

October 12, 2007

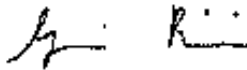
Mr. Harry Arthurs
Commissioner
Expert Commission on Pensions
PO Box 102
777 Bay Street
Toronto, Ontario
M5G 2C8

Dear Mr. Commissioner:

SUBMISSION OF TOWERS PERRIN TO THE EXPERT COMMISSION ON PENSIONS

We are pleased to enclose Towers Perrin's submission to the Ontario Expert Commission on Pensions. We look forward to discussing our submission with you on November 7th.

Sincerely,



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Submission of Towers Perrin to the Expert Commission on Pensions

October 12, 2007

Introduction

We thank you for the opportunity to make this submission to the Ontario Expert Commission on Pensions (OECPE) on behalf of Towers Perrin.

“Ontarians are entitled to pension legislation that is fair and up to date. This review will ensure that plan members and pensioners know that their contributions are protected by a modern set of rules.”

-- *Minister of Finance Greg Sorbara, Nov. 9, 2006*

Towers Perrin shares the view expressed by Minister Sorbara when he announced the creation of the OECPE – that Ontarians are entitled to legislation that is “fair and up to date.” The OECPE’s mandate is focused on defined benefit (DB) pension plans. These plans represent a significant portion of retirement income for many active and retired employees, and can be of significant assistance to employers in attracting, retaining and managing their workforce. They should be preserved as a viable, affordable option in promoting and facilitating retirement savings.

The OECPE’s guiding principles highlight the need to encourage the DB system and safeguard the security of pension benefits while balancing the rights and obligations of members and plan sponsors. With this in mind, we welcome the opportunity to offer observations and suggestions aimed at updating the system to make it fair, effective and affordable.

Objectives of changes to DB system

(Addresses Discussion Paper questions 1.4, 3.3, 4.1 and 4.4.)

The primary objective of any significant changes to the DB pension system should be to improve retirement income security for Ontarians by increasing DB pension coverage. DB pension plans will not be embraced by plan sponsors if the regulatory environment is hostile, nor will members value DB plan membership if they do not have a realistic understanding of the advantages -- and limitations -- of DB participation. Thus, the DB pension promise must be clarified and the regulatory environment must change to reduce disincentives to sponsoring DB pension plans.

1. Clarifying the pension promise

One of the significant challenges and frustrations faced by DB plan sponsors, unions, members, pensioners and regulators is the lack of clarity and common understanding of what is the true pension promise. Plan sponsors who believed they had promised only the pension documented in the plan text have found themselves paying both the pension and surplus assets to employees upon partial windup. Pensioners who had assumed based on past practice that they were entitled to receive annual inflationary increases to their pensions, are told that the annual increases have always been provided at the discretion of the sponsor, and the sponsor has elected not to provide an increase in a given year. Much pension-related litigation has resulted from a lack of clarity and common understanding of the pension promise.

Ideally, for each DB plan it should be clear to all stakeholders through appropriate communication:

- What the pension promise is.
- Who benefits if the plan develops a surplus, and how these benefits can be realized.
- Who is responsible if the plan develops a deficit, and what options are available to address the deficit.

2. Increasing DB Coverage

The proportion of the Canadian workforce covered by DB plans is shrinking. If DB plans are to thrive, DB coverage must increase through the maintenance of current plans and the establishment of new plans. Increasing DB coverage will require that pension system stakeholders address current disincentives to the sponsorship of DB plans, such as:

- Lack of clarity concerning the pension promise;
- Uncertainty regarding surplus utilization and ownership;
- Complexity and non uniformity of pension standards legislation;
- Financial reporting volatility revealed by pension accounting standards; and
- Complex pension plan merger and split rules that have become an obstacle to changes in corporate structure.

Key recommendations

(Addresses Discussion Paper questions 3.3 and 4.4.)

In order to achieve the objectives of clarifying the promise and enhancing DB coverage, all key stakeholders will need to play a part in removing the existing disincentives for DB pension plans. As a key stakeholder, the Ontario Government can play a significant role in attaining these objectives by:

- Streamlining the regulatory process, with a mandate to promote the increase in pension coverage;
- Enhancing the security of benefits, thereby ensuring that in almost all cases the benefit promise will be honoured; and
- Ensuring that pension legislation facilitates the alignment of plan funding with the pension promise.

In the remainder of this submission, we elaborate on these key recommendations and provide some additional recommendations in response to the OECP's Discussion Paper. In Appendix A, we provide a summary of our recommendations.

The human dimension

(Addresses Discussion Paper questions 1.1, 1.2, 1.9, 2.2, 2.6, 3.1, 4.1 and 4.2.)

