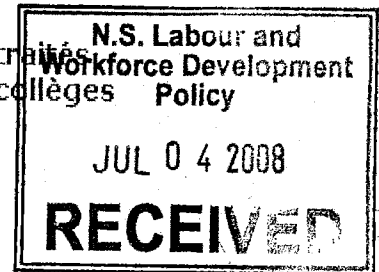


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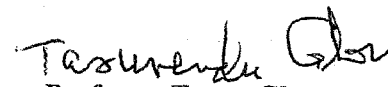
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SUBMISSION TO THE NOVA SCOTIA PENSION REVIEW PANEL

This brief from the CURAC/ARUCC Board and from the Association of Dalhousie Retirees and Pensioners [ADRP] concerning pension legislation in Nova Scotia is addressed to the Nova Scotia Pension Review Panel. As the only national Canadian federation of post-secondary retiree organizations, CURAC speaks for the interests of some twenty thousand retired faculty and staff in associations on sixty campuses of our major academic institutions in every Canadian province. Our Nova Scotia member organizations at this time include retirees' associations at Acadia, Dalhousie and St. Mary's universities. As the only retiree organization at Dalhousie University, the ADRP represents about 630 pensioners and surviving spouses, which include both former faculty and former staff.

The CURAC Pension Committee is composed of Emeritus Professors John Meyer, Chair, (Windsor); Howard Fink (Concordia) and Paul Huber (Dalhousie).


Professor J. Philip Welch
President, ADRP


Professor Tarun Ghose
President, CURAC

June 27, 2008

CURAC Member Organizations:

- Association of Dalhousie Retirees and Pensioners
- Association of Professors Emeriti at University of British Columbia
- Association of Retired Faculty of York University
- Associations de retraités des universités québécoises
- Carleton University Retirees Organization
- Fédération des retraités de l'Université du Québec
- Lakehead University Faculty Assoc. (Ret.)
- Laurentian University Faculty Assoc. (Ret.)
- Retired Academics and Librarians of the University of Toronto
- Retired Acadia Faculty Association
- The Ryerson Connection
- Trent University Association of Retired Persons
- University of Regina Academic and Administrative Pensioners Association
- University of Alberta Association of Professors Emeriti
- University of Guelph Retirees Association
- University of Manitoba Retirees Association
- University of Waterloo Retirees Association
- University of Winnipeg Retirement Association
- Windsor University Retirees Association
- York University Retirees Association
- Retirees Association of Queens
- Retirees Group of the McGill Association of University Teachers
- Concordia University Pensioners' Association
- Simon Fraser University Retirees Association
- University of New Brunswick Retired Employees Association
- Association of Professors Retired from the University of Ottawa
- McMaster University Retirees' Association
- University of Saskatchewan Retirees' Association
- Sir Wilfred Laurier Retirees' Association
- Memorial University of Newfoundland Pensioners' Association
- Ontario Colleges of Applied Arts and Technology Retirees' Association
- University of Victoria Retirees Association
- College and Institute Retirees Association of British Columbia
- Association des bibliothécaires et professeur(e)s retraité(e)s de l'Université de Moncton
- University of Prince Edward Island Retiree Association
- British Columbia Institute of Technology Retirees' Association
- Saint Mary's University Retirees Association
- St. Thomas University Retirees Association

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A. Preliminary Remarks:

Five weeks only separate the issuance of the Panel's Discussion Paper (DP) at the end of May and the Panel's deadline of 4 July for submissions. Hence, we have closely consulted the CURAC brief submitted to the Ontario Expert Commission on Pensions last October (which the present writers also drafted). That brief deals with the same general problems of pension regulation and embodies the same principles as this one. However, Nova Scotian pension legislation and its administration differ somewhat from those in Ontario, and the economic situations in the two provinces are dissimilar. You will thus find that the issues and arguments in this brief specifically address the Nova Scotia situation. We would welcome the opportunity to present our views directly to the Panel at a public hearing at a suitable time.

The first four sections of this submission are introductory; they deal generally with the pension concerns of Nova Scotia retirees and with changes in the economic environment, concluding in section D with a statement of what we consider the three priority issues. Section E contains our detailed analysis of the regulatory issues in this Province that most directly affect retirees and each sub-section includes a number of related recommendations.

In an appendix, we try to reply to some of the questions that the Discussion Paper raises, those that we regard as most pertinent to our major concerns. For ease of reference, we number each of the questions, keyed to the section of the DP in which each is found.

B. Pensioners' Interests and Concerns:

Pensioners are not simply "other stakeholders," [DP, 1] because they are receiving pensions, or because they are old. We are not people with only a secondary stake in our institution's pension and the Province's pension legislation, compared to employers and active employees. Pensioners are primary, central to any system of pensions. Without the principle – recognized already in the 19th century – that retirees need income support, there would be absolutely no reason for pensions to exist; nor any rationale for regulation to promote or limit them. Changes in pension legislation can threaten pensioners' acquired rights, indexation is an important example. Pension legislation ought not only to establish the pension rights of employees while active, it should also preserve, protect, and improve those rights over the course of each pensioner's retirement. Whether legislation best permits "pensions to work for both employers and employees" [Scope Document, Objective #1 = SDO1] is doubtless an important concern. But of greater significance is whether legislation enables pensions to work for pensioners.

Despite major reforms two decades ago, pension regulation in Nova Scotia remains skewed in favour of employers. Although occupational pensions play an important role in providing income security for Nova Scotians, active pension plan members in the Province enjoy limited rights to control or to influence the terms, administration or the investments of the plans to which they belong. Retirees are in an even weaker position. They are deeply apprehensive that the recommendations of the Panel may weaken the limited protection of the rights they now enjoy.

In the course of time, workers and executives generally increase their earnings even after adjustment for inflation. The only method for retirees to improve their pension payments – at best to match increases in the cost-of-living – is through pension indexation. CPP and OAS are fully indexed, major provisions of the personal income tax are indexed. Yet, retirees without either guaranteed formulaic indexation or performance-linked indexation must rely on the *ad hoc* sympathy of the employer for ongoing or occasional indexation. If the purchasing power of retirees' pensions is not protected, retirees will become much more dependent upon ongoing government financial assistance. Their interests, too, ought to be protected and defended. For this reason, there should be regulatory assurances that pension guarantees will continue to prevail over the coming decades. And indexation should be supported by regulation.

