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Submission to the Ontario Expert Commission on Pensions

MERCER



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Submission by Mercer to the Ontario Expert Commission on Pensions

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Preface

The Expert Commission's mandate is to examine the legislation governing defined benefit pension plan funding, the rules related to pension deficits and surpluses, and other issues related to the security and the sustainability of the pension system in Ontario. Principles informing the Commission's inquiry include the importance of encouraging the system of defined benefit pension plans, the importance of maintaining affordability of defined benefit pensions for members and sponsors, the need to safeguard the security of pension benefits and the need to balance the rights and obligations of employers, plan members and pensioners.

Mercer agrees that these are the key issues. If they are not understood thoroughly and addressed in a balanced and fair manner for all stakeholders the defined benefit system will continue to weaken and decline.

Mercer offers this submission based on Mercer's long and extensive experience working with employers and other plan sponsors who are making decisions about providing pension plans, appropriate benefit levels, and funding them. Mercer is the Canadian and global leader in providing advice and solutions for the full range of issues that affect employers' retirement plans. We consult on plan design and help our clients manage related financial and other risks. This work is performed in the context of our clients' overall workforce planning and business strategies. Accordingly we are in an especially good position to observe the impact of the current legislative regime in the areas that have been identified in the Commission's mandate as most important, and to speak out confidently on the direction that change should take.

This submission deals primarily with the most common type of defined benefit pension plan in which a single employer (or group of related employers) is the sponsor of the plan, bears all the risks of funding the plan, and is also the plan administrator. These types of plans are referred to as single-employer plans in this document.

We also provide commentary on legislative changes that are required for Multi-Employer Pension Plans (MEPPs) and certain other shared-risk plans. The legislative changes required for these kinds of plans are very different from those required for single-employer pension plans.

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Executive Summary

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 revised minimum funding standard would increase solvency funding and therefore decrease the risk of benefit loss on insolvent plan termination. The solvency funding standard would have the following attributes:

- Pure or nearly pure wind up valuation.
- Funding target at 100% solvency.
- Contribution holiday threshold above 100% solvency.
- Conservative solvency current service cost.
- 10 year amortization of solvency deficit.
- Letter of credit recognized as a plan asset.
- A long transition period.

A fair allocation of the financial risks and rewards between the stakeholders in pension plans is essential to this solvency funding standard. The stakeholder that bears the funding risks should benefit from the financial rewards. In the current environment in a single-employer plan, the employer must contribute and bear the downside risk of market change and investment return, but does not have enough share in the use of funding surplus when market conditions are good and returns are strong. In such an asymmetrical environment, employers either cannot or will not tolerate an increase in solvency funding. In order to restore a fair allocation of financial risk and reward to the Ontario retirement system for single-employer plans, the following measures should be implemented:

- Eliminate partial wind-ups.
- Legislate a fair allocation of funding risks and financial rewards for new plans.
- Permit existing plans to start a new fund with clear employer surplus ownership to provide for future benefit accruals and past service benefit increases, while freezing the existing fund.
- Permit employer contributions above current service cost to be directed to a reserve account to which employer surplus ownership applies.
- Create a legislative presumption that contribution holidays are permitted and that the employer owns surplus, unless plan documents expressly state otherwise.
- Ensure that there is no requirement to transfer surplus in business transactions.
- Permit ongoing employer surplus withdrawals.
- Permit the use of letters of credit to secure benefits.

The above comments and recommendations apply to single-employer plans. These comments do not apply to most MEPPs and certain other shared-risk plans. We recommend that MEPPs be exempted from solvency funding requirements and that disclosure to members of these plans be strengthened to ensure that they are aware that their benefits can be reduced.

In addition, this paper proposes several related measures:

- Ensure that plan mergers and other asset transfers are permitted and occur efficiently.
- Provide for regulatory intervention in extreme cases of imprudent asset mix.
- Eliminate the PBGF.
- Create benefit priorities for insolvent plan termination that reduce recent benefit improvements more than long standing benefits.
- Ensure that defined contribution members in the same plan as defined benefit members are not forced to share the risk of wind up deficiency and are not presumed to share in surplus distributions.
- Ensure that there are sufficient regulatory resources and expertise.

Context and Stakeholders

Reform of the legislation that governs pension plans in Ontario is long overdue. Since the *Pension Benefits Act* (the “Act”) came into effect in 1988, economic conditions have changed, significant litigation has occurred, defined contribution plans have become more common, and defined benefit plans are under severe strain from lower interest rates and increased pensioner longevity. Many of the shortcomings of the Act are easy to resolve because most if not all of the stakeholders would agree – address defined contribution plans separately from defined benefit plans, reduce procedural uncertainty and inefficiency, match the resources allocated to the regulation of pensions to the regulatory mandate. However the funding situation for employer-sponsored defined benefit pension plans is vastly complex and the various stakeholders do not even agree on how to describe the complexity.

The defined benefit pension plan is a desirable and important part of the retirement system. Many employers want to be able to provide these plans. From the employee’s point of view, having a defined benefit is extremely valuable. While a defined benefit plan is a going concern, or on wind-up with sufficient funds, the high degree of insulation of the benefit from market risk is an optimal arrangement for the employee. A defined benefit plan provides an employee with a predictable, very secure retirement income. A properly funded defined benefit plan allows employees to pool investment risk, interest rate risk and mortality risk. Typically a defined benefit plan will deliver a higher benefit for the same cost as a defined contribution plan due to the efficiencies gained in a defined benefit plan.

