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Risks and Returns for Defined Benefit & Defined Contribution Pension Plans

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Malcolm Hamilton
Toronto

MMC Marsh & McLennan Companies

From an employee's perspective, there are some obvious and some not so obvious risks of participating in a DC pension plan . . .

- the markets might perform poorly
- the employee might invest badly
- the employee might underestimate required savings due to
  - –underestimating retirement income
  - –long life
  - –forced early retirement
  - –inflation

Many of these risks can be managed . . .

- age-related asset mixes
- diversification
- education/advice
- annuitization

But there are no guarantees – sound strategies need not produce happy outcomes. Safe strategies often require significant sacrifice.

Risks that cannot be avoided or eliminated at an acceptable price must ultimately be borne. Losses can be addressed by

- saving more
- choosing more aggressive investments
- retiring later
- getting by on less

As employees age,

- their exposure to risk increases
- their ability/inclination to bear risk diminishes

When safe investments deliver poor returns, the elderly have nowhere to turn

While, in theory, employers with DC pension plans and employers without pension plans are not directly exposed to retirement saving risks, there is a hard-to-quantify indirect exposure . . .

- if relative returns are poor – the employer might be sued
- if employees contribute too little or invest poorly, the employer might be sued
- if employees can’t afford to retire at a reasonable age
  - the employer may be stuck with an angry old workforce
  - severance costs might explode

Moving to a DB pension plan usually creates, changes, eliminates and shifts risk

- Employees, in theory, no longer worry about
  - the performance of the capital markets
  - adequate savings rates
  - investment decisions
  - outliving their savings

But for employees DB plans create, often deliberately, new kinds of risk . . .

- forfeitures upon termination of employment or (sometimes) early retirement
- foregone benefits unless one retires early
- exposure to inflation
  - during employment
  - between cessation of employment and benefit commencement
  - after benefit commencement
- loss of benefits upon the winding up of poorly funded pension plans
- indirect exposure to poor market performance, as the plan sponsor looks for economies to counter the rising cost of the pensions

Finally, DB plans create many risks, some self-imposed, for plan sponsors . . .

- Economic risks
  - poor stock markets
  - declining interest rates
  - low inflation

Employer risks: DB plans

- Legal risks arising from new legislation and court decisions
  - requirements to improve benefit security
    - funding
    - PBGF
    - responsibility for deficits upon wind-up
  - requirements to improve benefits
  - loss of surplus upon
    - wind-up
    - partial wind-up
    - mergers & divestitures

Employer risks: DB Plans

- Collective bargaining risks
  - loss of surplus through negotiation/arbitration
- Changing standards:
  - actuarial
  - accounting
- Faulty design
  - handcuffs
  - early retirement incentives

As DB plans mature,

- benefits ratchet up in times of surplus
- retired populations increase relative to active populations
- assets/risks grow faster than the sponsoring enterprise
- unrecognized and unfunded costs can no longer be put off
- unmanaged and ignored risks can no longer be concealed

Today, many pension plans have some hard decisions to make . . .

- the pension fund needs to earn much more than the riskless rate to make the plan affordable, but
- the plan sponsor can no longer afford to take the risks required to earn these high returns due to
  - fiduciary responsibilities to members (i.e. don’t take undue risks)
  - risk of surplus forfeiture (when well-funded plans do “too well”)
  - inability of aging enterprises to bear risk, and/or to afford the cost of hedging it