

Are Automatic Balancing Mechanisms Appropriate for Private Sector Defined Benefit Pension Plans?

Doug Andrews, MBA, FCIA, FSA, CFA
University of Southampton

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ABSTRACT

The Swedish social security system contains a mechanism referred to as an automatic balancing mechanism (ABM) that adjusts the rate credited to contributor accounts and the amount of increase in pensions in payment when liabilities exceed assets. The Swedish social security system also includes some other adjustment features including adjusting annuity factors to reflect, in part, improvements in cohort mortality and crediting accumulations (and to a certain extent pensions in payment, as will be explained in the paper) with the rate of growth in average wage per capita, thus connecting the growth in contributions and pensions to economic growth. The German social security system adjusts benefits by a sustainability factor that has been calculated to maintain long-term contribution rates within a certain range.

The above description of Sweden's social security applies to the component of the system that is Notional Defined Contribution (NDC). The German system, as it has been modified, could be considered to be quasi NDC. Mathematically, NDC and career-average-earnings defined benefit (DB) plans are similar.

This paper considers the question of how the adjustment mechanisms described for the Swedish and German social security systems might be incorporated into private sector DB plans of the following types: multi-employer and single employer. The paper will argue that such adjustment mechanisms may be appropriate in multi-employer pension plans and will present innovative ways in which DB multi-employer pension plans could incorporate adjustment mechanisms. However, the paper argues that adjustment mechanisms are inappropriate in private sector single employer pension plans. The paper does present a modified approach to designing single employer pension plans that combines an employer-paid DB benefit and an employee-paid contribution account that would enhance financial sustainability and provide employees with greater flexibility.