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Cleaning Up The Pensions Mess:

Why it will take more than money

Keith Ambachtsheer

The Backgrounder in Brief

The collective balance sheets of workplace pension plans in Canada have deteriorated by some $180 billion over the course of the last three years. That is not good news. However, even if the missing $180 billion were magically restored tomorrow, there would still be a pensions crisis. Why? Because workplace pension plans have serious design and governance problems. Only by addressing these issues can we clean up the real pensions mess.

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Based on the performance of the assets and liabilities of a sample of 68 large Canadian defined benefit (DB) pension-plan funds over the course of the three years to the end of 2002, I estimate that the collective financial position of these plans deteriorated by about 9 percent per annum, or almost 30 percent in total over the three-year period. This came about because the assets earned a meagre median net return of 1 percent per annum due to depressed equity markets, while the pension liabilities grew by 10 percent a year. The main cause of this exceptionally high growth rate of pension liabilities was a significant decline in long-term interest rates over the period. How do falling interest rates boost pension liabilities? Everything else equal, the lower long-term interest rates are, the more money it takes to discharge a known stream of future pension payments.[1]

If the estimated 30 percent balance sheet deterioration since the end of 1999 is representative of the aggregate Canadian DB plan balance sheet of about $600 billion, an approximate balance sheet loss of $180 billion is implied for the Canadian DB plan sector over the three years to the end of 2002. This loss resulted largely from declining interest rates rapidly pushing up pension liabilities, rather than from a collapse in asset values. How can such large balance sheet losses occur? Because DB pension plans undertake material asset-liability mismatch risk by investing an average 60 percent of the pension fund in equities. The justification for undertaking this mismatch risk is that over the long term, it will pay off in 2 percent-to-3 percent higher asset returns.[2] Actually earning such additional returns on pension assets would permit the payment of adequate pensions at affordable costs. However, actual equity returns in relation to bond returns can be highly erratic for extended periods. If this were not the case, there would be no justification for any equity risk premium in the first place.

Is this estimated $180 billion DB balance sheet deterioration over the 2000-to-2002 period the Canadian pension crisis that the media regularly wrote about in

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1 Toronto-based Cost Effectiveness Measurement Inc. (CEM) benchmarks the organizational performance of 300 of the world's largest DB and defined contribution (DC) pension funds, of which about 33 percent are Canadian. For DB plans, it monitors net asset returns versus liability returns, where the liabilities are represented by bond portfolios that match plan liabilities in duration and inflation sensitivity. The results cited in this *Backgrounder* were based on a sample of 68 Canadian plans (total assets of $300 billion) with three years of continuous data ending with 2002.

2 The idea that equities earn a significant risk premium over bonds became an article of faith in the pension investments world of the 1990s. A 5 percent premium was a common assumption, based on historical experience. Recent research suggests that the equity risk premium is in fact not a constant, but a variable that can take on prospective values all the way from negative (during stock market bubbles) to over +10 percent (when investors are very pessimistic about the future). This research places today's expected equity risk premium at a very modest +1 percent-to-+2 percent, with a wide variation of possible results around this expectation for the next 10 years, or even longer. Such an assessment makes taking on material balance sheet mismatch risk on the assumption of a positive prospective equity risk premium a dubiously speculative proposition even today.

2003?[3] Yes, it is. Its impact on financially weak corporate employers, such as Air Canada and Stelco, has received special media attention. However, there is a more fundamental crisis behind the reported balance sheet losses. This deeper crisis arises from the way work-place pension arrangements have evolved in Canada, how they are financed, how they are governed, managed and regulated, and how financial results are disclosed and understood by pension plan stakeholders.

