



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

*Views from Aon Consulting*

*March 16, 2009*

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# Section 1: About Aon Consulting

Aon Consulting is a leading human capital consulting and employee benefit outsourcing firm. With more than 700 professionals in 12 offices across Canada, we collaborate with over 36,000 colleagues across 500 offices in 120 countries to link people strategies with business strategies to enable our clients toward excellence in performance in the areas of Retirement Strategies, Health Strategies, Human Capital Consulting and Employee Benefits Outsourcing.

We trust that this document will be of assistance in the review taking place under the discussion paper "Strengthening the Legislative and Regulatory Framework for Private Pension Plans Subject to the *Pension Benefits Standards Act, 1985*" (the "**Discussion Paper**").

## Section 2: General Comments

The negative returns of the global stock markets between 2000 and 2002, combined with the continuing slide in interest rates, had a major impact on defined benefit pension plan sponsors.

Plummeting stock markets in 2008 have further compounded this problem and plan sponsors are now aware of the magnitude of the risk associated with their pension plans.

Under these market conditions and the current state of pension regulation, many plan sponsors are finding the survival of their defined benefit pension plans untenable.

While Canada's pension system is among the top in the world, it is facing a critical challenge when it comes to ensuring its sustainability. A number of special commissions have been established to review pension standards across Canada and, while there are many different opinions and proposed solutions, stakeholders seem to universally agree that change is needed.

As a leading provider of advice and solutions to pension plan sponsors, Aon Consulting is committed to participating in the current dialogue around improving Canada's pension system. In this regard, we have collected our thoughts in a White Paper report entitled "Restoring Retirement Security: Recommendations for Updating Canada's Pension System" (the "**White Paper**").

The White Paper focuses on seven key issues and, in particular, highlights our proposed Affordable Defined Benefit pension plan, which has the distinct advantage of addressing many of the issues that have plagued both defined benefit pension plans and defined contribution pension plans, including cash funding and pension accounting volatility.

We invite you to consult this White Paper (appended). We hope that it will inspire legislative change that will allow current and future generations of workers to benefit from continued innovation to pension plan design in Canada.

# Section 3: Our Views

Over the next several pages, we will address the aspects of the Discussion Paper on which you seek stakeholders' views. The sections that follow are numbered to correspond with the relevant section number in the Discussion Paper.

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

There are two extracts from this section on which we would like to focus our response:

- 1) "Promoting the retirement income security of Canadians is an important goal of the Government of Canada."
- 2) "Improvements in the legislative and regulatory framework should be aimed at improving the security of pension plan benefits and ensure that the federal legislative and regulatory framework is balanced and appropriate in its incentives to establish and/or maintain pension plans. Considering these objectives, changes to the framework should be approached with the following principles in mind:
  1. The rules governing private pensions should be reflective of the voluntary and contractual nature of the arrangement;
  2. Employees and retirees should have the information to make informed decisions; and
  3. The legislative and regulatory framework should ensure that certain minimum standards are met in order to ensure a level of benefit security for plan members."

With these principles in mind, it is necessary to address the fact that the goal of advancing these principles is not aided by the continuing decrease in the number of defined benefit plans.

In addition, it is important to put the security of pension plan benefits into perspective. When we compare the security of pension plan benefits under defined benefit pension plans with those under defined contribution pension plans, clearly defined benefit pension plan benefits should provide greater security. Nonetheless, recent economic turmoil indicates that the security of defined benefit pension plans is not perfect. We believe that "perfect" security is not reasonably attainable under current rules and that the Government's focus should be to achieve a solution that provides an "affordable" security.

This is why all key stakeholders (plan sponsors, labour, retirees, pension professionals and legislators) must assist in the quest to determine the appropriate balance between reasonable security for pension benefits and the flexibility required to avoid plans from becoming too heavy a burden on plan sponsors.

## Section 3: Our Views

Furthermore, what has become clear in the last year is that the current system of going concern and solvency funding rules does not work. The concept of solvency funding was developed at a time when interest rates were high and solvency liabilities were much less than going concern liabilities. The likelihood of defined benefit plan members losing their pension entitlement is small, but the impact to the member could be significant. The solution offered for this "problem" to date is to throw money at it, money that may no longer be needed when conditions reverse themselves. Typically, in other situations, we would use some form of insurance to protect against this kind of loss; however, so far, no efficient insurance instrument has been developed for this purpose.

One interesting highlight of the BC/Alberta Report's commentary on funding deficits is the report's statement that " the test and the remedy are two separate issues." This is very true. Solvency valuations are appropriate and necessary tests to aid plan administrators in understanding the financial state of a plan. However, overly strict funding rules based on a solvency valuation basis place excessive financial pressure on sponsors.

We believe that the funding rules must provide :

- consolidation of previous funding schedules on both a going concern and solvency basis at each actuarial valuation.
- Funding of going concern deficits over a maximum of 15 years.
- Funding of solvency deficits over a maximum of 10 years.
- Permission to use letters of credit in lieu of solvency contributions and their treatment as an asset in determining the solvency funded position.
- Use of the CIA standards for solvency valuations, including the discount rate under those standards.
- Requirements with regards to a provision for adverse deviations (PAD) determined in relation to the risk associated with the pension plan obligations and the fund asset mix. However, it is important that a fair mechanism is in place to allow the recover of this PAD by the plan sponsor when it is not part of an agreement with the plan members.
- Elimination of the requirement to finance the solvency deficits when the plan sponsor is government-based.
- Elimination of the maximum surplus rule under the *Income Tax Act* (Canada) to allow more flexibility for plan sponsors to act responsibly.

Obviously, our suggestion of continuous consolidation of previous funding schedules creates a appearance that a deficit may never be eliminated; however, the following must be kept in mind:

## Section 3: Our Views

1. Deficits are eliminated by special contributions made toward this deficit and by positive gains made by the plan, including favourable returns on plan assets and increases in market interest rates.
2. When there is a possibility to smooth assets as a temporary relief measure in an actuarial valuation, the purpose of the smoothing is to allow the plan time to achieve a positive gain.

Therefore, we believe that the solution to improve the security of pension benefits, is as much a matter of setting appropriate provisions for adverse deviations as it is a matter of determining what is a fair period to pay for deficits.

If the requirements for special contributions are too strict, private sector sponsors are unlikely to be able to afford the costs associated with the special contributions, and may have trouble garnering the support of shareholders to bear the risk associated with defined benefit pension plans. This would defeat the goal of improving the security of pension benefits. Thus, we believe that a compromise must be reached between the flexibility required for plan sponsors and the reasonable (or affordable) security of benefits for plan members.

**3B. The Government of Canada is seeking 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 an 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.**

Most of the provincial legislations currently provides for the concept of employer debt upon plan termination for single employer pension plans. In principle, it would appear that the federal legislation should also adopt such a concept.

