

Pension plans travel the long road to recovery



BY JEFFREY MULLER

Headlines in the financial press show the Canadian economy has entered a recession deepened by the collapse of commodities, but this downturn should not have been unexpected.

Before pension plans can embark on the road to financial recovery, it is important to reflect on how they got to where they are today.

In the past decade there have been three significant market events that have influenced Canadian monetary and fiscal policy, and ultimately the economy: the collapse of long-term capital management (1998); the tech bubble and wreck (1999-2002); and most recently, the real estate bubble and associated toxic assets (2004-2007).

One lesson to be learned from these events is that, going forward, financial markets will likely be increasingly volatile. Therefore, plan sponsors will need to ask themselves “Can we continue to manage a pension plan with the expectation of lower contribution requirements in a highly volatile market environment?”

In addition, to provide a holistic picture of a plan’s financial health, a balance sheet approach that considers the surplus position is also recommended. However, the Canada Revenue Agency maximum rules for contributions and surplus retention restrict the accumulation of funds in

pension plans for “a rainy day” and, in the end, have proven to be punitive.

Establish a liability benchmark

As a result, we believe the first step on the route back to plan financial health is for defined benefit plan sponsors to confirm whether the best liability benchmark for the plan is going-concern liabilities, solvency liabilities or accounting liabilities.

It is difficult for a plan to satisfy more than one benchmark, but subject to the general financial position of the sponsor, the most appropriate measure to focus on is generally going-concern. This is because, barring employer insolvency, the ultimate goal of a pension plan is to pay out some level of pension benefit over the long-term, and going-concern liabilities are most closely aligned with this objective.

In addition, various provincial regulators have temporarily loosened some of the solvency funding requirements to support plan sponsors through these challenging times, measuring solvency over a longer term.

An understanding of the fundamental risks to the plan sponsor is also important. For example, a public-sector plan will face different risks than a plan sponsored by a private sector firm. A private-sector company in a cyclical industry, such as an automobile parts manufacturer, will have greater strains on their funding capabilities at different points in the

economic cycle than a slower, steady-growing company, such as a utility.

Asset-liability modeling

Assuming going-concern is the proper measure to focus on, is getting back to 100% funding realistic? What should sponsors do if they get there?

Asset volatility must be understood, and sensitivity- or worst-case-scenario testing conducted. Asset volatility has historically arisen from equity mismatch risk with the plan’s liabilities, especially when the market value of assets is used. This remains a viable approach; however, a sponsor needs to be able to afford, and stomach, the volatility.

A key risk management tool to help plans navigate out of their current situation is asset-liability modeling. A current ALM study is recommended given the significant changes recently in assets and interest rates.

The study will give a sponsor a greater appreciation of changes in the levels and variability in pension costs (defined as the amount of money a sponsor is putting into a plan) arising under different possible outcomes, including rates and asset shocks. It also identifies potential solutions.

An ALM study can also illustrate if and when a plan can reasonably expect to return to full funding using different investment approaches, as well as what cost model they are ultimately adopting.

Investment strategies

As part of an ALM study, a plan will end up considering one of two investment approaches:

- *Balanced approach.* A plan may simply choose to “ride it out” with a traditional balanced approach to the asset allocation, in the anticipation that with time the equity markets will come back. Along with special and regular contributions, the plan indeed may recover this way. Although it could take a decade or more, this may be the only chance for smaller, single-employer plans.

- *LDI approach.* Another possibility is a liability-driven investment approach. Instead of focusing exclusively on return, LDI strategies seek to ensure adequate diversification against a set of specifically identified risks faced by the plan. The strategies will require leverage, derivatives and greater education requirements for the pension committee. However, by removing the equity mismatch risk associated with the traditional balanced approach,

this allows the sponsor to seek excess market return from other sources.

With a balanced approach, the current portfolio is an efficient combination of equities and fixed income securities, whereas under an LDI approach the minimum risk portfolio on the surplus efficient frontier is a long-bond strategy representative of the liabilities.

Cost models

Ultimately, these two investment approaches will lead to one of two pension cost models:

- Expected low cost with high variability.
- Expected high cost with stable variability.

A balanced approach using mostly traditional asset classes, along with the expectation of a lower long-term cost with higher variability, is the model most frequently adopted today. However due to recent economic events and the 2011 accounting changes, LDI is rapidly gaining traction.

Furthermore, implementing LDI now is going to be expensive. Therefore, all things being equal, plans must choose whether to ride it out with a balanced approach to a better part of the funding cycle, or pay up now for a high-cost, but stable, LDI structure.

All of this addresses the assets of a plan assuming the liabilities remain as is. If a plan sponsor truly cannot afford a DB plan due to the high cost and variability of asset approaches required today, but does not want a DC plan, another possible option for consideration is a target-benefit plan, as put forth by the Ontario Expert Commission on Pensions, which addresses both the asset and benefit (liability) sides of a plan.

Stormy outlook

The economic outlook for pension plans at the moment is still very stormy, and the reality is that it will be difficult for every plan to make it out of this deep down-cycle.

However, with an examination of key plan risks and liability measures, a sponsor will gain an appreciation of the alternative investment approaches they can implement, along with their cost structures, either now or once their pension fund returns to financial health. **—E.B.N.C.**

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