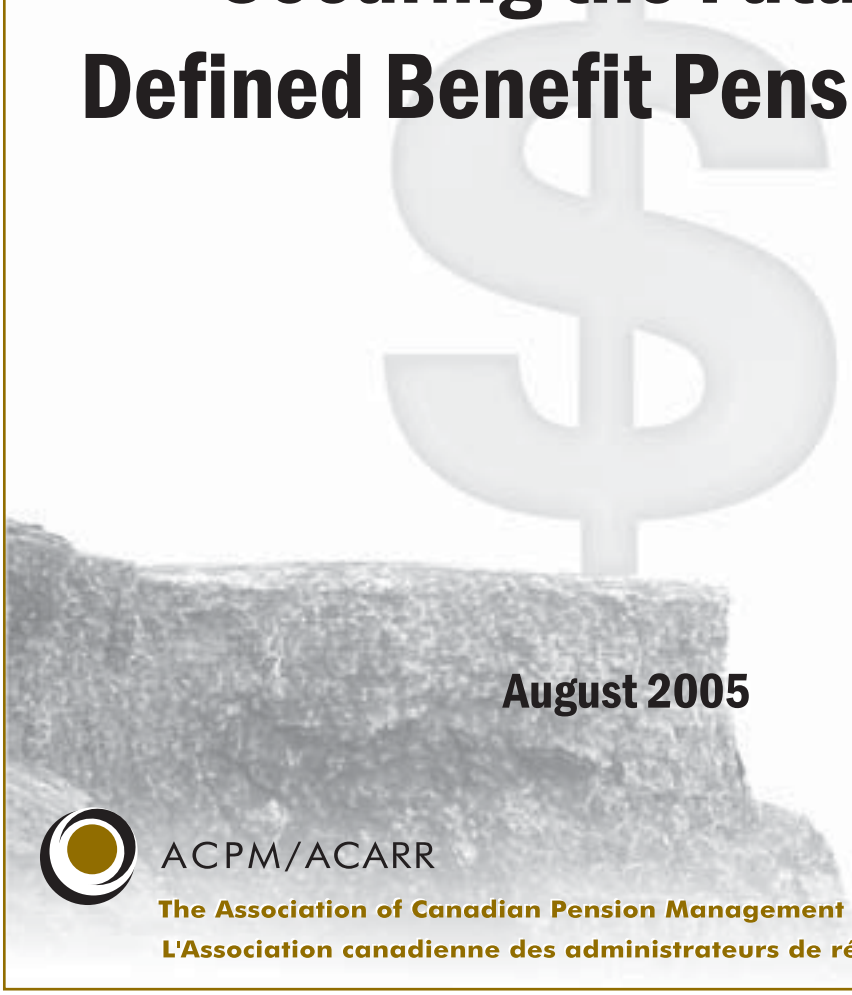
BACK FROM THE BRINK

Securing the Future of Defined Benefit Pension Plans



August 2005

ACPM/ACARR
The Association of Canadian Pension Management
L'Association canadienne des administrateurs de régimes de retraite

TABLE OF CONTENTS

A. FOREWORD 1

1. Introduction 1
2. Purpose of this Report 1
3. Defined Benefit Pension Plan Coverage in Canada is Threatened 1
4. Association of Canadian Pension Management 3
5. Plan Funding Issues Task Force 4

B. WHERE ARE WE TODAY? 5

1. Three Pillars 5
2. Funding Issues 6

C. ISSUES RELATING TO THE FUNDING OF DEFINED BENEFIT PENSION PLANS 7

1. What Prompted the ACPM's Concern? 7
2. Key Objectives in Defined Benefit Pension Plan Funding 8
3. Defining the Plan Sponsor 8
4. Issues to be Addressed 8
5. Summary 24

D. WHAT SHOULD BE DONE? 25

1. Guiding Principles 25
2. Recommendations 26

E. CONCLUSION/CALL TO ACTION 31

Attachments:

1. Proposal for Use of Letters of Credit to Meet Solvency Deficit Contribution Requirements for Registered Pension Plans
2. Members of the ACPM Funding Issues Task Force

A. FOREWORD

1. Introduction

Defined benefit (DB) pension plans have faced an increasing number of challenges in recent years, which has caused many in the pension industry – in Canada and elsewhere – to reflect on the adequacy of current funding rules and methodologies for DB plans.

It is generally agreed that 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.

The following summarizes the ACPM's views on the serious issues and problems affecting DB pension plan funding in Canada, and what improvements can be made.

The ACPM, with this report, hopes to accelerate a broader public dialogue around DB pension plan funding. We hope that the environment for DB plans will be improved to one in which rules are both clearer and fairer to all.

2. Purpose of this Report

Action is needed to fix the regulatory environment of DB pension plans. Ideally, a full review of pension and tax legislation should be conducted and the ACPM has urged this on many occasions. This report, however, focuses on the funding of DB plans. It looks at actuarial and legal issues as they affect plan funding, analyzes what we believe are shortcomings in the current system, and offers some suggestions to improve the situation.

The ACPM, with this report, hopes to accelerate a broader public dialogue around DB pension plan funding. We hope that the environment for DB plans will be improved to one in which rules are both clearer and fairer to all. Only then will we have an environment that will encourage and facilitate the maintenance, growth and establishment of DB plans across the country, to the benefit of us all.

Defined contribution (DC) plans and other retirement savings vehicles, all important components of Canada's retirement system, are not dealt with in this report.

3. Defined Benefit Pension Plan Coverage in Canada is Threatened

In many ways, Canada has a proud history of DB pension plans. While always somewhat limited in their extent (outside the public sector), they have been relatively well funded, compared to many other countries, and they have had a significant role in the country's overall retirement income strategy[1].

Today, however, the future does not look bright for DB plans in Canada. And as we have seen in other countries (e.g. Australia and Britain), under certain circumstances DB coverage can plummet. This outcome, we believe, would be bad for Canada. Could it happen here? It certainly is not inevitable, but there are definitely clouds on the horizon. For example:

1 See: ACPM, "A Retirement Income Strategy for Canada: Creating the Best Retirement Income System in the World" (1997), and "Dependence or Self Reliance: Which way for Canada's Retirement Income System?" (2000)

1. From 1992 to 2003, following the extensive overhaul of the pension and tax law in the late 1980's, DB coverage in Canada declined from 44% to 34% of the workforce. During this same period, the number of DB plans declined by 14%.[2]

2. In 1992, 91.5% of Canada's public sector employees and 28.6% of Canada's private sector employees were covered by a DB plan. By 2004, that percentage had dropped to 79% and 20.5% respectively. In absolute terms, the number of Canadian workers covered by a DB plan decreased by 218,135 from 1992 to 2004, with 168,095 (77%) of those occurring within the private sector. During the same period (1992-2004), Canada's total workforce grew by 2,707,800 workers, or 25%. Growth in the private sector workforce increased by 29%.[3] These statistics illustrate:

From 1992 to 2003... DB coverage in Canada declined from 44% to 34% of the workforce. During this same period, the number of DB plans declined by 14%.

- the large gap between DB plan coverage in the public and private sectors;
- DB plan coverage is clearly decreasing, with the private sector being the hardest hit; and
- declining DB plan coverage is occurring notwithstanding the growth in Canada's total workforce.

3. Today many DB plans are less than fully funded; for example, at December 31, 2003, 53% of DB plans supervised by the Federal Office of the Superintendent of Financial Institutions (OSFI) were underfunded (solvency ratio less than one). Over half of these were underfunded by more than 10%. Other jurisdictions are similar. In addition, a 2004 report by the Certified General Accountants Association of Canada estimated that more than half of DB plans in Canada had a funding deficit, and in total the shortfall was $160 billion at the end of 2003.[4]

4. There is little incentive for plan sponsors to generously fund DB pension plans. Too often they are caught in a difficult situation – they are required to fund plan shortfalls, yet are restricted from accessing plan surpluses. The pension promise has been secured, yet excess funds are beyond reach. Historical plan and trust provisions override current plan provisions and seriously constrain plan sponsors' flexibility in funding DB plans. Narrow and rigorous application of trust law principles to pension plans, by regulators and the courts, and the unwillingness of some legislators to address difficult political issues, have created "no win" situations for plan sponsors. In these circumstances, minimal funding strategies are rational responses and significantly underfunded plans with less benefit security can result – an unwelcome outcome.

