De-Risking Occupational Pension Plans

The German Perspective

Dr. Nicolas Roessler
Partner
+49 69 7941 2681
nroessler@mayerbrown.com

June 2013
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
Pension Plan Set-Ups in Germany

Typical Risks of German Plans

Inflation Risk
Benefits may increase faster than expected

Operative Risks
Benefits payments must be adjusted to cost of living increases under Sec. 16 of the German Pensions Act

Investment/Balance Sheet Risk
Assets available may not be sufficient to meet liabilities

Longevity Risk
Payments must be made longer than expected

Many experts consider the typically used “Heubeck”-tables to underestimate the longevity risk.

RoI must meet liability and cost maintain cost neutrality. Tough in low-interest environment and with changing accounting rules.
Pension Plan Set-Ups in Germany

*Pensionskasse*

**Pension Plan Set-Ups**
- Direct Commitments
  - Unfunded Direct Commitments
  - Direct Commitments Funded Re-Insurance
  - Direct Commitments Funded via Contractual Trust Arrangements

- Indirect Commitments
  - Direct Insurance
  - Support Fund
  - Pension Fund

**Pensionskasse**
Pension Plan Set-Ups in Germany

*Pensionskasse*

- Insurance-like vehicle exclusively for the purpose of financing pensions
- Often company owed 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
Pension Plan Set-Ups in Germany

Direct Insurance

- Direct Commitments
  - Unfunded Direct Commitments
  - Direct Commitments Funded Re-Insurance
  - Direct Commitments Funded via Contractual Trust Arrangements
- Pensionskasse
- Direct Insurance
- Support Fund
- Pension Fund

Indirect Commitments

- Pension Plan Set-Ups
Pension Plan Set-Ups in Germany

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

- Direct Commitments
  - Unfunded Direct Commitments
  - Direct Commitments Funded Re-Insurance
  - Direct Commitments Funded via Contractual Trust Arrangements
  - Pensionskasse
  - Direct Insurance
  - Support Fund
  - Pension Fund

- Indirect Commitments

Pension Plan Set-Ups
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**

- Direct Commitments
  - Unfunded Direct Commitments
  - Direct Commitments Funded Re-Insurance
  - Direct Commitments Funded via Contractual Trust Arrangements

- Indirect Commitments
  - Pensionskasse
  - Direct Insurance
  - Support Fund
  - Pension Fund

---

*Source: Mayer Brown*
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
Pension Plan Set-Ups in Germany

**Pension Funds**

- **Sponsoring Employer**
  - Pension Promise as part of employment relationship
    - either DB promise or „quasi“ DC promise (e.g. minimum benefit guarantee)

- **Beneficiary**

- **Pension Fund**
  - separate legal entity
  - supervised by insurance regulator
  - pays annuities or lump sum to beneficiaries
  - liberal investment opportunities

**Contributions**

**Direct Claim to Benefits**
Pension Plan Set-Ups in Germany

Direct Commitments

Unfunded Direct Commitments

Direct Commitments Funded Re-Insurance

Direct Commitments Funded via Contractual Trust Arrangements

Pensionskasse

Direct Insurance

Support Fund

Pension Fund

Indirect Commitments

Pension Plan Set-Ups
Pension Plan Set-Ups in Germany

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
Pension Plan Set-Ups in Germany

Direct Commitments via Re-Insurance Contracts

Diagram:
- Employer
- Insurance Company
- Beneficiary
- Arrows indicating Payments and Premiums

MAYER BROWN
Pension Plan Set-Ups in Germany

*Direct Commitments*

- Direct Commitments
- Unfunded Direct Commitments
- Direct Commitments Funded Re-Insurance
- Direct Commitments Funded via Contractual Trust Arrangements

*Indirect Commitments*

- Pensionskasse
- Direct Insurance
- Support Fund
- Pension Fund
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**

- **Trustee**
- **Employer**
- **Investment Company/Asset Manager**
- **Beneficiary**

**Administrative Trusteeship**
- Asset Transfer
- Segregate Asset Administration and Investment

**Conditional Security Trusteeship to the benefit of the employee**
- Employee has direct claim to benefits if employer is unable to make payments

**Direct pension promise**
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 replacing 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

Sponsoring Employer

Beneficiary

Pension Promise as part of employment relationship

Pension Fund

• separate legal entity
  • supervised by insurance regulator
  • pays annuities (or lump sum) to beneficiaries

Employer discharges book reserves accrued under direct commitments in trade and tax balance

• Difference amount between discharged book reserves and lump sum payment to pension fund can be deducted from taxable profit in equal installments over ten years time

• the more aggressive the pension funds investment strategy, the lower the lump sum for the sponsoring employer, however, the higher the remaining risk

• transferring the full risk to the pension fund requires that pension fund gives insurance guarantee (high cost for employer)

• lump sum payment is tax free for beneficiary

• no negative tax effect for past service; hence no consent needed
De-Risking Strategies

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

Sponsoring Employer

- Pension Promise as part of employment relationship
- Beneficiary

Beneficiary

Pension Fund

- separate legal entity
- supervised by insurance regulator
- pays annuities to beneficiaries

- contributions to pensions fund are only tax-free up to 4% of the social security contribution ceiling (roughly 2,800 EUR p.a.)
- negative tax effects trigger need for beneficiary (or works council) consent
- => feasibility of set up of pension fund plan for future service must be closely analysed

- employer can deduct ongoing contribution payments from taxable income as business expenses
- the more aggressive the pension funds investment strategy, the lower the costs for the sponsoring employer, however, the higher the remaining risk

MAYER BROWN
De-Risking Strategies

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

Sponsoring Employer

Beneficiary

Support Fund
- separate legal entity
- pays annuities to beneficiaries

Insurance Company

- employer can deduct ongoing contribution payments and lump sum payment for pensioners from taxable income as business expenses

- contributions to support fund are tax-free for beneficiary

Pension Promise as part of employment relationship

Direct Claim to benefits

ongoing contribution payments

premiums

benefits
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

Diagram:
- Trustee
- Employer
- Beneficiary
- Investment Bank

Administrative Trusteeship
- Asset Transfer
- Segregate Asset Administration and Investment

Conditional Security Trusteeship to the benefit of the employee
- Employee has direct claim to benefits if employer is unable to make payments

Direct pension promise
- Possibly with modern set-up
What we can do for our clients in Germany
What we can do for our clients in Germany

• 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
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.