Submission of Towers Perrin to the

Nova Scotia Pension Review Panel

July 2008

TOWERS PERRIN

PRIVATE AND CONFIDENTIAL

July 18, 2008

Pension Review Panel
c/o Nova Scotia Labour and Workforce Development
Policy Division
PO Box 697
Halifax, NS
B3J 2T8

Ladies and Gentlemen:

SUBMISSON OF TOWERS PERRIN TO THE
NOVA SCOTIA PENSION REVIEW PANEL

We are pleased to enclose Towers Perrin's submission to the Nova Scotia Pension Review Panel. We look forward to discussing any questions you may have about our submission.

Sincerely,

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V:_TOWERS PERRIN INTERNAL\08\RET\ISSUELEADERJLAFRANCE\NOVA SCOTIA PENSION REVIEW PANEL FINAL.DOC

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A. Introduction

We thank you for the opportunity to make this submission to the Nova Scotia Pension Review Panel (the Panel) on behalf of Towers Perrin.

We applaud the initiative of Nova Scotia to review its pension legislative framework. We share the main objective expressed by the Minister of Environment and Labour, Mark Parent: "We want our legislation to be modern, efficient and beneficial to all employees and employers in Nova Scotia."

Some 15 and 20 years ago, and earlier, the reforms introduced in pension legislation served to correct certain abuses to ensure that pension promises made to employees were honoured, and to facilitate greater mobility of the workforce. We see this current review of pension legislation to be quite different. We expect this review to identify problems that exist not only with the pension standards, but also with the pension system as a whole. Moreover, we hope that this review will result in changes creating a much more favourable environment for the creation, maintenance and improvement of occupational pension plans in the interest of increasing pension coverage and retirement income adequacy, particularly for private sector workers, more than 75% of whom have no pension coverage.

We have prepared our submission to correspond with the structure of the Panel’s Discussion Paper. As the Panel is aware, in the last months Towers Perrin made submissions to the Ontario Expert Commission on Pensions and to the Alberta – British Columbia Joint Expert Panel on Pension Standards, which are attached to this submission. In those submissions (the OECP Submission and the JEPPS Submission), we provided comments to questions addressing issues that were similar to many of those raised in the Panel’s Discussion Paper. For simplification purposes and to avoid repetition, several parts of this submission directly refer to relevant sections of our OECP Submission and our JEPPS Submission.

We would be pleased to meet with the Panel to discuss any questions you may have about our submission.

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B. Response to the Panel's Questions

The numbered sections below corresponds the numbered sections in the Panel's Discussion Paper.

2. Background

The decrease in pension coverage in the past years is concerning. Expanding pension coverage would have significant benefits. Several issues need to be addressed by key stakeholders, in particular the governments, in order to create an environment favourable for the implementation, maintenance and improvement of pension plans. We provide more information on these benefits and issues in the response to question 2(e) and on pages 15 to 18 of our JEPPS Submission.

The data presented in the Discussion Paper indicate that pension coverage in Nova Scotia dropped from 45.4% of employed workers to 41.1% from 1996 to 2006. This data, which aggregates coverage statistics for public and private sector workers, does not present a true picture of pension coverage in Nova Scotia. Data published by Statistics Canada on labour market and pension plan participation indicate that at the beginning of 2006, approximately 85% of Canadian public sector workers belonged to a pension plan, compared to less than 25% of private sector workers. Public and private sector pension coverage rates do not seem to vary significantly by province. Moreover, few private sector pension plans provide benefits as generous as a public sector pension plan. To address the issue of pension coverage and retirement income adequacy in a meaningful way, we believe the Panel's recommendations should focus on reforms that will help to close the gap between public and private sector workers in terms of pension coverage and retirement income adequacy.

3. Pension Plan Legislation

Should pension legislation and regulation have goals other than those listed [in the Panel's Discussion Paper]?

We believe that one of the primary objectives of pension legislation is to facilitate and encourage the expansion of pension coverage to supplement the minimum income level provided through government programs. We provide more comments on the goals of pension legislation in the response to questions 3(b) and 3(d) of our JEPPS Submission.

3.1 Types of Plans

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

For sponsors of defined benefit (DB) plans, there exist various techniques that reduce the risk of cost fluctuations. A good example of such technique is the use of an investment portfolio that matches the estimated benefit disbursements of the pension plan. Another vehicle, but nowadays rarely used, is to guarantee benefits through an insured group annuity contract. But like most financial risk reduction measures, minimizing financial risk for a DB plan has a price; it usually produces a lower benefit/cost ratio.

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Hybrid plan designs that have lower risk than a traditional DB plan do exist. They usually involve some defined contribution (DC) element. We note that, even though the risk of cost fluctuations is lower for DC plans, they do bring their own risks (e.g. insufficient retirement income, longevity). Consequently, hybrid plan designs typically bring both DB and DC risks at various levels. Canadian legislation, especially the federal tax legislation, makes the implementation of certain plan designs (e.g. the U.S. cash balance model) difficult or impossible. We would support legislative changes aimed at expanding plan design options available to Canadian employers.

Both government policy and legislation should encourage the adoption of a new form of multi-employer pension plan (MEPP). Moreover, pension legislation should allow the target benefit plan model. We provide comments on these new MEPP and target benefit plan alternatives in the response to questions 5(e) and 5(m) of our JEPPS Submission.

4. Policy Issues

4.1 DB Plans versus DC Plans

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?

We believe that DB pension plans are most effective in managing the financial risks faced by Canadians providing for their retirement. However, plan sponsors will not embrace DB pension plans if the regulatory environment is overly restrictive, nor will members value DB plan membership if they do not have a realistic understanding of the advantages – and limitations – of DB participation. Thus, the DB pension promise (benefit and financial) must be clarified and the regulatory environment must change to reduce disincentives to sponsoring DB pension plans. In the absence of DB pension plans, we encourage the implementation of DC arrangements that effectively deliver adequate benefits and prepare participants to deal with investment, longevity and inflation risks through comprehensive disclosure, communication, education and decision-making tools.

Pension legislation should be amended to reduce funding risks while providing reasonable assurance that members' pension promises will be honoured. In particular, letters of credit and contingency reserve accounts should be made available to provide funding flexibility. Please refer to pages 27 to 29 of our JEPPS Submission for comments on proposed changes to the funding rules.

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

In our experience, plan sponsors and administrators, often with the help of advisors, have spent considerable effort to review and comply voluntarily with guidelines. However, plan sponsors and administrators should have sufficient flexibility to select investment options that reflect the plan's own unique circumstances and the plan members' needs and risk tolerances.

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We support the continuance of guidelines, periodically updated as appropriate, by the Canadian Association of Pension Supervisory Authorities (CAPSA) with the concurrence of all of the pension regulators. We would not encourage individual pension regimes to make the leap from guidelines to statutory provisions.

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

As noted in our response in section 3.1, certain kinds of pension designs that could increase employers' willingness to sponsor a pension plan are not available under current tax rules. Such designs include cash balance pension plans and DB pension plans in which members are permitted to take on some or all of funding risk. Nova Scotia has an opportunity to lead the way to making such designs available by amending its legislation to accommodate them. We note that when Quebec amended its pension legislation to create "member-funded" DB pension plans, amendments to tax rules to accommodate this new design followed shortly thereafter. Similarly, tax rules were amended to accommodate the use of letters of credit to secure solvency deficiencies only after a number of pension standards jurisdictions amended their legislation to permit the use of letters of credit for this purpose.

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?

We would fully support amendments to pension legislation that would allow DC plans to offer variable disbursement options. These options could include variable payments currently permitted under a life income fund and other types of flexible disbursement arrangements. However, offering such variable disbursements should always remain at the plan’s option; the ability to receive variable disbursements from a DC plan should not be a plan member’s right, considering the significant additional administration it would involve.

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4.2 Pension Plan Funding

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

The statutory focus of minimum funding should be benefit security now and in the future. From a benefit security perspective, the solvency valuation is most essential. Thus minimum funding rules should focus on solvency liabilities using a forward-looking, probability-based approach. For more comments on funding rules, please refer to pages 28 to 30 of our JEPPS Submission.

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

In the determination of exceptions to the funding rules, consideration should be given to negotiated-cost MEPPs, new risk-sharing arrangements with plan members and the particular differences for certain public-sector pension plans. Any exemption from the solvency funding rules, or their limited application, may be subject to the application of more demanding requirements in terms of going-concern margins and/or amortization of deficits. We suggest that a working group composed of representatives from the Canadian Institute of Actuaries and from Canadian pension and tax authorities discuss and develop appropriate special funding rules for these plans.

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

We understand that, under current funding rules, the cost of current service benefit accruals must be funded by contributions. However, a plan's surplus assets may be used to fund this cost. We support the maintenance of this principle and such use of surplus must continue to be permitted.

An exception to these principles may be appropriate only for social programs like the Canada/Quebec Pension Plans, subject to the accumulation of a reasonable reserve.

Should there be a requirement for full funding at wind-up?

We support the general principle that pension promises should be clearly articulated and honoured by plan sponsors. We thus support full funding on plan termination; however, we believe that such a requirement should not be implemented without consideration to surplus uncertainty issues.

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With the goal of maintaining (or enhancing) the current levels of benefit security while, at the same time, addressing the surplus uncertainty question, we invite the governments to strongly consider the two-pronged approach (letters of credit and contingency reserve accounts) outlined in the response to question 5(f) in our JEPPS Submission. In the attached paper titled "The 21st Century Pension System: Solving the DB Funding Conundrum" and issued by Towers Perrin in January 2008, we provide more details on how contingency reserve accounts could work.

Note that DB MEPPs in which contributions are limited to the negotiated amounts should be exempted from the requirement for full funding on plan termination.

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?

Pension legislation should facilitate the adoption of MEPPs, especially MEPPs that would enable participation by small employers. Participation in MEPPs by private employers should remain optional. For more comments on a new from of MEPP, please refer to our response to question 5(e) in our JEPPS Submission.

4.3 Surpluses

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

When establishing the pension deal, surplus, beyond a cushion, should be available to the party or parties that take on the plan's financing risk. The regulatory environment must accommodate this type of pension deal. Transition/grandfathering arrangements from current surplus ownership rules will be important, and must be addressed in legislation.

If the issue of surplus ownership is not clarified and made more commensurate with the pension risk, DB plan sponsors will naturally continue minimum funding policies that reduce the likelihood of a large surplus developing. In the absence of such clarification, additional funding flexibility must be provided by permitting the use of letters of credit and separate contingency reserve accounts.

For more comments on this issue, please refer to pages 17, 28, 29 and our response to question 5(f) in our JEPPS Submission.

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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?

We support the notion that the value of DB pension credits is deferred compensation; each employee may forego cash compensation today in exchange for pension benefits payable in the future. For this reason, we support the general principle that pension promises should be honoured by plan sponsors. However, any application of the "deferred compensation" concept is limited to the pension promise; it has no relevance to the dollars that were required to fund these promises, unless otherwise clearly specified in the pension plan deal. The funding contributions are based on actuarial estimates.

4.4 Multi-Employer Pension Plans

How should funding concerns for MEPPs be addressed? Which of the funding tests should apply to MEPPs?

Please refer to our response in section 4.2.

Would permitting the implementation of a different type of Hybrid pension plan be useful for MEPPs? Should regulators facilitate the further development of hybrid plans?

Please refer to our responses in sections 3.1 and 4.1.

Would the Quebec model be an attractive option for Nova Scotia employers?

Under a Quebec member-funded pension plan, the employer contributions are fixed and the plan members are responsible for the balance of the cost of the defined benefits. Consequently, the funding responsibilities under this type of plan are exactly the opposite of those under a traditional DB plan. In order to reduce the risk of high fluctuations in member contributions and the risk of reduction in benefits, member-funded pension plans have to comply with severe funding requirements and plan design restrictions. For example, pensions under such a plan cannot be based on a final or best-average-earnings formula, and going-concern funding must be based on deemed indexation of pensions even though such indexation is not actually guaranteed. Member-funded plans can cover employees of one or several employers.

The member-funded plan concept may be attractive for some employers because it can entail reduced funding risk. We welcome the additional pension plan design option that this concept offers. A wider range of plan design options may potentially accommodate a larger number of pension coverage needs. We support the general objectives of the restrictive funding and plan amendment rules prescribed by the Quebec regulation for member-funded plans.

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4.5 Governance

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

The key question should be what are the related risks to be defined and managed? In pension governance there are many risks to both the administrator and the members. In our experience, plan sponsors and administrators, often with the help of advisors, have spent considerable effort to review and comply voluntarily with guidelines. However, plan sponsors and administrators should have sufficient flexibility to develop governance models that reflect their own unique circumstances, needs and risk tolerances.

We support the continuance of guidelines, periodically updated as appropriate, by CAPSA with the concurrence of all of the pension regulators. We would not encourage individual pension regulators to make the leap from guidelines to statutory provisions. Uniformity of governance standards should be maintained.

Given that there are associated costs with governance, what is an appropriate cost for "good governance"?

Based on our experience, there is no rule-of-thumb for determining what is an appropriate cost to ensure good governance. In most cases, the costs associated with implementing good governance practices will be more than offset by savings realized by avoiding costly errors that can and do arise as a result of poor governance practices. Each plan's governance structure and activities must reflect the plan's own characteristics and risks. We are reasonably confident that most plan sponsors and administrators, with the assistance of advisors, have implemented a governance plan and structure that allows an appropriate management of the plan's risks, at a reasonable cost.

4.6 Harmonization

Towers Perrin strongly advocates harmonization of pension legislation in Canada. For more information on our position, please refer to our response to questions 4(a) and 4(b) in our JEPPS Submission. Moreover, considering the expertise and expenses required to develop and monitor compliance with highly technical pension standards, we invite the Atlantic Provinces to fully harmonize their pension standards.

4.7 Role of Regulators

We support the statement that the selection of the type of pension plan (including the decision to sponsor a pension plan or not) should be made by employers. However, we note that the current legislative environment creates significant impediments to the implementation and maintenance of DB plans. Urgent attention must be given to removing unnecessary obstacles for DB plans and thus allowing employers to select the type of pension arrangement that will most appropriately address the retirement income security needs of their workforce.

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Does the current regulatory system work effectively? Should the appeal process be changed? If so, how?

The objectives of the key aspects of pension legislation should be clearly articulated. This would assist plan sponsors, regulators and courts when interpreting legislation. The Pension Benefits Act (PBA) should be amended to state explicitly that the core principles (Guiding Principles) of pension legislation are:

- increasing pension coverage and improving Nova Scotians' opportunities to accumulate adequate retirement income; and
- ensuring that the pension promise is clearly understood and will be honoured.

The PBA should further state that the regulator and courts must consider these Guiding Principles when interpreting and applying the statute and its regulations. We note that, as part of her mandate under the PBA, the Superintendent of Pensions must promote the establishment, extension and improvement of pension plans throughout Nova Scotia. Many would argue that this part of the Superintendent's mandate has not been fulfilled.

We suggest that Nova Scotia create a pension plan tribunal (PPT) dedicated solely to adjudicating pension disputes, including appeals of proposed Superintendent's decisions or orders. The majority of PPT members must be pension experts and the PPT should be granted a privative clause under its applicable legislation. Under this approach, we expect that the decisions of the PPT would be given significant deference by the courts.

Are there currently unnecessary rules and regulations in place? If so, what are they?

We have suggested a number of changes to the pension standards in our answers to question 5(n) in our JEPPS Submission.

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?

Nova Scotia should consider exempting small plans from the application of certain requirements (e.g. annual audit of the pension fund). We invite Nova Scotia to work other CAPSA members in defining appropriate and uniform exemptions.

4.8 Group Registered Retirement Savings Plans (Group RRSPs)

Employers who wish to sponsor capital accumulation plans for their employees should continue to be free to choose between a DC registered pension plan, a deferred profit sharing plan, a Group RRSP and another type of savings plan. Since Group RRSPs may serve for purposes other than saving for retirement (e.g. protection for periods of low earnings), Group RRSPs should continue to be exempted from the application of the PBA, including locking-in requirements.

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4.9 Unlocking Funds

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

Locking-in has been hotly debated in recent years and several jurisdictions have introduced measures that relax this policy. We encourage the Panel to consider the merits of locking-in relative to the complexities involved in administering locked-in accounts. At a minimum, while current rules can be simplified, pension plans must, at the discretion of the plan sponsor, continue to be allowed to lock in benefits during, as well as after, employment with the participating organizations.

4.10 Grow-in Benefits

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 on full or partial wind up inappropriately creates winners and losers and lack of predictability in the cost of pension funding. We see no reason why an employee involuntarily terminated should receive less generous benefits because the termination did not occur in connection with a general downsizing or business closure. We therefore suggest that grow-in (based on the expected retirement age, rather than the retirement age that maximizes the pension value) be provided to all terminating members, regardless of whether or not they are included in a windup. If this change is adopted, we believe that the concept of a partial windup would cease to be relevant, in which case partial windups could be eliminated, as has occurred in Quebec. For more information on these suggestions, please refer to pages 12 and 13 of our OECP Submission.

5. New Developments

5.1 "Safe Harbour" Rules

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

DC plan sponsors, administrators and financial institutions should be provided safe harbour protection in some form to provide a defence to a claim of breach of statutory duty. For more information on this suggestion, please refer to the response to question 5(k) in our JEPPS Submission.

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5.2 Phased Retirement

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

We urge Nova Scotia to immediately amend the PBA in order to allow pension plans to offer the maximum flexibility permitted by the recent changes to the tax legislation with respect to phased retirement. We note that the Quebec government has already enacted such legislative changes (the federal and British Columbia governments have adopted, but not yet enacted, such amendments to their pension standards). For more comments on phased retirement, please refer to the response to question 5(l) in our JEPPS Submission.

5.3 Tax Free Savings Accounts

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

TFSAs will create attractive tax-advantageous saving opportunities for Canadians. They will be used for various saving purposes. Most of these purposes will not be related to retirement. For this reason, they must not be subject to the provisions of the PBA.

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C. About Towers Perrin

Towers Perrin is a global professional services firm that helps organizations to optimize performance through effective people, risk and financial management. With more than 70 offices in 26 countries around the world, Towers Perrin has the people, expertise and presence to provide innovative solutions to client issues in the areas of human resource consulting, actuarial and administration services, management and actuarial consulting to the financial services industry, and reinsurance intermediary services.

