Optimal investment strategies and intergenerational risk sharing for target benefit pension plans

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Mathematical Finance Colloquium
Department of Mathematics
University of Southern California

September 18, 2017
1. **Introduction**

2. **TBP model, control problem and solutions**
   - Model formulation
   - Optimal control problem
   - Solutions

3. **Numerical illustrations**

4. **Conclusion**
Sources of retirement income in Canada

- Canada Pension Plan (CPP)
- Old Age Security (OAS) pension
- Employer-sponsored retirement and pension plans
  - Defined benefit (DB) pension plans
  - Defined contribution (DC) pension plans
  - Group Registered Retirement Savings Plans (RRSP)
  - Pooled registered pension plans
- Converting your savings into income
  - Registered Retirement Income Fund (RRIF)
  - Annuities (term-certain or life)
  - Cash
- Getting money from your home

**DC and DB Plans**

**Defined Contribution (DC) pension plan**
- Predefined contribution level (employee and/or employer)
- Sponsor liability limited to contributions
- Benefit levels depending on investment preference

**Defined Benefit (DB) pension plan**
- Predefined lifetime retirement benefits
- Contributions from both employer and employee
- Collective investment fund
- Mortality risk pooled among members
## Registered Pension Plans and Members in Canada, by Type of Plan, 1992 and 2014

<table>
<thead>
<tr>
<th>Type of Plan</th>
<th>Variable</th>
<th>1992</th>
<th>2014</th>
<th>Difference (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defined Benefit Plan</td>
<td>Plan</td>
<td>7,870</td>
<td>10,414</td>
<td>32.3</td>
</tr>
<tr>
<td></td>
<td>Members</td>
<td>4,775,543</td>
<td>4,401,970</td>
<td>-7.8</td>
</tr>
<tr>
<td>Defined Contribution Plan</td>
<td>Plan</td>
<td>9,901</td>
<td>6,511</td>
<td>-34.2</td>
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<tr>
<td></td>
<td>Members</td>
<td>469,144</td>
<td>1,036,747</td>
<td>121.0</td>
</tr>
<tr>
<td>Others</td>
<td>Plan</td>
<td>257</td>
<td>832</td>
<td>223.7</td>
</tr>
<tr>
<td></td>
<td>Members</td>
<td>73,403</td>
<td>746,442</td>
<td>916.9</td>
</tr>
<tr>
<td>Total</td>
<td>Plan</td>
<td>18,028</td>
<td>17,757</td>
<td>-1.5</td>
</tr>
<tr>
<td></td>
<td>Members</td>
<td>5,318,090</td>
<td>6,185,159</td>
<td>16.3</td>
</tr>
</tbody>
</table>

Target Benefit Plans (TBPs)

- An emerging pension regime in Canada; TBP regimes in New Brunswick, Alberta, and British Columbia
- Collective Pension Scheme (CPS) with “fixed” contributions
- Target benefit amounts modified according to affordability and plan’s investment performance
- Intergenerational Risk Sharing (IRS): investment and longevity risks

References:


Target Benefit Plans

Literature on CPS/IRS

- Cui et al. (2011) and Gollier (2008) estimated welfare gains from IRS within a funded CPS; welfare is improved comparing to DB/DC plans.
- Westerhout (2011) and Van Bommel (2007) pointed out that it is critical that IRS be implemented with a view to fairness.
- Boelaars (2016) compared welfare gains from IRS in funded collective pension schemes with individual retirement accounts.
- CIA (2015) provided a report of the task force on Canadian TBPs.
Target Benefit Plans

Practical objectives of a TBP

- Provide adequate benefits
- Maintain stability
- Respect intergenerational equity

Our work

- Considered a continuous-time stochastic optimal control problem for the TBP on asset allocation and benefit distribution
- Proposed an objective function which balances three practical objectives regarding benefit risks and discontinuity risk
- Obtained optimal asset allocation policy and benefit adjustment policy
Optimal Control Problems

Literature review

- **DC plans**: focused on optimal investment allocation and income drawdown strategies (Gerrard et al., 2004; He and Liang, 2013, 2015)
- **DB plans**: concerned with optimal asset allocation and contribution policies (Boulier et al, 1995; Josa-Fombellida and Rincón-Zapatero, 2004, 2008; Ngwira and Gerrard, 2007)
- **TBP-like plans**: explored rules to reduce discontinuity risk (Gollier, 2008) and studied risk sharing between generations for a variety of realistic CPSs (Cui et al., 2011)
- **Others**: studied optimal portfolio problems (Haberman and Sung, 1994; Battocchio and Menoncin, 2004; Josa-Fombellida and Rincón-Zapatero, 2001)
DYNAMICS OF FINANCIAL MARKET

- Risk-free asset $S_0(t)$

\[ dS_0(t) = r_0 S_0(t) dt, \quad t \geq 0, \]

where $r_0$ represents the risk-free interest rate.

