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Funding Status of Defined Benefits Plans

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Funding Status of Defined Benefits Plans

Good Afternoon,

Thank you for granting the Certified General Accountants Association of Canada the opportunity to discuss with the Committee the current state of defined benefit pension plans in Canada. The Canadian retirement system is an ongoing area of interest at CGA-Canada as is the financial condition and prospect of Canadian households. Today, we would like to underscore the magnitude of the pension challenge by identifying how the deficits of private pension plans have deepened.

Our work on the topic of defined benefit pensions plans was initiated in 2004 – revealing that with indexation of accrued benefits, an estimated \$160 billion would be required to fully fund deficit pension plans as at the end of 2003¹. Revisiting that number in 2005 for the 2004 year end, we learned that that it had increased to an estimated \$190 billion². While we are continuing to study the 2008 year end results, preliminary analysis signals a funding shortfall significantly exceeding \$300 billion.

¹ Addressing the Pensions Dilemma in Canada; CGA- Canada (June 2004)

² The State of Defined Benefit Pension Plans in Canada: An Update; CGA-Canada (2005)

Relying on the supporting expertise of MERCER Human Resources Consulting and the information contained in its 2008 Pension Database, the funding position of Canadian pension plans as at December 31, 2008 has been estimated under the risk free basis approach. The risk free basis as reflected in Table 1 before you, removes any discretion in the selection of going-concern assumptions of each plan and it removes the influence of the investment policies in the selection of such assumptions. In short, the interest rate has been pegged at 3.5 % based on long-term Government of Canada bond yield and indexation set at 2.0% based on blended pre (*wage increases*) and post (*CPI increases*) retirement indicators.

TABLE 1
Summary of main assumptions (risk free basis)

	December 31, 2004	December 31, 2008
Interest rate ³	5.00%	3.50%
without indexation of benefits	0%	0%
with indexation of benefits⁴	3.25%	2.00%
Mortality table ⁵	UP94G	UP94G
Retirement age	Plan's own assumption	Plan's own assumption

³ Determined from the yield on long-term bonds of the Government of Canada.

⁴ Represents a blended rate of pre-retirement indexation (based on wage increases) and post-retirement indexation (based on CPI increases)

⁵ UP94G stands for "uninsured pensioner mortality table 1994 generational". This table allows for expected future improvements in pensioners' mortality and is currently the most commonly used mortality table for the funding valuations of pension plans. Even though it is generally seen as a best estimate mortality table for Canadian pension plans, it is worth mentioning that it is not based on Canadian mortality experience (there is no generally accepted Canadian mortality table).

Our analysis is based on 761 plans, covering a total of 1,496,000 members as on December 31, 2008 compared to 784 plans and 1,787,000 members for calculations as at December 31, 2004. These plans represent approximately 1/3 of the total DB plan market. Including trusts and insurance companies, there are an estimated 7,000 DB plans and an estimated 8,000 DC plans having an estimated 4.5 million and 0.8 million members respectively. DB assets exceed \$550 billion while DC assets represent an estimated \$50 billion.

It is apparent that the overall funding position has significantly deteriorated since December 31, 2004 – with and without indexation. That is, the average funding ratio has decreased from 112% to 77% on a without indexation basis and from 71% to 57% on the with indexation basis.

And whereas 59% of plans were found to be in deficit at the end of 2004, that number stood at 92% by the end of 2008.

Not necessarily a surprise given the performance of the capital markets but nevertheless notable.

The main results as at December 31, 2004 and December 31, 2008 are summarized in Tables 2 and 3 before you. The first “with no indexation of benefits”) and the second with indexation of benefits”.

TABLE 2
Overall funding position of Canadian pension plans
Results with no indexation of benefits

December 31, 2004

Status	Number of plans	Plan assets		Surplus/(Deficit) (\$Bn)	Funding ratio
		market value (\$Bn)	Plan liabilities (\$Bn)		
Plans with deficit	460	45.5	54.1	(8.6)	84%
Plans with surplus	324	177.8	145.6	32.2	122%
Total	784	223.3	199.7	23.6	112%

December 31, 2008

Status	Number of plans	Plan assets		Surplus/(Deficit) (\$Bn)	Funding ratio
		market value (\$Bn)	Plan liabilities (\$Bn)		
Plans with deficit	696	239.3	315.4	(76.1)	76%
Plans with surplus	65	10.1	8.7	1.4	116%
Total	761	249.4	324.1	(74.7)	77%

