THE one BRIEF
AON EXPLORES THE WORLD'S MOST PRESSING BUSINESS ISSUES

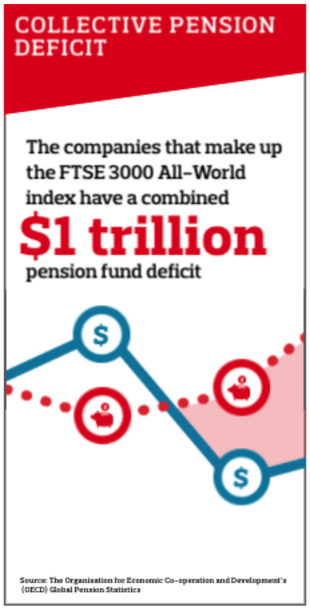
PEOPLE & ORGANIZATIONS

The Trillion-Dollar Pension Gap: Strategies To Close It

OVERVIEW

There's a trillion-dollar gap in our pensions. Together, the companies that make up the FTSE 3000 All-World index have a combined pension fund deficit – the difference between the assets a fund has and its pension payment obligations – of some $1 trillion.

Meanwhile, the number of retirees is rapidly increasing. It's estimated that 10,000 American Baby Boomers retire every day, and 19.2 percent of those living in the European Union are now over 65 years old. Japan's working age population is projected to fall by 7.9 million by 2030, as many of their workers retire without the younger workers to replace them.



A combination of low interest rates and increasing lifespans is making it more and more difficult for pension funds to meet the rising demand for retirement income.

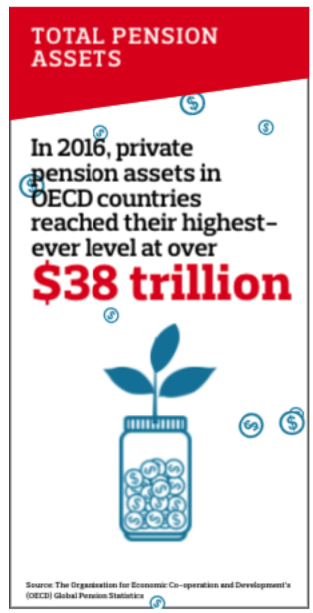
As this problem doesn't look as though it will go away any time soon, it's vital that organizations address the challenge now and find ways to de-risk their pension liabilities. This can be done either by changing the way they fund their plans, or changing how the plans themselves work. Paul Rangecroft, Retirement Leader, North America, Aon, emphasizes the need for business leaders to "seek custom solutions that help manage their pension liabilities, while helping provide for employee needs – both active and retirees – around the globe."

IN DEPTH

Ideally, a pension fund's assets and liabilities should match up. However, broadly speaking, there is a stubborn gulf between the two. In low-interest rate environments, and with increases in life expectancy, more often than not, assets have not been able to keep up with liability growth.

"In light of the current pension fund gap, we're seeing a greater appetite for pension sponsors to better define their overall strategy," says Rick Jones, Senior Partner, U.S. Retirement Practice, Aon.

Jones notes that organizations are becoming more active in managing their current liabilities and predicted retirement payouts, which help them *proactively* evaluate the best investments to reach their goals. And it's not just the organization's goals that need to be met, it's also about the retiree: "As organizations move to more proactive ways of reducing their cost of risk, they do still have legacy obligations to meet which impact millions around the globe," says Jones.

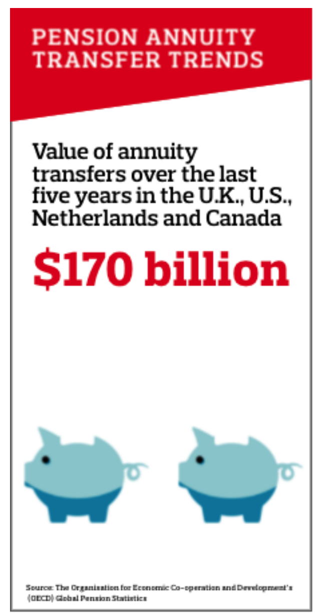


If pension plans are to close their deficits, they need to assess how they are managing their assets and liabilities.

Restructure Plans

One way pension funds can address their deficit is to limit the burden of liabilities by controlling plan costs, and restructuring their plans and schemes. Steps they are taking to achieve this include:

Closing or reforming defined benefit plans in favor of defined contribution plans: Defined benefit plans guarantee retirees a fixed pension income, based on data such as a retiree's earnings history, length of employment service, and age at retirement. A defined contribution plan, on the other hand, puts aside a sum of money every year, which then becomes a retiree's "pension pot." By switching to the latter, pension fund sponsors reduce the scale of their fixed commitments.