Obviously it is important to minimize the risk of benefit loss for the employee which will occur if the employer’s business fails while the plan is insolvent. However, the risk of business failure cannot be controlled, and elimination of the risk of benefit loss simply by requiring higher employer contributions so that the plan is never insolvent is too great an economic burden for most businesses to bear. From an employer’s or shareholder’s point of view, the value of providing defined benefits to employees is generally recognized, however the financial risk makes the economics of doing so unattractive.

A regulatory regime has to anticipate how those affected will behave – and consider the exit strategies that will be used if the environment is not balanced. The behaviour and needs of the plan member are relatively straightforward. Members should receive value for their contributions and labour. They need benefit security. They should have full disclosure about the manner in which the benefit promise is underwritten. The Act conceived in 1988 focussed on these things. The courts have recognized this and have interpreted the Act as remedial legislation whose primary purpose is the creation and protection of member rights. Had economic conditions continued as they were in 1988, the lack of attention to employer interests might not have become evident or been a problem. As it is, with increasing financial pressure and with the implications of some of the statutory provisions becoming clear, especially around surplus distributions on partial wind up, employers are pulling back or exiting.

There are many things about the Act that could be corrected or improved. The single most serious issue is the failure of the Act to treat sponsors of defined benefit single-employer pension plans fairly. Employers and employees alike desire this type of plan, but the economic proposition facing the employer is at best unattractive. If this is not addressed, there is little that can be done to strengthen the defined benefit system in Ontario. Recognizing that there are two competing goals – benefit security and affordability for employers, we propose a revised minimum standard solvency funding regime in combination with a fair balance of risks and rewards to improve benefit security without undue burden to business. It is not fair to plan sponsors to strengthen the funding regime if they bear all the funding risks but do not receive fair reward for assuming the risk. Similarly, it is reasonable for plan members to expect a stronger funding regime if the employer gains better access to the surplus.

For a MEPP there is also a need to rebalance the way the Act affects the distribution of risks and rewards. In particular the solvency funding requirements which were designed for single-employer plans force sudden benefit reductions in periods of insolvency, disrupting the way these plans were designed to operate.

A Revised Funding Standard Based on Solvency

Overview

The Act requires funding on two different bases – going concern and solvency. Going concern funding places more weight on the assumption that the employer’s business will continue. The risk of benefit loss on insolvent plan termination is recognized but accepted, so that more risk is allocated to a future generation of plan members. A solvency funding system addresses the risk of benefit loss more rigorously, placing a greater burden on the contributing employer. The current funding regime produces a volatile pattern of funding requirements highly leveraged on market conditions. Surpluses and deficits arise and disappear relatively quickly.

Most of the volatility is a result of employers choosing to finance their pension promise by investing a significant portion of the pension fund in equities. The volatility could be largely eliminated if pension funds were invested in a portfolio of matching fixed income securities or through the use of derivative instruments. However, in today’s low interest rate environment, this comes at too high a price for most employers. This strategy could easily increase the expected level of funding contributions by 30% or more.

Consequently, investing in equities is a necessary choice for most employers who wish to provide meaningful defined benefit pensions to their employees. However, in the current environment, the consequences of this necessary choice are unpalatable.

In the current environment for single-employer plans, deficiencies are the responsibility of the employer while surpluses are often shared or dedicated exclusively to plan members. Even though most employers can have contribution holidays when there is a funding surplus, the potential for asset distribution triggered by the existence of a solvency surplus at the date of a partial wind up is a significant problem. It makes poor economic sense for a business to make large contributions that may later become solvency surplus that may be paid out of the plan on partial wind up. If this issue were corrected, many employers would choose to fund their pension plans more

conservatively and to make contributions above the minimum statutory level when they are able to do so.

The current allocation of risks and rewards makes an otherwise well-calibrated minimum funding regime unattractive to employers. It ensures that most employers will choose to fund at the minimum possible level, to the detriment of benefit security for plan members

From today's starting point, an increased contribution requirement will only weaken the system by worsening the disincentives for employers to maintain their defined benefit plans. If Ontario wants better benefit security while maintaining or improving defined benefit coverage, then Ontario must be fair to plan sponsors.

Why a Solvency Funding Regime?

It would be desirable to have more assets in the defined benefit system to allay the risk of insolvent plan termination. In today's low interest rate environment there is an obvious trend in thinking toward solvency as an appropriate standard for funding. If Ontario concludes that the risk of benefit loss under current solvency standards for single-employer plans is too high, then solvency funding standards need to be more robust. However, it is simply incorrect to assume that strengthening solvency funding standards will strengthen the defined benefit system. Furthermore, additional solvency funding requirements may not be justifiable for the financially strong employers. Those employers will be required to divert additional capital to the pension fund with little improvement in benefit security. If the current allocation of risks and rewards is not corrected, making solvency funding standards more rigorous will only encourage or force more employers to seek a way out. As it is, the current environment already prevents the creation of new defined benefit plans.

In addition to correcting the asymmetrical sharing of risks and rewards, there are three main strategies that would work toward improved solvency of pension plans:

- Require a funding margin, with a funding target above 100% solvency.
- Allow a contribution holiday after a threshold of funding above 100% solvency is achieved.
- Require a conservative calculation of the current service cost in the solvency valuation.

