Remarks by Julie Dickson, Acting Superintendent
Office of the Superintendent of Financial Institutions Canada (OSFI)
to the
Institute of Corporate Directors

Toronto, Ontario
Tuesday, April 24, 2007

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Introduction

Boards of directors do not like surprises.

So the “Perfect Storm” that hit the pensions sector a few years ago was certainly not welcome. On top of historically low interest rates and stock market losses, Canadian pension plans, in the past few years, have also had to cope with new actuarial rules which reflect increased life expectancy, a more market-based approach to valuing pension liabilities, as well as several landmark court decisions. This has been a very challenging period for many pension plan sponsors and members, and, indeed, some significant challenges still remain.

But these types of stresses can also have benefits. One positive outcome, I believe, is that closer attention is now being paid to risks, and how those risks can be managed.

Today, pension plan sponsors and administrators are more aware than ever before of how economic factors, actuarial and accounting practices, and litigation, can affect the health of their pension plans, and what they can do to predict and control the outcomes.

The pension world’s perfect storm, and its aftermath, is largely responsible for this heightened awareness. And with the recent spate of good news about strong investment returns and improving pension finances, it is important to reflect on the perfect storm, and ask what lessons have been learned, and how can they be applied going forward.

So what is the current state of pension plans? Let me share with you the results of OSFI’s most recent review of pension solvency in the plans that we regulate.

Latest ESR Results

According to OSFI’s latest estimates, conducted as at December 31, 2006, the average solvency ratio of federally registered defined benefit (DB) pension plans was 1.06. In other words, calculated on a solvency basis, the total value of assets of all federal defined benefit plans was six per cent higher than liabilities. Of course, the situation of individual pension plans will vary, but six per cent on the plus side is a marked improvement from the low-point reached at the end of 2005, when there was an average shortfall of some 10 per cent.

The December 2006 estimates also show that about half of all defined benefit plans are now fully funded, compared to only about a quarter of plans one year earlier. And among those pension plans that are still under-funded, we found that the funding shortfall is less severe.

Also of note is the aggregate surplus of nearly $7 billion for all federally regulated plans, compared to an aggregate deficit of more than $12 billion in 2005. And if we take into consideration only those plans that have a deficit, the total solvency deficit of the under-funded plans is estimated to be about $2 billion, down from more than $14 billion at the end of 2005.

These improvements can be attributed in large measure to strong investment returns in 2006. Our results also show a small positive contribution from interest rates, but the impact of this was minor, as the rates used to calculate pension plan liabilities at the end of 2006 were almost unchanged from a year earlier. Pension plan solvency was also strengthened by an estimated $2 billion in special payments made by plan sponsors during the year to meet funding requirements.

This is very positive development, and our results are broadly consistent with recent reports on pension plan health from Watson Wyatt and Mercer.

Volatility

But the real story in these year-over-year results is as much the volatility of pension plan solvency as it is the improved financial position. Volatility should clearly be on the minds of plan sponsors, and I do not expect the concern about volatility to be swept away by one period's strong investment returns.

These improved results do not justify complacency. Rather, we think they provide an opportunity for plan administrators and sponsors to take a fresh look at techniques to manage risk, in order to control the volatility of required pension contributions and enhance benefit security going forward.

Review investment and funding policies

Pension plan administrators have access to the tools needed to understand and manage risks affecting defined benefit plans. They should not be caught ill-prepared for changes in interest rates and investment returns that might affect their pension plan, and which could potentially spill over to affect the company's core business objectives.

Boards of directors should be asking whether the investment and funding policies of their pension plans have been developed with a clear understanding of how they affect pension funding costs and risks. They should ask whether the policies are appropriate to the needs of the pension plan, and the expectations and resources of the plan sponsor. And at the same time, they need to ask whether the policies serve the best interests of plan members.

This is a good time for plan sponsors and administrators to review the investment risk and interest rate risk imbedded in their investment policies. In recent years, some plans have moved to reduce these risks, but many others may have thought the cost of doing so too high. Now, with the strong recovery in equity markets, plans will likely reconsider their options.

OSFI is indeed seeing pension plans make adjustments to their investment strategies that they see as appropriate to their circumstances. There was recently a public statement by a major pension plan in Ontario that they had deliberately traded off potentially higher returns on equity investments in order to reduce risks to a level that they could afford.

Prudent choices that favour long-term stability over short-term gain are one way to address concerns about volatility. Back in 2004, the Conference Board reported that 78 per cent of survey respondents who took contribution holidays said that they did so without being forced to, or that they would have done so even if that had not been forced to by tax rules.

Hopefully, the attitude reflected in that result is changing. I would like to think funding policies that are framed with a full understanding of the risks, and of the desire of plan sponsors to control funding volatility, will emphasize the benefits of maintaining a funding cushion. All parties need to keep the perfect storm in mind when looking at surpluses and contribution holidays. A culture of risk management needs to prevail.

Conclusion

Recent improvements in the solvency position of DB plans are welcome news.

However, I do not expect that we will see a return to “business as usual” for these plans. Some sponsors have already made their decision, and have converted to DC plans or closed their DB plans to new members. The latest positive results are not likely to change their minds.

But, as a UK investment house recently commented, “reports of the death of the Defined Benefit plan have been greatly exaggerated.” We know that some plan sponsors will continue to offer DB pension plans. Fundamentally, because they still view DB plans as serving the interests and needs of their employees, and are an important element of their compensation package.

For these employers, I expect that increased awareness of the volatility of defined benefit plans will drive their boards of directors and plan administrators to take the necessary steps to better understand and manage the risks in their DB pension plans.

Ultimately, that is my message here today. Take the time to understand your defined benefit plans, their purpose, goals, and risks. A little attention paid now will pay off in spades down the road.

Thank you.