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Pension Plan Risk Management In Canada

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Abstract

Pension plans, and their members and sponsors, face various risks, including investment, inflation, funding, longevity and regulatory risks. Where a plan sponsor takes action aimed at addressing or minimizing one or more of these risks, this is known as de-risking or risk management. De-risking or risk management may take various forms along a broad spectrum of options, from LDI, asset allocation and other investment strategies to plan design changes and risk transference strategies.

An 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, such as defined contribution or other capital accumulation plan 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 multi-nationals 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.

This article explores what options are available to Canadian sponsors and administrators in their search to find suitable ways to de-risk volatile DB pension obligations and what Canadian governments and regulators are doing to expand the available risk management tools while at the same time adequately protecting stakeholder interests.

Introduction

Pension plans, and their members and sponsors, face various risks, including investment, inflation, funding, longevity and regulatory risks. Where a plan sponsor takes action aimed at addressing or minimizing one or more of these risks, this is known as de-risking or risk management. De-risking or risk management may take various forms along a broad spectrum of options, from LDI, asset allocation and other investment strategies to plan design changes and risk transference strategies.

Recent Trends

An 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, such as defined contribution or other capital accumulation plan 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 multi-nationals 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, in 2012 one Canadian pension jurisdiction[1] (the Province of New Brunswick) 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 unionized workforces. Another jurisdiction (Quebec) has in place target benefit legislation, 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 (once in force) in Ontario and Nova Scotia will only permit implementation of such plans in unionized workplaces. The federal jurisdiction recently announced a consultation process for target benefits for federally regulated private sector and Crown corporation plans. In some of these jurisdictions where target benefit plan legislation is pending it is expected that such legislation will provide both for the establishment of such plans as well as the conversion of existing DB and DC plans.

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. Also, longevity swaps have garnered attention.

Why Now?

The trend away from traditional DB pension plans is not new. Unfortunately 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 polarized risks remain an industry-wide concern. This is one of the reasons why the target benefit or shared risk design is a worthwhile design alternative once enabling legislation is in place in the applicable jurisdiction. These plans provide employers with cost certainty, but continue to deliver a targeted pension benefit to plan members, which benefit may be reduced.

Over the last few years DB plan funded ratios reached unprecedented lows, primarily due to:

- prolonged periods of low long-term interest rates,

[1] Pension standards regulation in Canada is under provincial jurisdiction (except for federally regulated industries, such as airlines, railways, telecommunications, and the territories). Accordingly, each province (other than PEI) has in place pension standards legislation and there is also such legislation for federally regulated industries and the territories

- volatile investment returns below expected results,
- increases in mortality risk due to longer retiree life expectancies, and
- greater than expected unreduced and partially subsidized early retirement pensions.

Over 95 per cent 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 per cent (Aon Hewitt Toronto Canada April 2, 2013 Press Release). We are starting to see a turnaround in the funded position of many plans in Canada, however, commentators warn that the recent investment gains will not necessarily be sufficient to address the long term sustainability issues facing some plans.[2]

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 Risk Management Options

There are a broad spectrum of pension risk management 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:

- conversion to future service DC,
- changing future DB benefit accruals from a final or best average earnings formula to a career average earnings formula;
- closing DB plan membership to new hires,
- cessation of future service DB accruals, with or without a pensionable earnings freeze,
- reducing the future service DB benefit formula,
- reducing or removing expensive early retirement and other subsidized ancillary benefits, including pension indexing (or making such pension indexing conditional),
- 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
- DB plan termination and fund wind up.

Generally, accrued legacy DB benefits cannot be reduced or converted without individual member consent and therefore, other than plan wind up, certain of these

[2] http://www.thestar.com/business/personal_fnance/2014/04/01/teachers_pension_plan_produces_first_surplus_in_a_decade.html

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. New Brunswick's rules permit the conversion to shared risk of accrued defined benefits. Where a plan is converted to shared risk, all benefits in the plan become subject to possible benefit reductions in the unlikely event they are required under the plan's funding policy and any cost of living adjustments will be conditional on the plan having sufficient funds in the year to pay it. The federal consultation on target benefits also includes the possibility of conversion of accrued DB to target benefit if the requisite consent (not specified) is attained.

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 – is the payment of a cash settlement equivalent to the lump sum value of the member's pension benefit. If 100 per cent paid while the plan is underfunded, a top up contribution may be required to preserve the plan funded ratio.

Annuity buy-in – 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 – 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 Risk Management 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:

(1) What de-risking steps are permitted under applicable legislation and regulatory policy?

(2) What is the resulting impact of de-risking on the plan?

(3) What is the accounting impact on the sponsor?

(4) Do the impacts in 2 and 3 satisfy the plan's risk management objectives?

(5) What implementation strategy best minimizes administrator's 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 currently no statutory discharge available (see discussion on proposed Alberta changes below) and pension regulators consider the plan and the employer to remain responsible for annuitized 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 annuitized 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.

We note that Alberta's proposed Bill 10 provides new provisions regarding purchases of annuities for ongoing plans and on wind up. Specifically, for ongoing plans the changes will permit the transfer of assets of the plan to an insurance company to buy a life annuity for deferred members or persons who are receiving pensions and entitled to a benefit under a plan's defined benefit provisions. Where an annuity is purchased for a deferred member, the administrator must ensure that the annuity provides the deferred member with the same benefits as the member would have received from the pension plan. Where an annuity is purchased for a person who is receiving a pension, the administrator must ensure that the annuity provides the person with the same amount and form of pension that the member is entitled to under the pension plan. Importantly, the proposed legislation provides that as long as the administrator complies with the relevant legislative rules in respect of the annuity purchase, the administrator, a participating employer, a former participating employer or another person who was required to make contributions to the plan are

discharged from further liability to the person whose benefits were purchased.

There are similar provisions in Alberta's proposed new legislation regarding purchases of annuities on wind up. Subject to certain exceptions, the proposed new provisions would require the administrator to buy an annuity for each person in receipt of a pension plan under a defined benefit component of a plan as part of the wind up. The life annuity would have to provide the same type of benefit and the same income that the retired member is receiving from the plan or be in compliance with the regulations. Again, where the administrator has complied with the relevant legislative rules, the same discharge would apply.

Concluding Remarks

Although well managed defined benefit plans are often recognized as the preferred means of delivering pension income to employees, there are inherent risks with such plans. As a result, for some employers there has been an increased focus on strategies aimed at decreasing or minimizing the risks. As discussed above, the risk management strategies include plan design changes as well as risk transference strategies. These strategies are designed to share or shift some of the defined benefit risks.

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