Pension Investment
Association of Canada
Association canadienne des
gestionnaires de caisses de retraite

Pension Investment Association of Canada Response to Nova Scotia Pension Review Panel: Discussion Paper

Pension Review Panel
c/o Nova Scotia Labour and Workforce Development
Policy Division
PO Box 697, Halifax, NS, B3J 2T8
e-mail: lwdpolicy@gov.ns.ca

July 4 2008

39 River Street, Toronto, Ontario M5A 3P1
Tel 1-416-640-0264
Fax1-416-646-9460
info@piacweb.org
www.piacweb.org

Executive Summary

The Pension Investment Association of Canada (PIAC) is pleased to have the opportunity to contribute to the review of pension legislation in Nova Scotia. PIAC has played an active role in the recent provincial pension reviews by Quebec, Ontario, and B.C./Alberta.

PIAC has been the national voice for Canadian pension funds since 1977. Senior investment professionals employed by PIAC's member funds are responsible for the oversight and management of over $940 billion in assets on behalf of millions of Canadians. PIAC's mission is to promote sound investment practices and good governance for the benefit of pension plan sponsors and beneficiaries.

PIAC applauds the initiative of the Nova Scotia government in establishing a Review Panel to comprehensively review pension legislation in Nova Scotia. The management of pension plans has fundamentally changed in the two decades since the last major review of pension standards. Capital markets have changed dramatically with the introduction of more sophisticated investment tools such as derivatives and hedge funds, the increased pace and use of technology/electronic trading, and the impact of globalization and increased economic competition. The pension system today is facing enormous challenges arising from an aging population, low interest rates, market volatility, rising stakeholder expectations, regulatory burdens and the evolution of case law.

The Commission has observed that the number of defined benefit plans has declined in Nova Scotia. This decline is consistent with trends observed in other provinces across Canada. PIAC believes that, in general, defined benefit ("DB") pension plans deliver the most cost-effective pensions to retirees. DB pension plans pool both longevity and investment risk and address inflation risk if indexed. Yet, DB pension plans are becoming less and less a feature of the private-sector pension system. Overall coverage of paid workers in Canada by registered pension plans declined from 46.2% in 1977 to 39.3% in 2003. The decline in DB pension plans was more pronounced, with the percentage of plan members in a DB pension plan declining from 92.7% to 81.5% over the same period while for private-sector workers alone the decline was even greater, from 90.6% to 74.2%[1]

PIAC believes that the fundamental reason the number of DB pension plans are declining is due to funding and regulatory challenges. Plan sponsors are experiencing increasing financial pressures from the volatility of pension expense due to ever changing equity market levels and interest rates, and changes in accounting standards. Recent court decisions regarding partial windups, expenses, asset transfers and surplus (Stelco, Kerry, Transamerica and Monsanto) have created an uncertain and negative legal environment for plan sponsors. The pivotal Supreme Court ruling in the Monsanto case exacerbated the asymmetrical sharing of pension risk between employer and

[1] B. Baldwin, "Determinants of the Evolution of Workplace Pension Plans in Canada", March 2007.

employee groups. Adding to this burden are the onerous requirements for funding solvency deficits. Plans operating in multiple jurisdictions must also contend with the labyrinth of pension law and regulators across the country. This makes plan administration more difficult and costly. Finally, employees, especially younger ones, are not always aware of the benefits and risks of their pension plans. All of the above mentioned points encourage plan sponsors to freeze or terminate their existing DB pension plans, and do not encourage plan sponsors to create new defined benefit plans.

On October 17, 2007, the Pension Investment Association of Canada ("PIAC") presented a submission to the Ontario Expert Commission on Pensions (the "Commission"). The Commission was interested in knowing whether plan sponsors have or will be taking steps to decrease benefits or close Defined Benefit (DB) plans. There was also some discussion about the extent to which plans are trying to "de-risk" their investments.

