Are Automatic Balancing Mechanisms Appropriate For Private Sector Defined Benefit Pension Plans?

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Overview

- **Briefly describe key components of Automatic Balancing Mechanisms in Sweden and Germany**
- **Consider differences between Social Security Retirement Systems and private sector pension plans**
- **Possible application of ABM to Multi-Employer Pension Plans**
- **This presentation only examines financial sustainability, not equitable balance**
- **The bottom line: ABM are inappropriate for Single Employer Pension Plans but may be appropriate for risk-shared plans, such as MEPPS**

Features Of Swedish Adjustment Mechanisms

- **Increasing age for full-benefit entitlement and annuity factors adjusted to reflect improvements in cohort mortality**
- **ABM that adjusts rates credited to accounts and increases to pensions in payment based on ratio of assets to liabilities (when assets < liabilities)**
- **Unadjusted crediting rates based on average wage growth per capita forming a connection with economic growth**

Features Of German Adjustment Mechanism

- **Adjustment depends on changes to net (maximum) contribution to SSRS and supplementary pensions**
- **Adjustment depends on change in dependency ratio that is the ratio of pensioners to contributors including the unemployed**
- **Sustainability parameter shares the burden of adjustment between pensioners and workers**

Laudable Aspects of These Adjustments

- Adjusting the age of full-benefit entitlement
- Basing pensions on the average increase in wages
- Attempting to relate the adjustment to the broader economy

Weaknesses In The Application Of These Adjustments

- The rate of average wage growth per capita may increase even when the total economy is contracting
- For financial sustainability, pensions could be increased by the rate of total wage growth and decreased if total wages are declining
- Neither country’s mechanism is “bullet proof”, both require some heroic assumptions

Differences Between SSRS And Private Sector Pension Plans

- Most SSRS operate on a paygo basis (with a small buffer fund)
- There is generally a greater sense of social solidarity among members of SSRS
- There is often greater willingness of citizens to accept that changes can be made to SSRS

Flexible Pension Promises Not ABM For Non-Negotiated SEPPS

- Contract unilaterally established by employer
- Legally binding with respect to accrued benefits
- Employer retains the right to terminate
- Advance funding is appropriate to enhance security of members' benefits
- Flexible pension promises could be adopted

ABM Could Be Appropriate For Private Sector Plans With Risk Sharing

- Opportunity for members and sponsor to agree on ABM
- Advance funding should still be used
- Basic retiree benefits should be annuitized

Flexible Pension Promises Described

- Establish a "floor" benefit level that can be maintained regardless of the plan's financial position
- Ad hoc benefit increases above the floor level could be granted or eliminated
- Termination benefits to be based on the floor level
- Annuities to be purchased for floor pensions
- Immunized or LDI policy used for floor benefits
- Investment policy for non-floor benefits would permit risk-taking but should consider industry risks

Developing An ABM For MEPPS By Adapting Swedish ABM

- Most suitable for DC MEPP with negotiated contributions
- Credit account balances with the average annual increase in industry wages
- Convert balances to a basic pension using 0% interest and allowing for mortality improvements
- Invest excess funds and provide ad hoc indexing up to the level of the full increase in average wage
- If excess funds insufficient, apply ABM to reduce indexing and rate credited to balances

Developing An ABM For MEPPS By Adapting German ABM

- Suitable for DB MEPP with negotiated contributions that do not have contractual indexing
- Adjust pensions based on changes in the dependency ratio of pensioners to contributors including unemployed
- However this adjustment alone does not ensure financial balance
- Could also adjust sustainability parameter or contribution rate

Developing An ABM For MEPPS By Making An Adjustment For Industry

- ABM needs to make adjustment for economic state and degree of maturity of industry
- Two suggestions to stimulate discussion

1. Create or use reserves depending on the market share of participating employers
2. Establish liabilities for non-floor benefits using industry bond rates

Some Regulatory Issues

- ABM may require reduction of accrued benefits
- Flexible pension promise may be questioned because

1. Lack of uniform accrual of benefits
2. May result in margins or contingency reserves
3. May result in unacceptably high surpluses
4. Termination benefits may be less than value of accrued benefits
5. Increases in pensions may exceed acceptable limits
6. Pension Adjustment may be difficult to calculate

Conclusions

- Both Swedish and German ABM have interesting features but neither ensures financial balance
- Adjusting the age of full-benefit entitlement and increasing pensions in respect of wage growth improves financial sustainability
- MEPPS are dependent on the state of their industry and special industry adjustments are needed
- Before ABM could be used in private sector pension plans regulatory change would be required
- ABM are inappropriate for non-negotiated SEPPS but could be adapted to risk-shared plans