

Valuation of Pension and Similar Obligations for the Purposes of a Corporate Transaction

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About the speaker



Graham Pearce

- Global Consulting Group Leader, Multinational Client Group
- Since 1994 Fellow of the Institute and Faculty of Actuaries (UK)
- Focus on managing employee benefits around the world



Mercer

- Consulting and digital solutions that help companies meet the health, wealth and career requirements of a changing work environment.
- More than 22,000 employees in 44 countries.
- In Germany, more than 600 employees at 7 locations.
- Focus on consulting companies on all aspects of occupational pensions, investments and pension administration as well as remuneration, human capital strategy and M&A.

The problem...

- On acquiring a company or business, liabilities relating to pensions and other long-term employee benefits are often also acquired
- The ultimate amount and timing of cashflows required for uninsured benefits is not known
- The amount of future returns on assets or reserves held is not known

Future interest rates
and/or asset returns

How long will the
member or other
eligible dependants
live?

Future inflation

Legal restrictions on
investment strategy
and on changing
benefits in the
future

Future employee
turnover

...and many other
factors



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The solution...

- International accounting standards are often used as a proxy to assess the economic value of the unfunded liability
- ...but this measure ignores some key facts

Relative cost of capital

How debt like are the liabilities?

What funding and investment restrictions are there?

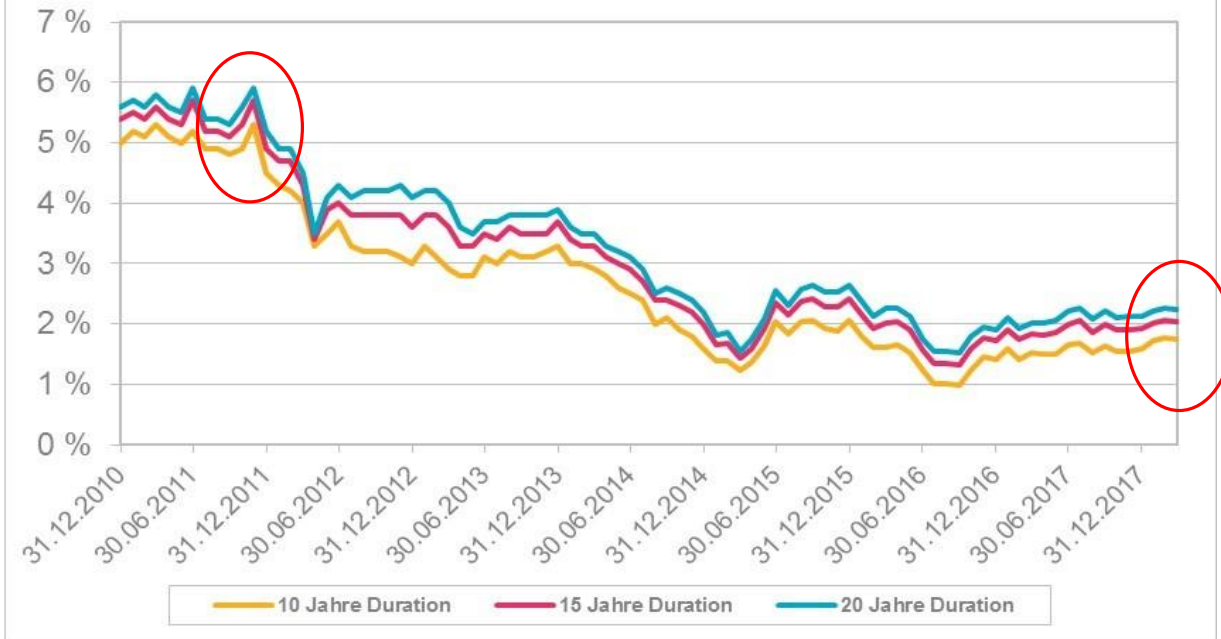
Who really pays for a shortfall?