To aid the Commission in its work, PIAC decided to conduct further research on these issues. In November 2007, PIAC surveyed its membership, which consists of 140 plan sponsors across Canada. The survey results are shown in Appendix 1. The clear trend among PIAC plan sponsors is towards closure or conversion of DB pension plans.

While the situation may appear dire to some, solutions are at hand. Governments have the ability to alter the policy underpinnings of the pension system and thereby alleviate some of the funding and regulatory challenges that most plan sponsors and administrators are facing. In this submission, PIAC proposes that the Province of Nova Scotia:

1. Exempt all public sector plans from solvency funding requirements due to their low probability of default, as already exists in Quebec, Alberta, and B.C., and is being reviewed in Ontario.

2. Take steps to ease solvency requirements and to address risk asymmetry in the rules regarding surplus entitlement by:

    (a) providing non-public sector plan sponsors the flexibility to use Letters of Credit, which exists in Alberta,

    (b) permitting corporate plan sponsors to establish special purpose accounts ("solvency accounts") that are independent from the main pension trust; and

    (c) researching the feasibility of allowing non-public sector pension plans to have reduced solvency funding requirements based on the credit worthiness of the plan sponsor

3. Facilitate the opportunity for plan sponsors to enhance the funded position of the plans when plan sponsors are able to do so by:

    (a) encouraging the Federal Government to amend the *Income Tax Act* to allow plan sponsors to make contributions beyond the current 110% limit; and

    (b) allowing plan sponsors to earmark contingency reserves to fund pension plans, where plan sponsors would have the clear entitlement to reclaim funds not required to fund pension benefits.

4. Hold pension investments to the standard of a prudent person and eliminate all quantitative limits on investing.

5. Eliminate the concept of partial wind-up as it exists in Alberta.

6. Eliminate the concept of grow-in rights as exists in every other province except Ontario and Nova Scotia.

7. Harmonize pension law across Canada and establish one regulatory system for pensions with one set of rules. Due to limited resources in Nova Scotia and the fact that the majority of plan members in Nova Scotia are regulated by pension jurisdiction outside of Nova Scotia, we recommend that Nova Scotia seriously consider adopting the B.C./Alberta pension regulations, or those of another appropriate jurisdiction. This will be applauded as a significant step towards pension harmonization.

It is time for the Nova Scotia government to amend the *Pension Benefits Act*. Defined benefit plans have not declined as much in Canada as in other nations such as the U.S., U.K. and Australia. Before the trend accelerates, the policy approach to funding rules and other regulatory issues needs to change significantly. The changes that PIAC is recommending will create a more conducive environment for creation and maintenance of DB pension plans. The Commission and the Nova Scotia government have an opportunity to demonstrate leadership in this area.

Response to Questions Posed by the Nova Scotia Pension Review Panel

Note: PIAC chose not to answer all questions

3. *Should pension legislation and regulation have goals other than those listed?*

In addition to the list provided by the Panel, the Province should address whether they wish to:

- extend coverage of pension plans to those who do not currently have pension plans;
- encourage the maintenance of existing defined benefit plans in Nova Scotia;
- assist plan sponsors in maintaining the affordability of defined benefit plans for single-employer-sponsored pension plans and jointly-sponsored pension plans; and
- balance the rights and obligations of stakeholders, including employers, current and future plan members and pensioners.

#1, 2, 4, and 5 in the Panel's list of goals on Page 8 could be simplified in an overall objective to safeguard the security of pension benefits.

If increased coverage of retirement savings is a goal for the Government of Nova Scotia, significant changes will need to be made to provincial and federal pension and tax regulations to provide more equitable retirement arrangements for all Canadians irregardless of the type of vehicle used to save for retirement. We refer you to the CD Howe's list of published and soon to be published papers recommending changes to Canada's pension and retirement savings legislation. The CD Howe is an independent Canadian non-partisan think tank.

