

Submission by the Canadian Institute of Actuaries to the Ontario Expert Commission on Pensions

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Preface

The Canadian Institute of Actuaries (CIA) is pleased to respond to the invitation of the Ontario Expert Commission on Pensions (the “Commission”) to make written submissions and to assist the Commission in making recommendations to the Minister of Finance about the regulation of Defined Benefit pensions in Ontario. The CIA establishes the Rules of Professional Conduct, guiding principles and monitoring processes for actuaries, all of which adhere to the profession’s standards of practice and support Guiding Principle 1 that the public interest is paramount. The CIA also assists the Actuarial Standards Board in developing standards of practice applicable to actuaries practising in Canada, including those governing actuarial valuation of pension plans.

The CIA is currently reviewing some of the standards related to Defined Benefit pension plans. In particular, new standards of practice are being developed by the Actuarial Standards Board for funding of pension plans and for determining the commuted value of a pension benefit.

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Canadians are not saving enough for their retirement. One third of Canadians have no retirement savings at all, and a good portion of the remainder is not saving enough to fund an independent retirement. Layered on to that, the Defined Benefit plan, an important component of the Canadian retirement system, and a highly effective retirement income security vehicle, is in decline. *It is apparent that public policy measures need to be put in place to turn this trend around.*

Actuaries are concerned that Canadians may ultimately be deprived of access to Defined Benefit pension plans as a viable retirement income accumulation alternative. While Canada has one of the best retirement systems in the world, there has been a steady erosion of Defined Benefit pension plans such that they now cover only 21% of private sector employees. *Urgent action is needed to safeguard this key component of our retirement income system.*

Defined Benefit plans are in the best interest of Canadians. Our submission identifies the influences that have undermined this critically important part of the overall pension system.

Benefit security requires strong funding. The major issue is around balancing the related challenges of benefit security and funding fairness. Actuaries understand the pension system from all perspectives – plan member (employee), plan sponsor (usually the employer), legislator and regulator.

The current retirement system contains disincentives for plan sponsors to adopt stronger funding beyond the minimum statutory requirements. Weaker funding could put benefit security at risk for plan members. This is mainly caused by uncertainty over surplus ownership and utilization for many Defined Benefit plans. A plan sponsor who makes extra contributions to the plan to improve its solvency position

when investment returns are poor may find that those past extra contributions become unnecessary when the investment environment improves, yet the resulting surpluses could be claimed by plan members in the event of a partial or full wind-up. Plan sponsors perceive this as unfair and tend to be unwilling to fund plans above minimum levels. This, in turn, reduces the ability of a plan to withstand adverse economic conditions, reduces security for plan members and may eventually lead to plan wind-ups. ***Legislation should be adopted that removes these disincentives.***

Executive Summary

The current and future financial security of retired and retiring Ontarians is being endangered by the decline of Defined Benefit pension plans. Helping Ontarians build adequate retirement income in an optimal way is a critical public policy issue. Given the importance of Defined Benefit pension plans in the provision of retirement income to Ontarians, changes to the retirement system are needed to facilitate the maintenance of existing plans and encourage increased coverage by such plans.

In our view, the government should:

- **Permit the use of a Pension Security Trust.** The Pension Security Trust would be complementary to, but separate from, the regular pension plan fund and would be used to increase funding levels and enhance benefit security for plan members. If the tax-deductible contributions made to the Pension Security Trust were subsequently found not to be needed to fund benefits, they would be released back to the plan sponsor.
- **Require all Defined Benefit pension plans to establish and maintain a Target Solvency Margin to enhance benefit security.** The level of the Target Solvency Margin would be related to the risks faced by the plan. Plan sponsors would be required to continue making current service contributions, even if the plan had assets in excess of the solvency liabilities, as long as plan assets are less than the sum of the solvency liabilities and the Target Solvency Margin.
- **Enact flexible, principles-based legislation that encourages innovation in plan design and financing arrangements and promote the growth of Defined Benefit pension plans.** Again, enabling legislation needs to be flexible to allow for innovative measures such as Pension Security Trusts and Letters of Credit.
- **Enact pension legislation that permits the use of letters of credit for solvency amortization payments.** Allowing the use of letters of credit for this purpose would provide plan sponsors with additional flexibility without decreasing the security of the plan member benefits. Letters of credit could be held as an asset in the Pension Security Trust.
- **Change the way pension plan wind-ups are processed to address practical difficulties in applying solvency valuation requirements.** The annuity market in Canada is not large enough to handle significant one-time annuity purchases, and some types of annuities are difficult to purchase (e.g., indexed pensions). Therefore, plan wind-ups that occur will likely be protracted over time, exposing the plan to additional market risk. Yet solvency valuations must measure liabilities under the

unrealistic scenario that all obligations are settled at once. Allowing alternative methods of settling plan obligations on wind-up must be explored.

