



**Watson Wyatt Worldwide Submission to the Department of Finance on**  
*Strengthening the Legislative and Regulatory Framework for Private Pension Plans Subject to*  
*the Pension Benefits Standards Act, 1985*

March 16, 2009



Watson Wyatt is pleased to review and comment on the Department of Finance (Finance) Consultation Paper, *Strengthening the Legislative and Regulatory Framework for Private Pension Plans Subject to the Pension Benefits Standards Act, 1985* (Consultation Paper). Our submission responds to the Consultation Paper's proposals for permanent solutions for many pension issues from the standpoint of sponsors of single employer defined benefit (DB) and/or defined contribution (DC) pension plans.

## **Background**

We support Finance's interest in creating permanent funding relief for DB plan sponsors in a way that accommodates the needs of plan members. Despite the value of DB pension plans, their continued viability is now threatened by a combination of potential disputes over a range of issues. Surplus ownership (once surpluses return), high and volatile solvency contribution requirements, partial wind-ups and administrative difficulties all weigh against DB structures in employers' plan design deliberations.

## **Current Environment**

The current rules governing DB pension plans have evolved as a political compromise between maximum possible benefit security and providing adequate retirement income at an affordable cost. A direct trade-off exists between risk and expected return that is currently not adequately understood, nor appropriately reflected in the *Pension Benefits Standards Act* (PBSA) and Regulations. Employers have implemented DB pension plans that relieve their employees of the fees and headaches relating to maintaining personal retirement savings funds, while generally improving on both the risk and expected return associated with those funds.

### *i. Pension Funding Issues*

The issue of who ultimately owns pension funds, together with the related risks and rewards, needs to be resolved definitively. The pension system needs action now by governments to address the present asymmetry (particularly in regard to the treatment of surplus in the event of a wind-up or other major pension plan event) and contribution volatility (particularly that resulting from the current solvency funding requirements). In the absence of changes, private-sector plan sponsors who want to avoid the costs and risks will increasingly decide to dismantle their DB pension plans, at the next opportune moment.

We realize that surplus is not an immediate concern for many plan sponsors in the current economic climate. However, when combined with existing funding rules, the current economic crisis illustrates the severe effect market volatility can have on pension plan funding levels. If the funding rules go unchanged, many pension plans will experience significant over-funding once the markets recover. Sooner or later, it is almost inevitable that a combination of investment gains and the extra funds pumped into the plan during the lean years will produce a surplus that is too large to be effectively consumed through contribution holidays.



The extra funds become “trapped capital”—funds that were posted by the employer as extra security during lean years and become lost to the business during good years. Once the annual return on the surplus exceeds the cost of current benefits, the result is “runaway surplus”—a surplus that can keep growing, despite a continuing contribution holiday. This could lead to a return of disputes between plan members and plan sponsors over surplus ownership. Despite the challenges, we believe that a clarification of surplus ownership would help plan sponsors be more willing to provide a funding cushion, and thereby avoid or reduce future solvency deficits.

*ii. New Pension Structures*

Other pressing concerns include the need to provide innovative pension products that can address affordability, risk sharing and coverage. Increased latitude is needed in both the PBSA and Regulations to accommodate a choice of balanced financial arrangements. This includes pension plans controlled jointly by employers and plan members, and also pension plans controlled exclusively by either employers or plan members.

Currently, the PBSA and Regulations differ from virtually every other Canadian jurisdiction, in that they effectively treat a defined benefit pension plan as having some elements of a “target benefit pension design” (TBP—*see the discussion of this design later in our submission*) and some elements of a typical DB pension plan where the employer must fully fund the promised benefit. Under the current federal regime, the employer is obligated to make both going concern and solvency contributions based on the full benefit promise while the plan is ongoing but benefit reductions are permitted in extreme circumstances, and the employer is not required to fund any shortfall that exists if the plan is terminated.

This creates an ambiguity in the federal system that must be resolved. We feel that employers with federally-registered pension plans must be given the opportunity to expressly choose between a TBP, where the governing body may reduce benefits, and a traditional DB plan that requires terminal funding. As suggested by pension review bodies in Ontario, Alberta and British Columbia, different rules should apply depending on the option chosen.