3.1 *Are there plan designs not in use that would provide the benefits of DB plans while minimizing risk?*

We are not aware of plan designs not in use that would minimize risk. Immunizing liabilities can minimize risk, but not eliminate it since liabilities are estimated by actuaries. Immunizing pension plan liabilities in today's interest rate environment would significantly increase the contributions required by employers and employees. These contribution levels would be above levels that are tolerable. Risk taking is an integral part of DB pension plans. Who owns the risk and how it is shared needs to be transparent.

4.1 *Should the current trend towards less DB plans be accepted, or should regulators permit DB plans that may be more attractive to employers by reducing funding risks?*

We believe that low-cost pension plans should be encouraged. The advantages of DB pension plans include the minimization of investment and longevity risks through the pooling of risks, and the minimization of inflation risk, if indexed. However, we recommend that public sector plans be exempt from the contribution volatility associated with funding solvency deficits due to their extremely low probability of default. We also recommend that corporate DB pension plans be allowed to use Letters of Credit and "solvency accounts" mentioned on Page 2.

In the case of DC plans, to what extent should an employee's right to make investment choices be limited, and by whom?

If plan sponsors have the responsibility to select and monitor investments, the number and type of investment options offered must be compatible with the plan sponsor's ability to select and monitor investments. If pension regulators would like to offer unlimited investment choice to plan members, this can be easily accomplished. However, the responsibility for selecting and monitoring investment options would need to be transferred to plan members.

We don't believe that the number and types of investment options should be regulated. We refer you to the CO-OPERATIVE SUPERANNUATION SOCIETY Plan in Saskatoon. It offers two investment choices: a balanced fund and a cash fund used to crystallize values if a plan member does not elect to take an annuity from the plan. It is run in a not-for-profit manner, has extremely low operating costs (0.15%), and is able to pay on-going pensions from its asset base, rather than buying market based annuities. Plan members value the plan and the pension deal is easily understood by plan members. The plan does not have to deal with excessive agency costs or complex regulation.

Should new forms of DB pension plans be permitted to enhance their availability?

Yes. Pension plans are voluntary benefit plans unless negotiated with unions. Employers, in conjunction with unions where applicable, should determine the type of plan that best suits their competitive situation and employee needs.

Should new forms of Hybrid pension plans be permitted to enhance their availability?

Yes.

Should DC members have the ability to use different disbursement options, such as LIF type payments, rather than be required to convert funds on their retirement date?

Yes.

4.2. *Are current rules for measuring and remediation of going concern and solvency deficits appropriate?*

No. Public plans should be exempt from funding solvency deficits due to the extremely low default probability of these plans.

Should there be exceptions to the funding rules for universities, multi-employer pension plans and municipalities, or anybody else?

Yes. Exceptions should be made for public sector plans such as municipalities, universities, and public sector plans that have multiple participating employers.

Should going-concern funding still be a requirement?

Yes. A 15-year amortization is an appropriate time horizon for managing the funded status of a pension plan.

Should there be a requirement for full funding at wind-up?

In the case of a single-employer sponsored non-contributory pension plan, there should be a requirement for full funding at wind-up. In the case of a jointly trusteed plan, there should not be a requirement for full funding at wind-up because a portion of the funding, e.g. 50%, would have to be collected from members. If a participating employer voluntarily withdraws from a plan that has multiple participating employers, there should be a requirement for the withdrawing participating employer to fund any deficit attributed to that participating employer.

Is the idea of a province wide pension plan for some public and private employers a good idea? Should such a plan operate as a multi-employer pension plan?

Yes. Some smaller plans that lack resources may wish to take advantage of the benefits of pooling their assets with a larger plan that has a strong governance structure in place. However, this should be voluntary since the establishment of pension plans is voluntary. Key factors that plan sponsors will assess before agreeing to join forces with another pension plan are value for money, the ability of plan administrator to demonstrate strong governance, and transparency of critical information. Plan sponsors may decide to pool investments, or operate as a multi-employer plan or a plan that has multiple participating employers if they are willing to harmonize plan design.

