

Research Mandate #7: An Analysis of Asymmetry and Deferred Wages

Research Paper: Arguments about Asymmetry of Risks and Rewards and Deferred Wages in Pension Plans

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Executive Summary

A Conceptual Framework

Defined-benefit (DB) plans create fixed claims and liabilities and residual claims and liabilities. Employees in a DB plan receive a fixed claim to pension benefits, while the plan incurs a fixed liability to pay those benefits. If a DB plan's assets exceed its liabilities (a pension surplus), the party entitled to surplus assets holds the residual claim. If the liabilities of a DB plan exceed its assets (a pension deficit), the party responsible for the shortfall incurs residual liability. The debate over pension surpluses involves conflicting claims about how the residual claims and liabilities in a DB plan *are* allocated and how these claims and liabilities *ought to be* allocated. All parties to the debate agree, however, on the rule that should govern ownership of surplus entitlements. The benefit of a pension surplus should belong to the party who bore the burdens that produced the surplus. In the discussion that follows, the *quid pro principle*, as I call it, provides the benchmark for assessing claims to surplus entitlement.

The Asymmetry Argument

The asymmetry argument views DB plans as contracts in which employees forgo wages in return for a fixed claim to pension benefits. The Pension Benefits Act (PBA) requires employers that sponsor a DB plan to maintain a separate pension fund that secures the plan's obligations. If a plan develops a deficit, the PBA and its regulations make the employer liable for funding the deficit. If the plan develops a surplus, current law grants employees a residual claim to some or all of the surplus when a plan winds up. Proponents of the asymmetry argument contend that the funding regime is asymmetric because the employer alone bears the residual liability for pension deficits while it must share pension surpluses with employees. They claim that this asymmetry discourages employers from funding and may provoke employers to shift to DC plans. A symmetric allocation of burdens and benefits, in which employers' residual liability for all deficits was balanced by a residual claim to all surpluses, would be fairer to employers and more protective to employees.

Under the PBA, a pension surplus is the excess of a plan's assets over its "liabilities" for pension benefits. Presumably a plan's "liabilities" should correspond to the benefits employees believe they are earning. As section 3.2 explains, however, it is not entirely clear what level of pension benefits employees believe they are earning. At

any given time, the service an employee has already performed may lead to her receiving a quit benefit, a wind-up benefit (which is larger than her quit benefit), or a stay benefit (which generally is larger than her wind-up benefit). If, as the *quid pro quo* principle suggests, employees pay for the pension benefit they expect to receive, which level of benefit are employees paying for? Unless this ambiguity can be resolved, the asymmetry theory may not provide clear guidance on surplus issues.

To gauge the validity of the asymmetry argument requires addressing three broad issues: (1) Is the pension-funding regime asymmetric? (2) If the pension-funding regime is asymmetric, is this a problem? For example, does asymmetry discourage employers from funding pension obligations or induce employers to drop DB plans in favor of defined-contribution (DC) plans? (3) If asymmetry creates adverse incentives, do these incentives have harmful effects? For example, does asymmetry reduce the level of solvency in pension plans?

Whether the pension-funding regime is asymmetric depends on who bears the burden of pension deficits, who pays for pension surpluses, and who benefits from pension surpluses. The incidence of these burdens and benefits depends on the policies that produce a surplus or deficit and the context in which the surplus or deficit arises. There are two major reasons for deficits and surpluses: funding policy and investment policy. (See sections 4.1.1 and 4.1.3) If an employer pursues a policy of overfunding pension obligations (perhaps by funding on the basis of conservative actuarial assumptions), a plan is likely to develop a surplus. If an employer pursues a policy of underfunding (perhaps by funding on the basis of aggressive actuarial assumptions), a plan is likely to develop a deficit. A plan with a policy of investing in risky assets or mismatching its assets and liabilities may develop a surplus or deficit depending on experience in capital markets. Surpluses and deficits occur in two contexts: ongoing plans or plans that wind up.