- Risky asset $S_1(t)$

\[ dS_1(t) = S_1(t)[\mu dt + \sigma dW(t)], \quad t \geq 0, \]

where $\mu$ is the appreciation rate of the stock, $\sigma$ is the volatility rate, and $W(t)$ is a standard Brownian motion.
Membership provision

Fundamental elements in a TBP model:

- \( n(t) \): density of new entrants aged \( a \) at time \( t \),
- \( s(x) \): survival function with \( s(a) = 1 \) and \( a \leq x \leq \omega \).

Density of those who attain age \( x \) at time \( t \) is

\[
n(t - (x - a))s(x), \quad x > a.
\]
Dynamics of salary rates

- We assume that the annual salary rate for a member who retires at time $t$ satisfies

$$dL(t) = L(t) \left( \alpha dt + \eta d\overline{W}(t) \right), \quad t \geq 0,$$

where $\alpha \in \mathbb{R}^+$ and $\eta \in \mathbb{R}$. $\overline{W}$ is a standard Brownian motion correlated with $W$, such that $E[W(t)\overline{W}(t)] = \rho t$.

- For a retiree age $x$ at time $t$ ($x \geq r$), we define his assumed salary at retirement ($x - r$ years ago) as

$$\tilde{L}(x, t) = L(t)e^{-\alpha(x-r)}, \quad t \geq 0, \ x \geq r.$$
Plan Provision: time-age structure
Plan Provision: Benefit Payments

- Individual pension payment rate at time \( t \) for those aged \( x \):

\[
B(x, t) = f(t) \tilde{L}(x, t) e^{\zeta(x-r)} = f(t) L(t) e^{-(\alpha-\zeta)(x-r)}, \quad x \geq r.
\]

where \( e^{\zeta(x-r)} \) represents the cost-of-living adjustments, and \( f(t) \) is the benefit adjustment variable at time \( t \).

- Aggregate pension benefit rate for all the retirees at time \( t \):

\[
B(t) = \int_{r}^{\omega} n(t-x+a)s(x)B(x, t)dx = l(t)f(t)L(t), \quad t \geq 0.
\]

- \( B^* \) is a pre-set aggregate retirement benefit target at time 0 and updated aggregate benefit target at time \( t \) is \( B^* e^{\beta t} \), where \( \beta \) can be viewed as a inflation related growth rate.
**Plan Provision: contributions**

- Individual contribution rate for an active member aged $x$ at time $t$:
  \[ C(x, t) = c_0 e^{\alpha t}, \quad a \leq x < r, \]
  where $c_0$ is the instantaneous contribution rate at time 0 in respect of each active member, expressed as a dollar amount per year.

- Aggregate contribution rate in respect of all active members at time $t$:
  \[ C(t) = \int_a^r n(t - x + a)s(x)C(x, t)dx = C_1(t) \cdot e^{\alpha t}, \quad t \geq 0. \]
Pension Fund Dynamic

Let $X(t)$ be the wealth of the pension fund at time $t$ after adopting the investment strategy $\pi(t)$.

The pension fund dynamic can be described as

$$ \begin{align*}
\left\{ \begin{array}{l}
    dX(t) = \pi(t) \frac{dS_1(t)}{S_1(t)} + (X(t) - \pi(t)) \frac{dS_0(t)}{S_0(t)} + (C(t) - B(t))dt, \\
    X(0) = x_0,
\end{array} \right.
\end{align*} $$

where $\pi(t)$ denotes the amount to be invested in the risky asset at time $t$. 
The objective function

- Let $J(t, x, l)$ be the objective function at time $t$ with the fund value and the salary level being $x$ and $l$. It is defined as

$$
J(t, x, l) = E_{\pi, f} \left\{ \int_t^T \left[ (B(s) - B^* e^{\beta s})^2 - \lambda_1 (B(s) - B^* e^{\beta s}) \right] e^{-r_0 s} ds 
+ \lambda_2 (X(T) - x_0 e^{r_0 T})^2 e^{-r_0 T} \right\},
$$

$$
J(T, x, l) = \lambda_2 (X(T) - x_0 e^{r_0 T})^2 e^{-r_0 T},
$$

where $\lambda_1, \lambda_2 \geq 0$.

