Pension and Health Care Liabilities in the Corporate Sector
An International Dialogue
May 25-26, 2006

Summary of Proceedings

Introduction:

By all accounts, the recent seminar on private pension and health care liabilities was a success. The one day symposium came to life with a champagne reception at Christ Church College, University of Oxford on Thursday evening. Participants were then invited into a banquet dinner followed by formal introductions. The following day, participants took part in seven panel sessions, a working lunch, an opinion survey, and some networking over tea and coffee. The entire event spanned less than 24 hours. The key to the seminar's success: momentum.

Executive Summary:

Panellists were given considerable freedom to choose their topics of discussion. Indeed, panel titles often served only as a reference or starting point for discussions. Consequently, certain subjects seemed to be raised on numerous panels. As such, several broad themes emerged:

- Many acknowledged that the current single employer DB system is failing.
- Each industry has its own story as to why DB is not working. In certain industries the legacy issue is of great concern; in others moral hazard appears to be a significant problem.
- The point was made several times that the employer may not be the ideal guarantor of pensions considering the incongruous life cycles of pension plans and sponsors.
- Nevertheless, there remained a considerable amount of optimism regarding the future of a DB variant, such as a hybrid pension.
- With a nod towards the post-DB world, several panellists argued that 'best practices' for DC plans were required. These would govern DC contribution characteristics (for stability) and even have annuity pay out characteristics (for retiree security).
- The option of using multi-employer plans as a possible solution to the current DB problems was raised on three separate panels by six different panellists.
- Finally, many argued that the above options were not enough. A path out of private single employer DB plans will be required, and government may need to play a role in facilitating this transition.

Panel Summaries:

Below are summaries for each panel session. Attempts have been made not to editorialise the proceedings, but rather to present the main findings, opinions and points from each panel in an objective manner. Consequently, some of the bullets are contradictory due to differing panellist views. The below is not, and could never be, a comprehensive report of what was said during the seven hours of vibrant debate. However, it will hopefully serve as a reminder of the amazing day shared by all.

As promised, individuals and institutions remain anonymous.

Panel I: Trustee and Plan Sponsor Perspectives

- The private pension debate need not be polarised between final salary and non-contributory DC – we need a middle ground.
- The debate should not be focused on the "either / or" of DB and DC pensions but rather on how best to implement both in an efficient and sustainable way.
- Collectively, DB is better than DC. "DC is tomorrow's disaster."
- In order to save DB, we need to find a way to lower accrued benefits and increase cost sharing.
- Seeking returns without regard for risk is a problem. Moreover, certain trustees and managers were 'addicted' to return seeking assets. However, this trend has completely reversed and has led sponsors to be overly concerned with risk. This polarisation of strategies is inefficient.
- In order to save the DB pension model for future generations, we must change the model towards something more sustainable.
- The current trustee model of pension governance was questioned. Trustees need to be able to stand up to management if necessary.
- Some believe FDs / CFOs should never be trustees because of conflicts of interest.
- Are companies in the new economy ideal guarantors of pensions? The decline of corporate paternalism and the declining longevity of plan sponsors engender instability for employees. The life cycle of the corporation is out of sync with the life cycle of the DB plan in terms of costs and commitment.
- The declining longevity of plan sponsors likely comes from a rise in "efficient balance sheets" and a rise in the buying and selling of businesses (mergers & acquisitions).
- Shareholders (managers) are averse to maintaining the level of free cash required to fund pensions.

Panel II: Labour Perspectives

- DB pensions have positive labour market effects. In fact, older workers are attracted by DB plans and, controlling for early retirement, they may work longer when in a DB plan.
- Legacy costs do not lead to corporate uncompetitiveness. Rather, uncompetitiveness leads to burdensome legacy costs and defaults on promises.
- Determining causality within the legacy debate is very difficult – this is perhaps the single most difficult thing to prove using econometric regression analysis. The 'chicken and egg' debate surrounding legacy costs and competitiveness will no doubt inspire further research.
- The future of DB pensions relies on two conditions: 1) ongoing support by plan sponsors and 2) support by government. These two conditions are, however, moving in the wrong direction.
- Employees value DB pensions because they see them as deferred wages.
- The countercyclical nature of DB funding rules poses a real threat to DB sustainability, as companies must fund more in downturns, exactly when they cannot afford to do so.
- Organised labour is a flexible and responsive force – unions are already renegotiating pension deals.
- The current DB system is broken. In order to move forward the plans must be secured and the past accrued legacy has to be de-politicised. In order to do this, federal government intervention is required to solve the legacy cost problem.
- The future of pension design is likely a mix of DB / DC design options:
    - DB – implement a minimal annuity based on highly conservative assumptions.
    - DC – risks will be moved towards the employee. Therefore, employees will own surpluses as well as deficits. There also needs to be a mix of employee and employer contributions.

