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Notes for remarks to John Deutsch Institute
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Pensions are a risky business: Issues in Pension Regulation

Good morning [personal remarks.] I'm pleased to be here to help open your conference discussions on retirement policy issues. Let me congratulate the John Deutsche Institute for hosting this conference. This topic is particularly relevant to me as I approach my own retirement from the Bank of Canada, but it is also extremely important for Canada as a whole as we deal with the impact of demographic changes on our workforce. I see that you're going to deal with a wide range of interesting topics pertaining to retirement issues. I intend to use my few minutes to pose some challenges for you with respect to the question of ensuring the viability of private pension plans.

We already have a very solid public pension platform to build on, through the Canada Pension Plan, Quebec Pension Plan, as well as the Old-Age Security and Guaranteed Income Supplement. There are also the tax-sheltered RRSP structures to help people save for their retirement. But for many individuals, neither their public pensions nor their personal savings will adequately replace a significant portion of their employment income. Rather, experience has shown that an employer-based system of contractual savings through a pension plan is really the most effective and important means to ensure an adequate retirement income. So, today what I'd like to do is consider just how we can get the right incentive structures in place to encourage the private sector to offer well-constructed, voluntary pension plans.

A few of the questions that I'll discuss include: what are some of the incentives that drive the creation of an efficient and effective system of private, voluntary pension plans? What are the key risks that face parties to such pension plans, and how can we best manage these risks so they can be tolerated by all? And finally, I'll discuss the principle of pooling and how a greater and more effective application of this principle could make risk more manageable in private pension plans.

Finding the right incentives to facilitate an effective pension plan

It's sometimes said in economics that good incentives lead to good outcomes, and this has often been the case with pension plans. Let's consider just a few good incentives, first from the individual's perspective. Protecting and enhancing one's retirement income is certainly a strong incentive to join a pension plan. And a properly structured plan creates the proper incentives to ensure individual choice in terms of when to retire. From the employer's perspective, there have been two longstanding incentives for sponsoring a pension plan. First, a plan can serve as a means to recruit and retain good workers; second, it can ensure that older staff can afford to retire rather than remain at work well past the point of their greatest productivity. A pension plan also removes the need for a firm to make ex gratia payments to former employees. Finally, society has an incentive to support a sound system of private, voluntary pension plans. We want to know that our older members have an adequate income when their working days are over. In part, this is because we know that if incomes are not sufficient for the retired, the pressures on government for much greater spending could become significant.

So these are some of the incentives that influence how people save for retirement. It's useful to think of pension plans, which facilitate these savings, as essentially agreements as to who bears the risks – such as market and longevity risk – that are associated with saving for retirement. Given that different people find themselves in different circumstances, it's important that their pension plans can suit their particular needs. The best way to deal with this is through sponsored, private pension plans that are voluntary, rather than mandatory. I realize that this latter point is a contentious issue and that many people I respect would argue for mandatory pension plans. I believe that voluntary plans offer greater choice, but it certainly is an issue for further debate.

Risky business

It seems clear that understanding the risks involved in a pension plan and getting the incentives right so that these risks can be effectively managed, are really the key points at the heart of the pension debate. I'll devote several minutes now to this crucial topic, reviewing what risks confront individuals, plan sponsors, and society as a whole; and what incentives can be put in place to mitigate these risks. This is an extremely important issue, because understanding and managing risk is absolutely crucial to protecting the present and future stability of any pension plan.

Pension plans, by their very nature, exist because they are better able to manage risk at a lower cost than an individual can with his or her own savings. For a person who is planning his retirement, there is the tendency to be overly cautious. This inclination would likely lead him to invest too much in low-risk securities relative to the portfolio that would maximize his expected pension while maintaining risk within tolerable bounds. Or, he would try to manage his risk by finding a financial advisor or putting savings into managed, diversified retail investment vehicles such as mutual funds. However, that latter choice can be costly, since an individual outside a pension plan would have to purchase investment advice and ongoing funds management at retail, not wholesale prices. In contrast, the individual's risk could be more efficiently and effectively managed if he were part of a larger pension group, where risks and transaction costs are spread more widely and thus, reduced for each individual.