Incorporated in its present form as Towers, Perrin, Forster & Crosby, Inc. in 1934, Towers Perrin traces its roots through predecessor firms back to 1871. We have provided services to Canadian organizations since 1938; we opened our first Canadian office in Montreal in 1956, followed by Toronto in 1960, Vancouver in 1973, and Calgary in 1980. Today, Towers Perrin is one of the world's largest HR consulting firms, with annual revenues of about $1.5 billion.

We serve clients through two wholly-owned business units: Towers Perrin Human Capital Services, and Towers Perrin Risk & Financial Services. Retirement consulting is the largest practice in our Human Capital Services unit and represents nearly two-thirds of its annual revenues in Canada.

Towers Perrin is privately-held and wholly owned by a group of active employees (Principals) who are stockholders in the firm.

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Submission of Towers Perrin to the

Alberta – British Columbia Joint Expert Panel on Pension Standards

March 2008

TOWERS PERRIN

PRIVATE AND CONFIDENTIAL

March 7, 2008

Pension Standards Review
Room 402
9515 – 107 Street
Edmonton, Alberta
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Ladies and Gentlemen:

SUBMISSON OF TOWERS PERRIN TO THE ALBERTA – BRITISH COLUMBIA JOINT EXPERT PANEL ON PENSION STANDARDS

We are pleased to enclose Towers Perrin's submission to the Alberta – British Columbia Joint Expert Panel on Pension Standards. We look forward to discussing any questions you may have about our submission.

To contact us regarding our submission, please call David Morton at (604) 691-1022 or Kim Young at (403) 261-1460.

Sincerely,

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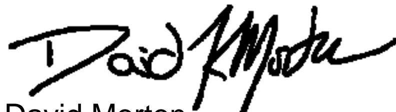

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1. Introduction

We thank you for the opportunity to make this submission to the Alberta – British Columbia Joint Expert Panel on Pension Standards (JEPPS) on behalf of Towers Perrin.

We applaud the initiative of Alberta and British Columbia to jointly review pension standards in this cooperative manner. We share the hopes and objectives expressed by the Finance Ministers, Carole Taylor and Lyle Oberg, which include:

- Albertans and British Columbians must be "confident about their pension plans".
- "Employees and employers must be treated fairly".
- This is an opportunity to create "stronger", "competitive" economies that "benefit the residents of both provinces" and serve to "attract and retain workers, as well as business," to the provinces.
- "The review will serve as a model for the modernization of pension legislation across Canada".

Some 15 and 20 years ago, and earlier, the reforms introduced in pension legislation served to correct certain abuses to ensure that pension promises made to employees were honored, and to facilitate greater mobility of the workforce. We see this current review of pension legislation to be quite different. We expect this review to identify problems that exist not only with the pension standards, but also with the pension system as a whole.

The primary concern to be resolved in the coming years may be perceived by many stakeholders to be a matter of degree. From our perspective, the problem can be stated in the following form:

The majority of the current generation of working Canadians will not have sufficient financial resources:

a. to maintain a desired standard of living throughout their full retired lifetime, or

b. to maintain an adequate standard of living throughout their full retired lifetime, or

c. to meet basic needs throughout their full retired lifetime, without liquidating estate-related assets like the family home, resort property, and other investments, or

d. to meet basic needs throughout their full retired lifetime, and will become fully dependent on government retirement programs and social assistance.

The greatest risk is whether a significant percentage of Canadians will fall into the last category.

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The JEPPS Discussion Paper and this submission identify and discuss a number of issues that are contributing to the above-noted overriding concern, including the following:

- Canadians, in general, are not saving sufficiently for their retirement.
- For a host of reasons, coverage in occupational pension and savings plans is in decline, particularly coverage under defined benefit (DB) pension plans.

We have prepared our submission to correspond with the structure of the Discussion Paper while drawing on first principles. In each section, we provide a background discussion, input to each question posed by the JEPPS, and a summary of key recommendations.

We would be pleased to meet with the JEPPS to discuss any questions you may have about our submission.

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2. Occupational Pension Plans in the Canadian Economy

2.1 Background Discussion

For the purposes of our review of the pension system in Alberta and British Columbia, we clarify that our definition of the three pillars of the retirement income system corresponds with that recognized by the Organization for Economic Co-operation and Development (OECD)[1], namely:

Pillar 1 – Government sponsored plans, including universal and wage-related programs, which in particular include the Canada/Quebec Pension Plans (C/QPP), Old Age Security (OAS), Guaranteed Income Supplement (GIS) and other provincial supplements, as may be applicable.

Pillar 2 – Occupational pension and savings programs, including DB and defined contribution (DC) pension plans, group registered retirement savings plans, deferred profit sharing plans, company stock ownership savings/purchase plans and supplementary arrangements.

Pillar 3 – Personal arrangements, whether tax-assisted or not, including personal RRSP accounts, home ownership, vacation property, business ownership, other investments and, most recently announced, Tax-Free Savings Accounts (TFSA).

In combination, the system can be judged on its ability to deliver income security in retirement. Please note that we exclude from our deliberations those individuals who may be considered financially independent and fully derive financial security in retirement primarily out of Pillar 3.

For all others, income security in retirement should consider the following components:

- Adequate replacement of pre-retirement income – In this regard, some base minimum level of income should be deemed necessary for survival. Above this level, personal circumstances and preference should dictate the level of income desired in retirement. Annual retirement income targets may range from 50% to 80%, or more, of an individual's pre-retirement income level. This level may also be influenced by the individual's need to provide for dependents.

- Continuation of income for life – The desired level of income required for personal security must persist for an individual's lifetime. For many Canadians, some portion of retirement income must also persist beyond the primary individual's lifetime to protect surviving dependents.

[1] In Canada, we acknowledge that the three pillars are often defined differently: Pillar 1 – Government pay-as-you-go programs (OAS/GIS); Pillar 2 – Government funded programs (C/QPP); and Pillar 3 – Private deferred-income programs (occupational pension and savings plans).

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- Inflation protection – The general trend of increasing prices can erode the purchasing power of individuals on fixed incomes. Currently, government plans fully account for this loss. When considering this component, individuals need to understand the expected pattern of expenditures in retirement. Full indexation of income from occupational and individual plans may not be warranted, since a person's ability to spend generally decreases with age in retirement (except maybe end of life health-related costs) mitigating the need for cost-of-living adjustments.

When reviewing each pillar of the retirement income system, the foregoing components of income security in retirement should be considered relative to the following principles.

Adequacy

Government plans and programs should establish targets that provide residents with a minimum subsistence level of income in retirement. Individuals make choices about employment and personal savings that allow them to set retirement income targets commensurate with the standard of living they hope to enjoy in retirement. The government should not mandate a particular standard of living greater than the minimum, but can encourage greater pension coverage and savings patterns for the greater good of the economy and society.

Reliability

In planning for retirement and assessing retirement income needs, individuals must be able to rely on retirement income estimates expected to be received from various sources, particularly those where the benefit is defined (i.e., government plans and DB pension plans). In assessing occupational plans, the pension deal should be clearly articulated, including identification of the risks whereby expected benefits may vary. This risk in single-employer DB pension plans should also be clarified and evaluated.

One key feature for reliability in DB occupational pension plans is advance funding. However, it must be clarified for employees and regulators that the benefit promise defined in the plan is not without some risk. The pension fund was established as a mechanism to help secure that promise. As DB plans have evolved, away from government annuity and group annuity contracts, plan sponsors sought to secure and deliver better benefits at a lower cost by establishing segregated pension funds. However, it was not generally intended that pension assets would fully fund accrued benefits one-hundred percent of the time. There was no "financial promise" beyond prudent funding from a going-concern perspective.

Inaccurate communication to members and a minority of imprudent governance practices may have caused regulators to shift their focus to expect that the pension fund should at all times be sufficient to fully fund accrued benefits. This requirement is a tall order for the majority of plans that have established mismatched asset/liability structures intended to deliver better benefits at a reasonable expected cost.

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Recent changes to pension standards and the regulators' administration of minimum funding requirements has imposed a more restrictive definition of the financial promise beyond what was originally intended and has contributed to the decline in DB pension plan coverage.

Transparency

Individuals must be given the relevant information necessary for them to adequately plan for their retirement income needs and to assess the risks associated with each delivery source. Pensions are expensive, and the process of saving for retirement is complex and is not a natural aptitude for many Canadians. Adequate and ongoing education is required to provide individuals with the financial literacy they need to plan for their retirement. This transparency should foster appropriate behaviours amongst workers as they make informed decisions about, for example, the amounts to save for retirement and an expected retirement age.

Valuable Component of Compensation

Employees, and their employers, remit taxes to support the delivery of income from government programs that they trust will one day be provided to them.

The value of pension benefits provided by occupational plans should not be overlooked. Our current tax rules for tax-assisted retirement savings, by way of the pension adjustment mechanisms, has proven to highlight, at least for many terminating employees, certain inadequacies of traditional DB pension plan designs and helped raise the call by employees for DC arrangements.

As well, employees without pension coverage, and their employers, need to consider the portion of income that should be used for retirement savings when assessing competitive pay practices.

Tax-Assisted Deferred Wages

The deferred status of income directed to DC arrangements is clear. This classification applied to payroll taxes directed to the C/QPP is less clear, and to some extent obscured by the current generation of working Canadians funding benefits of current C/QPP retirees. For occupational DB pension plans, the circumstances of each plan may dictate the extent plan assets represent deferred wages.

In general, the obligation of the plan sponsor to pay benefits, and the liability value representing that obligation, should be recognized as an individual's deferred wage. The assets backing that obligation should be recognized only as a mechanism or financial instrument used to secure that obligation.

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Economies of Scale and Pooling of Risk

Sufficiently large arrangements can create certain efficiencies, particularly by:

- developing more sophisticated investment strategies that better manage pension financial risk,
- obtaining access to investment vehicles (e.g., private equity, infrastructure, hedge funds) that require reasonably large minimum investments and greater oversight,
- reducing per-capita investment management and administration fees, and
- creating pooling opportunities to manage longevity risks.

Redistribution of Wealth

The OAS and GIS are mechanisms that serve to redistribute the wealth of high-income Canadians to those with lower incomes. This is particularly true for individuals with retirement incomes above prescribed thresholds who are subject to the claw-back of OAS benefits.

To some extent, low-income individuals who happen to have retirement savings that reduce GIS benefits, to which they might otherwise be entitled, also experience an unfortunate redistribution. In this latter case, it is impractical for low-income Canadians to save for their retirement and protect any savings they may have accumulated from prior more-productive years.

Macroeconomic Benefits

In a speech to the Canadian Club of Toronto on December 10th, 2007, then Governor of the Bank of Canada David Dodge stated, "Pension funds can generate important gains in terms of economic efficiency. They help to achieve a more efficient allocation of savings; they are invested by asset managers who have the incentive and the ability to invest across varied asset classes; and, with their very long investment horizons, pension funds can be used to finance long-term investment projects at competitive rates of return. Reviews of pension regulations are under way at both the provincial and federal levels. If we can collectively get these changes right, sponsors would have the appropriate incentives needed to manage risk effectively, thus enhancing the viability of our system of private, voluntary defined-benefit pensions for the good of Canadian workers and firms, and for the benefit of our capital markets."

We also believe that a strong retirement income system will create an attractive environment for labour.

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2.2 Responses to Questions

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

Assuming that government plans provide Canadians with the necessary base subsistence level of income in retirement, occupational plans provide the means for employees to achieve personal standard of living objectives they hope to enjoy in retirement. When occupational pension plans are recognized by employees and employers as part of an individual's total compensation package, employees should value this partnership with their employers in providing for their secure retirement.

Occupational programs of any nature can be effective in enabling Canadians to meet their financial needs in retirement; however, plans where the sponsor has taken responsibility for the overall financial management have proven to be effective in delivering satisfactory benefits to employees. We believe occupational DB pension plans have been most effective in this regard.

Moreover, the effort to prepare individual Canadians to take full responsibility for this task may be overwhelming. In the absence of occupational plans, should communication and education efforts fail, many Canadians must necessarily change their retirement expectations and there may be over-utilization of our social safety net.

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

When occupational plans are seen and appreciated, by everyone, as a valuable component of total compensation, they serve as effective tools for attracting, retaining and managing the workforce.

Traditional plan designs focused on rewarding those who ultimately retired from an organization, for which adequate retirement incomes were achieved, often including some provision for inflation protection. However, employees who voluntarily or involuntarily terminated employment often left without the value of early retirement subsidies, wage growth, and post-retirement inflation protection. Worker mobility would be enhanced if plan provisions were adjusted to include these provisions, producing portability values that are more commensurate with pension values deemed by tax rules.

Where plans do not provide for these ancillary benefits, we would encourage employers to find ways to allow plan members to preserve the value of early retirement subsidies, wage growth, and post-retirement inflation protection, possibly by using employee optional ancillary contributions. Otherwise, terminating long-service employees may lose the opportunity to effectively save toward such important and valuable benefits.

In addition, productive employees now eligible for early retirement may face substantial loss of subsidized benefits by not exercising their option to retire. We encourage the regulators to consider more flexible

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regulations to permit innovative plan designs that are intended to accommodate the aging workforce (e.g., phased retirement).

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

The Canadian cost of living, culture and compensation structures, in some sectors, make it difficult to compete with many of the labour markets accessible throughout the world. Expensive retirement income programs may have a detrimental effect on the Alberta – British Columbia workforce as employers seek to reduce costs to remain competitive and/or outsource to labour markets that are more economical. Conversely, an economy where a higher proportion of employees are covered by pension plans would be attractive to employees.

Simplified, clear and uniform pension standards that recognize the voluntary nature of occupational pension plans would favour the implementation and maintenance of pension plans. In this regard, the regulators' understanding of the pension deal must be revisited. In recent years, regulators have moved to an objective under which all DB pension funds should exceed the plan's windup or solvency liability at all times. This is a worthy objective but it is difficult to attain in the economic and legal environments affecting today's pension plans. Furthermore, it was not an intended goal for plans that flourished in the 1960s to 1980s, but are now in decline. Government should maintain legislation that guarantees that registered pension plans will deliver on the pension promise in "almost" all cases. The likelihood of achieving this goal would be enhanced by higher funding levels encouraged by resolving the surplus uncertainty question.

As the current economic and demographic environments evolve, it is also important that pension standards be flexible enough to accommodate different types of risk-sharing arrangements between employees and employers to facilitate the maintenance, and expansion, of effective retirement income programs.

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

We would consider sufficient retirement income, in respect of a particular individual, to be made up of two components: that which is necessary to meet basic living expenses, and the additional amount needed to meet the standard of living objective established by the individual. The latter is dependent on the individual's current and developing financial position and personal preference.

We propose that a base minimum level of retirement income, determined relative to national or provincial average wages, be provided from mandatory Government plans, considering the following:

- What minimum level is deemed sufficient?
- Are current government programs covering this minimum level?

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Saving for retirement above this minimum level will be beneficial for the welfare of individuals and for the growth of the economy. To achieve these benefits, government should take an active role in educating constituents about the need to, and principles of, saving for retirement. We also regard this as a necessary preventive measure designed to ensure that future taxpayers do not suffer undue tax burdens to support retirees who have insufficient incomes.

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

Expanding pension coverage would have significant benefits, including:

- Higher standards of living for retired Canadians,
- Reduced burden on society in later retirement years, and
- Improved economic efficiency and enlarged source of capital to improve productivity.

Participation in mandatory government programs, providing an adequate base minimum level of retirement income and funded by employer and employee contributions, would prove to be efficient, equitable and broad-based. However, in doing so, extreme care would need to be taken to ensure that the supporting funds are invested purely in a return-seeking manner (at an appropriate level of risk), rather than trying to achieve non-investment objectives.

The establishment and participation in occupational pension plans should not be mandatory, but should be encouraged for several good and valid reasons. Please refer to question 3(d) for suggested initiatives to increase coverage.

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

The economic activity of employers provides the source for all financial security programs in Canada, whether sponsored by government, by individuals, or by the employers themselves. In addition, employers are in daily contact with their staff and well positioned to support the transmission of important messages, including the need to, and process of, saving for retirement. For these reasons, we submit that employers play a critical role in ensuring that Canadians have sufficient income in retirement.

Some may argue that employers have a responsibility to clearly and frequently communicate the need to plan for retirement and the role that the employer's retirement program (if any), government benefits and personal savings play in the process. However, this task is costly and onerous for small employers in which case support from government resources would be beneficial, if not essential.

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Employers should be encouraged to work with their various providers to develop a comprehensive long-term communication strategy that addresses employee information and education needs throughout the employment lifecycle – from on-boarding to termination of employment or retirement. Strategies should include a variety of tactics, designed to engage employees, including print materials, face-to-face meetings, personal statements, web-based retirement modeling tools and retirement planning websites.

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

Sun Life Financial's recent survey of 1,500 Canadians indicates that 62% were unsure about what their annual income will be when they retire. When asked how much money they would need for retirement, three out of five indicated they didn't know or guessed at an amount. As well, the 2008 TD Waterhouse RSP Investor Poll indicates that less than one-third (31 percent) have ever tried to calculate how much they will need to retire comfortably. These examples support the assertion that people are demonstrably less successful at preparing financially for retirement if left to their own devices.

However, the statistics provided in these examples and those provided in the Discussion Paper should be interpreted with care. There is a cohort of lower-paid Canadians for which saving for retirement in a deferred-income vehicle is impractical and inappropriate, and for whom mandatory government programs should provide sufficient retirement income. Likewise, we expect that a cohort of higher-paid Canadians, who are financially secure, make up a significant component of those actively engaged in saving for retirement. To identify those who may be at risk, a clearer picture of the savings habits of Canadians between these extremes may prove instructive.

Government can participate in education initiatives targeted at those who are most at risk, through:

- Initiating public awareness campaigns and/or agencies, broadly directed and/or targeted (In Québec, the Régie des rentes offers a retirement planning tool on their website),
- Updating information disclosure guidelines,
- Clearly articulating public policy on the pension environment,
- Providing reliable information on benefits provided by government programs, and
- Introducing financial education into the school curriculum as early as possible.

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

Achieving financial literacy is a two-way street – governments/employers and employees must all take an active role in retirement education. All too often, government/employer sponsored education initiatives get disregarded by employees who have the mentality that "they can wait to save for their retirement." Employers and/or governments need to instill an appropriate sense of urgency in the workforce to save for retirement and should seek to inspire employees to take ownership of their portfolios.

Governments can play a key educational role in ensuring public education (see question 2(g)).

