
Is your pension safe?

Chances are the benefits you've already earned are safe.

  **All Access**



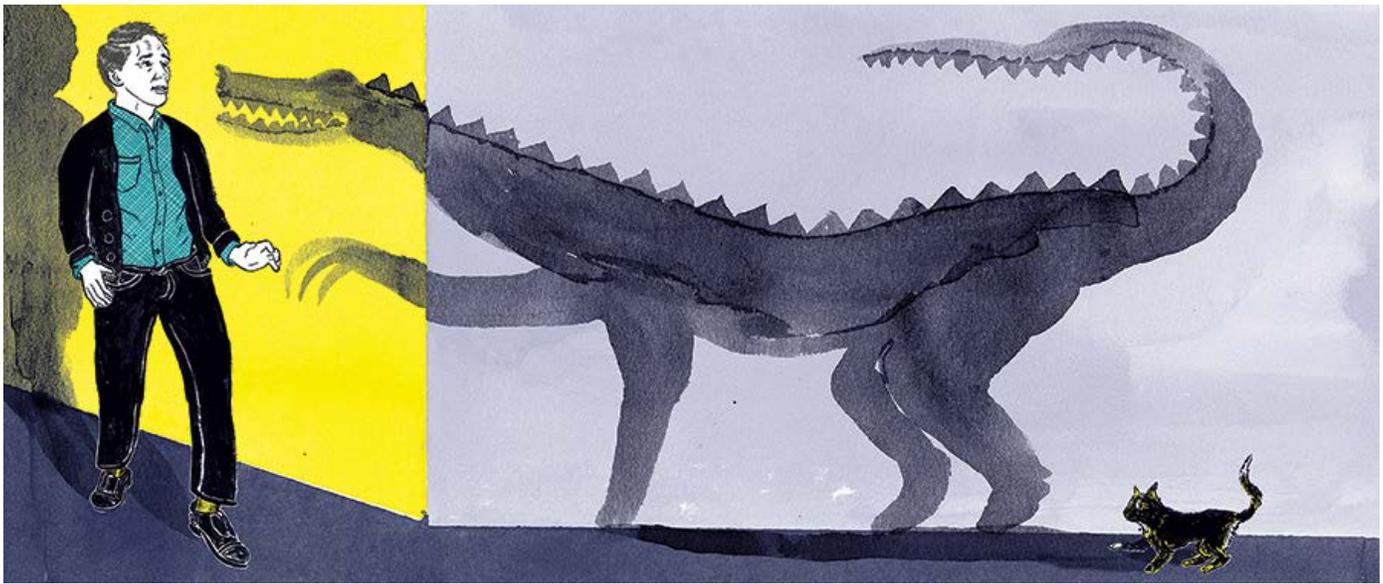
by **David Aston**

October 8th, 2013

From the **November 2013** issue of the **magazine**.

Share:





You're likely aware that traditional defined benefit pension plans are having a tough time these days. They're beset by low interest rates and increasing life expectancy, both of which make pensions more expensive to run. And you've probably read about threatened U.S. public sector pensions in places like recently bankrupt Detroit. All of which may cause you to wonder: is my pension safe?

You may have less to worry about than you think: Canadian plans have robust legal safeguards and cases of promised pensions being cut back are rare. Even if you lose a portion of your pension, you'll probably still get the lion's share. That said, the enormous cost of these plans means unearned future pension entitlements are less secure.

ADVERTISEMENT

Who makes up the shortfall?

In a typical workplace pension, the employer (and often the employee) makes

contributions while the employee is working, and that money is earmarked to pay benefits due in retirement. But plenty can go wrong with the calculations, and the plan can end up with a shortfall.

For example, low interest rates have reduced expected bond returns, which means pension plans now need more money to pay promised benefits. Rising life expectancies can also hurt, since benefits will have to be paid out for longer. The consulting firm Towers Watson recently said new mortality tables will increase many Canadian pension plans' liabilities by 5% to 10%. All this is having a major impact on pension funding. A study of 461 plans in Canada, the U.S., Japan and Europe by ratings agency DBRS found the average funding level in 2012 had fallen to only 78%. DBRS considers funding levels under 80% represent "a danger zone."

But even if your pension plan has a large shortfall, that doesn't necessarily mean you should start to worry about getting shortchanged. With most private sector pensions, employers are solely responsible for making up the difference. Typically, regulators require them to do so with extra pension contributions over a period of five to 10 years, until the deficit is fully eliminated.

The main cause for concern over the safety of your pension comes when both the plan *and* your employer are in poor financial shape. A shortfall in and of itself is little cause for worry. "If someone works for a stable company with a good credit rating and their pension is less than 80% funded, I would shrug my shoulders," says Fred Vettese, chief actuary at Morneau Shepell, pension and benefits consultants, and co-author of *The Real Retirement*.

