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**IPEBLA MILAN CONFERENCE: WORKSHOP 16**

**CURRENT TOPICS IN DB PENSION PLAN FUNDING**

**BACKGROUND INFORMATION TO SET THE SCENE FOR THE DISCUSSION IN WORKSHOP 16 ON TUESDAY, 28TH MAY, 2024 AT 9:45AM**

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**Part I – Preliminary**

**A. Introduction**

1. In this **Part I Section B** explains some of the terminology used in this document and which will be used in the Workshop. Some readers will be familiar with the terminology. But others may be unaware that, at least between the UK and the US, different terms mean very different things.

2. **Part II** of this document contains some background themes which relate to funding of DB pension plans and will help to set the scene for the discussion in the Workshop.

**B.** **Terminology**

**1. Pillar 1, Pillar 2 and Pillar 3 pension systems**

1.1 A common classification used in relation to pension systems is to divide them into three pillars:

* **Pillar 1**: the old age retirement pension system or retirement social security scheme provided by the State. This system is, for the four countries covered by this workshop, a defined benefit system.
* **Pillar 2**: the old age pension or retirement savings arrangements made by employers for their employees. We use this terminology in relation to Belgium, UK and the US.

**Note 1**: The obligation of the employer to provide or participate in a Pillar 2 system may be:

* free market (ie voluntary for the employer),
* required, at least as to a minimum level, by legislation of the jurisdiction in question, or
* although free market (in part) may be collectively bargained, in relation to particular industry or occupation, with no right for employers and employees covered by that collective bargaining agreement to opt out.

**Note** **2**: However, the Pillar 2 system for France is treated as part of the Pillar 1 system (as explained later in this paper).

* **Pillar 3**: these are for Belgium, the UK[[1]](#footnote-2) and the US, voluntary (but usually taxed privileged) retirement savings arrangements made by individuals to supplement their Pillar 1 and Pillar 2 pensions or retirement savings. However, in France, Pillar 3 is used to denote pension or retirement savings arrangements set up by employers (free market or collectively bargained) and retirement savings arrangements made by individuals.

**2. Plan or Scheme**

2.1 UK pensions legislation refers to “occupational pension scheme” or “personal pension scheme”.[[2]](#footnote-3)

2.2 Similarly, in the English language version of the IORP II Directive[[3]](#footnote-4) (see **3** below), the term used is “pension scheme”.

2.3 In contrast, in the US the terminology used is “pension plan”.[[4]](#footnote-5)

2.4 Note, however, that the definition of “pension scheme” in the IORP II Directive, in the French language version, is “*régime de retraite*”.

**3 IORPs and the IORP Directives**

3.1 The term “**IORP**” or “institution for occupational retirement provision” comes from an EU Directive (the “**IORP I Directive**”) as consolidated and replaced by the IORP II Directive[[5]](#footnote-6).

3.2 An EU Directive is a directive to Member States of the European Union to transpose the requirements of that Directive into their national legislation.

3.3 However, in essence, any funded occupational pension scheme (whether DB or DC) which is in Pillar 2 (Pillar 3 for France in the terminology used in this paper) would fall within the definition of “institution for occupational retirement provision”[[6]](#footnote-7) or “IORP” (but see **3.7** below as to the regulatory distinction between a pension scheme provided by an IORP and the occupational retirement or annuity business of an insurance company).

3.4 The principal aims of the IORP I Directive (and now in the IORP II Directive) can be summarised as:

* to create a minimum harmonised set of rules regulating **funded** Pillar 2 occupational pension schemes.
* to permit the cross border (within the EU) investment of the assets of IORPs- so removing, for example, restrictions on investing in shares and bonds issued by issuers in the same jurisdiction as that of the IORP.
* to permit an IORP to appoint investment managers and depositaries/custodians who may be established in a different EU Member State to that of the Member State in which the IORP is established.
* to permit an IORP established in one Member State to offer pension scheme services to employers and employees in another Member State (cross border pension provisions).

3.5 The IORP II Directive:

* does not apply to unfunded Pillar 2 pension schemes, and
* does not apply to Pillar 1 pension schemes.[[7]](#footnote-8)

3.6 Pillar 2 pension schemes in France operate on a pay-as-you-go basis and so are excluded from the scope of the IORP II Directive by Article 2(2)(c). They also have features of a Pillar 1 social security schemes in that, if a worker works in a particular industry sector or profession, then the worker must join the pension scheme and the worker plus, where applicable, the worker’s employer, must pay compulsory contributions to that scheme.