However, recent market declines have shown to defined benefit pension plan sponsors all the magnitude of the risk that they were bearing. The lesson that has come out of the market declines is that the "perfect" security is too expensive for many plan sponsors. Additionally, the Ontario Expert Commission on Pensions' report, "A Fine Balance", demonstrates that there is a desire for legislators to allow the creation of "target benefit plans". The concept behind such plans is that security of benefits would be supported by rules for provision for adverse deviations and accrued benefits could be reduced if the plan's financial situation would make the plan's survival untenable. In comparison, negotiated contribution multi-employer pension plans allow (except in Quebec) for a reduction in accrued benefits under certain conditions, and this right is usually only used as a temporary measure to permit the plan's survival.

## Section 3: Our Views

In our view, federal legislation should adopt the concept of full funding at plan termination (except for negotiated contribution multi-employer plans), **but only** if the creation of target benefit plans is also allowed. Employers and their employees would be able to choose the type of plan best suited for their needs and particular situation. We also assume that if the concept of full funding at termination is introduced, there will be transitional measures (as was set for example, in Quebec in 1990) to smooth the impact for employers and their financial partners.

**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.**

The requirement for immediate vesting would obviously create additional costs for pension plans. However, from our observations of Quebec's experience, these additional costs are more than offset by the advantages of the elimination of partial terminations.

Therefore, we agree with the elimination of partial terminations, combined with the requirements of immediate vesting.

**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 as the Statement of Investment Policies & Procedures (SIP&P). The SFP would be examinable upon request, like the SIP&P.**
- **Allow required disclosure items to be disseminated by electronic means, at the option of the receiving member or beneficiary.**
- **Expand the categories of members required to receive plan information to include former members and retirees, where it is appropriate.**

### Statement of Funding Policy (SFP)

Indeed, a SFP would bring advantages with regard to transparency and plan governance. However, the cost of developing such a policy must remain affordable for small plans. To this end, template policy statements should be developed to assist smaller plans.

It is also useful to note that, for most pension plans, the asymmetric treatment of deficits and surpluses does not encourage conservatism in pension funding. Any legislative developments to solve this problem would contribute to the overall improvement to the security of pension plan benefits.

# Section 3: Our Views

## Communication through electronic means

We agree with the dissemination of plan information, at the option of the receiving member or beneficiary.

## Information to former members and retirees

Even considering the additional costs associated with the expansion of categories of members required to receive information, it is hard to oppose such a requirement which serves to improve transparency for these additional persons with rights under the plan. We trust that such a requirement would be offset by relief for plan sponsors with respect to plan financing.

### **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.**

## Policy on contribution holidays

It seems reasonable for transparency purposes, that such a policy be developed since we do not believe that it would result in much higher fees. We agree with this proposition.

## Annual actuarial certification for contribution holidays

Given the recently observed high market volatility which is still expected to continue in the future, it appears reasonable to require an annual certification to permit a contribution holiday, but only if, as permitted in the Quebec legislation, "**partial**" actuarial valuations are allowed for this purpose.

### **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.**

In the case that the concept of a prescribed solvency ratio remains, it does not appear unreasonable that a solvency ratio level of 0.85 be used, but only if amendments continued to be permitted where a special contribution is made and is equal to the lesser of a) the value of plan improvements or b) remaining assets to reach a ratio of 0.85.

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### **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.**

Safe harbour protection should be granted to plan sponsors that offer default investments to the plan members, provided the default investments meet certain criteria. The criteria to determine whether a default investment is appropriate could include options that are:

- based on a member's age;
- risk level based;
- diversified by asset class and style.

Generally accepted default options would then include target date funds (i.e. diversified funds where the risk level is decreased as the member's retirement date approaches) and risk based lifestyle funds (i.e. diversified funds that are managed to a specific risk tolerance level, regardless of age). Diversified funds that offer a guarantee of principal would also be appropriate assuming prudent associated costs.

Please note, it is important to ensure that plan sponsors continue to offer communication and education to members even if safe harbour protection for default investment allocations has been granted as it is in the member's best interest to actively participate in the plan by maximizing contribution levels and take accountability for investment decisions and future retirement needs.

### **4B. The Government of Canada is seeking views on whether to allow the payment of variable retirement benefits directly from the defined contribution account.**

The payment of variable retirement benefits directly from a defined contribution account should be allowed as a potential option under a plan. An employer could decide whether to offer the option to the plan members based on their desire to accept the additional administrative burden but this should not be a required plan feature.

Where the employer decides to offer the option, employees should be given this option along with current payment options which include the purchase of a life annuity or transferring of their assets to another registered product. Employees should not be required to accept this option.

Costs to offer this new option must be clearly identified and allocated to those who have selected the option; total plan costs that are shared by all members should not be increased due to the option's inclusion.

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**4C. The Government of Canada is seeking views on whether it is appropriate to revise the standard of care for employers sponsoring defined contribution plans to "good faith" rather than "fiduciary".**

It is not appropriate to revise the standard of care for employers sponsoring defined contribution plans to "good faith" from "fiduciary". While some plan sponsors may find the "fiduciary" standard of care to be onerous, we believe that this is a minimum requirement to protect the fundamental interests of the members. It would be helpful for plan sponsors if specific fiduciary duties and standards to uphold those duties be itemized.

Please also note, employers may be hesitant to offer a defined contribution plan and favour a group RRSP not because of the standard of care requirement under a DC plan but because of the extra administrative burden that does not exist as the sponsor of a group RRSP (i.e. filing of plan documents, filing of an annual information return, requirement to have a pension committee (Quebec only) etc.).

**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.**

It seems appropriate to encourage clarity and eliminate uncertainties by including in the legislation any elements that would simplify plan administration.

Our suggested solution, as discussed in the White Paper, is that plan sponsors should be permitted to "refresh" their pension deals by replacing existing inflexible trusts with new trusts or funding contracts for future service.

**4E. The Government of Canada is seeking views on required administrative practices that may impede the proper and efficient administration of defined contribution plans.**

Plan sponsors should have the option to amend their current and future plans to require that terminated members remove their assets from the plan; plan sponsors should not be required to make this a plan option.

Where plan sponsors require terminated members to remove plan assets, the plan sponsor should provide sufficient notice to the terminated member and, if the member takes no action, the assets should be transferred to a pre-determined tax-deferred retirement savings account where the cost could be allocated to the plan member and deducted from the transferred assets.

**5A. The Government of Canada is seeking views on whether there is interest in alternative plan designs that may not currently be accommodated by the legislative framework.**

## Section 3: Our Views

We believe it is essential for the future of pension plans in Canada that new types of pension plans be allowed by the legislation. We invite you to consult the Aon Consulting White Paper presenting the potential associated with innovative ideas. We do wish to stress that in order to allow the development of such innovations for the benefit of current and future generations of Canadian workers, collaboration among legislators in all jurisdictions is necessary.

**5B. The Government of Canada is seeking views on whether there are legislative impediments to the creation or operation of multi-employer pension plans, and if there are improvements that could usefully be made to the legislative framework for these arrangements.**

It is often mentioned that negotiated contribution multi-employer pension plans require special rules for funding for the following reasons:

- The presence of many plan sponsors reduces the risk that a particular situation causes the plan total termination. This allows the plan more flexibility to adapt to certain circumstances.
- Benefits provided by a negotiated contribution multi-employer pension plan is periodically adjusted, by a Board of Trustees, in accordance with the results of actuarial valuations and projections. The important volatility associated with funding rules on a solvency basis often also creates too much volatility for plan benefits.

