A n increasing number of public and private sector employers around the world are either abandoning the traditional defined benefit (DB) pension plan model in favour of more affordable and sustainable alternative arrangements, or are doing away with their employer sponsored retirement plans altogether. In the private sector, such action often requires country subsidiaries and affiliates of large multinationals to adopt head office’s global pension strategies which can include a broad spectrum of investment and plan design options, in addition to traditional plan termination.

Canada is no exception to this global trend. Even among domestic employers, the search to find suitable ways to de-risk volatile DB pension obligations is becoming a more common strategic corporate priority. Many consider the Dutch model based on risk sharing and target benefits to be worth pursuing, subject to appropriate enabling legislation. In fact, one Canadian pension jurisdiction (the Province of New Brunswick) has recently passed such legislation which is intended to provide both public and private sector employers with a framework...
to establish shared risk plans, as well as to convert existing DB plans to shared risk arrangements, for both non-union and unionised workforces. Another jurisdiction (Quebec) is in the process of finalising legislation that will enable target benefit plans to be implemented, but only for the pulp and paper sector. In Ontario, Nova Scotia, British Columbia and Alberta, regulations enabling target benefit plans have yet to be passed, but the legislative framework in Ontario and Nova Scotia only permits implementation of such plans in unionised workplaces.

Canadian employers are also taking notice of the number of recent lump sum transfer and annuity ‘buy-out’ programs being initiated in the UK and the US to remove the impact of all or a portion of former employee DB pension liabilities from corporate financial statements.

Why now?
The trend away from traditional DB pension plans is not new. Employers in Canada’s private sector have been moving away from DB plans (at least for non-union employees) and into defined contribution (DC) type plans for well over a decade. One of the most common reasons for this trend is to achieve a better balancing of risk between the employer/sponsor which traditionally bears most of the benefit funding risk, and plan members who bear most of the benefit security risk. These often polarised risks remain an industry-wide concern.

Over the last few years DB plan funded ratios have reached unprecedented lows, primarily due to: (i) prolonged periods of low long-term interest rates; (ii) volatile investment returns below expected results; (iii) increases in mortality risk due to longer retiree life expectancies; and (iv) greater than expected unreduced and partially subsidised early retirement pensions.

Over 95 percent of Canadian pension plans had a solvency deficiency at the end of March 2013 and the median solvency ratio among a large sample of DB plans was 74 percent, according to an April 2013 press release from Aon Hewitt Toronto Canada.

In addition to increased cash funding and benefit security concerns, changes to accounting rules have resulted in DB plan obligations having a more direct impact on employer balance sheets. Many Canadian jurisdictions have attempted to ease these funding issues through temporary relief measures, however, such measures have not been enough for many employers who continue to look for additional ways to reduce or eliminate the financial risks associated with their DB plans.

A closer look at DB plan de-risking options
There is a broad spectrum of pension de-risking options available to DB plan sponsors and administrators.

Liability driven investing. At the one end of the spectrum, plan administrators may mitigate risk through investment strategies, such as liability driven investing (LDI). Most administrators are already doing some form of LDI as a matter of prudence.

Plan design options. In the middle of the spectrum, there are plan design options that many sponsors have already implemented or are considering alone or in combination, such as: (i) conversion to future service DC; (ii) closing DB plan membership to new hires; (iii) cessation of future service DB accruals, with or without a pensionable earnings freeze; (iv) reducing the future service DB benefit formula; (v) reducing or removing expensive early retirement and other subsidised ancillary benefits, including pension indexing; (vi) conversion to a target benefit or shared risk plan.
under which sponsors and members share funding obligations, and target benefits can be reduced if funding levels become unaffordable; and (vii) DB plan termination and fund wind up.

Accrued legacy DB benefits cannot normally be reduced or converted without individual member consent and therefore, other than plan wind up, these strategies may involve lengthy transition periods where legacy DB benefits remain in the plan with attendant ongoing funding/benefit security risks and little immediate impact on the employer’s bottom line.

**Risk transference**

At the far end of the spectrum, there are risk transference options under which a plan sponsor may fully or partially eliminate DB plan volatility and funding risks through lump sum transfers, ‘buy-in’ annuities, and ‘buy-out’ annuities affecting former member benefits.

**Lump sum transfer.** This involves the payment of a cash settlement equivalent to the lump sum value of the member’s pension benefit. If 100 percent is paid while the plan is underfunded, a top up contribution may be required to preserve the plan funded ratio.

Annuity *buy-in.* This is an insurance contract held as a plan investment and therefore can be acquired while the plan is underfunded without triggering any top up contribution. Once the annuity premium is paid, the insurer is responsible for benefit funding, but the plan remains responsible for payment administration.

Annuity *buy-out.* This is a traditional annuity contract most often used in plan wind ups under which benefit liability risks are transferred from the plan sponsor to the insurer. Top up contributions are required if the annuity premium is paid from an underfunded plan.

**Planning a de-risking strategy and assessing legal issues**

There are key planning issues and legal/regulatory risks to be managed when considering and implementing any de-risking strategy, including regulatory approvals, identification of any legal restrictions or impediments, member communications and whether the desired outcome is achieved. The appropriate strategy could depend on a number of factors, such as the funded status of the DB plan, the business goals of the employer and the employer’s tolerance for legal risk and affected employee/former employee reaction.

Consideration of some key questions may assist in the process, including: What de-risking steps are permitted under applicable legislation and regulatory policy? What is the resulting impact of de-risking on the plan? What is the accounting impact on the sponsor? Do the above impacts satisfy the plan’s de-risking objectives? What implementation strategy best minimises administrator risk?

**A closer look at risk transference**

Over the last few years, employers in the UK and the US have been leading the charge on pension risk transference options, with a number of employers seeking annuity buy-outs and implementing lump sum transfers. A word of caution – Canada is different.

Lump sum transfers. These transfers must be elected by the member and are generally permitted by Canadian pension regulators, including re-election by ‘deferred vested’ members who previously chose to leave their benefits in the plan. Once pensions commence, however, regulators are unlikely to permit lump sum transfer elections, absent specific legislation (e.g., in Ontario, specific legislation was passed for Nortel retirees). This is
significant, since pensioners are often the bulk of former member liabilities. Clear and accurate disclosure of any lump sum transfer option will be important and should include a sufficiently detailed explanation of the potential member financial risks. Pension legislation in most, but not all, Canadian jurisdictions provides an express discharge to the employer from further liability in connection with lump sum transfers that are in compliance with statutory requirements.

Annuity buy-ins. Buy-ins may be unilateral (no member consent required) and can be used to reduce risk associated with both active and former members. However, while buy-ins may reduce contribution volatility, no statutory discharge is available and Canadian regulators consider the plan and the employer to ultimately remain liable for benefit funding in the event of any insurer default.

Annuity buy-outs. Buy-outs may also be unilateral. Like buy-ins, there is no statutory discharge available and pension regulators consider the plan and the employer to remain responsible for annuitised benefits in the event of any insurer default. Does this mean that Canadian plan sponsors cannot achieve settlement accounting treatment for buy-out strategies similar to lump sum options? Perhaps, but it may be possible for sponsors to rely on express annuity discharge provisions in the terms of their plans to fully satisfy plan obligations in relation to annuitised benefits (McLaughlin v. Ultramar Ltd., 16 C.C.P.B. 276).

In addition, if annuities are purchased so as to fully protect the benefits under Assuris (policyholder insurer default protection) insurance limits (the prudent course in any event), the risk of sponsor default liability may be rendered sufficiently remote to result in settlement accounting treatment despite the technical regulatory view. This should be the subject of advance discussions with the employer’s auditors.