

September 15, 2005

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Dear Ms. Lafleur,

Thank you for this opportunity to participate in the Department of Finance consultation process to strengthen the legislative and regulatory framework for Defined Benefit Pension Plans registered under the Pension Benefits Standards Act, 1985 (PBSA).

Please accept this submission on behalf of the Pensions Task Force of FEI Canada. FEI Canada is a professional association representing over 1700 CFOs and other senior financial executives in Canada. The Pensions Task Force is a panel of experts representing the FEI Canada Issues and Policy Advisory Committee. It is with pleasure that we make this submission and look forward to our further involvement in the consultation process. These are the views of the Issues and Policy Advisory Committee and may not necessarily represent the views of the membership of FEI Canada at large.

As you know, defined benefit (DB) pension plans represent a very long undertaking encompassing thirty plus years while pension benefits are accruing for working members and hopefully an equal number of years while pensions are paid out to retired members. Any point in time estimate of the present value of such future benefits compared to the assets set aside to date to pay such future benefits is an estimate at best. It is an estimate that probably will not reflect the future payouts, as the assumptions upon which it is based will probably not become future fact. In addition the present value of such long-term payouts is subject to significant swings based on small changes in the interest or discount rate used. Any systematic regular funding of such long-term obligations that are subject to changes in interest rates must make allowance for significant swings in the present value resulting in large deficits or surpluses.

We believe that the current regulations that are intended to safeguard the security of the benefits of the plan members are now endangering those same benefits.

In our view, there are two major issues that are intertwined with one another. The first issue concerns the asymmetry of the ownership and size of deficits and surpluses. The second issue is the DB plan solvency calculation based on the hypothetical windup scenario prescribed by the pension regulations and the short period of funding of solvency deficits arising mostly from currently low long-term rates.

#### **DEFICIT SURPLUS OWNERSHIP ASYMMETRY:**

Current regulations make sponsors of defined benefit pension plans fully responsible to fund a point in time pension deficit however calculated. The plan sponsors own the deficits. Sponsors do not equally own any such plan surpluses. The sponsors right to withdraw these surpluses are for practical purposes prevented unless such right is explicitly provided for in the plan documents. The paper mentions that some plan members look on pensions as deferred compensation that periodic surpluses protect. This does not recognize that pensions were promised which carry less certainty than current compensation.

Periodic surpluses are probable and significant in a pension plan point in time estimates of financial position. In these circumstances the Income Tax Act prevents plan sponsors from continuing systematic funding if the surplus is over an arbitrary limit. The paper mentions that CRA would not want to defer taxes on pension funding if the surpluses were too great. This limitation prevents the sponsor from managing his obligation to provide future pensions.

Plan sponsors should own plan surpluses to the same extent that they own plan deficits unless they have contracted something different in the pension documentation. The essence of a DB plan is the sponsor's promise to pay a future benefit to the member. The present value of that promise may result in a plan surplus or deficit. Today plan sponsors own the deficits but not the surpluses. By regulation and court decision plan surpluses are being carved up among past and current plan members. If the surplus is beyond a certain amount, the CRA disallows the deduction of funding amounts.

We urge the Government of Canada to begin immediately the process to encase in the PBSA that plan sponsors own equally the DB plan surpluses and deficits and in the Income Tax Act to permit DB plan sponsors to deduct from taxable income DB funding payments when surpluses are in excess of the current CRA limit.

#### **FUNDING OF A SOLVENCY DEFICIT:**

The current solvency rules designed to protect the security of benefits of some plan members are flawed and the funding requirement unduly onerous on plan sponsors. The current low solvency interest rates create additional liabilities that will disappear when rates move higher. In the meantime the requirement to fund fully over a short period of five years the currently determined higher liabilities will lead to surpluses when rates move higher in the future.

The current low level of interest rates used in determining the actuarial liabilities for solvency purposes has led and is leading to significant DB plan deficits that under current rules plan sponsors must fund in five years. Such funding is required regardless of the size of the funding payments relative to the sponsor's other capital investments and the probability that such payments will lead to surpluses in the future. Approximately 80 percent of the pension plans under the PBSA are estimated to have had a solvency deficit as at the end of July 2005. It is unrealistic to assume that all of those plans are in danger of not meeting their respective sponsors' promised pension benefits when they come due during the plan members' retirement years. Under the current solvency rules, financially strong companies would be forced to divert significant cash flows in the short term from their successful capital investments. This situation could negatively impact our economy.

