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The Association of Canadian Pension Management

L'Association canadienne des administrateurs de régimes de retraite

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DB Pension Plan Funding:

Sustainability Requires a New Model

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FOREWORD

THE ASSOCIATION OF CANADIAN PENSION MANAGEMENT (ACPM)

ACPM is a national non-profit volunteer-based organization acting as the informed voice of plan sponsors, administrators and their service providers, advocating for improvement to the Canadian retirement income system. Our membership represents over 400 retirement income plans consisting of more than 3 million plan members, with assets under management in excess of $330 billion.

ACPM believes in the following principles as the basis for its policy development in support of an effective and sustainable Canadian retirement income system:

Diversification through Voluntary / Mandatory and Public / Private Options
Canada's retirement income system should be comprised of an appropriate mix of voluntary Third Pillar and mandatory First and Second Pillar components.

Third Pillar Coverage
Third Pillar retirement income plan coverage should be encouraged and play a meaningful ongoing role in Canada's retirement income system.

Adequacy and Security
The components of Canada's retirement income system should collectively enable Canadians to receive adequate and secure retirement incomes.

Affordability
The components of Canada's retirement income system should be affordable for both employers and employees.

Innovation in Plan Design
Canada's retirement income system should encourage and permit innovation in Third Pillar plan design.

Adaptability
Canada's retirement income system should be able to adapt to changing circumstances without the need for comprehensive legislative change.

Harmonization
Canada's pension legislation should be harmonized.

Introduction

One of the most significant issues facing the retirement income system in Canada is the low level of pension coverage in the private sector. Historically, defined benefit (DB) pension plans have been the dominant model in Canada. In fact, they continue to hold the great majority of pension assets and serve the majority of pension plan members in Canada – and for good reason. They have been very effective at providing risk-pooled, cost-effective retirement income to millions of Canadians.

Today a prolonged low interest rate environment resulting from unusually accommodative monetary policy is causing problems with funding, particularly for single employer DB plans in the private sector. Funding rules established about thirty years ago in a much higher interest rate environment are producing extreme contribution levels, pressuring these plans. The Association of Canadian Pension Management (ACPM) believes that this is a leading factor in the current trend away from DB pension plans in the private sector. Temporary relief measures have been tried to relieve this pressure. However, it is becoming clear that more fundamental changes are required to ensure that these plans remain sustainable.

ACPM strongly supports the preservation of DB plans in the private sector as a vital component of the Canadian retirement income system. They are an important part of the business model and HR strategy of many of our members.

ACPM recognizes that the rules governing DB pension plan solvency are contentious. DB sponsors are seeing an increasingly unaffordable pension model; the labour movement has long viewed a DB pension benefit as deferred wages achieved through negotiation. ACPM understands both views – but believes that a new funding regime must be developed to preserve private, single employer DB pension plans. Without change, the number of such plans will continue to decline. It is our concern that they may all but disappear from the retirement landscape. This will not strengthen or improve Canada's retirement income system. [1]

ACPM recognizes there are other changes that would enhance the Canadian retirement system, including the wide-spread introduction of target benefit plans as defined in our Target Benefit Plan Paper March 30, 2012, and that there are other reasons for the decline in defined benefit pension plans (including accounting rules and Income Tax Act contribution limits). However, this paper explains why, in our view, the funding requirements for private single employer DB pension plans – requirements that are currently dominated by solvency funding – specifically need an overhaul. The paper will then describe an alternative funding model – one that we believe is better aligned with the long-term nature of a pension promise. We hope that the paper will generate a discussion among DB stakeholders about the changes necessary to ensure the continuation of single employer DB pension plans in the private sector.

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[1] ACPM's Five-Point Plan (released in June 2010) outlines our strategy to strengthen Canada's retirement income system. The Plan is focused on improving retirement income security and adequacy. Its five points include removing barriers to group coverage, ensuring the continuation of DB Plans, enabling more innovation, promoting simplicity in plan administration and increasing incentives to save.

Funding Rules Require Rebalancing

ACPM believes the current defined benefit pension plan funding requirements do not represent an appropriate balance between member benefit security, and the sustainability and affordability of DB pension plans. We suggest that funding rules should not seek to "guarantee" pension benefits but rather facilitate a reasonable and appropriate level of risk sharing between plan sponsors, active members and pensioners.

Why the Status Quo must Change

When solvency funding rules were first designed in the 1980s, their primary objective was to protect plan members' benefits in the event of plan termination. This benefit security was to be achieved by requiring additional employer contributions to the plan (over a 5-year horizon) if a solvency test, required to be conducted at each actuarial valuation, revealed a deficit.

