

## Granting Higher Priority to DB Plan Deficits: Solving Problems or Creating Them?

October 2010

### Highlights

Granting higher priority to defined benefit (DB) pension plan deficits in insolvency will impact:

- **Corporate bond spreads** to a varying degree depending on a range of factors;
- **DB plan sponsors** by increasing the cost of financing while reducing its availability, deterring investors, and lowering corporate credit ratings; and
- **DB plan members** by increasing the risks they face.

In response to concerns about the impact of corporate insolvency on the benefit security of employees with DB pension plans, opposition bills have been introduced in both the House of Commons and the Senate proposing changes to priority of payments outlined in legislation governing bankruptcy and insolvency. The object of these bills is to give higher priority to the entire deficit of a DB pension plan, including priority over corporate bondholders, with respect to the total unfunded DB liabilities.

Fixed income experts from more than 20 investment firms expressed their views on how granting higher priority to DB plan deficits in insolvency would affect the Canadian corporate bond market.

The impact on corporate bond spreads is the result of a complex combination of factors and varies widely depending on individual corporate credit quality, relative size of the DB plan, pension plan funded positions and economic conditions.

The cost of financing could increase by hundreds of basis points for BBB-rated companies, which could see their credit ratings lowered to below investment grade if they have large pension deficits. This would have a devastating effect on the financial situation of these companies. DB plan sponsors with higher credit ratings and fully funded pension plans are less likely to be materially affected, although very few plans are fully funded over the economic cycle.

The availability of financing for DB sponsors might dry up completely under tight credit conditions during periods of financial turmoil. This would lead to an increased incidence of these companies filing for bankruptcy protection, inadvertently imposing greater risk upon DB members.

While the purpose of granting higher priority is ostensibly to protect DB plan members at a time when they need that protection most, it will actually increase the risks to DB plan members. The higher priority will have a significantly negative impact on companies attempting to raise capital, particularly when funded ratios are down and the economy is weak. For non-investment grade issuers, this could jeopardize their ability to restructure their debt while under bankruptcy protection, and it might increase the likelihood that they be unable to emerge from such protection.

The funded ratio of a DB plan will play a more important role in determining credit spreads. Pension deficits are very volatile through the economic cycle, implying increased volatility in credit spreads, and their dynamic is not widely understood. A drastic decline in a DB plan's funded ratio will not only trigger a substantial increase in funding contributions, but also rapidly increase the cost of issuing debt; therefore, fluctuations in funded ratios will become an additional source of financial volatility for DB sponsors that issue bonds, potentially deterring professional investors from investing in Canadian corporations with DB plans.

It is extremely difficult to precisely quantify the impact of granting higher priority to DB plan deficits on individual plan sponsors, as a wide range of factors must be considered. While respondents to our questions generally agreed on the factors involved, many indicated that it is impossible to provide a precise number without detailed modeling.

While changing bankruptcy priorities as proposed by the current bills is one way to enhance benefit security for Canadian workers, it comes coupled with potentially tremendous costs to DB plan sponsors and members, as well as to the overall Canadian economy and capital markets. The bills actually appear to create more risk for the DB plan members they aim to protect, and would add a layer of risk to Canadians who have invested their retirement savings with these DB plan sponsors.

## Introduction

In the aftermath of the financial crisis, there have been calls to reform the current scheme of priorities in the federal Bankruptcy and Insolvency Act (BIA) to provide greater protection to DB plan members. The BIA currently provides “super priority” status to certain DB pension obligations, including unremitted regular employer and employee contributions.<sup>1</sup> Recent proposals, such as bills C-501 and S-214, would end up granting higher priority to the entire deficit of a DB pension plan in the context of insolvency. If implemented, this change would give the DB plan priority over corporate bondholders with respect to the total unfunded DB liabilities.

The proposed expansion of priority could greatly increase the cost of financing for DB plan sponsors and affect their ability to issue debt in the capital markets. As the vast majority of corporate bonds available in the Canadian market have been issued by corporations that sponsor DB plans, this change could also have broad potential repercussions for the overall bond market. A sudden repricing of existing bonds would negatively impact the retirement investments of the large number of Canadians who have registered and nonregistered portfolios that are exposed to corporate bonds issued by DB sponsors. It would also affect the funded position of DB pension plans, as portions of their assets are invested in these corporate bonds.

