ALLEN & OVERY

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The eurozone crisis:

corporate risk management for retirement benefits – a guide for contingency planning

Contents

Why read this guide?

The European Central Bank has promised to do 'whatever it takes' to support the eurozone but, despite positive moves in September 2012, the future remains unclear. Corporates operating across Europe will be affected if the uncertainty comes to a head and a member leaves the eurozone, or if it breaks up completely. Your corporate contingency planning to date may not cover retirement benefit issues: we'll help highlight the risks so you can assess your exposure.

This guide will help **corporate risk teams looking at eurozone issues** think about retirement benefit issues. It will also be relevant to **employers and anyone with responsibility for pension funds** or retirement benefit plans.

Preparing for a crisis isn't easy – for many it falls into the 'too difficult' box – but information is power: identifying your key risk areas will mean you can act promptly when it counts. No checklist can be comprehensive, and we can't offer all the answers, but we'll help you identify issues you need to investigate and areas where you need expert advice.

Pension arrangements vary in structure from one country to another, so some issues may be more relevant to you than others. It's a risk assessment exercise: looking at your liabilities from all angles, and analysing your overall exposure in different ways, will help you assess how vulnerable you are to the risks you consider most relevant to you. You can then drill down further to work out what protections are available.

What are the potential risks?

Currency break-up: in the most extreme scenario, the euro could cease to exist. A break-up of the current currency union could also occur if a weak member defaults (effectively where a state goes bankrupt) or a stronger member decides to leave to protect its own interests. Several stronger members could join to form a new bloc. Any break-up could have immediate and severe economic effects.

Euro exit: a country which exits the euro because of sovereign insolvency could also see its banking system collapse: the downgrading of the state's credit rating is likely to be mirrored for its banks. This could affect cash and bank deposits as well as the availability of funding. It could lead to downgrades for, and further defaults by, corporate entities. For any exiting country (even in the absence of default), there are complex legal questions around whether contracts with businesses in that country would remain in euros or be redenominated. You may need to amend key commercial and banking contracts to cover possible future contingencies.

Exchange controls: Exchange or capital control restrictions imposed to protect a weak currency may restrict cross-border transfers or make them much more onerous. They could trap cash and prevent access to capital. They could be imposed prior to a country exiting the euro. The extent to which you are affected will depend on the precise terms of the restrictions, whether any relevant contracts are expressly subject to the law of another jurisdiction than the exiting country, and whether any exceptions apply to outweigh any insulating effect of that choice of law.

Redenomination: any country which leaves the euro will introduce its own currency as the legal tender for payments in that state – for example, pensions would be payable in the new currency. Initial exchange rates for converting euros to the new currency would be fixed at the time of exit, but would be likely to diverge rapidly, moving up for a strong member or down for a weaker member, causing shifts in the value of assets and liabilities in that country. Payment obligations may no longer be met in the amount and currency you expect – since the value of any new currency may drop sharply, the value you receive could be much less than you bargained for. Would you accept payments in the new currency? You should seek legal advice on ways of insulating key contracts as far as possible.

Issues for employers

Pension structures vary widely across Europe. Pensions may be provided, for example, through state-operated mandatory arrangements, through insurance-type arrangements, through funded vehicles linked to the employer, or through unfunded book reserves. The degree of risk to the employer – or to the provider – from eurozone turbulence will vary accordingly.

In Germany, for example, most pension savings are held in insurer-provided vehicles, so the insurer has liability for providing benefits and for funding any guaranteed rate of return. It's important to check the precise wording of any contractual promise to assess whether you might be liable for any gap between what the insurer pays out and the amount promised. If the insurer can't make payments because of redenomination, or exchange or capital controls, or if it fails completely, would liability revert to you as the employer?

Similarly, as a result of low interest rates, insurers in Belgium are struggling to match the mandatory minimum return guarantee due by employers in defined contribution arrangements, which may expose employers to additional liabilities in the future.