A DB pension plan:

- Enables members to determine their retirement incomes in advance, and therefore plan appropriately for retirement;
- Frees members from investment decision-making;
- Substantially shields members from market risk;
- Pools the investment risk, enabling an increase in risk-taking capacity. This provides opportunity for the plan to increase the expected return on plan assets by increasing investment risk. Increasing the expected return on plan assets increases the expected pension provided by each dollar of contribution (or lowers the expected cost of providing each dollar of pension benefit);
- Assures members of lifetime retirement income as their longevity risk is taken on by the plan sponsor and is pooled with other members;
- May protect the purchasing power of retirees through inflation-related increases, provided either automatically or on an *ad hoc* basis; and
- Achieves economies of scale with respect to administration costs.

Investment, longevity and inflation risk protection will increase in value as the population ages and Canadians continue to live longer than ever before. No other retirement arrangement offers a comparable package of attractions, and it is therefore in the interest of both employers and employees that DB plans remain viable.

Given the demographic changes that are occurring, it is important that DB plans respond to the needs of employers and employees in an aging workforce. For example, the regulatory environment and plan designs should accommodate phased retirement by permitting retirement-eligible plan participants to receive a pension while continuing in employment. Also, sponsors should consider removing the early retirement subsidies that are a common feature of many of today's plans, so that the plan terms do not provide a disincentive for retirement-eligible employees to continue working.

Despite the many positive features of DB plans, in relative terms, fewer workers in the future can look forward to the security and predictability of the DB pension promise, especially in the private sector. DB coverage has been declining, especially among corporate employees. It is our belief that, because of the disincentives cited earlier, few -- if any -- new plans are being established. It is our understanding that the OECF is sponsoring a research project that will likely confirm this.

Statistics Canada reports that just 39% of paid workers were covered by a registered pension in 2005, which is down from 45% in 1991. Given that the Canadian workforce grew by 25% in this period, it appears that many of the new jobs that were created lack pension coverage.

The levels of pension coverage quoted above mask a significant difference between public and private sector DB coverage. In 2005, 80% of public sector workers participated in a DB plan, while in the private sector, the participation rate was only 20%.

Without the legislative and regulatory changes required to make them affordable and fair to all stakeholders, DB plans will eventually cover only a privileged few -- just public sector employees and the small percentage of private sector workers who are represented by a union. And, in scenarios that are far from worst-case, Canada's social safety net might well have to undergo dramatic expansion in the future to meet the needs of everyone else, with a corresponding increase in income taxes required to support this expanded social safety net.

The economic dimension

(Addresses Discussion Paper questions 1.9, 2.8 and 6.5.)

The collective health of DB plans – as measured by solvency valuations -- has little effect on the near-term robustness of the economy as a whole. Witness the last 4-5 years when the financial health of pension plans deteriorated, but the economy was vibrant. The key issue is not the aggregate financial standing of pension plans, but rather the effect of the financial health of any one plan on its particular sponsor. This can become particularly problematic during a downturn, as a company already under financial stress is required to direct to the pension fund scarce cash that might otherwise be used to maintain operations.

As well as managing the funding of their pension plans, sponsors also face financial accounting challenges. It is not uncommon today for the balance sheet and income statement impact of many corporate DB plans to match or exceed the impact of operating divisions. Given the materiality of DB plans to the financial results of many sponsors and the global trend in accounting rules towards marking these plans to market in sponsors' corporate statements, many corporations who sponsor DB plans face a significant increase in the volatility of reported corporate equity and earnings.

We are not suggesting that pension plans are of no macro-economic consequence. DB pension funds are, in fact, an important source of investment capital, as noted by Bank of Canada Governor David Dodge:

“Pension funds generate important benefits in terms of economic efficiency. By transferring risk from individuals to collectives, pension funds help achieve a more efficient allocation of savings. Pension funds—particularly the very large ones—tend to have sophisticated asset managers. These large funds have the incentive and the ability to invest pools of contributions across appropriately varied asset classes. Further, they invest over very long time horizons, so they can finance large investment projects at competitive rates of return. All of this contributes significantly to economic efficiency by transferring risk to those investors that are best able to bear it.”¹

¹ 9-Nov-2005. <http://www.bankofcanada.ca/en/speeches/2005/sp05-14.html>

As well, broad changes to the asset allocation of pension plans have an effect on the capital markets. Globally, pension plans are lengthening the duration of their bond holdings to ease funding and financial accounting volatility for sponsors by more closely matching assets and liabilities. At the same time, aging baby boomers are increasing their individual fixed-income allocations. As these two trends have injected ever-greater amounts of cash flow into the bond market and at the same time the amount of government borrowing has decreased, bond yields have fallen – increasing the solvency valuation and financial accounting burden on pension plan sponsors and making it much harder for individuals to meet their savings targets. Ontario cannot halt or reverse this shift in asset class preference, but can assume a leadership role in easing its pace by providing enough DB funding flexibility for sponsors to feel less need to increase and extend fixed-income weightings. Also, since the continuation of the above trends may mean that yields remain at current levels (or lower) for the foreseeable future, any improvements that Ontario makes to the funding rules must work in a low yield environment.

