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Off the Hook, For Now: Taxpayers Should Hope that Talk of Federal Pension Guarantees Ends With the Minority Government

By William Robson

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The November 14 mini-budget gave Canadians some new dollars-and-cents calculations to weigh in judging whether they want to vote in the snow. But they should not overlook another risk that has been hanging over this minority government — the possibility of a huge and costly mistake in pension policy.

Pension policy in Canada needs a fresh look. Canada's defined-benefit pensions are in trouble: many are underfunded and exposed to the financial stresses of their sponsors. But some proposed fixes could make matters worse. NDP leader Jack Layton has talked in recent months about pension protection as a condition for keeping the Liberals in power. While we do not know what he has in mind, a federal pension-benefit guarantee agency — a deeper-pocketed version of Ontario's Pension Benefits Guarantee Fund — is an obvious option.

Such an agency, like counterparts in the United States and the United Kingdom, would backstop pension plans when sponsors went bankrupt. The agency would levy premiums on the plans it covered, and pay all or part of their benefits if a sponsor failed.

Especially for current, or soon-to-be beneficiaries of troubled plans, the idea has obvious appeal. But pension policy is a poster-child for the notorious law of unintended consequences. Desire to improve the lot of pension-plan participants has motivated decades of decisions by legislators, regulators and judges. The result? Many existing defined-benefit plans have huge deficits, next to none are starting, and the number of workers they cover is in decline. A federal pension guarantee would either expose Canadian taxpayers to ill-defined and possibly huge liabilities, or push defined-benefit pensions one step closer to extinction.

Mr. Layton is not alone in worrying about Canada's troubled defined-benefit pensions. Bank of Canada Governor David Dodge recently noted that plans paying pensions geared to years of service and earnings have many merits (Dodge 2005).

By pooling investment and longevity risks among large numbers of people, they open up investment opportunities that individuals cannot easily access on their own. Skilled management of these large pools of capital steers saving to high-value investments. So defined-benefit plans can pay higher pensions at lower cost than RRSPs

We would miss these plans if they disappeared for other reasons. On average, workers in the future will be scarcer, older, and wealthier. Employers and employees will need plenty of tools to craft deals that keep people happy and working. Many workers and businesses value defined-benefit pensions. These plans offer workers more predictability about their retirement income than defined-contribution plans do, and can be tailored to reward loyalty. Removing them from the toolkit will make courting and keeping employees harder.

If we like defined-benefit pensions, why is policy undermining them? A central problem arises from one of their core features: because their managers do not have the same risk and liquidity concerns that individuals saving for retirement do, they can invest in assets whose value does not move identically with their liabilities — the discounted value of their future payments. This mismatch means that their net worth fluctuates. Sometimes, combinations of poor returns on assets and low interest rates, used in discounting future payments, mean they have deficits. At other times, good returns on assets and high discount rates for future payments mean they have surpluses.

Since sponsors must cover deficits, logic suggests they should have access to surpluses. But policymakers and the courts have eroded that access. Sponsors fear that if market movements give rise to a temporary surplus, they could lose it. Consequently, they shrink from funding their plans as well as they should. Moreover, the Income Tax Act forbids contributions to most defined-benefit plans if their surpluses are larger than 10 percent of their liabilities, but provides no offsetting subsidy when plans have large deficits. Since normal fluctuations, even in well-run plans, can create either surpluses or deficits larger than 10 percent, this asymmetry also promotes underfunding.

When, as now, plans have deficits, and regulators impose penalties and mandate larger contributions, a vicious circle arises. Current practice lets managers who invest in riskier assets that generated higher returns in the past project those returns into the future. Those projections improve the look of plan balance sheets, and better plan balance sheets are good for reported earnings. Pressure from regulators, therefore, can encourage riskier bets. Spectacular smashes in the car, airline and steel industries have shown how bad pension plan bets can damage a company with healthy operations, and finish a sick company off.

Hence the attraction of a federal backstop for underfunded pensions — and the danger. The moral hazards government guarantees create are on lurid display south of the border, where the unfunded liability of the US Pension Benefit Guaranty Corporation is US$26 billion and mounting. As the US Comptroller General testified to Congress earlier this year, this backstop encourages managers who cannot afford higher compensation to offer higher pensions instead of wages, and encourages companies to shirk funding pensions the government will have to pick up (Walker 2005).

If he had been rude enough to cite examples, the Comptroller General might have pointed to United Airlines, which hiked the promises of a badly underfunded pension plan in 2002, and dropped a US$6.6 billion obligation on the Guaranty Corporation when it declared bankruptcy nine months later. A government backstop allows companies that slough their pension obligations to get a leg up on competitors that honour theirs.

In principle, a pension guarantee agency could address moral hazard by gearing premiums to sponsors' risk. Only in principle, however — three difficulties make it unlikely in practice.

First, politics. The federal EI program should penalize industries that lay more workers off. It doesn't — in fact, it subsidizes them at the expense of those that lay off fewer.

Second, assessments of risk tend to be backward-looking. Risk-adjusted premiums will therefore fall more heavily on plans already in trouble. The UK's Pension Protection Fund only started operation this year but is already confronting the inevitable dilemma. It can charge premiums too low to cover its obligations. Or it can charge the rates — far higher than the UK government's original estimates — that would keep it out of deficit, imposing costs that encourage firms that are less likely to need the backstop to wind up their plans.

Third, the risk-based premiums currently charged by pension-insurance agencies ignore mismatches between plan assets and liabilities (Bonner 2005). Charges geared only to plan balances, or the financial condition of the sponsor, have the same effect as regulatory penalties. They encourage managers to invest in riskier assets with higher projected returns, amplifying swings in plan fortunes and the damage when those bets do not pay off.

The moral hazard of government guarantees, moreover, can easily sweep away pre-set limits. The Pension Benefits Guarantee Fund in Ontario, the only Canadian province to travel this dangerous road, covers pensions only up to $1000 per month, and has used partially risk-based premiums for years. Yet the depletion of its fund by the Algoma Steel bailout necessitated an interest-free loan from the government of Ontario last year.

Now, fears that the $1.3 billion deficit in Stelco's pension plan might swell the Fund's $100-million-plus deficit inspired Ontario's recent offer to extend Stelco a $100 million loan. The terms of that loan could make the government of Ontario a shareholder in the bankrupt company. The US Guaranty Corporation is already a major shareholder in one US airline, and will likely soon get sizeable stakes in others. So a pension backstop can be a backdoor to nationalization of declining industries.

An early election could spare Canadians other problematic details — such as the federal-provincial squabble over a federal role in a predominantly provincial area. If it does not, however, Canadians should heed last month's warning from a former executive of the US Pension Benefit Guaranty Corporation (Dellinger 2005): "The entire pension insurance idea encourages high-risk behaviour, unfunded promises, a corrupt competitive environment and ultimately will shift the burden of the private defined-benefit pension system to the taxpayers."

Many avenues toward healthier defined-benefit pensions exist, such as balancing sponsors' risks with regard to plan surpluses and deficits, ending penalties for "over contributions," and closer attention by sponsors and regulators to asset-liability mismatches. A federal pension guarantee, however, illustrates the truth of the adage that when a deal looks too good to be true, it almost certainly is. Legislation, regulation and litigation have already brought defined-benefit pensions in Canada to the edge of a cliff. Reacting with a federal pension guarantee, ironically, could help push them over.

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This e-brief is a publication of the C.D. Howe Institute. For more information contact: William B.P. Robson, Senior Vice-President and Director of Research, C.D.Howe Institute (416) 865-1904, ext: 223, cdhowe@cdhowe.org, www.cdhowe.org.