4.3 *Should regulators speak to the question of the ownership of plan surpluses? If yes, what should they say?*

No. Surplus ownership should be decided by the employer in the case of a single-employer defined benefit pension plan, or by the employer(s) and unions/non-union employee associations in the case of a jointly-trusteed pension plan and /or multi-employer plan. This should be clarified in the Plan Text. If the Plan Text is silent on this

matter, the cost-sharing arrangement for contribution rates should determine how surpluses/deficits are shared.

Is the concept of deferred wages valid? And if so, is there any current validity to it with respect to the determination of the responsibility for funding and for entitlement of surplus?

The concept of deferred wages is valid. However, deferred wages implies an employment contract as opposed to a trust contract. The employment contract provides for a defined benefit based on a formula, not necessarily the entitlement to surplus. Plan Texts should expressly address the rules of the pension deal including whether funding, surplus entitlement, and funding of deficits is shared.

4.4 *Should regulators facilitate the further development of hybrid plans? Would the Quebec model be an attractive option for Nova Scotia employers?*

Regulators should regulate clear pension rules passed by policy makers that meet public policy objectives. As such, Government should encourage the use of a variety of different pension arrangements so that plan sponsors may choose an option that best suits the needs of their employer and employees. The Quebec model should be included as an option for consideration. The legislation should be broad enough to include different models not yet contemplated by the Government.

4.5 *Should government attempt to define, audit, and regulate "good governance"? Why or why not? If so, what types of governance issues should be regulated?*

No. The government should provide guidance to plan administrators in terms of high level governance principles, similar to CAPSA's Pension Plan Governance Guidelines. Governance best practices are always evolving and regulating good governance is therefore inappropriate.

4.7 *Does the current regulatory system work effectively? Are there currently unnecessary rules and regulations in place? If so, what are they? Should the appeal process be changed? If so, how?*

The current regulatory system could be made to operate much more effectively. Pension legislation requires clarity in many areas, such as, the recognition of jointly-funded plans (refer to Alberta and Ontario pension law), definition of a partial wind-up, employer responsibility on wind-up, etc.

Appealing to the Superintendent of Pensions via reconsideration hearings is redundant since plan administrators are appealing to the person who declined the request in the first place. This is an unnecessary waste of time, resources, and money. We recommend that the Government establish an Expert Pension Ombudsman or Expert Pension Tribunal to hear disputes prior to going to a lengthy and costly court process, where some judges may not have the necessary pension expertise.

Regulatory changes seem to happen very rapidly and with little public notice or input. Stakeholders appreciate the ability to provide input into proposed legislation/regulation. Plan sponsors in Nova Scotia need to be able to provide pensions with confidence that rules of the game won't dramatically change.

Should a plan have a minimum number of members before the government will regulate it? If so, what minimum number of members would be appropriate?

All pension plans should be regulated regardless of the number of members, with the exception of plans that only cover persons connected with the employer within the meaning of the Income Tax Act.

4.10 *Should the legislation require grow-in benefits to be provided on plan wind-up?*

No. Vesting rules protect accrued benefits. Grow-in rules do not make sense since they provide benefits to certain members who have not accrued these benefits, at the expense of other plan members.

5.1 *Should "safe harbour" rules be established that would give DC plan sponsors and administrators protection from litigation?*

Yes. Provide a safe harbour to those plan sponsors and administrators that adhere to the CAP Guidelines.

5.2 *What other issues are raised by phased retirement and what should be the regulatory position of Nova Scotia?*

We recommend that Nova Scotia allow employers and plan members to adopt phased retirement on a voluntary basis.

5.3 *What should be the regulatory position of Nova Scotia be with respect to TFSAs for pension purposes?*

TSFAs are not a pension structure. They can be used to save after-tax dollars for a variety of purposes, including retirement, education, vacations, etc. We recommend that Nova Scotia not include TSFAs in pension legislation. TSFAs should be treated like a non-RRSP savings account.