- **Require annual actuarial valuations for plans whose solvency ratio is less than 100 percent.** Plans with solvency ratios above 100 percent would continue to conduct valuations every three years. This represents a reasonable balance between the desire for more timely intervention when a plan is headed into financial difficulty and the concern about excessive administration costs.
- **Amend the legislation and policies to facilitate adjustments in pension plan designs and workplace policies to deal with increasing longevity and workforce planning.** In particular, changing the maximum normal retirement age under pension legislation would allow plan sponsors and members to adapt to an environment of increasing longevity. Pension legislation should be changed to accommodate phased retirement policies.
- **Explore alternative ways of protecting benefits in wind-ups of underfunded plans by insolvent employers.** Look at what other jurisdictions are doing, for example, the availability and usage of privately managed insolvency guaranty schemes or insurance contracts for this purpose should be researched. In the meantime, unfunded pension liabilities should be given priority similar to that of unpaid wages in bankruptcy proceedings.
- **Require plan sponsors to establish a formal funding policy for Defined Benefit pension plans.** The written funding policy would: a) define the roles of the plan sponsor and the actuary; b) address both going concern and wind-up bases; and c) address timing of valuations, giving specific consideration to benefit security and stability of contributions. This recommendation would increase transparency and provide stakeholders with an enhanced understanding of the funded status of the plan and the associated risks.
- **Take the lead in coordinating the development of pension legislation in Canadian jurisdictions.** Currently, moving pension issues on to the national agenda is impossible as the respective ministers responsible for pension matters, provincially and federally, never meet. For example, responsibility for the pension file falls under the Minister of Finance in only three provinces.
- **Eliminate partial plan terminations.** This would not only eliminate the surplus distribution issue on partial termination but would also remove the administrative and cost burdens related to partial terminations. However, if partial plan terminations are maintained in the pension legislation, the government should more clearly specify the criteria for any special situations in which “grow-in” or full vesting rights must be provided.
- **Enact more flexible legislation and policies to streamline the process for plan mergers, splits and asset transfers.** Restrictions that impede the merger of pension plans and the often lengthy approval process for asset transfers and plan splits create administrative complexity and increase the cost of the transaction.

Introduction

The CIA is the national organization of the actuarial profession in Canada. It is dedicated to serving the public through the provision, by the profession, of actuarial services and advice of the highest quality. To this end, the CIA promotes the advancement of actuarial science and sponsors programs for the education and qualification of members and prospective members. It maintains programs to ensure that actuarial services provided by its members meet accepted professional standards. In carrying out its activities and programs, the CIA holds the duty of the profession to the public above the needs of the profession and its members.

The CIA has more than 3,750 members across Canada. Approximately half of these members work in the pension field. Pension actuaries work with plan sponsors, plan administrators, unions and trustees to design, finance and administer their pension plans. The members of the actuarial profession play a major role in the creation of pension plans and public income security programs, and in establishing the funding standards required to ensure their viability. Fellows of the CIA have a legislated role in the production of actuarial valuations for defined benefit pension plans.

One of the CIA's goals is to assist legislators in developing pension plan legislation that responds well to the needs of all parties. Mindful of its responsibility to the public interest, the CIA aims to promote a legislative approach that is conducive to efficient and effective pension plan management, consistent with the interests of all concerned parties.

The CIA shares the Ontario government's concern about pension plans' sustainability and their capacity, over the long term, to help provide retirement income to an aging population. Our profession pays special attention to Defined Benefit pension plans on account of their importance in providing plan members with financial security during their retirement years.

Issues addressed in our submission

In preparing our submission, we have focused on those aspects of the Commission's mandate that are most directly related to the role of actuaries in the establishment and management of Defined Benefit pension plans, and for which we believe the CIA has unique expertise to offer meaningful input to the Commission's deliberations. We reviewed the questions raised in the Commission's February 2007 discussion paper *Reviewing Ontario's Pension System: What are the Issues?* (the "Discussion Paper"), as well as additional questions posed to us in face-to-face meetings with the Commission and its Advisory Panel. Our submission has been organized into three main themes:

1. Improving the regulatory and business environment for Defined Benefit pension plans in Ontario.
2. Putting Defined Benefit pension plans on a more sound financial footing.
3. Enhancing public understanding of the "pension promise."

In the Appendix, we identify recent publications and ongoing research initiatives by the CIA related to pension policy in Canada, as well as developments in updating professional standards for actuaries practising in pensions, which we believe might be of interest to the Commission.

Both the Discussion Paper and this submission focus mainly on single employer Defined Benefit pension plans. However, the Commission should keep in mind that certain types of Defined Benefit plans, such as multi-employer pension plans and jointly-sponsored pension plans, present unique circumstances and issues because they involve different methods of spreading risks between plan sponsors and plan members. We encourage the Commission to consider this uniqueness in developing its recommendations, and to ensure that new legislative measures aimed at single employer Defined Benefit plans do not inadvertently jeopardize other types of plans that combine elements of both Defined Benefit and Defined Contribution designs. Applying the same rules to all plans may not always be appropriate.

1. Improving the regulatory and business environment for pension plans

Inherent in the Discussion Paper is a belief that the future of Defined Benefit pension plans is at risk unless changes are made to the pension system. The Background section of the Discussion Paper offers a thoughtful and well-reasoned analysis of the environment under which Defined Benefit plans are currently operating. It also acknowledges the decline in the percentage of workers covered by such plans and cites a number of reasons for this trend.

The CIA agrees with the arguments put forward by the Commission for this decline. Canada's patchwork of regulations, legal decisions, tax rules and changes in accounting standards has created problems. These problems have been compounded over the recent past due to: a) low interest rates; b) increasing longevity; c) volatile market yields; and d) the uncertainty regarding contribution holidays and plan surplus ownership and utilization.

1.1 Importance of Defined Benefit Pension Plans to Canadians

Statistics Canada reports that participation rates in public and private employer-sponsored Defined Benefit pension plans has decreased substantially over the last decade.

Both the adequacy and security of retirement income are threatened by the decline in coverage by Defined Benefit pension plans. Saving and improving these plans is a better choice for Canadians than allowing their continuing steady erosion. A Defined Benefit pension plan provides security that cannot be found in Defined Contribution pension plans or RRSPs. The pension benefit is pre-defined, usually as a percentage of pre-retirement salary or as a fixed rate per year of service. While plan members may provide a defined level of contributions to these plans, the plan sponsor undertakes to contribute at whatever additional level is necessary to fund the promised benefits.