Unfortunately, the theory behind solvency funding rules has not turned out as well in practice as was hoped. Particularly in recent years, the unexpected high incidence of insolvent organizations winding up their underfunded DB pension plans has subverted the benefit security objective. Further, it was probably never contemplated that solvency valuations could result in a measurement of liabilities that far exceeds the going concern liabilities, but that is what has occurred. Corporate plan sponsors with otherwise healthy balance sheets are being put into difficult financial situations because of the funding requirements of their pension plans, resulting in repeated rounds of solvency relief granted by governments. As DB pension plans mature in a low interest rate environment, "as and when needed" exemptions have become the norm.

There are a Number of Unintended Consequences of Solvency Funding Rules

I. **Contribution Volatility** – Due to the volatility of capital markets, the solvency funded positions of pension plans and resulting contribution requirements can vary considerably from one valuation to the next. This makes annual budgeting, long-term planning and balance sheet management a difficult exercise.

II. **Share Price Uncertainty** – Investors in entities that sponsor DB pension plans are uncertain how to value these entities and which measure of the pension obligation is considered a liability of the entity. The extreme low level of solvency funded ratios, even in financially sound companies, represents a potential overhang on market valuations of these companies and a potential obstacle to merger and acquisitions transactions.

III. **Terminating or Amending DB Plans** – Corporate sponsors are walking away from the burden of solvency valuations by either amending plan provisions (e.g. elimination of post-retirement indexing) or by closing DB plans in favour of Capital Accumulation Plans (CAPs). These actions are motivated by short-term solvency funding pressures, even when going concern valuations indicate reasonably healthy funded positions. The recent introduction of single employer target benefit plans in legislation is a positive move that will help sponsors and members potentially find some common ground, but we still require a better measurement of the obligation than the solvency basis.

IV. **Capital Drain** – Requiring funding of solvency liabilities by plans that have sound going concern funding ratios represents over-funding and potentially stranded capital as the contributions cannot be withdrawn when interest rates rise and such plans are in surplus. Financially sound companies may be borrowing to fund large cash injections into their plans or purchasing letters of credit to satisfy solvency funding requirements. Both represent potentially significant uses of capital that would otherwise be invested in the productive economy to fund future economic growth.

V. **No Greater Benefit Security in Risky Plans** – Plan sponsors that are unable to access capital markets to fund cash injections or letters of credit and are unable to meet solvency funding requirements are at risk of defaulting on these obligations. This could be placing companies that were already in a financially tenuous situation even closer to failure. With many past temporary solvency relief measures granted in various jurisdictions and special ad-hoc relief measures for some major Canadian corporations, the plan members who face the greatest risk of benefit security are not being protected by the very rules designed to protect them.

VI. **Pressure on Interest Rates** – Canada's position as a safe-haven country and its current monetary policies are said by some to be placing downward pressure on Government of Canada (GOC) yields. Pension plans themselves are fuelling the demand for GOC bonds and exacerbating the solvency funding problem further. Pension plans, in an attempt to limit the consequences of volatility from mark-to-market accounting and solvency valuations, are investing plan assets in the very GOC bonds that are used to value solvency obligations. Plans are also turning to annuity purchases, indirectly having the same effect on market yields. The cycle is adding to the overwhelming demand that is already driving interest rates lower. Locking in record-low yields to protect against further solvency volatility does not bode well for future recovery in the health of DB pension plans.

VII. **Commuted Value Payments Harm Remaining Members** – Plan members leaving before full entitlement to pensions are being paid commuted values at amounts that, if invested at rates closer to going concern rates of return over the long-term if interest rates ease, could deliver a better retirement income stream than the promised pension. It is inconsistent with the concept of risk sharing among plan members to calculate and pay commuted values at near risk-free rates while remaining members are exposed to risk. This is resulting in a transfer of plan value from members that remain in the plan to those that are leaving and, at the margin, reducing the benefit security of the remaining plan members.

The Solution: A New Funding Model

ACPM believes Canada needs a long-term solution to DB plan funding rather than additional rounds of tinkering with existing rules. If we are truly seeking a better long-term funding model, we should be examining the alternatives from the ground up – what are we aiming to achieve and is there a better way to get there than our current approach?

The new funding model that ACPM recommends has four objectives:

i. To be clear to all stakeholders;

ii. To not increase the cost burden on plan sponsors;

iii. To be based on sound funding and risk management principles, and

iv. To be reflective of the long-term nature of DB pension plans.

