



HUMAN RESOURCE CONSULTING AND ADMINISTRATIVE SOLUTIONS

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October 5, 2007

Mr. Harry W. Arthurs
Commissioner
Expert Commission on Pensions
PO Box 102
777 Bay Street
Toronto, Ontario M5G 2C8

Dear Mr. Arthurs:

RE: Morneau Sobeco Submission to Expert Commission on Pensions

We are pleased to take this opportunity to participate in the process of reviewing Ontario's employer-sponsored pension system. As the largest Canadian-owned actuarial consulting firm, we are keenly interested in promoting a thriving pension system that meets the needs of plan members while safeguarding the interests of the sponsoring employers.

Morneau Sobeco has over 1,000 employees, including approximately 100 actuaries and Associates of the Society of Actuaries and 14 pension lawyers. Four of our 12 offices are in Ontario, including our headquarters in Toronto. A number of our clients are in the public sector but the clients that most acutely feel the need for reform are the private sector Canadian companies that sponsor defined benefit (DB) pension plans.

The public sector DB plans as well as the larger union-negotiated plans will likely continue to provide DB pensions, regardless of the regulatory environment. The same cannot be said for the non-union private sector plans, especially the small to mid-sized plans. The companies that sponsor these plans operate in a very competitive global environment and have a limited appetite for coping with risk that does not contribute in some way to the bottom line. They also have limited resources for managing their pension plans.

It is not news that the decline in DB pension coverage over the past two decades has been dramatic. A number of our clients have wound up their DB plans and many others have converted them to defined contribution (DC) arrangements. Very few new DB plans have been created. Some of our clients that converted to DC were historically staunch supporters of DB plans. Many of them did not want to abandon their DB plans but at least some felt they had no choice. While pension reform was not the sole reason for this trend away from DB, the current reality is indisputable: *Employer-sponsored plans are voluntary arrangements and employers are prepared to walk away from them.*

We need a more user-friendly environment for DB plan sponsors. Bringing in better pension legislation in Ontario is a good start. Whether doing so will entice employers who have already jumped ship to return to DB is debatable, but it will at least improve the health of the private pension system that remains.

Our premise in this submission is that the system of employer-sponsored retirement plans should continue to play an important role in providing retirement security to Ontarians. Such plans may eventually be supplemented by government-sponsored or industry-sponsored multi-employer arrangements but they will not be easily replaced. Here then, are our recommendations for change.

Entitlement on Plan Termination

The primary reason for the global trend away from DB pension plans is the volatility in pension cost. (We note that plan sponsors can largely avoid this problem by immunizing their portfolio with fixed income investments but this creates an even greater problem: that of consistently higher pension costs than sponsors have been used to.) The cost volatility stems from the inherent volatility in the market rates that must be used to determine liabilities in solvency and accounting valuations. While there is nothing that legislation can do about market rates, the legislation can redefine pension obligations on plan wind-up in a way that would dampen the volatility.

At present, settlement of obligations on wind-up means providing annuities (or the actuarially equivalent lump sum). There are two problems with the requirement to provide annuities. The first is a practical one. If a large enough pension plan were to be wound up, the Canadian annuity market would not be big enough to allow for the purchase of annuities for all members. The second is that annuity prices are tied to prevailing interest rates, which have been very low in recent years. The tie to annuity rates is what makes the cost of pensions so volatile, and in recent years, so high. Furthermore, annuity prices build in the cost of expenses and profits for the annuity providers; this is a legislated source of profit for the insurance industry at the expense of the pension system.