Although most people agree that granting higher priority to pension deficits in bankruptcy is likely to result in a general increase in financing costs of DB plan sponsors, the magnitude of the increase is difficult to quantify with any degree of accuracy. Very few empirical studies have been conducted to examine the potential effects on Canadian companies. While some argue (e.g., Urquhart 2010<sup>2</sup>) that the overall impact on the cost and availability of credit in the Canadian debt market could be minimal, many DB plan sponsors fear that higher financing costs would significantly affect their long-term competitiveness. One BBB-rated company informed us that giving preferred creditor status to DB pension deficits would put the company into technical default of its loan covenants, which state that no other debt can be given preferred status; therefore, the proposed change to existing bankruptcy priorities would likely necessitate the renegotiation of all their existing debt covenants.

To fill this knowledge gap, Towers Watson conducted a comprehensive research study to examine how the Canadian corporate bond market would be affected if DB pension deficits were granted higher priority in insolvency. Fixed income experts and money market managers from 23 major investment firms participated in an in-depth survey in the summer of 2010. Follow-up interviews were then conducted on a significant subset of survey respondents to gain a deeper understanding of their views on this subject. Towers Watson also sought the viewpoints of several large corporate bond issuers.

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<sup>1</sup> This refers to regular employer current service contributions that have become due and payable but have not been paid, plus employee contributions withheld from employee’s pay.

<sup>2</sup> Diane Urquhart (2010). “Consolidated and Updated Report – Bankruptcies and Employee Claims – Nortel Case.

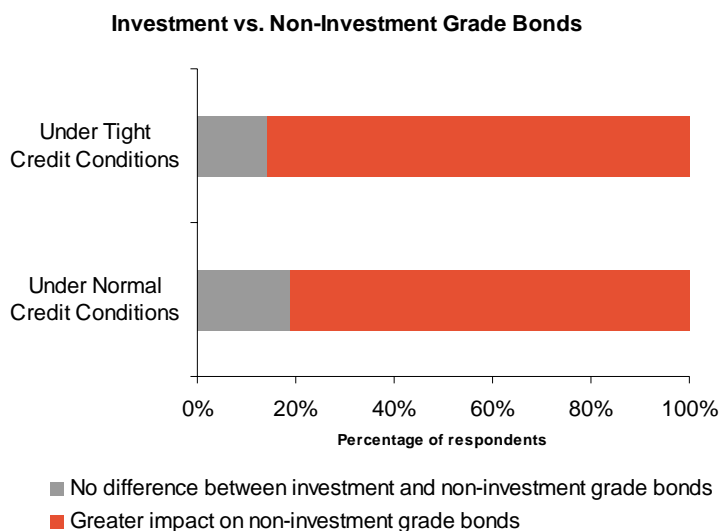
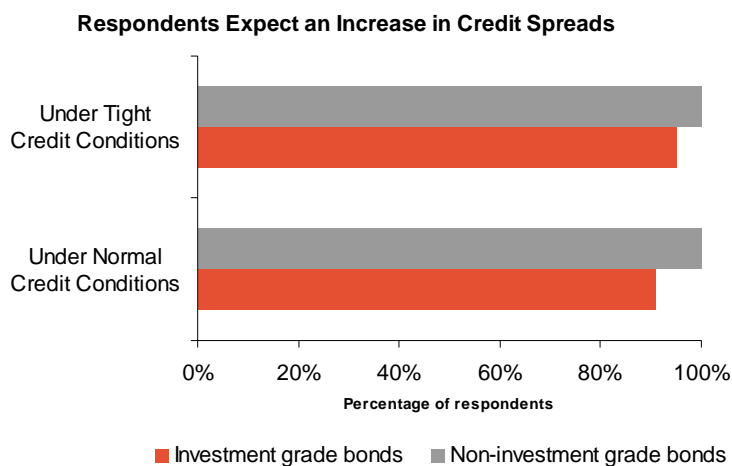
The key lesson from the survey and the interviews is that changing bankruptcy priorities is a highly complex issue. While conducting research focusing on the average impact of the proposed change on the corporate bond market as a whole is an interesting exercise, the findings of such research only present a narrow, and potentially misleading, view of what is actually a multifaceted picture. It is important to understand that the magnitude of the impact will vary significantly depending on a number of factors that are specific to each company, including credit quality, the size of the pension plan and its deficits relative to the corporate balance sheet, and other issues related to the unique nature of the company’s business or financial structure. Putting all these factors into the equation would give us a wide spectrum of results for different plan sponsors under various economic conditions. In contrast, looking at the impact of changes in the aggregate significantly understates the range and extent of potential impacts.

