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Work-Related Pensions in Nova Scotia:
Moving from Tactical Fixes to Strategic Reforms

Submission to the Pension Review Panel
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Introduction and Overview[1]

The Discussion Paper for the Nova Scotia Pension Review Panel aptly remarks that the environment for occupational pensions in Canada is going through important changes, many of which require re-examination of existing practices and regulations. The theme of this response to the Paper is that public custodians of the pension system must respond to immediate stresses while ensuring that their responses do not detract from – and preferably advance – the emergence of an improved system of voluntary/contractual pensions for Nova Scotians.

The following section of this submission discusses some of the factors that are stressing the current system and their implications for future pension design. It argues that many problems arise from flaws in the classic single-employer defined-benefit (DB) plan, which for many designers and regulators has up to now been the model pension arrangement. Accordingly, it makes a case for measures that would improve the environment for other arrangements. The next section responds to specific questions in the Discussion Paper. It looks for ways Nova Scotia can respond to recent stresses while ensuring that its residents will have greater opportunities in the years ahead to save for retirement capital accumulation plans (CAPs) and hybrid plans that protect them from various risks related to saving, investment and drawing down, without the hazards associated with the classic DB plan.

Pensions in Canada and Nova Scotia: Problems and Options

The prevalence of current and deferred compensation for work shows that post-work income is an attractive part of many employment contracts. Canada's tax system recognizes the equivalence of current and deferred compensation in one key way: it allows tax deductions for retirement saving, and taxes deferred compensation at ordinary personal income-tax rates. Deferred compensation is by its nature harder for the contracting parties to understand and execute than current compensation, however, and it is not surprising that some arrangements for deferred compensation have proved disappointing to one side or the other or both. Legislators and regulators therefore have to deal with the disappointments and their consequences, while creating an environment in which more robust deferred-compensation arrangements will thrive.

[1] Much of this brief draws on work in the C.D. Howe Institute's *Pensions Papers* series (available at www.cdhowe.org). The opinions expressed here are personal, however, and do not necessarily reflect those of the *Pensions Papers* advisory group, nor those of the C.D. Howe Institute's members or board of directors.

The Classic DB Plan: Stresses and Responses

In the classic DB plan – one sponsored by a single employer – the deferred-compensation "deal" had some attractive features. Typically, employees gave up a comparatively modest amount of current compensation and, in return, employers promised regular, predetermined payments after retirement. By protecting employees from such hazards as saving too little, investing unwisely, or failing to arrange an attractively priced annuity, these plans appeared more attractive to many commentators than CAP alternatives.

These features noted, chronic difficulties and declining coverage of single-employer DB plans are evidence of some serious flaws in the model. To begin with, the classic DB plan distorts the labour market in ways that become more obvious when labour becomes scarcer. The accrual of benefits in a typical DB plan is not neutral as regards place of work or timing of retirement. Since benefits accrue at rates different from the progression of value-added by a worker at his/her current or alternative employers, DB plans may lock employees into jobs that make less than optimal use of their talents, and tip employees into retirement while they still have important human capital to deploy.

The financing of the classic DB plan is also problematic. In general, the core of the attractive balance of low current cost and high, secure, future benefits in these plans rested on an assumption that plan sponsors could underwrite their promises with one or both of rapidly growing revenue from operations and high risk-adjusted investment returns. A world in which both economic growth rates and investment returns are likely to be lower than at times in the past, and in which the tradeoff between risk and return offers no "free lunch", is one in which such promises are bound to be broken.

In the private sector, the disappearance of natural and policy barriers to competition in sectors such as transportation, telecommunications and basic industries undercut what once appeared reliable revenue bases. In the public sector, slower economic growth and fiercer pressure on the public purse to tax less and deliver more, have likewise made "pay-as-you-go" financing look unwise. As for investment returns, many DB plan sponsors overestimated the premiums consistently available from equity investment and underestimated the hazards of asset-liability mismatches.

