GLOBAL FINANCIAL CRISIS
FOCUSING ON PENSION

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09/02/2009

With the Morgan Stanley Capital International (MSCI) World Index showing a negative return of 25.8% for 2008, private pension systems took a major blow across the globe. As shown by an OECD research recently published, pension funds in certain countries representing two thirds of total private pension assets in the OECD area have experienced by October 31, 2008 negative returns of over 20% in real terms (i.e. after taking into account inflation). Countries where pension funds had larger exposure to equities, such as the US, the UK, Belgium, Canada and the Netherlands experienced greater pension asset losses.

This newsletter outlines the critical impact for plan participants, including the reactions of some policymakers, as well as the lessons to learn from the ongoing financial crisis.

Impact on participants

With the recent trend from defined benefit to defined contribution schemes globally, the market downturn has heavily hurt participants in defined contribution schemes, and their losses depended largely on the fund's asset allocation and their age. Older workers with high equity exposure suffered the most. In defined benefit schemes, the main concerns are the deterioration of the funding level of schemes and possible benefit cutbacks if the plan sponsor goes bankrupt.

In Canada, plan participants in defined contribution schemes can generally make their own investment choices within guidelines. While such features are valued by employees, they can be highly risky in periods of crisis if no proper mechanisms are in place to address the "timing risk" when buying annuities or transferring funds at retirement. With the average Canadian pension funds experiencing large negative returns, a lot of pressure is placed on the defined benefit plan sponsors who are facing additional cash flow requirements.

Moreover, pension funding positions in company accounts (in Canada and other countries) may have improved in 2008, since significant asset losses in pension schemes could have been matched by reductions in the pension liabilities accounting value due to credit spreads being higher than normal. The fact that certain AA corporate bonds have lost value during the credit crunch does not necessarily mean that such pension liabilities are truly lower on a fair value basis, and is hiding the problems faced by plan sponsors. Some companies are looking at strategies for exiting their pension liabilities, often at the detriment of plan participants.

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Policymaker reactions

After such disappointing investment returns, some regulators have decided to provide plan sponsors with more time to allow funding levels to return to the targeted levels. For example, the Federal Government in Canada extended the amortization periods to fund solvency deficiency for certain schemes. In addition to increasing the amortization period, Quebec's proposal contains some guarantees that protect retirees in the instance of plan sponsor's bankruptcy. In the US, Congress enacted, at the end of 2008, amendments to their recent pension reform in order to mitigate the impact of moving towards a closer-to-market valuation basis. The Dutch regulators are considering an extension of recovery periods to targeted levels for under-funded pension schemes, on a case-by-case basis, although the existing funding regime already has "built-in cushions". Similar policies are being considered or put in place in many other countries.

In defined contribution schemes, policymakers are considering, in certain territories, the introduction of default options that shift towards lower risk investments as the retirement date approaches.

More drastic approaches have been taken such as nationalizing the private pension system in Argentina, in October 2008, and bringing contributions and assets back into their social security system. In some Eastern European countries, there are also discussions to allow participants to go back to the public pension system.

Some lessons to learn

In concluding, stronger pension fund governances are required across countries, especially for smaller plans. Greater expertise and knowledge are needed on pension boards, including the appointment of independent experts. Finally, in view of the financial crisis and rapid growth in defined contribution schemes in many countries, effective financial education programs and information disclosure are key elements to the proper functioning of private pension systems.

I am pleased to address any questions you may have, and also provide you with further assistance on local or international pension issues.

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