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Submission by the Canadian Institute of Actuaries to the Nova Scotia Pension Review Panel

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Preface

The Canadian Institute of Actuaries (CIA) is pleased to present its comments for sustaining and improving the pension system to the Nova Scotia Pension Review Panel (the Panel) in response to the request for comments made in the Panel's discussion paper of May 28, 2008.

The CIA establishes the Rules of Professional Conduct, guiding principles and monitoring processes for qualified actuaries. The CIA's Guiding Principle 1 states that the public interest is paramount. The CIA also assists the Actuarial Standards Board in developing Standards of Practice applicable to actuaries practising in Canada, including those standards governing the actuarial valuation of pension plans.

The CIA continuously reviews its Standards related to Defined Benefit pension plans and new Standards of Practice are being developed by the Actuarial Standards Board for the funding of pension plans and for determining the commuted value of a pension benefit.

Recently, the CIA has made a number of recommendations for changes to the regulatory framework for pension plans in Canada, which we believe are relevant to the work of the Panel and which we understand the Panel will be incorporating in its review. Our previous submissions containing these recommendations include:

1. The Canadian Institute of Actuaries' Prescription for Canada's Ailing Pension System ("CIA Prescription") (http://www.actuaries.ca/members/publications/2007/207061e.pdf, June 2007).
2. Submission by the Canadian Institute of Actuaries Presented to the House of Commons Standing Committee on Finance ("CIA Finance Committee Submission") (http://www.actuaries.ca/members/publications/2007/207076e.pdf, August 2007)
3. Submission by the Canadian Institute of Actuaries to the Ontario Expert Commission on Pensions ("CIA Ontario Submission") (http://www.actuaries.ca/members/publications/2007/207097e.pdf, October 2007)
4. Submission by the Canadian Institute of Actuaries to the Alberta-British Columbia Joint Expert Panel on Pension Standards ("CIA Alberta-BC Submission") (http://www.actuaries.ca/members/publications/2008/208018e.pdf, March 2008)

Our approach to this submission is not to repeat the content of our previous submissions, but instead to respond to the questions in the Panel's discussion paper either by referring to relevant material in our previous submissions, or by providing new commentary on issues not covered in our previous submissions. We have decided to omit responses to a few questions where we feel that the CIA is not well qualified to provide useful input to the Panel.

Responses to Panel's Questions

Section 3: Pension Plan Legislation

3. *Should pension legislation and regulation have goals other than those listed?*

We believe that all of the goals of pension legislation listed in the discussion paper are valid and appropriate.

In addition, we believe that the legislation should articulate, as an explicit goal, the expansion and improvement of pension coverage for Nova Scotians. The Pension Regulation Division's mandate should be enhanced to promote and to encourage the establishment and support for pension plans, in addition to the Division's current regulatory oversight role. This includes expanding the number of employees covered and ensuring appropriate security of any benefits provided.

For additional commentary on the importance of pension coverage to Canadians and the role of government in promoting pension plans, please refer to the last paragraph of section 1.1 of the CIA Ontario Submission (page 7), and to sections 3(b) through 3(e) of Chapter 2 of the CIA Alberta-BC Submission (pages 23-24).

Section 3.1: Types of Plans

3.1 *Are there plan designs not in use that would provide the benefits of DB plans while minimizing risk?*

For some thoughts about innovation in pension plan design and financing arrangements, please refer to section 1.5 of the CIA Ontario Submission (pages 9-10) and section 1.4 of Chapter 1 of the CIA Alberta-BC Submission (page 9). We note that there also exist strategies that reduce financial risks and increase security for DB plans (e.g., Pension Security Trust, a Target Solvency Margin, asset/liability matching, use of insured annuity contracts).

Section 4.1: Defined Benefit (DB) Plans versus Defined Contribution (DC) Plans

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?*

The CIA firmly believes that DB plans are beneficial to Canadians, and concurs with the sentiments expressed in 2005 by the former Governor of the Bank of Canada, David Dodge, in his comments cited in the Panel's discussion paper. For additional commentary in this regard, please refer to the CIA Prescription (page 3), section 1.1 of the CIA Ontario Submission (pages 6-7), section 1 of Chapter 1 of the CIA Alberta-BC submission (page 7), and section 1 of the CIA Finance Committee Submission (pages 2-3).

We do not believe that the government or the pension regulator should necessarily promote DB over DC plan design, or vice versa. However, current rules inadvertently discriminate against DB plans, often resulting in DB plans being much more "risky" and costly to administer than DC plans. If the regulatory environment allowed for more flexibility around DB plans, and the potential to

develop more innovative methods for managing and sharing of plan risks, DB plan administration costs could be reduced and DB plans could compete more evenly with DC plans. Legislation should be flexible enough to allow stakeholders to determine the most suitable balance of costs and risks that meets both the needs of employers and the security of employees.

We invite the Panel to examine the combination of recommendations presented in the CIA Prescription, as its main objective is to provide such additional flexibility while improving the security of member benefits.

4.1(b) Should new forms of DB pension plans be permitted to enhance their availability? Should new forms of Hybrid pension plans be permitted to enhance their availability?

The CIA believes that there are hybrid designs that should be investigated. Please refer to section 3(a) of Chapter 2 of the CIA Alberta-BC Submission (pages 22-23) for some ideas on how Nova Scotia and other Canadian governments can facilitate an environment for the development of new types of DB or hybrid DB/DC pension plan designs.

Section 4.2: Pension Plan Funding

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

We believe that it is important to improve the security of members' pensions while also providing an environment that encourages sponsors to continue/start DB plans. Our previous submissions have recommended a number of modifications to improve the current framework for remediation of going-concern and solvency deficits, including:

- the introduction of the Pension Security Trust;
- the Target Solvency Margin;
- raising maximum surplus levels;
- letters of credit;
- changes to solvency valuations;
- frequency of actuarial valuations.

For details on the CIA's recommendations, please refer to section 2 of the CIA Ontario Submission (pages 10-17), section 2 of Chapter 1 of the CIA Alberta-BC Submission (pages 9-15), and section 3 of the CIA Finance Committee Submission (pages 3-5).

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

Several provinces have already adopted exceptions for pension plans of certain public-sector employers (such as municipalities or universities). Examples of these exceptions include partial or full exemption from solvency funding rules, on a temporary or permanent basis. Although employers in the public sector are, in

general, less likely to default on their pension funding obligations than in the private sector, pension plans in the public sector should continue to be subject to appropriate funding standards. For additional commentary, please refer to sections 5(a) and 5(b) of Chapter 2 of the CIA Alberta-BC Submission (pages 26-28).

We believe that variations in funding rules should reflect the method for sharing of risks between employers and plan members, and the common understanding of the parties who are bearing the risks in each situation. For example, single-employer plans in which the employer bears the funding risk should be treated differently from negotiated-contribution multi-employer plans. If the risk is shared equally between the parties (i.e., "jointly sponsored" plans), there may be no need to accelerate funding requirements as the risk is understood between the parties. On the other hand, if the employer bears the funding risk, members may have an expectation of greater protection which may be delivered using the approaches discussed in our response to question 4.2(a).

We believe it is vital to enhance public understanding of the "pension promise." Among the CIA's recommendations in this regard are the establishment of a formal funding policy for each plan, improved disclosure of funding information to plan members, and better public education of pension and retirement savings concepts. For additional commentary, please refer to section 3 of the CIA Ontario Submission (pages 17-18), section 3 of Chapter 1 of the CIA Alberta-BC Submission (pages 15-17), and section 2(h) of Chapter 2 of the CIA Alberta-BC Submission (page 22).

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

In most situations solvency requirements are the most valuable tool for regulators to monitor security of members' benefits. The going concern funding allows the employer to identify long-term sufficient and stable contributions required to cover benefits promised. Please refer to section 5(a) of Chapter 2 of the CIA Alberta-BC Submission (pages 26-28) for further comments.

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

We do not understand the context of this question. The CIA would be pleased to meet with the Panel to seek clarification and to respond accordingly. In any event, pension legislation should continue to allow surplus assets of pension plans to fund future benefit accruals, subject to any prescribed solvency funding margin.

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

As mentioned in our response to question 4.2(b), we believe that the funding rules, including the rules that apply on plan wind-up, should reflect the method for sharing of risks between employers and plan members.

For example, single-employer plans in which the employer bears the funding risk should require full funding on wind-up. If it is clear that the risk is borne by plan members (e.g., negotiated contribution multi-employer plan where benefits may be reduced), there should be no need for full funding on wind-up as the employers' obligations are limited to the negotiated contributions.

Section 4.3: Surpluses

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

To encourage employers to maintain DB plans and provide adequate funding and hence improve the security of members, the CIA believes that it is vital to remove the present uncertainty about surplus ownership and utilization. For additional commentary, please refer to section 1.2 of the CIA Ontario Submission (pages 7-8) and section 1.2 of Chapter 1 of the CIA Alberta-BC Submission (page 8).

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?

Whether or not a pension plan represents "deferred wages" depends on how the plan was established and maintained, the compensation policies in the particular workplace setting, and how the pension promise is articulated and communicated. Conceptually, we believe that viewing pension plans as "deferred wages" may be valid in some situations, but it is not necessarily valid in every situation. We are not qualified to comment on this issue from a legal perspective.

To the extent possible, disputes over surplus and the concept of deferred wages should be resolved through the establishment of a clearly communicated funding policy, and by other methods of enhancing the understanding of the "pension promise." For additional commentary, please refer to section 3 of the CIA Ontario Submission (pages 17-18), section 3 of Chapter 1 of the CIA Alberta-BC Submission (pages 15-17), and section 2(h) of Chapter 2 of the CIA Alberta-BC Submission (page 22).

Section 4.4: Multi-Employer Pension Plans (MEPPs)

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?

MEPPs present a lot of unique issues. For a detailed discussion of the specific challenges and possible ways to address them, please refer to section 5(a) of Chapter 2 of the CIA Alberta-BC Submission (pages 26-28).

4.4(b) Which of the funding tests should apply to MEPPs?

MEPPs come in several varieties but for those where the benefit is a target rather than a promise, a solvency valuation may not be appropriate and alternative funding standards should be explored. Please refer to section 5(a) of Chapter 2 of the CIA Alberta-BC Submission (pages 26-28).

4.4(c) Should regulators facilitate the further development of hybrid plans? Would the Quebec model be an attractive option for Nova Scotia employers?

Please refer to section 3(a) of Chapter 2 of the CIA Alberta-BC Submission (pages 22-23) for some ideas on how Nova Scotia and other Canadian governments can facilitate an environment for the development of new types of DB or hybrid DB/DC pension plan designs.

Section 4.5: Governance

4.5 *Should government attempt to define, audit, and regulate "good governance"? Why or why not? If so, what types of governance issues should be regulated?*

With respect to pension plan governance, we believe that principles-based guidelines should be established that permit sufficient flexibility to allow for the unique circumstances of each plan. Statutory provisions should not be imposed unless such guidelines are shown to have failed. Please refer to section 4(d) of Chapter 2 of the CIA Alberta-BC Submission (page 25).

Section 4.7: Role of Regulators

4.7 *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?*

One of the greatest obstacles to the effective operation of the current regulatory system is the proliferation of different rules which apply to members in different jurisdictions. Many plans have members in multiple provinces, which makes administering such plans time consuming and costly.

Even though harmonization at a national level is the ultimate objective, as an initial step we strongly encourage the Atlantic Provinces to work together (as Alberta and British Columbia are currently doing) at developing common pension standards, thus creating lower compliance and supervisory expenses.

For additional commentary on efforts to improve inter-jurisdictional harmonization, please refer to sections 4(a) and 4(b) of Chapter 2 of the CIA Alberta-BC Submission.

Section 4.9: Unlocking Funds

4.9 *To what extent should regulators attempt to regulate an employee's right to access funds?*

The primary purpose of a pension plan is to provide income during a person's retirement. While some limited flexibility may be appropriate, it is important to keep in mind that employers have established pension plans on a voluntary basis to allow employees to retire at an appropriate time with, hopefully, a sufficient income. Prior to reform of pension legislation 20 years ago, employees could only access funds to provide retirement pensions, and few plans allowed for portability. While portability is an important provision to allow mobile employees to consolidate their retirement savings into a single account, we believe that it would be contrary to the purpose of a pension plan for the legislation to allow employees access to their retirement funds for purposes other than retirement income, except in very unique situations.

Section 4.10: Grow-in Benefits

4.10(a) Should the legislation require grow-in benefits to be provided on plan wind-up?

For commentary about grow-in benefits and their implications for solvency funding, please refer to section 2.5 of the CIA Ontario Submission (bottom of page 13).

4.10(b) Should legislators maintain the requirement to fund grow-in benefits upon wind-up?

Under the current funding rules in Nova Scotia, grow-in benefits may be excluded from solvency funding while a plan is ongoing, but they must be funded following an actual plan wind-up. This “terminal funding” requirement for grow-in benefits could be extremely onerous for an employer at the time of winding-up the plan.

The requirement for terminal funding of benefits which are not otherwise pre-funded is undesirable and, possibly, inconsistent with the objectives of pension plan funding set out in the CIA Standards of Practice. According to those Standards (section 3400.05), the objectives of funding a pension plan are:

- the systematic accumulation over time of dedicated assets which, without recourse to the employer’s assets, secure the plan’s benefits in respect of members’ service already rendered, and
- the orderly and rational allocation of contributions among time periods.

Assuming grow-in benefits continue to be granted on wind-up under Nova Scotia legislation, alternative approaches to funding which would better align with the above objectives would be either: (a) to pre-fund grow-in benefits both on an ongoing basis and on actual plan wind-up; or (b) not to pre-fund grow-in benefits on an ongoing basis and, therefore, not to require that they be funded on actual plan wind-up.

Section 5.1: “Safe Harbour” Rules

5.1 Should "safe harbour" rules be established that would give DC plan sponsors and administrators protection from litigation?

The CIA supports greater disclosure of information to members and “safe harbour” protection for DC plan administrators who at least meet the standards set out. Please refer to sections 5(j) and 5(k) of Chapter 2 of the CIA Alberta-BC Submission (page 30).

Section 5.2: Phased Retirement

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

Pension legislation should be reviewed to permit phased retirement without mandating phased retirement rights. Please refer to section 5(l) of Chapter 2 of the CIA Alberta-BC Submission (page 30).

Section 5.3: Tax Free Savings Accounts (TFSAs)

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

The federal government's design of the TFSA allows for tax-sheltered savings together with considerable flexibility to use funds for any number of purposes. We do not believe that the primary purpose of TFSAs is necessarily for retirement income, and therefore we do not see a need for TFSAs to be covered by pension legislation. TFSAs essentially provide for immediate vesting, and if a plan sponsor wishes to put other rules around accessing funds during employment, they can do so on their own terms.

Conclusion

The CIA supports the work being conducted by the Panel on behalf of the government of Nova Scotia. We appreciate the opportunity to participate in this consultation, and would be pleased to offer any additional assistance requested by the Panel.

Canadian Institute of Actuaries' Prescription for Canada's Ailing Pension System

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CANADIAN INSTITUTE OF ACTUARIES' PRESCRIPTION FOR CANADA'S AILING PENSION SYSTEM

Defined Benefit pension plans are in crisis

Healthy Defined Benefit pension plans are a key element of the financial security of Canadians. However, most workers in the private sector do not have the opportunity to participate in a Defined Benefit pension plan. According to Statistics Canada, only 21% of private sector workers were covered by Defined Benefit plans in 2003, down from 29% in 1992. Pension plan sponsors in many industries are turning away from Defined Benefit plans and turning instead to Defined Contribution plans, with many large marquee name companies among those curtailing Defined Benefit plans or switching to Defined Contribution plans.

The Canadian pension system is built on four pillars:

- Universal government plans (Old Age Security, Guaranteed Income Supplement);
- Employment-related government plans (Canada Pension Plan/Quebec Pension Plan);
- Other employment-related pensions (e.g., employer or industry-sponsored plans, including workplace Defined Benefit and Defined Contribution plans); and
- Personal savings.

Weakness in any one of these pillars puts pressure on the other three.

Right now, weaknesses in private sector Defined Benefit plans threaten both the adequacy and security of Canadians' retirement income. Canada's patchwork of regulations, legal decisions, tax rules and changes in accounting standards has created problems. These problems have been compounded over the past several years by:

- Low interest rates;
- Increasing longevity;
- Volatile market yields;
- Rising pension costs; and
- Uncertainty regarding contribution holidays and plan surplus ownership.

Because of the critical importance of Defined Benefit plans in the overall pension system in Canada, the Canadian Institute of Actuaries (Institute) chooses to concentrate its prescription on Defined Benefit plans.

Saving and improving Defined Benefit pension plans is a better choice for Canadians than allowing their steady erosion

Defined Benefit plans are in the best interests of Canadians for many reasons:

1. ***Greater predictability for plan members.*** Defined Benefit plan members have a good sense of what they will receive in retirement, making future planning easier and reducing uncertainty. A strong Defined Benefit plan system also means less uncertainty for governments.
2. ***More security and less risk to plan members.*** Individuals in an ongoing Defined Benefit plan face lower risks related to low interest rates, longer-than-expected longevity and volatility of market returns.
3. ***Better workforce management***. Defined Benefit plans help employers retain good employees and they can be a tool to help employers to better manage their workforce (e.g., enhance early retirement).
4. ***Higher investment return.*** By having larger pools of money to invest and longer investment time horizons, a more aggressive, diversified and informed investment strategy with lower management fees can be used. The higher yields and lower administration costs result in greater value for dollars invested in Defined Benefit plans compared to Defined Contribution plans over the long run.
5. ***Greater economic benefit to society and the economy***. Bank of Canada Governor David Dodge supports Defined Benefit pension plans. He believes that they promote economic efficiency by allowing better allocation of savings and that they contribute efficiency gains for financial markets. He has stated that managers of Defined Benefit plans have both the ability and desire to invest in the kinds of assets which the average individual investor might not normally consider. They have a superior knowledge of financial markets and of the associated risks that make them willing to invest in alternative asset classes, and that plans invest over very long time horizons so they can finance large investment projects at competitive rates of return. An example would be investment in critical infrastructure to support Canada's future production capacity.
6. ***Better pension coverage for employees in all sectors.*** If the decline in private sector Defined Benefit plans continues unabated, in a few years the only working Canadians with a Defined Benefit plan will be in the public sector. This is a situation that private sector employers and workers would be increasingly unwilling to support.

Ten recommendations to heal Defined Benefit pension plans

The Institute believes that bold policy measures combined with plan sponsor and plan member leadership are needed now to ensure adequate retirement conditions for those who will leave the workforce in 10 years and beyond.

Saving Defined Benefit plans is an important part of the solution. The Institute's 10-point prescription aims to secure Defined Benefit plan benefits for participants and create an environment conducive to maintaining and strengthening Defined Benefit plans for plan sponsors.

