Responding to Pension Challenges

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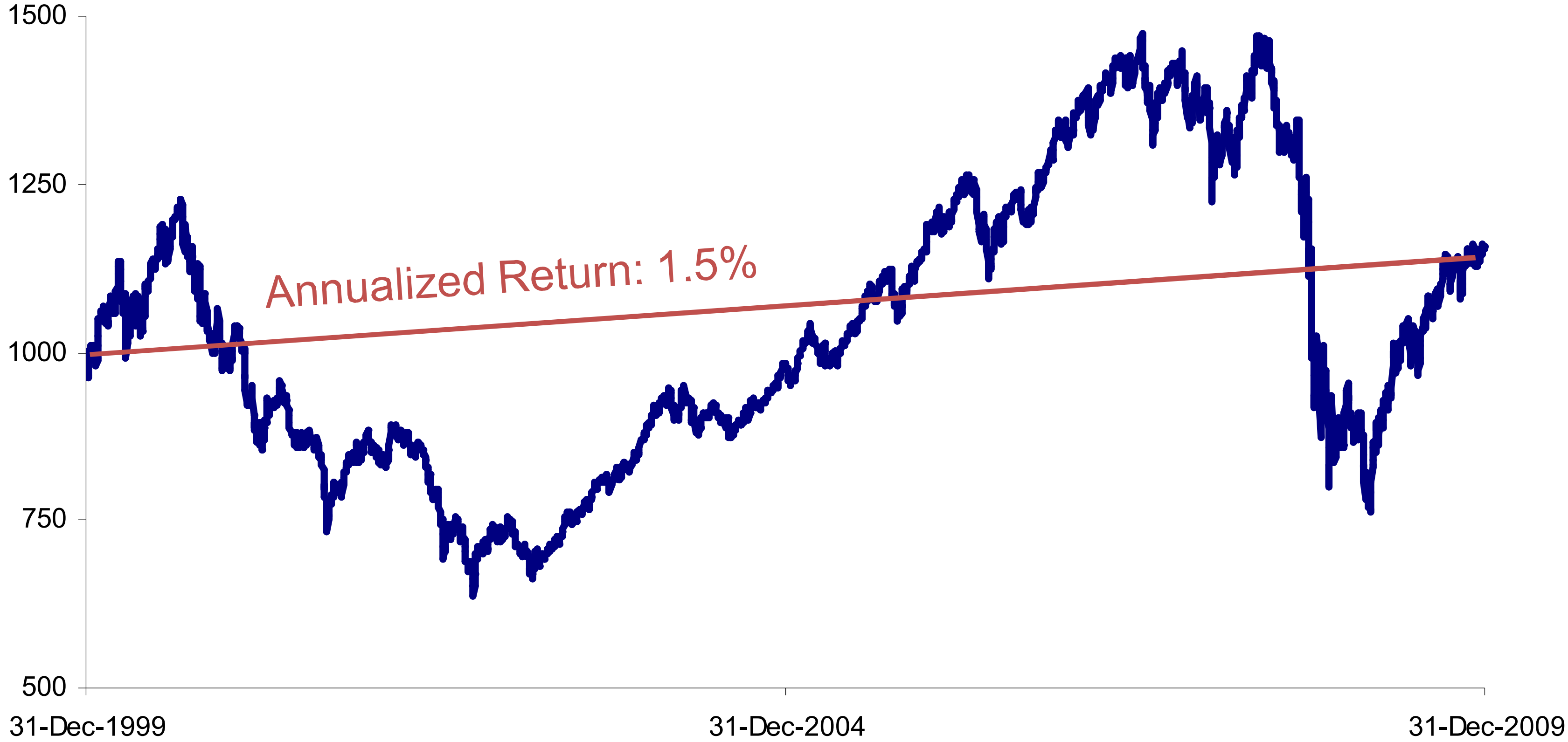
Overview

