



**TOWERS
PERRIN**

HR SERVICES

Perspectives on:
MANAGING COST & RISK

FACT, FICTION AND FUNDING

Authors of historical fiction sometimes create interesting what-if scenarios by supposing changes in selected past events. “What if Columbus had turned back before reaching America?” “What if John F. Kennedy had not been assassinated?” Such literary devices allow the reader to imagine the world that might have been and compare it to the world that is. In this issue, we apply this brand of fiction to key developments in the history of pension funding.

IN THIS ISSUE: PENSION FUNDING

In 2004, Towers Perrin released a White Paper proposing a framework for building a 21st century private pension system. This article is part of a series that develops those ideas.

In the series, we examine what changes would need to be made to sustain the pension system for Canadians in the five key areas of Accounting, Design, Funding, Investing and Communication. The full White Paper is available at www.towersperrin.com.

PERSPECTIVES

What if regulators had collaborated with actuaries to establish funding standards that focused on securing “most of the promised benefits all of the time” and “all of the promised benefits most of the time”?

Let’s imagine. What would pension funding look like if we suppose that:

■ **Clear deals:** Courts, legislators and plan stakeholders had all consistently characterized the pension promise principally as a contractual arrangement (consistent with its roots, in fact) rather than as a trust arrangement.

■ **Surplus flexibility:** Surplus assets could revert to the employer upon plan termination, or be applied towards a contribution holiday so long as a sizeable cushion was retained in the pension fund.¹

■ **Sensible tax limits:** Tax authorities had not frozen for 25 years the limits on the level of benefits that could be paid out of a pension plan, and had not overly restricted the amount of surplus that could be built up in a pension fund.

■ **Realistic funding:** Regulators had collaborated with actuaries to establish funding standards that focused on securing “most of the promised benefits all of the time” and “all of the promised benefits most of the time”.

■ **Risk-sensitive funding:** These funding standards took into account, in a dynamic way, the investment risks undertaken by the plan fiduciaries. In other words, as more investment risk is taken, the required funding cushion increases. Long-term funding costs, however, may still be reduced eventually.

With this context, let’s now compare the situation of two hypothetical employees. The first, Izzy, works in the world that is. The second, Woody, works in the world that would have been if pension funding history had unfolded as outlined above.

HERE IS WHAT THEY EACH FACE

Pension Funding

Izzy’s plan is thinly funded. His employer is unsure whether contributions to the plan will serve a beneficial purpose (pay promised benefits; reduce future contributions otherwise required) or will simply give rise to a future dispute over surplus ownership. As a result, his employer makes the lowest contributions possible under the law.

In stark contrast, Woody’s plan is well funded at all times, though never excessively so. When business is good, his employer increases contributions into the plan. When business turns down, his employer slows or even stops contributing. But in any event, the plan almost always has assets in excess of liabilities, plus a prudent margin.

Investment Policy

Izzy’s employer is taking big investment risks, mostly by investing heavily in equities. Under current rules, this maximizes tomorrow’s expected returns and minimizes today’s funding costs. Izzy’s employer hopes things will work out – and so does Izzy if he understands what’s going on!

Woody’s employer is taking some investment risks too, but in a very measured way. His employer knows that higher investment returns – once they are earned – will reduce tomorrow’s funding costs. However, as more risk is taken today, current funding must actually be strengthened to ensure safety during the interim. As a result, Woody’s employer has adopted an investment policy that balances the hope for future reward against the impact on current cash flow. The result is a more modest commitment to equity investments and a short-term increase in funding that protects against adversity.

Surplus Utilization

Izzy’s employer tries to keep surplus low at all times. This strategy avoids surplus-related disputes and minimizes the stakes in the event of either a full or partial plan windup. If possible, Izzy’s employer takes contribution holidays at every opportunity.

¹ In some plans, such as a shared-risk plan with joint employee/employer management, the employer ownership of surplus might better be characterized as joint employee/employer ownership of surplus (and deficits).