### **Key Recommendations**

Our key recommendations in response to the Consultation Paper pertain to the rules that will apply to DB Plans. They include providing plan sponsors with an extended solvency amortization period, clearer ownership rules for the assets represented by solvency contributions, more frequent filing of actuarial valuations, full funding following plan termination, improved disclosure to members, the elimination of partial wind-ups, and the introduction of flexible rules in the PBSA that permit innovative plan designs. Each of these recommendations is discussed in detail in our submission.



## **Section One: Issues Pertaining to DB Plans**

### **A. Solvency and Funding Issues**

We endorse a number of measures that could help DB plan sponsors adapt to ongoing funding challenges, while protecting benefit security.

#### *i. Extended Solvency Deficit Amortization Period*

The current solvency funding rules require pension plan sponsors to fund large market-driven deficits over a relatively short period. Funding a solvency deficit over five years requires a plan sponsor to divert capital from corporate needs that could enhance the viability of the company and the pension plan to a highly volatile solvency funding target. The five-year amortization schedule also increases the likelihood that surpluses will emerge over time, due to the combination of high solvency payments coupled (eventually) with higher investment return rates.

An extended amortization period would help ease the high volatility in solvency funding that exists under the current rules requiring a five-year amortization period, and would also partially address the issue of pension surplus. As well, it would balance the impact of the Consultation Paper's recommendation for full funding on voluntary plan termination, discussed in more detail later in our submission. If a sponsor winds-up a plan a five-year amortization period would be appropriate for any deficiency.

We recommend the permanent implementation of a 10-year solvency amortization period for most DB plans, applied to the new deficit that arose at December 31, 2008 and any new solvency deficits in the future. To address concerns about the impact of this change on benefit security, we propose that the extended amortization be coupled with a requirement to file annual information with the regulator on the plan's financial position and adjust contributions on the basis of that information. We recommend that annual roll-forward valuations be allowed on solvency and going concern valuations in some circumstances, in lieu of a full actuarial valuation, as discussed below.

We would not support a requirement for consent from plan members to implement these proposals, as the relief would become difficult to attain. However, we do strongly support disclosure to plan members of the funding choices made by plan sponsors.

#### *ii. The Timing and Nature of the Solvency Calculation and Filing of Valuations*

The frequency and nature of the solvency calculation are important determinants in the solvency funding framework. Several factors can impact funded status of a pension plan, as discussed below.



- *Discount Rate Assumptions:* The Consultation Paper acknowledges that an important component of the solvency funding framework is the discount rate used in determining a plan's liabilities. We believe that the discount rate used in solvency calculations should be in accordance with professional actuarial standards, as developed by the Canadian Institute of Actuaries (CIA). The CIA completed a review of this issue in 2008 and revised the commuted value discount rate. We are pleased with that revision. The CIA has also provided guidance on how to determine the solvency discount rate for those members eligible for an annuity. We find continued government reliance on CIA standards on the discount rate issue acceptable.
- *Frequency of Valuations:* Recent economic times have demonstrated the importance of closely monitoring the financial position of pension plans. Therefore, we support the need for annual valuations for all plans if a ten year amortization period is introduced. We recognize that the Office of the Superintendent of Financial Institutions (OSFI) already requires an annual valuation filing for plans that had a solvency deficit at their last filing, but this does not protect plans that move swiftly from surplus to sizeable deficit as we have recently witnessed with so many plans.

However, full annual valuations can be expensive and at times are unnecessary. Accordingly, we recommend that the nature of the filing requirement be based on the size of a plan's deficit, such that a full annual valuation would be required for plans with a solvency deficit greater than \$100 million (in current dollars). Plans with a solvency deficit below \$100 million (in current dollars) would be allowed to choose annual roll-forward valuations for the solvency and going concern deficits, which would reflect the impact of the return on assets and the change in solvency discount rate but would be based on membership data from the last full valuation of the plan. Regardless, all plans would be subject to full valuations at least every three years, subject to the Superintendent's discretion to require more frequent full valuations if warranted in the circumstances.