3.7 There is an important regulatory distinction drawn between

* providing retirement benefits through an IORP regulated by the IORP II Directive, and
* an insurance company’s occupational retirement business under which pension or annuity contracts entered into between the employer and the insurance company provide retirement benefits for the employees and former employees (and their eligible survivors) of the employer regulated by the Solvency II Directive.

3.8 Both arrangements have considerable similarities. However, the regulatory distinction is drawn by excluding certain employer sponsored retirement benefit arrangements from the scope of the Solvency II Directive[[8]](#footnote-9).

3.9 In terms of regulatory capital requirements, insurance companies in the European Union must comply with the Solvency II Directive[[9]](#footnote-10) where the regulatory capital requirements (and associated regulations) are seen as more stringent than those applicable to IORPs.

3.10 For regulatory capital and funding requirements, IORPs are divided, by necessary implication, under the IORP II Directive into three categories:

* **Category 1**: those which provide pension schemes which do not contain any guarantee as to the level of benefits; so pure DC only benefits are provided,
* **Category 2**: those which provide pension schemes that contain a full or partial guarantee of the retirement benefit (or cover against biometric risks such as longevity) but where the sponsoring employer (rather than the IORP itself) ultimately underwrites the risk arising from that guarantee or that cover, and
* **Category 3**: those which provide pension schemes which contain a full or partial guarantee on the retirement benefit (or cover against biometric risks such as longevity) but there is no underwriting of the risk arising from that guarantee or that cover by the sponsoring employer.

3.11 In the language of the IORP Directive, Category 3 IORPS are referred to “regulatory own fund IORPs” and must hold regulatory capital complying with the requirements in the IORP II Directive which were originally in the Solvency I Directive.[[10]](#footnote-11)

3.12 These “Solvency I Requirements” are seen as less onerous than the Solvency II Requirements. This, in turn, has led to a certain amount of regulatory arbitrage.

**4. Funded/Unfunded**

4.1 Where:

* the employer arranges for the retirement benefit for its employees to be paid by another person; and
* the employer pays contributions to that other person to fund or finance the payment of the retirement benefit,

the pension scheme can be classified as funded.

4.2 In contrast, if there is no pre-funding and any contributions collected are paid out almost immediately to meet the benefits due to those who are already retired, the arrangement is “unfunded” and will be classified as a pay-as-you-go scheme or a book reserve scheme.

4.3 It is possible to have hybrid arrangements which are partly funded and partly unfunded; for example for what is predominantly an unfunded arrangement to also have a “buffer fund” to serve as a contingency against a decline in contributions or a substantive change in the demographic assumptions underpinning the calculation of the contributions in respect of the unfunded pension plan. There is some more detail, in **Annex A,** in respect of pension schemes in France; for example, the AGIRC[[11]](#footnote-12)/ARRCO[[12]](#footnote-13) pension scheme.

4.4 In the US, plans that cover rank and file employees are required to be funded whereas executive top up plans are required to be unfunded. Although unfunded, employers are permitted to establish dedicated trusts from which executive benefits are paid however those arrangements must meet certain rules including that the assets in such a dedicated trust must be available to the employer’s creditors.

**5. ERISA, DoL and IRS**

5.1 ERISA is the abbreviation commonly used to refer to the Employment Retirement Income Security Act of 1974, as amended.

5.2 DoL is the abbreviation commonly used to refer to the US Department of Labor which has substantial regulatory oversight over pension plans in the US.

5.3 IRS is the abbreviation commonly used to refer to the US Internal Revenue Service which also has substantial regulatory oversight over US pension plans to ensure that the tax reliefs granted in relation to contributions to, investment income and gains arising within, and benefits paid out are in compliance with rules within the applicable tax legislation that are heavily focused on requiring plans to pay meaningful benefits to employees who are not highly compensated.

**6. DB and DC**

6.1 In its simplest form, a defined benefit benefit (or DB benefit), is a lump sum or pension payable by a person where the payer has a legal obligation to pay that pension or that benefit to the plan member (or another eligible beneficiary). That legal obligation to make that payment may derive from the employment contract, it may derive from the employment contract coupled with trust law (if the pension plan is funded and the funding mechanism chosen is that of a trust) or under legislation relating to the pension plan in question.

6.2 In contrast, a defined contribution benefit (or a DC benefit) is one where the contributions paid to provide the benefit must, of necessity, be sufficient to provide the benefit. So, for example, if the benefit is a lump sum payable on attaining a retirement age (which could be used or must be used to purchase an annuity or pension from the plan or may be drawn in whole or part of the lump sum), it is the amount of the investments held by the plan representing those contributions (less expenses and charges) which will be available to provide the lump sum. If the investments are shares in companies that become worthless or are bonds where the issuer of the bonds becomes insolvent and no amount is payable out in the insolvency, then the amount payable would be zero.[[13]](#footnote-14)

6.3 Where terminology becomes more difficult is where the retirement benefit looks like a DB benefit but the amount may be reduced if certain conditions are satisfied (excluding for this purpose, the insolvency of the person providing the pension promise).