**Most Concerned: BBB-Rated Companies Downgraded to Non-Investment Grade**

When asked to assess the overall impact of a change to BIA pension priorities on corporate bonds issued by DB sponsors, the vast majority of respondents expect bond spreads to rise, resulting in higher financing costs for DB sponsors (**Figure 1**). In particular, the widening in credit spreads is expected to be greater for non-investment grade bonds than for investment grade bonds. In the follow-up interviews, bond managers also distinguished between BBB bonds and those of higher credit quality.

In order to fully examine the degree to which investment grade bonds of different credit qualities would be affected, the survey includes four examples of DB plan sponsors with different credit ratings operating in various industries: (i) a transportation company (BBB/Negative); (ii) a telecommunications company (BBB+/Stable); (iii) a major bank (A+/Stable); and (iv) a major utility/infrastructure company (A+/Stable). These industries were selected as they represent the key bond issuers for each credit rating. The companies in all four examples are assumed to

**Figure 1: Overall Impact on Corporate Bond Spreads**



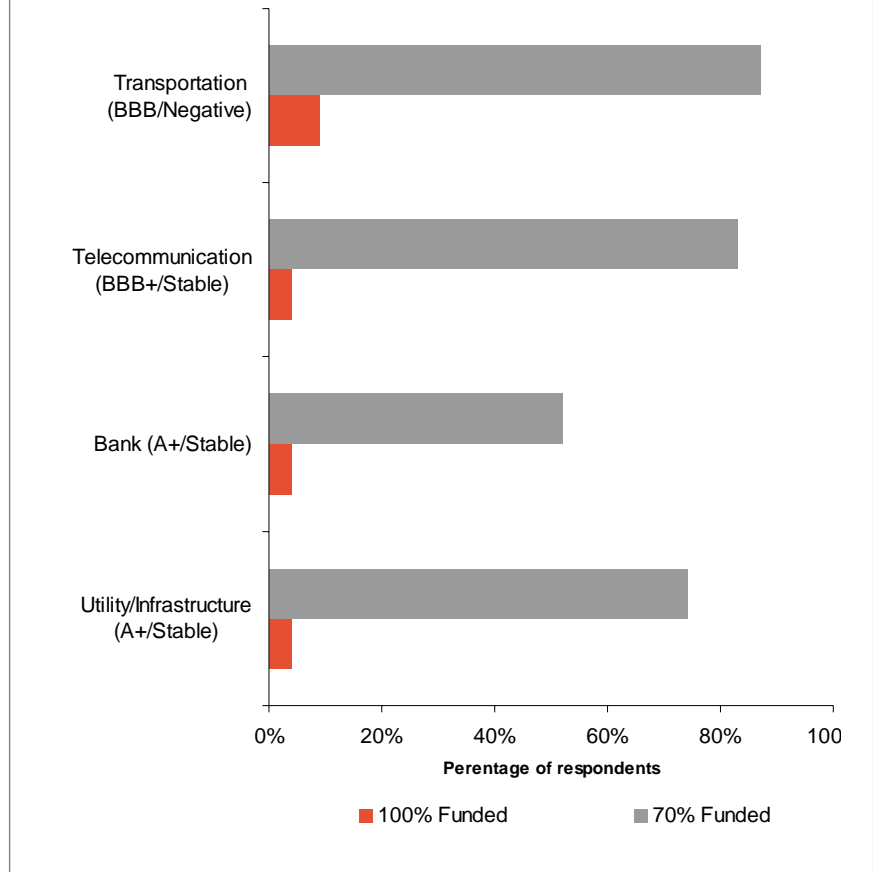
have sizable DB pension plans with significant assets (defined as more than \$3 billion). Respondents were asked whether granting higher priority to DB pension plan deficits would cause a credit rating downgrade under normal financial market conditions.<sup>3</sup>

