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De-Risking Occupational Pension Plans

The German Perspective

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Agenda

- The German Market
- Pension Plan Set-Ups in Germany
 - Characteristics of a Typical German Plan
 - Typical Risks of German Plans
 - Existing Financing Vehicles
- De-Risking Strategies
- Potential Clients and what we can do for them in Germany

The German Market

The German Market

- The German market comprises roughly 500 billion EUR of pension assets
- These assets are divided between
 - Direct commitment plans (ca. 53%)
 - *Pensionskasse* plans (ca. 23.5 %)
 - Direct Insurance plans (ca. 11%)
 - Support Fund plans (ca. 7 %)
 - Pension Fund plans (ca. 5.5 %)
- The pension liabilities of the biggest German companies (DAX) are funded to roughly 59 % only

The German Market

- Relatively immature market due to historically strong state pensions
- State pension level is still declining
- Market is still growing and being steadily developed by German legislator
- De-Risking issues have come more and more into the focus since 2008

Pension Plan Set-Ups in Germany

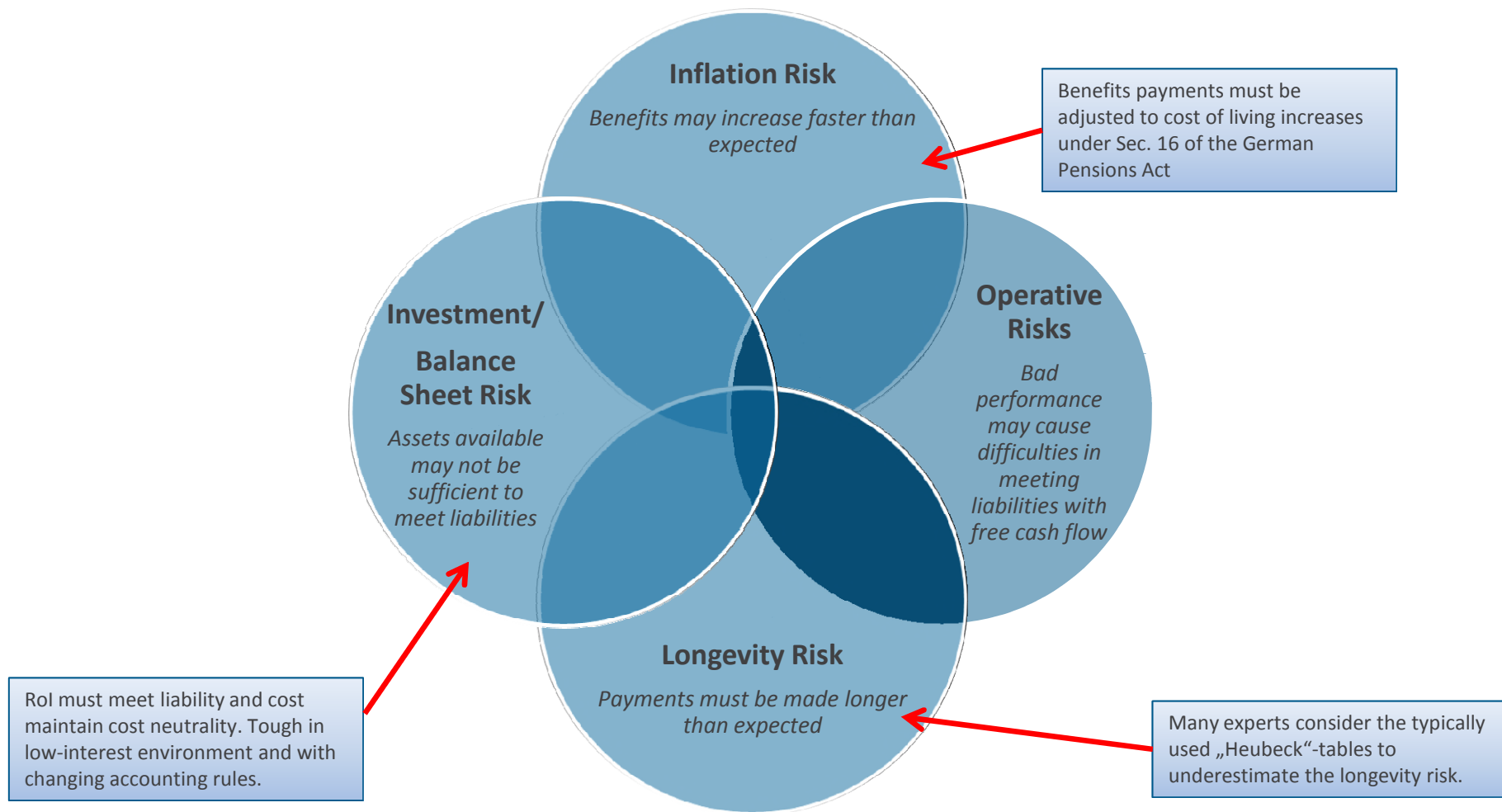
Pension Plan Set-Ups in Germany

The Typical German Plan

- Defined Benefit Plans
- Level of benefits tied to employee's seniority and pensionable income
- Partially unfunded or funded via insurance-like vehicle
- Employer is always (secondary) liable for benefit payments
- „quasi“ DC plans relatively new, but very attractive

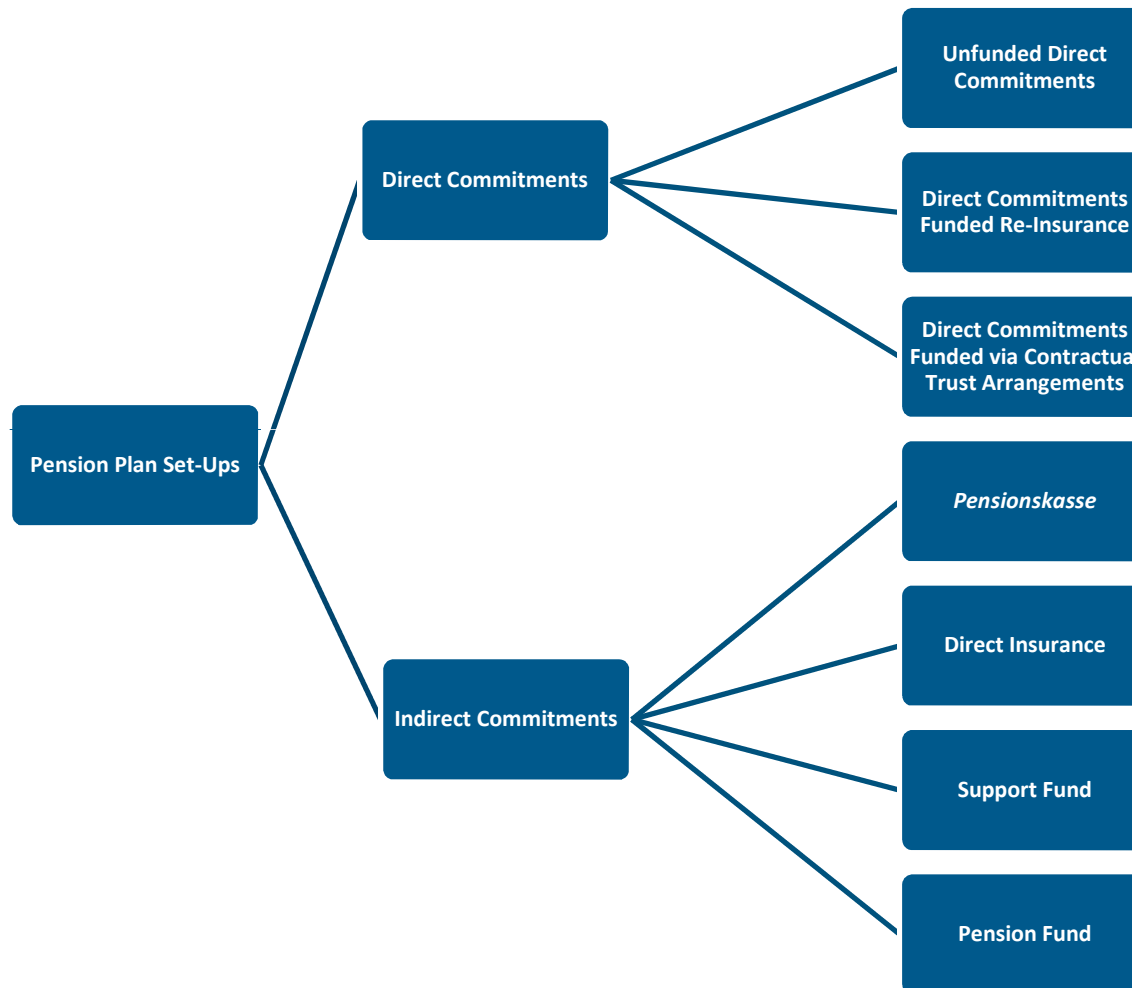
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Typical Risks of German Plans