2 Source: Statistics Canada, "Pension Plans in Canada, Key Tables at January 1, 2003".

3 Source: Statistics Canada, "Pension Plans in Canada, January 1, 2004" and "Labour Force Historical Review, 2004"

4 "Addressing the Pensions Dilemma in Canada", Certified General Accountants Association of Canada (2004).

The current environment for DB pension plans in Canada is not encouraging. DB pension plans have been, and are, a positive force both in the Canadian economy and in Canada's social fabric. DB pension plans are one of the best ways for a group of people to share and mitigate risk. As a result, members can look forward to the future with a greater level of confidence. At the same time, the Canadian economy benefits by having huge pools of capital productively invested by professionals in a more efficient manner than would be the case with equivalent amounts made up of individual accounts.[5] Retirement plans (DB and DC) are one of Canada's economic engines.

If DB pension plans continue to decline as they have elsewhere, many Canadians may pay a price in view of the burden of risk being transferred to them from their employers. The ACPM believes the DB pension plan system needs urgent attention.[6]

DB pension plans have been, and are, a positive force both in the Canadian economy and in Canada's social fabric

4. Association of Canadian Pension Management

The Association of Canadian Pension Management (ACPM) represents private and public sector pension plan sponsors, administrators and other stakeholders. The ACPM's 700 members across Canada represent plans with assets of over $300 billion and over 3 million plan members.

Since its founding in 1976, the ACPM has advocated policies and activities that promote the growth and health of the retirement income system in Canada. The ACPM champions the following principles:

- clarity in pension legislation, regulation and arrangements,
- good governance and administration, and
- balanced consideration of stakeholder interests.

The ACPM regularly advocates and participates in public dialogue on pension issues. Notably, in recent years, this document is the third in a series of significant reports offered to further public debate on the retirement income system in Canada. The previous two reports were:

1997: "A Retirement Income Strategy for Canada: Creating the Best Retirement Income System in the World"

2000: "Dependence or Self-reliance: Which way for Canada's Retirement Income System?"

These reports are available on the ACPM web site (www.acpm-acarr.com).

5 "Global Aging - Capital Market Implications", Goldman Sachs (February 8, 2001).

6 These remarks should not be interpreted as advocating DB plans at the expense of DC plans. The ACPM believes that DB plans are per se a positive and important component of the Canadian retirement income system. DC plans are also a positive aspect of Canada's retirement income system, but do not have the same funding concerns as DB plans and hence are not addressed in this report.

5. Plan Funding Issues Task Force

The ACPM's Advocacy and Government Relations Committee (AGRC) commissioned this report. The AGR committee is made up of 26 pension professionals from across Canada. Their backgrounds are varied and represent all aspects of pension plans – legal, actuarial, economics, investments, finance, plan sponsor, administrator, member, labour and consultant.

A task force established by the AGRC – the Pension Plan Funding Issues Task Force – prepared the report. The Task Force members were: Paul Litner (Chair), Michael Beswick, Serge Charbonneau, Malcolm Hamilton, Laurie Hutchinson, Greg Hyatt, Ian Markham, and Becky West, ably supported by the ACPM staff. Task Force members were drawn from the legal and actuarial professions, as well as from both public and private pension plans (see Attachment 4).

The Task Force examined the statistics around DB pension plan funding and coverage; identified causes of declining coverage, declining funding levels, and barriers to improving the health of DB pension plans; considered developments in other jurisdictions, both within Canada and elsewhere; discussed and debated possible solutions; and developed recommendations for improvements.

The Task Force also prepared a response to the Canadian Institute of Actuaries (CIA) Task Force's "Preliminary Report on Public Policy Principles in Pension Plan Funding", released in January, 2004.[7] The Task Force also developed a Proposal for the Use of Letters of Credit to Meet Solvency Deficiency Contribution Requirements for Registered Pension Plans. Copies of these documents are available from the ACPM office or web site, or see Attachment 1 for the letters of credit proposal. The Task Force also met with Canadian Labour Congress (CLC) representatives to discuss funding issues, a dialogue which we hope will continue.

7 This preliminary report was subsequently revised by the CIA, and the final "Report of the Task Force on Public Policy Principles in Pension Plan Funding" (the "CIA Task Force Report") was released by the CIA in November, 2004.

B. WHERE ARE WE TODAY?

1. Three Pillars

Canada has a retirement income system based on three pillars, a model which was endorsed by the World Bank in 1994.[8]

Pillar #1: A tax financed, means-tested, minimum pension income provided by governments (Old Age Security, Guaranteed Income Security, provincial subsidies and the like).

Pillar #2: An employment-based, mandatory pension plan to which all working Canadians must belong (Canada/Quebec Pension Plans). It is self-financing through contributions by working Canadians and their employers.

Pillar #3: A variety of voluntary retirement savings or employment pension plans, defined benefit or defined contribution in nature.

Canada has built a reasonably balanced three-pillar retirement income system which has raised materially the income levels of older Canadians since World War II. It is a system of which Canadians can be proud.

To breathe life into these components, the 1997 ACPM Report, "Creating the Best Retirement Income System in the World", proposed five measures by which to judge a retirement income system.

1. Adequacy: does the retirement income system reflect an appropriate income replacement rate target?
2. Fairness: does the system reward self-reliance and fairly apply the same set of rules and standards to all citizens?
3. Sustainability: is the system sustainable with a reasonable alignment between input and output for any given generation?
4. Transparency: do participants understand the system and their roles in it?
5. Efficiency: does the system produce good results at reasonable cost?

Canada has built a reasonably balanced three-pillar retirement income system which has raised materially the income levels of older Canadians since World War II. It is a system of which Canadians can be proud and is much better positioned for the future than that of many other countries which, for example, have relied too heavily on Pillar No. 2.[9] Canada's balanced approach has also created substantial amounts of investment capital which has helped fuel the growth of its economy.

8 "Averting the Old Age Crisis", a World Bank Policy Research Report, Washington D.C., (1994)

9 See: Note 5 (above).

2. Funding Issues

While, in general, Canada has a good retirement income system, it is not without difficulties and challenges. Some of these are more serious than others.

One of these issues, and a very important one in the eyes of the ACPM, is the funding of DB pension plans. DB plans are in trouble. They are not growing and their funded status has raised concerns. As noted earlier, DB plan coverage fell from 44% to 34% between 1992 and 2003, and few new plans are being registered. Many plans are not well funded.

In addition, poor pension funding has been a significant factor in the ability of several high-profile companies to carry on business, playing a material role in the bankruptcy or near bankruptcy of Algoma Steel, Stelco and Air Canada, for example.

DB plans are in trouble. They are not growing and their funded status has raised concerns.

Clearly, there are serious issues and problems affecting DB pension plans which need addressing. The remainder of this report will focus on DB funding issues and what can be done to improve the situation.

C. ISSUES RELATING TO THE FUNDING OF DEFINED BENEFIT PENSION PLANS

1. What Prompted the ACPM's Concern?

The decline in long term interest rates to 45-year lows, the 2000-2002 stock market decline, changes in accounting rules, and some high-profile insolvencies have caused many in the pension industry, in Canada and elsewhere, to reflect on the adequacy of current funding rules and methodologies for DB plans. Changes are being proposed in the U.S. and U.K., for example. Some provincial regulators in Canada are reviewing solvency requirements. There is much discussion in the actuarial profession about assumptions and valuation techniques. For example, the Canadian Institute of Actuaries (CIA) recently released a discussion document on this matter (the "CIA Funding Report").[10]

In addition to this, legal and regulatory issues around surplus ownership and use continue to burden DB plans. The 2004 Supreme Court of Canada decision in *Monsanto* is a good example of how surplus distribution issues can polarize various interest groups in relation to DB plans.[11] These issues continue to stir emotions and the uncertain legal environment results in sponsors of voluntary DB plans adopting minimal funding strategies or deciding to discontinue existing DB plans.