Section 4.1.2 analyzes the context of pension bargaining and concludes that, with one significant exception, employers generally bear the burden of pension deficits in an ongoing plan. Because employers are legally obligated to fund pension deficits, it is difficult for them to shift this burden to employees. This analysis does not apply, however, when a pension deficit is the result of a benefit increase that creates unfunded pension liabilities. In such a case, the employer can require the employees to bear the burden of the deficit as a condition for granting the increase.

When a plan winds up, the incidence of a deficit depends on the employer's solvency. If the employer is solvent, the PBA requires it to fund a wind-up deficiency, in which case the stockholders bear the burden. If the employer is insolvent, employees bear the burden of deficits that result from adverse investment experience or other actuarial losses. If employees are aware of this risk, they can demand a risk premium. If employees have received a risk premium, granting them a surplus entitlement compensates them twice. If employees have not received a risk premium, the analysis in section 5.2 suggests that surplus entitlements leave much to be desired as compensation for insolvency risk. If the employer is insolvent and a pension deficit is the result of a

benefit increase that the employer has not fully amortized, the employees cannot be said to bear a burden because they did not pay for the benefits that they will not receive.

As is the case with pension deficits, funding policy and investment policy are the major reasons for pension surpluses. If a surplus is the result of a policy of overfunding, it seems unlikely that employees bore the burdens that produced the surplus. As section 4.1.4 explains, because employers possess extensive control over business operations and plan administration, they generally get the benefit of surpluses in an ongoing pension plan. It makes little sense for employees to bear the burden of overfunding when the surplus will inure to the employer's benefit. A surplus also may be the result of a policy of choosing risky investments or mismatching a plan's assets and liabilities. Such a policy exposes employees to insolvency risk, which, as noted above, may lead them to demand a risk premium.

As section 4.1.4 explains, whether employers or employees get the benefit of pension surpluses depends on the context in which a surplus arises. When a plan winds up, some or all of the surplus belongs to the employees. In an ongoing plan, the benefit of a pension surplus generally inures to the employer.

Because surplus entitlements are very different in ongoing and wound-up plans, it matters greatly where the line between "ongoing" and "wound up" is drawn and who draws the line. This highlights the importance of the Supreme Court of Canada's decision in *Monsanto Canada v. Ontario (Superintendent of Financial Services)*, 242 D.L.R. (4th) 193 [2004]. The Court held that the surplus entitlements of members and former members affected by a partial wind-up vest when the partial wind-up occurs, rather than when the plan as a whole winds up. The line *Monsanto* establishes between ongoing and wound-up plans gives employers much less control over surpluses than if the Court had held that surplus entitlements do not vest until a plan winds up entirely. Whatever may have been the case before the Court decided *Monsanto*, this decision does appear to create significant asymmetry.

Table 1 on page 5 summarizes the benefits and burdens of pension funding.

As section 5.1 explains, the claim that asymmetry reduces an employer's incentive to fund is both less compelling and more complicated than it seems. An employer's contribution to a pension fund will decrease the plan's deficit or increase the surplus. If an employer must share the surplus, it necessarily gets less benefit from a contribution that produces or increases a surplus than if the employer owned the entire surplus. All other things equal, a regime that gives an employer exclusive ownership of pension surpluses gives the employer more of an incentive to contribute.

This point is even more compelling if the employees' residual claim is viewed as a liability rule that requires the employer to pay damages if the plan winds up with a surplus. From the employer's perspective, a rule that gives employees a residual claim to a wind-up surplus is no different in effect than a rule that makes the employer liable for damages if the plan winds up with a surplus. Tort law requires people to pay damages for

harms that result from negligent conduct as a means of inducing people to avoid negligent conduct. In like manner, a rule that requires an employer to pay “surplus damages” gives employers an incentive to avoid conduct that produces pension surpluses.

But viewing the employees’ surplus entitlement as a liability rule also highlights the fact that an employer does not incur liability for making contributions to its pension plan. It incurs liability for winding up a plan with a surplus. Contributions are not the only source of pension surpluses. Investment policy also plays a major role. In particular, an investment policy that mismatches the investments and liabilities of a pension plan will produce pension surpluses (or deficits). The critical role of investment policy implicates broader regulatory and policy issues, such as the policy that allows employers to make lower pension contributions when their plan selects risky or mismatched investments and the trade-off between ensuring that pension promises are paid and ensuring that pension promises are large enough to support a comfortable retirement.

