ACPM Brief to the Expert Committee on the Future of Pensions in Québec

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ACPM/ACARR

The Association of Canadian Pension Management

ACPM CONTACT INFORMATION

Mr. Bryan Hocking
Chief Executive Officer

Association of Canadian Pension Management
1255 Bay Street, Suite 304
Toronto ON M5R 2A9
Tel: 416-964-1260 ext. 225
Fax: 416-964-0567
Email: bryan.hocking@acpm.com
Web: www.acpm-acarr.com

TABLE OF CONTENTS

Foreword 3

- **Association of Canadian Pension Management** 3
- **Introductory Comments** 3

Reinvigorating Defined Benefit Plans 4

Concern for Defined Benefit Plan Arrangements 5

Solvency and Attractiveness of Defined Benefit Programs 5

- **Letters of Credit** 5
- **Solvency Accounts** 6

Reducing the Impact of Prescribed Transfer Values 7

Improved Benefit Security 7

Settlement of Pensions upon Plan Windup 8

Target Benefit Plans 9

Multi-Employer Plans 9

FOREWORD

The Association of Canadian Pension Management (ACPM)

The Association of Canadian Pension Management (ACPM) is the informed voice of Canadian pension plan sponsors, administrators and their allied service providers. Established in 1976, the ACPM advocates for an effective and sustainable Canadian retirement income system through a non-profit organization supported by a growing membership and a team of volunteer experts. Our members are drawn from all aspects of the industry from one side of this country to the other. We represent over 400 pension plans consisting of more than 3 million plan members, with total assets under management in excess of $330 billion.

The ACPM promotes its vision for the development of a world leading retirement income system in Canada by championing the following Guiding Principles:

- Clarity in legislation, regulations and retirement income arrangements;
- Balanced consideration of other stakeholders' interests; and
- Excellence in governance and administration

The ACPM regularly advocates and participates in public dialogue on pension issues.

Introductory Comments

This brief is submitted on behalf of the Association of Canadian Pension Management (ACPM) and in conjunction with ACPM's Québec Regional Council.

The ACPM commends the Government of Québec on the establishment of the Expert Committee on the Future of Pensions in Québec and welcomes the opportunity to make this submission to the Committee.

REINVIGORATING DEFINED BENEFIT PLANS

On behalf of the Association of Canadian Pension Management (ACPM), we would like to express our gratitude to the members of the Expert Committee on the Future of Pensions in Québec for granting us the opportunity to meet with them on February 10, 2012 and allowing us to submit the formal presentation which follows.

ACPM has long argued that the underlying principles of pension legislation should be clear and flexible enough to allow plan sponsors to deliver the pension promise to plan members in an efficient and cost effective manner, and to accommodate future changes in plan demographics.

In this regard, the general workforce is increasingly coming to rely more on social programs for their retirement needs. Observers see this trend away from workplace retirement income support escalating. Government should recognize the long run advantage to supporting the role of the occupational pension plan pillar since that will result in less future reliance on the social program safety nets.

Our Five-Point Plan recognizes that for workplace pension arrangements to be a vital part of improving the adequacy of retirement incomes for current and future Canadian workers, not only must new vehicles be introduced but the decline in the use of defined benefit arrangements should, and can, be reversed.

ACPM welcomes this opportunity to provide our comments on the issues that must be dealt with in order to achieve the shared objective of ensuring defined benefit plans do their part to create additional retirement security for Canadians.

Concern for Defined Benefit Plan Arrangements

The current environment for DB pension plans in Canada is not encouraging. DB pension plans have been, and still are, a positive force both in the Canadian economy and in Canada's social fabric. DB pension plans are one of the best ways to efficiently provide a predictable retirement income to employees. As a result, members can look forward to the future with a greater level of confidence.

At the same time, the Canadian economy benefits by having huge pools of capital productively invested by professionals in a more efficient manner than would be the case with equivalent amounts made up of individual accounts. Retirement plans (DB and DC) are one of Canada's economic engines. If DB pension plans continue to decline as they have elsewhere, many Canadians may pay a price in view of the burden of investment and longevity risks being transferred to them from their employers. The ACPM believes the DB pension plan system needs urgent attention.

The decline in long term interest rates to 50-year lows, stock market decline, changes in accounting rules, and some high-profile insolvencies have caused many in the pension industry, in Canada and elsewhere, to reflect on the adequacy of current funding rules and methodologies for DB plans.

