



Pension Investment
Association of Canada

Association canadienne des
gestionnaires de caisses de retraite

PIAC Submission to the Financial Sector Division of the Department of Finance in Response to the Consultation Paper on Private Pensions

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Executive Summary

The Pension Investment Association of Canada (PIAC) is pleased to have the opportunity to contribute to the review of the legislative and regulatory framework for private pension plans subject to the *Pension Benefits Standards Act, 1985* by the Financial Sector Division of the Department of Finance.

PIAC has been the national voice for Canadian pension funds since 1977. Senior investment professionals employed by PIAC's member funds are responsible for the oversight and management of over \$940 billion in assets on behalf of millions of Canadians. PIAC's mission is to promote sound investment practices and good governance for the benefit of pension plan sponsors and beneficiaries.

The Government is looking to improve the legislative and regulatory framework to respond to concerns that have been raised by stakeholders. The consultation paper identifies a number of key questions related to this goal and is looking for suggestions that balance the interests and incentives of both plan sponsors and plan members. Specifically, the Government has expressed an interest in enhancing safeguards for plan members' benefits while allowing more funding flexibility for plan sponsors, recognizing that these two goals may at times be conflicting and that a balanced approach could require potential tradeoffs.

PIAC applauds the initiative of the Government in undertaking a broad review of pension standards. The management of pension plans has fundamentally changed in the past two decades. Capital markets have changed dramatically with the introduction of more sophisticated investment tools such as derivatives and hedge funds, the increased pace and use of technology/electronic trading, and the impact of globalization and increased economic competition. The pension system today is facing enormous challenges arising from an aging population, low interest rates, market volatility, rising stakeholder expectations, regulatory burdens and the evolution of case law. The temporary funding relief measures issued in 2006 and 2008 have not adequately addressed the problems that have surfaced with the current legislative and regulatory framework and a permanent solution is not only welcome but necessary for the on-going viability of private pension plans.

In general, defined benefit ("DB") pension plans deliver the most cost-effective pensions to retirees. DB pension plans pool both longevity and investment risk and address inflation risk if indexed. Yet, DB pension plans are becoming less and less a feature of the private-sector pension system. Overall coverage of paid workers in Canada by registered pension plans declined from 46.2% in 1977 to 39.3% in 2003. The decline in DB pension plans was more pronounced, with the percentage of plan members in a DB pension plan declining from 92.7% to 81.5% over the same period while for private-sector workers alone the decline was even greater, from 90.6% to 74.2%¹

¹ B. Baldwin, "Determinants of the Evolution of Workplace Pension Plans in Canada", March 2007.

PIAC believes that the fundamental reason that the number of DB pension plans is declining is due to funding and regulatory challenges. Plan sponsors are experiencing increasing financial pressures from the volatility of pension expense due to ever changing equity markets and interest rates, and changes in accounting standards. Recent court decisions regarding partial windups, expenses, asset transfers and surplus (Stelco, Kerry, Transamerica and Monsanto) have created an uncertain and negative legal environment for plan sponsors. The pivotal Supreme Court ruling in the Monsanto case exacerbated the asymmetrical sharing of pension risk between employer and employee groups. Adding to this burden are the onerous requirements for funding solvency deficits. Plans operating in multiple jurisdictions must also contend with the labyrinth of pension law and regulators across the country. This makes plan administration more difficult and costly. Finally, employees, especially younger ones, are not always aware of the benefits and risks of their pension plans. All of the above mentioned points encourage plan sponsors to freeze or terminate their existing DB pension plans, and discourage the creation of new plans.

While the situation may appear dire to some, solutions are at hand. Governments have the ability to alter the policy underpinnings of the private-sector pension system and thereby alleviate some of the funding and regulatory challenges that plan sponsors and administrators are facing. In this submission, PIAC proposes that the Government of Canada consider:

1. Taking steps to ease solvency funding requirements and to address risk/reward asymmetry in the rules regarding surplus entitlement by:
 - (a) unconditionally extending the amortization period for solvency funding from five years to ten years for financially strong companies;
 - (b) providing plan sponsors the flexibility to use Letters of Credit, which already exists on a permanent basis in Alberta and British Columbia; and
 - (c) permitting plan sponsors to establish special purpose accounts (“solvency accounts”) that are independent from the main pension trust.
2. Facilitating the opportunity for plan sponsors to enhance the funded position of the plans when plan sponsors are able to do so by amending the *Income Tax Act* to allow plan sponsors to make contributions beyond the current 110% limit to at least 125%; and
3. Holding pension investments to the standard of a prudent person and eliminate all quantitative limits on investing.

It is time for the Government of Canada to revamp private-sector pension plan standards. DB pension plan coverage is declining but has not declined as much in Canada as in other nations such as the U.S., U.K. and Australia. Before the trend accelerates, the policy approach to funding rules and other regulatory issues needs to change significantly. The changes that PIAC is recommending will create a more conducive environment for creation and maintenance of DB pension plans and the growth of defined contribution pension plans.

