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Work-Related Pensions in Ontario: Uncertain Present, Brighter Future

Submission to the Expert Commission on Pensions
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Introduction and Overview¹

Ontario's Expert Commission on Pensions is undertaking its work at an opportune time. The laws governing defined-benefit (DB) pension plans in Ontario do need re-examination, especially at a time when many of the assumptions and practices that supported voluntary/contractual pensions in the past are being revised.

That said, producing an influential and constructive report might require the Commission to interpret its mandate carefully. A charge to maintain and encourage DB pension plans as they are generally understood, and as they tend to exist in the public sector, should not deter the Commission from considering ways in which the classic single-employer DB plan has failed to live up to its promise. Indeed, this classic model may have flaws so fundamental as to make it an inappropriate element in employment compensation in the future. The recent difficulties of DB plans in Ontario, and elsewhere, resulted from changes in the economic environment that hurt their balance sheets and from changes in accounting that starkly revealed the damage. But DB plans were in decline long before the recent crisis. Evidence is mounting that the classic single-employer DB plan creates risks larger than sponsors or participants typically understand, and that rather than propping up the classic DB system, Ontarians should seek alternatives.

Existing RRSPs and money-purchase plans tend to impose high decision-making and administrative costs on individuals. Unsatisfactory though this situation is, the fact that most Ontarians will do most of their retirement saving through these plans in the years ahead means that measures to improve their situation are imperative.

In the long run, the development of plans with good features from both the DB and defined contribution models is highly desirable. Such hybrid plans could combine money-purchase elements with an appropriately backed minimum benefit; pool investment risk across many individuals at reasonable administrative cost; gear contribution rates to a target payout; and steer individual portfolios toward an asset mix that would insulate them from fluctuating annuity prices approaching retirement. For the Commission to foster a policy environment in Ontario in which such plans could develop and flourish would constitute a key contribution to a brighter future for pensions in the province.

¹ Much of this brief draws on David Laidler and William Robson, *Ill-Defined Benefits: The Uncertain Present and Brighter Future of Employee Pensions in Canada*, C.D. Howe Institute Commentary 250, June 2007. The opinions expressed here are the author's own, and do not necessarily reflect those of the C.D. Howe Institute's members or Board of Directors.

Ontario's Pension System and its Problems

While Canada's tax-funded income supports for seniors, and the work-related Canada and Quebec Pension Plans (C/QPP), appear sound and stable for the foreseeable future, the private voluntary/contractual component of Canada's retirement system is in flux. One widely noted trend is that DB plans are covering fewer workers. Their sponsors account for a declining share of total employment, and few new plans are starting.

DB plans represent a particular approach to deferred compensation. Their essential feature is that employees give up a certain amount of current pay for a promise of a predetermined amount in retirement. For this reason, many commentators prefer DB plans to alternatives in which participants bear the risk that their accumulated funds will yield less (or more) than they expect, and typically also may choose how much, or little, to contribute.

Notwithstanding this argument from its advocates, the DB approach to deferred compensation is under chronic pressure. Until the turn of the millennium, its difficulties were mainly manifested in declining coverage and underfunding in industries such as steel or airlines. Since then, however, four factors combined to prompt talk of a "crisis". Largely unforeseen increases in life expectancy increased expected payouts. The end of the long post-1987 equity-market boom prompted reassessment of often-extravagant assumptions about equity returns. The onset and persistence of low nominal interest rates increased the present value of liabilities more than it boosted the value of bond holdings. And a shift to "mark-to-market" valuations brought these other effects into sharp focus.

At the risk of painting with too broad a brush, I would note that a not uncommon response to this "crisis" was to argue that it resulted from an unfortunate series of accidents, and that policy should respond with measures that would help hide the problem until it went away. My argument, by contrast, would be that the environment in which the classic DB plan grew up was unusual enough to allow people with too-short time horizons to implement arrangements based on unrealistic expectations, and that the problems with DB plans today require a major rethink of deferred compensation.

