Pension Clarity

THE LEADER'S GUIDE TO SMARTER PLANNING FOR OUR FUTURE

M. CATHERINE MILLER

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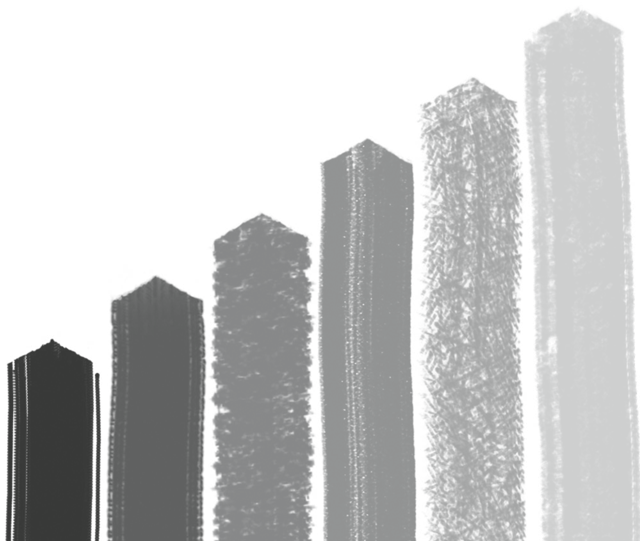

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For my family

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INTRODUCTION

GLOBALIZATION has led to a shift in social, political, and economic factors, which include geo-political and financial boundaries, trans-governmental and local policies, and the nature of resource allocation and regulation, as well as aspects of business and social cultures. Under globalization, the way in which authority and risk control is applied in practice could be said to be changing, and this includes the pension sector.

At the same time, in the pension market, these shifts are not fundamental enough to help companies transform their pension promises quickly. Instead, in the last few years, we've seen many globally significant companies try to rapidly change the way that they manage their pensions in response to downturns in their industries, and we've seen firms accumulate significantly underfunded pensions. But these approaches have more often than not put these companies, and their shareholders, at risk. Bloomberg Markets reported that by the end of 2017, the

largest S&P 500 companies' pension funds were facing a $382 billion funding gap. As a case in point, General Electric (GE), although it was sitting on a pension surplus of $14.6 billion in 2001, was running a deficit of $7 billion a mere seven years later, in 2008. By the end of 2016, the GE deficit was $31 billion. One year later, by the end of 2017, the deficit was about $100 billion.[1]

Something has to change. In the new global economy, businesses and organizations need renewed optimism for their pensions. And change is coming: we are seeing expansions in the pension industry and progressive, sustainable solutions that can lead to a different way of thinking about pensions and offer hope for those who want a better way of doing business, or at least a more realistic one.

To build a prosperous future for people, business, and society, leadership has to be at the centre of our decision-making process when creating and sustaining pension plans.

Pension obligations consist of payments owed to current and future retirees, this year and the year after, and the year after that, and far into the future—obligations that should have been advance-funded by paying into the relevant pension funds the amounts needed to cover those benefits, year by year, as those benefits were accrued. Every year that an organization fails to do this, or the pension industry fails to advise on such actions, is a year in which they place obligations on future generations

of employees and of the company itself. This is a risk that no leader should be willing to take.

How do we define true leadership in this context of pension transformation? As fairness? Ownership? A will to manage?

We must be realistic about our expectations for pensions.

Leadership means that we need to imagine a different future for the pension market: one in which there is an agreement about what will mitigate risk and keep our people, our organizations, and our global society safe and secure. To this end, trusting that the market will correct itself is no longer enough, as clearly we have proved ourselves incapable of relying on market forces alone. If we are to be a sustainable global society, then we need to create, implement, and monitor regulations that will work in this environment. The current shifts are reflective of our first steps towards this goal, but more needs to be done to ensure a high level of risk management in our pension planning over the long term.

In this book, we'll explore just how to address these insufficiencies and opportunities in pension planning for the future. We'll discover just how much our risk management has to do with leadership, rather than with crunching numbers.