6.4 This type of benefit can be classified as a collective defined contribution benefit or as a conditional DB benefit.

6.5 Furthermore, the “safety valves” commonly included in DB pension plans such as a reserved power to reduce benefits in light of adverse circumstances while the plan was ongoing (eg the actual investment return was lower than assumed or the plan members living longer than assumed) may have been removed by overriding legislation.

6.6 In addition, what may be described as a DC plan (because it depends on the level of contributions received as to the benefits to be paid) may, in practice, end up being treated as a DB plan because of the practical politics of not permitting the benefit to be reduced.

6.7 In the US, a defined contribution plan refers only to a plan that provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant’s account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant’s account.[[14]](#footnote-15) Any other type of retirement plan is referred to in the US as a defined benefit plan.[[15]](#footnote-16)

**7. Defined contribution or money purchase**

7.1 A defined contribution retirement benefit is conceptually the same as a money purchase retirement benefit.

7.2 Defined contribution is the term used in common parlance. However in UK legislation that term is replaced by “money purchase”[[16]](#footnote-17).

7.3 In the US, a money purchase retirement benefit is a specific type of defined contribution retirement benefit that has largely disappeared.

**8. Plan fiduciary or trustee**

8.1 In the US, the person with the fiduciary obligations imposed under ERISA is the person who is the plan fiduciary in relation to the power in question under the pension plan. The trustee of the plan assets often has the limited role of acting as custodian of the plan assets (with no investment duties). Such a trustee is referred to as directed trustee. However, it is permissible for a trustee to be a named fiduciary with investment responsibilities (in fact this is the default under ERISA and is common for certain types of plans), which is referred to as a discretionary trustee.

8.2 In contrast, in the UK the pension scheme trustee (usually a single purpose company acting through its Board of Directors) is the person in whom the investment powers are invested under the terms of the plan trust deed (and also required by legislation[[17]](#footnote-18)). The trustee is required to appoint a custodian/depositary to hold the scheme assets (there are some limited exceptions).

8.3 So when UK lawyers are talking about pension scheme trustees they mean the plan fiduciary who determines the plan’s investment strategy. However, day to day investment management decisions are usually delegated, for regulatory reasons, to an external investment manager who has the required regulatory authorisations.

**Part II – Some themes to draw out which relate to funding of DB pension plans**

**A. Tax**

1. Tax reliefs are an important influence on pension plan structure, benefit design and funding of Pillar 2 and Pillar 3 pension plans.

2. A commonly use system of tax reliefs in relation to a funded DB pension plan is the EET system.

2. In brief:

* employer and employee[[18]](#footnote-19) contributions to the pension plan are, within certain limits, tax deductible (so the State is providing a substantial incentive to defer consumption and encourage retirement provision),
* the investment income and investment gains earned on the contributions to the pension plan are tax exempt (trading income and gains are usually taxable).
* the retirement benefit when paid out is subject to tax ( or in some jurisdictions part may be drawn as a lump sum without tax up to certain limits and the balance is taxable).

3. At the risk of stating the obvious, the tax regime of a particular jurisdiction will affect the design of Pillar 2 and Pillar 3 pension plans in that jurisdiction.

**B. Funding of DB benefits**

1. A DB benefit earned by an employee in respect of a particular year of employment will not come into payment until a number of years after it has been earned; for example, 30 plus years for benefits earned when an employee is aged under 30.

2. Once in payment, if in pension form, the pension will, usually, be payable for the life of that retired employee[[19]](#footnote-20). That retired employee may have a life expectancy at the time of retirement of 20 or more years.

3. To determine the contribution rates needed to finance one year’s accrual of DB benefit requires assumptions to be made as to how the future will unfold. The key assumptions include:

* how long any pension will be paid (ie how long will the recipient live from when the pension starts), and
* what rate of investment return will be earned on the contributions which are paid to the pension plan to finance the retirement benefit.

4. Using the key assumptions, it is then possible to work backwards to a measuring point from the projected amounts of retirement benefit to be paid out and the expected investment return to be earned on the contributions to determine:

* the present amount as at that measuring point (or valuation date) of those future retirement benefit obligations, and
* to compare that amount with the value, as at the same measuring point, of the assets set aside to fund those retirement benefits.