Introduce innovative ways to meet funding requirements

Employers would be more likely to fund more conservatively a Defined Benefit plan if they knew they could get back surpluses that might arise from their contributions. This would assure maintenance of existing Defined Benefit plans and the creation of new Defined Benefit plans. Recommendations 1 and 2 are intended to address this reality.

1. Introduce legislation that allows employers to set up 100% employer-funded Pension Security Trusts that would be separate from but complementary to the regular Defined Benefit pension funds. The contributions arising from going concern valuations would go into the regular pension fund, while additional contributions (including those required to fund solvency deficiencies) could be made to the Pension Security Trusts. Money in the Pension Security Trusts could be released back to the employer if a subsequent solvency valuation shows that it is not needed for the Defined Benefit plan. Amounts contributed into the Pension Security Trusts would be tax deductible, while amounts withdrawn would be taxable.
2. Introduce legislation that allows the use of irrevocable Letters of Credit to secure solvency deficiencies, as some provinces and the federal government have done.

Improve the transparency of plan funding

Many plan sponsors do not have a formal funding policy for their Defined Benefit plans. Recommendations 3 and 4 are intended to rectify this situation and encourage better governance and communication.

3. Introduce legislation that would require plan sponsors to establish a written funding policy for Defined Benefit plans in order to promote clear objectives and transparency.
4. Expand the required annual disclosure by plan administrators to plan members, to include the key elements of the funding policy, investment policy and current funded status.

Change pension benefits laws and the Income Tax Act to enable improvement of Defined Benefit plans' funded status

Recommendations 5, 6 and 7 are intended to require a higher level of funding using approaches that make it more attractive for plan sponsors to develop and maintain a surplus within their Defined Benefit plans. Higher funding levels will enhance the security of members' pensions.

5. Introduce legislation that would require each Defined Benefit plan to have a Target Solvency Margin related to the risks in the Defined Benefit plan's asset mix and funded by a Pension Security Trust, a Letter of Credit or the regular pension fund. Contribution holidays would not be permitted if the plan's surplus was less than the Target Solvency Margin. For example, a particular plan might have a Target Solvency Margin of 10%, so that the plan sponsor would have to make contributions, as long as the plan assets were less than 110% of the solvency liabilities.
6. Establish a task force with representation from the Canadian Institute of Actuaries and pension regulators to develop guidance on the required levels of Target Solvency Margins. The Target Solvency Margin for a particular plan should take into account the risks faced by the plan, reflecting its member demographics and investment policy.
7. Change the tax rules to allow Defined Benefit plans to develop surpluses that are the greater of two times the Target Solvency Margin on a solvency valuation, or 25% of the going concern liability.

Other measures

The remaining recommendations are intended to enhance the security of Defined Benefit plan members' pensions.

8. Introduce legislation to protect underfunded pension benefits by according them treatment similar to that of unpaid pension plan contributions in bankruptcy and restructuring proceedings.
9. Amend legislation where required so that pension matters fall within the authority of the Ministers of Finance throughout the country to allow for pensions to be included on the national agenda and to promote consistency of pension legislation among jurisdictions.
10. Explore the feasibility of alternate ways of handling underfunded plan wind-ups for insolvent employers, such as establishing new pension insolvency insurance vehicles.

Conclusion

Time is of the essence. If all parties act on our prescription now, it will dramatically improve the health of the Canadian pension system.

APPENDIX

Why actuaries are involved in finding solutions to the Defined Benefit plan crisis

The Canadian Institute of Actuaries sees the shrinkage of Defined Benefit plans and coverage as a threat to Canadians' future financial security.

We believe that a healthy Defined Benefit pension plan environment is in the best interests of Canada and Canadians. Actuaries have long been involved in the country's pension plan system and can play an even more vital role in crafting improvements because of our unique qualifications:

- The first Guiding Principle of the Canadian Institute of Actuaries is: "In carrying on its activities and programs, the Institute holds the duty of the profession to the public above the needs of the profession and its members."
- Actuaries are the experts in the pension field as evidenced by the unique role given to them by the federal and provincial governments in assessing the cost of the pension promises made to plan members.
- Almost half of all actuaries working in Canada are involved in pension plan work and have therefore developed a unique and extensive expertise. They regularly assess and report on the funding status and future costs of Defined Benefit plans and advise pension plan stakeholders on the risks and costs inherent in alternative courses of action.

Seeing Beyond Risk Canadian Institute of Actuaries Institut canadien des actuaires Voir au-delà du risque

Submission by the Canadian Institute of Actuaries Presented to the House of Commons Standing Committee on Finance

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Executive Summary

The Canadian Institute of Actuaries is pleased to provide input to the 2007 pre-budget consultations being undertaken by the House of Commons Standing Committee on Finance.

Canadians are not saving enough for their retirement. One third of Canadians have no retirement savings at all, and a good portion of the remainder is not saving enough to fund an independent retirement. Layered on to that, the Defined Benefit plan, an important component of the Canadian retirement system, and a highly effective retirement income security vehicle, is in decline. It is apparent that public policy measures need to be put in place to turn this trend around.

Actuaries are concerned that Canadians may ultimately be deprived of access to Defined Benefit pension plans as a viable retirement saving alternative. While Canada has one of the best retirement systems in the world, there has been a steady erosion of Defined Benefit pension plans such that they now cover only 21% of private sector employees. Urgent action is needed to safeguard this key component of our retirement income system.

Defined Benefit plans are in the best interest of Canadians. Our submission points out why and identifies the influences that have undermined this critically important part of the overall pension system.

Benefit security requires strong funding. The major issue is around balancing the related challenges of benefit security and funding fairness. Actuaries understand the pension system from all perspectives – plan member (employee), plan sponsor (usually the employer), legislator and regulator.

The current system contains disincentives for plan sponsors to adopt higher levels of funding, which could compromise benefit security for plan members. A sponsor who makes extra contributions to the plan to improve solvency when investment returns are poor may find that those extra contributions become unnecessary when the investment environment improves, yet the resulting surpluses are still claimed by plan members. Plan sponsors perceive this as unfair and tend to be unwilling to fund plans above minimum levels. This in turn reduces the ability of a plan to withstand adverse economic conditions, reduces security for the plan members, and may eventually lead to plan wind-ups. Our submission outlines innovative solutions to this challenge.

A 10-point prescription to strengthen Defined Benefit plans has been developed by the Canadian Institute of Actuaries. In this submission, we have identified the key recommendations that require changes to the *Income Tax Act* and Regulations, each of which would enhance benefit security for plan members:

1. **Permit the use of a Pension Security Trust**, which would be complementary to, but separate from, the regular pension plan fund. This would be used to increase benefit security. If contributions made to the Pension Security Trust were subsequently found not to be needed to fund benefits, they would be released back to the plan sponsor.
2. **Establish a Target Solvency Margin for each plan**, based on the plan's level of risk, and permit funding of the plan up to this level.
3. **Increase the maximum allowable surplus in a pension plan** to the greater of:
   a) two times the Target Solvency Margin, and
   b) 25% of the going concern liabilities.

1. Introduction – promoting a healthy and vibrant private pension system

Our input is intended to address the theme that the tax system should support the prosperity and productivity of employees and businesses. In particular, **the tax system should facilitate a healthy and vibrant private pension system for Canadians**.

Saving and improving Defined Benefit plans is essential for millions of Canadians who are planning and saving for their retirement. Allowing their continued erosion weakens the whole system.

Helping Canadians save for retirement is a critical public policy issue. A recent study by the Department of Statistics and Actuarial Science at the University of Waterloo, shows that two thirds of Canadian households expecting to retire in 2030 are not saving at levels required to meet necessary living expenses. Old Age Security and the Canada and Quebec Pension Plans; home ownership; Workplace pension plans; and Registered Retirement Savings Plans each play an important role, but are unlikely, on their own, to fill the gap for many individuals. A healthy retirement system needs a variety of funding strategies to meet people's diverse situations. However, one highly effective retirement savings vehicle, the Defined Benefit pension plan, is in trouble.

A significant decline in Defined Benefit pension plans threatens Canada's pension system, considered to be among the world's best. According to Statistics Canada, only 21% of private sector workers were covered by Defined Benefit plans in 2003, down from 29% in 1992. Pension plan sponsors in many industries are turning away from Defined Benefit plans and switching to Defined Contribution plans and this threatens the adequacy and security of many Canadians' retirement income.

A Defined Benefit plan provides security that cannot be found in Defined Contribution plans or RRSPs. The pension benefit is pre-defined, usually as a percentage of pre-retirement salary or as a fixed rate per year of service. While plan members may provide a defined level of contributions to these plans, the plan sponsor undertakes to contribute at whatever additional level is necessary to fund the benefits promised, shouldering such risks as fluctuating investment conditions and increases in the longevity of plan members.

Why are Defined Benefit plans in crisis? Canada's patchwork of regulations, legal decisions, tax rules and changes in accounting standards has created problems. These problems have been compounded over the past several years because of a) low interest rates, b) increasing longevity, c) volatile market yields, and d) the uncertainty regarding contribution holidays and plan surplus ownership.

Defined Benefit plans are in the best interest of Canadians for a number of reasons:

1. ***Greater predictability for plan members.*** Defined Benefit plan members have a good sense of what they will receive in retirement, making planning and saving for the future easier and reducing uncertainty. A strong Defined Benefit plan system also means less uncertainty for governments, as there will be less pressure to increase benefits in the government sponsored C/QPP and OAS plans.
2. ***More security and less risk to plan members.*** Individuals in an ongoing Defined Benefit plan face lower risks related to changing interest rates, longer-than-expected longevity and the volatility of market returns.
3. ***Better workforce management.*** Defined Benefit plans help employers retain good employees and they can be a tool to help employers to better manage their workforce (e.g., enhance early retirement).
4. ***Higher investment return.*** By having larger pools of money to invest and, importantly, longer investment time horizons, a more aggressive, diversified and informed investment strategy with lower management fees can be used. The higher yields and lower administration costs result in greater value for dollars invested in Defined Benefit plans compared to Defined Contribution plans over the long run.

5. ***Greater economic benefit to society and the economy.*** Bank of Canada Governor David Dodge supports Defined Benefit pension plans. He believes that they promote economic efficiency by allowing better allocation of savings and that they contribute efficiency gains for financial markets. He has stated that managers of Defined Benefit plans have both the ability and desire to invest in the kinds of assets which the average individual investor might not normally consider. They have a superior knowledge of financial markets and of the associated risks that make them willing to invest in alternative asset classes, and plans invest over very long time horizons so they can finance large investment projects at competitive rates of return. An example would be investment in critical infrastructure to support Canada's future production capacity.

2. Prescription to Heal Defined Benefit Pension Plans

Bold federal policy measures are needed now to remove disincentives for plan sponsors to adopt higher levels of funding. Combined with plan member and plan sponsor leadership, this can halt the decline in Defined Benefit pension plans.

The Institute has developed a 10-point prescription to secure Defined Benefit plan benefits for participants and create an environment conducive to plan sponsors maintaining and strengthening Defined Benefit plans for plan members. Our 10-point prescription balances two related needs of plan members and plan sponsors: benefit security and funding fairness.

1. **Plan members need greater security** that their benefits will be provided to them when they retire. This requires stronger funding of Defined Benefit pension plans as well as improved governance.
2. **Plan sponsors need certainty** that when they fund Defined Benefit plans on a more secure basis, they will have access to any surplus funds that may arise when economic conditions are favourable. In the current environment, when economic conditions are unfavourable, plan sponsors must pay more into the pension plan; but when conditions turn favourable, the resulting surplus often belongs to the plan members. This imbalance is perceived by plan sponsors as unfair, and it discourages the secure funding of Defined Benefit pension plans, decreasing the security of members' pensions, and may contribute to the discontinuation of these plans.

A copy of the 10-point prescription is attached. For this submission, we have selected the prescription elements that require changes to the federal tax system.

3. Our Recommendations for Tax Changes

A. Pension Security Trust – an innovative approach to pension funding

A new type of funding vehicle is needed, with clear ownership of assets, to supplement the existing registered pension plan trust.

We believe that **most plan sponsors would be willing to fund a Defined Benefit plan more securely**, thereby improving benefit security for the members, if they knew that they could access any surpluses that might arise from their excess contributions. This confidence would encourage plan sponsors to continue their Defined Benefit plans or to start new Defined Benefit plans.

We propose a Pension Security Trust as an innovative way to facilitate this improvement. Plan sponsors would be able to contribute to the Pension Security Trust, which would be complementary to the regular Defined Benefit pension funds. The assets would be invested in a manner similar to the regular pension plan, and would be held as a side fund by the trustee and custodian. Unlike the registered pension plan trust, however, the Pension Security Trust would include plan sponsor contributions only and would be "owned" by the plan sponsor.

Solvency deficiency payments and additional payments that the plan sponsor may choose to make to strengthen the funding of the plan would be placed in the Pension Security Trust. Contributions

arising from going concern valuations would go into the regular pension fund. If subsequent valuations showed that some of the assets in the Pension Security Trust are not required to pay plan benefits, then the excess could be released back to the plan sponsor. All money contributed to the Pension Security Trust would be tax deductible, while amounts withdrawn would be taxable.

The establishment of a Pension Security Trust would not require an increase to the current tax limits on contributions to pension plans. The plan sponsor's contributions to the Pension Security Trust would be considered, together with the contributions to the pension fund, when applying the current *Income Tax Act* limits on plan sponsor contributions each year.

We recommend the establishment of a tax-deductible Pension Security Trust under the Income Tax Act and Regulations in order to facilitate these pension contributions, resulting in higher levels of funding and enhanced benefit security for the members of Defined Benefit pension plans.

B. Target Solvency Margin – more secure funding based on the level of risk

A higher level of pension plan funding should be required, to improve the security of member benefits. This higher level of funding would be accomplished if the proposed Target Solvency Margin were introduced in a manner that recognizes the potential volatility of a plan's funded position.

Risk-based solvency through a Target Solvency Margin should be applied to pension plans. This is a concept already used by government to ensure the security of other risk-bearing financial institutions. Some pension plans are subject to greater volatility than others, partly as a result of the asset mix of the plan. (A pension plan invested mostly in high quality bonds would have a lower risk than one with an asset mix with high percentages of Canadian and foreign equities). Hence each plan should have a Target Solvency Margin (the target percentage by which the assets of a plan should exceed the liabilities) established based on its specific risk factors and its exposure to volatility. Establishing Target Solvency Margins for plans that have different risks will create a risk-based approach to plan funding.

The Target Solvency Margin would determine when a plan sponsor could take a contribution holiday. Unless the sum of the assets in both trusts exceeded the solvency liabilities by at least the Target Solvency Margin the sponsor would be required to continue current service contributions.

The Target Solvency Margin could work in tandem with the Pension Security Trust. Plan sponsors could pay the additional solvency contributions required as a result of the Target Solvency Margin into the Pension Security Trust. Use of the Pension Security Trust instead of the pension trust fund would ensure that any part of the Target Solvency Margin not ultimately needed to provide plan benefits would be accessible by the plan sponsor.

The Institute is currently working with Quebec regulators, researching the appropriate level of solvency margins, and this research will be published shortly.

We recommend that a task force be set up with representation from pension regulators, the Department of Finance and the Institute to review this research and establish the Target Solvency Margin framework.

We recommend that the Income Tax Act and Regulations be amended to facilitate the concept of a Target Solvency Margin, which would permit contributions to fund pension plans up to this higher level.

C. Increase the allowable plan surplus – a cushion against volatility

The current maximum amount of surplus permitted in a pension plan is too low. Currently plan sponsor contributions must be suspended when the surplus reaches an amount based on a formula, which for most plans is 10% of actuarial liabilities. Once that level is achieved, no further current service contributions can be made to the pension plan by the sponsor.

Based on past volatility a higher limit is needed. In the past decade changes in achieved and presumed future investment yields have resulted in many plans moving from a surplus to a deficit. A higher permitted surplus and fewer forced contribution holidays would have reduced the resulting deficits. The Pension Security Trust would also encourage plan sponsors to accumulate such a surplus.

As part of the Institute's study on solvency margins (referenced above), a significant amount of research is being completed on the volatility of a pension plan's funded position over different time periods. The results of this research will illustrate the level of funding and margins needed to provide enhanced levels of benefit security.

We recommend that the Income Tax Act and Regulations be changed to permit a maximum surplus, before plan sponsor contributions must be suspended, as follows:

The greater of:

- ***a) two times the Target Solvency Margin; and***
- ***b) 25% of going concern liabilities.***

This recommendation will better protect the security of plan members by enabling plan sponsors to continue to pay their regular current service contributions even when a modest surplus exists if a higher surplus position is justified by the risk profile of the plan. It also enables plan sponsors to set aside surplus funds appropriate to the risk profile of the pension plan to better protect benefits if economic and demographic conditions in the future turn less favourable.

4. Conclusion

Canada's actuaries are convinced that the loss of Defined Benefit pension plans ultimately hurts working Canadians. We believe our recommendations will encourage current plan sponsors to continue to offer Defined Benefit pension plans to their employees and other employers to launch new Defined Benefit plans.

Seeing Beyond Risk Canadian Institute of Actuaries Institut canadien des actuaires Voir au-delà du risque

Submission by the Canadian Institute of Actuaries to the Ontario Expert Commission on Pensions

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Preface

The Canadian Institute of Actuaries (CIA) is pleased to respond to the invitation of the Ontario Expert Commission on Pensions (the "Commission") to make written submissions and to assist the Commission in making recommendations to the Minister of Finance about the regulation of Defined Benefit pensions in Ontario. The CIA establishes the Rules of Professional Conduct, guiding principles and monitoring processes for actuaries, all of which adhere to the profession's standards of practice and support Guiding Principle 1 that the public interest is paramount. The CIA also assists the Actuarial Standards Board in developing standards of practice applicable to actuaries practising in Canada, including those governing actuarial valuation of pension plans.

The CIA is currently reviewing some of the standards related to Defined Benefit pension plans. In particular, new standards of practice are being developed by the Actuarial Standards Board for funding of pension plans and for determining the commuted value of a pension benefit.

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Canadians are not saving enough for their retirement. One third of Canadians have no retirement savings at all, and a good portion of the remainder is not saving enough to fund an independent retirement. Layered on to that, the Defined Benefit plan, an important component of the Canadian retirement system, and a highly effective retirement income security vehicle, is in decline. ***It is apparent that public policy measures need to be put in place to turn this trend around.***

Actuaries are concerned that Canadians may ultimately be deprived of access to Defined Benefit pension plans as a viable retirement income accumulation alternative. While Canada has one of the best retirement systems in the world, there has been a steady erosion of Defined Benefit pension plans such that they now cover only 21% of private sector employees. ***Urgent action is needed to safeguard this key component of our retirement income system.***

Defined Benefit plans are in the best interest of Canadians. Our submission identifies the influences that have undermined this critically important part of the overall pension system.