Fuzzy Pension Plans

By way of example, let us start with the typical DB pension arrangement. Its name suggests that the underlying plan in DB arrangements is clearly defined and understood by all. In fact, this is seldom the case. Specifically, the embedded risks in these plans, and who bears them, are seldom clearly stated and rarely understood by the plan fiduciaries, or by the plan participants themselves. In defined contribution (DC) plans it is reasonably clear that plan participants bear the risk that the assets accumulated at retirement may not be sufficient.[4] In DB plans however, there is a fiction that all risk-bearing is done by the employer, and that employees are guaranteed a pre-defined pension on retirement. In practice, this is not how things usually work. It is true that the employer is on the hook to make additional contributions when calculated plan liabilities exceed assets. However, plan participants are risk bearers too.

For example, the employer may go broke or simply terminate the plan. Employee pension contributions may also rise. Even if not directly, higher employer pension contributions could lead to lower current compensation for employees. Different plans have different vesting provisions. A significant portion of the inflation risk embedded in DB plans is typically borne by plan participants, and not the employer. For example, some plans promise only fixed dollar pensions that may be updated from time to time, depending on the financial health of the pension plan balance sheet. Other plans promise pension benefits related to final

3 A recent study commissioned by The Association of Canadian Pension Management (ACPM) estimated that pension assets roughly equalled liabilities at the end of 2002 without any projection in the liabilities for future wage and price inflation. Were such projections to be included in the calculation of the pension liabilities, they would rise by about $275 billion, reducing the aggregate Canadian DB pension plan funded ratio at the end of 2002 to 70 percent from 100 percent. Thus, one way to characterize the three-year, $180 billion balance-sheet deterioration we calculate is to say that it wiped out balance-sheet reserves sufficient to fund 65 percent ($180 billion–to–$275 billion) of future pre-and post-retirement inflation indexation in Canadian DB plans.

4 However, some legal experts argue that in DC plans sponsored by large, sophisticated employers, plan members have an implicit put option on employers for a floor pension if accumulated savings are insufficient to produce such a pension. For example, the collapse in the asset values of some corporate 401(k) plans in the U.S. has already led to a number of lawsuits. Gold 2003 recently argued in an article in *Benefits Canada* that DC plans sponsored by sophisticated employers in Canada should be subject to the same expert prudence standards as DB plans ("Can DC Plans Pass the Prudence Test?", September 2003). In light of these considerations, it is interesting to note that TransCanada PipeLines Ltd. recently reconverted its relatively new DC plan back to a DB plan. I know of other Canadian corporations contemplating such a move. Fear of the aforementioned employee put option is part of the motivation.

earnings, but are silent regarding post-retirement inflation protection.[5] In short, despite the risk-free fiction, DB plans are virtually always risk-sharing arrangements.[6]

A fundamental governance problem in most DB plans is that the risk-sharing arrangement implicit in DB plans is usually not acknowledged, or even understood. As a result, decisions about how much asset-liability mismatch risk to expose the DB plan balance sheet to are often made for reasons having little or nothing to do with the underlying risk-sharing pension deal and its economic consequences. Many pension plan fiduciaries have turned to outside experts to help them make their DB plan funding and balance sheet mismatch risk decisions. Unfortunately, the actuarial, accounting, and investment professions have not always been less than totally helpful in this regard.

The Shortcomings of Generally Accepted Actuarial, Accounting, and Investment Principles and Practices

Rather than identifying the embedded risks in DB plans, quantifying them, and explicitly allocating the risks among the various stakeholders, pension actuaries have often focused on controlling DB plan liabilities through their generally accepted actuarial methods. For example, actuaries often arbitrarily reduce the funding target liability by assuming pension assets will earn a risk premium. They argue that this justifies the use of a higher discount rate for the funding target liability calculation. The strange result is that the more risk you take on the asset side of the pension balance sheet, the lower the balance sheet reserve required to hedge that risk needs to be.[7] It is our view that this actuarial practice leads to an artificial bias towards taking on asset-liability mismatch risk in the DB pensions sector.

