DB Solutions

InSights

What's your Pension Dashboard telling you?

It's often commented that the Canadian defined benefit (DB) pension market is maturing. But what does that mean? For starters, there are few new DB plans being established, instead many are being closed in favour of defined contribution (DC) plans as the main source of retirement savings. The demographic profile of existing DB plans will generally see more retiree liabilities relative to active liabilities, which implies a shorter life cycle; although for most sponsors the ongoing oversight will continue for decades.

Should a maturing DB pension market signal the start of a change in philosophy from a focus on investment management and the goal of optimizing returns to a greater focus on risk management and managing the volatility of liabilities? Considered in isolation, the level of a DB plan's maturity is not enough to trigger such a change in philosophy. Other factors also come into play and can be more important. This article introduces key factors to be included in a pension dashboard assessment to help determine whether a plan sponsor's focus should be moving more towards risk management.

The Dashboard

When you get into the driver's seat of your car, the dashboard provides the key information to help you safely navigate the roads ahead. The speedometer helps you check your speed so you don't go too fast and receive a fine. The fuel gauge reminds you to make timely top-ups and avoid running out of gas, which would disappoint those who rely on you to get them to their destination. Determining the key factors to be included in a pension dashboard is subjective, but a number of measurable factors will provide a framework to assess the importance of investment versus risk management. The Sun Life Financial pension dashboard is made up of the following factors:

- *Plan status – whether a plan is open, closed or frozen.*
- *Ratio of inactive (retirees and deferred vested) members to active members – a measure of the demographic sensitivity of the plan by considering the percentage of retiree and deferred liabilities compared to active plan member liabilities.*
- *Pension liabilities as a percentage of company liabilities – this is one measure of the importance of the DB plan to the plan sponsor's financial health. By considering the pension liabilities as a debt on the company balance sheet, its impact can be considered in relation to other corporate liabilities.*
- *Percentage of earnings' volatility – a measure of how much the DB plan contributes to earnings' volatility. The high-equity bias of DB plans and the associated equity market volatility contributes to earnings' volatility.*
- *Contributions as a percentage of cash flow from operations – a measure of the extent to which cash is being diverted to the pension plan away from other important uses in running the business.*

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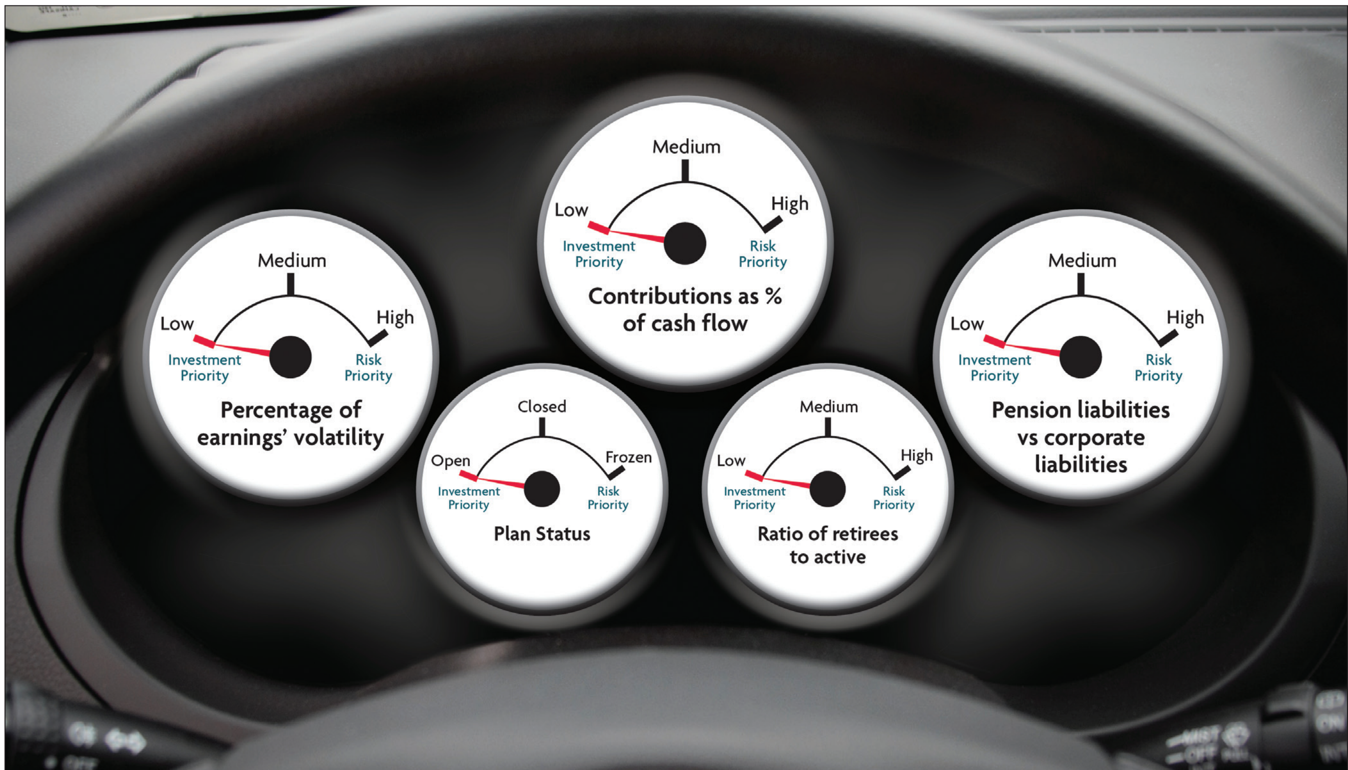
The illustration below shows the pension dashboard. For each of the factors, there is a scale to assess the investment versus risk priority.



