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THE VALUATION OF DEFAULTABLE PENSION LIABILITIES

Abstract:

Current approaches to asset-liability management employ a sequence of distinct procedures to value liabilities and determine the asset allocation. First, a discount rate that is usually dictated by accounting standards is used to value liabilities. Second, the asset allocation is determined by maximizing some objective function in the surplus of assets over liabilities, taken as given the valuation of liabilities. We introduce a model that allows for the joint valuation of liabilities and the determination of the optimal asset allocation using discount rates that appropriately reflect default risk. We focus on the case of a defined benefit pension plan.