When challenged on this point, actuaries commonly respond that the long-term nature of pension arrangements justifies the smoothing of pension asset and liability values for funding and disclosure purposes. It seems to me that such responses confuse the legitimate need to smooth contribution rate changes in DB plans with the equally legitimate need to quantify, allocate, and report on the risks

5 Inflation protection in DB pension plans has been a subject of controversy for decades. I don't pass judgment here on how inflation uncertainty risk should be borne. Instead, I merely point out that it is a risk that must be borne. Any part of inflation risk-bearing not explicitly written into the pension deal falls back on individual plan members by default.

6 Current pension legislation and its interpretation implicitly recognizes the risk-sharing nature of DB arrangements in its position that balance sheet surpluses should somehow be split among plan stakeholders. However, this philosophy is currently being implemented without sturdy conceptual underpinnings such as, for example, the need for symmetry between risk bearing and surplus sharing. The fuzziness in DB pension arrangements makes the assessment as to whether such symmetry exists difficult to establish. The result has been legal conflict in front of judges not schooled in these matters. Not surprisingly, the court decisions resulting from surplus ownership disputes have tended to be based on the peculiarities of individual cases rather than on the consistent application of economic principles.

7 There is a lower limit to any funding target liability calculation. Regulators require the use of a bond-market-related discount rate for the solvency liability calculation. However, no allowance needs to be made for future wage and price inflation experience in this calculation. (Regulators require that any asset shortfall in relation to the solvency liability calculation must be made up within five years.)

embedded in these plans. It is not correct to assert that these two legitimate needs pose an either-or dilemma. Both needs can be met without resort to artificial values for plan assets and liabilities. To their credit, a minority of finance-savvy actuaries have begun a revolt against the current common practices of asset smoothing and underestimating pension liabilities for funding purposes by assuming that pension assets will earn a risk premium.[8] The jury is still out on how successful they will be.

Pension accounting practices have also contributed to an artificial bias towards risk-taking in DB plans by falling into the same risk-is-value logic trap that many actuaries fall into when they calculate pension liabilities for funding purposes. In the accounting world, the trap is the ability to convert assumptions into earnings by permitting corporate DB plan sponsors to anticipate earning a risk premium on plan assets. The resulting anticipated spread between the return on plan assets and the liability discount rate can be booked as a component of current corporate earnings. So, for example, if for accounting purposes one assumes a 9 percent return on plan assets and a 6 percent discount rate to estimate the liabilities, the resulting spread is 3 percent, or a $30 million per annum profit for every $1 billion of pension assets. This makes the pension plan the only business unit where one can legally book a profit without actually having to earn it.[9] However, projecting a positive asset-liability return spread does require actually undertaking mismatch risk between balance sheet assets and liabilities (otherwise, there is no justification for projecting a spread). Yet, there is no requirement to report on the risk implications of undertaking this asset-liability mismatch risk. So yet again, the result is an artificial bias towards risk-taking in the DB pensions sector. As with the actuaries, the accounting profession is beginning to question its current practices in the pensions area, but once again it remains to be seen whether and when these practices will actually improve.[10]

Meanwhile, pension investment professionals typically take an assets-only approach, claiming that as long as they beat their capital market benchmarks, they have done their job. As a result, their starting point is a typical 60-40 equity-bonds asset mix, and the active return and risk they are accountable for is measured relative to this passive benchmark. Not surprisingly, the measured active returns

8 These issues were aired recently at a major global symposium entitled, "The Great Controversy: Current Pension Actuarial Practice in Light of Financial Economics", held in Vancouver, June 24–to–June 25, 2003. The Canadian Institute of Actuaries has created a special task force to examine how to best update its generally accepted actuarial principles. Central issues are the existence and size of an equity risk premium in the financial markets, whether it is appropriate to anticipate such a premium will be earned before it in fact is, and how the risks embodied in DB plans should be defined, calculated, and disclosed.

