SOCIETY OF ACTUARIES

Article from:

International News

"F gego dgt 2009 – Issue No.4;

Geoffrey Melbourne, FSA,FCIA, is a senior consulting actuary at Watson Wyatt in Toronto. He can be contacted at *geoffrey.melbourne@watsonwyatt.com*.

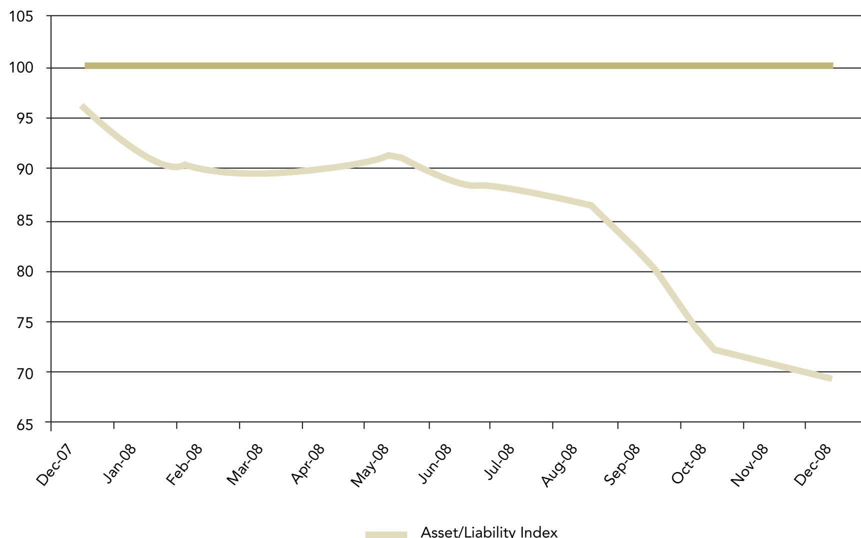
Canada-Pension Grief & Relief

By Geoffrey Melbourne

In the 1990s, Jamaica, my country of birth (and residence for most of my life), went through a financial sector meltdown afflicting its indigenous financial institutions, including banks and insurance companies (which manage large blocks of pension assets). The resolution of the crisis was multi-faceted, including multi-lateral support, "bailout" institutions and regulatory reform. The latter involved new legislation and regulations (e.g., the Insurance Act and the Pensions Act), and a new regulator in the form of the Financial Services Commission. The Canadian model and experience was a beacon in Jamaica's regulatory reform (especially in relation to the insurance sector). Fast forward to 2008 and the beacon is in the process of reforming its multi-jurisdictional pension regulatory environment, as it is widely felt that the status quo is not working effectively.

FIGURE 1

Solvency: Growth Portfolio, 50% Active Liabilities



Source: *http://www.watsonwyatt.com/canada-english/news/press.asp?ID=20364*

Like other global stock market indices, the S&P/TSX Composite Index, plummeted in 2008, with a calendar year return of negative 33 percent compared to the positive return of almost 10 percent in 2007. On the other hand, long-term Government of Canada benchmark bond yields, a key metric in determining pension plan solvency, declined by over 70 basis points in 2008. On the interest rate front, there was some redemptive good news in the following areas:

- For indexed plans, long-term Government of Canada real return bond yields actually increased by over 10 basis points in 2008.
- On an accounting basis, where high quality corporate bond yields are the pertinent metric, financial market turmoil and related widened corporate yield spreads over treasuries resulted in decreased pension benefit obligations to offset some of the investment losses.
- The prescribed standard for determining lump sum commuted values from pension plans was changed, with one of the changes allowing a higher yield spread over treasuries than obtained previously.

Nonetheless, the overall effect of the foregoing factors was a significant decline in defined benefit pension plan solvency ratios in 2008, with Watson Wyatt's Pension Barometer estimating a drop for the typical plan from 96 percent at the beginning of the year to 69 percent (73 percent after allowing for the new lump sum commuted value standard) at the end of the year (see Figure 1 to the left).

These reduced solvency ratios require significant increases in contributions at a time when many companies are facing financial stress and business issues such as reduced customer

"There are obviously valid concerns on either side, with plan sponsors facing huge funding issues in tough economic times, and some members facing under-funded benefits sponsored by companies which are bankrupt or against the ropes"

demand, tighter debt markets and collections challenges. The increased contribution requirements are also competing with corporate capital investment plans.

Canada's pension regulatory system is complex, with Canada Revenue Agency governing tax issues through the Income Tax Act, the province with the plurality of active members governing funding issues, and the province of employment of each member governing minimum benefit standards—some industries (such as banking, broadcasting and air transportation) fall under federal rather than provincial jurisdiction. Most jurisdictions have relief measures to ease the heavy contribution requirements imposed on plan sponsors. For the most part, the relief involves extending the amortization periods for pension solvency deficits (from the standard period of five years), subject to conditions like member consent or letter of credit security for deferred contributions in some cases.

