



Watson Wyatt Worldwide Submission to the Ontario Ministry of Finance on
A Fine Balance: Safe Pensions, Affordable Plans, Fair Rules
Final Report of the Ontario Expert Commission on Pensions

March 9, 2009



Introduction

Plan sponsors and other stakeholders welcomed the creation of the Ontario Expert Commission on Pensions (Commission) in late 2006, given increasing concern about the sustainability and continued viability of DB pension plans. This concern has been heightened by the current economic climate, which is having a significant impact on solvency funding. We commend the Ontario Government for forming the Commission, and Professor Harry Arthurs and all the Commission members and staff for their hard work.

As noted in our submission to the Commission in 2007, an effective review and revision of Ontario's *Pension Benefits Act* (PBA), Regulations and pension regulatory system is one that enhances the pension system for all stakeholders—pensioners, employees and plan sponsors. However, we do not believe that the Report strikes the balance suggested by its title with its recommendations for single-employer pension plans (SEPPs). We are concerned that many of those recommendations significantly disadvantage SEPP sponsors who, in most cases, have voluntarily established defined benefit (DB) pension plans.

Coverage

We do not believe the Report properly addresses the troubling decline of DB plan coverage, particularly among SEPPs. Instead, as detailed in our submission below, we are concerned that its recommendations will actually hinder the establishment or continuation of such plans. While we can see advantages behind the creation of jointly-governed target benefit plans and new multi-employer pension plans (MEPPs), we do not believe these will offset the future decline in SEPP membership. In the absence of meaningful changes that make it more palatable for SEPP sponsors to maintain their DB plans, we believe that it is inevitable that an expanded Canada Pension Plan (CPP) will eventually be required to enhance coverage in Ontario. Additional assistance is required to create an environment that encourages maintained and expanded coverage, particularly for SEPPs.

The Report concludes that the decline in pension coverage in Ontario has been proportional to the decline of manufacturing in the province, with the resulting loss of unionized jobs. While these factors partly account for the decline, they are not entirely responsible. The Report's conclusion ignores the strength of SEPP sponsor complaints about retroactive changes to the nature of the DB deal made by legislation and court decisions that have not only protected the accrued benefit promise (as they should), but also given members significant access to DB surpluses. What the resulting lopsided structure fails to take into account is the fact that, in most eras in the past, it is not only plan sponsors who have gained from the significant mismatch between assets and liabilities that is found in the vast majority of DB plans. This mismatch has also produced considerable gains for plan members and their representatives. Other than during market crashes, this mismatch has allowed a higher ratio of benefits to contributions than if the plan administrator had used immunization techniques to reduce the likelihood of large deficits and surpluses arising.



Many plan sponsors have been feeling caught by their past decisions to increase this benefit/contribution ratio and not de-risking. They feel trapped when higher contributions following a market downturn later become surpluses to which they do not have unfettered access—monies that should be capable of being invested back in their businesses, but which instead become “trapped capital.” SEPP sponsors need to see that the government recognizes their plight, and we do not believe that the Report gives them enough hope.

The Report fails to take into account the strong desire of most SEPP sponsors to control their fiduciary and funding decisions, which necessitates the avoidance of joint governance. Similarly, the Report does not take advantage of its proposed expansion of the benefits covered by the Pension Benefits Guarantee Fund (PBGF). The recommended expansion in benefit security for DB plan members through changes to the PBGF could have been accompanied by greater recognition of sponsor needs in the funding rules for their DB plans, but the Report did not do enough of this.

Structure of Submission

Our comments on the Report are grouped by issue below, with reference to particular recommendations where appropriate. While we remain convinced of the need to reform Ontario’s pension legislative and regulatory system, we believe that the concerns and issues raised in this submission must be addressed to ensure that this reform is truly balanced. The implementation of balanced reform will be essential to ensure that Ontario-registered DB plans continue to be viable.