Risks and options

...and many other factors

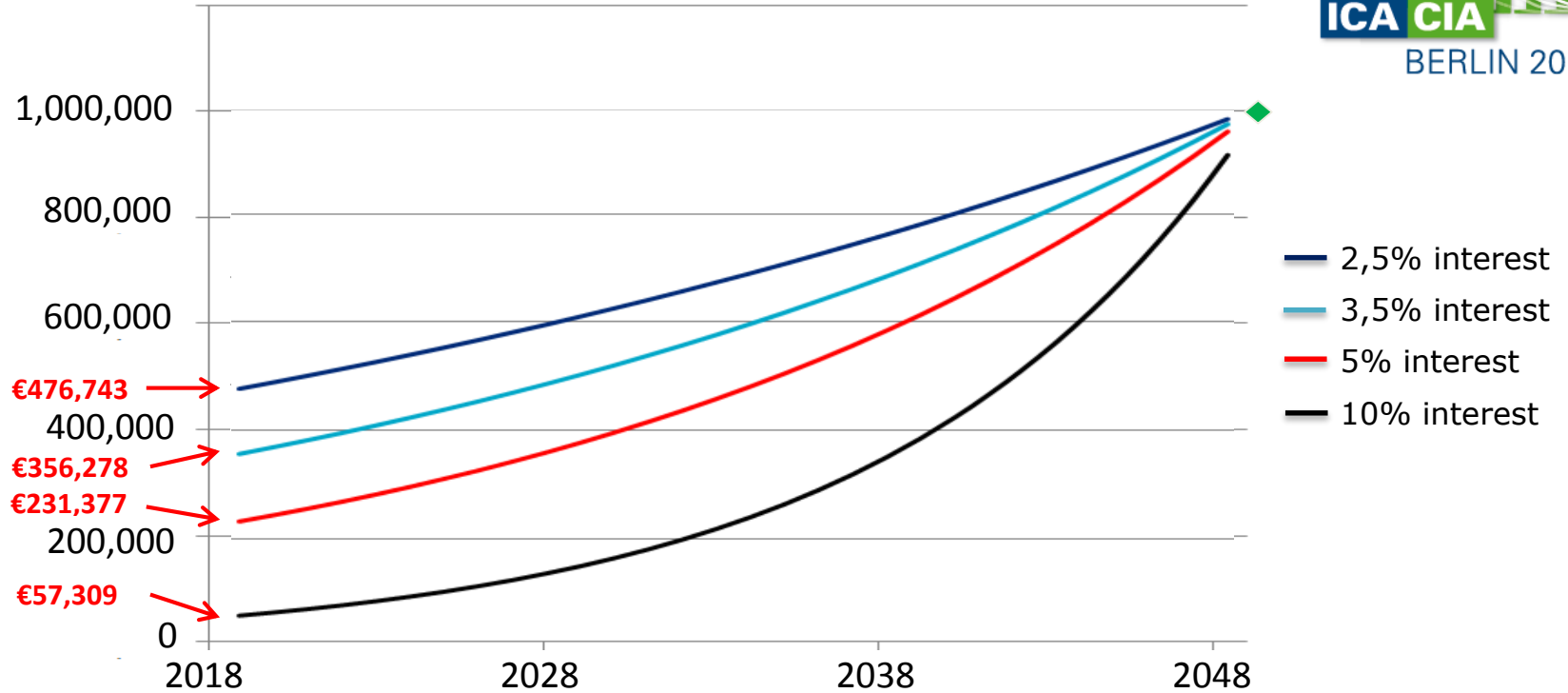
Discount rates

Mercer Yield Curve Eurozone (IFRS)