Employers should be encouraged (possibly through tax incentives) to engage their employees in the process as they are in the best position to capture their attention. They should be encouraged to:

- Inform employees of the pension benefits offered (or lack thereof) and provide personalized projections of benefits (or a modeling tool that allows employees to do their own projections),
- Provide financial education or direct employees to find such training,
- Make employees in DC arrangements aware of the risk that contributions directed to the plan may not be sufficient to provide adequate retirement income and must be supplemented to achieve desired retirement income objectives, and
- Conduct periodic employee surveys to assess understanding of the basic concepts of saving for retirement, and take remedial action where necessary.

2.3 Key Recommendations

- Government should continue to sponsor mandatory retirement income programs providing for a defined and adequate minimum level of income.
- Occupational pension plans should not be mandatory, but should be encouraged to effectively provide retirement income security for Canadians and for the benefit of the economy.
- Government should play an active role in educating Canadians about financial literacy and this should start with the secondary school curriculum.
- Employers should be encouraged to play an integral role in facilitating employee financial literacy education and, in particular, provide clear communication about the role that the compensation package plays, or does not play, in providing retirement income security.

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3. Pension Standards Legislation – Past, Present and Future

3.1 Background Discussion

The primary objective of any significant changes to the pension system should be to improve retirement income security for Albertans and British Columbians by increasing pension coverage. Statistics Canada reports that just 39% of paid workers in Canada were covered by a registered pension plan in 2005, which is down from 45% in 1991. Given that the Canadian workforce grew by 25% in this period, it appears that many of the new jobs that were created lack pension coverage.

The levels of pension coverage quoted above mask a significant difference between public and private sector coverage. In 2005, 80% of public sector workers participated in a DB plan, while in the private sector, the participation rate was only 20%.

Without the legislative and regulatory changes required to make them affordable and fair to all stakeholders, DB pension plans will eventually cover only a privileged few – just public sector employees and a small percentage of private sector workers who are represented by a union. And, in scenarios that are far from worst-case, Canada's social safety net might well have to undergo dramatic expansion to meet future demands, with a corresponding increase in income taxes required to support this expanded social safety net.

The lack of DB plan coverage is particularly concerning, as DB pension plans:

- Enable members to determine their retirement incomes in advance, and therefore plan appropriately for retirement,
- Free members from investment decision-making (a task for which many plan participants are not sufficiently adept),
- Substantially shield members from market risk,
- Pool the investment risk, enabling an increase in risk-taking capacity. This provides opportunity for the plan to increase the expected return on plan assets by increasing investment risk. Increasing the expected return on plan assets increases the expected pension provided by each dollar of contribution (or lowers the expected cost of providing each dollar of pension benefit),
- Assure members of lifetime retirement income as their longevity risk is taken on by the plan sponsor and is pooled with other members,

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- May protect the purchasing power of retirees through inflation-related increases, provided either automatically or on an ad hoc basis, and
- Achieve economies of scale with respect to administration costs.

The value of longevity and inflation risk protection will increase as the population ages and Canadians continue to live longer than ever before. No other retirement arrangement offers a comparable package of attractions, and it is therefore in the interest of both employers and employees that DB pension plans remain viable.

Despite the many positive features of DB pension plans, in relative terms, fewer workers in the future can look forward to the security and predictability of the DB pension promise, especially in the private sector. DB coverage has been declining, especially among corporate employees, and replaced by DC arrangements or possibly nothing at all.

In the absence of DB pension plans, we encourage the implementation of DC arrangements that effectively deliver adequate benefits and prepare participants to deal with investment, longevity and inflation risks through comprehensive disclosure, communication, education and decision-making tools.

However, we believe that DB pension plans are most effective in managing the risks faced by Canadians providing for their retirement. Plan sponsors will not embrace DB pension plans if the regulatory environment is overly restrictive, nor will members value DB plan membership if they do not have a realistic understanding of the advantages – and limitations – of DB participation. Thus, the DB pension promise (benefit and financial) must be clarified and the regulatory environment must change to reduce disincentives to sponsoring DB pension plans.

Clarifying the Pension Promise

One of the significant challenges and frustrations faced by DB plan sponsors, unions, members, pensioners and regulators is the lack of clarity and common understanding of what the true pension promise is. Plan sponsors who believed they had promised only the pension documented in the plan text have found themselves paying both the pension and surplus assets to employees upon plan windup. Pensioners who had assumed based on past practice that they were entitled to receive annual inflationary increases to their pensions, are told that the annual increases have always been provided at the discretion of the sponsor, and the sponsor has elected not to provide an increase in a given year. Much pension-related litigation has resulted from a lack of clarity and common understanding of the pension promise.

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Ideally, for each DB plan it should be clear to all stakeholders through appropriate communication:

- What the pension promise is,
- Who benefits if the plan develops a surplus, and how these benefits can be realized, and
- Who is responsible if the plan develops a deficit, and what options are available to address the deficit.

The Surplus Uncertainty Question

There is often a lack of clarity and agreement on what the true pension promise is in a DB plan. Due to the lack of clarity, there has often been a need to revert to the courts to resolve the various claims of pension stakeholders. The resulting court decisions have created a misalignment between plan funding and the pension promise.

In particular, the treatment of surplus assets has become a highly contentious issue. In most cases, plan sponsors are clearly responsible for the rapid funding of solvency deficits, but often members lay claim to any surpluses. From the perspective of sponsors, this situation creates a misalignment between the funding requirement and the pension promise (i.e., the sponsor shoulders the funding risk in the case of a deficit, but members benefit from some or all of any emerging surplus).

When establishing the "pension deal" described above, surplus, beyond a cushion, should be available to the party or parties that take on the plan's financing risk. The regulatory environment must accommodate this type of pension deal. Transition/grandfathering arrangements from current surplus ownership rules will be important, and must be addressed in legislation.

Increasing DB Pension Plan Coverage

The proportion of the Canadian workforce covered by DB pension plans is shrinking. If DB pension plans are to thrive, DB coverage must increase through the maintenance of current plans and the establishment of new plans. Increasing DB coverage will require that pension system stakeholders address current disincentives to the sponsorship of DB pension plans, such as:

- Lack of clarity concerning the pension promise,
- Uncertainty regarding surplus utilization and ownership,
- Complexity and non uniformity of pension standards legislation, and
- Financial reporting volatility revealed by pension accounting standards.

In order to achieve the objectives of clarifying the pension promise and enhancing DB coverage, all key stakeholders will need to play a part in removing the existing disincentives for DB pension plans. As key

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stakeholders, the Alberta and British Columbia Governments can play a significant role in attaining these objectives by:

- Streamlining the regulatory process, with a mandate to promote the increase in pension coverage,
- Enhancing the security of benefits, by ensuring that in almost all cases the benefit promise will be honoured, and
- Ensuring that pension legislation facilitates the alignment of plan funding with the pension promise.

3.2 Responses to Questions

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

In order to best enable plan sponsors to effectively manage their workforce, address the changing economic environment, and adapt to new investment vehicles and tax legislation changes, pension legislation must be sufficiently flexible to accommodate changing objectives and designs.

The JEPPS is conducting the first full review of the Alberta Employment Pension Plans Act (EPPA) and the British Columbia Pension Benefits Standards Act (PBSA) in two decades. Over time, issues and events emerge that were not anticipated at the time the EPPA/PBSA and their regulations were drafted. These unanticipated situations have often been dealt with through the courts.

The outcome of not fundamentally updating the pension legislation for so many years and addressing any issues through changing policies issued by the respective regulators and by recourse to the courts is akin to patchwork legislation. We recommend the following:

- The objectives of the key aspects of pension legislation should be clearly articulated. This would assist plan sponsors, regulators and courts when interpreting legislation. The EPPA and PBSA should be amended to state explicitly that the core principles (Guiding Principles) of pension legislation are increasing pension coverage and ensuring that the pension promise is clearly understood and will, in most cases, be honoured. The legislation should further state that the regulator and courts must consider these Guiding Principles when interpreting and applying the statute and its regulations.
- In order to ensure that the legislation remains current, the Alberta and British Columbia Governments should commit themselves to scheduled reviews of their respective pension legislation and related regulations, ideally every five years.
- Administrative guidance should be provided via an advance rulings service that provides binding opinions on administrative questions and proposed transactions in a timely manner. Such rulings would abide by the Guiding Principles and balance the interests of all affected stakeholders.

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

With reference to the OECD's wide-ranging list of Fifteen Principles for the Regulations of Private Occupational Pension Schemes, we believe the primary objectives of pension legislation should include:

- Protection of benefits for employees, through effective vesting, advance funding at arms length from sponsor, and adequate governance to meet fiduciary duties,
- Facilitate and encourage the expansion of pension coverage to supplement the minimum income level provided through government programs, and
- Facilitate clarification of the pension promise, raising awareness of the value of pension benefits through effective communication and disclosure requirements.

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

The Alberta and British Columbia Governments must prioritize their objectives for pension legislation. As outlined above, we feel that the primary goals for reforms to the pension legislation relate to expanding pension coverage and clarifying and securing the pension promise.

Social policy or labour market planning goals that support these primary objectives are encouraged. For example, permitting pension plans to accommodate phased retirement would provide plan sponsors with a useful tool to manage their labour force and would thereby encourage expanded pension coverage. Thus, as outlined in our response to question 5(l), we encourage the Alberta and British Columbia Governments to adopt legislation allowing plan sponsors the flexibility to offer phased retirement to their employees in a practical and administratively manageable way.

Locking-in has been hotly debated in recent years and several jurisdictions have introduced measures that relax this policy. We encourage the JEPPS to consider the merits of locking-in relative to the complexities involved in administering locked-in accounts. At a minimum, while current rules can be simplified, pension plans must, at the discretion of the plan sponsor, continue to be allowed to lock in benefits during, as well as after, employment with the participating organizations.

Other social policy goals, such as socially responsible investing, are admirable. However, pension funds should be primarily invested in a return-seeking manner (at an appropriate level of risk). Trying to achieve non-investment objectives may detract from that objective and should be carefully implemented at the discretion of plan sponsors or administrators (in particular, it should be left to the DB plan sponsor to decide if they are prepared to bear the potential higher cost that could result from placing restrictions on the universe of investments). We discourage the Alberta and British Columbia Governments from mandating

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any restriction that would add administrative or financial burden to plan sponsors and administrators. To do so would work against the primary objective of expanding pension coverage.

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

As described above, we believe that one of the primary objectives of pension legislation is to promote the expansion of the system. Most directly, the Alberta and British Columbia Governments can work to implement changes to their respective pension legislation to strive for that objective.

In addition, the respective provincial governments can work with their federal counterparts to encourage changes to the Income Tax Act that would remove barriers to the establishment of new pension plans.

Our responses in Section 5 outline in greater detail several specific changes that we believe would immediately promote the expansion of the pension system, including:

- Address the surplus uncertainty question that discourages plan sponsors from funding DB pension plans at higher levels than the statutory minima,
- Provide "safe harbours" to help protect DC arrangement sponsors and administrators from litigation from plan members as long as the plan sponsor or administrator has adhered to predetermined guidelines regarding investment options and member disclosure/communication, and
- Increase flexibility with respect to minimum funding requirements for DB pension plans, including the use of letters of credit to help secure solvency deficits and the introduction of contingency reserve accounts to promote additional benefit security.

Other changes that we believe would encourage the prevalence of pension plans are not directly within the control of the Alberta and British Columbia Governments. However, we encourage the provincial governments to urge the federal government to implement changes to the Income Tax Act, including the following:

- Increase the maximum pension and contribution limits permissible under a registered pension plan, and
- Increase the maximum permissible funding to a DB pension plan to at least 125% of the greater of going concern and windup liabilities.

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

As outlined in our responses in Section 5, we encourage British Columbia to permit the use of letters of credit to secure unfunded solvency liabilities, as has been adopted in Alberta.

In addition, we support the adoption of the following aspects of pension legislation from other jurisdictions:

- Phased retirement (federal jurisdiction),
- Elimination of partial plan terminations (Quebec),
- Simplified pension plans (Quebec), and
- Absence of successor plan rules (Quebec).

3.3 Key Recommendations

- Legislative reforms should primarily focus on clarifying and securing the pension promise and expanding pension coverage, highlighting the merits of the DB pension plan and the importance of education of participants in DC arrangements.
- The regulatory process should be streamlined, including introduction of guiding principles, an advance ruling service, and scheduled reviews every five years.
- The regulators should revisit and confirm its administration of the "financial promise" in pension plans and align the associated funding with the pension benefit promise (i.e., clarifying the pension promise and ensuring that the promise will be met almost all of the time).

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4. Broad Pension Policy Issues

4.1 Background Discussion

The complexity of Canada's multi-jurisdictional approach to regulating pension plans has often been cited as a major contributing factor to the decline in pension coverage. Some of the implications of the current approach include the following:

- Administrators must remain current on differences in legislation, policy guidelines and disclosure requirements,
- Variations in regulations contribute to member confusion and raise the potential for administrative errors by administrators and financial institutions,
- Plan sponsors with members in multiple jurisdictions are subject to additional costs, and
- Conflicts can arise between jurisdictions in respect of certain transactions (mergers, acquisitions, wind ups).

We encourage the JEPPS to review alternatives that result in a regulatory approach that is clear, simple and flexible, has a minimum regulatory burden, and does not compromise member protection. To that end, we would also encourage the JEPPS to pursue regulatory changes for consistency (e.g., locking in, governance) with the different vehicles used for retirement savings (e.g., RRSP, DPSP, etc.).

While harmonization of pension standards would be a significant first step, we also encourage the JEPPS to consider the benefits of having one national supervisory authority with responsibility to administer regulations delegated to it by participating jurisdictions.

4.2 Responses to Questions

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

Harmonization of Alberta and British Columbia pension standards, and establishing one supervisory agency to administer those standards, would be beneficial for the following reasons:

- Reduction in administration costs,
- Consistent application of common standards,
- Lead the charge for broader acceptance of harmonized pension standards across Canada, and
- Create a collective voice to influence change; for example, in areas where federal and/or provincial rules are working at cross purposes.

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We are supportive of a goal to establish a harmonized stream-lined pension system, across the country, which supports and encourages the establishment and continuation of pension plans. A divergent approach from other pension regimes may further fragment pension regulation in Canada.

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

Harmonization across Canada is a desirable objective that we believe is unlikely attainable in the near future. However, Alberta and British Columbia's joint approach to this review may provide a model for seeking solutions in a cooperative manner.

To evolve in that direction, we recommend that:

- Canadian jurisdictions, preferably in concert, continue to work towards the development of a common law,
- Each jurisdiction enact legislation adopting the common law, specifying particular areas where, after careful consideration, it is deemed necessary to deviate from the common law, and
- Create a national supervisory authority delegated to administer the regulations of partnering jurisdictions where full regulatory harmonization has been achieved.

While perfect uniformity may not be immediately achieved in this manner, we would expect to see a narrowing of differences between jurisdictions.

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

We encourage the provinces to cautiously review the evolving approach to securities legislation to determine what, if any, is transferable to the regulation of pension plans.

As we understand principles-based legislation, general continually improving high-level standards would be established by developing best practices for the maintenance of pension plans. This process engages the regulator and the regulated in a discussion or negotiation in the design of the relevant principles that should be followed. Senior management of the regulated plan sponsor, plan administrator or board of trustees, would have increased responsibility for adopting acceptable practices and introducing controls to ensure adherence to those practices.

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We anticipate that the pension regulator's role under principles-based legislation would be more difficult and require materially more resources:

- More extensive audits of the operation of pension plans,
- More difficult to confirm compliance with more subjective guidelines that are open to widely differing opinions,
- More difficult to bring a reluctant plan sponsor/administrator into compliance, potentially requiring legal action by the regulator and/or plan members, and
- More ongoing interaction with all plan sponsors/administrators to identify and adopt revised best practice principles, and convincing them of the merits of adoption.

We encourage continuation of the current Canadian approach whereby investment rules follow a principles-based prudent person standard but otherwise incorporate rules-based legislation providing clear and explicit rules with scheduled reviews every five years. However, if the legislation/regulations outlined the principles intended by its various components, with a range of acceptable results, additional context would be given to plan administrators (and the courts in the event of litigation).

As a minimum, we expect that rules-based standards will continue to be necessary for DB pension plans due to the complexities of minimum funding and disclosure.

DC arrangements may be well suited for the application of principles-based legislation whereby guidelines replace current rules that are force-fit into a framework meant primarily for the regulation of DB pension plans. However, to encourage the extent of communication and education needed by plan members, such principles-based legislation should be accompanied by "safe harbour" protection for plan sponsors, administrators and financial institutions.

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

The key question should be what are the related risks to be defined and managed? In pension governance there are many risks to both the administrator and the members. In our experience, plan sponsors and administrators, often with the help of advisors, have spent considerable effort to review and comply voluntarily with guidelines. However, plan sponsors and administrators should have sufficient flexibility to develop governance models that reflect their own unique circumstances, needs and risk tolerances.

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We support the continuance of guidelines, periodically updated as appropriate, by the Canadian Association of Pension Supervisory Authorities (CAPSA) with the concurrence of all of the pension regulators. We would not encourage individual pension regimes to make the leap from guidelines to statutory provisions.

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

The costs for regulating occupational pension plans should be derived from the plans under supervision on a cost-recovery basis. We suggest that the regulators develop a costing model that calculates and verifies the costs of discrete activities across the system, to accurately determine costs to be recovered through User Fees and General Assessments on a sector-by-sector basis, recognizing that large swings in year-to-year fees should be avoided.

Regulators must be accountable for fees collected and must demonstrate that the fees are appropriate vis-à-vis the services provided. Reference should be made to the federal Financial Administration Act, which embodies these principles. If disclosure in public accounts is deemed insufficient, regulators should report to a council with representation from the pension industry.

Regulatory costs should be kept at a low level. Accordingly, regulators should focus on key issues and reduce/eliminate low value activities (e.g., collecting unnecessary information).

Regulators should separately consider the appropriate recovery of costs incurred to promote expansion of occupational plans, for the betterment of the Canadian economy and social programs.

4.3 Key Recommendations

- All Canadian jurisdictions should continue to work together toward the development of one common law for pension standards. Each jurisdiction would adopt the common law subject to any specific exceptions where material deviation is deemed necessary.
- A national supervisory authority should be established to administer the pension standards for those jurisdictions that elect to delegate such responsibility to this organization.
- The current Canadian blend of principles-based investment rules and rules-based legislation is preferred for its ability to provide DB administrators and regulators with clear guidance for compliance.
- Pension administrators, and the courts, would benefit from the context provided by legislation that includes principles that outline the intent to be promoted by different components of the pension standards.
- Plan sponsors and administrators should continue to have the flexibility to develop governance models that reflect their unique circumstances and take into account guidelines promulgated by CAPSA with the concurrence of each jurisdiction.

