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MERCER

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27 February 2009

The Honourable Dwight Duncan
Minister of Finance
Attention: Comments on Report of the Expert Commission on Pensions
c/o Pension and Income Security Policy Branch
5th Floor, Frost Building South
7 Queen's Park Crescent
Toronto, ON M7A 1Y7

Private & Confidential

Re: Request for Comment on the Report of the Expert Commission on Pensions

This is Mercer's response to the Government of Ontario's request for comment on the October 31, 2008 Report of the Expert Commission on Pensions, "A Fine Balance - Safe Pensions, Affordable Plans, Fair Rules" (the Report).

The Report delivers a complex set of recommendations. The first thing to note about the recommendations is that it is unrealistic to expect all of them to be implemented, even if the economic conditions of early 2008 had continued. Changed economic conditions have overtaken the Report and the government has proposed temporary measures to assist in today's economic context. Our comments presume that those temporary measures are a separate initiative and Mercer has provided comments on the Minister's proposed funding relief under separate cover.

The approach we have taken in this submission is to focus on the most important recommendations in the Report that should be implemented on an indefinite basis regardless of the economic conditions of the day, as well as identify some recommendations that are not suitable for implementation.

The topics covered in this submission are:

- Funding rules for MEPPs
- Funding rules for SEPPs
- PBGF

- Plan splits and mergers
- Plan design
- Regulatory structure
- Governance
- Grow in
- Partial wind up
- Annuity purchase
- Conversion from DB to DC

The Report responds well to the need for different funding rules for different types of pension plans. The recommendation that multi-employer pension plans (MEPPs) be exempt from solvency funding is appropriate. However, the recommendations addressing the single employer pension plan (SEPP) are sharply disappointing. Two problems affect the SEPP: the risk of benefit loss due to failure of the sponsoring employer when the plan is insolvent, and the unfair balance of risk and reward adversely affecting the sponsoring employer. The risk of benefit loss cannot be eliminated but could be lessened with improvements to solvency funding. However, more stringent solvency funding can only strengthen SEPPs if the employer has a fair reward in the form of better access to funding surplus. The Report contains recommendations aimed at this fair reward but does not go far enough. Without adequate measures to improve the economics of the SEPP for employers, they will continue to choose other ways to deliver benefits to their employees.

Funding Rules for MEPPs

Recommendation 4-10, that MEPPs should fund only according to going concern valuations but also disclose solvency valuation results, should be implemented immediately. In addition, the disclosure of solvency valuation results should be complemented by full, clear and regular disclosure to members of the risk of benefit reduction.

Recommendation 4-9 is that following consultation with Ontario's MEPPs, comprehensive rules on funding, regulation and governance of MEPPs should be developed using the current rules for Specified Ontario MEPPs as a starting point. This is worth doing however the government should not delay implementation of Recommendation 4-10.

Funding Rules for SEPPs

Attention to the funding rules for SEPPs is at the heart of the Expert Commission's mandate. There are recommendations to increase solvency funding requirements, and to give sponsor employers some access to funding surplus. However, the recommendations in the Report do not go far enough to create fair rewards for the funding risk that the sponsor employer assumes. The Report strikes a "fine balance" for SEPPs with many new features and several trade-offs between stakeholders but does not change the balance to eliminate the unfairness to the sponsor employer.

There are two primary groups of recommendations affecting the funding of SEPPS.

1. The Report proposes more stringent funding requirements for SEPPs. SEPPs would continue to be funded according to both going concern and solvency valuations. Solvency valuations would be more pure and transparent without benefit exclusions and without smoothed asset values or discount rates. The solvency funding target would be set at 105% with a 8 year amortization period (5 years for plans below 95% solvency). Going concern valuations would no longer exclude promised indexing benefits. Mandatory indexing for inflation emergencies should apply. Contribution holidays would be allowed at 105% solvency with a requirement for contributions to resume if solvency deteriorates below 95%. There is mention of transitional relief for the inclusion of promised indexing and elimination of smoothing, but not for the 105% solvency target.

