TIME FOR A CHANGE

Canada's pension legislators need to fix the pension solvency funding system to reflect current realities

By *Ian Edelist*

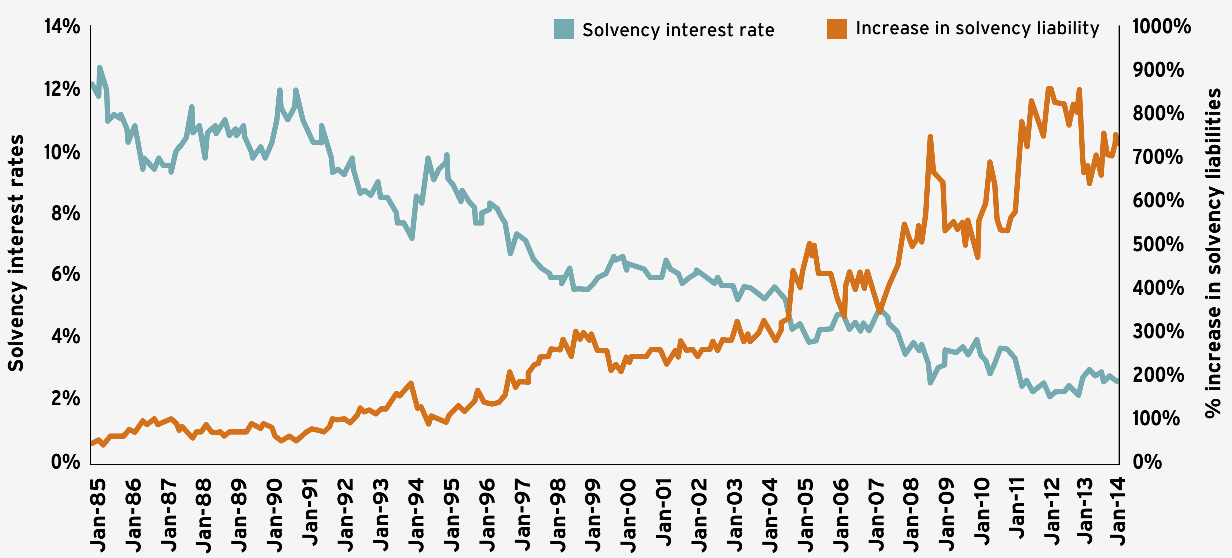
In 1987, Wayne Gretzky and Mario Lemieux combined to score the winning goal in the final game of the Canada Cup tournament. It was also the year Canada's first solvency regimes were introduced.

Jurisdictions across Canada introduced solvency regimes for pension plans in an effort to make sure DB plans would remain solvent—even if the companies sponsoring those plans became insolvent. Plan solvency would be tested at each actuarial valuation, and plan sponsors would be required to pay down any solvency deficit through additional employer contributions over a number of years. In doing this, the theory was, member pensions would be protected and the financial burden imposed on employers would be manageable.

But what was seen as an industry revolution in 1987 has since become outdated and ineffective. Falling interest rates have driven solvency liabilities eight or nine times higher than they were in the late '80s, making contribution levels unsustainable for organizations sponsoring DB plans. Even worse, the solvency rules currently in place haven't met their main objective: protecting members' pensions in cases when DB plans were wound up due to bankruptcy.

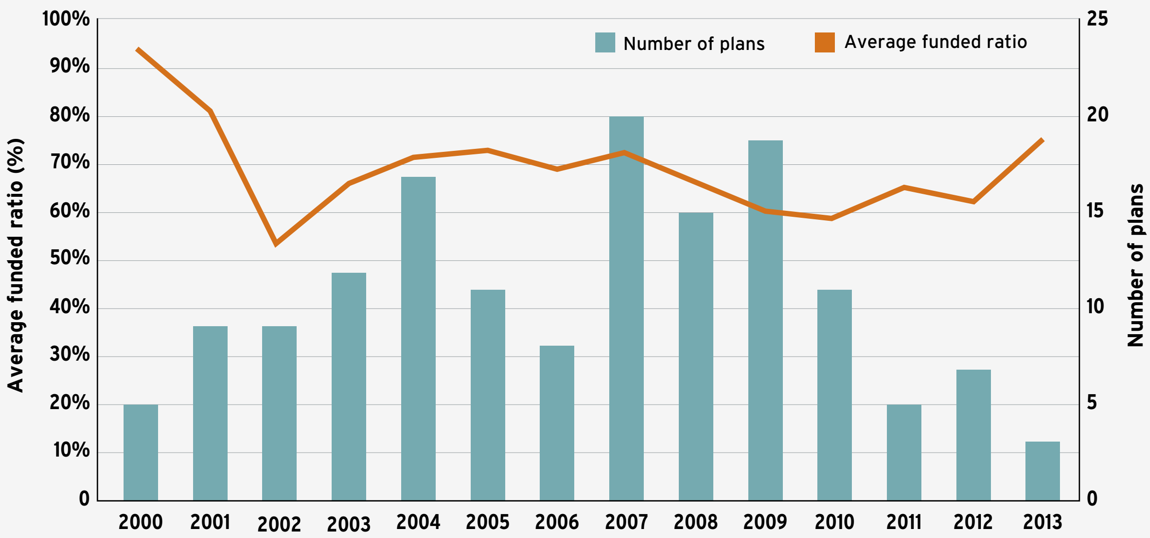
The long-term prognosis for DB pension plans—and the members counting on them for their retirement—isn't good unless something is done soon to fix the solvency regime.