Benefit security requires strong funding. The major issue is around balancing the related challenges of benefit security and funding fairness. Actuaries understand the pension system from all perspectives – plan member (employee), plan sponsor (usually the employer), legislator and regulator.

The current retirement system contains disincentives for plan sponsors to adopt stronger funding beyond the minimum statutory requirements. Weaker funding could put benefit security at risk for plan members. This is mainly caused by uncertainty over surplus ownership and utilization for many Defined Benefit plans. A plan sponsor who makes extra contributions to the plan to improve its solvency position
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when investment returns are poor may find that those past extra contributions become unnecessary when the investment environment improves, yet the resulting surpluses could be claimed by plan members in the event of a partial or full wind-up. Plan sponsors perceive this as unfair and tend to be unwilling to fund plans above minimum levels. This, in turn, reduces the ability of a plan to withstand adverse economic conditions, reduces security for plan members and may eventually lead to plan wind-ups. ***Legislation should be adopted that removes these disincentives.***

Executive Summary

The current and future financial security of retired and retiring Ontarians is being endangered by the decline of Defined Benefit pension plans. Helping Ontarians build adequate retirement income in an optimal way is a critical public policy issue. Given the importance of Defined Benefit pension plans in the provision of retirement income to Ontarians, changes to the retirement system are needed to facilitate the maintenance of existing plans and encourage increased coverage by such plans.

In our view, the government should:

- **Permit the use of a Pension Security Trust.** The Pension Security Trust would be complementary to, but separate from, the regular pension plan fund and would be used to increase funding levels and enhance benefit security for plan members. If the tax-deductible contributions made to the Pension Security Trust were subsequently found not to be needed to fund benefits, they would be released back to the plan sponsor.
- **Require all Defined Benefit pension plans to establish and maintain a Target Solvency Margin to enhance benefit security.** The level of the Target Solvency Margin would be related to the risks faced by the plan. Plan sponsors would be required to continue making current service contributions, even if the plan had assets in excess of the solvency liabilities, as long as plan assets are less than the sum of the solvency liabilities and the Target Solvency Margin.
- **Enact flexible, principles-based legislation that encourages innovation in plan design and financing arrangements and promote the growth of Defined Benefit pension plans.** Again, enabling legislation needs to be flexible to allow for innovative measures such as Pension Security Trusts and Letters of Credit.
- **Enact pension legislation that permits the use of letters of credit for solvency amortization payments.** Allowing the use of letters of credit for this purpose would provide plan sponsors with additional flexibility without decreasing the security of the plan member benefits. Letters of credit could be held as an asset in the Pension Security Trust.
- **Change the way pension plan wind-ups are processed to address practical difficulties in applying solvency valuation requirements.** The annuity market in Canada is not large enough to handle significant one-time annuity purchases, and some types of annuities are difficult to purchase (e.g., indexed pensions). Therefore, plan wind-ups that occur will likely be protracted over time, exposing the plan to additional market risk. Yet solvency valuations must measure liabilities under the

unrealistic scenario that all obligations are settled at once. Allowing alternative methods of settling plan obligations on wind-up must be explored.

- **Require annual actuarial valuations for plans whose solvency ratio is less than 100 percent.** Plans with solvency ratios above 100 percent would continue to conduct valuations every three years. This represents a reasonable balance between the desire for more timely intervention when a plan is headed into financial difficulty and the concern about excessive administration costs.
- **Amend the legislation and policies to facilitate adjustments in pension plan designs and workplace policies to deal with increasing longevity and workforce planning.** In particular, changing the maximum normal retirement age under pension legislation would allow plan sponsors and members to adapt to an environment of increasing longevity. Pension legislation should be changed to accommodate phased retirement policies.
- **Explore alternative ways of protecting benefits in wind-ups of underfunded plans by insolvent employers.** Look at what other jurisdictions are doing, for example, the availability and usage of privately managed insolvency guaranty schemes or insurance contracts for this purpose should be researched. In the meantime, unfunded pension liabilities should be given priority similar to that of unpaid wages in bankruptcy proceedings.
- **Require plan sponsors to establish a formal funding policy for Defined Benefit pension plans.** The written funding policy would: a) define the roles of the plan sponsor and the actuary; b) address both going concern and wind-up bases; and c) address timing of valuations, giving specific consideration to benefit security and stability of contributions. This recommendation would increase transparency and provide stakeholders with an enhanced understanding of the funded status of the plan and the associated risks.
- **Take the lead in coordinating the development of pension legislation in Canadian jurisdictions.** Currently, moving pension issues on to the national agenda is impossible as the respective ministers responsible for pension matters, provincially and federally, never meet. For example, responsibility for the pension file falls under the Minister of Finance in only three provinces.
- **Eliminate partial plan terminations.** This would not only eliminate the surplus distribution issue on partial termination but would also remove the administrative and cost burdens related to partial terminations. However, if partial plan terminations are maintained in the pension legislation, the government should more clearly specify the criteria for any special situations in which “grow-in” or full vesting rights must be provided.
- **Enact more flexible legislation and policies to streamline the process for plan mergers, splits and asset transfers.** Restrictions that impede the merger of pension plans and the often lengthy approval process for asset transfers and plan splits create administrative complexity and increase the cost of the transaction.

Introduction

The CIA is the national organization of the actuarial profession in Canada. It is dedicated to serving the public through the provision, by the profession, of actuarial services and advice of the highest quality. To this end, the CIA promotes the advancement of actuarial science and sponsors programs for the education and qualification of members and prospective members. It maintains programs to ensure that actuarial services provided by its members meet accepted professional standards. In carrying out its activities and programs, the CIA holds the duty of the profession to the public above the needs of the profession and its members.

The CIA has more than 3,750 members across Canada. Approximately half of these members work in the pension field. Pension actuaries work with plan sponsors, plan administrators, unions and trustees to design, finance and administer their pension plans. The members of the actuarial profession play a major role in the creation of pension plans and public income security programs, and in establishing the funding standards required to ensure their viability. Fellows of the CIA have a legislated role in the production of actuarial valuations for defined benefit pension plans.

One of the CIA's goals is to assist legislators in developing pension plan legislation that responds well to the needs of all parties. Mindful of its responsibility to the public interest, the CIA aims to promote a legislative approach that is conducive to efficient and effective pension plan management, consistent with the interests of all concerned parties.

The CIA shares the Ontario government's concern about pension plans' sustainability and their capacity, over the long term, to help provide retirement income to an aging population. Our profession pays special attention to Defined Benefit pension plans on account of their importance in providing plan members with financial security during their retirement years.

Issues addressed in our submission

In preparing our submission, we have focused on those aspects of the Commission's mandate that are most directly related to the role of actuaries in the establishment and management of Defined Benefit pension plans, and for which we believe the CIA has unique expertise to offer meaningful input to the Commission's deliberations. We reviewed the questions raised in the Commission's February 2007 discussion paper *Reviewing Ontario's Pension System: What are the Issues?* (the "Discussion Paper"), as well as additional questions posed to us in face-to-face meetings with the Commission and its Advisory Panel. Our submission has been organized into three main themes:

1. Improving the regulatory and business environment for Defined Benefit pension plans in Ontario.
2. Putting Defined Benefit pension plans on a more sound financial footing.
3. Enhancing public understanding of the "pension promise."

In the Appendix, we identify recent publications and ongoing research initiatives by the CIA related to pension policy in Canada, as well as developments in updating professional standards for actuaries practising in pensions, which we believe might be of interest to the Commission.

Both the Discussion Paper and this submission focus mainly on single employer Defined Benefit pension plans. However, the Commission should keep in mind that certain types of Defined Benefit plans, such as multi-employer pension plans and jointly-sponsored pension plans, present unique circumstances and issues because they involve different methods of spreading risks between plan sponsors and plan members. We encourage the Commission to consider this uniqueness in developing its recommendations, and to ensure that new legislative measures aimed at single employer Defined Benefit plans do not inadvertently jeopardize other types of plans that combine elements of both Defined Benefit and Defined Contribution designs. Applying the same rules to all plans may not always be appropriate.

1. Improving the regulatory and business environment for pension plans

Inherent in the Discussion Paper is a belief that the future of Defined Benefit pension plans is at risk unless changes are made to the pension system. The Background section of the Discussion Paper offers a thoughtful and well-reasoned analysis of the environment under which Defined Benefit plans are currently operating. It also acknowledges the decline in the percentage of workers covered by such plans and cites a number of reasons for this trend.

The CIA agrees with the arguments put forward by the Commission for this decline. Canada's patchwork of regulations, legal decisions, tax rules and changes in accounting standards has created problems. These problems have been compounded over the recent past due to: a) low interest rates; b) increasing longevity; c) volatile market yields; and d) the uncertainty regarding contribution holidays and plan surplus ownership and utilization.

1.1 Importance of Defined Benefit Pension Plans to Canadians

Statistics Canada reports that participation rates in public and private employer-sponsored Defined Benefit pension plans has decreased substantially over the last decade.

Both the adequacy and security of retirement income are threatened by the decline in coverage by Defined Benefit pension plans. Saving and improving these plans is a better choice for Canadians than allowing their continuing steady erosion. A Defined Benefit pension plan provides security that cannot be found in Defined Contribution pension plans or RRSPs. The pension benefit is pre-defined, usually as a percentage of pre-retirement salary or as a fixed rate per year of service. While plan members may provide a defined level of contributions to these plans, the plan sponsor undertakes to contribute at whatever additional level is necessary to fund the promised benefits.

Defined Benefit pension plans are an important component in the overall retirement system and are in the best interests of individual Canadians for a number of reasons:

a) **Greater predictability for plan members.** Defined Benefit pension plan members have a good sense of what they will receive in retirement, making planning and saving for the future easier and reducing uncertainty.

b) **More security and less risk to plan members.** Individuals in an ongoing Defined Benefit pension plan face lower risks related to changing interest rates, longer than expected longevity and volatility of market returns.

c) **Better workforce management**. Defined Benefit pension plans help employers retain good employees and they can be a tool to help employers better manage their workforce (e.g., enhance early retirement).

d) **Higher investment return.** By having larger pools of money to invest and, importantly, longer investment time horizons, a more aggressive, diversified and informed investment strategy with lower management fees can be used. The higher yields and lower administration costs result in greater value for dollars invested in Defined Benefit pension plans compared to Defined Contribution pension plans over the long run.

e) **Greater economic benefit to society and the economy**. Bank of Canada Governor David Dodge believes Defined Benefit pension plans promote economic efficiency by allowing a better allocation of savings and that they contribute efficiency gains for financial markets. He has stated that managers of Defined Benefit pension plans have both the ability and desire to invest in the kinds of assets that the average individual investor might not normally consider. Such managers have a superior knowledge of financial markets and of the associated risks that make them willing to invest in alternative asset classes, and Defined Benefit pension plans invest over very long time horizons so they can finance large investment projects at competitive rates of return.

We note that one of the principles guiding the Commission's work is the "importance of maintaining and encouraging the system of Defined Benefit pension plans in Ontario." ***We recommend that this principle become a formal mandate of the Financial Services Commission of Ontario (FSCO), so that FSCO can actively participate in promoting these plans rather than simply performing a regulatory oversight role. Further, we recommend that Ontario should take the lead in arranging discussions at the ministerial level, both provincially and federally, to address the key steps in saving and encouraging Defined Benefit pension plans.***

1.2 Removing Uncertainty about Surplus Ownership and Utilization

A critical issue that must be resolved is that of surplus ownership and utilization. The current uncertainty surrounding plan surplus ownership and utilization does not encourage higher levels of funding. Consequently, it has a detrimental effect on benefit security for members. This uncertainty may indeed be one of the most significant forces driving the decline in Defined Benefit pension plan coverage.

Plan sponsors need certainty that when they fund Defined Benefit plans on a more secure basis, they will have access to any surplus funds that may arise when economic conditions are favourable. In the current environment, when economic conditions are unfavourable, plan sponsors must pay more into the pension plan, but when conditions turn favourable, the resulting surplus often belongs to the plan members. This imbalance is perceived by plan sponsors as unfair, and it discourages the secure funding of Defined Benefit pension plans, decreasing the security of members' pensions, and may contribute to the discontinuation of these plans.

Plan members need greater security that their benefits will be provided to them when they retire. This requires stronger funding of Defined Benefit pension plans as well as improved governance.

We recommend that Ontario make legislative and regulatory changes that, for example, permit the use of Pension Security Trusts and require all Defined Benefit pension plans to establish and maintain a Target Solvency Margin and that:

- ***clarify rules for surplus ownership and utilization that recognize plan sponsors' right to and access to plan surpluses;***
- ***clarify that documents establishing pension plan funding vehicles are documents of the plan, subject only to the provisions of the*** **Pension Benefits Act** ***and its regulations; and***
- ***state explicitly that to the extent of any inconsistency with the common law, the provisions of the*** **Pension Benefits Act** ***and its regulations are paramount and supersede the common law.***

These changes should override legal precedents that have recently been established particularly where the plan documentation is silent on these issues, but they should also recognize that existing contracts or agreements between the plan sponsor and plan members will need to be respected. Removing this uncertainty surrounding surplus ownership and utilization will go a long way towards eliminating unanticipated costs to plan sponsors and will increase the palatability of sponsors to better fund their pension plans, thereby enhancing benefit security.

1.3 Partial Plan Terminations

The Monsanto decision has created uncertainty and is one reason that plan sponsors are discouraged from building up a funding cushion. The requirement to distribute surplus on a partial plan termination is not only damaging to the benefit security of remaining members, but also it creates inequities among the various groups of plan members. More specifically:

- Members affected by a partial termination will inevitably have a different share of surplus than the members in the plan on a full termination, if there ever is a full termination.
- Retirees are seldom included in a partial termination, although they might have been part of the affected group before retirement.
- The existence of surplus in a Defined Benefit pension plan at any given date is usually attributable to interest rates or stock market returns. This is largely a matter of chance and may easily be reversed over the future.
- The "surplus" at the date of a partial termination is only an estimate, since the actual surplus or deficit has not crystallized.
- Due to the "grow-in" rights, members affected by a partial termination may receive higher benefits (and a higher proportionate share of surplus) than remaining members.

- The question of what constitutes a partial termination has proven to be very difficult to interpret in practice. The criteria used to determine whether a partial termination has occurred appear to be somewhat arbitrary. The requirement to purchase annuities for certain members can cause problems (as noted later in Section 2.5). Therefore***, we recommend the elimination of partial terminations, as currently structured under Ontario legislation.***

We believe that grow-in rights generate inequities amongst members. If for public policy reasons, the government reasons that they must stay, then ***we recommend that the Pension Benefits Act and its regulations should clearly state the criteria to determine when these rights must be granted.***

1.4 Mergers, Splits and Asset Transfers

When one employer sells a business unit to another, and the employees of that business unit participate in a pension plan for all of the vendor's employees, it is often necessary for the purchaser to establish a pension plan and assume responsibility for the past service obligations of the vendor. Assets are transferred from the vendor's pension plan to a new or existing plan sponsored by the purchaser. Ideally, the basis for determining the amount of the asset transfer is fully defined by the purchase and sale agreement. Similarly, an employer may merge its operations with another employer and it may become necessary to merge the respective pension benefits into one new plan that covers all employees of the new entity.

The legislation should recognize the reality that these business transactions occur in a variety of forms and that time is usually a factor. However, in addition to the uncertainty created by the Transamerica decision, the current regulations and policies contain restrictions that impede or make impossible the merger of pension plans, and impose significant delays in asset transfers and plan splits due to the lengthy approval process. These delays create administrative complexity and can increase the cost of the transaction. The inability to merge pension plans may cause significant inefficiencies that unduly increase the cost of providing benefits to the affected members.

We recommend that greater flexibility in approaches and approval procedures be implemented to streamline these transactions recognizing, of course, that benefit security of affected employees will remain a key consideration. The adoption of the measures that we propose in Section 1.2 would be a significant step in removing a major obstacle for these transactions.

1.5 Innovative Designs and Financing Arrangements

The CIA would encourage innovation in plan design and financing arrangements that promote the growth of Defined Benefit pension plans. For example, cash balance plans, which are used extensively in the United States, are effectively prohibited in Canada under the existing legislation. Other designs that may offer additional flexibility to plan members and assist employers in attracting and retaining employees would be welcome.

Any measure that can alleviate operational costs or mitigate risks for organizations sponsoring Defined Benefit pension plans should be considered, especially for small

plans. The Discussion Paper alluded to pooling arrangements for employers on a sector by sector basis or otherwise on a multi-employer or cooperative basis. Such arrangements would likely be sponsored by financial institutions that would offer similar plan designs to the plan sponsors in the pool for simplicity in administration. The pooling would likely apply to investments and the longevity risk as discussed in Section 2.7. Clearly, the establishment of such arrangements would need to safeguard against unreasonable cross subsidization between participants in the pool.

We recommend that innovative designs be investigated and the CIA is willing to help. A move to principles-based regulation would be required to allow flexibility under any of these or other innovative concepts. Current legislation is too rigid and stifles some very innovative plan designs.

2. Putting Defined Benefit Pension Plans on a More Sound Financial Footing

The goal of funding Defined Benefit pension plans is the systematic accumulation over time of dedicated assets that, without recourse to the plan sponsor's assets, secure the plans' promised benefits. To continue to be successful, Defined Benefit pension plans must:

- provide plan members with reasonable confidence that the promised benefits will be paid; and
- offer plan sponsors reasonable predictability of costs.

Confidence on the part of plan members requires both adequate funding of the benefits and the development of an environment in which plan sponsors are encouraged to maintain and appropriately fund Defined Benefit pension plans. Predictability of costs requires the proper measurement and appropriate reporting of funding requirements and of the associated risks, and an enabling regulatory environment. The equitable treatment of the consequences of risks undertaken, must be clearly articulated and understood by all stakeholders.

2.1 Pension Security Trust

A new type of funding vehicle is needed, with clear ownership of assets, to supplement the existing pension plan trust fund.

We believe that most plan sponsors would be willing to fund a Defined Benefit pension plan more securely, thereby improving benefit security for the members, if they knew that they could access any surpluses that might arise from their excess contributions. This confidence would encourage plan sponsors to continue their Defined Benefit pension plans or to start new Defined Benefit pension plans.

We propose a Pension Security Trust as an innovative way to facilitate this improvement. Plan sponsors would be able to contribute to the Pension Security Trust, which would be complementary to the regular Defined Benefit pension plan trust fund. The assets would be invested in a manner similar to the regular pension plan trust fund, and would be held as a side fund by the trustee and custodian. Unlike the pension plan trust fund, however,

the Pension Security Trust would hold plan sponsor contributions only and would be "owned" by the plan sponsor.