Defined Benefit pension plans are an important component in the overall retirement system and are in the best interests of individual Canadians for a number of reasons:

a) **Greater predictability for plan members.** Defined Benefit pension plan members have a good sense of what they will receive in retirement, making planning and saving for the future easier and reducing uncertainty.

b) **More security and less risk to plan members.** Individuals in an ongoing Defined Benefit pension plan face lower risks related to changing interest rates, longer than expected longevity and volatility of market returns.

c) **Better workforce management.** Defined Benefit pension plans help employers retain good employees and they can be a tool to help employers better manage their workforce (e.g., enhance early retirement).

d) **Higher investment return.** By having larger pools of money to invest and, importantly, longer investment time horizons, a more aggressive, diversified and informed investment strategy with lower management fees can be used. The higher yields and lower administration costs result in greater value for dollars invested in Defined Benefit pension plans compared to Defined Contribution pension plans over the long run.

e) **Greater economic benefit to society and the economy.** Bank of Canada Governor David Dodge believes Defined Benefit pension plans promote economic efficiency by allowing a better allocation of savings and that they contribute efficiency gains for financial markets. He has stated that managers of Defined Benefit pension plans have both the ability and desire to invest in the kinds of assets that the average individual investor might not normally consider. Such managers have a superior knowledge of financial markets and of the associated risks that make them willing to invest in alternative asset classes, and Defined Benefit pension plans invest over very long time horizons so they can finance large investment projects at competitive rates of return.

We note that one of the principles guiding the Commission's work is the "importance of maintaining and encouraging the system of Defined Benefit pension plans in Ontario." *We recommend that this principle become a formal mandate of the Financial Services Commission of Ontario (FSCO), so that FSCO can actively participate in promoting these plans rather than simply performing a regulatory oversight role. Further, we recommend that Ontario should take the lead in arranging discussions at the ministerial level, both provincially and federally, to address the key steps in saving and encouraging Defined Benefit pension plans.*

1.2 Removing Uncertainty about Surplus Ownership and Utilization

A critical issue that must be resolved is that of surplus ownership and utilization. The current uncertainty surrounding plan surplus ownership and utilization does not encourage higher levels of funding. Consequently, it has a detrimental effect on benefit security for members. This uncertainty may indeed be one of the most significant forces driving the decline in Defined Benefit pension plan coverage.

Plan sponsors need certainty that when they fund Defined Benefit plans on a more secure basis, they will have access to any surplus funds that may arise when economic conditions are favourable. In the current environment, when economic conditions are unfavourable, plan sponsors must pay more into the pension plan, but when conditions turn favourable, the resulting surplus often belongs to the plan members. This imbalance is perceived by plan sponsors as unfair, and it discourages the secure funding of Defined Benefit pension plans, decreasing the security of members' pensions, and may contribute to the discontinuation of these plans.

Plan members need greater security that their benefits will be provided to them when they retire. This requires stronger funding of Defined Benefit pension plans as well as improved governance.

We recommend that Ontario make legislative and regulatory changes that, for example, permit the use of Pension Security Trusts and require all Defined Benefit pension plans to establish and maintain a Target Solvency Margin and that:

- *clarify rules for surplus ownership and utilization that recognize plan sponsors' right to and access to plan surpluses;*
- *clarify that documents establishing pension plan funding vehicles are documents of the plan, subject only to the provisions of the Pension Benefits Act and its regulations; and*
- *state explicitly that to the extent of any inconsistency with the common law, the provisions of the Pension Benefits Act and its regulations are paramount and supersede the common law.*

These changes should override legal precedents that have recently been established particularly where the plan documentation is silent on these issues, but they should also recognize that existing contracts or agreements between the plan sponsor and plan members will need to be respected. Removing this uncertainty surrounding surplus ownership and utilization will go a long way towards eliminating unanticipated costs to plan sponsors and will increase the palatability of sponsors to better fund their pension plans, thereby enhancing benefit security.

1.3 Partial Plan Terminations

The Monsanto decision has created uncertainty and is one reason that plan sponsors are discouraged from building up a funding cushion. The requirement to distribute surplus on a partial plan termination is not only damaging to the benefit security of remaining members, but also it creates inequities among the various groups of plan members. More specifically:

- Members affected by a partial termination will inevitably have a different share of surplus than the members in the plan on a full termination, if there ever is a full termination.
- Retirees are seldom included in a partial termination, although they might have been part of the affected group before retirement.
- The existence of surplus in a Defined Benefit pension plan at any given date is usually attributable to interest rates or stock market returns. This is largely a matter of chance and may easily be reversed over the future.
- The “surplus” at the date of a partial termination is only an estimate, since the actual surplus or deficit has not crystallized.
- Due to the “grow-in” rights, members affected by a partial termination may receive higher benefits (and a higher proportionate share of surplus) than remaining members.

- The question of what constitutes a partial termination has proven to be very difficult to interpret in practice. The criteria used to determine whether a partial termination has occurred appear to be somewhat arbitrary. The requirement to purchase annuities for certain members can cause problems (as noted later in Section 2.5). Therefore, ***we recommend the elimination of partial terminations, as currently structured under Ontario legislation.***

We believe that grow-in rights generate inequities amongst members. If for public policy reasons, the government reasons that they must stay, then ***we recommend that the Pension Benefits Act and its regulations should clearly state the criteria to determine when these rights must be granted.***

1.4 Mergers, Splits and Asset Transfers

When one employer sells a business unit to another, and the employees of that business unit participate in a pension plan for all of the vendor's employees, it is often necessary for the purchaser to establish a pension plan and assume responsibility for the past service obligations of the vendor. Assets are transferred from the vendor's pension plan to a new or existing plan sponsored by the purchaser. Ideally, the basis for determining the amount of the asset transfer is fully defined by the purchase and sale agreement. Similarly, an employer may merge its operations with another employer and it may become necessary to merge the respective pension benefits into one new plan that covers all employees of the new entity.