The ACPM has also long been concerned with what it perceives as legislative inertia in the area of pensions... The last overhaul of Ontario's pension legislation was in the late 1980's – over 15 years ago.

The ACPM has also long been concerned with what it perceives as legislative inertia in the area of pensions. This is particularly true in Ontario – the province with the most registered pension plans. Clearly there are many problems and challenges in pension law which need fixing but responses by legislators have been sparse. The last overhaul of Ontario's pension legislation was in the late 1980's – over 15 years ago. On the other hand, the ACPM is encouraged by very recent activity in the federal jurisdiction ("Strengthening the Legislative and Regulatory Framework for Defined Benefit Pension Plans under the *Pension Benefits Standards Act, 1985*" – a Department of Finance Consultation Paper) and in Quebec ("Toward Better Funding of Defined Benefit Pension Plans" – a Régie des rentes Working Paper). We applaud these steps towards broad discussion of long-term solutions to the problems facing DB plans and look forward to participating in the dialogue those papers generate.

Other organizations have also recognized the need for reform. In recent times, analyses and recommendations have been made by, among others: the Canadian Institute of Actuaries, Towers Perrin, Watson Wyatt Worldwide, Canadian Steelworkers, the Canadian Labour Congress, and the Conference Board of Canada/Watson Wyatt Worldwide survey of CFOs.

It is in this context that the AGR Committee of the ACPM established its Pension Plan Funding Issues Task Force, with a mandate to examine DB funding issues and to recommend remedial actions.

10 "Statement of Principles on Revised Actuarial Standards of Practice for Reporting on Pension Plan Funding", Canadian Institute of Actuaries (March 2005)

11 Monsanto Canada Inc. v. Ontario (Superintendent of Financial Services), [2004] SCC 54 ("Monsanto").

2. Key Objectives in Defined Benefit Pension Plan Funding

In this section of the report, an attempt will be made to identify and articulate key DB plan funding issues that need to be addressed, in our view, to make the system better. To the ACPM, "better" means:

- 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.

3. Defining the Plan Sponsor

For the purposes of this report, "sponsor" refers to the party or parties responsible for the ultimate funding of a DB pension plan (for greater clarity, this means directly responsible for plan deficits). It may be an employer, or the responsibility may be shared as in a jointly sponsored plan.

Defining the "sponsor" is not always simple, nor is it the same for all plans. In the typical corporate (single employer) plan, member contributions (if any) are fixed and the employer/sponsor is directly responsible for the residual cost of promised benefits, including plan deficits. Other plans may have different arrangements. Some government plans are jointly sponsored, whereby the members and employers share equally (or according to some formula) in all costs. In a typical multi-employer pension plan (MEPP), employer costs are fixed and the members' benefits are at risk if the plan is underfunded.

Most of the DB funding recommendations contained in this report would apply to all types of DB plans and sponsors. Where issues and/or recommendations vary by definition of sponsor, this has been specifically indicated. The ACPM recognizes however, 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.

4. Issues to be Addressed

While there are many issues related to the funding of DB plans, with varying degrees of detail and specificity, for purposes of discussion 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

a. Asymmetry

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 mandatory distribution of surplus on partial plan wind up).

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.

Asymmetry is a key issue related to the funding of most DB plans. This has been recognized by many including the Conference Board of Canada and the Governor of the Bank of Canada.[12] It is most acute for the typical single-sponsor corporate plan. 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 by sponsors in the context of more symmetry in the DB system.

Asymmetry is an impediment to the establishment and maintenance of DB plans, and leads to conservative, minimal funding strategies for existing DB plans. A company has many competing demands on its capital, as it seeks to maximize its investment return. Why would a company contribute more than the minimum amount to its DB plan if it is known that later, as markets recover and grow, any resulting excess above that needed to secure the pension promise cannot be removed, and in fact may be awarded to departing employees following a partial wind up (based on the *Monsanto* decision)? Any contributions above the minimum are likely to be regarded as "trapped capital".

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

- the growth of surplus during the 1990's 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".

12 "2005 Survey on Pension Risk", Conference Board of Canada/Watson Wyatt Worldwide; Remarks by D. Dodge, as reported by J. Thorpe in National Post on October 8, 2004 (p. FP4).

But the root causes of asymmetry in the DB system are largely legal in nature. In Canada, the asymmetry issue is best illustrated by a series of court decisions beginning with the Supreme Court of Canada's (SCC) 1994 decision in *Schmidt v. Air Products* concerning legal ownership of surplus.[13] In *Schmidt*, the SCC held that pension plans funded through trusts are "classic" or true trusts and are subject to all applicable "classic" trust principles. The Canadian courts have since extended the reasoning in *Schmidt* beyond the surplus ownership issue to such issues as pension plan terminations (*Buschau v. Rogers Cablesystems*), pension plan expenses (*Markle v. City of Toronto*) and pension plan mergers (*Transamerica*).[14]

Classic trust principles, however, do not translate neatly into the pension context. They were developed in the context of testamentary estates (wills) where the trust product was left by a settlor who was deceased. The trust was "fixed" and, except for gains or losses realized through investment, it did not change over time. All of the beneficiaries were entitled to a specific benefit – whether that be a specific portion or part of the trust or the residue of the trust after all of the specific benefits had been provided. The beneficiaries were typically set at the time the trust was created, and could not be changed by the settlor from time to time.

As with other compensation...this report proposes that pension matters should be viewed more in the context of "contract" rather than "trust".

Pension trusts are fundamentally different from classic trusts in a number of ways. A classic trust is a form of gift involving the transfer of property to a trustee for the benefit of one or more beneficiaries. A pension trust, on the other hand, is primarily a funding vehicle to provide security for future pension obligations. A pension trust is fluid in nature – new beneficiaries join the pension plan and current beneficiaries leave on a regular basis – and are closely intertwined with employment. Unlike a classic trust situation, the trustee of a pension fund typically has very little discretion in the investment or administration of the trust fund; rather, investments and payment of benefits are performed at the direction of the plan administrator and/or investment managers.

The result of applying traditional trust law principles to pension plans has been, in a word, unsatisfactory. Allowing a series of archaic rules not designed with pension plans in mind to take precedence over contractual arrangements between employers and employees adds an unnecessary complexity and uncertainty into what is intended to be a contractual (employment) relationship, capable of being changed from time to time. It also means that the DB pension promise is being overridden by extraneous factors.

As with other compensation, and pursuant to the intent of parties which negotiate pension plans, this report proposes that pension matters should be viewed more in the context of "contract" rather than "trust". This does not mean a weakening of the laws protecting pension funds which are held to secure pension promises from creditors of

13 Schmidt v. Air Products Canada Ltd. [1994] 2 S.C.C. 611 ("Schmidt").

14 Buschau v. Rogers Cablesystems Inc. (1998), 19 C.C.P.B. 131 (B.C.S.C.), affirmed (2001), 26 C.C.P.B. 47 (B.C.C.A.), leave to appeal to the Supreme Court of Canada refused [2001] S.C.C.A. No. 107 (S.C.C.); related proceeding Bushau v. Rogers Communications Inc. (2003), 35 C.C.P.B. 199 (B.C.S.C.), affirmed (2004), 39 C.C.P.B. 179 (B.C.C.A.), leave to appeal to the Supreme Court of Canada granted [2004] S.C.C.A. No. 350 (S.C.C.).

Markle v. Toronto (City) (2002), 30 C.C.P.B. 231 (Ont.S.C.J.), affirmed (2003), 63 O.R. (3d) 321 (C.A.), leave to appeal to the Supreme Court of Canada refused [2003] S.C.C.A. No. 138 (S.C.C.).

Aegon Canada Inc. v. ING Canada Inc. (2003), 36 C.C.P.B. 161 (Ont.S.C.J.), affirmed (2003), 38 C.C.P.B. 1 (Ont.C.A.), leave to appeal to the Supreme Court of Canada refused [2004] S.C.C.A. No. 50 (S.C.C.).

the sponsor or the members. Far from it. The rules and laws for these protections should remain and could even be strengthened. It does mean, however, that, for one reason or another, should excess funding arise beyond that necessary to secure the pension promise, the plan sponsor, the party at risk for plan funding, should not be unduly constrained from accessing this excess. As a result, the sponsor should be free to manage the funding of the pension plan in a more rational way and, along with employee plan members, should have a facility which allows them to refresh the pension "deal" as circumstances warrant.