FIGURE 1: EFFECT OF INTEREST RATES ON LIABILITIES



Source: Interest rate data is a select period of the Canadian Institute of Actuaries' transfer value basis; increase in solvency liabilities assumes a plan with the average age of 45.

FIGURE 2: WOUNDUP PLANS WITH INSOLVENT EMPLOYERS (2000–2013)



Source: Data from pension plan windups administered by PwC, Morneau Shepell and Mercer, 2000–2013

Impact of Interest Rates

Per the Office of the Superintendent of Financial Institutions, in 2002, 27% of private sector employees in Canada were members of a registered pension plan, with 73% covered by a DB plan. But by 2012, private sector pension coverage was down to 24%, and the percentage of those in DB plans had dropped sharply, to just 48%. Falling interest rates have been one of the key driving forces in this retreat.

Figure 1 (page 37) shows how low interest rates have dropped over the past three decades—from double digits in 1987 to just above 2% for the last three years. Since interest rates impact commuted values and annuity purchase rates, both of which make up solvency liabilities, it's no surprise solvency liabilities (the orange line) are eight times higher now than they were when the first solvency regimes were introduced.

At the same time, there have been two significant economic slowdowns since the turn of the 21st century. So, as employers were dealing with the negative effects of the economy on their bottom line, growing solvency deficits have required DB plan sponsors to make significant special payments in addition to their regular contributions—a balance sheet black hole many organizations have struggled to crawl out of.

Member Exposure

It's unsurprising, then, how many DB plans of insolvent employers have wound up in recent years.

Figure 2 (above) shows the solvency funding level of 151 DB pension plans in Ontario (representing $2.1 billion in liabilities) that have been wound up with insolvent employers since 2000.

Setting aside 2000, when pension plans were still benefiting from the effects of the '90s bull markets, the average windup funded ratio was between 60% and 70%.

Figure 3 (page 39) dissects this information further, grouping the funded ratios of all 151 woundup plans. Almost half (47%) of these plans had a windup funded ratio below 70%, which should be considered a failing grade under the current system. A funded ratio that low means large benefit cuts for employees and retirees of almost half of the pension plans sponsored by Ontario's bankrupt organizations.

This evidence strongly suggests the current solvency regime has failed to protect a significant proportion of members' benefit security when it matters the most. Solvency funding was a good concept, but it hasn't worked out well in practice for many plans.

The Association of Canadian Pension Management's May 2014 paper, "DB Pension Plan Funding: Sustainability Requires a New Model," provides a reasonable alternative to solvency funding. It proposes a new model built around a single funding framework, harmonized across Canada's various jurisdictions. That model should be clear to all stakeholders; not increase the cost burden on plan sponsors; be based on sound funding and risk management principles to protect member benefits; and reflect the long-term nature of DB pension plans.

Action Plan

In the latter part of the 2000s, various jurisdictions began tweaking their solvency rules to help private sector plan sponsors facing large solvency deficits. A number of provinces began allowing letters of credit to secure a portion of a plan's solvency shortfall, reducing cash contribution requirements. In 2010, rules for federally regulated plans were changed to allow minimum solvency contributions to be calculated based on a three-year average rather than the solvency ratio at the most recent valuation date. And 34 temporary solvency relief measures have been put in place across Canada over the past decade, mostly between 2009 and 2012.

All this activity means governments and regulators across Canada have begun to

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understand what many private sector DB plan sponsors already know: the existing solvency regime is failing to address its main purpose. That purpose is to ensure there are enough funds to pay out accrued benefits to plan members and retirees if no sponsor remains to provide future funding.

In the years since Canada's solvency funding regime first took shape, other financial sectors have updated their solvency rules to adapt to the changing times. The banking solvency regime has made significant changes in response to economic factors and sophistication in modelling methods, including Basel I (1988), Basel II (2004) and Basel III (2013). The insurance industry has also revisited its rules several times to better reflect the changing economic and business environment and to protect against risks.

Both the Great One and Super Mario knew it was time to hang up their skates when they saw the game they loved begin to change. There have been proposals in recent years to move away from the current funding model for select types of DB plans, but Canada's pension legislators have generally failed to heed the calls to overhaul the funding regime.

If the banking and insurance industries have responded to change by updating their solvency regimes, why haven't pension legislators followed suit?

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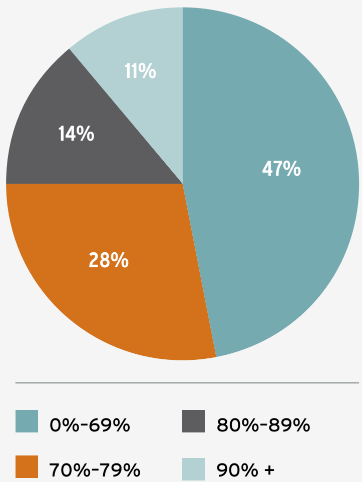
FIGURE 3: WOUNDUP PLANS WITH INSOLVENT EMPLOYERS BY FUNDED RATIO (2000–2013)



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