5. Some points to draw out are:

* the obligations to pay retirement benefits in the future can be categorised or described as the liabilities of the pension plan,
* the present amount of those liabilities as at a measuring point is the provision (often referred to as the technical provision) to be made in respect of those liabilities, and
* a discount rate used to discount those future payment obligations back to their present amount as at a measuring point.

6. An important point to draw out is that the discount rate chosen does not affect the amount of the instalments of the retirement benefits to be paid in the future. It is simply the yardstick to measure whether enough money has been set aside (the technical provision) to fund those benefits after making assumptions as to the future (including, for example, how long the recipients of the retirement benefits will live).

**C. Accounting for DB benefits versus accounting for DC benefits**

1. The common accounting standards used for US, EU and UK companies[[20]](#footnote-21) require, as at each balance sheet date, the surplus or deficit of a company’s defined benefit pension plans to be shown as, in simplified terms, an asset or a liability of the company in its balance sheet. The way in which contributions to a DB plan (and any deficit or surplus) are dealt with in the other elements of the accounts for the company are as specified in applicable accounting standard to which further reference should be made.

2. In contrast, if the pension plan is a funded DC plan, there is no balance sheet impact (in general), and the cost of the contribution is charged as an employment cost in the income statement for the accounting period in question.

3. In addition, accounting standards use the concept of “constructive obligation” where a customary practice (eg the regular giving of discretionary pension increases (which are not legally binding) can be required to be treated as if it were legally binding for the purpose of calculating pension costs in the income statement and the calculation of whether a provision is to be established in the balance sheet.

**D. Discount rates**

1. An obligation to make a payment of $100 in one year’s time:

* at a discount rate of 5%, requires just over $95 to be held today,
* at a discount rate of 10%, requires just over $90 to be held today.

2. The further into the future before the $100 is to be paid out the lower the amount to be set aside today. But, because of the effects of compounding, this can change the amount to be set aside today to vary dramatically. For example:

* at a 5% discount rate, if payment of $100 is to be made in just over 14 years time, just over $50 would need to be set aside today (as it is assumed to earn 5% (compounded) each year for just over 14 years).
* at a 10% discount rate, if payment of $100 is to be made in just over 7 years time, just over $50 would need to be set aside today (as it is assumed to earn 5% (compounded) each year for just over 14 years).

3. How the discount rate is set has, to put it mildly, huge financial implications for pension plans and plan sponsors.

4. **Table 1** below compares how the discount rate is set for DB pension plans in the four jurisdictions covered by this workshop.

**Table 1**

| **Jurisdiction** | **How determined** | **Notes** |
| --- | --- | --- |
| Belgium | 1.1 Prudent discount rate.  1.2 Derived from expected return on pension fund/insurance company investments OR high quality bonds OR a combination.  1.3 Legal maximum of 6% pa. FSMA (Belgium regulator) to consider prudent rate on a case-by-case assessment. | Under Belgian legislation transposing IORP II Directive, Article 13(4) |
| France | 2.1 Prudent discount rate.  2.2 Derived from expected return on pension fund/insurance company investments OR high quality bonds OR a combination | 2.1 Under French legislation transposing IORP II Directive, Article 13(4) for French IORPs  2.2 Not applicable to French Pillar 2 pension schemes (as pay-as-you -go – unfunded but not book reserve) |
| UK | 3.1 Prudent discount rate.  3.2 Derived from expected return on pension fund investments OR high quality bonds OR a combination.  3.3 Rate usually to be determined by plan trustee/fiduciary and employer. In default of agreement fixed by UK Pensions Regulator (no reported determination as parties usually agree given what Regulator may determine) | 3.1 Under UK legislation transposing IORP II Directive Article 13(4)  3.2 UK Pensions Regulator can challenge whether the discount rate is prudent and seeks to influence it. New Regulations (and a yet to be published Code of Practice seek to influence it further)[[21]](#footnote-22)  3.3 Currently unaffected by Brexit |
| USA | 4.1 For private sector employer plans specified in regulations (no discretion)  4.2 For collectively bargained plans covering more than one employer (multi-employer plans), must be reasonable and represent the actuary’s best estimate of anticipated experience  4.3 For governmental plans specified in applicable local law | 4.1 Internal Revenue Code and Regulations under it  4.2 Tax revenue incentive for Congress to keep discount rate higher as reduces deficit (and therefore tax deductible employer contributions) |

4. For accounting purposes, the way in which the discount rate is to be determined is specified in the applicable accounting standards:

* for Stock Exchange listed companies in Belgium, France and the UK, that accounting system is IAS 19, and
* in the US it is FASB ASC 715.

5. Under both sets of accounting standards, the discount rate must be derived, in general terms, from the yield, as at the balance sheet date of the accounts for the company in question, on AA credit rated bonds of corresponding maturities to the retirement benefit payment obligations of the DB pension plan.

