

# SIFTING THROUGH THE AFTERMATH

As Atlantic Canada recovers from the recession, how are pension plan sponsors adapting?

BY DEREK GERARD

**R**etirement plan sponsors and members in Atlantic Canada, like their counterparts elsewhere in the country, spent 2009 sifting through the aftermath of the economic storm. While the effects are different for defined benefit (DB) pension plans and capital accumulation plans (CAPs), the overall result is the same: a tremendous setback for retirement funding.

Many DB plan sponsors are questioning their continued commitment to the traditional DB model as they grapple with the financial implications of funding the DB promise. For CAP members, the market correction has left a serious dent in retirement income levels—though whether or not the CAP members themselves are fully aware of it is another issue entirely.

To make matters worse, pension plan coverage in Atlantic Canada has dropped to 40% of the paid workforce. According to the latest *Atlantic Provinces Economic Council Report*, private sector coverage now stands at just 23%. With public sector coverage at 84%, there is a widening gulf between public and private sector coverage in the region.

## 20% Funding Decline

The typical balanced pension fund in Canada lost more than 15% in 2008. Factor in the

5% to 6% rate of return assumed by the actuary, and the result was a remarkable 20% drop-off in the funded ratio of most DB plans.

Given that funding levels were already stressed, this 20% loss went straight to deficit for most DB plan sponsors. For an organization with a \$100 million DB plan, that's a \$20 million experience loss—with a regulatory requirement to come up with a shortfall funding strategy by the next regularly scheduled valuation.

For most plan sponsors, the immediate reaction is to hope that history repeats itself and markets bounce back. The second response is to look for regulatory relief. Fortunately, there has been some movement in the right direction on both of these counts. The average balanced fund achieved a return of 14% to Sept. 30, 2009, getting back roughly 8% of investment-related losses (relative to the 5% to 6% required rate of return), and short-term funding relief measures are currently in play for all four Atlantic provinces.

Nova Scotia recently announced that solvency deficits can be re-amortized over 10 years for valuations prior to Jan. 2, 2011. Newfoundland already had a 10-year solvency funding regime in place (which expired Jan. 1, 2009), and New Brunswick currently allows for a nine-year solvency funding schedule from Dec. 31, 2009. In addition, universities and municipalities have solvency exemption provisions in Nova Scotia, New Brunswick and Newfoundland.

Of course, P.E.I. enjoys the ultimate in funding flexibility, with no pension benefits act officially enacted.

However, despite these hopes for continued improvement in market conditions and regulatory funding flexibility, DB plan sponsors are still facing significant cash injections into their plans. Where will this non-budgeted cash come from? How material is it to the organization? Will employees be required to pay more into the plan? Given the current economic environment in Atlantic Canada, there are very few public or private organizations with extra cash sitting around—and those that do have other priorities for these funds.

## A New Reality

The simple reality is that the cost of current DB pension benefits in Atlantic Canada has moved well beyond the costs initially contemplated when many of the current plan designs were implemented. If the stock market decline wasn't enough, plan sponsors have also had to deal with the impact of improvements in life expectancy as actuarial reports continue to include new costs associated with updated mortality tables, not to mention record-low interest rates.

In the early 1990s, long-term government interest rates were as high as 10%, and the market cost of purchasing \$10,000 of lifetime pension for a 65-year-old was around \$80,000. Under the current low interest rate regime (4% to 5% on long-term bonds), this same pension now has a market cost of roughly \$130,000—a 62% increase.

Effectively, DB pension promises that may have been budgetable and affordable 20 years ago are now being cash-funded largely on the backs of stock market expect-

tations. Plan sponsors in Atlantic Canada are starting to question how prudent this approach is. Many are reviewing whether their current benefits and contribution provisions remain economically sound in light of current financial market conditions.

In many cases, this is leading to the bigger question of whether the DB plan is viable for the longer term—even though there are still many organizations in Atlantic Canada for which the DB design fundamentally makes sense. Long-service employment relationships are often highly valued, and there remains a strong desire on behalf of employers to provide a meaningful and defined retirement pension for retiring employees.

