



Defined Benefit Pension Assets and Liabilities as a Manicured Garden

Helping People Understand the “Big Picture” of Fiscal Health

BY KEVIN WACHTEL

What is a mental model?

A mental model is a representation people hold in their heads of how things work in the real world. A good mental model simplifies complex systems in a way that helps people make more informed and better decisions. Finance officers can improve their own thinking and support others in making better decisions by creating and sharing better mental models for complex public finance topics.

About the Defined Benefit Pension Assets and Liabilities model

Due to its complexity, public officials, pension fund stakeholders, and the general public may not fully understand the long-term effects on pension fund

assets and liabilities. This can have long-term implications on pension contribution rates and their overall financial health.

We think of maintaining a defined benefit pension plan as a large garden that needs a lot of work to make it look beautiful. In this model, contributions equate to the amount of work invested in tending and improving the garden. As time goes on, untended areas of the garden, which represent the liability, continue to grow with weeds and brambles. Left untamed, the plan's liability can become large and unmanageable.

Maintaining a defined benefit pension plan is like manicuring a garden to keep it in good shape, where paying toward the liability is like weeding areas of the

garden. Just like a garden, maintaining a defined benefit pension plan requires clear decisions and firm commitments on how much time and effort will be put into it. A well-managed plan, like a healthy garden, needs regular tending—and when something has gone off course, the amortization period is your plan for quickly restoring balance.

The more you work in the garden, the closer you will get to completion. By working in the garden more now, you will avoid unnecessary overgrowth that will require more work later. Working on the garden a consistent amount of time each week is the “level dollar” method of amortization; spending less time now and more time later is the “level percentage of pay” method. Completing your garden can take a long time, and you may be able to afford to spend more time now, or you may plan to spend more time later.

Questions this model answers

- What is the importance and impact of a defined benefit pension fund's liability?
- How can government decision makers better understand the effect of contributions on the long-term financial health of the defined benefit pension fund?

Why it works

The image of a growing garden is easily understood. It can either grow in a healthy, well-maintained manner or become overgrown and unhealthy. Overgrown gardens keep growing and can get out of control without a methodical approach to improvement and maintenance.

Limitations of the model

No model is a perfect depiction of reality. This model does not capture the potential impacts of positive investment returns or other factors that would positively or negatively affect contributions, assets, and liabilities. There are many other factors that impact the financial health of a pension plan that don't necessarily fit into this mental model. ■

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