A notable observation from **Figure 2**, which is reinforced and re-emphasized by the interviews, is that the risk of being downgraded increases exponentially as the DB plan becomes significantly underfunded and as pension deficits become more material relative to total debt. If the funded ratio drops to 70%, a level similar to that observed for a typical DB plan during the 2009 financial crisis, most survey participants predict rating downgrades for all four companies, regardless of their credit qualities.

A company’s credit rating is a critical factor in determining the downgrade risk. In general, BBB-rated companies will face a much greater downgrade risk than AAA/AA-rated companies. A major reason cited by the respondents for this is that the historical default rates of AAA/AA bonds are substantially lower than those of BBB bonds. In many cases, the former are financials in Canada, and pension risk is not a material element of their balance sheet.

Credit rating downgrades will lead to a substantial widening in credit spreads, thereby increasing the cost of financing for DB plan sponsors. Investment managers (and, we understand informally, rating agencies) use a rule of thumb that placing an additional 15% to 20% of total debt (including pension debt) into preferred creditor status over an existing bond results in a one-notch downgrade in the subordinated issue’s credit rating. Under today’s market conditions, a one-notch downgrade would translate to a spread increase of at least 25 bps, but in difficult credit conditions this spread increase would be much greater. Several respondents noted that the surge in yields, even under normal credit conditions, is particularly acute for the “fallen angels” — companies that are downgraded from BBB to non-investment grade — potentially experiencing an increase of well over 100 bps. One reason for this much larger spread is that most Canadian pension plans are prohibited by their Statement of Investment Policies &

**Figure 2: Credit Ratings Downgrade Under Normal Credit Conditions**



<sup>3</sup> We did not ask survey respondents to provide similar estimates under tighter credit conditions, except via their comments in our interviews, because of the difficulty of articulating a specific set of conditions.

Procedures from investing in non-investment grade bonds; therefore, a downgrade to below BBB rating will trigger forced selling of these bonds by the pension funds, causing a severe widening in their spreads and potentially jeopardizing their ability to raise money in future.

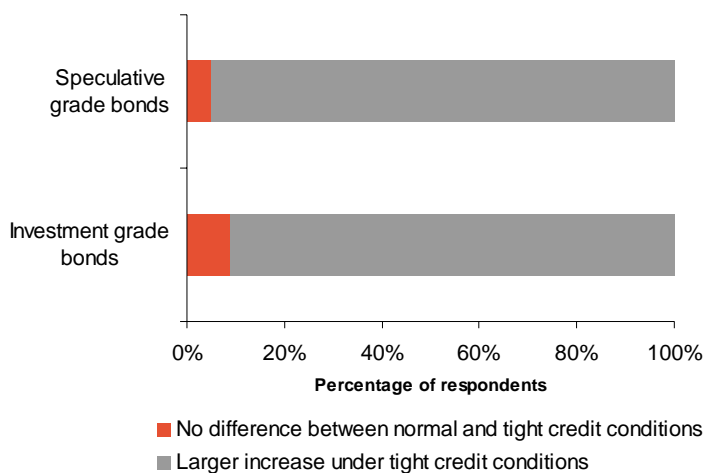
As the Canadian debt market is largely dominated by investment grade issues and has an immature high-yield market, fallen angels are forced to raise funds in external high-yield markets, particularly the United States. This exposes them to an additional risk, namely currency. If preferred creditor status is granted in Canada, such companies will be forced to compete for capital with American companies that are not subject to preferred creditor status rules, which would further increase the yields demanded by investors in fallen angel bond issues.

This BBB issue is not trivial. Currently, more than one-third of the top 60 Canadian corporate bond issuers are rated BBB and the majority of them have sizable DB plans (more than \$500 million). In terms of market value, existing BBB-bonds issued by large DB plan sponsors comprise 10% to 15% of the total investment grade corporate bonds in Canada; therefore, the risk of being downgraded to non-investment grade due to changes in priority status could create a material negative impact on the Canadian debt market.