9 Things are more complicated than the simple characterization of the pension accounting rules set out above. Actual experience different from that assumed must be recognized eventually. However, that "eventually" can be stretched out over extended periods of time, leading to such confusing results as reported pension profits continuing positive while the marked-to-market pension balance sheet is actually deteriorating.

10 Broad-based criticism of the current pension accounting rules has sent the international, U.S. and Canadian accounting standards bodies back to their respective drawing boards. It is expected that the accounting revisions will eventually eliminate current incentives to undertake asset-liability mismatch risk. However, when such revisions will eventually become part of GAAP is unclear.

and risks are dwarfed by the total balance sheet return and risk impacts created by the underlying passive 60-40 asset mix policy.[11] But worrying about total balance sheet return and risk is not the investment professionals' job. Their task is to modify these metrics a little bit at the margin by being modestly active, which is how they earn their fees.[12]

So who does manage the very material asset-liability mismatch risk embedded in the typical DB plan? The disturbing answer in most instances is: nobody. It is true that many pension plan fiduciaries can pull expensive asset-liability studies off their shelves. However, when asked why the asset mix answer always seems to come out at 60-40 for everybody, there is seldom a satisfactory answer.[13]

Poor Business Management Practices

Compounding the frequent failure to explicitly manage balance sheet risk in DB plans is the frequent failure to manage cost effectively the pension plan as a financial business. This is surprising, because in many cases pension plans spend many millions of dollars annually on managing the assets and administrating the benefits. Normal business units with pension plan-sized budgets are typically subject to rigorous business planning and review disciplines. Not so the typical pension plan. Here, a much more casual approach is often taken. Yes, investment performance is measured, but the focus is usually on the non-material active return and risk components, rather than on the performance of the total balance sheet. This is akin to assuring that the deck chairs are in good order as the Titanic speeds towards its rendezvous with the iceberg. The cost effectiveness of the pension benefit administration component is often not benchmarked at all.[14]

This casual approach is often even more pronounced with DC plans, or their close cousins, such as group RRSPs. Now, plan members typically pay the bulk of the fees associated with such arrangements themselves. At the same time, the degree of outsourcing now is usually almost total, with external service providers looking after a whole raft of services ranging from investments, to custody, to record-keeping, to education and advice. Taken together, the fees for all these

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11 Results from the CEM database suggest that the asset mix policy risk in Canadian DB plans is on average five times greater than active risk due to the influence of the actions of the pension funds' portfolio managers.

12 Investment management fees in DB pension funds can run anywhere from under 0.1 percent to over 1.0 percent of assets managed, depending on the nature of the mandate. So, for example, even a modest 0.3 percent fee on a single $100M mandate generates an annual fee of $300,000 for the external investment manager. Fees for similar mandates in DC funds can be considerably higher.

13 Principal-agent theory offers a perfectly sensible answer for this we're-all-the-same behaviour. Pension fund asset mix risk policy decisions are typically made by agents, and not the principals-at-risk. In a world where comparing asset-only returns is still the most common form of performance measurement, the worst possible outcome is to be wrong and alone – that is, end up with a poor relative return by having a different asset mix policy than everyone else. This possibility can effectively be eliminated by having the same asset mix policy as everyone else. As a result, almost everyone has the same asset mix policy.

14 CEM currently benchmarks the benefit administration practices of 60 pension plans globally, of which only nine are in Canada.

services can easily add up to an amount in excess of 1 percent per annum.[15] In the world of single digit investment returns we now live in, expenses at these levels are too high. For that matter, so are the number of investment choices that the typical DC plan offers. The idea that average DC plan participants can sensibly optimize their pension investment program from among a dozen or so investment choices is difficult to defend.[16] Awkwardly, then, while the employer's incentive to provide good oversight and management is less in connection with DC plans, the need for such oversight on behalf of plan participants is greater.