However, the funding burden would be far too great if all three strategies, or a combination of a funding margin together with a conservative basis for current service cost, were required.

A well balanced solvency funding regime should have the following attributes:

- Fair allocation of risks and rewards.
- Pure or nearly pure wind up valuation.
- Funding target at 100% solvency.
- Contribution holiday threshold above 100% solvency.
- Conservative solvency current service cost.
- 10 year amortization of solvency deficit.
- Letter of credit recognized as a plan asset.
- Long transition.

Decisions made within the minimum funding requirements, and any decisions made to contribute above the minimum statutory requirements, are and should be decisions of the contributing employer and not of the pension plan administrator. This is important because a fiduciary duty imposed on a contribution decision opens a debate about the stakeholder interests that should be taken into account when determining contribution levels, and invites assertions that the employer should fund as much as permitted regardless of the impact of that funding on the supporting business. Employers who are also plan administrators should not be placed in this untenable conflict. The courts have supported this point of view and this is a reasonable reading of the Act. In any revision of funding rules this important matter should not be overlooked and should be made abundantly clear in legislation.

Funding Measures

Several measures affecting solvency funding standards for single-employer plans, in combination with correction of asymmetry, would strengthen the current system without undue burden.

Solvency Valuations

A solvency valuation should be a pure or nearly pure wind up valuation that reflects the benefits that would actually be paid on plan wind up. The current rules that permit exclusion of certain liabilities from solvency valuations and that permit smoothing of solvency assets and liabilities would be eliminated.

Since the current solvency standard in Ontario permits certain liabilities to be excluded, a long phase-in of 15 years for including all liabilities, and grandfathering in special cases, will be needed to give employers sufficient time to adjust.

The current five year amortization period for funding solvency deficits should be changed to a ten year amortization period. This longer period will help to address the volatility of contributions determined on a solvency basis.

To fund sensibly on a solvency basis, the actuary should determine the “solvency current service cost”. This is the amount required if the initial solvency liability (together with the

solvency current service cost and accruing interest at the valuation interest rate i.e. the rate of interest used to calculate solvency liabilities) is to cover:

- the expected benefit payments, and
- the solvency liability at the end of the projection period.

The projection period should be set out in regulations – preferably 3 to 5 years.

This calculation takes no advance credit for the equity risk premium that the pension fund might reasonably be expected to earn. As such, particularly in a low interest rate environment, the solvency current service cost provides a conservative estimate of the contribution required to support a plan that would typically have 50% to 70% of its assets invested in equities. To the extent that the equity risk premium will be realized, this will generate future surplus. Regulators should obtain guidance from the CIA on the technical aspects of this calculation, including its impact on the development of a funding margin.

Going Concern Valuations

Where solvency valuations are required, going concern valuations should be optional for the employer.

The objectives of a going concern valuation are to establish stable and foreseeable contributions and the proper allocation of costs over time and between generations. Therefore a going concern valuation should not be required to include a funding margin. There should be no regulatory intervention in the selection of assumptions, which should be based solely on CIA practice standards.

Full Funding on Wind Up

Consistent with current standards, an employer should not be able to terminate a plan and continue in business without funding benefits in full. A funding period of five years is appropriate.

However, for some plans, a full wind up is problematic because of large pensioners' liabilities. Problems are further compounded if the pensions are indexed. The problems arise because the Canadian annuity market cannot absorb large purchases of annuities. Furthermore, when pensions are indexed, the annuity prices are far too high, or the insurance product is simply not available. Legislation is needed to set the minimum standard as the payment of commuted values in place of the current mandatory purchase of annuities.

This problem currently exists for partial wind ups as well as full wind ups. If the partial wind up is not eliminated, it should be made abundantly clear that the purchase of annuities is not required.

If alternative methods can be developed to fairly disburse the plan assets without unduly reducing benefit security for members, the regulator should be able to approve such a method. The onus would be on the employer to demonstrate that the security of benefits is not unduly reduced under the proposed mechanism.

Contribution Holidays

Contribution holidays are an essential element of a fair and balanced funding regime and they should not be constrained unless absolutely necessary. However, there are two ways in which contribution holiday rules should be modified. Both measures respect the principle underlying a contribution holiday, that when a plan is adequately funded contributions are not required.

The first modification of the rules addresses the definition of adequate funding for this purpose. Since the solvency status of a plan fluctuates considerably, it is desirable for plans to be funded at some level above 100% solvency. Placing the threshold above which a contribution holiday is permitted at a level above 100% solvency would encourage above-minimum funding by employers (presuming, of course, that funding risks and rewards are fairly allocated). Over time, funding margins would be achieved.

The level of the threshold (excess over solvency liability) should reflect the mismatch of assets to liabilities. For example, a plan with more equity exposure should have a higher threshold. In considering the definition of the threshold the following should be taken into account:

- The method to calculate the threshold should be suggested by the Canadian Institute of Actuaries and should take into account that contribution holidays are allowed only after the threshold is reached.
- The mismatch is difficult to measure, especially considering new types of investment options. Issues of timing for purposes of measuring the asset mix would also have to be addressed.
- The rules should be flexible enough to allow actuaries and employers to demonstrate that the threshold should be lower to reflect the plan's unique circumstances.
- The limit imposed by the Income Tax Act which prevents contributions when a modest surplus exists should be raised to accommodate this build-up of funds.

