

Pension de-risking – FAQs

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Clients turn to our pensions and benefits law experts for insight on pension risk management. Below are some of the most frequently asked questions.

Q: What sort of de-risking strategies do pension plan administrators typically consider?

A: When first considering de-risking, pension plan administrators typically will look at their pension formula. The conversion of a defined benefit (DB) plan to a defined contribution (DC) plan, for example, is a classic de-risking strategy. Switching from guaranteed indexation to conditional indexation is another common strategy. Pension plan investments are also typically at the top of the list when considering de-risking; for example, the administrator will seek to better match the assets (such as bonds) to the plan's liabilities (so-called "liability-driven investing").

Q: What is the advantage for a pension plan administrator to enter into a longevity transaction as opposed to an annuity buy-in or buy-out?

A: A longevity transaction transfers only the longevity risk to the counterparty. There is no lump-sum transfer of assets from the pension plan to the counterparty as there is in an annuity purchase, and therefore the pension plan administrator retains the ability to invest the assets, with the upside potential (but also the investment risk) that goes along with that. Also, the plan sponsor may wish to retain a link with its pensioners, and an annuity buy-out severs that link, at least in terms of the pension payments.

Q: Does entering into a longevity transaction make the DB plan more affordable for the plan sponsor?

A: De-risking strategies such as longevity transactions are not aimed at making the pension plan more affordable. Instead, what the plan sponsor achieves is greater certainty, in that the sponsor will be protected in the event that current best-estimate mortality assumptions turn out to be inaccurate.

Q: What risks should a pension plan administrator consider when entering into a longevity transaction?

A: One of the most important risks to consider is counterparty risk. A longevity transaction is

typically entered into for the life of the pensioners covered, and therefore can last many years if not decades. The administrator must consider the credit-worthiness of the counterparty, and ensure that it will be able to fulfill its obligations for the life of the contract.

Q: Is there a future for DB plans, or will all sponsors eventually switch to DC plans?

A: While there is certainly a trend in Canada towards DC plans, not all plan sponsors are switching from DB to DC, and in fact there have been instances of sponsors switching back to DB following a prior conversion to DC. Also, other innovative plan designs are now available to plan sponsors, for example target benefit plans in New Brunswick, which offer the advantages of a DB plan for the members while addressing the funding risk shouldered by the plan sponsor.