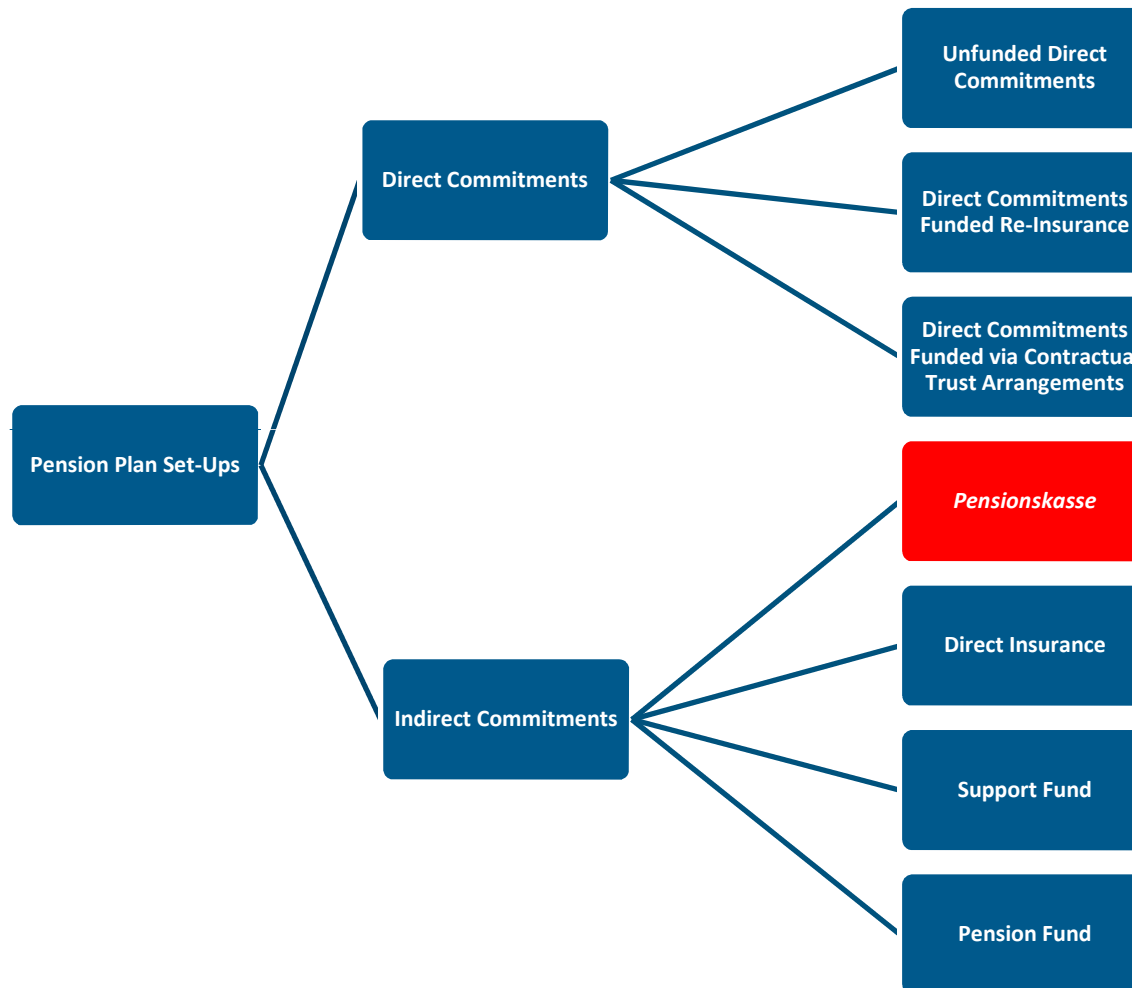
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Financing Vehicles



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Pensionskasse



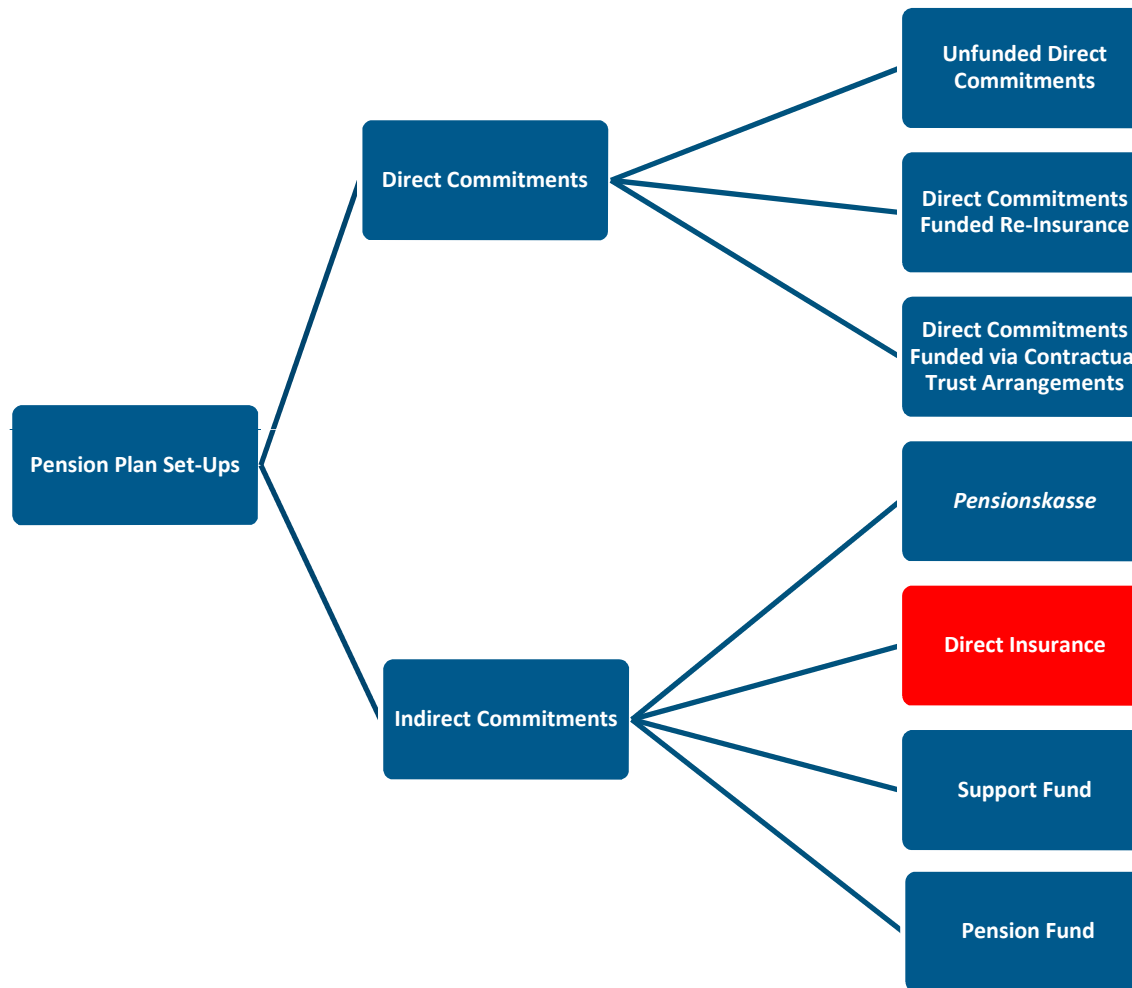
Pension Plan Set-Ups in Germany

Pensionskasse

- Insurance-like vehicle exclusively for the purpose of financing pensions
- Often company owned or industry-wide
- Mainly used for employee-sponsored plans (salary conversion)
- Subject to insurance law rules and supervision by BaFin
 - relatively low investment risk due to strict regulation
 - however, suffering from low interest environment and restricted investment possibilities
 - *Pensionskassen* often reserve the right to reduce their payment levels in bad economic conditions => employer is liable for gap between *Pensionskasse* payment and defined benefit promised

