

advisory

NOVEMBER 2009

Reform for federally-registered pension plans: The next building block to pension reform in Canada

The Federal Department of Finance announcement on October 27, 2009, addressing the modernization of the federal pension framework, now brings to five the number of jurisdictions that have released an “expert” report on pensions over the course of the past year. However, almost a year after the release of the first report in November 2008, no legislation has been enacted to provide meaningful pension reform. There is, of course, a huge potential that regulatory reform will be delivered that will benefit all stakeholders in these jurisdictions (and ultimately stakeholders in all jurisdictions). Ontario’s Finance Minister announced on October 28th that Ontario will introduce the first phase of its pension reform in November, with the second phase to follow in 2010.

To be fair to the regulators, progress has been slowed by the need to create dialogue between provincial and federal lawmakers in an attempt to reach a national (or even regional) consensus on the important issues of pension coverage and income adequacy. The upcoming mid-December meeting of Federal, Provincial and Territorial Finance Ministers will provide a forum to discuss pension adequacy and accept the report of the Research Working Group on Retirement Income Adequacy. No doubt further deliberations will follow from this meeting which we hope will lead to meaningful reform for Canadians.

The Department of Finance’s announcement has been shaped by extensive public and industry consultations held across the country since January 2009, and the deterioration in the Canadian economy through 2008 and 2009. While federally-regulated pension plans only represent approximately 7% of pension plans in Canada (and approximately 11% of plan members), they are typically larger than average and include pension plans sponsored by financial, transportation and communication companies.

This *Advisory* provides an overview of the proposals contained in the announcement by the Federal Department of Finance and addresses these topics:

- Enhanced protections for plan members
- Reduced funding volatility for plan sponsors
- Solution for plan-specific funding problems
- Defined contribution pension plans
- Negotiated contribution defined benefit plans
- Pension fund investment rules

While some of the proposed changes will be implemented quickly through regulation, other changes will require legislative approval by Parliament.

Enhanced protections for plan members

Highlights

- Full funding required on plan termination; any deficit becomes an unsecured debt of the company
- Restrictions on employer contribution holidays
- Restrictions on plan improvements
- Sponsor-declared partial terminations eliminated
- Immediate vesting of benefits
- Increased disclosure to plan members through annual statements

Overview

The proposals include changes which are intended to prevent employers from terminating a plan when assets are insufficient to provide the full amount of benefits, in order to avoid addressing the funding deficit. This change will give members increased protection with the added security that any wind-up deficit becomes an unsecured debt of the employer until it is funded. Immediate vesting will also be implemented, coupled with a full-funding requirement in the event of plan termination and the elimination of plan sponsor-declared partial wind-ups. The Superintendent will, however, retain the right to declare a partial wind-up in appropriate circumstances.

Contribution holidays will continue to be permitted, but only if the plan is fully funded with a solvency margin of 5% or more of solvency liabilities. When a plan sponsor elects a contribution holiday, that sponsor will be required to file annual actuarial valuations, to ensure that any contribution holiday will be based on the current financial position of the plan. Where plans are not fully funded, benefit improvements will only be permitted when the solvency ratio can be maintained at 0.85 or greater. Plan sponsors will have an option of fully funding the benefit improvement in advance so that the plan's solvency ratio is not reduced.

Enhanced disclosure requirements will be required on the annual member statements. Required information will include:

- the date of the solvency ratio reported in the annual statement along with the date of the next required valuation report
- the total assets and liabilities of the plan
- a summary of the plan's investment allocation and ten largest investment holdings
- a statement regarding members' right to examine the plan's Statement of Investment Policies & Procedures
- total employer contributions made for the reporting year

In addition, annual statements will be required for former members and retirees; the information to be contained in these statements will be prescribed. On plan termination, plan sponsors will need to send beneficiaries an information statement within 30 days of the termination date. The legislation will permit the disclosure of member information to be distributed electronically on a positive consent basis.

Impact

Most of these proposed measures will impact plan sponsors through either increased contribution thresholds or increased administrative costs. It is not surprising that enhanced protection for plan members comes with associated costs. However, an added challenge for plan sponsors will be the need for education for both current and former members so that they can better understand the increased plan information being disclosed.