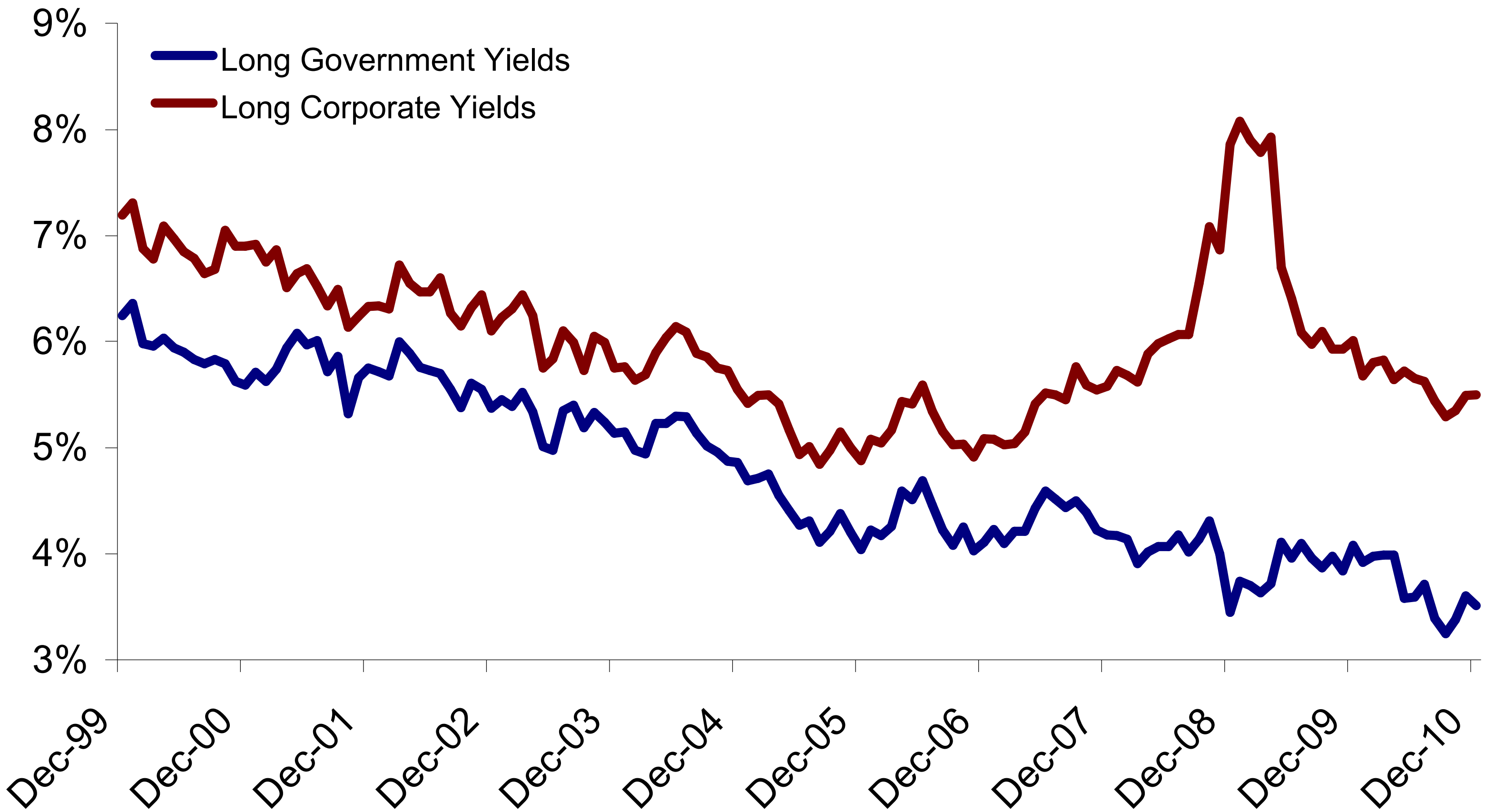
- Setting the Stage
- Lessons Learned
- How Organizations Respond
- Concluding Thoughts

Equity Markets in the 2000's: The "Lost Decade"?



