

# Corporate Canada's pension hole

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The rock-bottom interest rates and volatile equity returns of recent years have wreaked havoc on many investors' portfolios — and that includes the managers of corporate pension plans.

Disappointing returns have set up a vicious cycle in which pension plans become underfunded, and the companies that sponsor them have to pump in more money. That cash comes right out of operations, making the companies' shares less attractive than before.

Investors should take into account the possible effect of the pension gaps that are developing. A good place to start is with a sobering report from the folks at **Veritas Investment Research**, which examines Canada's corporate pension plans, focusing on the 45 companies in the S&P/TSX 60 that offer defined-benefit plans.

(A defined-benefit plan specifies what benefits it will pay, leaving the onus on the plan's sponsors and managers to come up with the cash. Defined-contribution plans only define what goes in, meaning that if there's not much there for you when you retire, well, tough.)

The report spotlights the large deficits at several of Canada's largest companies, ranging from BCE Inc. to Bombardier Inc. But its findings range across a broad swathe of the corporate sector.

**Veritas** found that, despite an increase in cash contributions since the 2008-2009 financial crisis, pension deficits keep rising because of falling interest rates and the "sluggish" returns on plan assets in 2011. Going into last year, the 45 companies combined for a cumulative \$10.4-billion pension deficit. By the close of 2011, the shortfall had ballooned to \$18.8-billion, an 81-per-cent increase, according to the report's authors, **Dimitry Khmelnitsky** and **Diana Akmal**.

To some extent, you can see the problem in companies' bottom lines, as they deduct what's referred to as "pension expense" before arriving at net income each quarter. But the true cost of an underfunded pension is actually worse because, in a quirk of accounting, the cash contributions can and do exceed the expense recorded on the income statement.

Pension expense "materially understates" the cash amount, the **Veritas** analysts say, as the total cash contributions of the companies they examined — \$6.4-billion — were more than double the recorded expense of just over \$3-billion.

Now, to be fair, a big part of this problem is record-low interest rates. When pension plans put a value on what they owe their retirees — their total liabilities — they have to count up all the expected future payments and put a present-day value on that stream of cash. To calculate that number, the plans need to use a discount rate. And the way the math works, the lower the interest rate, the bigger the current-day number. (The opposite is true: The higher the interest rate, the smaller the current-day liabilities number looks.)

If interest rates moved upward, a lot of these pension problems would be sorted out. **Veritas** figures that many of the companies could wipe out their pension deficits if interest rates rose 0.5 to 1 percentage points. Others, with larger deficits, probably need interest rates to rise 1.5 to 2 percentage points.

The problem is that interest rates show no sign of co-operating. They have remained parked near the bottom, year after year.

"Over all, we do not expect a meaningful reduction in deficits by the end of 2012," the **Veritas** analysts say. "The prospect of elevated deficits implies that future cash contributions and pension expenses are likely to keep rising for many members of the S&P/TSX 60."

Who, specifically?

Bombardier, with a \$2.3-billion pension deficit, equal to more than one-third of its market capitalization, "is most likely to experience a material hike in cash contributions," **Veritas** says.

Bombardier spokeswoman Isabelle Rondeau says the company's pension numbers represent plans throughout its worldwide operations, and other countries may have less-stringent funding requirements than Canada. Ms. Rondeau adds the deleterious effects of low interest rates on the company's plan, and said Bombardier has been consistent in putting hundreds of millions of dollars in its plan each year, recently.

**Veritas** says other companies that "may also face higher than average contribution requirements" are BCE, Canadian Pacific Railway Ltd, Imperial Oil Ltd. and George Weston Ltd. Their pension deficits, as a percentage of their market value, range from about 11 per cent down to about 4 per cent.

BCE and CP both made major cash contributions to their plans in 2011, which means they "should enjoy greater contribution stability" than the others in coming years, **Veritas** says. "The other companies may face the unattractive prospect of an additional rise in cash contributions over the next few years, assuming no change in discount rates and asset returns."

Unattractive, indeed, given how long pension managers have been waiting for good, consistent news on discount rates and asset returns.