Therefore, it is obvious that multi-employer plans need more flexibility when it comes to funding requirements. Ideally, they should be exempted from solvency funding. Alternatively, we believe that the funding rules that we suggested in response to point 3A, above, are particularly important for multi-employer pension plans.

Also, we believe that the current enacted rules for multi-employer pension plans do not encourage the formation of multi-employer plans ("collectives") where arm's length employers (likely in similar industries) come together for greater and more effective purchasing power. There is a need for those without the context of collective bargaining and without jointly trustee boards.

**5C. The Government of Canada is seeking views on the relevance of Simplified Pension Plans, and whether there are any impediments in the legislation to the adoption of such arrangements.**

While Simplified Pension Plans are less costly and less administratively burdensome than "standard" defined contribution plans, they are still less attractive than group RRSP plans to a small employer as there are more administrative requirements than a group RRSP.

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**5D The Government of Canada is seeking views on the appropriateness of reorganising the Act to provide greater clarity on the differing legislative provisions applicable to defined benefit and defined contribution plans. Specific examples of legislative impediments and uncertainties are particularly desired.**

It would be appropriate to reorganize the Act to provide greater clarity regarding which provisions apply to which type of plan, for the benefit of plan sponsors and members. Here are a few examples where greater clarity would be helpful:

- Which types of fees can be paid out of plan assets for both types of plans.
- Whether Section 27, the Sex Discrimination Prohibition, applies to defined contribution plans or only to defined benefit plans. If it is applicable to defined contribution plans, how the provision would apply should be clarified.
- Information required to be sent by a plan administrator to all members and beneficiaries of both plan types should be detailed as the information required to be sent should be different.

# Appendix

## Aon Consulting White Paper: Restoring Retirement Security



RETIREMENT

## Restoring Retirement Security.

○ Recommendations for Updating Canada's Pension System

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## About Aon

Aon Consulting is part of Aon Corporation ([www.aon.com](http://www.aon.com)), the world’s #1 choice for risk advice, insurance and reinsurance brokerages, and human capital management, delivering long-term value to clients through inspired, independent thinking and innovative, personalized business solutions that have tangible impact on the bottom line. The Aon team of 36,000 colleagues in more than 500 offices and 120 countries goes to work every day with the purpose of helping clients and helping colleagues help clients.

## Introduction: Setting the Stage for Change

Canada has long enjoyed one of the world’s most successful pension systems.<sup>1</sup> The environment in which the pension system operates is ever-changing, however, and the Canadian pension system itself is far from nimble. Regulatory, legal, tax, demographic and other factors all constrain the system’s flexibility. As a result, new developments have outpaced the pension system’s ability to adapt and evolve, and further challenges are on the way.

Today, some of the best features of the Canadian pension system are disintegrating, which places the future retirement security of Canadians increasingly at risk. Not surprisingly, therefore, there is a growing consensus of the need for a pension system overhaul.<sup>2</sup> Pension reform is necessary not just to enable the system to catch up with current developments, but also to allow it to anticipate and accommodate forthcoming ones. Many stakeholders have released various proposals for reform, however most of their recommendations address specific components of the pension system, in particular employment-related plans, rather than offering solutions directed towards the pension system as a whole.

This paper examines seven critical issues facing the Canadian pension system today, beginning with the constraints the system places on the efficient distribution of risk between employers and employees and the opportunity for an alternative to defined benefit and defined contribution pension plans. This paper offers suggestions to enable the pension system to work better now and in the future as well as:

- Address the central issue of pension system integration;
- Address the system’s adaptability to future change; and
- Includes innovative solutions to the pressing problems facing the pension system.

<sup>1</sup> For substantiation of this, see “Evaluation of the Québec System of Financial Security at Retirement in Relation to that of other Industrialized Countries” (Régie des rentes du Québec, Oct 2004).

<sup>2</sup> Recent pension reform proposals and related research papers include: “Back from the Brink, Securing the Future of Defined Benefit Pension Plans” (ACPM/ACARR, August 2005); “Addressing the Pensions Dilemma in Canada” (Certified General Accountants Association of Canada, 2005); Remarks by David Dodge, Governor of the Bank of Canada to L’Association des MBA du Québec, November 9, 2005; “Towards Better Funding of Defined Benefit Pension Plans” (Régie des rentes du Québec, June, 2005); “Strengthening the Legislative and Regulatory Framework for Defined Benefit Pension Plans Registered under the Pension Benefits Standards Act, 1985” (Department of Finance, May 2005 Consultation Paper), Manulife Investments Research Poll (conducted by Maritz Research, July 2006), “Canada’s Pension Predicament” (Canadian Federation of Independent Business, January 2007), “Findings from the 2006 Survey on Pension Risk” (Conference Board of Canada and Watson Wyatt Worldwide, April 2007), and the interim work conducted by Ontario’s Expert Commission on Pensions.

## The Canadian Pension System—An Overview

The Canadian pension system is based on three fundamental pillars:

- Government plans;
- Employment-related retirement plans; and
- Personal savings.

Government plans provide Canadians with a basic foundation of financial protection in retirement. Employment-related plans provide people with the opportunity to earn additional pensions in the workplace. Personal savings are used to close any gap that remains between an individual’s government and employment entitlements and a comfortable retirement income.

All three pillars of the system must work in combination and harmony to achieve these inter-related goals. Each pillar also has its sub-systems, and all of them also need to work with each other if an individual pillar is to fulfill its objectives and the overall system is to succeed.

## Primary Issue: Improving risk distribution between employers and employees: An alternative to Defined Benefit and Defined Contribution Pension Plans

There are two types of employment-related pension plans in Canada—defined benefit plans (DB) and defined contribution plans (DC)<sup>3</sup>. In recent years, there has been an accelerating trend among employers - especially in the private sector - to close DB plans, and this trend is expected to continue given the risks arising from financial volatility. When DB plans are closed, they are usually replaced with a DC plan. In situations where there is no replacement plan, employees must fend for themselves using personal savings (which are DC by nature).

With small accommodations by system architects, however, it would be possible to introduce an intermediate solution that allocates risk in a more balanced way than either DB or DC plans. This alternative would provide better retirement security for Canadians and also enable employers to control their financial risk exposure. It is important for the system decision-makers to act quickly, however, in order to intercept the further unnecessary transfer of risk.