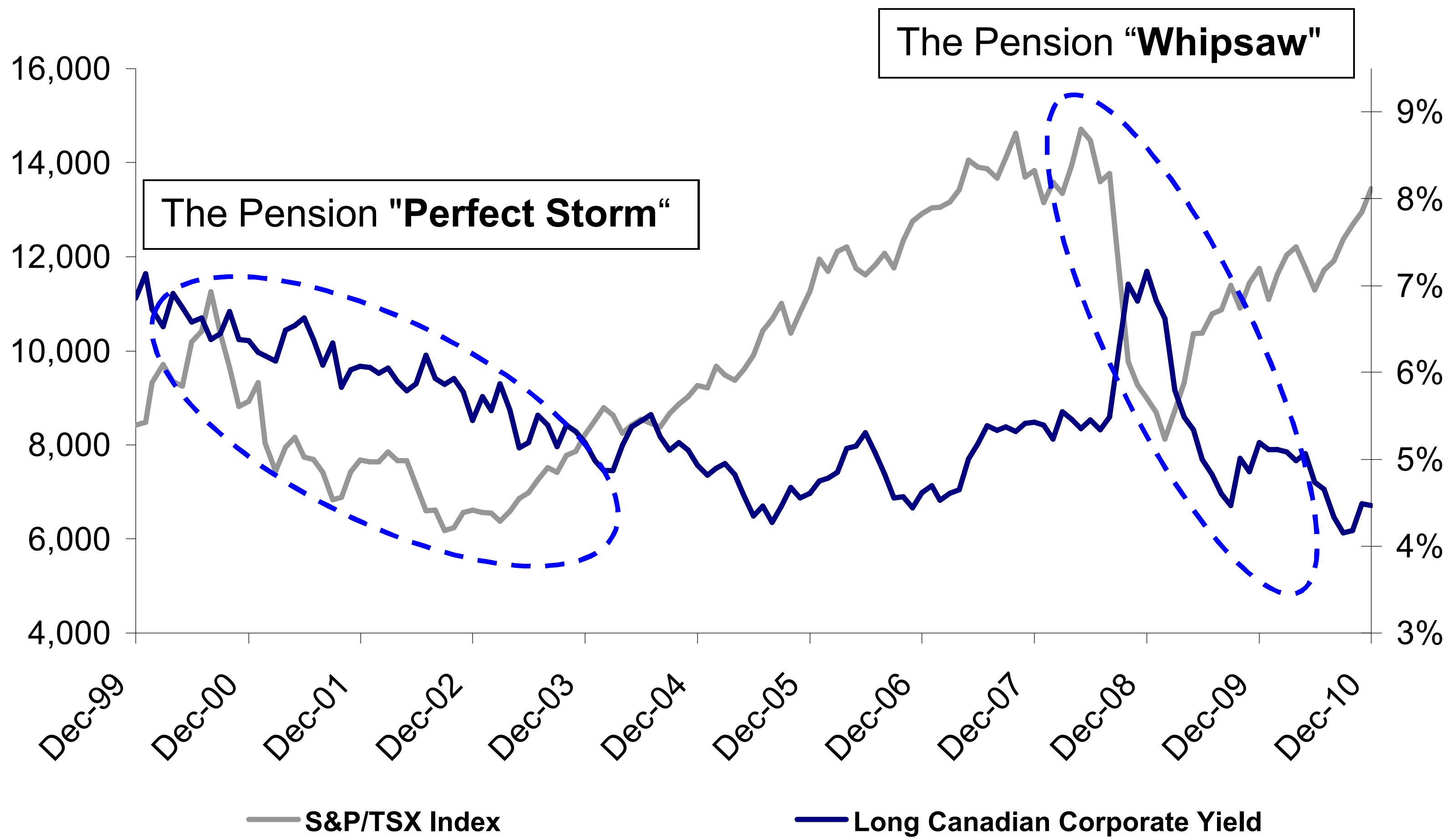
Sources – Standard & Poors, MSCI

And Declining Bond Yields Didn't Help!