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- The specific costs to regulate occupational pension plans should be managed responsibly and should be fully recovered from the plans that are subject to supervision.

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5. Specific Elements of the Standards

5.1 Background Discussion

One of the main purposes of pension standards is to establish funding rules to provide reasonable assurance that members' pension promises will be honoured by advance funding outside the reach of the plan sponsor and its creditors. Due to concerns about the lack of alignment, for DB pension plans, between funding rules and the benefit promise, many plan sponsors are funding at minimum levels, which may jeopardize benefit security and increase the volatility of contributions.

A DB plan's solvency position does not have to be volatile. What creates volatility is investing plan assets in equities or equity-like investments when liabilities inherently behave like nominal or real return bonds. Pension funds invest in equities to seek the additional return that is frequently required in order to make the plan affordable at existing benefit levels. This additional expected return comes with a price, however, greater uncertainty in the ultimate cost.

The effect of volatile equity returns on pension plans has been reasonably well understood – not welcome, but understood. To mitigate this effect, larger plans have been moving to diversify some of their conventional stock market exposure through alternative investment strategies, private equity and infrastructure.

The effect of falling bond yields was not well understood by many plan sponsors before the pension world's "perfect storm" a few years ago, when poor investment returns and a low interest rate environment converged to cause many DB pension plans to experience record-low solvency funding levels and, thus, record high minimum funding contribution requirements. Plan sponsors now have a much better understanding of the impact of duration mismatch in the fixed income portfolio and of the financial risk that comes with investing in non-matching assets; many larger plans have now taken conscious steps to mitigate these risks. We note, however, that there is no practical way for pension plans to fully hedge inflation risk. While the real return bonds of the Government of Canada and other issuers provide a hedge against price inflation risk, they are not a practical tool on a macro level because of their limited supply and do not hedge the wage inflation risk.

Based on recent research that we conducted, a typical plan's asset-liability mismatch has a roughly 10% probability of causing a change in going concern position over a three-year period of ± 25% or more. The windup position exhibits even greater volatility. This illustrates that the funding limits in the federal Income Tax Act and regulations (the greater of 110% of the going concern liabilities and 100% of the windup liabilities) is too low and should be increased in order to enable reasonable assurance of plan solvency.

Our recommendations below regarding minimum funding requirements aim at addressing the need to ensure solvency in a volatile economy.

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Minimum Funding Requirements

The statutory focus of minimum funding should be benefit security now and in the future. This implies:

- A forward-looking view. For example, the standard might be an 80% probability that the plan will be fully solvent five years from now.
- Investment policy should be reflected in determining the minimum funding requirement so that asset-liability mismatch risk is considered, albeit in a simplified manner. For example, target funding levels should be higher for plans with large mismatches between assets and liabilities than for plans with small mismatches.
- The minimum funding requirement should not be dependent on the sponsor's financial strength. When minimum contributions are based on financial strength, concessions granted to a once-strong company could accelerate a slide into bankruptcy when those concessions are removed and the now-weakened sponsor must assume the burden of the additional contributions required.
- Regulatory powers to address funding concerns, such as accelerating the timing of the next actuarial valuation, should be limited and clearly detailed in legislation so that a sponsor knows what to expect.

If sponsor concerns about the lack of alignment between funding rules and the pension promise (e.g., the access to surplus issues discussed below) are resolved, the need for additional security should be met through additional contributions to the pension fund. However, letters of credit (LoCs) and contingency reserve accounts (described further below) should be made available to provide funding flexibility. In the event that the above issues are not resolved, their availability to DB plan sponsors would be mandatory.

LoC issuance and pricing reflect changing business circumstances and the use of LoCs – already sanctioned by the federal regulator, Alberta and Quebec – recognizes that financial institutions can do a better job of assessing a sponsor's financial strength than inflexible legislation/regulation.

Contingency Reserve Account

The contingency reserve account referred to above would be a new form of rainy day cushion. Contributions required under the going concern valuation would be paid to the pension fund. Further contributions required under the solvency valuation would be paid to a special purpose trust. This contingency reserve would be tax-sheltered, held separate from the sponsor's assets and protected from non-pension creditors. Contingency reserve assets not required to meet benefit obligations on plan windup would revert to the sponsor. For an ongoing plan, the sponsor would be allowed access to the contingency reserve if the total assets of the pension fund and this reserve exceed a reasonable margin of safety that reflects the degree of mismatch between plan assets and liabilities.

The reserve could also hold voluntary contributions that would better enable sponsors to match funding to their business cycles and thereby decrease contribution volatility.

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To provide enough room to seed and maintain these trusts, Alberta and British Columbia should seek federal tax changes raising allowable funding limits for DB pension plans from the current maximum of the greater of 110% of going concern liabilities and 100% of windup liabilities. The determination of the increased funding thresholds could be based on an analysis of the volatility of a typical pension plan's funded ratios. Based on the research mentioned above, we believe that the funding maxima should be raised to roughly 125% of the greater of the going concern liabilities and windup liabilities.

In the event of a full windup, obligations would first be charged to the pension fund and then, as required, to the contingency reserve account. If money remains in the pension fund after all obligations are met, it would be distributed as under the current regime. Contingency reserve account assets not required to meet obligations would be returned to the sponsor. If the combined assets of the pension fund and contingency reserve account are not sufficient to meet obligations, the shortfall would be addressed as under the current regime, except that all sponsor contributions made after the windup date to address a windup shortfall would be made to the contingency reserve.

If the issue of surplus ownership is not clarified and made more commensurate with the pension risk, DB plan sponsors will naturally continue minimum funding policies that reduce the likelihood of a large surplus developing. While reducing the likelihood of a surplus, minimum funding also reduces benefit security and may increase contribution volatility. As described above, the use of LoCs and contingency reserve accounts should be made available. In the event that surplus issues are not resolved, these vehicles will become more important as a cost-effective way to secure the pension promise. Otherwise, faced with escalating financial liabilities, corporate-sponsored DB pension plans will likely continue to disappear, and with them, the retirement income security of ever more Canadians.

5.2 Responses to Questions

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

As long as a DB plan sponsor continues as a financially viable entity, benefit security need not be a concern to plan members or regulators, as additional funding is readily available. It is only in the event of the plan sponsor's bankruptcy that any potential arises that the benefits promised may not be available to members. Accordingly, from a benefit security perspective, the solvency valuation is most essential and thus minimum funding rules should focus on solvency funding.

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However, given a solvency valuation's traditional point-in-time representation of a plan's financial position, we recommend that a stochastic, probability-based approach be adopted. Such a methodology would better accommodate a forward-looking approach to solvency funding. Such an approach would require, for example, that an actuary certify that the plan's minimum funding requirements will provide an 80% probability that the plan is fully funded within five years. A simplified alternative may be necessary for smaller plans.

Notwithstanding the focus on the solvency valuation, we support funding policies that continue to use going concern valuations, given their longer-term focus. Further, because the significant majority of pension plans will not be terminated in any given mid-term period, we recommend that a DB plan sponsor's primary funding focus be the going concern valuation. Any additional funding required to satisfy solvency funding requirements would be remitted to the contingency reserve account.

This balanced approach ensures that the level of benefit security provided under the current pension system is maintained or enhanced, while the surplus uncertainty question is addressed.

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

The minimum funding standards should be independent of the financial health of the employer sponsoring the DB plan. If minimum funding standards were to be based on a plan sponsor's financial strength, concessions granted to a once-strong company could accelerate a slide into bankruptcy when those concessions are eliminated and the now-weakened sponsor must assume the burden of additional funding contributions.

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

We support minimum funding rules taking account of the risk profile of the plan. The stochastic approach to solvency valuations would accomplish this objective. Because of the volatility of a plan's funded position associated with a mismatch between assets and liabilities, the required contributions to achieve full funding within five years with, say, 80% probability would be greater for plans with a greater mismatch. Conversely, plans with little mismatch between their assets and liabilities would experience a corresponding decrease in the minimum funding requirements.

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

As a result of several factors, not the least of which is the surplus uncertainty question, most DB plan sponsors elect to fund at the statutory minimum levels. Accordingly, until the surplus uncertainty question is addressed, it is highly unlikely that plan sponsors would adopt a funding policy requiring funding in excess of the statutory minima.

Assuming the surplus uncertainty question was addressed, we encourage all plan sponsors to adopt a funding policy. However, we oppose such document becoming mandated by legislation.

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

In order to best support the objective of expanding pension coverage for Canadians, pension legislation needs to be sufficiently flexible to accommodate a wide variety of plan types. The existing legislation was drafted at a time when traditional DB pension plans were the norm. When DC arrangements gained popularity, the legislation was updated somewhat to accommodate the new plan type.

However, the legislation needs to be realigned to ensure that new models of pension plans are supported. In addition to the following example, consideration should be given to new risk-sharing arrangements with plan members and the particular differences for certain public-sector pension plans (e.g., application of solvency rules).

New multi-employer pension plan (MEPP)

Both government policy and legislation should encourage the adoption of a new form of MEPP. This type of arrangement should:

- Be open to many employers in different industries,
- Have an expert board of trustees that would set investment policy and overall contribution rates,
- Have each employer decide how it will split the contribution requirement with its employees,
- Design the plan to avoid any potential for subsidies between employers based on factors within their control,

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- Be designed and financed so as to best achieve equity between different generations of members and employers, and

- Pool longevity and investment risks, but no others.

The Canada and Quebec Pension Plans offer a design template, but other designs are also possible. In order to provide sufficient scale, such a plan would likely need to be sponsored by the government, or a large financial institution. Centralized administration, investment, and communication functions would enable participation by small employers.

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

As outlined in our preamble to this section 5, we believe a two-pronged approach is necessary to maintain (or enhance) the current levels of benefit security while, at the same time, addressing the surplus uncertainty question:

Letters of credit

As has already been adopted in Alberta, if pension standards were to permit plan sponsors to obtain letters of credit to secure the amount they would otherwise need to fund to liquidate the plan's solvency deficiency, plan sponsors would have additional flexibility in managing the funding of their DB pension plans. At the same time, the security of benefits would not be negatively affected.

While this alternative provides a suitable short-term solution in some situations, the additional cost of securing the letter of credit and the strain it could place on the ability of certain sponsors to borrow for other purposes may prevent it from being a viable longer-term alternative for some sponsors. In addition, permitting letters of credit in of itself would not encourage any improvement in the security of members' benefits; it would simply provide additional flexibility to plan sponsors while maintaining current levels of security.

To ensure that longer-term flexibility is readily available to plan sponsors, and to encourage plan sponsors to improve benefit security, another alternative is necessary.

Contingency Reserve Accounts

A complementary approach involves the use of contingency reserve accounts. Because these contingency reserve accounts would not be subject to trust law, the concerns over the surplus uncertainty question may be addressed, at least partially. Further, as this approach would not diminish the actual minimum funding requirements for any plan sponsor, benefit security would be maintained.

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In fact, by partially addressing the surplus uncertainty question, it seems likely that plan sponsors would be far less reluctant to remit additional contributions beyond the statutory minima, thus leading to improved benefit security.

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

The long-term volatility of required funding contributions may be mitigated through the development of asset management strategies that are more directly linked to liability management. Many plan sponsors elect to absorb the additional financial risk in order to achieve expected higher long-term investment returns and make the plans more affordable in the long term. What is of paramount importance is not necessarily the smoothing of long-term contribution volatility, but rather the provision of sufficient funding flexibility to permit plan sponsors to accommodate the volatility effectively within their business cycles. Addressing the surplus uncertainty question will also permit plan sponsors to manage this issue more effectively by permitting them to build buffers against adverse events (without worrying that the funds will ultimately be lost to them).

We believe that such flexibility should be provided through the provisions described in our response to question 5(f) – letters of credit and contingency reserve accounts.

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

The investment environment is continuously evolving. Many sound investment vehicles and products that were unheard of ten years ago are now readily available. Pension legislation must be sufficiently flexible to accommodate this evolution. It would be impractical for a rules-based investment system to be fluid enough to remain up-to-date. Accordingly, we recommend that a principles-based approach be taken, with the "prudent person" philosophy at the core. We note that virtually all developed countries have moved in this direction.

We further recommend that the quantitative limits incorporated with the current investment rules be eliminated. Such limits are unnecessary in a "prudent person" environment, and they limit pension plan sponsors' ability to benefit from the evolving investment markets.

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

Required Margin of Surplus

Under the British Columbia pension legislation, plan sponsors are required to maintain a margin of 5% of going concern liabilities before any surplus assets may be used to offset required contributions. As long as

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the surplus uncertainty question inherent in the current pension system continues to exist, we oppose any requirement that leads to the development and maintenance of actuarial surplus.

Payment of Windup Expenses

British Columbia pension legislation prohibits a plan from paying expenses associated with its windup from its assets unless the plan sponsor is bankrupt or ceases to exist. No other jurisdiction in Canada has such restriction in its pension legislation. The PBSA offers no relief from this restriction even where the windup valuation reveals a plan surplus. We recommend that plans be permitted to pay windup expenses from its assets. Under pension legislation, expenses related to the administration of a plan windup should not be treated differently from expenses for administering an ongoing plan. We note that any solvency deficiency upon plan windup reflects estimated windup expenses and is required to be paid by the plan sponsor under the PBSA. The maintenance of the above restriction amplifies the surplus uncertainty question.

Limitations on C/QPP Offset

DB pension plans may elect to integrate their benefit accrual formula with C/QPP benefits. While some DB plans elect to do so implicitly by establishing a step-rate accrual formula linked to the Year's Maximum Pensionable Earnings (YMPE, the maximum earnings level considered for C/QPP benefit accrual), others integrate explicitly by reducing the ultimate plan benefit payable by a C/QPP benefit estimate.

The PBSA requires that in this latter situation, the amount of the C/QPP offset may not exceed the actual amount of the member's C/QPP benefit (the EPPA integration restriction is not clear as to the determination of the C/QPP benefit for the purposes of the restriction). This has proven to be unworkable, because the plan administrator does not know the amount of C/QPP benefit actually payable to the member; such a benefit is ultimately based on a variety of factors, including years of employment in Canada and historical earnings, much of which may have been earned with prior employers. Moreover, it could produce inappropriate results: for example, if the member retires at age 60 and elects to receive immediately a reduced C/QPP benefit, it would be unreasonable to establish the maximum integration based on the reduced C/QPP benefit. The C/QPP benefit used to determine the integration under the plan must not be affected by the member's decision as to when he/she starts to receive C/QPP benefits.

We recommend that this restriction be amended to be based on the maximum benefit payable under the C/QPP to a person who has attained the age where the pension is not reduced (currently age 65), rather that the member's actual C/QPP benefit.

Even though many integrated plans adjust the C/QPP integration amount when the member's earnings are less than the YMPE, we suggest not mandating such an adjustment. We prefer that this be left at the plan's discretion. We observe that establishing a mandated earnings adjustment mechanism that would accommodate all pension formulae of affected plans could represent a significant challenge.

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

As previously stated, one of the primary objectives of pension legislation should be to clarify the pension promise. For DB pension plans, this clarification should focus on the treatment of pension surpluses and deficits:

- Who benefits if the plan develops a surplus, and how are these benefits realized?
- Who is responsible if the plan develops a deficit, and what options are available to address the deficit?
- What is the possibility of a deficit developing, taking into account the plan sponsor's funding and investments policies?

We recommend that responses to these questions be clearly outlined in member communication.

For DC arrangements, the pension promise is of a different nature. The focus of the pension promise for DC arrangements should be on the plan sponsor's role in providing retirement income. Accordingly, we recommend that the following information be added to the annual disclosure requirements for DC arrangements:

- Estimated retirement income that could be provided commencing at age 65, with the member's current account balance,
- The estimated replacement ratio (expressed as a percentage of pre-retirement income) that the pension determined above represents, and
- The estimated contribution rate (expressed as a percentage of pay) required to increase the estimated replacement ratio outlined above to some predetermined level (e.g., 50%).

As an alternative to providing this information in annual pension disclosure, plan sponsors should be permitted to provide members with access to pension modeling tools that can produce the same, or similar, information.

However, to ensure that these recommended additional disclosure requirements not create additional litigation risk for plan sponsors and administrators, it is essential that any such changes be accompanied by "safe harbour" protection for plan sponsors, administrators and financial institutions, as outlined in greater detail in our response to question 5(k).

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

While DC arrangements do not suffer from many of the same deterrents inherent in DB pension plans, they do generate their own unique risks for plan sponsors and administrators. One of the primary risks of DC arrangements is that of litigation from plan members and former plan members. In order to most effectively expand pension coverage, plan sponsors and administrators must be provided with some level of protection against certain types of litigation.

We note that the concept of "safe harbour" is not intended to provide a defense against all claims of breach of fiduciary duty in common law, trust law or contract law. Rather, the proposed "safe harbour" is to provide a defense to a claim of breach of statutory duty.

We recommend that protection should be given to plan sponsors and administrators where:

- Compliance with pension legislation has been demonstrated, or
- The claimant has failed to demonstrate non-compliance.

It is only through the provision of such "safe harbour" protection that the mandating of current governance recommendations outlined in the Capital Accumulation Plan Guidelines could be considered acceptable.

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

In order for phased retirement programs to be viable to plan sponsors and members alike, the following criteria must be met:

- Pension plans must be permitted to pay phased retirement benefits without regard to a reduction in work schedule.
- Pension plans must be permitted to offer phased retirement to members who meet the plan's eligibility for retirement. Many plan members have substantial early retirement subsidies available to them under their DB plan with no way to access the value of these subsidies other than to leave their current employer. This is very disadvantageous for employers who wish to retain valuable employees.
- Phased retirement programs must not be a right for plan members. Rather, they must be the result of an agreement between a member and the plan sponsor. Some plan sponsors may offer phased retirement programs on a time limited basis similar to early retirement windows. Some may target specific employees or groups of employees.

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Allowing this degree of flexibility in DB pension plans would help revitalize the DB pension system. If legislation were to permit active employees to receive benefits any time after they meet the plan's eligibility for retirement, DB pension plans would become more meaningful and attractive to employees and would make them a more powerful tool for plan sponsors addressing future workforce needs.

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

In our response to question 3(a), we highlighted the need for pension legislation to be sufficiently flexible to accommodate changing objectives and designs. Not offering such flexibility will impede the objective of expanding pension coverage. In general, we recommend that the legislation be adaptable in order to accommodate the continuously-evolving arena of pension plan design. In particular, below we describe an alternative plan design that should be accommodated within the legislation.