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Direct Insurance



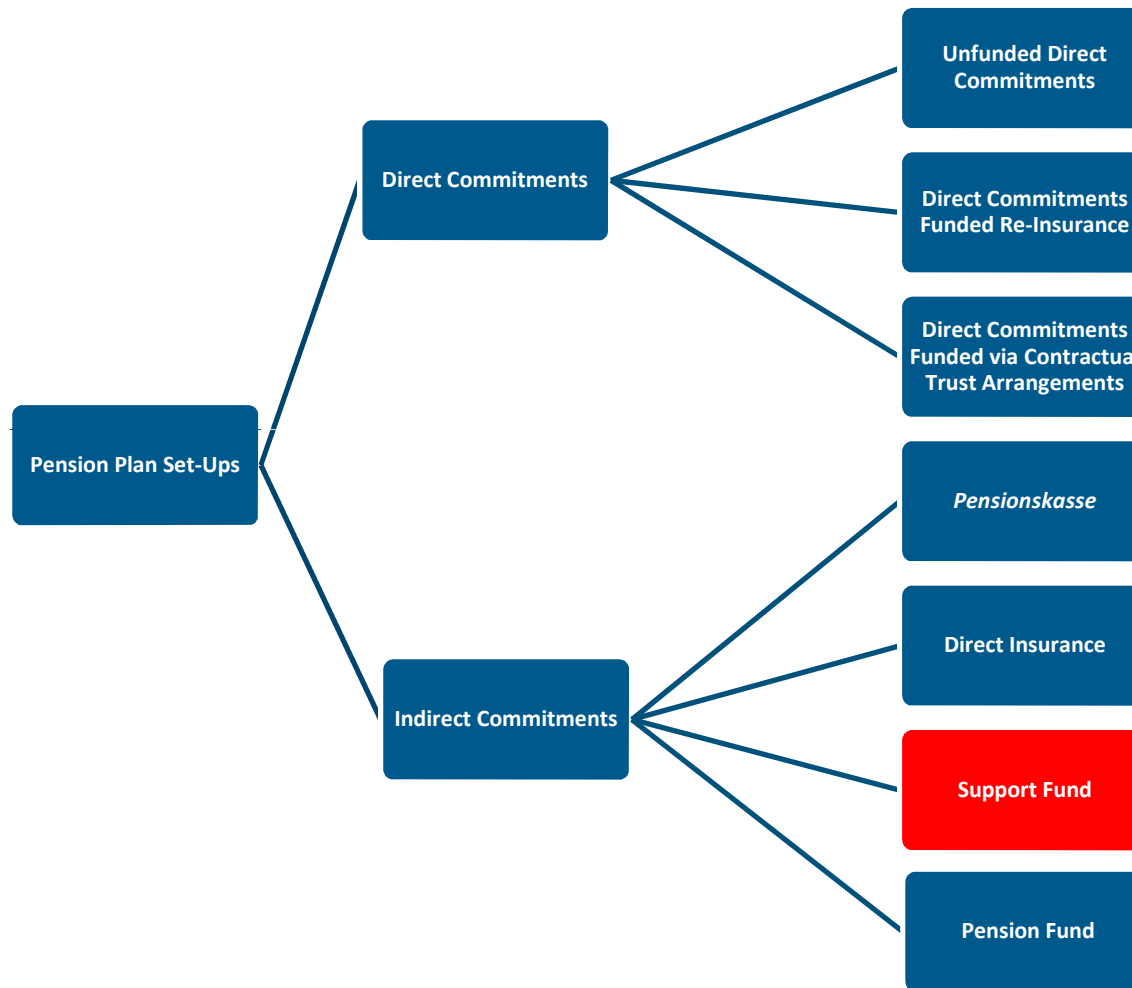
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Direct Insurance

- Life insurance contract taken out by the employer for the benefit of the beneficiary
- Mainly used for employee-sponsored plans (salary conversion) or for specific beneficiaries (e.g. managerial employees)
- Subject to insurance law rules and supervision by BaFin
 - relatively low investment risk due to strict regulation
 - however, suffering from low interest environment and restricted investment possibilities
 - obliged to meet guaranteed interest rate (up to 4%)
 - if guaranteed interest rate cannot be met, employer is liable

Pension Plan Set-Ups in Germany

Support Funds



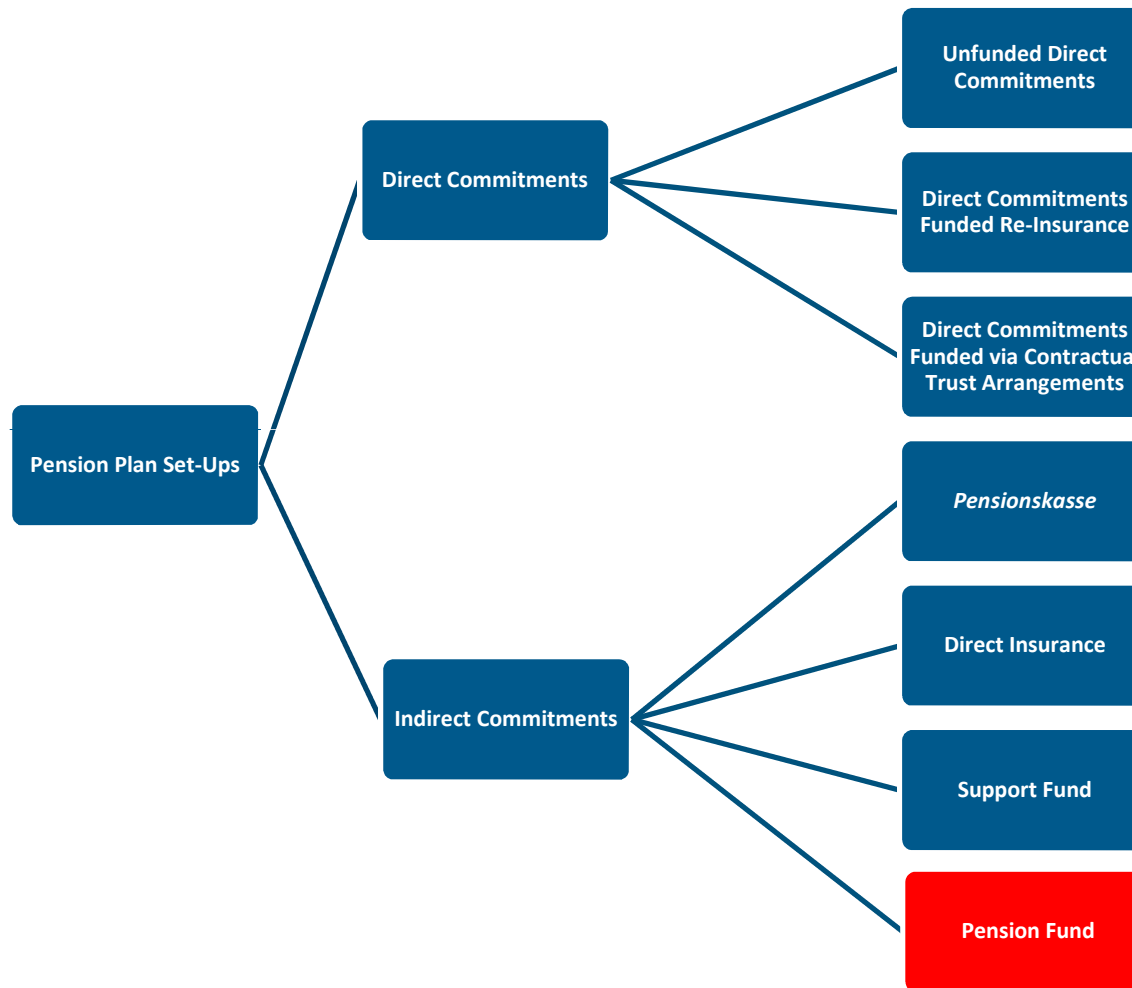
Pension Plan Set-Ups in Germany

Support Funds

- Flexible investment possibilities, however, low allowed funding levels
- Often support funds take out re-insurance contracts in order to close funding gap (allows full funding)
- Often used as instrument to fund ongoing pension payment obligations
- Funds held by support fund can be loaned back to sponsoring employer, provided that market-standard interest rates are agreed
- Relatively high risk without re-insurance and low risk with re-insurance