### Potentially Enormous Impact Under Tight Credit Conditions

Almost all respondents agree that the impact on spreads will become even more noticeable when credit conditions worsen during financial turmoil (**Figure 3**). A major recurring theme identified in the follow-up interviews is that the potential impact of granting higher priority to DB deficits could become enormous during periods of adverse credit conditions. As credit spreads inevitably expand significantly in a recession, small differences in perception regarding the credit quality of a bond will create larger impacts on spread differentials. As recessions also tend to be periods during which DB pension deficits become significantly larger, the combined impact on credit spreads and downgrades becomes even more striking. A number of interviewees suggested that, for current BBB issuers, spreads could surge by hundreds of basis points if DB deficits were given priority status. In such circumstances, companies will find it extremely difficult or impossible to obtain affordable financing at a time when it is needed most.

**Figure 3: Impact on Credit Spreads: Normal vs. Tight Credit Conditions**



Furthermore, several interviewees suggested that liquidity in the Canadian market often evaporates for low-quality credits in a crisis situation, regardless of the yield offered. They indicated that granting higher priority status could potentially choke up access to capital for these DB sponsors during an economic crisis, especially as many fixed income managers note that it will be very difficult to effectively model the degree of increased risk that the pension plan creates for the sponsoring organization in these conditions. This, in turn, could lead to an increased incidence of bankruptcy filings and, in some cases, could increase the likelihood of organizations ceasing business entirely.

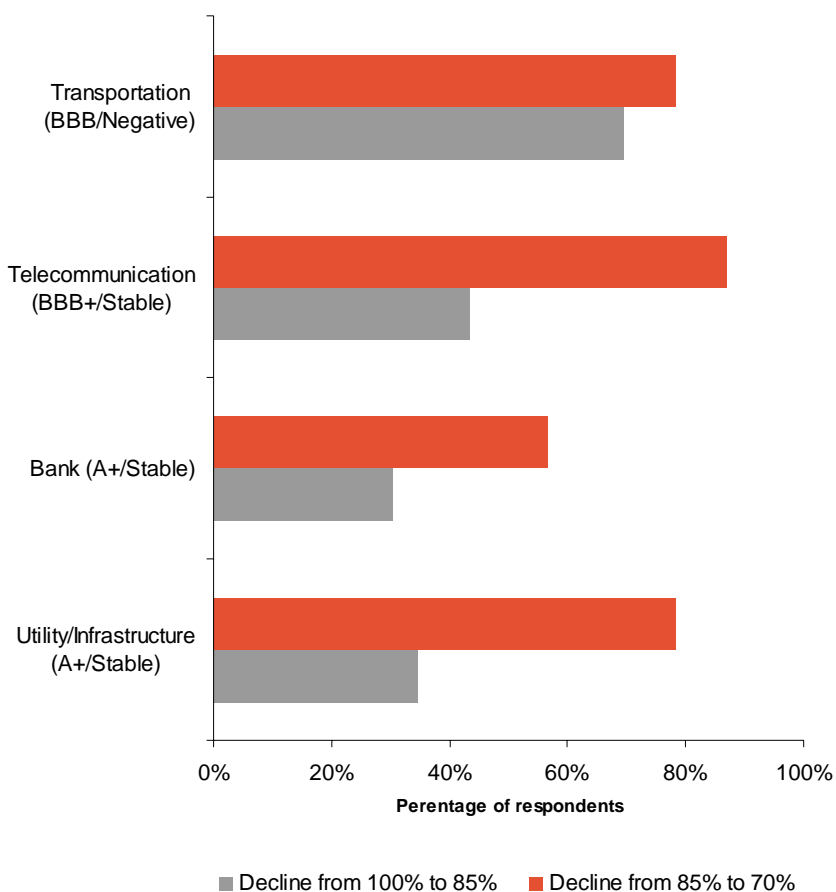
Such an acceleration of bankruptcy filings is a disastrous outcome that will inadvertently pose more risk to DB members, and it runs contrary to the likely original aim of bills C-501 and S-214 to protect members of poorly funded DB plans sponsored by companies that today are neither insolvent nor under bankruptcy protection. Interviewees indicated that several companies that have undergone successful restructurings in recent years might not have been able to emerge from bankruptcy protection had these legislative proposals been in place.