We will cover three essential pension leadership strategies in this book.

1. **How to design your pensions for financial security.** An employer's financial obligation to pension promises is a long journey; the pension promises offered today need to be sustainable throughout the lives of individual members. At the same time, the regulatory landscape is shifting. This offers companies more flexibility, not necessarily more complexity or cost. For example, many companies' existing benefit plan provisions were likely established decades ago: these need to be examined on a regular basis, especially when regulations change. Many expensive options that are adding cost to the plan, but little value, are likely still in your provisions. Employers need to look anew at their defined benefit promises, and focus on funding the most profitable benefits and offloading outdated provisions.

2. **How to create pension plans designed for people, not the experts.** Pensions are misunderstood, both by companies and by employees, partially because their benefits are not clearly communicated. Client letters and employee pension statements are math heavy and full of industry jargon, and most look more like a legal document than like something that people can use. With a simple and pleasant approach to communication, people will understand and appreciate their pension programs. They'll engage in pension processes, and that means they'll act like true stakeholders in the company. Evidence shows

that plans designed for people increase overall accountability for pension performance and have a positive impact on employee performance.

3. **How to build responsiveness into your business environment.** Supporting pension discussions with data brought to the table by experts is important; but even more so, executives need to be able to understand pension benefits and their implications in the moment. Instead of raising questions and then waiting two weeks for a team of pension analysts to come back with answers, leaders can access up-to-date information, trends, and projections easily mined from new HR system technologies. Knowing how to view and use this data can help executives cut through the clutter and focus on strategies that deliver immediate results.

We can make pensions work. But the pervasive, ongoing uncertainty means that organizations need to get their actuaries and pension advisors working in a fundamentally different way. Modern pension design should work for individuals and society while building successful companies at the same time. Pensions are about people, not simply numbers. To build a long-term, sustainable pension plan that's beyond the norm of traditional pension management, we need to think creatively, reflexively, and confidently, and we need to start with leadership.

1

WHAT'S PAST IS PAST

Pension success is about resilient performance and parity in an age of uncertainty. But pension security, our way of working, and the capital market have become more intertwined than we're willing to admit.

Why is this challenge important? In economic terms, financial security and stability create the peace of mind we feel when we aren't worried about covering our expenses thanks to our reliable income amount. It also means that we have enough money saved to cover emergencies and future goals. Financial security means having enough money for the rest of our lives once we retire from work. Our pensions are meant to deliver that money.

In the past, however, loopholes in corporate and organizational policy frameworks for the pension market have made it difficult, if not impossible, to ensure adequate funds for employee retirement. That's because a pension manager's ability to use business acumen and good judgement affects whether a pension plan will provide after-work financial security for employees.

But before we get to how to provide that security, we need to look to the past to examine what legacies we're dealing with when it comes to pension planning.

The human organization, namely, the ability of a company to recognize the value of its human assets through compensation practices, has been cited by writers in all fields of international business as a key differentiator between those companies that will be successful and those that will not in the next century. A firm's way of managing its employees, including its pension benefits, can give it an advantage over its competitors and lead to positive organizational growth. But, as the examples below show, the reality is that growth has been and is still being leveraged in a way that does not sustain employee needs. No matter what pension plan is developed, attention to accounting practices in pension management will only increase in the wake of widespread challenges associated with the current global economic crisis and the ensuing media criticism of pensions, executive pay packages, and perquisites.

Let's examine some of the challenges that organizations have faced in the last few years and explore why they have been so deeply problematic.

Sears Canada. The Sears Canada pension made headline news in late 2018 because of an underfunded pension plan that seemed to be, according to a lawsuit against

Sears Canada's largest shareholders, created to benefit investors rather than those who contributed to it in the first place. While $509 million in dividends was paid to Sears Canada shareholders in 2013, the pension fund was short $133 million by the time the company shuttered its doors in 2018, according to court documents.[1] In a deal structured in October 2019, pensioners stand to collect about $48 million, which, according to the lawsuit, is less than a tenth of what they should have received as a result of their investment in the company. Nonetheless, Sears did not do anything exceptional; in comparison to its industry, its actions were status quo and the company did not break funding rules. The more damaging challenge to employees, therefore, may be the pensioners' argument that the 2013 dividend payment crippled the retailer's ability to remain in business, because it made it difficult for the company to gain access to liquid capital when it was required.