Useful Steps: Reducing Asymmetries

Before proceeding to discuss that rethink, however, let me point to some relatively low-hanging fruit: steps that many people who disagree with me about the fundamental flaws in the classic DB system would agree on as ways to improve the environment for those plans. An almost universal feature of these plans is that they do not balance their liabilities with assets that have matching cashflows. This mismatch means that managers who wish their plans to be fully funded (or perhaps in modest surplus) on average should accumulate surpluses in good times and tolerate deficits in bad. But several tax, regulatory and legal provisions make this approach difficult in practice.

First, the federal income-tax code prohibits sponsors of ordinary DB pensions from contributing to their plans when assets are more than 110 percent of plan liabilities. If the Income Tax Act really does need to prevent sponsors from overfunding their plans – a proposition that merits debate – the limit should be high enough to allow for normal variability in fund balance sheets. While this provision is not within the power of the Ontario government alone to change, it is important and straightforward enough to merit inclusion in the Commission's report.

The legal status of Canadian pension funds also works against their prudent management. As emphasized already, DB pensions are deferred compensation the employer must pay when the time comes. While plan participants have an interest in seeing that obligation secured, an economist would say their entitlement is

to the payments, not the assets that secure them. Legal language and case law, however, have led in a different direction. Not surprisingly then, sponsors hesitate to accumulate surpluses to which they may lose title. Since plans with asset-liability mismatches will swing between surpluses and deficits even when they are, on average, fully funded, this asymmetry encourages underfunded plans.

I also note, parenthetically, that grow-in provisions affecting wound-up plans create liabilities beyond those that participants have actually earned. I am no fan of grow-ins, but if Ontario is determined to preserve them, they create another reason to prefer public policies that encourage surpluses.

Until these problems are addressed, letting sponsors put contributions in special trust accounts where they will not be “trapped” has considerable appeal.

Letters of credit to bridge solvency gaps also merit comment. I don’t know how common their use will be: they are unattractive from a tax point of view, and the financial consequences of calling them are so severe that they have a last-resort feel to plan sponsors. They do, however, bring a useful new element into the picture: counter-party judgments about the financial condition of a plan sponsor, considered separately from that of the plan.

This has appeal compared to making the creditworthiness of plan sponsors a formal consideration for regulators. While the latter has compelling logic, it raises problems. In particular public-sector regulators might see public-sector plans as more secure in this respect than private-sector plans. If regulation creates a more permissive regime for public-sector employers than private-sector ones, a tilt toward richer deferred compensation in the public sector, which is already in evidence, would get worse. This tilt distorts labour-market decisions and creates an uncertain but potentially large liability for taxpayers. The independent judgment of quality made by private providers of letters of credit is less problematic from this point of view.

Agency Problems and the Case for More Fundamental Reform

Beyond the case-by-case action required by sponsors and regulators to meet the immediate problems facing Ontario’s private DB pension plans, some larger issues loom. Ultimately, pension funds that cannot now meet their commitments and fail to get lucky enough, fast enough, face unpalatable choices. In many cases, hindsight will doubtless show that the parties involved would do better to turn to a suitable financial intermediary, such as an insurer, to transform a problematic DB plan into a set of better-secured promises, than to wait until litigation further dissipates the plan’s inadequate assets. If facilitating that transition is unappealing as an extension of this Commission’s mandate, I apologize, and proceed to an argument for even more fundamental reforms.

Why more fundamental reforms? The problems of DB plans are so pervasive – in Ontario, in other provinces, and in other countries with similar labour-market institutions and histories – as to suggest that the classic single-employer DB plan has flaws that transcend Ontario, and that legal and tax changes to assist their management, and regulatory ingenuity to alleviate their troubles, are not enough. What might those flaws be?

One difficulty is the widespread practice of divided responsibility for their balance sheets. Investment professionals manage their assets. But human resources departments manage the employment contracts that determine their liabilities. In those cases, no single person or body deals with the overall asset-liability picture – which is essential if employers and employees are to make informed tradeoffs between current and deferred compensation. The difficulties of valuing deferred compensation have also given rise

to gray areas where the line between professional judgment and wishful thinking is unclear – gray areas that help explain the frequency of litigation over pension assets.

