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Submission to the Nova Scotia
Pension Review Panel
Response to Discussion Paper

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Preface

In the Discussion Paper released May 28, 2008, the Nova Scotia Pension Review Panel describes the key objectives for the pension review process in Nova Scotia as follows:

- *To recognize current legislative standards and review improvements that will allow pensions to work for both employers and employees;*
- *To enhance the affordability and availability of defined contribution and defined benefit pension plans for employers and employees;*
- *To protect the sustainability and security of pension benefits;*
- *To enhance the sharing of information to plan members;*
- *To eliminate unnecessary rules and regulations.*

In general, Mercer agrees that these objectives encompass the key issues. In particular, it is essential that any pension review focus on a balancing of interests between plan members and plan sponsors. A pension system that fails to consider and fairly balance the interests of both sides of the pension equation will continue to weaken and decline.

Mercer is appreciative of this opportunity to share its thoughts and suggestions for improvement of Nova Scotia's pension legislation. We offer this submission based on our long and extensive experience working with employers and other plan sponsors who are making decisions about providing pension plans, determining appropriate benefit levels, and funding them.

Mercer is the Canadian and global leader in providing advice and solutions for the full range of issues that affect employment-based retirement plans. We consult on plan design and help our clients manage the financial and other risks associated with pension plans. This work is performed in the context of our clients' overall workforce planning and business strategies. Accordingly, we are in an especially good position to observe the impact of the current legislative regime in the areas identified as key objectives for the Review Panel's mandate, and to speak out confidently on the direction that change should take.

This submission deals primarily with the most common type of defined benefit pension plan in which a single employer (or group of related employers) is the sponsor of the plan, bears all the risks of funding the plan, and is also the plan administrator. These types of plans are referred to as single-employer plans in this document.

We also provide commentary on legislative changes that are required for Multi-Employer Pension Plans (MEPPs) and certain other shared-risk plans. The legislative changes required for these kinds of plans are very different from those required for single-employer pension plans.

Our submission provides our commentary on a principled redesign of pension legislation. We also provide specific commentary on several of the questions posed in the Discussion Paper.

We would be pleased to discuss any aspect of this submission with the Review Panel or its staff, or to provide any additional information or support that would assist in this important pension review process.

Much of the content of this submission is principles-based. Such principles would have to be translated into technical detail in many cases if legislative changes were enacted. We urge the Review Panel to encourage government to permit interested stakeholders to review and comment on any changes to pension legislation in draft form before changes are enacted.

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Executive Summary

The single most serious issue to address in this process is the failure of the *Pension Benefits Act* (the “Act”) to treat sponsors of defined benefit single-employer pension plans fairly. Recognizing that there are two competing goals – benefit security for members and affordability for employers, we propose a revised minimum standard solvency funding regime in combination with a fair balance of risks and rewards to improve benefit security without undue burden to business. In order to make the defined benefit pension system stronger for single-employer plans, two measures must be implemented together:

1. Revising a minimum funding standard based on solvency to provide plan members with better protection against benefit loss on insolvent plan termination, and
2. Rebalancing the financial risks and rewards between the stakeholders by allocating rewards to the employer who bears the funding risk.

In addition, legal safe harbour protection should be provided to sponsors of defined contribution plans who choose to take good faith actions designed to steer employees away from sub-optimal enrolment, savings and investment decisions.

Negotiated cost pension plans, where contribution levels are fixed by collective bargaining, independent of the financial status of the plan, and where benefit reductions are possible, and other plans for which wind-up is not an issue, should be exempted from solvency funding requirements.

Finally, legislation should be modified to better accommodate new pension plan designs.

Revised Minimum Funding Standard

The revised minimum funding standard would increase solvency funding and therefore decrease the risk of benefit loss on insolvent plan termination. The revised minimum standard solvency funding regime would have the following attributes:

- Pure or nearly pure wind-up valuation;
- Funding target at 100% solvency;
- Conservative solvency current service cost – that is, calculated without taking advance credit for equity risk premiums;
- Contribution holiday threshold above 100% solvency;
- Reserve account into which the following contributions are deposited:
 - Employer contributions for special payments to eliminate a deficiency, and
 - Employer solvency current service contributions made that would not otherwise have been required had the contribution holiday threshold not been in place;
- On a wind-up basis, to the extent that the reserve account is not required to provide benefits and fees related to wind-up, the unused portion would be refundable to the employer;
- 10-year amortization of solvency deficit;
- Letters of credit recognized as a plan asset; and
- A long transition period.

Create Economic Fairness for Plan Sponsors

The second measure that would be implemented along with the revised minimum funding solvency standard is a fair allocation of the financial risks and rewards between the stakeholders in pension plans. It is essential that this change accompany the solvency funding standard. Pension legislation should clearly recognize that the stakeholder that bears the funding risks should benefit from the financial rewards. In order to ensure a fair allocation of financial risk and reward in the Nova Scotia retirement system for single-employer plans, the following measures should be implemented:

- Legislate a fair allocation of funding risks and financial rewards for new plans;
- Permit the adoption of a contract-based approach to the creation, operation and regulation of pension plans;
- Permit existing plans to start a new fund with clear employer surplus ownership to provide for future benefit accruals and past service benefit increases, while freezing the existing fund;
- Create a legislative presumption that contribution holidays are permitted and that the employer owns surplus, unless plan documents expressly state otherwise;
- Permit employer contributions made to a reserve account, to the extent not required to provide benefits and fees related to wind-up, to be refundable to the employer;
- Ensure that there is no requirement to transfer surplus in business transactions;
- Eliminate partial wind-ups;
- Permit ongoing employer surplus withdrawals; and
- Permit the use of letters of credit to secure benefits.

Other Measures

In addition, this paper proposes several related measures:

- Ensure that plan mergers and other asset transfers occur efficiently;
- Provide for regulatory intervention in cases of imprudent asset mix;

- Clarify that defined contribution members in the same plan as defined benefit members are not forced to share the risk of wind-up deficiency and are not presumed to share in surplus distributions;
- Encourage the federal Department of Finance to increase defined benefit plan surplus limits; and
- Ensure that there are sufficient regulatory resources and expertise.

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Assessment of the Current Pension System

Reform of the legislation that governs pension plans in Nova Scotia is needed. Since the current Act came into effect, economic conditions have changed, significant litigation has occurred, defined contribution plans have become more common, and defined benefit plans are under severe strain from lower interest rates and increased longevity. Many of the shortcomings of the current legislation are easy to resolve since most (perhaps all) stakeholders would agree that the following changes are necessary:

- Provide a legislative framework to address defined contribution plans separately from defined benefit plans;
- Introduce flexibility to accommodate new plan designs that transcend the traditional categorizations of defined benefit and defined contribution;
- Reduce procedural uncertainty and inefficiency; and
- Match the resources allocated to the regulation of pensions to the regulatory mandate.

However, some issues like the funding of defined benefit plans, are more complex to define and to resolve, with significant disagreement among the stakeholders. The legislation should strive to provide a comprehensible and logical framework from which pension stakeholders can develop and maintain arrangements that serve the unique needs of their organizations and members.