- The value function is defined as

$$
\phi(t, x, l) := \min_{(\pi, f) \in \Pi} J(t, x, l), \quad t, x, l > 0,
$$

where $\Pi$ is a set of all the admissible strategies of $(\pi, f)$. 
Using variational methods and Itô’s formula, we get the following HJB equation satisfied by the value function $\phi(t, x, l)$:

$$
\min_{\pi, f} \left\{ \phi_t + \left[ r_0 x + (\mu - r_0)\pi + C_1(t)e^{\alpha t} - fl \cdot I(t) \right] \phi_x + \alpha l \phi_l \\
+ \frac{1}{2} \pi^2 \sigma^2 \phi_{xx} + \frac{1}{2} \eta^2 l^2 \phi_{ll} + \rho \sigma l \pi \phi_{xl} + \left[ \left( fl \cdot I(t) - B^* e^{\beta t} \right)^2 \\
- \lambda_1 \left( fl \cdot I(t) - B^* e^{\beta t} \right) \right] e^{-r_0 t} \right\} = 0.
$$
SOLUTIONS

\[
\min_{\pi} \left\{ \phi_t + \left[ r_0 x + (\mu - r_0) \pi + C_1(t) e^{\alpha t} \right] \phi_x + \alpha l \phi_l + \rho \sigma \eta l \pi \phi_{xl} + \frac{1}{2} \pi^2 \sigma^2 \phi_{xx} \right\} = 0
\]

\[
\min_{f} \left\{ -f \cdot l(t) \phi_x + \frac{1}{2} \eta^2 l^2 \phi_{ll} + \left[ (f \cdot l(t) - B^* e^{\beta t})^2 - \lambda_1 (B(t) - B^* e^{\beta t}) \right] e^{-r_0 t} \right\} = 0
\]

Then the optimal solutions are given by

\[
\pi^*(t, x, l) = -\frac{\delta \phi_x + \rho \eta l \phi_{xl}}{\sigma \phi_{xx}},
\]

\[
f^*(t, x, l) = \frac{1}{l(t)} \left[ \phi_x e^{r_0 t} + \lambda_1 \frac{1}{2} + B^* e^{\beta t} \right],
\]

where \( \delta = (\mu - r_0) / \sigma \) is the Sharp Ratio.
By the terminal condition, we postulate that $\phi(t, x, l)$ is of the form

$$\phi(t, x, l) = \lambda_2 e^{-r_0 t} P(t)[x^2 + Q(t)x] + R(t)x l + U(t)l^2 + V(t)l + K(t).$$

The boundary condition implies that $R(T) = U(T) = V(T) = 0$ and

$$P(T) = 1, \quad Q(T) = -2x_0 e^{r_0 T}, \quad K(T) = x_0^2 e^{2r_0 T}.$$
Solutions

By comparing the coefficients, we get the following system of differential equations:

\[ P_t + (r_0 - \delta^2 - \lambda_2 P(t)) \, P(t) = 0 \]
\[ U_t + (2\alpha + \eta^2) U(t) - \left( P(t) + \frac{(\delta + \rho\eta)^2}{\lambda_2} \right) \frac{e^{r_0 t}[R(t)]^2}{4P(t)} = 0 \]
\[ R_t + (r_0 - \delta^2 + \alpha - \delta\rho\eta - \lambda_2 P(t)) \, R(t) = 0 \]
\[ Q_t + \left[ \frac{P_t}{P(t)} - \delta^2 - \lambda_2 P(t) \right] Q(t) + 2 \left( C_1(t)e^{\alpha t} - B^*e^{\beta t} \right) = 0 \]
\[ V_t + \alpha V(t) + \left( C_1(t)e^{\alpha t} - B^*e^{\beta t} - \frac{1}{2} (\delta^2 + \delta\rho\eta + \lambda_2 P(t)) \, Q(t) \right) R(t) = 0 \]
\[ K_t + \lambda_2 e^{-r_0 t} P(t)Q(t) \left[ C_1(t)e^{\alpha t} - B^*e^{\beta t} - \frac{1}{4} (\delta^2 + \lambda_2 P(t)) \, Q(t) \right] - \frac{\lambda_1^2 e^{-r_0 t}}{4} = 0 \]
Solution to the optimization problem