For many organizations, it's not the DB premise itself that is the problem; it is the inability to provide DB benefits under a predictable compensation budget. Having budgetable costs is a reasonable and prudent requirement for any organization offering a pension plan to its employees. In fact, this is the main appeal of the CAP alternative.

### Focus on Risk Management

A key problem heading into the market correction has been the application of simplistic approaches to the complex risks associated with retirement income planning. A more positive outcome is that this storm has largely exposed the tremendous flaws in the traditional thinking behind retirement savings approaches for post-retirement incomes.

Risk management has become the issue of the day for pension plan sponsors in Atlantic Canada and a key topic of discussion. Many DB plan sponsors are exploring more robust approaches to risk management, with a much greater emphasis on asset/liability mismatch and the overall financial exposure of the plan's liability structure to the sponsoring entity. And CAP sponsors are putting greater emphasis on the need to educate plan members about the inherent risks in both the accumulation

phase and the retirement income phase of their savings programs.

### A New Plan Design

Governments and regulators in Atlantic Canada have a tightrope to walk when it comes to regulatory requirements for DB plans. Many sponsors are quick to point out that offering a DB plan is largely a voluntary undertaking. If government funding laws are intended to protect employees from the systematic underfunding of pensions and/or reduced benefits on windup, this begs the question of how well protected employees will be if today's DB plan sponsors simply opt out of

approaches or even changing the very nature of the pension promise.

To achieve more flexibility around minimum funding, the Nova Scotia panel has indicated that it is necessary to change the very nature of the promise under the pension deal. Specifically, the panel has proposed that a single employer be eligible to set up a jointly trustee target benefit plan. Currently, only multi-employer pension plans (MEPPs) are eligible to use this plan design in Nova Scotia. Because these plans have the ability to reduce the benefit promise, different minimum funding rules are permitted. This is currently the case for funding MEPPs in most jurisdic-

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providing retirement benefits. The argument that 90% of something is better than 100% of nothing is a common refrain these days. Nonetheless, it is difficult to dispute the counter-argument: "Don't promise what you can't afford to pay." If you can only afford to fund 80%, promise 80% not 100%. Pay the other 20% if and when you can afford it.

"Pay for what you promise" was the key premise of the Nova Scotia Pension Review Panel's recommendation on pension funding. Relying on stock market gains yet to be experienced when making future pension promises is not a sound financial practice. The natural corollary to this premise is that plan sponsors need to think hard about changing practices that aren't working or are unaffordable, revising funding and investment strategy, benefits design and contribution

tions in Canada, and the Ontario and Alberta/B.C. pension panels had similar recommendations to expand the use of jointly sponsored target benefit plans for single employers.

If the main appeal of the CAP model is its fixed-cost nature, target benefit plans should offer a very attractive alternative for many plan sponsors—one that combines budgetable costs with collective risk management practices and more predictable retirement benefits. The result may be a more sustainable pension plan for the long term, where members enjoy the full benefits provided by all contributions and investment earnings under the plan in a transparent and professionally risk-managed environment.

The old pension model of simple blind reliance on the stock market to deliver the goods over the long term is fraught with pitfalls. A more robust approach to pension risk management is required to ensure that workers in Atlantic Canada can attain a reasonable level of retirement income. If the government and the industry are willing to learn from recent experience, retirement security should take a large and progressive step forward in the near future. **BC**

### The Dangers of DC

Many defined benefit (DB) plan sponsors in Atlantic Canada remain committed to looking after their long-service employees and question the ability of capital accumulation plans (CAPs) to deliver a sound and predictable pension income. From their perspective, if DB plan sponsors with access to expert consultants, pooled asset strategies and internal resources cannot manage the multitude of risks to meet their pension income promises without additional funding, what hope do individuals have to successfully manage all of these risks on their own?

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