Despite the fact that pensioned retirees and active employees with future pension entitlements in a given institution may belong to the same pension plan, subject to the same actuarial rules and the same pension committee decisions, differences prevail between them. Retirees rely directly on their monthly pensions for income, not wages or salaries. Most retirees from defined benefit plans have little or no say regarding the administration of their pension plans after retirement, and they possess almost no leverage to prevent adverse changes in their terms or in the interpretation of their terms. Retirees from DC plans may face limited options at retirement or later.

For employees nearing retirement, their pension entitlement is a major (and often their largest) personal asset. The prospect of losing one's retirement savings as a result of deficiencies in pension governance is not one anybody would wish to contemplate.

Gordon Hall, (2003) *Twenty Questions Directors should ask about their Role in Pension Governance*, CICA website, p.5)

And what if this happens during retirement? Active employees who are plan members have well-funded associations or unions to negotiate, arbitrate or litigate changes, with the usual power of collective action. In contrast, once you retire, you lose your leverage with your employer.

On the other hand, it should be obvious that pension arrangements that benefit retirees will also be beneficial in future for active plan members, who are, in effect, retirees-in-waiting. Most of our suggestions will therefore be pertinent to the pension plans of all employees, active as well as retired.

C. The Changing Economic Environment:

The last major changes to pension legislation in Nova Scotia were introduced twenty years ago. At that time, inflation in Canada had been brought down to 4.0% per annum, but long Canada bonds were still yielding over 10%. The TSE 300 yielded a total return in 1988 of about 10%, also. The Canadian dollar was worth about 80 cents American. Unemployment was nearly 8%.

Over the two decades since 1988, unindexed pensions have lost approximately 40 percent of their purchasing power to inflation. And the economic environment was transformed. Inflation is now running at around 2.0% annually, but widely expected to rise. Interest rates have dropped to levels not experienced since the early 1950s. Treasury bills sell at 3.0% discount; long Canada bonds at 4.1%. The major consequence for pension plans is to increase the likelihood of solvency deficits greatly, because PBA regulations require present value calculations of pension fund liabilities to be based on a lower discount rate.

In addition, the TSX is up by about 5% over the past year, while the S&P 500 has dropped nearly twice as much over the same period. The Canadian dollar is now nearly at par with its US counterpart. Large federal deficits on the public accounts twenty years ago, and the resulting increases in public debt, have been replaced by large surpluses and energetic debt reduction. Today the Federal Government should be far less revenue-conscious; this could facilitate Federal regulatory solutions to some pension problems.

Mandatory retirement has been partly eliminated in Nova Scotia and will soon disappear completely. This change will very likely only slightly raise the average age of retirement. Although many employees who continue to work will have their number of years of pensionable service increased, this will not alter their life expectancy. Hence they will receive on average an enhanced monthly pension, but over a shorter period. This change will have mixed effects on defined benefit pension plans, but it will probably encourage larger defined contribution pensions, somewhat lowering the likelihood of running out.

Part-time employment – in academe as elsewhere – has greatly increased in the labour force, with negative consequences for the income levels of those so employed and thus for their pension entitlements.

D. Priority Pension Issues:

The Pension Review Panel's Discussion Paper poses 28 questions under thirteen headings. In addition, the Panel's "Scope Document" identifies four "problems that need to be considered," five "key objectives," and five issues that the review should address. All these questions, problems, objectives and issues are listed in Appendix 1. Despite the overwhelming detail in these Panel questions, and the wide sweep of some of the Scope Document's issues, the most significant priorities for retirees – issues that are also important for active plan members and for plan sponsors – are touched on marginally, if at all. These priorities – obviously also important for active plan members and employers, as well – are the following:

1. **How can pension regulation and delivery be restructured in Nova Scotia to promote outstanding long-term investment performance by pension funds?**
2. **How can pension regulation best promote full indexation of pension entitlements?**
3. **How can the effective involvement of retirees as well as of active plan members in the administration and management of their plans' assets be enhanced?**

We address these issues in section E below, keying our discussion to the numbers of the above three priorities, and make recommendations.

E. Discussion and Recommendations:**1.1 Pension Plan Funding: Enhancing the Viability of Pensions in Nova Scotia by Improving the Performance of Pension Investments**

Good investment returns are essential for pension fund health. In DC plans, good investment returns directly result in improved annuities at retirement or in higher pension payments. In DB plans, they enable indexation of pensions, improvement of plan provisions and reduced employer pension contributions. Bad investment returns have the opposite effects. This is because the funding of pensions in a mature pension plan normally comes only one-third or less from contributions and two-thirds or more from investment earnings.

It is scarcely accidental that this re-examination of pension regulation and funding assumptions comes after a seven-year period of relatively low returns on both bonds and equities. There is a real danger, however, that proposals to fix a short-term problem will have negative long-term consequences. The duration of the liabilities of most (DB) pension plans is 16-20 years, a length of time over which equities will generally deliver

annual returns two to six percent higher than fixed income investments. On the other hand, returns on equities are more volatile over short periods. Although pension investing is very long-term in nature, pressures and constraints from accounting rules and pension regulation promote short-term thinking. In addition, much of the financial services industry continues to promote the false *mantra* that there are only three asset classes: bonds, cash and market-traded equities in Canada and the USA. The reality is different.

Well-managed large pension funds, such as the Canada Pension Plan and the Ontario Teachers' Pension Plan, have already shifted their portfolios substantially toward holding a high proportion of equity and assets that produce long-term returns similar to those achieved on equity but which are largely uncorrelated with large-cap equity markets in North America. The most successful institutional investment managers in North America, like David Swenson at Yale University, have for nearly 20 years consistently produced annual returns 6% to 12% above those of the median Canadian pension fund. Today Swenson holds only 4% of his Yale portfolio in bonds (Federal issues only), because of the poor risk-reward characteristics of this traditional asset class. Only 11% is held in U.S. stocks. Half of his portfolio is in "real assets" and "absolute return" vehicles; over a sixth is in private equity. Managers such as Swenson successfully control portfolio volatility by diversifying into these other asset classes. [A thirty-page report on the Yale Endowment can be accessed on the Yale University website.]