Defined contribution plans are an important element of the Canadian pension system. Some plan participants will inevitably make sub-optimal enrolment, savings and investment decisions. The prospect of litigation is a growing concern for defined contribution plan sponsors, even for those who act in a prudent manner. Employers are already abandoning defined benefit plans because of legal and cost concerns. It would be a significant blow to the retirement system if employers also withdrew from sponsoring defined contribution and group RRSP arrangements.

The defined benefit pension plan is also a desirable and important part of the retirement system. Many employers want to be able to provide these plans. From the employee's point of view, having a defined benefit is extremely valuable. While a defined benefit plan is a going concern, and upon wind-up with sufficient funds, the high degree of insulation of the benefit from market risk is an optimal arrangement for the employee. A defined benefit plan provides an employee with a predictable, very secure retirement income. A

properly funded defined benefit plan allows employees to pool investment risk, interest rate risk and mortality risk. Typically a defined benefit plan will deliver a higher benefit for the same cost as a defined contribution plan due to the efficiencies gained in a defined benefit plan.

It is vital to remember that pension plans are voluntary arrangements. No employer is required to offer a registered pension plan (absent private contractual arrangements outside pension legislation). Pension legislation must protect members, but it must balance that protection with employer needs as well, or pension plans will not continue to exist.

Obviously, it is important to minimize the risk of benefit loss for the employee that will occur if the employer's business fails while the plan is insolvent. However, the risk of business failure cannot be controlled, and elimination of the risk of benefit loss simply by requiring higher employer contributions so that the plan is never insolvent is too great an economic burden for most businesses to bear. From an employer's or shareholder's point of view, the value of providing defined benefits to employees is generally recognized, however the financial risk in the current asymmetric environment makes the economics of doing so unattractive.

A regulatory regime has to anticipate how those affected will behave – and consider the exit strategies that will be used if the environment is not balanced. The behaviour and needs of the plan member are relatively straightforward. Members should receive value for their contributions and their labour. In a defined benefit plan, they need benefit security. They should have full disclosure about the manner in which the benefit promise is underwritten. Pension legislation has historically focused on these things. The courts have recognized this and have interpreted pension legislation as remedial legislation whose primary purpose is the creation and protection of member rights.

For negotiated cost pension plans (typically referred to as multi-employer pension plans or "MEPPs"), there is also a need to rebalance the way the Act affects the distribution of risks and rewards. In particular, the solvency funding requirements designed for single-employer plans force sudden benefit reductions in periods of insolvency,¹ disrupting the way these plans were designed to operate.

¹ Subject to recent temporary relief granted to specified multi-employer pension plans in Nova Scotia.

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Occupational Pension Plans in the Canadian Economy

Ideally, the role of occupational pension plans in the Canadian economy should be to benefit both plan participants and sponsors. An occupational pension plan can, if designed, communicated and administered well, be an important element of an individual's accumulation of retirement savings and a tool in helping an employer attract and retain employees.

In earlier days, defined benefit plans held sway and in fact were taken for granted in some sectors as more or less an expected element of compensation. However, as acknowledged in the Pension Review Panel's Discussion Paper, the economic climate – and the very nature of the Canadian workforce itself – has changed. Defined benefit plans are no longer considered affordable or desirable by some employers. Many younger employees do not place the same value on pension plans that the generations before them did. Under the current legislative environment, many employers perceive that the costs of a pension plan outweigh the benefits.

The existing strains on the retirement system should not be misconstrued as meaning that occupational pension plans no longer have a viable place in the Canadian retirement income system. From a purely financial standpoint, all three traditional pillars of the retirement system – government-administered pension programs, occupational pensions, and personal savings – are generally considered necessary to ensure an acceptable level of income upon retirement. Coverage by a pension plan of any design can only be of financial benefit to an employee, whether they understand the value of the plan or not. But employers only benefit from sponsoring a pension plan if their employees value it and it helps them achieve their organizational goals.

The role that an employer plays in ensuring their employees' income adequacy in retirement should depend on that employer's organizational objectives, benefits philosophy, and the labour market challenges they face. The existence and design of an employer-sponsored pension plan should not be mandated by legislation, but rather left up to each employer based on its financial and human resource objectives or

agreements with employees or unions. Employers have different reasons for establishing or continuing pension plans. If expansion of pension coverage is to be achieved, then pension legislation must permit enough flexibility in plan design to allow employers' varying objectives to be achieved.

Pension Standards Legislation – Past, Present and Future

The pension deal resides between employers and their employees, unions, and pensioners. The role of pension legislation should not be to influence or legislate the design of pension plans, but rather to provide minimum standards, secure the pension deal and protect the members' rights in respect of the pension deal that is already contractually provided between the employer and the employees. Pension legislation should be sufficiently flexible to support this fundamental purpose while accommodating new and evolving plan designs.

Current pension and tax legislation stifles innovation and is unresponsive to both short and long-term strategies that employers might otherwise consider in utilizing their retirement programs to assist with workforce management strategies.

Few employers have a workforce comprised of a single generation of employees, and indeed this would be considered short-sighted. At no other time in history have so many generations been actively employed in the labour market at the same time, and equally unique is the impending retirement of the baby boomer population. It is very unlikely that long-service employees who are 59 years old have the same retirement planning perspective as new employees in their early 20s. Yet each of these employees is valuable to the employer – given the tightening labour market, chances are that the employer will want to encourage the older employee to delay retirement, while also providing meaningful incentive to the younger employee to remain with the company.

Employers are being challenged like never before to deal with the varying wants and needs of their employee population, and the only way in which pension coverage will assist employers in meeting their challenges is if pension plan design is permitted to be innovative and flexible. Continued rigidity in design rules will only serve to alienate sponsors from establishing and maintaining pension plans, as a plan will not be perceived as an effective way to achieve organizational objectives, whatever they may be. One size does not fit all. An example of rigidity in the current legislation can be found in the narrow application of “class” rules, which have been applied with the effect of limiting the ability of employers to implement targeted design rules that are rational and necessary for their organizations. The “class” concept applies specifically to eligibility for plan membership under the current Act, but has been applied far beyond

the eligibility tests to restrict flexibility in benefit offerings. In addition, the currently prescribed list of classes frequently does not adequately reflect the variety of distinctions actually in issue in many organizations.

The Discussion Paper raises the question of alternative plan designs. It is Mercer's position that pension legislation should facilitate a wide variety of plan designs by giving sponsors increased flexibility. Pension legislation should not mandate particular plan designs, nor limit future design developments through application of excessively rigid rules.

The sponsorship of pension plans is voluntary and should continue to be so. Given the voluntary nature of the retirement system, caution must prevail in using pension legislation to meet broad social policy objectives that would not otherwise be mandated for employers who choose not to sponsor a pension plan.