**E. Surpluses and deficits: A reminder**

1. A surplus, as at a measuring point in relation to an ongoing DB pension plan, arises where;

* the present amount of the future retirement benefit obligations (calculated on the assumptions including how long members will live and the discount rate to be used),

is **lower** than

* the value of the plan assets available to meet those retirement benefit obligations as at the same measuring date.

2. A deficit, as at a measuring point in relation to an ongoing DB pension plan, arises where:

* the present amount of the future retirement benefit obligations (calculated on the assumptions including how long members will live and the discount rate to be used),

**exceeds**

* the value of the plan assets available to meet those retirement benefit obligations as at the same measuring date.

3. Where there is a mismatch between the discount rate used for funding purposes and the discount rate used for accounting purposes, it is possible to have:

* a DB pension plan which is in deficit for funding purposes, but
* is in surplus for accounting purposes,

and vice versa.

4. The cost of securing DB plan benefits on plan termination or winding up will also differ (absent serendipity) from the accounting provision or the funding provision for those benefits.

**F. Funding and security for members’ DB retirement benefits**

1. There is a very difficult judgment to be made as to the balance to be struck between the following aspirations:

* the highest level of retirement benefit,
* for the lowest cost, with
* the highest level of certainty (security) that the retirement benefit obligations will be paid in full as and when they fall due to be paid.

2. Insofar as contributions are tax deductible, the tax payer has “skin in the game”. Equally, those to whom the retirement benefit promise in the DB plan has been made, have a very keen interest in receiving payment of their retirement benefits in full.

3. Neither politicians nor regulators wish to have to deal with situations where the DB retirement benefit obligations cannot be paid in full[[22]](#footnote-23) which leads, among other things, to

* regulation of the funding of DB pension plans through a requirement for annual or tri-annual valuations to measure the “financial health” of the pension plan as at that measuring point and deficit recovery contributions,
* constraints on how the assets of the DB pension plan may be invested, and
* passing the parcel to employers in many jurisdictions to underwrite the obligations of the pension plan to pay the DB benefits if there are insufficient assets, and
* regulators regulating, where they have power or influence to do so, funding to protect themselves rather than to promote the provision of DB retirement benefits.

**G. The investment of DB plan assets**

1. There is a tension in both the regulatory rules on funding DB pension plans and the accounting rules between:

* avoiding having a deficit at any periodic valuation or measuring point (or where the DB pension plan has to be wound up), and
* the DB pension plan assets being invested with time horizons which reflect the time horizons of the retirement benefit obligations (and pension plans being seen as long term investors of “patient capital” with the opportunity to earn superior risk adjusted investment returns by harvesting an “illiquidity premium”.

2. Furthermore, there is an inherent tension between the way, as at each balance sheet date every year, the accounting surplus or accounting deficit in the pension plan affects the balance sheet of the sponsoring employer.

3. This leads, or can lead to, investment strategies that seek to achieve an investment return (and asset valuation as at a valuation date) which is in alignment with the way the discount rate is calculated.

**H. Investment of the plan assets**

1. The prudent person rule applies as the qualitative standard for investing plan assets in Belgium, France and the UK (see Article 19 of the IORP II Directive as transposed into member state/UK law). There are some additional elements of specificity also to be found in Article 19 including restrictions on borrowing and the purposes for which derivatives can be used.

2. One of the requirements of Article 19 is that:

“ *the assets shall be invested in the best long-term interests of members and beneficiaries as a whole. In the case of a potential conflict of interest, an IORP, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries;*”

3. In the US the prudent person rule also applies and is specified in the Employment Retirement Income Security Act 1974 as amended (“**ERISA**”) , Section 404(a):

“ *(a) Prudent man standard of care*

*(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a*[*plan*](https://www.law.cornell.edu/definitions/uscode.php?width=840&height=800&iframe=true&def_id=29-USC-3443497-854092651&term_occur=999&term_src=)*solely in the interest of the*[*participants*](https://www.law.cornell.edu/definitions/uscode.php?width=840&height=800&iframe=true&def_id=29-USC-767422259-854092655&term_occur=999&term_src=)*and beneficiaries and—*

*(A) for the exclusive purpose of:*

*(i) providing benefits to*[*participants*](https://www.law.cornell.edu/definitions/uscode.php?width=840&height=800&iframe=true&def_id=29-USC-767422259-854092655&term_occur=999&term_src=)*and their beneficiaries; and*

*(ii) defraying reasonable expenses of administering the*[*plan*](https://www.law.cornell.edu/definitions/uscode.php?width=840&height=800&iframe=true&def_id=29-USC-3443497-854092651&term_occur=999&term_src=)

*(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;*

*(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and*

*(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of [ERISA].*”

**Note 1:** Referred to as duties of loyalty, prudence, diversification, and to follow plan documents.

**Note 2:** US Department of Labor regulations specify that the duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors and not subordinate the interests of participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan. This standard is the regulatory core of the debate in the US regarding consideration of ESG factors in retirement plan investing.