2. The Report proposes to increase an employer's access to funding surplus by eliminating surplus distribution on partial wind up and making the employer's right to a contribution holiday very clear. It would require surplus distribution on wind up according to the plan documents or, if the documents are not clear, according to employer and member agreement failing which there would be a dispute resolution mechanism or a Tribunal order to establish the agreement. Any employer withdrawal of surplus from an ongoing plan (subject to quantitative limits) would be governed by the same rules. Letters of credit would be recognized as a plan asset but only on a time limited basis.

The increased funding requirements would, of course, increase benefit security. However, in the absence of a viable way for plan sponsors to recover surplus, we believe that the funding target should be no higher than 100% of solvency.

Further, plan sponsors should be able to use one or more of the following:

- a longer amortization period – say 10 to 15 years,
- smoothing of assets, and
- letters of credit.

A longer amortization period is required to reduce volatility relative to the current situation.

The current financial crisis along with the "perfect storm" of 2001/2002 has exposed the magnitude of funding risks that sponsors bear. Solvency smoothing has proven to be an invaluable tool to give plan sponsors the time they need to adjust to this kind of extreme downside event. Removing this weapon from the arsenal of plan sponsors would likely require frequent funding relief intervention by the Government in the future. Improved transparency was cited as one of the rationales for the elimination of smoothing. We believe that this goal could be accomplished simply by requiring the clear disclosure of balance sheets without smoothing.

Mandatory indexing should not be introduced in any event for voluntary pension plans, and certainly should not be introduced when employers are required to manage increased solvency funding requirements.

The recommendation to eliminate surplus distribution on partial wind up is simple and should be implemented immediately, whether or not funding requirements are increased. Similarly, the recommendation to make the employer's right to a contribution holiday very clear should be implemented. This should extend to holidays for defined contribution funding as well as defined benefit funding for combination plans.

The other recommendations for employer access to surplus assets (withdrawal on wind up or from an ongoing plan) are inadequate because they do not address legacy issues for existing plans. The legacy is that existing assets are more often than not subject to documents that grant member ownership of surplus, and prevent surplus withdrawal while the plan is a going concern. Without overriding rights attached to existing assets, there are measures that can be taken to create new rights applicable to new assets. The November 14, 2008 Report of the Joint Expert Panel on Pension Standards prepared for the governments of Alberta and British Columbia (the JEPPS Report) contains two recommendations that the Ontario government should adopt to address this problem. We refer to recommendation 8.1.2-A Pension Security Funds and recommendation 8.1.2-D

Legacy Surplus Issues. The recommended changes to solvency funding should not be implemented without such substantial measures.

Pension Benefits Guarantee Fund (PBGF)

The Report recommends that the PBGF be enhanced by increasing the dollar amount of benefit coverage, imposing premiums on pension plans on an insurance basis and creating an independent agency to adjust premiums and benefit levels so that the PBGF is self-sustaining. The PBGF would apply to SEPPs but not to MEPPs or other types of plans. The government should assess whether to continue the PBGF after five years.

The economic decline that has occurred since these recommendations were formulated makes them impossible to contemplate.

For the longer term, we disagree with the recommendation to make the PBGF a self-sustaining insurance arrangement. While there is indeed pressure on the government to mitigate the risk of benefit loss, this method for dealing with the risk is problematic and expensive. The Report raises important issues but does not provide sufficient analysis to support its recommendations. The government should not invest in a newly structured PBGF unless it establishes a good reason for doing so.

Plan Splits and Mergers

If we understand recommendations 5-17, 5-18 and 5-20 correctly, the Report recommends that surplus in a SEPP that is to be split or merged into another SEPP need not be allocated pro-rata to liabilities, provided that each plan is funded at 105% solvency. Allocation of surplus to a merged plan would be permitted provided the members of the original plan remain members of the merged plan. Where plans of a given employer are merged, 100% funding is required immediately, and achieving 105% funding can be done over 5 years if the Superintendent consents.

The flexibility offered for surplus above the funding threshold is welcome and should be implemented. However, the recommendations seem only to address fully funded and surplus situations. It should also be made clear that when plans in deficit are merged the existing level of funding should be protected with clear rules concerning the new funding requirements for the merged plan.

