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Risks and Returns for Defined Benefit & Defined Contribution Pension Plans IFID Conference

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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

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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.

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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

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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

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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

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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

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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

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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