The following are PIAC’s responses to selected questions posed in the Department of Finance consultation paper that specifically relate to PIAC’s mission.

Response to Selected Questions Posed in the Department of Finance Consultation Paper

3A. The Government of Canada is interested in stakeholders' views regarding the rules for funding solvency deficiencies and the solvency calculation itself.

PIAC firmly believes that the current five-year amortization period for funding solvency deficits is too short for financially strong companies. These companies have a very low risk of having an insolvent pension plan and should be allowed to fund solvency deficits over a longer period. The financial health of an employer could be measured through the debt rating agencies and not by the regulator. For example, a longer amortization period might be granted to a company that is investment-grade. We suggest that the amortization period for 'financially stronger' companies be extended to ten years, while the amortization for companies that are not 'financially stronger' would remain at five years.

In addition, PIAC believes that the extension to the solvency amortization period should be allowed without any constraints such as plan member consent or letters of credit. The requirement to obtain plan member agreement involves a complicated and difficult communication process that will be impractical for most plan sponsors to implement. Also, the ability and cost to obtain letters of credit (LoCs) has been impacted by the difficult state of the credit markets and will not be a realistic option for many plan sponsors.

The imbalance in the current DB funding model arises almost exclusively from solvency valuations. Solvency valuations have increasingly gained in importance over the years creating significant contribution requirements for plan sponsors (many of which are not at risk of failure), and leading to unnecessary over funding for the majority of plans. In addition to the extension of the amortization period for solvency payments, PIAC recommends two methods that will address this issue directly while balancing the interests of sponsors and beneficiaries. The first one is the use of LoCs **in lieu of** solvency funding payments. The second is permitting plan sponsors to set up special purpose accounts ("solvency accounts") that are independent from the main pension trust.

LoCs are a secure option for plan sponsors to deal with the volatility of solvency valuation results. They are a pragmatic way of addressing plan risk/reward asymmetry by providing an effective way to secure plan benefits and possibly avoid the growth of excessive surplus in the future. However, LoCs are expensive and not available to all plan sponsors and, because the costs are not refundable, they are a direct significant cost to the plan sponsor.

While LoCs provide welcome flexibility to many existing plan sponsors, they may not work for all. Consequently, PIAC believes that providing plan sponsors with the ability to set up solvency accounts offers a more permanent solution and addresses some of the drawbacks associated with LoCs. Under this method, contributions required under the going concern valuation would be paid to the main pension fund as is the case under the current defined benefit funding model. Where the employer is the sole contributor to the pension plan, or where the employee contributions are fixed, further employer contributions required under the solvency valuation would be paid to a solvency account.

In order to avoid the current problems associated with beneficial trusts, the side account must not be treated as a trust. However, similar to the pension fund, the solvency account would be segregated from the employer's assets, invested in accordance with the plan's Statement of Investment Policies and Procedures, tax-sheltered, and protected from non-pension creditors. Upon full plan windup, any assets in the solvency account that are not required to satisfy benefit entitlements would revert back to the employer. In an ongoing situation, assets in the solvency account could also be accessed by the employer provided the sum of the assets in the pension fund and the solvency account exceed the plan's solvency liabilities.

Employers should also have the ability to make additional contributions above the minimums required by the going concern valuation to the solvency account. The maximum employer contribution funded ratio under the *Income Tax Act* needs to be eliminated, or at the very least, increased to at least 125%. The ability to make these additional voluntary contributions will provide employers with greater flexibility to manage their cash requirements within their own business cycles and would lead to enhanced benefit security for plan members.

3B. The Government of Canada is interested in stakeholders' views on whether to require that plan sponsors fully fund pension benefits when a plan is fully terminated, but provide that payments can be made over a period of five years, and treat the outstanding obligation as unsecured debt of the company. In addition, the Government is seeking views on conditions, if any, where a plan could be terminated in an underfunded position by virtue of an agreement between the sponsor and plan members.

Given the importance of extending the amortization period for solvency funding payments as described above, PIAC believes it is reasonable to expect plan sponsors to fully fund pension benefits when a plan is fully terminated on a voluntary basis, and agrees with the five year time period for the funding. It would also be imperative that the outstanding obligation be treated as unsecured debt of the company and not rank ahead of any of the company's other unsecured debt.

3C. The Government of Canada is seeking views on whether to eliminate the concept of partial termination from the Act but require immediate vesting of pension benefits for all members.

PIAC agrees with the elimination of the concept of partial terminations from the Act. However, the corresponding requirement for immediate vesting of pension benefits should be limited to plan members who are involuntarily terminated to better align the vesting provision to the requirements currently under the Act for partial terminations. Additional pension benefits should not be given to plan members who voluntarily terminate prior to the required two year vesting period.

