Mega merger and mega pension liabilities

The recent proposal by the Government of India (GOI) to consolidate ten public sector banks into four large banks is expected to increase efficiency and reduce the cost of lending, but consolidations of such magnitude can pose several challenges. One such challenge that fails to attract the attention it deserves is the significant exposure to pension and other long-term employee benefit liabilities. **In case of these 10 PSU banks, the reported 'Defined Benefit' (DB) obligations represent over 85% of their total market capitalisation and the annual DB cost contributes almost 20% to the total net loss reported by these 10 banks in FY 17-18 and FY 18 -19.**

During a merger or an acquisition, pension and benefits related issues are often the big-ticket items with significant impact on the company's future financial viability. Therefore, a thorough due diligence is required to ascertain that the liabilities are not underreported and that the plans are sustainable in the long term. Before the pension plans merge, the amalgamated banks must undertake a complex review of their long-term liabilities to avoid unforeseen or unmanageable risks. These include a true and fair assessment of these uncertain obligations, which may give rise to significant risk in the future. Identifying and managing such risks early will enable banks greater certainty and confidence.

The consolidated DB liability of the 10 banks has crossed the milestone figure of One Lakh Crore as at 31 March 2019*. Due to the long-term nature of these retirement benefit plans, their liabilities are extremely sensitive to the assumptions. With bond yields declining globally and in India over the past couple of decades, the DB liabilities are only expected to rise, driving up the employee benefits expense and significantly impacting the banks' future P&L. For instance, even a 100 bps change in bond yields, could increase the aggregate pension costs for the year by INR 15,000 crores, causing a massive stress on the profitability of these banks.

While one may argue that the DB liabilities are well-funded and backed by assets, the following questions still need to be addressed:

- Are the liabilities currently reported accurate? For example, the future salary growth assumptions considered by almost all the 10 banks are in the range of 5-6% when actual increases may have been higher. Additionally, have the increases in Dearness Allowances and future pension increases been appropriately factored into the calculations? To demonstrate this, if we were to assume a higher future salary growth assumption of say 8% and a higher pension increase assumption, then the possible impact could be as much as INR 30,000 crores.
- Are the benefits sustainable in the long term? The ongoing cost of these schemes may continue to rise and have a high impact on the bank's overall costs. Now with declining interest rates and increasing life expectancy, how these DB Pension Liabilities are managed will be crucial to ensure that they are sustainable in the long-term.
- What risks do these plans pose to the long-term profitability of the merged banks? For example, what impact may future wage revisions have on the overall cost of these plans which are linked to final salary? What could be the impact if the Government were to increase the pensions in the future due to demands from employee unions?
- Whether the funds backing the liabilities are adequate and are the assets and liabilities appropriately matched?

To address these questions, it will be prudent to reassess the DB liabilities as part of the merger. In practice, such assessments require complex

calculations based on actuarial modelling taking into account several projections and assumptions related to economic and demographic factors which can be extremely uncertain in the long term. As such, proper consideration should be given in determining these assumptions and an independent assessment must be carried out when the opening balance sheet of the merged banks are created.

Assumptions should reflect the actual past experience of the merged banks. The merger provides an opportunity to undertake an independent detailed analysis on a much larger database, which can lead to more credible results. For example, the mortality experience of pensioners can be assessed and built into the assumptions. In addition, aspects like mortality improvements and future wage / pension revisions should be given due consideration when determining assumptions.

Further, as part of the merger process, there is an opportunity to consolidate the various retirement trusts into larger funds which can lead to operational efficiencies and offer better investment opportunities for the funds going forward.

As the government tries to set up robust next generation banks, concrete steps are needed to tackle this major long-term risk of retirement liabilities. Assessing the fair value of these liabilities and developing a plan to mitigate these risks should be a priority to create a cleaner balance sheet, thus fulfilling one of the key objectives of this merger. Driving down the 'Mega' lane, 'pension liabilities' is a much needed 'pit stop' to fix things and keep sight of the chequered flag!

**The article was first published in Business Standard on 24 January 2020.*

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