The legislation should recognize the reality that these business transactions occur in a variety of forms and that time is usually a factor. However, in addition to the uncertainty created by the Transamerica decision, the current regulations and policies contain restrictions that impede or make impossible the merger of pension plans, and impose significant delays in asset transfers and plan splits due to the lengthy approval process. These delays create administrative complexity and can increase the cost of the transaction. The inability to merge pension plans may cause significant inefficiencies that unduly increase the cost of providing benefits to the affected members.

We recommend that greater flexibility in approaches and approval procedures be implemented to streamline these transactions recognizing, of course, that benefit security of affected employees will remain a key consideration. The adoption of the measures that we propose in Section 1.2 would be a significant step in removing a major obstacle for these transactions.

1.5 Innovative Designs and Financing Arrangements

The CIA would encourage innovation in plan design and financing arrangements that promote the growth of Defined Benefit pension plans. For example, cash balance plans, which are used extensively in the United States, are effectively prohibited in Canada under the existing legislation. Other designs that may offer additional flexibility to plan members and assist employers in attracting and retaining employees would be welcome.

Any measure that can alleviate operational costs or mitigate risks for organizations sponsoring Defined Benefit pension plans should be considered, especially for small

plans. The Discussion Paper alluded to pooling arrangements for employers on a sector by sector basis or otherwise on a multi-employer or cooperative basis. Such arrangements would likely be sponsored by financial institutions that would offer similar plan designs to the plan sponsors in the pool for simplicity in administration. The pooling would likely apply to investments and the longevity risk as discussed in Section 2.7. Clearly, the establishment of such arrangements would need to safeguard against unreasonable cross subsidization between participants in the pool.

We recommend that innovative designs be investigated and the CIA is willing to help.

A move to principles-based regulation would be required to allow flexibility under any of these or other innovative concepts. Current legislation is too rigid and stifles some very innovative plan designs.

2. Putting Defined Benefit Pension Plans on a More Sound Financial Footing

The goal of funding Defined Benefit pension plans is the systematic accumulation over time of dedicated assets that, without recourse to the plan sponsor's assets, secure the plans' promised benefits. To continue to be successful, Defined Benefit pension plans must:

- provide plan members with reasonable confidence that the promised benefits will be paid; and
- offer plan sponsors reasonable predictability of costs.

Confidence on the part of plan members requires both adequate funding of the benefits and the development of an environment in which plan sponsors are encouraged to maintain and appropriately fund Defined Benefit pension plans. Predictability of costs requires the proper measurement and appropriate reporting of funding requirements and of the associated risks, and an enabling regulatory environment. The equitable treatment of the consequences of risks undertaken, must be clearly articulated and understood by all stakeholders.

2.1 Pension Security Trust

A new type of funding vehicle is needed, with clear ownership of assets, to supplement the existing pension plan trust fund.

We believe that most plan sponsors would be willing to fund a Defined Benefit pension plan more securely, thereby improving benefit security for the members, if they knew that they could access any surpluses that might arise from their excess contributions. This confidence would encourage plan sponsors to continue their Defined Benefit pension plans or to start new Defined Benefit pension plans.

We propose a Pension Security Trust as an innovative way to facilitate this improvement. Plan sponsors would be able to contribute to the Pension Security Trust, which would be complementary to the regular Defined Benefit pension plan trust fund. The assets would be invested in a manner similar to the regular pension plan trust fund, and would be held as a side fund by the trustee and custodian. Unlike the pension plan trust fund, however,

the Pension Security Trust would hold plan sponsor contributions only and would be “owned” by the plan sponsor.

Solvency deficiency payments would be placed in the Pension Security Trust. Contributions arising from going concern valuations would go into the regular pension fund. The Pension Security Trust could also be used by plan sponsors who wish to contribute more than the minimum required under the going concern valuation to strengthen the funding of the plan. If subsequent valuations show that some of the assets in the Pension Security Trust are not required to pay plan benefits, then the excess could be released back to the plan sponsor.

The assets held in the Pension Security Trust fund would be included in the value of assets for the purposes of the solvency actuarial valuation and, in case of plan wind-up, the monies held by the Pension Security Trust may be refunded to the sponsor to the extent not necessary to cover any excess of the wind-up liabilities over the assets in the regular pension fund. The pension plan would be granted a priority claim to the Pension Security Trust fund in the event of the sponsor’s insolvency, ahead of other creditors, up to the amount needed to satisfy plan wind-up obligations.

2.2 Target Solvency Margin

One method of achieving more secure funding of benefits would be for all plans to maintain a portion of that surplus as a Target Solvency Margin. The amount of the Target Solvency Margin would vary according to the potential volatility of a plan’s funded position, thereby ensuring more secure funding based on the level of risk of the plan.

Risk-based solvency through a Target Solvency Margin is a concept already used by governments to ensure the security of other risk-bearing financial institutions. Some Defined Benefit pension plans are subject to greater volatility than others, partly as a result of the asset mix of the plan. A pension plan invested mostly in high quality bonds would typically have a lower risk than one with an asset mix with high percentages of Canadian and foreign equities. Other risk factors include the demographic profile of the plan membership, the investment policy and the associated asset/liability mismatch (i.e., the extent to which the cash flows of the assets deviate from the cash flows of the liabilities). Hence, each plan should have a Target Solvency Margin equal to the percentage by which the assets of a plan should exceed the liabilities on a solvency valuation basis established based on its specific risk factors and its exposure to volatility. Establishing Target Solvency Margins for plans that have different risks will create a risk-based approach to plan funding.

