

# THE PERFECT PENSION STORM

*Converging fronts of low returns and high regulatory standards created a tempest.*



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## PLAN SPONSORS MUST GO BEYOND THE RESULTS OF THE LATEST ACTUARIAL VALUATIONS

Batten down the hatches: the Canadian pension forecast was accurate, and a perfect storm is indeed on the way. More than 70% of Canadian pension plans were estimated to be insolvent by the end of 2002.

There was also an aggregate deficit of \$20 billion (on an accounting basis). And if you think that it is fed solely by hostile economic fronts, please read on.

Sure, the market downturn was enough to create serious turbulence, but not the crisis. It took the downturn's collision with two fronts to set things in motion.

The first of these two fronts was the spending spree. The 1990s' bull market made it easy for plan sponsors to spend some of the "excess" money, money that would have helped weather the storm. As sponsors looked at the long-term financial situation of their plan, it was easy to increase benefits and take contribution holidays. Receiving signals from the tax authorities that contributions would no longer be tax-deductible once the plan became "over" funded also supported the decision.

The last front involved the failure to recognize the short-term nature of liabilities. Beginning in the late 1980s, accountants and pension regulators introduced new sets of rules for accounting and to ensure the minimum funding of pension plans. But more importantly, they introduced new measures of liability. Regulators introduced solvency liability, around which the solvency test is built. This new liability measure moved away from the "long term" smoothed measure used for funding to a much more volatile, interest rate sensitive marked-to-market measure. This shifted the focus of liabilities to a much shorter-term view. This is where the crisis originated. Many took the view that the long-term measure should drive pension plan funding and investment policies. With the long term in

sight, many increased their plan equity exposure (from around 30% on average in the early 1990s to approximately 60% in 2000). With that, the storm began to brew, with long-term assets meeting short-term liabilities.

As managers increased their equity exposure, the impact of failing to recognize the short-term nature of liabilities was ready to take its toll. As interest rates fell, solvency liability grew to the point where it even surpassed long-term funding liability. Meanwhile, assets declined with the market downturn. And no cushion was left after the spending spree.

Suddenly, solvency mattered, and the result was painful: where you once had a small "long-term" funding deficit, you were now faced with a solid solvency shortfall. To make matters worse, this deficit has to be paid over five years. Moving from a regimen of zero contributions for many years to one requiring 20-30% of payroll clearly set the stage for a crisis.

While traditional solvency, funding and accounting rules work in isolation, it's almost impossible for them to coexist. This uneasy union forces plan sponsors and administrators to assume undue risk because each set of rules rests on a different measure of liability. Moving all measures towards a marked-to-market liability measure could definitely help. This would shift the traditional funding view from long-term to short-term. It's debatable whether this makes sense for all plan sponsors.

For now, proper planning and budgeting is essential. Plan sponsors must go beyond the results of the latest actuarial valuation. They need to understand both what's ahead and the inherent risks faced by their plan. Simple questions involving, for example, the impact of deflation must be asked. Working closely with the actuary, money manager and the pension and investment consultants has become essential in the eye of the storm. ■