Funding and Provision for Adverse Deviation (PfAD)

***Recommendation 4-14:** SEPPs should be required to maintain a security margin (or provision for adverse deviation) of 5% of solvency liabilities. This margin should be amortized over an eight-year period. The security margin should be deemed to be part of the plan surplus on wind-up, but not for other purposes.*

***Recommendation 4-15:** For plans that have achieved 95% of solvency funding, the normal amortization period for achieving the new required funding level, inclusive of the security margin, should be extended from five to eight years. For plans funded below 95%, the current amortization period of five years should continue to apply until such time as they become eligible for the extended amortization period.*

In our 2007 submission to the Commission, we noted that the requirement to establish a PfAD would only be practical if issues relating to the current “excessively high solvency funding basis” were resolved. We do not believe that the Report resolves this issue, particularly for SEPPs, and we are concerned that its recommendations will aggravate an already problematic funding proposition for SEPP sponsors. In fact, the Report calls for the accumulation of a PfAD through real contributions (or through use of part of the sponsor’s credit facility if letters of credit are used), which is more onerous than the approach taken by Quebec, which only insists that the PfAD be built through the application of actuarial gains.



The increase in the solvency deficit amortization period from 5 to 8 years when the solvency ratio is above 95% does not provide SEPP sponsors with sufficient relief to offset the increased costs that will result from the implementation of other recommendations in the Report. In addition to the proposed PfAD, costs will be increased by the proposed elimination of all smoothing, the proposed elimination of excluded benefits, the extension of grow-in rights to all involuntary terminations, the prospect of emergency indexation, and the increase in levies to the PBGF that will likely be required to implement the proposed increase in benefits payable from the Fund. A number of these issues are discussed later in our submission.

To provide some relief for SEPP sponsors, we recommend increasing the solvency deficit amortization period from 5 to 10 years on a permanent basis. To address concerns about the impact of a 10-year amortization schedule 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 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 if a plan's solvency deficit was greater than \$100 million. On the other hand, plans whose solvency deficits are below \$100 million would be allowed to choose to perform annual roll-forward valuations, and these could be limited to reflecting the impact of the difference between the actual and expected return on assets as well as the change in solvency discount rate—similar to the process outlined in the recent Report of the Nova Scotia Pension Review Panel, *Promises to Keep*. Regardless, all plans would be subject to full valuations at least every 3 years, subject to the Superintendent's discretion to require more frequent full valuations if warranted in the circumstances. We note that the Canadian Institute of Actuaries may need to establish standards or guidance governing the use of roll forward calculations.

If annual valuations are introduced, then no further funding cushion or PfAD would be necessary, and we would discourage any move to require them. However, if plan sponsors are required to establish a solvency PfAD, we encourage Ontario to follow the model set out by Quebec, which funds the PfAD through actuarial gains.

We also believe that the PBA and Regulations should be amended to permit the establishment of a separate Pension Security Fund (PSF), similar to the one recommended in the Report of the Alberta-British Columbia Joint Expert Panel on Pension Standards (JEPPS Report). A PSF is a separate fund that would allow the SEPP sponsor to access any PfAD contributions if they were not required to fund benefits. However, the PSF also provides a convenient vehicle to track the excess of solvency over going concern contributions, thereby facilitating the return of this excess to the plan sponsor (or fund owner) if it is not needed on wind-up. The use of a PSF would encourage plan sponsors to fund any solvency deficiencies more rapidly, instead of adopting a funding policy which minimizes contributions.

Contrary to Recommendation 4-14, we do not believe that any PfAD should be treated as surplus on plan wind-up. The purpose of a PfAD, if one were to be mandated, is to provide an additional level of benefit security, and the requirement to establish and fund a PfAD will represent a significant new financial burden for SEPP sponsors, regardless of the length of time



given to fund it. This is particularly true if the PfAD must be funded through contributions rather than through the utilization of actuarial gains. To offset this additional burden, plan sponsors should be guaranteed the ability to receive a refund of the PfAD in the event that it is not needed to fund benefits on wind-up, without the necessity of complying with the rules regarding a refund of surplus. One method of accomplishing this is through the use of the PSF discussed earlier.

Our 2007 submission also noted that the institution of a PfAD could be a reasonable alternative to the Pension Benefits Guarantee Fund (PBGF), but questioned the need for both individual PfADs and a provincial PBGF. The Report proposes continuing and indeed expanding the PBGF, at least for the time being, while introducing a PfAD. We question the need for both security mechanisms, particularly given the urgent need for measures to protect the current level of pension coverage in Ontario. While it might seem logical that a PfAD within sponsors' DB plans, which can help reduce the size of plan deficits over time, would reduce the size of potential PBGF claims, it would place too great a financial burden on plan sponsors to expect them to fund both an expanded PBGF *and* a PfAD.

