Are your pension risks being managed?

Is it time to de-risk?

Prepared by the Pension Committee, FEI Canada Policy Forum, April 2015

Are your pension risks being managed: Is it time to re-risk?

There continues to be considerable media attention and debate on the topics of pension risk management, de-risking, and which pension savings vehicle is better. While these topics are good reading and worthwhile debating, the question we hear most plan sponsors and FEI members ask is "How do I provide a meaningful pension to my employees while keeping my costs under control and managing financial and legal risks? In other words, what are some practical actions that can be implemented today to achieve better outcomes for my current pension plan?

The following is an introduction to a series of articles that address pension risks and practical ways to help better manage those risks.

1) Are Your Pension Risks being Managed – Is it Time to De-Risk
2) DB Plan Risks and Available De-risking Strategies
3) Capital Accumulation Plan Risks and Available De-risking Strategies

The first article of the series outlines the key stakeholders and risks within the traditional single employer Defined Benefit (DB) and Capital Accumulation Plans (CAP) (i.e., Defined Contribution (DC) and Group Registered Retirement Savings Plans) pension programs.

Key stakeholders to pension programs

A pension plan represents a formal program between an **employer** and some or all of its **employees** that is registered with the **government** who provides tax incentives to promote retirement savings. This section provides a definition of the key stakeholders to a pension plan as well as other common terms used in pensions such as **sponsor**, **fiduciary**, and **pension committee**.

Employees that join a pension plan become **members** of the pension plan. Members are primarily concerned about how secure their pension promise is and whether they can rely on that money when they retire. In addition, they should be concerned about whether their post-retirement income levels will be adequate to meet their needs.

Employers have a balancing act, on the one-hand they worry about their ability to bear the cost and risks of their pension programs. On the other hand, employers are also the **Sponsor** of the pension plan which means they have a fiduciary duty. Employers have the difficult task of needing to wear two hats and balancing the interests of plan members and the company's shareholders.

A **fiduciary** is responsible for prudently managing the pension commitment made to the members of the pension plan which means they are required to act in the best interest of plan members.

A **pension committee** is often established to oversee the day-to-day operations of the pension plan and to handle the fiduciary responsibilities of the employer. Pension Committees typically are comprised of 2-4 management level employees with pension knowledge and roles in HR and Finance. Depending on the size of the employer, the CEO, CFO, and SVP of HR may be on the Pension Committee.

Government is concerned about the adequacy of retirement income for their citizens (an example of this is the proposed Ontario Retirement Pension Plan). In addition, government is concerned with the cost and risk of future reliance of citizens on the tax system during retirement.

DB and DC pension programs

Traditionally, the pension world has been defined by two basic pension models: i) the Defined Benefit Plan (DB) and ii) Capital Accumulation Plans (CAP) which include Defined Contribution (DC), Group RRSPs (GRRSP), and Deferred Profit Sharing Plans (DPSP).

Defined benefit plans

A DB plan provides a guaranteed retirement income determined by a formula based on years of service with the company and actual earnings (a salary based plan) or a retirement income based on a flat rate per year of service (a flat benefit plan) .

The DB plan model consists of a commitment by the sponsoring employer to make regular funding contributions to the plan which will vary depending on the investment returns on the pension assets, current interest rates, and the future economic outlook of future investment returns. The plan is required to maintain sufficient assets (which are held in a trust fund) to be able to make the pension payments promised many years into the future. The pension trust assets are managed by investment managers with oversight by a pension committee and ultimately the plan administrator. Often employees are also required to contribute a percentage of their salary to a DB plan. If employees do contribute to a DB plan, they would usually only be responsible for making their scheduled contributions and would not fund shortfalls in the traditional single employer DB plan. The company is solely responsible for funding any deficits regardless of the underlying reasons and causes for the deficit.