On the other hand, smaller pension plans in Canada continue to hold a relatively large proportion of fixed income investments, partly because the prevailing pension wisdom in Canada and pension regulation both emphasize traditional investment practices and partly because they are small. This penalizes their sponsors, their pensioners, their active members and, indirectly, taxpayers. They need encouragement to emulate the large plans; and they may need institutional innovation to enable them to do so. This is the rationale for recommending changes to legislation and regulation that will promote a long-term investment perspective for pension funds, while hedging against short-term investment volatility wherever possible by the methods used by large well-managed pension funds.

Recommendation #1:

Regulatory disincentives to investing for the long term should be eliminated or reduced, and pension fund trustees encouraged to deal more flexibly with the mix of equity and fixed-income investments.

* * *

Small pension funds need help to secure some of the advantages of greater size. For example, investment management fees depend on the amount of assets to be managed, some interesting asset classes for

diversification (such as protected equity notes – over the counter products that today likely have a \$40 million minimum) may be inaccessible for small institutions, and investment expertise is expensive if the costs must be met from a small asset base. One way of addressing these problems is through setting up a public pension investment fund in Nova Scotia, as suggested by question DP 4.2(f). We envisage several potential roles for such a fund. But we do not suggest that universities be required to join. (We are strongly opposed to the idea, for example, of the Dalhousie Pension Plan being forced to amalgamate with other less well funded N.S. university pension plans that offer significantly inferior benefits. Dalhousie employees paid larger pension premiums than in many other plans.)

An obvious role for this provincial investment fund would be to offer professional investment in both traditional and non-traditional asset classes, such as private equity and absolute return investments. For DC plans that chose voluntarily to use this fund, this would lower management costs and likely improve the range of investment options. The major role of this fund for small and medium-sized DB plans in the Province would be to enable them to gain asset class diversification at relatively low cost. Such a fund could operate in a manner somewhat analogous to re-insurance for a casualty insurance firm, enabling smaller pension plans to transfer some investment risk to a much larger well-managed fund. Should such a fund be established, someone capable of thinking outside the traditional institutional investment mindset would be required to manage it.

Recommendation #2:

Serious consideration should be given to establishing a public-sector investment fund for Nova Scotia with a mandate to accept assets from Nova Scotian pension funds on a voluntary basis, and to invest these in ways that reduce market risk for participants while maintaining or improving long-term returns.

1.2 Enhancing the Viability of Defined Benefit Pensions by Reducing Regulation

The administration of a defined benefit pension plan in most provinces, including Nova Scotia, is time-consuming and onerous, since such plans are regulated provincially – with the broad goal of ensuring that pension promises will be met – but also regulated at cross-purposes by the CRA, which apparently wants to limit tax losses that arise through deferral of income tax on pension contributions and earnings. The conflict between provincial establishment of minimum pension benefit standards and Federal restrictions on pension benefits and pension plans has long – and justly – been criticized for being dysfunctional, regressive and costly.

Federal pension regulation under the Income Tax Act is extraordinarily complex and sweeping, limiting contributions, transfers, maximum pensions (in several dimensions), pension deferrals, and many other matters. As it has mushroomed over the last generation, it has imposed major compliance costs on defined benefit pensions and pension sponsors. These ever increasing DB compliance costs are a major factor influencing sponsors to switch to a DC pension plan.

The development of excessive Federal regulation of private pension plans has also reversed the broad thrust of Federal policy with respect to pensions from the 1960s. When the Federal government set up registered retirement savings arrangements at that time, it recognized that the general welfare of Canadians would be well-served by encouraging private savings for retirement. As the population ages and baby-boomers gradually reach retirement, and as life expectancy increases, occupational pension arrangements and registered retirement vehicles have become even more important as an element of social policy than forty years ago. The "tax expenditures" (by government) involved in deferring income tax for lengthy periods remain significant, but must be viewed in the current context of great fiscal flexibility. Furthermore, tax expenditures to support worthy goals, such defined benefit pension plans, are scarcely unique. Tax expenditures also support mineral and petroleum exploration, wind power development, installation of insulation, sale of books, and many other goals. So there is every reason why they should generously continue to support defined benefit pension arrangements.

The CRA started three years ago to ramp up enforcement of its pension rules, imposing new compliance costs on defined benefit pension plans. Yet most, if not all Federal pension regulation infringes on provincial jurisdiction and is no longer needed to protect Federal revenues (if it ever was). Nova Scotia should seek the cooperation of other provinces to bring this unnecessary and generally counter-productive Federal activity to an end.

Recommendation #3:

The Federal Government should be persuaded to phase out all CRA regulation of pension arrangements that are provincially regulated.

We fully realize that some Nova Scotia PBA regulations interact with the Federal tax regulations; that such a major change would take time to implement; and that Federal authorities may be reluctant to act. Yet this change would do more to make defined benefit pensions viable in Canada than any other conceivable action.

Given the diversity of pension arrangements, considerable regulation under the Nova Scotia PBA is doubtless necessary. However, some regulations, as well as some provisions of the legislation appear to work against the goal of ensuring that pension promises are kept. By engendering legal uncertainty, they inevitably generate litigation.

Recommendation #4:

The Review Panel should review Nova Scotia's PBA Regulations with the goal of making the rules simpler, clearer and more effective in protecting both active and retired plan members.

1.3 Enhancing the Viability of Defined Benefit Pensions by converting a regime of long-term plan deficits into one with long-term plan surpluses

Fluctuations in surpluses of pension plans are a genuine problem for a long-term investment policy, a problem artificially created in large part by an inflexible Federal CRA 'going-concern' surplus cap imposed on pension plans. Introduced a generation ago to limit the revenue lost through deferral of taxing pensions, the surplus cap was sold on the grounds of "tax fairness." It generally forces employers to halt pension contributions if the "going-concern" surplus reaches 10% of the pension fund's liabilities, threatening that otherwise the plan may be de-registered. Many informed observers have commented negatively about this perverse Federal surplus restriction. The forced dispersal of "excess" surpluses that arise from good performance leaves pension funds in danger of bad-year deficits, some so large as to threaten the future of sponsoring institutions.

Many DB pension plans have suffered from on-going plan deficits since the beginning of this decade because the technology-driven investment "bubble" of the late 1990s burst: Both the TSE and the NYSE fell by 30% over the 13 months from August 2000 to September 2001. During the bubble many plans were forced by the Federal CRA surplus cap to take contribution holidays. Other plans were induced by large surpluses to do this. (See below, under heading 2.4.) As investment markets turned sour and surpluses turned into deficits, many plan sponsors were slow to resume normal contribution levels. The high performance expectations generated by the previous long bull market may have been a disincentive to controlling deficits.