Even in a worst-case scenario—where there's a large pension shortfall and your employer goes bankrupt—your risk is limited to the extent of the shortfall. If your pension is 80% funded, say, you won't lose more than the other 20%. In addition, if you work in Ontario, its Pension Benefits Guarantee Fund guarantees private sector pensions up to \$1,000 a month under certain circumstances. (Unfortunately, no other Canadian province has a similar pension guarantee.)

The best-known recent example of Canadian pensioners being caught short occurred after Nortel went bankrupt in 2009 with a large pension shortfall. Nortel's partially indexed pensions were cut back to 59% of promised levels, says Nortel retiree Peter

Benedek, who blogs at retirementaction.com. Ontario residents received a bit more because of the province's guarantee fund. All Nortel pensioners may get modest bump-ups if there are sufficient assets once the bankruptcy is resolved, he says. "It's not all or nothing," says Brian FitzGerald, consultant with Actuarial Solutions Inc. and co-author of *The Pension Puzzle*. "In a worst case scenario, you might lose something—and it could be substantial—but you won't lose everything."

Taxpayers to the rescue

In the public sector, pensions are even safer. In Canada the risk of a pension collapse like those in some U.S. jurisdictions seems negligible because of stricter regulations that require more conservative assumptions and practices. "There is a fundamental difference," explains Vettese. "In the U.S., funding ratios are only loosely based on actuarial valuations. They aren't tied to them as strictly as in Canada." When U.S. state and municipal governments come under fiscal pressures, they may give themselves a pension contribution "holiday" at the worst possible time, says Vettese. In Canada, they are not permitted to do so.

ADVERTISEMENT



A No-Fee RESP. Very Smart.

Get up to \$25 cash back and 5 free equity trades when you transfer funds to a CIBC Investor's Edge® No-Fee RESP* by October 31st.

Tell me more ►

CIBC CIBC Investor's Edge

But while the risk of public sector pension collapse in Canada is very low, these plans face the same cost pressures as those in the private sector. In the event of a shortfall, taxpayers are on the hook for at least 50% of it. In some jurisdictions, like the federal government, they're responsible for all of it.

Few Canadians realize how massive some of these unfunded liabilities are. The most egregious offender is probably the federal government itself. The C.D. Howe Institute recently revealed Ottawa's unfunded pension liability using government

accounting was \$148.9 billion at the end of the 2011-12 fiscal year. That's more than \$4,200 for each of the country's 35 million people, and more than a quarter of the federal government's entire debt load. (Using "fair value" accounting favored by the C.D. Howe Institute, the unfunded liability is even bigger: \$267 billion, or a whopping \$7,600 per person.) Many provinces and municipalities also have gaping shortfalls.

While you can expect public service pension credits already earned to be unaffected, future benefits are likely to be curtailed. "Just because your pension is safe doesn't mean it's affordable, and it doesn't mean there won't be significant pressures to make these deals more cost-effective," says retired Mercer actuary Malcolm Hamilton, now a senior fellow at C.D. Howe. Future benefits are already getting pared back in several key areas, or contributions are being increased. "It's a trend that's coming," says Alexandre Laurin, associate director of research at C.D. Howe. For example, employees in the main federal government workplace plan will be gradually upping their share of pension contributions from around one-third to half. Also, new federal government hires will be able to retire with unreduced pensions after a long career only at age 60, rather than the 55 enjoyed by current employees.

But the most significant trend may be to remove inflation protection guarantees. Currently, many public sector plans pay out benefits that are fully and automatically indexed to inflation, regardless of fund assets. But an increasing number of plans are starting to make inflation protection contingent on adequate funding. Pension plans for New Brunswick public sector employees and Ontario teachers are among those that have introduced some version of this change. It means future retirees may share some of the burden of making up shortfalls, rather than placing that responsibility entirely on taxpayers, or splitting it between taxpayers and employees who are still working. Rule changes like this usually don't apply to pension credits already earned, so it is unlikely to affect you if you're already retired, and probably won't affect you much if you're close to retirement.

"When you get into a world where you have almost as many retired public servants as working public servants—and we're fast getting there—the retired public servants need to take some of this risk," says Hamilton. "That's the most important and useful reform—shifting a chunk of the risk to retired members in a sensible, thoughtful, reasonable way."

Where do you stand?

If you want to know where you stand with your own pension, check your annual statement. It normally gives you a snapshot of the overall financial health of your plan by indicating the extent to which it is funded. Every pension plan is required to undergo regular valuations, whereby actuaries determine whether it has enough assets to fund its obligations. The result of this analysis is normally disclosed in the statement.