In identifying these issues, the ACPM is not suggesting that the Canadian courts do not recognize the complexities inherent in applying classic trust principles to pension trusts. Many courts have questioned whether "classic" trust principles are compatible with pension trusts. However, as long as the courts feel that they are bound by the reasoning in *Schmidt*, they will be constrained by "classic" trust principles (or their interpretation of how "classic' trust principles ought to be applied).

The ACPM believes that governments should pass legislation overriding common law trust precedents and establishing the paramountcy of contract law for pension plans.

Accordingly, the asymmetry conundrum should be addressed by the legislatures, not the courts. Only in this way can a holistic solution be found. Some regulators have taken minor steps to alleviate this problem by permitting agreements to be made for the use of surplus (between the sponsor and plan members) which override trust document wording and they are to be lauded for this. Even so, results are limited and do not address the underlying asymmetry issue. A solution must be found which reasonably enables the parties to a pension plan to refresh or redefine their relationship, in a manner that is not so constrained.

The ACPM believes that governments should pass legislation overriding common law trust precedents and establishing the paramountcy of contract law for pension plans. This view is not unique to ACPM. Indeed, the British Columbia Law Institute's Committee on the modernization of the Trustee Act suggested at page 7 of its October 2004 report, *A Modern Trustee Act for British Columbia*, that: "[i]t is appropriate for separate pension legislation to prevail over the *Trustee Act* where pension funds are concerned."

Alternatively, if it is not feasible to override common law trust precedents, or otherwise exempt pension plans from the application of such trust laws, alternative solutions could be considered. For example, one possibility would be a newly created (by legislation) type of tax-effective vehicle, different than a trust, to hold pension funds. Another possible solution would be to create a statutory trust vehicle designed specifically for pension plans. In both cases, the pension funds would be kept distinct from the sponsor's assets for insolvency law purposes, but the funds would not be subject to common law trust principles. Yet another solution might involve allowing sponsors to establish a separate "solvency account" within a pension fund. Contributions could be made to this account, which would be available as a plan asset if needed i.e., in the event of a plan wind up. However, this account would (by virtue of an express statutory override) 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 ACPM also believes that governments should amend pension legislation to provide that surplus distribution is not required on a partial plan wind up, in those jurisdictions where this is not already clear (i.e., to address the so-called "Monsanto issue").

b. Measure of Plan Funding

What is the best measure of DB plan funding? What should regulators regulate? What should the funding rules be? What needs to be disclosed? Should all plans have a funding policy? Should the rules be the same for all plans?

These questions, and others, highlight the complexity and challenges of DB plan funding, and the regulation of such plans. This section of the report will examine some of the issues raised by these questions under the following headings:

The ACPM also believes that governments should amend pension legislation to provide that surplus distribution is not required on a partial plan wind up... where this is not already clear.

(i) Solvency or Going Concern?
(ii) Funding Rules
  a) Flexibility and Choice
  b) Solvency Rules
  c) Smoothing
  d) Amortization
  e) Triennial Valuations
(iii) Funding Policy
(iv) Disclosure
(v) Same Rules for all Plans?
  a) Valuations – Exemption of Plan Provisions
  b) Solvency Valuations – Exemption of Specified Plans
(vi) Other Issues
  a) Sensitivity Testing
  b) Funding Targets
  c) Income Tax Act Surplus Threshold
  d) Letters of Credit

(i) Solvency or Going Concern?

A *solvency valuation* is a measure of a DB plan's ability to provide promised or required benefits in the event it is wound up. A *going concern valuation* is a measure of a plan's funded status assuming it will continue into the future and is used primarily to establish the plan's contribution strategy.

Currently, pension regulators regulate both solvency and going concern valuations. Yet each valuation is very different in how it is performed, in the assumption choices permitted, and in its purpose.

Since the going concern valuation is primarily a tool of the plan sponsor, used to establish predictability of contribution levels, and since there is a wide range of choice of assumptions, does it make sense for regulators to continue to regulate going

concern valuations, particularly if the key concern of pension regulators is that plan assets are sufficient to provide for promised and required benefits in the event of plan wind up?

The ACPM believes that legislators should set minimum requirements and regulate solvency valuations as their key concern. In this context, going concern valuations would be a tool of the plan sponsor, guided by the plan's funding policy and the standards of practice of the actuarial profession both as to whether they should be done and how they are done. At most, regulators may require going concern valuations to be performed in a given timeframe and perhaps filed for information purposes.[15] Solvency valuation results would set a floor on contribution requirements. To this end, a methodology for establishing a solvency "normal cost" would need to be established, to help set minimum contribution requirements between valuations.

The ACPM believes that legislators should set minimum requirements and regulate solvency valuations as their key concern.

(ii) Funding Rules

Current funding rules have served Canada reasonably well to date, but are increasingly being questioned by regulators, plan sponsors and actuaries. The ACPM believes a broad dialogue on the adequacy of current funding rules should be held. Some matters which would form part of the discussion include:

a) Flexibility and Choice

Currently there is little choice and flexibility involved with solvency valuations and considerable choice and flexibility involved with going concern valuations. The ACPM believes this is a reasonable approach, in general, particularly if regulators focus on solvency valuations. Indeed, elsewhere in this report it is argued that less flexibility and choice should be available for solvency valuations (provided the asymmetry issue is addressed).

For going concern valuations, which may be used by plan sponsors to set contribution strategies, the range of flexibility and choice should continue to be guided by the standards of practice of the actuarial profession. These choices, however, should be transparent and explicitly acknowledged in the valuation, in the context of the plan's funding policy (see below) and subject to comment by the plan actuary as to their appropriateness.

b) Solvency Rules

With the drop in long-term interest rates, solvency valuation results have created increased concern among plan sponsors. For example, in a recent Conference Board of Canada/Watson Wyatt Worldwide CFO survey, 67% of respondents consider volatility of future financing contributions a threat to the sustainability of DB pension plans in the private sector. In a Hewitt Associates' "Report on Trends in Canadian Retirement Programs Survey" (April 2004), funding requirements were ranked by plan sponsors as the most important threat to DB plans. Regulators too, appear to be concerned with solvency

15 All contributions, both going concern and solvency, would nevertheless remain tax-deductible to the plan sponsor, as is currently the case, and going concern valuations may have to be filed with tax authorities to support such deductibility.

funding, especially in light of some high profile bankruptcies or near bankruptcies.

Are current solvency rules sufficient and efficacious? Do they need revising? Do they accomplish the goals for which they were set? Should there be a solvency "normal cost"? Should the financial health of the plan sponsor be considered, as is proposed in the U.S. and the U.K.? Should targets be set based on the plan's asset liability risk mismatch? These and many other questions are raised at different times.

The ACPM believes a wide-ranging public discussion about appropriate DB plan funding rules, in particular solvency rules, should be held and any appropriate changes made. The ACPM proposes some changes later in this paper. However, none of these changes would obviate the over-arching need to fix the problem of asymmetry. DB pension plans are voluntary and what is needed are better incentives for plan sponsors to establish, maintain and generously fund DB pension plans, rather than more mandatory rules.

DB pension plans are voluntary and what is needed are better incentives for plan sponsors to establish, maintain and generously fund DB pension plans.

c) Smoothing

Currently, asset smoothing is accepted practice for going concern valuations. In Ontario both asset and liability (solvency discount rate) smoothing are permitted for solvency valuations in certain circumstances. Most other jurisdictions permit asset smoothing for solvency valuations.[16]

The ACPM believes that smoothing should continue to be available as a risk management tool for going concern valuations, at the option of the plan sponsor. However, it should not be an available technique for solvency valuations, as it is contrary to the objective of such valuations i.e., a picture of the plan's wind up status at a point in time. Note, however, that removing this technique would increase the volatility of results even though it can be mitigated by the choice of filing date and by the amortization periods. Indeed, it may be appropriate to reexamine and lengthen the amortization period if smoothing is removed as a risk management tool. Once again, however, any recommendation for change is contingent on a resolution of the asymmetry issue.

d) Amortization

The rules for deficit amortization for DB plans (solvency and going concern) would benefit from a review. Are they appropriate? Do they accomplish their objectives? Under what circumstances, if any, should there be flexibility? Should the amortization period be related to plan risk, however measured?

