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International Fisheries Commissions Pension Society

International Fisheries Commissions Pension Plans

At its recent Annual General Meeting, the International Fisheries Commissions Pension Society discussed the need to assist Commissioners of International Fisheries Commissions and government representatives by raising their level of awareness and knowledge about the pension plans for Commission employees and the funding issues associated with those plans. It was decided that as a first step it would be useful to prepare a backgrounder on the pension plans and their financing/funding. This could assist the respective Commissions in briefing the Commissioners and participants on their Finance and Administration Committees.

BACKGROUND

Pension plans can contribute very significantly to providing financial security in retirement and are therefore often a key element of compensation in recruiting and retaining employees in Canada and the U.S. Given the legal inability of the commissions to enter into contracts during the 1950s, in 1957 the International Fisheries Commissions Pension Society was established to set up pension arrangements for international fisheries commissions headquartered in the United States and Canada. Over many years and after many discussions between the Society and the commissions, a policy developed whereby the pension arrangements for employees of the commissions were to be set at levels that provided comparability in value to the pension plans of the federal public service of the respective countries in which the commissions were located. This policy was approved in 1991 by senior levels of the Department of Fisheries and Oceans in Canada and the Department of State in the United States.

The end result was that the Society has maintained what can be considered as two very good defined benefit pension plans, one for the employees of the US based commissions and one for employees of the Canada based commissions.

Both plans represent a legal liability on the part of the Commissions to pay the benefits which are determined under provisions set out in Plan Documents.

Defined Benefit Pension Plans

Under defined benefit pension plans, the benefits are determined by a set formula based on salary and service, such as 1.5% of the best three average annual salaries for each year of service. In addition to providing life income at retirement, defined benefit pension plans also allow for benefits in the event of an employee's death. Employee contributions are fixed and the employer is responsible for paying any additional funding costs. Essentially the employer bears the risk of costs that are in excess of those that are anticipated and also receives the rewards should costs be less than expected.

Defined Contribution (Money Purchase) Pension Plans

The other main type of pension arrangement is called a defined contribution or money purchase pension plan whereby employee and employer contributions are fixed and invested to provide for benefits on retirement. The ultimate benefits depend directly on the performance of the invested funds. The employees bear the risks and obtain the rewards of investment performance.

Note: Employees of US based commissions who became employed prior to 2000-2001 participate in a defined benefit plan. New employees since that time have been

contributing to defined contribution plans established by each of the US based commissions.

The new arrangements reflected:

1. A trend in pension plans in the United States at that time to the money purchase approach including the adoption of a hybrid of a defined benefit and defined contribution scheme for US Government employees.
2. A perceived need to better meet the pension requirements of generally more mobile employees who are not expected to spend their entire career at a particular Commission.
3. The desire by the Commissions to reduce their exposure to pension funding risks.

Funding of a Defined Benefit Pension Plan

A fund is established to pay for benefits under defined benefit pension plans for two main reasons: One is to provide for the security of the benefits. The other is to attempt to properly provide for the costs of the benefits over the working career of the employees under the plan.

In practice, this means that an employer relies on an actuary to estimate the amount of contributions that needs to be made each year to a fund that, together with future investment earnings, will be sufficient to pay for the future benefits that are expected to be paid in respect of that year of service.

In estimating the future benefits that will become payable, the actuary has to make assumptions about rates of salary increases, inflation, retirement and mortality. The present value of those benefits (and therefore the contributions required) is then determined by assuming a rate of return on the invested funds.

Given the uncertain nature of the various long term assumptions that are involved, every three years a valuation is undertaken by the actuary to assess the difference between expected and actual experience - actual assets and new estimated liabilities are compared to establish whether a surplus or deficit exists for the pension plan. If there is a deficit, then action is taken to pay for the deficiency either in a lump sum or, most often, to amortize it over a number of years. At the next valuation, the financial status of the plan is reassessed to determine whether additional or reduced deficiency payments are required. If there is a surplus in the fund, then no further payments would be needed.