Target benefit plan

This is an alternative approach in which legislation would allow a sponsor to offer a plan in which it commits to make fixed contributions aimed at funding a target retirement income, but does not guarantee that the target level will be delivered. Ancillary benefits and accrued benefits could be reduced or member contributions may increase in the event of adverse experience – a risk that must be clearly communicated to plan members. This type of plan would operate under rules appropriate to MEPPs, but would not require the involvement of multiple employers or necessarily be subject to a collective agreement. As risk is borne by the membership, intergenerational equity would again be an important objective for such plans. This approach is similar to member-funded plans in Quebec.

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

Throughout this submission, we have outlined several ways in which the current pension legislation must be changed to ensure the future viability of pension plans – especially DB pension plans. These changes are essential to ensure the continuing viability of such arrangements, with the objective of expanding pension coverage. Our recommendations have, in general, focused on high-level changes required to generate a fundamental shift in the decrease in pension coverage. However, below we have identified several specific elements of the current legislation that should be eliminated or amended.

Multiple-Jurisdictional Coverage

In today's mobile workforce, it is not uncommon for an employee to have worked in multiple jurisdictions throughout their career. In many instances, this mobility may be experienced while a member of a single pension plan. The next generation of pension legislation should clearly specify the jurisdiction for which legislation should apply. In order to avoid excessive administrative burden, we recommend that the legislation for the jurisdiction of final employment be adopted.

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Retroactive Plan Amendments Affecting Ancillary Benefits

In order to encourage the expansion of the pension system, plan sponsors must be provided with sufficient flexibility to modify their pension plans to adjust for changing economic and demographic environments. The next generation of pension legislation should clearly permit plan sponsors to make retroactive plan changes to benefit provisions not directly related to the benefit accrual rate, including:

- Permitting plan sponsors to freeze accrued pension benefits based on the final average earnings in effect on the date of adoption of such an amendment.

- Permitting plan sponsors to reduce or eliminate early retirement subsidies for members who have not yet met the eligibility requirements for early retirement. (This requirement will be essential if plan sponsors are to be able to use pension plans as a tool for managing their workforce in the current environment of the ageing workforce and the resulting labour shortages.)

Successor Plan Rules

The next generation of pension legislation should eliminate the successor plan rules, as the current rules impede a plan sponsor's ability to effectively manage their pension plans.

Transfer on Termination of DC Plan Membership

Under current pension legislation in British Columbia, if a DC plan member terminates employment, the plan may only force the member to transfer their account value out of the plan when the balance is less than a specified minimum amount or when the member is not eligible for an immediate pension irrespective of the amount accumulated under the DC provision. We recommend that DC plans be permitted to force terminated members to transfer their account balance to a separate vehicle with no limitations based on the value of the member's DC account nor limitations based on eligibility for an immediate pension. Restrictions on forcing out monies by terminating DC plan members are a significant factor in employers turning to retirement saving vehicles other than registered pension plans. The abolition of such restrictions will be a step toward increased coverage under the registered pension plan regime.

Pension Division on Marriage Breakdown

When a member of a DB pension plan undergoes a marriage breakdown, their former spouse may be able to claim entitlement to a portion of the member's benefit entitlement. The treatment of pension benefits on marriage breakdown is governed, not by pension legislation, but by the Family Relations Act (British Columbia) and the Matrimonial Property Act (Alberta). However, neither of these acts was intended to address the complexities associated with the division of defined benefit pension entitlements. Accordingly,

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the legislation is unclear and incomplete. We recommend that the provincial pension legislation be amended to explicitly address the treatment of pension on marriage breakdown.

In addition, the legislations require that, in certain circumstances in Alberta and in all circumstances in British Columbia, the settlement of the former spouse's benefit entitlement be deferred until the earlier of the date the plan member terminates employment or the earliest date at which the member may elect to retire in accordance with the plan's provisions. This approach is known as a deferred settlement approach.

We recommend that an immediate settlement approach should be available to plan administrators in all circumstances. This would simplify the burden placed on plan administrators who must otherwise maintain records for both the member and their former spouse. This would also allow the former spouse to make retirement planning decisions independently of the member's decisions about retirement or termination of employment. Similarly, there would be less uncertainty for the member as to the effect of the pension division on his/her future retirement benefits.

Acceptable Classes of Employment for Eligibility

We encourage the British Columbia regulator to consider the recent changes made to the EPPA that permits plan sponsors more flexibility in delivering pension benefits in cases of merger or acquisition. The EPPA provides that the Superintendent, upon written application by the plan administrator, may designate a class of employees that is considered identifiable and appropriate for categorization as a class. This change permits the exclusion of employees who might have otherwise been eligible to participate after a specified date.

5.3 Key Recommendations

- The current regime of pension standards has resulted in DB pension plan sponsors following a minimum contribution funding policy, placing the benefit security of current and future pensioners at risk. To address the surplus uncertainty question, to encourage expanded coverage in DB pension plans and to enhance benefit security, additional funding flexibility must be provided by permitting the use of:
  - Letters of credit to conditionally fund solvency deficits, and
  - Separate contingency reserve accounts.
- Regulatory minimum funding rules should focus on solvency liabilities using a forward-looking, probability-based approach.
- Plan sponsors should continue to follow sound actuarial principles in establishing their funding policies with a going-concern perspective, taking into account an appropriate assessment of any short-term risk of plan

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termination and the mismatch in duration between assets and liabilities. Such funding policies should be an integral component of a plan's governance process and, as such, should not be a regulatory requirement.

- Pension standards need to be sufficiently flexible to accommodate new plan designs and different models developed for the efficient delivery of retirement income security in an environment experiencing a significant demographic shift and recognizing that many Canadians may approach retirement with inadequate savings.
- Pension standards must be sufficiently flexible to accommodate a continuously evolving investment environment while continuing to use a principles-based approach and the prudent person philosophy.
- Disclosure requirements for DB pension plans should serve to clarify the pension promise and benefit security risks.
- Disclosure requirements for DC arrangements should be enhanced to provide members a better understanding of the income they can expect to receive from their account balances and future contributions.
- Plan sponsors, administrators and financial institutions should be provided safe harbour protection in some form to encourage enhanced disclosures under DC arrangements and to improve financial literacy education.
- Pension standards must be reviewed with an eye to accommodating phased retirement with optimum flexibility to satisfy probable phased retirement designs.
- We have suggested a number of changes to the pension standards in our answers above to questions 5(i) and 5(n).

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6. Related Legal Frameworks

6.1 Background Discussion

In reviewing the pension legislation, we encourage the JEPPS to consider the following related legal frameworks:

- Income Tax Act,
- Matrimonial Property Acts,
- Employments standards, and
- Common trust law and its conflicts with the pension plan as a component of the employment contract.

6.2 Responses to Questions

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

Current federal tax rules are a substantial barrier to development of new types of pension plans (e.g., cash balance, member-funded) and structures (e.g., jointly-funded, multi-sponsor) and unnecessarily link pension accrual to employment.

Provincial governments should, perhaps through organizations such as CAPSA, encourage the federal government to update the pension tax regime.

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

By definition, federal tax rules and provincial standards work at cross-purposes, but cases where conflicts are insurmountable are rare and can often be accommodated by Ministerial intervention. Areas where conflicts occur include:

- Tax rules restricting contributions:
  - Excess surplus threshold may be set inappropriately low, and
  - In jointly-funded plans (often government sponsored) the plan members' assigned share of the costs may exceed the limits on employee contributions, and
- Tax rules imposing a limit on the maximum amount transferable on a tax-deferred basis:
  - Lump sum values may exceed limit primarily due to current economic environment.

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We encourage the Alberta and British Columbia collective voice to influence change by lobbying the federal tax authorities to:

- Raise the limit on excess surplus,
- Remove the maximum transfer limit, and
- Facilitate the introduction of contingency reserve accounts.

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

Trust law, which is within provincial jurisdiction, has created significant problems for pension plans, which are currently subject to a mix of sometimes-conflicting statutory and common law requirements.

Pension plans should be subject to a purely statutory regime.

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

Legislators can and should address this issue by amending pension standards legislation to create a comprehensive statutory regime for pension trusts that supersedes the common law of trusts.

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

See question 6(d).

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

The weight of historical and arguably defunct plan and trust documentation is an albatross weighing on pension plans that creates uncertainty about member and sponsor rights and increases plan sponsor costs. Legislation should specifically provide that current, validly executed plan and trust documents supersede historical documents to the extent of any inconsistency.

6.3 Key Recommendations

- To encourage expanded pension coverage in Canada, governments at all levels need to recognize the primacy of pension standards in promoting and protecting the retirement income security of many Canadians and to influence change in related legal frameworks that work in harmony toward achieving this important goal.

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7. About Towers Perrin

Towers Perrin is a global professional services firm that helps organizations to optimize performance through effective people, risk and financial management. With more than 70 offices in 26 countries around the world, Towers Perrin has the people, expertise and presence to provide innovative solutions to client issues in the areas of human resource consulting, actuarial and administration services, management and actuarial consulting to the financial services industry, and reinsurance intermediary services.

Incorporated in its present form as Towers, Perrin, Forster & Crosby, Inc. in 1934, Towers Perrin traces its roots through predecessor firms back to 1871. We have provided services to Canadian organizations since 1938; we opened our first Canadian office in Montreal in 1956, followed by Toronto in 1960, Vancouver in 1973, and Calgary in 1980. Today, Towers Perrin is one of the world's largest HR consulting firms, with annual revenues of about $1.5 billion.

We serve clients through two wholly-owned business units: Towers Perrin Human Capital Services, and Towers Perrin Risk & Financial Services. Retirement consulting is the largest practice in our Human Capital Services unit and represents nearly two-thirds of its annual revenues in Canada.

Towers Perrin is privately-held and wholly owned by a group of active employees (Principals) who are stockholders in the firm.

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TOWERS PERRIN

HR SERVICES

October 12, 2007

Mr. Harry Arthurs
Commissioner
Expert Commission on Pensions
PO Box 102
777 Bay Street
Toronto, Ontario
M5G 2C8

Dear Mr. Commissioner:

SUBMISSION OF TOWERS PERRIN TO THE EXPERT COMMISSION ON PENSIONS

We are pleased to enclose Towers Perrin's submission to the Ontario Expert Commission on Pensions. We look forward to discussing our submission with you on November 7th.

Sincerely,

Gavin Benjamin
Principal
Direct Dial: 416 960-7419

Steve Bonnar
Principal
Direct Dial: 416 960-2735

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Submission of Towers Perrin to the Expert Commission on Pensions

October 12, 2007

TOWERS
PERRIN
HR SERVICES

Introduction

We thank you for the opportunity to make this submission to the Ontario Expert Commission on Pensions (OECP) on behalf of Towers Perrin.

"Ontarians are entitled to pension legislation that is fair and up to date. This review will ensure that plan members and pensioners know that their contributions are protected by a modern set of rules."

-- Minister of Finance Greg Sorbara, Nov. 9, 2006

Towers Perrin shares the view expressed by Minister Sorbara when he announced the creation of the OECP – that Ontarians are entitled to legislation that is "fair and up to date." The OECP's mandate is focused on defined benefit (DB) pension plans. These plans represent a significant portion of retirement income for many active and retired employees, and can be of significant assistance to employers in attracting, retaining and managing their workforce. They should be preserved as a viable, affordable option in promoting and facilitating retirement savings.

The OECP's guiding principles highlight the need to encourage the DB system and safeguard the security of pension benefits while balancing the rights and obligations of members and plan sponsors. With this in mind, we welcome the opportunity to offer observations and suggestions aimed at updating the system to make it fair, effective and affordable.

Objectives of changes to DB system

(Addresses Discussion Paper questions 1.4, 3.3, 4.1 and 4.4.)

The primary objective of any significant changes to the DB pension system should be to improve retirement income security for Ontarians by increasing DB pension coverage. DB pension plans will not be embraced by plan sponsors if the regulatory environment is hostile, nor will members value DB plan membership if they do not have a realistic understanding of the advantages -- and limitations -- of DB participation. Thus, the DB pension promise must be clarified and the regulatory environment must change to reduce disincentives to sponsoring DB pension plans.

1. Clarifying the pension promise

   One of the significant challenges and frustrations faced by DB plan sponsors, unions, members, pensioners and regulators is the lack of clarity and common understanding of what is the true pension promise. Plan sponsors who believed they had promised only the pension documented in the plan text have found themselves paying both the pension and surplus assets to employees upon partial windup. Pensioners who had assumed based on past practice that they were entitled to receive annual inflationary increases to their pensions, are told that the annual increases have always been provided at the discretion of the sponsor, and the sponsor has elected not to provide an increase in a given year. Much pension-related litigation has resulted from a lack of clarity and common understanding of the pension promise.

Ideally, for each DB plan it should be clear to all stakeholders through appropriate communication:

- What the pension promise is.
- Who benefits if the plan develops a surplus, and how these benefits can be realized.
- Who is responsible if the plan develops a deficit, and what options are available to address the deficit.

2. Increasing DB Coverage

The proportion of the Canadian workforce covered by DB plans is shrinking. If DB plans are to thrive, DB coverage must increase through the maintenance of current plans and the establishment of new plans. Increasing DB coverage will require that pension system stakeholders address current disincentives to the sponsorship of DB plans, such as:

- Lack of clarity concerning the pension promise;
- Uncertainty regarding surplus utilization and ownership;
- Complexity and non uniformity of pension standards legislation;
- Financial reporting volatility revealed by pension accounting standards; and
- Complex pension plan merger and split rules that have become an obstacle to changes in corporate structure.

Key recommendations
(Addresses Discussion Paper questions 3.3 and 4.4.)

In order to achieve the objectives of clarifying the promise and enhancing DB coverage, all key stakeholders will need to play a part in removing the existing disincentives for DB pension plans. As a key stakeholder, the Ontario Government can play a significant role in attaining these objectives by:

- Streamlining the regulatory process, with a mandate to promote the increase in pension coverage;
- Enhancing the security of benefits, thereby ensuring that in almost all cases the benefit promise will be honoured; and
- Ensuring that pension legislation facilitates the alignment of plan funding with the pension promise.

In the remainder of this submission, we elaborate on these key recommendations and provide some additional recommendations in response to the OECP's Discussion Paper. In Appendix A, we provide a summary of our recommendations.

The human dimension

(Addresses Discussion Paper questions 1.1, 1.2, 1.9, 2.2, 2.6, 3.1, 4.1 and 4.2.)

A DB pension plan:

- Enables members to determine their retirement incomes in advance, and therefore plan appropriately for retirement;
- Frees members from investment decision-making;
- Substantially shields members from market risk;
- Pools the investment risk, enabling an increase in risk-taking capacity. This provides opportunity for the plan to increase the expected return on plan assets by increasing investment risk. Increasing the expected return on plan assets increases the expected pension provided by each dollar of contribution (or lowers the expected cost of providing each dollar of pension benefit);
- Assures members of lifetime retirement income as their longevity risk is taken on by the plan sponsor and is pooled with other members;
- May protect the purchasing power of retirees through inflation-related increases, provided either automatically or on an *ad hoc* basis; and
- Achieves economies of scale with respect to administration costs.

Investment, longevity and inflation risk protection will increase in value as the population ages and Canadians continue to live longer than ever before. No other retirement arrangement offers a comparable package of attractions, and it is therefore in the interest of both employers and employees that DB plans remain viable.

Given the demographic changes that are occurring, it is important that DB plans respond to the needs of employers and employees in an aging workforce. For example, the regulatory environment and plan designs should accommodate phased retirement by permitting retirement-eligible plan participants to receive a pension while continuing in employment. Also, sponsors should consider removing the early retirement subsidies that are a common feature of many of today's plans, so that the plan terms do not provide a disincentive for retirement-eligible employees to continue working.

Despite the many positive features of DB plans, in relative terms, fewer workers in the future can look forward to the security and predictability of the DB pension promise, especially in the private sector. DB coverage has been declining, especially among corporate employees. It is our belief that, because of the disincentives cited earlier, few -- if any -- new plans are being established. It is our understanding that the OECP is sponsoring a research project that will likely confirm this.

Statistics Canada reports that just 39% of paid workers were covered by a registered pension in 2005, which is down from 45% in 1991. Given that the Canadian workforce grew by 25% in this period, it appears that many of the new jobs that were created lack pension coverage.

The levels of pension coverage quoted above mask a significant difference between public and private sector DB coverage. In 2005, 80% of public sector workers participated in a DB plan, while in the private sector, the participation rate was only 20%.

Without the legislative and regulatory changes required to make them affordable and fair to all stakeholders, DB plans will eventually cover only a privileged few -- just public sector employees and the small percentage of private sector workers who are represented by a union. And, in scenarios that are far from worst-case, Canada's social safety net might well have to undergo dramatic expansion in the future to meet the needs of everyone else, with a corresponding increase in income taxes required to support this expanded social safety net.

The economic dimension

(Addresses Discussion Paper questions 1.9, 2.8 and 6.5.)

The collective health of DB plans – as measured by solvency valuations -- has little effect on the near-term robustness of the economy as a whole. Witness the last 4-5 years when the financial health of pension plans deteriorated, but the economy was vibrant. The key issue is not the aggregate financial standing of pension plans, but rather the effect of the financial health of any one plan on its particular sponsor. This can become particularly problematic during a downturn, as a company already under financial stress is required to direct to the pension fund scarce cash that might otherwise be used to maintain operations.

As well as managing the funding of their pension plans, sponsors also face financial accounting challenges. It is not uncommon today for the balance sheet and income statement impact of many corporate DB plans to match or exceed the impact of operating divisions. Given the materiality of DB plans to the financial results of many sponsors and the global trend in accounting rules towards marking these plans to market in sponsors' corporate statements, many corporations who sponsor DB plans face a significant increase in the volatility of reported corporate equity and earnings.

We are not suggesting that pension plans are of no macro-economic consequence. DB pension funds are, in fact, an important source of investment capital, as noted by Bank of Canada Governor David Dodge:

"Pension funds generate important benefits in terms of economic efficiency. By transferring risk from individuals to collectives, pension funds help achieve a more efficient allocation of savings. Pension funds—particularly the very large ones—tend to have sophisticated asset managers. These large funds have the incentive and the ability to invest pools of contributions across appropriately varied asset classes. Further, they invest over very long time horizons, so they can finance large investment projects at competitive rates of return. All of this contributes significantly to economic efficiency by transferring risk to those investors that are best able to bear it."[1]

[1] 9-Nov-2005. http://www.bankofcanada.ca/en/speeches/2005/sp05-14.html

As well, broad changes to the asset allocation of pension plans have an effect on the capital markets. Globally, pension plans are lengthening the duration of their bond holdings to ease funding and financial accounting volatility for sponsors by more closely matching assets and liabilities. At the same time, aging baby boomers are increasing their individual fixed-income allocations. As these two trends have injected ever-greater amounts of cash flow into the bond market and at the same time the amount of government borrowing has decreased, bond yields have fallen – increasing the solvency valuation and financial accounting burden on pension plan sponsors and making it much harder for individuals to meet their savings targets. Ontario cannot halt or reverse this shift in asset class preference, but can assume a leadership role in easing its pace by providing enough DB funding flexibility for sponsors to feel less need to increase and extend fixed-income weightings. Also, since the continuation of the above trends may mean that yields remain at current levels (or lower) for the foreseeable future, any improvements that Ontario makes to the funding rules must work in a low yield environment.

