Discount Rate Key to Pension Financing

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It was one of the feel-good corporate stories of the Christmas season: **BCE Inc.** announced not only a dividend increase and a share buyback, but also a special $500-million contribution to its employee pension plan. BCE described it as something for all its stakeholders and said the pension boost was helping put its retirement plan on the path to full funding.

It wasn't the December decision to dump a chunk of cash into the plan that made the biggest impact, however. It was BCE's selection back in January, 2009, of a new, higher discount rate for the pension plan's obligations. By deciding to change the rate to 7 per cent from 5.6 per cent, BCE sliced nearly $2.3-billion off its pension deficit in a single stroke. As a result, it cut tens of millions of dollars of pension expense from its bottom line last year.

The problem, however, is that BCE's discount rate is now decreasing, raising the spectre of higher pension expenses in the future. What's worse, BCE is not alone: While nearly all of Canada's major corporations benefited from similar interest-rate increases in 2008, they're all on the hook as interest rates head in the other direction.

Before we get too far, let me explain the basics of what's going on here, which is what economists call the "time value of money." Quite simply, it's better to have a dollar in hand now than to have the promise of a dollar years down the road.

And a pension system is nothing if not promises of dollars, lots of them, years down the road. To estimate what a pension system owes its members in current-day dollars, it has to pick an interest rate to discount all those future payments.

The lower the interest rate, the smaller the discounting, and the bigger those payments look in present-day dollars. Conversely, if you raise the rate, the discount gets bigger, and the obligation looks smaller.

The companies that sponsor these plans aren't just pulling the interest-rate numbers from a hat.

For the purposes of calculating pension obligations under generally accepted accounting principles, Canadian companies choose a discount rate in line with the interest paid by high-quality corporate bonds.

As you may recall, high quality was hard to find in 2008 during the worldwide credit crunch. Widespread fear and a greater appreciation of risk helped drive corporate yields significantly higher, faster.

And Canadian companies took note when it came time to value their pension plans. Analyst ***Dimitry Khmelnitsky*** at ***Veritas Investment Research Corp.*** found the average discount rate among companies in the S&P/TSX 60 jumped more than a full percentage point from 2007 to 2008. Some companies have chosen a rate higher than BCE's. Yellow Pages Income Fund, for example, increased its rate to 7.5 per cent from 5.5 per cent in a single year.

And what is the aggregate impact of a simple interest-rate change? The S&P/TSX 60 companies cut a total of $15.7-billion from their pension liabilities in 2008, ***Mr. Khmelnitsky*** said. He estimates the deficits would have exceeded $25-billion without the adjustment. More importantly, he said, the benefit from increasing the interest rate virtually offset the market losses the pension plans suffered, neutering the impact of a disastrous investing year.

While the markets enjoyed a healthy rebound in 2009 (BCE said its plan assets grew by 15 per cent thanks to investment gains), the stabilization of credit means the yields on high-quality corporate debt are falling from the 2008 highs. As a result, the interest rate-related gains of 2008 will turn into losses in 2009 and beyond.

BCE said earlier this month it cut its discount rate for 2009 to 6.4 per cent from 7 per cent, which means the plan's liabilities will grow by a number approaching $1-billion. (We'll know the details when the company files its annual report next month.)

That also helps explain BCE's decision to put $500-million into the plan last December. The special injection, combined with last year's investment returns, means the company will report about $100-million less in pension expense in 2010 - although the number would be even higher if the company didn't have to cut its discount rate.

"The reason we made the $500-million special funding was to improve the overall funding and reduce the volatility of funding going forward, on both a cash basis and a pension-expense basis," BCE chief financial officer Siim Vanaselja said.

BCE wasn't the only company to make this kind of decision. Canadian Pacific, which also has a large unfunded liability, also put $500-million into its plan in December. The question is, with discount rates falling, obligations rising, and pension expense increasing for all of Canada's pension-plan sponsors, why didn't more companies make this move?