



15 October 2007

Expert Commission on Pensions
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Dear Commissioner:

Thank you for this opportunity to participate in the discussion about the issues that the Expert Commission has been asked to review in its mandate from the Minister of Finance. We commend the Minister for undertaking this initiative and agree with the principles that guide your work as detailed in the section, The Commission and its assignment, of your discussion paper “Reviewing Ontario’s Pension System: What are the Issues”, February 2007.

FEI Canada is a professional association of senior financial executives, with eleven chapters across Canada and more than 2000 members. Membership is generally restricted to senior financial officers of medium to large corporations, as well as senior financial officers in public sector organizations. There are currently 862 members in Ontario.

The Issues and Policy Advisory Committee (IPAC) is one of two national advocacy committees of FEI Canada. IPAC comprises more than 35 senior financial executives representing a broad cross-section of the Canadian economy who volunteer their time, experience and knowledge to consider and recommend action on a range of topics of interest to Canadian business and governmental agencies. The current composition of IPAC is designed to address the following areas: corporate governance, capital markets, tax policy, pensions, internal controls and public sector accountability. In addition to advocacy, IPAC is devoted to improving the awareness and educational implications of the issues it addresses, and is focused on continually improving these areas.

FEI Canada has been active in commenting on pension matters since the 1970’s, at which time it initiated a series of pension plan surveys, the first of their kind in Canada. Since then it has sponsored many pension papers. These include, Canada at the pension crossroads 1978 and Business Committee on Pension Policy Papers (1983). Its recently established Canadian Financial Executives Research Foundation is currently tabulating its Canada-wide pension survey.

Those before you are members of IPAC who chair currently the task forces focusing on pension and capital market issues.

We congratulate the Commission for its Discussion Paper. We would like to discuss in particular those issues that touch our members and answer the question your paper asked to the extent they are within our purview. Many of the corporations who employ our members sponsor defined benefit (DB) pension plans. Such plans of even large corporations are dwarfed by the public sector pension plans such as OMERS and Teachers.

Our members deal with their DB plans as part of their finance function responsibilities, not with a staff of many experts, but with employees involved with other duties and with outside advisers. Our members are responsible to ensure the plans comply with relevant funding and filing legislation, are properly reported according to generally accepted accounting principles (GAAP) in the corporation's financial statements, budget for the employer's contributions and supervise proper governance of the plans activities. The activities include investment of fund assets, determination of its liabilities and updating of the plan documents together with the plan's actuaries, collection of any contributions and the determination and making of payments to pensioners and provisions for withdrawing plan members. This list is not exhaustive but provides a flavour of the many diverse tasks involved.

Payments to pensioners as contracted by employers form the base of the pension superstructure that has arisen in Ontario. Historically corporations paid these amounts directly from their cash flow to retired employees until the income tax authorities (CRA) provided a vehicle to permit deductions from taxable income for prefunding of such payments. These payments were clearly a deferred benefit to the employees through their employment lives for which the employer was responsible. Documents drawn up to cover such prefunding and payments did not need to address or even define ownership of surpluses which may arise on what became periodic plan evaluations by actuaries. The basic contracted promise was that of the employer to its employee after retirement.

Since those simple days Ontario's pension regulations that your paper noted required periodic filings of point in time valuations of pension plans assets and promised benefit to actual and potential retirees, the members of that pension plan. Although such filings and valuations became routine it is important to highlight two points. First, the point in time evaluation of the promise to pay, the pension liabilities, are artificial and subject to many assumptions not least of which is the interest rate used to discount the future payments. The resulting calculations of present value of such pension payments vary significantly with changes in the assumed discount rate. The most readily available analogy is the price of bonds with a term equivalent to the average of the pension payments. A thirty year bond with a semi-annual coupon interest of 8% issued at \$100 would be priced at \$169.50 if the effective interest rate was 4% and at \$67.50 if the effective interest rate

was 12%. The coupon interest throughout and principle payable at the end of thirty years have not moved one cent. The present value of pension payments subject to the same interest rate swings would move probably more than bond prices. The bond coupon is being paid throughout the term with the principal at the end. The pension payments would begin on average fifteen years into the term and would not have a balloon payment at the end. Second, the intervening machinery of a pension plan and its regulation does not alter the employer's promise to pay the pension.

Despite the instability of the going concern pension liability valuations and because of other events, Ontario's pension regulations have focused on evaluation of liabilities on a solvency basis, the unlikely assumption of an immediate plan windup. These requirements include a narrower definition of interest rates to be used, grow in rights to be discussed below, and a short time horizon to fund any resulting solvency deficit.

The current situation is one in which many pension plans are experiencing large solvency deficits resulting mainly from low long-term interest rates after a period of surpluses. These surpluses were in part due to above average returns on the plan assets but more to higher than prevailing long-term interest rates. CRA has restricted the deduction of plan contributions when the surpluses exceed an arbitrary limit. This limit did not consider the significant swings in plans' market valuations due in no small measure to swings in liabilities because of varying interest rates. In addition there has arisen much dispute over the ownership of such surpluses in event of a partial windup of the plan if such ownership was not clearly defined in the plan document.

Another ingredient to this mix was the inadequate GAAP reporting on pension plan costs. Even now the CICA Handbook requires only an income statement pension expense resulting from well smooth impact of plan and assumption changes, and experience losses. The footnote description of plan assets and liabilities was a recent CICA Handbook requirement.