The combined effects of poor investment returns with lack of employer contributions often led to drawdowns of pension plan assets by 20-25% – enough to convert a 10 percent surplus into a 15 percent

deficit at market values. Viewed in a different time-frame, the ratio of pension fund assets to liabilities deteriorated by about five to six percent per quarter for over four consecutive quarters. Various asset-smoothing formulae applied by actuaries initially masked the extent of the drop in pension assets, however, and many pension plans were able to continue contribution holidays or to delay increasing contributions to reduce or eliminate their deficits for up to three years under the currently prevailing requirements for actuarial valuations. Both asset smoothing and delays in actuarial valuations effectively prolonged the pension funding crisis.

Opportunistically scheduled valuations and actuarial asset smoothing may involve good intentions by pension plan sponsors and actuaries. The understandable goal of both actions is to even out fluctuations in employer contribution rates, hence enabling the sponsor to plan cash flows better. With respect to asset smoothing, the problem is that no one can accurately predict when financial markets will peak or bottom out, nor at what levels this will take place. All of the many different approaches to smoothing assets are thus inevitably flawed, promote lack of transparency, and may delay necessary responses to changes in financial markets and may even yield perverse outcomes. In our experience, actuaries frequently and opportunistically change their method of asset smoothing. PBA Regulation 16(1)(c)(i) explicitly permits smoothing in solvency valuations, and it is commonly employed in going-concern valuations as well.

Recommendation #5:

PBA Regulation 2(h), the definition of “going-concern assets,” should be modified so as to prevent asset smoothing. PBA Regulation 16(1)(c)(i) should be altered to remove any reference to an “averaging” method.

A minimum three-year valuation cycle is required under PBA Regulation 13(1). A somewhat longer cycle might enable a somewhat longer term investment perspective under conditions where normal or super-normal contributions are occurring. Hence, we suggest:

Recommendation #6:

The frequency of required actuarial valuations should not be changed at this time, but a study should be conducted regarding the incidence of opportunism in filing valuations early and the consequences of that opportunism for plan members, pensioners and sponsors.

Accounting rules now require the annual financial statements of pension trusts to include a note that updates the actuarial status of the pension plan to which the trust relates. Hence the Superintendent of Pensions receives (up to nine months in arrears) annual information about the financial health of pension plans, even though valuations are required only at three-year intervals. To prevent severe pension deficits from developing during the inter-valuation period of a plan, the Superintendent could be empowered to intervene pre-emptively.

Recommendation #7:

The Superintendent of Pensions could be empowered to require a pension plan administrator to submit a new actuarial valuation as at the end of the most recent plan fiscal year if she has good reason to believe that the plan may be in significant deficit.

* * *

Rigid federal excess-surplus regulation ignores normal market cycles which predictably cause pension-plan surplus/deficit cycles. By lopping off the top part of the cycle, deficits at later stages of the cycle are made more prolonged and severe; provincial regulators are forced to respond by constructing convoluted rules for making good these deficits. The interaction at cross purposes of federal and provincial regulations tends to cause pension plans to incur ongoing deficits leavened with occasional relatively modest surpluses. The goal of regulation should be precisely the opposite: healthy pension plans with actuarial surpluses in most years, punctuated with occasional modest deficits at the bottoms of normal economic cycles.

It is axiomatic that persistent plan deficits endanger pension benefits, including indexation. They also have negative economic and psychological effects on plan sponsors, forcing them to consider alternative pension arrangements or plan windup. Pension fund trustees may see themselves compelled by deficits to immunize their portfolios, a "final solution" to short-term market fluctuations that not infrequently is advanced by investment consultants. Immunization predictably prevents any surpluses from ever troubling the trustees or the sponsor in the future, thus causing extremely negative effects on pension benefits, including indexing.

Recurring plan surpluses, on the other hand, have the opposite effects. Plan sponsors may be persuaded to improve benefits if their DB pension plans enjoy surpluses, fund investment policies can aim at long-term success and plan members will trust the future reliability their pension arrangements.

Recommendation #8:

If the Federal Government is unwilling to completely eliminate its 'going-concern' pension surplus cap, Nova Scotia should make the strongest possible representations to increase the flexibility of the CRA restrictions on pension surpluses.

One method would be to change the inflexible cap to a rolling multi-year formula (say over four or five years) which would reflect the ongoing investment performance cycles, a formula that would enable a pension fund to overshoot its surplus cap during highs in the investment performance cycles by balancing these 'excess' surpluses against undershooting of the cap in poor years. Such a rolling formula would enable a pension fund to retain enough performance-related increased value in good economic years to offset the poor performance in bad years. An alternative method of achieving this necessary flexibility would be to move the cap at the top of allowable surplus higher, say to 20 or 30 %. Such increased flexibility would help minimize deficit problems of pension funds in poor investment years, such as we have recently experienced, and it would only minimally reduce federal tax revenues over each business cycle.

1.4 Solvency Shortfalls: Do we really need to Punish DB Plans?

Much ink has been spilled recently over solvency questions. Need some quasi-public entities be subject to solvency valuations; should the payback period of deficits be reduced or lengthened? Two decades ago, solvency was scarcely mentioned as a problem, so what changed? Long-term interest rates were then at much higher levels. Since solvency valuations assume that all of DB fund's assets must be wound up into fixed-income government instruments, the historically low interest rates that prevail at present create the solvency problem. Suppose instead that "wind-up" provides plan pensioners and plan members with the option to transfer their pension entitlements and associated pension assets into a government-run pension fund (see above, section 1.1). Since a reasonably well-run pension fund can easily achieve annual returns 2% to 5% above the rates to maturity on long-bonds over almost every 5-10 year time horizon, this option would be particularly attractive to pensioners in index-linked plans. At the same time it would offer solvency calculations an alternative interest rate that would be 1% to 3% higher than the long Canada rate at times of low interest. In other words, change the meaning of plan wind-up, not the solvency rules.

Recommendation #9:

Alter the meaning of wind-up to permit transfer of assets and liabilities at “wind-up” – at the option of the plan members and pensioners – to the public-sector investment fund for Nova Scotia established under Recommendation #2. This should be done in such a way that the actuarial risk to the public-sector fund is modest; such a fund is NOT intended to be a “guarantee” fund, but instead, a source of higher returns than investment in supposedly riskless long-term government bonds.