DB plans enhance the stability of the Canadian workforce by facilitating the orderly retirement of workers over time. In a world of only defined contribution plans, the incidence of retirement could fluctuate significantly as volatility in equity returns and interest rate levels make retirement more or less affordable at any given time. Due to (a) providing for a more predictable pension that is not as closely tied over short periods to fluctuations in financial markets, and (b) the ability of employers to use their pension plans to assist with the management of their workforce, DB plans enhance orderly retirement patterns over time.

The economy's long-term health is best served when companies are not prevented by regulation from adapting to market conditions and when ownership is able to move from weak hands to strong ones. Currently, the complexity and uncertainty of legislative and evolving common-law rules governing pension plan splits, mergers, and asset transfers, as well as lengthy delays to complete such transactions, are a major impediment to the rationalization of pension arrangements and the restructuring of corporate operations and ownership. This major issue that affects the competitiveness of Ontario employers should be addressed through legislative and regulatory change to establish clear rules for restructuring pension arrangements.

Streamlining the regulatory process

(Addresses Discussion Paper questions 1.5, 1.8 and 9.6.)

The OECP is conducting the first full review of the Pension Benefits Act (PBA) in two decades. Over time, issues and events emerged that were not anticipated at the time the PBA and its regulations were drafted. These unanticipated situations have often been dealt with through the courts. Some notable court decisions, within a long list of jurisprudence, include:

- *Kerry (Canada) Inc. v. DCA Employees Pension Committee* (Ontario Court of Appeal, 2007);

- *Monsanto Canada Inc. v. Ontario (Superintendent of Financial Services)* (Supreme Court of Canada, 2004);

- *Aegon Canada Inc. v. ING Canada Inc.* (Ontario Court of Appeal, 2003);

- *Schmidt v. Air Products Canada Ltd.* (Supreme Court of Canada, 1994); and

- *Collins et al. and Pension Commission of Ontario et al.* (Ontario High Court of Justice, 1986).

The outcome of not fundamentally updating the PBA for so many years and addressing any issues through changing policies issued by the Financial Services Commission of Ontario and by recourse to the courts is akin to patchwork legislation. We recommend that the PBA and Regulation be fundamentally updated with a focus on clarifying the following rules, so that the pension promise is clarified and DB pension coverage is encouraged, with less need to revert to the courts:

- Minimum funding requirements;
- Surplus ownership and distribution;
- Mergers, splits and asset transfers; and
- Partial windups, if the concept is not eliminated from legislation.

In addition, we recommend the following:

- The objectives of the key aspects of pension legislation should be clearly articulated. This would assist plan sponsors, regulators and courts when interpreting legislation. In line with the thrust of the OECP's mandate, the PBA should be amended to state explicitly that the core principles (Guiding Principles) of pension legislation are increasing pension coverage and ensuring that the pension promise is clearly understood and will be honoured. The PBA should further state that the regulator and courts must consider these Guiding Principles when interpreting and applying the statute and its regulations. We note that prior to merging into the Financial Services Commission of Ontario, the mandate of the Pension Commission of Ontario included promoting the establishment, extension and improvement of pension plans throughout Ontario.

- In order to ensure that the legislation remains current, the Government should commit itself to scheduled reviews of the PBA and its regulations, ideally every five years.

- Administrative guidance should be provided via an advance rulings service that provides binding opinions on administrative questions and proposed transactions in a timely manner. Such rulings would abide by the Guiding Principles and balance the interests of all affected stakeholders.

- While many employees may accrue long service and then retire on the DB pensions they were promised all along, many others will not. These employees may quit, be laid-off or lose their jobs if their employer fails. The value of DB pension credits is deferred

compensation; each employee, in effect, foregoes compensation today in exchange for pension benefits payable in the future. This concept is rooted in design provisions that were forged long ago when career employment was the norm and pension benefits were viewed as a way to retain staff or reward long service. This view means, however, that the value of such DB pension benefits from a typical plan often drops significantly if employment is terminated prior to retirement eligibility.

Furthermore, it is inequitable that an employee who is laid off in circumstances where a windup is declared -- thereby "growing-in" to a plan's early retirement subsidies -- should receive more pension than another employee who loses his or her job but is not fortunate enough to be included in a windup. A further inequity is that if the plan has a surplus, a member included in a windup may receive a distribution of surplus, in addition to "grow-in" rights.

At present, the termination benefit for a pre-retirement departure does not commonly include the value of the early retirement subsidies often built into the DB plan. As discussed earlier, due to the aging of the Canadian workforce and the need to retain experienced workers, we recommend that sponsors consider removing early retirement subsidies from their plans. However, for those who wish to maintain these subsidies, grow-in to the early retirement subsidies should be provided for all pre-retirement departures. For sponsors who wish to maintain their current costs, this will mean redirecting benefit dollars from retiring to terminating employees. If this change is made, the commuted value for terminating members who elect to transfer their lump sum value from a pension plan should be determined using the expected retirement age of the member, not the retirement age that maximizes the commuted value.

- The PBA should clarify that once benefits are annuitized, the plan and sponsor have been released of the liability with respect to the benefits purchased.

- When a pension plan sponsored by an insolvent employer winds up with a deficit, pension plan members will receive less than they were promised under the plan. To the extent that pension benefits are regarded as deferred compensation, this outcome is inequitable. Currently, a pension plan ranks as a general, unsecured creditor of an insolvent employer with respect to a windup deficiency. In many cases, this means that after assets have been distributed to secured and other priority creditors, there may remain little or nothing to satisfy the claims of the pension fund.

  If the sole objective is to preserve the value of deferred compensation and enhance the credibility of the pension system, pension plan funds should have priority creditor status, which would increase the likelihood that promised pension benefits will be delivered when a sponsor becomes insolvent. On the other hand, such a change may well increase an organization's cost of capital. Because this change affects federal insolvency legislation, we recommend that the Ontario Government pursue further analysis of this issue with the Federal Government.

In its 2004 decision in *Monsanto Canada Inc. v. Ontario (Superintendent of Financial Services),* the Supreme Court of Canada applied a "correctness" standard to the decision

made by the Ontario Financial Services Tribunal (FST) in part because the Court found that there was "no requirement that members necessarily have special expertise in the subject matter of pensions."

Pension disputes of any significance have invariably been resolved in the courts. And, as reflected in the Monsanto decision, the courts have shown limited deference to the decisions of the FST. Thus, the effectiveness of the FST has been constrained in resolving disputes and stakeholders have faced increased cost and delay as matters are appealed to the courts as a matter of right. A new approach is needed.

The Province should create a pension plan tribunal (PPT) dedicated solely to adjudicating pension disputes. The majority of PPT members must be pension experts and the PPT should be granted a privative clause under its applicable legislation. Under this approach, we expect that the decisions of the PPT would be given more deference by the courts. In the event that a PPT is not created, we suggest that a privative clause be considered in any event in respect of FST decisions, given the considerable expertise among FST members.

Making the changes suggested above to the PBA and the legislative process would go a long way towards streamlining pension administration and pension-related transactions.

Lastly, although it would be beneficial to have uniform pension laws across Canada, we do not believe that this is an achievable goal for the foreseeable future. However, we suggest that all Canadian jurisdictions continue to work towards an arrangement in which a common law is still adopted. Under this arrangement, each jurisdiction would then enact legislation that specifies the areas where it chooses to deviate from the common law. Although uniformity would not be achieved under this approach, we believe that this arrangement would narrow the differences between jurisdictions, since each jurisdiction would need to consider carefully and justify all deviations. This would also go a long way to simplifying the administration and employee equity issues faced by plan sponsors with employees across the country.

Enhancing the security of benefits

(Addresses Discussion Paper questions 2.4, 5.2, 5.4, 5.5, 5.7, 6.1, 6.3, 6.4, and 8.6.)

The main purpose of pension plan funding rules is to provide reasonable assurance that members' pension promises will be honoured by putting pension money outside the reach of the plan sponsor and its creditors.

Due to concerns about the lack of alignment between funding rules and the benefit promise, many plan sponsors are funding at minimum levels, which may jeopardize benefit security and increase the volatility of contributions.

Ensuring solvency in a volatile economy

A pension plan's solvency position does not have to be volatile. What creates volatility is investing plan assets in equities or equity-like investments when liabilities inherently behave like nominal or real return bonds. Pension funds invest in equities to seek additional return. This additional expected return comes with a price, however – greater uncertainty in the ultimate cost.

The effect of volatile equity returns on pension plans has been reasonably well understood -- not welcome, but understood. To mitigate this effect, larger plans have been moving to diversify some of their conventional stock market exposure through alternative investment strategies, private equity and infrastructure.

The effect of falling bond yields was not well understood by many plan sponsors before the pension world's "perfect storm" a few years ago. They understand better now, and many larger plans have been mitigating this risk. We note, however, that there is no practical way for pension plans to fully hedge inflation risk. While the real return bonds of the Government of Canada and other issuers provide a hedge against price inflation risk, they are not a practical tool on a macro level because of their limited supply.

Based on recent research that we conducted, a typical plan's asset-liability mismatch has a roughly 10% probability of causing a change in going concern position over a three-year period of ± 25% or more. The windup position exhibits even greater volatility. This illustrates that the funding limits in the federal Income Tax Act and regulations (the greater of 110% of the going concern liabilities and 100% of the windup liabilities) is too low and should be increased in order to enable reasonable assurance of plan solvency.

Our recommendations below regarding minimum funding requirements aim at addressing the need to ensure solvency in a volatile economy.

Minimum funding requirements

The statutory focus of minimum funding should be benefit security now and in the future. This implies:

- A forward-looking view. For example, the standard might be an 80% probability that the plan will be fully solvent five years from now;
- Investment policy should be reflected in determining the minimum funding requirement so that asset-liability mismatch risk is considered, albeit in a simplified manner. For example, target funding levels should be higher for plans with large mismatches between assets and liabilities than for plans with small mismatches;
- The minimum funding requirement should not be dependent on the sponsor's financial strength. When minimum contributions are based on financial strength, concessions

granted to a once-strong company could accelerate a slide into bankruptcy when those concessions are removed and the now-weakened sponsor must assume the burden of the additional contributions required; and
- Regulatory powers to address funding concerns, such as accelerating the timing of the next actuarial valuation, should be limited and clearly detailed in legislation so that a sponsor knows what to expect.

In response to question 6.3 of the OECP's Discussion Paper regarding earmarked reserves, we do not believe that earmarked reserves within the financial control of the corporate sponsor provide sufficient security for plan members. If additional security is warranted, it can be made via one of the following, or some combination thereof:
- Additional contributions to the pension fund;
- Letter of Credit (LoC); or
- Contingency reserve account, as described below.

If sponsor concerns about the lack of alignment between funding rules and the pension promise (e.g., the access to surplus issues which are discussed below) are resolved, the need for additional security should be met through additional contributions to the pension fund. However, LoCs and contingency reserve accounts should be made available to provide funding flexibility. In the event that the above issues are not resolved, their availability would be mandatory.

LoC issuance and pricing reflect changing business circumstances and the use of LoCs – already sanctioned by the federal regulator and a few provinces – recognizes that financial institutions can do a better job of assessing a sponsor's financial strength than inflexible legislation/regulation.

The contingency reserve account referred to above would be a new form of rainy day cushion. Contributions required under the going concern valuation would be paid to the pension fund. Further contributions required under the solvency valuation would be paid to a special purpose trust. This contingency reserve would be tax-sheltered, held separate from the sponsor's assets and protected from non-pension creditors. Contingency reserve assets not required to meet benefit obligations on full or partial plan windup would revert to the sponsor. For an ongoing plan, the sponsor would be allowed access to the contingency reserve if the total assets of the pension fund and this reserve exceed a reasonable margin of safety that reflects the degree of mismatch between plan assets and liabilities. As well, the reserve could hold voluntary contributions that would better enable sponsors to match funding to their business cycles and thereby decrease contribution volatility. To provide enough room to seed and maintain these trusts, Ontario should seek federal tax changes raising allowable funding limits for DB plans from the current maximum of the greater of 110% of going concern liabilities and 100% of windup liabilities. The determination of the increased funding thresholds could be based on an analysis of the volatility of a typical pension plan's funded ratios. Based on the research mentioned above, we believe that the funding maximums should be raised to roughly 125% of the greater of the going concern liabilities and windup liabilities.

In the event of a full windup, obligations would first be charged to the pension fund and then, as required, to the contingency reserve account. If money remains in the pension fund after all obligations are met, it would be distributed as under the current regime. If the combined assets of the pension fund and contingency reserve account are not sufficient to meet obligations, the shortfall would be addressed as under the current regime, except that all sponsor contributions made after the windup date to address a windup shortfall would be made to the contingency reserve. Contingency reserve account assets not required to meet obligations would be returned to the sponsor.
In the event of a partial windup (assuming that this concept is maintained in Ontario legislation), the actuary would simulate a full windup and then determine the obligations due to those in the partial windup group. The trust assets and contingency reserve account would both be notionally split on an appropriate basis between the ongoing and partial windup portions of the plan and the assets allocated to the partial windup group would be distributed as described above for a full windup.

Alignment of plan funding with the pension promise
(Addresses Discussion Paper question 5.3.)

There is often a lack of clarity and agreement on what the true pension promise is in a DB plan. Due to the lack of clarity, there has often been a need to revert to the courts to resolve the various claims of pension stakeholders. The resulting court decisions have created a misalignment between plan funding and the pension promise.

Access to surplus

In particular, the treatment of surplus assets has become a highly contentious issue. In most cases, plan sponsors are clearly responsible for the rapid funding of solvency deficits, but often members lay claim to any surpluses. From the perspective of sponsors, this situation creates a misalignment between the funding requirement and the pension promise (i.e., the sponsor shoulders the funding risk in the case of a deficit, but members benefit from some or all of any emerging surplus).

For DB pension plans, the “pension deal” should be clearly communicated so that everyone understands which party or parties are undertaking the risks associated with the plan. It should be clear to all stakeholders through appropriate communication:

1. What the plan terms are, including:
   - Whether or not annual inflationary increases, if any, to pensioners are provided at the discretion of the plan sponsor. If they are not discretionary, under what conditions the increases will be provided.
   - If benefits are enhanced upon full or partial wind-up, precisely what conditions trigger a windup.
2. Who benefits if the plan develops a surplus, and how these benefits can be realized:
   - Does the sponsor benefit? Can the benefit be realized through a contribution holiday and/or withdrawal of surplus assets from the plan?

- Do members benefit? Can the benefit be realized through decreases in contributions, improvements in their pension and/or a distribution of surplus assets from the plan?
- Do both the sponsor and members share the benefit and, if so, how?

3. Who is responsible if the plan develops a deficit, and what options are available to address the deficit:
   - Is the sponsor responsible? Are deficits addressed by an increase in employer funding?
   - Are members responsible? Are deficits addressed by increasing member contributions, reducing future pension accruals, and/or reducing past pension accruals?
   - Do both the sponsor and members share responsibility and, if so, how?

When establishing the “pension deal” described above, surplus, beyond a cushion, should be available to the party or parties that take on the plan’s financing risk. The regulatory environment must accommodate this type of pension deal. Transition/grandfathering arrangements from current surplus ownership rules will be important, and must be addressed in legislation.

If the issue of surplus ownership is not clarified and made more commensurate with the pension risk, sponsors will naturally continue minimum funding policies that reduce the likelihood of a large surplus developing. While reducing the likelihood of a surplus, minimum funding reduces benefit security and may increase contribution volatility. As described above, LoCs and contingency reserve accounts should be made available. In the event that surplus issues are not resolved, these vehicles will become more important as a cost-effective way to secure the pension promise. Otherwise, faced with escalating financial liabilities, corporate-sponsored DB plans will likely continue to disappear, and with them, the pension security of ever more employees.

Other recommendations

Plan windups, mergers and splits
(Addresses Discussion Paper questions 8.1, 8.4, 8.5 and 8.6.)

Ontario and Nova Scotia are the only jurisdictions with “grow-in” provisions that extend subsidized early retirement pensions to qualified members affected by windups who are not eligible for such benefits under plan terms. Recently, Nova Scotia eliminated the advance funding requirement for its provision and only requires that “grow-in” benefits be provided if sufficient assets exist at the time of windup. As indicated earlier, we recommend that grow-in (based on the expected retirement age, rather than the retirement age that maximizes the pension value) be provided to all terminating members, regardless of whether or not they are included in a windup.

The declaration of a partial windup can have significant adverse implications for plan sponsors. Grow-in benefits must be provided to qualified members and surplus must be distributed when the partial windup effective date happens to coincide with a date on which

the plan has a surplus on a windup basis. Annuities must be purchased to settle the benefits of a portion of the partial windup group. Also, the declaration of a partial windup often results in a significant delay in the settlement of members' benefits. To make matters worse, it is often unclear whether a given event should or should not lead to a partial windup.

If grow-in to the expected value of early retirement subsidies is provided to all terminating members, we believe that the concept of a partial windup would cease to be relevant, in which case they could be eliminated, as has occurred in Quebec. On the other hand, if grow-in remains an entitlement only for qualified members upon windup, and partial windups are not eliminated, guidance should be provided by the Government with respect to the objectives being fulfilled by partial windups. For example, what is the purpose of providing grow-in benefits to an employee who terminates along with a significant number of other employees versus an employee who terminates alone? Regulatory guidance with respect to the objectives would be helpful to sponsors, members, regulators, and the courts when determining what is and is not a partial windup situation.

If partial windups are not eliminated, legislative requirements should be changed as follows:

- Eliminate the requirement to distribute surplus;
- Eliminate the requirement to purchase annuities. With many types of annuities unavailable or in limited supply, the legislation should reflect the reality that the only practical solution in many partial and complete windups will be the continuation of the pension fund in a "passive mode" to pay pensions for an indefinite period of time. In the event that a sponsor chooses to settle pension benefits via an annuity purchase, as noted previously, the plan sponsor and plan should be relieved of further liability; and
- Improve clarity with respect to the circumstances in which a partial windup will be ordered. If a sponsor is still unclear with respect to a particular situation, they should be able to seek clarity through the advance rulings service recommended above.

