Presentation to House of Commons Standing Committee on Industry Science and Technology

Cost of credit impact is small on investment grade bond owners and corporations with DBPPs. By comparison the damages to retirees and severed workers of maintaining the status quo is unacceptably high.

Impact of Bill C-501 is an increase of 20 bps for the interest rate on investment grade bond issuers with DBPPs; in the middle of the range of 12 to 29 bps in PHN research and close to the 25 bps in the Towers Watson Report; 20 bps to 25 bps impact is consistent with other international research I have reviewed. My estimate of the impact on cost of credit for bond issuers with DBPPs has increased a bit from one year ago due to higher long term credit default rates for the period 1920 to 2009, caused by record high credit defaults in 2009.

When mid-term bonds that yield 3.25% goes to 3.50%, the market value of the bonds goes down -1.5%.

PHN has done some good work on the Top 60 bond issuers that shows over 90% of the bond issuers and 95% of bond values have DBPPs. So with the new PHN research we see that a much higher percentage of bonds are impacted than I thought a year ago. The good news is that the impact on the bond issuers with DBPPs is small, so the fact that almost all of the bond issuers are affected does not change my conclusions on Bill C-501 having a small impact on the cost and availability of credit.

From the new PHN research on the Top 54 bond issuers with DBPPs, the average DBPP deficit % is about -20%. The pension fund deficit results in a pension income cut at the time of the pension fund wind-up, when the corporation liquidates. Bill C-501 therefore protects against this 20% cut in pension income at the expense of the -1.5% bond price decline.

Using the higher incidence of bond issuers with DBPPs that the PHN research found, I get Bill C-501 causing a bond market capital loss of $4B. The PHN bond market capital loss is in the range of $2B to $4B so I agree with them on this point.

I get an aggregate increase of corporations' interest expense of $3B. This makes a combined bond owners and corporations impact of $7B. I cannot figure out how PHN comes up with a combined bond owners and corporations impact of $9B to $22B. I suspect this is an unusually high estimate based on their assumption that there will be new bond issuance at the record high levels of the last decade.

The opponents to Bill C-501 have not taken into account the fact that the estimated DBPPs deficit of $50B offers an interest free loan to the employer over the 5 to 10 year period before the deficit is eliminated with Special Contributions. I estimate that the PV of interest not paid to the pension funds is about $7B. Coincidently, the $7B benefit from the interest free loan granted by the pension funds is the same as the estimated cost of Bill C-501. So either require the employers to pay interest on their pension fund deficits or adopt Bill C-501. I prefer the latter policy change as it is more targeted and helpful to seniors that should not be asked to bear the burden of the financial crisis and their bankrupt employers who have billions of dollars in their estates.

When examining the impact of Bill C-501, it is important to put today's DBPP deficits in perspective of the total capital structure of the corporations with DBPPs. I have put together stats from the PHN research, National Accounts Balance Sheet data for non-financial companies and OSFI financial institutions balance sheet data and have learned the following:

DBPP deficits are about 15% of the total debt for corporations with DBPPs.

DBPP deficits are about 5% of the total debt and equity for corporations with DBPPs.

With DBPP deficits at these percentages of corporations' capital structure, Bill C-501 is manageable.

A brief comment on the matter of super-priority versus preferred status. For recovery rates of 40% and better, super-priority would appear to not seriously impact the secured bank debt. The unsecured creditor however will make a much lower recovery at the bankrupt companies with DBPPs that have deficits. It is for this reason there is an increase in the cost of credit. The cost of credit impact is so low because the credit default rate amongst investment grade companies is only 4% over an average 10 year period.

If Bill C-501 were to amended to set pension deficits and severance at preferred status rather than super-priority, the secured creditors would be better protected.

The impact on junk bonds is higher than on the investment grade bond market. The junk bond market is very small in Canada and individual and pension funds are not generally investors in this segment of the bond market. I have the impact of Bill C-501 on the junk bonds at 90 bps. This compares to 100 bps estimated by Towers Watson for BBB credits that fall into junk status. Tower Watson says that Bill C-501 may trigger this credit rating downgrade and higher cost of credit. PHN has a much higher cost of credit for the speculative portion of the bond market saying the cost of credit could increase by 150 bps to 200 bps. There is no analytical backup for this high estimate.

No impact on international competitiveness since other countries do it or have public pension insurance.

Availability of credit and causing liquidations over restructuring as an ongoing concern is incorrect conclusion.

CDS innovation has changed the idea that all creditors are losing money in a bankruptcy and that all creditors must accept an equal compromise so that the business may be restructured as an ongoing concern. CDSs provide an incentive for bond owners to seek a court filing for bankruptcy protection in order to trigger an insurance settlement, that results in no loss of money on their investment. The credit default damages are reimbursed in a cash settlement shortly after the bankruptcy protection filing. The insured bond owners get to keep their bonds and fully participate in the bankruptcy proceeding. The old dynamic of preferring a restructuring as an ongoing concern over liquidation no longer applies, since bond owners that were either fully hedged or short the bonds are not persuaded by the need to restructure as an ongoing concern or be worth nothing on liquidation. In fact liquidation becomes the preferred option for these combo CDS- bond owners, because liquidation permits the corporation to walk from the pension deficits, whereas these are not compromised for ongoing concerns.

So a new business model is borne and it is called profit from bankruptcies, at the direct expense of retirees and severed workers. Furthermore, the bias towards liquidation over restructured ongoing concern causes job losses.

Protection of retirees and severed employees is good social policy for individual Canadians, who are facing dramatic cuts of their income. More importantly, due to the bias created by CDSs to liquidate companies for profit, priority status for pension deficits and severance provides a countervailing force to deter liquidations and to promote restructuring as ongoing concerns. Bill C-501 in short will have numerous economic benefits:

Less liquidations. Pension plans more likely to be fully funded and more prudently invested.

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