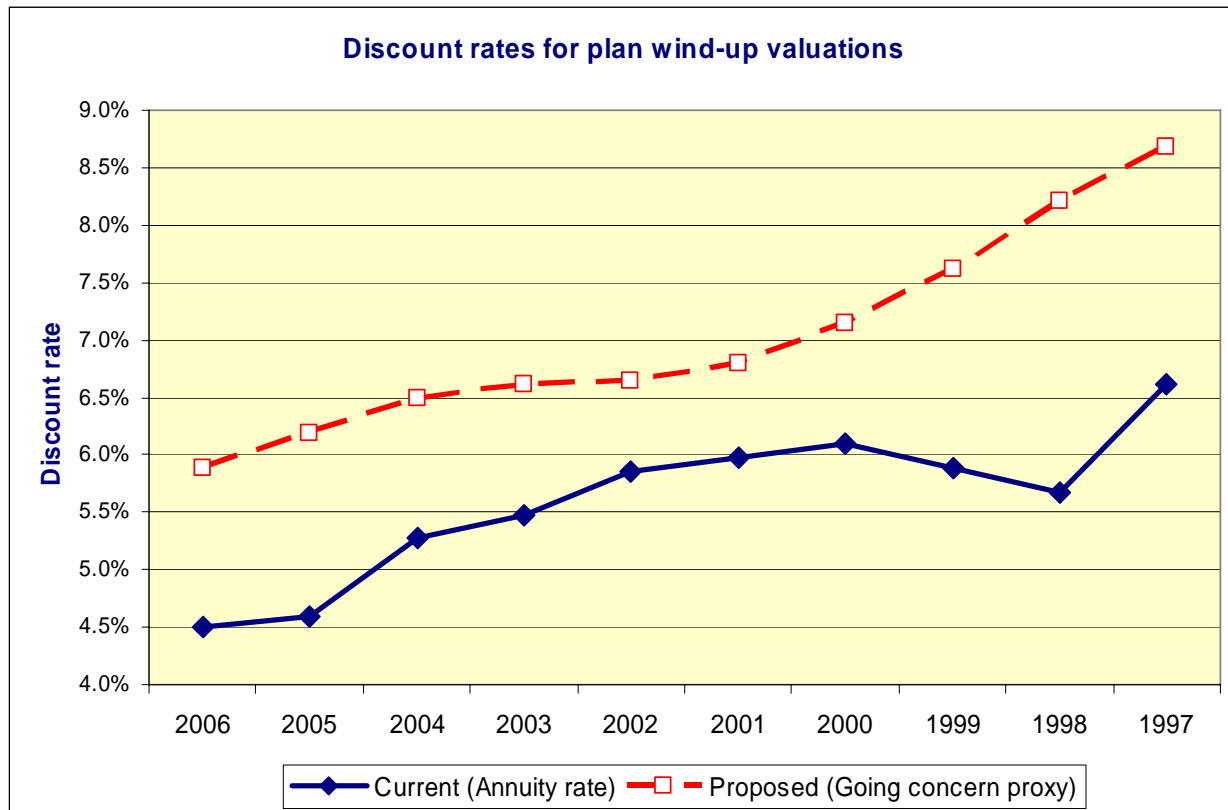
We recommend that a different approach that would reduce volatility. In the event of a plan termination, all members (including retirees) should be entitled only to a lump sum equal to the commuted value of their accrued pension. Each affected member would be required to transfer this lump sum into a LIF, to be invested at the member's direction (the same as occurs in DC pension plans).

We further recommend that the commuted value be calculated on a basis that is different in two ways from the current CIA basis used to calculate transfer values:

- > First, it should smooth year-to-year volatility by taking a moving average of interest rates rather than just the current market rate,
- > Second, it should more closely resemble a long-term going-concern return (based on a balanced portfolio).

One way to accomplish these two ends is to base the discount rate on the annualized yields on Government of Canada long bonds averaged over the past five years plus 75 basis points. The 75 basis points would represent a fraction of the additional return one could expect over the long term from

investing in equities. The smoothed basis would be factored into the calculation of solvency liabilities and accounting liabilities and would serve to decrease the volatility in both funding requirements and accounting expense.



This particular approach proposed above is for illustration purposes only. An alternative is for the going-concern discount rate to be capped at 8%, which is essentially the highest interest rate that regulators have allowed for going concern valuation purposes any time in the past 40 years. Another possibility is to set the rate annually as the median valuation interest for all valuations of plans registered in Ontario. If the Expert Commission accepts the notion that the commuted value should be based on a long-term going concern investment return, the Canadian Institute of Actuaries would be in the best position to recommend a basis that accomplishes this.

Using a discount rate that factors in some of the equity risk premium reduces the commuted value of the termination benefit. Some members will earn back that shortfall over time by investing in a balanced portfolio of stocks and bonds but this is not guaranteed. The net effect of this proposal is that some investment risk gets transferred to plan members. The degree of risk they would face, however, is still significantly less than under a DC arrangement. We believe this is a healthy compromise and certainly better than the alternative of more conversions to DC.

