Critics of defined benefit (DB) pension plans have called them dinosaurs; presumably in reference to the fact that dinosaurs are extinct and these plans appear headed on the same path. No one is certain what caused the dinosaurs' demise but a commonly accepted theory is that a giant meteor collided with Earth, catastrophically changing the environment. Dinosaurs could not adapt quickly and perished.

Will Canadian DB plans perish due to a pension equivalent of a giant meteor? No. Rather, our cosmic equivalent is closer to a series of pension meteorite showers. It's the cumulative effects of a number of events over the last three decades that might cause DB's extinction.

Fact: pension coverage, particularly in the private sector, is declining. While no one knows what the exact level of coverage DB pension coverage is in Canada — the Ontario Expert Commission on Pensions identified a lack of accurate data as a gap in determining the size of the problem — estimates are in the 20%-25% range. For the employed workforce as a whole (DB and DC), coverage is now about 40%, which continues a downward trend.

Can DB plans be saved?

If DB plans were truly dinosaurs, they'd probably be labelled an 'endangered species' and be protected under something akin to the Migratory Birds Convention Act.

One challenge comes from the DB-DC arena, where positions have become polarized to such an extent that any pretence of a debate has been replaced by a dialogue of the deaf — akin to Question Period in the House of Commons, but with no real time limits. (con't on pg. 2)
While DB plans have limitations, they also offer a number of real advantages over DC plans. Some of these relate to pooling of investment and mortality risk, better cost containment and the potential for better decision-making and governance. In our view, DB plans are the more efficient vehicles for generating and preserving retirement wealth. If DB plans are such a good thing, why has private sector DB coverage declined so much? What destroyed this ‘superior’ system?

The following is a perspective from a private sector employer, offered in chronological order.

No national pension act: — Canada has 30 million people, 10 provinces, 1 federal government and 10 pension acts (9 provincial and one federal — PEI passed legislation years ago but never proclaimed it). So pensions in Canada are largely under provincial jurisdiction. This forces national employers to use more complicated or expensive plans in order to comply with varying Acts. By contrast, USA has 300 million people, 50 states, 1 federal government and 1 pension act (called ERISA). Logically, a unified single pension act for Canada makes sense, but given how provinces jealously guard their powers, there is a higher probability of getting turkeys to vote in favor of Thanksgiving than getting 11 jurisdictions to agree to one national pension act.

The Surplus issue: When cases dating back as far as the 1970s, courts have largely viewed pension surpluses as belonging to members. This has made the employer responsible for funding deficits but unable to claim ownership of any surpluses. Obviously, from an employer perspective, this appears unfair.

The Financial Reporting Issue: In 1986, changes relating to the determination of pension expense was altered from the actual amount of employer contributions to the cost of the pension benefit earned during the year. This produced a change in the way information was reported on a firm’s financial statements and led to higher earnings volatility. Proposed changes to global accounting standards will only increase the volatile nature of the pension expense.

The Income Tax Act: The 1990 overhaul curtailed funding limits and imposed maximum pension accruals. Putting a 110% ceiling on funding prevents the accumulation of surpluses to cover shortfalls in years such as 2008-2009. Also, the introduction of Pension Adjustments and low DB accrual limits penalized DB pension plans relative to DC pension plans.

Timing of Funding Shortfalls: The timing and high costs associated with funding sudden shortfalls caused by difficult market conditions is impossible for many employers to bear. Legislative funding relief has not been uniform across the country.

Obviously, this list alone would diminish any employer’s appetite to maintain such plans. Despite this, DB plans actually survived successive meteor showers. When you examine the factors in aggregate, what is truly amazing is not that private sector DB pension coverage is so low today, but rather, that it’s as high as it is.

Dinosaurs are extinct, but they lived for millions of years. DB plans actually survived successive meteor showers. When you examine the factors in aggregate, what is truly amazing is not that private sector DB pension coverage is so low today, but rather, that it’s as high as it is.

Dinosaurs are extinct, but they lived for millions of years. DB pension plans should be so lucky.

Just A Matter of FX (continued)

Obviously, the volatility of our currency is problematic. But for investors, particularly long-term pension plans, it’s more so. That’s because Canadian pension plans were strongly encouraged to lower their risk by diversifying abroad.

Recall that since 1971, our pensions operated under the Foreign Property Rule which capped foreign investments at 10%. The limit was slowly raised over a 5 year period starting in 1991 to 20%. Then, under pressure from the investment community, the limit was again raised to 30% by 2001. And in 2005, the rule was repealed. So today, there are no limits.

If you examine the data carefully, you’ll find a remarkable coincidence. As large Canadian pensions were diversifying their assets (selling CAD to buy foreign denominated investments), the loonie was declining. Once this process reached equilibrium in 2001, within just 12 months, the CAD stopped declining and began a sharp reversal. So did Canadian pension flows have a material impact on the currency? There’s some debate on this, but also, a correlation. What’s now clear is the foreign buying spree by Canadian pensions is over. Actually, many Canadian plans have recently adopted hedging strategies to cope with the CAD volatility to reduce their FX risk. This helps underpin or bolster the CAD.

Canada is lucky; it has many positive attributes (resources, banking system, stability). At the same time, USD’s role as the world’s reserve currency is being debated by nations and IMF. So is parity possible again? Yes. And maybe soon.