Solvency deficiency payments would be placed in the Pension Security Trust. Contributions arising from going concern valuations would go into the regular pension fund. The Pension Security Trust could also be used by plan sponsors who wish to contribute more than the minimum required under the going concern valuation to strengthen the funding of the plan. If subsequent valuations show that some of the assets in the Pension Security Trust are not required to pay plan benefits, then the excess could be released back to the plan sponsor.

The assets held in the Pension Security Trust fund would be included in the value of assets for the purposes of the solvency actuarial valuation and, in case of plan wind-up, the monies held by the Pension Security Trust may be refunded to the sponsor to the extent not necessary to cover any excess of the wind-up liabilities over the assets in the regular pension fund. The pension plan would be granted a priority claim to the Pension Security Trust fund in the event of the sponsor's insolvency, ahead of other creditors, up to the amount needed to satisfy plan wind-up obligations.

2.2 Target Solvency Margin

One method of achieving more secure funding of benefits would be for all plans to maintain a portion of that surplus as a Target Solvency Margin. The amount of the Target Solvency Margin would vary according to the potential volatility of a plan's funded position, thereby ensuring more secure funding based on the level of risk of the plan.

Risk-based solvency through a Target Solvency Margin is a concept already used by governments to ensure the security of other risk-bearing financial institutions. Some Defined Benefit pension plans are subject to greater volatility than others, partly as a result of the asset mix of the plan. A pension plan invested mostly in high quality bonds would typically have a lower risk than one with an asset mix with high percentages of Canadian and foreign equities. Other risk factors include the demographic profile of the plan membership, the investment policy and the associated asset/liability mismatch (i.e., the extent to which the cash flows of the assets deviate from the cash flows of the liabilities). Hence, each plan should have a Target Solvency Margin equal to the percentage by which the assets of a plan should exceed the liabilities on a solvency valuation basis established based on its specific risk factors and its exposure to volatility. Establishing Target Solvency Margins for plans that have different risks will create a risk-based approach to plan funding.

The implementation and ongoing monitoring of the Target Solvency Margin should not involve overly high complexity, cost and work. The development of such a margin should balance the need to accurately reflect the plan's risk exposure with the need for simplicity, recognizing the small size of some plans.

The Target Solvency Margin could work in tandem with the Pension Security Trust and letters of credit (discussed in Sections 2.1 and 2.4). Plan sponsors could pay the additional contributions required to meet solvency funding requirements into the Pension Security Trust or use a letter of credit for this purpose. Use of the Pension Security Trust and/or a letter of credit instead of the regular pension fund would ensure that any part of

the Target Solvency Margin not ultimately needed to provide plan benefits would be accessible by the plan sponsor.

The Target Solvency Margin would determine when a plan sponsor could take a contribution holiday. Unless the sum of the assets in both the regular pension fund and the Pension Security Trust (including the face amount of the letter of credit, if applicable) exceeded the solvency liabilities by at least the Target Solvency Margin, the sponsor would be required to continue making current service contributions (i.e., contributions determined in accordance with the going concern valuation).

The CIA is currently working with Quebec regulators, researching the appropriate level of solvency margins, and this research will be published shortly. We also acknowledge that amendments to the income tax legislation may be required to accommodate this concept. ***We recommend that a task force be set up with representation from pension regulators, the federal Department of Finance and the CIA to review this research and establish the Target Solvency Margin framework.***

2.3 Raise Maximum Surplus Levels

As seen in the current decade, the financial position of Defined Benefit pension plans can experience significant fluctuations within a relatively short timeframe. It would be desirable to allow these plans to maintain a surplus level that would be sufficient to ward against negative experience. The maximum surplus level allowed under the current federal tax rules is too low to provide adequate financial protection. With a view to increasing benefit security, ***we invite the Ontario government to encourage the federal government (as has the CIA) to change the tax rules in order to allow Defined Benefit pension plans to maintain reasonable funding margins before contribution holidays are required*** (e.g., allow developing surpluses that are the greater of two times the Target Solvency Margin or 25 percent of the going concern liability).

2.4 Letters of Credit

We recommend that legislation should be adopted to permit the use of letters of credit to guarantee solvency deficiency amortization payments. Some provinces and the federal government have already adopted legislation to allow this practice.

Letters of credit provide plan sponsors with additional flexibility without decreasing the security of the benefits accrued by the plan members. They provide plan sponsors the opportunity to better manage their cash flow and utilization, which are important considerations in the current environment of worldwide competition and the struggle for increased efficiency. Instead of paying additional contributions to the pension fund, the plan sponsor will be able to provide a letter of credit whose amount can fluctuate according to the economic context and the financial health of the pension plan.

The letter of credit could be held as an asset in the Pension Security Trust. The face amount of the letter of credit would be considered a plan asset and taken into account for actuarial valuation purposes. It should remain in effect unless it is reduced or cancelled by paying an equivalent contribution into the Pension Security Trust or having a surplus on a solvency basis. Upon plan termination, the letter of credit would be usable only up to the amount of any actual deficiency.

We recommend imposing reasonable limits on the face amount of the letter of credit. For example:

- ***Limit letters of credit to the payments required to amortize solvency deficiencies.***
- ***Impose a dollar or percentage limit of the deficiency that may be supported by letters of credit, similar to the limits on other permitted investments in the pension fund.***
- ***Limit letters of credit to the amount of the Target Solvency Margin discussed above.***

2.5 Solvency Valuations

Actuarial valuations on a plan wind-up basis show how secure the promised benefits are. Actuarial valuations on a going concern basis are more concerned with calculating sufficient yet stable contribution levels. Actuarial valuation reports should highlight both of these two key objectives – the security of benefits in the event the plan is wound up, and the appropriate level and stability of contributions if the plan is continued for the long term.

However, in recent years the solvency valuation results have had a significantly increasing influence on the level and stability of contribution requirements for a variety of reasons. These include:

- low interest rates, and concomitant higher annuity purchase rates and commuted values;
- volatile investment markets that can cause considerable swings in the market value of assets recognized for solvency purposes;
- increasing proportions of retiree liabilities (including those eligible for early retirement and other members with associated "grow-in" rights) in many plans, due to general aging of the workforce, increased longevity, closing of the Defined Benefit portion of the plan to new entrants upon conversion to a Defined Contribution plan and, particularly for certain multi-employer plans, employment in a declining industry; and
- "front-loaded" legislative contribution requirements, since solvency deficiencies must be amortized over a five-year period.

Ontario and Nova Scotia are the only jurisdictions in Canada that require "grow-in" benefits to be provided on plan wind-up, and Ontario is the only jurisdiction that requires recognition of these "grow-in" rights for solvency funding purposes. In some situations, where the rates of early retirement take-up under the plan are relatively low, this means that the plan sponsor is required to make extra contributions to fund early retirement benefits that, in all probability, will never be received. This is particularly true for multi-employer Defined Benefit pension plans with negotiated contributions, which typically have a lower likelihood of plan termination. These factors can put an unnecessary strain on the funding requirements of plan sponsors. Coupled with the problems associated with surplus ownership and utilization, it is obvious why plan sponsors are reluctant to fund at levels that exceed minimum legislative requirements.

Current Ontario legislation presumes that on plan windup all annuities will be purchased at the same time. The group annuity market in Canada is limited in size and in the types of product offered. It is highly unlikely that the plan administrator of even a medium-sized plan would be able to purchase annuities for all its retirees (including those eligible for early retirement) in one transaction upon plan termination. It could take many years before all the retiree obligations of the terminating plan can be satisfied through the purchase of annuities. Further, some types of annuities, such as those that are indexed, are difficult, if not impossible, to purchase.

As a way of dealing with the absence of an annuity market for certain types of pension liabilities, ***we recommend that Ontario allow the pension plan to settle a larger proportion of its obligations through the payment of lump sum commuted values than is allowed under current legislation.*** For example, a plan could be permitted to settle all liabilities for active members by paying lump sum settlements rather than giving such members a choice between a deferred annuity or a lump sum. Retired members could be offered a choice between an immediate annuity or a lump sum. The CIA is prepared to conduct further study into what commuted value standards would be appropriate under these circumstances.

Since plan wind-ups tend to be conducted in multiple transactions over an extended period of time, the plan is exposed to extra market risk, due to the uncertainty about the ultimate cost to settle the plan's obligations. The proposed Target Solvency Margin would serve as a buffer against this market risk for the duration of the wind-up process, thereby minimizing the likelihood of additional contributions by the sponsor or loss of benefits by members.

2.6 Frequency of Actuarial Valuations

Under current Ontario legislation, actuarial valuations must normally be conducted at three-year intervals. Annual valuations are required for plans with solvency ratios less than 80 percent, or for plans with solvency ratios less than 90 percent and solvency deficits greater than $5 million. As recent market experience has demonstrated, the solvency positions of pension plans can change very quickly and dramatically. Some argue that a three-year valuation interval is too long. Others point out that actuarial valuations impose a cost to the plan or to the sponsor, and more frequent valuations can be a significant and often unnecessary financial burden, particularly for smaller plans.

We recommend that all plans whose solvency ratio is less than 100 percent be required to conduct actuarial valuations annually. A plan would revert to the triennial valuation interval once the insolvent financial position is eliminated. This would be consistent with the legislation that exists in other jurisdictions, and in our view represents a reasonable balance. For plans with solvency ratios greater than 100 percent, a requirement to maintain a Target Solvency Margin would provide some degree of protection to plan members against unfavourable experience before the next triennial valuation is conducted.

2.7 Managing Longevity Risk

One of the questions raised in the Discussion Paper is how longer life expectancies and the end of mandatory retirement will affect occupational pension plans.

While increasing longevity is certainly a positive development for individual Canadians, it means that providing adequate lifetime income to retirees will become an ever greater challenge. For sponsors of Defined Benefit pension plans, pension payments must be extended to increasingly higher ages, raising the total cost of the plan. For employees accumulating retirement savings in Defined Contribution pension plans or personal RRSPs, the level of retirement income at a given retirement age will decrease as longevity increases; they will have to either save more, retire later or enjoy a poorer retirement lifestyle. Or more likely, they will run out of retirement income while they are still alive.

Over the long term, the only way for society to deal with increasing longevity is gradually to adapt its workforce policies and its retirement income arrangements to the new reality. This will require some combination of raising retirement ages, reducing benefit accrual rates, introducing phased-in retirement benefits, or raising costs to plan sponsors or to members.

Faced with a choice between delaying their retirement age and receiving a lower pension to keep plans affordable, many workers might be willing to accept a delay in their retirement age, knowing that they will need to extend the productive stage of their lives if they want to keep a reasonable standard of living into their extended retirement years.

As plan sponsors and workers adapt to the new environment, it will be important for actuaries to keep up with trends in mortality and longevity to ensure that the most realistic available demographic assumptions are used to determine the estimated future costs of pension benefits. The CIA is committed to ongoing reviews of professional standards for actuaries, including updates to guidance on the selection of appropriate mortality assumptions for the valuation of pension benefits. The CIA is supported by research from the Society of Actuaries, which sponsors regular studies of mortality experience among populations of active workers and group annuitants in the United States and Canada.

We recommend that the government consider increasing the maximum normal retirement age (currently 66) under the Pension Benefits Act. Adjustments to deal with increasing longevity must be adopted gradually through voluntary changes to pension plan design and other workplace policies. Government policy should, therefore, support the greatest possible flexibility for pension plan sponsors and members so they can find the best solutions to meet their needs.

To give the Commission some perspective on the possible financial effects of increased longevity relative to other factors affecting the costs of a pension plan, we show in the following table the estimated cost of a pension payable to a 65-year-old and the effect of projected improvements in mortality over a period of 50 years. For each gender, we have assigned a “relative cost” of 100 to represent the present value of an immediate pension that starts to be paid to an individual who attains age 65 in the year 2010.

	Relative cost of immediate pension	
	Male	Female
Age 65 in 2010 (base case)	100	100
Age 65 in 2020	103	101
Age 65 in 2030	106	103
Age 65 in 2040	109	104
Age 65 in 2050	112	105
Age 65 in 2060	114	107
Age 65 in 2010; delay retirement to age 66	94	94
Age 65 in 2010; delay retirement to age 67	89	89
Age 65 in 2010; increase investment return by 0.5% per annum	94	94

Assumptions: Mortality based on the Society of Actuaries' Uninsured Pensioner 1994 Table, with generational mortality improvement using Projection Scale AA. [Source: Transactions of the Society of Actuaries XLVII (1995)] The calculated present values are for an indexed pension payable to a single life, discounted at a real rate of investment return of 3% per annum (3.5% per annum for the final row of the table).

The above table illustrates that, even if currently projected mortality improvements continue for the next 50 years, the financial consequences for Defined Benefit pension plans are likely to be manageable, when viewed in comparison with potential changes in the retirement age or variations in investment returns earned by the pension fund. For instance, costs for an immediate pension for a male increases 14 percent in 50 years, yet a mere two-year increase in the retirement age reduces pension costs by a very comparable 11 percent.

Allowing phased retirement flexibility is a good way to facilitate new workplace policies aimed at mitigating the negative impact of the aging of our population. Employees considering retirement would be encouraged to continue working for their employer on a part-time basis, while collecting only part of their pension for a while. According to FSCO's interpretation of the *Pension Benefits Act*, a member is not currently allowed to collect part of his/her accrued pension before normal retirement date if still employed with the plan sponsor. In recent days, the federal government tabled legislation allowing pension plans to pay a pension to an employed member who is age 60 or entitled to an unreduced pension. ***We recommend that Ontario change its legislation to allow at least as much flexibility as proposed in the new federal tax rules***.

2.8 Pension Benefits Guarantee Fund

For a pension benefits guarantee fund (PBGF) to be viable in the long term, the price for the protection must be fair and equitable to each plan sponsor. To achieve this, the premium for the guarantee should take into account at least the following three factors:

1. the financial strength of the plan sponsor;
2. the degree of underfunding of the plan; and

3. the mismatch between the assets and the liabilities of the plan.

The current PBGF under the Ontario legislation ignores the first and third of these factors, but not without some reason. It can be difficult to assess the financial strength of a plan sponsor, particularly if the plan sponsor is a private company. However, ignoring this important factor in the determination of the PBGF premium unfairly penalizes plan sponsors that have a low risk of bankruptcy. These plan sponsors perceive the premiums as another tax that subsidizes the underfunded plans of financially weak plan sponsors, and if the premiums are too high, it creates an incentive to terminate their Defined Benefit pension plans in favour of something less costly.

We maintain that the government's efforts would be better directed towards improving the funding environment for private pension plans, thus reducing the very need for a government-supported backstop. Establishment of the Pension Security Trust mechanism and the inclusion of a Target Solvency Margin to reflect the mismatch between assets and liabilities in the calculation of the solvency liability are preferable alternatives to a PBGF over the long-term. The result would be to increase the likelihood that benefit promises are kept in the first place. PBGF premiums would be much lower than at present, as fewer plans would be underfunded on plan wind-up.

Ontario is the only jurisdiction in Canada that has a PBGF and it does not apply to all plans (e.g., negotiated contribution defined benefit plans) or all members in a plan that covers employees in provinces other than Ontario. ***We recommend that Ontario should explore the feasibility of alternative ways of handling underfunded plan wind-ups for insolvent employers.*** For example, other countries use privately-managed insolvency guaranty schemes or insurance contracts.

We believe that the implementation of our recommendations in this submission will improve the funding environment for defined benefit pension plans and reduce the need for the PBGF. Consideration could then be given to phasing out the current PBGF, particularly if other vehicles are available as a backstop. This would promote equitable competition across the country and alleviate the patchwork of legislation that currently exists.

3. Enhancing Public Understanding of the "Pension Promise"

3.1 Formal Funding Policy

Many plan sponsors do not have a formal funding policy for their Defined Benefit pension plans. ***The CIA recommends that Ontario should introduce legislation that would require plan sponsors to establish a written funding policy for their Defined Benefit pension plans in order to promote clear funding objectives and transparency. Further, the required annual disclosure by plan administrators to plan members should be expanded to include the key elements of the funding policy, as well as the investment policy and the current funded status of the plan.*** Such actions will encourage better plan governance and member communication.

The funding policy should address both going concern and wind-up valuation bases, giving specific consideration to at least two objectives: benefit security and stability of contributions. It should include a description of the key risks faced by the pension plan

and how these risks will be addressed. The funding policy should normally address items such as actuarial cost methods, the basis to determine best estimate actuarial assumptions, types and magnitude of margins in the actuarial assumptions, target contribution levels (or target benefit levels for plans with fixed contributions), utilization of surplus and contribution holidays and frequency of valuations. The roles of the plan sponsor and the actuary would also be defined in this policy.

For negotiated contribution plans, the funding policy would also need to address benefit policy and other issues related to fixed contributions.

The plan sponsor is responsible for establishing the funding policy, including the articulation of the level of margins to be used in the actuarial assumptions and the funding targets. The actuary would be responsible for the proper measurement and reporting of plan liabilities and costs, including disclosure of pertinent risks, in accordance with the policies adopted by the plan sponsor, regulatory requirements and actuarial standards. The actuary would likely assist the plan sponsor in the development of the funding policy and would be guided by this policy when selecting appropriate actuarial assumptions and methods.

The funding policy should be reviewed on a periodic basis to ensure that it remains appropriate to the changing circumstances of the plan. However, there need not be a requirement to file this policy with the regulatory authorities. In this manner, the treatment of the funding policy would be consistent with the treatment currently in place for the investment policy.

3.2 Disclosure of Funding Information to Plan Members

The CIA supports greater disclosure to plan members on the financial position of the plan, funding decisions and contribution holidays, provided that it is meaningful and does not create excessive administrative expenses. This information could be provided through the annual pension statement or it could be displayed on the plan sponsor website or through some other vehicle.

We acknowledge that increased transparency in the valuation process would be beneficial to all stakeholders. In particular, the CIA is proposing greater disclosure in actuarial valuation reports with respect to justifying the actuarial assumptions and the relative margins for adverse deviation contained within these assumptions. Key aspects of the plan sponsor's funding policy and investment policy would also be disclosed. These increased disclosure requirements would provide the reader with an enhanced understanding of the funded status of a pension plan and the associated risks.

4. CONCLUSION

The CIA supports the extensive research being conducted by the Commission on behalf of the province of Ontario. Given the number of discussion/working papers released in the last few years by various governments (provincial and federal) and the Canadian Association of Pension Supervisory Authorities (CAPSA), and the breadth of the Ontario research, it is clear that the issues related to Defined Benefit pension plans are a priority. It is also a welcome sign that Ontario and the other jurisdictions are committed to

improving the security of pension plan benefits and ensuring the viability of Defined Benefit pension plans.

The current funding regime applicable to Defined Benefit pension plans can and must be improved. Any revision to the funding rules must reflect the voluntary nature of these plans. We also encourage Ontario to explore other alternatives aimed at persuading plan sponsors to both maintain and better fund their defined benefit pension plans.