It should be noted that in the U.S., the U.K. and in some Canadian jurisdictions, changes have been made to amortization period requirements applicable to private sector DB plans in light of new circumstances. Other

16 Quebec and Alberta do not.

Canadian jurisdictions have made changes for public sector plans. It is time for a broad discussion on this matter.

There likely is no unique best solution for all plans, for all times, regarding amortization. This has been acknowledged in Quebec, Nova Scotia and New Brunswick, by changes made to pension legislation/regulations in those jurisdictions. What are the legislative objectives of current amortization rules (essentially 5 years for solvency, 15 years for going concern)? What underlay the choices of 5 and 15 years? The current 5-year amortization period for solvency deficits is short and, coupled with potential volatility of results, can create surplus in the future which, under current rules, is relatively inaccessible to plan sponsors (asymmetry).

It is time for a reconsideration of amortization rules, particularly for solvency deficits. Some ideas to be discussed include:

It is time for a reconsideration of amortization rules, particularly for solvency deficits.

- If smoothing benefits exemptions are removed from solvency valuations (as recommended above) both greater deficits and greater volatility of deficits are a likely outcome. These improvements to solvency valuations should be balanced by a lengthening of the permissible solvency amortization period e.g., to 10 or even 15 years.

- Perhaps the amortization period could be related to the solvency funded ratio. For example, a 10-year amortization period could apply to solvency deficiencies up to 10% of the solvency liability, and a 5-year period for solving deficiencies in excess of this threshold.

- Perhaps a longer (10 or 15 years) solvency amortization period could be permitted for plan sponsors who secure all or a portion of a solvency deficit with a letter of credit. This would be another use of letters of credit in addition to the ACPM's specific recommendations (see Attachment 1) on this subject.

Plan sponsors, as well as plan members, want to secure pension benefits and endorse legislative efforts to do so. But there is clearly a higher cost to the sponsor when more onerous funding standards are introduced to enhance benefit security. The system needs to be balanced, and sponsors need protection from excessive volatility and the risk of accumulating too much plan surplus unnecessarily. If DB plans become too costly to maintain, further reductions in DB coverage would appear to be inevitable.

e) Triennial Valuations

The ACPM believes that the current requirement of triennial valuations is sufficient. However, it recognizes that there may be times when accelerated valuations are appropriate. If so, this should happen in accordance with open and published criteria, and should not be perceived as arbitrary. Transparency is a critical objective for all stakeholders. Regulatory discretion without

proper controls and publicly available guidelines can create problems.

(iii) Funding Policy

The ACPM believes that every DB plan should have a written funding policy. This is good governance. Were such policies in place in the past, some of the current difficulties faced by plans today may have been less severe. In this belief, the ACPM agrees with the recent proposals put forth in the CIA Funding Report (March 2005) and the CIA Task Force Report (November 2004).

A funding policy would be best dealt with in the same manner as plans' Statement of Investment Policies and Procedures (SIPP).[17] That is:

The ACPM believes that every DB plan should have a written funding policy. This is good governance.

- it would be mandated but not regulated;
- it would be given to the plan actuary;
- it would be available to plan members and other interested parties;
- it would be the responsibility of the plan sponsor (or committee of trustees in jointly sponsored plans); and
- it would set out the plan sponsor's funding objectives, contribution strategy and policies for the management of funding risks.

As in the development of the SIPP, the forms and expressions of funding policies would evolve with time. Note, however, that unless the issue of asymmetry is resolved, it is likely that most funding policies will reflect minimum funding strategies.

(iv) Disclosure

Disclosure should apply to all filed plan valuations based on the most recently filed valuation report. In order to enhance transparency to plan members and regulators, disclosure should include:

- plan funding policy, investment policy and objectives,
- actuarial techniques used, including actuarial margins,
- funded status, and
- any comments by the actuary on material risks inherent in the valuation.

Funded status information should be included on members' annual statements. Other information should be available on request.

The need for better disclosure was also recognized in the recent CIA Funding Report, and the ACPM endorses this position.

17 In this paper, we use the term "SIPP" (the terminology used in the majority of jurisdictions) and the term "investment policy" interchangeably. Other jurisdictions may use different terminology but all jurisdictions require a written statement of a plan's investment policies.

(v) Same Rules for All Plans?

a) Valuations – Exemption of Plan Provisions

The ACPM firmly believes that all plan provisions should be included for the purposes of plan valuations. Under certain circumstances, exceptions might be appropriate, such as some grandfathered plant closure benefits, but these should be limited. Further, exceptions should be required to be valued as part of plan valuations for purposes of disclosure, but could be excluded for the purposes of calculating contributions. Solvency valuations and going concern valuations should fully reflect legal and contractual obligations, or else they dilute their meaning and provide misleading information. Exceptions should be rare. Once again, the ACPM is establishing its position on this issue in the context of rules which are symmetrical i.e., on the assumption that the issue of asymmetry is satisfactorily resolved through legislative action.

Solvency valuations and going concern valuations should fully reflect legal and contractual obligations, or else they dilute their meaning and provide misleading information.

One issue which exacerbates the impact of solvency valuations in Ontario, the jurisdiction with the greatest number of plan members, and which creates an extra burden for sponsors with more generous early retirement benefits, is what is called "grow-in". The ACPM has serious concerns about the impact of grow-in benefits and has stated so in other documents. At the least, funding relief should be considered for grow-in benefits, such as was recently done in Nova Scotia.

b) Solvency Valuations – Exemptions of Specified Plans

As a general rule, the ACPM supports consistency of rules and regulations for all DB plans. It is argued by some that governments may have good reasons to exempt certain plans from valuation requirements. For example, does it make sense for government plans, with virtually no risk of wind up, to have to follow solvency funding rules? Are there other circumstances involving quasi-public sector plans and private sector plans where exemptions might also be justified based on this rationale or similar criteria? The dividing line is not always clear and not all plans are the same. But if some plans are to be exempted, the criteria for exemption should be made very clear.

In the event that plans are exempted from solvency funding requirements, they will need to be regulated or managed based on going concern valuations (i.e., an exception to the ACPM's position in paragraph (i) above).

(vi) Other Issues

a) Sensitivity Testing

As an aid to promote better decision-making for DB plan sponsors, actuarial sensitivity testing should be promoted but not mandated. Such testing can model circumstances in which plans can get into difficulty, or the reverse.

Cost-effective tools for this need to be developed by the actuarial profession so that sensitivity testing can be more accessible to a wider range of DB plans.

b) Funding Targets

Should funding targets (regulated valuations) be set with a consideration of the mismatch between a plan's assets and liabilities? For example, should a plan funding target be (100 + x)% of solvency liabilities if it has a target asset mix of 65% equities? If so, such a change would have a better chance of being accepted by plan sponsors if the legislation does not require additional contributions for any portion of the funding target in excess of 100% of solvency liabilities. The "solvency margin" would rather be achieved through experience gains or additional contributions on a voluntary basis. Moreover, until the funding target is met, contribution holidays would not be permitted and surplus assets could not be used to reduce additional contributions required for the funding of benefit improvements.

The Income Tax Act currently has a DB plan surplus limit... A change to the limit could result in greater financing management flexibility for sponsors of DB plans.

This would be a significant change to plan funding requirements. Such a change would increase the short term contributions to plans, but should also increase longterm stability and security. A quid pro quo for such a change could be longer amortization periods.

Such a requirement would need changes to the maximum surplus limits under the *Income Tax Act* (Canada) ("ITA"), and would not work in the current asymmetrical environment. Further discussion is needed.

c) Income Tax Act (Canada) Surplus Threshold

The ITA currently has a DB plan surplus limit, above which an employer sponsor can no longer contribute to the plan. In effect, it is 10% of the plan's liabilities, with some exceptions.

