Pension Insolvency: Intelligent Solutions Needed

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Pensions
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The plight of retirees and other members of Nortel’s and other insolvent pension plans brings into focus the need for intelligent solutions to complex pension issues. Unfortunately, much of the recent public debate has been unbalanced, ill-informed and has failed to properly recognize the policy objectives of insolvency legislation and pension legislation.

Greater Protection

Bankruptcy and insolvency legislation in Canada (the Companies Creditors Arrangement Act and the Bankruptcy and Insolvency Act) was recently amended to provide greater protection for pension plan members (see Heenan Blaikie’s Labour & Employment in the News dated July 17, 2008). Changes to the legislation had been subject to lengthy debate and public consultation. The amendments received Royal Assent in 2005 and were proclaimed in force in 2008.

Bankruptcy legislation now provides a super-priority for employee and employer contributions to Defined Contribution pension plans and employee and employer “current service” contributions to Defined Benefit pension plans. This means that these amounts rank ahead of claims of ordinary creditors and secured creditors. The super-priority does not, however, apply to employer “past service” contributions required to pay off the underfunding in DB pension plans that is the subject of the recent turmoil.

The funded status of pension plans and the associated deficits and surpluses are calculated by actuaries using various economic assumptions. The amount of employer and employee contributions to a pension fund, the investment performance of the fund, prevailing interest rates, the demographics of the pension plan membership, the design of the pension benefits, termination rates, mortality risk and other factors all affect how well funded a pension plan is at any particular point in time.

Never Constant

The funded status of a pension plan is never constant. Prevailing interest rates, for example, which are out of the control of plan sponsors, can have a marked impact on liabilities in a pension plan. The lower the prevailing rates are, the higher the liabilities, resulting in a decline in the funded status of pension plans. Just this month, the federal Office of the Superintendent of Financial Institutions reported that defined benefit pension plans in its jurisdiction are, on average, 88 per cent funded as of June 30, 2009. This is up from 85 per cent in December 2008.

In the 1980s and 1990s much of the debate centred around pension surpluses, who had a right to surpluses and whether employers could take contribution holidays. At that time pension surplus was coined as “actuarial error.” The Supreme Court of Canada, in its landmark decision in Schmidt v. Air Products in 1994 referred to the distinction between “actuarial” surplus and “actual” surplus. During the ongoing operation of a pension plan, a surplus is simply an actuarial number. It becomes “actual” or certain upon wind-up.

Now the focus is on pension deficits. The same Schmidt characterization can be used for pension plan deficits. An on-going pension plan may have an ‘actuarial’ deficit, that will go up and down as actuarial assumptions, economic conditions and the experience of the pension fund change. An actuarial deficit becomes ‘actual’ or certain only upon wind-up of the pension plan. It is upon wind-up that the extent of underfunding and its impact on the plan members is determined.

Pension legislation in each province (except Prince Edward Island) and at the federal level in respect of federally-regulated employers, imposes funding requirements on plan sponsors in order to provide protection for plan members. The funded status of a pension plan must be calculated every three years and, in many cases, annually depending upon the jurisdiction of the pension plan and the degree of underfunding. Contributions are set according to a schedule of payments to amortize (pay off) the deficits.

Too Rigid

Pension legislation is public policy legislation designed to fairly balance the interests of plan sponsors and pension plan members. Many argue this is where the focus should be, to address pension funding issues in an intelligent and efficient manner. In fact, legislatures across Canada have recently
introduced temporary solvency funding relief measures. In doing so, they have recognized, albeit too slowly, that solvency funding rules were too rigid and burdensome on plan sponsors and failed to account for the current economic conditions.

In the recent debate focused on members of the Nortel pension plan, there have been calls to further amend bankruptcy legislation in order to fully protect, or give a super-priority for, the entire underfunding of pension plans in the event of insolvency or bankruptcy. This would indeed represent a fundamental change in the bankruptcy scheme. It would, in effect, place the burden of pension funding on an employer’s creditors. Question whether the more appropriate focus should be on pension reform, rather than on bankruptcy reform.

The policy objectives of pension legislation and bankruptcy legislation are quite divergent. From the above it is apparent that it would be inconsistent for governments, on the one hand, having introduced more flexible funding rules to ease the burden on plan sponsors and, on the other hand, to amend bankruptcy legislation in such a way as to place the burden of pension underfunding on a plan sponsor’s creditors. Pension funding rules are best dealt with in pension legislation. Such legislation should strike a fair balance between the rights of plan members and the obligations of plan sponsors.

*Mark Newton is with Heenan Blaikie. This article appeared in the October 23 issue of Heenan Blaikie’s Pension Pulse.*