The use of book reserves is common in Germany, in which case there are no investments to monitor – just a promise to be met from future cash flow. Is there a risk that cash flow might not be sufficient to pay pensions as they fall due?

Lump sum payments

Employers need to consider how they provide for any lump sums payable to staff on leaving service, such as long service awards or retirement indemnities. You may think this is the least of your problems, but you need to be covered in the event that mass redundancies have to be made. Has sufficient funding been set aside, or might you be faced with a cash call that is difficult to meet? Are there any penalties or reputational risks if you can't meet those obligations? The impact here will vary from country to country.

In France, if an employer has to dismiss workers for economic reasons, it will generally not be liable for retirement indemnity payments to those workers unless it has previously made specific commitments in this respect.

In the Netherlands, employers must ensure that all premiums are paid up to the end of employment but will have no additional financial obligations.

Spanish employers are required to externalise their pension commitments (including retirement awards) through insurance to guarantee the payments.

Liability and accounting issues

If your pension fund is based in a country which benefits from the ECB's programme of outright monetary transactions (OMT – bond-buying, subject to the imposition of fiscal conditions), liability values may be affected. UK pension plans which were in deficit before the Bank of England's programme of quantitative easing – the UK equivalent of OMT – have seen liabilities increase significantly as the price of bonds increases, bringing yields down. Some countries have allowed pension funds to adjust their funding requirements to take account of historically low gilt yields, but this is not currently the case in the UK. What impact would any similar effect from OMT have on funding requirements? Forthcoming changes to IAS19 could in any case make balance sheets more volatile: how might this affect your corporate accounts?

Other issues

Even basic issues like paying wages could be difficult in some circumstances: you might end up with a mismatch between the currency in which wages need to be paid, and the assets you use to pay them. You could aim to match income-producing assets with the liabilities in each jurisdiction to reduce the risk of a liquidity crunch. On the other hand, until a crisis point is reached, you may wish to sweep cash more frequently from countries which are considered to be at risk, to limit the risk of loss. You should also consider how your payment systems will cope with any currency redenomination.

Issues for pension funds and trustees/managers

Sponsor strength

If you look after a pension fund, how exposed is your pension fund sponsor to a collapse in the euro? Does that pose a risk to the fund, or to member benefits? Does the sponsor have key markets in countries which are particularly vulnerable to the crisis? Has it carried out its own risk assessment?

Trustees of defined benefit pension funds in the UK are required to monitor the strength of the employer covenant. That includes understanding the current and prospective financial position of the employers supporting the pension fund, including the scale of pension obligations compared with operating cash flow; the nature and health of the relevant industry sector and the employer or group's position within that industry; the position of the economy as a whole and an estimate of where the pension fund might stand in the event of an employer becoming insolvent.

How often does the pension fund get updates on the strength of the sponsor? How dependent is the sponsor on intra-group arrangements such as loans or guarantees – could it be affected by a problem elsewhere in the group? Are there triggers in place for additional reporting or funding in the event of changes in the sponsor's financial position? How important are local subsidiaries to the overall strength of the group, and do any subsidiaries face particular economic risks?

Paying pensions

Think about managing cash flows, distinguishing between the short-term cash flow you need to pay pensions, and income from your investments which may need to be safeguarded. If you hold too little cash to pay pensions, you could be hit by a liquidity crunch where the pension fund has insufficient cash reserves to pay pensions: income-producing assets in the same jurisdiction as your payment liabilities could help you to mitigate this risk.

Safeguarding investments and returns

For investment returns, regular sweeping or conversion of cash to a 'safe' currency might help offset the risk of holding cash in the 'wrong' currency in the event of bank defaults.

Some risks which are currently hedged – for example, payment streams in relation to longevity risk – could potentially become unhedged if the derivative investment underlying the hedge is redenominated or becomes unenforceable.

Remember that the value of local assets might not only be redenominated, but might also decrease sharply. For example, if you own real property in a country which goes into a sharp recession following an exit from the euro, any rents might be payable in the new currency (and so might be worth much less than you expected to receive) – but you may not have any tenants to pay the rent anyway, if businesses cease trading. A review of your investment portfolio will help you check that your investment risk is as diversified as you think it is (or as you might like it to be).

