Régie des rentes du Québec

Supplemental Pension Plans

Newsletter express

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The financial situation of defined benefit pension plans: a call for responsible and prudent action

Current situation

In the last few years, the decline in financial markets has had a major impact on the financial picture of pension plans. The exceptional yields of the 1990s have given way to very low and even to negative yields.

In order to quantify the extent of this phenomenon, the Régie des rentes du Québec recently carried out an analysis of the financial situation as at 31 December 2002 of the defined benefit pension plans under its supervision.[1] The analysis required projections based on the most recent financial data held by the Régie so that the value of commitments and of plan assets could be estimated as at that date. The projected data were used to determine each plan's degree of solvency as well as the additional contributions required to fund each plan, supposing that an actuarial valuation of each plan had been made as at 31 December 2002. Our consultations with major actuarial consulting firms lead us to believe that the results obtained faithfully reflect, on the whole, the financial situation of the plans studied.

Our projections indicate that around 70% of the plans would have been insolvent at that date. The degree of solvency of most of them would have been greater than 80%. Only a very small number of plans fall into a more delicate financial situation.

For 25% of the defined benefit plans under our supervision, the projections also show that the additional contributions required would have been greater than 10% of the total payroll if an actuarial valuation of the plans had been made as at 31 December 2002.

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[1] The analysis was made public at the end of February 2003 at a press conference. It is available on our Internet site (www.rrq.gouv.qc.ca) under the headings Services, Publications, Supplemental pension plans.

In our opinion, the data indicate that the financial situation of defined benefit pension plans is a cause for concern but is not alarming.

Causes and effects

Several factors can explain the funding shortfall that most plans are experiencing at this time. For some of those involved in plan funding, it may be that the vitality of the financial markets during the 1990s inclined them to be less prudent. In fact, large sums were allocated to funding plan improvements and contribution holidays. Those sums are thus not available to offset the actuarial losses of recent years. Because those years were so good in terms of investment yields, those involved were not encouraged to review the funding risks of their plans.

However, a plan's funding policy must be reviewed periodically because risk factors change over time. For example, higher volatility in the financial markets increases risk. Moreover, like the Québec population, pension plans are aging and that increases their funding risks. A company's financial soundness (i.e., its capacity to meet its commitments) as well as the risks related to its sector of activity are also elements that vary over time and must be taken into account in evaluating the inherent funding risks.

Our study shows that a significant number of those involved in plan funding underestimated the impact of "plan maturation" (plan aging). One way to measure a plan's maturity is to determine the ratio of the value of its commitments to the total payroll of the plan's active members. At the beginning of the 1970s, we estimate that the ratio was, on average, equal to 1. Today, the average is 3 and several plans have a ratio equal to or greater than 6.

Take the example of a plan whose finances are in balance on the basis of solvency. Suppose that the plan's rate of return on investments for the first year following its valuation is 0% instead of the 6% assumed for actuarial purposes. If the ratio described above is equal to 1, then an actuarial valuation made at the end of the first year would result in additional expenditures of around 1,2% of the total payroll (1 x 6% / 5) for the next 5 years. If the ratio is 6, the same unfavourable deviation would result in additional expenditures of more than 7% (6 x 6% / 5) of the total payroll.

It is obvious that a plan's maturity acts like a lever whose effects can be devastating if the plan's rate of return on investments is below the interest rate assumed by the actuary to determine the actuarial value of the plan's commitments.

Solutions

Responsibility of those involved

Under the *Supplemental Pension Plans Act* employers and plan administrators are expected to act responsibly to implement the measures required to manage a plan's financial situation and take any necessary corrective action.

In the short term, several mechanisms can be used to rectify plan funding:

- Reduce benefits for future service. If necessary, revise the overall plan design in order to reduce the employer's retirement burden;
- Raise member contributions;
- Pay additional employer contributions to the plan in the form of sums raised on the financial markets by issuing securities. For example, bonds issued by a municipality could be used to fund a pension plan;
- Fund the plan by remitting to the pension fund securities issued by the employer in lieu of cash contributions. However, no more than 10% of a plan's total assets can be in the form of securities controlled by the employer.

The current situation represents a call to plan sponsors and administrators (with the aid of their consultants, including actuaries and investment advisors) to review their management of plan funding risks. We must emphasize that it is the responsibility of those involved to periodically measure their level of risk tolerance and to adjust their investment policies accordingly. There are tools to better evaluate or quantify funding risks. Understanding risks could lead to major adjustments of certain funding parameters.

For example, a plan's investment policy could be changed. The policy must be suited to the plans characteristics and be based on an acceptable level of risk. It should, for example, provide for weighting based on a plan's maturation and the financial risk that the employer is willing to take. It must also make provisions for investment fluctuations (market volatility) and the related risk of financial loss.

Also, the use of surplus assets could be reviewed and adjusted. In the 1990s, several plan parties were quick to use almost all the surplus assets in their plans to take contribution holidays or to increase plan benefits. Constituting an adequate cushion to be used in the event of unfavourable deviations can certainly contribute to reducing a plan's funding risks.

Solvency rules

Some people might be tempted to call into question the solvency rules under the *Act*. In the current context, it seems premature to consider relaxing those rules. They were adopted in 1990, and are intended to protect the rights of plan members and beneficiaries while at the same time, allowing for funding flexibility.

Taxation rules

The taxation rules set a limit on the amount of surplus assets that can be held by a plan. In the case of relatively mature plans, the rules do not allow for the constitution of an adequate cushion to be used in the event of unfavourable deviations. The Régie is of the opinion that raising the limit could contribute to reducing plan funding risks. We intend to make the taxation authorities aware of the need to review the rules.

The administrators' duty to provide information

We are reminding plan administrators of their duty to inform plan members and beneficiaries of the financial situation of their plans. The *Act* provides that this subject must be addressed at the annual meeting. All annual statements must also indicate the plan's degree of solvency as at the date of the last actuarial valuation of the entire plan as well as any measures taken to restore solvency.

We also emphasize the importance of openness in plan administration and of providing members and beneficiaries with clear, objective information on the security of the benefits offered by the plan and on the plan's financial stability.

Conclusion

The Régie is urging plan sponsors and administrators to review without delay the funding risks of their plans. We are convinced that this is the approach to take and we will continue to apply the requirements of the *Act* to ensure that benefit security is not compromised.

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