Table 1
Benefits and Burdens of Pension Funding: The Bottom Line

Who Bears the Burdens of a Pension Deficit?

1. If a plan is ongoing, employers bear the burden of a deficit caused by adverse investment experience or other actuarial losses.
2. If a plan is ongoing, employees bear the burden of a deficit caused by a benefit increase that creates unfunded liabilities.
3. If a plan winds up and the employer is solvent, stockholders bear the burden of a deficit caused by adverse investment experience, other actuarial losses, or a benefit increase that creates unfunded liabilities.
4. If a plan winds up and the employer is insolvent, employees bear the burden of a deficit caused by actuarial losses. If employees are aware of this risk, they can demand a risk premium. If employees do not bargain a risk premium, section 5.2 suggests that entitlement to a share of a wind-up surplus is a poor substitute.

Who Bears the Burden of Policies That Produce Pension Surpluses?

5. If a surplus is the result of a policy of overfunding, it is unlikely that employees bore the burden of the policy. But see discussion in section 3.2.
6. If a surplus is the result of a policy of mismatching investments, the employer bears most of the downside risk but the policy also exposes employees to insolvency risk. If employees are aware of this risk, they can demand a risk premium. If employees do not bargain a risk premium, section 5.2 suggests that entitlement to a share of a wind-up surplus is a poor substitute.

Who Gets the Benefit of Pension Surpluses?

7. If a plan is ongoing, the employer gets the benefit of pension surpluses.
 8. If a plan winds up, employees receive some or all of the surplus.
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Section 5.2 suggests that the incoherent allocation of surplus entitlements may pose a greater threat to DB plans than any asymmetry in the burdens and benefits of pension funding. The rules governing residual claims to pension surplus create sequential entitlements. Employers get the benefit of surplus in an ongoing plan, while employees get some or all of the surplus when a plan winds up. The sequential character of these entitlements means that the employer cannot benefit from the surplus in an ongoing plan without reducing the surplus that will be available to employees when the plan winds up. Moreover, the sequencing of entitlements gives the employer an incentive to get as much benefit as it can from pension surpluses while the plan is ongoing. This structuring of entitlements is bound to – and does – produce conflict.

Proponents of the asymmetry argument claim that the mismatch in the burdens and benefits of pension funding makes DB plans more burdensome, which hastens the ongoing shift from DB to DC plans. As section 5.3 explains, whether asymmetry in the funding regime gives employers an incentive to shift to DC plans depends on how it affects the relative costs and benefits of DB and DC plans as perceived by the parties to the pension bargain. As Richard Ippolito has argued, DB plans are complex arrangements that play out over many decades. As a result, it is often very difficult for employees to weigh the burdens and benefits of a DB plan. Because DB plans are hard to assess, they require a significant degree of trust from employees. In contrast, DC plans require much less trust because they are (or appear to be) transparent. If the structure of surplus rights produces conflict that undermines employees' trust in DB plans, employers will have all the more reason to prefer DC plans.

Section 6.1 discusses a natural experiment on the effect of surplus entitlements on funding practices. Between 1986 and 1990, the U.S. Congress passed a series of laws that impose excise taxes on pension assets that revert to an employer after a DB plan terminates. These taxes create residual claims that parallel surplus entitlements in Ontario. Employers own the surplus in an ongoing plan, but when a plan terminates with a surplus the excise tax gives the federal government a residual claim to most of the surplus. Research on the excise tax suggests that it has had a very detrimental effect on the solvency of DB plans in the United States. Over the last two decades, there have been major changes in actuarial assumptions and contribution levels. In a period in which equity markets produced unprecedented gains, the funding status of DB plans declined. The apparently deleterious effects of the U.S. excise tax deserve close consideration from policymakers in Ontario.