DB plans enhance the stability of the Canadian workforce by facilitating the orderly retirement of workers over time. In a world of only defined contribution plans, the incidence of retirement could fluctuate significantly as volatility in equity returns and interest rate levels make retirement more or less affordable at any given time. Due to (a) providing for a more predictable pension that is not as closely tied over short periods to fluctuations in financial markets, and (b) the ability of employers to use their pension plans to assist with the management of their workforce, DB plans enhance orderly retirement patterns over time.

The economy's long-term health is best served when companies are not prevented by regulation from adapting to market conditions and when ownership is able to move from weak hands to strong ones. Currently, the complexity and uncertainty of legislative and evolving common-law rules governing pension plan splits, mergers, and asset transfers, as well as lengthy delays to complete such transactions, are a major impediment to the rationalization of pension arrangements and the restructuring of corporate operations and ownership. This major issue that affects the competitiveness of Ontario employers should be addressed through legislative and regulatory change to establish clear rules for restructuring pension arrangements.

Streamlining the regulatory process

(Addresses Discussion Paper questions 1.5, 1.8 and 9.6.)

The OECP is conducting the first full review of the Pension Benefits Act (PBA) in two decades. Over time, issues and events emerged that were not anticipated at the time the PBA and its regulations were drafted. These unanticipated situations have often been dealt with through the courts. Some notable court decisions, within a long list of jurisprudence, include:

- *Kerry (Canada) Inc. v. DCA Employees Pension Committee* (Ontario Court of Appeal, 2007);

- *Monsanto Canada Inc. v. Ontario (Superintendent of Financial Services)* (Supreme Court of Canada, 2004);
- *Aegon Canada Inc. v. ING Canada Inc.* (Ontario Court of Appeal, 2003);
- *Schmidt v. Air Products Canada Ltd.* (Supreme Court of Canada, 1994); and
- *Collins et al. and Pension Commission of Ontario et al.* (Ontario High Court of Justice, 1986).

The outcome of not fundamentally updating the PBA for so many years and addressing any issues through changing policies issued by the Financial Services Commission of Ontario and by recourse to the courts is akin to patchwork legislation. We recommend that the PBA and Regulation be fundamentally updated with a focus on clarifying the following rules, so that the pension promise is clarified and DB pension coverage is encouraged, with less need to revert to the courts:

- Minimum funding requirements;
- Surplus ownership and distribution;
- Mergers, splits and asset transfers; and
- Partial windups, if the concept is not eliminated from legislation.

In addition, we recommend the following:

- The objectives of the key aspects of pension legislation should be clearly articulated. This would assist plan sponsors, regulators and courts when interpreting legislation. In line with the thrust of the OECP's mandate, the PBA should be amended to state explicitly that the core principles (Guiding Principles) of pension legislation are increasing pension coverage and ensuring that the pension promise is clearly understood and will be honoured. The PBA should further state that the regulator and courts must consider these Guiding Principles when interpreting and applying the statute and its regulations. We note that prior to merging into the Financial Services Commission of Ontario, the mandate of the Pension Commission of Ontario included promoting the establishment, extension and improvement of pension plans throughout Ontario.
- In order to ensure that the legislation remains current, the Government should commit itself to scheduled reviews of the PBA and its regulations, ideally every five years.
- Administrative guidance should be provided via an advance rulings service that provides binding opinions on administrative questions and proposed transactions in a timely manner. Such rulings would abide by the Guiding Principles and balance the interests of all affected stakeholders.
- While many employees may accrue long service and then retire on the DB pensions they were promised all along, many others will not. These employees may quit, be laid-off or lose their jobs if their employer fails. The value of DB pension credits is deferred

compensation; each employee, in effect, foregoes compensation today in exchange for pension benefits payable in the future. This concept is rooted in design provisions that were forged long ago when career employment was the norm and pension benefits were viewed as a way to retain staff or reward long service. This view means, however, that the value of such DB pension benefits from a typical plan often drops significantly if employment is terminated prior to retirement eligibility.

Furthermore, it is inequitable that an employee who is laid off in circumstances where a windup is declared -- thereby "growing-in" to a plan's early retirement subsidies -- should receive more pension than another employee who loses his or her job but is not fortunate enough to be included in a windup. A further inequity is that if the plan has a surplus, a member included in a windup may receive a distribution of surplus, in addition to "grow-in" rights.

At present, the termination benefit for a pre-retirement departure does not commonly include the value of the early retirement subsidies often built into the DB plan. As discussed earlier, due to the aging of the Canadian workforce and the need to retain experienced workers, we recommend that sponsors consider removing early retirement subsidies from their plans. However, for those who wish to maintain these subsidies, grow-in to the early retirement subsidies should be provided for all pre-retirement departures. For sponsors who wish to maintain their current costs, this will mean redirecting benefit dollars from retiring to terminating employees. If this change is made, the commuted value for terminating members who elect to transfer their lump sum value from a pension plan should be determined using the expected retirement age of the member, not the retirement age that maximizes the commuted value.

