International 2
Managing International Employee Benefits

Assignment 2 Notes

(Part 3 – Funding and Risk Management of Long-Term Employee Benefits)
(Part 4 – Management and Provision of Risk Benefits)

Recommended Time: 3 hours

1. Explain how the funding position of pension funds has changed since the 1990s, the external factors impacting on this and why this has led to the closure of many Defined Benefit plans.

10 marks

Your answer should include:

- The funding position of Defined Benefit plans has deteriorated in general due to a fall in asset values.
- reduction in interest rates (leading to a fall in discount rates used to value liabilities and therefore an increase in the value of these liabilities) and
- improved life expectancy.
- changes in financial reporting requirements significantly increased the level and volatility of the pension-related charges on company balance sheets and income statements. At the same time, regulations increased in response to the notable failure of some larger schemes. The result has been a trend towards DB pensions being considered a legacy risk issue to be managed away, rather than actively embraced as a recruitment or retention tool. Continued volatility in the financial markets, including the recession of 2007/08 and the 'debt crisis' of 2011 to 2013, led to significant additional declines in the funded position of plans and further pressure on plan sponsors.

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2. How do regulators affect a company's funding decision and practice?

15 marks

The key challenge answering this question is to keep to the time limit and decide which points are important to cover.

Your answer should include the following points:

- General Introduction to role of regulators for 2 or 3 marks

List and brief description of areas where regulations impact on funding practice:

- Frequency of required actuarial valuations to assess the financial status and funding requirements of the plan – this is usually set at 1 or 3 years.
- Actuarial funding method – while allowable methods vary, there is a trend toward required use of the unit credit and projected unit credit methods. These methods are consistent with those required for financial accounting purposes and are more transparent and easier to understand than other methods. The unit credit (or accrued benefit method) is the method underlying solvency valuations, which are increasingly becoming the focus of the pension regulators.
- Actuarial assumptions – may be prescribed by regulators or chosen by the actuary; generally each major individual assumption should represent a best estimate.
- Valuation of assets – generally assets are valued at market value or smoothed market value. Using market value can be problematic as it can contribute to large and volatile swings in funding levels. Opponents of smoothing, who include some members of the accounting profession and some financial analysts, indicate that it distorts reality. However, if funding is viewed from a long-term perspective, then smoothing can provide for the accumulation of assets in a structured and sound way.
- Insolvency protection – in several countries, measures are in place to provide at least partial protection of the accrued pensions of members in the event plan assets do not cover the liabilities following the insolvency of the plan sponsor. These include the Pension Protection Fund (PPF) in the UK and the Pension Benefit Guarantee Corporation (PBGC) in the US, which are funded by levies on all covered plans. In Germany, there is a statutory requirement for insolvency insurance through the PSVaG for all book reserved promises.

- Two or three examples of how these impact in practice (e.g. if regulation requires that all surplus belongs to members, this will reduce the tendency of companies to overfund)

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3. Give two examples of how a company's business objectives may affect its employee benefit funding decisions.

5 marks

This question requires you to take two examples from the study manual and describe the link between business objectives and funding policy. Any two from below.

- Favourable tax treatment – a plan sponsor may enjoy an immediate corporate tax deduction and indirectly benefit from the tax-free earnings on invested monies.
- Reduced long term costs – a larger proportion of plan costs will be provided through investment returns; also, an improved funded position may also reduce administrative expenses (e.g. frequency of required actuarial valuations, reduced PPF levies in the UK or PBGC premiums in the US).
- Improved short-term results – sponsors can avoid short-term problems that could result from underfunding such as benefit restrictions, member notices of underfunding, regulatory scrutiny, etc.
- Enhanced benefit security for plan members.
- Reduced P&L charge – the earnings on the additional funding contributions which are assumed for a given period would reduce the sponsor's P&L charge.
- Greater predictability of contributions – as a funding cushion can be built up in good years to help shield against future volatility

4. How may a company change the nature of benefit provision to reduce the risk it takes on? Give three examples.

15 marks

This question asks for 3 examples of risk reduction and risk transfer.

- Closing their DB pension plans and providing a DC or hybrid plan for new hires or for future benefit accruals.
- Reducing either accrued (if permitted) or future benefits.
- Introducing or adjusting employee contributions to the plan.
- Adjusting benefits to provide lump sums rather than pensions at retirement (thereby reducing the company's longevity risk exposure).
- Limiting the earnings and/or earnings increases that are used for purposes of calculating pensions (for example, excluding variable compensation and bonuses from pensionable earnings or adopting a career average earnings formula rather than a final average earnings formula).

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5. Describe the difference between passive and active investment management, including potential advantages and disadvantages of each approach.

10 marks

This question requires a clear description of the key differences.

