ACPM/ACARR

ACPM – The Association of Canadian Pension Management
FUNDING OF DEFINED BENEFIT PENSION PLANS

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EXECUTIVE SUMMARY

INTRODUCTION

Significant change is needed to improve the financial management and health of DB pension plans, thus ensuring their continued important role in Canada's retirement system. Such improvement will ensure:

- all parties are treated fairly according to the risks they face;
- sponsors have the appropriate tools and flexibility to manage pension plan contributions;
- fiduciaries/administrators have the appropriate tools and flexibility to manage the pension plan risks;
- there is transparency for stakeholders; and
- there is high probability of benefit security.

This report considers a number of key issues facing DB pension plans in Canada, and includes several recommendations of the ACPM for improving the future of these plans.

In reviewing the issues and what improvement can be made, reference was made to the 1997 ACPM report "*A Retirement Income Strategy for Canada: Creating the Best Retirement Income System in the World*", which proposed five measures by which to judge a retirement income system - adequacy, fairness, sustainability, transparency, and efficiency. (Within these measures are implied many others, such as security, affordability, balance, and intergenerational equity.) These measures continue to hold true today, and provided excellent guideposts for judging the changes and proposals in this report.

ISSUES AND RECOMMENDATIONS

There are many issues related to the funding of DB plans. In this report they have been grouped as follows:

a. Asymmetry
b. Measure of Plan Funding
c. Clarification of Roles
d. Funded Status and Benefit Security

Many recommendations are supported and endorsed in the context of a resolution of the first issue - asymmetry. The need to resolve asymmetry is not repeated with every applicable recommendation stated below, but these recommendations are made by this report only in the context of a resolution of the asymmetry issue.

For the purposes of this report, “plan sponsor” refers to the party or parties responsible for the ultimate funding of a DB pension plan (i.e., directly responsible for plan deficits). It may be an employer, or the responsibility may be shared as in a jointly sponsored plan. In a typical multi-employer pension plan (MEPP), employer costs are fixed and the members’ benefits are at risk if the plan is underfunded.

The ACPM recognizes that flexibility is needed as the funding issues/risks can differ depending on the type of DB pension plan involved and depending on the sponsor. Most of the DB funding recommendations contained in this report would apply to all types of DB plans and sponsors.

A. **Asymmetry**

Asymmetry is a key issue related to the funding of most DB plans. As used in this report “asymmetry” is the mismatch between “risk” and “reward” in a DB pension plan. It refers to the fact that a plan sponsor (whether a single or joint sponsor):

- is responsible for the ultimate funding of pension benefits, the cost of which may be offset by fixed employee contributions;
- is usually wholly responsible for funding shortfalls; but
- is prevented or severely constrained from access to or use of any excess funds (surplus) in the plan, other than using it toward benefit improvements (including, based on the *Monsanto* decision, mandatory distribution of surplus upon partial plan wind up).

In these circumstances, minimal funding strategies are rational responses and underfunded plans with less benefit security can result – an unwelcome outcome. It is the belief of the ACPM that resolving the issue of asymmetry would not only lead to better long-term funding of DB plans, but also would improve the environment for, and facilitate the establishment of, new DB plans to the benefit of future generations as well as current members. Conversely, a lack of action will worsen the situation. Further, other potential changes to the rules of funding for DB plans, changes that would directly benefit plan members, could gain greater acceptance in the context of more symmetry in the DB system.

ACPM Recommendations

- Governments should move quickly and decisively to deal with asymmetry. Governments should pass legislation overriding common law trust precedents and establishing the paramountcy of contract law for pension plans.

- Alternatively, other solutions might be examined. One possibility would be a tax-effective vehicle (different from a trust) to hold pension funds, that is kept distinct from the sponsor's assets for insolvency law purposes. Another possible solution would be to create a specific statutory trust vehicle specifically designed for pension plans. Another solution might involve allowing plan sponsors to establish a separate "solvency account" within a pension fund, which would not be subject to traditional trust law principles and would allow an employer to more freely withdraw or otherwise reallocate excess amounts in the account which are not required to protect the solvency position of the plan.
- The use of plan surplus for contribution holidays should continue, where permitted under plan provisions. Governments should provide greater flexibility for plan sponsors to withdraw plan surplus (subject to clearly defined limits) and to merge pension plans. Governments should also pass legislation, where required, to rectify the *Monsanto* problem. These barriers to rational plan funding should be removed.