The second modification of the contribution holiday rules addresses a weakness in the triennial valuation requirement. A shorter valuation cycle is not desirable due to cost, but the triennial cycle fails to address the problem of contribution holidays based on two or three year old valuations when the health of the supporting business has deteriorated and the funded status of the plan has also deteriorated. In these cases, the principle underlying the contribution holiday, i.e. adequate funding, is no longer operative.

Although the introduction of a new threshold for taking a contribution holiday assists with this problem, there is still a need for monitoring by the employer. If there is a deterioration of the solvency position causing a solvency concern before the next filed valuation, contributions should resume. Any requirement for a financial update should

be simple, and inexpensive, for employers. For example, a form of simplified opinion could be developed that updates the financial position annually based on changes in long term interest rates and actual investment returns.

It also makes sense for regulators to have the discretion to require a full valuation when the monitoring shows a solvency concern, and to require annual valuations until the plan emerges from the deficiency. Solvency concern would be defined for these purposes by regulation.

Letter of Credit

An irrevocable letter of credit is an effective form of security, since payment to the pension plan from the issuing institution would be required in the event that the letter of credit is not renewed. A contribution by the employer would offset the amount to be paid under the letter of credit. Therefore letters of credit or similar guarantees such as a government guarantee should be a recognized asset for valuation purposes. Letters of credit increase funding flexibility for employers without reducing the security of benefits.

If the current allocation of risks and rewards is allowed to persist, it is crucial that employers be allowed to use letters of credit to provide for benefit security, to avoid the risk of forfeiting contributions made to fund deficiencies.

Letters of credit would be an important improvement to the system for financially healthy employers even when symmetry is restored. For example, some plans provide for very generous benefits to be paid in certain circumstances, such as the closing of a plant. The likelihood of the circumstance may be low and the amount of assets that would be required to provide the benefits could be far in excess of what would be required while the plan remains a going-concern or if the plan is wound up in circumstances which do not trigger the payment of these additional benefits. In these situations, requiring the employer to fund the plan assuming the most expensive scenario will occur may be unreasonable. It could divert much needed capital away from the business. In such cases, the use of a letter of credit to provide security for the additional liability related to such a scenario may be useful as a long term approach for securing such a benefit.

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Creating Economic Fairness for Employers

Overview

The ideal environment for businesses to support single-employer defined benefit pension plans is one in which the obligation to members is to provide the promised benefit, and in which the potential for economic gain and loss in setting aside funds to pay those benefits is balanced. The employer who assumes the funding risk would own surplus on wind up. The employer's right to take a contribution holiday would be clear. Assets would be available to the employer for withdrawal when the funding is excessive. There would be no partial wind ups requiring distributions of actuarial surplus. In such an environment, and over the long life of the pension plan, the contributions made to fund the benefits would equal the actual cost of those benefits. The system would encourage employers to fund above minimums and allow employers to justify the cost of providing defined benefit pensions to their employees.

The status quo is substantially different from this ideal. In order to correct the status quo completely, legislation that overrides existing rights would be required. Many older pension plans funded through a trust provide that the assets can not be paid to the employer and the courts have affirmed that it is not possible to amend a pension trust to provide otherwise. Statutory reversal of these existing rights, while desirable, is not realistic. However, other measures can be implemented to rebalance the financial risk.

Currently the Act permits pension plans to provide for payment of assets to the employer but it imposes member consent restrictions on these payments:

- For a going concern withdrawal, 100% member consent.
- For a wind up (partial or full) withdrawal, 2/3 member consent.

These member consent provisions are inconsistent with a fair allocation of risks and rewards.

The member consent restrictions are at their most problematic in a partial wind-up where an employer who is entitled to surplus on wind up has no desire to remove assets from the pension plan. Retention of the assets in the plan provides greater security for current and future members, and can reduce employer contributions, while members in the partial wind up have received full benefits. Nevertheless, with the member consent provisions in place, there is pressure on the employer to apply to withdraw the assets so that members in the partial wind-up can negotiate to receive a share of it. Currently the regulator takes the position that the surplus assets associated with the partial wind-up cannot be considered part of the going concern, and that in order to remain in the plan and continue to be part of the going concern assets, the employer must apply to withdraw the assets. In the absence of legislative change, only further litigation will resolve this state of affairs.

Measures to Rebalance The Sharing of Risks and Rewards

There are several measures that should be implemented to make a significant correction to financial asymmetry for single-employer plans. All or substantially all of the following measures are needed.

Partial Wind-up

The notion of partial wind-up should be eliminated, as has been done in Québec. This is the single most important problem in Ontario's system today. If Ontario wishes to impose benefit improvement requirements on substantial downsizing events (i.e. "grow-in" and immediate vesting) it could continue to do so without the concept of a partial wind up.

New Plans

Legislation that creates a fair and balanced environment for new defined benefit plans should be enacted. For example, a new plan would be presumed to provide for unfettered employer ownership of surplus and contribution holidays in the absence of clear language to the contrary, and would not be subject to partial plan wind-up.

New Rules for Future Contributions

A symmetrical environment could be created prospectively for existing plans. For example, legislation could be created to support freezing benefit accruals in a current plan at the current solvency level, while a new fund is set up to provide for future service accruals, increases in past service benefits and funding of deficits for past service. The employer would have clear ownership of surplus in the new fund and benefits would be paid from the first fund until it is depleted.