Most of the issues we highlighted in the previous section relate specifically to traditional employer-risk DB pension plans. The first evolution in plan design to deal with these issues was the employee-risk CAP. There are also plan models that share risk (jointly sponsored, target benefit and shared-risk pension plans). For more recently implemented shared risk plans, the pension promise is being re-crafted, and sponsors and employees are going in with eyes wide open that the pension benefit is not guaranteed. With these types of plans, there seems to be little need for solvency valuations. A robust risk-management framework that strives for a high probability of meeting the benefit obligations, including appropriate pension plan governance, structured policies that cover funding, benefits and investments policies, and clear frequent reporting should be sufficient for all stakeholders in these models.

ACPM proposes replacing the current solvency and going concern funding rules for DB plans with a new funding model. The new model would consist of a single funding regime with the features described below. To the greatest extent possible, this new model should be harmonized across all Canadian jurisdictions (some of whom have already indicated support for changes similar to those described below).

Components of the New Funding Model

i. The Discount Rate - A new funding model would include a new valuation of the pension obligation. Prescribed solvency valuation discount rates in Canada are based on GOC bond yields plus spreads that are set periodically by the Canadian Institute of Actuaries (CIA) in reference to a representative cost of purchasing a non-indexed group annuity. The GOC interest rate is the "risk free" rate in our economy and we question whether that is too conservative a starting point to value an obligation which does have some inherent risks. The decline to generational low levels of these reference interest rates has caused the ballooning of solvency liabilities for Canadian pension plans. Similar trends in interest rates are seen across most of the major economies of the world. The fact that much of the decline during this period is encouraged by monetary policy actions being taken by central banks (e.g. “quantitative easing” and accommodative rate policy) is reason enough for governments to step in now to de-link pension liabilities from these policy-driven rates. Moreover, the spread added for annuity purchases and the other calculations used to arrive at solvency discounts rates are not reflective of true market rates available to pension plans.

ACPM believes corporate bond yields and/or provincial bond yields should be part of the discount rate benchmark. Corporate bond yields reflect and are similar to the cost of borrowing funds by creditworthy plan sponsors required to fund their pension deficits and therefore acknowledge that the pension promise is not without some acknowledged risk by all stakeholders. The use of provincial bond yields could also be included in the discount rate benchmark as these bonds do compose a significant proportion of the fixed income investible universe. Provinces are likely to remain a significant component of the supply going-forward, thus ensuring a broader investment universe.

We recommend that governments with the assistance of the actuarial profession consider various discount rate benchmarks and examine the impact they would have on plan funded status. One option for the discount rate benchmark is a broad basket of corporate bond yields such as the yield on the DEX Corporate Universe and Long-term Bond Indices – using the DEX Universe excluding GOC bonds, blended as appropriate to reflect the duration of plan liabilities. We do not recommend using the same discount rate that is used for financial statement reporting purposes: the AA corporate bond yield curve. The universe of AA corporate bonds in Canada is too small, is dominated by a small number of issuers, is concentrated in one industry (banks), is too short term to match the duration of most pension obligations and is therefore not reflective of either the cost of funds to most plans or the existing corporate credit risk faced by most plan members. Further, there has been considerable debate already as to the measurement methodology and rationale for using this discount rate as a reference discount rate under International Financial Reporting Standards (IFRS) for accounting valuations. The DEX Indices have the benefit of being observable, widely quoted, largely investable or at least able to be replicated with investing strategies and reflective of the broad market of credit risk faced by sponsors and plan members.

Another approach for the discount rate benchmark would be to build a customized zero coupon yield curve composed of a universe of corporate and provincial bonds providing for a better tool to discount the liabilities compared to a single discount rate.

ACPM cautions against the use of average discount rates like those used in the U.S., particularly over as long a period as 25 years, as that discount rate becomes a non-market rate. A shorter period average such as 24 months may provide some additional stability to the valuation measure but does have the detraction of not being available in the market, making it difficult to design investment hedging strategies to address discount rate risk.

Another factor that could be considered in determining the discount rate under a new funding model is whether and to what extent one should consider the expected investment return on the plan's investments as reflected in its investment policy, and particularly any expected equity risk premium. Until now, the going concern basis has considered the expected investment return, including an equity risk premium, while the solvency basis has not.