TABLE 3
Overall funding position of Canadian pension plans
Results with indexation of benefits

December 31, 2004

Status	Number of plans	Plan assets market value (\$Bn)	Plan liabilities (\$Bn)	Surplus/(Deficit) (\$Bn)	Funding ratio
Plans with deficit	751	220.6	310.5	(89.9)	71%
Plans with surplus	33	2.7	2.2	0.5	123%
Total	784	223.3	312.7	(89.4)	71%

December 31, 2008

Status	Number of plans	Plan assets market value (\$Bn)	Plan liabilities (\$Bn)	Surplus/(Deficit) (\$Bn)	Funding ratio
Plans with deficit	735	247.8	436.7	(188.9)	57%
Plans with surplus	26	1.6	1.4	0.2	118%
Total	761	249.4	438.1	(188.7)	57%

The global events that eroded pension asset values, interest rates, and investment returns had a devastating effect on Canadian pension plans. In the six months from September 2008 to February 2009, the typical pension plan lost about 20% of its asset value, measured on a market value basis. At the end of 2008, almost 40% of defined benefit plans had solvency ratios under 70%, and over 70% of defined benefit plans had solvency ratios under 80%.

Table 4

	2007	2008	2009
Proportion of Plans in Solvency Deficit	66%	71%	92%
Total assets ÷ total liabilities – all plans	103%	104%	82%
Total assets ÷ total liabilities – plans in deficit	89%	92%	81%

Going forward, CGA-Canada encourages the federal government to affect the previously announced measure of increasing the pension surplus threshold for employer contributions from 10% to 25%.

We continue to see well also enhanced protection for plan members – recognizing more fully the character of pension benefits as deferred

compensation requiring greater recognition as secured debt of the company and enhanced consideration in the creditor hierarchy.

Consistent with our submission of March 16th, 2009 to the Department of Finance and other work of the Association, we contend also that deliberate clarification is required regarding the ownership and distribution of surpluses on plan termination, letters of credit, the time span for the funding of deficits, and prescribed solvency ratio levels.

Should more radical departures be envisioned, one potential opportunity resides in the alternative of designing a “time-weighted” methodology which reflects and accounts for respective contributions and actions of plan sponsors and members. In time, we expect also that the establishment of pooled defined contribution arrangements and multi-employer pension plans (MEPPs) will gain greater acceptance.

The main factors underlying these decreases include:

- *The return for a typical asset mix⁶, net of administrative expenses, which was 2.1% per year over the years 2005 through 2008, as compared to the assumption of 5%. This represents a cumulative loss on assets of approximately 10%.*
- *The reduction in the market interest rates. For the basis with no indexation of benefits, the rate has decreased by 1.5% (i.e. from 5.0% to 3.5%), which represents an increase in plan liabilities of approximately 30%. For the basis with indexation of benefits, the discount rate net of the assumed inflation has decreased by 0.25% (i.e. from 1.75% to 1.5%), which represents an increase in plan liabilities of approximately 5%.*
- *In the fall of 2008, the financial crisis which had been prompted in 2007 deepened substantively. Markets lost significant value in almost every asset class. For example: The S&P/TSX Composite index fell by almost 29% in September-October 2008 alone; During this same period, U.S. stock values fell by 13% and international stock values fell by 22% (returns measured in Canadian dollars), and the main nominal bond indices fell by 3% to 8%.*

⁶ 25% Canadian equities, 15% US equities, 15% international equities, 42.5% fixed income and 2.5% money market

- *From September 2008 to March 2009, yields to maturity on long-term high-quality corporate bonds rose from about 5.5% per year to 8.00% per year. This “flight to quality” pushed yields on long-term Government of Canada bonds from about 4.3% per year to about 3.5% in the last two months of 2008. The resulting increase in the “credit spread” (the difference between corporate and government bond yields) dramatically illustrates the effect of the financial crisis on the bond markets. This effect has reversed somewhat since the spring of 2009. Yields on long-term high-quality corporate bonds have fallen back to around 6.0% per year, and long-term government yields are around 4.0% per year. The 2.0% credit spread is still quite a bit higher than the level seen from 2003 through mid-2007 (well under 1.0%), but this is still a meaningful change from its high in spring 2009 of about 4.25%.*