The Factors

The plan status is often the first lever used by plan sponsors to stem the growth of their pension liabilities by closing the DB plan to new members, and in some cases, also freezing future service for all existing members. While such a decision is typically discussed at great lengths by the sponsoring company before being made, it often has little impact on the pension financials for many years. But the transition to a risk management priority must start at some point.

The market declines of 2008 provided a reminder that economic and investment conditions can more than offset good intentions if not combined with changes in the asset mix risk profile. In particular, many closed and frozen DB plans suffered along with open plans from a high-equity asset mix, which underlines the need for a range of factors under the pension dashboard.

The ratio of retiree and deferred member liabilities compared to the liabilities for active members can serve as an early indicator of a change in the ability for a plan sponsor to tolerate risk. For example, a large retiree liability may also imply large net cash outflow to cover the retiree payroll. A high-equity asset mix would have seen large losses in 2008 and some of these losses will have been crystallized to meet benefit payments. In this scenario, higher retiree liabilities would generally favour risk management as a priority.

Board room impact

The remaining three factors reflect the significance of the pension liabilities in the board room, and how the financial experience of the DB plan can impact the plan sponsor's decision-making in running its business.

Rating agencies, financial analysts and shareholders are looking more closely at pension liabilities and the inherent risk when they evaluate companies. A 2008 survey by Mercer[1] reviewed the annual reports of 125 of the largest TSX-listed companies to determine total pension (retirement) liabilities as a percentage of corporate liabilities. The median result saw pension liabilities represent 12% of corporate liabilities, but for a quarter of the companies surveyed, the pension liabilities represented more than 28% of their corporate liabilities. For these companies, risk management of the pension plan's assets and liabilities is an important consideration.

While pension liabilities as a debt on the company balance sheet are not always large in the context of other corporate liabilities, the high-equity asset mix of DB plans means that the impact on earnings' volatility can be much greater. A 2008 survey by Towers Perrin[2] measured earnings impact by considering pension expense for 83 Canadian companies and the impact it had on reducing aggregate operating income. The overall impact was to reduce operating income by 4.0%. New accounting rules are expected to more rigorously factor market volatility into pension accounting figures, which could further emphasize the earnings' volatility depending on where the accounting changes land on this particular issue.

The final board room impact relates to contributions as a percentage of cash flow from company operations. The 2008 credit crisis was felt most in terms of the impact to future contributions, since DB plans suffered from both a decline in assets from the fallout of equity markets and a rise in the funding (solvency) liabilities. The increase in pension deficits will result in materially higher cash amounts being diverted to shore up DB plans compared to previous years.

The drastically different assessment for pension contributions as a percentage of cash flow from operations post-2008 highlights that the position on the scale for some of the factors will vary depending on the market environment. It is therefore important to be aware of the sensitivity to the market environment when assessing the investment versus risk management prioritization.