Two funding measures are commonly used. The “solvency ratio” identifies the proportion of liabilities that are funded if the plan were wound up immediately. The “going concern ratio” embodies some longer-term assumptions and assumes the plan will continue into the indefinite future. Vettese says the solvency ratio is most relevant in the private sector, where the threat of an employer going out of business can be grave. The “going concern” test is more relevant in the public sector.

If there is a shortfall, your statement should also tell you what’s being done to make it up. Sometimes there is a lot of reassuring detail about extra payments your employer has made to close the gap. Other times there’s an unhelpfully terse statement saying only that the shortfall is being addressed in accordance with regulations.

The importance of these funding ratios is obvious if you have a private sector pension. However, they can also be relevant if you have one of those public sector pensions where responsibility for the shortfall is split between the employer and employees who are still working. In this case, if there’s a shortfall and it persists, it means yet-unearned future benefits will have to be reduced or contributions by current employees will have to increase. That means if you’re a younger employee who has yet to build up a large pension entitlement, you may be on the hook not only for contributing more to your own pension, but also helping cover the share of pension shortfall attributable to older colleagues who are already retired.

Funding hope

The pension funding situation is serious but some relief may be on the way. In addition to employers (and sometimes employees) making extra payments, the prospects of rising interest rates could help a great deal. In fact, the DBRS study found that under a scenario of reasonable market returns and an increase in interest

rates of 1.5 percentage points, the average pension fund (mostly in the private sector) in its study may be able to return to fully funded status by 2014. However, relief for public sector pensions depends not only on higher interest rates, but also on little or no increase in inflation, since public sector pension payouts are usually indexed.

There are risks in both the private and public sectors but remember that having any kind of defined benefit plan at all places you among the fortunate minority. "I tell people to put things into perspective," says Hamilton. "Those who are in defined benefit pension plans in Canada are in a good place relative to just about any other group.

Commuting for cash

If you leave an employer before being eligible to start your pension, you may be able to take its current value in cash, which is known as "commuting" your pension. That lump sum will then be moved to a Locked-In Retirement Account (LIRA) or Locked-In RRSP, where you'll control how it is invested, though you can't withdraw the money until retirement.

If you have that choice, should you stick with the pension or take the cool, hard cash? Large sums of money may be involved, and the cash can be tempting, but you need to understand the tradeoffs.

The commuted value of your pension will be calculated by actuaries using a standard formula, which can be extremely complex. The idea is to determine the lump-sum value today of, for example, a promised \$20,000 annual pension payable 20 years from now. This is called determining its "present value." You need to plug in a "discount rate" that assumes the lump sum would be invested and therefore would grow over time. Pensions use a discount rate based on long-term Government of Canada bond rates, plus a modest premium, and assume average life expectancy, Malcolm Hamilton explains. Recently the rate has been about 3.5% to 4%, he says. That means the actuaries assume money left in the plan is effectively guaranteed to earn a 3.5% to 4% return compared to the lump sum you would get from commuting.

You may think you can do better than that by taking the commuted value and investing it yourself, but you can't be certain. "You're welcome to think you can do

better,” says Hamilton. “But recognize that to do better, you’re taking risks.” That probably means you’ll have to load up on riskier investments like stocks because you’ll have trouble matching that return with lower-risk fixed-income investments. Even five-year GICs typically pay less than 3% these days.

In my view, once you consider all the risks, commuting is unlikely to make sense in most circumstances. A pension is an asset you can’t outlive or deplete, and it’s unaffected by market crashes, exceptionally long life, or bad investment decisions. You can’t say the same about your own portfolio. “When you’re retired, you don’t have the luxury of getting things wrong,” says Hamilton. “You don’t get a redo.”

However, commuting may make more sense if you’re in poor health and have below-average life expectancy. It may also make sense to commute if the financial health of both your employer and pension plan are in serious jeopardy—but in those circumstances you’ll probably be restricted in how quickly you can withdraw commuted money, notes Hamilton. If the commuted value of your pension is quite small—say only \$10,000 or \$20,000—you may want to commute purely for convenience.

The pension option may not be as valuable to affluent retirees not worried about outliving their wealth, but even then sticking with the pension may make sense. After all, you’ll want a portion of your portfolio in safe, reliable investments, rather than having 100% in stocks. The pension provides an ideal way to provide that steady income you might otherwise get from investment-grade bonds. “There’s nothing bad about having the safe part of your portfolio grinding away producing a 4% return,” Hamilton says.

David Aston, CFA, CMA, MA, writes about personal finance. You can share your retirement spending experiences by emailing letters@moneysense.ca. He might include your experience in a future article.