**I. Liability driven investment and leveraged LDI of plan assets: Background**

1. The combination of the accounting rules and the fall in interest rates led many sponsoring employers with DB plans in the UK and the US to look at whether plan assets could be invested in a way which meant that the expected return on the plan assets mirrored the way the discount rate would be determined to calculate the present amount as at a valuation date of the plan’s DB estimated future benefit payment obligations.

2. If the asset value and the liability amount moved in harmony, then there would be no future deficits (and future benefit provision would be on a DC only basis). Investing plan assets in line with the way the discount rate would be determined is commonly referred to as liability driven investment (“**LDI**”).

3. If the plan was in deficit, then through the use of leverage, the pension plan could try to match the discount rate for all of its future estimated benefit obligations - leveraged LDI or **LLDI**- while seeking to generate a higher return on some plan assets to reduce the cost to the employer of making good the deficit (and reducing, if the strategy was successful, the plan’s dependency on the sponsoring employer).

4. This all went spectacularly wrong in the UK in October 2022. There is more detail in this paper:[https://www.durham.ac.uk/media/durham-university/departments-/law-school/pdfs/news-pdfs/Leveraged-LDI---Prudent-deficit-risk-manage-or-ultra-vires-speculation.pdf](file:///C:\Users\AUD\AppData\Local\Microsoft\Windows\INetCache\Content.Outlook\71ZIWYMX\ https:\www.durham.ac.uk\media\durham-university\departments-\law-school\pdfs\news-pdfs\Leveraged-LDI---Prudent-deficit-risk-manage-or-ultra-vires-speculation.pdf)

**J. Legal issues arising out of LDI and leveraged LDI**

1. The aim of the investment strategy is not to maximise risk adjusted investment return but to reduce the likelihood of future deficits for accounting and employer deficit make up contribution purposes.

2. This raises the issue whether a LDI investing approach is in breach of the duty of loyalty owed by the plan fiduciary to the plan participants. In this context the US Department of Labor has provided an opinion on the duty of loyalty point in relation to this strategy. See <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/advisory-opinions/2006-08a>.

3. In the UK there are a range of legal issues which are covered the paper referred to at **I4** above. However, it was outside the scope of that paper to discuss the corresponding duty of loyalty point as it applies in the UK. There is a question as to the extent of the plan trustee/fiduciary’s duty of care owed to the employer (as the first port of call to make good any valuation deficit). If the investment strategy is over cautious (“reckless prudence”), it can have a severe impact on the ability of the plan’s assets to generate an adequate investment return and on the strength of the employer covenant. And, an LDI investment strategy focussed on avoiding a deficit at an annual or tri-annual valuation date converts the long term investor of patient capital into an investor driven by a one year or three year time horizon.

4. Leverage LDI is not used in the US for a number of reasons including some tax reasons on unrelated business taxable income (“**UBTI**”). Leverage/debt-financed income is considered UBTI to the fund. UBTI is taxable at the US federal level at trust rates (top 37%), allocable and apportioned to states potentially resulting in state filing and tax obligations, and worst case excessive income from UBTI can result in the trust losing tax-exempt status.

**K. Interest rate changes in the period from January 2022 to December 2023 and their impact on the funding and accounting treatment of DB pension plans**

1. Discount rates do not affect the amounts of retirement benefits payable in the future. But they do affect the funding and accounting calculations.

2. Central banks lawfully rigged the interest market following the 2008 financial crisis to reduce interest rates to historically low levels (there were even negative interest rates in the Eurozone).

3. Where the discount rate is derived from the yield on high quality bonds, the present amount (technical provision) as at a valuation date of future payment obligations is increased (with both a funding impact and accounting impact on the employer balance sheet) unless a full LDI strategy is in place.

4. **Table 2** below shows the changes in the ten year government bond rate in the two year period from January 2022 to January 2024.

**Table 2**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Country** | **1st January, 2022** | **1st January, 2023** | **1st January, 2024** | **Interest rate in Column 4 ÷ Interest rate in Column 2** |
| Belgium | 0.55% | 2.93% | 2.79% | 5.25 |
| France | 0.31% | 2.69% | 2.74% | 8.84 |
| UK | 1.20% | 3.51% | 3.93% | 3.28 |
| USA | 1.76% | 3.53% | 4.06% | 2.3 |

5. If no, or a limited amount of, LDI was applied in relation to a pension plan, these dramatic increases in interest rates have led to a massive improvement in the funding of many DB pension plans.

