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Funding The Solvency Gap

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While attending a global investment conference recently, I had a chance to speak with quite a number of pension sponsors. Without fail, the topic discussed the most was pension solvency. Not one sponsor in the group I spoke with had a fully funded pension at their last valuation.

The issue of solvency is not unknown. The Mercer's "Pension Health Index" which measures the ratio of assets to liabilities for a model pension plan. The ratio has been arbitrarily set to 100 per cent at the beginning of the period. The Index assumes contributions equal to current service cost and no plan improvements. As the chart below clearly indicates, solvency is a recent issue – plans have been largely underfunded for most of the past decade.

One of the reasons solvency has become an issue over the years is the asymmetry of pension fund surplus. In simple terms, if employers over-contributed to defined benefit pension plans, the excess/surplus is deemed to belong to the plan and its members – not the employer. In years gone by, when interest rates were high and market returns positive, pension provisions were improved or negotiated. Amendments like COLA clauses and beneficial early retirement enhancements have become increasingly more expensive with an aging workforce and lowered interest rates.

Other reasons for the deterioration in solvency come from a variety of sources:

- excessive return expectations built into the valuation model. By raising the expected returns, employer contributions have been minimized.
- actual disastrous investment returns – improper asset allocation, including the redirection of assets toward global markets at the 63 cent nadir of the Canadian dollar, and generally bad advice have all led to returns which did not meet the valuation expectation.
- greater life expectancy, which increases the number of years in retirement – in fact, experts have argued that mortality tables used to calculate liabilities do not accurately reflect longevity risk.

- demographic change which affects funding by altering the ratio of workers to retirees. The pressure of baby boomer retirement, with a corresponding reduction to the overall workforce, will put additional pressure on funding ratios.
- last, but by no means least, interest rates. Simply stated, the cost of a future annuity is determined by long term interest rates ie government bond yields - when interest rates are low, costs are higher.

In the U.S. and U.K., equity markets have been rebounding on the expectation that governments will pursue a second round of quantitative easing. While possibly beneficial to stimulate the economy (though the jury is out here), the drag on bond yields that would result from further easing would raise pension fund liabilities far above any increase in assets.

However recent changes to legislation are likely to reduce the funding volatility for Canada's federally regulated defined benefit plans, while giving plan participants enhanced benefit security. These changes stem from the Federal Pension Reform Framework, which was released in October 2009.

The expected reduction in volatility comes from two major reforms to the minimum solvency contribution requirements:

- The minimum solvency contributions will be determined based on a three-year average solvency ratio rather than the solvency ratio at the valuation date.
- At each valuation, solvency deficits are consolidated and re-amortized over five years; currently, previous deficits are not re-amortized.

Other amendments include:

- The availability to plan sponsors of letter-of-credit financing on an ongoing basis
- A "workout scheme" available to distressed pension plans whereby employers, plan participants and retirees can negotiate temporary changes to funding requirements, subject to approval by the appropriate provincial ministry
- The removal of the 5%, 15% and 25% quantitative investment limits applying to resource and real property investments. These changes will also apply to plans in provinces that have adopted federal investment rules: Alberta, British Columbia, Manitoba and Saskatchewan
- The adoption of immediate vesting of benefits — currently, employees have to complete two years of plan membership
- A ban on contribution holidays unless the plan has a solvency margin of at least 5%, as well as a surplus on a going-concern basis and a prohibition on plan improvements when the solvency ratio is below a prescribed limit, expected to be set at 85%
- A requirement that an employer fully funds benefits in the event of a full-plan termination and the removal of employer-initiated partial-plan terminations

Unfortunately there are no perfect answers on how to close the funding gap. Each plan sponsor has to assess their own circumstances. However, there were some solutions discussed in the corridors at the Ottawa conference:

1. Freezing the existing plan – establishing a new plan for employees that join the company. The new program could be less generous than the existing plan.
2. Reducing or eliminating early retirement – the cost of early retirement provisions are becoming quite prohibitive. Ontario law allows for changes to these provisions without recourse.
3. Adopting an LDI investment strategy – liability-driven investing ("LDI") isn't something new; insurance companies have used this technique for decades. In short, the plan consciously allocates to assets which closely correlate to the plan liabilities. In the case of underfunded plans, allocate both to correlated assets like corporate bonds, and to "growth" assets which show less correlation to the liabilities but potentially offer superior returns to close the funding gap. Segregating asset classes into liability-matching assets versus growth assets can help focus the investment committee on the ultimate goal of closing the funding gap. Variations on this include adding a dynamic asset allocation process to optimize excess return while considering the nature of the liabilities.
4. As of August 2010, British Columbia and Saskatchewan have allowed sponsors to fund solvency deficiencies with a letter of credit. While not yet adopted in Ontario, Bill 236 has been introduced in the legislature which incorporates the letter-of-credit along with a number of other temporary relief measures.

While not a solution to the funding gap, improving governance, including the addition of more independent investment and supervisory expertise to minimize conflicting interests, will minimize future potential increases in the funding gap. Most plan sponsors cannot afford internal investment expertise - leaving aside the problem of recruiting the managers with the right level of skills and experience, the pension fund would then be committed to using the skills of those managers it has recruited.

In the US and Canada, the large retirement schemes and university endowment funds such as CALPERS, Canada Pension Plan, Harvard, and Yale typically can afford fully resourced investment boards to handle the management of their assets, most of which is outsourced to fund managers. However, for smaller programs, outsourcing the fund management function can become an unwieldy process for plan trustees with limited technical qualifications or experience to manage an increasingly complex business.

We believe the solution to ongoing investment expertise lies in "fiduciary management". Fiduciary management refers to the outsourcing of pension fund management to a single third party. This manager would normally take over responsibility for advice, portfolio construction, manager selection, monitoring and reporting. The trustees decide on an overall investment strategy, but the fiduciary manager takes responsibility for the asset mix, benchmark selection, risk budgeting and the hiring and firing of managers. Advocates of the approach say the decision process is quicker, allowing more nimble decision-taking in the current volatile markets.

We also know that the solution to the funding gap is NOT to take on greater risk by allocating assets indiscriminately to areas like emerging markets. While there are many investment companies touting this tactic as potential relief to the asset growth equation, we believe that increasing volatility and higher valuations will only result in a worsening of solvency issue.

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