B. **Measure of Plan Funding**

The ACPM is proposing several modifications to DB plan funding rules, methodologies and disclosure requirements. A brief description of each is provided below.

Funding Policy
- All DB plans should have a written funding policy, as a responsibility of the plan sponsor.
- Funding policies should be required to be developed and maintained but not regulated, much the same as Statements of Investment Policies and Procedures.
- Funding policies should be given to the plan actuary, and available to plan members and other interested parties.

Solvency or Going Concern?
- Governments should shift their regulatory approach to focus solely on solvency valuations, except for plans which may be exempted from solvency valuation requirements.
- Going concern valuations should become a tool of plan sponsors, used to assist plan sponsors to set plan contributions, in conjunction with advice from their actuaries. For plans that might be exempted from solvency valuations, going concern valuations should continue to be required and regulated.
- Both going concern and solvency contributions should remain tax deductible to the plan sponsor.

Funding Rules
- Governments, plan sponsors, unions, the actuarial profession and other interested parties should begin a broad dialogue on the adequacy of current DB plan funding rules and methodologies. Issues to be included in the dialogue include:

- *Flexibility and Choice* – The ACPM believes that the current range and choice of assumptions for both solvency and going concern valuations is reasonable (subject to exceptions noted below), but there is a need for greater transparency. Assumptions need to be more explicitly acknowledged, in the context of a plan funding policy and risk characteristics, and subject to comment by the plan actuary.
- *Solvency Rules* – Solvency valuation rules and requirements need to be carefully reassessed in the context of today's environment, to assess whether they are accomplishing government objectives or causing undue hardship either to plan sponsors or plan members.
- *Smoothing* – Asset and liability smoothing should not be allowed for solvency valuations, but should continue to be available as a risk management tool for going concern valuations.
- *Amortization* – Deficit amortization rules should be reviewed. Greater flexibility is needed, with a goal of lengthening the amortization period in many situations.
- *Triennial Valuations* – The current triennial valuation requirement is generally sufficient. There may be times when this needs to be accelerated – if so, regulators should act in accordance with clear, open and published criteria.

Disclosure

- The funding of DB plans should be transparent to plan members and regulators. Full and sufficient information should be available about both solvency and going concern valuations. Specifics of disclosure need to be broadly discussed and clearly delineated by legislators.

Same Rules for all Plans?

- In general, all contractual obligations should be reflected in a DB plan valuation, solvency or going concern. Exceptions should be rare and limited to determination of contributions, not disclosure.
- "Grow-in" requirements, where found, should be reviewed with an aim to soften their impact in solvency valuations, such as was recently done in Nova Scotia.
- In general, all DB plans should be subject to the same rules and regulations for funding. However, governments may see fit to exempt certain plans from specific rules, such as solvency funding/valuations. Criteria for such exemption should be clear and, if exempted, alternate means for regulation (e.g., going concern valuations) would need to be substituted.

Other

- *Sensitivity Testing* – Plan sponsors should be encouraged to perform actuarial sensitivity testing as an aid to better decision making. The actuarial profession needs to develop cost-effective tools to facilitate such testing.
- *Funding Targets* – The concept of establishing variable funding targets based on the mismatch between a plan's assets and liabilities needs to be discussed by regulators, actuaries and plan sponsors (e.g., higher funding targets for plans with higher risk investment profiles).
- *Income Tax Act (ITA) Surplus Threshold* – The federal government should make more flexible, increase or abolish the current ITA surplus threshold to enable plan sponsors to better manage the funding of their DB plans.
- *Letters of Credit* – Plan sponsors should be permitted to use letters of credit as an asset towards solvency valuation deficiency contribution requirements.

C. **Clarification of Roles**

In the funding of DB plans, the roles of the key players (legislator, plan sponsor, plan administrator, plan actuary) need to be clarified and understood, in legislation if necessary.