In addition to this issue of reduced incentive to provide expert oversight, pension fund size (or lack of it) presents a related problem. Small DC (and DB) pension plans simply cannot deliver value for money to their stakeholders because their small scale leads to unit costs that are too high.[17] Unfortunately, without adequate competitiveness information and the disciplines that come with good governance and management practices, there is no impetus to find a good solution to this problem. Good solutions can be found in two possible directions: merge with a larger plan that has lower unit operating costs, or outsource the management of the plan altogether to an external value-for-dollars provider. The Canadian Catch–22 is that available cost data indicate that such providers are difficult to find.

A Search for Best Practices

The point of all this is that today's pensions crisis does indeed go deeper than simply the balance sheet losses caused by the recent simultaneous declines in stock prices and interest rates. Many Canadian pension plans suffer from faulty design, compounded by less than effective governance and management practices. This raises an obvious question. Is it possible to design plans with clearly articulated, sustainable pension deals that also have effective governance and management structures and practices? The answer must be yes, because reasonable facsimiles of such plans already exist in Canada. Three examples are the Nova Scotia Association of Health Organizations Pension Plan, the Ontario Teachers' Pension Plan Board, and the IWA-Forest Industry Pension Plan. (Three of about 150 organizations with which I have a professional relationship.)

All three have reasonably transparent pension deals negotiated by stakeholder representatives.[18] These arrangements include a description of the embedded risks and

15 A sample of 36 Canadian DC plans in the CEM database had an average total cost of 0.92 percent of assets in 2002, and had an average of 11 investment options.

16 Canadian pension regulators have been working with the pension industry to devise a set of best practices guidelines for the governance and management of capital accumulation plans, such as DC plans and Group RRSPs. However, this well-intended effort cannot deal with the fundamental problem of too many choices at too high a cost.

17 In the previously cited sample of 36 Canadian DC plans, the scale co-efficient was – 0.45. This means that for every tenfold decrease in plan asset value in the database, costs expressed as a percentage of asset value increased by 0.45 percent on average.

18 This does not mean that relations among the various pension-deal stakeholder groups is always warm and wonderful. Total compensation arrangements still have to be negotiated and renegotiated, with the pensions component being an important element of the total. Those negotiations will still take place, with or without acrimony. However, the more rigorously pension promises and ownership shares in pension balance sheet surpluses or deficits are valued, the less likely it becomes that negotiations involving pensions will lead to financial win-lose, or lose-lose, outcomes among stakeholder groups.

how they are shared among stakeholders. All have arms-length, co-operatively owned legal entities accountable for cost-effectively implementing the plan, including the management of balance sheet risk. All have fiduciary bodies with clear accountability for governance, and with clear delegation of authority to an expert internal management team. All have outsourcing strategies that turn external service providers into value-enhancing partners. All evaluate and compensate organizational performance in line with explicit organizational goals. All have the scale necessary to produce value for money for stakeholders. Even better news is that these three pension plans are not alone. I could have described another handful of Canadian examples with many of these same characteristics.

But I would be hard-pressed to cite such examples from Canada's corporate sector. Why is that? Because corporate DB plans tend to be fuzzier regarding their embedded risks and how and by whom they are borne. There are no arms-length, co-operatively owned legal entities accountable for implementing the pension arrangement cost-effectively. Balance sheet risk is not typically managed in a dynamic, transparent manner. The fiduciary bodies accountable for pension plan governance tend not to be in a position to assess total balance sheet risk and how it is borne. Operational authority is seldom delegated to an expert internal management team. Organizational performance is rarely measured and compensated in line with the plan's goals.[19] Instead, corporations tend to follow the pension silo approach, chopping up responsibilities into so many little unconnected pension containers that few can see, let alone understand, the landscape. On top of all this, many corporate plans lack the physical scale to be value-for-money producers of pensions.