In Woody's world, the pension plan's assets, liabilities, required margin and extra surplus, if any, are all in plain view.

On the other hand, Woody's employer sees surplus as a good thing – to a point. When business is good, his employer gladly builds up a cushion against leaner times. If surplus becomes unnecessarily large – say, due to unexpected investment windfalls – his employer makes a withdrawal. Woody is not troubled by this because he understands the “deal” and knows his pension interests are protected.

Actuarial Valuations

Izzy's employer uses all the options permitted under law to minimize funding. Poor investment returns and/or decreases in liability discount rates are smoothed, assumptions are set at the upper (or lower) bounds of acceptable ranges, valuation dates are judiciously chosen, and contribution holidays or deferrals are maximized.

By contrast, Woody's employer has no need for cleverness as wisdom is more than sufficient. The pension plan's assets, liabilities, required margin and extra surplus, if any, are all in plain view. Funding policy and investment policy provide an appropriate balance between risk and reward, between

reducing contributions tomorrow and maintaining benefit security today. The party ultimately responsible for the funding and investment policies, the plan sponsor, strikes this balance.

Uniform Security

Izzy is highly paid but, due to low tax limits, most of his total pension benefit is unfunded. His employer has promised to pay the excess pension promise from its general revenues. However, if his employer goes out of business, Izzy would lose not just his job but much of his pension too.

Woody is highly paid as well, but all of his pension benefit is payable from the pension fund. He has the same benefit security on the last dollar of his pension as he does on the first. Even if his pension becomes partially unfunded, the bulk of his retirement income is secured.

Member Communication

Izzy gets statutorily required information about his plan, but nothing more. He may even think his pension benefits are fully guaranteed. After all, the pension fund holds millions of dollars!

Woody knows a lot more, the result of more clarity in the system overall as well as receiving better education on his retirement. He understands that:

- Surplus assets will be built up in the pension fund – whenever practical but never beyond excessive levels

- Employer contribution holidays or even surplus refunds will occur from time to time – but only when it is prudent to do so

- His employer will pay off deficits quickly – though not necessarily immediately

- A windup deficit could arise in extreme circumstances – but not much of his pension would ever be at risk.

THE BOTTOM LINE

Inevitably, Izzy's employer hits a rough patch in its business results. This is also a poor time for other companies. Equity values fall throughout the country, and indeed throughout the world. Central bankers cut interest rates to try and bolster the economy. The overall effect is that pension assets fall while liabilities rise – a disastrous combination.

The economy rebounds, eventually, but it is too late for Izzy. His employer has been pushed into bankruptcy, partly by spiralling pension contributions. This also means that Izzy's pension is underfunded; and his employer can't make up the shortfall, especially from a fire sale of its assets.



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Fortunately, Woody is much better off. His employer has higher pension costs too, but not catastrophically so. Woody's pension is temporarily underfunded, but not by much and never for long. Eventually, better times return and the storm is weathered.

Unfortunately, Woody's fictional world is just that, fictional. Izzy's world is today's reality. But it doesn't have to stay that way! The needed changes are all doable and the overall package would ultimately benefit all stakeholders: employers, plan members, regulators, actuaries and so on.

Of course, there would be tradeoffs to make and transitions to manage. For example:

- In exchange for employer claims on surplus, plan members may demand a better pension deal on other fronts. In our 2004 article entitled "The Changing

View of the Golden Years" (available on www.towersperrin.com), we proposed several ideas on possible improvements, such as more valuable termination benefits.

- While waiting for funding levels to build up during transition, regulators might demand that interim benefit security be provided. For example, the employer could post a letter of credit to cover any interim windup deficit.

Currently, sponsors face massive funding contributions over the upcoming decade as a consequence of recent economic events. If ever there was a time to remove funding disincentives, now must surely be that time.

The path to change may be long and involve many stakeholders. However, the prize is worthwhile. The fact is that our present pension funding regime is broken. The real fiction is pretending that only minor changes are necessary. ■

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