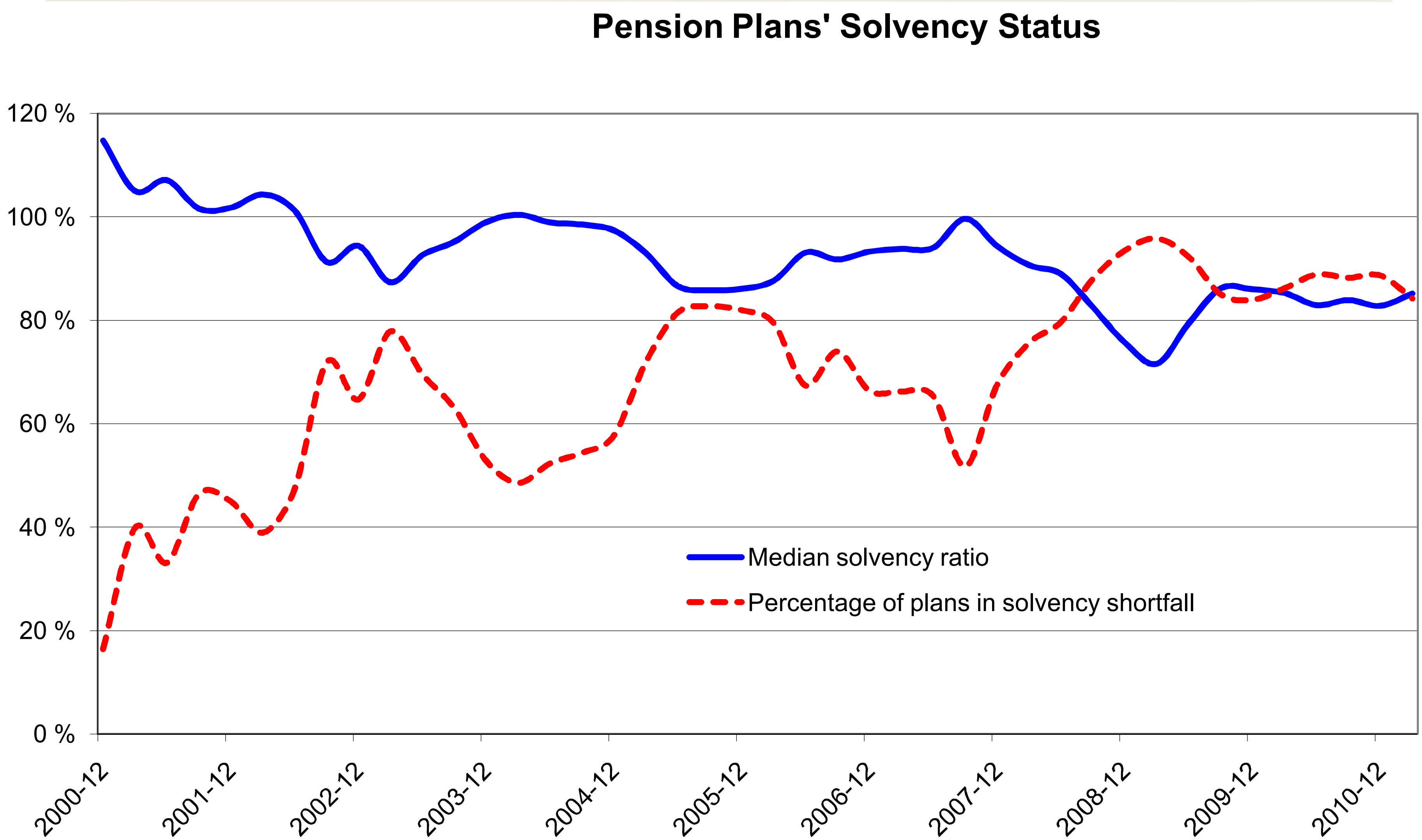
Source : Bank of Canada, Barclays Capital Live

Once in a Lifetime Event…Twice in a Decade



Sources – Standard & Poors, Barclays Capital Live

Current State of Funding



DC World – Is it Better?

- For the employee:
  - Contribution rates, generally, are modest
  - Administration and investment costs are often high
  - Engagement is a challenge
  - Risk can be significant to manage
    - Investment risk
    - Inflation risk
    - Longevity risk

- For the employer:
  - Known cost
  - Workforce planning challenges:
    - No economic disincentive for employees to retire
    - Savings may not be sufficient for employees to retire voluntarily

- Most DC plans are not yet "mature" so experience is still unknown

Compared to US Public Pension System…

- Estimated unfunded pension debt in state funded pension plans: $3 trillion at 31-Dec-2008
- Estimated non-pension recognized state debt: $1 trillion
- Assume future contributions are used to fund new benefits in full, when will state pension funds run out?

