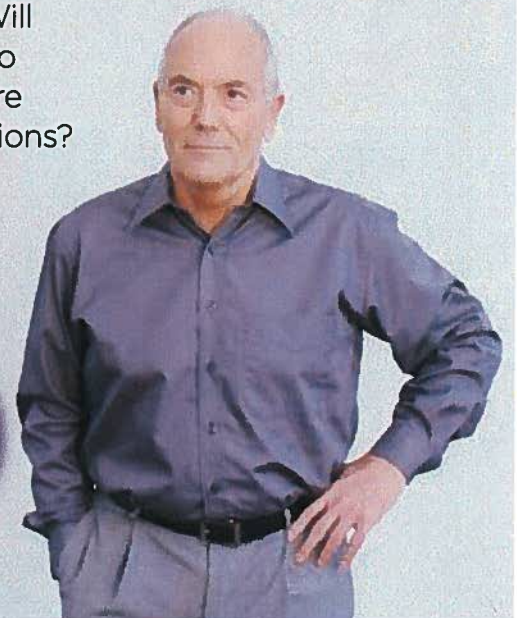




The recession means that some employees and plan sponsors will need to adjust their retirement expectations. Will they just have to wait it out, or are there other options?

ON HOLD



BY CATHERINE ROBERTSON

It's the primary rule of pensions and, arguably, the most widely cited principle in pension plan management: pension plans are built to last. They are designed to operate over the long term, and they should be managed and invested accordingly. After all, someone joining a plan today will likely still be collecting a pension 50 years from now. But how does this rule hold up after a year like 2008?

With many Canadians reeling from the blow to their retirement savings and plan sponsors scrambling to shore up their struggling pension plans, 2008 has clearly had a dramatic impact on our retirement system. In fact, it might well have triggered a fundamental shift in the pension landscape.

For plan members, adapting to the new environment requires a clear grasp of the options available to meet changing retirement expectations. For plan sponsors, the ability to adapt requires an understanding of legislative and plan design changes that could help control costs and, ultimately, meet the evolving needs of plan members.

Fallout From 2008

Most of the world's stock markets fell by 30% or more in 2008. The impact of that decline was felt immediately by defined contribution (DC) plan members, who assume the full burden of investment risk. Although members with less exposure to equities may have fared better than others, virtually all DC plan members took a direct personal hit and saw their pension accounts shrink.

In all likelihood, those planning to retire in the short or medium term will have to revise their retirement expectations. DC members who are unwilling to accept a lower standard of living have only a couple of options.

The first is to delay retirement to recoup some of their losses—assuming that the markets recover in time. This option would also reduce the retirement period, which means their savings wouldn't have to stretch as far. The second option is to increase contributions (if permitted) or save more money outside of the employer plan.

Even those DC members who plan to retire well into the future

are not immune to the current economic conditions. To avoid having to adjust their retirement expectations, these individuals should review the long-term growth expectations of their investments and determine whether higher contributions are needed to keep their retirement forecasts on track. They may also need to consider their job stability and whether they'll continue to have earnings that permit contributions.

Impact on DB Plan Members

Members of defined benefit (DB) plans are also likely to feel the pinch, despite the fact that DB plan sponsors bear, or at least share, the burden of investment risk. While the pensions provided by DB plans are typically based on a formula and not directly linked to investment returns, plan sponsors must still deal with the fallout of market losses. *How* they deal with that fallout could have an indirect impact on members and their pensions.

Many, if not all, DB plan sponsors would list 2008 fund returns—and their potential impact on pension costs—as one of their most pressing concerns. Due to historically low interest rates, many DB plans were in an unfunded position even *before* the market declines of 2008 eroded asset values, which means they are required to file an actuarial valuation on an annual basis. Most of these plan sponsors will start to feel the full impact of their situation in October of this year, since plans that operate on a calendar-year basis must file their valuations by the end of September (except for federally regulated plans, which must file by the end of June).

Sponsors of DB plans are already assessing the damage to ensure that they can manage costs going forward. One option is to adjust future benefits by either reducing benefits for future service or moving to a DC plan for future service. Obviously, both options could affect members' retirement plans.

Under the circumstances, members planning to retire from a DB plan within the next year or so are the least likely to have to adjust their expectations. However, this assumes that the bulk of their retirement income is coming from DB pension plans. If they plan to supplement it through registered retirement savings plans (RRSPs) and/or other personal savings, they may find themselves in the same boat as most DC plan members.

So, what options exist for members who need and want a more flexible approach to retirement?

Phased Retirement

Some members may consider phased retirement as a way to make the transition. Although the federal government amended the *Income Tax Act* in early 2007 to permit phased retirement under DB plans, only two provinces—Alberta and Quebec—have enacted legislation. (It's also an option for federally regulated plans.)