6. However, in some cases surpluses have been replaced by deficits (even if asset values may be down substantially).

7. But some pension plans in the UK using LLDI ended up on the wrong side of a long/short carry trade with value destroying effects as noted in the paper at **I4** above.

8. Where there are these surpluses in DB plans, these are leading to a substantial increase in derisking/LDI/buy in or planned termination and buy-out of DB benefits with insurance companies.

**L. But a pay-as-you -go retirement benefit system avoids these issues**

1. In contrast, a pay-as-you -go retirement benefit system avoids the accounting, funding and investment issues outlined above while providing a DB form of retirement benefit.

2. This is discussed further, in relation to France, in **Annex A** albeit that there are other issues relating to the sustainability of such a system.

3. Though quite rare, a pay-as-you-go retirement benefit system is possible in the US through the ongoing purchase of immediate and deferred annuities, as the case may be, from an insurance company, however such an arrangement either must meet specific rules including that it is funded exclusively by the purchase of individual insurance contracts or meet generally applicable funding rules.

**ANNEX A**

**Overview of the French retirement system for employees**

**by Auriane Damez**

# French employee’s retirement system : principles

|  |
| --- |
| Pillar 3 |
| Pillar 2 |
| Pillar 1 |

* The first pillar is the mandatory social security plan : ‘pay as you go’ scheme. Salaried workers and employers contribute to this scheme.
* The second pillar is mandatory (also) inter-professional complementary retirement plan (AGIRC –ARRCO). This pension scheme is also financed on a pay-as-you-go basis.
* The third pillar includes all the supplementary pension plans undertaken by the employers and also all other options (for example for independent workers). Therefore, DB plans are in this pillar.

# Some figures : the modest part of supplementary pensions (Pillar 3) in French retirement system

* The supplementary pensions sector (Pillar 3) is growing but remains modest.
* In 2021,
  + 5.8% of contributions for all the retirement system (from the 3 pillars) finance supplementary retirement plans
  + less than 3% of the global pension comes from the optional system

Une image contenant texte, capture d’écran, ligne, Police

Description générée automatiquement

[rapport DREES, Les retraités et les retraités, edition 2023]

* Among the supplementary retirement plans, the most common plans are defined contribution plans and long-term savings plans. The defined benefit plans are less common.
* In 2021,
  + Only 8.8% of contributions to all supplementary retirement plans finance DB plans
  + DB plans provide only 14.1% of all supplementary retirement benefits.

Une image contenant texte, capture d’écran, nombre, menu

Description générée automatiquement

# Main rules about Pillar 3 on DB Plans in France

* Reform by Ordinance of July 3, 2019 (implementing the mobility Directive 2014/50/UE)
* For whom ?
  + Employers are free to determine the category of beneficiaries of these plans. However, in practice, DB plans are primarily implemented for executives. But the employer can set up DB plans conditional upon implementing, for all the employees a long-term savings plan (PERCO or PERECOL) or a mandatory plan (as a DC plan ; PER-OB)
  + Membership of the plan can be subject to:
    - A minimum seniority
    - A minimum period of contributions (In theory, the plan can be funded by employer and employee contributions. In practice, this plan is mainly financed solely by the company.)

The sum of these two periods cannot exceed three years.

* Which kind of benefit ? a lifetime pension annuity, from the retirement date (No lump sum except in case of death)
* DB must provide vested benefits
  + The member’s pension rights remain vested even if he/she leaves the company (vs the previous rule according with the DB pension rights were conditional upon the fact the employee retires from the company which provide the DB plan)
  + Rights are accrued each year
* How much ?
  + Pension rights must be calculated as a percentage of the annual pay slip of the year up to 3 per cent of this pay, capped to 30% if the beneficiary has several employers.
  + For corporate officers and all employees whose pay exceeds 8x the social security ceiling (46 368€[[23]](#footnote-24) x 8 = 370 944€ for 2024), the annual rights are accrued conditional upon professional objectives
  + The vested rights are revalued annually on the basis of a coefficient at most equal to the evolution of the social security ceiling
* DB Plan may only be offered by an insurance provider or an Additional Occupational Pension Fund (FRPS[[24]](#footnote-25)) regulated by the Directive IORP 2
* Financial rules to ensure rights to the beneficiary
  + Insolvency of the employer : In any case, the beneficiary has to receive “at least half of the old-age benefits arising out of the accrued pension rights for which he has paid contributions under a supplementary occupational pension scheme”. Employer has to contract with an insurance company which guarantees at least 50 per cent of the pension rights of each beneficiary in case of insolvency of the employer company
  + Therefore, each year, the insurer calls for a capital sum to build up the annuity.