***EFFECT OF CRISIS ON FUNDING STATUS OF CANADIAN
PENSION PLANS***

It is worth mentioning that, in stark contrast to the sharp increases in funding requirements caused by the recent crisis, the cost of pension plans reported in most sponsors' financial statements experienced significant decreases in 2009. This is because most plan sponsors set the discount rates used to calculate the cost of their pension plans for financial reporting purposes by reference to high-quality corporate bond yields. Those bond yields irregularly soared to as high as 8%, with such target yields increasing dramatically the results in the last quarter of 2008 and the first quarter of 2009. For sponsors whose fiscal year-end fell within that time frame, such increased rates typically caused the reported pension expense to be much lower in the following year. This disparity between lower reported costs on financial statements and greatly increased cash needs in the same year may prove difficult for sponsors to explain to stakeholders.

PLAN SPONSORS' RESPONSE TO PENSION FUNDING CRISIS

In the wake of the crisis, plan sponsors have been anxious to find solutions to address the rising funding costs of their pension plans.

Direct cost reduction

Some sponsors have attempted to reduce pension funding costs by reducing the benefits offered by the plan, or abandoning the defined benefit plan altogether, often in favor of a cheaper, more predictable defined contribution plan.

Liability-driven investing

Liability-driven investing (LDI) refers to a variety of investment approaches, which are specifically designed to mitigate this mismatch risk. In some cases, implementing such a strategy can cause the pension plan to be more expensive on average than under the typical approach, but with much less volatility. After suffering from the rapidly changing costs in 2008 and 2009, many plan sponsors are willing to consider this trade-off more seriously.

Increased focus on plan governance

Whether sponsors have taken any concrete actions to alter their plans' risk

profiles or not, the crisis has illuminated the need for a greater emphasis on pension governance. Having clearly articulated the decision-making structure and process can help sponsors feel more confident in their decisions and in the documentation of these decisions during uncertain times. In addition, the crisis has given sponsors a greater understanding of the risks they assume in sponsoring defined benefit plans.

EFFECT OF CRISIS ON PLAN MEMBERS

The crisis has had a significant effect on many pension plan members, some more directly than others.

For some members of defined benefit plans, there have been significant and direct effects. At worst, in cases of sponsor insolvency, or winding down, where the plan is also significantly underfunded, the plan members will experience permanent reductions in benefits already accrued. The high-profile nature of some of these cases⁷ has highlighted for members that even in defined benefit plans, there is no 100% guarantee. Moreover, it underscores that pensioners continue to be dependent on the long-term financial viability of their former employer.

⁷ Notable cases include Nortel Networks, AbitibiBowater, Fraser Papers, and CanWest

CGA-Canada believes that the crisis can best be soothed by adopting a holistic approach rather than piecemeal measures unless those ad hoc measures deliberately respond to the desired end state. Many of the issues that impair the optimal funding and condition of defined pension plans have existed in some instances for decades.

We applaud the current public initiatives to study and to reform the rules and expectations surrounding pension plans. We support fully also the implementation of necessary strategic and structural changes that contribute to a fair, responsible, sustainable, and efficient retirement system that secures the future of all Canadians. Changes that more copiously recognize that earned pension benefits represent deferred compensation – not a conditional game of chance.

We must be mindful also that a majority of Canadians are not afforded employer sponsored pension plans and that as much as 35% of the adult Canadian population do not commit to any type of regular savings. Taken in tandem with CGA-Canada findings on escalating household indebtedness and reduced proclivity to save, we understand full well the apprehension of Canadians in relation to retirement security⁸.

⁸ Where Does the Money Go: The Increased Reliance on Household Debt in Canada; CGA-Canada (2008)

And while economic growth may once again be in our grasp, the full benefit onto society will only be felt over time as the government again achieves a balanced budget, as real income grows, and as capital markets recover.

In closing, while we appreciate that the opportunity may be ripe to pursue pension reform, we encourage that adequate time be afforded to study and to understand this relatively complex matter.

We are encouraged to observe this Committee hosting these consultations. We are likewise encouraged by the growing appetite for coordinated pan-Canadian action that harmonizes the efforts of federal and provincial stakeholders. In so doing, we are more likely to enhance information symmetry and to introduce comprehensive, systematic, and lasting improvements.

Thank you for your time!