In most cases if a funding surplus exists, the trust document and plan document will indicate who "owns" the surplus between the employee and employer. This is typically only an issue when a DB plan is frozen or going through a plan termination or wind up. If the employer bears 100% of the deficit funding risk but does not own 100% of potential surplus then this creates risk asymmetry. This was a much, much bigger issue before 2008 with the current trend moving towards some form of surplus sharing.

The primary risk associated with DB plans is the complexity, high number of moving parts and exposure to uncontrollable external variables; all of which contribute to risk (volatility) and lack of transparency arising from a 'knowledge/understanding gap' on the part of both employers and employees.

Capital Accumulation Plans (CAP)

In a CAP, the amount of retirement income is dependent upon the level of employer and employee contributions while working, investment returns on those contributions, the amount of fees paid by the employee, and interest rates at retirement or investment returns during retirement depending on whether an annuity is purchased or if the member's account balance continues to be managed during retirement.

Employer contributions are fixed as percentage of salary and remitted monthly. Employee contributions are made via payroll deduction on a pre-tax basis, meaning the contributions do not attract payroll taxes. Employer contributions may be structured as a core contribution that is a fixed percentage of salary that is independent of employee contribution plus a matching contribution that requires the employee to make a contribution to get the matching contribution. Typically matching formulas are 100% and 50% of employee optional contributions up to a prescribed amount. All contributions – employer and employee - are invested in an account in the employee's name. The investment decisions that determine returns on the invested funds in the member's account are managed by the employee for the duration of his or her career.

The biggest knocks on the CAP model are that employees are required to make all investment decisions regardless of their investment knowledge creating additional risk when the person is trying to understand the level of income at retirement. Insufficient information coupled with the lack of investment knowledge creates additional uncertainty, making retirement planning more difficult.

What do we mean by "pension risk"?

In offering any type of pension program, an employer is taking on a significant fiduciary role with associated financial and legal risks. The employer should consider the types of potential risks associated with each type of plan and ensure there is a commitment of time and resources to properly support and manage the fiduciary and administration requirements of the program being sponsored.

The level of 'pension risk' depends on the type of pension program and stakeholder. All members of a pension program – current employees, former employees with vested rights, and pensioners - are the beneficiaries of the program.

Figure 1 below shows key pension risks and who between the employer and employee bears that risk.

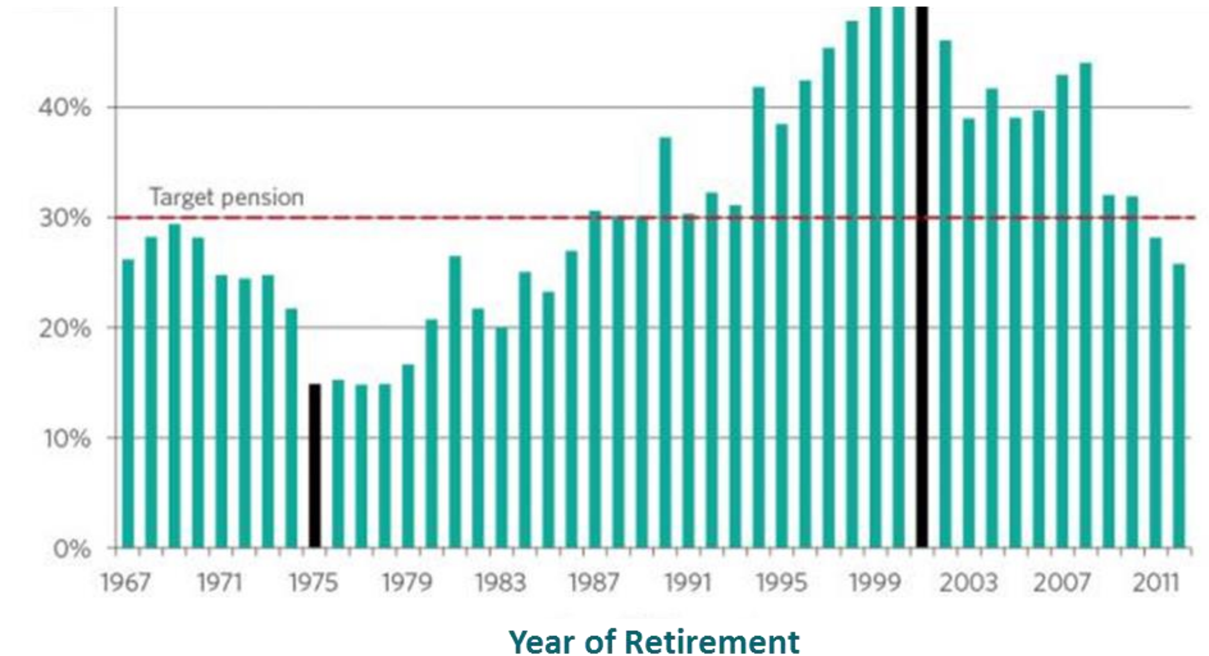
Figure 1 – Who bears the risks of DB and DC plans?