Looking for Corporate Best Practices Pension Plans

Are there any corporate pension plans out there that meet my plan design, governance, and management best practices standards? The answer, once again, is Yes; however, at least to my knowledge, not in North America. For corporate DB best practices examples, the Netherlands is one exemplar. That country requires corporate pension plans to be managed as arms-length, integrated trusts. Also, Dutch pension arrangements promise only nominal pensions, unadjusted for wage or price inflation, but make contributions high enough that inflation adjustments should usually be affordable. As is the case with many corporate DB plans in North America, such adjustments are not guaranteed before the fact, and are only granted if a healthy pension balance sheet makes them affordable. Within this legal

19 Some Canadian and U.S. corporations have established separate pension investment subsidiaries. Unfortunately, such subsidiaries reinforce the assets-only mindset so prevalent in the corporate sector. For example, a number of public sector and industry-wide DB pension plans have moved, or are moving, to dynamic balance sheet risk management disciplines. These involve the regular measurement of balance sheet mismatch risk exposure and ensure that this exposure stays below some pre-determined maximum risk-budget level. The few pension plans employing this discipline in the late 1990s and early 2000s were forced to reduce equity exposure as their risk measurements showed their balance sheets becoming increasingly risky over this period. Unbeknown to most pension plans, this mix became increasingly risky over the late 1990s and early 2000s. Experience shows that dynamic risk measurement and management disciplines have been extraordinarily difficult to install in corporate DB plan contexts in Canada and the U.S.

and risk-sharing framework, the Royal Dutch-Shell Group of Companies, KLM Royal Dutch Airlines, and Philips corporate pension plans for example, stand up well to the best practices standards.

For the corporate DC best practices, Australia is an exemplar. There, SunSuper is the pension co-op that manages the assets and the benefit administration for most corporations and their employees in the State of Queensland. Employers and employees contribute a portion of current compensation into employee accounts. The pension co-op offers participants three investment options — low, medium, and higher risk — which are dynamically optimized over time on their behalf. A knowledgeable board delegates operational responsibilities to an expert internal management team. Value-for-dollar results are defined, measured, and compensated when achieved. While specific investment and administrative tasks are largely outsourced, it is the inside brains trust that retains overall plan accountability and control. It is this group that optimizes the reward/risk characteristics of the three investment options, and not the plan participants. In short, SunSuper is doing the right things for the right reasons.

Why Not Here?

With such clear best practices to emulate as those in Europe and Australia, why are Canadian and U.S. corporate employers still operating with second-best DB and DC pension models? The answer may be found in the origin and evolution of workplace pensions in corporate North America. They have in the main been voluntary, rather than negotiated or mandated, affairs, initiated by the employer. Corporate employers have historically taken the view that pensions are more perks than formal components of total compensation. Admittedly, this view has evolved over time, especially with the passage of pension legislation that has formalized, at least in part, the contractual nature of DB plans. Still, the legal structure of corporate pension plans in North America has never quite evolved to the mandatory separate legal entities of the Netherlands and Australia. And that helps explain the current corporate pension structure in North America.

It is, in fact, the voluntary nature of North American corporate pension arrangements that has been an important contributor to their current status, and seems to be a barrier to the evolution of the kind of best practices forms of corporate pension delivery systems that have evolved in the Netherlands and Australia. North American corporate plans still have the organizational silo problem, which leads to HR departments worrying about pension benefits, while treasury departments are concerned about pension assets. This internal organizational problem in corporations is compounded by the not-quite-right actuarial and accounting practices related to DB plans. These approaches create an artificial bias, subjecting corporate DB plan balance sheets to material, though unmeasured and unmanaged, asset-liability mismatch risk. At the same time, investment professionals compound the problem by bringing a strong assets-only bias to the table.

This combination of factors has presented corporate pension committees responsible for plan governance with a series of *faits accomplis*, and in the process risked turning them into ineffective rubber-stamp bodies. On the DB side, this has

led to static plan design, funding, and investment policies largely determined by outsiders. On the DC side, the internal corporate silo problem, combined with a lack of incentives to provide expert oversight, has produced an overwhelming bias towards total outsourcing, often leaving plan participants grappling ineffectively with too many investment choices at fee levels that are too high.