The implementation and ongoing monitoring of the Target Solvency Margin should not involve overly high complexity, cost and work. The development of such a margin should balance the need to accurately reflect the plan’s risk exposure with the need for simplicity, recognizing the small size of some plans.

The Target Solvency Margin could work in tandem with the Pension Security Trust and letters of credit (discussed in Sections 2.1 and 2.4). Plan sponsors could pay the additional contributions required to meet solvency funding requirements into the Pension Security Trust or use a letter of credit for this purpose. Use of the Pension Security Trust and/or a letter of credit instead of the regular pension fund would ensure that any part of

the Target Solvency Margin not ultimately needed to provide plan benefits would be accessible by the plan sponsor.

The Target Solvency Margin would determine when a plan sponsor could take a contribution holiday. Unless the sum of the assets in both the regular pension fund and the Pension Security Trust (including the face amount of the letter of credit, if applicable) exceeded the solvency liabilities by at least the Target Solvency Margin, the sponsor would be required to continue making current service contributions (i.e., contributions determined in accordance with the going concern valuation).

The CIA is currently working with Quebec regulators, researching the appropriate level of solvency margins, and this research will be published shortly. We also acknowledge that amendments to the income tax legislation may be required to accommodate this concept. ***We recommend that a task force be set up with representation from pension regulators, the federal Department of Finance and the CIA to review this research and establish the Target Solvency Margin framework.***

2.3 Raise Maximum Surplus Levels

As seen in the current decade, the financial position of Defined Benefit pension plans can experience significant fluctuations within a relatively short timeframe. It would be desirable to allow these plans to maintain a surplus level that would be sufficient to ward against negative experience. The maximum surplus level allowed under the current federal tax rules is too low to provide adequate financial protection. With a view to increasing benefit security, ***we invite the Ontario government to encourage the federal government (as has the CIA) to change the tax rules in order to allow Defined Benefit pension plans to maintain reasonable funding margins before contribution holidays are required*** (e.g., allow developing surpluses that are the greater of two times the Target Solvency Margin or 25 percent of the going concern liability).

2.4 Letters of Credit

We recommend that legislation should be adopted to permit the use of letters of credit to guarantee solvency deficiency amortization payments. Some provinces and the federal government have already adopted legislation to allow this practice.

Letters of credit provide plan sponsors with additional flexibility without decreasing the security of the benefits accrued by the plan members. They provide plan sponsors the opportunity to better manage their cash flow and utilization, which are important considerations in the current environment of worldwide competition and the struggle for increased efficiency. Instead of paying additional contributions to the pension fund, the plan sponsor will be able to provide a letter of credit whose amount can fluctuate according to the economic context and the financial health of the pension plan.

The letter of credit could be held as an asset in the Pension Security Trust. The face amount of the letter of credit would be considered a plan asset and taken into account for actuarial valuation purposes. It should remain in effect unless it is reduced or cancelled by paying an equivalent contribution into the Pension Security Trust or having a surplus on a solvency basis. Upon plan termination, the letter of credit would be usable only up to the amount of any actual deficiency.

We recommend imposing reasonable limits on the face amount of the letter of credit. For example:

- ***Limit letters of credit to the payments required to amortize solvency deficiencies.***
- ***Impose a dollar or percentage limit of the deficiency that may be supported by letters of credit, similar to the limits on other permitted investments in the pension fund.***
- ***Limit letters of credit to the amount of the Target Solvency Margin discussed above.***

2.5 Solvency Valuations

Actuarial valuations on a plan wind-up basis show how secure the promised benefits are. Actuarial valuations on a going concern basis are more concerned with calculating sufficient yet stable contribution levels. Actuarial valuation reports should highlight both of these two key objectives – the security of benefits in the event the plan is wound up, and the appropriate level and stability of contributions if the plan is continued for the long term.

However, in recent years the solvency valuation results have had a significantly increasing influence on the level and stability of contribution requirements for a variety of reasons. These include:

- low interest rates, and concomitant higher annuity purchase rates and commuted values;
- volatile investment markets that can cause considerable swings in the market value of assets recognized for solvency purposes;
- increasing proportions of retiree liabilities (including those eligible for early retirement and other members with associated “grow-in” rights) in many plans, due to general aging of the workforce, increased longevity, closing of the Defined Benefit portion of the plan to new entrants upon conversion to a Defined Contribution plan and, particularly for certain multi-employer plans, employment in a declining industry; and
- “front-loaded” legislative contribution requirements, since solvency deficiencies must be amortized over a five-year period.

Ontario and Nova Scotia are the only jurisdictions in Canada that require “grow-in” benefits to be provided on plan wind-up, and Ontario is the only jurisdiction that requires recognition of these “grow-in” rights for solvency funding purposes. In some situations, where the rates of early retirement take-up under the plan are relatively low, this means that the plan sponsor is required to make extra contributions to fund early retirement benefits that, in all probability, will never be received. This is particularly true for multi-employer Defined Benefit pension plans with negotiated contributions, which typically have a lower likelihood of plan termination. These factors can put an unnecessary strain on the funding requirements of plan sponsors. Coupled with the problems associated with surplus ownership and utilization, it is obvious why plan sponsors are reluctant to fund at levels that exceed minimum legislative requirements.