General Motors. In his book *While America Aged*, Roger Lowenstein describes GM's unsustainable pension promises—which shifted from a symbol of generosity and endearment of the employer to a horrendous debt that all but bankrupted the company—as a warning call.[2] GM built back its pension after a debilitating few years of poor management, with the company closing its Canadian plants, while employees were left confused about

what they may have sacrificed in the short term. Active plan members and retirees are likely to be simultaneously relieved that the company recovered and reinvested $1.6 billion in its Canadian pension plans and deeply concerned about GM shutting down its operations. And yet, the company had the pension industry's best and brightest advisors, including actuaries, investment experts, lawyers, and accountants who created a plan that was regulatorily sound. As with Sears Canada, there may be worry that the company has only shifted money from one part of the business to another, leaving employees' needs at the bottom of its concerns. Counting on the market to prosper and fix the issues is a classic mistake.

GE. GE has the largest pension deficit among S&P 500 companies, affecting 600,000 people, and that deficit is $11 billion worse than the next closest company, according to S&P Dow Jones Indices, and likely running close to $50 billion in 2020. It's also going into freefall. Although a pension shortfall now, it was once a surplus of $14.6 billion, in 2001, when Jack Welch retired as CEO. At his leaving, GE decided to put money into mergers and acquisitions instead of keeping it safe for employees. With the company's current cash challenges, it has relied on stock buybacks to try to stem the tide, but this has not resulted in positive changes. GE cashed out at the bottom of the market and created alternative investment plans, and even

though the Dow Jones recovered, alternatives did not provide GE the same level of return. New deficits piled up on the old deficit so much that GE's original position was never recovered. In fact, GE's massively underfunded pension may not only be a risk to its existence, and to the livelihood of its employees and retirees, but may also have larger economic implications because of the scale of its operations, should the company fold.[3]

CPP/QPP. Even the Canada and Quebec Pension Plans are going through a major transition. In 2018, it was announced that starting in 2019, Canadians' Canada Pension Plan contributions would increase from 4.95 per cent to 5.1 per cent on earnings between $3,500 and $57,400. It was the first of five years of graduated increases running until 2023, when the rate will reach 5.95 per cent. "You can think of it as a cost right now, but you're actually going to be contributing toward an enhanced Canada Pension Plan benefit over time, ultimately leading to a higher amount of pensionable earnings," said Jamie Golombek, managing director of tax and estate planning with CIBC. "So you're actually going to get something in return for that extra contribution."[4] This increase in contributions is necessary because CPP, like corporate pensions, has become underfunded. The goal of the government, however, is to recognize our changing demographics and the need for a more sustainable retirement plan for Canadians,

and these increased contributions are a means to shift the status quo. The Canadian government has chosen to take this route because of the ongoing insecurity in the corporate pension world as well.

These examples illustrate what can happen when deals are made to shortchange the pension system and chronically underfund individual plans. They go well beyond poor financial planning, illustrating the collapse of what we believed were our retirement certainties. In fact, cases such as these don't reveal a lack of financial analysis, but rather a human tendency to stay on the path of least resistance, or, in some cases, a lack of ethical boundaries between the interests of those in leadership positions and those who serve these firms as employees.

There is a bigger issue, however.

Over the last two decades, the concept of retirement has shifted to become an aspirational lifestyle in which we will travel, experience freedom, and generally get all the benefits that we expect. We have also experienced a sociological shift in how we live after the age of sixty-five; few families support the elderly at home, and independence has become the norm. These changes have placed a huge burden on pensions and retirement investments that, because of larger economic forces as well as market shifts, may or may not come through. And when the investments don't generate sufficient income, the finance industry

is always eager to offer fixes such as hedge funds and derivatives that can't solve the long-term problem either.