This limit is arbitrary and may be too low. It can interfere with the rational management of DB plan funding. This fact was recognized in a recent change to the limit for cost shared plans. Unless some cogent arguments can be produced to support maintaining the limit at its current level, the ACPM believes the limit should be removed or at least raised or somehow made flexible to be more relevant to a plan's specific risks. A change to the limit could result in greater financing management flexibility for sponsors of DB plans. Again, however, it would be of limited impact unless the asymmetry issue is resolved.

d) Letters of Credit

Recently, the ACPM urged regulators to permit greater flexibility around funding solvency deficits through the use of letters of credit. This is a creative and secure option for plan sponsors to deal with the volatility of solvency

valuation results. It is cost effective and does not threaten the security of benefits. It also is an effective way to secure plan benefits while possibly avoiding the growth of excessive surplus in the future. This is a significant consideration in the current environment of asymmetry.

Attachment 1 contains a summary of the ACPM's preliminary position on the use of letters of credit for meeting solvency deficiency payments.

The ACPM is pleased to note that the Province of Quebec's recent Bill 102 *"An Act Respecting the Funding of Pension Plans"* (passed into law on June 17, 2005) embraces the concept of use of letters of credit to meet pension plan solvency funding requirements.

Note that to date the use of letters of credit has been discussed in the context of solvency valuations. However, if the issue of asymmetry is not resolved, then the use of letters of credit in the context of going concern contributions should also be examined.

The use of letters of credit is cost effective and does not threaten the security of benefits. They are also an effective way to secure plan benefits while possibly avoiding the growth of excessive surplus in the future.

c. Clarification of Roles

In the funding of DB plans, the roles of the following key players need to be clarified and understood, in legislation if necessary. The four key players are:

(i) the legislator,
(ii) the plan administrator,
(iii) the plan sponsor, and
(iv) the plan actuary.

(i) The Legislator

In Canada, legislation has played an integral part in ensuring adequate funding for DB plans and security of member pensions. This role should continue.

It is the role of the legislator to establish statutory minimum requirements for the funding of DB plans. The legislator can most effectively play this role, as has been done to date. It is not the responsibility of the actuary to do this. In this the ACPM agrees with the conclusions of the CIA Funding Report.

(ii) The Plan Administrator

In every jurisdiction save Quebec, the plan administrator (Administrator) plays a role which influences DB plan funding, even if not directly responsible for it. The Administrator generally is responsible for causing the actuarial valuation to be done, even if not responsible for the plan's funding strategy (although that is not always clear). More importantly, the Administrator is responsible for the plan's investment policy. This has a direct impact on a DB plan's funding policy and status.

Currently, roles and responsibilities are not always clear. Legislators need to act to provide greater clarity. This report believes that the plan sponsor should be responsible for the plan funding policy (see below). The plan Administrator, as fiduciary, currently has responsibility for investment policy. This requires the two key players to consult and co-operate, producing a result that is appropriate for all stakeholders.

(iii) The Plan Sponsor

The plan sponsor may be a single body (e.g., an employer) or the responsibility may be shared as in a jointly trusteed plan. In any event, with respect to the funding of DB plans, it is the party(ies) responsible for the funding of the plan who are directly at risk for contribution shortfalls.

Legislators need to clarify that the plan sponsor should have a responsibility to develop a funding policy and funding strategy for the DB plan.

Legislators need to clarify that the plan sponsor should have a responsibility to develop a funding policy and funding strategy for the DB plan, and that the plan sponsor should be responsible for the actuarial valuation(s) of the plan. The funding decision should not be a fiduciary decision. It should be a plan sponsor's (policy) decision constrained by legislative and regulatory requirements in the form of minimum funding standards and procedures, any contractual commitments (e.g., collective bargaining), and guided both by the plan's funding policy and by the expertise and practices of the actuarial profession.

This should be recognized more clearly in law and current ambiguities should be removed. For example, current legislation may require the Administrator to cause the plan valuation to be prepared, but it is not clear who is responsible for the content of the valuation. Benefit security is provided, to the extent possible, by legislative requirements, by the practices of the actuarial profession, and possibly by other contractual obligations between the sponsor and plan members.

As acknowledged above, however, the Administrator (a fiduciary) can indirectly affect the funding decisions of the plan sponsor by virtue of the fact that the Administrator is responsible for the plan investment policy. This relationship would be strengthened by greater clarity of roles and the establishment of a funding policy.

(iv) The Plan Actuary

The ACPM agrees with the CIA Funding Report with respect to the role of the actuary in the DB plan funding process. The basic role of the actuary is that of an advisor. The plan sponsor makes funding decisions; basic rules and minimum standards are set by the legislator.

The sponsor makes funding decisions guided by the expertise and accepted practices of the actuarial profession. It is the role of the actuary to:

- perform the actuarial valuation in accordance with the funding policy of the plan sponsor;
- state that the valuation has been performed in accordance with accepted actuarial practice;

- state whether the valuation conforms to the plan's funding policy (if such exists) or the plan's historical practices (in the absence of a funding policy); and
- comment on any material risks inherent in the valuation.

Thus, the basic objectives of the actuary are to provide professional advice and to aid in the understanding of the valuation through comment and disclosure to interested persons.

In summary, the roles of key players in the funding of DB plans are often not well understood. They need to be clarified, in legislation if necessary. There may also be a need to re-examine the rules governing the appointment of administrators of DB plans to minimize the possibility of conflicts of interest. For example, should the role of Administrator (fiduciary) and plan sponsor (non-fiduciary) be more clearly split? Today, the same people often play both roles. Should this be re-examined?

No one has discovered a way to operate a self-supporting guarantee fund.

d. Funded Status and Benefit Security

In the past few years, deterioration of DB plans funded ratios as well as some high-profile bankruptcies, or near bankruptcies, have raised the question, what more can be done to increase the benefit security of plan members? To this end, this report examines the following issues:

(i) pension guarantee funds;
(ii) lower priority for recent pension improvements on plan wind up;
(iii) financial status of plan sponsor;
(iv) seniority of pension debt; and
(v) obligations on wind up.

(i) Pension Guarantee Funds

Recently, some commentaries have called for expansion and/or replication of the pension insurance concept found in Ontario and known as the Pension Benefits Guarantee Fund (PBGF). While on one level this idea may seem attractive, the ACPM does not believe that such insurance schemes work very well, and does not support their expansion.

Ontario, the United States and, most recently, the United Kingdom have created institutions to guarantee, within prescribed limits, the pensions promised by insolvent companies. From time to time it is suggested that other Canadian jurisdictions follow Ontario's lead in establishing such a fund or that the federal government, presumably with the support and encouragement of the provinces, establish a national guarantee fund. We urge the federal and provincial governments to think carefully before moving in this direction and to learn from the experiences of other jurisdictions.

Guarantee funds have done a good job of providing additional (partial) support to pensioners in their hour of need. On the other hand, no one has discovered a way to operate a self-supporting guarantee fund. All of the existing guarantee funds are

insolvent if their assets and liabilities are properly measured. For example, as at March 31, 2004 the Ontario PBGF showed a deficit of $107 million, and further significant claims are possible from three companies currently under CCAA protection. Similarly, the U.S. equivalent of the PBGF reported close to a U.S. $24 billion shortfall as of September 30, 2004.

There are several reasons for this, the most important being the following:

- Those with the greatest need for protection (financially troubled companies with poorly funded pension plans) are also those least able to pay for it. Events causing plan sponsor insolvencies also tend to affect certain industries (e.g., steel) disproportionately. Consequently, guarantee funds subsidize poor risks and overcharge good ones. However, the good risks have alternatives; for example, they can contribute more to their pension plans to avoid assessments. Ultimately, the taxpayer will be expected to bail out the guarantee fund when it becomes clear that there is no way to make it self-supporting, and this fact should be acknowledged from the outset and recognized explicitly when developing the premium structure for the guarantee fund.

Guarantee funds are a poor substitute for proper funding.