<sup>3</sup> Pension plan coverage in Canada was reported as follows in Statistics Canada’s 1/1/2004 Survey of Pension Plans in Canada:

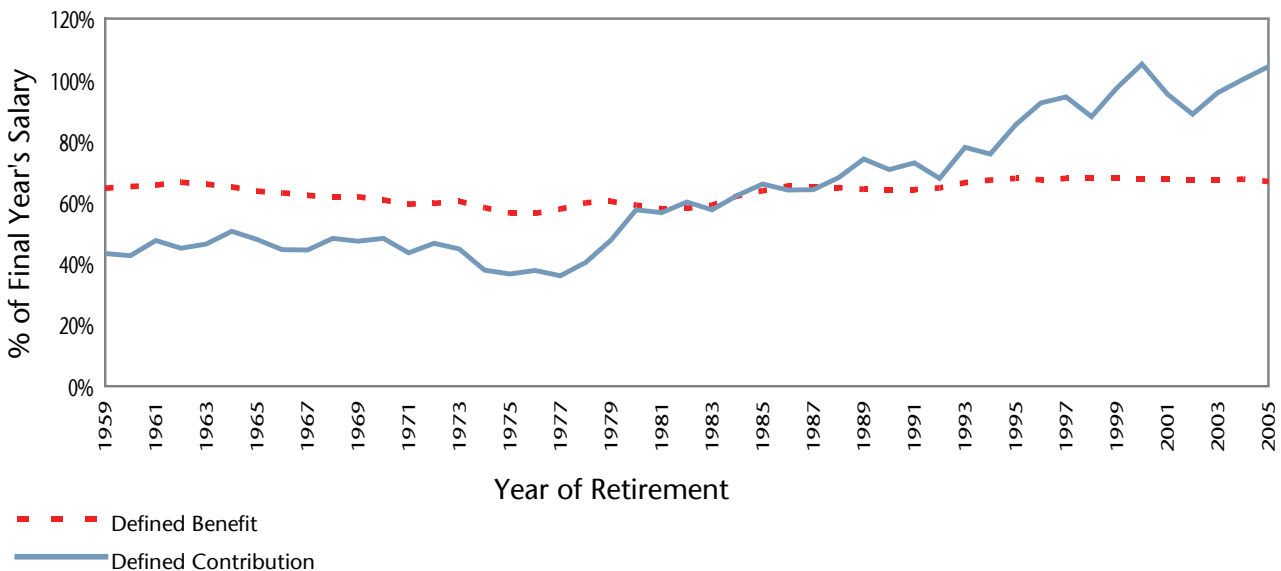
Stats Canada 1/12/2004	Private Sector			Public sector			Total		
	DB	DC	Total	DB	DC	Total	DB	DC	Total
No. of plans Thousands	7.0	7.3	14.3	0.4	0.9	1.3	7.4	8.2	15.6
%	48.7%	51.3%	100.0%	34.2%	65.8%	100.0%	47.5%	52.5%	100.0%
No. of members Millions	2.2	0.8	3.0	2.4	0.2	2.6	4.6	1.0	5.6
%	71.7%	28.3%	100.0%	92.9%	7.1%	100.0%	81.5%	18.5%	100.0%

## The DB to DC risk transfer

DB pensions are widely recognized as being more predictable than those from DC plans, however the degree of unpredictability of DC pensions is not well understood and is seldom quantified.

The following chart models the pension that would have been received by an employee retiring from a DB plan after a 35-year career at various times between 1959 and 2005. It also presents the estimated pension that would have been received by that employee from a DC plan with similar expected employer cost.

**Historical Comparison of Pensions Provided Under Defined Contribution and Defined Benefit Pension Plans**



The blue line shows the varying retirement income provided by a defined contribution plan. The reason for large variations is that the level of retirement income derived from a defined contribution plan depends on the economic conditions experienced prior to retirement. A member retiring in 1985 would have experienced the conditions of 1951 to 1985, while a member retiring in 2005 would have experienced the conditions of 1971 to 2005.

- Assumptions:
- Retirement at age 65
  - 35 years of service
  - 50/50 bond/stock mix (money purchase)
  - annual DC contributions of 10.96% of salary
  - defined benefit formula = 2% of final average 5 years' salary
  - pensions are non-indexed

The following table illustrates the risk difference in terms of “replacement ratio” (i.e. pension expressed as a percentage of salary at retirement).

	DB		DC	
	Year	Replacement Ratio	Year	Replacement Ratio
Maximum Replacement Ratio	1995	68%	2000	105%
Minimum replacement ratio	1976	56%	1977	36%

As a direct result of significant, real-world variations in economic conditions over which an employee has no control, depending upon the timing of an individual’s retirement, a DC plan would have produced a pension of between 36% and 105% of that employee’s final earnings. By comparison, a DB plan would have produced a pension of between 56% and 68% of final earnings.

Although many other factors may affect an employee’s pension — such as the employee using an income option other than an annuity — both the preceding chart and table illustrate the greater predictability of a DB pension compared to a DC pension. Given the choice, many employees would not willingly exchange an expected pension within the range of 56% to 68% for one within the range of 36% to 105% as they would likely perceive the downside risk of a DC plan to be too great<sup>4</sup>. Yet, for more than a decade this type of risk transfer has occurred with increased frequency across Canada’s pension system and as well as in countries around the world.

<sup>4</sup> Most DB-to-DC conversions occur by giving existing members the choice of staying DB or moving to DC, along with risk information relevant to that choice, and by allocating new members to the DC plan. Thus, in general, existing plan members have a say in what type of entitlement they receive, but new members do not.

## Why this risk transfer has occurred

Four main forces initiated this risk transfer:

- Lower interest rates have forced up pension plan liabilities. Lower nominal rates increase liabilities for non-indexed plans and lower real rates cause increases for indexed plans. Both have occurred in Canada in recent years.
- Corporate financial accounting rules have brought pension expense into the income statement and pension liabilities onto the balance sheet. Even with the current availability of “smoothing” mechanisms (i.e. averaging asset values and amortizing gains/losses), the volatility of results is too great for many shareholders to willingly tolerate. Furthermore, the convergence of international accounting standards towards a new “mark-to-market” model will eliminate these smoothing methods.
- Solvency funding requirements have created significant cash-flow strains on many corporations that, in some instances, have been significant enough to affect the very survival of the corporation.
- Corporate consolidation is helping to spread DC design. In mergers and acquisitions the parent organization often seeks consistency across its overall organization. In a growing number of cases, DC design has become the preferred platform on which to consolidate. As more Canadian firms move to DC, the companies they acquire tend to follow suit. The pension systems in the U.S. and U.K. have also moved towards DC design so, as global consolidation proceeds, Canadian companies acquired by U.S. and U.K. parents will also move towards DC plans.

## An alternative to the current risk transfer

It is true that some employers consciously choose DC plans as the best solution for their organization and employees. However, in many instances both employers and shareholders would have preferred to continue a DB promise had it been possible to control the associated financial risks. As no intermediate solution currently exists, these companies are forced to choose between their financial performance and their DB plan.

There is a category of DB pension plans in Canada, however, which provides for such financial control, the multi-employer plan, which has the following features:

- The employers’ costs are contractually limited, usually to what is negotiated in collective bargaining;
- Benefits can usually be reduced for past as well as for future service (except in Quebec) in the event that the plan becomes unaffordable;
- The plan is treated like a DC plan for the purposes of the employer’s financial accounting, so there is no employer balance-sheet risk; and

- The pension comes to employees in the form of a DB promise that is subject to an affordability test. In a well-managed plan, this is much more predictable than a DC promise.

At present, the Canadian regulatory environment is conducive to this type of design only for multi-employer situations. However, it would appear that the concept could be enhanced and extended to single-employer situations to provide a “win-win” solution that enables employers to limit their risk and contain the risk transferred to employees.