We are confident that it is possible to adopt appropriate legislative changes that implement a framework to alleviate the current problems related to the uncertainty about surplus ownership and utilization, and, consequently, provide a better environment for the long-term viability of Defined Benefit pension plans. The regulatory system should provide a clear understanding to each stakeholder of their respective entitlements and obligations appropriate to their particular circumstances. Actuarial standards of practice related to funding and reporting that reflect and support this system can then be developed. This combination will go a long way to encourage higher funding and increased benefit security.

The legislation governing Defined Benefit pension plans is complex, in particular for organizations with plan members in more than one province. With the passage of time, this complexity and the differences among provinces are only becoming more pronounced.

We often see ministers with specific portfolios from across the country meeting to discuss issues of common interest. It would be helpful if pensions could be put on the agenda for the next Finance Ministers' Meeting, however, only a handful of ministers have responsibility for the pension file in their jurisdictions. In Saskatchewan, pensions fall under the Justice ministry. In New Brunswick, it resides in Justice and Consumer Affairs. In Quebec, pensions fall within Employment and Social Solidarity. This combination of ministers never meets.

We encourage the Financial Services Commission of Ontario, the government of Ontario, to take the lead with other pension regulators and governments in Canada to come together to define pension standards that are consistently applied across the country. These need to reflect the need for increased pension coverage, the risks assumed by the various stakeholders and the members' concerns about better benefit security. Building on the high degree of cooperation in CAPSA would be helpful in this regard.

It seems that the last time the *Pension Benefits Act* was reviewed was in 1988. With the pace of change in society, it would seem that 20 years between reviews is too long. However, too frequent reviews may create instability and increase the risk of deterioration in harmonization of pension legislation in Canada. The CIA recommends that reviews should be conducted every 10 years and should include strong harmonization considerations.

The CIA would welcome further discussion on these crucial issues.

APPENDIX

RECENT CIA PENSION INITIATIVES

The CIA establishes standards of practice that support the ongoing operation of Defined Benefit pension plans. The CIA has a number of initiatives underway or recently completed that are intended to help maintain, encourage and improve the system of Defined Benefit pension plans in Canada. Some of these initiatives are described below.

While it is difficult to predict the results of these initiatives, it is anticipated that both benefit security and stability of contributions (albeit potentially at a higher level) will be enhanced.

Prescription for Canada's Ailing Pension System – The CIA has developed a pension prescription with 10 recommendations for change, which is aimed at better securing benefits for participants of a Defined Benefit pension plan and creating an environment conducive to maintaining and strengthening Defined Benefit pension plans for plan sponsors. This 10-point prescription was released in late June, 2007. (http://www.actuaries.ca/members/publications/2007/207061e.pdf)

2006 Pension Review Project – A CIA team recently completed reviews of a random sample of about 60 funding valuation reports for various multi-employer pension plans across Canada (results are summarized in a report entitled, "Canadian Institute of Actuaries 2006 Pension Review Project", which was released in July 2007). The purpose of this review was to promote the highest quality of actuarial work with respect to the valuation of multi-employer pension plans.

Review of Pension Funding Standards – The CIA's standards of practice applicable to funding and reporting on the funding of Defined Benefit pension plans are currently being reviewed. This review and consultation process is expected to result in significant changes to the standards (and hence to the actuary's funding valuation and report), to ensure that such standards evolve and remain appropriate and up to date. A working document, entitled, "Proposed Changes to the Practice-Specific Standards for Pension Plans" (http://www.actuaries.ca/members/publications/2007/207020e.pdf) was released in March 2007, and outlined the proposed changes and invited comments. The ultimate changes to the standards and the timing of these changes are under the jurisdiction of the Actuarial Standards Board, an independent standard-setting body established by the CIA in 2006.

Research on the Volatility of Hypothetical Wind-Up and Solvency Valuation Results
A CIA task force has been researching the volatility of a pension plan's funded position determined on a hypothetical wind-up or solvency valuation basis, for the purpose of improving benefit security. This research is partly in response to Quebec's recent changes to its pension legislation, and will assist with the determination of appropriate funding margins aimed at specified levels of benefit security. It is expected that the research paper will be released later this year.

Commuted Value of a Pension Benefit – The current CIA standards of practice for determining the commuted value of a pension benefit, which expire in February 2008, are

being reviewed for on-going appropriateness and for consistency with approaches in other areas of actuarial practice.

Additional Guidance and Educational Material – On an on-going basis, material is prepared to provide additional guidance to actuaries who are undertaking the funding valuation of a Defined Benefit pension plan. In 2007, material has been published on the following issues: assumptions for hypothetical and wind-up valuations in 2007, the content of the actuary's pension plan valuation report, the expense assumptions in a funding valuation and the treatment of events that occur after the calculation date for the actuary's report. Educational material is currently being prepared on a number of other topics related to the funding valuation of a Defined Benefit pension plan.

Seeing Beyond Risk Canadian Institute of Actuaries Institut canadien des actuaires Voir au-delà du risque

Submission by the Canadian Institute of Actuaries to the Alberta-British Columbia Joint Expert Panel on Pension Standards

March 2008

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Preface

The Canadian Institute of Actuaries (CIA) is pleased to present its recommendations for sustaining and improving the pension system to the Alberta-British Columbia Joint Expert Panel on Pension Standards (the Panel).

The CIA establishes the Rules of Professional Conduct, guiding principles and monitoring processes for qualified actuaries, all of whom must adhere to the profession's Standards of Practice and Guiding Principle 1, which states that the public interest is paramount. The CIA also assists the Actuarial Standards Board in developing Standards of Practice applicable to actuaries practising in Canada, including those standards governing the actuarial valuation of pension plans.

The CIA continuously reviews its standards related to Defined Benefit pension plans and new Standards of Practice are being developed by the Actuarial Standards Board for the funding of pension plans and for determining the commuted value of a pension benefit.

Recently, the CIA has made a number of recommendations for changes to the regulatory framework for pension plans in Canada, which we believe are relevant to the work of the Panel. These include the Canadian Institute of Actuaries' Prescription for Canada's Ailing Pension System, submissions to the House of Commons Standing Committee on Finance, and Ontario Expert Commission on Pensions. These documents are appended to this submission. A summary of the profession's recommendations made in these submissions follows:

Helping Canadians build adequate retirement income in an optimal way is a critical public policy issue. Given the importance of Defined Benefit pension plans in the provision of retirement income to Canadians, changes to the retirement system are needed to facilitate the maintenance of existing plans and encourage increased coverage by such plans. **The current and future financial security of retired and retiring Canadians is being threatened by the decline of Defined Benefit pension plans.**

In our view, the governments should:

- **Require all Defined Benefit pension plans to establish and maintain a Target Solvency Margin to enhance benefit security.** The level of the Target Solvency Margin would be related to the risks faced by the plan. Plan sponsors would be required to continue making current service contributions, even if the plan had assets in excess of the solvency liabilities, as long as plan assets are less than the sum of the solvency liabilities and the Target Solvency Margin.
- **Permit the use of a Pension Security Trust.** The Pension Security Trust would be complementary to, but separate from, the regular pension plan fund and would be used to increase funding levels and enhance benefit security for plan members. If the tax-deductible contributions made to the Pension Security Trust were subsequently found not to be needed to fund benefits, they would be released back to the plan sponsor.

- **Enact flexible legislation that encourages innovation in plan design and financing arrangements, and promotes the growth of Defined Benefit pension plans.** Again, enabling legislation needs to be flexible to allow for innovative measures such as Pension Security Trusts and letters of credit.
- **Enact pension legislation that permits the use of letters of credit for solvency amortization payments.** Allowing the use of letters of credit for this purpose would provide plan sponsors with additional flexibility without decreasing the security of the plan member benefits. Letters of credit could be held as an asset in the Pension Security Trust.
- **Change the way pension plan wind-ups are processed to address practical difficulties for annuity purchases.** The annuity market in Canada is not large enough to handle significant one-time annuity purchases, and some types of annuities are difficult to purchase (e.g., indexed pensions). Therefore, plan wind-ups that occur will likely be protracted over time, exposing the plan to additional market risk. Allowing alternative methods of settling plan obligations on wind-up must be explored.
- **Require annual actuarial valuations for plans whose solvency ratio is less than 100 percent.** Plans with solvency ratios above 100 percent would continue to conduct valuations every three years. This represents a reasonable balance between the desire for more timely intervention when a plan is headed into financial difficulty and the concern about excessive administration costs.
- **Amend the legislation and policies to facilitate adjustments in pension plan designs and workplace policies to deal with increasing longevity and workforce planning.** In particular, pension legislation should be changed to accommodate phased retirement policies.
- **Explore alternative ways of protecting benefits in wind-ups of underfunded plans by insolvent employers.** Look at what other jurisdictions and countries are doing, for example, the availability and usage of privately managed insolvency guaranty schemes or insurance contracts for this purpose. In the meantime, unfunded pension liabilities should be given priority similar to that of unpaid wages in bankruptcy proceedings.
- **Require plan sponsors to establish a formal funding policy for Defined Benefit pension plans.** The written funding policy would: a) define the roles of the plan sponsor and the actuary; b) address both going concern and wind-up bases; and c) address timing of valuations, giving specific consideration to benefit security and stability of contributions. This recommendation would increase transparency and provide stakeholders with an enhanced understanding of the funded status of the plan and the associated risks.
- **Take the lead in coordinating the development of pension legislation in Canadian jurisdictions.** Currently, moving pension issues forward on to the national agenda is impossible as the respective ministers responsible for pension matters, provincially and federally, never meet. For example, responsibility for the pension file falls under the Minister of Finance in only three provinces.

- **Eliminate partial plan terminations.** This would not only eliminate the surplus distribution issue on partial termination but would also remove the administrative and cost burdens related to partial terminations. However, if partial plan terminations are maintained in the pension legislation, the government should more clearly specify the criteria for any special situations in which full vesting rights must be provided.

Summary of CIA Recommendations in this Submission

- Alberta and British Columbia should make legislative and regulatory changes that:
    - Clarify the rules for surplus ownership and utilization that recognize plan sponsors' right to, and access to, Defined Benefit pension plan surpluses;
    - Clarify that documents establishing pension plan funding vehicles are documents of the plan, subject only to the provisions of the *Pension Benefits Acts* and regulations;
    - State explicitly that to the extent of any inconsistency with the common law, the provisions of the *Pension Benefits Acts* and regulations are paramount and supersede the common law; and
    - Require that all plans whose solvency ratio is less than 100% be required to conduct actuarial valuations annually.
- The CIA would be willing to have further discussions with the Alberta and British Columbia authorities to flesh out the possibilities of encouraging more plan coverage by providing more flexibility in plan design and financing arrangements.
- Defined Benefit pension plans should be required to establish and maintain a Target Solvency Margin to enhance benefit security. A task force should be set up with representation from pension regulators, the federal Department of Finance and the CIA to review the CIA's research on appropriate margins for solvency valuations and to establish the Target Security Margin framework.
- With a view to increasing benefit security, we invite the Alberta and British Columbia governments to encourage the federal government to change the tax rules in order to allow Defined Benefit pension plans to maintain reasonable funding margins before contribution holidays are required (e.g., allowing developing surpluses that are the greater of two times the Target Solvency Margin or 25% of the going concern liability).
- Legislation should be introduced to:
    - Enable Pension Security Trusts as an innovative way to facilitate improvement in benefit security.
    - Allow a pension plan to settle a larger proportion of its obligations at plan termination through the payment of lump sum commuted values than is allowed under current legislation in order to accommodate the limited group annuity market in Canada.
    - Require plan sponsors to establish a written funding policy for Defined Benefit pension plans in order to promote clear objectives and transparency.

- The required annual disclosure by plan administrators to plan members should be expanded to include the key elements of the funding policy, as well as the investment policy and the current funded status of the plan.
- We recommend that governments provide the basics of financial literacy in high school, and encourage employers and financial institutions to become more intimately involved in the education of plan members, potentially involving government incentives and effective safe harbour protection.
- We encourage Alberta and British Columbia to take the lead in getting all pension regulators and governments in Canada to work together at defining new improved pension standards that are consistently applied across Canada and reflect the need for increased pension coverage, the risks assumed by the various stakeholders and the members' concerns about better benefit security. The CIA would be pleased to participate in discussions on these crucial issues.
- The CIA believes that retirement savings ought to be on the national agenda and has encouraged the federal Minister of Finance to initiate a meeting of all provincial and territorial ministers responsible for regulating pensions in order to establish a common framework for pension legislation to resolve the coming challenges to the retirement savings system. We encourage British Columbia and Alberta governments to strongly support this initiative by promoting it among the other provinces and with the federal government.

Issues Addressed In Our Submission

Our submission focuses on those aspects of the Panel's mandate that are most directly related to the role of actuaries in the establishment and management of pension plans, and for which we believe the Institute has unique expertise to offer meaningful input to the Panel's deliberations. In Chapter 1 of our submission, our comments are organized into three main themes:

1. Improving the regulatory and business environment for pension plans in Alberta and British Columbia.
2. Putting Defined Benefit pension plans on a sounder financial footing.
3. Enhancing public understanding of the "pension promise."

In Chapter 2, we provide input to each question posed by the Panel in its consultation paper.

CHAPTER 1 – MAIN CIA RECOMMENDATIONS FOR IMPROVING OUR PENSION SYSTEM

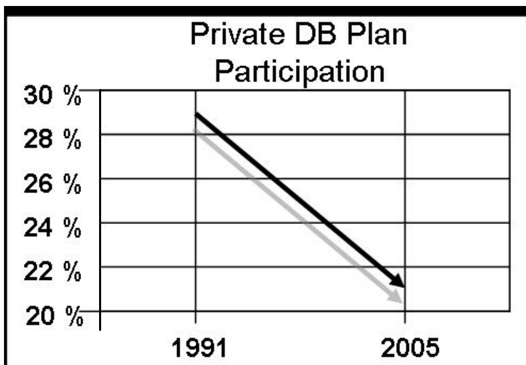
1. Improving the Regulatory and Business Environment for Pension Plans

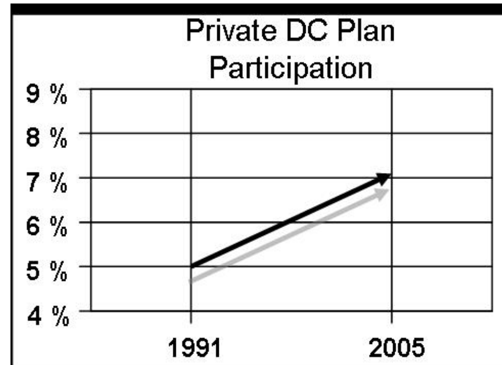
Defined Contribution plans, Defined Benefit plans, and other arrangements are all part of a strong and vibrant retirement savings system. Weakness in any one element puts pressure on the others. The CIA believes that **the future of Defined Benefit pension plans is at risk** unless changes are made to the pension system.

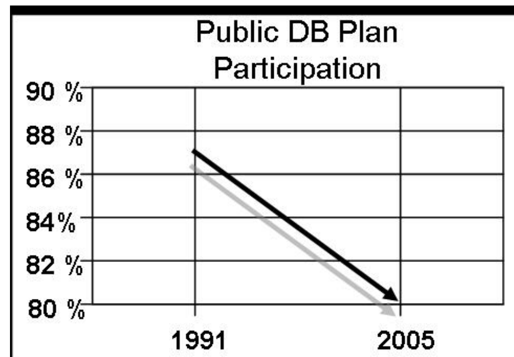
Our concern is reflected in the percentage decline of workers covered by Defined Benefit plans. There are a number of reasons for this trend, including Canada's patchwork of regulations, legal decisions, tax rules and changes in accounting standards. These problems have been compounded over the recent past due to:

- low interest rates;
- increasing longevity;
- volatile market yields; and
- the uncertainty regarding contribution holidays and plan surplus ownership and utilization.

1.1 Importance of Occupational Pension Plans and, in particular, Defined Benefit Pension Plans To Canadians







The graphs above show that in the private sector, participation in pension plans has decreased from 34% in 1991 to only 28% in 2005. The growth of Defined Contribution plans has not offset the decline in Defined Benefit plans. Moreover, public sector Defined Benefit pension plan participation also declined in the same time period.

Both **the adequacy and security of retirement income are seriously threatened by the decline in coverage by all types of occupational pension plans**. In addition, a Defined Benefit pension plan provides security that cannot be found in Defined Contribution pension plans or RRSPs. The pension benefit is pre-defined, usually as a percentage of pre-retirement salary or as a fixed rate per year of service. While plan members may provide a defined level of contributions to these plans, the plan sponsor undertakes to contribute at whatever additional level is necessary to fund the promised benefits. Saving and improving Defined Benefit pension plans is a better choice for Canadians than allowing their steady erosion.

Defined Benefit pension plans are an important component in the overall retirement system and are in the best interests of Canada and Canadians for a number of reasons:

a) ***Greater predictability for plan members.*** Defined Benefit pension plan members have a good sense of what they will receive in retirement, making planning and saving for the future easier and reducing uncertainty.

b) ***More security and less risk to plan members.*** Individuals in an ongoing Defined Benefit pension plan face lower risks related to changing interest rates, longer than expected longevity and volatility of market returns.

c) ***Better workforce management***. Defined Benefit pension plans help employers retain good employees and they can be a tool to help employers better manage their workforce (e.g., enhance early retirement or provide incentives to delay retirement).

d) ***Higher investment return.*** By having larger pools of money to invest and, importantly, longer investment time horizons, a more aggressive, diversified and informed investment strategy with lower management fees can be used. The higher yields and lower administration costs result in greater value for dollars invested in Defined Benefit pension plans compared to Defined Contribution pension plans over the long run.

e) ***Greater economic benefit to society and the economy.*** Recently-retired Bank of Canada Governor David Dodge supports Defined Benefit pension plans. He believes that they promote economic efficiency by allowing a better allocation of savings and they provide efficiency gains for financial markets. He has stated that managers of Defined Benefit pension plans have both the ability and desire to invest in the kinds of assets that the average individual investor might not normally consider. Such managers have a superior knowledge of financial markets and of the associated risks that make them willing to invest in alternative asset classes, and Defined Benefit pension plans invest over very long time horizons so they can finance large investment projects at competitive rates of return. An example would be investment in critical infrastructure to support Canada's future production capacity.

1.2 Removing Uncertainty About Surplus Ownership And Utilization

Plan members expect reasonable assurance of the delivery of the promised benefits, which is achieved by the level of funding of the plan. **Plan sponsors seek reasonable predictability of costs** and will resist making contributions to pension plans to increase the solvency, and hence security of plan members' benefits, when they do not feel they have control over any amounts that may turn out to be excess to those needed to provide the promised benefits.

A critical issue that must be resolved for Defined Benefit pension plans is surplus ownership and utilization. The current uncertainty surrounding plan surplus ownership and utilization does not encourage higher levels of funding. Consequently, it has a detrimental effect on benefit security. This uncertainty may indeed be one of the most significant forces driving the decline in Defined Benefit pension plan coverage.

