CLOSING THE GENERATIONS GAP: MANAGING INTERGENERATIONAL EQUITY RISK

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INTERGENERATIONAL EQUITY HAS BEEN GARNERING A GREAT DEAL OF ATTENTION these past few years. Generally speaking, this becomes a very sensitive topic when tough choices must be made, particularly when governments are grappling with public finance deficits.

For pension plans, the concept of intergenerational equity arises when the talk turns to deficit sharing\(^1\), as the manner in which deficits are shared can give rise to inequities.

When those contributing to a pension plan feel that the deficit sharing method is unfavourable, the plan itself can be compromised. The consequences can then affect the members, the plan sponsor, and in the case of a public plan, the taxpayer.

However, there are measures that can be taken to manage that risk and allow for all Canadians for generations to come to continue enjoying sustainable pension plans.

CONTRIBUTING FACTORS

The financial situation of defined benefit pension plans has deteriorated mightily since the early 2000s. Population aging—which is reflected in a declining proportion of pre-retired versus retired members—and ever-tumbling interest rates are two of the chief factors behind the deficits in such plans.

What is more, the consequences of an aging population are made worse by rising longevity—a very important issue for these plans that have to pay out over longer-than-expected timeframes.

When the deficit level is such that pension plans must reduce the benefits they pay to decrease the value of the benefits, or increase the members’ obligations to cover the deficits, the issue of intergenerational equity...
arises in discussions about these decisions. Which members will see their benefits lowered or their contributions raised? While there are compelling reasons for keeping pensioners’ benefit levels where they are, this inevitably leads to intergenerational inequity, or at least the perception of a degree of inequity.

When plans are doing well, surplus sharing can also affect the intergenerational balance—although the idea of inequity seems different when the conversation turns to sharing a surplus rather than sharing a deficit.

This issue is not a recent one, but is more front and centre in the presence of a deficit, when the sacrifice seems greater.

THE PERCEPTION OF INEQUITY

The perception of inequity, intergenerational or not, arises when a pension plan member feels that they are in one of the following situations:

- One is paying more than others (the cost is too high);
- One is receiving less than others (the reward is too low);
- One is paying more than others for what he or she is receiving (the cost/reward ratio is too low);
- One is receiving less than others for the risk he or she is taking (the risk premium is too low).

Inequity may arise between the plan sponsor and the members, which does not constitute intergenerational inequity per se. But when “the other guy” is personified by a cohort of members from another generation—when, say, younger workers feel that they are paying more into a pension plan in order to fund higher benefits to pensioners who are living longer—then it is intergenerational inequity.

This inequity can appear between active members and pensioners, but also among active members—for example, between young employees and those nearing retirement.

WHAT IS INTERGENERATIONAL EQUITY?

Intergenerational equity is the concept that resources do not belong to a specific generation but must instead be administered, and preserved, for future generations. It is often applied to environmental issues (e.g., many believe the Amazon rain forest must be preserved in order to help sustain the planet’s climate for generations to come), but has also been used by economists and financial professionals:

In 1974 economist James Tobin applied the concept to endowed funds: The trustees of endowed institutions are the guardians of the future against the claims of the present. Their task in managing the endowment is to preserve equity among generations.

Intergenerational equity is about protecting the future from the claims of the present. It means not running down resources—be it fishing stocks, river quality, or, indeed, money. In financial terms the proceeds of an endowed fund should not be spent [at] a rate that exceeds the after-inflation return on its investments. This ensures that the proceeds are spent equally on current and future constituents of the endowed assets.

The issue can also arise in connection with, for example, public pension plans. Given Canadians’ increasing longevity, larger amounts will be required to fund retirement and healthcare programs for the general population. The bill will have to be met by younger generations. Intergenerational equity involves finding ways to avoid an undue increase in taxes and contributions for these young generations. This can mean that today’s governments might reduce pension plan benefits or change long-term healthcare funding strategies. Either step would call on actuaries’ expertise.

2 The very high investment earnings of the 1970s are now a distant memory, and some plans are taking steps to support their members’ benefits; the Ontario Teachers’ Pension Plan, for instance, uses conditional inflation protection for services computed after 2009. Governments are also using new forms of plans to encourage today’s working generation to save; for example, the Ontario Retirement Pension Plan, the federal Pooled Registered Pension Plan (PRPP), and the Québec Voluntary Retirement Savings Plan (VRSP)—these have different levels of risk pooling among members.
It would appear that intergenerational inequity depends on sources that are all linked with the notion of sharing: cost sharing, deficit sharing, risk sharing. This notion of sharing basically comes from risk pooling, the extent of which varies according to the type of pension plan, as the above illustration shows.

