MAKING DEFINED BENEFIT PENSION PLANS **LESS PAINFUL**

Defined benefit pension plans (DB plans) in Canada face many challenges, and have been a thorn in the side of many employers in recent years. With DB plans, employers need to manage the assets and risks of their plans and are dealing with issues like: unpredictable life expectancies, volatile investment returns in today's uncertain economy and changing accounting rules. The good news is that there are several solutions available in Canada to help plan sponsors reduce some of their DB plan pain.

WHAT IS DE-RISKING?

De-risking is the new buzzword in DB plan circles. Recent events have highlighted the risks inherent in many DB plans. Key risks include operational risk, investment risk, longevity risk and inflation risk (for indexed plans).

Pension de-risking means implementing strategies to remove or reduce these risks, so employers can focus on their core business. Strategies range from retaining these risks (but better managing them) to fully transferring these risks to an insurer.

Employers around the world are de-risking their pension plans to reduce the volatility of cash contributions and earnings per share and to reduce management time and attention for the DB plan.

U.K. employers have been on the de-risking journey for many years, and the numbers are staggering – since 2006, over £40 billion of U.K. DB pension liabilities have been transferred to insurance companies.

Canadian employers are just beginning their de-risking journey and as more plans take action, many developments are expected. In 2011, CA$1.4 billion of pension liabilities were transferred to Canadian insurers – the largest amount seen in one year. Demand for de-risking solutions will continue to increase and there may be a first mover advantage for plan sponsors that get out of the gate quickly.

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WHY IS DE-RISKING GAINING MOMENTUM?

- ***The impact of pension risk can be significant.*** For example, longevity risk can have material financial consequences. A one year increase in life expectancy can increase pension liabilities by three per cent to four per cent. But one year may not be enough. A study by Kaishev et al (2007) estimated that curing three major diseases (heart disease, cancer, respiratory disease) would increase life expectancy by six years!

- ***Solutions are becoming more affordable.*** Recent research has shown that the rate of return on an annuity can be higher than the expected rate of return on a matching bond portfolio. This means that the longevity and investment risk protection provided by annuities can be free.

- ***Benefit security.*** Insurance companies are highly regulated and carefully managed to ensure that employees' benefits are well protected. Pension risk is reduced and employers can do what they do best and focus on their core business.

- ***De-risking can improve share price.*** Research from Kelvin Wilson at Grant Thornton UK LLP ("DB pension plan de-risking," 2011) found empirical evidence that U.K. companies that have de-risked their pension plans enjoyed an average increase of more than 10 per cent in their share price. Why? Because removing pension risk reduces future earnings volatility and allows management to concentrate on their core business.

- ***High profile companies are taking action.*** In June, General Motors announced that it was de-risking its salaried pension plan and reducing its pension obligations by US$26 billion through a combination of lump sums and annuities. This is the largest pension de-risking transaction ever announced. It signals a shift in the way that organizations think about their pension obligations.

CANADIAN PENSION **DE-RISKING SOLUTIONS**

Liability driven investing (LDI)	Investing pension plan assets to behave in the same way that the plan's liabilities behave, using pooled funds or a customized portfolio.
Longevity insurance	Insurance against the possibility that plan members live longer than expected, with the insurer covering the cost of additional pension payments for longer-lived members.
Annuity buy-out	A traditional group annuity contract that transfers all the risks for a group of members from the employer's balance sheet to an insurer's balance sheet.
Annuity buy-in	An innovative, flexible group annuity that transfers all the risks for a group of members to an insurer, but is invisible to plan members. An annuity buy-in is an investment of the plan that requires no additional cash contribution from the plan sponsor and triggers no accounting settlement.[1]
Plan design changes	Changes to future benefits or cost sharing arrangements or implementing a new pension arrangement for new members.

TIME TO TAKE ACTION?

Here are some steps for plan sponsors considering de-risking:

- Contact a pension consultant to assist in evaluating the available solutions.
- Contact an investment banker to help evaluate the pension plan within the broader corporate finance framework.
- Contact an insurer to get a free illustrative quote showing the cost of pension risk transfer.

There is no single solution or quick fix to de-thorn or de-risk Canadian DB plans. While the road to lower risk can be a long one, it's important to start the journey and take advantage of the de-risking opportunities that are now available – before market volatility or regulatory changes create new unforeseen pains. Employers need to take action or else risk that their DB pension plan pain may be with them for years to come.

[1] Plan sponsors should confirm the need for an accounting settlement with their own auditors.

ABOUT THE AUTHOR

Brent Simmons leads Sun Life Financial's Defined Benefit Solutions business, providing a wide array of customized de-risking solutions for defined benefit pension plan sponsors.

Brent has been in the pension and insurance industry for 17 years, as a consultant, strategist and executive. His experience includes the design, pricing and governance of insurance and pension products, including buy-in and buy-out annuities, GMxB products, registered pension plans, executive pension plans and group RRSPs.

For more information about how annuities might help your pension plan, contact your pension or investment consultant. For more information about Sun Life Financial's de-risking solutions for defined benefit pension plans, please contact:

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