Many plan sponsors have been reluctant to fund their pension plans beyond minimum legislative requirements because they are uncertain whether they will have access to any surplus funds that may subsequently arise. In most single-employer Defined Benefit pension plans, the plan sponsor backstops the funding risks. When economic conditions are unfavourable and funding deficits occur, whether measured on a going concern or wind-up basis, the plan sponsor must increase contributions to the plan. When conditions turn favourable, plan sponsors often feel that they should control the use of funding surpluses, whether through contribution holidays, surplus reversions or benefit improvements. However, the surplus is often claimed by the plan members upon a partial or full plan wind-up, even in cases of clear surplus ownership by the plan sponsor according to plan documents. This imbalance is perceived by plan sponsors as unfair, and it discourages the secure funding of Defined Benefit pension plans, decreasing the security of members' pension benefits.

We believe that Alberta and British Columbia should make legislative and regulatory changes that:

- Clarify the rules for surplus ownership and utilization that recognize plan sponsors' right to, and access to, Defined Benefit pension plan surpluses;
- Clarify that documents establishing pension plan funding vehicles are documents of the plan, subject only to the provisions of the *Pension Benefits Acts* and regulations; and
- State explicitly that to the extent of any inconsistency with the common law, the provisions of the *Pension Benefits Acts* and regulations are paramount and supersede the common law.

These changes should override legal precedents that have recently been established particularly where the plan documentation is silent on these issues, but they should also recognize that existing contracts or agreements between the plan sponsor and plan members will need to be respected. Removing this uncertainty surrounding surplus ownership and utilization will go a long way towards eliminating unanticipated costs to plan sponsors and will increase the palatability of sponsors to fund on a more secure basis, thereby enhancing benefit security.

1.3 Mergers, Splits and Asset Transfers

When one employer sells a business unit to another, and the employees of that business unit participate in a pension plan for all of the vendor's employees, it is often necessary for the purchaser to establish a pension plan and assume responsibility for the past service obligations of the vendor. Assets are transferred from the vendor's pension plan to a new or existing plan sponsored by the purchaser. Ideally, the basis for determining the amount of the asset transfer is fully defined by the purchase and sale agreement. Similarly, an employer may merge its operations with another employer and it may become necessary to merge the respective pension benefits into one new plan that covers all employees of the new entity.

The legislation and approval policies should continue to recognize the reality that these business transactions occur in a variety of forms and that time is usually a factor.

1.4 Innovative Designs and Financing Arrangements

The CIA encourages innovation in plan design and financing arrangements that promote the growth of pension plans. Often, pension legislation, the *Income Tax Act* or interpretations of them have excluded some good plan designs or features. Such innovations, if allowed, may encourage more pension plan coverage by providing increased flexibility.

Three examples of features that could be considered are:

- Partial or full payment of accrued benefits under phased retirement agreements;
- Express benefit accruals in the form of a number of "shares", which would increase in value during the members' working careers through an excess interest approach;
- Cash balance plans (used extensively in the United States).

Other designs that may offer additional flexibility to plan members and assist employers in attracting and retaining employees would be welcome.

Any measure that can alleviate operational costs or mitigate risks for organizations sponsoring pension plans should be considered, especially for small plans.

The CIA is looking forward to having discussions with the Alberta and British Columbia authorities to flesh out the possibilities. In any event, less rigid legislation and regulations at provincial and/or federal levels would be required to allow flexibility while retaining security of members' benefits under any of these, or other, innovative concepts.

2. Putting Defined Benefit Pension Plans on a Sounder Financial Footing

The goal of funding Defined Benefit pension plans is the systematic accumulation over time of dedicated assets that, without recourse to the plan sponsor's assets, secure the plans' promised benefits. To continue to be successful, ***Defined Benefit pension plans must:***

a) provide plan members with reasonable confidence that the promised benefits will be paid; and

b) offer plan sponsors a reasonable predictability of costs.

Confidence on the part of plan members requires both adequate funding of the benefits and the development of an environment in which plan sponsors are encouraged to maintain and appropriately fund Defined Benefit pension plans. Predictability of costs requires the proper measurement and appropriate reporting of funding requirements and of the associated risks, and an enabling regulatory environment. There must be an equitable treatment of the consequences of risks undertaken, which is clearly articulated and understood by all stakeholders.

2.1 Target Solvency Margin

One method of achieving more secure funding of benefits would be for plans in a surplus position to maintain a portion of that surplus as a Target Solvency Margin, the target percentage by which the assets of a plan should exceed the liabilities on a solvency valuation basis. The amount of the Target Solvency Margin would vary according to the potential volatility of a plan's funded position,[1] thereby ensuring more secure funding based on the level of risk of the plan.

The implementation and ongoing monitoring of the Target Solvency Margin should not involve overly high complexity, cost and work. The development of such a margin should balance the need to accurately reflect the plan's risk exposure with the need for simplicity, recognizing the small size of some plans.

The Target Solvency Margin would determine when a plan sponsor could take a contribution holiday. Unless the sum of the assets in both the regular pension fund and the Pension Security Trust (see below) – including the face amount of the letter of credit, if applicable – exceeded the solvency liabilities by at least the Target Solvency Margin, the sponsor would be required to continue making current service contributions (i.e., contributions determined in accordance with the going concern valuation).

For Multi-Employer Pension Plans (MEPPs) in which the employer contributions are not negotiated, and the pension "deal" is for a defined benefit in which the individual contributing employers are responsible for the risk of unfunded liabilities, solvency deficiencies and increases in the normal cost, the Target Solvency Margin concept must also be considered. In Chapter 2 of this submission, we provide comments on special rules that should be explored for Negotiated Cost Defined Benefit (NCDB) plans in which the employer contributions are negotiated and the pension deal is for the negotiated contributions combined with a target benefit (not a promised benefit) established by a board of trustees.

In November 2007, the CIA published a research paper on the determination of appropriate provisions for adverse deviations in hypothetical wind-up and solvency

[1] Risk-based solvency through a Target Solvency Margin is a concept already used by governments to ensure the security of other risk-bearing financial institutions. Some Defined Benefit pension plans are subject to greater volatility than others, partly as a result of the asset mix of the plan. A pension plan invested mostly in high quality bonds would typically have a lower risk than one with an asset mix with high percentages of Canadian and foreign equities. Other risk factors include the demographic profile of the plan membership, the investment policy and the associated asset/liability mismatch (i.e., the extent to which the cash flows of the assets deviate from the cash flows of the liabilities). Hence, each plan should have a Target Solvency Margin established based on its specific risk factors and its exposure to volatility. Establishing Target Solvency Margins for plans that have different risks will create a risk-based approach to plan funding.

valuations. We expect that the Québec supervisory authorities will reflect this research paper in the development of their rules mandating solvency provisions for adverse deviations. We acknowledge that amendments to the income tax legislation may also be required to accommodate the Target Solvency Margin concept. ***We recommend that a task force be set up with representation from pension regulators, the federal Department of Finance and the CIA to review this research and establish the Target Security Margin framework.***

As seen in the current decade, the financial position of Defined Benefit pension plans can experience significant fluctuations within a relatively short time-frame. It would be desirable to allow these plans to maintain a surplus level that would be sufficient to ward off against negative experience. The maximum surplus level allowed under the current federal tax rules is too low to provide adequate financial protection. With a view to increasing benefit security, ***we invite the Alberta and British Columbia governments to encourage the federal government to change the tax rules in order to allow Defined Benefit pension plans to maintain reasonable funding margins before contribution holidays are required (e.g., allowing developing surpluses that are the greater of two times the Target Solvency Margin or 25% of the going concern liability).***

2.2 Pension Security Trust

The Target Solvency Margin would work best in tandem with a **Pension Security Trust,** a separate sponsor-funded and sponsor-owned trust, or letters of credit (discussed in section 2.3). Plan sponsors could pay the additional contributions required to meet solvency funding requirements into the Pension Security Trust or use a letter of credit for this purpose. **Use of the Pension Security Trust and/or a letter of credit instead of the regular pension fund would ensure that any part of the Target Solvency Margin, not ultimately needed to provide plan benefits, would be accessible by the plan sponsor.**

We believe that most plan sponsors would be willing to fund a Defined Benefit pension plan more securely, thereby improving benefit security for the members, if they knew that they could access any surpluses that might arise from their excess contributions. This confidence would encourage plan sponsors to continue their Defined Benefit pension plans or to start new ones.

We recommend that legislation[2] be introduced to enable Pension Security Trusts as an innovative way to facilitate this improvement.

Plan sponsors would be able to contribute to the Pension Security Trust, which would be complementary to the regular Defined Benefit pension plan trust fund. The assets would be invested in a manner similar to the regular pension plan trust fund, and would be held as a side fund by the trustee and custodian. Unlike the pension plan trust fund, however, the Pension Security Trust would hold plan sponsor contributions only and would be "owned" by the plan sponsor.

Solvency deficiency payments would be placed in the Pension Security Trust. Contributions arising from going concern valuations would go into the regular pension fund. The Pension Security Trust could also be used by plan sponsors who wish to

[2] To allow Pension Security Trusts will mean changes to both the *Income Tax Act* and provincial legislation.

contribute more than the minimum required under the going concern valuation to strengthen the funding of the plan. If subsequent valuations showed that some of the assets in the Pension Security Trust are not required to pay plan benefits, then the excess could be released back to the plan sponsor.

The assets held in the Pension Security Trust fund would be included in the value of assets for the purposes of the solvency actuarial valuation and, in case of plan wind-up, the monies held by the Pension Security Trust may be refunded to the sponsor to the extent not necessary to cover any excess of the wind-up liabilities over the assets in the regular pension fund. The pension plan would be granted a priority claim to the Pension Security Trust fund in the event of the sponsor's insolvency, ahead of other creditors, up to the amount needed to satisfy plan wind-up obligations.

2.3 Letters of Credit

We applaud Alberta for adopting legislation that permits the use of letters of credit to guarantee solvency deficiency amortization payments. We recommend that British Columbia adopt amendments to its legislation to allow this practice.

Letters of credit provide plan sponsors with additional flexibility without decreasing the security of the benefits accrued by the plan members. They provide plan sponsors the opportunity to better manage their cash flow and utilization, which are important considerations in the current environment of worldwide competition and the struggle for increased efficiency. Instead of paying additional contributions to the pension fund, the plan sponsor will be able to provide a letter of credit whose amount can fluctuate according to the economic context and the financial health of the pension plan.

The letter of credit could be held as an asset in the Pension Security Trust. The face amount of the letter of credit would be considered a plan asset and taken into account for actuarial valuation purposes. It should remain in effect unless it is reduced or cancelled by paying an equivalent contribution into the Pension Security Trust or having a surplus on a solvency basis. Upon plan termination, the letter of credit would be usable only up to the amount of any actual deficiency.

2.4 Solvency Valuations

Security of plan benefits is promoted by actuarial valuation results on a plan wind-up basis and, typically, contribution stability is promoted by valuation results on a going concern basis. Actuarial valuation reports should highlight these two key objectives – the security of benefits in the event the plan is wound up, and the stability of contributions if the plan is continued for the long term.

However, in recent years the solvency valuation results have had a significantly increasing influence on the level and stability of contribution requirements for a variety of reasons, including:

- Low interest rates, and concomitant higher annuity purchase rates and commuted values;
- Volatile investment markets, which can cause considerable short-term swings in the market value of assets recognized for solvency purposes;

- Increasing proportions of retiree liabilities (including those eligible for early retirement and other members with associated "grow-in" rights) in many plans, due to general aging of the workforce, increased longevity, closing of the Defined Benefit portion of the plan to new entrants upon conversion to a Defined Contribution plan and, particularly for certain multi-employer plans, employment in a declining industry;
- "Front-loaded" legislative contribution requirements, since solvency deficiencies must be amortized over a five-year period.

We note that the group annuity market in Canada is limited. For many plans, it is highly unlikely that the plan administrator would be able to purchase annuities for all of its retirees (including those eligible for early retirement) in one transaction upon plan termination. In fact, it could take many years before all the retiree obligations of the terminating plan could be satisfied through the purchase of annuities. Further, some annuities are difficult, if not impossible, to purchase (e.g., indexed annuities).

One suggestion for dealing with this issue might be to **allow the pension plan to settle a larger proportion of its obligations through the payment of lump sum commuted values than is allowed under current legislation.** For example, a plan might be permitted to settle all liabilities for active members by paying lump sum settlements (rather than giving such members a choice between a deferred annuity or a lump sum), while retired members might be offered a choice between an immediate annuity or a lump sum. The CIA is willing to conduct further study into what commuted value standards would be appropriate under these circumstances.

In practice, plan wind-ups tend to be conducted in multiple transactions over an extended period of time; this process exposes the plan to extra market risk, because it adds uncertainty about the ultimate cost to settle the plan's obligations. However, for plans that have accumulated a Target Solvency Margin, the margin would serve as a buffer against this market risk for the duration of the wind-up process, thereby minimizing the likelihood of additional contributions by the sponsor or loss of benefits by members.

2.5 Frequency of Actuarial Valuations

Under current Alberta and British Columbia legislation, actuarial valuations must be conducted at three-year intervals, except that annual valuations are required for plans registered in Alberta with funding or solvency ratios less than 85%. As recent market experience has demonstrated, the solvency positions of pension plans can change very quickly and dramatically, and some observers argue that a three-year valuation interval means that the sponsor of a plan whose financial position is deteriorating will respond too slowly to ensure a reasonable level of benefit security for plan members. On the other hand, actuarial valuations impose a cost to the plan or to the sponsor, and excessive requirements for frequent valuations can be a significant financial burden, particularly for smaller plans.

We suggest that the Panel consider recommending that all plans whose solvency ratio is less than 100% be required to conduct actuarial valuations annually. A plan would revert to the triennial valuation interval once the insolvent financial position is eliminated. This would be consistent with the legislation that exists in other jurisdictions, and, in our view, represents a reasonable balance between the desire for more timely

intervention when a plan is headed into financial difficulty and the concern about excessive costs. For plans with solvency ratios greater than 100%, a requirement to maintain a Target Solvency Margin would provide some degree of protection to plan members against unfavourable experience before the next triennial valuation is conducted.

2.6 Managing Longevity Risk

While increasing longevity is certainly a positive development for Canadian society overall, it also means that providing adequate lifetime income to retirees will become an ever greater challenge. For sponsors of Defined Benefit pension plans, pension payments must be extended to increasingly higher ages, raising the total cost of the plan. **For employees accumulating retirement savings in Defined Contribution pension plans or personal RRSPs, the level of retirement income at a given retirement age will decrease as longevity increases; they will have to either save more, retire later or enjoy a poorer retirement lifestyle.**

Over the long term, the only way for society to deal with increasing longevity is gradually to adapt its workforce policies and its retirement income arrangements to the new reality. This will require some combination of raising retirement ages, reducing benefit levels, or raising costs to plan sponsors or to members. The relative emphasis on each of these measures will depend on the circumstances within each employment setting or each sector of the economy.

In practice, some of these measures might be very contentious and difficult to implement. For example, raising the normal retirement age at which a worker qualifies for a full pension might be resisted particularly strongly in some workplaces. On the other hand, it might be argued that one of the causes of increasing longevity is an improvement in overall public health, leading to an increasing ability for older workers to remain in the workforce longer than they could in the past. Faced with a choice between delaying their retirement age or receiving a lower pension to keep plans affordable, many workers might be willing to accept a delay in their retirement age, knowing that they will need to extend the productive stage of their lives if they want to keep a reasonable standard of living into their extended retirement years.

As plan sponsors and workers adapt to the new environment, it is important to keep up with trends in mortality and longevity, and for actuaries to ensure that the most realistic available demographic assumptions are used in determining the estimated future costs of pension benefits. This will enable informed decision-making in the process of modifying pension plan provisions or workplace policies. **The Institute is committed to ongoing reviews of professional standards for actuaries**, including updates to guidance on the selection of appropriate mortality assumptions for the valuation of pension benefits. The Institute is supported by research from the Society of Actuaries, which sponsors regular studies of mortality experience among populations of active workers and group annuitants in the United States and Canada. The Society of Actuaries is an actuarial education and research organization based in Chicago, many of whose activities are jointly sponsored by the CIA.

To give some perspective on the estimated financial effect of increasing longevity, relative to other factors affecting the costs of a pension plan, we performed a series of

calculations showing the estimated cost of a pension payable to a 65-year-old and the effect of projected improvements in mortality over a period of 50 years. The results are presented in the following table. For each gender, we have assigned a "relative cost" of 100 to represent the present value of an immediate pension that starts to be paid to an individual who attains age 65 in the year 2010.

	Relative cost[3] of immediate pension	
	Male	Female
Age 65 in 2010 (base case)	100	100
Age 65 in 2020	103	101
Age 65 in 2030	106	103
Age 65 in 2040	109	104
Age 65 in 2050	112	105
Age 65 in 2060	114	107
Age 65 in 2010; delay retirement to age 66	94	94
Age 65 in 2010; delay retirement to age 67	89	89
Age 65 in 2010; increase investment return by 0.5% per annum	94	94

The above table illustrates that, even if currently projected mortality improvements continue for the next 50 years, the financial consequences for Defined Benefit pension plans are likely to be manageable, when viewed in comparison with potential changes in the retirement age or variations in investment returns earned by the pension fund.

3. Enhancing Public Understanding of the "Pension Promise"

3.1 Formal Funding Policy

Many plan sponsors do not have a formal funding policy for their Defined Benefit pension plans. ***The CIA recommends that the Alberta and British Columbia governments introduce legislation that would require plan sponsors to establish a written funding policy for Defined Benefit pension plans in order to promote clear objectives and transparency. Further, the required annual disclosure by plan administrators to plan members should be expanded to include the key elements of the funding policy, as well as the investment policy and the current funded status of the plan.*** These recommendations are intended to encourage better governance and communication.

The funding policy should address both going concern and wind-up bases, giving specific consideration to at least two objectives: benefit security and stability of contributions. It should include a description of the key risks faced by the pension plan and how these

[3] Assumptions: Mortality based on Society of Actuaries' Uninsured Pensioner 1994 Table, with generational mortality improvement using Projection Scale AA. [Source: Transactions of the Society of Actuaries XLVII (1995)] The calculated present values are for an indexed pension payable to a single life, discounted at a real rate of investment return of 3% per annum (3.5% per annum for the final row of the table).

risks will be addressed. The funding policy should normally address items such as actuarial cost methods, the basis to determine best estimate actuarial assumptions, types and magnitude of margins in the actuarial assumptions, target contribution levels (or target benefit levels for plans with fixed contributions), utilization of surplus and contribution holidays and frequency of valuations. The roles of the plan sponsor and the actuary would also be defined in this policy.

For negotiated contribution plans, the funding policy would also need to address benefit policy and other issues related to fixed contributions.

