

Pension Funds: Does Fund Risk Increase with Lower Rated Sponsors?

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Pension provision is changing globally, with a move from defined benefit (“DB”, where the sponsoring company or public body takes the risk) to defined contribution (“DC”, where the saver takes the risk).

But while DB schemes are gradually being phased out, they still represent trillions of dollars spread across bonds, equities, real estate and various specialised assets. In some cases, they are fully funded, closed to new business, and “de-risked”. Others are running significant risks in the hope that they can eliminate their deficits; shortfalls have grown in recent years as low interest rates boost the value of liabilities.

Fully funded schemes are no longer a burden for their sponsor; but public bodies and private firms with significant DB pension deficits are under increasing scrutiny – what happens if the sponsor runs into financial trouble?

Figure 1 shows the relationship between the credit risk of a fund and that of its sponsor, covering 117 funds in UK, Canada, Australia and New Zealand. Figure 2 shows the same plot for 250 funds in the US.

Figure 1: UK, Canada, Australia, New Zealand (117 funds)

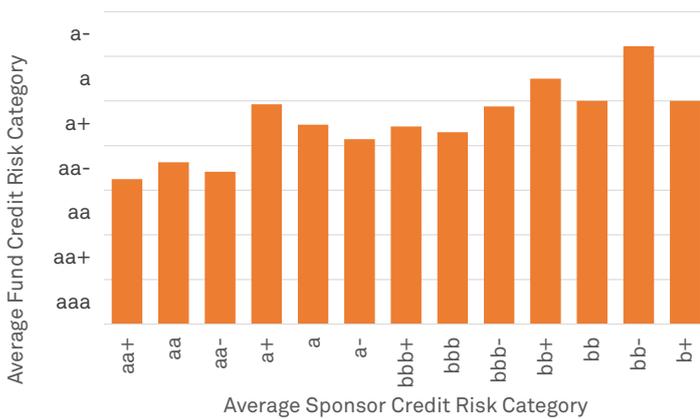
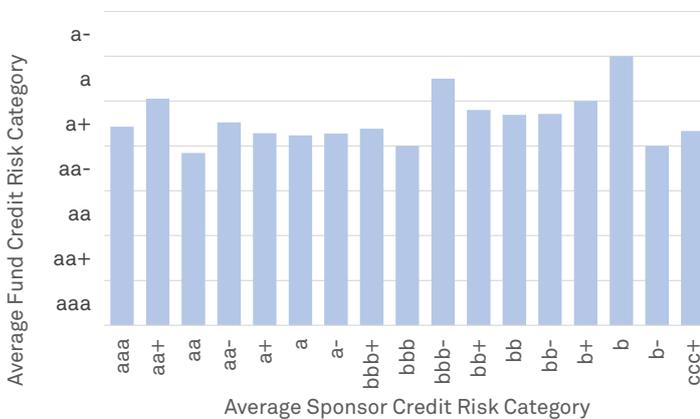


Figure 2: United States (250 funds)



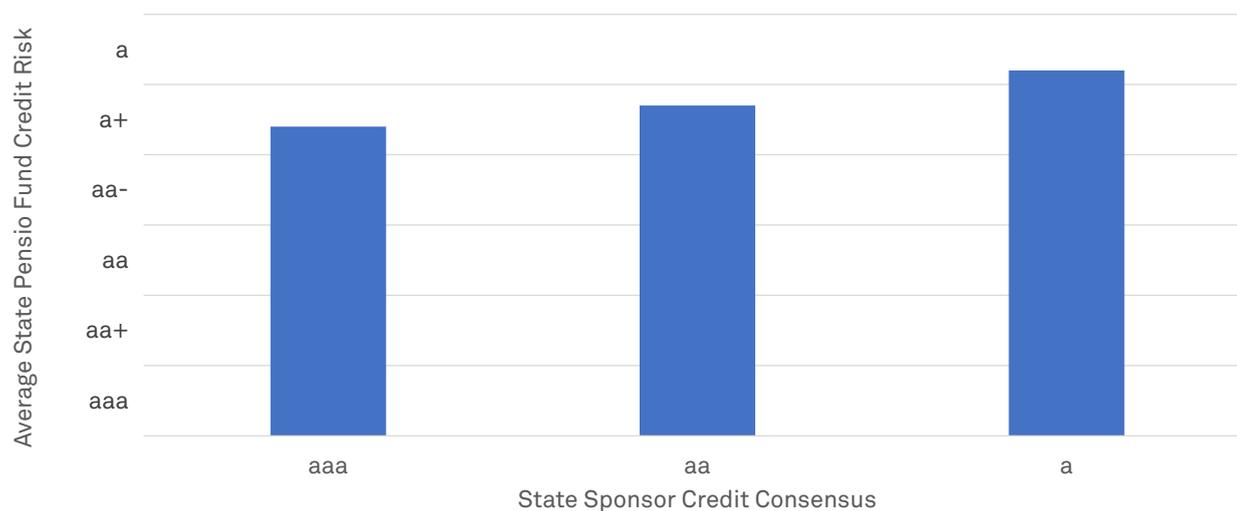
Not surprisingly, for both groups the consensus credit risk range for pension funds is much narrower than the range for the sponsors.

There is a clear positive (and statistically significant) relationship between sponsor and fund average risk in the combined fund sample across UK, Canada, Australia and New Zealand, despite one possible outlier in the a+ sponsor risk category.

Data for the United States shows no clear relationship. This may in part be due to the potentially more complex legal links between sponsor and fund there; in recent years, there have been some successful US court cases establishing employer liability for their pensioners. But some of these rulings are state-specific; and fact that there have been a number of court cases at all shows that the link is sometimes legally tenuous.

The relationship seems clearer for public (State-level) funds. Figure 3 shows the relationship between fund and state sponsor for 23 of the US States.

Figure 3: US State Retirement Fund credit risk



This shows that for this sample, the lowest average pension fund risk is for US States rated as **aaa**, the highest is for US States rated as **a**, with the **aa** state funds approximately midway between them. On average, a one notch increase in state credit risk on the 7-category scale is associated with slightly less than a half-notch increase in typical state pension fund risk on the 21-category scale.

Overall, this data suggests that there can be a relationship between sponsor risk and fund risk, but it depends on geography and legal status.

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