MORNEAU SHEPELL

30,000 Feet

The biggest pension stories of the quarter and why plan sponsors should care

Fourth quarter, 2014

Brace yourself for higher solvency deficits

While most DB plans improved their funding position as of December 31, 2013, discount rates for solvency valuations have dropped substantially in the interim. For a typical DB plan with non-indexed pension benefits, the solvency discount rate (a blend of commuted values and annuity rates) is now about 100 basis points lower than it was last December. This translates into an increase in solvency liabilities of 15-20%.

Why plan sponsors should care

If a fully funded DB plan earns a 10% investment return in 2014, it may still end 2014 with a solvency deficit of 5-10% as of December 31, 2014. If a solvency deficit previously existed, it may grow by even more than 5-10%. DB sponsors who held off on de-risking their pension funds last year because interest rates were at historical lows face the difficult decision of whether to immunize now, when rates are even lower, or to weather the interest rate storm and hope for an eventual return to higher rates. Given the prospect of potential deflation, this is not an easy decision.

Increasing pensionable age

A growing number of pension pundits are calling for an increase in the pensionable age. Some are even suggesting that the normal retirement age should be raised to age 70, but with the flexibility to retire earlier on a reduced pension.

Why plan sponsors should care

With longevity rising and interest rates remaining at historical lows, it is becoming increasingly clear that the pension adequacy problem cannot be solved by higher contributions alone. Later retirement will also be necessary. Most developed countries have already addressed the issue with their social security programs and in many cases are upping the normal retirement age to 67 or higher. We may not be immune forever.

At some point, our federal government will need to explain why the earliest retirement age under OAS is rising to 67 while the latest normal retirement age allowed under workplace pensions, including plans for civil servants, is 65. Change is already underway as a number of pension plans, especially in the public sector, have been eliminating or paring back their early retirement subsidies. Further alignment of pensionable ages under the three pillars seems inevitable.

Decline of DB plan participation continues

Morneau Shepell has completed the latest update of its pension database covering hundreds of DB pension plans. It shows that 57% of DB plans in the private sector are now closed to new hires, and in many cases, closed to all employees in respect of further DB accruals.

Why plan sponsors should care

Managing closed plans differs from managing open plans in at least three respects. First, the risk profile and cost of a closed plan can shift rapidly without the influx of young members to keep the average age stable. Second, the investment policy of closed plans tends to differ as sponsors may want to gradually de-risk. Third, plan sponsors may want to delegate the various governance functions so they can focus on the ongoing retirement arrangements they provide their employees.