What has to be recognized, no matter how you crunch the numbers, is that today's corporations, as both stock fund providers and pension providers, are taking on more than just the role they did in the past by providing retirement support for the majority of Canadians. Our society relies on pensions to ensure that our retired and elderly community members are safe and secure as they age. Organizations have a responsibility to shift towards equity and to recognize the value of employees.

The pension leadership path forward

The path ahead will be an awakening—a time for pension plan managers to look at seizing opportunities and not just at surmounting challenges. Potential external shocks to the system continue to lurk, and growth cannot be taken for granted.

Successful organizations will have come to terms with the fact that in the new paradigm taking shape around them, some of the old rules simply don't work. Regardless of size and segment, pension funds now need to be nimble, resilient, and easy to understand and upgrade over time. Pension managers need to prepare for uncertainty, and achieve ever-greater value for cost. They need

to take an active stance on social issues, satisfy member demands for radical transparency and sustainability, and, most importantly, have the courage to disrupt their own sources and their traditional beliefs to realize these changes and win new generations of workers so that they can better compete in the new global economy.

Major trends are beginning to define the pension agenda.

Ownership

On the investment side, we foresee shifts in understanding what ownership means to pensions: Is the company or the employee the owner of the fund? One of the most important challenges is evolving pension planning from a mechanical exercise based on number-crunching into a transformational-change mentality based on leadership and common sense. More secure and efficient joint governance platforms in which employees have a stake in what can be achieved with their pensions are needed.

Common sense is all about achieving parity. This requires

- understanding controllable risks;
- deliberation about how age, gender, and other social differences affect what people can expect to earn on their pension during their working years; and

- understanding fundamental management challenges in the type of pensions that are chosen, and the systems behind each.

The management of pensions is often focused on the financial makeup of the pension design, when in fact the economic benefit may be better derived from a broader approach that accounts for the macro economy as well as the performance of the firm. Because demographic changes have intensively affected pensions over the last thirty years in particular, pundits posit that it may also be helpful to measure the impact of political and regulatory changes as well as future growth in the development of a pension management program.

Externalities may affect the development and management of funds. Because more and more corporations are putting the onus on their employees to participate in choosing and managing the mutual funds that now make up the majority of their pensions, this must be considered on an ethical level.[5] Pension management research shows that underlying this global movement of participant choice is an implicit assumption about behaviour: that employee-citizens to whom the responsibility of choice has been handed are well-informed economic agents who act rationally to maximize their self-interest. But, as one can clearly understand based on what happens in real-life pension situations, this ideal is not reflected in reality.[6]

Most individual employees make decisions based on emotions rather than on rational thought, which means that pensions are not necessarily the retirement panacea they are thought to be.[7] Overconfidence in their own financial planning abilities means that many people believe they can live well on relatively small asset pools during retirement. Yet after leaving work, they then find they run out of money, sometimes within a few months of retirement. This also means that because employees in Canada will likely not be able to solely rely on the CPP/QPP system, they will need to understand the value of their company pension to their own long-term security. This should be accounted for when managing a pension plan at a corporation.

If human decision making regarding financial planning is flawed, then less risky investment choices may be more ethical components of a well-developed pension program. It is also clear from the research that if an external mutual fund system is used, then companies must create an ethical way to introduce their employees to financial management. Because employees may not be able to choose well for themselves, and because they have been proven to be overconfident, the company must complete due diligence in ensuring that employees understand the choices in funds. A company that follows these recommendations will likely be able to create a sound and sustainable corporate pension strategy.

Sustainability

There is a need to examine ongoing concerns about sustainable returns and how to alleviate pensions' impact on the environment—for example, through investments in oil and gas.[8] More and more pension members and stakeholders will also push for greater transparency into resources and financial security, which makes shared-risk relationships a priority.