It is less controversial now than it once was to observe that, in pensions as in most things in life, guarantees cost money: the most reliable DB pension promise is one backed by assets that match pension liabilities as closely as available technology permits, and funded with whatever contributions are appropriate to that model. To the extent that any pension plan of any description deviates from that model, a clear understanding of the rights and responsibilities of the parties to the contract, and ability to execute in accordance with that understanding if problems arise, is critical if such deferred compensation arrangements are to survive.

For employers and employees who are party to classic single-employer DB plan arrangements now, the observation that policy should promote other arrangements in the future will seem beside the point at best, and

wrong-headed at worst. In responding to their requests for help, policymakers need to ensure that actions responding to immediate pressures do not pre-empt – and, ideally, further – the development of systems likelier to foster healthy retirement incomes for larger numbers of Nova Scotians.

One set of actions offering short-term gains without impeding longer-term progress are those that remove disincentives to fuller funding of plans. Whether or not asset-liability matching is wise, it is currently not standard practice, so obstacles and disincentives to maintaining surpluses in plans that will naturally swing between surplus and deficit are bound to lead to underfunding on average. The federal Income Tax Act's restriction on contributions to plans with assets equal to 110 percent or more of liabilities is not within Nova Scotia's power to change, but falls so squarely in this category that it merits mention in any event. Clarification of legal uncertainty about access to surpluses by sponsors is another key avenue for action: employees are entitled to the deferred compensation they have agreed to, not the assets that secure it, and pension laws that do not make this clear will discourage proper funding. Failing action that addresses the problem squarely, letting sponsors put contributions in special trust accounts where they will not be "trapped" and/or allowing letters of credit to bridge solvency gaps are measures with appeal.

Much less attractive are measures that allow sponsors of underfunded plans to maintain them in an underfunded state. Marking to market may be difficult when it comes to illiquid assets or uncertain liabilities, but difficulties in some areas do not undermine the general case for providing regular financial statements that reflect economic reality as closely as possible. Both smoothing and estimating from artificial assumptions simply hide the volatility that pension-fund managers, regulators, shareholders and employees all must see if they are to respond appropriately. And the appropriate response to deficits is to make them up quickly. Plan sponsors who wish to take risks in the hope of achieving superior returns should be allowed to do so, provided that the results of their exposure are displayed regularly in a form that participants, shareholders and other interested parties (as well as regulators) can see and understand. Since Nova Scotia is one of the two provinces with grow-in provisions, this seems an apt point to remark that such provisions, if they exist, ought to be included in valuations and funded – to maintain them and not to require their funding builds in a key bias toward pension underfunding.

Capital Accumulation Plans: Stresses and Responses

As observed already, the classic DB plan appears attractive to many advocates because it protects employees from key hazards: saving too little, investing unwisely, and annuitizing unsuccessfully. These are not small problems. Experience and a growing body of academic research testify to the problems most people face in planning and executing what is in many respects a once-in-a-lifetime task.

When it comes to amounts saved, Nova Scotians again face a funding limit imposed by the federal government: in this case, limits on contributions to CAPs. These limits effectively constrain saving in CAPs to less than the equivalent accrual in DB plans, and should be made more generous.

On the investing front, the recently published Survey of Financial Security from Statistics Canada provided

fresh evidence that individuals tend to invest in vehicles that are not well suited to retirement saving and have high administrative costs. Providing "safe harbour" legal protection for CAP sponsors who create default investments to steer employees toward better, more cost-effective vehicles would likely improve the situation of many CAP savers over time.

When it comes time to cash out, CAP members often annuitize or convert to RRIFs outside a plan, because regulations – particularly about investments – prevent sponsors offering these options within the plan. Reforming such regulations would allow retirees to continue benefiting from the economies of scale of pooling and expert administration of their funds. The prospect of impediments to accessing their funds in retirement may also discourage individuals from saving in CAPs or incline them to withdraw their savings in ways that leave them worse off in retirement than they could have been – a consideration that makes liberalization of locking-in rules appear attractive.