These are not small issues. It seems fair to say that representatives of employers and employees have often made arrangements that suit their short-term purposes, but are not in the longer-term best interests of the shareholders and workers on whose behalf they were acting. This sort of agency problem forces the question of whether it makes sense for the voluntary/contractual component of Ontario's pension system to rely on an arrangement where employers bear and manage the risks inherent in DB plans.

The strongest argument for the DB model is that most people dislike financial risk, and lack the skills, time and resources to monitor and cope with it. An employer-sponsored DB plan lets them delegate that to specialists. As DB advocates rightly emphasize, DB plans reduce the chance that two otherwise similar individuals, who contribute identical amounts to identical funds over their working lives, end up with different incomes because they activate their pensions on different dates in different investment environments. Placing investment decisions in expert hands, moreover, may improve their quality, creating higher returns for savers and for the economy as a whole.

These considerations, however, do not make a case for the classic DB arrangement.

While private-sector sponsors whose businesses were insulated from the competitive shocks of the marketplace seemed able to promise defined-benefit pensions in the past, the disappearance of the old monopolies and barriers to competition in sectors such as transportation, telecommunications and basic industries revealed that promise to be hollow. I would argue that the allegedly superior risk-bearing and management capabilities of many DB plan sponsors led them to overestimate the premiums available from equity investment and to underestimate the hazards of asset-liability mismatches. It is true that returns on pooled funds managed in a not-for-profit environment typically exceed that on other forms of saving, such as RRSPs. It is doubtful, however, that a calculation of the returns implicit in the difference between actual pensions received in these industries and the pay employees forewent to get them would always show them as superior to the alternatives. That DB plans appeared to relieve their members of the responsibility for managing risk did not mean that their members actually ceased to bear it.

In the public sector, the DB model appears more viable, because plan sponsors can force taxpayers to meet their commitments if their fund managers let them down. However well government employees may like that arrangement, it does not serve the interests of the average citizen. Ability to shift costs onto third parties does not promote responsible behaviour from either the sponsors or the beneficiaries of public-sector pension plans. In the event of trouble, future taxpayers will end up with the bill. And while defaults when taxpayers become unable or unwilling to fund their government's commitments have been rare in Canada, they have occurred quite regularly elsewhere. Government budgets will be under heavy stress in the years ahead, as demographic changes put upward pressure on spending and downward pressure on revenue. The spectacle of mass early retirements on relatively lavish pensions by public sector workers will not incline private-sector taxpayers to fund deficits in government-worker plans.

Blind Alleys

The agency problems in the classic DB arrangement make government-sponsored insurance for DB plans a bad idea. If such programs are voluntary, they will suffer from adverse selection: only bad risks will opt in. If they are compulsory, they turn into devices for bailing out badly run plans, first at the expense of better-run ones, and usually later at the expense of taxpayers. If Ontario's current limited regime cannot be eliminated, at least it ought not to expand.

Another bad response to the problems with DB plans is to blame the move to market-based valuations. This response amounts to shooting the messenger. Indeed, in Ontario, marking to market has not gone far enough – it is peculiar and indefensible to omit indexed benefits from liability calculations, when discounting them at the real-return bond rate typically reveals that they are very large. “Marking to market” may not always be straightforward. But the occasional need for judgment in valuing illiquid assets or uncertain liabilities does not justify using smoothed or forecast values for readily observable variables such as interest rates or prices of liquid securities. Nor can one justify smoothing and forecasting with reference to the need to avoid volatility in the bottom line. Volatility is a fact of life. Pension-fund managers, regulators, shareholders and employees need to be aware of it. And they need to respond to it. Annual or even quarterly statements to shareholders and regulators using market-based valuations would be a good idea for all plans, both those flagged with solvency problems, and those that appear to be in better shape.