Hybrid Plans

The foregoing recommendation is essentially a call to permit a type of hybrid plan that is currently not permissible. Given the obvious shortcomings of both DB and DC plans – which are at opposite ends of the employer/employee risk-sharing spectrum – we believe pension plans that share risk between employers and employees should be the future.

The problem is that existing pension legislation does not readily accommodate hybrid plans. The legislation was originally written with defined benefit plans in mind. To this day, the interpretation of that legislation does not allow for certain hybrid plans with both DB and DC features, even when such plans enhance individual security. We acknowledge it is difficult to write legislation that automatically accommodates a wide variety of hybrid plans, including plan designs that have not yet even been invented. Another approach is to provide discretion to the Superintendent to approve a hybrid plan design as long as it meets one important criterion: If the hybrid plan is at least as good as, or better than a comparable DB or DC plan, then the plan should be permitted.

For instance, consider a simple DC pension plan. This DC plan is acceptable under the current legislation even though it imposes all of the investment risk and longevity risk onto the employee. In the event of prolonged poor investment performance, a concerned plan sponsor might want to add a guarantee to that plan in the form of a minimum DB pension that a member would receive if he or she remains in active employment until retirement age (i.e. 55). Doing so, however, puts the plan offside under the existing rules. The reason is the lack of vesting of the DB guarantee before age 55. Another reason is the apparent breach of the rule of “gradual and uniform accrual”. Either way, the end result is not acceptable. Such a hybrid plan would be better for members than the current DC plan and hence should be permitted.

We note that this is merely one example. Other obstacles arise if one were to try to create other types of hybrid plans such as cash balance plans. It is important that the legislation be flexible enough to accommodate a variety of hybrid plan designs.

“Grow-in” Benefits

Grow-in benefits were introduced in Ontario in 1980, at the same time as the Pension Benefits Guarantee Fund (PBGF). Their purpose was to preserve the early retirement rights that a member would otherwise lose in the event of a plan termination. Grow-in benefits were brought in “under the radar”; it was the PBGF that received all of the attention. Both the grow-in benefits and the PBGF were a knee-jerk reaction to some high-profile insolvencies such as Massey-Ferguson, which occurred at a time when the government was more interventionist in propping up private sector employers that were deemed “too big to fail”.

In the early 1980s, interest rates were very high, which meant that wind-up liabilities were low and the incremental cost of grow-in rights did not immediately affect plan funding in most cases. Over time, circumstances have changed dramatically. Interest rates have fallen and grow-in benefits have become very costly. The Ontario government intervenes less in the affairs of failing private sector companies. DB pension plans are no longer the norm which means that grow-in benefits help just the privileged minority that have DB benefits, not the majority of Ontarians. Finally, we are now in an era where

worker shortages are more likely to be the problem, not finding ways to ease working-age employees in failed companies out of the work force. As circumstances change, the legislation should be modified accordingly.

The only other jurisdiction in Canada with grow-in benefits like Ontario's is Nova Scotia, and Nova Scotia no longer requires that grow-in benefits be pre-funded. To our knowledge, no other jurisdiction in the world legislates grow-in benefits. We recommend that grow-in benefits be repealed. If this is not politically feasible, the requirement to pre-fund them should be eliminated at a minimum. Moreover, they should be excluded from the benefits that are guaranteed under the PBGF.

We would submit that our proposal would have the net effect of improving the welfare of the average Ontario worker. Fewer employers would be discouraged from establishing or continuing DB plans.

We further note that about half the employees in DB plans are in public sector plans where plan terminations are virtually non-existent. Another large portion of DB members are in collectively bargained plans where the union leadership could be free to negotiate grow-in benefits if they so wish. The remaining group of DB members is relatively small, consisting of non-union private sector employees. These are the DB plans that are most likely to be closed down to new members, ironically because of onerous provisions such as grow-in.

Surplus Asymmetry

Virtually every DB plan sponsor believes that if it is responsible for funding pension deficits, it should also be able to use pension surpluses for its own purposes. On the other hand, we recognize that labour groups feel differently. The current situation of asymmetry has developed over the last two decades as a result of a number of factors, including,

- > the growth of surpluses in DB plans in the 1980s and 1990s;
- > legislation originally not addressing surplus, and subsequently addressing surplus issues in only a piecemeal fashion;
- > original plan documents not even contemplating surplus, much less addressing it;
- > litigation over surplus use and the tendency of the courts to interpret the pension trust as a classic trust rather than a contract or a purpose trust; and
- > required "exclusive benefit" wording imposed by the tax authority in the past, the repercussions of which were not anticipated or intended.

