

# Strengthening the Legislative and Regulatory Framework for Private Pension Plans Subject to the Pension Benefits Standards Act, 1985

Submission to the Department of Finance

Canadian Bankers Association

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## INTRODUCTORY COMMENTS

The Canadian Bankers Association is pleased to respond on behalf of its members, the chartered banks of Canada, to the Consultation Paper, 'Strengthening the Legislative and Regulatory Framework for Private Pension Plans Subject to the *Pension Benefits Standards Act, 1985*' through which Finance Canada is seeking the views of pension plan sponsors on a number of key issues. We strongly support the Finance Canada initiative to seek ways whereby the regulatory regime can become more responsive to the needs of private pension plan sponsors.

The six large banks' pension plans which total over \$ 18 billion in assets continue to be well funded and well managed, and they will weather the current financial and economic turmoil safely and securely. Nonetheless the issues raised in the Consultation Paper are issues that have been of concern to the CBA's members for many years. They are issues of fairness, clarity and flexibility for pension plan sponsors who need to manage their pension funds in relation to the circumstances and viability of their businesses, to the risks inherent in the external environment and for the long term - always balanced by the need to protect the benefits of their plan members and beneficiaries. The issues under discussion here need to be addressed regardless of whether external conditions are favourable or unfavourable and for well funded plans as well as for those that may have particular challenges from time to time with respect to their pension funds or their businesses.

The *Pension Benefits Standards Act* is weighted in favour of protecting the interests of plan members and rightly so. But that protection is not balanced by adequate provisions for the financial sustainability of pension plans. The Act must recognize and respond to the challenges facing plan sponsors. These challenges arise not only from the current crisis in the financial markets, but also from the broader external environment that has changed so substantially in the last 20 years -- trends and conditions in labour markets, demographics, the increasingly litigious private pension plan environment and the unprecedented range and complexity of financial products and services available to fund managers. Furthermore, the Act should be comprehensive and flexible enough so that the Minister of Finance does not need to intervene with temporary relief measures whenever economic conditions deteriorate as has happened twice in the past four years.

We urge the government to make use of this opportunity of listening to the concerns of plan sponsors and to keep to the timetable that has been set out – i.e., to introduce legislation to amend the PBSA by the end of 2009.

Our views on the issues raised in the Consultation Paper are essentially the same as those we conveyed in 2005. They are set out below following the order in which the issues are set out in the Paper. The issues raised by Finance Canada are entered in bold face followed by our views in regular type. We have not responded to all of the issues, but only to those on which our members have experience and concerns. First, however, we would like to comment on the Government of Canada's intent to review the 10% rule under the *Income Tax Act*.

### **PENSION SURPLUS THRESHOLD IN THE *INCOME TAX ACT***

The *Income Tax Act* requires that if plans have a going concern surplus that exceeds 10% of liabilities, employer contributions must be suspended so that tax deferrals are limited over and above those required to finance the benefits promised by the plan. We strongly support the government's intent to review this rule and strongly recommend that the 10% limit be eliminated or raised significantly or made much more flexible to allow plans to maintain a larger surplus as a safety margin against economic downturns - thereby reducing the risks to the plan.

Plan sponsors require flexibility to manage their contributions to the plan within the context of their business needs, the external economic conditions, and the conditions of the plan (e.g., ratio of active to inactive members, unexpected costs to the fund, etc.). The 10% surplus threshold places an arbitrary and unnecessary constraint on the plan sponsors' ability to manage effectively through the highs and lows of the business cycle.

## **ISSUES FOR DISCUSSION PERTAINING TO DEFINED BENEFIT PLANS**

### **A. Solvency Measurement and Funding Rules (*Should the law be more flexible with respect to the solvency funding rules, and could this be achieved with a view to (1) enhancing benefit security, and (2) providing a more stable funding framework?*)**

The CBA strongly supports amending the *Pension Benefits Standards Regulations* (PBSR) to allow for a number of alternative means for funding solvency deficiencies. The plan sponsor should be allowed to select, subject to approval by the Office of the Superintendent of Financial Institutions, the method best suited to the precise needs of the organization, e.g., considering the degree of the funding shortfall, and whether the need is short-term or long-term, etc.

#### **Solvency Accounts**

The CBA supports the concept of a special account to function as a 'cushion' or 'solvency margin account' for a defined benefit pension plan separate from the basic pension plan trust and going concern assets. The objective of such an account would be to provide the plan with a fund well above the statutory minimum funding for a plan which could be used to mitigate significant solvency deficiencies when they occur particularly if there is a deficiency when the plan is wound up. The initial establishment of such a fund or account could increase short-term contributions to plans, but once in place it would also substantially increase long-term stability as well as the security of member benefits.