1.5 Pension Plan Surpluses: Partial or Complete Contribution Holidays

Suspension or cessation of contributions to a pension fund is sanctioned by PBA Regulation 9(4):

If there is no going concern unfunded actuarial liability or solvency deficiency, the actuarial gain referred to in subsection (1) may be applied to reduce any employer contributions for normal cost.

PBA Regulation 9(4).

Essentially, if a going-concern surplus is identified in an annual report to the Superintendent of Pensions, this regulation permits a contribution holiday to be put in place by the plan sponsor without any notification to plan members or pensioners and without seeking permission from the Superintendent. However, in practice, she insists on reviewing applications for contribution holidays and approving them. Other regulations appear to require little monitoring of the holiday, inasmuch as no interim reports are mandated, annual reports with respect to DB plans may be filed up to nine months after the end of the plan's fiscal year, and triennial valuations twelve months in arrears.

Experience over the last decade (cited above) has shown that many plan sponsors did not halt contribution holidays on a timely basis and resume normal contribution levels as surpluses were turning into deficits. In a very few cases this delay may have been wilful, in others it resulted from lags in perception of the changed environment, and lags in reaching and implementing decisions. This suggests that the surplus threshold for starting a contribution holiday is set too low and that monitoring of its effects inadequate to prevent the contribution holiday from leading directly to future funding difficulties.

There is a further problem. During most contribution holidays, pensioners receive no increased benefit, while the plan sponsor – and in some cases, active plan members – gain financially through the reduction or cessation of contributions. Although going-concern surpluses can arise in many ways – for example, changed actuarial assumptions or method, reduced plan benefit provisions, mortality greater than

projected, etc. – the major source of the surpluses that lead to contribution holidays is almost invariably the investment earnings in excess of the level projected on pension funds. Since a significant proportion of a mature plan's pension assets (in some cases as much as half) typically relates to retired members, it is manifestly unfair that pensioners seldom if ever share in the financial gain from the holiday. This unfairness can be rectified.

If these two problems were properly addressed through stricter regulatory control of contribution holidays, using a portion of a pension plan surplus through a partial or total contribution holiday would not be unreasonable. We urge that the following set of changes to the PBA and the PBA regulations be introduced, as follows:

Recommendation #10:

Every defined benefit or hybrid pension plan in Nova Scotia should be required to establish a normal level of employer contributions, which – given the 50% rule – could not be lower than the matching level. This would be the level at which, under the prevailing actuarial assumptions of mortality, rates of return, etc, the plan could expect to be fully funded over time, starting from a zero 'going-concern' surplus/deficit position.

A plan sponsor seeking to contribute less than this "normal level" should be required to submit to the Superintendent of Pensions for approval a proposal to that effect, together with an actuarial valuation and an estimate of surplus reduction projected to arise from the lower than normal contributions and from other benefits expected to be provided under the proposal.

Approval of the sponsor's proposal by the Superintendent of Pensions would require that

- (a) the initial level of 'going concern' surplus measured at market values of assets be equal to at least 10% of plan liabilities,**
- (b) a share of the surplus reduction under the proposal be provided (as lump-sum non-pension benefits) to plan pensioners in proportion to the plan liabilities related to those pensioners, and**
- (c) the proposal provide that active plan members receive a share of the overall surplus reduction related to the ratio of employee contributions to total normal plan contributions (i.e., normal employer contributions plus normal employee contributions).**

Recommendation #11:

To avoid “overshooting,” updates of the actuarial status of the plan be required to be reported promptly after quarter-end to the Superintendent of Pensions every quarter year during any contribution holiday. If such a report revealed that the Plan surplus was five percent of liabilities or less, the contribution holiday would terminate forthwith.

2.1 Indexation Issues - Effects of Indexation on a Plan's Funded Status:

Three DB plans exist at Nova Scotia universities (Acadia, Dalhousie and Kings), all of which incorporate some indexation. Four universities have DC plans (CCB, MSVU, SFX, SMU). Although there are many hybrid plans in universities in Ontario and other provinces to the west, there are none at universities in Atlantic Canada. Most plans in universities elsewhere provide for some adjustment of pensions to inflation. These indexation arrangements vary considerably, but may be divided into three categories, which may be combined with one another:

- (a) those that determine indexation by a contractual formula alone;
- (b) those that link indexation to investment performance of the pension fund in excess of some threshold rate; and
- (c) those in which at least some indexation is at the (*ad hoc*) discretion of the plan sponsor or administrator.

Actuaries are permitted in some circumstances to use professional judgement, but generally must “conform to accepted actuarial practice.” [Canadian Institute of Actuaries, “Consolidated Standards of Practice”, May 2002, Section 1210. See also Section 1130.] Section 1730 (“Appropriate assumptions”) of the Actuaries’ manual makes it clear that actuarial going-concern and solvency calculations for pension funds should make assumptions that take account of the plan’s indexation provisions.

As we understand “accepted actuarial practice,” the mechanisms for prefunding contractual and linked indexation differ. Formulaic (contractual) indexation would require (1) an estimate of the rate of inflation anticipated over the next three years, (2) a calculation of the resultant amounts of incremental pension payments expected under the formula, and (3) application of these amounts in the calculation of current service costs of the pension plan. Linked indexation generally would require an assumed post-retirement rate of return for the pension plan that is lower than the assumed pre-retirement rate (e.g., 4.5% instead of 6.5%, for 2.0% spread). In effect, this would increase the plan’s actuarial liability for current and future

pensions, funding indexation by the same percentage point spread when fund returns just match the assumed pre-retirement level. If the pension fund's rate of return exceeds the pre-retirement rate, more indexation is available; if the rate of return falls short of the lower post-retirement rate, all indexation is postponed until this shortfall is made good. The key implication of linked indexation for a pension plan's funded status is that some fluctuations in investment results are being absorbed by variations in indexation, implying that pensioners are bearing a portion of the investment risk of the pension fund.

In Nova Scotia, however, the regulatory environment with respect to inflation protection is best described as hostile. Nova Scotia PBA Regulations #10(1) and #10(3) prescribe that

- (1) If a pension plan provides for escalated adjustments, the estimated future costs of the escalated adjustments may be excluded from the funding requirements set out in sections 5, 6 and 8.
- (3) For the purposes of a report required by Section 12 or 13, factors attributable to an escalated adjustment may be excluded in determining the existence or amount of any going-concern unfunded actuarial liability.