APPENDIX 1

Pension Plan Funding Challenges: 2007 PIAC Survey

December, 2007

Introduction

On October 17, 2007, the Pension Investment Association of Canada ("PIAC") presented a submission to the Ontario Expert Commission on Pensions (the "Commission"). The Commission was interested in knowing which plan sponsors have or will be taking steps to decrease benefits or close Defined Benefit (DB) plans. There was also some discussion about the extent to which plans are trying to "de-risk" their investments.

To aid the Commission in its work, PIAC decided to conduct further research on these issues. In November 2007, PIAC surveyed its membership, which consists of 140 plan sponsors across Canada. The survey instrument is attached. The total assets of PIAC's member plans as of December 31, 2006 were $910 billion. PIAC plan sponsors represent an estimated 80% of Canada's pension industry (excluding RRSPs), by asset size. Results are being reported for Ontario as well as Canada, in order to aid the Commission in its work.

Findings

Response Rate

79 plan sponsors responded to the survey. This represents 60% of PIAC's membership, by number. Asset size of respondents ranged from less than $500 million (11.4%) to more than $5 billion (22.8%). Of the 79 plan sponsors, 45.6% were in the public or not-for-profit sector and 54.4% were in the private sector. The majority of plan sponsors (88.6%) provide DB plans, 32.9% provide Defined Contribution (DC) plans, 15.2% provide group RRSPs and 13.9% provide Hybrid plans. (Note: some plan sponsors provide more than one type of plan to employees.)

In Ontario, 39 plans responded, representing virtually all of PIAC's membership in Ontario. Of these, 35.9% were in the public or not-for-profit sector, and 64.1% were in the private sector. The majority of plan sponsors in Ontario (87.2%) provide DB plans, 41.0% provide DC plans, 20.5% provide group RRSPs and 20.5% provide Hybrid plans. (Note: some plan sponsors provide more than one type of plan to employees.)

Plan Closure and Benefit Changes

A significant portion of plan sponsors have already closed or converted their DB plans or are in the process of doing so. The trend towards closure or conversion is stronger in

Ontario than in the rest of Canada (See Table 1). (Note numbers add to greater than 100% as some plan sponsors are considering more than one option.)

Table 1: DB Plan Closure/Changes, Canada and Ontario

Have you in the past, or are you now in the process of, seriously considering one or more of the following:	Canada	Ontario
Closing your DB plan	17.8%	30.6%
Moving from your DB plan to a defined contribution plan	24.7%	33.3%
Moving to a hybrid DB/DC plan	4.1%	8.3%
Moving to a Group RRSP	2.7%	2.8%
Reducing future benefit accruals (e.g. elimination of early retirement benefits, making indexation conditional on funding)	20.5%	19.4%
Considering some other form of DB plan closure/wind up without a successor pension plan	2.7%	5.6%
No change is being considered	53.4%	44.4%

Of the Ontario respondents, 50% of private sector plan sponsors are considering closing their defined benefit plans, and 0% of public sector plan sponsors are. Only 27.3% of private sector plan sponsors are not considering any change to their DB plan. In the Ontario public sector, 66.7% of plan sponsors are not considering any change, while 13.3% are considering moving to a DC plan and 33.3% are considering reductions in future benefits. (See Table 2)

Table 2: DB Plan Closure/Changes, Ontario, Private Sector vs. Public Sector

Have you in the past, or are you now in the process of, seriously considering one or more of the following:	Private	Public
Closing your DB plan	50.00%	0.00%
Moving from your DB plan to a defined contribution plan	50.00%	13.30%
Moving to a hybrid DB/DC plan	13.60%	6.70%
Moving to a Group RRSP	4.50%	0.00%
Reducing future benefit accruals (e.g. elimination of early retirement benefits, making indexation conditional on funding)	13.60%	33.30%
Considering some other form of DB plan closure/wind up without a successor pension plan	9.10%	0.00%
No change is being considered	27.30%	66.70%

Of those who are seriously considering changes, 52.9% of Canadian plan sponsors and 65.0% of Ontario plan sponsors have already made the decision, while the remainder see it being made in the next one to three years. (See Table 3)