Pension Plan Set-Ups in Germany

Pension Funds



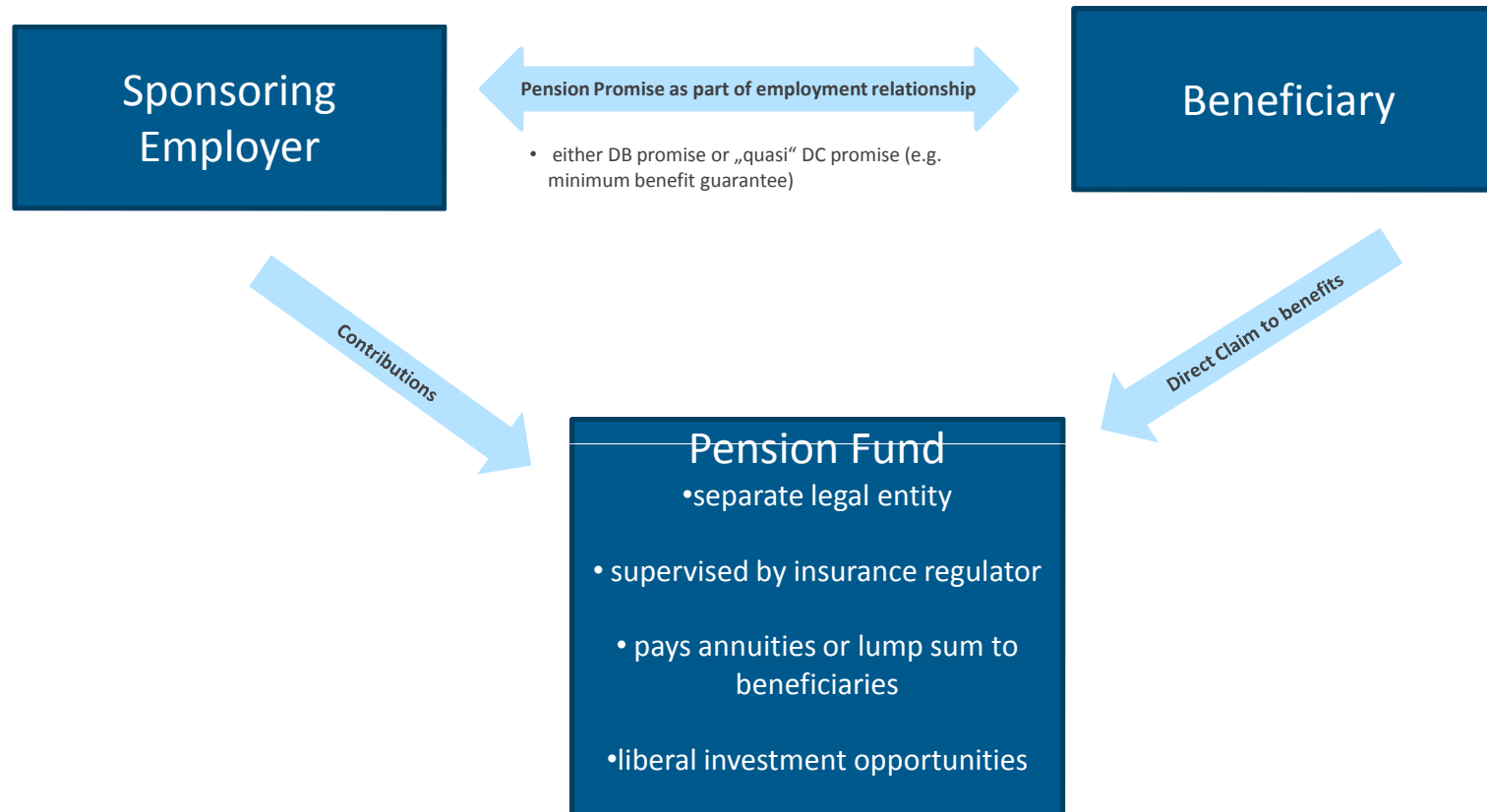
Pension Plan Set-Ups in Germany

Pension Funds

- Separate legal entity, providing pension payments either insurance-like or capital market oriented
- Liberal investment rights
- Capital market oriented pension fund set-up allows flexibility in calculating discount rates (with limits of reasonableness) and does not require insurance guarantee
 - however employer must make up for underfunding, if higher than 10%
- Reduced contributions to Pensions Protection Fund (*PSVaG*)
- Transfer of direct commitment liabilities to a pension fund (buy-out) is tax privileged

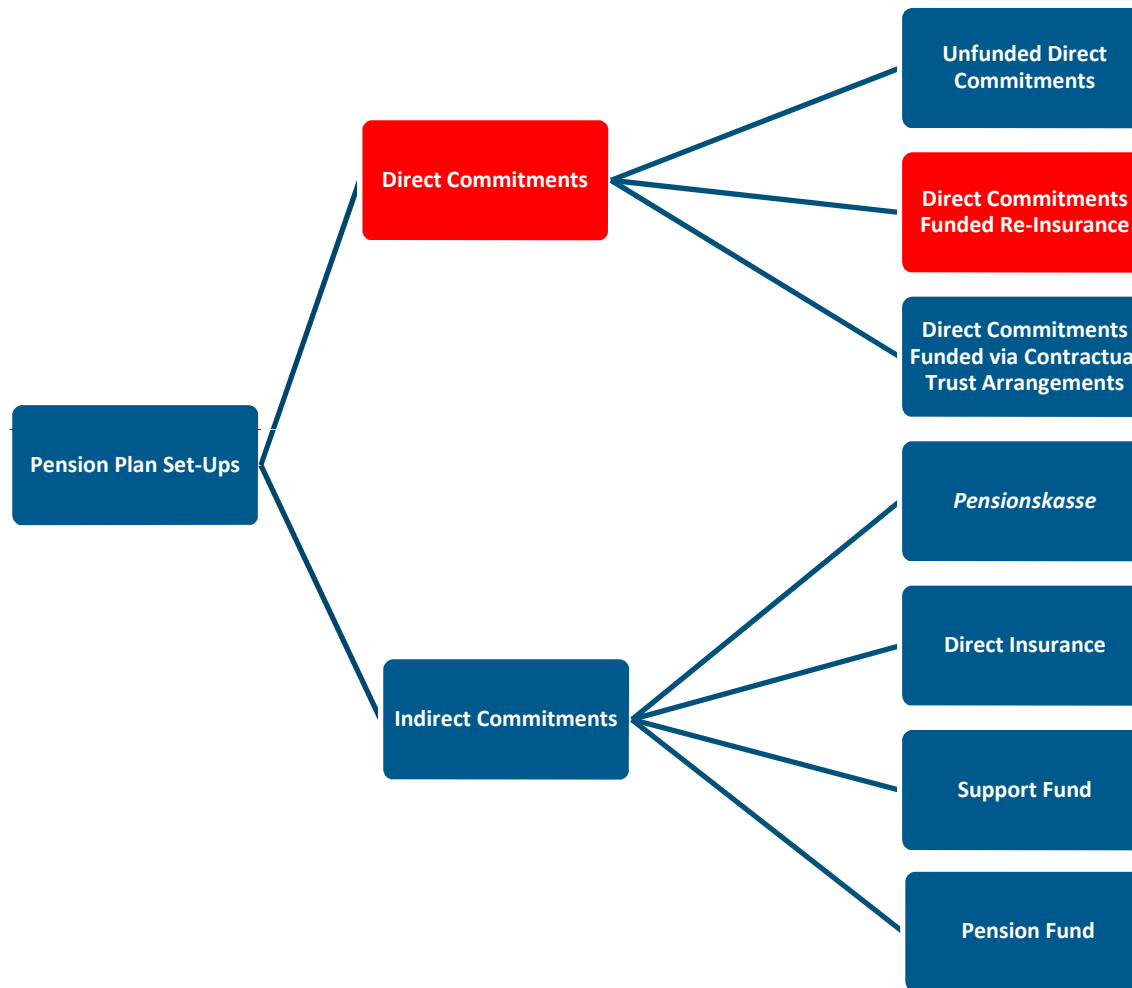
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Pension Funds