Aon Consulting urges Canadian regulators to enact the changes necessary to accommodate such a plan, which we call the affordable defined benefit (“ADB”) plan.

## The ADB plan

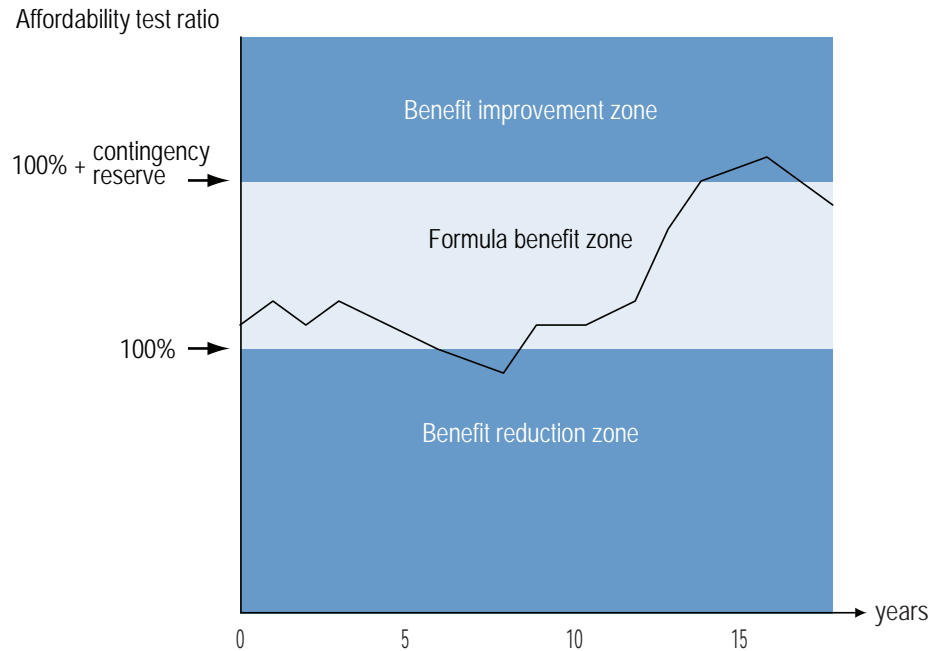
An ADB plan combines the “best” of DB and DC plans. It offers members most of the security of a predictable DB promise while giving the employer most of the financial risk control of DC design. It has the following features:

- The employer provides a conditional “formula benefit” promise (this is a DB promise subject to an affordability test);
- If costs rise to a level at which the full formula benefit promise is unaffordable, the benefit is scaled back to a level commensurate with the available financing. The adjustments would be applied equitably and automatically in accordance with contractual and well-communicated provisions of the plan; and
- If funding increases beyond expected needs, the excess is first applied to reinstate any past benefit reductions, then used to build a strong contingency reserve and only after that to increase benefits. To prevent the plan’s ongoing cost from elevating, the increases apply for past service only. If benefits reach the tax maximum, any excess funding is paid into a non-registered trust for the gradual distribution to members.

The following diagram illustrates how an ADB plan works:

Operation of ADB Plan – Action Triggers

Based on Affordability Test Ratio: Funds available / Funds needed



ADB Case Study – British Columbia

The current negotiated cost plan rules in the province of British Columbia allow for a basic version of an ADB plan, an example of which is described in the appendix. In this simple design, the employer contributions are fixed - which ensures a DC accounting treatment - and funds do not revert to the employer at any time. The appendix also describes four desirable features that, with regulatory accommodation, could enhance the basic ADB design. These are:

- Employer contributions that can vary within a corridor;
- All benefits are variable, including pensions in payment and vested past service entitlements;
- All lump sum payments are calculated as “asset shares”; and
- Variable normal retirement age.

## Why the ADB plan is important

From an accounting perspective, ADB plans are designed to be treated in the same manner as DC plans. This makes them an attractive option to employers who are considering converting to a DC plan to avoid balance-sheet risk. This design could, therefore, evolve into a viable solution to Canada’s biggest pension challenge—providing employers with a way to limit their financial risk while still providing a form of DB pension.<sup>5</sup>

## How regulators can enable ADB plans to flourish in Canada

Some regulatory changes are necessary to enable ADB plans to be introduced across Canada. A basic ADB design would require:

- Provincial and federal tax and pension standards regulation that accommodates the basic ADB design without the need for special interpretations of legislation that did not specifically contemplate it; and
- Accommodative rules and guidance that enable sponsors to convert existing DB designs to ADB without being required to operate legacy DB plans for an entire generation<sup>6</sup>.

An enhanced ADB design would require regulatory changes that:

- Implement accounting rules to recognize ADB designs and confirm that, like multi-employer plans, they can incorporate limited employer contribution variability<sup>7</sup> and still receive DC accounting treatment;
- Afford ADB plans - subject to acceptable benefits/funding policies - the same treatment as multi-employer plans in relation to solvency funding rules and prohibitions on amendments to reduce accrued benefits;
- Permit ADB plans to determine lump sums using an “asset-share” approach as opposed to the current commuted value approach; and
- Permit ADB plans to incorporate a normal retirement date which varies according to a reasonable benchmark of changes in life expectancy.

<sup>5</sup> In a recent survey sponsored jointly by Aon and the Financial Executives Institute, over 40% of the respondents said they would be at least somewhat interested in considering a plan design with risk features intermediate between DB and DC.

<sup>6</sup> Such a set of rules could be built around a minimum guarantee of the member’s vested DB entitlement at the date of conversion.

<sup>7</sup> We would contemplate setting a base employer contribution rate in the initial design and having the plan state that, in the event of adverse experience, the employer contribution could rise to the base rate plus a fixed percentage of pay. This would form an employer cost ceiling. After employer contributions reached the ceiling, the benefit variability provisions would come into play.

## How ADB plans compare with other existing and proposed designs

The design of an ADB plan is similar to that of multi-employer plans in that benefits can be varied to keep them in balance with available financing. However, unlike multi-employer plans, ADB plans would:

- Be available to single employers;
- Contractually “fix” employer contributions or limit them within a corridor; the contributions would not be regularly negotiated;
- Have contractual long-term benefits/funding policies to provide in advance for:
  - Prudent funding, including the carry-forward of contingency reserves from good times to bad times;
  - Automatic and equitable benefit adjustments when necessary to respond to fluctuations in plan experience; and
  - Forward-looking funding methods that anticipate risk and spread it over generations of members.

The design of an ADB plan is also similar to Quebec’s member-funded pension plans (“MFPPs”); both are complementary ways of addressing the same problem. However, ADB plans differ from MFPPs in the following respects:

- When a DB promise is made in an uncertain world, the risk has to go somewhere. In a traditional DB plan, that risk falls to the employer via contribution and financial statement fluctuations. Both ADB plans and MFPPs address situations in which employers are no longer willing to take the risk but still want to offer a form of DB pension. MFPPs transfer the risk to the members as exposure to contribution fluctuations and conditional indexing. ADB plans transfer the risk to members through benefit variability, with indexing being the primary variable. In the ADB design, members need not be exposed to any contribution variability.
- The MFPP design is intended primarily for union environments<sup>8</sup>. Because members are exposed to the risk of fluctuating contributions, MFPP plans are less likely to be attractive in non-unionized environments where competition for labour pushes employers to make their compensation packages as appealing as possible.