Without being part of a larger pension group, an individual can face other types of market risk; for example, weak market conditions at the time of retirement could make the value of his assets abnormally low. Or, unusually low interest rates at the time of retirement could make an annuity unusually expensive. In either case, the person acting alone could need to spend a much greater amount to purchase a guaranteed stream of income, compared with a period when market conditions were more favourable.

So there are great advantages for an individual to join an employer-based pension plan. In such a plan, a number of risks are transferred – partially, or in large part – from the individual to the employer. One of the great advantages of a private pension plan, whether a defined-benefit or a defined-contribution plan, is that pooling and governance structures allow for the efficient management of funds at wholesale costs. And employer-based plans have another benefit in that members are able to purchase an annuity at group rates that are applicable to the larger pool of members in the plan.

But, of course, not all the risks applicable to the individual are avoided. Defined-contribution plans only partially mitigate risks of adverse market conditions at the time of retirement; risks that I previously mentioned. Hence, there is an advantage to individuals of belonging to a defined-benefit plan. Of course, defined-contribution plans aren’t risk free for employers, either. These plans do shift some risk from the individual to the sponsor, creating potential fiduciary and legal risks for that sponsor.

In contrast, an appropriately structured defined-benefit plan, in theory, can provide greater benefits for members, sponsors and, I should mention, society in general. These plans, if made to work effectively, can mitigate various risks.

Risks can be spread across plan members – past, present, and future – and this largely ensures that the retirement income of an individual member does not depend on market conditions at the time of his retirement. With a defined-benefit pension plan, professional managers have both the ability and the incentive to invest in more risky or longer-duration assets than the DC plan manager would consider. This helps to reduce the risk that these pools of contributions could be invested in a less-than-optimal way, which could eventually reduce the supply of long-term risk capital for the economy. Further, DB pension managers are more likely to invest in alternative asset classes and to engage in arbitrage between markets. These activities can make financial markets more complete, and thus enhance their efficiency. But to achieve these benefits, funding regulations must balance the need to ensure adequate funding by the sponsor, with the sponsor's ability to recoup whatever overfunding may occur.

To be sure, defined-benefit plans do mean greater risk for the sponsor. If a sponsor opts for a DB plan, he must ensure that regardless of market conditions, the company pension plan is adequately funded to pay out agreed-upon benefits. Further, as the workforce ages, the liability associated with a defined-benefit plan can dwarf the sponsors' net worth. And finally, the defined-benefit plan sponsor must make up actuarial deficits in the plan without being assured that he will have equal access to any actuarial surpluses in the future. To avoid these risks, a number of DB plan sponsors have been closing their plans and opting instead to open a defined-contribution plan – or at least considering such action.

However, no matter how good the regulatory framework, there is one risk that no pension plan can eliminate; and that is group-longevity risk. But this risk can be mitigated in a number of ways. For example, contribution rates can be adjusted periodically to reflect changes in average life expectancy. Or, the level of benefits can be adjusted periodically, or the date at which a person becomes eligible to collect a pension can be linked to changes in the life expectancy tables. But legal and contractual obstacles stand in the way of mitigating this longevity risk. It won't be easy to overcome these obstacles, but it is absolutely necessary to do so. Sponsors and plan members both need to have the incentives to deal with group-longevity risk properly.

Those are just a few of the key risks facing pension plan members and sponsors – risks which I know you will discuss over the course of this conference. There would also be risks to society from a lack of private pension plans and in particular, defined-benefit pension plans. For example, younger workers may not be able to generate adequate private savings or even build up enough in a system of defined-contribution plans to fund a sufficient retirement income. That would mean that post-retirement, pressures would be heightened on governments to spend ever greater amounts on income-support programs. Further, there would also be risks to efficient market functioning and long-term risk capital in the economy if there weren't enough well-managed, private pension funds able to take a longer view with their investments.

Now, I've talked a great deal on the topic of risk and risk management, and how crucial this is the planning of pension arrangements. I've argued on previous occasions that an appropriately structured defined-benefit plan can deliver benefits to pension plan members, sponsors and society. But I'd like to leave an important question with you: How do we preserve the many advantages of a defined-benefit pension plan but make it possible to distribute risk more appropriately and enhance the viability of these plans?