Broad Pension Policy Issues

Harmonization of pension standards as raised in the Discussion Paper is a laudable objective, particularly in a jurisdiction such as Nova Scotia where a very significant proportion of plan members within the province are actually members of plans registered elsewhere. Lack of uniformity continues to burden the retirement system, including regulators, plan sponsors and plan members. However, it is imperative that changes are made to the regulatory system to re-establish fairness for sponsors of defined benefit plans. Such changes should take precedence over harmonization objectives.

In order to fulfill the fundamental purpose of pension regulation, to secure the pension deal, we acknowledge that a blend of principles-based legislation and rules-based legislation is the most feasible and practical approach. Minimum funding designed to secure the pension deal for single-employer plans should continue to be based on prescribed rules, provided an appropriate principles-based framework for surplus ownership is established that aligns the rewards of a plan sponsor to the risks undertaken in sponsoring the plan.

It is not possible to have a successful pension regulatory system without the appropriate regulatory structure and resources. In our view, the fundamentals are:

- If the regulator is going to have discretion, it must have expertise; and
- If the regulator is going to have a heavy workload, it must have adequate staff.

The best legislative scheme in the world will be ineffective if it cannot be implemented competently and with sufficient resources. In this paper, several key areas of regulatory discretion (existing or potential) are identified:

- Require a full valuation when there is a solvency concern, taking into account all relevant circumstances;
- Intervene if there is clearly an imprudent asset and liability mismatch;
- Grant relief and negotiate in distress situations such as bankruptcy and court-protected reorganization; and
- Grant exemptions to accommodate plan design.

None of these powers or powers similar to them should be created or continued unless the decision makers and their staff are qualified to properly exercise them.

Should the Nova Scotia government decide to use pension legislation to promote broader pension coverage and financial literacy, the costs associated with such activities should not be subsidized by plan sponsors.

Specific Elements of the Standards – A Revised Funding Standard Based on Solvency

Overview

The Act currently requires funding on two different bases – going concern and solvency. Going concern funding places more weight on the assumption that the employer's business will continue. The risk of benefit loss on insolvent plan termination is recognized but accepted, so that more risk is allocated to a future generation of plan members. A solvency funding system addresses the risk of benefit loss more rigorously, placing a greater burden on the contributing employer. The current funding regime produces a volatile pattern of funding requirements highly leveraged on market conditions. Surpluses and deficits arise and disappear relatively quickly.

Most of the volatility is a result of employers choosing to finance their pension promise by investing a significant portion of the pension fund in equities. The volatility could be largely eliminated if pension funds were invested in a portfolio of matching fixed income securities or through the use of derivative instruments. However, in today's low interest rate environment, this comes at too high a price for most employers. This strategy could easily increase the expected level of funding contributions by 30% or more. Consequently, investing in equities is a necessary choice for most employers who wish to provide meaningful defined benefit pensions to their employees. However, in the current environment the consequences of this necessary choice are unpalatable.

In the current environment for single-employer plans, deficiencies are the responsibility of the employer while surpluses are often shared or dedicated exclusively to plan members. If this issue were corrected, many employers would choose to fund their pension plans more conservatively and to make contributions above the minimum statutory level when they were able to do so.

The current allocation of risks and rewards makes an otherwise well-calibrated minimum funding regime unattractive to employers. It ensures that most employers will choose to fund at the minimum possible level to the detriment of benefit security for plan members.

From today's starting point, an increased contribution requirement will only weaken the system by compounding the disincentives for employers to maintain their defined benefit plans. If Nova Scotia wants better benefit security while maintaining or improving defined benefit coverage, then there must be a legislative system in place that is fair to plan sponsors.

Why a Solvency Funding Regime?

It would be desirable to have more assets in the defined benefit system to allay the risk of insolvent plan termination. In today's low interest rate environment there is an obvious trend in thinking toward solvency as an appropriate standard for funding. If Nova Scotia concludes that the risk of benefit loss under current solvency standards for single-employer plans is too high, then solvency funding standards need to be more robust. However, it is simply incorrect to assume that strengthening solvency funding standards will strengthen the defined benefit system. Furthermore, additional solvency funding requirements may not be justifiable for financially strong employers. Those employers will be required to divert additional capital to the pension fund with little improvement in benefit security. If the current allocation of risks and rewards is not corrected, making solvency funding standards more rigorous will only encourage or force more employers to seek a way out. As it is, the current environment already prevents the creation of new defined benefit plans.

In addition to correcting the asymmetrical sharing of risks and rewards, there are three main strategies that would work toward improved solvency of pension plans:

1. Require a funding margin, with a funding target above 100% solvency;
2. Permit a contribution holiday after a threshold of funding above 100% solvency is achieved; and
3. Require a conservative calculation of the current service cost in the solvency valuation that excludes advance recognition of any equity risk premium.

However, the funding burden would be far too great if all three strategies, or a combination of a funding margin together with a conservative basis for current service cost, were required. In addition, the first two strategies could not be applied in isolation without compromising the overall objectives. Requiring a funding margin without allowing a contribution holiday would lead to further deterioration of the defined benefit system.

Our recommendation is to build a well balanced solvency funding regime based on the latter two strategies, with the following attributes:

- Fair allocation of risks and rewards;
- Pure or nearly pure wind-up valuation;
- Funding target at 100% solvency;
- Conservative solvency current service cost – that is, calculated without taking advance credit for equity risk premiums;
- Contribution holiday threshold above 100% solvency;

- Reserve account into which the following contributions are deposited:
 - Employer contributions for special payments to eliminate a deficiency, and
 - Employer solvency current service contributions made that would not otherwise have been required had the contribution holiday threshold not been in place;
- On a wind-up basis, to the extent that the reserve account is not required to provide benefits and fees related to wind-up, the unused portion would be refundable to the employer;
- 10-year amortization of solvency deficit;
- Letters of credit recognized as a plan asset; and
- A long transition period.

In a single-employer plan, decisions made within the minimum funding requirements, and any decisions made to contribute above the minimum statutory requirements, are and should be decisions of the contributing employer and not of the pension plan administrator. This is important because a fiduciary duty imposed on a contribution decision opens a debate about the stakeholder interests that should be taken into account when determining contribution levels, and invites assertions that the employer should fund as much as permitted regardless of the impact of that funding on the supporting business. Employers who are also plan administrators should not be placed in this untenable conflict. The courts have supported this point of view and this is a reasonable reading of the Act. In any revision of funding rules this important matter should not be overlooked and should be made abundantly clear in legislation.

Financial Strength of Plan Sponsors

We recognize that the proposed minimum funding regime is designed to allay the risk of insolvent plan terminations and, therefore, may not be justifiable for financially strong employers or in situations where wind-up is not an issue. For example, where the promise is essentially guaranteed by government or where plan termination is not a realistic possibility given the nature of the sponsoring entity, it may be reasonable to exclude plans from solvency requirements entirely. We encourage the Pension Review Panel and the government of Nova Scotia to analyze whether the funding standards could reflect the financial strength of the employer sponsoring the plan.

Solvency Valuations

A solvency valuation should be a pure or nearly pure wind-up valuation that reflects the benefits that would actually be paid on plan wind-up. No smoothing of solvency assets is appropriate.