Consequently Nova Scotia regulation and actuarial practice are in conflict, producing the confusing situation where some going-concern and some solvency actuarial valuations in Nova Scotia include prefunding of both contractual indexation and linked indexation, while others do not. We regard this situation as unacceptable and discriminatory. If a defined benefit pension plan contains provisions for indexation – whether contractual or linked, those benefits should be prefunded, just as bridging benefits, early-retirement benefits, minimal spousal benefits, and other ancillary benefits are prefunded.

Recommendation #12:

The PBA regulations should be amended to ensure that the estimated future costs of contractual indexation and of linked indexation provisions in Nova Scotia pension plans are always included in the funding requirements of those plans.

Although inflation is relatively benign at the present time, even the federal norm of 2 % annually, compounded, suggests that the occupational pensions of current and future retirees will lose a significant amount of purchasing power over their remaining years. The Canada Pension is fully linked to inflation, as is OAS, but for many seniors, occupational pensions are more important than these two other sources of retirement income.

We strongly suggest that indexation is such an important matter that all DB and hybrid pension plans in the Province should be required to set aside a modest amount of funds annually to provide some indexation to their pensioners. The amount involved would roughly match the savings that small plans might enjoy in investment management fees by utilizing the Provincial investment fund. The "tax" on DB pension plans proposed would suffice to provide about 1.5% indexation to pensioners, since roughly one third or more of the liabilities of a mature plan relate to pensioners. Note that this recommendation would ensure some minimal funding for indexation over time without specifying the indexation method to be used.

Recommendation #13:

Every DB and hybrid pension plan under the jurisdiction of the NSPBA that has been in operation for a decade or longer should be required to allocate a minimum of 0.5 % of its assets annually to provide indexation to its retired pensioners (and their surviving spouses), using a systematic and fair method approved by the Superintendent of Pensions.

2.2 Pension Plan Surpluses: Distribution on Wind-up

Nova Scotians whose pension plans provide partial or complete indexation should be concerned about the negative potential of a wind-up. Not only does the PBA fail to protect their interests adequately, Regulation # 10 may reduce their entitlements by excluding inflation protection provisions in their pension contracts from the calculation of solvency liabilities. In other words, some of the pension promises that have been agreed between plan sponsors and plan members and former members can simply be ignored, if the sponsor decides on a partial or complete plan wind-up. Not only does this regulation appear to conflict with the normal applications of contract law; it may also be inconsistent with trust law. No wonder that litigation develops in wind-up situations.

It might be countered that calculations of future rates of inflation, future rates or return and other future contingencies is too difficult. But actuaries make assumptions about future events all the time; that is a major part of their professional responsibilities. [Canadian Institute of Actuaries, *Consolidated Standards of Practice*, May 2002, Section 1710 ("Needed assumptions")] This assertion therefore has no merit.

The normal wind-up process of purchasing annuities puts indexed pensions immediately at risk because most annuities incorporate no escalator provisions, whether linked to performance or based on rates of inflation. Two possible solutions to this problem involve changing the wind-up process fundamentally:

- (a) to permit the pensioners as group to take over the pension fund to be wound up, and to continue to administer the deferred pensions and pensions-in-pay by selecting trustees of their own choosing, or
- (b) to transfer both the assets and the liabilities of the pension fund being wound up to a public-sector investment fund for Nova Scotia established as described in *Recommendation #2* above. Essentially this process would be analogous to the takeover of a small troubled bank by a larger, better capitalized one, like the experience a generation ago with the Unity Bank and the Continental Bank.

Recommendation #14:

Give serious consideration to permitting pensioners and deferred pensioners of plans being wound up the right to administer their own DB pension funds, subject, of course to regulatory restrictions.

Recommendation #15:

Extend the mandate of a voluntary public-sector investment fund for Nova Scotia (see *Recommendation #2* above) to include the administration of pension funds that are being wound up.

2.3 Pension Plan Surpluses: Distribution from Continuing Plan

In Nova Scotia, distribution to the employer of surplus that has arisen over the past two decades requires the text of the plan to have contained explicit wording permitting such an action. In addition, other onerous conditions must be met. Effectively, these rules tightly restrict direct withdrawal of surplus from a continuing plan. Thus, the indirect approach of taking a contribution holiday is used by plan sponsors instead. In our view, these are reasonable constraints on dissipation of pension surpluses.

Recommendation #16:

The PBA's currently prevailing restrictions on surplus withdrawal by employers should continue.

3.1 Effective Involvement by Pensioners and Plan Members in Governance of Pension Plans and Pension Funds: The Advisory Model

Section 30A of the PBA provides for the establishment of an advisory committee of active and retired plan members for any Nova Scotia pension plan. Retirees are disadvantaged, however, because they are permitted only one representative, while active plan members might readily have seven or eight. This is far

from the parity representation of retired members compared to active members; it also signally fails to reflect the liabilities attributable to the various groups. Moreover, the retired members have to share their one representative on the committee with deferred pensioners. There is also the absence of a mechanism for appointing representatives of many of these groups, (who may not be unionized).

Even if a committee is established, its real powers are limited. It may examine the pension plan's and pension fund's records and it can monitor the plan's administration; but it is unclear whether it can make complaints to the plan's administrator. The committee cannot prevent adverse amendments from being advanced or implemented by the plan sponsor, it cannot grieve misinterpretation of plan provisions by the plan administrator or administration of the plan that is inconsistent with the plan's terms, and it has no power to approach the Superintendent of Pensions with its concerns.

Recommendation #17:

The rules for advisory committees should be revised to make them easier to establish, more democratic in composition, more representative of relative numbers in various groups and more capable of intervening.

3.2 Effective Involvement by Pensioners and Plan Members in Governance of Pension Plans and Pension Funds: Learning from Quebec

Even with the change proposed above, the advisory model appears incapable of giving retirees and employees the powers they need to safeguard their future benefits. Effective governance at all levels is crucial to the management of pension plans. It promotes accountability and transparency. Unfortunately, many pension plans lack proper governance in one or more dimensions. For example, the Rotman International Centre for Pension Management Study (Toronto, ICPM, 2007) compared 2006 to 1996 survey data and found that inadequate selection procedures and the weak competence of some board members were continuing problems. These problems have a direct impact on pension plan performance. Weak governance begets weak investment performance, and it is likely to lead to repeated employer-employee and employer-pensioner confrontations.