Current Ontario legislation presumes that on plan windup all annuities will be purchased at the same time. The group annuity market in Canada is limited in size and in the types of product offered. It is highly unlikely that the plan administrator of even a medium-sized plan would be able to purchase annuities for all its retirees (including those eligible for early retirement) in one transaction upon plan termination. It could take many years before all the retiree obligations of the terminating plan can be satisfied through the purchase of annuities. Further, some types of annuities, such as those that are indexed, are difficult, if not impossible, to purchase.

As a way of dealing with the absence of an annuity market for certain types of pension liabilities, *we recommend that Ontario allow the pension plan to settle a larger proportion of its obligations through the payment of lump sum commuted values than is allowed under current legislation.* For example, a plan could be permitted to settle all liabilities for active members by paying lump sum settlements rather than giving such members a choice between a deferred annuity or a lump sum. Retired members could be offered a choice between an immediate annuity or a lump sum. The CIA is prepared to conduct further study into what commuted value standards would be appropriate under these circumstances.

Since plan wind-ups tend to be conducted in multiple transactions over an extended period of time, the plan is exposed to extra market risk, due to the uncertainty about the ultimate cost to settle the plan's obligations. The proposed Target Solvency Margin would serve as a buffer against this market risk for the duration of the wind-up process, thereby minimizing the likelihood of additional contributions by the sponsor or loss of benefits by members.

2.6 Frequency of Actuarial Valuations

Under current Ontario legislation, actuarial valuations must normally be conducted at three-year intervals. Annual valuations are required for plans with solvency ratios less than 80 percent, or for plans with solvency ratios less than 90 percent and solvency deficits greater than \$5 million. As recent market experience has demonstrated, the solvency positions of pension plans can change very quickly and dramatically. Some argue that a three-year valuation interval is too long. Others point out that actuarial valuations impose a cost to the plan or to the sponsor, and more frequent valuations can be a significant and often unnecessary financial burden, particularly for smaller plans.

We recommend that all plans whose solvency ratio is less than 100 percent be required to conduct actuarial valuations annually. A plan would revert to the triennial valuation interval once the insolvent financial position is eliminated. This would be consistent with the legislation that exists in other jurisdictions, and in our view represents a reasonable balance. For plans with solvency ratios greater than 100 percent, a requirement to maintain a Target Solvency Margin would provide some degree of protection to plan members against unfavourable experience before the next triennial valuation is conducted.

2.7 Managing Longevity Risk

One of the questions raised in the Discussion Paper is how longer life expectancies and the end of mandatory retirement will affect occupational pension plans.

While increasing longevity is certainly a positive development for individual Canadians, it means that providing adequate lifetime income to retirees will become an ever greater challenge. For sponsors of Defined Benefit pension plans, pension payments must be extended to increasingly higher ages, raising the total cost of the plan. For employees accumulating retirement savings in Defined Contribution pension plans or personal RRSPs, the level of retirement income at a given retirement age will decrease as longevity increases; they will have to either save more, retire later or enjoy a poorer retirement lifestyle. Or more likely, they will run out of retirement income while they are still alive.

Over the long term, the only way for society to deal with increasing longevity is gradually to adapt its workforce policies and its retirement income arrangements to the new reality. This will require some combination of raising retirement ages, reducing benefit accrual rates, introducing phased-in retirement benefits, or raising costs to plan sponsors or to members.

Faced with a choice between delaying their retirement age and receiving a lower pension to keep plans affordable, many workers might be willing to accept a delay in their retirement age, knowing that they will need to extend the productive stage of their lives if they want to keep a reasonable standard of living into their extended retirement years.

As plan sponsors and workers adapt to the new environment, it will be important for actuaries to keep up with trends in mortality and longevity to ensure that the most realistic available demographic assumptions are used to determine the estimated future costs of pension benefits. The CIA is committed to ongoing reviews of professional standards for actuaries, including updates to guidance on the selection of appropriate mortality assumptions for the valuation of pension benefits. The CIA is supported by research from the Society of Actuaries, which sponsors regular studies of mortality experience among populations of active workers and group annuitants in the United States and Canada.

We recommend that the government consider increasing the maximum normal retirement age (currently 66) under the Pension Benefits Act. Adjustments to deal with increasing longevity must be adopted gradually through voluntary changes to pension plan design and other workplace policies. Government policy should, therefore, support the greatest possible flexibility for pension plan sponsors and members so they can find the best solutions to meet their needs.

To give the Commission some perspective on the possible financial effects of increased longevity relative to other factors affecting the costs of a pension plan, we show in the following table the estimated cost of a pension payable to a 65-year-old and the effect of projected improvements in mortality over a period of 50 years. For each gender, we have assigned a “relative cost” of 100 to represent the present value of an immediate pension that starts to be paid to an individual who attains age 65 in the year 2010.

	Relative cost of immediate pension	
	Male	Female
Age 65 in 2010 (base case)	100	100
Age 65 in 2020	103	101
Age 65 in 2030	106	103
Age 65 in 2040	109	104
Age 65 in 2050	112	105
Age 65 in 2060	114	107
Age 65 in 2010; delay retirement to age 66	94	94
Age 65 in 2010; delay retirement to age 67	89	89
Age 65 in 2010; increase investment return by 0.5% per annum	94	94

Assumptions: Mortality based on the Society of Actuaries' Uninsured Pensioner 1994 Table, with generational mortality improvement using Projection Scale AA. [Source: Transactions of the Society of Actuaries XLVII (1995)] The calculated present values are for an indexed pension payable to a single life, discounted at a real rate of investment return of 3% per annum (3.5% per annum for the final row of the table).