Reserve Account

Certain employer contributions could be singled out for special treatment with respect to ownership and withdrawal. These assets would be tracked separately in a reserve account, as follows:

- Any contribution above current service cost would be allocated to the account.
- The account would earn the fund rate of return for the whole plan.
- All or a portion of the amount held in the account would be refundable to the employer.
- On an ongoing basis, if all assets exceed the solvency liability plus a margin and also exceed the going concern liability where applicable, the excess (up to the amount held in the account) would be refundable.
- On a wind-up basis, to the extent that the account is not required to provide benefits and fees related to wind-up, the unused portion would be refundable.
- A contribution holiday that cannot be justified by reference to the main fund would be charged to the reserve account.

Contribution Holiday

Statutory provisions should expressly grant a presumed right to a contribution holiday unless there is a contrary stipulation in the plan rules. The employer's ability to amend the plan to expand contribution holidays should be clearly supported by legislation. Although currently the common law provides this result, and most legislation can be interpreted consistently with this result, express legislative codification of these rules is needed.

Business Transaction

Legislation should make it clear that actuarial surplus need not be included when assets and liabilities are transferred to a successor employer's pension plans. The role of the legislation should be to ensure that existing levels of benefit security, up to 100% solvency, are protected in these transactions.

Ongoing Surplus Withdrawal

Withdrawal of surplus by the employer while the plan is a going concern should be permitted, where surplus is in excess of a solvency margin (for example, if the solvency funded ratio of the plan is above the level at which contribution holidays are permitted), at the option of the employer. There should be no member consent requirement.

Surplus Ownership on Total Wind-up

There should be statutory provisions that presume employer entitlement to surplus, unless provided otherwise in plan rules and other trust documents. The process for determining ownership as provided in plan rules and other documents should be fair and efficient. If the legislation provides for arbitration, it should allow alternative access to the courts to determine surplus entitlement. If an employer can establish ownership there

should be no conditions on recovery of those assets by the employer, such as the current member consent rules.

Letter of Credit

Letters of credit or similar guarantees should be a recognized asset for valuation purposes. This would be an important improvement to the system for financially healthy employers who are otherwise reluctant to make contributions that result in trapped capital. This mechanism is urgently needed if the current unfair allocation of funding risks and rewards persists.

Increased Income Tax Act Limit

The Income Tax Act prohibits employer contributions for most plans when the plan has an actuarial surplus of 10% of actuarial liabilities. If employers were permitted to fund to a higher level of surplus when able to do so, with an expectation that the surplus would not become trapped capital, pension security would be improved. Of course a change in the tax limit is not within Ontario's power. However, the effect of raised limits is something that Ontario should recognize and consider.

Other Measures

Controls on Investment

Asset mix can create significant risk of insolvency. Too much equity exposure for a financially weak employer in an underfunded plan with mature liabilities is imprudent. However, investment decisions are particularly complex and difficult to regulate and control. The current system already imposes a fiduciary duty on investment decisions. In theory, this should be an effective control. However, it would make sense for regulators to monitor to a greater degree and to order a change to the asset mix when insolvent plans have clearly imprudent investment exposure.

Despite being able to say that there is a link between the financial health of a sponsoring employer and tolerable investment risk, there is no universal way to define imprudent investment for regulatory purposes since each situation is unique. Accordingly, for purposes of a regulator's monitoring, discretion to take into account all the circumstances is necessary. At least at one end of the spectrum, the employer and the regulator can be assisted in determining that a higher degree of asset and liability mismatch is acceptable when a letter of credit or similar guarantee is in place.

Guarantee Fund

It is tempting to think that if immediate and constant full funding of a defined benefit pension plan is too expensive for employers, then the risk of pension plan (and business) failure should be insured in a pooled arrangement. However, the existing guarantee fund and similar funds globally have significant problems:

- Risk of wind-up is very heterogeneous, with each business and plan having unique characteristics. Risk premiums could not be equitable unless a complex risk-based approach were developed. It would be very difficult to establish an equitable sharing of risk between employers.
- It would be too expensive for the employers to insure all benefit loss through a guarantee fund. Even with restricted benefit loss coverage, substantial claims could drain the fund. The idea of a government back-up for full or nearly full coverage would be tantamount to creating a new tier of public pension plan.

Guarantee funds create the potential for moral hazard under which financially weak employers take imprudent pension plan risks, knowing that benefit losses will be covered by other plan sponsors and ultimately by taxpayers.

Experience with guarantee funds shows that it is extremely difficult to make the system self-supportive, and taxpayers bear this risk. In the United States the system is under severe pressure. In the United Kingdom, where full coverage is intended, the proposed premiums for employers below investment grade are astronomical. Further information about guarantee fund experience is appended to this paper.

If the Ontario Pension Benefits Guarantee Fund is eliminated, a transition period will be needed.

Creditor Priorities on Bankruptcy

Bankruptcy laws are not for Ontario to change. However, there are some measures that Ontario should seek to obtain from the federal government.

Currently, payments that were due to be made before the employer's insolvency may or may not have priority over other creditors' claims under deemed trust rules. The additional money needed to fully fund the benefits may be an ordinary debt, ranking below secured debt.

