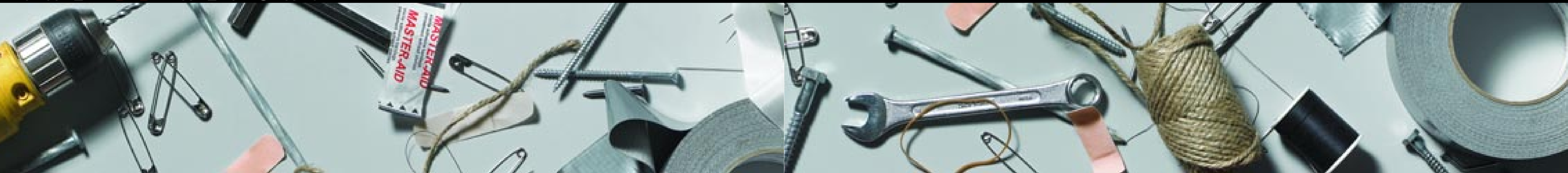

DB: can it be fixed?

Without a closer look by governments and politicians, the Canadian defined benefit plan could become extinct.

By Ian Markham

The defined benefit (DB) pension plan system in Canada is a mess. And it has the potential to get much worse. The big question is whether governments and regulators will act quickly enough to stop the flight of employers away from the risks posed by DB plans. Consultation papers are one thing—decisive government action is another.

That is not to suggest that these plans, or the entities that sponsor them, are generally being mismanaged, or that many DB plans will fail to pay their promised benefits. But it is now readily apparent to most plan sponsors that these plans have the power to destabilize an entire organization. One needs look no further than Air Canada and Stelco for evidence.

The risks to DB plans were always there, but they have dramatically revealed themselves over the last five years. During much of the 1990s, strong markets beneficial to plan performance hid these risks. Before this boom, DB pension funds had not been regarded as especially significant for many organizations. However, the good times came to a halt in the early part of the current decade.

Today's problems would be much less significant had plan sponsors and administrators "de-risked" themselves at the end of the '90s by moving heavily into long bonds, an investment that yielded steady returns with little risk (assuming the supply of long bonds had permitted such a move). Of course, that did not happen: most plans remain heavily invested in equities. This has led the typical plan's funded ratio to hover around 80% as of June 2005, down from around 85% only six months earlier.

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

In a survey of chief financial officers (CFOs) conducted earlier this year by Watson Wyatt Worldwide and The Conference Board of Canada, the largest threats to DB plans (according to the percentage of respondents who regarded a particular issue as a major threat) were:

- Volatility of future funding contributions (67%);
- Asymmetry between risk and reward (57%);
- Volatility of accounting pension expense (53%);
- Changing employer views of DB plans as a tool for attraction and retention (50%); and
- Requirements to distribute surplus on partial wind-up following the Monsanto decision (48%).

These CFO concerns are exacerbated by rating agencies that are now downgrading a corporation's bond ratings if they regard the pension risk as excessive. And the rating firms are not the only external parties waking up to the issues. Globally, the accounting profession has been moving for some time towards the volatile world of "mark-to-market," whereby financial statements are adjusted to remove the impact of the smoothing of pension assets—the removal of year-to-year fluctuations in investment returns and actuarial assumptions so that pension fund accounts are not dramatically over- (or under-) stated—and the amortization of gains and losses.

WORRIED MEMBERS

How do plan members view the state of DB plans today? In the private sector, most members are likely worried that their pension plan could wind up, leaving them with a significant loss of pension, despite any sponsor communications they receive. In fact, many DB members believe the asymmetrical proposition that if their plan has a deficit, they are entitled to their entire accrued pension but if their plan has a surplus, they own the plan's assets.

This is causing CFOs to review plan designs. The CFO survey showed that, within the previous 24 months or the next 12 months, 47% of respondents have been, or will be, changing their plan design to the detriment of active plan members. They are reducing benefits, increasing employee contributions, or converting to a defined contribution plan or group RRSP—at least for future hires.

Many CFOs were particularly upset at one of the statements in the Supreme Court's Monsanto decision. "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." Yet, by establishing actuarial margins of conservatism for funding their plans, CFOs do expect that actuarial surpluses will emerge over time. Unfortunately, this single Supreme Court statement will in itself have increased DB risks significantly because of its influence over future court decisions.

The CFO survey also revealed a trend towards minimizing employer contributions. Few private sector organizations are willing to justify to their shareholders a decision to contribute more than the law permits. Otherwise, they may find that once markets improve those extra dollars will become an actuarial surplus plan members and unions fight over.

So is there any hope for the future? It is not enough to simply pray. We need a change to the entire regulatory framework governing DB plans.

GOVERNMENT INTERVENTION

Traditionally, governments avoid pension issues like the plague. Yet if there is no action, we will see the gradual disappearance of DB plans, despite the attraction and retention advantages they can offer in a world of pending labour shortages. Recently, there has been some cause for optimism: Quebec's Régie des rentes and the federal Department of Finance have released consultation papers seeking input on a number of topics. Between them they cover many big picture issues, including: surplus ownership asymmetry; surplus entitlement on partial plan wind-up; allowing alternative financial vehicles in lieu of solvency contributions: 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; and limiting contribution holidays.

The Quebec paper takes a strong position in many of these areas. It describes what many sponsors see as the issues; until now, we have seen little appetite by any government to acknowledge that there is a critical viewpoint beyond that of members.

The federal paper seeks input from all stakeholders, rather than taking a strong position. But there is language indicating that the Department of Finance has a good understanding of how each of the major stakeholders see the issues.

All interested parties should be strongly encouraged to make a submissions regarding both consultation papers. The decision-makers in Quebec and Ottawa will need plenty of evidence to back up the policy decisions they are about to make. And 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.

Pension plans can play a useful role in helping to attract and, especially retain, employees. With proper financial management, plan design should enable them to continue to play this role in the future. **BC**

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