In fact, we believe that any expansion of the PBGF will take Ontario in the wrong direction, as it will place the burden of paying PBGF assessments on a shrinking pool of SEPPs. As a result, the PBGF could well prove to be unsustainable, as SEPP sponsors who continue to provide a DB plan realize that they will face an impossible burden of paying off the legacy of PBGF deficits relating to earlier insolvencies. This could exacerbate the current decline in DB pension coverage, and should not be encouraged.

Asset Smoothing

***Recommendation 4-3:** Going concern valuations should no longer permit the exclusion of promised indexation benefits. Solvency valuations should no longer permit the use of smoothing practices or the exclusion of benefits. A special exception should be made for those plans that continue to provide plant closure benefits pursuant to a specific, longstanding commitment to continue their non-funded status. Potential increases in sponsor contributions attributable to these enhanced transparency measures should be offset so far as possible by the extension of amortization periods, by selective relief from contribution increases for well-funded plans or by other means.*

We support the elimination of smoothing of liabilities and discount rates, as this is consistent with the practice in other Canadian jurisdictions. However, the elimination of asset smoothing would place a significant financial burden on those DB plan sponsors who have adopted it. Without some form of offsetting relief, such as the introduction of a permanent 10-year amortization schedule, as discussed above, we believe that asset smoothing should remain within any constraints imposed by regulation or the pension regulatory authority.



Letters of Credit (LOCs)

Recommendation 4-22: Irrevocable LOCs should be permitted as security for a fixed proportion of contributions owing to a plan, and for a maximum period of time, provided they are enforceable by the plan and immune from inclusion in the sponsor's estate in the event of insolvency. The Superintendent should have no power to relieve against these requirements either before or after the fact. After five years, experience with LOCs should be reviewed by the regulator. If no difficulties are found, they should be made available as a permanent feature of pension funding in Ontario.

We support the use of LOCs as security, and we do not believe they should be subject to the restrictions on amount and duration detailed in Recommendation 4-22. Instead, we believe that Ontario should adopt LOC rules similar to those currently in place in Alberta and British Columbia. These jurisdictions only limit the use of a LOC to the extent that solvency liabilities exceed going concern liabilities. In addition, while they require that each LOC have a 1-year term, they 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:

- The LOC must be an irrevocable and unconditional standby LOC, issued by prescribed issuers that cannot be the plan sponsor or an affiliate thereof;
- The LOC must be made out to the pension fund holder in trust who holds it for benefit of the pension fund;
- The insolvency or bankruptcy of the employer has no effect on the obligation of the issuer or holder of the LOC; and
- 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 contributions for a pension fund without placing an undue burden on the plan sponsor or undue risk on the plan members. Unless Ontario commits to making LOCs a permanent feature of the solvency funding regime for SEPPs, they will not be an option for addressing the problem of accumulation of unnecessary assets inside ongoing pension plans.

Surplus Thresholds

Recommendation 4-18: Sponsors may apply to withdraw surplus from an ongoing plan pursuant to the procedures set out in Recommendation 4-16, provided that the plan remains funded subsequent to withdrawal at 125% of full solvency funding, or 105% of full solvency funding plus two years of current service costs, whichever is greater.

We believe that the 125% surplus withdrawal threshold contained in Recommendation 4-18 is too high, when considering the many other elements that increase the costs borne by plan



sponsors. Under the SEPP funding rules recommended in the Report, the almost inevitable result, under some plausible economic conditions, will be that gains from years with favourable investment returns will combine with special solvency contributions from years with unfavourable investment returns to produce a surplus that is too large to be used up through contribution holidays. A lower surplus withdrawal threshold would be viewed today as a partial solution to the problem of “trapped capital.” To rectify this situation, we believe that a more appropriate threshold should be used—if 85% is an acceptable threshold for requiring the employer to make a lump sum contribution to cover a plan amendment, its mirror figure of 115% should apply to a situation where it is acceptable for the employer to remove funds.

Filing Deadlines

***Recommendation 4-4:** The current requirement for an actuarial valuation every 3 years should be maintained. The time for filing the valuation after it is due should be reduced from 9 to 6 months. Extensions should be given only in exceptional circumstances.*

We believe that the deadline to file valuation reports should remain at 9 months. The Ontario government previously shortened the filing deadline to 6 months, but subsequently reverted to the 9-month deadline. For many large pension plans, the time required to clean and reconcile data, complete the assumption-setting process, review and discuss preliminary results, allocate contributions amongst participating employers (for MEPPs) and finalize the report takes most of the currently allotted 9 months. This is also true for plans, regardless of size, with good governance processes in place, as sponsors of such plans are typically heavily involved in each step of the valuation process. We believe that any benefits to be attained by attempting to shorten the current valuation filing deadline are more than offset by our suggestion that annual valuations be filed, and accordingly we recommend leaving the filing deadline at 9 months.