ACPM Recommendations

- It is the role of governments to establish statutory minimum requirements for the funding of DB plans and to ensure plan member benefit security.

- It is the role of the plan sponsor to develop a funding policy and funding strategy for the DB pension plan and to perform the actuarial valuation(s) of the plan. The funding decision should not be a fiduciary decision – it is the plan sponsor's policy decision, constrained by regulatory requirements and any contractual commitments, and guided by actuarial practice. This should be recognised more clearly in law.

- The plan administrator, as fiduciary, can indirectly affect funding decisions of the plan sponsor by virtue of the fact that the administrator is responsible for the plan investment policy. Fiduciary pension committees should not exercise funding decision powers, except to the extent that they also act as plan sponsor. This should be recognised more clearly in law.

- The role of the actuary in the DB pension plan funding process is that of an advisor. While not "certifying" the plan's funding soundness, the actuary should perform the actuarial valuation and comment on the process of the valuation itself by:

    - stating that the valuation has been performed in accordance with accepted actuarial practices;
    - stating whether the valuation conforms to the plan's funding policy;
    - commenting on any material risks inherent in the valuation results (within the actuarial domain); and
    - explaining the potential impact of plan sponsor insolvency (without specifying the risk of such insolvency).

D. **Funded Status and Benefit Security**

Recent deterioration of DB plans funded ratios as well as some high-profile bankruptcies, or near bankruptcies, have raised the question of what more can be done to increase the benefit security of plan members. The ACPM has examined and made recommendations in respect of five benefit security related issues.

Pension Guarantee Funds

- Pension guarantee funds are an ineffective means of increasing member benefit security and expansion or creation of such schemes should be avoided.
- Resolving the asymmetry issue and creating better incentives for sponsors to "over-fund" pension plans are preferable solutions.

Recent Benefit Improvements and Wind up

- Benefit improvements made within a specified period before a plan is wound up (to be determined) should have a lower priority if there are insufficient plan assets to pay for them. The risk of benefit loss on plan wind up, with respect to recent benefit improvements, should be clearly communicated to plan members at the same time the benefit improvements are communicated to them, especially if the plan is underfunded.
- The ACPM does not support an absolute prohibition on plan amendments to provide benefit enhancements where a plan is underfunded. Such an approach would be too rigid for plan sponsors and punitive to plan members.

Financial Status of Plan Sponsor

- Governments, together with the actuarial profession, plan sponsors and industry representatives, should investigate whether there is a feasible way of taking into account the financial status of a plan sponsor as a risk (positive or negative) factor when assessing the sponsor's pension plan, the assessment of which might lead to some sort of regulatory action or relaxation of regulatory requirements (to be determined).
- In any event, a pension regulator with reasonable concerns should be able to request more up-to-date information about a sponsor's pension plan, provided this is done in accordance with clear and open criteria.

Seniority of Pension Debt

- The seniority of the pension debt on plan wind up should remain as is and not be increased, unless (i) the asymmetry issue is addressed, and (ii) there is broad and extensive consultation with plan sponsors and lenders on how such changes could impact the cost of borrowing and the ability of plan sponsors to raise capital.

Obligations on Wind up

- Where legislation currently permits a plan sponsor to avoid paying the pension debt on plan wind up, this right should be removed, subject to an appropriate transition period.

CONCLUSION/CALL TO ACTION

There are many issues and their impact in the problems facing DB pension plan funding is significant. The ACPM believes that the recommendations in this report, if followed, will result in a stronger environment for the funding of DB pension plans and an environment in which plan sponsors will be encouraged both to maintain existing DB pension plans and to establish new ones.

It is not too late to reverse the trend to lower DB plan coverage. The ACPM urges governments to consider the recommendations in this report and to make appropriate changes. The DB environment will likely continue to deteriorate without government leadership in the form of changes to legislation. Other stakeholders cannot, by themselves, make significant progress in resolving DB funding issues without legislative change.

The time for response is now. The ACPM encourages its members and other pension plan stakeholders to work together to turn these recommendations into actions.