The current five-year amortization period for funding solvency deficits should be changed to a ten-year amortization period. This longer period will help to address the volatility of contributions determined on a solvency basis.

To fund sensibly on a solvency basis, the actuary should determine the “solvency current service cost”. This is the annual amount required if the initial solvency liability (together with the solvency current service costs and accruing interest at the solvency

valuation interest rate) is to cover the expected benefit payments and the solvency liability at the end of the projection period. The projection period should be set out in regulations – preferably 3-5 years.

This calculation takes no advance credit for the equity risk premium that the pension fund might reasonably be expected to earn. As such, particularly in a low interest rate environment, the solvency current service cost provides a conservative estimate of the contribution required to support a plan that would typically have 50% to 70% of its assets invested in equities. To the extent that the equity risk premium will be realized, this will generate future surplus. Regulators should consult with the Canadian Institute of Actuaries (“CIA”) on the technical aspects of this calculation, including its impact on the development of any funding margin.

Going Concern Valuations

Where solvency valuations are required, going concern valuations should be optional for the employer.

The objectives of a going concern valuation are to establish stable and foreseeable contributions and the proper allocation of costs over time and between generations. Therefore a going concern valuation should not be required to include a funding margin. There should be no regulatory intervention in the selection of assumptions, which should be based solely on CIA requirements.

Full Funding on Wind-Up

Consistent with current standards, an employer should not be able to terminate a plan and continue in business without funding benefits in full. A funding period of five years is appropriate.

However, for some plans, a full wind-up is problematic because of large pensioners’ liabilities. Problems are further compounded if the pensions are indexed. The problems arise because the Canadian annuity market cannot absorb large purchases of annuities. Furthermore, when pensions are indexed, the annuity prices are far too high, or the insurance product is simply not available. Legislation is needed to give the regulator discretion to set the minimum standard as the payment of commuted values to pensioners in place of the current mandatory purchase of annuities where it can be demonstrated that annuity purchase is not reasonably available. The federal government should be encouraged to relax limits on tax-sheltered transfers in such circumstances to avoid unduly harsh tax consequences to affected pensioners.

If alternative methods can be developed to fairly disburse the plan assets without reducing benefit security for members, the regulator should be able to approve such a method.

Contribution Holidays

Contribution holidays are an essential element of a fair and balanced funding regime and they should not be constrained unless absolutely necessary. However, there are two ways in which contribution holiday rules should be modified. Both measures respect the principle underlying a contribution holiday, that when a plan is adequately funded contributions are not required.

The first modification of the rules addresses the definition of adequate funding for this purpose. Since the solvency status of a plan fluctuates considerably, it is desirable for plans to be funded at some level above 100% solvency. Placing the threshold above which a contribution holiday is permitted at a level above 100% solvency would encourage above-minimum funding by employers (presuming, of course, that funding risks and rewards are fairly allocated). Over time, funding margins would be achieved.

It is imperative that any threshold above 100% funding only be implemented if the employer also has clear entitlement to both contribution holidays on an ongoing basis and a refund of excess funding through the reserve account on a wind-up basis.

In principle, the level of the threshold (excess over solvency liability) should reflect the mismatch of assets to liabilities, without being overly prescriptive. For example, a plan with more equity exposure should have a higher threshold. In considering the definition of the threshold the following should be taken into account:

- The regulators should consult with the Canadian Institute of Actuaries to determine the method to calculate the threshold. This method should take into account that contribution holidays are allowed only after the threshold is reached;
- The mismatch is difficult to measure, especially considering new types of investment options, therefore the threshold should be principles-based. Issues of timing for purposes of measuring the asset mix would also have to be addressed;
- The rules should be flexible enough to allow actuaries and employers to demonstrate that the threshold should be lower to reflect the plan's unique circumstances. For example, some plans have substantially eliminated interest rate exposure through investment strategies that defy an overly simplified equity versus bond classification. The rules should be sufficiently flexible to accommodate these more sophisticated investment strategies; and
- The limit imposed by the *Income Tax Act* (Canada) ("ITA") which prevents contributions when a modest surplus exists should be raised to accommodate this build-up of funds.

The second modification of the contribution holiday rules addresses a weakness in the triennial valuation requirement. A shorter valuation cycle is not desirable due to cost, but the triennial cycle fails to address the problem of contribution holidays based on two or three year old valuations when the health of the supporting business has deteriorated and the funded status of the plan has also deteriorated. In these cases, the principle underlying the contribution holiday, *i.e.*, adequate funding, is no longer operative.

Although the introduction of a new threshold for taking a contribution holiday assists with this problem, there is still a need for monitoring by the employer. If there is a deterioration of the solvency position causing a solvency concern before the next filed valuation, contributions should resume. Any requirement for a financial update should be simple and inexpensive for employers. For example, a form of simplified opinion could be developed that updates the financial position annually based on changes in long-term interest rates and actual investment returns.

It also makes sense for regulators to have the discretion to require a full valuation when the monitoring shows a solvency concern, and to require annual valuations until the plan emerges from the deficiency. Solvency concern would be defined for these purposes by regulation.

Letter of Credit

Irrevocable letters of credit are an effective form of security, since payment to the pension plan from the issuing institution would be required in the event that the letter of credit is not renewed. A contribution by the employer would offset the amount to be paid under the letter of credit. Therefore, letters of credit or similar guarantees such as a government guarantee should be a recognized asset for valuation purposes. Letters of credit increase funding flexibility for employers without reducing the security of benefits.

If the current allocation of risks and rewards is allowed to persist, it is crucial that employers be allowed to use letters of credit to provide for benefit security, to avoid the risk of forfeiting contributions made to fund deficiencies.

Letters of credit would be an important element to the system for financially healthy employers even when symmetry is restored. For example, some plans provide for very generous benefits to be paid in certain circumstances, such as the closing of a plant. The likelihood of the circumstance may be low and the amount of assets that would be required to provide the benefits could be far in excess of what would be required while the plan remains a going concern. In these situations, requiring the employer to fund the plan assuming that the most expensive scenario will occur may be unreasonable. It could divert much needed capital away from the business. In such cases, the use of a letter of credit to provide security for the additional liability related to such a scenario may be useful as a long-term approach for securing such a benefit.

Note that while letters of credit would provide welcome flexibility to plan sponsors, we do not believe that they address the risk/reward asymmetry directly enough to stem the tide towards terminations of defined benefit plans. They are not available to all plan sponsors and for some sponsors are expensive.

Specific Elements of the Standards – Creating Economic Fairness for Employers

Overview

The ideal environment for businesses to support single-employer defined benefit pension plans is one in which the obligation to members is to provide the promised benefit and in which the potential for economic gain and loss in setting aside funds to pay those benefits is balanced. The employer who assumes the funding risk would own surplus on wind-up. The employer's right to take a contribution holiday would be clear. Assets would be available to the employer for withdrawal when the funding is excessive. There would be no partial wind-ups requiring distributions of actuarial surplus. In such an environment, and over the long life of the pension plan, the contributions made to fund the benefits would equal the actual cost of those benefits. The system would encourage employers to fund above minimums and allow employers to justify the cost of providing defined benefit pensions to their employees.