Since the plan sponsor is responsible for establishing the funding policy, including articulation of the level of margins in the actuarial assumptions and funding targets, the actuary would then be responsible for proper measurement and reporting of plan liabilities and costs, including disclosure of pertinent risks, in accordance with the policies adopted by the plan sponsor, regulatory requirements and actuarial standards. The actuary would likely assist in the development of the funding policy and would be guided by this policy when selecting appropriate actuarial assumptions and methods.

The funding policy should be reviewed on a periodic basis to ensure that it remains appropriate to the changing circumstances of the plan. However, there need not be a requirement to file this policy with the regulatory authorities. In this manner, the treatment of the funding policy would be consistent with the treatment currently in place for the investment policy.

3.2 Disclosure of Funding Information to Plan Members

The CIA supports greater disclosure to plan members on the financial position of the plan, funding decisions and contribution holidays, provided that it is meaningful and does not create excessive administrative expense. This information could be provided through the annual pension statement or it could be displayed on the plan sponsor website or through some other vehicle.

We acknowledge that increased transparency in the valuation process would be beneficial to all stakeholders. In particular, the CIA has already implemented greater disclosure in actuarial valuation reports with respect to the rationale for the actuarial assumptions and is investigating increased disclosure for the relative margins for adverse deviations contained within these assumptions. Key aspects of the plan sponsor’s funding policy and investment policy would also be disclosed. These increased disclosure requirements would provide the reader with an enhanced understanding of the funded status of a pension plan and the associated risks.

3.3 Education of the Public

Defined Contribution plans, Defined Benefit plans, and other arrangements are all part of a strong and vibrant retirement system. Individuals could conceivably work at different times for employers with any one of the entire array of retirement plans available, or where no plan is offered at all.

All individuals, therefore, should understand and be engaged in the process of saving for retirement from an early age. Education should be available right from secondary school where the seeds of financial literacy can be planted and nurtured. Education could come in many forms – formally, in a classroom setting, or by

government communications using a variety of media, or advertising programs provided by government, employers or financial institutions.

We recommend that governments provide the basics of financial literacy in high school, and encourage employers and financial institutions to become more intimately involved in the education of plan members, potentially involving government incentives and effective safe harbour protection.

4. Conclusion

The CIA supports the extensive work being conducted by the Panel on behalf of the provinces of Alberta and British Columbia. Given the number of discussion/working papers released in the last few years by various governments (provincial and federal) and the Canadian Association of Pension Supervisory Authorities (CAPSA), and the breadth of the research and consultation performed by the Ontario Expert Commission on Pensions, it is clear that the issues related to occupational pension plans (in particular Defined Benefit plans) are top of mind. It is also a welcome sign that Alberta, British Columbia and the other jurisdictions are committed to improving the security of pension plan benefits and ensuring the viability of Defined Benefit pension plans.

The current funding regime applicable to Defined Benefit pension plans can and must be improved. Any revision to the funding rules must reflect the voluntary nature of these plans. We also encourage the governments of Alberta and British Columbia to explore other alternatives aimed at encouraging plan sponsors to both maintain and better fund their Defined Benefit pension plans.

We are confident that it is possible to adopt appropriate legislative changes that implement a framework to alleviate the current problems related to the uncertainty about surplus ownership and utilization and consequently provide a better environment for the long-term viability of Defined Benefit pension plans. We contend that the regulatory system should provide a clear understanding to each stakeholder of their respective entitlements and obligations that is appropriate for their particular circumstances. Actuarial Standards of Practice related to funding and reporting that reflect and support this system can then be developed. This combination will go a long way to encourage higher funding and increase benefit security.

The legislation governing Defined Benefit pension plans is complex, in particular for organizations with plan members in more than one province. With the passage of time, this complexity and the differences among provinces are not lessening; on the contrary, they are only becoming more pronounced. ***We encourage all pension regulators and governments in Canada to work together at defining new improved pension standards that are consistently applied across Canada and reflect the need for increased pension coverage, the risks assumed by the various stakeholders and the members' concerns about better benefit security. The CIA is anxious to participate in discussions on these crucial issues.***

Canada's population is aging; the proportion of people covered by occupational pension plans is falling; together these trends are moving Canada towards a potential pension crisis.

The CIA believes that retirement savings ought to be on the national agenda and has encouraged the federal Minister of Finance to initiate a meeting of all provincial and

territorial ministers responsible for regulating pensions[4] in order to establish a common framework for pension legislation to resolve the coming challenges to the retirement savings system. Pensions are never on the agenda when Finance ministers meet, as only four of them have responsibility for the pension portfolio. ***We encourage the British Columbia and Alberta governments to strongly support this initiative, promoting it among the other provinces and with the federal government.***

[4] To illustrate the varied ways in which pension regulation is handled in Canada, the following list shows the ministry involved in each jurisdiction:
Alberta–Finance
British Columbia–Finance
Manitoba–Labour & Immigration
New Brunswick–Justice and Consumer Affairs
Newfoundland and Labrador–Government Services and Lands
Nova Scotia–Environment and Labour
Ontario–Finance
Québec–Employment and Social Solidarity
PEI– none
Saskatchewan–Justice
Canada–Finance

CHAPTER 2 – INPUT ON SPECIFIC QUESTIONS FROM THE PANEL

The call for submissions posed a great number of questions, many of which have been addressed in Chapter 1 of this submission. For your convenience, we have included them below along with some commentary and references to other papers that have addressed the issue in question.

Questions re: Occupational Pensions Plans in the Canadian Economy

2(a) What role, if any, should occupational pension plans play in the Alberta and British Columbia retirement income systems?

> The CIA recently sponsored a study titled, "PLANNING FOR RETIREMENT: ARE CANADIANS SAVING ENOUGH?" by the University of Waterloo's Department of Statistics and Actuarial Science (the Waterloo Study). Here is a quote from the introduction.
>
> "Our research examined the financial adequacy of retirement preparation for those expected to stop working in 2030.
>
> Our conclusion: two thirds of Canadian households expecting to retire in 2030 are not saving at levels required to meet necessary living expenses. Old Age Security (OAS) and the Canada and Québec Pension Plans (C/QPP) provide a modest base, and by themselves, are not designed to fill the gap. Home ownership will help to narrow the gap, but, by itself, won't be enough. Participation in a workplace pension plan (RPP), by itself, won't be enough. And, saving through a Registered Retirement Pension Plan (RRSP) plays an important role, but is unlikely to fill the gap." [5]

According to the study, **occupational pension plans have a critical role to play as part of an individual's financial plan,** especially considering that over 30% of Canadians have no financial plan for their retirement.

For more comments on the importance of occupational pension plans to Canadians, please refer to section 1.1 of Chapter 1 of this submission.

2(b) What role, if any, should occupational pension plans play in attracting and retaining the future workforce and facilitating worker mobility?

> "***Better workforce management.*** Defined Benefit plans help employers retain good employees and they can be a tool to help employers to better manage their workforce (e.g., enhance early retirement.)" [6]

The primary role of an occupational pension plan is to provide retirement income, however, these plans are also excellent tools to attract and retain staff. Defined Benefit plans can include features to improve workforce management, whether that means encouraging early, phased or late retirement. Moreover, the portability requirements of the current legislation help accommodate the transfer of benefits and consequently, worker mobility. Most Multi-Employer Pension Plans facilitate mobility within an industry.

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5 Planning for Retirement: Are Canadians Saving Enough?, Executive Summary, p. 2.

6 CIA Pension Prescription, Saving and improving Defined Benefit pension plans is a better choice for Canadians than allowing their steady erosion, p. 3.

With appropriate changes to pension legislation aimed at better accommodating phased retirement programs, occupational pension plans could play an enhanced role in helping Alberta and British Columbia employers manage an aging workforce in a context of high competition for talent.

2(c) How can pension standards contribute to the competitiveness of Alberta and British Columbia with other jurisdictions in the global economy?

Clear, simplified and efficient pension standards encourage the maintenance and enhancement of a strong and vibrant retirement system. A pension standards environment that favours maintaining, implementing and improving occupational pension plans in a cost-effective manner would allow Alberta and British Columbia employers to attract, retain and manage the workforce they need, particularly in an economy with changing demographics, while maintaining their costs at an affordable level in an increasingly competitive global economy. Amendments to the existing standards need to be made to attain such a positive environment.

In Chapter 1 of this submission and through our input to the questions, we provide suggestions and recommendations as to amendments to pension legislation aimed at creating a positive context for occupational pension plans.

2(d) To what extent can or should the governments deal with the issue of sufficiency of retirement incomes, and how?

"The Canadian pension system is built on four pillars:

- Universal government plans (Old Age Security, Guaranteed Income Supplement);
- Employment-related government plans (Canada Pension Plan/Québec Pension Plan);
- Other employment-related pensions (e.g., employer or industry-sponsored plans, including occupational Defined Benefit and Defined Contribution plans); and
- Personal savings.

Weakness in any one of these pillars puts pressure on the other three." [7]

Governments influence and encourage the last two pillars through tax and regulation. With occupational pension plans in decline; Canadians not saving enough for their retirement; and universal government plans structured to replace only a portion of pre-retirement income, we believe that governments should work to save and improve the environment for occupational pensions, especially Defined Benefit plans. For a variety of reasons, including, for example, solving the longevity risk problem by promising lifelong benefits, we believe that current Defined Benefit plans need to be saved and new Defined Benefit plans encouraged.

We understand that the Panel's mandate does not encompass the review of universal and employment-related government plans. Should the Panel decide to include potential changes to these plans in its work, the CIA would be pleased to provide input for such a review.

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[7] CIA Pension Prescription, Saving and improving Defined Benefit pension plans is a better choice for Canadians than allowing their steady erosion, p.3.

2(e) Is it important to promote expanded pension coverage? If so, should the establishment of, or participation in, a pension plan be mandatory and, if so, what is the best model? If not mandatory, what could be done to increase coverage?

We recommend that **expanded pension coverage become part of a formal mandate of the Alberta and British Columbia pension regulators** so they can actively participate in promoting occupational pension plans rather than simply performing a regulatory oversight role.

The Waterloo Study shows that Canadians are not saving enough to fund an independent retirement. For this reason and others that are mentioned above, the CIA strongly believes that expanded pension coverage through occupational pension plans must be encouraged. However, individuals' needs and preferences are diverse, as are employers' needs and preferences. Requiring mandatory pension coverage is a massive change requiring agreement among many stakeholders. This concept would involve significant and long debate before deciding on the merits of implementing it and on its details (e.g., what would be the minimum mandatory plan). We rather suggest that governments focus on creating an environment that expands occupational pension plan coverage where both Defined Benefit and Defined Contribution plans can survive and thrive. The initiatives put forward in the CIA's Pension Prescription would help establish that environment and we are convinced that in such a milieu, pension coverage will increase significantly. These initiatives can be implemented in a reasonably short timeframe, therefore rapidly producing a positive impact on pension coverage.

2(f) What role, if any, should employers play in ensuring sufficient pension coverage and income in retirement?

Many studies (including the Waterloo Study) lead us to believe that, when they are left to their own devices, **Canadian individuals lack the discipline and/or resources to appropriately save and plan for retirement.** Employers have an interest in facilitating transition from work to retirement in a manner that meets their workforce management needs. For example, employees who happen to be older and less productive, who have not planned correctly for retirement and/or cannot afford to retire may have a negative impact on the staff's morale and overall productivity of the organization. For these reasons, employers should be encouraged to provide pension coverage. Our sense is that a significant step in providing such encouragement would be achieved if governments worked together to improve the Defined Benefit pension plan regulatory environment and produce a legislated solution to the surplus ownership issue.

2(g) Some have said that people are demonstrably less successful at preparing financially for retirement if left to their own devices. Is this a problem that governments should be addressing and, if so, to what extent?

The Waterloo Study tells us that almost a third of Canadians have no savings, no occupational pension plan and do not own a house. Two thirds of Canadians over 40 are not saving enough for an independent retirement. Other surveys indicate that a majority of Canadians are unsure about what their retirement income will be when they retire or have ever tried to calculate how much they will need to retire comfortably. **A large group of retirees with inadequate incomes will likely become a social, and hence, government issue;** thus it makes sense for **governments to foster the growth of occupational pension plans and individual savings now, rather than wait for the crisis in 20 years.**

2(h) Should governments and/or employers be responsible for the financial literacy of the public and/or employees? If so, how?

The CIA believes that **this is a joint responsibility**. Individuals, whether in an occupational pension plan or not, must be engaged in the process of saving for retirement from early ages. Governments can implement financial literacy programs in the school system, while employers can take on the continuing education process in the workplace. In addition, the CIA recommends that plan sponsors improve the transparency of Defined Benefit plan funding through improved communications to plan members.

"3. Introduce legislation that would require plan sponsors to establish a written funding policy for Defined Benefit plans in order to promote clear objectives and transparency.

4. Expand the required annual disclosure by plan administrators to plan members, to include the key elements of the funding policy, investment policy and current funded status." [8]

Several surveys indicate that, by and large, members of Defined Contribution plans tend not to fully appreciate the relationship between the value of the assets accumulating in their savings account and the level of retirement income that may be produced from that account. As a result, many plan members confuse the retirement income objective of a pension plan with other asset accumulation goals, such as estate planning. Educating members of occupational pension plans (especially Defined Contribution plan members) about saving for retirement is not necessarily a simple task when all relevant elements are considered. These include the investment horizon, expected date of retirement, structure of lifetime retirement income, protection of dependents, inflation protection and the tax implications of various savings vehicles.

To improve the information provided to plan members in Defined Contribution arrangements, current Capital Accumulation Plan Guidelines could be expanded to provide additional direction for disclosure and decision-making tools where the primary purpose of the plan is to provide retirement income.

Please refer to section 3.3 of Chapter 1 for recommendations to improve education of the public.

Questions re: Pensions Standards Legislation – Past, Present and Future

3(a) Should pension legislation deal not only with the current reality but be flexible enough to deal with future issues and plan designs? If so, how?

In many organizations, the pension plan model has been shifting over the past several years, from one in which the plan sponsor assumes all risk (the traditional Defined Benefit plan) to one in which plan members assume all risk (the traditional Defined Contribution pension plan). This transfer of risk has been from one end of the spectrum to the other. However, we believe there are many plan sponsors who would be willing to share pension risk with plan members, if the opportunity were available.

"One-size-fits-all" legislation is too rigid to accommodate a number of risk-sharing plan designs. We recommend that the British Columbia and Alberta governments introduce standards that would accommodate the variety of plan designs that are currently in place, and encourage new designs. For example, cash balance plans

[8] CIA Pension Prescription, Improve the transparency of plan funding, p.7.

should be allowed and it should be possible for a pension plan to express the benefit accruals in the form of a number of "shares", which will increase in value during the members' working careers through an excess interest approach.

We would note, however, that often in the past, it has been the *Income Tax A*ct or Canada Revenue Agency's interpretation of the *Income Tax Act* that has stifled more innovative plan designs. Any initiative to create flexibility in plan design would have to include the federal Department of Finance and, possibly the Canada Revenue Agency.

We recommend that the governments of British Columbia and Alberta create a task force consisting of representatives from the pension standards branches of both provinces, representatives from the Department of Finance and representatives from the pension industry (including CIA representatives) to review provisions of the *Income Tax Act* and pension standards legislation that inhibit the development of innovative plan design. The mandate of the task force could include:

- a review of plan designs that consultants within Canada have contemplated and would have some attraction for plan sponsors, but which have not been developed because of legislative constraints;
- a review of pension standards legislation in other countries to determine how their legislations might accommodate certain plan designs that are not permitted within Canada.

3(b) What should be the goals of the legislation?

The primary goals of pension legislation should be:

1. **Protection of benefits for plan members, through reasonable and efficient benefit standards and advance funding at arms length from sponsor;**
2. **Provide increased certainty to plan sponsors to encourage the expansion of occupational pension coverage to supplement the minimum income level provided through government programs; and**
3. **Facilitate clarification and understanding of the pension promise.**

3(c) To what extent should pension legislation be an instrument for social policy or labour market planning (e.g., locking in, phased retirement, socially responsible investing)?

Pension legislation should be primarily aimed at ensuring that as many individuals as possible will have enough income to live independently in retirement. It should not be used as an instrument of social policy that in any way detracts from that aim, but only when it aligns with that aim. For instance, legislation that makes it easier for plans to be designed around phased retirement may encourage many older employees to remain in the workforce longer. This will reduce pressures on the economy that might result from a too rapidly shrinking workforce, but at the same time will shorten the amount of time the individual will be fully dependent on retirement income.

3(d) Should the goals of the legislation include promoting expansion of the system in Alberta, British Columbia and throughout Canada? If so, in what way?

The CIA believes that **governments need to amend their legislation to encourage the safeguarding of occupational pension plans and encourage employers to**

implement more plans. The recommendations mentioned in Chapter 1 of this submission are mainly focused on this important objective.

We believe that pensions need to be put on the national agenda, and soon.

We often see ministers with specific portfolios from across the country meeting to discuss issues of common interest. It would be helpful if pensions could be put on the agenda for the next Finance Ministers' Meeting, however, only a handful of ministers have responsibility for the pension file in their jurisdictions. In Saskatchewan, pensions fall under the Justice ministry. In New Brunswick, it resides in Justice and Consumer Affairs. In Québec, pensions fall within Employment and Social Solidarity. This combination of ministers never meets. Thus pension issues never get a national airing.

We encourage the governments and Finance ministries of Alberta and British Columbia to take the lead with other pension regulators and governments in Canada to come together to define pension standards that are consistently applied across the country. These need to reflect the need for increased pension coverage, the risks assumed by the various stakeholders and the members' concerns about better benefit security. Building on the high degree of cooperation in CAPSA would be helpful in this regard.

3(e) What approaches to pension standards legislation in other jurisdictions have potential applicability in Alberta and British Columbia?

Ontario has just begun a review of its pension legislation, and Nova Scotia is about ready to start. The Finance Committee of the federal government included some changes to pension regulation as one of its recommendations to the Finance Minister in the most recent budget submission. Other provinces will likely soon follow. **A meeting of the ministers responsible for pension regulation in Canada would be very useful in determining a list of 'best of class' pension regulation practice in Canada.**

Some of the recommendations we made in Chapter 1 have been adopted in other Canadian jurisdictions (e.g., Target Solvency Margins, allowing letters of credit for solvency amortization payments and annual actuarial valuation requirement). Other approaches that we would recommend adopting include:

1. Elimination of partial plan terminations (Québec): This would not only eliminate the potential surplus distribution issue on partial termination but would also remove the administrative and cost burdens related to plan terminations;
2. Phased retirement (Federal): Allow payment of accrued pension and further accrual of pensions under phased retirement agreements;
3. Simplified Defined Contribution pension plans (Québec).

A meeting of the ministers responsible for pension regulation in Canada would be very useful in determining a list of 'best in class' pension regulation practice in Canada.