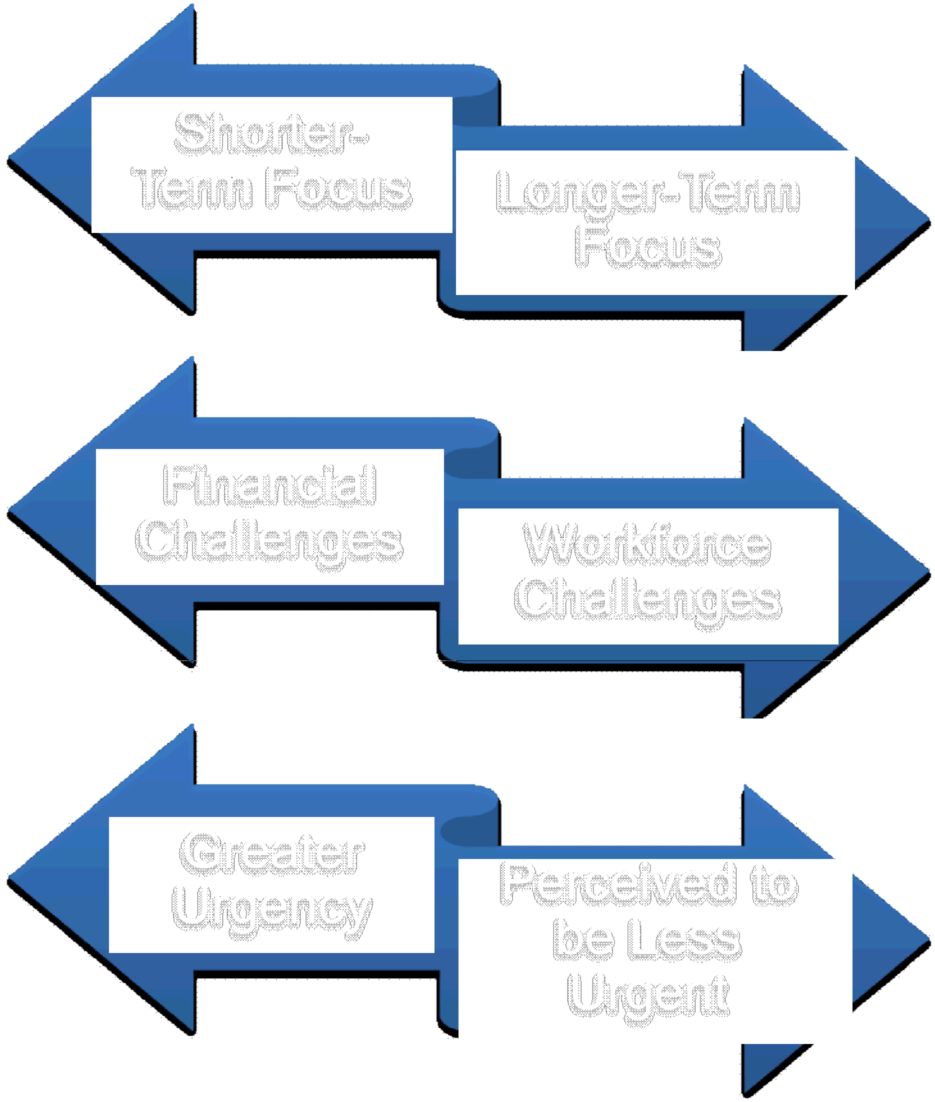
State	Year Run Out (8% Returns)	Annual Benefits / Revenues
Illinois	2018	35%
Connecticut	2019	29%
Indiana	2019	20%
New Jersey	2019	35%
Hawaii	2020	26%
Louisiana	2020	29%
Oklahoma	2020	32%

Source: Are State Public Pensions Sustainable, Joshua D. Rauh, 2010

Lessons Learned or Reinforced with DB Plans

Employer	Member
Long-term investment principles do not hold in the short term • Returns • Currency	A promise is not a guarantee • Insolvency risk of the employer
Importance of having benefits, funding and investment policies aligned	A deal too good to be true…likely was • Active members now having to bear legacy costs
Pension promises are complex: • Diverse interests • Long histories	