Grow-in Rights

***Recommendation 5-8:** Existing “grow-in” rights that provide access to early retirement benefits for all qualifying single-employer pension plan members in the event of a full or partial plan wind-up should be extended to all such members who are involuntarily terminated. “Qualifying members” should continue to be those whose age and years of service add up to 55.*

We expect the determination of whether or not a termination is “involuntary” will be problematic, particularly in non-unionized situations. The requirement to determine whether an individual’s termination will be involuntary could lead to increased litigation, which will increase costs for both employers and terminated employees. The introduction of this concept into pension legislation could also undermine the role of pension plans in providing dignity to older workers who are forced to retire early.



This recommendation could also cause unproductive employees to coast and wait for the much larger involuntary pension payout, which would adversely impact the morale of the more productive workers.

Despite the concerns noted above, we are sensitive to the Commission's desire to craft a legislative solution to ensure that valuable early retirement benefits are maintained in situations where the loss of employment is beyond an employee's control—particularly in the current economic climate. As an alternative to Recommendation 5-8, we suggest that grow-in rights should be provided to all qualifying members who are part of a termination of 50 or more employees over a 4-week period. This is similar to the “mass termination” rules under the *Employment Standards Act, 2000*. We believe this option would allow grow-ins to be provided to vulnerable employees while reducing the likelihood of litigation.

Joint Governance

Recommendation 4-8: Multi-employer pension plans (MEPPs), jointly-sponsored pension plans (JSPPs) and SEPPs should have separate funding rules related to their distinctive characteristics. In general, MEPPs and JSPPs should be allowed more flexibility in funding, while SEPPs should be subject to stricter rules than other plans.

Recommendation 4-11: JSPPs should be required to fund only according to going concern valuations on the same basis as Specified Ontario Multi-employer Pension Plans, but should continue to provide solvency valuations for the information of the regulator as well as their active and retired members. The comprehensive legislation and regulations governing the funding of multi-employer pension plans, to be developed pursuant to Recommendation 4-9, should apply, perhaps with appropriate modifications, to JSPPs.

Recommendation 4-12: Jointly governed target benefit pension plans that are based on an agreement between one or more sponsors and one or more unions, that have established explicit arrangements for joint governance, and that permit accrued benefit reduction in an ongoing plan in order to deal with funding deficiencies, should be funded in a manner similar to jointly sponsored pension plans, as provided in Recommendation 4-11.

The Report places considerable importance on jointly-governed pension arrangements, and links more liberal funding rules to the presence of shared governance. While we are in favour of providing stakeholders with a range of plan design options, we believe the design chosen depends on considerations unique to each plan sponsor, and that a jointly-governed pension plan is not always appropriate or desirable.

In our 2007 submission to the Commission, we indicated that the appropriate governance model for a pension plan depends on the allocation of responsibility for funding risks within that plan. Joint governance is appropriate, indeed essential, where plan members share funding



risk (either through increased member contributions or decreased accrued benefits), but is not necessary where responsibility for funding deficits ultimately rests with the employer.

Some of our SEPP clients have told us that their employees or unions would be pleased to accept joint governance, but would refuse to accept any of the downside funding risk, which is one of the main reasons that joint governance is not a viable option for many SEPP sponsors.

Although we agree that jointly-governed pension plans should be one of the range of design options from which plan sponsors and members can choose, we reject the Report's implied conclusion that joint-governance is superior to other plan governance mechanisms. The strength of a plan's governance is determined by a range of factors, including the skill and knowledge of decision-makers, the frequency of meetings and the size of the decision-making body¹.