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Direct Commitments



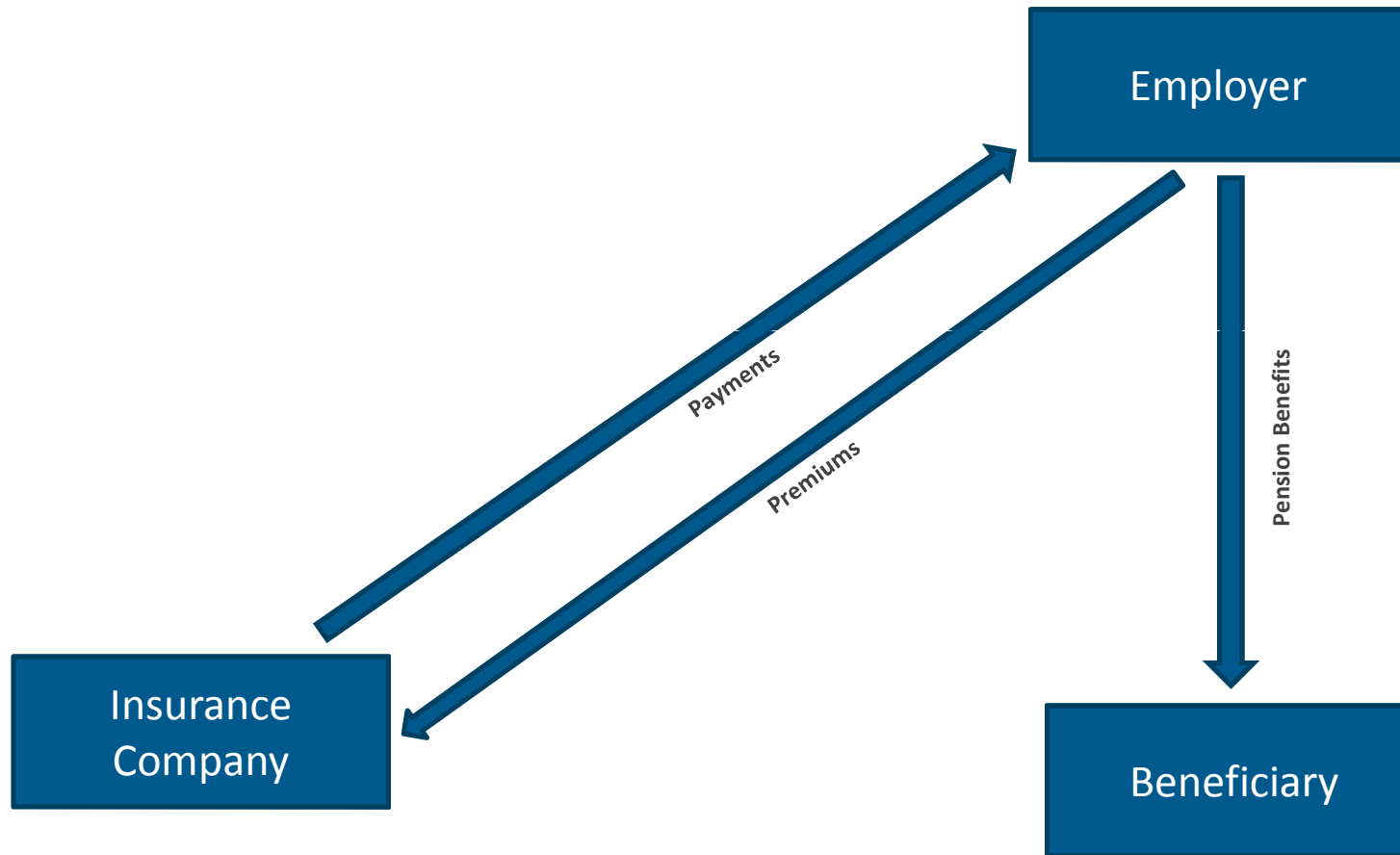
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Direct Commitments via Re-Insurance Contracts

- Traditionally often used method to fund direct commitment liabilities
- Rights under re-insurance contract are often pledged to beneficiary to increase insolvency remoteness
- Pledged rights can qualify as plan assets under international accounting standards
- Low interest environment leads to reduced payments from insurance company => often triggers a funding gap

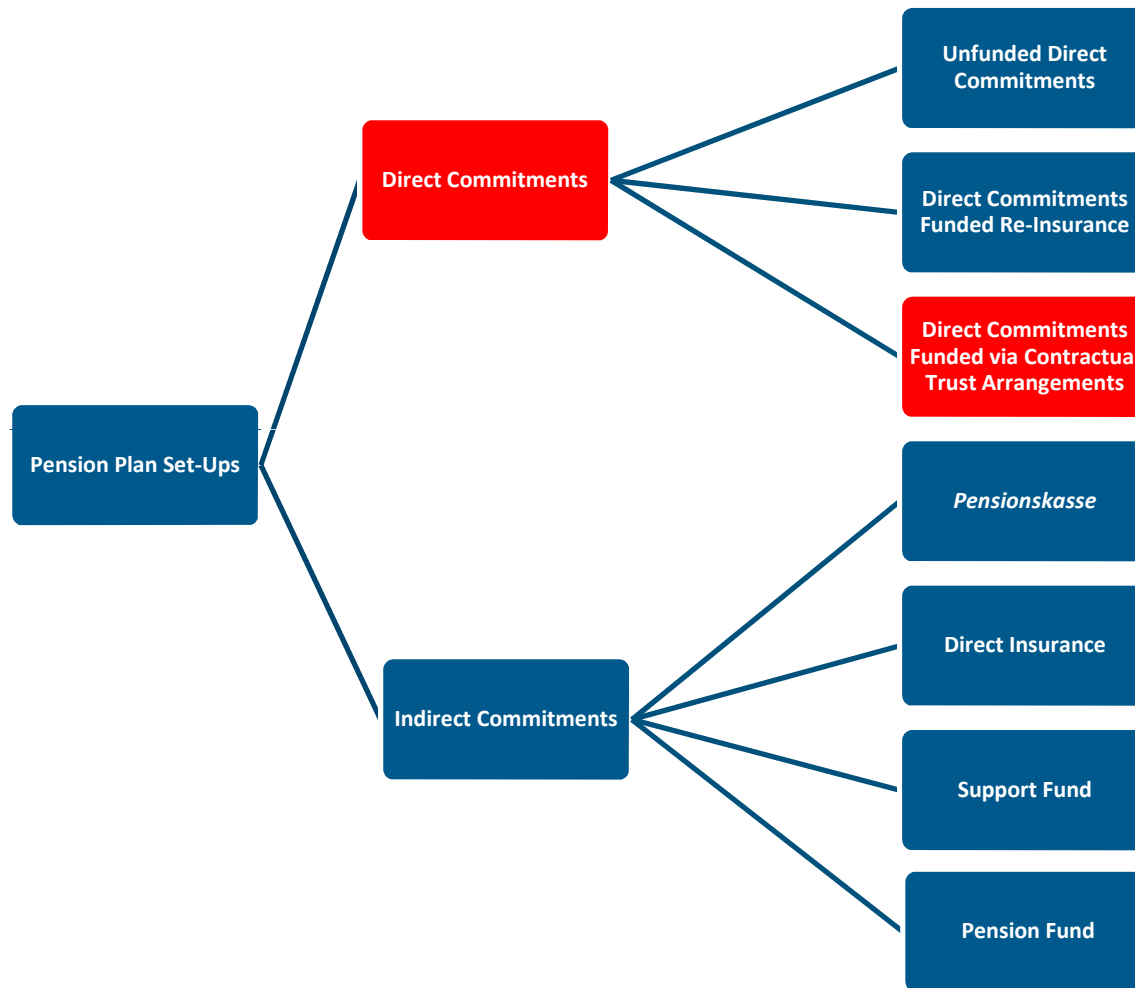
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Direct Commitments via Re-Insurance Contracts