Recommendation 5-23 proposes that the Superintendent scrutinize mergers and other pension transactions of related corporate entities to ensure that the financial prospects of a plan are not compromised by being assigned to a less solvent entity. Specified criteria should apply. Our response to this recommendation is that it is unrealistic to expect the pension regulator to assess the financial viability of a business or entity.

These recommendations only address plan changes made by a single employer or related group of employers, and do not address purchase and sale transactions between arms length entities. For these transactions the rules should not require transfer of surplus, should ensure that accrued benefits are not reduced and should protect existing levels of funding up to the funding target.

Plan Design

The Report responds positively to a call for flexibility in the regulatory regime to support new pension plan designs. Recommendations include drafting legislation to enable change through regulation-making, 8 year reviews of policy, legislation and performance and establishing a Pension Champion to promote and facilitate innovation. Substantive recommendations call for promotion of large-scale plans, cooperation among small and medium sized plans and the promotion of large commingled target benefit plans. The Report also states that the government should look at the creation of a provincial plan comparable to the Canada Pension Plan.

We agree with revising the Pension Benefits Act in ways that enables change and we suggest that in addition to what is recommended a simple and immediate measure would be to give the Superintendent the power to exempt plans from existing requirements when it is reasonable to do so, with a complementary power to impose conditions.

As a means to expand pension coverage the idea of a provincial plan is worthy of careful consideration. The government of British Columbia has announced that it will proceed with the creation of a provincial defined contribution plan as recommended in Section 11 of the JEPPS Report. The participation of Alberta and Saskatchewan will be sought. The government of Ontario should consider a defined contribution model as opposed to a target benefit model in order to avoid the extra effort that would be required to manage a target benefit plan. A defined contribution approach is also desirable in order to have uniformity of provincial plans.

Regulatory Structure

The Report's recommendations on regulatory structure are extensive and ambitious. There would be an Ontario Pension Regulator, a revised Pension Tribunal, and a Pension Champion. The Superintendent would have increased powers and a quasi judicial role. There would also be the independent agency that runs the PBGF and an Ontario Pension Agency to run a new pension fund that holds abandoned pension entitlements on a target benefit basis.

Our view of the recommendations in total is that they overreach the need for reform. It is not clear that greater bureaucracy would deliver stronger pension plans. There is a need for more resources to be allocated in the existing regime, and for appropriate expertise to be used in every regulatory decision or function. Among the recommendations, we support increased allocation of resources to regulation of pensions, enhancing the Superintendent's powers to facilitate more effective first instance decisions, and use of a privative clause and an expert Financial Services Tribunal to minimize recourse to the courts.

We agree that an arrangement should be established to deal with abandoned pension entitlements but this would be far more feasible if done on a defined contribution basis.

Governance

The recommendations in the Report for governance are numerous and follow a common theme following principles of member involvement and transparency. They include: more active union involvement, retiree member involvement, establishing benchmarks for performance, education for participants, creation of codes of best practice by the regulator, improved disclosure and mandatory Pension Advisory Committees (unless voted down).

The principles informing the governance recommendations are sound. However, the model forwarded by the Report is suitable for large public sector plans and large MEPPs, but not for smaller plans or SEPPs.

An issue that is critical for SEPPs is to have clarity concerning when a sponsor employer is acting in a fiduciary capacity. In particular the current rules fail to establish that an employer's decisions on funding are not, and should not be, subject to a fiduciary duty. Employers who are also plan administrators should not be placed in a conflict between maximum funding for member interests and appropriate funding with regard to the supporting business, provided that minimum funding standards are followed. This issue is not addressed in a specific recommendation by the Report but action is needed.

Grow-in

The Report recommends that the grow-in currently triggered by partial or full wind up be dissociated from the wind up event and be provided to all qualifying members (those with 55 points of age and service) of a SEPP whose employment is involuntarily terminated. Grow-in would not be required for MEPPs, jointly sponsored plans (JSPPs) or jointly governed target benefit plans (JGTBPPs). The rationale for this exception is that these plans are shared risk plans and jointly governed, so the benefit design should be theirs to decide. Further, since solvency funding is not required for these plans, funding for grow-in benefits is not required.