In early reports, ACPM identified and articulated key DB Plan funding issues that need to be addressed to make the system better:

- All parties should be treated fairly according to the risks they face;
- Sponsors should have the appropriate tools and flexibility to manage pension plan contributions;
- Fiduciaries/administrators should have the appropriate tools and flexibility to manage the pension plan risks;
- There should be transparency for stakeholders; and
- There should be high probability of benefit security.

Ensuring the vigour of DB plans means finding a balance between the interests of plan sponsors and plan beneficiaries.

Solvency and the Attractiveness of Defined Benefit Programs

A large part of the risk/reward imbalance in the current DB funding model arises from solvency valuations. Solvency valuations have created significant contribution requirements for plan sponsors and led to unnecessary over-funding for the majority of plans.

Governments have recognized the particularly onerous implications posed by existing solvency requirements in current economic and market conditions. Many have implemented temporary measures to ease the burden. These measures should be extended in light of continuing economic challenges. But the solvency issue needs more; there need to be permanent changes to reflect the ongoing implications for the attractiveness of DB plans.

ACPM believes that the risk/reward asymmetry that currently exists, whereby plan sponsors are generally responsible for funding shortfalls but are severely constrained from accessing surpluses, is a major impediment to not only the secure funding of private sector DB pension plans but to their continued existence. Consequently, it is imperative that governments introduce some meaningful, permanent solutions to deal with the risk/reward asymmetry. We support legislative changes that recognize that stakeholders who are exposed to downside risk should quite reasonably be entitled to the upside benefits of taking such risk.

A large part of the risk/reward imbalance in the current DB funding model arises from solvency valuations. Solvency valuations have created significant contribution requirements for plan sponsors and led to funding levels that may well turn out to be excessive for the majority of plans if bond yields reverse their recent downward trend. Such a reversal could create a liquidity trap that may impede severely the ability of some sponsors to reinvest in their business and thus create economic growth.

Two practical methods address this issue directly while striking a balance between the interests of sponsors and beneficiaries:

1. Letters of credit (LOCs), and
2. Special purpose "solvency accounts", independent from the pension fund.

1. Letters of Credit

The ACPM considers Letters of Credit to be a useful tool to help some plan sponsors face the responsibility for solvency contributions while protecting plan members and we are pleased that Québec has been a pioneer in this important area.

LOCs are a flexible option for plan sponsors to deal with the volatility of solvency valuation results. They are also an effective way to secure plan benefits and possibly avoid the growth of excessive surplus in the future. The main drawbacks of LOCs are that they are not available to all plan sponsors for a variety of reasons: corporate structure, lack of credit availability, etc., and they are a direct, and not always insignificant, cost to the employer.

The LOC requires that the sponsor pay a fee to the bank, but the sponsor has the flexibility to decide whether he prefers to pay that fee rather than contributing in cash, which allows him to use that cash for other business purposes. The plan members are protected by the bank so the LOC is as secure as the bank itself.

When Québec legislation was amended to allow the use of the LOC a few years ago, this was seen as an innovative approach that might not be satisfactory to all parties, so it appears that the 15% limit was created to address the concerns of those who were not comfortable with this approach.

We believe that, since the implementation of that new rule, most observers have become more familiar with how the LOC works and now understand that the LOC is safe for plan members. The LOC innovation was also introduced at a time when many pension plans had solvency ratios between 85% and 90%, while very few pension plans had solvency ratios in the 65%-85% range. However it is this latter range in which most pension plans have their solvency ratio today. For those two reasons, the ACPM would recommend that the LOC rules be modified in order to remove the overall 15% limit applicable to solvency amortization payments. Because an LOC is not permissible for going concern contributions (i.e. normal cost plus going concern amortization payments) and LOCs are not included for the determination of the plan's going concern financial position, we note that a significant portion of the plan liabilities would still be secured by the pension fund even with the elimination of the 15% rule for the LOC.

Such a change in the current rules would be useful in providing plan sponsors with more flexibility to manage the solvency cost.

However since the LOC is only as secure as the bank backing it and since the financial stability of financial institutions may evolve over time, it may be useful to apply a limit to any LOC that is backed by a given financial institution (e.g. 15% of the plan's solvency liability).

For example, we envisage that a plan sponsor could use LOCs of up to 15% with two separate financial institutions, which could cover 30% of the plan's solvency liabilities – recognizing in today's market it is not rare to see plans that have assets representing less than 70% of solvency liabilities.