Pension Plan Set-Ups in Germany

Direct Commitments



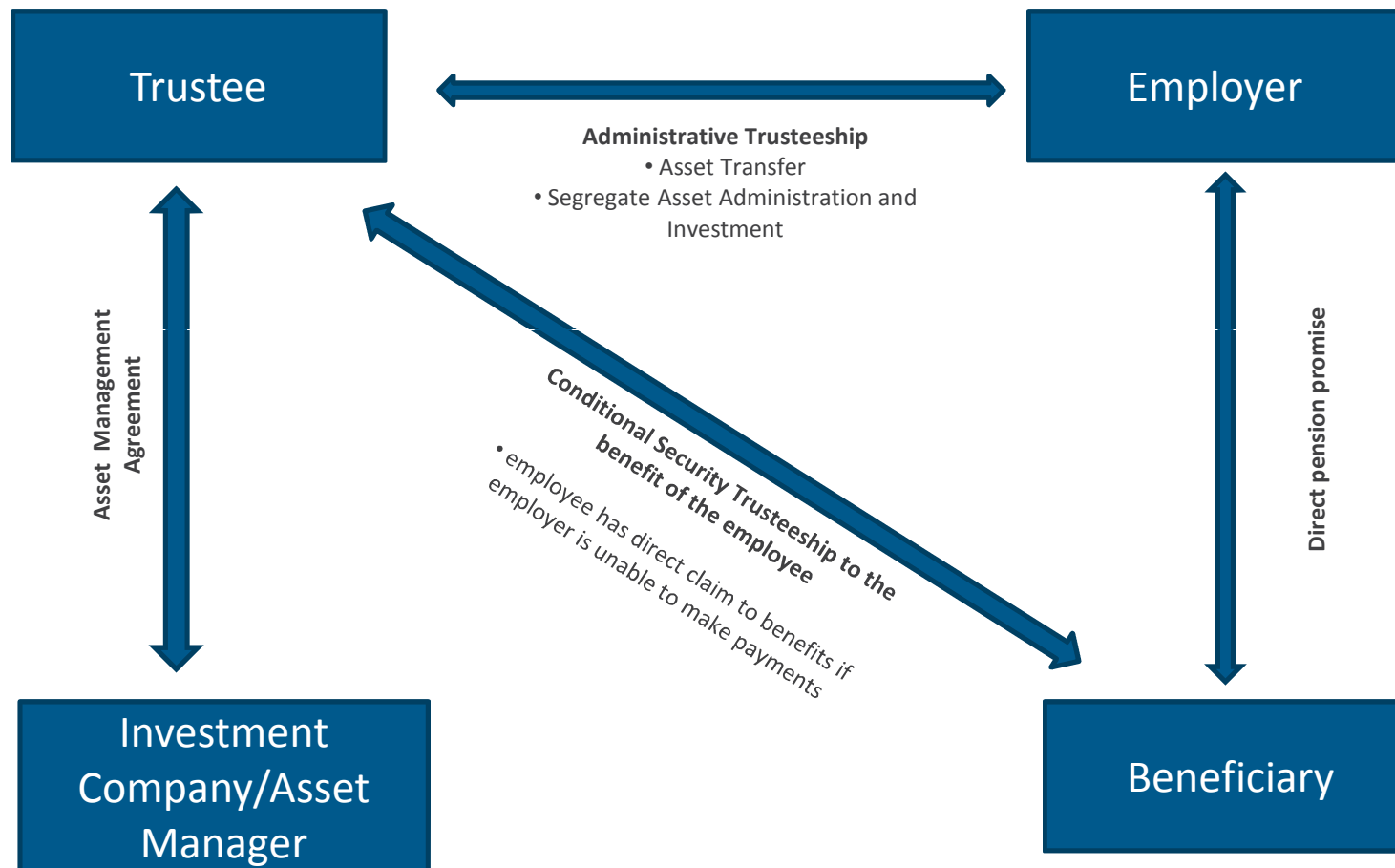
Pension Plan Set-Ups in Germany

Direct Commitments via CTAs

- preferred vehicle for modern, risk-oriented pension plan designs
- Key drivers
 - tax and balance sheet efficient
 - allows creative plan designs
 - e.g. matching contributions or success-oriented employer contributions
 - „quasi“ DC-plan designs
 - CTAs allow cost-efficient and flexible funding approaches
 - LDI/ALM (e.g. via special funds)
 - Balance-sheet neutral funding with non-operational assets
 - cross-border asset pooling

Pension Plan Set-Ups in Germany

Direct Commitments via CTAs



De-Risking Strategies

De-Risking Strategies

The Objective: Exclude surprises and tie the development of pension liabilities to the economic development of the sponsoring employer and/or its pension assets

The Path:

- Step 1:
 - analyze existing plan set-up and resulting risks
- Step 2:
 - close or transform old plans
- Step 3:
 - implement modern DC-like scheme with CTA asset-backing for future service
- Step 4:
 - choose LDI/ALM investment strategy

De-Risking Strategies

- Examples for modernized plan set-ups:
 - security-oriented commitments: promised benefit amount is tied to performance of security investments (life cycle funds, indices, etc)
 - brick system: employee earns one „pension brick“ every year, paid out as lump sum upon retirement (problematic to implement for employees who already have an annuity promise)
 - performance-related systems: contributions are interrelated to company or personal performance
 - matching contributions or salary conversions
 - addressing the inflation risk by introducing a guaranteed increase of running benefits of 1% per year

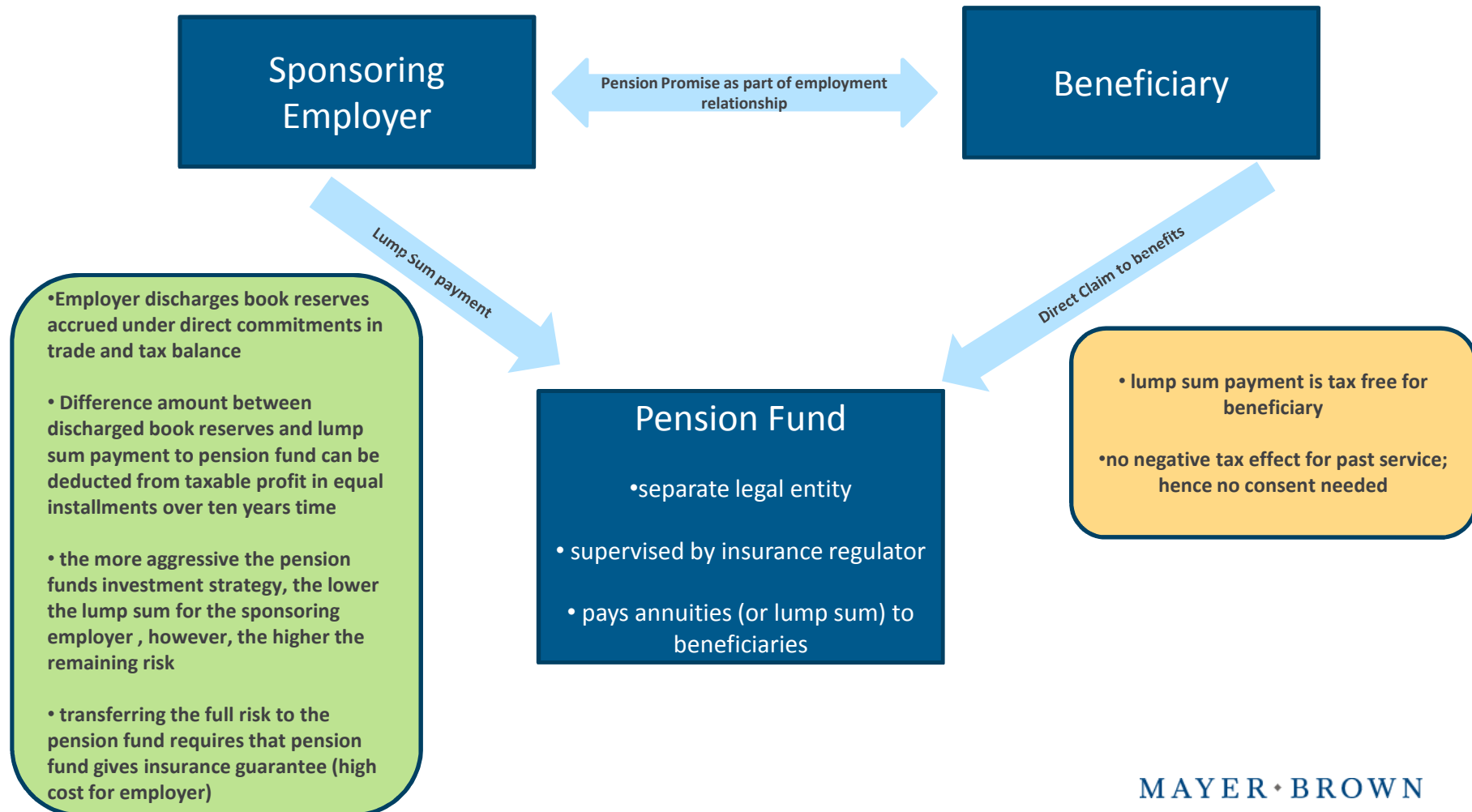
De-Risking Strategies

- Employment law consideration with regard to closing, amending and replaching existing plans
 - Unproblematic for new hires
 - For existing commitments
 - past service rights must not be affected
 - reducing future service rights requires reasonable justification
 - co-determination rights must be observed

Note: A full risk transfer is not allowed under German law! The employer always remains at least secondary liable.