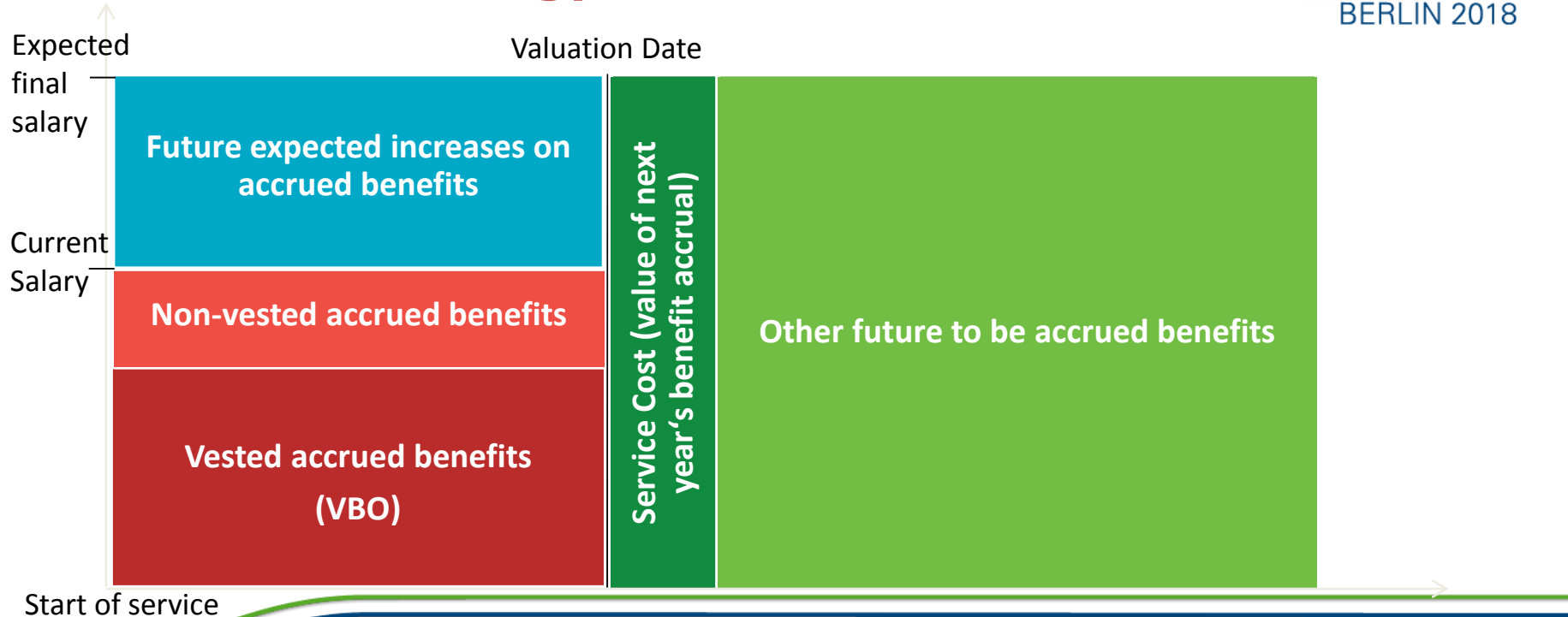
- Quantitative Easing has had a profound impact on long term AA-rated bond yields
- This has pushed up asset prices, and the value of liabilities under IFRS
- Does this measure overvalue unfunded obligations in particular?
 - To what extent is 2% p.a. representative of the weighted average cost of capital, or the cost of borrowing?