The regulations for a solvency margin account should be flexible enough so that the account could be truly effective in enabling the plan sponsor to sustain the health of the plan, i.e., not "trapping" capital but allowing capital to be available when needed (when solvency ratios fall in an economic downturn, for example) with a view to the long-term viability of both the pension plan and the business. The CBA would appreciate being consulted when the regulatory details for such accounts are being developed.

#### **Letters of Credit**

The law should allow for the use of letters of credit. A letter of credit would act as a temporary substitution for cash to make up a shortfall so that a plan sponsor can direct existing cash to other business needs and so that market risk may be temporarily transferred. Letters of credit would be useful mainly to plans that are close to fully funded status, whose overall financial outlook is sound, but have a temporary deficiency. However, the law and the letters of credit need to be clear regarding the right of the sponsor to reduce or cancel them if the pension plan returns to a fully funded status.

#### **Funding Periods**

Depending on the particular situation of a plan, the law should allow amortization periods for up to ten years (rather than five) for paying down solvency deficits -- balanced by certain conditions relevant to the situation at the discretion of the regulator. In general, the current five-year repayment period is too short, requiring the diversion of too much business capital to the pension plan thereby increasing the risks to the business as well as the plan. This should be treated as an acceptable

business practice to reduce risk and therefore, it should not be necessary to obtain approval from plan members or beneficiaries in order to qualify for a ten-year amortization.

### **Ownership of Surplus**

We strongly recommend that the PBSA be amended to clarify that pension plan sponsors have ownership of and access to surplus funds (including at wind-up) unless the terms of the most recent version of the plan state otherwise. Currently the plan sponsor is responsible for the ultimate funding of pension benefits, and while the cost of benefits may be offset by fixed employee contributions, the sponsor alone is entirely responsible for funding shortfalls. At the same time, the sponsor is largely prevented from having access to or use of any surplus funds in the plan other than using them toward benefit improvements.

The lack of clarity and balance with regard to the rights of defined benefit pension plan sponsors is a fundamental flaw in our existing regulatory regime that has a detrimental effect on all other funding and surplus issues. For example, pension plan surpluses, if the sponsor had access, could provide a major source of funds for building a solvency account as described above. This is also an example of why the *Income Tax Act* 10% ceiling needs to be eliminated or raised substantially.

If this lack of balance or asymmetry were to be rectified so that the employer's obligation to fund the full cost of benefits plus funding shortfalls were balanced by the removal of the artificial constraints on the right of the employer to access surplus funds when they occur according to some balanced and reasonable criteria, it is our view that employers would be less reluctant to maintain or initiate new defined benefit pension plans and that more effective management would be promoted.

### **B. Requiring Full Funding on Voluntary Plan Termination**

The CBA strongly supports the principle of full funding on plan wind-up: employers should be obligated to fulfill their pension promise. At the same time, this concept would have wider support if symmetry were achieved, that is, if plan sponsors could have access to any surplus on wind-up subject to the terms of the plan.

Recent plan improvements should be given lower priority on a terminated plan's assets (see Void Amendments, below) if there are not sufficient plan assets to pay for them. If a plan is marginally underfunded the risk of benefit loss on plan wind up, with respect to recent benefit improvements, should be clearly communicated to plan members at the same time the benefit improvements are communicated to them.

### **C. Partial Termination and Immediate Vesting**

All of the large banks are in favour of eliminating partial terminations from the PBSA. While we do not have consensus on full and immediate vesting from the beginning of service for active members, the majority of banks support it if that is a necessary step to achieving elimination of partial terminations.

Most of the banks believe that these steps would eliminate the need to have special provisions for partial terminations and would be the most effective means of responding to the current uncertainties relating to partial plan terminations. There are some concerns that immediate vesting would add significant costs to some plans.

If partial terminations are not entirely eliminated, then the Act should clearly specify that surplus distribution is not required on partial plan terminations.

#### **D. Disclosure of Information - Annual Statement of Funding Policy to be Examined Upon Request by Members**

The CBA agrees that a written funding policy is desirable for defined benefit plans. However while we support the principle of transparency and access to information for plan members and retirees, we would not support an amendment to the PBSA *requiring* plan sponsors to make an annual statement of funding policy available to plan members. In our view the current level of disclosure under the PBSA that includes, among other things, an annual statement of member contributions, benefit entitlements and the solvency ratio if less than 1 is appropriate for most plans. Furthermore, the Act already requires that other plan documents be made available to members upon request (e.g., plan valuations and audited financial statements). In the banks' experience these are requested very rarely even though they could provide members with a technical view of the financial health of the plan.