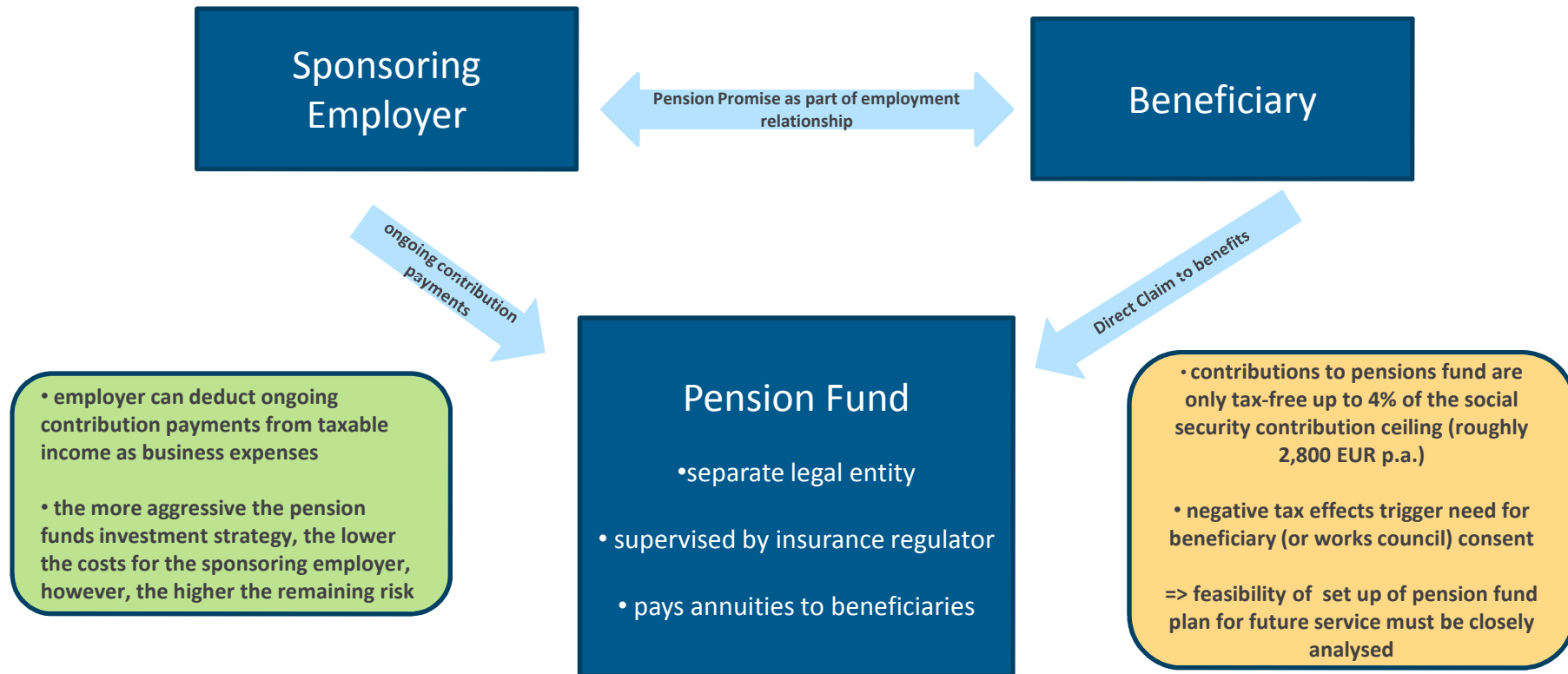
De-Risking Strategies

- Annuity Buy-Outs for past service liabilities under direct commitment plan: Changing Plan Set-Up by transferring past service liabilities to pension fund



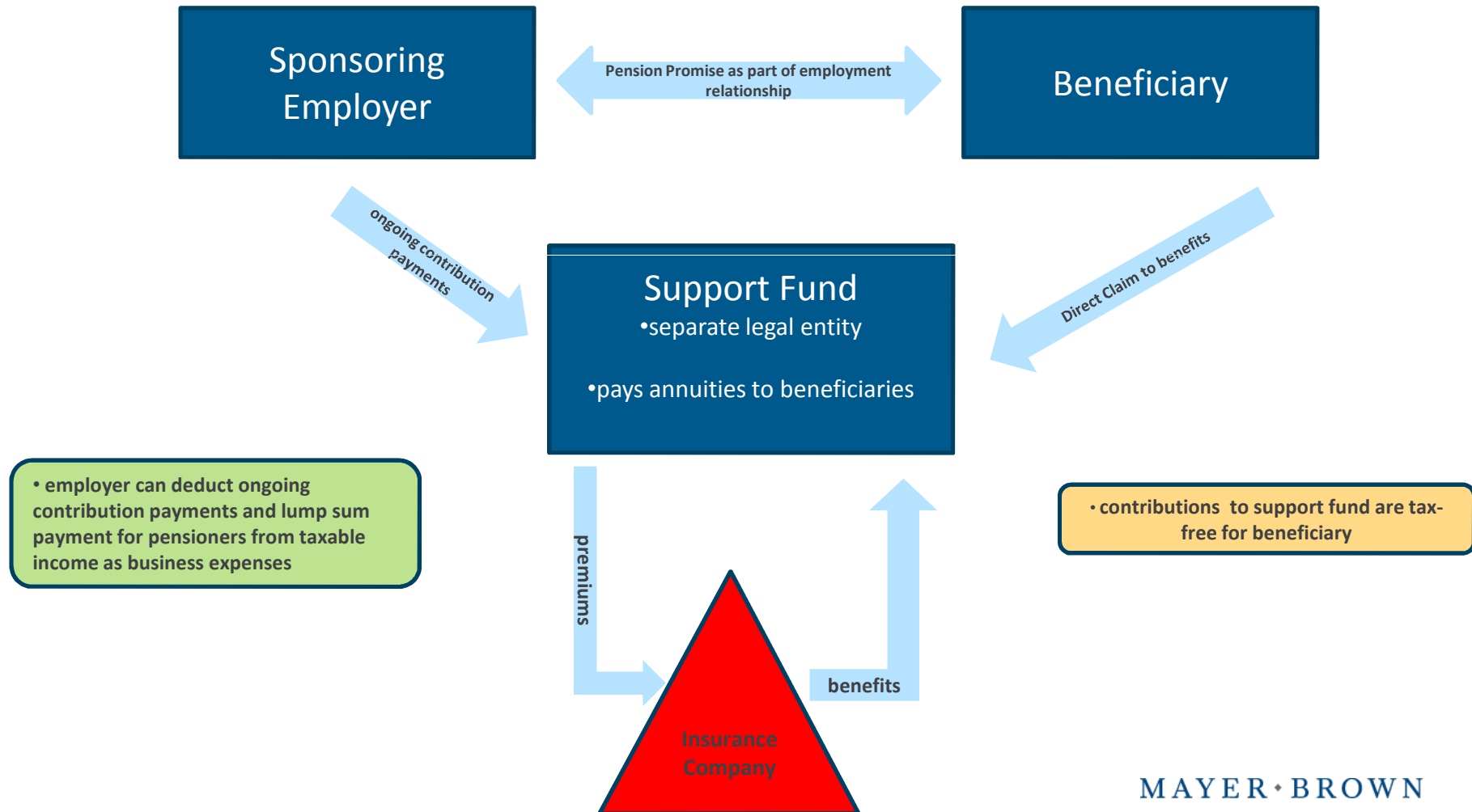
De-Risking Strategies

- Annuity Buy-Outs for future service liabilities under direct commitment plans: Changing Plan Set-Up to pension fund plan



