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Is the Sky Falling?

Reports of the widespread demise of defined benefit pension plans have been greatly exaggerated. Here's why.

A brilliant article by Warren Buffett in the December 2001 issue of *Fortune* magazine has sparked widespread concern about the state of defined benefit pension plans and their impact on corporate sponsors. Scary headlines abound. "A time bomb is ticking in pension plans," cautioned *The Toronto Star*. "Pension crisis" warned *The Globe and Mail*. Those aren't today's headlines: they are from 1975—the end of the last major bear market.

As with any economic downturn, some organizations will not survive. Some employees will feel real pain in losing their jobs and potentially not receiving their full pension—if the plan is underfunded at the time.

There is no doubt pension plans can affect their sponsors' balance sheets and income statements. At some large Canadian companies, pension assets comprise more than 25 per cent of total corporate assets. Contributions consumed 12 per cent or more of last year's operating cash flow for a number of Canadian corporations, and pension expenses equalled ten per cent or more of operating income.[1]

The prolonged bear market means that sponsors' pension contributions will increase. There will be pain, especially for those accustomed to contribution holidays. History's longest bull market has obscured the reality that there is a market cycle and sponsors must add money from time to time.

Research analysts are raising fears that stepped-up funding will siphon cash needed elsewhere and stock market valuations will suffer as income statements show pension expense instead of pension income. Contributions are rising rapidly due to the mechanics of solvency valuations, but they need not scuttle worthwhile capital projects. For organizations with good credit status, banks are willing to lend and investors are willing to buy bonds. With interest rates at a 40-year low, companies can still fund capital investment without unduly hurting debt coverage ratios.

Pension expenses are rising too, albeit more slowly. Those not versed in pension accounting rules have assumed corporations are using pension trickery to protect the bottom line. They fail to recognize that, although corporations have choices in accounting methodology, they cannot change approaches at will. The basic purpose of pension accounting is to allocate the costs of an extremely long-term and uncertain obligation appropriately to each year's shareholders. Smoothing techniques to dampen volatility are completely appropriate. Dampening does work both ways.

Is Warren Buffett off base? No. His concerns are valid —for U.S. companies that assumed plan returns (ROA) of 10 per cent to 10.5 per cent. Canadian sponsors used more conservative ROA assumptions: a seven per cent to nine per cent range that is now creeping down.

Two recent studies made headlines by applying Buffett's warnings to Canada.[2] Unfortunately, they overstated the situation by comparing the return assumption to last year's actual return. Where were these concerns when plan sponsors were using an eight per cent ROA and earning actual returns of 15 per cent? As Buffett stated, ROA targets are meant to be longer-term, forward-looking averages.

Arguably, Canadian sponsors are better positioned now than when the last crisis hit. Indeed, most plans began this bear market with more assets than obligations. Even after three years of awful market returns, most plans continue to be better than 85 per cent funded on a going-concern measure. And borrowing is now viable, in contrast to the 1970s when interest rates were 11 per cent to 13 per cent.

All is not well, but the current degree of angst is unwarranted at this time. Yes, we are experiencing showers and heavy rainfall, but the sky is not falling. ▮

1. Towers Perrin 2001 survey of 100 large Canadian corporations
2. Christine Wiedman and Daniel Goldberg (*Ivey Business Journal*, May/June 2002) and National Bank Financial (*Quantitative Strategist*, June 5, 2002)