2. ***Solvency Accounts***

We propose that sponsors also have the ability to set up a solvency account, independent from the pension trust. This concept also addresses some of the drawbacks of LOCs. Going concern funding contributions continue to be paid to the main pension fund. Further employer contributions required under the solvency valuation could be paid to the solvency account.

Similar to the main pension fund, the solvency account would be segregated from the employer's assets, tax-sheltered, and protected from non-pension creditors. Upon full or partial plan windup, any assets in the solvency account not required to satisfy benefit entitlements would revert back to the employer. In an ongoing situation, assets in the solvency account could be accessed by the employer only if the sum of the assets in the pension fund and the solvency account exceed the plan's solvency valuation obligation.

Employers would be able to make additional contributions, on a voluntary basis, above the going concern minimums to the solvency account. The ability to make these additional contributions will provide employers with greater flexibility to manage their cash requirements within their own business cycles. Such additional contributions will lead to enhanced benefit security for plan members.

Consistent overfunding of a pension plan through the application of the solvency rules is an unproductive use of corporate capital. We believe the solvency account approach provides a compromise. Employers have access to funds in the solvency account under certain conditions and as a result have assurance that they will receive full value for their solvency funding contributions.
At the same time, these proposed changes that provide plan sponsors with additional contribution flexibility should also enhance the benefit security for plan members.

Reducing the Impact of Prescribed Transfer Values

Upon plan windup, the Québec Supplemental Pension Plans Act (SPPA) requires that the DB entitlements of non-retired members be settled through the payment of transfer values. The SPPA and its Regulations prescribe the actuarial basis to be used for the computation of these transfer values, i.e. the plan administrator must use the actuarial assumptions specified in the Standards of Practice for Pension Commuted Values published by the Canadian Institute of Actuaries.

Many stakeholders believe that this prescribed transfer value basis is overly conservative, thereby producing excessive windup liabilities for non-retired members. It also creates excessive solvency obligations for plans. This issue is even more problematic for plans providing CPI-based indexed pensions. For such indexed pensions, the prescribed liability discount rate is based on real-return Government of Canada bond yields that are abnormally low due to the high demand (and low supply) for these bonds. A low discount rate produces high transfer values.

We encourage the Québec government to amend its pension legislation in order to prescribe a less conservative and more appropriate basis for the computation of transfer values for both indexed and

non-indexed pensions. The use of high quality corporate bond yields is an example of what could be done.

Improving Benefit Certainty

Pensioners' financial security can also be improved within the context of DB plans without increasing the uncertainty for employers.

As many pension plans have now reached maturity (having a large proportion of the obligation relating to retired participants), one way to substantially reduce risk for both DB plan sponsors and pensioners is to purchase annuities from insurance companies.

However, it is not currently possible in Québec to fully transfer the financial risk from a DB plan sponsor to an insurer when annuities are purchased unless the DB plan is terminated (meaning that if the pensioner loses benefits as a result of a subsequent insolvency of the insurer, the DB plan sponsor remains responsible toward the pensioner). This is a major hurdle to annuity purchase. DB plan sponsors will not buy annuities from insurers unless there is a full transfer of responsibilities to the insurer.

We therefore recommend that measures be put in place to facilitate partial (or total) annuity purchases from insurers without having to terminate the DB plan and with full transfer of responsibilities to the insurer.

It should also be possible to create pension plans which include only pensioners and deferred pensioners. This would allow such plans to have appropriate, more conservative investment policies and funding policies (given their shorter investment horizon and lower risk tolerance), without increasing the expected cost of DB plans for active members. These plans could be maintained for a long period or for a transition towards an insurance buy-out. Measures should be put in place to allow for the creation (on a voluntary basis) of pension plans that include only pensioners and deferred pensioners and to facilitate the transfer of assets and liabilities from existing plans to these new plans.

The current large solvency deficits for Canadian pension plans are mainly due to the sharp decline of long-term (e.g. 30-year) government bond yields in Canada. Current 30-year Canada bonds yields (2.6%) are even lower than they were during the worst of the 2008 financial crisis (3.4%).These extremely low yields are in large part due to excess demand over the existing supply of bonds.

