The State of Defined Benefit Pension Plans in Canada

IAN MARKHAM, FCIA

Defined benefit (DB) pension plans in Canada are a mess and have the potential to get much worse. The big question is whether governments and regulators will act quickly enough to stop the flight away from employer DB risk, lest DB plans go the way of the dodo. Consultation papers are one thing—decisive action is another.

That is not to suggest that these financial entities generally are being mismanaged, nor that many DB plans will fail to pay the benefits they promise. But it now is readily apparent to most plan sponsors, especially to those officers with financial responsibilities, that these entities have the power to destabilize a plan sponsor’s entire organization. One need look no further than Air Canada and Stelco as evidence.

The risks to DB plans were always there, but they have revealed themselves dramatically during the past five years. During much of the 1990s, strong markets beneficial to plan performance hid these risks from many observers, and before this boom time the size of DB pension funds was not regarded as especially significant for many organizations. However, as we well know, the good times came to a crashing halt in the early part of the current decade and problems emerged.

Today’s issues would be much less significant had pension fund managers “de-risked” at the end of the past decade by moving heavily into long bonds, if the supply of long bonds had permitted such a move. Of course, that did not happen and most plans remain heavily invested in equities, which have led the typical plan’s funded ratio to hover around the 85-percent mark as of December 31, 2005.

The DB pension situation also would be much less of an issue if the rewards for taking funding risks went automatically to the party bearing the risks—a symmetrical system—but that mostly is not the case. The asymmetry between risk and reward for plan sponsors rapidly is becoming a major driver of investment, funding, and plan-design decisions—further jeopardizing the DB plan system.

A survey conducted last year by Watson Wyatt and The Conference Board of Canada found that chief financial officers consider the following to be the largest threats to DB plans (measured according to the percentage of respondents who regarded a particular issue as a major threat):

- Volatility of accounting pension expense (53 percent)
- Changing employer views of DB plans as a tool for attraction and retention (50 percent)
- Requirements to distribute surplus on partial wind-up following the Monsanto decision (48 percent)

These CFO concerns are exacerbated by rating agencies that now are downgrading bond ratings if they regard the pension risk as excessive. And the rating agencies are not the only external parties waking up to the issues. The accounting profession globally has been moving toward the volatile world of mark-to-market, whereby financial statements are adjusted to remove the impact of the smoothing of pension assets and the amortization of gains and losses. The Canadian actuarial profession also is considering some far-reaching proposals that, among other changes, would give more power to the plan sponsor to influence the size of actuarial margins in going-concern funding valuations.

We know that plan sponsors are concerned. So how do plan members view the state of DB plans today? In the private sector, most members likely are worried that their pension plans could wind up, leaving them with a significant loss of pension. Our education system does nothing to enlighten the masses about this subject. And the tone used by the media in recent years has left many DB members believing that if their plans have deficits, they own their accrued pensions, but if their plans have surpluses, they own all the assets.

Few plan members understand how unhealthful this belief is for...
the future of their pension plans. For those who actually stop to think about the impact of this asymmetry, it probably would sound like a win-win situation. But it is precisely this impression that is causing CFOs to review plan designs. Our CFO survey showed that, within the previous 24 months or the next 12 months, 47 percent of respondents have been, or will be, changing their plan designs to the detriment of active plan members. They are reducing benefits, increasing employee contributions, or converting to a defined contribution plan or group registered retirement savings plan (RRSP)—at least for future hires.

The survey also revealed a trend toward minimizing employer contributions if the plan sponsor has the flexibility to do so. In the private sector, relatively few organizations are willing to justify to shareholders a decision to contribute more than the law permits, because markets may improve in a later year and those extra dollars may become an actuarial surplus for plan members and unions to fight over.

Many CFOs were upset particularly about the following statement in the Supreme Court of Canada decision on Monsanto:

A surplus is, in effect, a windfall because it was not within the expectations of either the employer or the employees when the regime was implemented.

By establishing actuarial margins of conservatism for funding their plans, CFOs do expect that actuarial surpluses will emerge over time. However, this single statement by the Supreme Court has increased DB risks significantly because of its influence over future court decisions.

So is there hope for the future? It is not enough to simply pray that a major bull market in equities will occur at the same time as a significant increase in long-bond yields, thereby creating actuarial surpluses that can be used to finance a large-scale de-risking move from equities into long bonds. We need a change to the entire regulatory framework governing DB plans.

Traditionally, governments avoid pension issues like the plague. Elections can be lost over an apparent lack of sympathy for the plight of pensioners. Yet without action, we will see the gradual disappearance of DB plans, despite all the attraction and retention advantages that they offer.

Two recent signs of optimism come from Régie des Rentes du Québec and from Department of Finance Canada. Both have released consultation papers seeking input about a number of issues. Between them they cover many big-picture issues, including the following:

- Surplus ownership asymmetry
- Surplus entitlement on partial wind-up
- Allowing alternative financial vehicles in lieu of solvency contributions, such as letters of credit or funds placed in trust
- Extending the amortization period for solvency deficits, or refunding excess employer contributions that turn out not to have been required
- Disclosure of financial information and funding policy to plan members
- Voiding plan amendments when solvency is poor
- Full funding on plan wind-up
- Establishing a pension guarantee fund to protect plan members on wind-up
- Establishing long-term funding targets
- Limiting contribution holidays

The Québec paper takes a strong position in many of these areas and is quite refreshing from a CFO’s perspective.1 This working paper describes how many plan sponsors see the issues; until now we have seen little appetite from any government to acknowledge that a critical viewpoint exists beyond that of the members. The Department of Finance Canada consultation paper seeks input from all stakeholders rather than taking a strong position on issues.2 But as with the Québec paper, language indicates that the Department of Finance has a good understanding of how each major stakeholder seems the issues.

In addition, Alberta Finance released a discussion paper in December 2005 that seeks comments concerning an amendment to the Employment Pension Plans Regulation.3

All interested parties are strongly encouraged to make their voices heard on any or all of these consultation papers. The decision makers in Québec, Ottawa, and Edmonton will need plenty of evidence to back up the policy decisions they are about to make. They should be applauded for having the courage to air the issues. They will deserve a standing ovation if they succeed in creating a regulatory system that levels the playing field for all types of plan designs. Originally, pension plans were designed to attract and retain—and, with proper financial management, that is how they should be able to be designed in the future.

Ian Markham is director of pension innovation at Watson Wyatt in Canada. He has 30 years of experience in the actuarial, pensions, and benefits fields. Contact him at ian.markham@watsonwyatt.com.

Endnotes