If annual valuations are introduced, then no further funding cushion or provision for adverse deviation (PfAD) would be necessary, and we would discourage any move to require them.

### *iii. Deficit Financing Options*

There are a number of options, some of which are already in place in other jurisdictions and discussed in the Consultation Paper, which could provide some relief to plan sponsors in the current pension crisis. These proposals attempt to clearly establish that the surplus resulting from solvency funding that is not needed at plan termination belongs to the plan sponsor. Unless such funds are needed in the event of insolvency, they would be returned to the employer without being subjected to the rules regarding refund of surplus, and thus any surplus would thereby be available to other creditors of the employer.



- *Introduce Letter of Credit (LOC) Financing:* We support the use of LOCs as security, and we believe that an employer should be able to use an LOC to cover all or any portion of solvency special payments, and they should not be subject to restrictions on duration. Instead, we believe that the governments should adopt LOC rules similar to those currently in place in Alberta and British Columbia. These jurisdictions do not limit the proportion of contributions that can be secured by an LOC. In addition, while they require that each LOC have a one-year term, the LOC can be renewed or cancelled upon the expiry of each term based on the wishes and needs of the plan sponsor. To guarantee the reliability of LOCs as a pension funding vehicle, both Alberta and British Columbia impose conditions on the nature and use of LOCs, including:
  - a. The LOC must be an irrevocable and unconditional standby LOC, issued by prescribed issuers that cannot be the plan sponsor or an affiliate thereof;
  - b. The LOC must be made out to the pension fund holder in trust for benefit of the pension fund;
  - c. The insolvency or bankruptcy of the employer has no effect on the obligation of the issuer or holder of the LOC; and
  - d. The LOC cannot be assigned, and cannot be amended except on renewal or to reflect a change in the holder.

We believe that the conditions listed above will ensure that LOCs can guarantee solvency contributions for a pension fund without placing an undue burden on the plan sponsor or undue risk on the plan members.

- *Permit the establishment of a separate trust fund:* In addition to the use of LOCs, plan sponsors could be permitted to deposit solvency payments into a separate trust for the sole purpose of covering a shortfall in the event of a plan wind-up. Assets in this separate trust should not be subject to the current onerous rules regarding payment of surplus to the employer, and the employer would be entitled to receive such assets if a subsequent valuation shows that they are no longer required. This account has been referred to as a “solvency account” or “contingency reserve fund” or “pension security fund,” and is discussed in detail in the Alberta/British Columbia report entitled [\*Getting Our Acts Together, the Report of the Joint Expert Panel on Pension Standards\*](#) (JEPPS Report).<sup>1</sup>

These measures would simultaneously provide benefit security and address the issue of trapped capital. Benefit security is guaranteed by the financial institution providing the LOC or by the assets in the solvency account which would be available if needed on plan termination. To the extent that this extra security is not needed, the LOC could be cancelled or the employer could withdraw funds from the solvency trust as the case may be, thus reducing the likelihood of future surplus disputes and trapped capital. We recognize that LOC financing may be more difficult to obtain in today’s economic climate, but nonetheless support their availability as an option for current and future years.

---

<sup>1</sup> Report of the Joint Expert Panel on Pension Standards, (Albert and British Columbia) at 8.1.2.



We stress that LOCs should not be a condition to enable the amortization period to be extended from five years to ten. We believe that 10-year amortization should be available without conditions. However, a plan sponsor that utilizes the 10-year amortization should be able to secure the resulting solvency contributions through an LOC, if desired.