Buying by large global investors who currently perceive Canadian government bonds as a safe haven in the current economic environment along with demand from pension plans and insurance companies (who want to hedge their long-term interest rate risk) have pushed the price of high-quality bonds to record highs and, consequently, their yields to record lows. The better financial position of Canada versus other countries is creating larger pension deficits and reducing future income from pensions by making it more expensive for Canadians to save for retirement and buy annuities.

The aging Canadian population will require more and more access to high-quality long-term bonds and attractively priced annuities to secure their retirement. ACPM believes that the provincial and federal governments need to issue more long-term bonds to reduce the pricing pressure on high-quality bond yields and consequently reduce the cost of life annuities and the level of solvency deficits (this would also allow governments to lock-in extremely low borrowing rates for the long term).

Settlement of Pensions upon Plan Windup

Upon plan windup, the SPPA requires that the benefit entitlements of retired members and beneficiaries be settled through the purchase of annuities from an insurer. Due to various factors (e.g. reserve constraints applicable to insurance companies), the annuity purchase is considered by many to be an expensive settlement option. Furthermore, the Canadian annuity market is limited and cannot accommodate large and indexed plans. We encourage the Québec government to permit other settlement options, such as the payment of commuted values or an equivalent transfer to another plan, which could be administered by a government approved agency.

While an innovative idea for which details and potential pitfalls would have to be carefully considered, we note that temporary provisions of the Québec pension legislation currently allow the transfer of a terminated plan's assets relating to its retired members to the Régie des rentes where the plan sponsor is insolvent. Based on similar principles, we could envision a permanent change to the legislation to implement provisions with respect to the settlement of retiree liabilities through a scenario of delayed liquidation, which could be assumed upon plan windup irrespective of the solvency or insolvency of the plan and the plan sponsor:

Delayed liquidations may be helpful even if the plan administrator intended to pursue the insured annuity purchase option, to deal with capacity and pricing issues in this market particularly where the retiree liability amount is high (e.g. in excess of $100M). A further delay option, involving the transfer of assets to a separate plan or account might be considered as the plan could have the benefit of adopting an investment policy that manages risks by constructing a replicating portfolio of various fixed income investments, and could implement a gradual annuitization strategy that helps to capture favourable market opportunities rather than being forced to accept current annuity rates that may be priced unattractively. Depending on the maturity of the retiree group being transferred, using a rate reflecting to a small degree some higher yields that could be expected to be produced by equity investments might be considered, especially if the pensions are indexed. It would be expected that such an alternative may lead to a lower solvency obligation.

We recognize that many details will need to be fleshed out and that some pitfalls will need to be analyzed carefully. Moreover, we acknowledge that there are various opinions on the extent, if any, to which the parties (i.e. plan members and/or the government) would bear the risks during and at the end of the liquidation period. If such an alternative is of interest to the authorities, the ACPM would be pleased to provide assistance in analyzing pros and cons of various details.

Target Benefit Plans

While certain problems plaguing defined benefit plans can be addressed in pension standards legislation (e.g., solvency funding, benefit security, asymmetry, complexity of regulation), many others cannot. Factors such as accounting treatment, market volatility and interest rates are beyond the control of pension legislation and will continue to feed employer's concerns about uncertainty. Finding a way to bridge employers' need for certainty of costs with the preference of plan members for the certainty of benefits, will be required to ensure a vigorous market for workplace pension arrangements.

One potential solution to many is the concept of the "target benefit plan". Already widely in use in multi-employer plans, target benefit structures have the dual advantages of being defined contribution from the employer perspective but also providing a defined benefit to plan members.

ACPM supports expanding the use of target benefit plans into the single-employer plan context.

Multi-Employer Plan Issues

Related to the expansion of the Target Benefit Plan concept are two issues which currently exist under Québec pension legislation pertaining to multi-employer plans: (1) employer responsibility for deficits, and (2) the inability to reduce benefits.

The approach in Québec's legislation on these issues is inconsistent with most other jurisdictions in Canada. Further, it is incompatible with fundamental aspects of the "target benefit" plan concept which makes this concept impossible to implement in Québec, whether for existing multi-employer plans or for single-employer Target Benefit Plans as contemplated above.

In order to address the concerns with defined benefit plans and to make Target Benefit Plans (whether single or multi-employer) a viable alternative for employers, ACPM strongly believes that the true "target benefit" nature of such plans must be reflected in the legislation by eliminating employer responsibility for deficits and by providing the ability to reduce benefits where necessary and appropriate.