Pension Risk Management: Financial Risks

May 30, 2016

Risk management relating to pension plans has been a much-discussed topic among plan sponsors and administrators in recent years, particularly after the market crash in 2008.

Our Pension and Benefits Group has been assisting our clients in addressing different risks regarding their pension plans. The Group will issue a series of Pension Alerts to discuss the key risks, the strategies to reduce or eliminate such risks and the considerations that an employer needs to take into account in adopting a particular strategy.

This Pension Alert discusses financial risks and the upcoming Pension Alerts will cover the following:

- Investment Risks
- Administration Risks
- Litigation Risks
- Plan Restructuring or Termination Risks

Most of these risks are relevant to both defined contribution and defined benefit pension plans although some of them are more important to one type of plan than the other.

Financial Risks

Financial risks relate to the costs in maintaining a pension plan. There are two key costs: costs for funding benefits and costs in administering a pension plan. This Pension Alert focuses on the costs of funding benefits as their related risks are much more significant than those relating to administrative costs.

By the nature of a defined benefit (DB) pension plan, risks associated with funding benefits are more relevant to this type of plan than defined contribution (DC) pension plans. Funding risks can be caused by different factors: market fluctuations, low interest rates, increasing longevity of plan members and increase in annuity costs.

General Considerations

There is a broad range of options to address funding risks. The appropriateness of an option for a plan depends on the specific circumstances of the plan and the employer. Some of the risk management strategies discussed below (i.e., plan termination, plan closure or freeze, plan type changes, changes in benefit and/or contribution formula, plan merger or use of letters of credit) are a plan sponsor's options while the strategies of annuity purchases, longevity risk hedging contracts and liability-driven investments are a plan administrator's options. In most circumstances, the employer is both the plan sponsor and plan administrator.

The employer, as plan administrator, is subject to fiduciary duties and a duty of care in selecting and implementing the appropriate strategy. The employer, as plan sponsor, has considerable flexibility in adopting a risk management strategy. However, the employer needs to bear in mind its fiduciary duties as plan administrator to ensure that if there is a conflict of interest between the "sponsor" role and the "administrator" role, such conflict is not ignored but is appropriately addressed in the circumstances (e.g., by giving notice to members).

Proper due diligence needs to be done in determining the strategy to be adopted and in implementing the strategy. The relevance and significance of a particular consideration varies among the options. Below are some key considerations:

- The pension standards legislation prohibits the reduction of accrued pension benefits. The strategy must not result in a reduction of accrued pension benefits and the plan amendments to implement a strategy need to be carefully drafted to avoid an unintentional reduction of accrued pension benefits rendering the amendments void.
- The pension standards legislation prescribes requirements which are applicable to some of the strategies. Sometimes it is difficult to comply with the requirements because of the specific circumstances of a plan.
- Employment agreements and/or collective agreements may contain constraints.
- There may be risk of constructive dismissal claims if the strategy involves changes to plan design, closing the plan or terminating the plan as the employer, by adopting such strategy, is unilaterally changing a term of employment.
- Employee communications are crucial to the successful implementation of most strategies and to minimizing the risk of employee claims.

Strategies

1. Plan Termination

A drastic measure to remove the funding or contribution risk is to terminate the pension plan. This step will remove the risk of funding further accrual of benefits under the plan (be it DB or DC) in the future.

However, for a DB plan, if the assets are not sufficient to pay the accrued benefits, the employer is required to fund the deficit over a period of time. Additional benefits are triggered on plan termination in some jurisdictions (e.g., "grow-in" benefits in Ontario), resulting in additional required funding. If there is a surplus, the surplus is required to be dealt with. Surplus distribution to the employer requires regulatory approval. It can be a lengthy and costly process.

There is also an immediate administrative cost associated with plan termination.

2. Plan Closure or Freeze

This option has been quite popular among employers as a risk management option in recent years.

A plan closure (for DB or DC) means that new members are not permitted to join the pension plan. There are variations of this option. If the change affects only new hires, the change can be made by simple prospective plan amendments. Some pension plans include a membership eligibility period or provide for voluntary participation. If the plan closure applies to current employees who have not joined the plan (i.e., they can no longer join the plan as a result of the plan closure), the process will be more complicated. Considerations like appropriate grandfathering need to be taken into account.

A plan freeze means that further pension accrual ceases from a prospective effective date. This option is relevant for a DB plan. It can be a "soft" freeze (i.e., cessation of the accrual of pensionable service only) or a "hard" freeze (i.e., no further accrual of pensionable service and future increase in earnings will not be taken into account in the benefit formula). Case law has cast doubt on the legality of a "hard" freeze in some jurisdictions and its availability can depend on the plan language used in the benefit formula. Extra care is therefore required if a "hard" freeze is contemplated. A plan freeze is implemented by plan amendments which are considered as "adverse" amendments under the pension standards legislation in some jurisdictions (e.g., Ontario) and prior notice to members is required under such legislation. This legislative requirement needs to be taken into account in determining appropriate employee communications.