Why is pooling so important (or; everyone into the pool)

I'd like to pose two further questions for you as well. How can we extend the advantages of an appropriately structured defined-benefit plan to small businesses and their employees, and to those who do not otherwise have access to a private pension plan? How can we help to make plans more portable, so they do not unduly constrain our flexible labour market?

As I mentioned earlier, pooling is a fundamental risk-management strategy of pension planning, and so creating powerful incentives to encouraging pooling makes a great deal of sense. Taking that logic a step further, we can easily imagine the benefit of a strong incentive to create broader pools comprised of a collection of smaller pension plans and individuals. In the larger pool, the risks and expenses of offering a pension are mitigated by spreading these across a wider collection of employers and plan members.

I'll now cite just a few examples of pooling that might be instructive for this discussion and perhaps stimulate further debate on this issue. The Ontario Teachers Pension Plan – a defined-benefit plan – has successfully brought together employees performing the same type of job, but in many different school boards. In the United States, the TIAA-CREF retirement system – a defined-contribution plan – demonstrates the breadth of a membership pool that could be possible. Now, I'm certainly not advocating any particular form of pool or suggesting how one might best be structured. Rather, I want to provoke discussion about how pools could be broadened to meet the needs of Canadians.

There are many reasons for workers and plan sponsors to support a properly structured and broader pension pool. It could increase portability and thus remove what has been a disincentive for some to join pension plans. This might also be an incentive for attracting younger workers to a plan. The larger pool could reduce expenses by allowing overhead costs to be spread more widely. The larger investment pool and greater economies of scale could yield greater returns. Further, it could reduce the risk from insolvency of any single employer.

For society, the benefits are similar: larger, more stable pooled pension plans could reduce the risk of retirees facing inadequate pensions. Larger pools of pension funds should also be able to better accept the risk of investing in alternative assets and in infrastructure. This is certainly an area that will require much greater amounts of capital investment in future. And indeed, pension and endowment funds are now allocating an increasing share of their portfolio assets to infrastructure investments, in an attempt to ensure reasonable rates of return over a very long time horizon, and to provide a better match to their liabilities.

But there are certainly a great many factors to consider with a broader pension pool; factors that must be dealt with correctly if the wider pool is to be effective. Let me raise just a few examples. There would have to be incentives to ensure that employers, once in a larger pool, would remain current with their contributions. Incentives to ensure good governance and continuing relevance of benefit plans would be necessary. Incentives could also be needed to ensure the pool could expand and diversify.

Finding an appropriate set of incentives for these types of pension plans is extraordinarily difficult. But just because we have not been very successful in the past doesn't mean that we should not try in the future. And as the CFIB has noted, smaller employers in particular would benefit from a broader pool in which they could participate for the benefit of their own employees. And perhaps it is worthwhile considering the CFIB's suggestion that a voluntary component be added to the CPP, with a segregated fund administered by the CPP Investment Board.

Conclusion

Ladies and gentlemen, let me conclude. Regulation can help foster the development of broader, more effective pension pools by reinforcing the right incentives to make private, voluntary plans work, and to ensure choice. I've talked about some of the risks that these pension plans face and have suggested that a greater use of pooling could help to put these plans on a more sustainable footing. This could be particularly valuable in supporting defined-benefit pension plans, which have been under a great deal of pressure in recent years. However, success will hinge on strengthening the legal, regulatory, accounting, actuarial, and economic frameworks that determine how pension plans operate. Reviews are underway, both at the provincial and at the federal levels. If we collectively can get it right, these changes would give sponsors the appropriate degree of flexibility needed to manage risk effectively.

I don't have a legislative blueprint to develop the kinds of regulatory changes needed to better balance risk and promote a greater use of pooling. My job today is not to provide prescriptions but rather to challenge you to deal with these issues, during this seminar and in the months and years ahead. If you are successful, then Canadians will have a better-managed pension system that is good for members, good for employers, good for the economy, and good for society.