### HOW PENSION PLANS CAN REDUCE INEQUITY

Greater pooling of risks (longevity, interest rates, investments, etc.) would seem to contribute to the risk of intergenerational inequity.

A simple solution, then, would be to select plan types that minimize forms of pooling. At this end of the spectrum, the personal registered retirement savings plan (RRSP) embodies this principle perfectly. Each individual accumulates as a benefit the amount of his or her contributions and investment income, no more and no less, thus completely eliminating the risk of intergenerational inequity; at least to the extent that investment management fees do not vary too much over time and affect different generations similarly.

Greater individualization of risks, while offering obvious advantages in terms of simplicity, is not ideal for the following reasons:

- There is a higher average cost per saver:
  - Individual longevity coverage is very expensive, since the time of death is far less predictable for one individual than for a group of individuals; and
  - Individual investment products can have high management fees; and
- Non-optimal retirement planning is frequent due to a level of financial literacy that is highly variable from one individual to another, and very low among Canada’s population in general (see the April 2014 edition of Seeing Beyond Risk).

The consequences of risk individualization argue in favour of maintaining a certain degree of pooling. However, maintaining a defined benefit plan or eventually putting in place a target benefit plan must not come at the cost of intergenerational equity. Too much inequity inevitably causes members to disengage from their plan, not to mention the possibility of financial insecurity on the part of certain groups of members. Such circum-

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3 It should be noted that a target benefit-type plan, under which benefits are adjusted according to the plan’s finances and allowing for extensive risk pooling, is still in its infancy. The legislation in most of the provinces does not yet allow for such a plan to be put in place. Many of the proposed target benefit plans transfer the risks almost totally to the members. A CIA task force is examining the issues associated with this type of plan, including the issue of intergenerational equity.
In recent years, government legislation and regulations have made increasing reference to the work and responsibilities of the actuary. In most of these documents, the term “actuary” is defined as a Fellow of the Canadian Institute of Actuaries. In some instances would cause the plan sponsor to disengage as well, the latter seeing no benefit in maintaining a plan that is not valued by the employees. This is, needless to say, something to be avoided.

A COMPROMISE OBJECTIVE

One compromise would be to maintain significant pooling of risks while explicitly managing the risk of plan inequity. This way, the benefits of pooling would be maintained while the risks of inequity would be reduced.

In theory, a defined benefit plan sponsor could adjust the benefits and contributions to reduce inequity. In practice, legal and tax constraints lead to very limited action to reduce a high level of inequity. For example, reducing benefits for past service, which would be necessary to eliminate a high level of inequity, is currently not allowed for most pension plans.

Thus, the risk of inequity, like any other risk associated with a pension plan, could be closely monitored and managed through the following steps:

- Define the risk;
- Establish a measure of the level of inequity;
- Establish a target and a tolerance zone;
- Monitor changes in the risk; and
- Make defined changes if the measured risk exceeds the tolerated level.

The success of this process depends on the following factors:

- The process must be agreed to by the various parties:

  ◦ All the stakeholders (sponsor, retired members, active members, trustees) must be consulted and involved in putting the process in place.

- The target and the tolerance zone must be realistic and based on members’ mutual responsibility:

  ◦ Zero inequity is not an achievable target; and
  ◦ Greater members’ solidarity allows for greater tolerance.

- The method of measuring risk must be clear and easily interpreted—for example, by assessing the gaps among cohorts with respect to the following measures:

  ◦ The ratio of total benefits to total contributions;
  ◦ The ratio of total contributions to annual payments; and
  ◦ The rate of internal yield on contributions.

- Any necessary changes to the plan must be planned for:

  ◦ In the event that too much inequity is observed, corrective measures should be established beforehand and set out in a policy.
Examples of corrective measures include:
- Increased employer contributions;
- Increased members’ contributions;
- Increased age at retirement;
- Reducing subsidies for early retirement; and
- Reducing indexing formulas.

Drastic degrees of correction are not desirable and might be difficult to implement. However, close monitoring of inequity risk would lead to moderate levels of corrective measures, with conditional inflation protection in some pension plans being a tangible example.

CONCLUSION: PREDICTING INSTEAD OF CURING

Putting in place a process to explicitly monitor intergenerational equity would have major advantages. First, maintaining pension plans with pooling of risks, like the risk of longevity, is conducive to improved retirement planning and optimal funding. And from a human resources angle, greater commitment by members to their plan offers the sponsor a valuable tool for attracting and retaining members.

But most of all, careful monitoring of the level of intergenerational inequity in a plan would enable stakeholders to make gradual or minor changes before inequity can reach a level that would jeopardize the plan’s viability.

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