As with any change in rules designed to improve the long-term, there may be perceived "winners" and "losers" in the short-term. Careful consideration should be given to plans that may see short-term increases in funding requirements caused by any proposed changes and adequate transition periods allowed to accommodate such changes. Increased volatility in funding requirements should be avoided. Finally, we encourage governments to work closely across the country to adopt similar funding rules.

ii. **Provisions for Adverse Deviations (PfADs)** - ACPM suggests that PfAD's should be determined in accordance with the plan's funding policy as set by its sponsor. These PfADs would be just one part of a robust risk management framework. That framework would reduce the volatility of the plan's funded position and contribution demands. It would also create an environment where the funded status of the plan would have less chance of resulting in severe cash flow problems for the employer sponsor while protecting plan members' pensions through prudent risk management.

ACPM believes that legislated PfADs will not produce optimal results for DB stakeholders. Instead, we recommend a more flexible approach, based on factors such as (i) the asset allocation of the plan, (ii) the ratio of retiree liabilities to total plan liabilities, and (iii) the difference between the expected duration of retiree liabilities and the assets supporting these liabilities. We believe that proper consideration of such factors by plan sponsors will produce reasoned risk management decisions with respect to the funding level and asset allocation of their plans.

An important factor to be considered would be the expected investment return of the supporting assets, including expected equity risk premium where relevant to the plan's asset allocation. One option could be to require any expected investment return in excess of a desired bond index to be fully offset by an equivalent PfAD. However, this would effectively eliminate the equity risk premium from the expected investment return. Another option could be to set a level of PfAD that partially offset the equity risk premium at a level defined by the funding policy. This level could be set to manage risk at an appropriate level given the totality of the plan's circumstances and characteristics.

Finally, once an appropriate level of PfAD was determined, it would be necessary to establish how it would be funded. One possibility would be to require that contribution levels take into account the desired level of PfAD. Another option would be to fund the PfAD only if and when experience gains were available for the purpose.

iii. **Amortization Periods** - The appropriate amortization periods need to be considered when moving to a single (non-solvency) funding regime. One possibility would be to adopt the Plan's expected average remaining service lifetime (EARSL) as the amortization period. It would be consistent with a goal of achieving a fully funded position for employees at their expected retirement, on average. Another possibility would be to dynamically increase amortization periods as funding discount rates decrease. A third possibility would be a longer amortization period where it is coupled with a credit risk rating requirement, notwithstanding the acknowledged practical difficulties that regulators could face in evaluating some sponsors' credit risk under such an approach.

    Some additional consideration should be made for closed plans (that have no active members and zero EARSL) or very mature plans (with EARSL less than 5 years).

iv. **Benefit improvements** - Under the new funding model, governments may want to impose some methods of restriction on benefit improvements unless the plan has sufficient assets to cover the full cost. Alternatively, improvements could be allowed with a requirement to achieve full funding of the incremental benefit over a relatively short period of time (e.g. 3 to 5 years, or a collective bargaining contract period) or in a "side-car" funding vehicle, like letters of credit or the solvency reserve account proposed in British Columbia and Alberta, such that the incremental funding shortfall created by the benefit improvement does not affect the benefit security of the benefits before the improvements.

v. **Portability** - When pension portability was introduced, it was never the intent to provide terminating and transferring members a premium over the long-term cost of keeping the deferred pension in the plan. ACPM prefers the portability provisions of the New Brunswick shared-risk pension plan that put the two features of portability and plan cost back in balance. Section 18 of the New Brunswick Shared Risk Plans Regulation provides that a terminating employee is paid their share of the actuarial reserve based on the funded status of the plan at the date of calculation. Should the member not like the portability "deal", the member is free to keep the entire value of the deferred pension within the plan and commence the pension at retirement. Under this regime, ACPM would also be open to allowing portability during the deferral period so a member can access their funds if a plan becomes better funded. We believe that this solution, or some similar restriction on portability, could also provide a fair balance between the interests of departing and remaining members in a single employer DB plan in the private sector.

Conclusion

ACPM believes that the issues outlined in this paper require urgent attention. ACPM also believes that an alternative funding model such as the one proposed could reduce, and perhaps even reverse, the current downward trajectory of DB pension plan coverage in the private sector in Canada.

While ACPM prefers harmonization of pension legislation across Canada, it is recognized that this important issue might have to be adopted by jurisdictions at different times and we would support these improvements even if they were adopted on a non-harmonized basis.

By issuing this paper, ACPM hopes to encourage a dialogue among DB stakeholders as to how their pension plans can be preserved as a valued part of Canada's retirement income system. ACPM looks forward to participating in this dialogue.