- Guarantee funds must be protected from practices that deliberately expose them to the risk of large claims. Struggling organizations with poorly funded pension plans should not be allowed to improve pension benefits and/or adopt reckless investment policies knowing that the guarantee fund will make good any deficiency.
- Finally, guarantee funds are a poor substitute for proper funding. A guarantee fund does not lessen the need for adequate funding and it does not diminish the importance of creating an environment where pension plan sponsors can fund their pension plans responsibly without forfeiting the surplus created by their own contributions.

As a result, the ACPM believes the pension insurance scheme concept is, at best, a "second best" solution and should be avoided. It is much better for legislators to put in place funding rules which encourage good and responsible behaviour on the part of plan sponsors. This report makes many such suggestions, including dealing with the issue of asymmetry.

(ii) Lower Priority for Recent Pension Improvements on Wind up

The ACPM has discussed the possibility of lowering the priority for recent benefit improvements on plan wind up if the plan is in deficit and the sponsor is unable to contribute additional funds to the plan. This concept has been in place in Quebec for many years. It is also being discussed in the U.S and it has been reviewed by the federal pension regulator in Canada.

The ACPM believes that there is merit in this suggestion, although the details remain to be established. For example, the precise meaning of "recent" needs to be determined, as does the methodology for allocating funds on the basis of priority.

Further, to the extent a plan is underfunded, this risk of benefit loss should be clearly communicated to plan participants.

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.

(iii) Financial Status of Plan Sponsor

It has been suggested that special rules should apply, or that regulators should be able to intervene, in the event that a DB plan is seriously underfunded (level to be defined) and a plan sponsor is in financial difficulty (to be defined). This is a concept which is currently under discussion in the U.S. and U.K.

Regulatory intervention could take many forms in such circumstances, such as:

- requiring a more up-to-date and frequent valuation,
- accelerating deficiency payments, or
- shifting plan investments into less volatile asset classes.

In times of concern... it is reasonable for regulators to want additional information... It is critical that the regulators act in accordance with clearly defined and articulated criteria.

On the one hand, this concept is attractive. It broadens the definition of risk to the DB plan and enables regulators to act, perhaps, before it is too late.

On the other hand, it is a difficult concept. How would "financial difficulty" be determined – not all organizations have a public credit rating? Where would regulators obtain information to alert them to an organization's problems? Media reports on such subjects are difficult to verify and circumstances can change quickly. Would action on the part of the regulator make things worse for the company (by definition, it would be a company in trouble)? Would smaller plans be exempt – like the U.S. proposal? Should plan sponsors having low risk of financial difficulty benefit from relaxed regulatory requirements or less onerous funding standards? Since plan sponsor solvency is not a precondition to establishing or registering a plan, why should it subsequently become a relevant consideration? As can be seen, a seemingly reasonable idea may be very difficult to implement and should be approached very cautiously.

In times of concern, however, it is reasonable for regulators to want additional information, such as, for example, a more up-to-date valuation. In this event, however, it is critical that the regulators act in accordance with clearly defined and articulated criteria, available for all to see and understand.

(iv) Seniority of Pension Debt

Sometimes it is suggested that the seniority (or priority) of the pension debt be increased, in comparison to other debt holders, as a means of increasing benefit security on wind up. Once again, while this concept might appear attractive, it is difficult to implement, especially in the context of the whole regime of capital markets and given the current asymmetric system.

Increasing the seniority of the entire pension debt would likely cause a reaction from suppliers of capital to plan sponsors and could discourage plan sponsors further from establishing or maintaining DB plans. Risks and challenges in this approach include:

- a possible increase in the sponsor's cost of capital;
- some firms with significantly underfunded plans could have serious difficulty raising capital;
- it could have an impact on a company's share price, potentially affecting the company's ability to meet debt obligations;
- it could impact the value of that company in the investment portfolios of other pension plans;
- the transition to the new rules would have to be carefully thought out. Applying new rules retroactively could well be unworkable. Some form of "grandparenting" would have to be considered (e.g., debt incurred before a certain date);
- solvency valuations can be very volatile, and usually are not performed very frequently. In this context, it is not clear how a company's credit-worthiness would be determined; and
- would lenders of capital insist on constraints around a company's pension plan (e.g., on benefit improvements, its funding strategy, or investment policy) to protect themselves, or even call for the wind up of the plan?

The right to "walk away" from the underfunded pension debt obligation on plan wind up...is a threat to the security of plan members' benefits and the right should be removed.

(v) Obligations on Wind up

In the federal pension jurisdiction and in some provinces, a plan sponsor has the right to "walk away" from the underfunded pension debt obligation on plan wind up. The ACPM believes this is a threat to the security of plan members' benefits and the right should be removed, subject to an appropriate transition or adjustment period.

5. Summary

In the above section of the report, issues related to the funding of DB plans have been identified and discussed. There are many issues and their impact on the problems facing DB pension plan funding is significant. In particular, the ACPM believes that the asymmetry issue must be addressed.

The time for response is now. Solutions are possible and all stakeholders would benefit from changes to and a strengthening of the current rules.

D. WHAT SHOULD BE DONE?

In the previous section of this report, issues surrounding the funding of DB plans were identified and discussed. In this section, some recommendations on how to improve the funding of DB plans will be presented. The recommendations as presented are mostly at a high level, with details and transition issues left to be worked out later as part of what the ACPM hopes is a broad public consultation by governments across Canada.

1. Guiding Principles

All proposals and actions need to be judged in the context of objectives and principles which relate to them. The ACPM strongly believes this and has developed objectives and principles to guide its activities, as noted earlier in this report.

Meeting these measures... would ensure a fairer and healthier environment for the funding of DB pension plans.

Overall, the ACPM champions the following principles:

- Clarity in pension legislation, regulation and arrangements,
- Good governance and administration, and
- Balanced consideration of stakeholder interests.

In addition, the 1997 ACPM report "A Retirement Income Strategy for Canada: Creating the Best Retirement Income System in the World", proposed five measures by which to judge a retirement income system. These are:

1. Adequacy,
2. Fairness,
3. Sustainability,
4. Transparency, and
5. Efficiency.

These measures continue to hold true today. Within these measures are implied many others, such as: security, affordability, balance, intergenerational equity, and so on. But the five measures provide an excellent summary of objectives and are good guideposts for judging changes and proposals.

Meeting these measures, as the ACPM believes is possible with some changes to the current system, would ensure a fairer and healthier environment for the funding of DB pension plans. In such an environment, all are treated fairly and with respect. As a result, we believe that DB plans will be better funded and sponsors will be more encouraged to establish new ones, something that rarely happens today.

2. Recommendations

In the following, references to "governments" mean provincial legislatures or the federal parliament acting as pension regulators, unless otherwise stated. Recommendations are grouped in a similar order to the Issues Relating to the Funding of Defined Benefit Pension Plans, discussed in the previous section.

In the body of this report many recommendations discussed were supported and endorsed in the context of a resolution of the asymmetry issue. The need to resolve asymmetry is not repeated with every applicable recommendation stated below, but several of these recommendations are made by this report only in the context of a resolution of the asymmetry issue.

Governments should also provide greater flexibility for plan sponsors to withdraw plan surplus, subject to clearly defined limits, and to merge pension plans.

a. Asymmetry

a.1 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.

a.2 Alternatively, other solutions might be examined. One possibility would be a tax-effective vehicle (different than 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 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.

Amendments to both tax and pension standards legislation would be required to give effect to the foregoing proposed solutions.

a.3 The use of plan surplus for contribution holidays should continue, where permitted under current plan provisions. But governments should also 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

Solvency or Going Concern?

b.1 Governments should shift their regulatory approach to focus solely on solvency valuations, except for plans which may be exempted from solvency valuation requirements.

b.2 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

b.3 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* – The rules for deficit amortization should be reviewed. Greater flexibility is needed with a goal of lengthening the amortization period in many circumstances.
- *Triennial Valuations* – The current triennial valuation requirement is generally sufficient. There may be times when this needs to be accelerated but, if so, regulators should act in accordance with clear, open and published criteria.

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.

Funding Policy

b.4 All DB plans should have a written funding policy, as a responsibility of the plan sponsor

b.5 Funding policies should be required to be developed and maintained but not regulated, much the same as SIPPs.

b.6 Funding policies should be given to the plan actuary and available to plan members and other interested parties.

