

The Ambachtsheer Letter

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CAN TRADITIONAL DB PLANS BE SAVED?

... SHOULD THEY BE SAVED?

“We – the CFOs of our seven organizations – strongly believe that meaningful, permanent actions by the Federal Government are urgently required to address the onerous and volatile nature of the current solvency deficit rules for defined benefit pension plans...”

Joint Submission to the Federal Government by
seven major Canadian corporations, March 5, 2009

Saving the Unsavable?

With ‘fair value’ funded ratios well below 100% for the second time in this decade, most traditional DB plans with ‘hard’ pension promises are in serious difficulty. Or more precisely, the risk bearers in these plans are in serious difficulty. For example, in the Joint Submission cited above, the CFOs of seven large Canadian corporations estimate that under the current solvency funding rules, they will have to start contributing at a collective \$3.5 billion annual rate for the next five years, compared to the actual \$1.0 billion they contributed in 2008. They assert that a \$2.5 billion increase in contributions would have serious negative implications for their organizations. As a result, they want relief from the current funding rules, which they consider too demanding.

The seven CFOs quoted above are not unique in holding this view. The global crisis has materially reduced the ‘fair value’ funded ratios of DB plan balance sheets everywhere, into the 50%-75% range in many cases. What should be done about this serious problem? Is the answer, as the seven CFOs suggest, to ease up on current funding standards? Would such actions really save DB plans, as the CFOs imply? Or has the time come to ask more fundamental questions about the merits, management, and sustainability of traditional DB plans? These questions are the subject of the rest of this *Letter*.

A Framework for Analysis

Traditional DB plans have both legal and financial dimensions. The legal dimension recognizes that a traditional DB plan is a contractual arrangement between the employer and its current and former employees. The financial dimension recognizes that pension accruals are a form of employer debt secured by a segregated trust fund. This would be a very short *Letter* were it not for two seldom-acknowledged, related realities:

1. DB pension contracts are seldom fully spelled out: there is fuzziness about surplus ownership, about the ranking of accrued pension debt in financial reorganizations, about maximum allowable DB balance sheet mismatch risk, and about inflation indexation rules.
2. Employers attempt to earn a risk premium with pension assets: if a pension fund’s only purpose was to secure pension promises, it would always be fully funded and fully immunized. This is clearly not the case. Instead, employers expose DB balance sheets to mismatch risk in the hope of earning a risk premium on pension assets. Earning such a risk premium means not having to pay the full economic cost of the pension promise.