In addition, several jurisdictions are considering permanent reform measures to sustain and improve the pension system. To my mind, the Alberta-British Columbia report is perhaps the most innovative, as exemplified below:

- It was a joint effort of two provinces, and recommended harmonization of pension standards between them, as well as the exploration of the viability of uniformity across Canada. Any baby steps towards harmonization would represent a huge improvement over the hop-scotch approach prevailing at present.
- It included a number of recommendations to overcome restrictions on the use of surplus, and thereby encourage stronger funding of pension plans.
- It recommended that plan sponsors be allowed to use letters of credit to fund solvency deficiencies.

A plan sponsor wish list for permanent reforms, given the current environment, might include longer amortization periods for pension solvency deficits (without conditions), higher interest rates to determine pension solvency liabilities and other approaches to mitigate the impact of solvency funding requirements, and no elevated priority for pension claims in bankruptcy. Labour asks would include more security for accrued pension benefits, both within ongoing pension plans (longer amortization periods would be a negative) and in the form of a guarantee fund (only Ontario has such a fund for benefits up to a modest limit), and greater transparency and disclosure to members. There are obviously valid concerns on either side, with plan sponsors facing huge funding issues in tough economic times, and some members facing under-funded benefits sponsored by companies which are bankrupt or against the ropes. Hopefully any reforms will reflect a happy medium.

Some financial gurus have highlighted the role of various financial models in the recent financial and economic tsunami. Although financial economics as a defined term seems to have waned in prevalence in actuarial literature over the last couple of years, terms such as LDI and ERM seem to have increased in popularity, and plan sponsors should be re-assessing their ability to bear the risks imposed by their pension plans (especially investment risks), recognizing how low and real the bottoms can be and the correlation that those bottoms might have with other

CONTINUED ON PAGE 32

Canada-Pension … | from Page 31

risks facing their businesses. The models used to make these assessments in the past may not have the right answers for today's reality, or their results may require different interpretation.

The demise of defined benefit pension plans has been accompanied by a greater reliance on defined contribution plans, both at the occupational and individual levels. Defined contribution plans were by no means immune to the market crash in 2008, and while no funding issues for companies would have emerged as a result, workforce and HR issues likely will arise. Individuals relying on defined contributions plans for a significant portion of their retirement income may now be facing serious challenges with their retirement planning, especially at the older ages. Although legal challenges to companies regarding their sponsorship of defined contribution plans have probably been modest so far, who knows what the future might portend, especially without some of the safe harbour protection available to sponsors in other countries.

Some stakeholders, from both the corporate and labour sides, believe that the main avenue for improved retirement income security on a large scale basis is an expanded Canada Pension Plan (employment earnings based), which with its residence based counterpart—Old Age Security—is designed to replace about 40 percent of national average wages (CAD$46,300 for 2009). Interestingly, equities represented 57.5 percent of the CPP investment portfolio as at December 31, 2008, with significant allocations to real estate and infrastructure as well—an investment return of negative 13.7 percent was earned for the 9 months ended December 31, 2008 (negative 18.6 percent for the fiscal year ended March 31, 2009). However, no threats to the long-term sustainability of the fund were anticipated. There are other versions of this "CPP-plus" theme, with for example, Alberta and British Columbia proposing their "ABC Plan" at the provincial level, and Canadian life insurance companies which control most of the DC market arguing that any such supplement should be managed by them rather than at governmental levels.

Canada is widely perceived to have a relatively strong banking sector (which has emerged somewhat unscathed relative to the experience in other countries), a sustainable social security system and a culture lower on the risk tolerance spectrum than some other industrialized countries. There are definitely fundamental issues with defined benefit plan sponsorship and management relative to the expectations of stakeholders in this generation, but hopefully reasonable compromises can be achieved to preserve (and dare I hope expand?) this important leg of retirement income security, and maintain Canada's reputation for sound financial sector management.

This article was originally prepared in March 2009 when the impact of the market crash was much fresher. Since then, the Bank of Canada [http://www.bank-banque-canada.ca/en/mpr/pdf/2009/mpr230709.pdf] has forecast an end to the recession with growth expected for the 3rd quarter of 2009 (unemployment was expected to continue to rise). Furthermore, following negative investment performance for the typical pension plan in January and February 2009, investment returns have been strong in subsequent months, but with a relatively minor impact on the typical solvency ratio (from 73 percent at the start of the year to 75 percent at June 30, 2009) per Watson Wyatt's Pension Barometer [http://www.watsonwyatt.com/canada-english/news/press.asp?ID=21692]. Pension plans are therefore definitely not yet out of the woods—sponsors and other stakeholders continue to face great challenges and the need for reform and compromise remains as great as before. ☐