Solving the pension conundrum

In a world where executives are looking to spend less time and money looking after pension obligations, many are choosing to kick the can down the road. Matt Wilmington, partner at Aon Hewitt, questions whether this is the right strategy.

When Mick Jagger was singing Time Is On My Side in 1964, he was probably not thinking too much about whether he would feel the same way almost 50 years later. Today, at nearly 70 years old, Mick could be forgiven for feeling philosophical about the amount of time still being on his side. The reality is that Mick is expected to still be singing when he is 89 – which is ten years longer than a 70-year-old in 1964 would have expected. Given the implications for their pension obligations, should CEOs feel the same way?

The reasons for not doing anything today are clear. Pension funding levels are very low and the only solution to the problem seems to be cash, which most organisations are trying to conserve. There is also a timing question given the historically low level of interest rates: is it not reasonable to wait for interest rates to rise and to carry your funding level with them? Another consideration is the number of executives who struggle with the proliferation of pension settlements and their attractiveness in markets that have invaded what has traditionally been a sleepy and conservative part of the business.

However, as the then US Secretary of Defence, Donald Rumsfeld, said in 2002, “...there are known unknowns...but there are also unknown unknowns.” It is common for an organisation to decide that there is no material risk exposure to the known unknowns, but what about the unknown unknowns? From a pension perspective it is important to prepare an inventory of your global pension obligations, to understand the risks they present, to consider the options for addressing those risks and to have a strategy for taking action on those that are most material.

The risk of doing nothing

The biggest threat will be from your competitors. The size and frequency of pension settlement transactions are increasing. Organisations are moving liabilities off of their balance sheet by paying lump sums directly to members or by transferring them (or the risk associated with them) to a risk settlement provider in the form of an annuity buy-in, buy-out or longevity insurance transaction. Mega Systems, General Motors and Verizon have been capturing headlines with their recent transactions and analysts and investors have reacted positively. The attention that is being given to these transactions ensures that a second-mover advantage is at a premium, and many companies are now looking to quantify the potential cost savings and benefits of the transactions they would like to do. But as financial markets are volatile and move quickly, it is important to ensure that all stakeholders have been consulted and, where appropriate, have approved of the ultimate plan of attack. In addition, plan sponsors should be working to ensure that pension data is accurate, as this data will be critical in any risk transfer transaction. A well thought-out plan with stakeholder approval will ensure that there is little work remaining when the time is right to execute.

Attacking the issue

It seems counter-intuitive when talking about long duration pension obligations to talk about speed of execution, but it is the most important determinant of long-term financial success. Even for organisations that are committed to waiting for rates to rise it is important to know beforehand how much they need to raise, in which countries, and at which points on the yield curve, in order to be able to take advantage of the opportunities as they present themselves – markets are volatile and more quickly. It is also critical to ensure that all stakeholders have been consulted and, where appropriate, have approved of the ultimate plan of attack. In addition, plan sponsors should be working to ensure that pension data is accurate, as this data will be critical in any risk transfer transaction. A well thought-out plan with stakeholder approval will ensure that there is little work remaining when the time is right to execute.

Just as the market for risk settlement solutions has evolved, much has changed over the past decade in the approach to pension plan funding. Cash is no longer the only source of contributions. One approach is to use contin-