

Point of View



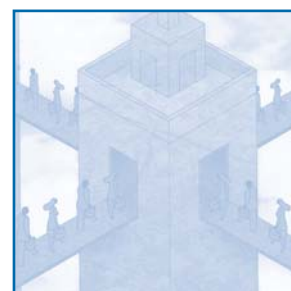
Preparing for a Pandemic:

Avian Flu and your Pension Plans

Author: Marc Duguay

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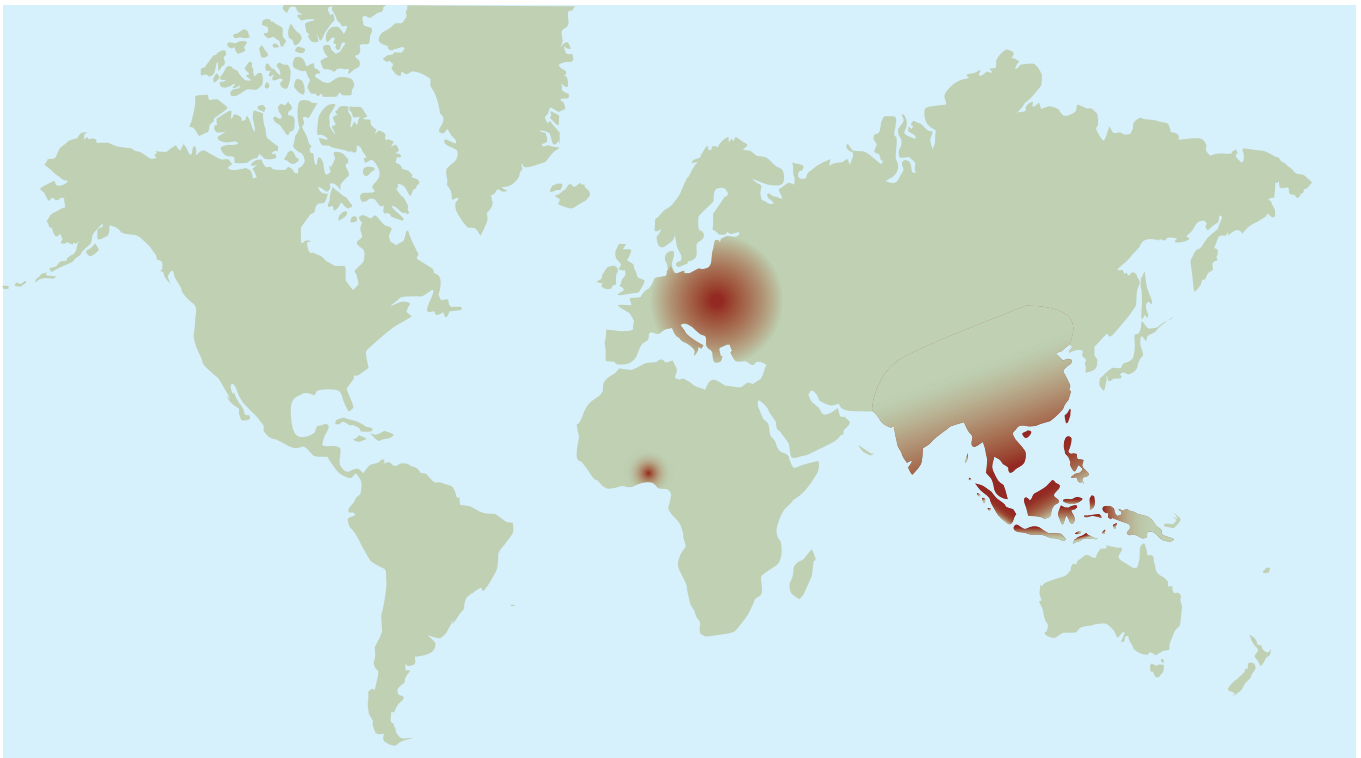
Introduction

One of the hot topics last year in the world of pension was the impact of increased longevity on pension plans' liabilities. Suddenly, avian flu turns the question around: What would be the impact of increased mortality and ill health on pension plans' sponsors?

There are great uncertainties about the timing, virulence, and general scope of a future human flu pandemic. The World Health Organization observes that "Best case scenarios, modeled on the mild pandemic of 1968, project global excess deaths in the range 2 million to 7.4 million. Other estimates that factor in a more virulent virus, similar to that responsible for the deadly 1918 pandemic, estimate much higher numbers of deaths."¹ Despite what most people believe, young adults were the worst affected group in 1918 rather than the elderly.

Others argue that "If we translate the rate of death associated with the 1918 influenza virus to that in the current population, there could be 1.7 million deaths in the United States and 180 million to 360 million deaths globally."²

A sudden surge in death rates would have different impacts depending on the pension plan design and its financing method and the overall uncertainty will make it hard to model simple scenarios. It could be that the increase in death rates comes as single surge or spike. It may, as in 1918, affect considerable numbers of young people rather than older. However, there could be scenarios where similar strains of flu become endemic over a period of years and lead to increased numbers of deaths among the old on a more continuous basis. We just do not know.



