

Protection for Defined Benefit Plans

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April 28th 2005

Introduction

- Recent pension problems-rise in pension defecits
- Benefit Security back on the agenda
- Options / Responses include
 - funding rules
 - guarantee scheme
 - bankruptcy priority rights

Protecting against the risk of an insolvent plan sponsor with a DB scheme in deficit

Funding Rules

- One form of protection - make sure pension never underfunded
- Reforms in several countries - UK / US, Netherlands
- But can't always be 100% funded (assumptions, volatility, other regulations)

Important to combine with other protection measures

Pension Guarantee Funds

- **Arguments for**

- wage / pension trade off theory not reality
- diversification of risk not possible

- **Arguments against**

- Moral Hazard
- Adverse Selection
- Systematic Risk

Is Pension Benefit Insurance Prohibitively Expensive?

Pension Guarantee Funds

continued

- **Practical Problems**
- **How to ensure they work successfully**
 - Limited coverage
 - Properly priced premiums
 - Proper funding
 - ALM
 - Necessary Powers

If too expensive combine with other protection measures; implicit government subsidies do more harm than good.

Bankruptcy Priority

- Needed for same reason as guarantee schemes (lack of knowledge, diversification etc.)
- In practice pension creditors often rank with ordinary creditors
- Actuality may even end up at the back of the queue – pensioners become the ‘lost voice’ in work out process

Unpaid contributions should be given priority and make sure pensioners voices heard

OECD Guidelines on Funding and Benefit Security

- *1.1 Occupational pension plans should be funded. Private unfunded pay-as-you-go plans at individual company level should generally be prohibited.*
- *4.7 Funding rules should set out the different mechanisms permitted for correcting a situation of underfunding.*
- *4.8 Funding rules should aim to be countercyclical, providing incentives to build reserves against market downturns. Regulators should take market volatility into account when limiting contributions (or their tax deductibility) as a certain funding level is reached. Tax regulations should not discourage the build-up of sufficient reserves to withstand adverse market conditions.*

OECD Guidelines on Funding and Benefit Security

- **Guarantee Funds**

2.2 The establishment of an insolvency guarantee scheme should in general be required for occupational DB plans that are financed through the book reserve system

2.3 Insolvency guarantee schemes should rely on appropriate pricing of the insurance provided in order to avoid unwarranted incentives for risk-taking.

- **Bankruptcy Protection**

5.2 The legal provisions recognise the creditor rights of pension plan members and beneficiaries in the case of bankruptcy of the plan sponsor. Priority rights relative to other creditors should be required for due and unpaid contributions. Priority status may also be recommended for underfunded pension commitments (with reference to the terminal liability) that are the responsibility of the plan sponsor.