Hybrid and New Models: Fostering Innovation

Listing the deficiencies and challenges facing existing DB plans and CAPs implicitly highlights desirable features in a pension arrangement that would offer, if not the best of both worlds, at least some good features from each. For instance:

- A plan could be predominantly money-purchase to avoid the problems with a larger guarantee than a sponsor can underwrite at acceptable cost, yet provide a minimum guarantee, backed by appropriate assets.
- A plan could impose contribution rates — preferably a default rate, with participants allowed to opt for something different, provided they accept the consequences — geared, in light of evolving investment experience, to providing a target payout.
- A plan could impose a portfolio — again, preferably a default portfolio, with the participants allowed to opt out provided they accept the consequences — that would increasingly insulate participants against movements in annuity prices as they approached retirement.

It would further be desirable to have such arrangements available to people who currently have no access to an employer-supported pension, or whose employers have too little purchasing power or sophistication to offer more than a group RRSP. For that reason, some advocates envision multiemployer arrangements that would reap economies of scale while pooling investment risk – and, if annuitization within the plan is an option, longevity risk as well – across larger populations. Arrangements with some of these features exist in countries such as the Netherlands and Australia, where pension coverage is a mandatory part of the employment contract. The province could even contemplate a province-wide system to cover all employees who do not currently have a plan of some kind through their workplace – a provincial analogue to the "Canada Supplementary Pension Plan" proposed by Keith Ambachtsheer.

For Nova Scotia, mandatory enrolment, contributions at a specified rate, and annuitization specified by law or regulation would not be desirable. In the Netherlands and Australia, the tax-funded and compulsory

employment-related systems that correspond to Canada's "first pillar" OAS/GIS and "second pillar" C/QPP are smaller or missing. In Canada, modest-income earners cannot, and should not be forced to, save for a retirement income no better than the first and second pillars will provide for them. Provincial programs for seniors that are income-tested, such as Nova Scotia's Seniors Property Tax Rebate, fees for home care and long-term care, or relief from premiums for the Seniors' Pharmacare Program, also reduce the returns from retirement saving to the point where an individual may rationally wish not to save. The new federal TFSA – in which contributions get no tax relief but withdrawals trigger no tax or benefit clawbacks – will also allow many savers, including those with modest incomes, to do better outside existing retirement-saving vehicles. So any actively encouraged or mandated system should ensure that people can make an informed decision not to participate, or to participate in ways different from those specified in the default arrangements.

Responses to Questions in Discussion Paper

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

Pension legislation and regulation could usefully include the over-arching goal of facilitating mutually beneficial and sustainable agreements about deferred compensation between employers and employees.

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

The benefits of economies of scale, expert management, pooling of investment risk, and – if annuitization within the plan is available – pooling of longevity risk as well, are all in principle achievable through money-purchase arrangements. More certainty about benefits than current CAPs offer is also achievable, if contribution rates were to vary with investment experience.

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?

This question presents an either/or proposition, but in principle, the choice between DB or money-purchase, or a hybrid, is one about which regulators should be neutral, as long as the arrangement does not impose costs on third parties. One risk with the classic single-employer DB plan is that various legal restrictions and agency problems may lead sponsors to underfund – which can impose costs on people who were not party to the original arrangement. So regulatory forbearance in the face of underfunding is not desirable.

In the case of DC plans, to what extent should an employee's right to make investment choices be limited, and by whom?

Limitation of investment options is a normal and acceptable aspect of a CAP or a post-retirement vehicle and, subject to the principles outlined in the CAP Guidelines, is a legitimate decision for the plan sponsor to make. Subject to proper fiduciary safeguards, plan sponsors ought also to be able to establish default options that will

protect financially unsophisticated participants from expensive and otherwise inappropriate investments.

Should new forms of DB pension plans be permitted to enhance their availability?

The context of this question suggests that the answer should be "probably not." Asymmetries with respect to "ownership" of surpluses and deficits are addressable through legislation, as are other disincentives to fully fund DB plans. Arrangements that reduce the impact of, say, asset/liability mismatches on the sponsor's funding obligations or reported financial position are not desirable.

Should new forms of Hybrid pension plans be permitted to enhance their availability?