Questions re: Broad Pension Policy Issues

4(a) How important is harmonization of pension standards between Alberta and British Columbia?

We believe that **harmonization of pension standards between Alberta and British Columbia is very important.** Such harmonization will reduce the confusion that can

exist due to the various pension standards from province to province, and also administrative costs. This process is a good model for other provincial governments and the federal government to follow. With pension regulation reviews happening this year in Ontario, Alberta, British Columbia and Nova Scotia, we encourage these governments and regulators to work together to increase stability by harmonizing their pension regulations. This core group could encourage many other provinces and the federal government to join the process.

4(b) Should harmonization of pension standards be addressed more broadly across the country and, if so, how should the harmonization goal be addressed?

> "9. Amend legislation where required so that pension matters fall within the authority of the Ministers of Finance throughout the country to allow for pensions to be included on the national agenda and to promote consistency of pension legislation among jurisdictions." [9]

This suggestion will be complex for governments to implement, however, a meeting of all federal and provincial ministers responsible for pension regulation is a necessary first step. The **CIA would be excited to work with governments to organize a Pension Summit to explore ways for regulatory harmonization to be established.**

4(c) To what extent should legislators establish principles in the legislation vs. specific rules? How would moving to principles-based legislation change the regulators' role? Should the regulators' role be to enforce specific standards or more broadly to assess whether pension plans are being administered in a safe and sound manner using best practices?

There needs to be a **mixture of rules-based and principles-based regulation**. For example, for investments, regulation should be principles-based. For items like vesting and locking-in, it is difficult to have something other than rules-based regulation.

4(d) Should the governments set standards for good governance? If so, what would those standards consist of? How should they be monitored and enforced?

The CIA agrees that pension plans should be operated using good governance principles, and to the extent legislation is required to make it happen, we would encourage it. Plan sponsors and administrators have spent considerable effort to review and comply voluntarily with guidelines. Such guidelines **should be principles based and provide sufficient flexibility to develop governance models that reflect the unique circumstances and needs of each plan.**

Uniform and relevant governance guidelines (periodically updated as appropriate) that accommodate the various sizes, designs and circumstances of pension plans, constitute the preferred regime. Unless it is demonstrated that this regime does not work, **we would not encourage making the leap from guidelines to statutory provisions.**

4(e) Various parties participate in the pension system, and regulatory resources are costly. Who should pay for the cost of regulating the pension system?

The **cost of regulating pension plans should be kept at a low level**. Otherwise, this cost, if recovered through fees charged to plans under supervision, would become another obstacle to achieving increased pension coverage. Accordingly, pension regulators should focus on high risk situations and avoid ineffective initiatives (e.g.,

[9] CIA Pension Prescription, Introduce innovative ways to meet funding requirements, p. 5.

collection of unnecessary information). We encourage clear disclosure and accountability by regulatory authorities for fees charged to pension plans.

Questions re: Specific Elements of the Standards

5(a) Should minimum funding rules continue to address both going concern and solvency liabilities, or should the focus be solely on solvency funding?

Actuarial valuations on a solvency basis show how secure the promised benefits are. Actuarial valuations on a going concern basis are more concerned with calculating sufficient yet stable contribution levels. **Actuarial valuation reports should highlight both of these two key objectives – the security of benefits in the event the Defined Benefit plan is wound up, and the appropriate level and stability of contributions if the plan is continued for the long term.** As the main concern of governments is expected to be benefit security, we believe that minimum funding rules should focus on the solvency results.

However, below we outline special considerations for Multi-Employer Pension Plans (MEPPs) and Negotiated Cost Defined Benefit (NCDB) pension plans. Current pension standards legislation presumes that on plan wind-up all annuities will be purchased at the same time. However, the group annuity market in Canada is limited in size and in the types of product offered. As a way of dealing with the absence of an annuity market for certain types of pension liabilities, we recommend that British Columbia and Alberta allow the pension plan to settle a larger proportion of its obligations through the payment of lump sum commuted values than is allowed under current legislation.

Special Considerations for MEPPs and NCDB Plans

For MEPPs in which the employer contributions are not negotiated, and the pension "deal" is for a Defined Benefit in which the individual contributing employers are responsible for the risk of unfunded liabilities, solvency deficiencies and increases in the normal cost, then the same solvency tests should apply to the MEPPs that apply to single employer pension plans.

For MEPPs in which the employer contributions are negotiated and the pension deal is for the negotiated contributions combined with a target (but not promised) benefit established by a board of trustees, solvency funding may not always be appropriate. These plans are referred to as NCDB pension plans, and they have no source of contributions to fund solvency deficiencies emerging as a result of short-term fluctuations in the markets. This structure applies to most MEPPs in the pension environment. A variation of NCDB plans is one in which the benefit is defined by the plan text (and fixed), the contributions are defined by the plan text (and fixed), and the trust agreement or other plan document prescribes a process for sharing the risk of unfunded liabilities, solvency deficiencies and increases in the normal cost.

The structure of a NCDB plan also applies to some single employer pension plans, in which the employer has negotiated with one of its unions a pension plan in which the contributions are negotiated and fixed during the term of the agreement. The pension plan is also administered through a board of trustees, like a MEPP. In our following discussion of NCDB plans, we are including single employer pension plans that are NCDB plans along with any MEPP that is a NCDB plan.

Funding issues for NCDB plans can be complex. Under these plans, the fixed component is the contributions from the contributing employers. These contributions cannot be changed until the next contract with each employer is

negotiated, and often these contracts are negotiated at different times for different employers. The CIA acknowledges that NCDB plans have a high degree of risk. These risks arise from the following characteristics, amongst others:

- A diffuse decision-making process, because of the consultative nature of the board of trustees. In some cases, decisions are based on compromise approaches;
- The withdrawal of one or two key employers can put the plan at risk;
- Some NCDB plans are in declining industries and have a shrinking contribution base to support financial shortfalls;
- Some NCDB plans have an aging population which, in turn, places upward pressure on the current service cost;
- Many NCDB plans are unable to meet the cost of deficiencies arising from short-term fluctuations in the market or deficiencies arising from long-term shifts such as improvements in mortality.

The structure of NCDB MEPPs (i.e., multiple employers contributing to a single trust) tends to mitigate the chances of a NCDB MEPP being wound up. Occasionally, though, this does happen. Even when a NCDB plan is not fully wound up, contributing employers can withdraw from a plan at any time. Withdrawal from a NCDB MEPP can occur for a variety of reasons (insolvency of the contributing employer, plant closure, decertification, etc.). The consequences to the plan of the employer withdrawal are similar to the consequences on full plan wind-up with respect to the benefits of the affected members. This raises the question of how to protect the benefits of plan members whose employers contribute to a NCDB MEPP, given these risks and the potential for a shortfall in benefits on employer withdrawal or the wind-up of the NCDB MEPP.

For NCDB plans in which the employer contributions are negotiated through collective agreements, solvency funding creates certain problems in the current economic environment:

- It creates intergenerational transfers within the pension plan;
- It limits, or prevents, legitimate improvements to pension benefits even though there is a going concern surplus in the plan;
- It forces the plan to consider benefit reductions even if the plan is fully funded on a going concern basis using reasonably conservative actuarial assumptions.

Thus, when economic problems emerge, and the NCDB plan is unable to meet minimum funding standards, it is the target benefit that must give way, since the contributions cannot be adjusted upwards.

NCDB plans are rather like Defined Contribution pension plans where a target benefit is stated. These target benefits can be increased (as they have in the past), and they can be decreased (as some have been forced to more recently).

Since NCDB plans are delivering target benefits, the issues from a regulatory perspective may be the following:

- How can the NCDB plan provide some level of certainty that the target benefit will be met?
- What sort of disclosure should be provided to plan members?

The CIA recommends that the Panel explore developing different funding standards for NCDB plans. These funding regulations could eliminate solvency funding for NCDB plans, and focus on the going concern valuation. The regulations should include constraints on the amortization period for going concern unfunded liabilities, the selection of actuarial assumptions and/or the investments. When developing different funding standards for NCDB plans, the CIA recommends that the Panel explore the impact that any proposed standard would have on a sample of the NCDB plan's population, to ensure that the proposed funding standards are reasonable, and not overly onerous or lax.

Secondly, the CIA recommends that benefit improvements for NCDB plans be conditional upon the plan attaining a certain funding threshold. This threshold could be based on different formulas, such as assets exceeding a certain percentage of the accrued liabilities on the going concern basis, or tests against the liabilities determined using a risk free rate of return.

5(b) Should the minimum funding rules take into account the financial health of the employer sponsoring a Defined Benefit plan, and if so, how?

The ability of a pension plan to become well funded depends on a number of factors, including the health of a plan sponsor. However, it can be difficult to assess the financial strength of a plan sponsor, particularly if the plan sponsor is a private company, a wholly owned subsidiary of a company, or if the plan is a Multi-Employer Pension Plan.

It would be very difficult for the minimum funding rules to take into account the financial health of the employer sponsoring a Defined Benefit plan. However, the British Columbia and Alberta regulators might, in their risk assessment models, incorporate "financial health ratings" by industry or by individual plan sponsors that prompt closer scrutiny of these pension plans.

If the Alberta, British Columbia and federal governments **implement Target Solvency Margins and Pension Security Trusts, this would reduce the number of situations where the financial health of the plan sponsor becomes a concern.**

5(c) Should minimum funding rules take into account the risk profile (asset/liability mismatch and asset mix) of the plan and, if so, how?

The risk profile of the pension plan is easier to assess than the financial health of the employer, and we believe it would be appropriate to build the risk profile into the minimum funding rules. One method of recognizing the risk profile of the pension plan would be for all plans to maintain a portion of the surplus as a Target Solvency Margin. **The amount of the Target Solvency Margin would vary according to the potential volatility of a plan's funded position,** thereby ensuring more secure funding based on the level of risk of the plan. Please refer to section 2.1 of Chapter 1 of this submission for further details on the concept of a Target Solvency Margin.

5(d) Should each Defined Benefit plan be required to have a funding policy? If so, should it be a regulatory filing requirement?

Answers to these questions are found in section 3.1 of Chapter 1 of this submission.

5(e) Is "one-size-fits-all" legislation adequate – or should there be different rules for different pension models? If so, how should they vary?

"One-size-fits-all" legislation is too rigid in the current economic and pension environment, and to accommodate a number of risk-sharing plan designs. We recommend that the British Columbia and Alberta governments **introduce**

standards that would accommodate the variety of plan designs that are currently in place, and encourage new designs. For more details, please refer to our response to question 3(a).

Current pension models that would attract different rules include single employer Defined Benefit plans, single employer Defined Contribution plans, flexible plans, hybrid plans and NCDB plans. Legislation should accommodate the differences in these plans, in terms of benefit standards, funding standards and disclosure standards.

5(f) Are there compromise solutions to the conflict between risk-reward asymmetry and benefit security in Defined Benefit plans?

In section 2 of Chapter 1 of this submission, we discuss **the concepts of a Pension Security Trust and Target Solvency Margins. We believe that the adoption of these concepts, combined with an increase to the maximum surplus level and the use of letters of credit to guarantee solvency deficiency amortization payments, would help significantly to address the conflict between risk-reward asymmetry and benefit security in Defined Benefit plans.**

However, we would emphasize that these measures need to be adopted as a package. If only some of the measures are adopted, the solution to this conflict will not be adequately addressed.

5(g) How can the conflict between short-term benefit security and long-term contribution predictability for Defined Benefit plans be best addressed?

Please refer to our response to question 5(a) and also sections 1.2 and 2 of Chapter 1.

5(h) What changes, if any, in investment standards are required to allow enough investment flexibility while continuing to protect benefit security?

The CIA believes **the current investment standards are adequate.** We recognize there is a relationship between the ability of a plan sponsor to ensure the pension plan is consistently fully-funded and the investment policy. To measure this relationship, the amount of the Target Solvency Margin would vary according to the potential volatility of a plan's funded position, thereby ensuring more secure funding based on the level of risk of the plan.

Furthermore, in a risk assessment regulatory system, regulators would be able to take into consideration the Target Solvency Margin and the asset mix to determine the risk profile of the pension plan.

5(i) What specific standards could be classed as "irritants," and how should they be changed?

The **solvency funding standards have created significant challenges for NCDB plans.** Many of these plans have a surplus on a going concern basis and a deficit on a solvency basis. Moreover, it is difficult to argue that solvency funding should apply to these plans, since the employer's obligation is the negotiated contribution. The stated benefit is only a target, albeit one where a decision to reduce it would not be made lightly. As mentioned in our response to question 5(a), we believe that the regulators should consider the employers' obligation under these plans, and develop different funding requirements accordingly. Moreover, the following standards are seen as "irritants" by many stakeholders:

- **Under British Columbia legislation, the requirement that plan wind-up expenses be paid by the plan sponsor; and**
- **For Defined Benefit plans using a pension formula based on a C/QPP benefit offset, restrictions based on the C/QPP benefit payable to the member in lieu of the maximum benefit payable by the C/QPP to an individual aged 65.**

5(j) What changes, if any, should be made to disclosure requirements while ensuring that the interests of plan members and sponsors are balanced?

The CIA supports greater disclosure of meaningful financial information.

For Defined Benefit plans, information should be provided to members on the financial position of the plan, funding decisions, the funding risks inherent in the asset mix and contribution holidays, provided that it is meaningful and does not create excessive administrative expenses. This information could be provided through the annual pension statement or it could be displayed on the plan sponsor website or through some other vehicle.

For Defined Contribution plans, information should be provided to members on the type and amount of expenses that members are paying through reduced returns or flat assessments, the implications of the different asset mixes the members have access to, the expected accrued pension in current dollars and the expected pension at retirement in current dollars, assuming contributions continue at the same level and the fund the member has chosen achieves investment returns that are consistent with the asset mix for that fund. Any requirement to provide these additional information items should involve effective safe harbour protection for plan sponsors and administrators, and should not create excessive administrative expenses.

The CIA recommends that disclosure be improved for NCDB plans. This disclosure could include some indication of the risks assumed by the plan members, including the risk of target benefit reduction (see question 5(a)), and current information on how the risks are being addressed by the trustees (e.g., funded status, funding approach, etc.).

5(k) Should pension legislation establish safe harbour rules that would give Defined Contribution plan sponsors and administrators protection from liability if they follow certain minimum standards? If so, in what way?

As mentioned above, **minimum standards that require providing pension or future investment return information to Defined Contribution plan members should involve safe harbour protection for plan sponsors and administrators,** considering the litigation risk involved with providing such information.

5(l) Are the current standards in each province's legislation adequate to facilitate phased retirement programs? If not, what changes or additions are needed?

The CIA believes that the **pension standards legislation should be reviewed in the context of recent *Income Tax Act* amendments that accommodate phased retirement agreements and permit plans to give members the option to receive partial pension payments while continuing to work and accrue further pension benefits.** Pension standards legislation should accommodate phased retirement agreements but without mandating phased retirement options for plan members.

5(m) Are there new plan designs that should be specifically contemplated in the legislation?

The CIA would **encourage innovation in plan design and financing arrangements that promote the growth of occupational pension plans.** For example, cash balance plans, which are used extensively in the United States, are effectively prohibited in Canada under the existing legislation. Other designs that may offer additional flexibility to plan members and assist employers in attracting and retaining employees would be welcome.

We would note that, often in the past, it has been the *Income Tax Act* or Canada Revenue Agency's interpretation of the *Income Tax Act* that has stifled more innovative plan designs. Any initiative to create flexibility in plan design would have to include the federal Department of Finance and, possibly, Canada Revenue Agency.

5(n) Are there some pension standards that should be abandoned or changed significantly, and why? What new pension standards, if any, are required in the next generation of legislation?

The two key issues that have created significant burdens for sponsors of Defined Benefit plans have been **the lack of uniformity amongst the minimum standards of different jurisdictions, and the trust environment within which pension plans operate.**

The CIA recognizes that uniformity of pension legislation across all Canadian jurisdictions is a difficult, if not impossible, objective to achieve. Essentially, the constitution would have to be changed. Having said that, the CIA believes it is important to achieve as much uniformity as possible. We strongly encourage British Columbia and Alberta to take the lead on this issue, and align both the *British Columbia Pension Benefits Standards Act* and the *Alberta Employment Pension Plans Act* so that their minimum standards are as uniform as possible.

The second issue, the trust environment for pension plans has created significant challenges for the administration of Defined Benefit pension plans, and we comment on this issue extensively in our submission to the Ontario Expert Commission on Pensions. The CIA recommends that British Columbia and Alberta clarify that documents establishing pension plan funding vehicles are documents of the plan, subject only to the provisions of the *British Columbia Pension Benefits Standards Act* and the *Alberta Employment Pension Plans Act*, as the case may be, and their regulations; and state explicitly that to the extent of any inconsistency with the common law, the provisions of the *British Columbia Pension Benefits Standards Act* and the *Alberta Employment Pension Plans Act*, as the case may be, and their regulations are paramount and supersede the common law.

These changes would provide significant support to Defined Benefit pension plans, and would ease the regulatory burden of partial terminations, mergers, splits and asset transfers.

Questions re: Related Legal Frameworks

6(a) To what extent are legal issues beyond provincial jurisdiction creating problems in the pension system and what role, if any, should the provincial governments have in addressing them?

Federal-provincial and intra-provincial differences make the system unnecessarily complicated. Here's a concrete example. Recently, when working on an educational pamphlet for plan members from across the country, a plan sponsor

was surprised when it was found that the definition of the term, "spouse" ran to more than eight pages. This was precisely because the legal definition of the term varies from province to province.

Once again, harmonization of legislation federally and provincially would be helpful.

Finally, throughout this submission, we have highlighted changes to the provincial and income tax legislation that are aimed at creating a more positive environment for the maintenance, implementation and improvement of occupational pension plans.

6(b) Are there areas in which federal and provincial rules are working at cross-purposes, and how could these conflicts be corrected?

See 6(a)

6(c) To what extent are other legal issues within provincial jurisdiction creating problems in the pension system, and how could these problems be corrected?

See 6(a)

6(d) Can and should legislators address the historical interplay between trust law and pension plans? If so, how?

This is an area for lawyers, however, please refer to our response to question 5(n) regarding trust and common law issues.

6(e) Are there legal problems in the pension system for which it would be appropriate for legislators to intervene and override common law?

A critical issue that must be resolved is that of **surplus ownership and utilization**. Comments on this issue and suggested legislative changes are provided in section 1.2 of Chapter 1 of this submission.

6(f) What is the best way to deal with legacy issues, such as language in old plan documents, court decisions, and old standards applying to old periods of service?

Any solution to deal with legacy issues should balance:

- **the need to recognize that existing contracts or agreements between the plan sponsor and plan members will need to be respected; and**
- **the urgent necessity to create a positive context for the continuation and creation of occupational pension plans.**