We urge that the funding period for solvency deficits be increased immediately from five to something closer to the long-term funding period of 15 years. Plan sponsors can adjust cash flows over such a period to make these payments without disrupting their capital investment activities. Solvency interest rates may drift higher over such a period, reducing the calculated liabilities, reducing the solvency deficit and the related funding requirements.

We suggest that, in the mid term the government investigates other ways of determining an equivalent of the solvency test to reduce the variation of interest rates that may be used in such a test.

Unless the Government of Canada takes immediate action on the solvency funding period while resolving the deficit surplus asymmetry injustice, DB plan sponsors will opt for a minimum funding approach at all times, more defensive investment policies increasing long-term pension costs leading to reduced future pension improvements and defined contribution plans over a defined benefit plan for new employees at least.

We turn to respond to the specific requests for views in the consultation paper by repeating the request and providing the response. To borrow an analogy from medicine we believe the exercise is akin to treating the symptoms without treating directly the underlying disease of deficit surplus asymmetry and onerous solvency funding.

## A. Surplus

The Government of Canada is seeking views as to whether there are any disincentives or obstacles preventing plan sponsors from adequately funding their plans and building up a funding cushion.

There currently are strong disincentives. Plan sponsors do not own the surplus in the same way that they own the deficit. As noted in the opening of this letter, surpluses at a point in time evaluation are part of the pension landscape where liabilities are long term. However, why should plan sponsors fund to generate surpluses at these point in time evaluations if they may have to be distributed to members in event of a partial or total plan windup?

The Government of Canada is seeking views on whether the dispute settlement mechanism for surplus distribution contained in the PBSA requires improvement or clarification.

Yes. Unless the plan text specifies that plan members are entitled to some of the surplus, the sponsors should clearly have discretion over the use of surpluses.

The Government of Canada is seeking views on whether there should be partial plan terminations under the PBSA and if so, should there be a requirement to distribute surplus at the time of the partial termination.

Partial plan terminations are not only a disincentive to funding more than the minimum required but also they represent an administrative burden for the sponsor. We support the decision of the Quebec regulator to eliminate partial plan termination by requiring that plan members be immediately vested with the caveat that short-term workers be excluded. We believe that it is inappropriate to have any part of a surplus distributed upon a partial plan termination to those members included in the partial termination.

## B. Funding

The Government of Canada is seeking views on whether there are alternative financial vehicles, such as letters of credit, that could allow for greater funding flexibility.

What types of conditions or rules should be required if greater funding flexibility is given to plan sponsors, to ensure that the risk to benefit security is minimized?

If there is to be solvency funding, the best alternative to cash is letters of credit as they promote benefit security while giving employers greater flexibility in cash flow management. Cash flow management is a major concern for sponsors operating in asset-intensive industries.

Some of the rules that should apply for letters of credit include:

- (1) The government should not seek higher funding levels from sponsors who are making use of letters of credit.
- (2) The cost of letters of credit and deemed interest should be tax deductible.
- (3) The letter of credit should be included in the plan solvency assets but not in the going concern assets. Also, letter of credit should be used in plan assets when calculating the solvency ratio of the plan.

The Government of Canada is seeking views on what the appropriate amortization period is and whether it is different for financially vulnerable and financially strong companies.

Extending the solvency period to something approaching the going concern period of 15 years would be more appropriate for financially strong companies meeting certain criteria. There is little reason for a different time frame from the on-going concern valuation at least for financially strong companies.

The Superintendent should monitor DB pension plans and their sponsors and issue orders for funding in the case of financially weak sponsors as it has in the past.

The Government of Canada is seeking views on what types of conditions or rules should be attached to any extended amortization period for solvency funding for companies under CCAA or BIA.

If the objective is to ensure the security of the promised benefits, it is not reasonable to allow an extended amortization period for solvency funding for companies under CCAA or BIA unless the government is prepared to take the risk of such an extension.

