, with the potential to impact the company’s covenants and hamper business operations – and create unexpected cash calls, large expenses to be recognized in profit and loss (P&L), or big liabilities on the balance sheet.

For most multinationals, their DB plans around the world have different levels of funding. The risks outlined above are starkest in unfunded and underfunded arrangements, but even plans with assets greater than their obligations may create significant challenges.

At the same time, DB plans represent a significant administrative and operational commitment, especially if they are funded, so there is also a financing vehicle to operate. This is a significant consideration for multinational companies that are looking to simplify their operating models globally.

In this article, we outline the common techniques multinational organizations have deployed to manage pension risk as well as provide insights on optimizing global pension debt management and de-risking decisions using a systematic approach that addresses all aspects of the risk, including the impact to employees.

## Common techniques

A desire to reduce risk from DB plans is not new. A common starting point to control risk is to close DB plans to new entrants and, increasingly, to future accrual. This article focuses on steps beyond these, which bear down on the DB legacy that is left behind as the future state moves toward DC. Common techniques to reduce the legacy risks include:

- Funding and investment strategy:
  - Set funds aside to help mitigate the impact from the debt, typically in a trust-based structure (e.g., a pension fund) or an insurance-based structure. These take various forms around the world – including stand-alone, multi-employer, multi-local and cross-border.
  - Invest these funds in assets that more closely track liabilities to neutralize volatility in the P&L statement or balance sheet. As the size of the underlying obligation (debt) moves with market conditions, so do the assets. This liability-driven investment approach has become much more sophisticated over the years, taking advantage of new financial instruments and incorporating dynamic investment allocation strategies.
- Transfer the risk to an insurer, which makes payments directly to employees, thus taking the responsibility away from the employer. This option is not available in all countries, however, as there may not be any providers interested in taking on such business where it is not already commonplace.
- Offer members a different form of benefit to replace all or some of their existing entitlement. Growing significantly in importance in the past decade, such offers come in various forms around the world. The simplest and most common is a lump sum offer (i.e., a one-time payment to the member or to a DC pension plan) in place of defined benefits.

Within and around these common techniques, a raft of variations and adaptations have emerged over recent years – and continue to emerge – as companies and providers seek and find ways to address different circumstances and constraints in different jurisdictions.

These de-risking techniques require a significant investment of time and effort. Even in countries where such techniques are relatively common, building agreement within the organization to take actions can prove quite cumbersome. If an approach is more novel, the time required to gain traction can increase exponentially. What's more, headquarters and local company management may lack direct control of key decisions, particularly in countries such as the Netherlands, Switzerland and the U.K., where trustee-like bodies exert significant control over various aspects of plan operation, including options for employees or how assets are invested.

## Looking at opportunities with a global perspective

Given vast differences in “the art of the possible” between countries, a centrally established approach to managing DB risk achieves the best outcomes for a multinational company. All too often, however, companies take a country-by-country approach to determining the path forward. In doing so, they miss the big picture – and often better opportunities. Put simply, a single-country viewpoint may identify that de-risking option A is more efficient than option B. However, what a single-country focus fails to uncover is that, just across the border, there may be a third option that is a better use of time and capital than either A or B.

With limited financial resources and time available to spend on de-risking, organizations would benefit from utilizing a systematic approach to assess their significant DB risks across the globe to determine which approach(es) will truly have the biggest overall impact to address their specific pain points. And it is important to recognize that what causes “pain” does vary industry by industry and even company by company. Some companies and industries are most focused on P&L considerations, others on balance sheet (and in the case of financial services companies, capital adequacy) considerations, and still others on cash flow.

Understanding what risks matter and how much it is worth to the business to mitigate or remove them allows prioritization between the available potential opportunities. It is seldom the case that the optimal set of opportunities will all be sufficiently attractive to be actioned immediately, but there may well be a number that are “bubbling under” and should be monitored, discussed more below.

Equally important to monitor are legislative or quasi-legislative changes happening in a multinational's key DB countries. To take a couple of examples:

- Conventional wisdom in the U.S. held that a lump sum offer could not be extended to someone once a pension was in payment. Several years ago, Ford and General Motors challenged that convention and began offering lump sum payouts to pensioners. Shortly afterward, the IRS announced it would no longer approve such payments, only to reverse that decision in 2019.
- In the U.K., a similar evolution of regulatory views has occurred on what is permissible and appropriate to offer employees upon transfer of their entitlements out of DB plans.

Figure 1. **Five key dimensions to mastering pension risks globally**



*Tracking such legislative and regulatory changes and interpretations helps identify triggers for action or further investigation, thus enabling the full range of significant opportunities to be considered.*

Partnering with an experienced global pension risk management specialist will enable an organization to more effectively identify, assess and prioritize the best opportunities for their context and circumstances. At Willis Towers Watson, we consider de-risking opportunities using five dimensions as shown in the diagram above, to ensure a systematic approach and consistent assessment of all the implications of any potential de-risking action, and how this fits into a multinational's wider employee benefit and business strategy.

While the lens used to view such transactions is often a financial one, it is no less important to consider the implications for a company's employees and former employees experience, such as:

- How will former employees feel about their pension now being paid from an insurer instead of the company or its pension fund?
- What support will employees need if given an option to exchange their pension entitlements in exchange for a lump sum to invest?

Other considerations include administrative ones: Many de-risking actions can reduce or outsource administrative complexity, and this can be an important part of the business case for some companies.