Key pension risks	Who bears the risk? DB Plan	Who bears the risk? CAP	Comments
Investment & interest rate risk – affects amount of assets and funding	Er	Ee	• DB – poor returns and lower interest rates can create deficits and increase funding costs for Employer • CAP – Employees make investment decisions and bear risk of insufficient savings at retirement
Fiduciary risk – duty of care, loyalty, and prudence (aka **Legal** risk)	Er	Er	• CAP arguably greater risk than DB since employee retirement income dependent on member decisions based on info provided by employer and vendors; risk of class action by members of CAP and DB
Longevity risk – financial impact of people living longer than assumed	Er	Ee	• DB – Employer bears risk of people living longer and funding additional costs • CAP – Member bears risk of outliving his or her savings during retirement
Er = Employer		Ee = Employee	

The risk of poor investment decisions and returns and, insufficient contributions during the member's working years - also known as the "accumulation phase" - is a critically important risk faced by employees.

Figure 2 below provides an example of investment and interest rate risk to an employee in a CAP. The example assumes 8% contributions (4% employer plus 4% employee) per year for 30 years invested in a balanced investment fund of 60% equities and 40% bonds. At retirement (age 65), the account balance is converted into a level dollar amount of lifetime pension by buying an insurance annuity.

Figure 2 – DC pension income as a % of pre-retirement earnings can vary significantly depending on market condition at the year of retirement



The individual that retired in in 2001 enjoyed three (3) times more income during retirement than the individual that retired in 1975 despite having the same contributions made for 30 years and the same investment strategy. This is because of the combination of very strong investment returns in the 1980s and 1990s and the level of long term interest rates in 2001 used to convert the account balance into a monthly pension or annuity was more favorable than the 30 year period leading up to 1975. We note that the level of long term interest rates at the time of retirement can have a big impact on the income producing power of a given amount of accumulated capital with higher interest rates producing a higher post-retirement income.

Where do we go from here?

Pension programs are complex financial and legal structures that have evolved over time. As discussed in this article, there are risks to all stakeholders – employers, employees, former employees, pensioners, and government – and the pension landscape has changed significantly over the past twenty years. As an employer it is often difficult to wear both the plan sponsor and plan fiduciary hats at the same time. And, in some cases, the pension program represents the biggest liability and risk to an organization.

Pension programs also have enormous potential to ensure that employees can retire with an adequate pension that they can rely on throughout retirement. However, if the pension plan is not well managed and proper oversight and support is not provided to employees especially in the case of CAPs, the result could be disastrous to all stakeholders – employees, employer, and government.

The next article in this series will explore in greater detail the specific pension risk management and de-risking strategies that are available to DB and DC pension stakeholders. In the meantime, we encourage you to ask yourself (1) “What are my Pension Risks?” and (2) “Is it time to de-risk your pension plan for the benefit of all stakeholders?”

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