How Organizations Respond – Understanding the Context



How Organizations Respond – Reshaping the Pension Deal

- Balancing the needs of the Employer, Employees and the Regulator

Employer Needs	Employee Needs	Regulator Needs
Financial certainty	Security	Funding discipline
Lever to attract talent	Affordability	Ensuring promises kept
Lever to manage workforce	Coverage	Proper governance

- Traditional DB and DC designs generally do not satisfy all needs
- Reshaping future service accruals is manageable
- Reshaping the past is difficult

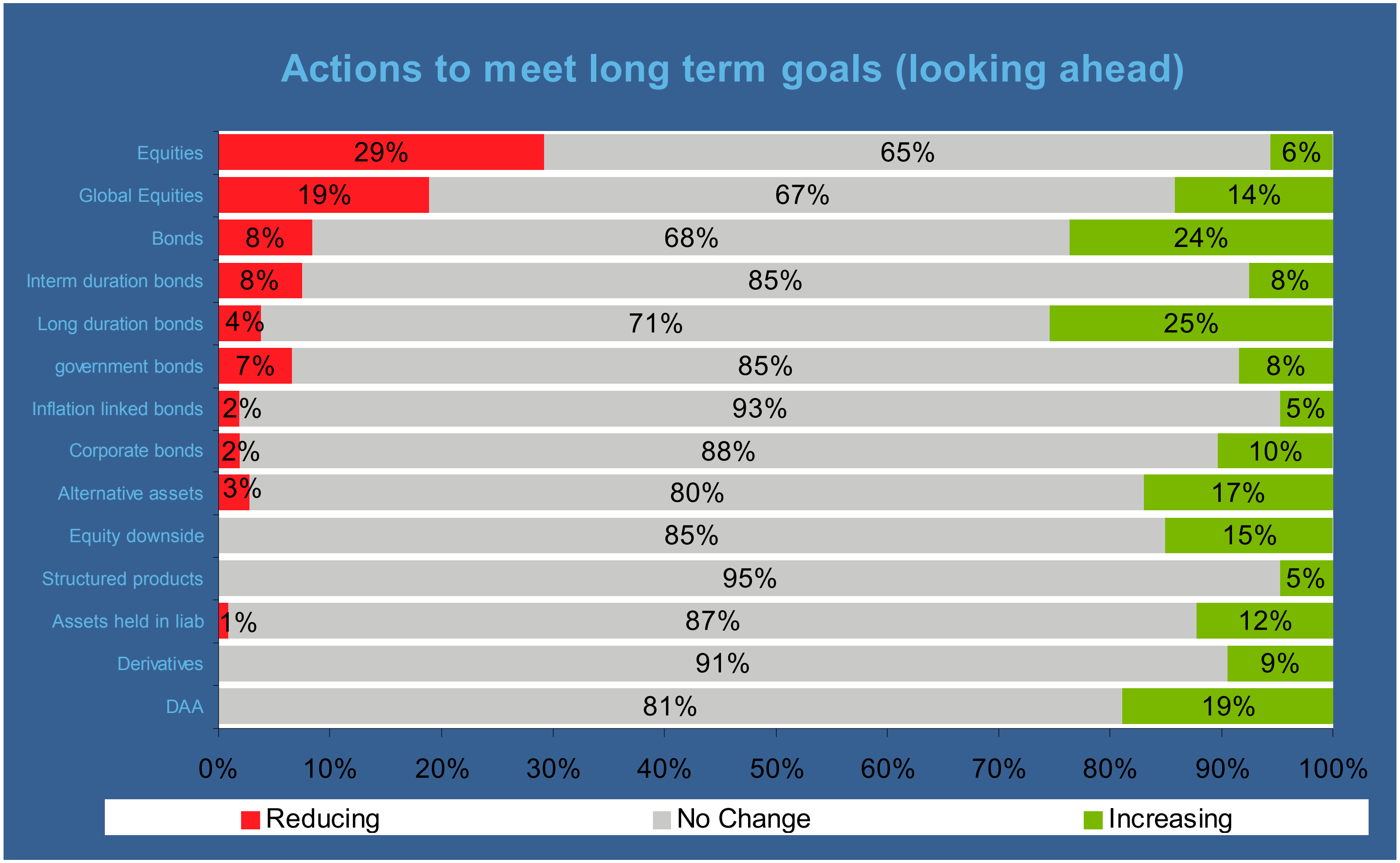
How Organizations Respond

- Urgency is around responding to DB problems
- Strategy is typically developed from four angles
  - Financing
  - Lobbying
  - Governance
  - Negotiating