Table 3: Timing of Decision to Close/Change DB Plan, Canada and Ontario

	Canada	Ontario
Have you already made this decision (even if you still are in the "notice to employees" period),	52.9%	65.0%
Do you see this decision being made in the next year,	11.8%	15.0%
Do you see this decision being made in the next 2 years, or	17.6%	5.0%
Do you see this decision being made more than 3 years from now?	17.6%	15.0%

Investment Strategy

Plan sponsors are divided on the question of whether to adopt an investment strategy which would de-risk investments to the maximum extent possible (e.g. using bonds or other assets to match better the characteristics of liabilities). In Canada, 73.2% of plan sponsors have discussed the issue, and 54.9% of these would seriously consider implementing such a strategy. For these plans, slightly more than half (54.8%) would do so whether or not they had a surplus or are fully-funded. In Ontario, 62.9% of plan sponsors have discussed the issue, and 72.7% of these would seriously consider implementing such a strategy. For these plans, exactly half would do so whether or not they had a surplus or are fully-funded.

Plan sponsors who are seriously considering implementing a de-risking strategy differ on the amount by which they would increase their bond exposure, but the majority (85.1% of Canadian and 80% of Ontario plans) would not go beyond 60% bonds in their asset allocation. (See Table 4)

Table 4: Proposed Bond exposure, Canada, Ontario

	Canada	Ontario
less than or equal to 40%	25.9%	13.3%
41-50%	25.9%	20.0%
51-60%,	33.3%	46.7%
61-70%	0.0%	0.0%
71-80%	7.4%	6.7%
81-90%	3.7%	6.7%
91-100%	3.7%	6.7%

Real estate and infrastructure were most commonly mentioned as assets that were being used to minimize risk and stabilize returns over the long-term (15 out of 27 respondents across Canada). Other assets being used to minimize risk include: interest rate overlays/swaps, delayed settlement bonds, repos, private debt, hedge funds, real return bonds, high dividend yield equities and income trusts.

85.7% of Canadian and 80.0% of Ontario plan sponsors who are considering a de-risking strategy have assessed the funding implications of de-risking, with varying estimates on the extent to which funding will increase. Most of the plan sponsors who are able to assess the increase in funding costs estimate the increase to be less than 10%. (See Table 5)

Table 5: Estimated increase in funding costs due to de-risking, Canada and Ontario

	Canada	Ontario
0-10%	46.2%	53.8%
11-25%	7.7%	0.0%
26-50%	7.7%	0.0%
51-75%	0.0%	0.0%
over 76%	7.7%	0.0%
don't know	30.8%	46.2%

35.7% of Canadian plans and 40% of Ontario plan sponsors have already made the decision to de-risk investments. (See Table 6)

Table 6: Timing of Decision to De-risk Investments, Canada and Ontario

	Canada	Ontario
You have already made this decision, (even if you are still in the process of implementing the strategy)	35.7%	40.0%
This will happen in the next year	17.9%	13.3%
This will happen in the next 2 years	39.3%	40.0%
This will happen more than 3 years from now	7.1%	6.7%

Conclusion

The clear trend among PIAC plan sponsors is towards closure or conversion of DB pension plans. The trend is stronger in Ontario than in Canada. Note that there may be a selection bias in the results for Canada, as not all of PIAC's Canadian members responded. Most of the plan sponsors who are considering this direction have already made the decision, and a significant portion of the remaining DB plan sponsors anticipate making the decision to close or convert in the next one to three years. De-risking investments is also being discussed broadly within the industry, with a variety of asset mixes and asset classes being considered. While a large majority of plan sponsors have assessed the funding implications of de-risking, a significant portion of them do not know what the funding implications are. It is difficult to estimate future funding costs when so many uncertainties exist, such as interest rates and market conditions. Changes to investment strategy have not been implemented to as great an extent as have those regarding plan design; however, the majority of plan sponsors who are considering de-risking think that it will unfold over the next one to two years.