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Pensions

The Dawn Of A New Funding Era?

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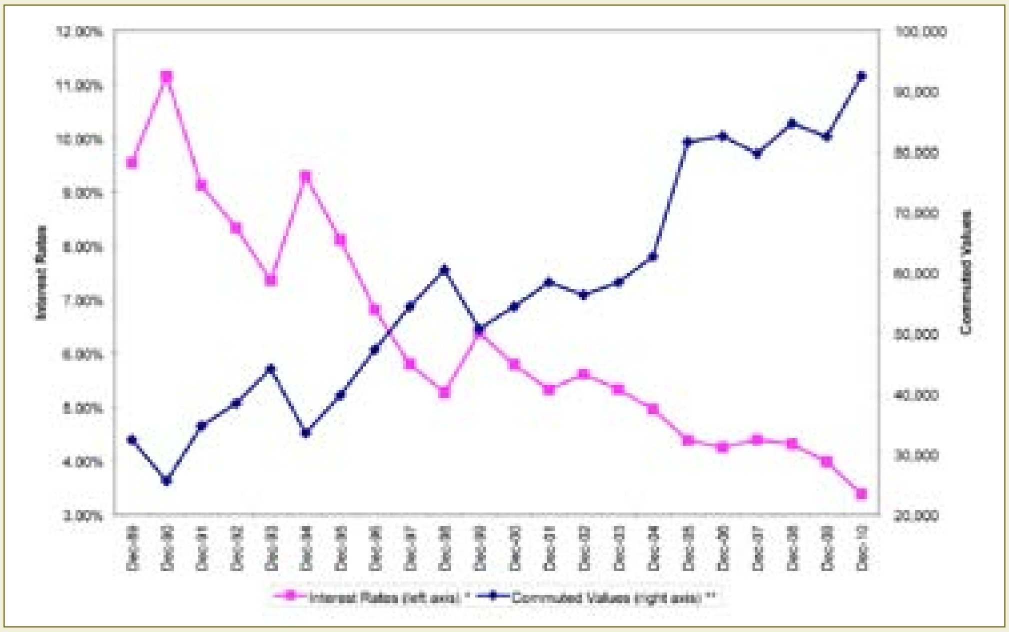
In the 30 to 40 years since most multi-employer and public sector pension plans have been in existence, the most significant change in funding requirements occurred in the late 1980s when the majority of jurisdictions introduced solvency funding requirements. More recently, while there may not be complete agreement on the reasons for additional change or the type of change required, plan sponsors, members, regulators, and the Canadian Institute of Actuaries have all expressed opinions that new changes to the funding rules are now required. This article places this important development in context and addresses the implications for sponsors of multi-employer and public sector pension plans.

Rising Funding Costs

The economic conditions in the late 1980s facilitated the introduction of solvency funding as pension plans were generally well funded and interest rates were high. Generally, solvency funding was a non-issue for most pension plans when the concept was first introduced.

Over the last two decades, both going-concern and solvency funding requirements have increased. During that period, solvency funding has replaced going-concern funding as the primary determinant of funding for most pension plans due to decreasing interest rates and the corresponding increasing commuted values. For the majority of active members in a pension plan, the solvency liability is equal to a member's commuted value. As depicted in *Chart 1*, pension plan commuted-value payments have been increasing continuously and, for the most part, relentlessly since 1990 in conjunction with declining interest rates.

Chart 1: Solvency History



** Long-term Government of Canada bonds — Bank of Canada V122487 (B14013)*
*** Commuted value for a 45-year-old male deferred to age 60 with a 10-year guarantee*

Funding costs for pensioners have also been on the rise. From the interest rate peak in 1990 to today, the cost of purchasing a $500 monthly life annuity for a 65-year-old male participant has increased more than 70 per cent from $46,000 to $78,000. Depending on the plan design and the economic strength of the underlying industries, some plans have been able to manage within this rising cost environment much better than others.

The pension industry has generally been reluctant to accept that it now costs more to provide the same monthly pension benefit that could previously be provided for far less money. This new reality also made for a very difficult transition from the 1970s and 1980s, a period over which reducing costs, increasing contributions, and reasonably consistent investment results allowed boards to increase benefits on numerous occasions. Regardless of the extent to which additional funding has been secured by each pension plan, over the last 10 to 20 years, the going-concern margins for adverse experience that previously existed in the 1990s generally eroded or were superseded over the last decade. Hence, many plans had little or no margin when the broad-based equity declines in late 2008 dealt a significant blow to the financial position of any pension plan having equity exposure.

Plan Sponsors' Concerns

Single employer pension plan sponsors are seeking a solution to the asymmetrical rules that expose them to significant liabilities in the face of poor experience, while constraining the gains resulting from any good experience. Combined with rising and volatile funding requirements, the corporate response in this environment has been predictable: minimize funding, freeze the accrued pension and convert to a Defined Contribution approach, or terminate the Defined Benefit coverage completely.

Multi-employer plan stakeholders have been fighting their own battle against solvency funding requirements. The relatively inoffensive introduction of these rules in the late 1980s turned invasive when lower interest rates meant that going-concern funding requirements were superseded by solvency funding standards. Mandated benefit reductions revealed the fallacy of the benefit security argument for solvency funding requirements as applied to multi-employer plans. Affected plan participants received a crash course on the nature of their 'guaranteed'pension plans and much of the bad news has yet to be shared as required corrective actions arising from 2008 year-end actuarial valuations are still being developed.