(Source: World Health Organization)

¹ World Health Organization, January 2005, "Avian Influenza: Assessing the Pandemic Threat."

² Michael T. Osterholm, May 2005, "Preparing for the Next Pandemic." New England Journal of Medicine.

Potential consequences of a sudden increase in mortality

The most significant liabilities for pensions around the world are in the form of payments at retirement or annuity payments during retirement, and often matched by significant assets. In these typical situations, the first effect could be to remove a large number of participants or members and so reduce liabilities. However, the full effects could be mixed.

For example, sponsors of unfunded lump sum plans (e.g. Japan and Turkey) pay a pre-defined amount upon retirement and, amongst other events, death. These organizations could face important cash outflows at a moment when the business might not be doing well.

Another case is when pension plans pay death lump sum benefits directly from the pension funds (e.g. UK). Most pension plans insure this risk and some larger funds prefer to self-insure. Faced with multiple deaths, the latter may experience deteriorating funding levels while the former would see increased insurance premiums. As mentioned above, higher death rates for current pensioners could also mean a reduction in pension liabilities, as would a significant number of deaths among those near retirement or among their spouses if they also have entitlements.

For a typical funded pension plan, the overall effects might be a long term reduction in liabilities after a short-term very difficult period.

Another short-term effect could be difficulty in staffing delivery of the administration and accounting of the flow of pension payments on which many in the population would rely. Administrative systems would need to be robust to the removal of a proportion of people in the same way as would apply to other payroll systems.

Potential consequences of a sudden increase in sickness and disability

Most pension plan designs give employees the possibility to retire before normal retirement age. Employees eligible to early retirement could take up this option if their health was badly affected by the

disease. Other employees might receive ill-health (disability) pension.

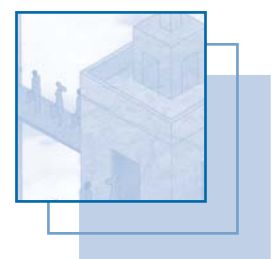
If pension plans offer generous early retirement or ill-health (disability) terms, this could significantly increase the organization's pension liabilities. This could also create staffing issues if too many employees take up early retirement. Organizations should be aware of their early retirement terms and conditions.

A significant increase in the sickness rates may also impact the waiver of premiums provided by some pension plans including defined contribution plans (e.g. Netherlands). A waiver of premiums is a provision that allows payment of insurance premiums / employee contributions to be permanently or temporarily stopped in the event the employee becomes incapacitated. This benefit is normally insured and premiums could increase as a result.

Potential consequences of a financial market downturn

One would hope that pension plan sponsors have learned the lessons of the financial market downturn at the beginning of this decade. However it is also worth noting that markets are often driven as much by anticipation as reality. The fear of an outbreak could be nearly as bad as the real thing – for example, triggered by an 'ordinary' global wave of flu.

The World Bank has warned of a global financial crisis in case of a pandemic which could cause a two percent loss of global gross domestic product (GDP), representing around US\$800 billion³ over a whole year. Equity and bond investments would suffer right at the moment when they would be called upon to pay benefits. Some people may remember the effect of SARS in 2003 on the Hong Kong stock market when it plunged by about 10% over a period of six weeks. Fortunately, the SARS outbreak was quickly contained and the economy recovered. An eventual avian flu pandemic could last one to two years and its effects felt well beyond. The effects could be a multiple of what we saw with SARS.



³ World Bank, November 2005, "East Asia Update".

The impacts of a financial market downturn on pension plans should be well known by now: increased contribution rates, higher accounting pension expense, larger deficit on organizations' balance sheets, increased industry guaranty levy (e.g. PBGC in the US and PPF in the UK), etc. Can your organization withstand these outcomes for a second time running? Have you taken appropriate measures since the last market crash?

Small pension plans are often insured or invest their assets in the general accounts of insurance companies. State guaranty funds would have to kick in if insurers failed, and no one knows how readily they could respond to the demand for payment of claims due. When was the last time you assessed the credit ratings of your providers?

Other disruptive effects

Even a random removal of individuals from the workforce could have some significant disruption. The issues are similar to other talent management problems where some organizations have discovered that encouraging the early retirement of certain key individuals has meant specific knowledge has departed the organization which cannot be replaced. One could therefore expect that within the overall economy any significant number of deaths would cause other random disruption as those individuals dropped out with very specific skills required to keep, for example, utilities networks operating or transport systems or indeed computer networks.

After the event

Specific events often cause a backlash both in terms of behavioral reactions, culture and new legislation.

It is widely known that the investment risk for defined contribution plans, most commonly known as 401(k) in the United States, is borne by the employees. However, a second financial market downturn in less than a decade can make insufficient levels of benefit provisions surface. Unhappy employees and unions could decide to put more pressure on organizations to increase contribution levels.

As we noted above, the liability side in some pension funds may also be very much an unknown although it could be reasonable to conclude that effects which might lead to say a 10% reduction in liabilities through deaths of members and pensioners would certainly cause huge financial turmoil and disruption which would have a far greater effect on asset values. Some defined contribution and cash balance plans also offer minimum investment guaranteed returns (e.g. Switzerland). These pension plans would likely show deficits again and demand higher contribution rates to their sponsors thus increasing costs.

