Vulnerabilities in Defined-Benefit Pension Plans

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Motivation

- An effective pension system is important for economic and financial efficiency
- 95 per cent of registered pension plan members in Canada are in a DB plan
- DB plans are under stress
- What are the fundamental reasons for this stress?

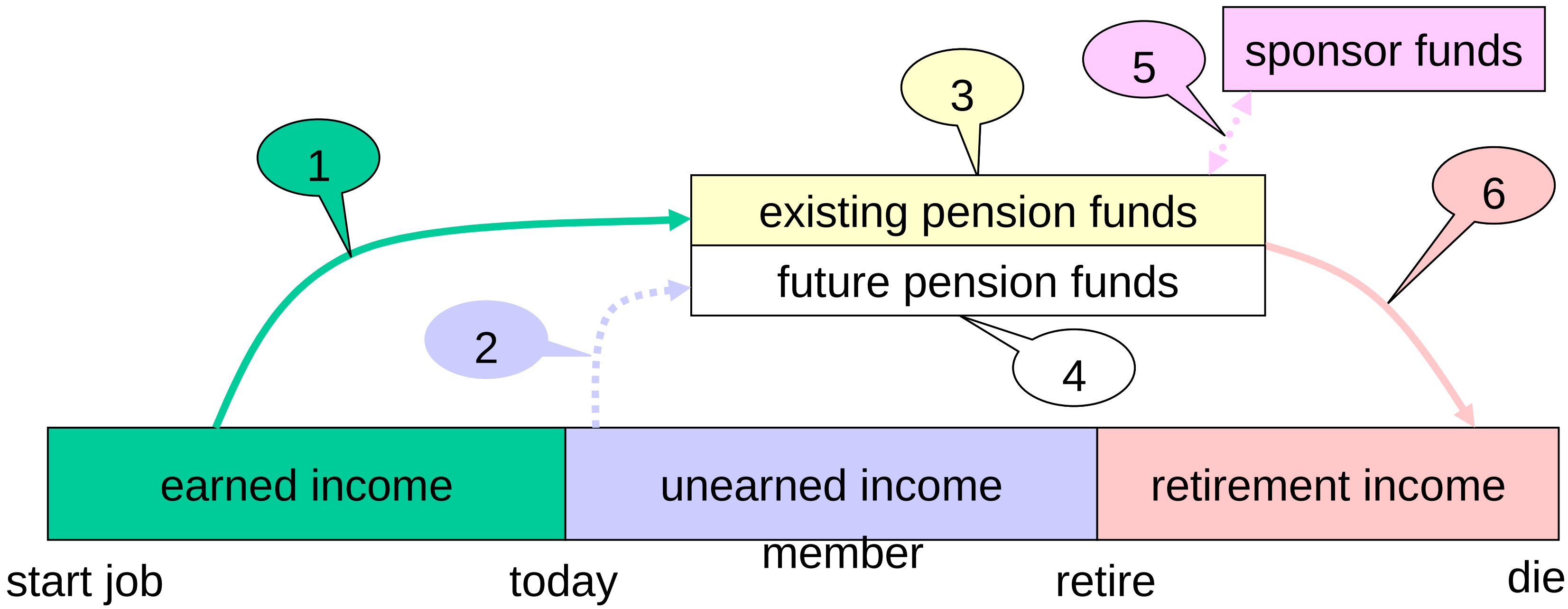
Proximate causes of the stress

- Increasing longevity of plan members
- Low long-term interest rates
- The vanishing equity premium

The fundamental cause of the stress

- DB pension plans are not well understood because of their complexity
- They have many interdependent elements
- Parties tend to take narrow perspective when dealing with changes in each element
- The result has been a series of marginal changes that combine to place an heavy burden on sponsors

The functioning of a DB pension plan



Economic Basics

- A contract between members and the sponsor
- Members earn their pensions
- The sponsor indemnifies the pension promise
- The pension fund is collateral for this promise
- The sponsor takes on pension investment risk
- Surpluses and deficits are outcomes of this risk
- Incentive alignment rewards the sponsor for this risk
- Two types of insurance: aggregate and idiosyncratic
- Regulation and supervision protects the collateral

Popular misconceptions

- Employers pay for part of DB pensions
- Sponsors can transfer risk to members
- The pension fund keeps the plan in balance
- A surplus means contribution rates were too high

Inappropriate restrictions on pension fund management

- The sponsor needs some control over the pension fund to manage the risk of the benefit guarantee
- Ambiguous ownership and limited access to surpluses weakens the incentive to deal with deficits
- Deficits motivate regulators to tighten rules and supervision
- The result is an increased regulatory burden on sponsors