Therefore, phased retirement still isn't a viable retirement planning tool for many DB plan members. And when legislation allowing phased retirement is implemented, it's expected to be introduced on a voluntary basis, meaning that DB plan sponsors won't be required to offer it.

Without phased retirement legislation, DB plan members cannot build benefits in a pension plan while receiving a pension from the same plan. In other words, plan members who are looking for some form of phased retirement must either enter into a new contract with

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their existing employer (based on reduced hours and no pension benefits) or retire altogether and seek new employment.

Other Options

Another way to ease the road to retirement is through a flexible pension plan. A flexible pension plan allows members to make voluntary contributions to a "flexible component" of the pension plan. These voluntary contributions are used to purchase or improve ancillary benefits at termination, retirement or death. Such improvements do not affect the basic lifetime pension. Instead, they are used to add or enhance early retirement provisions, bridging benefits or post-retirement indexing.

Some provinces also permit the unlocking of pension benefits. In most cases, however, unlocking is available only on a restricted basis. For example, it is more likely to be an option at termination, rather than retirement, and for members of RRSPs rather than members of registered pension plans. From the plan member's perspective, unlocking could be a useful transition tool—but only if it provides the desired flexibility.

Need for Change

While phased retirement may be an attractive option for many plan members, it carries a price tag: higher benefits and administrative costs. Those higher costs, in turn, could lead to higher contributions. Yet for most plan sponsors, cost control is a key issue. After all, a plan is viable only if it's affordable.

So the question becomes, How can we control costs? Here are a few possibilities to consider.

Provide funding relief – Plan sponsors and pension regulators don't always see eye to eye on the topic of benefits security. Under the current rules, plan sponsors are required to make additional contributions to pay off any solvency shortfall identified in a valuation filed with a pension regulator. Many plan sponsors argue that those contributions could be put to better use—for example, improving benefits or even preserving jobs. But the reality is that a combination of low interest rates and declining asset values has hit many plan sponsors with a double whammy: bigger deficits resulting in an increase in additional contributions.

A number of provinces have introduced, or will shortly introduce, solvency funding relief. Although this is a welcome step, the relief is expected to be temporary. Moreover, some provinces are being

accused of introducing relief that isn't practical because few plan sponsors will actually be able to take advantage of it. If that's the case, the rules should be relaxed to make relief more accessible. At the same time, plan sponsors should be required to communicate the details of any relief that is accepted and what it means to the plan members.

Eliminate the need for solvency funding – In lieu of solvency funding, plan sponsors could be required to develop and maintain a funding policy that clearly identifies plan objectives, funding targets and tolerance for funding deficits on an ongoing basis, and that limits ongoing assumptions. That policy should also address unexpected events, such as the impact of a 10% decline in stock markets in a given year, and outline an action plan to address such events.

Review tax-related limits – One of the benefits of providing a pension plan is tax effectiveness. However, it's been years since the various tax-related limits placed on pension plans have been fully examined. For example, a review of the pension adjustment factor is long overdue. The current "factor of nine" for DB plans was set more than 20 years ago, at a time when interest rates were higher and DB plans generally provided richer benefits. Reducing this factor would increase the RRSP room available to DB plan members, allowing them to save more and providing them with greater flexibility when planning for retirement.

Likewise, accelerating increases in the annual 18% contribution limit for DC plan members would allow them to save more, help to offset market losses and lead to less reliance on government retirement programs. It would also help to bring the Canadian limits more in line with those in the U.S. and the U.K.

Increase flexibility – Regulators should also consider new plan designs that offer greater flexibility. DB and DC pension plans have their own strengths and weaknesses, so why not expand the legislative framework to accommodate a hybrid plan that brings together the best of both plan types? Expert panels formed to review pension legislation in Ontario, Nova Scotia and B.C./Alberta have all recommended the introduction of such a plan: the jointly governed target benefit plan (JGTBP).

For plan members, a JGTBP works much like a DB pension plan. Pensions are determined based on a formula, assets are invested on an aggregate basis and mortality risk is pooled. For employers, a JGTBP works much like a DC plan: there is a fixed schedule of employer contributions, effectively eliminating the contribution volatility and risk associated with DB plans.

If the assets of a JGTBP are insufficient to meet the liabilities, the benefits are reduced. As a result, three safeguards are required.

1. Plan governance must be shared between employers and employees.
2. Comprehensive communications must be provided to everyone entitled to a benefit under the plan.
3. A funding policy based on conservative actuarial assumptions must be developed so that deficits are the exception, not the norm.

JGTBPs would give plan sponsors the ability to better manage costs and the flexibility to provide members with the best available plan. That, in turn, would enable members to better manage their retirement expectations—even in challenging markets.

So far, the economic downturn has generated little in the way of positive outcomes. But it has become clear that we need to knock down the legislative barriers that stand in the way of effective pension management and introduce flexibility to ensure that private sector pension plans remain a valuable source of retirement income in the future. **BC**

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