- The PBA should clarify that once benefits are annuitized, the plan and sponsor have been released of the liability with respect to the benefits purchased.
- When a pension plan sponsored by an insolvent employer winds up with a deficit, pension plan members will receive less than they were promised under the plan. To the extent that pension benefits are regarded as deferred compensation, this outcome is inequitable. Currently, a pension plan ranks as a general, unsecured creditor of an insolvent employer with respect to a windup deficiency. In many cases, this means that after assets have been distributed to secured and other priority creditors, there may remain little or nothing to satisfy the claims of the pension fund.

If the sole objective is to preserve the value of deferred compensation and enhance the credibility of the pension system, pension plan funds should have priority creditor status, which would increase the likelihood that promised pension benefits will be delivered when a sponsor becomes insolvent. On the other hand, such a change may well increase an organization's cost of capital. Because this change affects federal insolvency legislation, we recommend that the Ontario Government pursue further analysis of this issue with the Federal Government.

In its 2004 decision in *Monsanto Canada Inc. v. Ontario (Superintendent of Financial Services)*, the Supreme Court of Canada applied a "correctness" standard to the decision

made by the Ontario Financial Services Tribunal (FST) in part because the Court found that there was "no requirement that members necessarily have special expertise in the subject matter of pensions."

Pension disputes of any significance have invariably been resolved in the courts. And, as reflected in the Monsanto decision, the courts have shown limited deference to the decisions of the FST. Thus, the effectiveness of the FST has been constrained in resolving disputes and stakeholders have faced increased cost and delay as matters are appealed to the courts as a matter of right. A new approach is needed.

The Province should create a pension plan tribunal (PPT) dedicated solely to adjudicating pension disputes. The majority of PPT members must be pension experts and the PPT should be granted a privative clause under its applicable legislation. Under this approach, we expect that the decisions of the PPT would be given more deference by the courts. In the event that a PPT is not created, we suggest that a privative clause be considered in any event in respect of FST decisions, given the considerable expertise among FST members.

Making the changes suggested above to the PBA and the legislative process would go a long way towards streamlining pension administration and pension-related transactions.

Lastly, although it would be beneficial to have uniform pension laws across Canada, we do not believe that this is an achievable goal for the foreseeable future. However, we suggest that all Canadian jurisdictions continue to work towards an arrangement in which a common law is still adopted. Under this arrangement, each jurisdiction would then enact legislation that specifies the areas where it chooses to deviate from the common law. Although uniformity would not be achieved under this approach, we believe that this arrangement would narrow the differences between jurisdictions, since each jurisdiction would need to consider carefully and justify all deviations. This would also go a long way to simplifying the administration and employee equity issues faced by plan sponsors with employees across the country.

Enhancing the security of benefits

(Addresses Discussion Paper questions 2.4, 5.2, 5.4, 5.5, 5.7, 6.1, 6.3, 6.4, and 8.6.)

The main purpose of pension plan funding rules is to provide reasonable assurance that members' pension promises will be honoured by putting pension money outside the reach of the plan sponsor and its creditors.

Due to concerns about the lack of alignment between funding rules and the benefit promise, many plan sponsors are funding at minimum levels, which may jeopardize benefit security and increase the volatility of contributions.

Ensuring solvency in a volatile economy

A pension plan's solvency position does not have to be volatile. What creates volatility is investing plan assets in equities or equity-like investments when liabilities inherently behave like nominal or real return bonds. Pension funds invest in equities to seek additional return. This additional expected return comes with a price, however – greater uncertainty in the ultimate cost.

The effect of volatile equity returns on pension plans has been reasonably well understood - not welcome, but understood. To mitigate this effect, larger plans have been moving to diversify some of their conventional stock market exposure through alternative investment strategies, private equity and infrastructure.

The effect of falling bond yields was not well understood by many plan sponsors before the pension world's "perfect storm" a few years ago. They understand better now, and many larger plans have been mitigating this risk. We note, however, that there is no practical way for pension plans to fully hedge inflation risk. While the real return bonds of the Government of Canada and other issuers provide a hedge against price inflation risk, they are not a practical tool on a macro level because of their limited supply.

Based on recent research that we conducted, a typical plan's asset-liability mismatch has a roughly 10% probability of causing a change in going concern position over a three-year period of $\pm 25\%$ or more. The windup position exhibits even greater volatility. This illustrates that the funding limits in the federal Income Tax Act and regulations (the greater of 110% of the going concern liabilities and 100% of the windup liabilities) is too low and should be increased in order to enable reasonable assurance of plan solvency.

Our recommendations below regarding minimum funding requirements aim at addressing the need to ensure solvency in a volatile economy.

Minimum funding requirements

The statutory focus of minimum funding should be benefit security now and in the future. This implies:

- A forward-looking view. For example, the standard might be an 80% probability that the plan will be fully solvent five years from now;
- Investment policy should be reflected in determining the minimum funding requirement so that asset-liability mismatch risk is considered, albeit in a simplified manner. For example, target funding levels should be higher for plans with large mismatches between assets and liabilities than for plans with small mismatches;
- The minimum funding requirement should not be dependent on the sponsor's financial strength. When minimum contributions are based on financial strength, concessions

granted to a once-strong company could accelerate a slide into bankruptcy when those concessions are removed and the now-weakened sponsor must assume the burden of the additional contributions required; and

- Regulatory powers to address funding concerns, such as accelerating the timing of the next actuarial valuation, should be limited and clearly detailed in legislation so that a sponsor knows what to expect.