The Deferred-Wage Argument

According to the deferred-wage argument, employees are owners of the pension fund, rather than creditors whose debt is secured by the fund. Proponents of the deferred-wage theory claim that employers bargain employees' pay on a *total-compensation* basis. Employers and employees agree on the total compensation employees will receive then apportion this amount among the various components of compensation such as wages, pensions, and other employee benefits. Employers and employees estimate the level of

contributions needed to pay for pension benefits. Employers then withhold this amount from employees' wages and contribute it to the pension fund. Proponents of the deferred-wage argument contend that employees own the "deferred wages" the employer contributes to the pension fund every bit as much as they own the wages they receive on payday. The employees' ownership of pension contributions entails that they own the pension fund. As owners of the pension fund, employees are entitled to the entire benefit of the fund, including any surplus that develops.

Section 8.1 looks at how the proponents of the deferred-wage model use this argument. The deferred-wage model only comes into play when the model conflicts with the governing documents of a pension plan. In other words, proponents invoke the deferred-wage argument when plan or trust documents include language that conflicts with the implications of the model. When the governing documents of a plan are ambiguous, advocates use the deferred-wage model to justify an interpretation that accords with the view that pension contributions are deferred wages. In such a case, the deferred-wage argument justifies an interpretation that has a textual basis in the governing documents of the plan. When the governing documents of a plan contradict the deferred-wage model, however, the model justifies decisions and policies that override the express provisions of a plan in favor of an interpretation that has no basis in the plan text. The latter use of the deferred-wage model raises the question whether it is a good idea to use a theory of the pension bargain to override provisions in plan documents that are the result of actual bargaining between employers and employees.

The deferred-wage argument reasons that employees own the pension fund because they own the money their employer contributes to the fund. This line of reasoning considers the employees' ownership of amounts withheld from their wages as a *sufficient condition* for their ownership of the pension fund. As section 8.2 explains, the employees' ownership of the money their employer contributes to the pension fund may be a *necessary condition* for the employees to own the fund, but it is not a sufficient condition. There are a variety of circumstances in which a sequence of transfers that is virtually identical to the sequence hypothesized by the deferred-wage model leads to the provider of capital becoming a creditor with a fixed claim to regular payments from the recipient of the provider's capital but with no residual claim to surplus revenues that arise from the recipient's use of the capital. This analysis undermines the inference that employees, as providers of the "deferred wages" their employer contributes to the pension fund, necessarily retain ownership of the assets in the pension fund.

Section 8.3 points out a contradiction in the deferred-wage model. Proponents of the deferred-wage argument contend that employees agree to forgo an amount of wages that will fund the estimated cost of the fixed benefits promised by a pension plan, while their employer agrees to contribute these forgone wages to the pension fund. If the employer and employees overestimate the cost of pension benefits and the plan ends up with a surplus, proponents of the deferred-wage argument contend that employees, who "overpaid" for pension benefits, should receive the benefit of their overpayment. This line of reasoning involves a contradiction. According to the deferred-wage argument, the employer and employees estimate the level of pension contributions based on the

assumption that employees will receive a fixed claim to pension benefits. If employees are entitled to the pension surplus, this assumption turns out to be wrong because the deferred-wage model gives employees both a fixed claim to pension benefits *and* a residual claim to any surplus that develops. In this way, the deferred-wage argument implies that employees get more than it assumes they bargained for.

The deferred-wage argument holds that employers and employees negotiate employees' pay on a total-compensation basis. Pension contributions are a component of total compensation, so employees allow their employer to withhold from their wages the money the employer contributes to the pension fund. Recent experience illustrates that fluctuations in interest rates or equity markets may have a dramatic effect on the contributions an employer must make to its pension plan. If, as the deferred-wage argument contends, pension contributions are forgone wages, there should be a strong inverse correlation between pension contributions and wages. The very significant increases in pension contributions that employers recently have experienced should have produced a corresponding reduction in wages. As section 8.4 explains, both logic and evidence suggest that no such reduction occurred. Yet if employees' wages are not reduced by the full amount of their employers' pension contributions, shareholders bear some of the burden of pension contributions. If this is so, a key premise of the deferred-wage argument – that is, that all pension contributions are deferred wages – is false.