## Changing market considerations and windows of opportunity

Often multinationals may have identified a number of potential de-risking opportunities of interest. The need then becomes to identify when it is sufficiently attractive to act on those opportunities and whether other opportunities should be considered. By establishing key metrics that can be monitored centrally as markets evolve around the world, a multinational can systemize this process. The following are just a few examples that highlight the importance of monitoring to pick the right time to act:

- In the U.K., several insurers compete for pension business. Because they use a variety of bonds and other investments to back the business, the price of insurance varies relative to the value of government bonds that may be held by the pension plan against the pension obligations. Tracking these differences – as we do in our publication *Settlement Watch*<sup>1</sup> – enables a multinational to identify windows when the pricing is relatively attractive.
- Timing anomalies can also be caused by legislation or other quirks. In the U.S., for example, lump sum offers to members must use actuarial assumptions which for many plans are set only once a year. As markets move, the gap between this annually set price and the accounting obligation fluctuates, since the accounting measure moves daily with bond yields. During rising interest rate environments, companies may prefer not to provide such offers.
- In Sweden, there is a monopoly insurer for the pension arrangements covering the bulk of white-collar workers in Swedish industry. The insurer revises its pricing only occasionally, and when it does, the price tends to jump up or down significantly. When, for example, there has been a period of falling interest rates, accounting measures of the obligation will have risen in a way that isn't immediately reflected in the insurance price – and the timing of when that difference may close is not known. Similarly, if there are assets held in a pension foundation to fund the obligations, then their value will move in a different way to the insurance price. So, it's crucial to stay on top of what's happening on an ongoing basis.

*These examples highlight that even if a multinational has identified potential actions of interest to mitigate pension debt, the need then becomes to monitor the changing market conditions that impact the financial outcome.*

To help, *Willis Towers Watson's Global Pension Finance Watch*<sup>2</sup> provides quarterly updates on how capital market performance affects DB pension plan financing in major retirement markets worldwide. More powerful, though, is to partner with an experienced global consultant who can help identify both when the price and other factors become right, and how to move to the next stages promptly and effectively. If the groundwork hasn't been laid out in advance, optimizing the timing of opportunities may be missed.

## Turning strategy into action

While a centrally established systematic approach often translates into specific actions, it may also inform a conscious decision not to take action – or at least not yet.

- One of the multinational organizations we provide consulting to wanted to reduce the size of its balance sheet liability and set out to transfer risk externally at a reasonable price. We assisted its HQ to identify opportunities and develop metrics for tracking the priorities, which were its three largest and most volatile DB plans: U.S., UK and Canada. When pricing became compelling and aligned with other developing business priorities, we partnered with them to execute insurance transactions in all three countries optimizing the timing over a five-year period. The groundwork laid by HR and Treasury provided the ability to track and monitor the situation, which positioned them to act confidently when all the factors came into alignment.
- For another multinational, the board of directors announced that the company would not offer a DB plan anywhere by 2020. Major plans were addressed swiftly, but despite the strong mandate, the path forward on the next tier of plans was unclear. Not only do regulatory requirements demand or entrench DB plans in some locations, but diverse stakeholders and business considerations needed to be managed. Following a thorough evaluation of the situation in each country and partnering with the local and regional teams, we were able to highlight the situations and competing interests to HQ. In the end, the company did close most of its plans, but some remained open through a formal exception process by which the voices of all stakeholders were heard. Now attention has shifted to actions to reduce the legacy obligations: An insurance transaction in one country is in preparation, and a scorecard is being developed to prioritize and monitor opportunities elsewhere.

## Using the waiting time well

Once potential de-risking actions have been identified, there is typically a degree of work required to be ready to transact. This varies widely by country and situation but may involve, for example, data cleansing, identifying potential counterparties, developing project plans for a transaction, and preparing draft documentation and communications.

Clearly, if this work hasn't been done, it may not be possible to transact promptly when a window of opportunity presents.

*So, even if the stars are not currently in alignment to proceed with a transaction, it's worth considering carefully what work should be done in preparation — with particular focus on aspects that may take significant time to execute, such as data cleansing.*



## Summary

De-risking pension plans around the world is complicated, with many moving pieces. A centralized and systematic approach can overcome the vast differences in practices, regulations and perspectives across different countries and find the most attractive opportunities wherever they may lie. Such an approach consists of:

- Being clear about what risks matter and what it is worth to reduce them
- Systematically identifying and prioritizing opportunities, including those that are not yet ripe for action
- Keeping track of legislative and regulatory developments that may give rise to new opportunities or close off existing ones
- Ensuring internal agreement in principle has been secured and preparation has been done on the most attractive opportunities, so there is no impediment to action
- Establishing and tracking metrics that will flag up when “the price is right”

An increasing number of companies that approach these issues in such a structured, holistic way have succeeded in implementing their risk reduction goals around the world. The key lies in laying the groundwork up front, so you'll be able to recognize when the time has come and act promptly.

<sup>1</sup>Settlement Watch: [https://www.willistowerswatson.com/en-GB/Insights/all-insights#sort=%40fdate13762%20descending&f:@publication=\[Settlement%20Watch\]](https://www.willistowerswatson.com/en-GB/Insights/all-insights#sort=%40fdate13762%20descending&f:@publication=[Settlement%20Watch])

<sup>2</sup>Global Pension Finance Watch: <https://www.willistowerswatson.com/gpfiw-insights>

## About Willis Towers Watson

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