Building Better Pension Plans

So what can be done? By defining the problems, we also create a foundation from which pensions can change for the better. There are some concrete actions that would start to move pension management in the right direction:

- Today's work-place pension arrangements should be fully articulated and communicated, especially regarding the embedded risks, who is to bear them, and how they are going to be measured and managed. The Association of Canadian Pension Management (ACPM) has initiated a project that would foster greater clarity in DB and DC pension plan arrangements. This work is currently underway, and is targeted for ACPM membership approval at its next AGM, in September.

- Asset-liability mismatch risk in DB plans should be measured and disclosed regularly, and managed dynamically in relation to an explicitly established balance sheet risk budget. Risk cannot be totally eliminated; it can be controlled and appropriately compensated. DC plan participants should be clearly informed of the various types of risks — uncertainty regarding financial market returns, inflation, and longevity — and the costs they are exposed to.

- Securities regulators could require the annual disclosure of a metric representing DB balance sheet mismatch risk embedded in publicly traded corporations.

- Work that will lead to a more solid theoretical foundation for pension plan design as well as proper risk definition, measurement, and management should be accelerated. On a more practical level, more research is needed on how Canadian corporate DB plans could evolve from their current states towards more effective, efficient, win-win risk-sharing co-op structures.

- Pension regulators could help facilitate a move towards greater pension-deal clarity by recognizing that their current captive insurance company model of regulating DB plans is only one of several. An alternative — and I believe superior — model that they could help espouse and foster is the risk-sharing co-op pension model. Such stand-alone structures force the clarification of risk-bearing and the management of balance sheet risk subject to explicit risk budgets over time. At the same time, the relatively low 10 percent cap that the federal government has historically placed on DB balance sheet surpluses has impeded the proper management of balance sheet risk. The 10 percent limit is

now under review, and should be reset at a much higher level — such as 30 percent — if it is retained at all.

- Canada's legislators should foster a national debate on whether membership in a work place pension arrangement should be made mandatory for all members of the country's workforce. Such a requirement has led to the establishment of more effective and efficient work place pension plans in Australia and the Netherlands consistent with the risk sharing co-op model. Currently, only 40 percent of the Canadian labour force is covered by registered pension plans. Coverage rises to about 66 percent if RRSPs are included.

- The actuarial and accounting professions must step up their efforts to have their financial reporting standards reflect today's generally accepted financial economics principles based on fair value. Doing so would remove the risk-is-value logic trap embedded in current practices and eliminate current unintended incentives towards unwarranted risk-taking in corporate DB plans.

- The investment profession must refocus its efforts on dynamically managing total balance sheet return and risk rather than on assets-only active return and risk. It follows that the measurement of financial performance of DB plans should be based on this same principle.

- Corporate boards of directors, CEOs, and CFOs must give pension issues the attention they deserve. It is hard to imagine the break-up of the current corporate pension silos in Canadian DB and DC plans without strong leadership at the top.

A Silver Lining

I end where I started. Is there a pension crisis in Canada? Yes, there is, but not just for the financial reasons most people think. Behind the current balance sheet shortfalls of many pension plans lie ill-defined pension arrangements, ineffective governance and management processes, asset-only investment models, actuarial and accounting practices that obfuscate, rather than clarify, and regulatory models that lack a solid conceptual foundation. In order to clean up the pensions mess, these are the fundamental problems that must be tackled. The result would be greater pension deal clarity, more effective governance and management processes, integrated asset-liability risk management models, clearer actuarial and accounting principles and practices, and a legal structure that fosters more effective and efficient models of pension design and delivery. All this would produce more certain pensions for more people at sustainable costs.

The silver lining on today's pensions crisis cloud is that necessity is often the mother of invention. Sometimes it takes bad times for good things to happen.

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