<sup>8</sup> The Régie’s description of these plans states, “ Although MFPPs are not aimed at specific group, they should be of particular interest to unionized workers. Workers’ associations have indicated their members want to have access to a defined benefit plan. Moreover, at a time when employers are increasingly reticent about assuming the financial risks of defined benefit plans, workers’ groups say that they are ready to take on such risks. The new MFPP responds to the concerns of both groups in that the plan members collectively assume the ultimate financial responsibility for the plan.”

- The ADB plan’s forward-looking funding mechanism enables it to spread risk not only over groups of members, but also over time.
- The ADB plan’s contingency reserve feature enables these plans to avoid the tendency towards benefit improvement when full funding has been reached. In ADB plans, improvements occur only after strong additional contingency reserves have been built.
- Subject to regulatory accommodation, ADB plans could have a design flexibility that is not available in MFPPs, such as permitting:
  - Employer contributions to be variable within a corridor (i.e. thereby reducing the risk transfer to members);
  - Full benefit variability, including past service and pensions in payment (i.e. thereby distributing benefit variability risk more broadly, though this would require additional extra safeguards);
  - Asset share payouts (i.e. in an ADB context, these would be simpler, more equitable, and more consistent with the basic design principles); and
  - Variable normal retirement age (i.e. thereby, stopping long-term mortality improvement from disrupting the benefit/contribution balance).

In recent years, several suggestions for new pension plan designs have been put forward that would offer a range of risk distribution options between the DB and DC extremes. In considering these design proposals, it is important to bear in mind that the pooling of risk is more effective when it is applied to a group of people with an indefinite going-concern time horizon rather than when it is applied to an individual over a finite lifespan. No matter how well-designed and flexible the financial management of the individual arrangement is, the ADB plan would offer the fundamental advantage of the defined benefit plans that have served Canadians so well for so long: the ability to spread funding risk across the group and, over time, across generations. We, therefore, urge regulators and others to accommodate the ADB plan as opposed to focusing on solutions that are based on individual accounts managed over finite lifetimes.

## Part Two – Other Issues

Several outstanding issues require action in the short-term or long-term.

### Issue 2: The current retirement system is not conducive to evolution and innovation.

Pension plans operate in an environment that is continually changing and plan sponsors need to be able to adapt their plans to such changes. However, defined benefit pension “deals” have long-term horizons and are largely governed by trust law, which, by its nature, is inflexible. It is, therefore, very difficult to adapt and align these pension plans to changing environments.

There are many examples of provisions a sponsor did not clearly anticipate during plan set-up, but which later surfaced and due to trust law, could not be changed. These instances have often resulted in unfortunate levels of litigation, the outcome of which is perceived by many sponsors as “asymmetrical”, or biased against them, while also contributing to disenchantment with defined benefit pension plans. These problems have surfaced in areas such as surplus ownership on partial plan wind-up, the handling of disparate funding levels in plan splits and combinations which occur in the course of corporate reorganization, and payment of expenses from the plan fund.

On the other hand, plans that operate under contract law are subject to fewer constraints and can be more easily adapted to changing conditions.

DB plan sponsors should have an easy legal option to replace an existing trust with a new trust or contract for future service accruals. Therefore, we urge regulators to allow plan sponsors to “refresh” their pension deals by replacing existing trusts with new trusts or contracts for future service.

#### Proposed Short-term Solution:

Permit plan sponsors to “refresh” their pension deals by replacing existing trusts with new trusts or contracts for future service.

### Issue 3: The complexity of the Canadian pension regulatory system biases it against DB plans.

“Canada’s pension system is crucial to our future, not only because it will sustain us in our retirement, but also because it supports the efficiency of our financial markets and our overall economy in important ways... But as we have seen one important part of our pension system—defined benefit plans—has been in relative decline. This relative decline represents a transfer of return risk and longevity risk to individuals, who are less able to bear or manage them. This transfer has a negative impact on overall economic efficiency and could ultimately represent a threat to the ability of pension funds to finance the long-term investments that will maximize our economy’s future potential growth.

The task of establishing proper incentives is a difficult one... But policy-makers cannot avoid these difficult issues and the stakes are too high for us to get it wrong. For the sake of efficiency and for the future health of our economy, we must get the analysis right, and then we must act.”<sup>9</sup>

David Dodge, Governor of the Bank of Canada

When the pension adjustment system was first implemented, it was intended to create a level playing field for different types of plan. The pension adjustment “factor of 9” was intended to be a very rough approximation to the average ratio of pension value to pension amount over all DB plans in Canada. The assumptions on which it is based cannot be correct for every plan or for every time period. Instead, they reasonably reflect a typical plan in the Canadian public sector and the interest rate outlook at the time they were set.

However, when the pension adjustment system was implemented, it was impossible to predict what the effects of the new system would be in practice. Today, however, with almost two decades of experience, defined benefit plans are under threat for reasons that go far beyond the tax system. It is, therefore, appropriate to review the policy that led to the “factor of 9” and consider resetting it at a level that will help preserve defined benefit plans.

<sup>9</sup> Remarks to L’Association des MBA du Quebec, November 9, 2005.

The Income Tax Act imposes taxes on significant portions of commuted values when they are transferred to other registered vehicles. These taxes may be avoided by leaving the funds in the plan, although doing so would effectively deny members the portability promoted by pension standards legislation. In addition, there are many other controls on the value of a pension that a DB plan can provide, and this taxation does not apply to DC plans. After periods of high investment returns, DC plans have produced large account balances that may be transferred tax-free to other registered vehicles. Within the public sector, where this rule hits hardest, the limit on tax-free transfers from DB plans has been a significant contributory factor in the conversion from DB to DC. We suggest that it be removed.

The Income Tax Act limitation on carry-forward of “excess surplus” within a DB plan has been a major contributor to the recent pension deficit crisis. The amounts permitted for carry-forward have limited DB plans’ ability to carry surplus forward from good times to bad times. Accordingly, in good times (i.e. such as the mid-1990s) plans spent “surpluses” on contribution holidays and benefit improvements because they were forced to do so under the Income Tax Act. With some notable exceptions, the industry appeared to accept the carry-forward limit because it assumed the government had set that limit at a reasonable level. Hindsight now shows, however, that a more robust risk analysis at both government and industry levels would have exposed the limit as being inadequate for many plans. The result has been weakened resilience to the poor experience since 2000.

The appropriate level of surplus carry-forward should depend on the “pension deal” and the sponsor’s funding policy. Instead of regulating these limits by formula, it would be more appropriate for employer contributions and carry-forward of contingency reserves to be considered acceptable if they have been certified by an actuary as being appropriate under the terms of a written funding policy that is registered with and acceptable to the Canada Revenue Agency.