In response to question 6.3 of the OECP's Discussion Paper regarding earmarked reserves, we do not believe that earmarked reserves within the financial control of the corporate sponsor provide sufficient security for plan members. If additional security is warranted, it can be made via one of the following, or some combination thereof:

- Additional contributions to the pension fund;
- Letter of Credit (LoC); or
- Contingency reserve account, as described below.

If sponsor concerns about the lack of alignment between funding rules and the pension promise (e.g., the access to surplus issues which are discussed below) are resolved, the need for additional security should be met through additional contributions to the pension fund. However, LoCs and contingency reserve accounts should be made available to provide funding flexibility. In the event that the above issues are not resolved, their availability would be mandatory.

LoC issuance and pricing reflect changing business circumstances and the use of LoCs – already sanctioned by the federal regulator and a few provinces – recognizes that financial institutions can do a better job of assessing a sponsor's financial strength than inflexible legislation/regulation.

The contingency reserve account referred to above would be a new form of rainy day cushion. Contributions required under the going concern valuation would be paid to the pension fund. Further contributions required under the solvency valuation would be paid to a special purpose trust. This contingency reserve would be tax-sheltered, held separate from the sponsor's assets and protected from non-pension creditors. Contingency reserve assets not required to meet benefit obligations on full or partial plan windup would revert to the sponsor. For an ongoing plan, the sponsor would be allowed access to the contingency reserve if the total assets of the pension fund and this reserve exceed a reasonable margin of safety that reflects the degree of mismatch between plan assets and liabilities. As well, the reserve could hold voluntary contributions that would better enable sponsors to match funding to their business cycles and thereby decrease contribution volatility. To provide enough room to seed and maintain these trusts, Ontario should seek federal tax changes raising allowable funding limits for DB plans from the current maximum of the greater of 110% of going concern liabilities and 100% of windup liabilities. The determination of the increased funding thresholds could be based on an analysis of the volatility of a typical pension plan's funded ratios. Based on the research mentioned above, we believe that the funding maximums should be raised to roughly 125% of the greater of the going concern liabilities and windup liabilities.

In the event of a full windup, obligations would first be charged to the pension fund and then, as required, to the contingency reserve account. If money remains in the pension fund after all obligations are met, it would be distributed as under the current regime. If the combined assets of the pension fund and contingency reserve account are not sufficient to meet obligations, the shortfall would be addressed as under the current regime, except that all sponsor contributions made after the windup date to address a windup shortfall would be made to the contingency reserve. Contingency reserve account assets not required to meet obligations would be returned to the sponsor.

In the event of a partial windup (assuming that this concept is maintained in Ontario legislation), the actuary would simulate a full windup and then determine the obligations due to those in the partial windup group. The trust assets and contingency reserve account would both be notionally split on an appropriate basis between the ongoing and partial windup portions of the plan and the assets allocated to the partial windup group would be distributed as described above for a full windup.

Alignment of plan funding with the pension promise

(Addresses Discussion Paper question 5.3.)

There is often a lack of clarity and agreement on what the true pension promise is in a DB plan. Due to the lack of clarity, there has often been a need to revert to the courts to resolve the various claims of pension stakeholders. The resulting court decisions have created a misalignment between plan funding and the pension promise.

Access to surplus

In particular, the treatment of surplus assets has become a highly contentious issue. In most cases, plan sponsors are clearly responsible for the rapid funding of solvency deficits, but often members lay claim to any surpluses. From the perspective of sponsors, this situation creates a misalignment between the funding requirement and the pension promise (i.e., the sponsor shoulders the funding risk in the case of a deficit, but members benefit from some or all of any emerging surplus).

For DB pension plans, the “pension deal” should be clearly communicated so that everyone understands which party or parties are undertaking the risks associated with the plan. It should be clear to all stakeholders through appropriate communication:

1. What the plan terms are, including:
 - Whether or not annual inflationary increases, if any, to pensioners are provided at the discretion of the plan sponsor. If they are not discretionary, under what conditions the increases will be provided.
 - If benefits are enhanced upon full or partial wind-up, precisely what conditions trigger a windup.
2. Who benefits if the plan develops a surplus, and how these benefits can be realized:
 - Does the sponsor benefit? Can the benefit be realized through a contribution holiday and/or withdrawal of surplus assets from the plan?

- Do members benefit? Can the benefit be realized through decreases in contributions, improvements in their pension and/or a distribution of surplus assets from the plan?
 - Do both the sponsor and members share the benefit and, if so, how?
3. Who is responsible if the plan develops a deficit, and what options are available to address the deficit:
- Is the sponsor responsible? Are deficits addressed by an increase in employer funding?
 - Are members responsible? Are deficits addressed by increasing member contributions, reducing future pension accruals, and/or reducing past pension accruals?
 - Do both the sponsor and members share responsibility and, if so, how?