Governance

Recommendation 8-16: *An early task for the proposed Pension Champion should be to consult with pension stakeholders, relevant professional bodies, educational institutions and the pension regulator with a view to determining what lay and professional participants in plan governance ought to know about pension plans and the pension system, how they might best acquire such knowledge, and to what extent its acquisition should be a necessary qualification for service as a trustee or administrator of, or advisor or service provider to, a pension plan.*

Recommendation 8-17: *Following the consultations outlined in Recommendation 8-16, the Pension Champion ought to develop standards for educational programs for all participants in pension governance. The Pension Champion ought also to determine how educational programs should be provided and at whose expense, and whether acquisition of appropriate educational qualifications should be mandatory and, if so, for the performance of what functions.*

Recommendation 8-18: *The regulator should develop codes of best practice to guide plan governors, administrators and their agents. These codes of best practice should be based on the experience of successful plans, disseminated across the pension system and used to give meaning to the general statutory requirements for "prudence," "care," "diligence" and "skill."*

When developing the educational standards and codes of best practice in the recommendations listed above, care should be taken to ensure that they are not so onerous as to prevent part-time non-experts from being involved in the governance process. Accordingly, we believe the standards/codes should indicate that those involved in the plan governance process, particularly

¹ For a further exploration of these issues, please refer to J. Rabovsky, "[Experts Abound](#)" *Benefits Canada*, December 19, 2008.



member and retiree representatives, must either possess *or have access to* the necessary expertise. This would permit the administrator to obtain expertise by retaining professional advisors.

The development of fully professional governing bodies is only feasible for larger plans, particularly in light of the costs, so smaller plans can seek professional advice to assist decision making, and in some cases delegate operational matters to a qualified third party, and thereby ensure that a comparable level of governance expertise exists regardless of plan size.

Investment Rules

***Recommendation 4-25:** The Ontario government should endeavour to persuade the federal government to reform the federal investment rules and, in particular, to remove or amend particular quantitative restrictions that no longer make sense, such as those involving prohibitions on Canadian, but not foreign, investments. However, if the federal government does not do so within a reasonable time frame, the Ontario government should cease to rely on the federal regulations and establish its own investment rules, tracking the federal rules only to the extent that doing so is deemed good public policy in Ontario.*

***Recommendation 8-8:** Any plan with some recognized form of joint governance and with the requisite capacity to make complex investment decisions (as defined by regulations) should be allowed to adopt a resolution claiming an exemption from the 30% investment rule. The resolution should be filed with the pension regulator and have effect upon filing, unless and until it is successfully challenged.*

We believe that the Quantitative Investment Restrictions in Schedule III of the Federal Investment Regulations (Quantitative Restrictions) are difficult to interpret and apply, and do not reflect the market exposure of pension funds. As a result, pension industry stakeholders have repeatedly called for replacing the Quantitative Restrictions with the “prudent person/investor principle.” The JEPPS Report heeded this call, and recommended that the pension investment rules in Alberta and British Columbia be “uncoupled” from the Federal Investment Regulations to facilitate reliance on the prudent investor principle instead of the Quantitative Restrictions.

While we support the Report’s recommendation that Ontario pressure the federal government to change the Federal Investment Rules, we do not feel that Ontario should wait for federal action. Instead, we recommend that Ontario follow a procedure similar to that recommended by the JEPPS Report and exempt all Ontario-registered pension plans from the Quantitative Restrictions.



MEPP & JSPP Funding

***Recommendation 4-9:** Following consultation with Ontario's MEPPs, special legislation and regulations should be developed relating to all aspects of their funding, regulation and governance. The basis for such legislation and regulations should be the Specified Ontario Multi-employer Pension Plan (SOMEPP) regulation of 2007. After five years, the practical effects of these arrangements should be assessed.*

***Recommendation 4-11:** JSPPs should be required to fund only according to going concern valuations on the same basis as SOMEPPs, but should continue to provide solvency valuations for the information of the regulator as well as their active and retired members. The comprehensive legislation and regulations governing the funding of MEPPs, to be developed pursuant to Recommendation 4-9, should apply, perhaps with appropriate modifications, to JSPPs.*

We support the Report's recommendation that JSPPs be exempted from solvency funding rules, and only required to fund on the basis of going concern valuations. However, we are most concerned about the recommendation that all JSPPs be given a 12-year amortization period for going concern valuations. There are important differences between JSPPs and MEPPs:

- JSPPs involve member contributions towards deficits, and hence inter-generational equity is very important;
- The fact that there are member contributions towards deficits means that they typically respond to funding concerns more rapidly than MEPPs;
- The existing Ontario JSPPs place a major emphasis on good governance, and their members are well-protected; and
- JSPPs are generally far less likely to wind-up than MEPPs, particularly in the public sector.

Therefore, we believe the government should allow JSPPs to maintain their current 15-year amortization schedule.