Debunking The Myths

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."
~ Mark Twain

BY: **KENDRA KAAKE**

As ever more media coverage is allocated to the inherent flaws and failures within the Canadian pension system, its accomplishments are increasingly overlooked. As a response, our hope is to debunk the most prevalent fables and highlight why it works.

Myth 1: *Most Canadian DB plans have experienced onerous funding requirements*

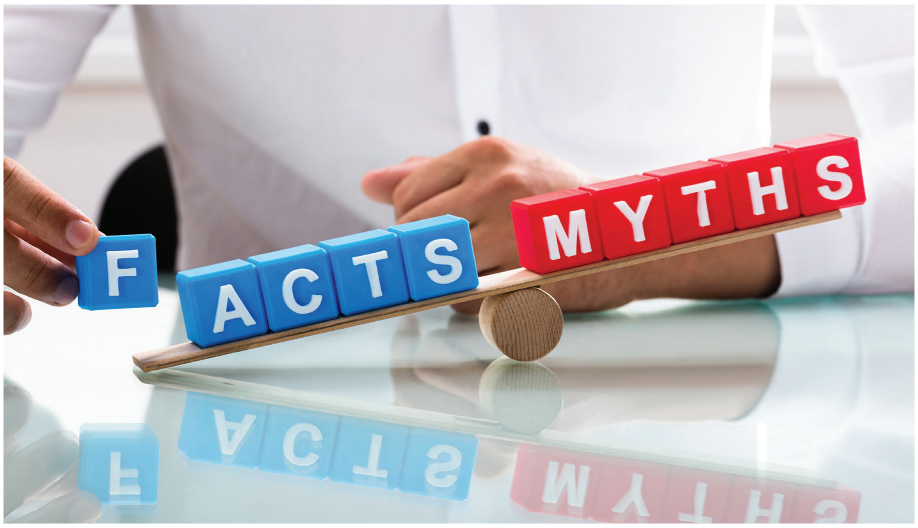
Throughout the life of a pension plan, funding health rests on three interconnected areas:

- The contributions we set aside
- The investment returns earned by the asset
- The ability of sponsors and/or stakeholders to provide a backstop if things don't turn out as expected

All of which can vary, and materially, from one plan to the next. Funding requirements (i.e., the timing and amount of contributions) depends on investment performance, plan type, structure, and regulatory jurisdiction.

Strategic asset allocation, a plan's target portfolio mix, can range considerably, too. The net result is that specific contribution requirements vary, even in cases where the true economic value of the benefit promise and the underlying assets in place to support those obligations are the same. The Canadian pension system is not monolithic. This is a distinction that doesn't get nearly enough attention.

A single employer corporate sponsor, for example, would likely be far more concerned about additional or unexpected contribution requirements than would a sponsor operating within a unionized or negotiated-cost paradigm.[1] A risk management strategy positioned to reduce the impact of a falling interest rate environment would have helped to cushion, or even eliminate, most of the onerous contributions we hear about so frequently. For plans with liability valuations linked directly to interest rates, sponsors that opted to take on a liability-driven approach to managing risk would have reduced unexpected contributions, versus those that did not.



In truth, Canada does not take a one-size-fits-all approach to pension design, structure, or regulation. Moreover, there has been continued support for pension funding relief, on a case-by-case basis, across multiple jurisdictions, particularly in times of economic distress.

Myth 2: *The Canadian pension model has failed to provide benefit security*

The premise that the Canadian pension model has failed to provide benefit security is difficult to corroborate. Have Canadian companies battled through bankruptcy proceedings, leaving plan members short (not stripped of) the full contractual obligations they were promised? Absolutely.

U.S. Steel Canada, Wabush Mines, and Sears Canada are a few that come to mind. These were exceptional circumstances, generally involving large companies who were granted special permission to defer special payments intended to cover unexpected shortfalls in solvency funding levels. Importantly, the rationale behind that special funding relief was intended to spur growth and preserve jobs, temporarily relieving those companies of their pension funding burden during recessionary periods.

Importantly, these plans were underfunded and were the exception rather than the rule.

The vast majority of pension plans in Canada are legally obligated to fund underlying entitlements, not simply by gross approximation, but rather on the basis of current economic value. That is, the amount estimated to cover the market value of liabilities must be ring-fenced for the sole purpose of funding current and future obligations. This is in contrast to many other pension systems globally which do not require entitlements to be fully, or even partially, funded. In addition, many systems do not value pension liabilities on the basis of their true economic value, but rather use a highly subjective proxy.

Truth be told, Canada supports one of the most secure and successful pension systems in the world.

Myth 3: *The Canadian pension model is antiquated and out of date*

In truth, it would be difficult to find another pension system globally that supports the sheer variety of structures we have in Canada and it's constantly evolving. This is often overlooked.

The Canadian model supports single-employer pension plans (SEPPs), multi-employer pension plans (MEPPs), jointly-sponsored pension plans (JSPPs), corporate plans, crown corporations, public plans, shared risk plans (SRPs), and target benefit plans (TBPs), to name just a few.

If you then layer on multiple regulatory jurisdictions, differential treatment between non-unionized and unionized schemes, and a broad range of different employer structures, what you get is a diverse model. While critics will argue that the Canadian model is cumbersome, it's clear that the Canadian model has stood the test of time, where others have not, in large part because it has not employed a monolithic approach to plan design, management, and regulation.

What's more, new innovation is reshaping the way Canadians think about saving and planning for retirement. New plan designs – shared risk plans (SRPs) or target benefit plans (TBPs) for example – promise to navigate some of the flaws known to traditional designs while maintaining many of their more favourable characteristics.

Regulatory reforms, across various jurisdictions in Canada, are also constantly reshaping how traditional designs are managed. New funding methodology – the provision for adverse deviation, or PfAD, for example – shifts focus away from the short-term headaches of solvency valuations, which are interest rate driven, toward less-cyclical, longer-term, approaches.

In truth, many jurisdictions across Canada are actively implementing new pension structures. And, although some aspects of the Canadian model have forced the industry to pause and reflect, the system has stood the test of time.

At the end of the day, the Canadian model has created significant wealth. In addition to providing cost savings through economies of scale, which are one of the more obvious benefits of defined contribution plans, defined benefit designs provide for an efficient pooling of longevity risk. They also produce stable income replacement ratios upon retirement, reduce aggregate contributions over the long-term, and significantly improve tax efficiency. Moreover, DB plans provide valuable workforce management controls for sponsoring organizations – recruiting and maintaining talent, for example.

All said, it has been widely documented that Canadians are not saving enough for retirement. Key to an improved pension framework is to leverage our accomplishments. From there, we'll need a continued effort to innovate new solutions and to improve access. **BPM**

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1. Although negotiated cost plans are not as sensitive to short-term interest rates and surplus volatility, intergenerational inequity remains a primary concern. Inadequate investment returns over the long-term, failures in the governance process, or the absence of a robust funding policy can all lead to funding shortfalls and/or benefit reductions.