Pension plans that transparently respond to changes in investment performance and longevity by altering a single participant's contributions (including those made by an employer on his/her behalf) and/or benefits, and plans that transparently respond to such changes by altering the contributions and benefits of groups of participants, would be a useful addition to the options currently available to Nova Scotians. In principle, such plans could provide many of the better features of DB and money-purchase plans. Encouraging such plans would be a worthy policy goal.

Should DC members have the ability to use different disbursement options, such as LIF type payments, rather than be required to convert funds on their retirement date?

Yes they should: many participants will benefit from continuity in these arrangements, rather than being obliged to "cash out" and confronting once-for-all decisions that they have no training to handle.

Are current rules for measuring and remediation of going concern and solvency deficits appropriate? Should going concern funding still be a requirement?

In principle, frequent and complete disclosure of financial position on a mark-to-market basis is better than rules. Shareholders, participants and other interested parties can and should make their own judgements about the financial soundness of plans and their implications for the financial condition of sponsors. To the extent that rules are needed, solvency valuations are more meaningful than going concern valuations, and are the more appropriate target for minimum funding rules. Forbearance with respect to plans that are underfunded is problematic, since it involves judgements about the likelihood that managers of a plan in trouble will be able to work their way out. Five years seems a reasonable maximum timeframe for remedying a solvency deficiency.

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

As noted already, regulators should be neutral when it comes to choices of pension arrangements – and they should be neutral as regards types of employers. The implicit assumption behind more relaxed funding rules for

public sector plans is that public-sector employers are likelier to fulfill their financial promises than private-sector ones. To the extent this is true – and the judgement that it is reflects a relatively happy history of sound government finances and good governance in Canada, rather than wider experience – it reflects an ability of government plans to impose costs on a third party: the taxpayer. This type of arrangement is problematic: it creates moral hazard problems, and likely distorts the labour market, since public-sector plans tend to offer richer benefits than private-sector ones. A more permissive regulatory regime for public-sector plans is therefore undesirable. As for multi-employer plans, there is no compelling reason for them to operate under a more permissive regime. Fostering their growth should be a matter of removing impediments to it rather than establishing artificial advantages.

Should promises as to future benefit accrual be restricted to the level that can be funded by contributions? Should there be a requirement for full funding at wind-up?

A critical flaw in the classic single-employer DB model is the scope it allows for wishful thinking about investment returns that will bridge the gap between modest contributions and comparatively rich, and guaranteed, benefits. Responsible regulation will limit the extent to which this agency problem causes benefits to be inadequately backed.

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

For the province to mandate coverage on a default-with-opt-out basis is an idea well worth considering. Such a plan could operate as a multi-employer plan, but obliging individuals to belong and leaving the arrangements to be worked out between them and their employers will interfere less with the workings of the labour market and will likely be easier to achieve. If universal coverage along those lines appears too difficult, Australia provides useful examples of sectoral plans.

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

This submission has consistently referred to the employment contract as involving a mix of current and deferred compensation. The logic of that approach is that employers are obliged to pay current compensation as agreed, and deferred compensation as agreed. The entitlement of the employee post-retirement is to the agreed deferred amount, rather than to the assets that back that payment – so the amounts set aside in the present do not confer any ownership right to plan assets. The plan sponsor must make the payment, but is not obliged to do more: the sponsor must therefore cover deficits, and ought to have access to surpluses.

How should funding concerns for MEPPs be addressed? Would permitting the implementation of a different type of Hybrid pension plan be useful for MEPPs? Which of the funding tests should apply to MEPPs?

MEPPs should be subject to the same funding requirements as other plans for the reason already outlined – that regulators should be evenhanded as between different pension arrangements, as long as they do not impose costs on third parties.

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

The Quebec model has features that are attractive in a hybrid plan, and deserves study for potential imitation.

Should government attempt to define, audit, and regulate "good governance"? Why or why not? Is so, what types of governance issues should be regulated? Given that there are associated costs with governance, what is an appropriate cost for "good governance"?