Cost/Funding Sensitivities

The most significant determinant of the eventual cost of a defined benefit plan is the rate of return on investments - a 1% long term increase or decrease in the rate of return can reduce or increase costs by 10-20%. Similar differences between actual and assumed rates of salary increases and inflation, taken together, can have an equivalent effect on costs.

Additionally, costs or liabilities for small plans such as the plan for employees of the international fisheries commissions can increase or decrease significantly (by several hundred thousand dollars) as a result of an early or late retirement or a premature or late death.

Investment of the Fisheries Commissions Pension Funds

As is the case for the majority of pension plans, the pension funds are invested in a mix of equities (stocks) and fixed income (bonds), managed by experienced money managers. The funds are managed within the parameters of an Investment Policy established by the Society. Currently the pension funds' asset mix targets are 60% equities and 40% fixed income, a policy which is in line with that of most plans in Canada. Plans in the United States tend to have a slightly higher equity component.

As is normal with other pension plans, the Society has an Investment Policy Statement which outlines the Society's investment beliefs. These include a belief that active management adds value over time, equities outperform bonds in the long run, active asset mix management (market timing) does not add value in the long run and rebalancing the asset mix to the target level should be reviewed annually. In particular, the Society believes that investments in value stocks outperform growth stocks over time with less volatility. The money managers and the funds have been selected according to these criteria.

The money managers present their results annually to the Society. In the United States, the Society is assisted by a pension investment consultant who reports results quarterly, with comparisons of the performance of the money manager against a universe of other managers and the investment policy benchmarks. In Canada, a pension investment consultant has provided comparative reviews against the performance of other pension funds and provided a study that supported the validity of the Society's investment beliefs. Both of these investment consultants provide additional due diligence by the Society and the Commissions in their oversight of the pension funds.

Recent Investment Results and Plan Deficiencies

Given the nature of financial markets, there will often be significant fluctuations in rates of investment return over time. Such fluctuations have been particularly pronounced since the global financial crisis in 2008. All pension funds have been negatively by the resulting economic recession and continuing financial instability in various regions of the world.

For the US plan, the rate of return averaged less than 1% for the 2008-2010 period (before plan administrative expenses). This compares to an assumed rate of return of 6.5% annually. This represents an annual shortfall of some 6% and was the main cause of the deficiencies determined to exist in the January 1, 2011 valuation of the US plan.

For the Canadian plan, the average rate of return for 2008-2010 was about 2.4% (before plan administrative expenses) which is over 3% less than the 6.5% assumed rate of return.

Early retirements at some commissions and higher life expectancies generally were the other significant cause of new deficits.

Funding Flexibilities

Pension plans in Canada and the U.S. are subject to legislation and regulations that place significant demands on plan sponsors (employers) with respect funding the plans. The legislative requirements are designed to protect the pension benefits of employees in the event of the insolvency of the plan sponsor. In particular the legislation dictates how funding deficiencies and surpluses are to be treated.

While the U.S. and Canadian fisheries commissions' plans are not directly subject to pension regulatory authorities or legislation (except for the Canadian Income Tax Act), the Society has followed the spirit of those laws, although with somewhat greater flexibility.

The Society has a policy of allowing all deficiencies to be amortized over periods of up to 15 years. The amortization payments are required on a one year delay basis rather than starting as of the effective date of a valuation.

The plan deficiencies also are not set on the basis of an assumed plan termination which can increase the liabilities and under Canadian and U.S. standards, for example, must be amortized over much shorter periods than 15 years.

Finally, the plan liabilities are determined using the long term rate of return assumption set out in the actuarial report. Other pension plans are required to use current long term bond yields which, if used by the Society, would substantially increase the plans' liabilities given the current low interest rates.