The *status quo* is substantially different from this ideal. Many older pension plans funded through a trust provide that the assets can not be paid to the employer and the courts have reaffirmed that it is not possible to amend a pension trust to provide otherwise. Statutory reversal of these existing rights, which were not always intended by the plan sponsor in the creation of the plan, is possible, but may not be feasible given the pressures facing legislators. In such case, other measures can be implemented to rebalance the financial risk.

An often-cited resolution to the risk/reward asymmetry is to permit pension plans to provide for payment of assets to the employer on a going concern basis but to impose member consent restrictions on these payments. These member consent provisions are inconsistent with a fair allocation of risks and rewards.

Measures to Rebalance the Sharing of Risks and Rewards

There are several measures that should be implemented to make a significant correction to financial asymmetry for single-employer plans. All or substantially all of the following measures are needed.

Partial Wind Up

The notion of partial wind up should be eliminated, as has been done in Québec. If Nova Scotia wishes to impose benefit improvement requirements on substantial downsizing events (*i.e.*, “grow-in” and immediate vesting) it could continue to do so without the concept of a partial wind up.

New Plans

Legislation that creates a fair and balanced environment for new defined benefit plans should be enacted. For example, a new plan would be presumed to provide for employer ownership of surplus and contribution holidays in the absence of clear language to the contrary, and would not be subject to partial plan wind-up.

New Rules for Future Contributions

A symmetrical environment could be created prospectively for existing plans. For example, legislation could be created to support freezing benefit accruals in a current plan at the current solvency level, while a new fund is set up to provide for future service accruals, increases in past service benefits, and funding of deficits for past service. The employer would have clear ownership of surplus in the new fund and benefits would be paid from the first fund until it is depleted.

Reserve Account

Certain employer contributions could be singled out for special treatment with respect to ownership. These assets would be tracked separately in a reserve account, as follows:

- Any employer contribution towards deficiencies would be allocated to the account;
- Any employer contribution of solvency current service made that would not otherwise have been required had the contribution holiday threshold not been in place would be allocated to the account;
- The account would earn the fund rate of return for the whole plan;
- On a wind up basis, to the extent that the account is not required to provide benefits and fees related to wind-up, the unused portion would be refundable; and
- A contribution holiday that cannot be justified by reference to the main fund would be charged to the reserve account.

Contribution Holiday

Statutory provisions should expressly grant a presumed right to a contribution holiday unless there is a contrary stipulation in the plan rules. The employer’s ability to amend the plan to expand contribution holidays should be clearly supported by legislation. Although currently the common law provides this result, and most legislation can be interpreted consistently with this result, express legislative codification of these rules would be beneficial.

For consistency with the minimum solvency funding regime, a contribution holiday should be permitted provided the contribution holiday threshold above 100% solvency is maintained after the application of the contribution holiday.

Business Transactions

Legislation should make it clear that actuarial surplus need not be included when assets and liabilities are transferred to a successor employer's pension plans. The role of the legislation should be to ensure that existing levels of benefit security, up to 100% solvency, are protected in these transactions.

Surplus Ownership

In the absence of legislative change that overrides common law on a retroactive basis, there should be statutory provisions that presume employer entitlement to surplus, unless provided otherwise in plan rules and other trust documents. Withdrawal of surplus by the employer while the plan is a going concern should be permitted, where surplus is in excess of a solvency margin (for example, if the solvency funded ratio of the plan is above the level at which contribution holidays are permitted), at the option of the employer without member consent.

The process for determining ownership as provided in plan rules and other documents should be fair and efficient. If the legislation provides for arbitration, it should allow alternative access to the courts to determine surplus entitlement. If an employer can establish ownership there should be no conditions on recovery of those assets by the employer, such as member consent requirements.

On plan wind-up, employer contributions in the reserve account that are not required to provide benefits and fees relating to the wind-up, should be refundable to the employer.

Letter of Credit

Letters of credit or similar guarantees should be a recognized asset for valuation purposes.

Increased Income Tax Limits

The ITA prohibits employer contributions for most plans where the plan has an actuarial surplus of 10% of actuarial liabilities. If employers were permitted to fund to a higher level of surplus when able to do so, with an expectation that the surplus would not become trapped capital, pension security would be improved. Of course a change in the tax limit is not within the province's power. However, the effect of raised limits is something that the province should recognize and consider.

Other Measures

Controls on Investment

Asset mix can create significant risk of insolvency. Too much equity exposure for a financially weak employer in an under-funded plan with mature liabilities is imprudent. However, investment decisions are particularly complex and difficult to regulate and control. The current system already imposes a fiduciary duty on investment decisions. In theory, this should be an effective control. However, it would make sense for regulators to monitor to a greater degree and to order a change to the asset mix when insolvent plans have *clearly* imprudent investment exposure.

Despite being able to say that there is a link between financial health of a sponsoring employer and tolerable investment risk, there is no universal way to define imprudent investment for regulatory purposes since each situation is unique. Accordingly, for purposes of a regulator's monitoring, discretion to take into account all the circumstances is necessary. At least at one end of the spectrum, the employer and the regulator can be assisted in determining that a higher degree of asset and liability mismatch is acceptable when a letter of credit or similar guarantee is in place.

Guarantee Funds

While not directly raised in the Discussion Paper, it is tempting to think that if immediate and constant full funding of a defined benefit pension plan is too expensive for employers, then the risk of pension plan (and business) failure should be insured in a pooled arrangement. However, guarantee funds and similar funds have significant problems:

- Risk of wind up is very heterogeneous, with each business and plan having unique characteristics. Risk premiums could not be equitable unless a complex risk-based approach was developed. It would be very difficult to establish an equitable sharing of risk between employers; and
- It would be too expensive for the employers to insure all benefit loss through a guarantee fund. Even with restricted benefit loss coverage, substantial claims could drain the fund.

Guarantee funds create the potential for moral hazard under which financially weak employers take imprudent pension plan risks, knowing that benefit losses will be covered by other plan sponsors and ultimately by tax payers. As a result, we do not support the establishment of guarantee funds.

Creditor Priorities on Bankruptcy

Bankruptcy laws are not for Nova Scotia to change. However, there are some measures that the province should seek to obtain from the federal government.

Currently, payments that were due to be made before the employer's insolvency may or may not have priority over other creditors' claims under deemed trust rules. The additional money needed to fully fund the benefits may be an ordinary debt, ranking below secured debt.

It would be helpful to make it abundantly clear that contributions already overdue have priority. However, there may not be much that can or should be done to give the remaining pension deficit greater priority. Any material improvement of the plan members' position in relation to secured creditors will affect the employer's ability to borrow, accelerating a business failure or, as the case may be, preventing financial reorganization. Ultimately, if such a measure were implemented, the cost of doing business in Canada may be too great.