Table1 illustrates the potential impact of some plan designs and sample countries where these designs are prevalent.

Table 1

Plan design	Potential impacts	Sample countries
Lump sum plans	Large cash outflows	Greece, Italy, Japan, Korea, Mexico, Taiwan, Turkey
Death benefits paid directly by the pension funds	Decreased funding level or increased insurance premiums	Belgium, UK
Funded plans	Decreased funding level and increased employer contributions	Canada, Ireland, Japan, Netherlands, UK, US
Minimum investment guaranteed return	Increased employer contributions	Austria, Belgium, Switzerland

How Mercer can help

Pandemic or not, the fact remains that pension plans operate in a more global and riskier environment. Organizations should ensure they know their pension risks, understand them and take sensible actions to reduce and mitigate these risks. This could include reviewing the plan design against the organizations' business objectives as well as introducing and monitoring global funding, accounting and investment policies. Are you comfortable facing your organization's key stakeholders (shareholders, employees, etc.) and telling them you are ready for a pandemic?

- Do you know how much cash your organization would need for pension-related issues over the next three years if mortality/sickness increases ten-fold?

Mercer can help you with projections of cashflows under different scenarios and include the results in your avian flu contingency plan.

- When was the last time your organization reviewed its pension plan design?

Mercer can help you review your plan design, identify potential risks and propose solutions to mitigate them while taking into account your business objectives.

- When was the last time your organization reviewed its investment strategy and who is responsible to monitor this?

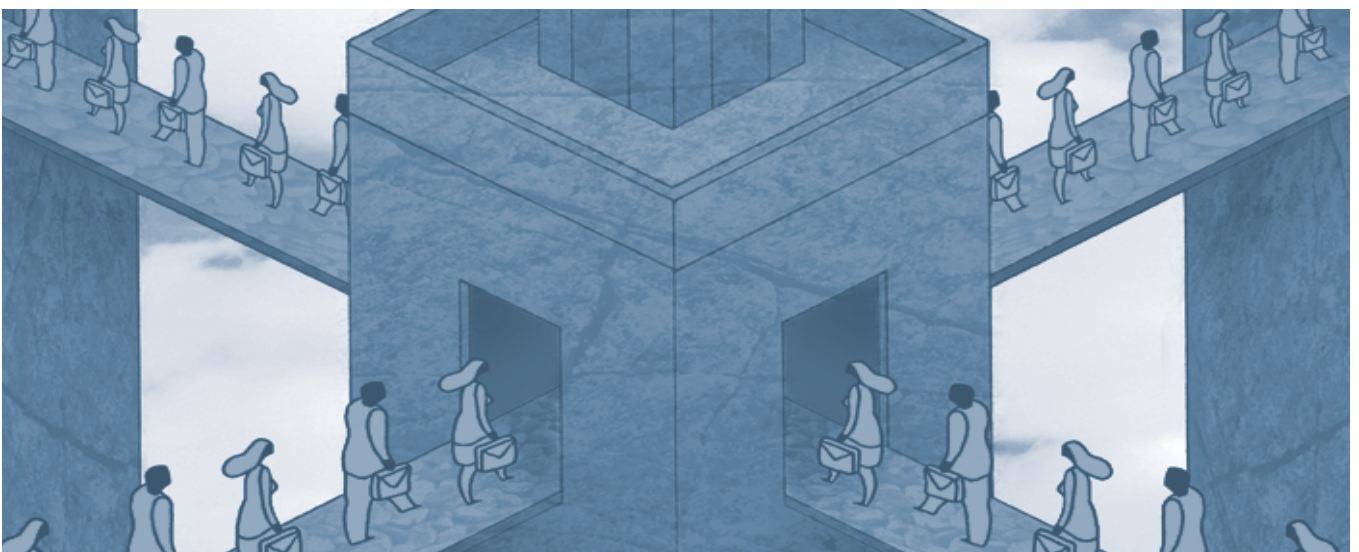
Mercer can help you review your investment strategy and propose solutions to better control investment risks while taking into account your business risk budget.

About Mercer Human Resource Consulting

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The company is a wholly owned subsidiary of Marsh & McLennan Companies, Inc., which lists its stock (ticker symbol: MMC) on the New York, Chicago, Pacific, and London stock exchanges.

For more information, Mercer can help you examine what measures your organization should take locally and globally to prepare for a pandemic. You can either visit Mercer's website at www.mercerhr.com/avianflu or email your questions to avian.flu@mercer.com.



Argentina	Malaysia
Australia	Mexico
Austria	Netherlands
Belgium	New Zealand
Brazil	Norway
Canada	Philippines
Chile	Poland
China	Portugal
Colombia	Puerto Rico
Czech Republic	Singapore
Denmark	South Korea
Finland	Spain
France	Sweden
Germany	Switzerland
Hong Kong	Taiwan
Hungary	Thailand
India	Turkey
Indonesia	United Kingdom
Ireland	United States
Italy	Venezuela
Japan	

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