The impact of the discount rate



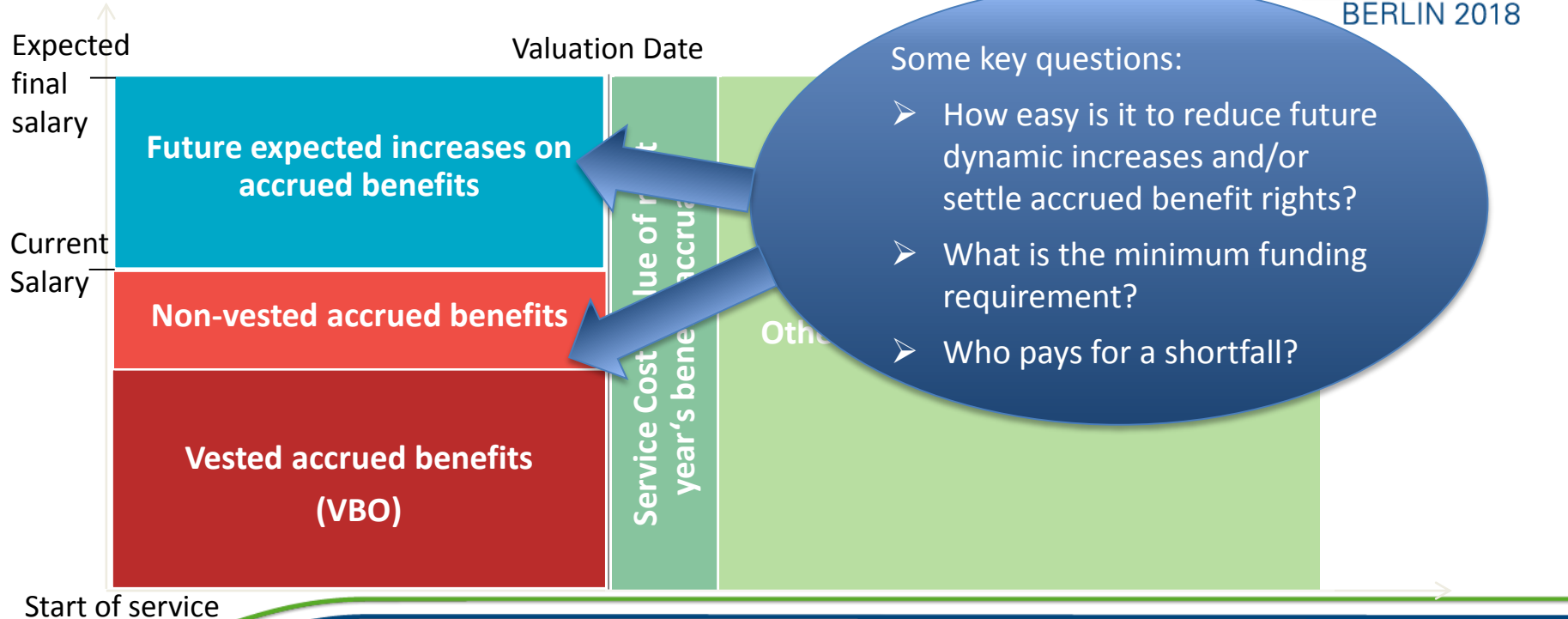
Valuing pension obligations

The basic methodology under IFRS/US GAAP



Valuing pension obligations

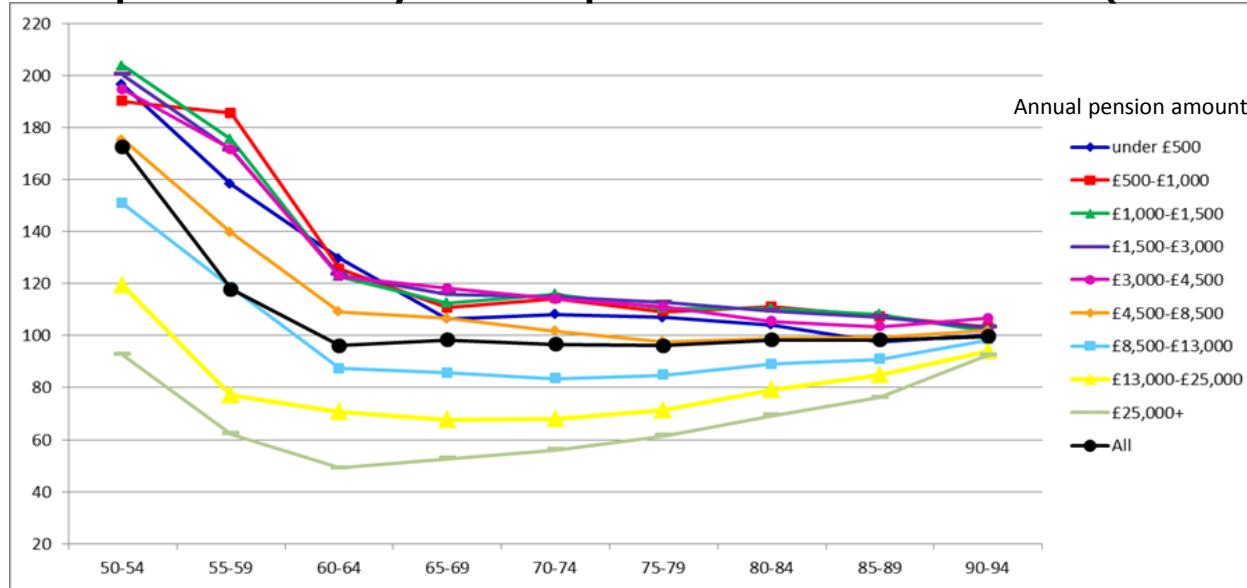
How debt-like are the liabilities?