In its model pension law – scheduled to be released this summer in final form – CAPSA recommends the Quebec approach to governance. Since CAPSA represents all but one province, this is a strong vote of confidence. In January 2004, it wrote in “Proposed Regulatory Principles for a Model Pension Law” (CAPSA web-site),

that the administrator of a pension plan be a pension committee with at least two members designated by the plan members: one by the active members and the other by the non-active members. The pension plan may also provide for other members to be designated. . . .

CAPSA views the primary advantages of the pension committee model to be

- a clearer distinction between the role of the employer and that of the pension plan administrator
- increased member access to decision-making processes and information; and
- enhanced supervision of pension plan operations and administration

Knowledgeable actuaries in Quebec indicate that this approach has worked well there over the past decade, partly by improving management-employee-pensioner interaction. Hence,

Recommendation #18:

That pension funds be invested and pensions administered by committees comprised of (and selected by) employees and pensioners. Where registered pensioner organizations and employee organizations exist, these should be involved in the selection process. Employer representatives could also be included on the committee. Quebec legislation is a good model to consider.

3.3 Better Governance of Pension Funds

Good governance is also important in another sense. Those administering most pension funds in Nova Scotia are dealing either with trust monies or funds held in trust, and consequently are fiduciaries. Under trust law their primary obligation is to act in the best interest of the pension plan's members and pensioners (and surviving spouses), not the interest of the employer. Section 29 of PBANS extends these obligations and the duties of prudence, diligence and skill, etc. to agents and employees of the administrator and to trustees of pension funds and enjoins them to avoid known conflicts of interest. The PBANS should include an explicit provision (present in the Quebec pension legislation) directing the pension administrator and fund trustees to act in the plan members' best interest. Lack of such an explicit clause results in some of these parties inappropriately acting in the best interests of the plan sponsor without realizing that there is a conflict of interest.

Recommendation #19:

Section 29 of the PBA of Nova Scotia should be amended to include a clause directing all parties subject to that section to act in the best interest of the plan members and pensioners.

3.4 **Better Enforcement of the PBA and the Regulations**

Section 26 of the PBA requires that pension plans be administered in accordance with the Act and the Regulations under the Act, as well as according to the filed plan documents, provided these are consistent with the Act and Regulations. (If these are inconsistent, the PBA and Regulations require plans to provide no less than the minimum required levels of benefits to plan members.) But pension legislation and regulation is complicated and opaque. So inadvertently, though not necessarily wilfully, some employers or plan administrators may not be in compliance, for example, by failing to keep pension funds “separate and apart from other money or property of the employer” as required by PBANS sec. 46 (6). There are three difficulties in enforcing the rules. First, the plan administrator is generally the plan sponsor, so is unlikely to disadvantage himself; second, few employees or pensioners possess the detailed information about administrative behaviour and pension rules, even if they were disposed to engage in whistleblowing; third, the regulator is overwhelmed by her normal duties and has too little time to deal with complaints brought by aggrieved pensioners and other plan members.

Recommendation #20:

That the Panel give serious consideration to the establishment and funding of a special pension ombudsman, separate and independent from the Superintendent of Pensions to deal with complaints from pensioners and plan members.

3.5 **Making Pension Plans more transparent to Plan Members**

Transparency results from good communications and appropriate reporting mechanisms. But few pensioners and plan members understand actuarial calculations, and they typically find pension terminology mysterious. So communication of pension information to plan members and former members is difficult. Moreover, despite legislative requirements for disclosure in the Pensions Benefits Act and regulations thereunder, [sections 31-36; Regulations 33, 35-37, 39-47] the information required to be disclosed is insufficient for concerned employees and retirees. For example, retirees and plan members cannot independently check on whether the funds of the plan are being invested properly. Nor can most verify the accuracy of pension calculations.

The result is an erosion of confidence in pension fund trustees and administrators. Quarterly and annual reports and pension meetings for the plan members are only as effective as the administrators and

managers wish to make them. With the increasing sophistication of software and the accessibility of electronic communication, general pension plan information, detailed documentation and simulation of the effects of choosing various pension options should readily be available on the plan sponsor's websites.

Recommendation #21:

The Act or Regulations should require regular reporting through electronic and other channels by the pension plan's administrator to active plan members and pensioners of relevant information.

Concluding Remarks:

We have addressed some of the significant issues relevant to your Discussion Paper and of special concern to retirees.

We thank the Nova Scotia government and the Review Panel for initiating this pension review. We look forward to the positive results of your analyses of the studies and hearings undertaken.

An appendix includes answers to some of the questions posed in your Discussion Paper.

* * *

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The submission was edited by Professor Howard Fink, former President of CURAC, and by Professor J. Philip Welch, President, ADRP.

Appendix # 1**Questions from the Panel's Discussion Paper and from Panel's Scope Document**

- 3.0 (a) *Question: Should pension legislation and regulation have goals other than those listed?*

The Panel's Discussion Paper (p. 18) points out that the "main objective of the Pension Benefits Act is to safeguard employee entitlements to benefits promised under pension plans." Federal pension legislation via the Income Tax Act aims primarily at restricting the deferral of taxes from all types of savings for old age. Considerable regulatory effort under the NSPBA is devoted to ensuring that pension funds are appropriately invested and that pension plans are properly administered. The five "goals" listed are neither the primary goals of Provincial pension legislation and regulation, nor are they listed in order of importance. Instead, they mostly are means to achieve the main objective indicated above. There is no question that pension legislation and regulation does and should have goals other than the ones listed.

- 3.1 (a) *Question: Are there plan designs not in use that would provide the benefits of DB plans while minimizing risk?*

A pension plan – whether DB, DC or hybrid – is an insurance arrangement to deliver incomes to seniors by setting aside funds during their working lives. A variety of risks are shared among plan sponsors, active plan members and pensioners, depending on the terms of the plan. It may be possible to reduce the risks or to transfer them to another party, but they cannot be eliminated.