3D. The Government of Canada is seeking views on whether to require administrators to establish a Statement of Funding Policy (SFP) in a similar fashion to the Statement of Policies & Procedures (SIP&P). The SFP would be examinable upon request, like the SIP&P.

The pension regulatory environment already has effectively given plan sponsors a funding policy. The Act provides a minimum funding requirement and the *Income Tax Act* provides a maximum funding requirement. The reason most plan sponsors do not have a formal funding policy is because there is no need to have one, when the regulations already provide a minimum and a maximum funding level. Formalized funding policies will have no impact unless the issue of the existing risk asymmetry in defined benefit pension plans is addressed. Currently, plan sponsors are responsible for funding deficits but must share surpluses. This is not a fair approach.

If the risk asymmetry issue is effectively addressed, PIAC would support formal funding policies by plan sponsors. We do not believe that funding policies should be treated in the same manner as plans' SIP&P. They should neither be mandated nor regulated. Guidelines for funding policies could be developed by the regulators to help sponsors develop and maintain their funding policies.

3E. The Government of Canada is seeking views on whether:

- **Plan sponsors be required to develop a formal policy on contribution holidays for inclusion in a statement of Funding Policy; and**
- **To the extent that employer contributions are permitted under the tax rules plan sponsors only be permitted to take a contribution holiday in the year in which a valuation report, filed with OSFI, shows a surplus in the plan on a solvency basis.**

Please see the response to 3D. PIAC would support a provision that requires plan sponsors to have a current valuation report filed with OSFI, supporting the ability to take a contribution holiday, before a contribution holiday can be taken in any one year period.

3F. The Government of Canada is seeking views on whether to amend the regulations to prescribe a solvency ratio level of 0.85 for the purpose of implementing the void amendment provision in the Act.

PIAC would support a prescribed solvency ratio of 0.85 for the purpose of implementing the void amendment provision in the Act. Furthermore, consideration should be given to only allowing benefit improvement amendments to a pension plan with a solvency ratio between 0.85 and 1.00 that are pre-funded and, as a result, do not impact the plan's solvency ratio.

4A. The Government of Canada is seeking views on the practicality and desirability of safe harbour protection, and what considerations should be made in the determination of the qualified default investment options.

PIAC agrees that proper investment choices are critical for members of defined contribution plans in order to meet retirement goals. In addition, despite significant attempts at communication and education of members, many plan sponsors find members unwilling to make an investment choice and consequently relying on a default investment option. As a result, it is important for plan sponsors and administrators to be allowed to choose a risk appropriate fund as a default option without having any legal liability concerns. Safe harbour protection should be given to plan sponsors and administrators to address this issue.

There are many possible options for a qualified default option. Consequently, any criteria should be broad and encompass the standards of prudent person investing rather than setting specific criteria.

4D. The Government of Canada is seeking views on whether it is appropriate to clarify that defined benefit surplus can be used to offset employer's defined contribution current service costs for hybrid plans.

The use of defined benefit surplus to offset employer's defined contribution current service costs in hybrid pension plans is currently allowed for federally regulated pension plans. PIAC would support strengthening these rules by solidifying them in the Act.

5E. The Government of Canada is seeking views on ways to improve the regulatory framework governing pension investment.

PIAC firmly believes that pension investments should be held to the standard of a prudent person and all quantitative limits on investing should be eliminated.

Capital markets do not have just a national dimension – they are global. Canadian dollar denominated assets can readily be substituted for any other asset in a global pool of liquidity. A greater opportunity set of investments leads to a higher probability of increased risk-adjusted returns. The greater range of investment options and strategies that are available, the more diversification can reduce risk, and the greater the opportunity pension funds have to ensure that the sum of diversified returns are greater than would be available from a more restrictive opportunity set.

Governments have influenced these strategies in the past by, for example, limiting the foreign content in pension plans. PIAC believes that the industry has evolved to the point that pension funds should be governed by the prudent person rule, which enables pension plan administrators to make the best investment choices for their plans. Canada is one of the few developed countries that uses quantitative limits instead of the more universally applied prudent person standards for investing. Studies have consistently shown that such restrictions, by limiting the pool of available assets, have a negative impact on pension fund performance.

The elimination of the 30% foreign content rule now allows Canadian pension plan sponsors to better manage the risk of their investment portfolios by allowing increased diversification of assets outside of Canada. However, quantitative limits, such as the 10% single issuer rule, restrict investments in such liquid assets as investment grade foreign sovereign debt, such as U.S. Treasury bonds, and other similar bonds of U.S. government agencies. While PIAC believes that all quantitative limits should be eliminated, an immediate exemption should be made from the 10% issuer rule for investment grade sovereign bonds, similar to the exemption currently provided for Canadian bonds issued by Canadian government issuers.