

Global DB Pension Risk – USA and UK in Focus

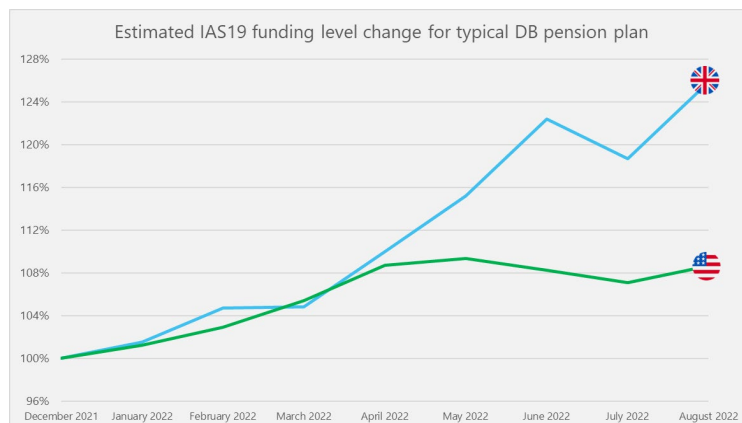
Will we look back upon 2022 as a period of fundamental change in the funding of defined benefit (DB) plans worldwide? After over a decade of historically low bond yields, the spectre of rising prices has triggered a rapid tightening in monetary policy across the developed economies. The resulting increase in bond yields has significantly reduced the value of DB pension liabilities, providing a welcome boost to the funding levels of DB pension plans despite the challenging period for growth assets.

Very recently, we have seen some substantial movements in exchange rates, with UK sterling weakening materially against the dollar. This provides further impetus for multinational companies to consider de-risking opportunities in the UK, particularly US-based companies.

In this note we consider how the two largest private sector DB pension markets, the USA and the UK, have fared during this time of important change. We also explore the key issues and opportunities multinational companies should be considering in this transformed environment: from cash funding and balance sheet management to investment and derisking.

Improvement in funding positions

The chart below shows the estimated change in IAS19 funding position for typical USA and UK DB pension plans over the period since 31 December 2021.



There are two main factors explaining the larger improvement in the funding position for UK pension plans:

- **Bond market movements** – both countries have seen steep increases in corporate bond yields over the period, pushing up IAS19 discount rates significantly. Bond yields have increased at a faster rate in the UK than in the USA, resulting in larger discount rate changes and a greater reduction in DB pension plan liabilities.
- **Duration differences** – the lack of inflation linkage in most private sector pension plans in the USA means the duration of USA pension liabilities is shorter than the duration of UK pension liabilities. This means that

pension liabilities in the USA are less sensitive to interest rate changes than those in the UK. The recent increase in bond yields has therefore resulted in a relatively larger fall in UK pension liabilities compared to the fall in the USA.

Impact on the company balance sheets

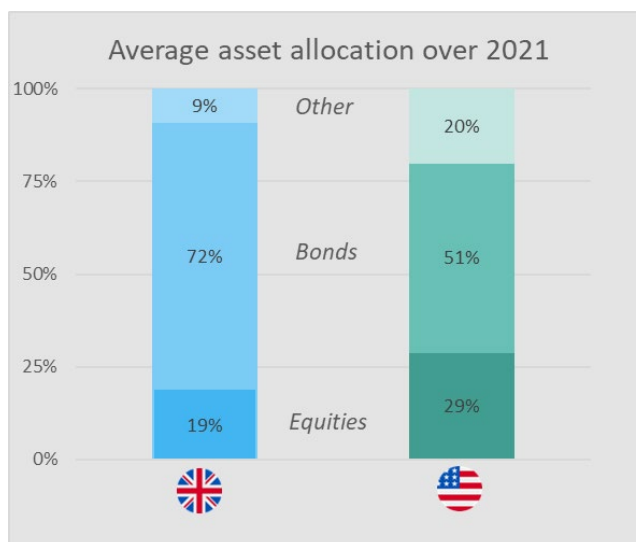
The improvement in funding levels means that pension plans may find themselves with an accounting surplus at the next balance sheet date (some for the first time in many years). For companies accounting under the IAS19 standard, surplus recognition will be an important consideration for UK plans and USA plans that report under IFRS, as will the requirements of IFRIC14 (which may require an additional liability to be disclosed if the company does not have an “unconditional right” to a refund of surplus). No similar restrictions apply for companies accounting under US GAAP; however, the improved funding levels will help reduce unrecognized losses in Accumulated Other Comprehensive Income (AOCI). Further detail can be found in this [note](#).

Monitoring investment strategies

Another important difference between USA and UK DB pension plans is investment strategy. The chart to the right shows the average allocation of private sector DB pension plans in both countries over 2021¹:

The recent improvement in funding positions and the challenging outlook for the global economy has persuaded a number of companies to revisit their DB pension plan investment strategy.

Given the relatively high equity allocations in the USA compared to the UK, our clients are seeing a potential opportunity to reduce investment risk and better match movements in liability values. Our USA team’s [FutureCost](#) tool provides an excellent foundation to explore the implications of making strategy changes.