When establishing the “pension deal” described above, surplus, beyond a cushion, should be available to the party or parties that take on the plan’s financing risk. The regulatory environment must accommodate this type of pension deal. Transition/grandfathering arrangements from current surplus ownership rules will be important, and must be addressed in legislation.

If the issue of surplus ownership is not clarified and made more commensurate with the pension risk, sponsors will naturally continue minimum funding policies that reduce the likelihood of a large surplus developing. While reducing the likelihood of a surplus, minimum funding reduces benefit security and may increase contribution volatility. As described above, LoCs and contingency reserve accounts should be made available. In the event that surplus issues are not resolved, these vehicles will become more important as a cost-effective way to secure the pension promise. Otherwise, faced with escalating financial liabilities, corporate-sponsored DB plans will likely continue to disappear, and with them, the pension security of ever more employees.

Other recommendations

Plan windups, mergers and splits

(Addresses Discussion Paper questions 8.1, 8.4, 8.5 and 8.6.)

Ontario and Nova Scotia are the only jurisdictions with “grow-in” provisions that extend subsidized early retirement pensions to qualified members affected by windups who are not eligible for such benefits under plan terms. Recently, Nova Scotia eliminated the advance funding requirement for its provision and only requires that “grow-in” benefits be provided if sufficient assets exist at the time of windup. As indicated earlier, we recommend that grow-in (based on the expected retirement age, rather than the retirement age that maximizes the pension value) be provided to all terminating members, regardless of whether or not they are included in a windup.

The declaration of a partial windup can have significant adverse implications for plan sponsors. Grow-in benefits must be provided to qualified members and surplus must be distributed when the partial windup effective date happens to coincide with a date on which

the plan has a surplus on a windup basis. Annuities must be purchased to settle the benefits of a portion of the partial windup group. Also, the declaration of a partial windup often results in a significant delay in the settlement of members' benefits. To make matters worse, it is often unclear whether a given event should or should not lead to a partial windup.

If grow-in to the expected value of early retirement subsidies is provided to all terminating members, we believe that the concept of a partial windup would cease to be relevant, in which case they could be eliminated, as has occurred in Quebec. On the other hand, if grow-in remains an entitlement only for qualified members upon windup, and partial windups are not eliminated, guidance should be provided by the Government with respect to the objectives being fulfilled by partial windups. For example, what is the purpose of providing grow-in benefits to an employee who terminates along with a significant number of other employees versus an employee who terminates alone? Regulatory guidance with respect to the objectives would be helpful to sponsors, members, regulators, and the courts when determining what is and is not a partial windup situation.

If partial windups are not eliminated, legislative requirements should be changed as follows:

- Eliminate the requirement to distribute surplus;
- Eliminate the requirement to purchase annuities. With many types of annuities unavailable or in limited supply, the legislation should reflect the reality that the only practical solution in many partial and complete windups will be the continuation of the pension fund in a "passive mode" to pay pensions for an indefinite period of time. In the event that a sponsor chooses to settle pension benefits via an annuity purchase, as noted previously, the plan sponsor and plan should be relieved of further liability; and
- Improve clarity with respect to the circumstances in which a partial windup will be ordered. If a sponsor is still unclear with respect to a particular situation, they should be able to seek clarity through the advance rulings service recommended above.

Cumbersome restrictions on plan mergers, transfers and splits plus the delays required for approvals impede the restructuring and sale of companies. This hurts shareholders and reduces the efficiency of the Canadian economy. It also hurts employees, as their accrued pensions are often frozen at the date of a sale due to the difficulties associated with transferring their benefits earned for service with the vendor to the purchaser's pension plan. Plan sponsors are saddled with increased administrative costs if plans cannot be more easily merged or split.

Clear rules regarding the requirements for plan mergers, transfers and splits must be documented in the PBA, regulations, and policies in order to create more certainty for plan sponsors and regulators. While we understand the complexity involved with balancing the rights of a number of stakeholders, it is important that the rules not be overly complex and cumbersome, so that the administration of these transactions can be streamlined. If plan sponsors follow the requirements laid out in the PBA, regulations, and policies, they should have the assurance that the transaction will be approved by the regulator. If a plan sponsor chooses to deviate from the policies, the advance rulings service recommended above should be available to rule on the acceptability of the proposed approach for the transaction.

*Inflation indexing
(Addresses Discussion Paper question 4.5.)*

Commitment to indexation is not common in private sector pension plans. Where indexing is provided in the private sector, this is typically accomplished through *ad hoc* increases, with their financing and timing under the sponsor's control.

Ontario previously considered making indexing mandatory for private sector DB plans, but did not do so. At issue is the affordability of such an open-ended commitment, particularly when there is currently no practical way to fully hedge the exposure.