It would be helpful to make it abundantly clear that contributions already overdue have priority. However, there may not be much that can or should be done to give the remaining pension deficit greater priority. Any material improvement of the plan members' position in relation to secured creditors will affect the employer's ability to borrow, accelerating a business failure or, as the case may be, preventing financial reorganization. Ultimately if such a measure were implemented, the cost of doing business in Canada may be too great.

Benefit Priorities on Bankruptcy

On insolvent plan termination it can become clear in hindsight that it would have been better if recent benefit improvements had not been made. The improvements may have worsened a solvency deficiency when they were made, increasing contribution requirements that may in turn have worsened the employer's financial position. It might also seem unfair to pay these benefits at the same level of reduction that applies to

previously accrued benefits. It is tempting for a regulator to want to control benefit improvements while a plan is a going concern, but this type of measure is a blunt tool and too intrusive. Ontario should not address risk in this manner.

Placing controls on benefit improvements in the context of an actual wind up with insufficient funds would be more effective. At that time, benefit improvements made within a reasonable period before the wind up could be given lower priority than long-standing benefits. Benefits that were created in the few years before wind up could be eliminated or more drastically reduced than benefits that existed before the amendment. A reasonable method for determining which benefits are reduced more drastically could be created, for example following the model already in place in Québec.

This is a small measure in the overall picture, but it could be meaningful in certain cases.

Exceptions and Temporary Relief

At the present time, or in the future, many employers may want relief from the impact of solvency funding requirements. For financially healthy employers the introduction of letter of credit financing is an appropriate response. For government guaranteed plans that have no solvency risk, suitable exemptions can be created by regulation.

For distress situations such as bankruptcy and court-protected reorganization, it is not feasible to consider in advance what type of relief would be warranted, if any. The appropriate response in those cases is to amend the regulations, if needed, on a case by case basis (or to provide the regulator with the power to grant relief through longer amortization periods or similar pre-defined measures), and to rely on mechanisms under insolvency legislation to balance the competing interests. In that context, the pension regulator should have a key role in negotiations.

Facilitating Transactions

Businesses buy and sell, combine and split, and reorganize to adapt to changing markets and to meet business objectives. Employers who sponsor pension plans must have some latitude to restructure the plans when business changes and transactions occur. One of the significant problems facing employers and plan members today in Ontario is the near impossibility of merging plans. The Act provides that the Superintendent may approve an asset transfer from one pension plan to another, if the rights and other benefits of affected plan members are protected. This broad discretionary authority has proven to be too vague and has resulted in a highly conservative approach by the regulator.

In addition, there is no regulatory clarity concerning the level of assets to be transferred to a new or existing pension plan when liabilities are being transferred.

These problems are particularly difficult when an employer or shareholder is negotiating a purchase or sale. In many cases, a successor employer would seriously consider or prefer taking on past service liabilities and continuing defined benefit coverage for employees in an acquired business. However, the prospect of being unable to secure the asset transfer approval from the regulator is prompting many successor employers to prefer defined contribution coverage for the employees of acquired businesses.

Litigation about the employer's right to amend a pension trust to provide for a merger has occurred and there will likely be more litigation, but the resulting court decisions cannot provide the kind of general, consistent and predictable guidance that legislation can bring.

The legislation should clearly permit pension mergers and other asset transfers and take the matter out of the courts. Regulatory involvement should be efficient so that the pension transactions are executed as soon as possible after the main transaction closes. Specific measures to be implemented include:

- Allow the transfer of defined contribution accounts in all cases.
- Make it clear that actuarial surplus need not be included when defined benefit assets and liabilities are transferred to a successor employer's pension plans (except perhaps for a pro-rata share of any accumulated margin below the contribution holiday threshold).
- Allow for the unrestricted transfer of assets and liabilities from the seller's plan to any existing plan of the successor employer.
- Ensure that accrued benefits cannot be reduced.
- Ensure that existing levels of benefit security, up to the solvency margin at which contribution holidays are permitted, are protected

Make Design Innovation Feasible

One of the obvious shortcomings of the Act is its failure to address differences in plan design. Sponsoring employers and plan members should be able to look to the Act for minimum standards that make sense for their specific pension plan.

Currently the Act does not even distinguish well enough between defined contribution benefits and defined benefits. With respect to defined benefits, new designs such as the “flexible pension plan” have arrived but some of the minimum standards should be revised or lifted, and some new ones created, so that these plans can flourish. Instead, there has been inattention, or perhaps inability to make the desired changes.

Without design flexibility, a key advantage of a defined benefit pension plan for employees and employers is lost. There is no good policy reason to maintain barriers to new plan design.

Recently Ontario has made some progress in this area by addressing the special characteristics of jointly sponsored plans (JSPs) and MEPPs. For example, the ability to classify MEPPs by regulation has been introduced and this can be used for a more efficient regulatory response.

The regulator should have the expertise to consider design innovations and the ability to ensure that viable new designs are supported. For example, the Superintendent might have authority to grant exemptions for new plan designs. Similarly, where unintended results are created by the Act for existing plans, there should be a mechanism for solving the problem quickly.