Cumbersome restrictions on plan mergers, transfers and splits plus the delays required for approvals impede the restructuring and sale of companies. This hurts shareholders and reduces the efficiency of the Canadian economy. It also hurts employees, as their accrued pensions are often frozen at the date of a sale due to the difficulties associated with transferring their benefits earned for service with the vendor to the purchaser's pension plan. Plan sponsors are saddled with increased administrative costs if plans cannot be more easily merged or split.

Clear rules regarding the requirements for plan mergers, transfers and splits must be documented in the PBA, regulations, and policies in order to create more certainty for plan sponsors and regulators. While we understand the complexity involved with balancing the rights of a number of stakeholders, it is important that the rules not be overly complex and cumbersome, so that the administration of these transactions can be streamlined. If plan sponsors follow the requirements laid out in the PBA, regulations, and policies, they should have the assurance that the transaction will be approved by the regulator. If a plan sponsor chooses to deviate from the policies, the advance rulings service recommended above should be available to rule on the acceptability of the proposed approach for the transaction.

Inflation indexing
(Addresses Discussion Paper question 4.5.)

Commitment to indexation is not common in private sector pension plans. Where indexing is provided in the private sector, this is typically accomplished through *ad hoc* increases, with their financing and timing under the sponsor's control.

Ontario previously considered making indexing mandatory for private sector DB plans, but did not do so. At issue is the affordability of such an open-ended commitment, particularly when there is currently no practical way to fully hedge the exposure.

We believe the choice of whether, when and how to index should be left to the sponsor/union – or even the individual member. Consider a choice that might be offered to a retiring employee: a non-indexed monthly pension of $1,000 or an $800 pension linked to the Consumer Price Index. The typical individual would likely choose the non-indexed pension and, perhaps, bank some of it to finance his or her own inflation protection. We do not recommend that legislation be amended to override this by mandating indexing. Consider as well that indexing is not required for the payout stream from a defined contribution plan, and there has been no member demand for it. Whatever the Government's decision, we would support plan sponsors, pension authorities and others providing the public with useful educational materials about the risks of inflation as they relate to retirement planning.

The Pension Benefits Guarantee Fund (PBGF)
(Addresses Discussion Paper questions 7.1, 7.2, 7.3 and 7.5.)

Problems have arisen with publicly administered pension benefit guarantee funds elsewhere in the world, such as the US and the UK. In Ontario, the PBGF does not have sufficient assets, without recourse to taxpayers, to guarantee pension obligations in the case of the windup of a very large pension plan or the windup of a few large pension plans. Also, the PBGF can cause moral hazard by encouraging sponsors to take an inappropriate amount of risk in their plans on the basis that the PBGF will bail them out if they and their plans cannot deliver the promised benefit.

We feel Ontario's PBGF should be abandoned in conjunction with the implementation of better-structured funding rules. We note that modifying the minimum funding rules in accordance with our recommendations would enhance benefit security, thereby lessening the need for a PBGF.

If the PBGF is not abandoned, the assessment mechanism should be restructured so that insurance principles are used to avoid taxpayer subsidies and subsidies among pension plans. Accordingly, assessments should be based on a plan's funded status, the investment policy of the fund, and the sponsor's financial strength – both current and projected.

In total, insurance-based PBGF assessments would likely cost more than now. However, that would be appropriate to reflect the true cost of insuring against high-value/low-

probability events, and would avoid inadvertent subsidization of the PBGF by Ontario taxpayers -- many of whom are not members of a DB pension plan.

Lastly, we suggest that details with respect to the governance of the PBGF be made publicly available, including:

- Comprehensive financial statements showing not just current operations but also any known likely future claims and the options being considered in these cases;
- A formal investment policy; and
- Risk analyses that have been conducted.

Innovation
(Addresses Discussion Paper questions 3.4, 4.6 and 4.8.)

Joint administration is often cited as a way to restore balance in the rights and obligations of pension plan stakeholders. By itself, joint administration would not make DB plans more attractive to employers. In some cases, the reverse would likely be true because of loss of sponsor control. However, the legislation should be sufficiently flexible to allow for and even encourage new types of risk sharing arrangements and plan designs. Depending on the specific details of these new designs, joint administration might follow naturally. In any event, joint sharing of financial risk should lead to joint administration.

New multi-employer pension plan (MEPP)

Both government policy and legislation should encourage the adoption of a new form of MEPP. This type of arrangement should:

- Be open to many employers in different industries;
- Have an expert board of trustees that would set investment policy and overall contribution rates;
- Have each employer decide how it will split the contribution requirement with its employees;
- Design the plan to avoid any potential for subsidies between employers based on factors within their control;
- Be designed and financed so as to best achieve equity between different generations of members and employers; and
- Pool longevity and investment risks, but no others.

The Canada and Quebec Pension Plans offer a design template, but other designs are also possible. In order to provide sufficient scale, such a plan would likely need to be sponsored by the Ontario Government or a large financial institution. Centralized administration, investment, and communication functions would enable participation by small employers.

Target benefit plan

This is an alternative approach in which legislation would allow a sponsor to offer a plan in which it commits to make fixed contributions aimed at funding a target retirement income,

but does not guarantee that the target level will be delivered. Ancillary benefits and accrued benefits could be reduced or member contributions may increase in the event of adverse experience – a risk that must be clearly communicated to plan members. This type of plan would operate under rules appropriate to MEPPs, but would not require the involvement of multiple employers or necessarily be subject to a collective agreement. As risk is borne by the membership, inter-generational equity would again be an important objective for such plans. This approach is similar to member-funded plans in Quebec.

Conclusion

As they currently stand, Ontario's PBA and regulations do not meet the current and future needs of employers and employees. Employees fortunate enough to be in a DB pension plan are generally well served, for now. But plan sponsors are not. Accordingly, they are not establishing new plans and in many cases are restructuring existing programs to reduce or eliminate future DB accruals for current employees and close their DB plans to new hires. Failure to sufficiently update the PBA and its regulations over the past two decades has burdened employers with an unbalanced allocation of rights and entitlements, rules that are too onerous and cumbersome, and a patchwork regulatory system that moves too slowly for the business world of the 21st century. The DB pension plan offers many positive features for individual employees, employers and the economy as a whole. But, without the needed legislative and regulatory change, the private sector DB plan is endangered, and the Ontario of the future will likely suffer from a huge gap between the relatively small number of "have" retirees with DB pensions and the much greater number of "have-nots" left largely on their own.

Despite the challenges, the gloomy scenario outlined above does not have to be. We are reminded of the Dickens tale, A Christmas Carol. A fortuitous vision allowed Scrooge to foresee the bleak future he faced -- in time for him to alter the course of his life. Time has run out for leading edge baby boomers who are now turning 60, but those born in the peak year – 1961 – are only in their mid-40s and the youngest boomers have just left their 30s. So, it is still possible for our retirement funding system to alter course and create an environment in which a thriving retirement pension system contributes to a strong Canadian economy. However, in order for this to occur, all parties involved must recognize the implications of the path we are now on and be willing to play a part in changing course. We applaud the Government of Ontario for establishing the OECP and believe that this provides Ontario with an unique opportunity to take the lead in making some of the fundamental improvements to the retirement system that are needed.

Summary of Recommendations

Objectives of changes to DB system

1. Clarification of the pension promise to ensure common understanding
2. Increasing DB coverage

Key recommendations

3. Streamline the regulatory process, with a mandate to promote an increase in pension coverage
4. Enhance the security of benefits, thereby ensuring that in most cases benefit promise will be honoured
5. Ensure that pension legislation facilitates the alignment of plan funding with the pension promise

The human dimension

6. The regulatory environment and plan designs should accommodate phased retirement
7. Sponsors should consider removing early retirement subsidies from their plans

The economic dimension

8. Provide enough DB funding flexibility for sponsors to feel less need to increase and extend fixed-income weightings
9. Ensure that any changes to the funding rules work in both a low yield and high yield environment

Streamlining the regulatory process

10. The PBA and regulations should be fundamentally updated with a focus on clarifying the rules in a few key areas, so that there is less need to revert to interim policies and the courts
11. The Government should elaborate on the objectives of the key aspects of pension legislation in order to assist plan sponsors, regulators and the courts when interpreting the PBA and regulations
12. The Province should commit itself to scheduled reviews of the PBA and its regulations, ideally every five years

Summary of Recommendations

13. The PBA should be amended to state explicitly that the core principles (Guiding Principles) of pension legislation are increasing pension coverage and ensuring that the benefit promise is clear and will be honoured
14. The PBA should state that the regulator, FST, and the courts must consider the Guiding Principles when interpreting and applying the statute and its regulations
15. Administrative guidance should be provided via an advance rulings service that provides binding opinions on administrative questions and proposed transactions
16. Grow-in to the expected value of early retirement subsidies should be provided for all terminations
17. The PBA should clarify that once benefits are annuitized, the plan and sponsor have been released of the liability with respect to the benefits purchased
18. The Province should create an expert pension plan tribunal dedicated solely to adjudicating pension disputes, with a privative clause
19. All Canadian jurisdictions should continue working towards an arrangement where a common law is adopted, and with each jurisdiction enacting legislation that specifies the areas where it chooses to deviate from the common law

Enhancing the security of benefits

20. The funding limits in the federal Income Tax Act and regulations should be increased to roughly 125% of the greater of the going concern liabilities and windup liabilities
21. The statutory focus of minimum funding should be benefit security now and in the future. This implies:
    - A forward-looking view
    - Investment policy should be reflected in determining the minimum funding requirement so that asset-liability mismatch risk is considered
    - The minimum funding requirement should not be dependent on the sponsor's financial strength
    - Regulatory powers to address funding concerns, such as accelerating the timing of the next actuarial valuation, should be limited and clearly detailed in legislation so that a sponsor knows what to expect
22. Legislation should permit the following approaches and vehicles for securing registered pensions:
    - Additional contributions to the pension fund
    - Letter of Credit (LoC)
    - Contingency reserve account

Summary of Recommendations

Alignment of plan funding with the pension promise

23. The "pension deal" should be clarified and communicated
24. Surplus, beyond a cushion, should be available to the party or parties that take on the plan's financing risk

Other Recommendations

25. Partial windups should be eliminated
26. If partial windups are not eliminated:
    - Eliminate the requirement to distribute surplus
    - Eliminate the requirement to purchase annuities
    - Improve clarity with respect to the circumstances under which a partial windup will be ordered
27. Clear rules regarding the requirements for plan mergers, transfers and splits must be documented in order to create more certainty for plan sponsors and regulators
28. Plan mergers, transfers and splits rules should not be overly complex and cumbersome, so that the administration of these transactions can be streamlined
29. The choice of whether, when and how to index pensions should be left to the sponsor/union – or even the individual member
30. Plan sponsors, pension authorities and others should provide the public with useful educational materials about the risks of inflation as they relate to retirement planning
31. Ontario's PBGF should be abandoned in conjunction with the implementation of better-structured funding rules
32. If the PBGF is not abandoned, the assessment mechanism should be restructured so that insurance principles are used and transparency with respect to governance should increase
33. Plan designs that should be accommodated and/or encouraged include:
    - New multi-employer pension plan
    - Target benefit plan

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TOWERS PERRIN

THE 21ST CENTURY PENSION SYSTEM: SOLVING THE DB FUNDING CONUNDRUM

The future of defined benefit pension plans in Canada hangs in a skewed balance: plan sponsors are made responsible for solvency deficits, but are unentitled to surpluses. Faced with escalating financial liabilities, employer-sponsored DB plans will continue to disappear, and with them, the pension security of ever more Canadians. It is time to reset the scale. In this paper, we offer a proposal on how to restore equilibrium to the Canadian pension system.

WHITE PAPER

EXECUTIVE SUMMARY

Regulatory changes enacted by (or pending in) some Canadian jurisdictions offer partial relief from the funding pressure on sponsors of single-employer defined benefit (DB) pension plans. But those changes still do not address the fundamental issue that is driving companies away from DB plans: the risk-reward asymmetry in which a plan sponsor is fully responsible for covering a solvency deficit but does not get full access to any surplus that later develops.

This paper outlines how the current pension and tax regimes might be altered to make DB plans more acceptable to employers and more secure for employees.

We propose that a going concern valuation be the primary test of a DB plan's health, recognizing that solvency valuations can create onerous burdens for the vast majority of companies that are not at risk of failure. Solvency valuations would still be done, but as a secondary test.

Contributions required under the going concern test would be paid to the pension fund. Further contributions required under the solvency valuation would be paid to a new special purpose trust. This contingency reserve would be tax-sheltered, held separate from the sponsor's assets and protected from non-pension creditors. To enhance benefit security, funded ratios for plans should be allowed to go at least as high as 120% before further employer contributions are prohibited.

Trust assets not required to meet benefit obligations on full or partial plan windup would revert to the sponsor. The sponsor would also be allowed to access the trust if the total assets of the pension fund and this contingency reserve exceed a reasonable margin of safety that reflects the degree of mismatch between plan assets and liabilities.

The contingency reserve could also hold voluntary contributions above the minimum required by the going concern valuation. These "prepaid contributions" would better enable sponsors to match funding to their business cycles. This would solve the issue of employer funding flexibility – as well as the issue of Canadian employees' ongoing access to the stability offered by defined benefit plans.

We believe the transition to this new system could be completed over 5 to 10 years.

HOW CAN WE SOLVE THE DB FUNDING CONUNDRUM?

In our original pension White Paper entitled *Renovate to Rejuvenate: Canadians Need a 21st Century Pension Plan* released in May 2004, Towers Perrin proposed a set of 27 comprehensive changes to the Canadian pension system. With these changes, defined benefit pension plans could adapt to today's realities, thus enabling both DB and DC forms of retirement savings to be viable options from which all parties could choose the arrangements that best suit their needs.

Since then, a wide variety of stakeholders have weighed in on this issue:

- The Governor of the Bank of Canada, David Dodge, urged policymakers, in a speech in November 2005, to encourage employers to maintain their DB plans and confirmed their importance as an "economically efficient way of transferring risk to those that are best able to bear it."
- The Association of Canadian Pension Management (ACPM), a pension industry group incorporating many of the key pension stakeholders, published its own paper in August 2005 entitled *Back From the Brink: Securing the Future of Defined Benefit Pension Plans*, which set out a series of desired changes to the pension system, many of which were consistent with the Towers Perrin White Paper.
- Ken Georgetti, President of the Canadian Labour Congress, expressed concern in a speech to the ACPM in September 2005 about the future of DB plans and applauded the ACPM on providing a blueprint for future dialogue.
- More recently, the December 2006 Report of the House of Commons Standing Committee on Finance called for "the federal government, in consultation with the provincial/territorial governments and relevant stakeholders, to undertake a comprehensive review of the Canadian retirement income system with a view to determining the adequacy of the system in meeting the retirement income needs of seniors".

An encouraging step forward is the Ontario government's recent establishment of an Expert Commission on Pensions to conduct a comprehensive review of the current pension system (with particular focus on the funding rules and surplus provisions) and determine how best to ensure a sustainable pension system. As stated in its Terms of Reference, the Commission "should observe" the following considerations and principles throughout the review and consultation process:

- the importance of maintaining and encouraging DB pension plans;
- affordability of DB funding;
- the importance of pension plans to economic competitiveness;
- pension benefit security;
- balancing rights and obligations of employers, plan members and retirees; and
- demographic changes and the changing nature of the Ontario workforce.

In some respects the above activities are encouraging as there is an undercurrent of uniformity (i.e., everyone seems to acknowledge that there is a problem). Private sector coverage by Canadian pension plans, particularly DB plans, has eroded over the past 15 years and virtually no new DB plans are now being established. Perhaps underlying this common concern is a fear that the Canadian pension system will follow in the footsteps of the U.K. (where DB pension plans are almost entirely closed for new entrants and employers are attempting to lay-off existing obligations) and the United States (where conversion to defined contribution plans is well established and is accelerating).

With the foregoing as context, this paper suggests a possible resolution to one of the largest conundrums in fixing the DB pension system, namely the funding rules. As outlined in the original White Paper, funding is the juggernaut issue.

The solution proposed is presented in the context of the typical single employer plan and would need to be modified to address risk-shared plans, such as those sponsored by a number of public sector organizations, and traditional multi-employer plans.

THE FUNDING CONUNDRUM

Much has been made in the media of the "funding crisis" in pension plans in Canada, the U.K. and the United States. The focus has been on publicly available information, primarily accounting disclosure information available through the notes to companies' financial statements. The confluence of the global equity market bust of 2000-2002 with decreases in the discount rate used to value accounting liabilities created the pension version of the "perfect storm". Increasingly, pension obligations are being explicitly recognized by financial analysts and the credit rating agencies in assessing the financial strength of companies. This recognition will only be heightened by the current direction of change, as we suspect that accounting rules will soon require pension surpluses/deficits to be put directly on employers' balance sheets[1].

Politicians and regulators have reacted to the public perception that pension plans are in financial difficulty. In the U.K., fundamental changes were introduced to the funding regime through the Pensions Act 2004, which seeks to improve the funding levels of pension plans and establishes a Pension Protection Fund (similar to the Ontario Pension Benefit Guarantee Fund) to cover workers who are denied their pension in employer bankruptcy situations. In the United States, the Pension Protection Act of 2006 introduced more aggressive funding targets for DB plans, while also providing more flexibility to employers in making those contributions when they are affordable. And while Canada has also seen change in minimum funding rules, both federally and in several provinces, it is important to recognize that Canadian minimum funding standards have been considerably more conservative than those of the U.K. and United States throughout the past 15 years.

The changes that some Canadian governments have enacted, however, still fail to deal with the fundamental issue that is driving plan sponsors away from DB plans: the asymmetry between the "risk" and "reward". In the original White Paper, we suggested that this asymmetry was the root cause of the underfunding of Canadian DB plans and employers' reluctance to establish new DB plans. Given the relatively conservative Canadian minimum funding standards and the uncertain ability of the employer to recover any of their contributions should they prove to be more than required, the logical response of many employers is to fund at the minimum required level. This means that there is little margin available to deal with unfavourable plan experience when it occurs – and inevitably it will occur from time to time.