- There is a desperate need to leverage the savings potential of low-income individuals. Exempting a portion of payroll taxes for social security or encouraging people to allocate certain existing tax credits to savings could help.
- It was noted on three separate occasions during this session that multi-employer pensions could serve as an alternative to the current single employer framework. Indeed, multi-employer plans offer the possibility of fixed, dependable contributions for sponsors.
- Two major problems:
    - How do we deal with an orderly exit from DB?
    - How do we provide for retirement security in the future?
- The 'perfect storm' was endogenous – we are in fact engineers of it.

Panel III: The Bankruptcy "Solution".

- The bankruptcy code via section 11.13 allows for plan termination, which sends distorting signals to the market. Reform should target this regulatory failure.
- Pension reform may end-up being about mitigating the impact of insolvency on beneficiaries because insolvencies themselves cannot be stopped.
- The lack of a Chapter 11 type law in Canada has not resulted in better management by plan sponsors – behaviour ex-ante are similar with those in the USA.
- Good pension funding translates into low insolvency issues.
- Resolving the pension crisis must involve government.
- The debate over the entitlement to surplus has distracted the debate on pensions. The level of funding is a contingency for insolvency.
- Pension funds are creditors with no bargaining power and no access to government regulation. This is the justification for government intervention and protection.
- DB is unaffordable, but for some reason reform only targets the funding rules rather than the benefit itself – this is a big problem.
- We are living in a post-apocalyptic environment in which "crisis" is now normal.
- We need flexible regulation that allows parties to come to an agreement. Government should simply act as an impartial party that sets boundaries.
- Labour is more flexible than employers. Employers are intent on maintaining all authority.
- There is an "artificiality" of pension funding rules and requirements. It is important to have enough money at the 'end' to pay for retirement -- not the beginning. Current actuarial rules are based on a contrived set of assumptions.
- The mantra "risk = value" is wrong.
- Fresh start (post bankruptcy proceedings) does not have to mean clean slate.
- Pensions are deferred compensation. The employees have earned this pension. Within the bargaining context, unions view DB explicitly as deferred pay.
- But are DB pensions deferred pay? DB is deferred pay *plus* a deferred annuity. This may mean a lot of people get back more than just deferred pay thanks to increasing longevity and higher final salaries than anticipated.
- Should pensioners view the DB obligation as a bond or a contractual commitment?

Panel IV: Wall Street Solutions I: Pricing the Components of Risk

- Long-term investors need to take on a different view of standard portfolio theory.
- 'Wall Street' solutions will mean nothing unless they are matched with an institutional solution and widespread collaboration.

- The basic measure of risk is volatility (the standard deviation of returns). Volatility is a big risk faced by pension sponsors. Yet, current volatility environment is within historical norms.
- The life insurance and pension literatures have big gaps that need to be developed. Tools need to be developed to better define the pension obligation. How do you define property rights with respect to pensions?
- Standard pricing models cannot be used for valuing the pension liability.
- Typically, firms are not completely aware of the value of their liability or the risks that they have taken on.
- Indeed, pension portfolios often have an increasing amount of structured products. Yet trustees are not fully aware of the risks associated with such products.
- The allocation of risks and the potential impact of these risks on the balance sheet have changed the nature of DB deferred compensation.
- There is a whole spectrum of beneficiaries within a DB pension. As such, risk sharing becomes an enormous problem, as it is difficult to put all those groups into one cohesive risk-sharing group.

Organisers' Lunch:

- The next generation of citizens may be wealthier than the current generation. As such, perhaps the next generation will be better able to pay for the costs of retirement.
- Even in situations where it is obvious that the corporation is promising more than it can deliver, it is still extremely rare to have a union leader say "no" to more generous benefits.
- Perfect storms may be predictable but they are not preventable. No financial instrument could have protected against the type of problems faced by sponsors in the early part of this decade.
- Cross ownership of assets between countries and widespread insurance were suggested as possible solutions.
- Two key concepts need to be examined:
    - Pension arrangements need to be transparent and sustainable.
    - Currently there is a pension delivery problem.
- Sharing risks to save the DB system could lead to other unintended consequences. A collectivisation of risks would suggest sharing risks amongst very different groups with different utilities.
- Win-win games deteriorate into win-lose games once funding no longer equals 100%. As such, risk sharing leads to adversarial problems.
- Solutions will need to incorporate an untangling of the current convoluted risk structure and utilise a DC-type structure with autopilot mechanisms. In addition, the end game will likely require an annuity.