Another problem related to plan design is the relationship between defined benefit provisions and defined contribution provisions in the same pension plan. The Act can be interpreted to place defined contribution accounts at risk if the defined benefits are underfunded on insolvent wind up. The Act does not adequately address the inclusion or exclusion of defined contribution members in surplus distributions or in benefit reductions

on insolvent wind up. Court decisions have affirmed that in the absence of plan terms to the contrary, contribution holidays are available for employer defined contribution costs, but the Ontario Court of Appeal suggested that where this is the case, defined contribution members then also have a share in surplus distribution on plan termination. It is not clear whether the Court also intended that defined contribution accounts be at risk for defined benefit insolvency. If so, this would be entirely inappropriate. Defined contribution members already bear the going concern investment and market risk. Exposure to further risk should not be imposed on them by the courts or by legislation.

This is another area for litigation that could be prevented with clear legislation under which:

- defined contribution provisions may co-exist in the same plan with defined benefit provisions,
- contribution holidays for defined benefit and defined contribution funding are allowed, and
- plans may be designed without surplus sharing or deficit sharing for the defined contribution members.

Multi-Employer Pension Plans

The comments and analysis presented in the majority of this submission relate to the most common type of defined benefit plan, namely a plan in which a single plan sponsor is responsible for providing defined benefits to eligible members. Many of these comments do not apply to special plan types such as MEPPs and to a lesser extent, JSPs and certain other shared-risk plans.

MEPPs constitute only a minority, but a very important minority, of the defined benefit plans in Ontario. From a regulation point of view, MEPPs are dramatically different from single-employer defined benefit plans. MEPPs have no issues relating to contribution holidays, employer rights to surplus, asymmetry of incentives, and guarantee fund coverage because none of these apply. Unlike single-employer plans, MEPPs have the ability to reduce accrued benefits for past service, which many MEPPs have recently been required to do due to funding shortfalls. Despite the many differences, MEPPs are similar to single-employer plans in that the current solvency funding requirements are a key issue, since the solvency funding requirements are ineffective and produce undesirable and unintended results for MEPPs.

MEPPs should be exempt from solvency funding requirements, and the actuarial valuations that are used to determine the benefit levels that can be supported by the contributions and available assets should be prepared on a going concern basis. There should be regular disclosure to plan members that benefit levels will be adjusted upward or downward from time to time, to reflect the benefits that the MEPP can provide.

For MEPPs, contribution levels are generally fixed by collective bargaining and independent of the financial status of the plan. The basic pension deal is that plan members receive the amount of pension that the contributions and investment returns can provide. This is very different from the basic deal for a member of a single-employer plan, where the employer is committed to providing the amount of pension promised, regardless of the cost of such pensions.

The existing solvency funding rules are intended to result in additional employer contributions to an inadequately funded plan and more assets to secure the promised benefits, but this does not happen for MEPPs because contributions are fixed. As a result, a MEPP is generally forced to address a solvency funding requirement by reducing accrued benefits. In effect, the MEPP is forced to implement a benefit reduction now in order to prevent having a benefit reduction in the future in the potential event of a wind-up. The solvency funding requirement just affects how benefits are allocated among groups of members - no more benefits can be provided to members because no additional contributions or assets are produced by the solvency funding requirement.

For MEPPs, the objective is generally to provide the maximum benefits that can be generated for members with a reasonable amount of investment risk, and to allocate those benefits equitably among plan members. The existing solvency funding requirements destroy the equity by generation, because benefit levels must be sharply reduced or contributions sharply increased for a temporary period of time, disproportionately disadvantaging those particular members facing the benefit reduction or contribution increase. A direct decision by the Board of a MEPP as to how benefits should be allocated is far more likely to result in equity for plan members than an indirect decision based on solvency funding requirements that were designed for another purpose.

Part of the irony of the dysfunctional effect of solvency funding requirements for MEPPs is that MEPPs are rarely wound-up. Given that MEPPs normally cover employees of numerous employers and that the participation of those employees and employer group is bargained, wind-up is unlikely. On the other hand, MEPPs are frequently in the situation where wind-up liabilities exceed going concern actuarial liabilities because of the generous early retirement provisions of these plans. As a result, the current solvency funding rules require MEPPs to fund for the additional early retirement benefits that would be paid in the event of a plan wind-up (in which case all eligible members benefit from the early retirement provisions, not just those who elect to take early retirement) but in fact no such additional early retirement benefits are expected to be paid because plan wind-up is unlikely.

We recognize that elimination of the solvency funding requirements for MEPPs would involve a significant decision, and that Ontario would want to take the time to satisfy itself that such a change is in the best interests of plan members. In the meantime, there is an extremely urgent need to change the application of the current solvency funding requirement to allow a MEPP (not just a JSP or a Specified Ontario MEPP) appropriate time to implement any benefit reduction or contribution increase required due to a solvency deficiency. Under the present funding requirements for a MEPP not covered by the existing exceptions, a required benefit reduction or contribution increase would have to be retroactive to the date of an actuarial valuation. In real life, no such retroactive change is possible, and no regulator working in the best interests of plan members would want a MEPP to make such changes retroactively. We note that the opportunity to delay

implementation of a funding change by one year from the valuation date is already in place for JSPs, whose needs in this regard are no different from MEPPs.

As indicated previously, we support reasonable measures that might be considered necessary in conjunction with the elimination of solvency funding requirements for MEPPs. In particular, we support additional disclosure to plan members regarding the possibility that benefits can be reduced in the event of a funding shortfall. Such disclosure could include specific reference to the likelihood of reduced benefits in the event of plan wind-up, along with information about the financial status of the plan in the event of wind-up. We would also support tighter standards by the Canadian Institute of Actuaries to ensure that actuarial valuation assumptions adopted for MEPPs are appropriate.