The ACPM stated its perception of the issue very clearly:

The current situation has resulted from the interaction of many circumstances, including:

- the growth of surplus during the 1990s and disputes around ownership;
- the reluctance of legislators to directly address the issue of surplus ownership;
- the tendency of courts to interpret the pension "deal" as a classic trust rather than as a contract or business trust; and
- standard plan wording imposed by the tax regulator in the distant past (as regards irrevocability of assets) which did not reflect the DB "pension promise".

The ACPM suggested that until this challenge is addressed the broad fundamental issues with DB plans could not be fixed. We concur, as outlined in the original White Paper.

We also believe that the optimal solution to DB plan issues lies in reaching an equitable solution on the issue of surplus ownership. As far back as 1985, Malcolm Rowan in the *Report of the Task Force on the Investment of Public Sector Pension Funds* suggested that the ownership of surplus should reasonably reflect the magnitude of the risks to which each party is exposed. This basic principle formed a fundamental part of the original Towers Perrin White Paper and remains our belief.

To effect an equitable solution, however, likely requires change in both tax and pension standards legislation. These changes would require the agreement, tacit or explicit, of all of the stakeholders to the pension deal in order to make them politically viable. Given the complexity of the issues involved and the politically-charged environment surrounding pensions, resolution does not appear likely in the near term.

AN ADDITIONAL QUANDARY

An additional quandary for many actuaries is the belief by many in the financial community that pension liabilities can be accurately determined at any point in time. This misconception has led the financial community to place increasing emphasis on mark-to-market measurement of liabilities and assets. Given the tendency for both asset values and the discount rate used to value mark-to-market liabilities to vary widely (in both directions), it is highly likely that the current estimate of a plan's funded position will not prove to be an accurate reflection of the future state[2].

In addition, many of the assumptions an actuary is required to make relate to future uncertain events, such as demographic assumptions (e.g., mortality, retirement and termination experience), salary increase rates and other assumptions related to workforce characteristics as people retire. For both retirement and termination, actuaries examine past experience and attempt to gauge the extent to which existing employees will continue to behave like their predecessors. At best, this is an inexact science particularly in an era when young employees are increasingly mobile and when the impending retirement of the baby boom generation is already being heralded by concerns about skills shortages and the need to encourage employees to work longer. Similarly, mortality assumptions are based on tables developed by the actuarial governing bodies using past experience of large groups of people and attempts to predict the future improvements that will occur in life expectancies.

Although actuaries attempt as best they can to reasonably assess all of these factors, the resulting liability can best be described as an educated estimate.

Regardless, the combination of the inability to accurately determine a pension's ultimate benefit obligations and the asymmetry of the risk/reward regime represents a potentially lethal combination for DB pension plans. It is essential that a resolution to the funding conundrum be developed if DB plans are to remain a significant part of the Canadian pension landscape. At present, each regulator is examining the funding issues within their own context and the changes being introduced are making pension standards legislation even less uniform. This, in turn, makes administering pension programs an increasing nightmare for organizations with employees across the country. The solution reached, for it to be truly effective, must result in national uniformity both in legislation and its application.

RETHINKING THE FUNDING CONTEXT

While the solution proposed in this paper does not attempt to specifically address the issues around pension surplus, it involves a reframing of the pension funding context. It also attempts, as much as possible, not to alter the basic funding concepts that are embedded in both the minimum funding regulation (namely the going concern valuation and the windup valuation) and actuarial principles. Despite this, changes would be required to both pension standards and tax legislation to implement this revised framework.

The solution we are proposing flows from the context that pension funding serves two main purposes, specifically to:

- provide reasonable assurance that members' pension promises will be honoured, and
- allow employers responsible stewardship of shareholder monies.

The proposed solution also borrows from insurance principles regarding the need to establish contingency reserves where protection is needed against potentially large financial consequences for which it is very difficult to establish a likelihood of the event occurring.

Going Concern Concept

Under accounting principles, organizations must report on the basis that they will continue as going concern entities until such time as their continued future viability is unlikely. This concept pervades all aspects of the organization's reporting, including the recognition of the compensation cost of an employee's pension benefits. Accounting principles attempt to appropriately spread those costs over the employee's expected employment period. They also require the "use of explicit assumptions, each of which individually represents the best estimate of a particular future event" in developing these pension costs.

The going concern concept has been present in actuarial principles for pension funding since the commencement of employer-funded plans. In fact, until solvency valuation standards were introduced by Canadian regulators in the 1980s, the going concern valuation was the only determination required under pension standards laws. The going concern funding concept (used to assess cash cost requirements) is similar to the accounting concept (used to assess expense cost requirements), except that the actuary recognizes the future expected return on the assets of the fund in setting the liability discount rate. Through much of history actuaries have used a relatively conservative expectation in setting the discount rate, although some would argue that this is much less the case today.

As the going concern premise is key to our suggested funding framework, mention is warranted of the distinction between bankruptcy and insolvency and the different treatments of these two circumstances. Bankruptcy involves an organization's complete liquidation because the courts have concluded that is not feasible for it to continue as a viable entity. Insolvency involves a period of protection from creditors during which the organization seeks to restructure its affairs. In Canada, unlike in the United States[3], a company that files for creditor protection has, at least to date, been required to honour its pension obligations when it emerges from that protection. Thus, the only situation in which beneficiaries of an under funded plan are potentially exposed to loss of benefits is when the employer becomes bankrupt and has insufficient assets to pay its creditors (including pension creditors).

The likelihood of a company becoming bankrupt within any particular time horizon is very difficult to determine (except perhaps in situations where the company is already in significant financial difficulty). Setting aside money to protect against such a potential future event is very consistent with the insurance concept of establishing a contingency reserve.

Windup Valuation

A windup valuation (or solvency valuation) is required as an alternative test of funding adequacy in minimum funding standards across Canada. This test requires the actuary to determine the adequacy of the pension fund assets to cover the pension obligations (with the ability to exclude certain benefits in some provinces) under the assumption that the plan will be wound up immediately. In general, assets and liabilities are assessed on a mark-to-market basis. To the extent that the plan is underfunded on this basis, the employer must make additional contributions (typically over 5 years) to fund that deficit.

Currently, many plans have a windup liability that is considerably higher than the going concern liability. In fact, it is becoming increasingly common to see plans with windup deficits and sizeable going concern surpluses[4]. The windup valuation has thus become the main force driving funding requirements for most pension plans. Due to the short amortization periods and large contributions required to eliminate these windup deficits, it is also highly likely that plans will be pushed into going concern funding surplus and perhaps even a windup surplus when favourable experience occurs.

This aggressive funding is required to cover a future contingency whose probability is typically not quantifiable. It results in companies being forced to tie up inordinate amounts of capital in pension vehicles from which they are unlikely to realize full value from their contributions. The resulting opportunity cost faced by employers is quite large, and given the choice, many would choose to deploy these assets elsewhere.

Contingency Reserve Proposal

Under our proposed new funding framework, a more appropriate recognition is given to the contributions made under the two valuation approaches. The going concern valuation will be the main test used to determine funding of the pension fund, which would continue to be subject to all of the current trust restrictions described earlier (until such time as those are resolved as well). The windup valuation would continue to be performed and any additional contributions related to the excess of the windup liability over the going concern liability would be deposited into a new vehicle, which would also be held separate from the employer's assets as a contingency reserve against the possible future insolvency of the employer. To fulfill its purpose, the contingency reserve must be protected from creditors (that is non-pension creditors) much like current pension plan assets are protected. However, the contingency reserve is explicitly recognized as being a special purpose trust; upon settlement of all plan benefits, that purpose would cease to exist and remaining assets would revert to the plan sponsor. Similarly, in the event of the contingency reserve becoming larger than is necessary, the sponsor of an ongoing plan would have access to a portion of that surplus. We also suggest that the tax authorities consider increasing the upper bound on plan funded ratios (to at least 20%) before prohibiting further employer contributions, to permit a larger buffer against unfavourable experience.

The going concern valuation would be conducted by the actuary in much the same way as in the past. The discount rate would be determined based on the future expected return that can be generated by the pension fund[5], using the forward-looking concept that is now embedded in accounting methodology. All future contingencies, including future expected salary increases, benefit increases and future committed post-retirement inflation increases, should be reflected in the liability. Smoothing of assets to eliminate the peaks and troughs of the markets should continue to be permitted. The going concern valuation would not reflect the assets held in the contingency reserve.

Going concern contributions would consist of the cost of benefits accruing (the service cost) and amortization of any unfunded liability over a reasonable period (such as the current 15 years). Should the employer make additional contributions above the minimum amount, the employer could choose to have the excess set up as prepaid contributions that could be used to meet future going concern contribution requirements. Any such prepaid contributions would not be considered as part of the plan's assets in determining whether a surplus exists under current trust law principles. Prepaid contributions would also not be included in the fund assets used to determine the plan's minimum going concern contributions.

The solvency valuation would be much like the current determination, except that it would be a true windup valuation. Assets would be recognized using their market value and would include the pension fund assets (except for any prepaid contributions), the contingency reserve assets and the present value of future amortization payments being made toward the funding of any going concern deficit. The discount rate used to calculate the liabilities would be determined in a manner similar to the present situation, except they would be based on current market discount rates[6]. The benefits valued would represent all amounts that would be provided to members in the event of a full plan windup[7].

Solvency contributions would consist of amortization payments to fund any deficiency of the assets relative to the windup liabilities. We recommend an approach to amortizing this unfunded obligation that requires more aggressive funding when the plan is less well funded. For example, for deficits of less than 10% of the liabilities (i.e., 90% funded or better), an amortization period of 10 years might be appropriate, whereas the portion of any deficit in excess of 10% would be amortized over 5 years.

In summary, going concern contributions would be deposited in the pension fund and solvency amortization contributions would be deposited in the contingency reserve account. It is critical to the viability of this structure that tax law provide the same tax-sheltered status to the contingency reserve account as is enjoyed by the traditional pension fund – in the absence of which the contingency reserve's ability to fulfill its desired function would be compromised. It is also critical that the contingency reserve vehicle be treated as a purpose trust, hence exempted from the current treatment of beneficial trusts.

What Happens if the Plan Winds Up in Full?

Should a plan wind up in full, the pension fund assets (including the prepaid contributions) and the contingency reserve assets would be combined to determine whether there are sufficient assets to meet the full pension obligations.

If there are not sufficient assets to cover the obligations, the treatment would continue to be similar to the current situation. In most jurisdictions, the employer has a continuing obligation to make good on this shortfall – in some cases through contributions spread over 5 years. Should the employer be bankrupt and unable to make up the shortfall, members' benefits would be reduced to equalize the benefit entitlements to the assets available, as is the current scenario.

If there are more than sufficient assets in the combined funds to meet the benefit obligations in full, the pension fund (excluding the prepaid contributions) would first be allocated to meet those obligations. Should additional assets be required, sufficient funds from the contingency reserve account would be set aside to ensure that the full benefit entitlements of all members are provided in full (the employer may also choose to use some or all of any prepaid contributions for this purpose). After all benefits have been settled, the remaining prepaid contributions

and contingency reserve assets would be returned to the employer – this being fully consistent with the "contingency nature" of the reserve. To the extent that there are more than sufficient assets in the pension fund (excluding the prepaid contributions) to settle the full benefit obligations, the surplus assets would continue to be handled in much the same way as currently.

What Happens in the Event of a Partial Plan Windup?

Should a partial windup be declared, the actuary would simulate a windup of the whole plan and, in doing so, will separately determine the obligations for those in the partial windup group. Hypothetically, the plan will be split into two – one segment for those in the partial windup group and the other for those not in the partial windup group. The contingency reserve account would also be divided. If there are not sufficient assets to meet the benefit obligations in full, then the assets in the contingency fund allocated to the partial windup group would be used to fund the obligations. A full windup would then ensue for the partial windup segment along the lines outlined above.

What Happens if the Contingency Reserve Becomes More Than Necessary?

While the pension plan remains ongoing, there will be times when the total assets of the pension fund and contingency reserve exceed the overall benefit obligations upon windup. In such a situation, the employer would have the opportunity to transfer any excess from the contingency reserve to the pension fund in fulfillment of its going concern contribution requirements.

Even with such transfers out of the contingency reserve, situations will arise where the total assets of the pension fund and contingency reserve become very high relative to the overall obligations[8]. In this situation, the employer should be provided a mechanism to recover some of the excess assets from the contingency reserve, although it is critical to maintain a reasonable margin of safety[9] within the plan. How large should regulators require this margin of safety (a provision for adverse deviation) to be?

In theory, the size of the provision for adverse deviation should be related to the potential size of the risk to which the plan is subjected. As suggested in the original White Paper, we believe that there should be a direct linkage between the aggressiveness of the investment policy adopted by the plan sponsor and the funding target established for the plan. The size of the required provision for adverse deviation should reflect the degree of mismatch between the nature of the assets and the liabilities (which are largely similar to fixed income investments in their behaviour). For example, a plan that has combined assets invested 60% in non-fixed income investments might be required to have combined assets equal to 120% of windup liabilities, while a plan with 30% invested in non-fixed income investments might require half that margin[10]. To the extent that combined assets are in excess of this level, contingency reserve assets above that level could be refunded to the employer. Following such a refund, potential for a subsequent "ramping up" in aggressiveness of investment policy would need to be constrained. This can easily be managed by regulators.

The Transition Process

One might, in an ideal world, wish to go backwards in time and reconstitute history as though the revised structure had always been in place. In this case, however, we do not believe that this would be a practical alternative. Assuming that the new system is only implemented on a prospective basis, how would the system evolve?

Currently, most plans are likely to demonstrate a significant going concern surplus, as they have been funding recently to the higher solvency target. It is likely that employers would, therefore, not need to make any new contributions to the pension fund until such time as the going concern funded position is closer to 100% funded. Employer contributions during this period (and to the extent necessary) would be focused mainly on the contingency reserve account. As many plans continue to be underfunded on a solvency basis and with the removal of solvency smoothing and benefit exclusions from some jurisdictions' current rules, we anticipate that most employers would be contributing to the contingency reserve account over the transition period – a period that on a "best guess basis" is estimated to last 5 to 10 years.

HOW WILL THIS BENEFIT MEMBERS AND EMPLOYERS?

The primary benefit in adopting this revised structure is to clear the way for employers to consider adopting new DB plans or, at the very least, to consider retaining those DB plans[11] that currently exist. While we do not advocate DB plans as the universal panacea for all members and employers, we do believe that they have a valid role to play in the Canadian retirement savings system and should be encouraged for many types of employee groups. At the very least, the disincentives to offer DB plans that currently exist must be removed and this would constitute an important first step.

From the employer point of view, there are some clear impacts that we would anticipate. Although this proposal does not solve the surplus ownership issue, it does better recognize the true nature of the funding obligations of the employer and provides a mechanism for the employer to recover contributions that prove not to be required to deliver on the pension promise. We believe that this will lead to better funded pension plans, which is the true goal of all stakeholders to the pension system, as employers adopt more rational funding policies than the current minimum contribution policy. This means that employers will better tailor their pension contributions to the cash cycle of their business, contributing additional amounts during the good years of their corporate business cycle. It also means that employers are more likely to be able to match their corporate "cash" budgets with their actual contributions, as they will be less reluctant to contribute additional money.

From the employee point of view, the main benefits are the likelihood that DB plans will continue to exist (and potentially increase in importance) and the improved security of benefits that will result from the expected increase in employer funding levels.

FINAL THOUGHTS

We are certainly encouraged by the fact that many stakeholders to the pension system have publicly embraced the need for changes to make the system more viable in future. In a companion paper to this, Towers Perrin has also published thoughts regarding the potential consequences of a world in which DC plans are the only option. In other countries (such as Australia), this has already come to pass and the U.K. and U.S. are potentially heading towards this type of pension environment.

We continue to believe that DB plans have an important role to play in the overall pension system in Canada. For many people, they represent the type of plan that is most likely to meet their long term retirement needs. As Mr. Dodge stated, they are the most economically efficient vehicle for delivering pension benefits to people.

This paper attempts to further broaden the discussion around solutions to the current perceived problems with DB plans. We exhort all pension stakeholders to consider the concepts enunciated herein and to participate and collaborate in developing a solution to the fundamental issues with DB plans. If we fail to do so, it is unlikely that DB plans will survive.

FOOTNOTES

1. Accounting disclosure rules for both US GAAP and for international accounting standards (IFRS) now require that the pension surplus/deficit be directly reflected on the balance sheet of the sponsoring company. Canada has indicated that it will be moving towards the international standards.

2. For most pension plans, a relatively small change in the discount rate can cause a large change in the liability value.

3. There have been a number of high profile cases in which a company that is restructuring under Chapter 11 has offloaded its pension obligations onto the Pension Benefit Guaranty Corporation.

4. It is also worth noting that (all other things being equal) an increase in discount rates of 1% would likely eliminate the solvency deficits of many pension plans.

5. In an ideal world (and subject to many of the other concepts outlined in the original White Paper), we would favour the use of a discount rate based on bond yields (i.e., not giving advance recognition to the equity risk premium). However, in an environment in which the risk/reward asymmetry issue has not been satisfactorily resolved, we do not believe that this is an appropriate recommendation.

6. The smoothing of discount rates currently permitted in some jurisdictions would no longer be allowed.

7. In certain jurisdictions, some of the benefits can be excluded from solvency funding; this practice would no longer be permitted.

8. This is a situation that existed for many plans through much of the 1990s and could easily happen again if equity returns continue to be strong and/or bond yields rise significantly.

9. The concept of a provision for adverse deviation (PfAD) has long been present in actuarial funding concepts and has recently been introduced into the Quebec funding rules.

10. These percentages are given merely by way of example; considerable work (related to the likelihood of the assets becoming insufficient to meet the obligations within a reasonable time horizon) would need to be performed in arriving at the appropriate percentages for different asset mixes.

11. As discussed at some length in the original White Paper, we believe that the future DB plan will have a very different design than the traditional plans that were established 30 or more years ago.

ABOUT TOWERS PERRIN

Towers Perrin is a global professional services firm that helps organizations around the world optimize performance through effective people, risk and financial management. The firm provides innovative solutions to client issues in the areas of human resource strategy, design and management; actuarial and management consulting to the financial services industry; and reinsurance intermediary services.

The firm has served large organizations in both the private and public sectors for 70 years. Our clients include three-quarters of the world's 500 largest companies. Towers Perrin has offices in 25 countries. Our businesses include HR Services, Reinsurance and Tillinghast.

The HR Services business of Towers Perrin provides global human resource consulting and related services that help organizations effectively manage their investment in people. We offer our clients services in areas such as employee benefits, compensation, communication, change management, employee research and the delivery of HR services.

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