### Increased Volatility as Funded Ratios Affect Cost of Financing

Over the last 5 to 10 years, credit rating agencies have increasingly consolidated pension deficits into a corporation's long-term debt (and pension contributions into a corporation's debt service costs) for the purpose of determining the corporation's credit rating. If a DB plan's unfunded liability is given priority over bondholders in insolvency, these pension deficits are likely to become an even larger risk factor for corporate bond issuers, as well as bondholders. In addition, the funded ratio of a DB plan is expected to have an even stronger influence on both credit ratings and credit spreads.

Consistent with the findings illustrated in **Figure 2**, our survey results indicate that the impact on credit spreads is

**Figure 4: Respondents Expect Credit Spreads to Increase as Funded Position Deteriorates**



highly correlated to the pension plan's funded position. As clearly shown in **Figure 4**, respondents expect further widening in spreads as the funded position deteriorates. This is particularly the case when the funded ratios drop from 85% to 70%.

Pension deficits are very volatile through the economic cycle, implying increased volatility in credit spreads. A drastic decline in a DB plan's funded ratio will not only trigger a substantial increase in funding contributions, but also rapidly increase the cost of issuing debt; therefore, fluctuations in funded ratios will become an additional source of financial volatility for DB sponsors that issue bonds and will clearly change senior financial executives' perceived value of operating DB pension plans. Should this lead to the closure of more DB plans, it will inexorably increase concerns about the retirement income adequacy of Canadian workers.

In addition, granting higher priority to DB deficits could have a significant impact on merger and acquisition activity. If one party has a DB plan, particularly one that is not well funded, and either party is or will be a major bond issuer, the changes could either kill proposed deals or dramatically affect their pricing.

### **No Consensus on the Magnitude of Credit Spread Increase**

While respondents generally agree that the impact of granting higher priority on DB plan sponsors depends on a wide range of factors (as previously noted), they find it extremely difficult to precisely quantify that impact based on general circumstances as opposed to the specific circumstances of a given plan sponsor. When asked to provide their best estimates on the change in corporate bond spreads as a result of changing the pension priority, many respondents expressed the belief that it is impossible to provide an accurate and precise number without detailed modeling.

Part of our research attempted to assess the impact on credit spreads under normal credit conditions for various industries. In light of the findings presented so far, it is not surprising that we obtained a wide dispersion in results and that we could not identify a consensus regarding the magnitude to which credit spreads will widen. The closest to a consensus view emerges when the funding status of the pension plan improves to 100%, a level not seen by most Canadian DB plans over the past decade. In this situation, the majority of respondents believe that preferred creditor status will not have a major impact. Of course, the focus of the two bills is on DB plans that are not well funded, so this may well be a moot point.

Many studies have been conducted to explain the movements of corporate bond spreads. In general, credit spreads can be decomposed into two main components: default risk and liquidity risk. As noted in a recent Bank of Canada paper (Garcia and Yang 2009<sup>4</sup>), the majority of a corporate bond's spread relates to the liquidity component for investment-grade companies. Yet, most existing

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<sup>4</sup> Alejandro Garcia and Jun Yang (2009). "Understanding Corporate Bond Spreads Using Credit Default Swaps." *Bank of Canada Review*



research on pension priority has focused on the impact on the default risk component. Anecdotal evidence suggests that changing pension priorities will not only affect the default risk, but also the liquidity risk. In the interviews, several fixed income experts indicated that their research teams will have to develop new models to assess risks associated with DB pension plans, something that many investment firms may be unwilling to do given the time and complexity involved. This could exacerbate the move from debt issued by companies sponsoring DB plans to those without DB plans. Furthermore, as Canadian debt markets are increasingly responsive to global forces, this could be a compelling reason for global bond managers to avoid investing in Canada. By the same token, domestic capital could begin to focus more on investment opportunities outside Canada. The rising risk of capital flight from Canadian companies sponsoring DB plans is likely to result in an increase in the liquidity risk premium.