# Further details

Further details will be covered in the presentation at Workshop 16.

1. But showing the limitations of this classification in the UK, for example, a personal pension scheme can be viewed as Pillar 3 but a “group personal pension scheme” which an employer arranges with a personal pension scheme provider (usually an insurance company) and to which the employer contributes in respect of its employees can be viewed as Pillar 2. [↑](#footnote-ref-2)
2. See, for example, the definition in Section 1 of the Pension Schemes Act 1993 (as amended). <https://www.legislation.gov.uk/ukpga/1993/48/section/1> [↑](#footnote-ref-3)
3. See, for example, the definition of “pension scheme” in Article 6(2). [↑](#footnote-ref-4)
4. See, for example, the definition of “pension plan” in the Employee Retirement Income Security Act of 1974, Section 3(2)(A) “any plan, fund or program...established ... by an employer ... to the extent that ... such plan, fund or program ... provides retirement income to employees”. <https://www.govinfo.gov/content/pkg/COMPS-896/pdf/COMPS-896.pdf> [↑](#footnote-ref-5)
5. Directive (EC) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institution for occupational retirement provision (IORPs). <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L2341> [↑](#footnote-ref-6)
6. See the IORP II Directive Article 6(1). [↑](#footnote-ref-7)
7. See the IORP II Directive, Article 2(2) (in particular Article 2(2)(c) (institutions which operate on a pay-as-you-go basis)) and Article 2(2)(e) (companies using book reserve schemes with a view to paying out retirement benefits to their employers) and Article 2(2)(a) (institutions operating social security schemes). [↑](#footnote-ref-8)
8. See, for example, the exclusion in Article 9(2) the Solvency II Directive (Directive 2009/138/EC) and also Article 4 of the IORP II Directive. [↑](#footnote-ref-9)
9. Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Insolvency II). <https://www.govinfo.gov/content/pkg/COMPS-896/pdf/COMPS-896.pdf> . [↑](#footnote-ref-10)
10. See the IORP II Directive, Article 15. [↑](#footnote-ref-11)
11. Association Générale des Institutions de Retraite des Cadres. [↑](#footnote-ref-12)
12. Association des Régimes de Retraite Complémentaires. [↑](#footnote-ref-13)
13. It is also possible to have an unfunded notional DC plan where the amount to be paid out by the employer at retirement is determined by reference to notional contribution amounts and the assumed investment return on those notional contributions by reference to a particular investment index or notional investment portfolio. [↑](#footnote-ref-14)
14. See section 414(i) of the Internal Revenue Code, 26 U.S.C. §414(i). [↑](#footnote-ref-15)
15. See section 414(j) of the Internal Revenue Code, 26 U.S.C. §414(j). [↑](#footnote-ref-16)
16. See, for example, the definition of “money purchase benefit” in the Pension Schemes Act 1993, Section 181. <https://www.legislation.gov.uk/ukpga/1993/48/section/181> [↑](#footnote-ref-17)
17. See, for example, the Pensions Act 1995, Section 34. <https://www.legislation.gov.uk/ukpga/1995/26/section/34/enacted> [↑](#footnote-ref-18)
18. In the US, employee contributions to a DB pension plan generally are not tax deductible. However, employee contributions made to governmental plans that meet specific conditions can be structured to be tax deductible. [↑](#footnote-ref-19)
19. Note, however, that, in Belgium, that an individual’s Pillar 2 retirement benefits are almost always paid out as a pension capital lump sum. [↑](#footnote-ref-20)
20. For EU and UK listed companies the accounting standard is IAS19. For US companies it is FASB ASC 715. [↑](#footnote-ref-21)
21. The Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024 which apply to valuation dates on or after 22nd September, 2024. <https://www.legislation.gov.uk/uksi/2024/462/made> [↑](#footnote-ref-22)
22. In the US, anticipated relatively imminent failures of a number of multiemployer pension plans led to passage of the American Rescue Plan Act of 2021 (ARPA), which included a provision allowing financially distressed multiemployer pension plans to apply to the Pension Benefit Guaranty Corporation (PBGC) for special financial assistance (that in total is expected to be approximately $90 billion in assistance over the 2022-2023 period). [↑](#footnote-ref-23)
23. Expressed as an annual amount [↑](#footnote-ref-24)
24. Fonds de Retraite Professionnelle Supplémentaire [↑](#footnote-ref-25)