Disclosure

b.7 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?

b.8 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.

b.9 "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.

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

b.10 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. If exempted, alternate means for regulation (e.g., going concern valuations) would need to be substituted, and the criteria for exemption should be clear.

Other

b.11 *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.

b.12 *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).

b.13 *Income Tax Act 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.

b.14 *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

c.1 It is the role of governments to establish statutory minimum requirements for the funding of DB plans and to ensure plan member benefit security.

c.2 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 should be a plan sponsor's (policy) decision constrained by regulatory requirements, any contractual commitments and guided by actuarial practice. This should be recognised more clearly in law. Fiduciary pension committees should not exercise funding decision powers, except to the extent that they also act as plan sponsor.

c.3 The role of the actuary in the DB pension plan funding process is that of advisor. While not "certifying" the soundness of the plan's funding status, the actuary should 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 (that are within the actuarial domain); and
- explaining the potential impact of plan sponsor insolvency (without specifying the risk of insolvency of the plan sponsor in question).

Benefit improvements made within a specified period before a plan is wound up should have a lower priority if there are insufficient plan assets to pay for them.

d. Funded Status and Benefit Security

d.1 *Pension Guarantee Funds* – Pension guarantee funds may at first glance be attractive, but do not work well in practice. Accordingly, the 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.

d.2 *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.

d.3 *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 factor (positive or negative) when assessing the sponsor's pension plan. Such an assessment might lead to some sort of regulatory action or a 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.

d.4 *Seniority of Pension Debt* – The seniority of the pension debt on plan wind up should remain as it 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.

d.5 *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.

E. CONCLUSION/CALL TO ACTION

This report has attempted to identify issues related to the funding of DB pension plans which need fixing or further dialogue. To this end, the report has made a number of recommendations. If these recommendations are followed, the ACPM believes that the result will be 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 ACPM encourages its members and other pension plan stakeholders to work together to turn these recommendations into actions.

ATTACHMENT 1

ASSOCIATION OF CANADIAN PENSION MANAGEMENT

PROPOSAL FOR USE OF LETTERS OF CREDIT TO MEET SOLVENCY DEFICIT CONTRIBUTION REQUIREMENTS FOR REGISTERED PENSION PLANS

Overview

In today's environment of 45-year low interest rates, current five-year solvency deficit funding requirements are causing significant increases in pension contribution requirements for many Canadian pension plan sponsors. Furthermore, when long-term interest rates rise and/or equity markets perform favourably over a sustained period, as will inevitably occur, many mature plans with a solvency deficit today will subsequently find themselves with surpluses that are too large to be effectively utilized over the foreseeable future.

This attachment describes proposed changes to pension funding regulations to permit the use of letters of credit to cover all or a portion of the current solvency deficit funding requirements. This proposal is a viable means of providing alternative solvency funding that will assist financially sound employers in addressing the issues identified above.

As is the case when letters of credit are utilized for supplemental pension arrangements, the letters of credit would be held by the plan's trustee. If the plan sponsor failed to renew the letters of credit, the trustee would call the existing letters of credit and the financial institutions that issued the letters of credit would be required to deposit the face amount of the letters of credit in the pension fund. Consequently, the issuance of letters of credit will have the same favourable impact on a less-than-fully-solvent plan's benefit security as the remittance of additional contributions to the plan.

Detailed Proposal

It is proposed that plan sponsors be able to elect to meet all or a part of their required solvency special payments (but not going concern special payments) by arranging for a letter of credit for the solvency special payments. The intent is that the sum of the plan's assets and the face amount of the letters of credit at any point in time will equal the expected assets at that time as if the solvency special payments had been made in cash. The proposed amendment to pension regulations would specify the following:

1. The sponsor may arrange a letter of credit in lieu of some or all of its required solvency special payments.

2. Once a letter of credit has been arranged for a specified amount of foregone contributions, it must remain in effect in such amount as long as the

contributions remain unpaid or, if earlier, until the plan has a solvency surplus (with plan assets valued at market value and taking into account the value of the letters of credit in place).

3. The letters of credit must be held by the pension fund trustee, and exercisable by the pension fund trustee independently of action, inaction or incapacity of the sponsor. Failure to renew a letter of credit will result in the letter of credit being called by the trustee, unless the letter of credit is no longer required (either as a result of the employer remitting the previously-foregone contributions or the plan reverting to a solvency surplus as per paragraph 2). Failure by the plan sponsor to remit any statutory minimum required contributions to the plan year in which they are due will result in all outstanding letters of credit being called by the trustee. (There may be circumstances where it is appropriate to call only a portion of the letters of credit.)

4. The letters of credit must be issued by financial institutions whose credit is rated by DBRS as "A-" or higher (or equivalent rating from another major credit rating agency), and who deal at arm's length with the plan sponsor.

5. In addition to the contribution requirements under existing regulations, additional contributions are required in the amount of the deemed interest on the accumulated balance of foregone solvency contributions, computed using the solvency liability discount rate used in the previous actuarial valuation.

6. To simplify the plan trustee's monitoring requirements, it is proposed that the plan sponsor be required to arrange, at the beginning of each year, the necessary letter of credit for the portion of that year's contribution requirements that will be met via letter of credit. The trustee would then be provided with the appropriate schedule setting out the statutory minimum contribution amounts for that year, including the portion being met by letter of credit. Any increase in contribution requirements for such year must be contributed to the pension fund in cash. Less restrictive requirements may be appropriate if the corporate trustee community deems that the monitoring is manageable.

7. In determining the solvency position of the plan, the face amount of the letters of credit is included in the plan assets.

8. In determining the going concern financial position of the plan (and hence the going concern special payments), any letters of credit in place would not be taken into account.

9. The face amount of any letters of credit in place can be reduced by the amount of any solvency special payments for a fiscal year that are in excess of the minimum requirement for such fiscal year.

10. The face amount of any letters of credit in place can be reduced if, at the effective date of the actuarial valuation, the sum of the market value of the plan assets and the face amount of the letters of credit exceeds the plan's solvency liabilities, in which case the face amount of the letters of credit can be reduced so that the sum of the market value of the plan assets and the adjusted face amount of the letters of credit equals the plan's solvency liabilities.

11. Normal (current service) cost contributions may be reduced to the extent that there is a going concern surplus, subject to there also being a solvency surplus. If the normal cost "contribution holiday" exceeds the solvency surplus, then such excess must be treated like unpaid solvency contributions (i.e., it is added to the minimum letter of credit face amount). In computing such surplus amounts, the face amount of any letters of credit in place is excluded in the calculation of the going concern surplus, and included in the calculation of the solvency surplus. Normal cost contributions may not be reduced if solvency liabilities exceed the sum of the plan's assets and the face amount of any letters of credit in place.

12. The plan sponsor is responsible for paying any fees for securing the letters of credit. If it is required that the fee for a letter of credit be paid from the pension fund, then the sponsor must first contribute the amount of the fee to the fund, in addition to any other required contributions.

13. Annual actuarial valuations would be required while any letters of credit remain in place.

14. A letter of credit would have to be in place as at the date at which a solvency contribution is due in order for the letter of credit to be utilized in lieu of contributing this amount.

15. In determining the plan's solvency ratio (i.e., the ratio used to compute any transfer deficiency contributions required when lump sum benefit payments are made from the plan), the face amount of any letters of credit would be included in the plan assets.

ATTACHMENT 2

THE ASSOCIATION OF CANADIAN PENSION MANAGEMENT

Members of the ACPM Funding Issues Task Force

Chair

Paul Litner
Partner
Osler, Hoskin & Harcourt LLP

Members

Michael Beswick
(Past AGRC Chair)

Stephen Bigsby
Executive Director
ACPM

Serge Charbonneau
Partner
Morneau Sobeco

Malcolm Hamilton
Principal
Mercer Human Resource Consulting

Laurie Hutchinson
(ACPM Board of Directors)

Greg Hyatt
Director, Pension Plan Management
Canadian Pacific Railway

Ian Markham
Watson Wyatt Worldwide

Becky West (AGRC Chair)
Client Service Executive
Frank Russell Canada Ltd.

Notes

Notes

Notes