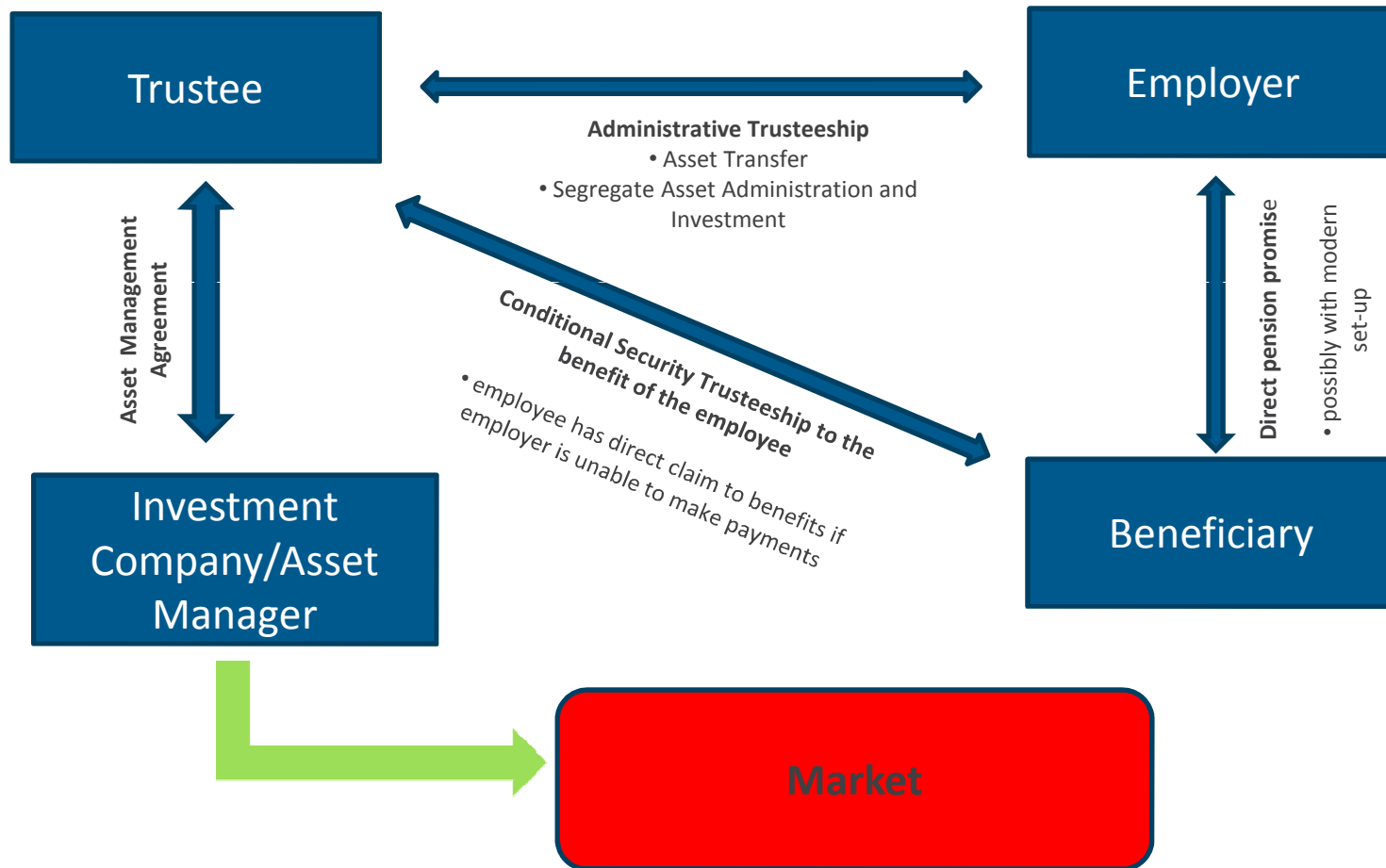
De-Risking Strategies

- Annuity Buy-Outs for future service liabilities under direct commitment plans:
Changing Plan Set-Up to re-insured support fund scheme



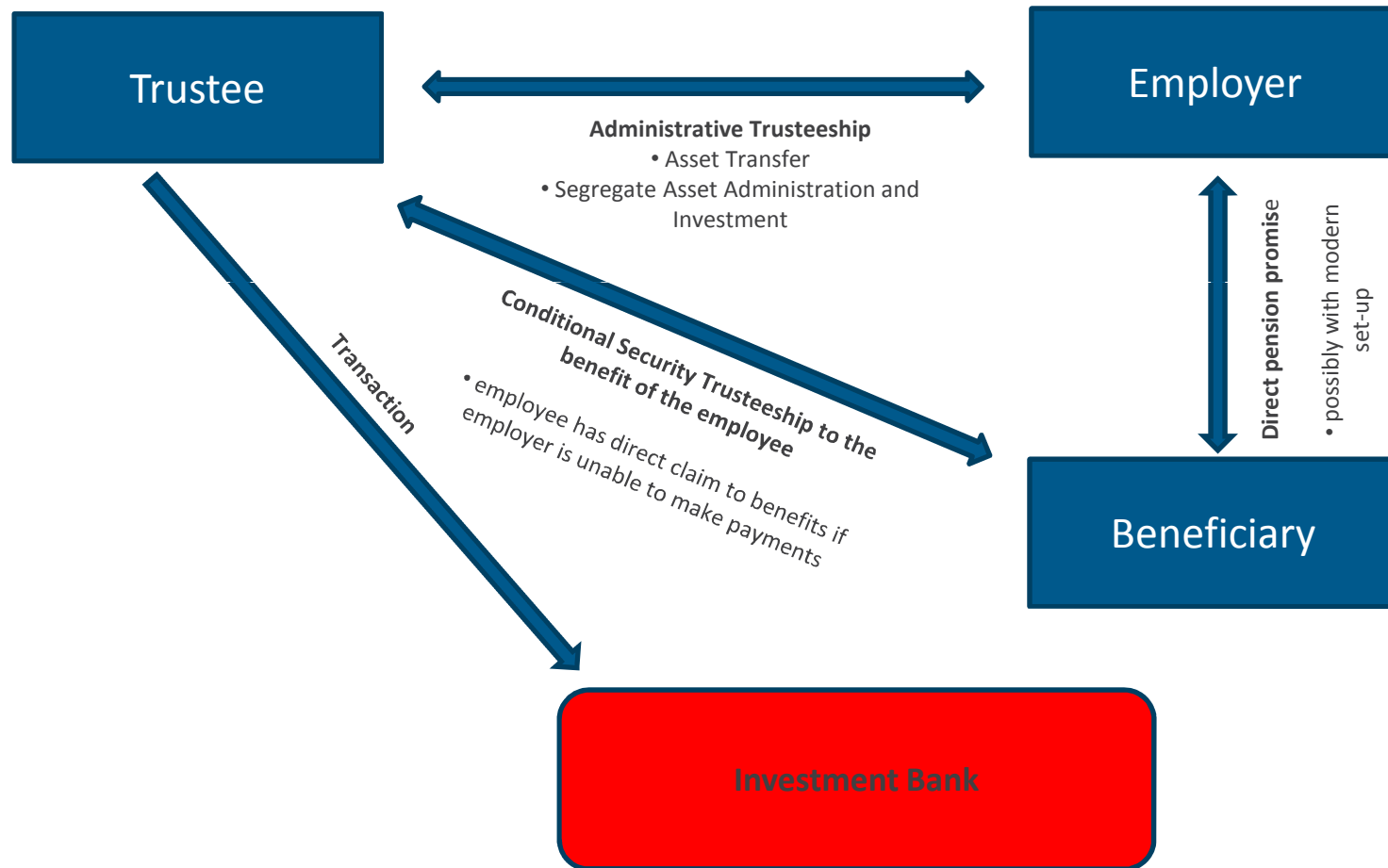
De-Risking Strategies

- Hedging risks by pursuing respective LDI/ALM strategies via a CTA



De-Risking Strategies

- Hedging risks by purchasing longevity swaps or longevity bonds



What we can do for our clients in Germany

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- We are well positioned to guide our clients through any de-risking project, because
 - we are recognized as a leading firm for pensions advice in Germany
 - we have experience with the structuring of many modern plan set-ups, including the implementation and administration of CTAs and advising on buy-ins
 - our finance group has in-depth experience in the structuring of derivative transactions, including swaps
 - our multi-disciplined pensions product group joins forces to advise on employment, tax, regulatory, insurance and insolvency law aspects
 - we have in depth relationships with the leading heads in the German pensions world and hence can easily and quickly bring in the necessary know-how from investment experts and actuaries
 - our global employment & benefits group enables to provide one-shop stop advice in all major business centres around the world

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Nicolas Rößler is a partner in our employment/benefits practice. He specializes in individual and collective employment law issues, business and workforce restructurings and benefit and pension related matters.

Nick Rößler is especially respected for his expertise in occupational pension issues such as the design, implementation and restructuring of occupational pension and benefit plans, such as stock option or phantom share plans. He is known for his mature handling of complex negotiations with works councils and unions. Inside the courtroom he has gained a reputation as a leading litigator in pension-related lawsuits in Germany.

Nick also regularly advises clients on employment related matters in M&A transactions, especially with regard to employee transfer issues and the employment law particularities of distressed M&A transactions.