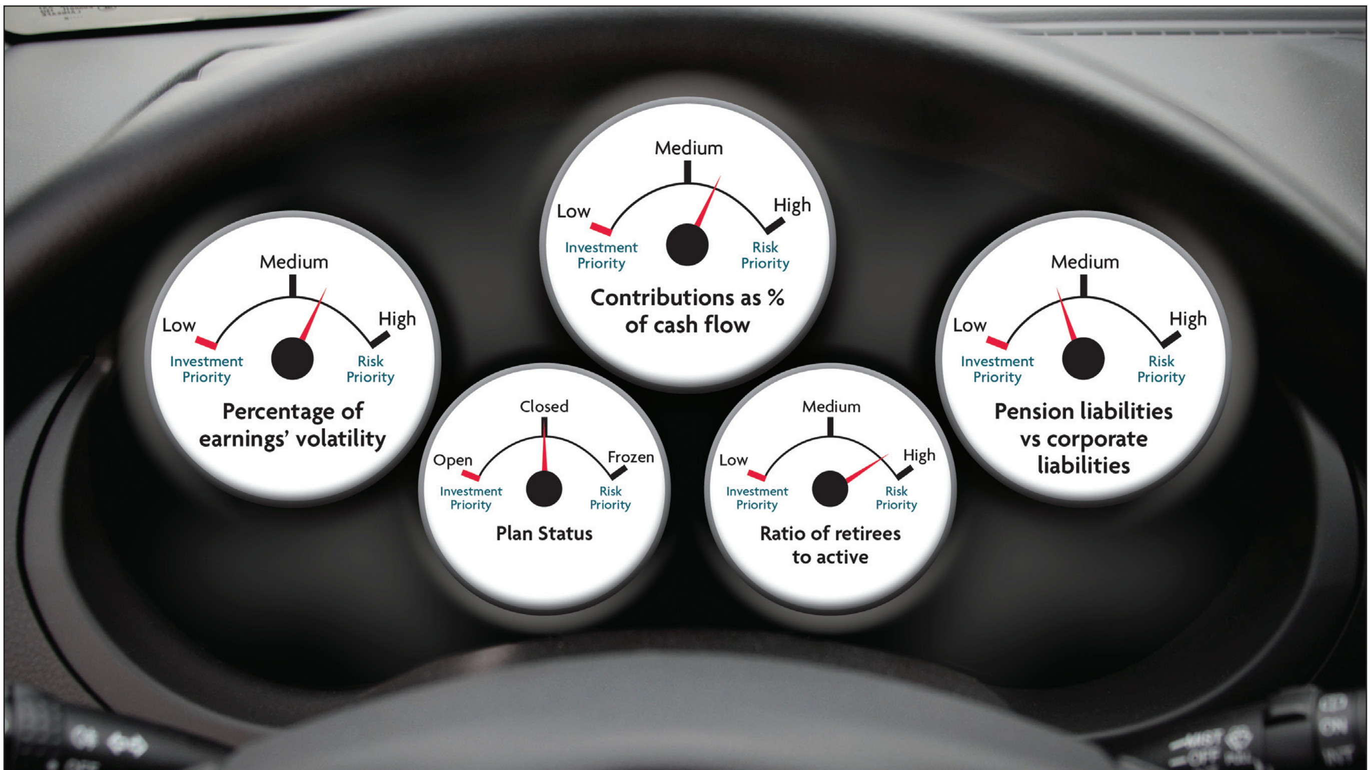
How do you stack up?

The illustration below shows how the pension dashboard looked for one particular DB plan. In this example, while the value of the pension liabilities is not too large relative to the corporate liabilities, the impact to earnings' volatility is much greater.

Moving to a greater risk management focus is unlikely to be a one-time decision, since there is no silver bullet solution to the current challenges facing DB plan sponsors. Some considerations, however, could include:

- *Assess the merits of viewing the retiree and non-retiree liabilities as two separate pools and optimizing the investment and risk management strategy for each pool.*
- *De-risk by transferring retiree liabilities to insurance companies through the purchase of annuities[3]. This approach can reduce the balance sheet risk associated with the DB pension plan.*
- *Consider whether to reduce equities in favour of liability-matched bonds. There may be the temptation to defer such a change until there has been some recovery in the equity markets. However, it is important to remember that a drop in interest rates will increase the liabilities, so this impact also needs to be considered. If it is decided to defer the decision, then it would be beneficial to establish guidelines to determine the level of recovery that is sufficient to reduce the plan's equity exposure. Otherwise there is the risk of another market downturn before any reduction is made.*

Any decision will likely need to be implemented over a three to five year time horizon. Sun Life Financial can draw on its extensive risk management approaches and techniques used globally to run its business to work with plan sponsors and consultants to create customized risk management solutions. The pension dashboard can help determine when your journey towards a greater focus on risk management should start.



[1] How does your retirement program stack up? Canadian Perspective for 2008

[2] 2008 Pension Plan Financial Disclosures: A Year In Review (preliminary report)

[3] The annuity de-risking solution was the discussion of an earlier article. Email the author if you would like to receive a copy.

About the author

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Sun Life Financial Inc. trades on the Toronto (TSX), New York (NYSE) and Philippine (PSE) stock exchanges under ticker symbol SLF.

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