

DB Dead?

NOT LIKELY.

In our Spring 2008 issue, we ran a paper by William Robson, called “DB is Dead; What Now?” It was our cover story and it garnered a lot of attention. In this paper, Bruce Kennedy, executive director of the BC Public Service Pension Plan, wants readers to know that DB plans are here to stay.

Responding to the pension plan downers.

BY BRUCE KENNEDY

DEFINED BENEFIT (DB)-based pension arrangements will be around for a long time to come because they are among the most efficient components in a compensation package. Many aspects of determining total compensation, such as the setting of wage rates, are largely zero-sum games. Synergies need to be found in order to produce optimally efficient compensation arrangements and bargaining agents are constantly searching for potential win-win situations. The fact that large professional organizations can manage retirement savings and longevity risk much more effectively than can inexperienced, distracted individuals creates a potential synergy. The cost to employers of providing adequate and secure retirement income to their employees should be much less than the value to employees of having that benefit provided. Stakeholder representatives who are unable to develop arrangements to provide effectively for retirement income have left a potential gain on the table, and have failed to produce an efficient compensation package.

This article is a response to recent pension papers coming from the C.D. Howe Institute that take a negative view of DB pension plans. “DB is Dead; What Now?” by William Robson, President and CEO of the C.D. Howe Institute, appeared in the Spring 2008 issue of *Canadian Investment Review*.¹ In the same vein are “Work-Related Pensions in Alberta and British Columbia: Short-term Patches and Long-term Reforms” by William Robson;² and “Ill-Defined Benefits: The Uncertain Present and Brighter Future of Employee Pensions in Canada” by David Laidler

and William Robson.³ These papers will be referred to here collectively as “the down-on-DB papers.”

THE CLASSIC CASE AGAINST DB

All of the down-on-DB papers start with a critique of stereotypical private-sector, single-employer, employer-sponsored DB pension plans. The case the papers collectively make against these classic DB pensions rests on a number of current irritants, and one fundamental problem. The fundamental problem is that, in today’s highly competitive business environment, individual employers are not appropriate entities for sponsoring DB pension risk. This observation is well founded. Some single-employer-sponsored DB pension plans have failed, and some employees have consequently found themselves bearing risks that they thought they were protected from. While we should not forget that there are some sound and well-managed classic single-employer pension plans in Canada, there are also some good reasons to avoid the classic single-employer, employer-sponsored DB pension plan as a model for the future.

The down-on-DB papers associate other irritants with classic single-employer-sponsored DB pension plans, including:

- Pension plan funding difficulties may not be fully reflected in the share and bond prices of corporate plan sponsors.
- Court-imposed asymmetries may deter adequate funding by an employer-sponsor (in plans that have not articulated employer and employee claims on plan surpluses).

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- Portability restrictions impede labour force mobility.
- Agency problems allow employers and employees to make arrangements that suit their short-term purposes but are not in the long-term best interest of the pension plan and its stakeholders.
- These plans may cost more than some sponsors realize, because equities should not be expected to outperform long bonds over the long term.

DC DILEMMA

To their credit, the down-on-DB papers acknowledge that workers who rely on individual retirement accounts tend to: underestimate what it will cost to secure their desired retirement income; under-save; invest poorly; pay high fees; cash out or convert to annuities ineptly; and may consequently outlive their assets and become a burden on public finances.

The down-on-DB papers also acknowledge that the DB model has some advantages over the defined contribution (DC) model in that most individuals stand to gain by delegating the management of their retirement savings; the overall efficiency of the economy benefits from having more expert investment management; and DB plans avoid situations where similar employees with similar contributions end up in widely different retirement circumstances due to factors beyond their control.

The down-on-DB papers correctly assess that there are flaws inherent in both the classic DB model and the classic DC model for pension plans. They acknowledge that sufficient scale is essential for efficient professional administration, and the effective management of risk. They also constructively conclude that “policy needs to encourage a search for new models that can offer Canadians more attractive ways to pool their resources and save for retirement in pension plans that mitigate not only financial risk and longevity risk, but agency risk as well.”⁴

From that promising start, however, all three of the down-on-DB papers somehow leap to the view that these new models must be predominantly DC. None of the papers articulate a strong rationale for why that is so. They each make a circular argument that the new model for employee pension plans should be predominantly money-purchase, because in the future most Canadians will do most of their retirement savings in money-purchase pension plans. In “Ill-Defined Benefits” the main rationale for the leap seems to be that basing the new model on DC would provide “greater transparency... about the risks inherent in market-based pensions.”⁵ In “Work-Related Pensions in Alberta and British Columbia” the explanation

is that a plan would logically be predominantly money-purchase “so as to avoid problems with a larger guarantee than a sponsor can underwrite at acceptable cost.”⁶

Beyond issues of DB versus DC characterization, however, the proposed solutions seem to suggest hybrid models with significant DB aspects. The new multi-employer plans:

- would provide a minimum guarantee backed by appropriate assets;
- could impose contribution rates determined in recognition of evolving investment performance and target payouts;
- could provide a default investment portfolio and default annuitization; and
- might even annuitize internally.

IS THERE AN IDEAL MODEL?

Consensus is emerging concerning the sort of entity best suited to delivering an ideal pension plan. The experience of successful pension plans in the public sector, the proposals advocated in the down-on-DB papers, and prior contributions to this debate by Keith Ambachtsheer all point toward the formation of large multi-employer pension plans delivered by professional organizations that are dedicated to that purpose alone.⁷ Size, professionalism and focus all matter for efficient asset management and administration.