Environmental, social, and governance (ESG) refers to the three central factors in measuring the sustainability and ethical impact of an investment in a business. These criteria help determine the future financial performance of companies (return and risk). This means that companies have to re-situate their responsibility to the needs of stakeholders (anyone who is influenced, either directly or indirectly, by the actions of the firm) rather than those of shareholders. It also requires a company to conceive and use a reciprocal social structure that takes the needs of all stakeholders into equal consideration. The company must also invest in sustainable development and business practices, which subject their pension management processes to a higher level of criticism, and will benefit from redefining profit as not simply financial gain but the total benefit enjoyed by the society in which the company operates.

Capitalism is premised on a system of unlimited growth, but this does not mean that it has to use all our

environmental resources to achieve this goal. Although there is no theoretical obstacle to profit for a given corporation, companies can shift the way that they invest in pension plans. Capital can acquire more capital, but it is not the case that this capital necessarily has to be sourced from the same value chains as in the past. One can invest capital in extracting natural resources that are not sustainable, or one can invest it in financialization sectors like hedge funds or mortgages that have been bundled together by a bank and sold as shares and traded: both are equally risky and equally able to provide a profit.

But what about the risks?

Five risks are tied to planning pensions *without* sustainability in mind, according to field research:[9]

- **Climate policy risks.** Constraints on the advancement of non-renewable technology means that businesses face new regulations on research, development, supply chain management, and transport, no matter what industry they are in.

- **Commodity price risk.** Take the oil industry as an example. The collapse of oil prices over the last five years means that expensive reserves forming the next phase of expansion in Alberta's north will remain undeveloped. In addition, although a recent decision by OPEC and its allies to cut production by 1.2 million barrels per day should be enough to bring the oil market into balance, this is not sustainable.

- **Energy innovation risk.** Renewable costs for electricity generation in many parts of the world are now about the same or less than those for building new fossil fuel plants, but demand will be growing.
- **Carbon liability risk.** The link between carbon emissions and damages is evolving, and it is possible that in the future carbon producers will be held liable for damages, in the same way that tobacco companies were sued for health damages resulting from use of their products.
- **Community opposition risks.** Global megaprojects and even local developments are facing greater scrutiny than ever before, and it has become the norm to ask whether a project has “social licence” to proceed in a community.

The goal, therefore, for the average company is to become aware of planning processes that aren’t modern and ethical and to become open to changing the status quo. The economic gains made from the business principles developed in the past have slowed as it becomes harder and harder to increase production capacity without harmful effects on the world around us. This can affect both a company itself and how it invests on behalf of its employees.

Expectations

Business managers need ever-simple and effective ways to improve their organizations' and their workers' financial wealth.

Wise companies are prepared to disrupt the pension ecosystem, strip down pension ideas to their basic principles, and focus on sustainability to reduce reactive acts that respond to noise instead of trends.

Let's say you have acquired a billion-dollar business and have expectations about how this new division should perform, and how you'll pay off your initial investment. That's what it should feel like when you think of pension plans, which, just like your acquisition, are going to cost you a significant amount of capital. Will you let your plan run wild or will you make sure you have a well-thought-out strategy to manage it?

What we've learned from the examples of the past is that perhaps even the biggest firms should start to manage their pensions like smaller ones do. Think about how this might work. Leaders of a larger company, one that has more assets at hand, may feel as if they are more likely to be able to mitigate the risk of pension investments because they have significant capital assets, whether or not they actually can. At the same time, these institutions may be more likely to take on pension fund risks, knowing that a small loss in one sector is not going to put another sector at risk unnecessarily. More prudent companies will

be more likely to invest in less risky assets for their pensions. This means that they will be less likely to encounter both the highs and the lows of the market, because they need to keep more capital in low-risk investments to protect their employees' interests.

In the next chapter, we'll discover what questions we can ask and what purpose we can create for our pensions so that we can mitigate the kind of risks that we've discussed here and instead move towards pensions that work for organizations and employees alike.