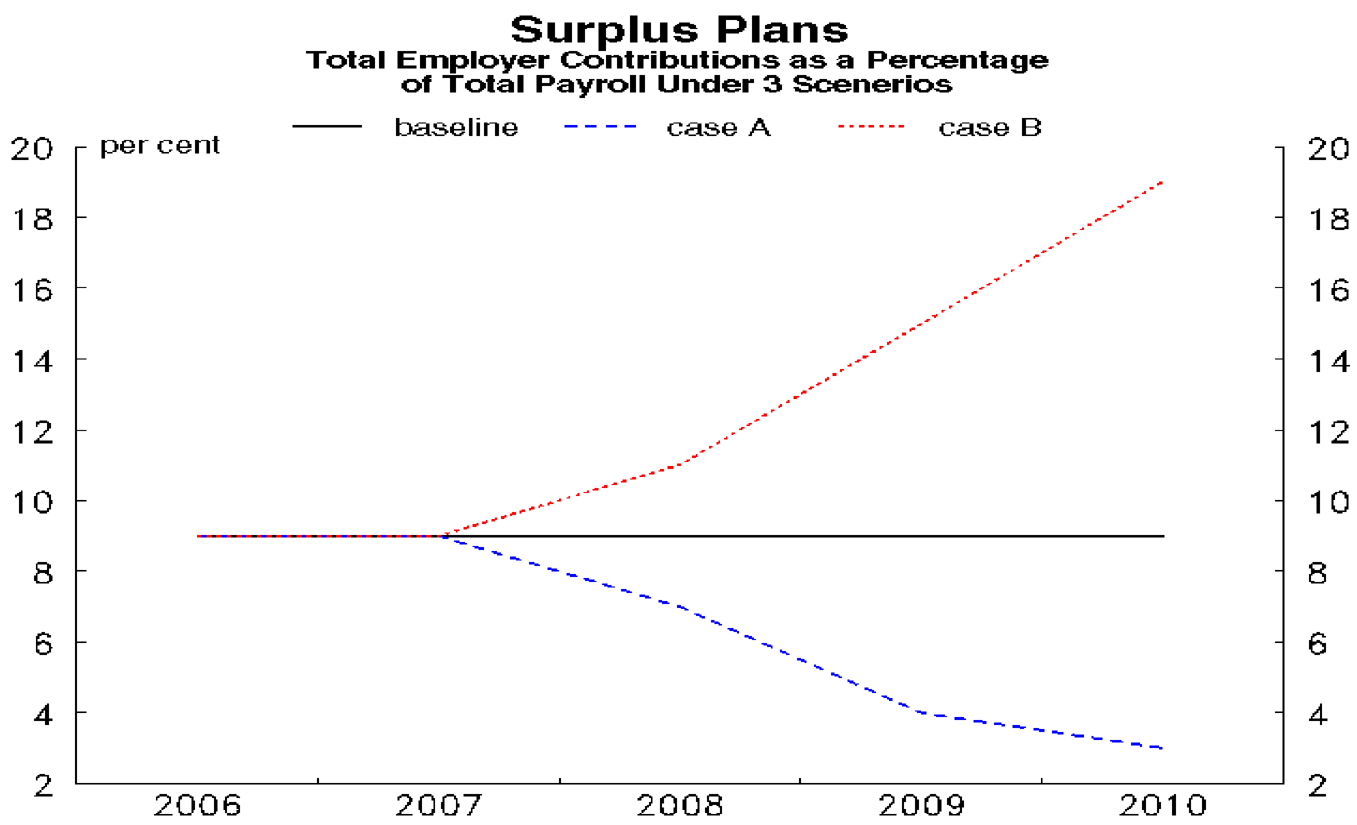
Inappropriate adequacy testing methodology for regulatory purposes

- Solvency <u>and</u> going-concern tests
- Solvency testing inappropriate for credit worthy sponsors
- Sponsors may have to inject money into the pension fund unnecessarily
- Sponsors may not get excess contributions back

Inappropriate pension accounting rules

- Market value (fair value) accounting rules improve accuracy but are sometimes inappropriate
  - Liabilities come due far into the future
  - Assets may be traded infrequently
- Pension liabilities can be contingent and therefore should not always be placed at full value on the balance sheet of the employer

Inappropriate operating practices



Inappropriate pension design

- Too much risk for small or highly concentrated sponsors to handle
  - Insuring an income stream that starts far into the future
  - Insuring an income stream that lasts a long time
  - Insuring against all possible shocks

Conclusion

- DB pension plans are complex and have interconnected elements
- Changes are being made in isolation
- The burden on sponsors is becoming unsustainable

Thank you