Managers would likely tend to respond to more market-based valuations by reducing the mismatch between their liabilities and their assets – adjusting their portfolios to hold more fixed-income, low default-risk securities that generates cashflows of the right size and timing to meet their obligations. This response strikes me as preferable to an alternative, in which regulators specify degrees of asset-liability mismatch that are acceptable. My own view is that the matched portfolio should be the default. Premiums – investment returns above the low-risk rate – on other asset classes are unlikely to be reliably available, and should certainly not be booked in advance: no asset class has “engulfed the world” the way the traditional equity-premium literature suggests should happen, and it is harder still to believe such premiums are available when so many investors who believe in them are bidding up prices. But plan sponsors who argue that a matched portfolio would make contribution rates unattractively high should be allowed to place that bet – provided that the resulting risk is displayed regularly in a form that participants, shareholders and regulators can see and understand.

Extended amortization periods, while helpful in defusing a crisis, also need skeptical consideration. They inevitably challenge regulators to distinguish situations where sponsors have legitimate work-out plans from situations where they are hoping for a miracle. While new asset categories and hedging techniques might improve the trade-off between long-term returns and risks in pension fund portfolios, and long-term interest rates may be higher over the next decade, neither outcome is guaranteed, and no work-out strategy that depends wholly on such developments is benign.

Before closing this discussion of inferior responses to the DB plan “problem”, let me add a final cautionary note about their labour-market effects. The classic single-employer DB plan’s ability to “guarantee” benefits does not work in the interest of all employees, and therefore has some adverse effects on Ontario’s labour market. The accrual of benefits in a typical DB plan is not neutral as regards place of work. Benefits do not vest at all at the outset of a worker’s time with a single employer, and the full value of the package one employer offers will not typically travel with an employee, or be compensated by the package offered by a subsequent employer, when a person switches jobs. So DB plans may lock employees into jobs that make less than optimal use of their talents. The uneven time-path of accruals tends to tip employees into retirement at a given age. Inflexibility on this front combined with unanticipated longevity has undermined the ability of private-sector sponsors to deliver the benefits anticipated by their plans. Government employees retire years earlier than their private-sector counter-parts, and the prospect that taxpayers will indefinitely underwrite promises that government-employee pension plans cannot support seems unlikely.

In short, the classic DB model tends to impose costs on people who are not party to the contract. If that is so, the presumption that policy should favour such plans looks weak; it may, in fact, be better for policy to encourage a transition away from them.

The Stresses Affecting Individual and Group RRSPs

Money-purchase pension plans avoid some of the key agency problems of the classic DB plan. As advocates of DB plans rightfully point out, however, currently available money-purchase plans have important drawbacks. Some of these are readily fixable; others require much more work.

An easily fixable problem – though not one Ontario can address on its own – is posed by limits on the amount participants can save in money-purchase plans. These limits are often less than the accruing value of benefits in DB plans – especially those in the public sector. Limits on contributions to these plans make no more sense than their counterparts on DB plans: amendments to the Income Tax Act should raise or abolish them.

Second, holders of RRSPs and similar individual accounts typically face important risks. In principle, individuals can hedge against investment risks. Phased transfers of retirement savings into Life Income Funds or Retirement Income Funds can reduce the market risk involved in having to buy an annuity on the day of retirement. Inflation-indexed annuities are expensive, but they are available. The option to hold deferred annuities within a DC plan enables a saver to introduce what amounts to a self-created DB element into it by locking in a given money pension long before retirement. But none of these is straightforward for a nonexpert who gets little chance to gain experience before making critical life-path decisions. Longevity and related risks for dependents are also easier to pool in a group plan.

A closely related issue is administrative costs. With the shift in responsibility for risk management from sponsors to members under money-purchase plans comes an obligation to inform members about dealing with it. Discharging this obligation means a shift in administrative burdens, rather than an outright reduction. Notoriously, individual and employer-sponsored RRSPs feature high investment-management costs as well. While competition among suppliers and instruments should lower these costs over time, and the lower charges typical in the United States suggest that this will happen in Canada, the loss of economies of scale in individual accounts is a problem. Lack of access at reasonable cost to certain types of assets is also a drawback of RRSPs and small money-purchase plans: highly leveraged or other business structures that cut out the corporate layer of taxation are obviously attractive for tax-deferred investors, but unless the federal and Ontario governments establish a dividend tax credit for pension savers, small investors will have difficulty accessing these assets.

