What options are available for de-risking DB pension plans?

By Linda Bicho-Vachon - Benefits Canada - September 2019

The 2008 financial crisis is an event that defined benefit plan sponsors won't soon forget. Roller-coaster markets exposed gaps in their investment strategies, while de-risking appeared on pension committee agendas as they assessed the damage and focused on the road to fully funded statuses.

Back in 2008, few tools were available to de-risk pension plans. But offerings have evolved since then, giving plan sponsors more options than ever.

Philosophy kings
Over the past decade, the impact of volatile markets on pension solvency ratios propelled DB plan sponsors to start asking more philosophical questions, says Ryan Kuruliak, senior vice-president at Proteus. "A lot of organizations have asked the fundamental question of to what degree they want to be in the defined benefit pension business, and some — a smaller minority — have reaffirmed their commitment that, for their own reasons, that type of plan makes sense for them."

But many other employers have opted to close their DB plans. According to data from Statistics Canada, there were 9,341 DB plans in 2018, down from 11,539 in 2008. And a 2017 survey by Aon found 58 per cent of private sector DB plan sponsors had closed their plan to new members to contain costs.

As well, a decade ago, plan sponsors weren't always putting assets and liabilities together, says Brent Simmons, senior managing director and head of DB solutions at Sun Life Financial. These liabilities include demographic risks, such as longevity, which nobody was talking about back then, he adds. "Folks in Canada

are living longer, which is a great news story for all of us. They're living longer, so we have to pay their pensions longer; that actually increases the cost of providing defined benefit pension plans by 25 to 30 per cent."

Definitions

Annuity buyout: A plan sponsor identifies a group of retirees to an insurer, which estimates how long they're going to live and, therefore, how much money to set aside to pay their pensions in the future. All of the responsibility for that group, including pension payments and governance and administration, are transferred to the insurer.

Annuity buy-in: This option follows the same process as a buyout, without the transfer of responsibility. Instead, the plan sponsor pays a lump sum to the insurer, which then pays that money back into the plan every month.

Liability-driven investment:Commonly used in DB plans to cover current and future liabilities through asset acquisitions. The approach consists of minimizing and managing liability risk followed by generating returns.

Plan sponsors are also dealing with the practical issue of improving their plans' solvency ratios. In the first quarter of 2009, Statistics Canada reported an average 79 per cent solvency ratio among trusteed plans. This compares to 92.1 per cent as of Dec. 31, 2017.

But while solvency rates have improved, the change has come at a significant cost to employers, says Simmons. "Twenty years ago, pension plans in Canada were more or less fully funded. And today, pension plans in Canada are more or less fully funded. However, during that period of time, plan sponsors have had to contribute $124 billion to their pension plans, because of deficits, because of losses that they've had in the plan, deterioration of their funded status."

This realization, notes Simmons, has led plan sponsors to take less risk and look for new opportunities.

Customizing the portfolio

The industry has seen an increasing demand from both large and small organizations looking to de-risk their DB plans, says Kuruliak. "Supply follows demand in the investment industry. Because of that [increased demand], the industry has responded."

Indeed, plan sponsors have access to a wider array of investment options. On the fixed income side, bond portfolios can be customized to a plan's liability to a much sharper degree, says Kuruliak.

As well, glide paths have become more practical and less theoretical, says Etienne Dubé, vice-president and portfolio manager at Phillips Hager & North Investment Management. They're structured to automatically adjust a fund's asset mix between a plan's growth and fixed income portfolio based on a plan's funded status. Better diversification in growth portfolios to include alternative asset classes and more customized fixed income portfolios have made these products more sophisticated and adaptable to plan sponsor needs, he says, noting the infrastructure that supports the monitoring and execution of the glide-path portfolio is also more robust.

Many plan sponsors are placing less emphasis on windup or risk transfer and setting their plan in hibernation mode, adds Dubé, referring to plans that achieve fully funded status and leave their assets in the plan instead of annuitizing. “So you could include in your portfolio a less liquid strategy, like real estate [or] commercial mortgages, while keeping a tight match to the liability characteristics of your plan. But you build a portfolio that will be higher yielding, less liquid, and you will keep that portfolio alive and pay your benefit payment with that.”

This option might save on the cost of purchasing annuities, but the responsibility for plan administration, governance and monitoring functions remains with the employer.

Shifting risk to a third party

While plan sponsors have always had the option to buy annuities, it wasn’t prevalent at the time of the financial crisis, according to Kuruliak. “Annuity buyouts have been available for a long time, but it wasn’t very popular because of the cost and, frankly, there wasn’t a lot of supply available until more recently.”

Jack Quon, a former pension and benefits lead at a large Canadian organization, agrees. “There wasn’t always an impetus to annuitize right away, but I think that has changed over time. In the last 10 years, you’re looking at [interest] rates that have bumped around at the bottom, and then as well, extended mortality rates. As the mortality rate tables kept getting updated, we were essentially taking on more risk simply because of the fact that the population was getting older.”

In 2012, when CAA Club Group closed its DB plan to new members, it started to have those conversations with respect to other segments of the plan membership, says Mara Notarfonzo, the organization’s assistant vice-president of compensation and benefits.

“We’re also seeing the price of annuities going down, so it’s like this untapped market. There’s a lot more businesses opening up offering lower priced annuities.”

Also, the industry wasn’t talking about annuities as a risk management strategy in 2008, says Simmons. “It was something that pension plans used when they were winding up the plan. And so, fast forward 10, 11 years now and the landscape is radically different.”

Indeed, since annuity buy-ins were introduced in 2009, they’ve gradually increased in popularity, he says. By the end of 2018, there were 87 buy-ins across Canada representing a total of $6.6 billion, according to Sun Life estimates.