Funding decisions are made by the employer in its role as sponsor of the pension plan, not as the plan administrator who has fiduciary responsibilities (we think it would be helpful if the legislation conveyed greater clarity regarding these two distinctive roles). Plan sponsors are governed by the Act's minimum funding requirements which are in place to protect plan members, but beyond those requirements, the employer has the discretion to make funding decisions that are compatible with the employer's business interests, competitive situation, and changing circumstances. Because these factors may include sensitive business issues and may require careful risk management and/or may be constantly evolving, it is our view that the plan sponsor should not be required to disclose the funding strategy with the possible exception of reporting to the regulator should the plan's solvency ratio fall below an agreed upon level. The Act should clarify that funding decisions are made by the employer in its sponsor role free of fiduciary constraints and restricted only by the minimum statutory funding requirements.

Furthermore, the provision of such information to participants wouldn't necessarily add to their understanding of the actual financial position of the plan or of the plan sponsor's business. The funding policy by its very nature is part of a dynamic process, and it would be challenging to present it in a meaningful way in a once-a-year format. A plan's funded status can change substantially not only from one solvency valuation to the next, but also, according to the Canadian Institute of Actuaries, a solvency deficiency at one date can become a solvency excess within six months or a year later. We believe it would be difficult to provide even a very broad funding statement in such a way that it would be of real significance to members.

It does, however, seem appropriate that in a situation where there is an approved restructuring plan in place, there should be a disclosure requirement for the plan sponsor to communicate at least the broad outline of the remedial funding plan to the members and beneficiaries.

#### **Electronic Provision of Plan Information**

The CBA supports the provision of pension plan information in electronic format where both parties consent to that form of communication. In the long run, this would help reduce administrative costs of plans in addition to which electronic format is more efficient and environmentally friendly.

#### **Inform Members and Beneficiaries if the Sponsor has Missed a Payment**

Current legislation requires that if a payment by the plan sponsor is not remitted within 30 days of the scheduled date the administrator and the custodian of the pension fund must notify the

Regulator. Members should be informed by the administrator at the direction of the Regulator if the sponsor has not remitted the payment within a reasonable period of the notice to OSFI. In our view 60 days from the date of the notice would be appropriate. Or, if more than one payment is missed within a fixed period such as six months. Either of these approaches would provide some leeway for rectifying cases of human and/or systems error.

#### **E. Contribution Holidays**

In general, the CBA would support the requirement that the plan sponsor develop a formal contribution holiday policy as part of the plan's overall funding policy. However the CBA is not in favour of making the contribution holiday policy available to plan members and beneficiaries for the reasons that are similar to those described above regarding the funding policy.

We are also opposed to the proposed requirement that a contribution holiday may be taken only in the year of filing a solvency valuation showing a surplus. This constraint is another example of how the law reduces the flexibility of well funded plan sponsors to manage the fund according to their overall business needs. We recommend that some kind of interim report, such as an actuarial "opinion" or update rather than a full actuarial valuation, be allowed for plans in surplus to demonstrate in the years between the triennial valuation reports that the fund continues to have an estimated surplus.

OSFI's statement on contribution holidays in the *PBSA Update*, #24, Fall 2004, is reasonable in conveying that contribution holidays are not appropriate when a plan is or may be underfunded (i.e., the estimated solvency ratio is below or marginally above 1.0). The statement describes the action that OSFI would take if the sponsor continues to take contribution holidays when the plan is in that condition. If, however, the plan sponsor maintains a solvency account that meets an acceptable standard, the account could support the right to take a contribution holiday under certain less favourable conditions. Further consultation in these matters will be essential once the broad outlines of possible amendments to the PBSA have been drafted.

#### **F. Void Amendments (*Should the regulations be amended to prescribe a solvency ratio level of 0.85 for the purpose of implementing the Act's void amendment provision?*)**

The CBA supports the concept of a specific threshold for allowing plan improvements. However, with respect to the proposed solvency ratio level of 85%, we suggest that some flexibility should be built into the standard. The view expressed some years ago by the Canadian Institute of Actuaries (CIA) seems reasonable – i.e., setting too high a standard for solvency funding before benefit improvements are permitted could unduly restrict the growth and improvement of pensions, and that a ratio between 75 and 85% could be appropriate if combined with certain conditions such as the adoption of reasonable minimum solvency funding standards, the establishment of priorities for retroactively voiding amendments which are not fully funded upon wind up, and clear disclosure to members regarding solvency deficiencies and benefits that may be at risk.