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

Federally regulated employers have, until now, operated their pension plans with the understanding that their funding obligation on plan termination is limited to making any outstanding payments to the plan, and that they are not required to remit any additional amounts that might be necessary to fully fund promised benefits. We support the change to this basic underlying principle that has been contemplated in the Consultation Paper. However, this is a significant change in the “deal” for plan sponsors who have operated their plans on the current assumption that full funding is not required upon plan termination. This brings us back to our belief that plan sponsors should be given the opportunity to expressly choose between a TBP (discussed in greater detail below), and a traditional DB. We recommend the following:

- For plan sponsors who choose to maintain a traditional DB pension plan, the additional requirement of full funding upon termination can be balanced by the extended amortization period for solvency deficiencies, discussed earlier in our submission. We feel this is further support for the extension of solvency amortization periods to 10 years.
- For situations where the plan sponsor is not prepared to accept the retroactive imposition of a terminal funding requirement, we believe that the sponsor should be permitted to convert the plan into a TBP. This would mean that the pension benefit is expressed as a DB formula but the body governing the plan can improve or reduce that benefit retroactively if a surplus or deficit emerges, much in the same way that a negotiated multi-employer plan operates. The TBP should be exempt from solvency funding and should be available to a single employer or multiple employers, and regardless of whether there is a union representing plan members. The transition process from the current state to a clearly articulated DB plan or TBP should be linked to the bargaining status of plan members:
  - If the majority of plan members are represented by collective bargaining agents, then we would expect that the employer’s choice of either a DB plan or a TBP would require the approval of the collective bargaining agents.
  - In other circumstances, we would expect that the employer’s choice would require the approval of the Superintendent, after consideration of any issues raised by plan members.

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

We support the elimination of partial wind-ups. Few jurisdictions in Canada continue to include partial wind-ups in their pension legislation, and partial wind-ups typically lead to a



significant deal of litigation between plan sponsors and members. The Supreme Court of Canada's recent dismissal of leave to appeal the Federal Court of Appeal's decision in the *Marine Atlantic* case<sup>2</sup> has established that surpluses are not required to be distributed on partial wind-up under the PBSA, and we believe the existing federal rules regarding pensionable age adequately address any concerns related to possible loss of early retirement benefits.

Concerns about the loss of unvested normal retirement benefits could be addressed by introducing immediate vesting, as discussed in the Consultation Paper. While we understand the rationale for immediate vesting, we caution that it will result in a greater administrative burden and associated cost due to the higher degree of turnover in employees' early years with a company. A shorter vesting period such as one year might alleviate concerns, while still retaining much of the administrative advantage of a vesting rule.

#### **D. Disclosure of Information**

The Consultation Paper states that enhanced disclosure could be obtained by requiring the *administrator* to establish a Statement of Funding Policy (SFP). We are not opposed to the concept, but we question the value that it will bring. In any event, we believe that if a SFP is required, it should be the responsibility of the plan sponsor, not the administrator. The plan sponsor, as the party having responsibility for funding the plan, is the logical party to draft the policy on funding.

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

In the Consultation Paper, Finance recommends that contribution holidays be limited to the year in which a valuation report is filed with the Superintendent. We support this recommendation but we suggest that plan sponsors should be permitted to provide streamlined information to regulators. If Finance decides not to require the filing of annual valuations, it would be appropriate to require plan sponsors who wish to continue contribution holidays beyond the first year following the valuation date to submit:

- The rate of return on the pension fund investments for each year since the last valuation;
- A roll-forward of the going concern and solvency surplus, taking account of interest at the valuation interest rate, the normal costs paid from surplus, the fund rate of return, and the approximate impact of the change in solvency discount rates;
- A statement by the Administrator describing any events subsequent to the date of the last valuation that could impair the surplus; and
- A statement by an actuary that on the basis of the information provided and the most recent valuation, the plan would still have a surplus if a full valuation were performed.

This less onerous standard will avoid the need for costly, timely and unnecessary valuations for pension plans with large surpluses.

---

<sup>2</sup> See *Cousins v. Canada (Attorney General)*, 2008 FCA 226 (CanLII) – leave to appeal to Supreme Court of Canada dismissed March 5, 2009.



## **F. Void Amendments**

We endorse the void amendment provisions as outlined in the Consultation Paper. Specifically, we believe that 85% is an appropriate approximate threshold, as suggested in the Consultation Paper. We believe, however, that plan improvements should be permitted for plans with a solvency ratio below this threshold, provided that offsetting funding occurs such that the additional liabilities are funded at the level of the solvency ratio. Prohibiting amendments at lower levels could have the effect of negating plan amendments that were negotiated in good faith between plan sponsors and plan members.