The complexity of documentation and administration is a well-recognized disincentive for employers to offer DB pension plans, particularly if they operate in more than one province. Despite province-level mandates to promote pension plan coverage, provinces have not been able to introduce a common set of rules to govern pension plans; too much time has elapsed and too much damage has been done to wait for further efforts. Plan sponsors that operate in national industries (i.e. such as banking or transportation) are regulated under a single set of federal laws. Employers in other industries that operate in more than one province should have a similar option.

We recommend that regulators permit all pension plan sponsors to choose, on a once-and-for-all basis, to make their plans subject to a single set of regulations. To be effective, this option would have to apply retroactively and should be permitted subject to the requirement that the value of a member’s accrued entitlement cannot be reduced in the course of the change.

#### Proposed Short-term Solutions:

- Reduce the “factor of 9” in the pension adjustment part of the tax system.
- Eliminate the limit on the amount which can be rolled over tax-free from a DB plan to another registered vehicle.
- Subject only to the requirement that such reserves must be in accordance with a reasonable written funding policy, permit registered DB plans to accept ongoing employer contributions while they carry “surplus” forward as contingency reserves from good times to bad times.

#### Proposed Long-term Solution:

- Provide pension plan sponsors with an option to have their plans made subject to a single pension standards legislation in preference to multi-provincial regulation. Allow this to be retroactive for existing members provided that commuted values do not reduce on transition.

### Issue 4: Pensioners’ retirement income needs are increasing as they need to pay increasing shares of rising health and long-term care costs.

According to Statistics Canada data, the life expectancy of men age 65 has increased by 17% since the beginning of the 1970s. Moreover, 14% of these men will reach age 90. For women, the life expectancy has increased by 14% and 29% of them will reach age 90. Life expectancy is expected to continue to grow as a result of medical research and the development of new drugs and medical treatments.

Unfortunately, the increase in longevity does not also mean that people are living their entire lives in good health. In Canada, based on 2001 data, the average life expectancy at age 65 is 17.1 years for a male. However, the average life expectancy at that age in good health is 12.7 years. In other words, a 65 year-old male can expect to live an average of 4.4 years or close to 30% of his retired life in poor health. The life expectancy for a female age 65 is 20.6 years, of which 14.4 years are expected to be in good health. A female can therefore expect to spend 6.2 years or more than 30% of her retired life in poor health.

In the coming years, health care costs are expected to continue to rise, due to the ever-increasing cost of drugs and medical treatments. To make matters worse, individuals must finance a larger share of the total health care bill because of cost-cutting measures affecting government programs and employers limiting their post-retirement benefit plans because of the large accounting liabilities they create.

To help individuals shoulder this additional financial burden, the Canadian government should allow individuals to use pre-tax dollars to pay for medical and long-term care premiums and expenses. Pension income used to cover these expenses should not be taxable and pension plans should be allowed to pay for such premiums directly without being considered taxable benefits. This approach would be much more effective than the current medical expense deduction, which gives rise to a non-refundable tax credit. Many active employees already have access to this type of tax treatment through health spending accounts.

To promote the advance accumulation of funds to pay for post-retirement health care costs, we recommend that the government should allow for the pre-funding of post-retirement health care premiums through registered employer-sponsored plans or through similarly tax-assisted individual insurance products. Funds that are set aside should be tax-deductible with no tax on investment income and the amounts used to pay for eligible health care costs should be non-taxable. In the absence of a tax-effective method of pre-funding, employer-provided post-retirement health benefits create unfunded liabilities which employers do not want on their balance sheets. There is, therefore, a trend towards elimination of these benefits<sup>10</sup>.

#### Proposed Short-term Solution:

- Make the application of pension income to pay medical and long-term care premiums and expenses tax-deductible and permit pension plans to pay such premiums directly without conferring taxable benefits.

#### Proposed Long-term Solution:

- Permit registered plan pre-funding of additional retirement income amounts designed to finance these costs.

<sup>10</sup> In a recent survey sponsored jointly by Aon Consulting and the Financial Executives Institute, approximately 50% of respondents said they had either taken steps to reduce the costs of these benefits or planned to do so within the next three years.

**Issue 5: Employees need increased and knowledgeable help with planning for retirement. In particular, members of DC and DB plans - who are offered the choice of lump sums - have a difficult time converting their capital to appropriate income streams.**

With the trend towards DC plans and the abundance of evidence that many people are ill-prepared for retirement, there is a critical need to make financial planning services broadly available to Canadians. The extent to which these services are accessible will assist workers managing their personal financial futures and will ultimately lessen the pressure on government programs. Indeed, the ability of these services to promote a social policy objective is such that the government should support them with tax assistance.

However, to qualify for this government support, the services must be objective and subject to full disclosure. In many instances, appropriate disclosure standards may need to be developed. For example, standards are required related to the calculation and effect of expense ratios, the way in which financial planners’ commissions are applied and calculated, and the variation in DC pension income projections.

There is a role for government in helping members convert their savings to income. The federal government should encourage the development of new instruments that offer flexibility and investment control along with longevity insurance and to issue debt instruments that would help plans and members achieve better asset-liability matches. Vehicles to accomplish these objectives would include very long bonds, an expanded supply of real-return bonds, and the issue of longevity bonds, such as those which have begun to appear in Europe.

**Proposed Short-term Solution:**

- Permit employers to offer financial planning services without conferring taxable benefits. Permit registered plans to pay for such services without conferring taxable benefits or exposing the plans to risk of de-registration.

#### Proposed Long-term Solutions:

- Establish standards for pension-related financial advice that cover:
  - Disclosure of expenses and their effects on savings accumulation;
  - Disclosure of the advisor’s degree of independence and any conflicts of interest; and
  - Income projections with illustrations of the degree of variability to which they are subject.
- Encourage more flexible instruments for conversion of capital to income that combine variable income, investment flexibility and longevity insurance.
- Encourage debt issues in a form suitable for retirement savings including:
  - Very long bonds;
  - Expansion of real return bond issues; and
  - Longevity bonds where payments vary with changes in a longevity benchmark.

### **Issue 6: The operation of pension plans is threatened by the fear of litigation among fiduciaries.**

Pension plan management is heavily constrained by the fear of litigation, which has resulted in many DC sponsors refraining from offering their members helpful choices, information, and advice due to liability concerns. This also limits the availability of qualified volunteer fiduciaries and leaves them challenged to find agents with sufficient insurance coverage.

The U.S. provides a safe harbour for DC plan sponsors who offer information and advice in accordance with minimum standards. Many public officials receive special liability protection without which they could not conduct their work in the public interest. In some respects, pension plan management teams are in a similar situation. We encourage the federal and provincial governments to explore the extent to which they can make similar safe harbours available to plan sponsors, fiduciaries and their agents without unduly prejudicing the rights of members.

#### Proposed Long-term Solution:

- Provide statutory safe harbours for fiduciaries, sponsors and agents of DB, DC and target benefit plans that protect them from liability if they meet minimum standards of governance conduct.