The current situation was not anticipated by plan sponsors. It encourages minimal funding and the closure of DB plans. It is frustrating to all parties and results in expensive and time-consuming litigation. A solution needs to be offered through legislation rather than the courts.

To ensure that the intention of the parties setting up pension plans is honoured, we propose that pension issues should be interpreted using contractual legal principles rather than trust legal principles. This would permit the plan sponsor and its employee groups to renegotiate the pension deal from time to time as circumstances warrant.

Valuation Basis for Funding Purposes

Before 1980, actuarial valuations were usually performed only on a going-concern basis. Solvency valuations became a requirement in the early 1980s. In the years that followed the introduction of solvency valuations, solvency liabilities were generally much lower than going-concern liabilities because the discount rate used for solvency purposes was much higher (being based on long-term interest rates). As interest rates declined, pension funding became “solvency-driven” rather than “going-concern driven”. We feel the time has come to re-examine the rationale for mandatory going-concern funding valuations.

Ostensibly, the main reason for going-concern valuations is to recognize the long-term nature of the pension promises and thus to establish a regular pattern of funding. If that is the case, it is clear that going-concern valuations have failed. The pattern of employers’ pension contributions has been a roller coaster ride for the past 30 years in spite of actuaries’ best attempts to provide funding recommendations based on regular going-concern valuations. Employer contributions to pension plans were very high in the 1970s and then dropped to zero in many cases in the 1980s and 1990s when large surpluses emerged. Contributions then soared again with the recent pension funding crisis.

We submit that the true goal of funding valuations should be to secure the payment of promised benefits that have already accrued. This goal is best fulfilled by regular solvency valuations, with an appropriate (as opposed to onerous) provision for adverse deviation. A secondary goal is to fund plans in a methodical and regular manner, but this is only a goal for plan sponsors, not for plan members or regulators. If a plan sponsor feels that the pace of funding can be better regulated by running going-concern valuations in parallel with solvency valuations, this should be an internal management decision, not a regulatory requirement.

Harmonization of Pension Legislation

Harmonization of pension legislation conjures up the notion of convergence of all pension benefits acts and regulations in Canada to just one set of rules that applies across all jurisdictions. We hold out little hope that harmonization of this type can be achieved under our constitutional and political system. Even though this has been the holy grail of pension regulators for over a quarter century, we are no closer to achieving it now than we were in the 1980s.

A somewhat more workable solution is to get the provinces to agree to administer pension legislation in accordance with the province of registration, regardless of where the employee works. For example, if a plan is registered in Ontario, then plan members in Saskatchewan or Quebec (or any other province) would be governed by Ontario’s Pension Benefits Act. This simple protocol for dealing with extra-provincial employees exists already in the case of federally regulated companies whose pension plans fall under the Pension Benefits Standards Act.

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Mandatory Indexation

The discussion paper asks questions about the effects of inflation on pensioners and the prevalence of indexation. While the government has backed away from the idea of mandatory indexation in recent years, we still fear it will raise its head again should inflation rise.

We strongly oppose the idea of mandatory indexation. It makes no sense to mandate inflation protection when the level of pension benefit is not mandated. Any plan can offer the option of an indexed pension by means of an actuarially reduced initial pension and if it did so, there would be virtually no takers. Mandatory indexation at employer cost would drive yet more employers away from DB plans which would exacerbate the existing two-tiered system of “haves” (the minority of Ontario employees in good DB plans) and “have-nots” (everyone else).

Transition

In the interests of brevity, we have presented our ideas in conceptual form. We have not dealt with the details of implementation and in particular with the difficult process of transition from the existing set of rules to new ones. The big question in this transition is the extent to which existing rights and entitlements will be grandfathered. We believe the best strategy is to decide first which proposals should be pursued and only then to deal with transition issues.

In closing, we would like to emphasize that if this pension reform initiative is to be effective, it will require bold measures. A mere tweaking of the existing legislation will accomplish little for the average DB plan sponsor.

We look forward to presenting our ideas to the Commission on October 23rd.

Yours truly,

Fred Vettese
Executive Vice President and Chief Actuary