## **Section Two: Issues For Discussion Pertaining to Defined Contribution Plans**

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

Some DC plan sponsors have requested that legislation provide safe harbour protection in respect of many aspects of administering a DC pension plan, including the selection of default investment options. The requests generally point to the safe harbour provisions of the United States' *Employee Retirement Income Security Act* (ERISA), which protects plan sponsors from legal liability when they provide a “qualified” default investment option, such as a balanced fund or a suite of target-date funds. ERISA also covers other areas of DC plan administration, including communication issues and investment fees.

While there is an obvious appeal to increasing certainty for plan fiduciaries and reducing the risk of legal liability, we are not convinced that safe harbour protection is the best solution. Safe harbour protection has not stopped litigation in the United States, but has instead changed the focus of litigation to the issue of whether or not the relevant safe harbour rules apply to the particular case. There is also a risk that safe harbour rules will hamper the evolution of best practices for plan design and administration, as deviation from the safe harbour provisions would create legal risk.

The JEPPS Report included an excellent discussion on safe harbour provisions (Section 7.3), and recommended the implementation of a statutory defense for plan fiduciaries, a “pension judgment rule” similar to the business judgment rule that protects corporate directors. Under a pension judgment rule, plan fiduciaries would be protected from legal liability in respect of decisions that were made:

- In good faith;
- On an informed basis (including obtaining expert advice, where appropriate);
- In the interests of plan beneficiaries; and
- In the absence of conflicts of interest.

We agree with the JEPPS Report that a pension judgment rule would better encourage plan fiduciaries to follow good governance practices and processes than would safe harbour



provisions, while still offering protection from legal liability if appropriate practices and processes are followed.

We also support the JEPPS Report's recommendations for clarifying in pension legislation the appropriateness of certain pension plan design features where there is currently some doubt, specifically automatic enrolment of members, automatic contribution increases over time, and providing no investment choice to members. The legislated clarification should confirm that such design features are not actionable in and of themselves, without removing the requirement for plan fiduciaries to exercise appropriate due diligence in making their decisions and appropriate care in plan administration.

Even with these improvements to the clarity of employers' legal obligations in regard to employee savings plans such as defined contribution pension plans, many employers, especially small employers, will continue to be reluctant to get involved in their employees' retirement savings plans. We believe the best approach to broaden retirement savings plan coverage to Canadians in these situations is a government-sponsored savings plan, along the lines of the JEPPS Report's proposal or the proposal for an optional tier in the Canada Pension Plan.

## **B. Retirement Funds Paid From the Pension Fund**

We support the implementation of a variable benefit as an optional feature in DC plans. This option exists in several Canadian jurisdictions and has recently been implemented in Manitoba<sup>3</sup> and Saskatchewan<sup>4</sup>. Given the additional administrative costs that could be incurred to implement this change, we recommend that it remain an optional feature, at least initially.

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

The Consultation Paper states that applying a DB fiduciary duty standard to a DC plan administrator may not be appropriate, given that the administrative responsibilities are significantly different for DB and DC plan administrators. The Consultation Paper notes that "such a change would not be expected to negatively impact plan members." We agree that this is an area of the PBSA that would respond well to distinctions between DC and DB plans, given the different responsibilities of DB versus DC plan sponsors.

Given the minimal impact this change would have on plan members, we strongly recommend adopting the standard of "good faith" to the employer administrator's role. We agree with the Consultation Paper that this could encourage more employers to sponsor DC plans, as it may result in a diminished potential for lawsuits over perceived breaches.

---

<sup>3</sup> Manitoba MR 78/2007 *Manitoba Pension Benefits Regulation*; Manitoba Pension [Update 34](#).

<sup>4</sup> Saskatchewan SR 41/2006 [The Pension Benefits Amendment Regulation 2006](#).