From the perspective of a DC pensioner, the risks faced may include longevity risk (living too long), liquidity risk (being unable to access retirement funds, perhaps because they are invested in ABCPs), timing risk (markets are down at the date of retirement), interest rate risk (annuities are expensive at retirement), inflation risk (prices rise) and investment risk (failure to earn an adequate return on the pension capital). A DB pensioner faces no longevity risk or liquidity risk, but faces instead sponsor funding risk (the sponsor of a seriously underfunded pension goes bankrupt or commingles pension and employer funds), fiduciary risk (the pension fund trustees fail to make decisions in the best interests of the plan beneficiaries) and inflation risk. If the DB pension is indexed contingent on investment performance, then the pensioners also bear some – but not all – of the investment risk. There is also regulatory risk (i.e., that the Federal or a provincial government remove protections to pensioners in existing legislation, or, alternatively, require sponsors to fund new protections).

Some of these risks for DB pensioners can be reduced by requiring/inducing trustees and sponsors to take their fiduciary responsibilities toward beneficiaries seriously, but they cannot be eliminated. Some investment volatility may be reduced through non-standard investment policies that make use of relatively unused asset classes, such as absolute-return vehicles.

From the perspective of a plan sponsor, the trustees of a pension fund, or active DB plan members, a similar listing of risks can be carried out. The precise terms of the plan (e.g., a partial sharing of contributions between sponsor and employees, indexation according to a formula) and the precise requirements of regulation (e.g., required frequency of actuarial valuations and required speed of making good deficiencies) will partly determine the analysis.

Questions:

- 4.1(a) *Should the current trend towards less DB plans be accepted, or should regulators permit DB plans that may be more attractive to employers by reducing funding risks?*
- 4.1(b) *In the case of DC plans, to what extent should an employee's right to make investment choices be limited, and by whom?*
- 4.1(c) *Should new forms of DB pension plans be permitted to enhance their availability?*
- 4.1(d) *Should new forms of Hybrid pension plans be permitted to enhance their availability?*
- 4.1(e) *Should DC members have the ability to use different disbursement options, such as LIF type payments, rather than be required to convert funds on their retirement date?*

Questions 4.1 (a), 4.1(c) and 4.1(d) are so vaguely expressed, that it is impossible to respond. With regard to question 4.1(b), highly speculative choices should not be available (no penny stocks!) by regulation. With respect to question 4.1(e), we believe that the restriction on disbursement options in the Income Tax Act should be removed.

Questions:

- 4.2(a) *Are current rules for measuring and remediation of going concern and solvency deficits appropriate?*

Smoothing of assets for going-concern calculations should be disallowed. This process does not stabilize contribution levels. The frequency of valuations might be varied from three years. Likewise, the payback period (now 15 years) might be longer. "Wind-up" might be handled differently, as well.

- 4.2(b) *Should there be exceptions to the funding rules for universities, multi-employer pension plans and municipalities, or anybody else?*

No substantial deviations should be permitted. Degree-granting institutions have disappeared within the last twenty years in Nova Scotia. So have municipalities. Hence, pension plan wind-up of these entities is possible, if unlikely.

- 4.2(c) *Should going concern funding still be a requirement?*

Yes. It alone ensures an orderly accumulation of pension assets. In the 1980s, solvency problems were unusual, but going-concern valuations sometimes revealed funding problems.

- 4.2(d) *Should promises as to future benefit accrual be restricted to the level that can be funded by contributions?*

No. This would undermine the principle of gradual and uniform accrual of benefits.

- 4.2(e) *Should there be a requirement for full funding at wind-up?*

Absolutely. But bear in mind that the current solvency rules in Nova Scotia do NOT require full funding because indexation costs need not be included.

- 4.2(f) *Is the idea of a province wide pension plan for some public or private employers a good idea? Should such a plan operate as a multi-employer pension plan?*

See the detailed discussion in text.

Questions:

- 4.3(a) *Should regulators speak to the question of the ownership of plan surpluses? If so, what should it say?*

This is an issue for the legislature. Nova Scotia law is already clear on this issue and no case has been made to alter the existing legislative provisions.

- 4.3(b) *Is the concept of "deferred wages" valid? And if so, is there any current validity to it with respect to the determination of the responsibility for funding and for entitlement of surplus?*

Of course it is valid. But this has no implications for funding. A pension holiday may reduce or eliminate surplus in favour of the plan sponsor, but entitlement to withdraw surplus should continue to depend on the provisions in the pension plan text, and on the deeds of trust.

Questions:

- 4.4(a) *How should funding concerns for MEPPs be addressed? Would permitting the implementation of a different type of Hybrid pension plan be useful for MEPPs?*
 4.4(b) *Which of the funding tests should apply to MEPPs?*
 4.4(c) *Should regulators facilitate the further development of hybrid plans? Would the Quebec model be an attractive option for Nova Scotia employers?*
 No comments.

Questions:

- 4.5(a) *Should government attempt to define, audit, and regulate "good governance"? Why or why not? If so, what types of governance issues should be regulated?*
 4.5(b) *Given that there are associated costs with governance, what is an appropriate cost for "good governance"?*
 See the main text. Good governance goes far beyond dotting i's and crossing t's.

Questions:

- 4.7(a) *Does the current regulatory system work effectively? Are there currently unnecessary rules and regulations in place? If so, what are they? Should the appeal process be changed? If so, how?*
 4.7(b) *Should a plan have a minimum number of members before the government will regulate it? If so, what minimum number of members would be appropriate?*
 Possibly. But this depends on applicable Federal tax law. An fully independent plan with fewer than five members that enjoys tax deferral should not require regulation by the Province.

Question:

- 4.9(a) *To what extent should regulators attempt to regulate an employee's right to access funds?*
 Under the law they already do so in a reasonable way.

Questions:

- 4.10(a) *Should the legislation require grow-in benefits to be provided on plan wind-up?*
 4.10(b) *Should legislators maintain the requirement to fund grow-in benefits upon wind-up?*

In an environment of labour shortages, special early retirement incentives should not be encouraged. Hence, no to both questions.

Question:

- 5.1(a) *Should "safe harbour" rules be established that would give DC plan sponsors and administrators protection from litigation?*
 Absolutely not. Why should DC plan sponsors be permitted by law to act irresponsibly and harm their employees without penalty? If the "safe harbour" would make the government responsible for righting the wrongs done to employees, why should Nova Scotia taxpayers take responsibility for the inadequacies of individual DC plan sponsors?

Question:

5.2(a) *What other issues are raised by phased retirement and what should be the regulatory position of Nova Scotia?*

Question:

5.3(a) *What should be the regulatory position of Nova Scotia be with respect to TFSAs for pension purposes?*

No comments.