Benefit Priorities on Bankruptcy

On insolvent plan termination, it can become clear in hindsight that it would have been better if recent benefit improvements had not been made. The improvements may have worsened a solvency deficiency when they were made, increasing contribution requirements that may in turn have worsened the employer's financial position. It might also seem unfair to pay these benefits at the same level of reduction that applies to previously accrued benefits. It is tempting for a regulator to want to control benefit improvements while a plan is a going concern, but this type of measure is a blunt tool and too intrusive. We do not believe that regulators should address risk in this manner.

Placing controls on benefit improvements in the context of an actual wind-up with insufficient funds is more effective. Benefit improvements made within a reasonable period before the wind-up could be given lower priority than long-standing benefits. Benefits that were created in the few years before wind-up could be eliminated or more drastically reduced than benefits that existed before the amendment. Legislation that requires allocation of accrued benefits based on an unfunded liability or solvency deficiency is more difficult to apply in practice compared to legislation that requires allocation of accrued benefits based on the date benefit improvements were granted. This arises since it is sometimes difficult to allocate an unfunded liability or solvency deficiency to a specific benefit improvement when plan experience has developed since the granting of the benefit.

Facilitate Transactions

The legislation should clearly permit pension mergers and other asset transfers. Regulatory involvement should be efficient so that the pension transactions are executed as soon as possible after the main transaction closes. Specific measures include:

- Allow the transfer of defined contribution accounts in all cases;
- Make it clear that actuarial surplus need not be included when defined benefit assets and liabilities are transferred to a successor employer's pension plans;
- Allow for the unrestricted transfer of assets and liabilities from the seller's plan to any existing plan of the successor employer;

- Ensure that accrued benefits cannot be reduced; and
- Ensure that existing levels of benefit security, up to the solvency margin at which contribution holidays are permitted, are protected.

Clarify Legislation for DC and DB within the Same Plan

Another problem somewhat related to plan design is the relationship between defined benefit provisions and defined contribution provisions in the same pension plan. Pension legislation can be interpreted to place defined contribution accounts at risk if the defined benefits are under-funded on insolvent wind up. Pension legislation does not adequately address the inclusion or exclusion of defined contribution members in surplus distributions or in benefit reductions on insolvent wind-up.

This is another area for litigation that could be prevented with clear legislation under which:

- Defined contribution provisions may co-exist in the same plan with defined benefit provisions;
- Contribution holidays for defined benefit and defined contribution funding are allowed; and
- Plans may be designed without surplus-sharing or deficit-sharing for the defined contribution members.

Exceptions and Temporary Relief

At the present time, or in the future, many employers may want relief from the impact of solvency funding requirements. For financially healthy employers the introduction of letter of credit financing is an appropriate response. For plans that have no solvency risk, suitable exemptions should be created by regulation.

For distress situations such as bankruptcy and court-protected reorganization, it is not feasible to consider in advance what type of relief would be warranted, if any. The appropriate response in those cases is to amend the regulations, if needed, on a case by case basis (or to provide the regulator with the power to grant relief through longer amortization periods or similar pre-defined measures), and to rely on mechanisms under insolvency legislation to balance the competing interests. In that context, the pension regulator should have a key role in negotiations.

Specific Elements of the Standards – Negotiated Cost Pension Plans and Risk-Shared Pension Plans

The comments and analysis presented in the majority of this submission relate to the most common type of defined benefit plan, namely a plan in which a single plan sponsor is responsible for providing defined benefits to eligible members. Many of these comments do not apply to special plan types such as negotiated cost pension plans, commonly referred to as multi-employer pension plans (“MEPPs”) and to a lesser extent, other risk-shared plans. We note that the Act’s definition of MEPPs is not technically limited to these types of plans, but has been applied in this way.

Negotiated Cost Pension Plans

MEPPs constitute a very important component of defined benefit plans in Nova Scotia. From a regulation point of view, MEPPs are dramatically different from single-employer defined benefit plans. MEPPs have no issues relating to contribution holidays, employer rights to surplus, or asymmetry of incentives, because none of these apply. Unlike single-employer plans, MEPPs have the ability to reduce accrued benefits for past service, which some MEPPs across the country have recently been required to do due to funding shortfalls. Despite the many differences, MEPPs are similar to single-employer plans in that the current solvency funding requirements are a key issue, since the solvency funding requirements are ineffective and produce undesirable and unintended results for MEPPs.

MEPPs should be exempt from solvency funding requirements, and the actuarial valuations that are used to determine the benefit levels that can be supported by the contributions and available assets should be prepared on a going concern basis.

There should be regular disclosure to plan members that benefit levels will be adjusted upward or downward from time to time, to reflect the benefits that the MEPP can provide.

Note that the condition that benefits move upward or downward should be a required condition for a plan to be considered a MEPP under this model. If benefits cannot be

reduced, the model is unworkable. Either benefits are fixed and contribution rates move (single-employer model), or contributions are fixed and benefits move (negotiated cost model).

For MEPPs, contribution levels are generally fixed by collective bargaining and independent of the financial status of the plan. The basic pension deal is that plan members receive the amount of pension that the contributions and investment returns can provide. This is very different from the basic deal for a member of a single-employer plan, where the employer is committed to providing the amount of pension promised, regardless of the cost of such pensions.

The existing solvency funding rules are intended to result in additional employer contributions to an inadequately funded plan and more assets to secure the promised benefits, but this does not happen for MEPPs because contributions are fixed. As a result, a MEPP is generally forced to address a solvency funding requirement by reducing accrued benefits. In effect, the MEPP is forced to implement a benefit reduction now in order to prevent having a benefit reduction in the future in the potential event of a wind-up. The solvency funding requirement only affects how benefits are allocated among groups of members – no more benefits can be provided to members because no additional contributions or assets are produced by the solvency funding requirement.

For MEPPs, the objective is generally to provide the maximum benefits that can be generated for members with a reasonable amount of investment risk, and to allocate those benefits equitably among plan members. The existing solvency funding requirements destroy the equity by generation, because benefit levels must be sharply reduced or contributions sharply increased for a temporary period of time, disproportionately disadvantaging those particular members facing the benefit reduction or contribution increase. A direct decision by the Board of a MEPP as to how benefits should be allocated is far more likely to result in equity for plan members than an indirect decision based on solvency funding requirements that were designed for another purpose.

Part of the irony of the dysfunctional effect of solvency funding requirements for MEPPs is that MEPPs are rarely wound-up. Given that MEPPs normally cover employees of numerous employers and that the participation of those employees and employer group is bargained, wind-up is unlikely. On the other hand, MEPPs are frequently in the situation where wind-up liabilities exceed going concern actuarial liabilities because of the generous early retirement provisions of many of these plans. As a result, the current solvency funding rules require MEPPs to fund for the additional early retirement benefits that would be paid in the event of a plan wind-up (in which case all eligible members benefit from the early retirement provisions, not just those who elect to take early retirement) but in fact no such additional early retirement benefits are expected to be paid because plan wind-up is unlikely.