3. Plan Type Changes

This option involves the employer changing the DB plan design to a different type of plan such as a hybrid DB/DC plan, a DC pension plan, a jointly-sponsored pension plan, a target benefit pension plan or a shared-risk pension plan. These plan designs result in either the shifting of risks to plan members (e.g., a DC pension plan where members bear the investment risk) or sharing the funding risks with plan members (e.g., a jointly-sponsored pension plan requires members to contribute towards unfunded liability and solvency deficiency; a target benefit plan permits the reduction of accrued pension if the pension fund is insufficient to pay the accrued pension).

There are complex and detailed statutory and regulatory requirements associated with these options and members' buy-in is required in some jurisdictions. In addition, some of these plan designs are not yet available in all jurisdictions (e.g., shared-risk pension plans are available only in New Brunswick).

4. Changes in Benefit and/or Contribution Formula

Funding or contribution risks may also be reduced by removing costly ancillary benefits (such as indexation or subsidized early retirement benefits), introducing a reduction in the benefit formula (for a DB plan), imposing required contributions on members, increasing the member contribution rate, or reducing employer contribution rates (this is more relevant to a DC plan), on a prospective basis.

Some pension standards legislation may have restrictions on the ability to modify a benefit or contribution formula (e.g., restrictions on removing indexation; 50% rule in respect of a DB plan).

5. Risk Transference

Another option is to transfer the funding risk away from the employer. This option has been gaining popularity in recent years, first in the U.K. and the U.S. and, recently, also in Canada.

Risk can typically be "transferred" to an insurance company through the purchase of "buy-in" annuities or "buy-out" annuities or entering into longevity risk hedging contracts by the plan administrator.

A "buy-in" annuity is an insurance policy held as an investment of the pension fund by a single premium payment. Once the premium is paid, the insurance company is contractually responsible for funding the benefits. However, under this option, the plan remains responsible for benefit payments and the employer is not discharged from funding the benefits under the pension standards legislation. In other words, if the insurance company becomes insolvent, the employer remains on the hook for funding benefits. Since it is an investment, it needs to be permitted by the plan's statement of investment policies and procedures and to comply with the applicable pension investment rules. As an investment, the plan administrator needs to assess the investment risk of the "buy-in" annuity.

A "buy-out" annuity is an insurance policy pursuant to which the liability to pay benefits is "transferred" to the insurance company upon payment of a single premium. This is typically used in connection with a pension plan wind-up. A "buy-out" annuity does not necessarily discharge the employer from funding benefits in all Canadian jurisdictions.

Longevity risk hedging contracts are designed to reduce the risks to pension plans of increased costs associated with unfavourable longevity experience. Pursuant to this arrangement, the plan administrator pays regular pre-determined periodic payments to the counterparty in exchange for the counterparty agreeing to provide the pension plan with regular floating payments. As a result, the pension plan has more predictable outflows during the term of the hedging contract. However, the plan retains the ultimate responsibility for paying the benefits. In other words, the employer remains on the hook for funding the benefits.

Risk transference options are expected to gain increased popularity in the pension world. Some pension regulators have issued guidelines and policies on the plan administrator's responsibilities in entering into agreements for these options in anticipation of their increased popularity.

6. Other Possible Options

There are other options which have been used by some employers.

Plan Merger. When an employer has a DB pension plan with a significant surplus and a DB pension plan with a funding deficit or a solvency deficiency or has a DC pension plan, an employer merges the DB plan (with surplus) with the other DB plan (with funding problem) or the DC plan to form one pension plan so that the surplus can be used to fund the merged plan as the predecessor plans become different components of one single plan with one pension fund after the plan merger. A plan merger requires the approval of the pension regulator. The process can be complicated and lengthy, particularly if the plans are registered, or have members, in different provinces. Before embarking on this process, the plan documents (current and historical) need to be reviewed to determine whether there are provisions which prohibit the "merger" of the pension funds into a single fund or limit the ability of cross-subsidization.

Liability Driven Investment. This strategy involves the plan administrator aligning pension fund investments to manage plan liabilities. This is one of the most popular traditional pension risk management strategies.

Letters of Credit. Most pension standards legislation in Canada permits the employer to use letters of credit to fund the solvency deficiency of a pension plan. The legislation sets out a statutory scheme which the employer needs to comply with for using a letter of credit. This strategy does not remove or reduce funding risk but it is a strategy to avoid trapping money in the pension plan, as it is anticipated that the solvency deficiency does not reflect the long term funding needs of the plan.

By

Sonia Mak

Expertise

Pensions & Benefits

BLG Offices

Calgary

Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3

T 403.232.9500
F 403.266.1395

Ottawa

World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9

T 613.237.5160
F 613.230.8842

Vancouver

1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2

T 604.687.5744
F 604.687.1415

Montréal

1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4

T 514.954.2555
F 514.879.9015

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749