Panel V: Wall Street Solutions II: Products and Prospects

- Trustees have increasing power due to changing regulation. As such, they need to be ready to act faster than they have done in the past.
- Investment banks exist to match risk and rewards for clients. They sell risks that they are adept at defining and judging. Banks have access to the financial products and the education to help plan sponsors with all their risk problems. In sum, banks know how to specify and remove risks for their clients.
- Investment banks exist to transfer risks to and from clients. In addition, they are in the business of designing financial products to meet their clients' needs.
- Risks faced by DB pensions include:
    - Financial – liabilities pose inflation and interest rate risks while assets pose investment risks.
    - Demographic – longevity and retirement age pose problems for plan sponsors.

- Companies view pensions as a one-way street since money goes in to fill deficits but they cannot get it back out.
- Solutions lie with simple and fairly priced products and widespread collaboration between implicated parties.
- Pension funds are leading to 'crowding out' in private sector debt markets – i.e. companies may be inclined to issue less debt.
- Pensions could be viewed as contingent liabilities. There are idiosyncratic risks like mortality. However, these may be more systematic.
- Perfect storm extension: increasing pension liabilities leads to companies issuing less debt and changing their entire capital structures. The systematic effect is a change in investor behaviour within the private sector. Conclusion: pension liabilities crowd out other types of debt.
- New insurance companies being set up to buy pension liabilities are not doing anything particularly innovative. Moreover, the financial entity with the greater financial backing (i.e. the insurance company) will not be interested in taking on the pension liabilities at low prices.
- What investments should pension funds avoid?
    - Sponsor's equity and debt.
    - Something that the trustees do not completely understand.
    - Lottery tickets.

<u>Panel VI: Compensation Systems for the 21st Century.</u>

- This panel was well timed considering the release of the UK White Paper on pensions published the proceeding day.
- The NAPF's super-trusts are an option for the future. These would be, in effect, large multi-employer plans. Considering the life span of most companies, this may be the cost effective delivery mechanism for all working people.
- The notion of "crisis" is not compelling. The defaults of only ten plans account for roughly 90% of the PBGC's deficit. Most firms and industries have managed to keep their promises.
- Perhaps the most pressing concern, rather than underfunding, is the persistent closure of adequately funded plans. This state of affairs may be being driven by the unpredictability of DB plans.
- What is needed for the future?
    - More flexibility in funding rules – particularly in good years.
    - Legislative clarity on hybrid pensions.
    - More investment education.
    - Employees need to share in DB risks.
- The employee's personal perspective on and expectations about retirement have changed drastically in the past 30 years. This suggests that employees need to be given choice over compensation and benefit structures.
- Going forward, the DC movement has the most traction.
- There is a "just right risk" for every individual, which is important for good investment design of DC plans.
- Education is an elusive strategy for DC. So "auto" strategies are really useful.
- The move towards DC should not be a marginalisation of the workplace pension. DC needs to be improved as an investment vehicle.
- The long-term success of DC requires that it provide a consistent income through one's lifetime.

<u>Panel VII: Regulation and Public Policy</u>

- The PBGC has for the most part been a success.

- Most of the DB plans are adequately funded; there is a small group causing most of the problems.
- All sources of retirement income are currently under stress; not just private DB sponsors.
- Multi-employer plans are the future. However, these plans may require a component of compulsion to be implemented successfully.
- Governments have difficulty dealing with pension issues because they are so short-term oriented.
- In the UK, the government wants to improve the financial position and the security of plans.
- Companies may begin buying up smaller companies with DB pension plans.
- In the US context, the CBO estimates the PBGC 'put' costs at roughly $63 billion with market risks over 10 years.
- The US pension bill was discussed in the context of airline relief, credit balances used against cash contributions, and credit ratings.
- Pension adequacy was likened to pension coverage.
- Solutions need to include risk pooling, universal coverage, securing assets and hybrid plans.
- Labour markets and financial markets move together in terms of retirement decisions.
- Intergenerational fairness is a shortcoming of the current retirement system.
- The question was raised over the degree of involvement the PPF is having in capital markets, which puts a premium on the PPF doing things well and quickly while maintaining integrity.
- The Pensions Regulator will not get involved in corporate transaction decisions.
- There is a lack of direction for policy makers. For example, a major flaw in the USA is the fact that the PBGC does not set its own insurance premiums; lawmakers do.

Adjournment:

The organisers closed the conference with their heartfelt thanks to all the participants, particularly those that journeyed from afar to engage in an open and thoughtful manner.