We support reasonable measures that might be considered necessary in conjunction with the elimination of solvency funding requirements for MEPPs. In particular, we support additional disclosure to plan members regarding the possibility that benefits can be reduced in the event of a funding shortfall. Such disclosure could include specific reference to the likelihood of reduced benefits in the event of plan wind-up, along with information about the financial status of the plan. We support the calculation and disclosure to members of the solvency position, even though it is not a direct funding

measure. We recommend the requirement for a written funding policy and we would also support tighter standards by the Canadian Institute of Actuaries to ensure that actuarial valuation assumptions adopted by MEPPs are appropriate.

Other Risk-Shared Pension Plans

Aside from the 'traditional' MEPPs described above, there are a number of other important multiple employer pension plans with risk-sharing between employers and members operating under Nova Scotia pension rules. Currently, the legislation is interpreted as not extending any of the special rules for MEPPs to these plans. It would be beneficial to establish legislative rules that acknowledge the importance of these plans and the special environment in which they operate. Examples of legislation dealing with plans such as these can be found elsewhere in Canada. For example, Ontario has specific rules regarding jointly-sponsored pension plans and Alberta has special rules for multi-unit pension plans.

We recommend adoption of specific rules within the Act that make it possible for risk-shared plans to operate effectively. Such rules would have the following attributes:

- They would allow a delay in contribution increases following a valuation, in recognition of the fact that the collection of retroactive contributions in a cost-shared environment is not workable;
- They would explicitly provide for affected employer/member allocations of responsibility on partial plan wind-ups (if that concept is retained) rather than having remaining employers take responsibility for any potential deficit associated with a departing employer; and
- They would allow payment of full transfer values when the plan has a transfer deficiency, in recognition of the difficulty in making additional contributions at the time of member departure.

Specific Elements of the Standards – Defined Contribution Pension Plans

We support the inclusion of safe harbour legislation for defined contribution plan sponsors.

It is generally recognized that some plan participants will make sub-optimal decisions even when a well-designed and implemented education program is in place. For those employers who would like to improve the likelihood of plan members making financially sound decisions, it would be beneficial for regulators to address the following:

- Eliminate roadblocks to automatic enrolment (including requirement to obtain written authorizations and consent);
- Ensure that electronic communication is a viable and protected alternative for plan sponsors to inform plan members;
- Provide employers with guidance on what kinds of automatic enrolment, default investment options, contribution escalation features and provision of financial advice would be protected under safe harbour legislation; and
- Provide employers with principles-based guidance on acceptable notice periods for employees to be bound by default positions.

The Discussion Paper raises the issue of whether defined contribution member investment choices should be limited and by whom. Selection and monitoring of investment options for defined contribution members is the responsibility of the plan's administrator. We believe this is the appropriate place for this responsibility, as decisions regarding investment options should be made in the context of the needs and abilities of the plan's specific membership. Pension legislation should not impose specific limits and requirements in this regard.

Specific Elements of the Standards – Pension Plan Design Innovation

One of the obvious shortcomings of all pension legislation across Canada, including the tax legislation (see Section 12), is its failure to address differences in plan design. Sponsoring employers and plan members should be able to look to the Act for minimum standards that make sense for their specific pension plan.

It is critical that we step away from thinking of all plans as either defined benefit or defined contribution. Many new plan designs over the last couple of decades have different features of the design that are risk-shared and other features where the risk lies entirely on the employer or plan member. In trying to force new designs into a rigid categorization, these new designs tend to flounder.

Regulators should have the expertise to consider design innovations and the ability to ensure that viable new designs are supported. Principles-based legislation would be far more flexible than rules-based legislation in meeting these objectives. Some new plan designs that need to be supported within pension legislation are:

- Target benefit plans;
- Defined benefit plans where members, at their option, can participate in asset risk and reward features (where the defined benefit pension moves up and down in line with asset returns, before and after retirement);
- Flexible ancillary accounts, where members can purchase ancillary benefits at retirement, when they know their family and financial circumstances;
- Lifecycle plans where members, at their option, can direct monies between registered pension vehicles, savings, loan repayment and insurance programs;
- Phased retirement plans; and
- Risk-shared hybrid plans.

The key is to allow enough flexibility in legislation to permit context-driven reasonable plan designs.

Other Issues Raised in the Discussion Paper

This submission presents general principles for substantial reform and improvement of pension legislation. The Discussion Paper raises a number of very specific questions. While our position on many questions will be clear from the content of the submission, we also want to make specific comments directed to several of the questions raised in the Discussion Paper.

Regulation of Other Arrangements

The Discussion Paper raises the prospect of potential regulation of group registered retirement savings plans (“GRRSPs”) and tax free savings accounts (“TFSA”). We strongly discourage the Review Panel and the government of Nova Scotia from regulation of these vehicles.

GRRSPs and TFSA (when they become available) are fundamentally different in nature and operation from registered pension plans. It is entirely possible that a GRRSP or TFSA may actually have no connection to retirement income at all. TFSA in particular were not designed to be used for retirement income. They were designed by the federal government as an individual savings arrangement for any purpose. Many GRRSPs also permit withdrawals for reasons unrelated to retirement.

Many employers have moved to GRRSPs as a simplified means of providing a retirement benefit to employees. No other jurisdiction regulates GRRSPs under pension standards legislation. A move to include GRRSPs and TFSA under Nova Scotia pension legislation would run directly counter to the expressed goal of reducing or eliminating unnecessary regulation, and would further burden the resources of the pension regulator.

Governance

Nova Scotia pension legislation already regulates many elements of plan governance. For example, it specifies who may administer a plan and the standard of care applicable to such administrator.

Appropriate pension plan governance is contextual and evolving. There should be no standard or “one size fits all” approach to plan governance. It is neither necessary nor desirable for pension legislation to include greater prescriptive detail on the elements of governance. Current legislation and guidelines, coupled with the law of fiduciary duty applicable to plan administrators, is sufficient.

On the issue of costs of governance, governance is inextricably linked to the administration of the plan under legislation. We recommend that legislation explicitly permit payment of reasonable administration expenses, including those related to governance, from the pension fund, subject to any other arrangements or agreements in place between the parties (e.g., where an employer has undertaken to pay plan expenses directly).

Phased Retirement

We support changes to Nova Scotia pension legislation to accommodate phased retirement. We urge the implementation of such changes in a manner that will permit employers flexibility in determining access to such programs. If employers are not permitted to offer targeted phased retirement benefits, such benefits will likely not be offered at all within pension plans (particularly in the private sector).

Role of Regulator

Appeal Process

We support changes to the reconsideration process under the current legislation. The current requirement for reconsideration of decisions by the person who made the original decision adds unnecessary time and expense to the appeal process. We recommend the adoption of a process similar to the one applicable under the Nova Scotia *Workers' Compensation Act*, with a specialized tribunal and subsequent appeal to the Court of Appeal. If a tribunal is created for the purpose of hearing pension appeals, we caution that it is necessary that tribunal members have the appropriate skills and experience to understand registered pension plan issues. Should government wish to refer pension appeal matters to an existing body, we recommend that the Nova Scotia Utility and Review Board be selected for this purpose.

