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THE PITFALLS OF MAKING PROMISES

With an aging population and tough solvency rules, managing risk over time is prudent.

TIME HORIZON IS VERY MUCH A RISK MANAGEMENT FACTOR

Pension plan deficits have sparked much discussion of risk management, focused mainly on the pros and cons of various asset classes. But what about another risk management factor, namely time horizon?

Those running defined benefit pension plans face a number of competing priorities:

Member security: The plan must be able to pay promised benefits as they become due. Obviously, plans heavily weighted toward current retirees and those nearing retirement have less flexibility. Plans with a relatively small number of active members and a huge number of retirees may have no flexibility at all. These plans may be so large that an asset-liability mismatch could sink the sponsor, as extra contributions required to cover a deficit consume substantial amounts of operating cash flow. Hence, there is growing interest in creating a series of time-based liability baskets and then earmarking assets for each one.

Contribution pattern: To what extent can the plan's need for cash be matched to the cyclical nature of the sponsor's operations?

Control over surplus: Pension fund managers naturally view outperformance as good news. But a plan sponsor may be less impressed if the surplus creates pressure for unsustainable benefit upgrades.

Picture a planet with four moons. The planet is the pension plan's financial objectives. The moons are the plan's four policies: benefits, funding, investment, and accounting. These policies should be set with a time horizon of at least 10 years, to cover multiple economic cycles. Each policy then needs a four-to-six-year strategy for the current cycle and, within that, a tactical facility to capitalize on short-term reward opportunities.

Don't forget gravity. Moving one moon affects the others. Yet only benefits policy and investment policy affect the underlying economics of the plan. Funding policy and accounting policy govern the timing and recognition of costs, but not the total level.

Let's apply this to surplus. Solvency rules require sponsors to cover today's deficits by injecting cash into their plans over coming years, based on return assumptions that largely reflect current bond yields. To the extent that plans holding equities beat those returns, we set the stage for a new era of surplus.

The risk management approach depends on the risk sharing arrangement:

Typical private-sector plans: The employer is fully responsible for any deficit, but may not fully benefit from a surplus. So, the reward of an extra dollar of performance does not match the pain of an extra dollar of deficit. Essentially, the asymmetrical treatment of surplus has made risk management for these plans very short-term-focused. Witness the use of minimum statutory contributions and aggressive actuarial assumptions to defer contributions as much as possible.

Public-sector and multi-employer plans: There is often more symmetrical risk-sharing between the employer(s) and members, but there is the potential for generational inequity among differing groups of members. A surplus benefits everyone, but a deficit hits current employees harder than pensioners.

Pension management used to be inherently long-term. Workers were young, employers were paternalistic, business was booming, and surplus-deficit ownership was balanced. Also, retirees didn't live very long. But, as the workforce ages and the pension system matures, the impact of "bad news" in the pension plan creates larger pressures on the sponsor. Meanwhile, longevity gains make benefit upgrades of years past increasingly costly. Time horizon is very much a risk management factor.■