Outsourcing pension obligations from the German and international balance sheet

For primarily historical reasons, the majority of occupational pension provisions in Germany still take the form of a pension commitment. These obligations not only appear as reserves set aside (book reserves) for pensions on the employer's tax balance sheet, but also on the commercial balance sheet as well as in annual financial statements according to international accounting standards.

Previously pension commitments were an attractive way for many employers to implement occupational pension schemes within their companies. Book reserves on the tax balance sheet led to tax deferral effects and thus additional equity. Since the accumulation of financial resources for funding pension obligations is voluntary, older pension plans are frequently underfunded. Furthermore, favourable tax deferral effects have significantly declined over the years due to the gradual reduction of corporate tax rates.

Challenge: demographic trend
Although most of the older defined benefits pension plans have since been closed and are not available to newly hired staff, they still pose considerable planning and financial risks.

Such plans are normally characterised by ageing populations, i.e. a growing number of retirees and ever fewer active employees. The active employees therefore have to generate the profits needed to pay the retirees' pensions and for longer than was initially assumed.

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What are the implications for employers?
If "tax savings" have not been used to build up earmarked funds for pension payments, the company must maintain sufficient funds from other sources to meet its pension obligations. Expected pension payments must therefore be taken into consideration in liquidity and investment planning. However, the development of pension payments is extremely difficult to forecast, as many different parameters outside the scope of the company's core competencies need to be considered. Parameters that are crucial for predicting of future pension payments include:

- **Longevity**
  Although mortality tables published by specialised institutes are available for calculating life expectancy, a significant risk of a random or systematic deviation remains. The risk of miscalculation can entail considerable additional costs and increases as the size of the collective declines.

- **Pension indexing in accordance with German labour law (Occupational Retirement Provision Act)**
  Pensions based on pension plans established before 1999 include the minimum adjustment according to the consumer price index for Germany and the development of net wages every three years. These uncertain future increases are not included in the calculation of book reserves for tax balance sheets according to the valuation principles of Section 6a of the German Income Tax Act (EStG). Reserves for pension indexing can only be found in book reserves on commercial and international balance sheets if they have been expressly stipulated by the company.

  Neither the consumer price index nor net wages are easy to predict. If pension adjustments are not taken into account in the valuation of pension obligations, the future pension expense is even more difficult to calculate.

- **Claims for disability or death benefits**
  This is an uncertainty factor with possibly far-reaching consequences. Book reserves are initially related to the normal retirement age and are gradually built up until retirement. If a claim for pre-retirement benefits arises the book reserve must immediately be increased to the full cash value of the annuities due (disability or life-long dependants' pensions). This increase can easily amount to a multiple of the original book reserve. Such a sharp increase in book reserves can result in a severe cut in profits reinforced by the annuities to be paid out to the beneficiary. In the worst-case scenario, the company's liabilities can even exceed the assets.

Possible consequences of miscalculations
If the cash earmarked for meeting current pension commitments, annuity payments must be financed from the operating business and consequently burden the cash flow – possibly over several decades! This can lead to fatal side effects not necessarily associated with occupational pension schemes: misjudgement can hinder investment projects that may be crucial to the future viability of the company.

If in one year, but pension payments amount to 0.5 % of sales the same year the return on sales is only 2 %, the annuities suddenly cost 25 % of the profit!
The financial margin for investment projects is therefore noticeably limited.

Unequal valuation principles cause phantom profits
In addition to the effects described above, unequal valuation requirements for pension obligations on tax and trade balance sheets can have adverse effects.

While the interest rate to be applied to pension commitments according to Section 6a of the German Income Tax Act remains constant at 6 %, the interest rate to be applied for the valuation of liabilities on the commercial balance sheet is continuously adjusted in accordance with the German Commercial Code Sections 253 (1) to (3) of HGB. The HGB interest rate corresponds to the average market interest rate of the last 10 years. Due to the low interest rate environment cemented during this period, the HGB interest rate has fallen continuously and will only gradually increase again despite the fact that market interest rates have risen in the meantime. Therefore, pension accruals in the commercial balance sheet will continue to grow strongly.

The gap between both balance sheets has far-reaching consequences, including:
- Phantom profits as a result of undervalued pension obligations on the tax balance sheet – possibly with simultaneous loss under commercial law
- Decreasing equity ratio/increasing debt ratio
- At worst, liabilities exceeding assets

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The answer to these problems: outsourcing pension obligations to a pension fund

It makes sense to use the earnings of a profitable fiscal year to transfer pension liabilities to a pension fund. This way, all negative implications of pension obligations resulting from traditional pension commitments can be defused or even eliminated and additional advantages can be achieved, including:

- Elimination of risk of sudden changes to the balance sheet: non-operational risks (longevity, disability and death) are separated from the core business company's, managed by a professional pension provider and no longer affect the tax balance sheet.
- Creation of earmarked pension assets based on a professional calculation and professional competence in the management of biometric risks.
- Reversal of negative impacts of phantom profits to achieve a profit reduction corresponding to the pension costs.
- Strengthening of the equity ratio and other key indicators such as return on investment and creditworthiness.
- Reduction of mutual pension insolvency insurance-costs (contributions to the pension insurance association "Pensions-Sicherungs-Verein auf Gegenseitigkeit – PSVaG") by about 80 %.
- Administrative relief: cost savings through outsourcing pension payments and pension management to the pension fund.
- Creation of plan assets: according to international accounting standards, assets invested in the pension fund are qualified as plan assets and can be netted against pension provisions.

Conclusion

Managing traditional corporate pension schemes is a complex challenge for companies, especially in terms of risk management, liquidity planning, cash flow management and the impacts on local and international balance sheets.

Outsourcing pension obligations to the pension fund rids the company of major non-operational risks and strengthens planning security and long-term balance sheet stability.

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