Assets and contingent assets

If the fund has security over particular assets (for example, under a contingent funding arrangement), could eurozone events compromise the enforceability of that security and the potential value of the underlying assets? Review any existing funding guarantees: what currency is the guarantee given in, and what events could trigger a call on the guarantee? Could the value of the guarantee be prejudiced by a redenomination? Is the guarantor itself at risk?

If funding arrangements depend on an assumed income stream from particular assets (for example, under an asset-backed contribution arrangement), is that assumption still valid? What back-up arrangements are in place if the income stream fails?

The wider picture

Remember that your funding assumptions and investment strategy need to be monitored in the light of changing economic conditions. National funding regimes may dictate how flexible you can be in response to events: do you know what the rules are for your pension fund?

Have you spoken to the fund's sponsor about what its contingency plans are in the event of a eurozone collapse? It's important to ask the question and feed that information into your own planning.

Equally, if you use third party administrators to administer benefits, have you checked what plans they have made to deal with a crisis – for example, if pressure on banks means that payments slow down or their own suppliers fail? Will pensions still get paid? Will you be able to communicate with members? What back-up procedures do you have in place, in the event of provider failure?

Investment and banking issues

How well do you know your pension fund's investment profile? Do you have key investments which could be directly affected by a break-up of the euro, or by a country exiting the eurozone? Your investment managers should be able to give you a detailed assessment of the risks in your current investment profile, and ways of limiting those risks. You need to slice your total risk in different ways to ensure that it is capped at appropriate levels in each case.

For example:

- What are your exposures in **key markets**? Some euro-denominated investments could be redenominated into the new local currency of an exiting state, and exchange controls could prevent you selling those investments or moving local assets in the immediate aftermath of an exit and redenomination. It may be possible to insulate key investments from those risks, but you need expert analysis to determine how much protection you can gain.
- What are your exposures to **key counterparties**? Do any of those counterparties appear vulnerable? Is any risk mitigation possible to offset counterparty credit risk? When Lehman Brothers failed, some pension funds discovered after the event that they had a wider range of exposures to Lehmans than they thought – not only as a direct counterparty, but also through a range of other arrangements such as swaps/derivative contracts, stock-lending, collective investment schemes, brokerage and cash deposits, increasing the overall aggregate exposure.
- What are your exposures in **key countries**? For example, the value of investments in a country which leaves the eurozone could be directly affected by a redenomination into local currency. This effect could be magnified if the impact on the economy of that country generally is that revenues or capital values decrease.
- Do you have any **key risks** that would be left unhedged if any derivative contracts collapse? You will need to check, for example, termination events and events of default in your master agreements to assess the likelihood of exposure, as well as reviewing the overall risk picture underlying those agreements.

If your pension fund has granted collateral for a derivative or swap contract in the form of government or bank bonds which are redenominated, or cash deposits where the currency is blocked, that could lead to margin calls. The value of the collateral may also be reduced if the issuers of bonds are downgraded. Conversely, you may need to make margin calls in relation to collateral you have received. You need to be aware of your agreed terms on the nature and liquidity of the assets posted as collateral; the enforceability of that collateral; the margin between the collateral value and the collateralised liability, and the frequency with which collateral is posted, to assess your exposure.

If a country defaults, it's possible that its banks will collapse too. Have you calculated your exposure if cash deposits are devalued in the countries which are at highest risk, for example for group entities which are funded locally? Are you insulated against any interruption in cash flow if exchange controls are introduced?

Is your investment strategy sufficiently diversified to cope with market volatility? This is an issue at pension fund level for defined benefit arrangements, but a reminder of the importance of diversification would also be valuable for defined contribution members who are responsible for their own investment choices.

Insolvency protection: what happens if an employer or insurer fails?

EU law requires a protection mechanism to be in place to secure employees' retirement benefits (though not necessarily in full) if their employer becomes insolvent.