The above table illustrates that, even if currently projected mortality improvements continue for the next 50 years, the financial consequences for Defined Benefit pension plans are likely to be manageable, when viewed in comparison with potential changes in the retirement age or variations in investment returns earned by the pension fund. For instance, costs for an immediate pension for a male increases 14 percent in 50 years, yet a mere two-year increase in the retirement age reduces pension costs by a very comparable 11 percent.

Allowing phased retirement flexibility is a good way to facilitate new workplace policies aimed at mitigating the negative impact of the aging of our population. Employees considering retirement would be encouraged to continue working for their employer on a part-time basis, while collecting only part of their pension for a while. According to FSCO's interpretation of the *Pension Benefits Act*, a member is not currently allowed to collect part of his/her accrued pension before normal retirement date if still employed with the plan sponsor. In recent days, the federal government tabled legislation allowing pension plans to pay a pension to an employed member who is age 60 or entitled to an unreduced pension. ***We recommend that Ontario change its legislation to allow at least as much flexibility as proposed in the new federal tax rules.***

2.8 Pension Benefits Guarantee Fund

For a pension benefits guarantee fund (PBGF) to be viable in the long term, the price for the protection must be fair and equitable to each plan sponsor. To achieve this, the premium for the guarantee should take into account at least the following three factors:

1. the financial strength of the plan sponsor;
2. the degree of underfunding of the plan; and

3. the mismatch between the assets and the liabilities of the plan.

The current PBGF under the Ontario legislation ignores the first and third of these factors, but not without some reason. It can be difficult to assess the financial strength of a plan sponsor, particularly if the plan sponsor is a private company. However, ignoring this important factor in the determination of the PBGF premium unfairly penalizes plan sponsors that have a low risk of bankruptcy. These plan sponsors perceive the premiums as another tax that subsidizes the underfunded plans of financially weak plan sponsors, and if the premiums are too high, it creates an incentive to terminate their Defined Benefit pension plans in favour of something less costly.

We maintain that the government's efforts would be better directed towards improving the funding environment for private pension plans, thus reducing the very need for a government-supported backstop. Establishment of the Pension Security Trust mechanism and the inclusion of a Target Solvency Margin to reflect the mismatch between assets and liabilities in the calculation of the solvency liability are preferable alternatives to a PBGF over the long-term. The result would be to increase the likelihood that benefit promises are kept in the first place. PBGF premiums would be much lower than at present, as fewer plans would be underfunded on plan wind-up.

Ontario is the only jurisdiction in Canada that has a PBGF and it does not apply to all plans (e.g., negotiated contribution defined benefit plans) or all members in a plan that covers employees in provinces other than Ontario. ***We recommend that Ontario should explore the feasibility of alternative ways of handling underfunded plan wind-ups for insolvent employers.*** For example, other countries use privately-managed insolvency guaranty schemes or insurance contracts.

We believe that the implementation of our recommendations in this submission will improve the funding environment for defined benefit pension plans and reduce the need for the PBGF. Consideration could then be given to phasing out the current PBGF, particularly if other vehicles are available as a backstop. This would promote equitable competition across the country and alleviate the patchwork of legislation that currently exists.

3. Enhancing Public Understanding of the "Pension Promise"

3.1 Formal Funding Policy

Many plan sponsors do not have a formal funding policy for their Defined Benefit pension plans. ***The CIA recommends that Ontario should introduce legislation that would require plan sponsors to establish a written funding policy for their Defined Benefit pension plans in order to promote clear funding objectives and transparency. Further, the required annual disclosure by plan administrators to plan members should be expanded to include the key elements of the funding policy, as well as the investment policy and the current funded status of the plan.*** Such actions will encourage better plan governance and member communication.

The funding policy should address both going concern and wind-up valuation bases, giving specific consideration to at least two objectives: benefit security and stability of contributions. It should include a description of the key risks faced by the pension plan

and how these risks will be addressed. The funding policy should normally address items such as actuarial cost methods, the basis to determine best estimate actuarial assumptions, types and magnitude of margins in the actuarial assumptions, target contribution levels (or target benefit levels for plans with fixed contributions), utilization of surplus and contribution holidays and frequency of valuations. The roles of the plan sponsor and the actuary would also be defined in this policy.

For negotiated contribution plans, the funding policy would also need to address benefit policy and other issues related to fixed contributions.

The plan sponsor is responsible for establishing the funding policy, including the articulation of the level of margins to be used in the actuarial assumptions and the funding targets. The actuary would be responsible for the proper measurement and reporting of plan liabilities and costs, including disclosure of pertinent risks, in accordance with the policies adopted by the plan sponsor, regulatory requirements and actuarial standards. The actuary would likely assist the plan sponsor in the development of the funding policy and would be guided by this policy when selecting appropriate actuarial assumptions and methods.

The funding policy should be reviewed on a periodic basis to ensure that it remains appropriate to the changing circumstances of the plan. However, there need not be a requirement to file this policy with the regulatory authorities. In this manner, the treatment of the funding policy would be consistent with the treatment currently in place for the investment policy.

3.2 Disclosure of Funding Information to Plan Members

The CIA supports greater disclosure to plan members on the financial position of the plan, funding decisions and contribution holidays, provided that it is meaningful and does not create excessive administrative expenses. This information could be provided through the annual pension statement or it could be displayed on the plan sponsor website or through some other vehicle.

We acknowledge that increased transparency in the valuation process would be beneficial to all stakeholders. In particular, the CIA is proposing greater disclosure in actuarial valuation reports with respect to justifying the actuarial assumptions and the relative margins for adverse deviation contained within these assumptions. Key aspects of the plan sponsor's funding policy and investment policy would also be disclosed. These increased disclosure requirements would provide the reader with an enhanced understanding of the funded status of a pension plan and the associated risks.