## Issue 7: The system of DB tax limits on benefits has become inequitable

In 1990, the process of pension tax reform was heavily driven by the government’s objective of preventing the abuse of registered vehicles as tax-shelters. Accordingly, front-end rules were designed to eliminate all possible tax abuse and then applied to all plans. These rules have resulted in levels of complication and restrictiveness that are inappropriate for most DB pension plans, which are intended to provide reasonable benefits for broad groups of members.

These rules now have such adverse implications for benefits security and international consistency that they warrant review. We urge the government to consider replacing the existing rules with a system of back-end penalties that would neutralize abusive tax advantages after actual abuse has taken place. In that way, only the guilty sponsors would be handcuffed.

The system of tax limits on defined benefits has created an undesirable and anomalous situation. Canadian limits are generally less than half of U.S. limits. Many sponsors do provide top-up benefits but because the only pre-funding vehicles available are tax-punitive (i.e. the RCA rules effectively impose a 50% tax rate on investment income of all types), many sponsors do so on an unfunded basis. This has resulted in many middle managers, professionals and executives having large amounts of pension “at risk” in a way that is inconsistent with the benefits security principles of pension standards legislation. We encourage the government to review and improve on its practice in this area, such as through the implementation of a tax-neutral top-up funding vehicle.

### Proposed Long-term Solutions:

- Deal with perceived tax abuse of registered tax treatment by means of back-end penalties that target actual abuse as opposed to front-end restrictions that constrain all plans in an attempt to prevent all possibilities of abuse.
- Revise the current system of tax limits and retirement compensation arrangement (RCA) rules to address the following problems:
  - Canadian limits are not competitive with those in the U.S.;
  - Public sector plans in Canada routinely provide government-backed supplemental plans so that the private sector is relatively disadvantaged; and
  - Instead of being tax-neutral, the RCA rules are penal in the private sector; contrary to solvency funding objectives, they encourage non-funding of significant portions of the pensions of middle management, professionals and more senior employees.

# Appendix

## The Affordable Defined Benefit Plan

### Basic Design

The basic ADB design was created within the current regulatory regime and is operable in British Columbia under current provincial rules.

### Main Features

- Fixed employer contributions
- Traditional DB plan with indexed formula benefits that are subject to an affordability test
- Because the employer commitment is limited to the making of fixed contributions, treated as DC for accounting purposes
- Benefit variability managed by a long-term benefits/funding policy
- If the plan becomes unaffordable or over-funded, formula benefits are adjusted to keep them in balance with the available financing
- Benefit adjustments are based on long-term projections of sustainable benefit levels so that they occur gradually and equitably over different generations.

### Details

Provision	Affordable Defined Benefit Plan
Benefit formula	<ul style="list-style-type: none"> <li>• Similar to defined benefit formula, (i.e. 1.5% of highest average three years’ earnings per year of service)</li> <li>• Normal ancillary benefits</li> <li>• Some indexing</li> <li>• Set at a level below what is expected to be supportable by the contributions over the long term</li> </ul>
Member contributions	Fixed formula or non-contributory
Employer contributions	Fixed formula
Benefits/funding policy	<ul style="list-style-type: none"> <li>• Establishes:</li> <li>• Test for sufficiency of funding for formula benefits (i.e. “benefits/funding test”)</li> <li>• Actions to be taken when funding is insufficient or excessive</li> </ul>

Provision	Affordable Defined Benefit Plan
Test sufficiency of funding	<ul style="list-style-type: none"> <li>• Valuations are conducted in the normal way, but projected valuations, on an open-group basis, are also performed over an extended period, for instance 25 years.</li> <li>• There is then a comparison between “funds available” (i.e. assets plus the value of future fixed contributions) with “funds needed” (i.e. liabilities plus the value of future normal costs). The “benefit/funding ratio” is the ratio of funds available (i.e. analogous to assets) to funds needed (i.e. analogous to liabilities).</li> </ul>
Actions to be taken when the benefit/funding ratio is less than 100%	<p>To the extent needed to restore the ratio to 100%:</p> <ul style="list-style-type: none"> <li>• Reduce indexing</li> <li>• Reduce benefit formula (i.e. but not below vested non-indexed entitlements)<sup>11</sup></li> </ul>
Actions to be taken when the benefit/funding ratio is greater than 100%	<p>To the extent possible without reducing the benefits/funding ratio to less than 100%:</p> <ul style="list-style-type: none"> <li>• Reinstate any benefit reductions</li> <li>• Build a contingency reserve to a pre-determined ceiling, subject to Canada Revenue Agency (“CRA”) rules</li> <li>• Improve formula benefits for past service, subject to CRA maxima (i.e. since future service benefits are not affected, this avoids raising the long-term cost of the plan)</li> <li>• If necessary, pay funds to a non-registered trust to be distributed to members over a predetermined period<sup>12</sup></li> </ul>
Plan wind-up	Assets distributed for the benefit of members in proportion to their entitlements. No reversion to the employer.
Solvency (subject to confirmation with some provincial authorities)	Inapplicable—promise of variable benefits is always delivered
Accounting	Treated as defined contribution – no balance sheet adjustments

<sup>11</sup> The scenario in which past and future funding cannot support vested past service benefits is a very remote possibility which, under current regulation, would necessitate plan redesign or wind-up.

<sup>12</sup> The payments could be made in part as tax-free savings account (TFSA) contributions.

### Desirable ADB Design Features

The following design features are desirable enhancements to the basic ADB concept that would require new regulatory interpretations and accommodations.

Provision	Comments
Employer contribution can vary within a corridor	<ul style="list-style-type: none"> <li>• Would offset some benefit variability</li> <li>• Would make the ADB design similar to well-managed multi-employer designs</li> <li>• Main question is the extent to which this could be done without prejudicing DC accounting treatment.</li> <li>• Consistent with the risk-sharing principles of the ADB design, member contributions could incorporate similar variability and surpluses and deficits could then be shared according to the fixed employer/employee contribution ratio</li> </ul>
All benefits variable, including pensions in payment and vested past service entitlements	<ul style="list-style-type: none"> <li>• Would provide a similar degree of flexibility to current multi-employer plans outside Quebec</li> <li>• Would ensure that the design could weather the most extreme experience without intervention</li> <li>• Would require strong up-front explanation of the nature of the pension deal and a more conservative benefit/contribution balance</li> <li>• Note that most of the benefit variability would be absorbed by the variable indexing buffer</li> </ul>
All lump payments calculated as “asset shares”	<ul style="list-style-type: none"> <li>• A member’s share of the assets would be based on the ratio of their liability to total plan liabilities for past service, as measured in the most recent benefits/funding test</li> <li>• This would ensure that departing members receive entitlements that reflect the variable benefit nature of the plan and its funding condition close to the date of exit.</li> <li>• It would eliminate inconsistency of entitlement based on mode of exit from the plan (i.e. termination of employment and full or partial plan wind-up)</li> <li>• This feature would simplify several details of enhanced ADB design</li> </ul>
Variable normal retirement age	<ul style="list-style-type: none"> <li>• A normal retirement age that increases, with retroactive effect, in line with increases in a life expectancy benchmark</li> <li>• This would make the design resilient to long-term mortality improvement</li> </ul>