The Government of Canada is seeking views on whether there are alternatives to address funding issues other than relaxing funding requirements. For example, would special accounts for pension plans be feasible?

If solvency contributions could be remitted to such a special account, it would address some of the asymmetry issues particularly when surpluses arise in the future because of rising solvency interest rates. It would not, however, address the need for longer solvency amortization periods. As compared to the letter of credit alternative, this alternative would require upfront cash payments to the separate trust, whereas letter of credit obligations might or might not have to be satisfied by cash payments in future.

Funds accumulated in the side fund should revert back to the plan sponsor even if the plan text is silent on the question of surplus ownership or provides that the surplus reverts to plan members.

The Government of Canada is seeking views on whether there should be greater disclosure provided to plan members regarding a plan sponsor's financial condition, funding decisions and contribution holidays and how this may be done.

We support greater disclosure of the funded status of the pension plan based on any report filed under the PBSA. Disclosure to members would be limited to data that can be made available to the investment community. We support also disclosure of a statement of funding policy, which would include the sponsor's policy regarding contribution holidays. Any information provided to members regarding the sponsor's financial condition would be restricted to publicly available data (i.e., credit ratings).

### C. Void Amendments

The Government of Canada is seeking views on its proposal to implement the void amendments of the PBSA based on a prescribed solvency ratio level of 85 per cent, and to reduce the priority of claims against pension plan assets for recent benefit improvements that have not been fully funded.

Specifically:

- Is an 85 per cent solvency ratio an appropriate threshold for applying the proposed controls and conditions on plan improvements?
- Should pension plans with solvency ratios below 85 per cent be permitted to make plan improvements provided that offsetting funding is provided at the time that the improvement comes into effect?
- Would the proposed priority scheme improve security of longer-established benefits?

- We support the principle of void amendments with a threshold that varies with the financial capacity of the plan sponsor.
- The plan sponsor could be permitted to make benefits improvements when the solvency ratio is at or below the applicable threshold if the improvements are immediately funded. In fact such funding would slightly improve the solvency ratio.
- The introduction of a lower priority claim for more recent benefit improvements would address a potential inequity between different member classes in the event the plan is terminated. If recent improvements have a lower priority claim in the event of a wind up, this information should be disclosed to affected plan members.

### D. Full Funding on Plan Termination

The Government of Canada is seeking views on full funding on plan termination, and in particular how it should be applied to financially vulnerable sponsors.

Plan sponsors should fully fund any solvency deficit on plan termination, provided surplus asymmetry has been corrected.

Such funding could be done through a lump sum payment or special annual payments starting at the effective date of wind up. The situation may need to be reviewed on a case-by-case basis for financially vulnerable sponsors.

## E. Pension Benefit Guarantee Fund

The Government of Canada is seeking views on the viability of a federal pension guarantee fund including any comments on its possible design, operation, and powers.

We do not believe that there is a need for a pension guarantee fund. As noted in the consultation paper such funds have not been successful in other jurisdictions where pension liabilities are not as concentrated among a few plan sponsors, as is the case with those regulated by the PBSA. In addition, if it is assumed that the funding of this Guarantee Fund would come from pension plan sponsors, it would be far too large of a contingent obligation a plan sponsor to take.

We trust that you will find our comments useful and will agree to act urgently on the funding period of solvency deficits while correcting in the near term the pension plan deficit surplus asymmetry. We suggest that the funding period changes can be implemented immediately on a transitional basis through amendments in the regulations. The resolution of the asymmetry injustice will probably take longer as a change in law will be required. You will prevent a reduction in capital spending in the Canadian economy by plan sponsors making large solvency payments over the current five year funding period rather than funding capital expansions. Without such changes, DB plan sponsors will likely adopt more conservative investment policies that will have a negative impact on the Canadian economy and capitals markets. Employers will accelerate the adoption of defined contribution plans with their related risks for employees. With such changes you will provide a legislative framework to enhance the viability of continuing private sector defined benefit pensions for Canadians.

You have our consent to post these comments on your web site.

Yours truly,



Peter Donovan  
Chair, Pensions Task Force  
Issues and Policy Advisory Committee  
Financial Executives International Canada



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