Regulatory Approach and Resources

It is not possible to have a successful pension regulatory system without the appropriate regulatory structure and resourcing. In our view, the fundamentals are:

- If the regulator is going to have discretion, it must have expertise.
- If the regulator is going to have a heavy workload, it must have adequate staff.

The best legislative scheme in the world will be ineffective if it cannot be implemented competently and with large enough resources.

In this paper, several key areas of regulatory discretion (existing or potential) are identified:

- Require a full valuation when there is a solvency concern, taking into account all relevant circumstances.
- Intervene if there is clearly imprudent asset and liability mismatch.
- Grant relief and negotiate in distress situations such as bankruptcy and court-protected reorganization.
- Approve or deny asset transfers.
- Grant exemptions to accommodate plan design.

None of these powers or any similar to them should be created or continued unless the decision makers and their staff are qualified.

Appendix

Guarantee Fund Experience

United States Pension Benefit Guaranty Corporation (PBGC)

PBGC premiums for each plan are based on the number of plan members and the size of the pension deficit. There are no risk adjustment factors for factors such as the financial strength of the sponsor or the level of mismatch between assets and liabilities.

The overall financial situation of the PBGC changed dramatically in a very short period of time. At the end of 2000, the PBGC had a surplus of \$10 billion. Within four-years it reached a record deficit of \$23 billion. This was due to the impact of the financial environment on the PBGC as well as several high profile business failures and restructurings. A number of large employers (particularly in the airline, auto and steel industries) were able to shed significant unfunded pension liabilities to the PBGC as part of their restructuring process.

The PBGC also discloses an off-balance sheet liability of \$73 billion for reasonably possible terminations.

The PBGC will almost certainly likely require a significant injection of taxpayers' money to remain solvent.

Ontario Pension Benefits Guarantee Fund (PBGF)

Similar to the PBGC in the U.S., PBGF assessment fees are based on the number of plan members and the size of the pension deficit. The premium is not based on risk factors such as the financial strength of the sponsor or the level of mismatch risk.

According to the March 31, 2005 financial statements, the PBGF has a deficit of \$237 million. The long term viability of the PBGF will likely require an injection of tax payer money.

In selective cases, the Ontario government has assist financially distressed companies by absorbing a portion of their pension obligations into the PBGF. Protests were raised by the competitors of those companies and from the Advocacy and Government Relations Committee.

United Kingdom Pension Protection Fund (PPF)

The PPF was enacted in the U.K. in 2005. Unlike the U.S. and Ontario systems, levies are risk based. Two elements of risk are considered: the risk of default by the plan sponsor and the funded status of the plan. The PPF decided against including investment risk as a factor in the calculation of the risk based levy.

The assessments for plan sponsors with below investment grade credit ratings are very significant, which has added further momentum to the rapid exit from defined benefit plans by employers.

Germany PSVaG

German companies rely heavily on book reserves rather than pre-funding their pension plans. Plan members are exposed significant risk since pensions are treated as wage claims in bankruptcy cases.

The current protection system is based on a pay as you go system. Premiums for each plan are determined as the previous 12-month losses supported by the PSVaG, divided by the ratio of the plan's liabilities to the total pension liabilities for all covered pension plans. The premiums contain no risk adjustment factors such as the financial strength of the sponsor or the level of mismatch risk.

Large, financially secure companies with significant pension liabilities are overly burdened by this system. It results in large fluctuations from year to year based on the business cycle. Assessments increase during poor business cycles when plan sponsors are least able to absorb the cost. For example, increased bankruptcies in recent years have significantly increased contribution rates. For example 2006 premiums were 36% higher than in 2005.

Organization for Economic Co-operation and Development (OECD) January 2007 paper on Benefit Security Pension Fund Guarantee Schemes

The OECD issued a paper in January 2007 on the situation of the major countries' Benefit Security Pension Fund Guarantee Schemes. It noted some very significant concerns that are caused by guarantee fund systems:

- Moral Hazard. "... if a plan sponsor knows that upon bankruptcy their pension fund liabilities will be covered, even if sufficient assets are not available to back these

- promises, they may be incentivized to indulge in irresponsible behaviour, leaving others to cover the costs of the pension promises they have made. Such behaviour may include raising benefits to unsupportable levels, cutting their own contribution rates, or pursuing a risky investment strategy.”
- Adverse Selection. “The problem of adverse selection also stems from the mispricing of premiums. If, when setting the premium rate, due consideration is not taken of the contributing firm’s bankruptcy risk, pension funding level and investment policy, stronger member firms will inevitably end up subsidising weaker ones. If these cross subsidies are too high the problem of adverse selection kicks in, with financially secure firms finding ways of pulling out of the guarantee system (e.g. by replacing their defined benefit schemes with defined contribution ones.)”
 - Systematic Risks. “Pension benefits can be insured for non-systematic events (such as poor corporate management, fraud etc.). They cannot, however, provide cover for systematic ones, such as macroeconomic weakness, which increases the bankruptcy risk of all companies, or sharp equity market and interest rate declines...”

The paper concluded that if a guarantee fund system exists, it should follow the following principles:

- Limited benefit coverage.
- Risk based pricing.
- Accurate and consistent funding rules.
- Prudent asset liability management.
- Adequate powers without undue political influence.

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