The principle that pension trustees should serve the financial interests of plan participants, as plan participants, is vital to good governance. Establishing this fiduciary principle, but avoiding detailed rules, is probably the best way to promote good governance without creating a regulatory maze that will discourage employers from sponsoring plans and discourage people from serving as trustees.

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? Should a plan have a minimum number of members before the government will regulate it? If so, what minimum number of members would be appropriate?

The author of this submission does not have experience of the workings of Nova Scotia's regulatory system in this area, and cannot offer an informed comment.

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

The national trend toward liberalization of access to locked-in funds appears sensible. The principle that public policy should restrict the uses of locked-in funds rests in part on the view that tax deferral is a privilege for which policymakers are entitled to extract a quid pro quo – the idea that pensions are deferred compensation, however, suggests that such restrictions make no more sense for retirement incomes than they would for current incomes. For some retirees, moreover, highly restrictive locking-in creates considerably hardship. We do not know whether potential loss of access to funds discourages participation in pension plans, but the possibility exists, and we also do not have any evidence that liberalization of locking in, where it has occurred, has facilitated rash behaviour.

Should the legislation require grow-in benefits to be provided on plan wind-up? Should legislators maintain the requirement to fund grow-in benefits upon wind-up?

Grow-in benefits are problematic in principle, since they create an entitlement that participants have not yet earned. Requiring them will, over time, discourage employers from offering provisions in their pension plans that create them – which one can argue needlessly limits the elements that employers and employees might otherwise include in a mutually advantageous package. That said, if the law requires them, they are an obligation that should be funded like any other, and should therefore figure in solvency valuations.

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

Worries over legal liabilities may discourage employers from sponsoring DC plans and even group RRSPs, and will certainly discourage those who do sponsor them from adding features to their plans – such as auto-enrolment, escalating contribution rates, or guidance about investment and annuitization – that would help financially unsophisticated participants avoid many common mistakes. Safe harbour protections for sponsors who act in good faith to protect the financial interests of plan participants would likely improve the willingness of employers to set up and maintain plans, and to add features that would improve participants' retirement bang for the saving buck.

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

The tendency for many pension plans to encourage retirement while people still have much to offer in the workforce is a problem, especially given the demographic challenges Nova Scotia will face in the coming decades. Measures to allow workers to transition gradually from work, and substitute income from saving for income from employment as they do so, make eminent sense.

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

Nova Scotia should try to accommodate TFSAs within its current system for DC plans and group RRSPs so that sponsors and participants will find the new system easy to navigate. Since the federal rules are not yet clear, it is not possible to comment in detail, but one option for employers who wish to lock their contributions in would be to anticipate the establishment of parallel accounts, one to hold employer contributions – which would be locked in – and one to hold employee contributions – which would not. A key issue for Nova Scotia, though not for the pension regulator particularly, is whether the province will exempt distributions from, and holdings in, TFSAs from all income and asset tests. If it does not, TFSAs will be less attractive to affected groups, and a saving vehicle that could serve groups – such as modest-income near-seniors – much better than existing vehicles will not fulfill its promise in Nova Scotia.

Conclusion

The Nova Scotia Pension Review Panel is undertaking its work at a key juncture. More than most other

provinces, Nova Scotia faces a challenging demographic future – declining numbers of people of traditional working age, and a rapidly increasing relative share of the population that is above traditional retirement age. Ensuring that the pension system does not distort the labour market, but rather enhances the likelihood that employers and employees will strike mutually beneficial bargains, is a vital task.

The key theme of this brief is that this task requires legislators and pension regulators to strike a delicate balance. They must respond to immediate economic and political stresses, and avoid gratuitous damage to a pension system that bears the scars of history. At the same time, they must foster the growth of new pension arrangements that avoid some of the agency problems evident in the traditional single-employer DB plan, yet offer some of the risk-pooling, scale economies and professional management, and guidance with respect to key life decisions, that are not available in current CAPs. This balance is not easy to strike, but if this review helps the province do it, future Nova Scotians will owe it a debt of gratitude.