## Conclusion

If higher priority status is granted to DB pension plan deficits in the event of insolvency, many companies with underfunded DB plans will experience difficulty rolling over their maturing debt and will be forced to reissue at higher interest rates. This is particularly the case for companies that are downgraded from BBB to non-investment grade, as the impact on yields of this type of downgrade is remarkably severe. Furthermore, fluctuations in pension-funded positions will cause increased volatility in credit spreads, which creates additional financial uncertainty for the company.

In addition to company-specific factors, such as the credit quality and size of pension deficits relative to the corporate balance sheet, overall economic conditions also play a critical role in determining the impact of priority status on corporate bonds. The dichotomy that exists between good and bad economic times deserves our particular attention. For companies in distress, a significantly underfunded pension plan could increase the cost of financing by hundreds of basis points in difficult economic times. More important, the availability of financing for these companies might dry up completely — just when attention to the plight of individuals and companies becomes most intense. This, in turn, could lead to an increased incidence of filing for bankruptcy protection, thereby inadvertently imposing more risk on DB members. We must never forget that the best form of security for the benefits of pension plan members is the existence of a financially sound employer, combined with pension benefits legislation that enhances the funding of ongoing plans in a sensible manner.

Although the survey suggests that there will be limited impact on companies with strong credit ratings and fully funded pension plans during good economic times and under normal credit conditions, it is reasonable to assume that the current legislative proposals are not intended to address bankruptcies arising in normal credit conditions for AAA-rated companies, but rather those arising under tight credit conditions when DB plan funded ratios also tend to be much lower;

therefore, special attention must be paid to the interviewees' comments addressing the potential impact of the proposed changes under adverse credit conditions.

Ultimately, the greatest challenge facing plan sponsors is managing the cost and volatility of funding contributions and accounting expenses. To date, the typical response of Canadian DB sponsors has been to close the DB plan to new hires. It has been well documented that private sector DB coverage in Canada has dropped substantially (by more than 10 percentage points) since the early 1990s<sup>5</sup>. Companies are likely to exit their DB plans as soon as possible if they believe that changes to bankruptcy priorities will significantly hamper their access to future capital. This would mean no future service accruals for existing plan members, combined with an attempt to offload the existing liabilities. If more DB sponsors choose to move away from offering this benefit — and this is a real risk — the quality and level of private pension coverage will be further reduced, raising more questions about the retirement income adequacy of Canadians. Furthermore, given the small size of the annuity purchase market in Canada, offloading the existing liabilities through annuity purchase is practically impossible and would have a dramatic impact on the Canadian equity market.

Ensuring that Canadians with private DB pension plans achieve a reasonable level of benefit security in the aftermath of an exceptional financial crisis is a highly complex challenge. While changing bankruptcy priorities as proposed by the current bills is one way to enhance benefit protection, it comes coupled with potentially tremendous costs to DB plan sponsors and members, as well as to the overall Canadian economy and capital markets. Upon further analysis, the bills appear at best to run counter to their original purpose, creating more risk for the DB plan members they aim to protect. They would also add a layer of risk to Canadians who have invested their retirement savings with these DB plan sponsors.

It is important to note that a wide range of legislative or regulatory options (e.g., mandatory provisions for adverse deviation to curtail contribution holidays and higher thresholds for requiring annual rather than triennial actuarial valuations) are being introduced in the wake of the financial crisis and are being used to improve benefit security for plan members; therefore, we believe it is incumbent upon all stakeholders to undertake additional study of the full implications of adjusting the scheme of priorities in a broader context, rather than viewing it as an isolated issue.

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<sup>5</sup> Statistics Canada's Labour Force Survey and Pension Plans in Canada; Towers Watson calculations.

## Appendix A – Selected Responding Investment Firms<sup>6</sup>

AllianceBernstein

Baker Gilmore & Associates

BMO Asset Management

Canso Investment Counsel Ltd.

Connor Clark and Lunn Investment Management

J.P. Morgan Asset Management

Lincluden Investment Management

Logan Circle Partners

McLean Budden

Newton Investment Management

Sun Life Financial

UBS Global Asset Management (Canada)

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<sup>6</sup> An additional 11 major investment firms completed the survey but elected not to have their names listed.