Some defined benefit plans are simply closing their doors to new entrants. In Aon's biennial Global Pension Risk Survey of plan sponsors and pension professionals, this was the route taken by providers in many regions: In Ireland, 87 percent of private plans had closed to new entrants. In the U.S., 81 percent of respondents reported they had done so and in Germany, it was 55 percent. However, in Japan only 22 percent of respondents had already closed defined benefit plans to new entrants, or intended to close them in the future.

Offering current beneficiaries lump sum settlements: Fund sponsors can buy out their liabilities altogether by offering a lump cash settlement all in one go. The payee can then re-invest that sum in another retirement fund. Sponsors are eager to engage with this.

Aon's survey showed 43 percent of U.S. respondents had already implemented lump sum settlements, with a further 49 percent expressing interest in doing so in the next 12 to 24 months.

However, liability management measures like these aren't as easy to implement elsewhere. "Pension rights in the U.K. are heavily protected, so it is difficult to carry out a liability management strategy without the consent of the members," says UK-based Matthew Arends, Partner, Retirement & Investment, Aon. However the U.K. is seeing change with liability-transfer models like flexible retirement options gaining acceptance. In 2013, 74 percent of U.K. respondents said that they were unlikely to implement such a plan. By 2017, that figure had dropped to just 31 percent. "This is a real hot topic area in the U.K. for managing risk, and for managing the overall size of the pension plan," says Arends.

Insured annuity buyouts: Plan providers can shift their liabilities on to insurers. An insured annuity buyout involves a pension provider offering an insurer a premium in exchange for assuming its pension liabilities. It's similar to a lump-sum payout, but with an insurance company taking over responsibility for the pension rather than the individual receiving cash.

Insured annuity buyouts are currently not as prevalent as lump-sum employee buyouts in North America. Only 8 percent of U.S. respondents have taken this approach, but they may become more widespread, with 33 percent of respondents saying they were either likely or very likely to implement them.

Overall, Aon estimates that 6 percent of global pension liabilities have been settled for large U.S.-based companies. "It's a small percentage, but a meaningful trend," says Rangecroft.

Revising Investment Strategy And Enlisting Expert Advice

Pension funds can also manage their risk by re-evaluating their investment strategy. Low interest rates in many countries are part of the reason for high pension deficits.

As a result, pension funds are diversifying their investment strategies to pursue assets that will generate higher future returns while reducing today's risk. Tom Ault, Partner of Aon's Canadian Retirement Practice, notes the growing popularity of "liability-matching" bonds. Speaking about the Canadian survey results, Ault states: "There was movement in bond investment and we expect further shifts from return-seeking equity investments to liability-hedging bonds."

On the other side of the globe, Irish respondents demonstrated a particular appetite for liability-matching products, with 46 percent reporting that they had increased their investment in index-linked government bonds over the last 12 months.

New investment strategies have been accompanied by a change in the way organizations perform their activities. In 2013, for example, 41 percent of U.S. survey respondents reported they had delegated manager monitoring. In 2017, 56 percent said the same – an increase of over a third. In the UK, a similar trend was observed, with 39 percent of repondents reporting delegation in 2013, up to 59 percent in 2016. "This is now a mainstream activity for organizations, and their leaders, to delegate all or part of the investment strategy, and it's an option that's available to plans of all sizes," says Arends

This behavior can also be observed across other managerial functions – like asset allocation or hedging – showing that pension funds are increasingly willing to enlist expert third parties to help advise organizations on how to better de-risk their plans and diversify their investments. A 2017 survey by Chief Investment Officer Magazine found that 40 percent of respondents were either currently outsourcing or planning on outsourcing their investment program during the next two years.

A Two-Part Problem With A Two-Part Solution

As the world's population continues both to grow older and retire for ever-longer periods, pressures on retirement and pension funds – as well as plan sponsors – are only set to get greater.

However, by approaching the challenge from both sides – redesigning both the pension plans themselves and their asset investment strategies, there is a greater likelihood of optimal results. Michael Clare, Head of Retirement, EMEA, Aon, believes organizations and their leaders should build "retirement and pension fund strategies that not only fulfill obligations, but also reduce the risk for future generations. This will better position all individuals – from pension plan sponsors to the retiree – to benefit."

TALKING POINTS

"In light of the current pension fund gap, we're seeing a greater appetite for pension sponsors to better define their overall strategy" – Rick Jones, Senior Partner, U.S. Retirement Practice, Aon

FURTHER READING

- Aon's 2017 Global Pension Risk Survey
- The Rise Of The Outsourced Chief Investment Officer – Aon's TheOneBrief.com
- Defined Pension Deficits Remain Stable – FT Advisor, June 1, 2017
- What Charities Can Do To Address Defined Benefit Affordability – Pensions Expert, November 1, 2017
- Pension Fund Problems Worsen In 43 States – Bloomberg, June 30, 2017
- Leaving Pension Management, And Pension Risk, Behind – CFO, October 3, 2017