4. CONCLUSION

The CIA supports the extensive research being conducted by the Commission on behalf of the province of Ontario. Given the number of discussion/working papers released in the last few years by various governments (provincial and federal) and the Canadian Association of Pension Supervisory Authorities (CAPSA), and the breadth of the Ontario research, it is clear that the issues related to Defined Benefit pension plans are a priority. It is also a welcome sign that Ontario and the other jurisdictions are committed to

improving the security of pension plan benefits and ensuring the viability of Defined Benefit pension plans.

The current funding regime applicable to Defined Benefit pension plans can and must be improved. Any revision to the funding rules must reflect the voluntary nature of these plans. We also encourage Ontario to explore other alternatives aimed at persuading plan sponsors to both maintain and better fund their defined benefit pension plans.

We are confident that it is possible to adopt appropriate legislative changes that implement a framework to alleviate the current problems related to the uncertainty about surplus ownership and utilization, and, consequently, provide a better environment for the long-term viability of Defined Benefit pension plans. The regulatory system should provide a clear understanding to each stakeholder of their respective entitlements and obligations appropriate to their particular circumstances. Actuarial standards of practice related to funding and reporting that reflect and support this system can then be developed. This combination will go a long way to encourage higher funding and increased benefit security.

The legislation governing Defined Benefit pension plans is complex, in particular for organizations with plan members in more than one province. With the passage of time, this complexity and the differences among provinces are only becoming more pronounced.

We often see ministers with specific portfolios from across the country meeting to discuss issues of common interest. It would be helpful if pensions could be put on the agenda for the next Finance Ministers' Meeting, however, only a handful of ministers have responsibility for the pension file in their jurisdictions. In Saskatchewan, pensions fall under the Justice ministry. In New Brunswick, it resides in Justice and Consumer Affairs. In Quebec, pensions fall within Employment and Social Solidarity. This combination of ministers never meets.

We encourage the Financial Services Commission of Ontario, the government of Ontario, to take the lead with other pension regulators and governments in Canada to come together to define pension standards that are consistently applied across the country. These need to reflect the need for increased pension coverage, the risks assumed by the various stakeholders and the members' concerns about better benefit security. Building on the high degree of cooperation in CAPSA would be helpful in this regard.

It seems that the last time the *Pension Benefits Act* was reviewed was in 1988. With the pace of change in society, it would seem that 20 years between reviews is too long. However, too frequent reviews may create instability and increase the risk of deterioration in harmonization of pension legislation in Canada. The CIA recommends that reviews should be conducted every 10 years and should include strong harmonization considerations.

The CIA would welcome further discussion on these crucial issues.

APPENDIX

RECENT CIA PENSION INITIATIVES

The CIA establishes standards of practice that support the ongoing operation of Defined Benefit pension plans. The CIA has a number of initiatives underway or recently completed that are intended to help maintain, encourage and improve the system of Defined Benefit pension plans in Canada. Some of these initiatives are described below.

While it is difficult to predict the results of these initiatives, it is anticipated that both benefit security and stability of contributions (albeit potentially at a higher level) will be enhanced.

Prescription for Canada's Ailing Pension System – The CIA has developed a pension prescription with 10 recommendations for change, which is aimed at better securing benefits for participants of a Defined Benefit pension plan and creating an environment conducive to maintaining and strengthening Defined Benefit pension plans for plan sponsors. This 10-point prescription was released in late June, 2007.

(<http://www.actuaries.ca/members/publications/2007/207061e.pdf>)

2006 Pension Review Project – A CIA team recently completed reviews of a random sample of about 60 funding valuation reports for various multi-employer pension plans across Canada (results are summarized in a report entitled, “Canadian Institute of Actuaries 2006 Pension Review Project”, which was released in July 2007). The purpose of this review was to promote the highest quality of actuarial work with respect to the valuation of multi-employer pension plans.

Review of Pension Funding Standards – The CIA's standards of practice applicable to funding and reporting on the funding of Defined Benefit pension plans are currently being reviewed. This review and consultation process is expected to result in significant changes to the standards (and hence to the actuary's funding valuation and report), to ensure that such standards evolve and remain appropriate and up to date. A working document, entitled, “Proposed Changes to the Practice-Specific Standards for Pension Plans” (<http://www.actuaries.ca/members/publications/2007/207020e.pdf>) was released in March 2007, and outlined the proposed changes and invited comments. The ultimate changes to the standards and the timing of these changes are under the jurisdiction of the Actuarial Standards Board, an independent standard-setting body established by the CIA in 2006.

Research on the Volatility of Hypothetical Wind-Up and Solvency Valuation Results

A CIA task force has been researching the volatility of a pension plan's funded position determined on a hypothetical wind-up or solvency valuation basis, for the purpose of improving benefit security. This research is partly in response to Quebec's recent changes to its pension legislation, and will assist with the determination of appropriate funding margins aimed at specified levels of benefit security. It is expected that the research paper will be released later this year.

Commuted Value of a Pension Benefit – The current CIA standards of practice for determining the commuted value of a pension benefit, which expire in February 2008, are

being reviewed for on-going appropriateness and for consistency with approaches in other areas of actuarial practice.

Additional Guidance and Educational Material – On an on-going basis, material is prepared to provide additional guidance to actuaries who are undertaking the funding valuation of a Defined Benefit pension plan. In 2007, material has been published on the following issues: assumptions for hypothetical and wind-up valuations in 2007, the content of the actuary's pension plan valuation report, the expense assumptions in a funding valuation and the treatment of events that occur after the calculation date for the actuary's report. Educational material is currently being prepared on a number of other topics related to the funding valuation of a Defined Benefit pension plan.