Differences of view persist over matters of cost versus adequacy, and who should bear which risks. These are largely distributional matters, not matters concerned with maximizing efficiency. They have no single ideal solution. Different stakeholders will hold different preferences. In a liberal-democratic society, associations of employees and associations of employers should be free to enter into binding agreements concerning such features as cost/adequacy and risk-sharing arrangements. A range of different models and solutions, all legitimate, should be expected to arise from such negotiations.

Little disagreement exists over the nature of the public policy challenge that faces Canadians. Public policy on pensions needs to foster the growth of large pooled pension arrangements that provide Canadian workers efficient accumulation of their retirement savings, and effective management of financial, longevity, and agency risks. The need for institutional innovation to achieve this is currently most urgent in the private sector.

Occupational pension plans in the public sector are doing a comparatively good job of efficiently providing adequate pension plan coverage to a large segment of the labour force. Pension models in the public sector are

improving as they evolve, and it should not be surprising that some of the solutions emerging in the public sector are similar to proposals made in the down-on-DB papers.

Consider for example BC's Municipal Pension Plan (MPP), the fifth largest occupational pension in Canada. MPP pools the retirement savings of hundreds of employers, and their employees, into a large multi-employer plan. Many of these employers are small not-for-profit agencies that would otherwise be incapable of providing pension benefits. Further scale economies, and highly professional management services, are achieved by participating with other plans in BC Investment Management Corporation, and BC Pension Corporation. MPP combines a modest DB pension promise with a flexible, negotiated DC top-up provision, and a non-guaranteed fixed-cost inflation adjustment arrangement. The MPP is also jointly sponsored, so employers and contributing plan members share the DB risks of the basic pension promise equally. These features produce a distribution of costs and risks between employers and employees that would be similar to those of the models envisioned in the down-on-DB papers. The plan's joint-governance arrangements effectively align control with risk exposure and create appropriate incentives. Bargaining agents cannot amend plan rules without the consent of independent trustees who are focused on the long-term interest of the plan and its members.⁸

The features that enable the MPP, and plans like it, to efficiently provide reasonable pension coverage to large numbers of workers are not inherently unique to the public sector. New private-sector multi-employer pension plans could potentially benefit from experience already gained in the public sector. Public-sector pension plans are certainly willing to share their experience and contribute constructively to policy discussions aimed at strengthening private-sector pension arrangements.

LESSONS FROM PUBLIC SECTOR

Given the potential for public-sector/private-sector collaboration in this area, it is disappointing that the down-on-DB papers sometimes stray from their main line of argument to disparage public-sector pension arrangements.⁹ A few words of response to some of these remarks would be appropriate.

Public-sector pension plan members are typically teachers, nurses, police officers, firefighters, infrastructure maintenance workers, public servants, not-for-profit sector employees, and soldiers. They are not powerful fat cats who delight in imposing onerous pension regulations on the private sector. It is true

that a few judges, Cabinet ministers, and public-sector executives do receive very good pension benefits. Overly generous executive compensation is a larger problem, however, in the private sector.

Public-sector pension plans are generally contributory. In BC, plan members typically pay about 8% of salary (in addition to their CPP contributions) toward their registered pension plans. Their employers also make contributions, and employees make other concessions in their total compensation package because of those employer contributions. Their pension plans help public-sector workers to make responsible provision for their retirement. As a result, their employment-related pension income will generally be quite sufficient to prevent them from relying on income-tested public pensions such as the Guaranteed Income Supplement.

The criticisms that the down-on-DB papers aim at classic employer-sponsored DB pension plans don't apply well to the large jointly sponsored, multi-employer DB-based pension plans that are emerging in the public sector. Asymmetry issues have generally not been a problem in these plans because claims on potential surpluses are set out in plan documents. Within the public sector many pension portability agreements are in place to support mobility. Public-sector transparency standards are relatively high, and abundant information on the financial status of these plans is made available to the public, plan members, participating employers, unions, member associations, the legislatures, and the agencies that rate sovereign debt.

Public-sector and private-sector pension experts should be able to work constructively together toward the shared goal of developing adequate and sustainable pension arrangements for the workforce as a whole. We increasingly share a common vision of the large pooled hybrid pension entities that will be required to achieve that goal. ■

ENDNOTES

1. "DB is Dead; What Now?", William B.P. Robson, Canadian Investment Review, Spring 2008
2. "Work-Related Pensions in Alberta and British Columbia: Short-term Patches and Long-term Reforms", a submission to the Alberta/BC Joint Expert Panel on Pension Standards by William Robson on behalf of the C.D. Howe Institute, February 2008
3. "Ill-Defined Benefits: The Uncertain Present and Brighter Future of Employee Pensions in Canada", David Laidler and William B.P. Robson, a C.D. Howe Institute Commentary, June 2007
4. loc. cit. 3, p.20
5. loc. cit. 3, p.19
6. loc. cit. 2, p. 6
7. *Pension Revolution; A Solution to the Pension Crisis*, Keith Ambachtsheer, (Wiley, 2007)
8. The MPP's Web site is at mpp.pensionsbc.ca
9. This is particularly so in "DB is Dead; What Now?", loc. cit. 1