Active Management:

- Offers the opportunity to add value to the index
- Also creates possibility of underperformance
- Allows opportunity to protect value in falling markets
- Incurs higher investment management fees
- Imposes need to monitor manager's portfolio
- construction and performance
- Avoids issue of Indices becoming "riskier" as market Ease of administration and monitoring (portfolio concentration increases indicated by index)

Passive Management:

- Offers no potential to add value Reduces underperformance risk
- Provides little ability to protect value in falling markets
- Benefits from lower investment management fees

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6. List the elements that make up the pension cost determination for international accounting purposes and briefly describe three of these elements.

5 marks

This question requires the listing and brief explanation of the seven elements of pension cost. By ‘briefly describe’ the question is looking for one or two lines of explanation.

Choose from the following…

- Service cost – the estimated value of benefits accruing over the period.
- Interest cost – the interest calculated using the discount rate on the liabilities over the period.
- Expected return on assets – the expected investment return (calculated using the expected return on assets assumption) on the fund assets over the period after allowing for the effects of monies paid in and out of the plan (contributions in and benefit payments out). Note that under the latest revision of the IFRS accounting standard, the expected return on assets is defined to be equal to the discount rate.
- Actuarial Gains and losses – gains and losses will occur when assets and liability values inevitably turn out to be other than expected; gains and losses also arise from changes in actuarial assumptions; these gains and losses can (or must) sometimes be recognized immediately or may be spread over several years depending on the applicable standard.
- Past service cost – the increase in liabilities due to improvements in benefits relating to previous accounting periods (may be recognized in full in the year the past service is granted or amortized over several years).
- Settlements – occur when benefit obligations are fully transferred out of plan to the members or to third parties, for example when annuity contracts are secured in the name of the member.
- Curtailments – occur when benefit obligations are reduced but remain in the plan, e.g., following a redundancy exercise, members’ benefits may have a lower value than had they remained in service.

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7. **Define and compare Loss Carried Forward and Stop Loss insurance systems**.

10 marks

For this question it may be useful to include a numerical example if that helps the explanation and demonstrates to the examiner your knowledge.

The Stop Loss System With this system, any aggregated loss over a specified amount at the end of the accounting period is cancelled (i.e. written-off) by the insurers. An additional charge is levied as part of the pool expenses, which is typically between 3% and 6% of pooled premium. The Loss Carried Forward System Under this system, any overall loss is carried forward to the account for the following year, to be offset against any surplus arising in the subsequent year(s). A positive overall balance at the end of the second year (after deduction of the year 1 loss carried forward) will be paid out as an international dividend. A negative overall balance will be carried forward to the third year, and so on.

There can be several variations of 'loss carried forward', including:

- unlimited loss carried forward
- a maximum amount of loss carried forward
- a limit on the time for carry forward of a loss arising in a particular year
- a contingency fund, under which the network withholds a proportion of surplus in a fund to be used to help finance any future losses; the effect is to aid the smoothing of any fluctuations in experience.

8. **Describe the quantitative and qualitative factors to consider when choosing a Multinational pooling network.**

15 marks

The question requires distinction between financial and non-financial drivers.

Financial drivers (quantitative factors) are based on the principle that by increasing the number of lives insured, the insurer has a lower risk (of fluctuation) and that this is reflected in lower premiums thereby reducing risk management costs.

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Pooling also:

- Identifies/unlocks excessive insurance margins
- Realises economies of scale
- Exploits experience rating
- Brings cash flow enhancements

Non-Financial Drivers (qualitative factors) include:

- Improved risk management (e.g., increased investment return on reserves, possibility to use captive insurance company etc.)
- Increased guaranteed coverage levels
- Improved quality of reporting and increased transparency (e.g. worldwide experience reporting on an annual basis)
- Improved underwriting conditions

9. Define a Captive Insurance company and outline the main reasons why a Captive is set up by a multinational.

15 marks

A Captive Insurance Company is an insurance company established primarily to provide insurance coverage to its owner or parent company. The owner enterprise is the principal beneficiary of the insurance. Many large multinationals operate one or more captives, although, historically, these have been, and continue to be, used mainly for the purpose of providing property and liability cover.

Captives may operate either as a direct (or primary) insurer or as a reinsurer. In the employee benefit environment, most captives function as reinsurers underwriting the risks of their parent(s) through fronting with local 3rd party insurers. Local legislation, administrative challenges and/or good governance practice often prohibit captives from insuring employee benefit plans directly, although, in some cases, captives may obtain a license in a local market for this purpose.

For a multinational company, a market-by-market approach is not generally practical and, typically, a captive solution will be implemented with a multinational insurance network to achieve local insurance cover.

There are two principal ways in which captives are used to support the provision of employee benefits for a multinational:

- Passive Agreement – This is simply a multinational pool where the captive becomes a substitute for the multinational and, as the multinational pooling contract holder, receives the multinational dividend
- Risk Transfer – Premium and risks are transferred to the captive using a treaty reinsurance approach. The captive takes all or part of the direct underwriting risk of the insured contracts.

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