Are standard assumptions appropriate?

Example – UK pensioner mortality

% expected mortality for male pensioners vs S2PML Tables (2005-2012)

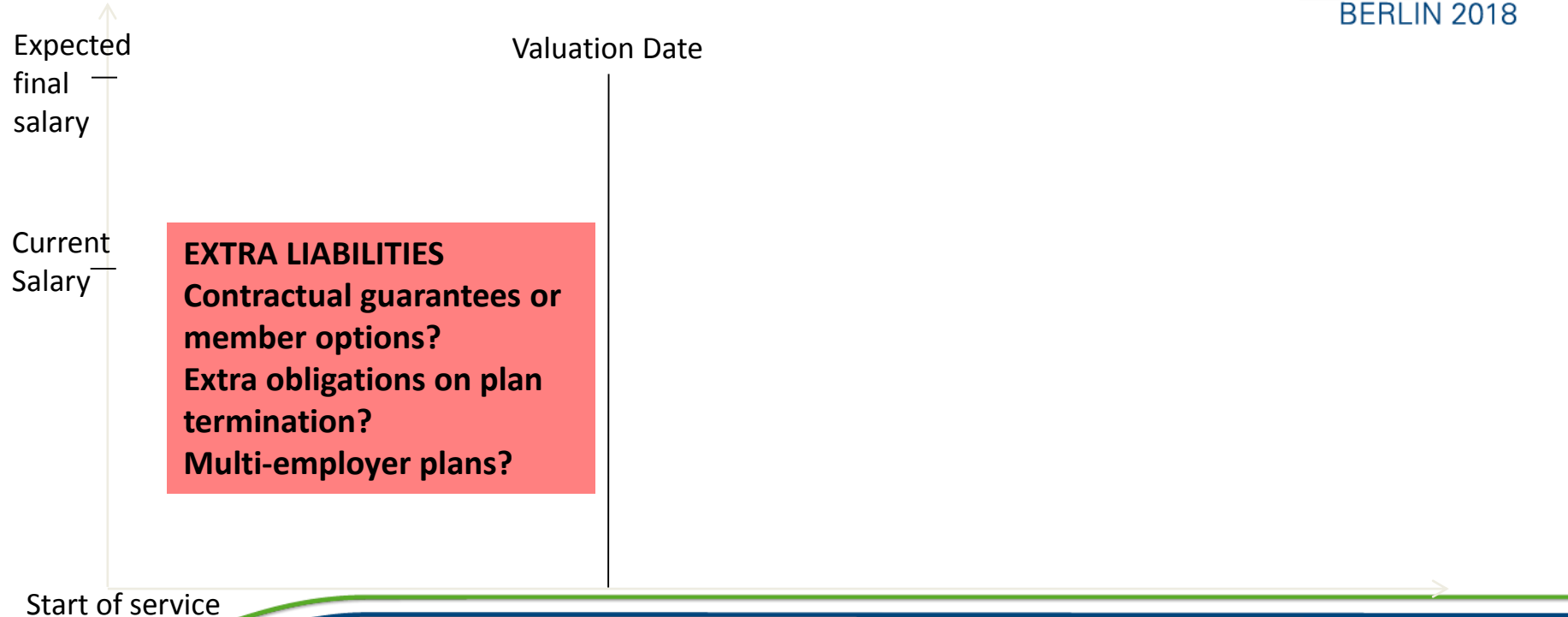


- In many countries we see standard assumptions used nearly all the time
- As well as select groups of employees, the company may have future plans which would materially impact liabilities
- Also the transaction itself may impact the liability and/or funding requirements!