We believe the choice of whether, when and how to index should be left to the sponsor/union – or even the individual member. Consider a choice that might be offered to a retiring employee: a non-indexed monthly pension of \$1,000 or an \$800 pension linked to the Consumer Price Index. The typical individual would likely choose the non-indexed pension and, perhaps, bank some of it to finance his or her own inflation protection. We do not recommend that legislation be amended to override this by mandating indexing. Consider as well that indexing is not required for the payout stream from a defined contribution plan, and there has been no member demand for it. Whatever the Government's decision, we would support plan sponsors, pension authorities and others providing the public with useful educational materials about the risks of inflation as they relate to retirement planning.

*The Pension Benefits Guarantee Fund (PBGF)
(Addresses Discussion Paper questions 7.1, 7.2, 7.3 and 7.5.)*

Problems have arisen with publicly administered pension benefit guarantee funds elsewhere in the world, such as the US and the UK. In Ontario, the PBGF does not have sufficient assets, without recourse to taxpayers, to guarantee pension obligations in the case of the windup of a very large pension plan or the windup of a few large pension plans. Also, the PBGF can cause moral hazard by encouraging sponsors to take an inappropriate amount of risk in their plans on the basis that the PBGF will bail them out if they and their plans cannot deliver the promised benefit.

We feel Ontario's PBGF should be abandoned in conjunction with the implementation of better-structured funding rules. We note that modifying the minimum funding rules in accordance with our recommendations would enhance benefit security, thereby lessening the need for a PBGF.

If the PBGF is not abandoned, the assessment mechanism should be restructured so that insurance principles are used to avoid taxpayer subsidies and subsidies among pension plans. Accordingly, assessments should be based on a plan's funded status, the investment policy of the fund, and the sponsor's financial strength – both current and projected.

In total, insurance-based PBGF assessments would likely cost more than now. However, that would be appropriate to reflect the true cost of insuring against high-value/low-

probability events, and would avoid inadvertent subsidization of the PBGF by Ontario taxpayers -- many of whom are not members of a DB pension plan.

Lastly, we suggest that details with respect to the governance of the PBGF be made publicly available, including:

- Comprehensive financial statements showing not just current operations but also any known likely future claims and the options being considered in these cases;
- A formal investment policy; and
- Risk analyses that have been conducted.

Innovation

(Addresses Discussion Paper questions 3.4, 4.6 and 4.8.)

Joint administration is often cited as a way to restore balance in the rights and obligations of pension plan stakeholders. By itself, joint administration would not make DB plans more attractive to employers. In some cases, the reverse would likely be true because of loss of sponsor control. However, the legislation should be sufficiently flexible to allow for and even encourage new types of risk sharing arrangements and plan designs. Depending on the specific details of these new designs, joint administration might follow naturally. In any event, joint sharing of financial risk should lead to joint administration.

New multi-employer pension plan (MEPP)

Both government policy and legislation should encourage the adoption of a new form of MEPP. This type of arrangement should:

- Be open to many employers in different industries;
- Have an expert board of trustees that would set investment policy and overall contribution rates;
- Have each employer decide how it will split the contribution requirement with its employees;
- Design the plan to avoid any potential for subsidies between employers based on factors within their control;
- Be designed and financed so as to best achieve equity between different generations of members and employers; and
- Pool longevity and investment risks, but no others.

The Canada and Quebec Pension Plans offer a design template, but other designs are also possible. In order to provide sufficient scale, such a plan would likely need to be sponsored by the Ontario Government or a large financial institution. Centralized administration, investment, and communication functions would enable participation by small employers.

Target benefit plan

This is an alternative approach in which legislation would allow a sponsor to offer a plan in which it commits to make fixed contributions aimed at funding a target retirement income,

but does not guarantee that the target level will be delivered. Ancillary benefits and accrued benefits could be reduced or member contributions may increase in the event of adverse experience – a risk that must be clearly communicated to plan members. This type of plan would operate under rules appropriate to MEPPs, but would not require the involvement of multiple employers or necessarily be subject to a collective agreement. As risk is borne by the membership, inter-generational equity would again be an important objective for such plans. This approach is similar to member-funded plans in Quebec.

Conclusion

As they currently stand, Ontario's PBA and regulations do not meet the current and future needs of employers and employees. Employees fortunate enough to be in a DB pension plan are generally well served, for now. But plan sponsors are not. Accordingly, they are not establishing new plans and in many cases are restructuring existing programs to reduce or eliminate future DB accruals for current employees and close their DB plans to new hires. Failure to sufficiently update the PBA and its regulations over the past two decades has burdened employers with an unbalanced allocation of rights and entitlements, rules that are too onerous and cumbersome, and a patchwork regulatory system that moves too slowly for the business world of the 21st century. The DB pension plan offers many positive features for individual employees, employers and the economy as a whole. But, without the needed legislative and regulatory change, the private sector DB plan is endangered, and the Ontario of the future will likely suffer from a huge gap between the relatively small number of "have" retirees with DB pensions and the much greater number of "have-nots" left largely on their own.