How Organizations Respond - Financing

- Typical responses:
  - Budget cuts elsewhere in the organization
  - Taking advantage of temporary funding relief where available
  - Exploring possible alternative financing strategies
    - Letters of credit
    - Issuing debt
  - Reviewing investment strategy
    - Significant interest and increase in improving the matching of assets and liabilities

How Organizations Respond - Financing



How Organizations Respond – Lobbying

- Debate ongoing as to whether solvency should be the minimum funding standard:
  - Solvency takes the view that a plan should have sufficient assets to settle all of its obligations at a given point in time
  - Assumes that settlements occur through purchasing pensions or lump sum settlements
  - Theoretically, if a plan was funded on the basis of 100% investment in bonds, then asset values should match the value of the solvency obligations

How Organizations Respond – Lobbying

- For large public sector / not-for-profit organizations, abolishing the solvency discipline may make sense:
  - Reduced risk of the pension plan terminating due to insolvency
  - Short-term funding volatility creates havoc with budgeting process
  - Impractical to assume that benefits for large plans can be settled – limited secondary market for pension obligations

- Many jurisdictions have granted either temporary or permanent relief from solvency
  - Practices not consistent across the country
  - Precedent has been established
  - Public sector / not-for-profit organizations are actively lobbying to make sure greater funding flexibility is available

How Organizations Respond – Governance

- Increased interest and reporting at the Board level
  - Moving well beyond investment performance
  - Broader reporting on all aspects of risk –pension plan can be one of the largest assets of the organization

- If solvency funding discipline removed, need to develop a discipline that will ensure sustainability

- Greater sensitivity to negotiations dictating funding policy

- Greater sensitivity to the perspective of inactive members (i.e. pensioners)

- Restructuring governance to ensure the benefit, funding and investment policies are better aligned

How Organizations Respond – Negotiating

- Initially, choices are seen to be binary:
  - increase contributions
  - reduce benefits

- Decisions are quickly complicated by issues such as:
  - Sensitivity to increasing funding to a level that is not affordable
  - What benefits can be reduced or rights eliminated
  - The desire to shift risk away from the organization

How Organizations Respond – Negotiating

- The framework for negotiating a shift in risk sharing involves two elements:
  – How much risk is to be transferred to the members?
  – How much pooling for the risks that are transferred to the members?
- Observations on risk transfer:
  – Transferring risk for benefits accrued to date requires the settlement (i.e. solvency) obligation to be fully funded
  – For plans with large deficits, practically, transferring risk is only in the context of future service benefits
  – In current environment, the cost of risk is perceived to be high
- Observations on risk pooling
  – New DB like plan designs are emerging
  – Designs operate like a DC plan for the sponsor and a DB plan for the member
  – Collectively, the members bear the risk rather than the organization
  – The key challenge is determining the "pooling charge" and "rebate" amounts

How Organizations Respond – Negotiating

How an Organization's Focus Varies by Plan Design			
	DB (Traditional)	Hybrid	DC (Traditional)
Financial Risk Management	High	Medium	Low
Contribution stability / affordability	High	Medium	Low
Benefit Security	Medium	High	Low
Intergenerational equity	Medium	High	Low
Benefit adequacy	Low	Medium	High
Member education	Low	Medium	High

Concluding Thoughts

- All hope is not lost – it just requires a lot of attention and discipline
  - There is no magic solution
  - Difficult choices will need to be made
- The implications of decisions made today to reshape the pension deal will not be felt until many years from now
  - Importance of "getting it right"
- Issues involving retirement extend well beyond any immediate challenges organizations currently face with their pension plans