Source: © Institute and Faculty of Actuaries (UK).
Continuous Mortality Investigation Self Administered Pension Schemes Working Committee Working Paper 73

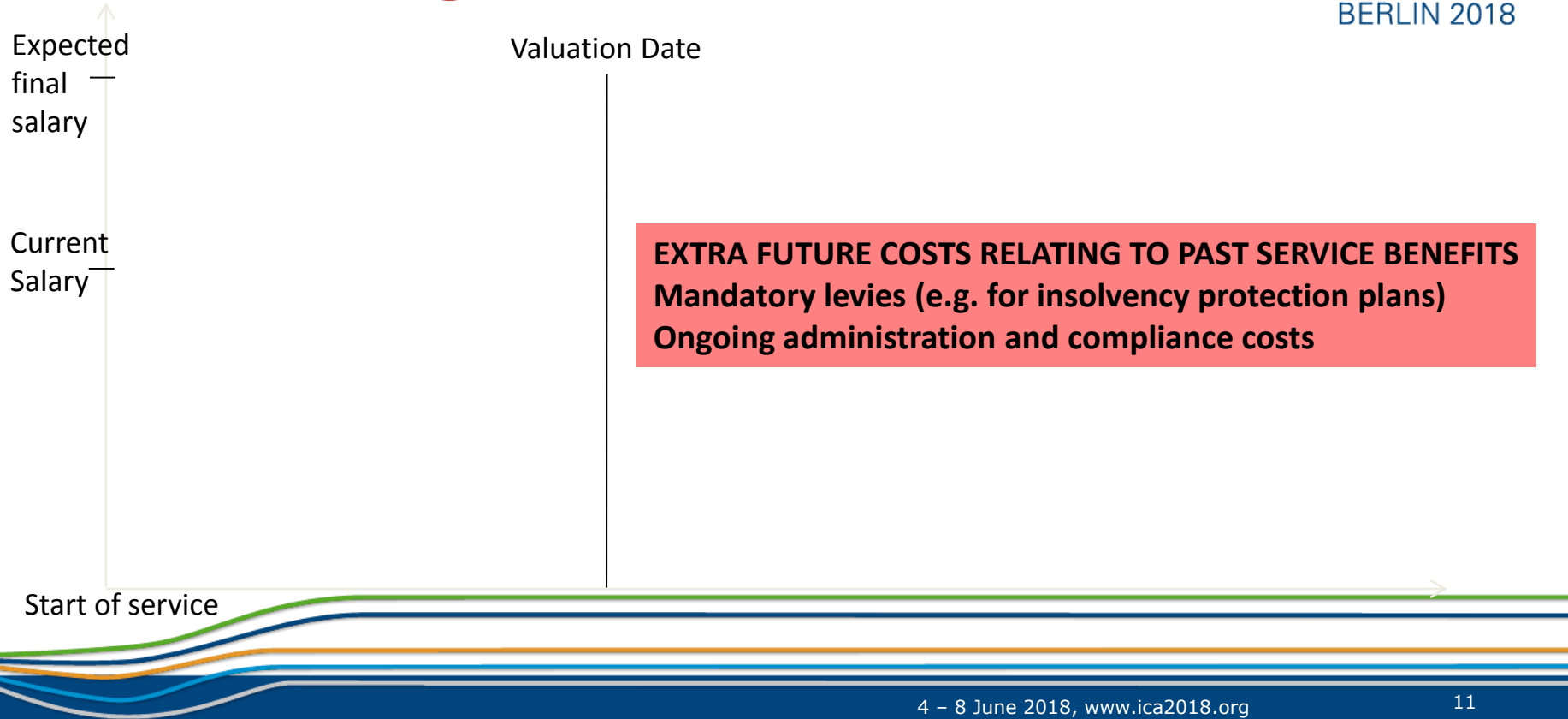
Valuing pension obligations

Are there hidden liabilities?



Valuing pension obligations

Are there unrecognised future costs?



Valuing pension obligations in transactions

How can we raise our game?



Consider factors beyond IFRS/US GAAP etc.

1. Are the assumptions reasonable for the population?
2. Is any impact of the company strategy and/or the transaction itself recognised?
3. Understand potential upsides...
 - Opportunities to amend plan benefits for past and future service
 - Who has to pay for deficits (100% employer, or also employees?)
 - Cost of capital
4. ...and potential downsides
 - Locked-in surpluses
 - Hidden liabilities (multi-employer plans, member options etc)
 - Impact of any planned restructuring
 - How have the assets been valued?

The amounts involved can be very significant!

Thank you very much for your attention!



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