

Pension shortfalls threaten to explode

By ELIZABETH CHURCH
From Monday's Globe and Mail

Canada's largest corporations face mounting demands on cash and higher expenses because of dramatically deepening losses last year in their employee pension plans. A Report on Business study of the 104 companies on the S&P/TSX index with defined-benefit pension plans found that only 23 showed a funding surplus in their most recent fiscal year, and even these firms saw once hefty cushions shrink substantially.

All the companies in the study had pension assets of more than \$10-million and filed audited financial statements by May 6.

Collectively, these companies saw a pension funding shortfall of more than \$18.7-billion in 2002.

And there is more bad news on the way. Three years of poor performance and optimistic estimates about pension returns have created a huge \$26-billion buildup of unrecognized losses at these companies that is unlikely to be wiped out by higher future returns or past pension gains still making their way onto the books. Look for them to translate into increased pension expenses down the road as they are brought onto the balance sheet.

After years of paying for themselves -- and in many cases actually contributing to the bottom line -- corporate pension plans are suddenly a major cost of doing business at some companies.

That's a detail corporations lost sight of in the heady days of double-digit fund returns, pension experts say. Now the free ride is over. It's time for companies to start shelling out or cutting back.

"We are really on the cusp of employers taking major action," says David Burke, head of the retirement practice at Watson Wyatt in Canada.

Mr. Burke believes that if pension deficits continue to climb, chief financial officers will start to regard their defined-benefit plans -- which guarantee retirement benefits based on salary and years of service -- as too expensive to carry.

"At the end of the day, you need more money or you pay out fewer benefits. There is no silver bullet," he says.

This funding crunch is coming just as the baby boomer bulge enters its retirement years. That's a fact that could add to the troubles as some employers find themselves with far more retired workers than active employees.

Although employers cannot alter benefits that have already been earned by employees unless a plan winds up, Mr. Burke says some firms may try to make changes to plan levels going forward.

Firms also could choose to stop enrolment in plans for employees who join after a certain date.

Marcel Larochelle, a practice leader at Mercer Investment Consulting, says companies must realize that unless markets bounce back dramatically, they are on the hook for mounting pension deficits created by negative returns.

"Basically a pension fund is a very simple animal," he says.

"You put in contributions and you get investment return. In the end, it has to be sufficient to cover the pension promises.

"So anything that hasn't been coming from investment return will need to come from contributions eventually."

That's exactly what is starting to happen.

Inco Ltd., for example, had a funding deficit in its plan of \$805-million (U.S.) last year and unrecognized losses of \$864-million.

This year, it is planning to pump double the amount of cash into pensions -- \$140-million compared with \$67-million in 2002. It also has braced shareholders for similar payments down the road. They should run between \$110-million and \$120-million next year, it estimates, and stay at that range for at least two additional years.

The pension expense on the balance sheet will move to \$99-million this year from \$67-million, the company expects.

The story is the same at many other firms.

At **Bombardier Inc.**, new chief executive officer Paul Tellier has said the company will boost its pension contributions by \$50-million (Canadian) to \$260-million during the current year. It will raise its pension expense number by \$75-million to \$329-million -- a move intended to bring some of the firm's close to \$2-billion in unrecognized pension debt onto its balance sheet.

At **Alcan Inc.**, pension contributions will rise to \$160-million (U.S.), from \$130-million last year and \$44-million in 2000. The company says pension expense will rise by \$55-million after taxes.

At **Quebecor World Inc.**, where the pension deficit grew to \$405.4-million last year, the company put an extra \$20-million into the plan -- roughly doubling recent annual contributions of \$18-million. This year, the company expects that required contributions will rise because of the funding gap, but company officials say they must wait for valuations to be completed to know what the increase will be.

With free cash flow at the company running about \$300-million in the past two years, they say the amount is not material.

Like **Quebecor World**, most companies stress that they have the cash to make good on their pension promises. But there is no denying that this is cash that will no longer be available for other purposes -- such as reinvesting in their business.

At **Canadian Pacific Railway Ltd.**, an extra \$40-million (Canadian) will be directed to the pension fund this year, says chief financial officer Michael Waites.

With \$850-million in annual cash flow, Mr. Waites says the railway can take care of its pension shortfall -- which sat at \$863-million at the end of last year -- but there will be tradeoffs.

"It should not represent a threat to our people. It is just a question of what impact it will have on funding for other parts of CPR's operations," he says.

Pension experts say many financial analysts are now keeping a keen eye on new funding benchmarks, such as pension expense as a percentage of profit. The calculation is used to gauge the strain on cash that pensions are exerting.

Analysts and auditors also are watching key pension assumptions, such as the long-term rate of return firms are using to estimate their pension positions. The rate is critical because it has a direct impact on operating earnings.

Last year, the average rate among the 104 companies in the Report on Business sample was 7.56 per cent, down from 7.75 per cent a year ago. But there are still a few firms such as CAE Inc., a Toronto-based flight simulator company, that have return estimates in the 9-per-cent range.

Rating agency Standard & Poor's also is aggressively scrutinizing pension figures and considering unfunded liabilities as part of its work. "Companies burdened with such liabilities are at a distinct disadvantage compared with otherwise similar companies that have better funded retiree obligations," the rating agency said in an April notice that put 13 U.S. companies on credit watch because of post-retirement liabilities.

The worry, of course, is that for some companies this new drain on cash flow from pension demands will prove too costly.

That's what Air Canada claimed last month when federal regulators told it to pony up \$200-million for pension funds, which had an estimated shortfall of \$1.3-billion at the beginning of January.

The demand was too much, the troubled airline argued in U.S. court filings, saying it was one of the immediate reasons for it to seek protection from creditors.

Mr. Larochelle at Mercer says the Air Canada example is the exception, not the rule, although he says there will be pension-created hardships for some firms.

"For most organizations, this is bad news, but it's not the end of the world," he says. "It means that they have to put in additional money to cover the investment losses. It starts becoming a problem when an organization closes its doors."

Still, Mr. Larochelle says, the state of pension investments was pretty grim last year -- especially around September, when the median return was running at minus 10 per cent. "Things were really catastrophic."

Markets recovered and funds ended the year down 4.6 per cent, but he says most of those gains have been wiped out in the first quarter of this year. "You can assume that for all companies the situation got worse by the end of the first quarter," he says.

In other words, those shrinking pension assets have gone on shrinking. Mr. Larochelle puts the damage for all funds in Canada -- public and private -- at an eye-popping \$100-billion last year.

Going forward, pension consultants expect that companies will be taking action to mitigate some of their pension risk.

Besides cutting future benefit levels, companies also may be looking to make up lost ground by altering their investment strategy and giving more attention to the way they manage plans.

Alan Marr, director of business development at Russell/Mellon Analytical Services, says data on pension fund money managers showed a trend to shift out of bonds and into foreign stocks at the end of last year.

There also is a move to what he describes as "alternative investments" such as hedge funds and private equity deals. Managers, he says, are looking to improve their risk-adjusted returns.

But higher returns are unlikely to take funds entirely out of their \$18.7-billion hole.

As Mr. Burke at Watson Wyatt points out, a fund expecting 7-per-cent returns will have to exceed that number to gain ground. That's an unlikely scenario for most funds, given market performance so far this year.

In the meantime, companies are going to have to get used to opening their wallets.

"This is really back to reality," Mr. Larochelle says. "Guess what, a pension plan costs money."

With files from reporter Peter Kennedy in Vancouver