\[ P(t) = \begin{cases} 
\frac{1}{\lambda_2(T-t)+1}, & r_0 = \delta^2, \\
\frac{r_0 - \delta^2}{\lambda_2 + (r_0 - \delta^2 - \lambda) e^{-(r_0 - \delta^2)(T-t)}}, & r_0 \neq \delta^2,
\end{cases} \]

\[ Q(t) = \begin{cases} 
2e^{r_0 t} \left[ \int_t^T C_1(s)e^{(\alpha - r_0)s}ds - B^*(T - t) - x_0 \right], & \beta = r_0, \\
2e^{r_0 t} \left[ \int_t^T C_1(s)e^{(\alpha - r_0)s}ds - B^* \left( e^{(\beta - r_0)T} - e^{(\beta - r_0)t} \right) / (\beta - r_0) \right] - x_0 \right], & \beta \neq r_0,
\end{cases} \]

\[ K(t) = \lambda_2 \int_t^T e^{-r_0 s} \left\{ P(s) Q(s) \left[ C_1(s)e^{\alpha s} - B^* e^{\beta s} \right. \\
\left. - \frac{1}{4} \left( \delta^2 + \lambda_2 P(s) \right) Q(s) \right] - \frac{\lambda_1^2}{4} \right\} ds. \]

\[ R(t) = U(t) = V(t) = 0 \]
Optimal strategies are

\[ \pi^*(t, x, I) = -\frac{\delta}{2\sigma} [2x + Q(t)], \]

\[ f^*(t, x, I) = \frac{1}{l \cdot I(t)} \left[ \frac{\lambda_1}{2} + \frac{\lambda_2}{2} (2x + Q(t)) P(t) + B^* e^{\beta t} \right]. \]

Corresponding value function is given by

\[ \phi(t, x, I) = \lambda_2 e^{-r_0 t} P(t)[x^2 + xQ(t)] + K(t). \]
Numerical illustrations

Assumptions for numerical illustrations

- \( a = 30, \ r = 65, \ \omega = 100 \)
- Force of mortality follows Makeham’s Law (Dickson et al., 2013)
- \( n(t) = 10 \) for all \( t \geq 0 \), implying a stationary population
- \( B^* = 100, \ \beta = 0.025 \)
- Cost-of-living adjustment rate \( \zeta = 0.02 \)
- \( r_0 = 0.01, \ \mu = 0.1, \ \sigma = 0.3 \Rightarrow \delta = 0.3 \)
- \( \alpha = 0.03, \ \eta = 0.01; \) initial salary rate \( L(0) = 1 \)
- Correlation coefficient \( \rho = 0.1; \ \lambda_1 = 15, \ \lambda_2 = 0.2 \)
- \( X(0) = 2500; \ c_0 = 0.1 \)
**Numerical analysis**

**Figure:** Percentiles of $\pi^*(t)/X^*(t)$ and $f^*(t)$
Figure: Sample paths of $f^*(t)$ and $B(t)$
**Figure**: Effects of risky asset model parameters
**Numerical analysis**

**Figure:** Effects of salary and target benefit growth rates
**Numerical analysis**

**Figure:** Medians of $f^*(t)$ for different values of $\lambda_1$ and $\lambda_2$
CONCLUDING REMARKS

- Assumed non-stationary population and applied the Black-Scholes framework for plan assets with one risk-free and one risky asset
- Considered three key objectives for the plan trustees (benefit adequacy, stability and intergenerational equity)
- Solved optimal control problem for TBPs in continuous time and found optimal investment and benefit adjustment strategies
- Analyzed properties of the optimal strategies and sensitivities to the model parameters using Monte Carlo simulations
- Observed that intergenerational risk sharing are effective under our model settings
References I