Reduced funding volatility for plan sponsors

Highlights

- New standard for minimum funding
- Letters of credit
- Surplus threshold increased

Overview

A proposed new standard for the minimum funding requirements on a solvency basis will use a three-year average of the plan's solvency funding position. The average solvency position of a plan will be the average of the solvency ratio over the current and previous two years, and will be based on the market value of a plan's assets. Past deficiencies can be consolidated on a permanent basis for purposes of establishing future solvency special payments. The amortization period of solvency deficiencies will remain unchanged at five years, and the going concern amortization period will remain at fifteen years.

Plan sponsors will be able to use letters of credit to satisfy solvency payments up to a limit of 15% of plan assets. This measure is consistent with the intent of other regulators across Canada.

The surplus threshold will be increased from 10% of liabilities to 25% for the purposes of determining maximum allowable contributions in 2010 and later years. This will allow plans to maintain a larger surplus cushion and reduce the likelihood of future funding deficiencies. The change will also apply to designated plans, and replaces the tax rules for fixed-cost shared plans where the responsibility is shared jointly by the employer and employee.

Impact

The new standard for minimum solvency funding may help control the year-to-year volatility of solvency funding requirements, and will be welcomed by plan sponsors. However, it remains to be seen what impact this will have on required solvency funding levels. Also, the new requirement to file an annual actuarial valuation when a plan is in surplus will increase plan sponsors' costs.

The increase in the surplus threshold will be a welcome change, even though plan sponsors will likely not take advantage of it. Even if funding levels improve substantially, there is currently no prize for leaving excess funds in a pension plan.

Solution for plan-specific funding problems

Highlights

- Plan sponsors of distressed plans will have the option to “work-out” funding difficulties

Overview

Plan sponsors who can't meet their short-term funding obligations under the legislation will have an opportunity to “work-out” a plan-specific solution. The intent seems to be to allow all stakeholders (sponsor, members, and retirees) in a distressed plan to negotiate a funding arrangement that doesn't meet the legislative requirements, in order to help enable a plan restructuring.

It's expected that the "work-out" feature will operate only in limited circumstances where the plan's existing structure imposes funding obligations which are detrimental to the benefit security of plan members. Eligible plan sponsors will receive short-term relief on special payments driven by short-term economic conditions, but will be required to negotiate longer-term payment obligations.

Impact

This is a unique feature and "the devil will be in the details" of the proposed legislation. However, re-negotiating the funding obligations of a "distressed" plan sponsor may be preferable to allowing the plan to deteriorate and eventually terminate.

Defined contribution pension plans

Highlights

- Legislation will be amended to specifically codify responsibilities and accountabilities of parties involved with defined contribution pension plans
- Eliminate the requirement for a Statement of Investment Policy and Procedures
- Payment of Life Income Fund (LIF)-style benefits from the plan will be permitted

Overview

The Pension Benefits Standards Act (PBSA) will be amended to include "explicit guidance on the responsibilities and accountabilities" applicable to stakeholders of defined contribution pension plans. While the proposed legislative amendments will consider the Capital Accumulation Plan (CAP) Guidelines released by CAPSA in 2004, the Department of Finance is implying that the proposed changes may go further.

Given the nature of defined contribution pension plans, the requirement for the plan to have a Statement of Investment Policy and Procedures will be eliminated.

Under the proposals, a defined contribution pension plan can allow a retiring member to leave his or her assets in the plan and have the plan pay the member an income stream, instead of transferring the assets to a LIF account at a financial institution.

Impact

Sponsors of defined contribution pension plans, or sponsors who have a defined contribution component under their defined benefit plan, will need to brace themselves for legislative changes. The CAP Guidelines are “best practices” which the vast majority of plan sponsors follow. But incorporating best practices in legislation will place a higher burden of compliance and care on plan sponsors, who will have to amend their defined contribution pension plans to comply with the proposed legislation.

In addition, if monies are now allowed to be kept in the plan’s pension fund at retirement, (rather than being transferred out to purchase an annuity or to some other income-type vehicle), the obligations of plan sponsors will carry on past the day employment ceases – which will lead to additional complexity and cost.

Negotiated contribution defined benefit plans

Highlights

- Improve the framework for negotiated contribution defined benefit plans (which are common in multi-employer plan arrangements)
- Create a formal definition of a negotiated contribution defined benefit pension plan under legislation
- Create a legislative authority for Boards of Trustees to reduce accrued benefits despite plan provisions to the contrary
- Specify criteria for the composition of the Board of Trustees
- Increase disclosure to plan members

Overview

The proposed changes are aimed at improving the operation of negotiated contribution defined benefit plans, which should improve the governance and transparency of these plans for all stakeholders.