Despite the challenges, the gloomy scenario outlined above does not have to be. We are reminded of the Dickens tale, *A Christmas Carol*. A fortuitous vision allowed Scrooge to foresee the bleak future he faced -- in time for him to alter the course of his life. Time has run out for leading edge baby boomers who are now turning 60, but those born in the peak year – 1961 – are only in their mid-40s and the youngest boomers have just left their 30s. So, it is still possible for our retirement funding system to alter course and create an environment in which a thriving retirement pension system contributes to a strong Canadian economy. However, in order for this to occur, all parties involved must recognize the implications of the path we are now on and be willing to play a part in changing course. We applaud the Government of Ontario for establishing the OECP and believe that this provides Ontario with a unique opportunity to take the lead in making some of the fundamental improvements to the retirement system that are needed.

Summary of Recommendations

Objectives of changes to DB system

1. Clarification of the pension promise to ensure common understanding
2. Increasing DB coverage

Key recommendations

3. Streamline the regulatory process, with a mandate to promote an increase in pension coverage
4. Enhance the security of benefits, thereby ensuring that in most cases benefit promise will be honoured
5. Ensure that pension legislation facilitates the alignment of plan funding with the pension promise

The human dimension

6. The regulatory environment and plan designs should accommodate phased retirement
7. Sponsors should consider removing early retirement subsidies from their plans

The economic dimension

8. Provide enough DB funding flexibility for sponsors to feel less need to increase and extend fixed-income weightings
9. Ensure that any changes to the funding rules work in both a low yield and high yield environment

Streamlining the regulatory process

10. The PBA and regulations should be fundamentally updated with a focus on clarifying the rules in a few key areas, so that there is less need to revert to interim policies and the courts
11. The Government should elaborate on the objectives of the key aspects of pension legislation in order to assist plan sponsors, regulators and the courts when interpreting the PBA and regulations
12. The Province should commit itself to scheduled reviews of the PBA and its regulations, ideally every five years

Summary of Recommendations

13. The PBA should be amended to state explicitly that the core principles (Guiding Principles) of pension legislation are increasing pension coverage and ensuring that the benefit promise is clear and will be honoured
14. The PBA should state that the regulator, FST, and the courts must consider the Guiding Principles when interpreting and applying the statute and its regulations
15. Administrative guidance should be provided via an advance rulings service that provides binding opinions on administrative questions and proposed transactions
16. Grow-in to the expected value of early retirement subsidies should be provided for all terminations
17. The PBA should clarify that once benefits are annuitized, the plan and sponsor have been released of the liability with respect to the benefits purchased
18. The Province should create an expert pension plan tribunal dedicated solely to adjudicating pension disputes, with a privative clause
19. All Canadian jurisdictions should continue working towards an arrangement where a common law is adopted, and with each jurisdiction enacting legislation that specifies the areas where it chooses to deviate from the common law

Enhancing the security of benefits

20. The funding limits in the federal Income Tax Act and regulations should be increased to roughly 125% of the greater of the going concern liabilities and windup liabilities
21. The statutory focus of minimum funding should be benefit security now and in the future. This implies:
 - A forward-looking view
 - Investment policy should be reflected in determining the minimum funding requirement so that asset-liability mismatch risk is considered
 - The minimum funding requirement should not be dependent on the sponsor's financial strength
 - Regulatory powers to address funding concerns, such as accelerating the timing of the next actuarial valuation, should be limited and clearly detailed in legislation so that a sponsor knows what to expect
22. Legislation should permit the following approaches and vehicles for securing registered pensions:
 - Additional contributions to the pension fund
 - Letter of Credit (LoC)
 - Contingency reserve account

Summary of Recommendations

Alignment of plan funding with the pension promise

23. The “pension deal” should be clarified and communicated
24. Surplus, beyond a cushion, should be available to the party or parties that take on the plan’s financing risk

Other Recommendations

25. Partial windups should be eliminated
26. If partial windups are not eliminated:
 - Eliminate the requirement to distribute surplus
 - Eliminate the requirement to purchase annuities
 - Improve clarity with respect to the circumstances under which a partial windup will be ordered
27. Clear rules regarding the requirements for plan mergers, transfers and splits must be documented in order to create more certainty for plan sponsors and regulators
28. Plan mergers, transfers and splits rules should not be overly complex and cumbersome, so that the administration of these transactions can be streamlined
29. The choice of whether, when and how to index pensions should be left to the sponsor/union – or even the individual member
30. Plan sponsors, pension authorities and others should provide the public with useful educational materials about the risks of inflation as they relate to retirement planning
31. Ontario’s PBGF should be abandoned in conjunction with the implementation of better-structured funding rules
32. If the PBGF is not abandoned, the assessment mechanism should be restructured so that insurance principles are used and transparency with respect to governance should increase
33. Plan designs that should be accommodated and/or encouraged include:
 - New multi-employer pension plan
 - Target benefit plan