### **ISSUES FOR DISCUSSION RE: DEFINED CONTRIBUTION PLANS**

**Please note:** *Not all of our members offer Defined Contribution Plans. The comments in this section reflect the views of those that do offer such plans.*

#### **A. Safe Harbour Protection for Qualified Default Investment Options**

In general, the CBA supports the views expressed by the Association for Canadian Pension Management (ACPM), in their paper, *Delivering the Potential of DC Retirement Savings Plans*, of May 2008. In that document, the ACPM describes “safe harbour” as providing legal protection from claims made against a stakeholder in respect of a particular plan design feature if the stakeholder has complied with all of its prescribed obligations under statute or regulation. They recommend adopting the “safe harbour” approach for certain design features of retirement savings - including DC plans - that meet criteria prescribed by legislation/regulation. It is also recommended that the criteria for the default options should be at the level of broad based rules thereby allowing for flexibility across a wide range of plan types.

## **B. Retirement Benefits Paid from the Pension Fund**

Again, in general we would support the views set out by the ACPM in the same paper mentioned above, i.e., the ACPM suggests permitting variable benefits to be paid to retirees directly from a DC pension plan and recommends certain conditions:

- They should be subject to an annual minimum payment after age 71.
- They should be subject to the same annual maximum withdrawal limit applicable to locked in retirement accounts under applicable pension legislation.

Where a plan sponsor offers a variable retirement income benefit, members are able to remain in their pension plan after retirement without having to assume greater responsibility for investment decisions or to pay higher investment fees that are typically charged within individual plan arrangements. Plan sponsors and members alike stand to benefit in situations where the retention of additional assets within the DC pension plan results in a lower management expense ratio.

Retiring plan members who prefer to purchase annuities or other options with all or a portion of their accumulated balance can continue to do so. This allows all members to choose the option which best suits their needs.

## **C. Standard of Care Changes**

## **D. Use of Surplus in Defined Contribution Plan Components in Hybrid Plans**

The law should clarify that plan sponsors who have hybrid plans should be permitted to use defined benefit surplus funds (consistent with our views on ownership of surplus in section "A" under defined benefit plans) to offset defined contribution requirements in such hybrid plans (consistent also with our comments on contribution holidays in section "E" under defined benefit plans).

## **E. Administrative Issues**

# **OTHER ISSUES RESPECTING THE FRAMEWORK FOR PRIVATE PENSION PLANS**

## **A. Flexibility of the *PBSA, 1985***

The CBA welcomes the government’s intended policy approach regarding openness to employer and employee agreements that meet certain defined minimum standards and regarding the possibility of making use of the potential in the PBSA for some types of alternative arrangements.

We are of the strong view that a one-size-fits-all approach is simply not effective in an environment in which so much is changing and expanding – labour markets, financial instruments, ways of doing business, globalization. While our members are not at present seeking alternative arrangements that are *outside* the scope of the PBSA, we would welcome greater accommodation to such arrangements in the Act.

- B. Multi-Employer Pension Plans**
- C. Simplified Pension Plans**
- D. Distinction between Defined Contribution & Defined Benefit Plans under the Act**

The CBA has no comments on these subjects at this time.

## **E. Investment Rules**

This is an area in which our members have strong views. Quantitative limits are not useful as a means of managing risk. Such limits are, in our opinion, arbitrary figures and are not based on realistic investment or economic rationales. They have been superseded by more sophisticated investment management methods consistent with the prudent person standard. In the CBA's view the quantitative limits with respect to achieving diversification, preventing industry concentration and maintaining passive investments should be eliminated and replaced by the prudent person standard.

## **CONCLUDING COMMENTS**

The CBA appreciates having the opportunity to comment on the Consultation Paper relating to the effective regulation of private pension plans under the *Pension Benefits Standards Act, 1985*. We have kept our comments at a fairly high level and look forward to engaging in further, more detailed discussion when the broad outlines of draft legislation have been prepared. We believe the pension community is ready for change, and it is our hope that you will be able to keep to your timetable of introducing new legislation next fall.

We hope our comments have been helpful. Again, thank you for providing the opportunity.