Economic Research Department

BBVA

Pension Highlights

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Defined Benefit Pension Plans

Soledad Hormazábal Delgado
Pension's economist
BBVA Pensions Analysis Unit
shormazabal@bbvaprovida.cl

- Defined benefit pension plans involve a commitment to pay a pension that is determined based on variables other than return on investment, such as wage or the number of years of service. According to Valdés, 2002, in this type of plan, the aggregate financial risk is not distributed to pension-savers or pensioners, which means that their benefits do not suffer changes due to variations in return on investment. The plan sponsor, the government or a private company, assumes this risk. However, pension-savers in these plans are exposed to other collective risks, as well as individual risks. An example of these individual risks is that the taxable wages may not be high enough. This risk increases as the benefit formula is based on a fewer number of years of wages to determine the pension amount.
- Then there are defined contribution pension plans, which involve a commitment to pay a pension in accordance with a series of variables, which include the financial investment risk. In these plans, the contributions that the pension-savers must make are determined in advance. This, together with the return on investment, will form the pension fund based on which the benefits will be awarded. Pension-savers in this type of plan assume the entire financial risk, although exposure to other risks, such as changing employer in a situation of fragmented pension plans, is much lower.
- The recent economic crisis has brought the financial risk out into the open. In 2008 there was a heavy fall in the value of pension funds, and as a result defined contribution plans were seriously questioned. Fortunately, pension funds are recovering (OECD, 2009). Nonetheless, concern over both government-sponsored and privately-sponsored defined benefit plans is rising. Although defined benefit plans are theoretically immune to financial risk, this is not necessarily the case for working pension-savers because intense financial variations can affect the solvency of the plan guarantor. As Valdés states, *a "defined benefit" plan awarded by a financially-fragile sponsor or by a fiscally-weak Government could pass on a greater investment risk to pension-savers than a defined contribution plan*. Even if the guarantor has a strong financial standing, the plan could end up in an insolvent position, which would mean amending the conditions, thus removing the predictability of the benefit related to the plan.
- In government-sponsored defined-benefit plans, the taxpayers might end up assuming the financial risk, and would have to pay more taxes to meet the plan obligations. A particularly complex situation from the point of view of incentives occurs in pension systems for public sector employees, because the pension-savers (a small group) receive these incentives, pushing the benefits up, while the greater cost is distributed among all taxpayers. This can potentially lead to a situation of financial inviability and a considerable decline in fiscal position. A book published recently (Mitchell, O. and Anderson, G.) sets out arguments in favor of generous pension systems for public sector employees, although it seems to be more sensible to keep a single pension system where incentives are common to the whole of society.