By contrast, public sector pension plan stakeholders have been relatively quiet. However, their concerns are rising because public sector plans are just as susceptible as other plans to rising pension funding costs. Jointly funded pension plans were the first to attract attention as the cost of these arrangements surpassed 18 per cent of pay en route to cost levels that can now easily exceed 30 per cent of pay. Where a joint funding approach is not in place, taxpayers have been bearing the rising costs. At some point, even this may change as the majority of Canadians are facing the harsh realities of readjusting their retirement expectations.

Simply put, there is significant turmoil in the pension world.

The CIA's Initiatives On Funding

In light of all the pressures mounting on pension plans and the diverging needs of the different types of these arrangements, the Canadian Institute of Actuaries' pension plan standards of practice are currently undergoing a significant overhaul. At the core of the changes is support for the development of a funding policy for each pension plan. Each funding policy would be tailored to the specific needs of each pension plan and would include a mandatory assessment of the risks to which that plan is exposed. The changes will also unmask some of the mystery behind an actuary's work, transforming the actuarial valuation process into a more open, educational undertaking.

The adoption of a funding policy conceivably could result in single employer pension plans being funded solely on a solvency basis. Conversely, public sector and multi-employer pension plans could be guided solely by going-concern considerations. With this latter approach, the solvency 'safety net' would be replaced by measures that promote the development of appropriate provisions to protect against potential future adverse events.

To support the changes being sought, the Canadian Institute of Actuaries adopted revisions to its standards of practice earlier this year. These revisions took effect on December 31, 2010. In addition to providing support for the development of plan-specific funding policies, the new standards increase disclosure requirements and add a requirement to include some risk analysis as part of the standard actuarial funding valuation.

Role Of The Regulators

The changes recently adopted by the Canadian Institute of Actuaries create the tools that can be used by plan sponsors and regulators to achieve their goals. Implementation of the tools is not a given and the success of the changes being pursued will largely be assisted, or hampered, by pension regulation. While the Canadian Institute of Actuaries plays a role in fulfilling public policy, public policy itself is defined through legislation. As such, regulators will play a key role in determining the extent to which funding policies will influence pension plans in the future because plan defined funding objectives are superseded by legislated funding requirements. Plan sponsors will also be less inclined to develop customized risk management policies if legislation hinders their implementation.

Even prior to the market collapse and the Canadian Institute of Actuaries' initiative, pension regulators were becoming increasingly concerned with the low or non-existent levels of margins included in some going-concern actuarial valuations. It also became apparent that the one-size-fits-all approach to regulation and funding has significant shortcomings. There is widespread recognition among regulators that solvency funding in its current form is not working as envisioned. This is evidenced by the number of temporary solvency funding relief measures initiated by various jurisdictions while permanent solutions are sought. However, there is no consensus on how funding should be reformed.

After years of effort, harmonization of funding rules across the jurisdictions remains an elusive goal. In fact, we are seeing increasing signs of divergence from some regulators. Even amongst those jurisdictions that may embrace the new tools being developed, the timing and extent of the changes adopted could vary considerably.

One commonality that is surfacing among regulators is the resurgence of the perceived value of DB arrangements. Governments are generally embracing the concept that their role should not be restricted to the regulation of these arrangements and should include the establishment of a framework that encourages growth in DB pension coverage for all Canadians.

The Risk/Return Tradeoff

In the midst of regulatory uncertainty, some pension plan sponsors have already commenced development of formal funding policies that aim to identify and measure risk as the first step towards mitigating risk where appropriate. Even prior to the adoption of any changes in legislation or actuarial standards, the work completed to date by more proactive plan sponsors has provided additional insights and awareness and has supported some difficult decisions facing these plan sponsors in the wake of the equity market collapse. Perhaps more importantly, these plans provide regulators with concrete evidence that properly constructed funding policies can better address the needs of public policy than the status quo.

No amount of actuarial expertise will ever be able to determine the 'right' amount of contributions required to support a given benefit structure, or alternatively, determine the plan design or funding strategy that perfectly addresses all future adverse events. However, improved identification and assessments of risk, along with enhanced explanations of the margins in place to cover those risks, should lead to better and more informed decision-making by plan sponsors. While far from a guarantee of success, it should illuminate many of the pitfalls discovered to date.

In situations where the prior assumption of risk has resulted in benefit curtailments, there may be a desire to eliminate risk completely. While this strategy may be desirable in some circumstances, it will not represent the best course of action in most circumstances any more than the best course of action for DC arrangements is to promote 100 per cent of investments be directed towards T-Bills and government bonds. A risk/reward tradeoff will always exist and it is the role of the actuarial profession to educate all pension plan stakeholders on the nature and implications of the tradeoff.

Actuaries have several analytical tools available to them to assess and communicate the inherent risk of pension plans. These tools can be used both to educate plan sponsors on the pension plan's risk, short and long term, and to aid in the development of comprehensive funding policies. Use of stochastic modeling techniques can provide sponsors with more robust information than the traditional, single-outcome deterministic best guess. These stochastic models can also illuminate future expectations of a plan's funded status and the related distributions. Plan sponsors can then use this information to broaden their understanding of total plan risk to help shape and guide their pension plans to achieve the desired risk/reward tradeoff.

When used effectively, these tools assist plan sponsors in properly discharging their fiduciary and governance obligations.

No Quick Fixes

While all of this activity will be occurring in a relatively short-term period, the long-term implications of the changes being brought about by the actuarial profession, combined with each jurisdiction's decisions, will not be known for many years. There are no quick fixes to the changing economic realities and, even in an environment of reasonable investment returns, it will take years to rebuild the levels of margins once enjoyed by most pension plans.

Nevertheless, there is now a sense of cautious optimism that the pension community is headed in the right direction. Plan sponsors may want to play an active role in shaping pension funding policy by sharing their concerns with regulators. ■

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