We advocate elimination of partial wind up and expect that if grow-in is separated from wind up, the elimination of partial wind up would be much easier for the government to do. Whether or not grow-in should be eliminated or continue is a matter on which well informed opinions vary considerably.

We do not agree that the logic offered by the Report for treating MEPPs, JSPPs and JGTBPPs differently from SEPPs is adequate. Our understanding of the policy basis for grow-in is that it protects individuals from pension loss resulting from late-career termination of employment. It is not unlike other protections created by the *Employment Standards Act* from a policy standpoint. There is no reason to think that this benefit would be of less importance or value to members of MEPPs, JSPPs or JGTBPPs than to members of SEPPs.

Partial Wind Up

The Report recommends that partial wind ups continue to exist in a changed form. It would no longer trigger surplus distribution, immediate vesting or grow-in (assuming that the latter two are already granted without a partial wind up event). Purchase of annuities to discharge liabilities to affected members would not be required. Its sole purpose would be to allow the regulator to assess the financial health of the going concern in the wake of significant change. The criteria for a partial wind up would be a 40% reduction over 2 years.

We disagree with the recommendation to maintain the concept of a partial wind up. Other recommendations in the Report – the ability of the Superintendent to require a valuation at any time, and the expectation of a triennial valuation soon after the proposed two year period has elapsed – should be sufficient to serve any need to check on the impact of a large membership reduction.

Annuity Purchases

In the context of a discussion of partial wind ups, Recommendation 5-13 says that when plan members are involuntarily terminated, it should be optional for the plan administrator to purchase an annuity. We agree that annuity purchase should not be required on partial wind up for the reasons discussed in the Report. Separation of affected plan members from the continuing plan should not be required. This recommendation should be implemented immediately.

The Report indicates that there is further work to do on the question of annuity purchase for full wind ups. This is a more complex question, affecting members' entitlements on wind up and solvency funding requirements during the life of the plan. It is already very clear that the cost of annuities is high and that the market could not meet the demand if a large plan is wound up under the current rules. The Report suggests that strategies for reducing the cost and the influence of the annuities market should be investigated. However, a simple and immediate response to this problem is to define the benefit entitlement on wind up as the commuted value. A variation of this approach is already in place in Quebec.

Member consent to DB DC conversion

Recommendation 5-22 would mandate delivery of a detailed notice to active and retired members when a conversion of a defined benefit plan to another type of plan (for example defined contribution) is proposed. The notice would contain prescribed content and be subject to regulatory approval. If two-thirds of the notice recipients approve the conversion in a secret ballot (or their union or other representative organization approves) the regulator can issue advance approval. In the absence of advance approval, on 90 days' notice to the regulator and members, the regulator would process the transaction in the normal manner.

The provision of detailed notice is appropriate. It is not clear however whether this recommendation requires an attempt to obtain consent, or merely recommends that a consent mechanism be available as an alternative to the normal process. If it requires the attempt it is too intrusive. Labour and employment law already provide a framework for managing changes to employee compensation. If it is intended to create a more expedient regulatory approval when consent is secured, it will only shift the time-consuming aspect of this type of change to an earlier stage. Apart from the simple requirement to give meaningful explanation and notice to members of a significant plan change, this recommendation should not be implemented.

Summation

We thank the commission for their work and for the opportunity to comment on the Recommendations. We urge the government to implement several measures found in the report, as discussed above.

The Report, however, does not address the key problems facing the SEPP. As we mentioned in our original submission, In order to make the defined benefit pension system stronger for single-employer plans, two measures must be implemented together:

1. A revised minimum funding standard based on solvency to provide plan members with better protection against benefit loss on insolvent plan termination; and
2. Rebalancing of the financial risks and rewards between the stakeholders by allocating rewards to the employer who bears the funding risk.

The Recommendations attempted to address the first measure, but failed at the second. We urge the government to follow the recommendations made in the JEPPS Report, most notably to permit the establishment of "pension security funds" and measures to deal with legacy surplus issues for existing plans.

Sincerely,

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