#### **D. Use of Surplus in DC Components**

We strongly support the concept of using DB surplus to offset DC current service costs within the same plan. This is consistent with recommendations from the Ontario Expert Commission on Pensions (OECPC)<sup>5</sup>. The OECPC recommends that even in hybrid plans, surplus should be used “to serve the purposes of the plan: to pay for contribution holidays or plan expenses.” Legislative action is required to support the clear intent of sponsors who have voluntarily established DB plans, in the face of unintended and sometimes inappropriate application of trust law principles to pension plans by the courts. Of course, surplus in a TBP would have to be dealt with in accordance with the terms of such a plan.

#### **E. Administrative Procedures for DC Plans**

The Consultation Paper raises the issue of terminating DC plan members who leave their assets in the pension plan, with the resulting administrative costs for the administrator. The Consultation Paper aptly states that it may not be appropriate for the administrative costs to be paid by the plan administrator when the plan member is no longer employed by the employer. We agree, and recommend that the legislation be amended to permit the plan terms to determine whether assets of terminated DC members may be transferred by default to a pre-determined alternative tax-deferred retirement savings account.

The Consultation Paper also suggests that the concept of one-time unlocking from federally regulated Life Income Funds (LIFs) be considered. We support the concept of limited unlocking. However, given the goals set out originally for pension plans as regards protecting of benefits, and consistent with our belief that pension plans exist to provide retirement income, we feel that increasing the level of unlocked funds in pension plans runs counter to these principles. We agree that unlocking relatively small amounts can reduce administrative costs for individuals, and that unlocking in circumstances of financial hardship may be appropriate. However, larger scale unlocking undermines the objectives of both governments and employers in supporting the private pension system.

---

<sup>5</sup> Ontario Expert Commission on Pensions, [A Fine Balance](#) at pp 103-106.



## **Section Three: Other Issues Respecting the Framework for Private Pension Plans**

### **Flexibility of the PBSA**

We strongly recommend that the legislation be amended to provide flexibility to permit a variety of alternative plan designs. Cost-shared plans, jointly sponsored plans, member-funded plans and target benefit plans should all be given the appropriate legislative provisions so that they are permissible designs. The Consultation Paper specifically refers to member-funded pension plans, which were recently implemented in Quebec. We support the introduction of member-funded pension plans, as they allow employers and workers to establish pension plans that allow for sharing of pension funding costs and risks.

Specifically, we support the concept of TBPs (also known as negotiated cost DB plans) as a type of pension plan that we believe should be explicitly permitted by the legislation for either a single employer or for a collection of employers, and it is a concept that was strongly supported by the OECF<sup>6</sup> and in the JEPPS Report. A TBP operates by using both a DB and DC approach in the plan. Essentially, the pension benefit is provided through a DB formula, but the employer's obligation to contribute is specified like a DC plan and the accrued benefits may be reduced if a deficit is emerging, much in the same way that a negotiated multi-employer plan operates. The advantage of a TBP to employers is that it reduces the DB liability risks by fixing costs. Plan members benefit by sharing risks across the membership, reducing individual exposure to investment, longevity and other risks typically associated with DC plans. Further, a TBP minimizes or eliminates the disputes regarding surplus that exist in many DB plans and thus could be a viable alternative to DC plans.

### **Investment Rules**

The Consultation Paper states that Finance is seeking views on how to improve the regulatory framework governing pension investment, noting that the Schedule III investment rules have not been reviewed in 15 years. We believe that this is a priority issue for the federal government to quickly address. Most other provincial governments are dependent on the federal rules and some are now contemplating creating their own rules, given that nothing has been changed in the federal provisions. We recommend that Finance quickly amend these rules, in order to provide a template for the provinces to adopt, thereby ensuring harmony in this area of pension legislation.

We support some amendment to the quantitative limits found in Schedule III. However, we are concerned that not all investment advisory committees have the requisite sophistication to manage investments without strong regulatory oversight. We agree that large pension plans with access to sophisticated investment management services may be capable of ensuring that investment activity is conducted prudently.

---

<sup>6</sup> For example, see OECF Report at p. 72.