And while buy-ins represented 50 per cent of the risk-transfer market in 2017, according to a report by Eckler Ltd., they fell below 15 per cent of total group annuity sales in 2018. On the other hand, buyouts were the dominant annuity option that year, likely due to strong equity markets and decent bond yields through the first half of the year.

Products have evolved to help plan sponsors with different types of challenges, including CPI indexation, which was difficult to de-risk in the past, says Simmons. “The suite of solutions that’s available for plan sponsors looking to de-risk is much greater than it’s ever been.”

Outsourcing risks

Alongside the expansion of these de-risking options, more employers are seeking third-party expertise. A 2018 survey by Freeman and Co. found a lack of resources and better expertise are the top two reasons Canadian plan sponsors are using outsourced chief investment officers. But plan sponsor obligations don’t end with a signed outsourcing contract, says Jana Steele, a partner in the pension and benefits group at Osler Hoskin & Harcourt LLP, noting failure to properly manage these suppliers is a big risk for employers.

“The employer can delegate, the plan administrator can delegate, but they have the obligation to personally select a delegate that is suitable to carry out the function. And then, once they do that, they can’t then take a hands-off approach.”

At CAA, Notarfonzo meets regularly with the company’s vendors as conditions dictate. “So we look at investments, we look at the types of communication, we listen to what our employees are saying about the service that they receive, but I think the key here is ongoing communication with those vendors, not just a once-a-year touchpoint.”

Indeed, plan sponsors are exercising greater oversight of their OCIO partners and are looking for more transparency, says Dubé. In the U.K., the Financial Conduct Authority’s investigation into OCIO arrangements found a prevalence of poor fund performance, a lack of transparency around fees and conflicts of interest where the consultant and the supplier worked for the same organization.

In numbers

9,341 -The number of Canadian DB plans in 2018, compared to 11,539 in 2008, according to Statistics Canada.
92.1% - The average solvency ratio of trusteed plans as of Dec. 31, 2017, compared to 79% in the first quarter of 2009, according to Statistics Canada.
58% - The percentage of private sector DB plans that have closed their plan to new members as part of a strategy to contain costs, according to Aon.

Pension regulation paving the way

At the same time, a wave of pension legislation to assist plan sponsors with solvency funding has balanced the goal of protecting members and their benefits while allowing DB arrangements to remain viable, says Kuruliak. “When the rules were written, they never envisioned a world where sovereign bond yields would be as low as they are, and even negative in a good portion of the world.”

After the 2008 financial crisis, pension regulators introduced provisions for temporary solvency relief as plan sponsors began reporting lower solvency rates. More recently, provinces have updated their rules to relax funding requirements. In 2016, Quebec shifted to a going-concern obligation for funding valuations, with Ontario following in 2018, lowering its definition of a funded status to 85 per cent.

In May 2019, Nova Scotia announced it will move forward with changes to its regulatory framework for DB plans, following a review that was launched in September 2017. The proposals include permitting plan sponsors to elect, on a go-forward basis, to permanently fund their plans to an 85 per cent solvency standard rather than the current 100 per cent. Other provinces, such as British Columbia, Alberta, Manitoba and New Brunswick, are reviewing their funding requirements.

For Quon, the changes to funding measures are too little too late. “The government should have done this 10, 15 years ago, because when plan sponsors had surpluses . . . they forced employers to take contribution holidays,” he says, noting that if plan sponsors had been able to maintain surpluses, they might have been able to keep their plans open.

In terms of legislation around annuitization, Ontario removed one of its barriers as of July 1, 2018, adding a discharge provision that fully absolves an employer from further obligations if an insurer becomes insolvent. This occurrence, commonly known as boomerang risk, was also eliminated by B.C. in 2015 and Quebec in January 2018. Again, other provinces, such as Alberta and Nova Scotia, are considering similar legislation. And in 2013, New Brunswick introduced a shared-risk pension plan model that requires plan sponsors and their members to share DB plan risk. Ontario is paving the way for a similar structure. The University of Guelph, Queen’s University and the University of Toronto are moving towards a jointly sponsored plan, combining their pension assets worth an estimated $8 billion. Once the new plan is set up in 2021, it will be able to diversify its assets more broadly and provide both plan sponsors and members with the opportunity to jointly consider benefit reductions or additional contributions to address any shortfall.

Looking at de-risking more broadly, another recent trend is smaller DB plans merging with larger plans, such as the Colleges of Applied Arts and Technology pension plan’s DBplus and the OPSEU Pension Trust’s OPTrust Select, both introduced in 2018.

Education is key

After CAA closed its DB plan to new members, it looked for additional ways to reduce the plan’s liabilities, offering deferred, vested members the opportunity to take a commuted value lump sum, says Notarfonzo. Fifty-five per cent of members took the option, which reduced plan liabilities by 8.5 per cent.

However, she notes CAA takes a more conservative approach in considering future de-risking strategies. “Primarily, we look at our fiduciary responsibility from a financial statement, but also how this is going to impact our associates that are currently in the plan. It’s that fine balance.”

As these de-risking products and services develop, education is key for plan sponsors to truly understand their implications. “If there are lots of options for the sponsor, it also becomes hard to assess and make the right decision of what tools are the most appropriate for a particular organization,” says Kuruliak.

For plan sponsors considering de-risking strategies, it’s also important to remember they’re not wiping their hands of the plan completely, he notes. “I think de-risking is a good thing. But don’t have an inaccurate impression of what you’re actually getting, and thinking that [you’re done] just de-risking or outsourcing. The reality is, you’re still involved.”

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