Strategies for Mitigating Financial Risk

There are a number of strategies that could be considered to reduce or partially eliminate cost fluctuations in pension plans:

1. Annuity Purchases

In the private sector, if a pension plan is being terminated by the employer or the employer is ceasing to exist, the obligations to existing pensioners can be met by the employer purchasing an annuity from an insurance company. In exchange for a single lump sum payment, the insurer assumes the liability to make all future payments. A similar approach could be adopted with respect to existing pensioners of the commissions' plans. It is important to note that while this option would eliminate much of future liability risk for these pensioners (except for the inflation related indexing) it would currently result in a very significant up front cost, due to current low interest rates.

2. Fund Investments

As noted above, the plans' funds are currently invested in a range of stocks and bonds. A change could be made to invest only in bonds that would produce income and mature as benefit payments become due. This approach is known as “immunizing**”.** While this option would reduce the risk of market fluctuations, it would result in an immediate increase in the plans liabilities, especially given the low interest rate on bonds at this time.

3. Conservative Assumptions

As noted previously, when determining funding requirements, an actuary must make assumptions with respect to the rate of return, mortality and retirement age. In determining appropriate assumptions, the actuary relies on historical data as well as standards established by the Actuarial Profession. It is possible to apply the most conservative acceptable assumptions with respect to the rate of return, mortality and retirement age. The impact of a very conservative strategy would be to increase the funds' estimated liabilities and current service costs in the short term and thus result in higher near term employer contributions. The long term implications would be less volatility in the funding requirements. That is, surpluses would be more likely than deficits.

4. Some pension plan sponsors also are considering market timing investment strategies such as short term asset mix decisions and/or active trading. Others are looking at alternative strategies and investment vehicles such as hedge funds, real estate and private equity.

Such strategies can require significant research and resources to be undertaken properly. Small plans such as those managed for the Pension Society are not properly equipped to adopt such strategies. In addition, the evidence is very mixed as to the effectiveness of such strategies in significantly reducing risk and/or increasing returns in the long term.

5. Deficiencies under the US Government pension plans can be amortized over as much as 30 years. Such a policy could be considered for the US based fisheries commissions' plan. This would lower the required annual deficit payments by some 28% but would cost more in the long run. Also, as the U.S. plan is closed to new entrants and 30 years is longer than the life expectancy of many participants, this may not be a suitable option.

6. Commissions can contribute extra amounts if they have extra funds available to either reduce the requirement for current deficit payments or decrease the probability of future deficiencies.

Plan Design Changes (Canada)

1. Prospective changes for the federal public service plans have been announced by the Government in the recent Budget. These would include increases in employee contributions to 50% of the current service cost and an increase in the early and normal retirement age by 5 years for new employees, i.e., from 55 and 30 years of service for early retirements to age 60 with 30 years of service with normal retirement age going to age 65 from age 60. These announced changes are subject to discussion with plan members through an advisory committee and exact details are unknown at this time.

The plan for Canada based commissions would likely follow suit to maintain value comparability. Employee contributions for the Canadian commissions’ plans are already slated to be raised by .5% of salary effective January 1, 2013 and again by .5% of salary effective January 1, 2014.

Increases in employee pension contributions serve to correspondingly lower commissions’ contributions for current service.

2. The Canadian commissions could adopt a defined contribution plan for future employees. This would eliminate cost risks for the commissions for those new employees.

Any such change would have to be made taking into consideration the human resource implications e.g., career patterns/mobility of employees, the effect of such a plan on recruitment, retention and retirement.. In addition, the mandate of the Society to ensure value comparability with the Federal Public Service and the Society's future role would have to be revisited.

To date, the Canada based commissions have not expressed any interest in adopting such a plan given its lack of comparability with the Canadian Public Service pension plan. Proposed changes should only be implemented after agreement is reached between the affected parties and the Society.

General Notes

1. Significant pension plan deficiencies have been the norm for Canadian and US pension plans in the last few years.

2. Over the last decade, the low interest rate policies of central banks have produced an enormous transfer of wealth from lenders to borrowers. Among the biggest lenders are pension plans, whereas governments are the biggest borrowers.