Actuarial valuation reports will have to include options that the Board of Trustees are considering to resolve any funding shortfall. A significant change is the proposal to legislate the authority of the Board of Trustees to amend the plan to reduce accrued benefits if negotiated contributions are insufficient to meet funding requirements (provided the plan amendment is first approved by the Superintendent).

The changes will enhance member disclosure requirements so that members and retirees more clearly understand the nature of the pension arrangement, including the Board of Trustees' right to reduce accrued benefits if negotiated contributions are insufficient to meet funding requirements.

Impact

The Board of Trustees and their suppliers will need to discuss and agree on a range of funding initiatives to be included in the actuarial valuation report where under-funding exists. The fact that these plans may still be subject to solvency funding may prove troublesome to all stakeholders. We can expect that increased disclosure of information to members will be the norm for all jurisdictions enacting regulatory change, and will apply to all plan types to various degrees.

Pension fund investment rules

Highlights

- Removal of quantitative limits of resource and real property investments
- Amend the 10% concentration limit to be based on the market value of assets rather than book value
- Prohibit an employer from directly investing in its own debt or shares

Overview

The quantitative limits on resource and real property investments will be removed. The PBSA currently refers to investments made “directly or indirectly” and its definitions of the terms “real property” and “Canadian resource properties” have been inadequate. This is overlain with the verbal advice that one has to “look through” an investment to ascertain whether the concentration limits apply to it. It's fair to say that current legislation is ambiguous in describing the concentration limits

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surrounding investments in real property and Canadian resources, and this change should be well received.

Current legislation bases the 10% limit on book value. Basing the limit on market value instead of book value would seem more relevant and easier to track. There is the intent to provide an exception to this rule for pooled investments over which the employer does not exercise direct control, such as mutual fund investments.

The PBSA permits investment in plan sponsor securities under rather liberal conditions (e.g. the securities are purchased through a public exchange). This new rule will tighten up those conditions by prohibiting an employer from directly investing in its own debt or shares.

Impact

The Canadian equity market has a large resource portion. It has been our experience that money managers who were aware of the concentration limits on real property and Canadian resource property interpreted them rather liberally. We wouldn't expect their investment strategies to change.

Pension funds not complying with this new 10% rule will need to rebalance their portfolios.

Pension funds holding investments in the employer's debt or shares will need to eliminate those holdings. We assume that employer securities held as part of a money manager's normal investment process will be deemed an indirect, onside investment.

Those sponsors whose pension plans are subject to a provincial jurisdiction which defers to Schedule III of the Federal investment rules will need to monitor the PBSA amendments to determine how provincial investment requirements are impacted by these proposed changes.

Miscellaneous

A number of technical changes have been proposed to support these changes and improve the legislative framework. The principles of these changes are:

- To reduce the administrative burden for plan sponsors and permit the orderly wind-up of plans upon termination
- To create a central repository for benefits of members who cannot be located
- To provide the Superintendent with additional powers to intervene when there are concerns about the work of a plan's actuary

A number of other technical improvements to the PBSA and the Regulations are planned to align the framework more explicitly with the way that it is commonly interpreted and administered.

Conclusion

These changes will be extensive and have a far-reaching effect on plan governance and plan disclosure requirements. However, they don't have the substance needed to encourage plan sponsors to maintain their defined benefit plans. The administrative details of the proposals have not been disclosed and plan sponsors will need to review the draft legislation to determine the extent of the impact on their plans.

Plan sponsors who have defined contribution pension plans, or a defined contribution component within a defined benefit plan should brace themselves for the legislative plan amendments that will be required. All plan sponsors will need to ensure that they meet the minimum prescribed level of member disclosure in annual statements.

If you would like to discuss any of the proposed changes and how they may impact your organization, please contact your Buck consultant.



This issue of *Advisory* was researched and written with input from consultants in Buck's offices across Canada. *Advisory* is published in both English and French. Editing, design, production and distribution is provided by the Buck Communications & Sales Support team.

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Buck Consultants
95 Wellington Street West, Suite 1500
Toronto, Ontario M5J 2N7
Phone: 416-865-0060 Fax: 416-865-1301
www.acsbuckcanada.com

Contact us at: infocanada@buckconsultants.com
or by telephone at:

TORONTO	416-865-0060
MONTREAL	514-987-1510
OTTAWA	613-798-2825

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