Since most Ontarians will save for retirement – nearly all to some extent, and many exclusively – through individual accounts, policy must not ignore their plight for the sake of focusing on DB plans. Higher contribution limits, more flexibility in drawing down and topping up, and intelligent mandates for consumer information about fees would all help to make these plans more congenial for the people who will use them. For sponsors of group RRSPs, the kind of “safe harbour” provisions now under consideration in the United States would create welcome legal protection against the possibility that good-faith attempts to encourage employees to save enough and in the right ways will expose the employer to litigation.

Scoping out Alternatives: The Promise of Hybrid Pooled Plans

While dealing with the challenges to the classic DB plan and the prevalent alternative of RRSPs, Ontario should consider alternative models that would provide some of the benefits of both, while mitigating their

problems. A number of advocates have pointed out that a variety of hybrid plans are conceivable. For instance:

- A plan would logically be predominantly money-purchase, so as to avoid the problems with a larger guarantee than a sponsor can underwrite at acceptable cost, yet provide a minimum guarantee, backed by appropriate assets.
- A plan could impose contribution rates — perhaps mandatory, perhaps a default rate with participants accepting the consequences of deviating from it — geared, in light of evolving investment experience, to providing a target payout.
- A plan could impose a portfolio — again, perhaps a default portfolio, with the participants accepting the consequences of deviating from it — that would increasingly insulate people against movements in annuity prices as they approached retirement.

A key feature of these proposals is that they typically envision pooled plans – multiemployer arrangements that would reap economies of scale while pooling investment risk across a large number of individuals. Arrangements with some of these features exist in countries, notably the Netherlands and Australia, where pension coverage is a mandatory part of the employment contract (and where parts of the tax-funded and compulsory state-run systems that in Canada are covered by OAS/GIS and the C/QPP are smaller or missing). Some examples of pooled money-purchase plans also exist in the United States and Canada. The Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF) south of the border is worth a look; here in Canada, the CSS Pension Plan in Saskatchewan has participants in other provinces, including Ontario.

A useful challenge for this Commission would be to define more precisely the requirements of healthy collective contributory systems along the lines just described, and focus on the public policy actions and private entrepreneurship necessary to bring them into existence.

Conclusion

Work-related pensions exist because employers and employees often want to strike a bargain that covers both current and deferred compensation. Public policy inevitably regulates labour-market contracts, and pensions in particular need such regulation because of the particular information and agency problems that can arise with regard to payments that will occur a long time in the future. For decades, the classic single-employer DB plan has found favour with commentators, and some advocates imagine a future in which a growing share of working Ontarians will belong to plans like those of most public servants. The mandate of the Ontario Expert Commission on Pensions appears to owe something to this inspiration.

The core thrust of this brief is that such a vision is misguided. While some of the policy-related problems facing classic DB plans are susceptible of improvement – through flexibility in the timing of, and tools for, shoring up balance sheets; changes in tax provisions and other laws that encourage underfunding – relaxed accounting and reporting standards, or tax-funded backstops would exacerbate the agency problems that led DB plans into their current fraught state. Attempts to re-establish a “golden age” of DB plans that never truly existed would be a dangerous distraction from two other urgent tasks.

One of those tasks is to improve the tax and regulatory environment for existing money-purchase alternatives. While individual and group RRSPs have key flaws as retirement-saving vehicles for most Ontarians, they are inevitably going to play that role for most Ontarians for years to come. Better tax and legal treatment of these plans is critical, and a narrow interpretation of this Commission’s mandate that neglected those people would be unfortunate.

The second task is to search for new models that can offer Ontarians more attractive means to pool their resources and save for retirement in ways that mitigate not only financial risk and longevity risk, but agency risk as well. The path from current multiemployer plans to the kind of hybrid pooled plan that could achieve these goals is not smooth, but the destination would make even a difficult journey worthwhile.