The UK, for example, has implemented this requirement by setting up the Pension Protection Fund (PPF), whose remit is to compensate members of defined benefit pension funds up to specified limits if all employers standing behind the pension fund become insolvent. The PPF is funded by levies on employers of pension funds which are potentially eligible for this protection. Those levies look set to increase year on year, partly as a result of depressed gilt yields in the wake of the financial crisis.

Similarly, the German Pensions-Sicherungs-Verein aG (PSV) guarantees pensions up to a cap (for most employees this covers 100% of their pension). Employers help to finance the PSV via a levy, which has become volatile in recent years as claims have risen.

Across much of Europe, pension funds are commonly insurer-held, so that employees' benefits should not be threatened if their employer becomes insolvent. However, there's a risk that some insurers could fail if there is a collapse in the value of their investments. You need advice on what protection mechanisms support your principal insurer in this scenario, and any caps or other restrictions on compensation payable. For example, is your provider ultimately backed by another insurer; and, if so, does that affect the availability of any state protection mechanism?

The level of protection available may depend on the nature of the investment and the name in which it is held. In the UK, for example, an aggregated cash fund for additional voluntary contributions held with a bank or building society could be subject to a single claim compensation limit under the Financial Services Compensation Scheme, whereas accounts in the name of individual investors could be compensated separately.

In Spain, by contrast, there is no guarantee fund to provide compensation in the event of insurer insolvency, though some protection is available to the holders of insurance contracts if the liquidation is carried out by the Insurance Compensation Consortium.

You also need to consider systems and administration issues in the event that your insurer fails or is subject to exchange or capital controls: has it done its own contingency planning to ensure that pensions will still get paid? What if redenomination causes a currency mismatch? Follow this up with your provider to ensure that they are prepared.

Liability for retirement benefits may rest ultimately with the employer, with insurance simply being a way of securing payment of the promise. If the insurer fails, the employer may still be liable for the payments promised. Co-insurance with a back-up insurer, particularly for key benefits, could reduce this risk if you are unsure about the stability of your current provider, but you need to consider how this might affect any state protection mechanism which pays out on a 'last resort' basis.

In Belgium, legal proceedings have been started between employees and their (former) employers as a result of the forced liquidation of a failing insurance company. The main question in these proceedings is whether, and to what extent, the employer bears ultimate liability when the insurer - with whom an employee benefit plan has been insured - fails. It is now being publicly debated whether additional measures are needed to improve the safety of the Belgian occupational pension system for the benefit of employers and/or employees.

Remember, if you need to act urgently in response to events in Europe, you won't be alone. There will be pressure from all sides on investment and asset managers as employers and pension funds scramble for safety. Good advance planning, so you know precisely what action you want to take, will be key to getting the best result.

This isn't a one-off exercise: the picture could change swiftly. You may perceive current risks in one way today, through the prism of current expectations about possible exits, but a changed contingency – total break-up, or a strong euro member deciding to leave – could radically alter the picture. You need to consider all eventualities, both now and on an ongoing basis. Setting up a crisis working group which can be convened quickly may help you keep track of all the issues so that you can act swiftly when required.

A checklist of the key questions to ask on any contract, to see how far you are protected from the risks you have identified, is available in The euro: the ultimate crib, a guide from Allen & Overy's Global Law Intelligence Unit.

Our pensions, investment, insurance and banking experts will be happy to discuss any of these issues in more detail, including recommended next steps.

Allen & Overy's Global Pensions Practice brings together lawyers with pensions expertise from our offices around the world. At local level, we advise clients – including companies, pension plan fiduciaries and national governments – on pensions issues relating to plan design, compliance, cost management, funding, investment and tax as well as the consequences of restructurings, terminations and corporate transactions. Working together with our banking, investment and regulatory colleagues, we can bring you the global overview and local detail you need in rapidly changing times.

You can contact members directly using the details in the attached contact card.

Key contacts

If you require advice on any of the matters raised in this document, please call any of our partners or your usual contact at Allen & Overy.

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