In the UK, the large movements in interest rates and short-term inflation expectations have resulted in clients re-evaluating their liability hedging portfolios. As well as potentially providing further opportunities to reduce investment risk, the general improvement in funding positions should also prompt companies to re-assess their plan’s funding target and the path to achieving that objective. For example, if the pension plan is now close to full funding on a buyout basis, should the investment strategy be revised to hedge insurer pricing rather than the funding basis to preserve the position?

Our UK team’s [DB Navigator](#) framework supports companies to make the important strategic decisions in relation to their DB pension plans in the UK.

¹ https://www.ppf.co.uk/sites/default/files/2021-12/PPF_PurpleBook_2021.pdf and <https://www.milliman.com/en/insight/2022-corporate-pension-funding-study>

Termination within reach?

The long-term trajectory for DB pension plans, particularly their route to termination, continues to be a key consideration for multinational companies. The recent improvement in funding positions has brought termination within sight for many more companies, and there has been a shift in focus towards monitoring insurance market pricing and preparing pension plans for executing a transaction.

Bulk annuity market overview



The UK bulk annuity insurers completed £28.6bn of business in 2021, slightly less than the £31.8bn written in 2020. Legal & General had the greatest value of business at £6.2bn. In the first of half of 2022, over £11bn on business has been announced so far in the UK market. Insurers are reporting an increased interest in bulk annuity transactions due to the improved funding levels of schemes. Read our UK team's overview of the 2021 bulk annuity market [here](#).



In 2021, the USA pension risk transfer market saw total single group annuity purchases exceed \$38 billion, which is the highest total on record. In addition, the share of buy-in transactions as a proportion of total bulk annuity transactions surged from 6.6% in 2020 to over 10.0% in 2021, reflecting the desire of some USA companies to shift pension risk to insurance companies while avoiding unbudgeted hits to the Profit and Loss account.

While historically buying out a UK DB pension plan has generally been an unattractive proposition for USA multinationals due to the accounting impact, the position may have improved over recent months. As mentioned above, the increase in corporate bond yields should help to reduce the size of the unrecognized losses in the AOCI that have built up over the years. As these losses are recognized in full through the Net Periodic Pension Cost upon the completion of a buyout transaction, this reduction should help to make a buyout transaction more attractive.

The following two measures provide an indication of the changes in the feasibility of an insurance transaction in the UK and the USA:

- **DB End Gauge:** Our UK team publish the “[DB End Gauge](#)” index, which provides an estimate of the average time for UK pension plans to reach full funding on a buyout basis. As of the end of August 2022, the index was 6.8 years, a reduction of around 3 years since the end of December 2021.
- **Pension Buyout Index:** Our USA team publishes a monthly “[Pension Buyout Index](#)” which provides an estimate of the cost of buying out retiree pension liabilities. At the end of August 2022, the index suggested that retiree buy-out cost as a percentage of the accounting liability was around 96.9% - an improvement relative to the 99.3% at the end of December 2021. Combined with the improvement in accounting positions outlined above, this suggests that it is now cheaper to buyout US pension plan liabilities than it was at the end of December 2021.

Other key issues



New funding regulations: The Department for Work and Pensions (DWP) has recently published a [consultation](#) on new funding and investment strategy regulations for UK DB pension plans. These lay the groundwork for a fundamental change to the UK DB pension funding regime, which will have implications for all DB pension plan sponsors.

Capital-backed journey plans: We are observing an increasing interest in capital-backed journey plan (CBJP) solutions. This is a new innovation in the UK pension market, and involves a third party providing a guarantee to achieve a particular funding level or investment return over a period of time (with capital provided to support this guarantee). These can provide an

opportunity to achieve a plan’s funding objective more quickly, or at a lower cost, and with significantly less volatility than traditional investment methods.



SECURE Act 2.0: The SECURE 2.0 bill was approved by the Senate Finance Committee on 22 June, building on the SECURE Act of 2019. The legislation aims to boost retirement savings for US workers, and includes certain provisions impacting on the funding of DB plans, including:

- Mandatory cash outs have increased from \$5,000 to \$7,000
- The indexing of PBGC variable rate premiums has been eliminated, keeping the current level of \$48 per \$1,000 of unfunded benefits
- The IRC Section 420 provision allowing the transfer of excess pension assets to pay for postretirement medical and life insurance benefits has been extended

Unfreezing DB plans: For organizations that would prefer to offer DB pensions to employees as part of their Employee Value Proposition, the current economic and regulatory environment may provide a unique opportunity to unfreeze DB plans and utilize their surplus funding. Read more [here](#).

Capitalise on new DB opportunities worldwide

Multinational organizations should be alive to the DB pension opportunities currently arising around the world. Increasing bond yields over recent months have significantly improved the funding position of DB plans in both the UK and USA. Yet there are important differences – for example, funding level improvements have been substantially greater in the UK, and there are key differences in the derisking opportunities in each market. Importantly, we see these trends playing out across the world.

The implications of the financial market changes and the related opportunities will be different in each market, so organizations should take the time to understand these and take action where appropriate. Companies with a robust monitoring process for their global DB plans will have a strong foundation to take advantage of these opportunities, and can move quickly where required to reduce cost and risk.

For more information, please contact [John-Paul Augeri](#), [Lewys Curteis](#) or your [local MBWL consultant](#).



CONTACT

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