

Reforming Private DB Plans



International Organisation

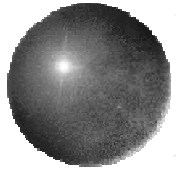


of Pension Supervisors



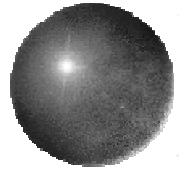
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Agenda

- ❖ Plan design reform (main topic).
 - ❖ DB actuarial funding methodology.
 - ❖ DB actuarial funding requirements.
 - ❖ DB pension fund investments
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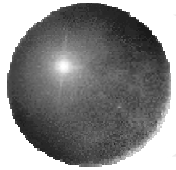


Problems with traditional DB plans

We all know the problems and we hopefully learned from mistakes made in 1990s.!!

- ❖ Everyone messed up on funding excesses (surpluses).
- ❖ Subsequent sharp declines in investment returns.
- ❖ Sharp declines in discount rates (especially if bond-based).
- ❖ Noticeable improvements in longevity.
- ❖ Influences of pension expensing standards.
- ❖ Etc, etc, etc...

Problems throughout private and public sectors, social security, legacy plans from privatization, etc...



Traditional DB pension plan

So, what do we mean by a “traditional DB pension plan”

- ❖ Benefit = function of “reference earnings” and years.
- ❖ Reference earnings = final-average, final, best-average, best, career-average, index career-average, etc...
- ❖ Pension usually payable for life.
- ❖ Often with a survivor benefit or minimum 5-10 year guarantee or cash refund annuity.

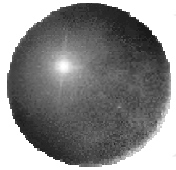




Alternatives being considered

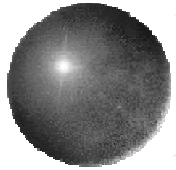
- ❖ Pure defined contribution plans.
- ❖ Defined benefit lump sum plans.
- ❖ Cash balance plans.
- ❖ DC plans with minimum guarantees.
- ❖ Other hybrid plans.





Pure defined contribution plans

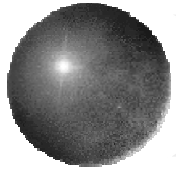
- ❖ Plan sponsor, accountants and most regulators are relatively relaxed.
- ❖ But, inevitably, cracks already beginning to show.
- ❖ Investments. What and how many choices?
Education re making good choices. Claims that traditional DB pension funds simply outperform.
- ❖ Forms of retirement payout; potential concerns.
- ❖ DC plans where the fund retains the annuity!!
Extra challenges for regulators!



DB lump sum plans

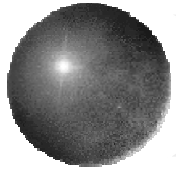
- ❖ Example = $20\% \times \text{final-average earnings} \times \text{years}$.
- ❖ As name indicates, benefit is paid as a lump sum.
- ❖ Often established to address concerns with traditional DB pension plans about gender equality, increased longevity, declining interest rates.
- ❖ Similar or identical to termination indemnity plans, although latter are less likely to be funded.





Cash balance plans

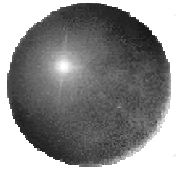
- ❖ Hypothetical account balance = accumulation of contributions + “interest credits”.
- ❖ Interest credit = fixed rate or variable rate tied to an index.
- ❖ Plan sponsor hopes to invest assets to outperform interest credits.
- ❖ If cash payout, similar or identical to notional DC plans, although latter are less likely to be funded.
- ❖ If fixed annuity conversion at retirement, similar or identical to traditional indexed career-average earnings DB pension plans.



DC with minimum interest guarantee

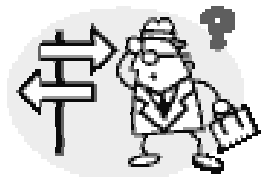
- ❖ In effect, from plan participant's perspective, better of cash balance and pure DC.
- ❖ From plan sponsor's perspective, a lose/lose situation.
- ❖ If minimum guarantee is zero, a fixed rate or similar formula, risk of encouraging conservative investments or pushing even large plans to insurance contracts.
- ❖ If minimum guarantee is a comparative performance rate, risk of encouraging herding.

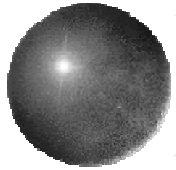




Other hybrid plans

- ❖ Better of pure DC and traditional DB.
- ❖ Floor plans: DB plan with unexciting DC minimum.
- ❖ Floor plans: DC plans with unexciting DB minimum.
- ❖ Nursery plans: DC at younger ages; DB at older ages.
- ❖ DB to salary ceiling; DC above.





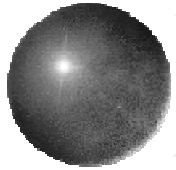
Actuarial valuation methodology

Traditional approach:

- ❖ Discount rate for liabilities = expected return.
- ❖ Asset valued at: market, smoothed market, etc...

Financial Economics approach..

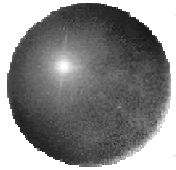
- ❖ Discount rate for liabilities = bond yield.
- ❖ Asset valued at current market value.



DB pension fund investments

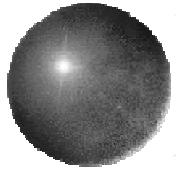
- ❖ Traditional approach = all assets classes, with appropriate asset mix determined by ALM studies, etc...
- ❖ Financial economics philosophy pushes fund towards (index-linked) bonds?
- ❖ Greater use of hedge funds, other derivatives (within constraints).





Regulatory funding requirements

- ❖ Some tightening where old standards weak.
- ❖ Some tightening in recent hard times.
- ❖ Some greater flexibility in recent hard times.
- ❖ Greater admissibility of letters of credit.
- ❖ Addressing asymmetrical treatment of funding shortfall and excess.



In conclusion

- ❖ Next few years will certainly not be dull or uncontroversial.
- ❖ Majority of the “reform” approaches have existed for decades.
- ❖ Many DB plans (especially legacy plans) need to be reformed.
- ❖ Other DB plans just need to be better managed, and in a positive regulatory environment.