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The impact of coronavirus on DB pension funding status, asset mix

Yaelle Gang, the Canadian Investment Review | March 26, 2020

With asset deterioration due to drops in equity markets and a decrease in long-term government bond yields causing an increase in solvency liabilities, pension funds are in a tough position.

A Canadian defined benefit solvency funding calculation assumes some plan members will elect to take a commuted-value lump sum, while other members will elect to collect an ongoing pension benefit secured by an annuity paid by an insurance company. Generally, at a high level, these liabilities are calculated using a Government of Canada bond yield plus a spread.

"Certainly, government bond yields have been decreasing at the mid and long end of the curve since Dec. 31, and so, as those bond yields come down, commuted values will go up and other liabilities will go up for solvency purposes for sure," says Jason Vary, president of Actuarial Solutions Inc.

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Whether or not this is a concern for some plan sponsors depends on how their plan is invested. For example, if a plan is immunized and has a fair amount of long-term bonds, it will be OK because, as bond yields come down, liabilities rise, but so does the value of the bond portfolio, says Vary. "That's going to be great. But equities are definitely down across the board and if that continues then plans are going to be less well-funded the next time they do their valuations."

That said, the situation is changing daily, says Andrew Whale, principal at Mercer Canada, noting the past week has seen a fair bit of recovery with government bond yields rising, boosting pension funding positions again. "It's definitely a roller coaster from both sides."

In addition to solvency funding, pension plans are also valued for accounting purposes. Under most accounting standards, pension plan liabilities are valued using the yields on high-quality corporate bonds. And, corporate bond yields have not declined as much as government bonds.

As such, accounting liabilities have stayed fairly steady, noted Whale. In fact, accounting discount rates for valuing liabilities went up at the mid-point of March. "This happened in 2008 with the financial crisis, we saw a big gap between government and corporate bond yields."

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For plans that are on a journey to de-risk through annuitization, the current impact of coronavirus volatility will be different depending on the plans' asset mix. For example, many pension plans that had decided to purchase annuities would have proactively moved their assets to fixed income to withstand an event such as this one.

However, for plan sponsors that haven't moved to fixed income, annuitization may now be less appealing because it's likely their solvency positions have dropped, says Whale, noting these plans may require additional funding compared to what they would have required at the end of last year. "And then, on the accounting side, most recently we were sending the message that there's less of an accounting hit, or a financial statement hit, on annuitization at the end of last year because the corporate spreads were low. And . . . now that those have widened, the difference between accounting and solvency has grown and that results in a bigger financial statement impact."

Since it's still early days, Whale says he's optimistic that plan sponsors that were planning to buy annuities in 2020 will have taken the right steps to put themselves in a position to withstand market events such as this one. "I'm hopeful that the 2020 market remains strong and the pipeline remains strong. I think, looking further out, it could be a little different because of recent events."

In addition to being valued on a solvency and accounting basis, pensions plans are also subject to going-concern funding, which is valued using a discount rate based on the long-term expected investment return for the plan assets.

Read: ACPM supports strengthened going-concern pension funding rules in B.C.

However, when it comes to this type of funding, it's still too early to call the impact of coronavirus, says Whale, noting that discount rates went down at the end of last year because the markets were up so much. "With the markets up so much, coupled with low bond yields, there was a lower future expectation of equity returns and so discount rates have dropped. Now, given the large drop in equities in the first quarter or 2020, it will be interesting to see if going-concern discount rates jump up again."

In the current market volatility, another consideration for pension plan sponsors is that plans are deviating from their target asset mixes because equity markets are dropping and fixed income markets are increasing, say Whale.

For example, where a plan's asset mix is 50 per cent equity and 50 per cent fixed income, it could suddenly be 45 per cent equity and 55 per cent fixed income, if not more, because those two asset classes swung in opposite directions.

Generally, for plan sponsors not looking to windup their plans anytime soon, Whale suggests they avoid making any drastic changes to their investment policy, since pension plan investing is a long-term game. However, this may not be the case for plans with concerns about their ability to pay benefits right away, he adds.

Further, some plan sponsors may not have an appetite to reset their equity risk and be OK taking lower risk because the allocation has changed. "Whereas others, especially others who are a bit more optimistic and can see an equity rebound, may want to rebalance back to the 50-50 to take advantage of that rebound."

Read: U.S. Fed cuts rates to zero in bid to quell coronavirus impacts

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