Minimum Number of Plan Members

We recommend regulation of all pension plans except those applying only to individuals who are connected persons for purposes of the *Income Tax Act*.

Unlocking Funds

We support greater flexibility in the area of unlocking of pension funds and simplification of unlocking processes. The changes announced to federal pension standards legislation in the last federal budget are an example that could be followed.

Grow-in

We note that only one other jurisdiction, Ontario, includes grow-in benefits in its pension standards legislation. From this perspective, grow-in benefits impose obligations on Nova Scotia plan sponsors that are not borne by sponsors in other jurisdictions (except Ontario).

Other

While not raised in the Discussion Paper, we recommend amendment of the current definitions and rules applicable to determination of spousal rights for pension plans in Nova Scotia.

Currently, an individual cannot establish a common law relationship with another person that is recognized for pension purposes if either individual is married to someone else. For example, an unmarried plan member may cohabit for an extended period of time with another person. If that person was legally married to someone else and never divorced, there would be no spousal benefits available in relation to the plan member's entitlements from the pension plan. This result does not seem logical, and in practice, can create significant difficulty in plan members' personal circumstances. We believe it would be preferable to adopt definitions that do not limit common law relationships in this manner. For example, the pension legislation in Newfoundland and Labrador allows a legally married member to establish a common law relationship recognized for pension purposes, but requires a longer period of cohabitation than it does for unmarried members. We recommend adoption of similar definitions in Nova Scotia, and support the concept of resolving spousal priority issues in favour of the member's most current relationship. We believe this treatment provides a logical resolution of spousal issues and aligns more closely with the reasonable expectations of plan members.

Related Legal Framework

While improvements to provincial pension standards legislation may have a positive impact in terms of increasing the ease of administration of currently active plans, in the absence of concurrent changes to the ITA and clarity around trust law and legacy issues, it is unlikely that these improvements will encourage employers to establish new registered pension plans and expand pension coverage.

Tax Reform Required to Permit Flexibility in Design

The federal Parliament and the provincial legislatures regulate the taxation of pension plans, their earnings and any distributions made from the plans. As a matter of practice, however, provincial legislatures harmonize their pension legislation with the ITA.

To the extent that one of the goals of provincial pension policy is the expansion of pension coverage, the ITA tends to frustrate that goal. The ITA and its administration have precluded the development of new types of defined benefit (“DB”) plans and hybrid plans. While defined contribution (“DC”) plans are lightly regulated, DB plans are subject to an array of invasive and overly prescriptive rules. Hybrid plans and other innovative types of DB plans would fall within the broad category of DB plans under the ITA, and would be subject to a complex maze of tax rules that were not designed to recognize these arrangements. In particular, the tax rules would fail to recognize the DC features of such plans. Given the apparent appetite of plan sponsors to develop innovative pension solutions to achieve their corporate goals and meet the needs of their workforce, the complexity of the ITA rules has very likely been a significant reason that hybrid plans are not more prevalent today.

The disaggregating of the many risks associated with pension plans (e.g., investment risk, mortality risk, default risk, agency risk, inter-generational risk) can only be accomplished if hybrid plan designs are permitted and are not unduly penalized by the rigidity of tax rules.

Pension coverage can only expand if new pension plan designs are allowed to flourish. As discussed in previous sections of this submission, we believe that flexibility in plan design is key in ensuring the health and prevalence of pension plans in Canada’s dynamic demographic and socio-economic landscape.

In summary, the ITA provisions represent a significant impediment to the development of new pension plan designs. When coupled with the generally restrictive attitude adopted by the revenue authorities, the ITA rules have effectively stalled innovation in pension plan design, while at the same time restricting, as much as possible, tax expenditure costs associated with registered pension plans. Where the ITA rules appear restrictive to the extent of prohibiting flexibility in plan design, and in fact repelling employers from establishing registered plans, the province should use its influence to seek to have such provisions changed.

Settling the Trust vs. Contract Debate

With the exception of the province of Québec, provincial statutes do not prescribe whether pension plans that are funded by trusts are contracts that govern trusts, or trusts that govern contracts. In the absence of prescribed principles, the Canadian courts have filled this void and concluded, by and large, that pension plans are primarily trusts. As the Supreme Court of Canada has recently held, pension plans may be a unique breed of trusts, but they are trusts nevertheless.

The trust analysis has resulted in participants being granted rights to the corpus of the trust funds in addition to the rights that they possess as beneficiaries of the pension promise. This has had the effect of inviting litigation, as sponsors and participants have conflicted over contribution holidays, expenses, surplus ownership and plan mergers. Nova Scotia plans have not been immune to this type of litigation.

While pension plans have been in existence for decades, the judicial finding of the supremacy of trust law is relatively recent. The retroactive nature of judicial lawmaking in this area (unlike many decisions in the constitutional realm) is an issue of concern. This retroactivity has saddled many plans with legacy costs – costs which were not anticipated when the plans were established.

It has been argued that the role of the courts is to simply uncover and confirm the law, leading to the problem of retroactivity. However, we would contend that, by their judgments, courts are not merely confirming the law, but have the power to effectively make the law. In our view, this role is more appropriately the place of the legislature.

The problems resulting from the trust analysis could be corrected by legislation. Provincial legislatures have full powers to legislate in matters of property and civil rights, both prospectively and retrospectively, and could reverse judge-made law and impose a more contract-based approach to pension plans. Indeed, legislation is the approach that the courts themselves have repeatedly recommended.

“The courts have on a number of occasions been required to determine the allocation of pension surplus. Yet the courts are limited in their approach by the necessity of applying the sometimes inflexible principles of contract and trust law. The question of entitlement to surplus raises issues involving both social policy and taxation policy. The broad policy issues which are raised by surplus disputes would be better resolved by legislation than by case-by-case consideration of individual plans.”³

³ *Schmidt v. Air Products Canada Ltd.*, [1994] 2 SCR 611; ¶ 39.

“One would have thought that an issue as critical as the ‘key issue’ would have been clarified authoritatively long before now ... That, regrettably, is not the case... We make this observation at the outset as a reflection of our respectful view that the result intended by the Legislature ought to be set out in language that is clearer than that presently contained ... at the earliest reasonable opportunity ..”⁴

In our view, the adoption of a more contract-based approach to pension plans would provide more clarity to plan sponsors and participants respecting rights, responsibilities and entitlements under pension plans. If a contract-based approach were adopted, changes could be made to the pension contract without revoking the underlying trust. Beneficiaries would not necessarily be granted rights to the trust corpus, except as necessary to satisfy the pension promise. Provided the plan is adequately funded, the plan sponsor could have access to trust funds, directly or indirectly, subject to the provisions of the contracts. We do not consider these changes to be “take-aways” for pension plan participants; rather, we believe that the relative clarity afforded by a contract-based approach will be to the benefit of plan sponsors and participants alike.

⁴ *Monsanto Canada Inc. v. Ontario (Superintendent of Financial Services)*, [2001] OJ No. 963; March, 19, 2001; Ont. SC, Divisional Court; ¶ 7-8.

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