It is not surprising that during an era of plan surpluses there were contribution holidays, some required by CRA. There was also leveraging of plan liabilities in wage settlements, as they did not immediately affect reported results. In addition, if the plan's ownership of surplus was in dispute it made sense for a plan sponsor to limit the surplus even if not required by the income tax authorities in case there was an unforeseen partial windup. We believe all were aware that it was the nature of periodic point in time evaluations of pension plans to produce large surpluses and deficits. It was the case of people acting rationally within a context of contradictory rules.

Following on the description above we would like to discuss two issues before answering in details the questions you asked. The first issue deals with the asymmetry of the ownership and size of deficits and surpluses. The second issue is the solvency calculations based on the hypothetical windup scenario with grow in provisions

prescribed by the current regulations and the short period of funding of solvency deficits arising mostly from currently low long-term rates.

DB pension plan periodic surpluses are probable, significant and fleeting in a pension plan point in time estimates of financial position. The CRA limitation on pension surpluses prevents the sponsor from managing its obligation to provide future pensions by disallowing the deduction of plan contributions when the plan surplus is above an arbitrary limit.

We recommend that 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. The courts have ruled that pension plans should be based on trust law.

We recommend that the Income Tax Act be amended to permit DB plan sponsors to deduct from taxable income DB funding payments when surpluses are in excess of the current CRA limit. We recommend that the law of contract rather than trust law govern pension plans.

The current solvency rules designed to protect the security of benefits of some DB 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 eventually move higher. In the meantime the requirement to fund fully over a short period 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. 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 find the grow in requirements of the solvency rules harshly unrealistic. The result produces an increased solvency obligation to be funded in five years. The increase covers an extremely remote event, which is the immediate windup of the plan. The funding of such a grow in liability should not take place. Nova Scotia is the only other province with such a regulation.

The funding period for solvency deficits should be increased immediately from five to something the lesser of the remaining active service life and 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.

It is appropriate to note here our answer to your question concerning partial wind-ups. We believe that this concept be removed from the current regulations. Such a change would check mate the recent Supreme Courts' ruling in the Monsanto case that was based on trust law. As you point out, Quebec has done so.

We now answer specific questions in the numbering of your paper.

I General Questions

1.1 & 1.2 Private occupational pension plans are only an element of the need to save for income security in retirement. These elements include:

- 1) CPP
- 2) OAS
- 3) Private plans
- 4) GIS/GAINS for low income Ontarians
- 5) Private individual savings either through tax deferred plans as RRSP and DPSP or after tax capital formation

1.3 No comment

1.4 DB pension plans have proportionately declined through

- Increased sponsor costs associated with lower investment returns and interest valuation interest rates.
- Violation of the risk/reward equation through surplus awards to plan participants in partial wind-ups.
- Punitive legislation on solvency deficit funding exacerbated by
- Grow-in provisions which are harshly unrealistic

1.5-1.6 No comment

1.7 There should be one regulation for all. There should be no second-class citizens.

1.8 FEIC supports harmonization of national regulations to facilitate ease of administration to lower plan costs and uncertainties of interpretations for national employers.

1.9 As we do not know the impact, our comments would be speculative.

II The effects of a changing social and economic environment

2.1 The change factor with the biggest impacts include:

- Strong, healthy and productive economy
- Industrial productivity of labour and capital
- Low inflation
- Currency exchange rates with major trading customers and competitors.

2.2 All other things being equal, longer life expectancies increase DB plan funding costs.

2.3 The active to retired ratio varies from plan to plan. The greater the proportion of retirees to actives, the less flexibility the employer DB plan sponsor has to improve the benefits of the actives if it has to fund a DB plan deficit.

2.4-2.6 No comment

2.7 Inflation has a meaningful impact on the real value of pension benefits. It is an uninsurable risk both to plan sponsors and plan members. It is incumbent on federal monetary and federal and provincial fiscal policies to promote real economic growth combined with low and controlled inflation. Benefit indexation is less common than ad hoc adjustments. Private DB plan sponsors can make ad hoc adjustments if and when affordable.

2.8/2.9 These are too speculative for us to comment on.

III Innovation and constraints in pension policy-making

3.1 – 3.4 As the FEIC members are responsible for single employer plans, we do not have much informed advice on occupational DB pension plans. Any mechanism to spread the risk and administrative costs of such plans would be beneficial to all concerned.

IV The role, risks and attractions of defined benefit pensions plans

- 4.1 DB pension plans feature a unique way to diversify risks and thereby participate in the rewards associated with underlying investment success.
- 4.2 With intensifying international competition in basic industries there is little room to enhance compensation benefits in the private sector. It is only affordable on verifiable productivity improvements, which themselves can be short lived.
- 4.3 Pension costs are essentially a deferred compensation benefit and are only one of the many costs of running a viable business.
- 4.4 The major policy initiative that legislators should consider is to establish a better balance between those assuming the investment risks and those claiming a portion of transitory plan surpluses.
- 4.5 Plan sponsors should have the discretion to make ad hoc adjustments only if these are affordable. Please see the answer to 2.7 above for background.
- 4.6 The federal government should be encouraged to enhance the tax assisted savings framework currently in place. This would be conditional on the capital so generated is channelled into productive investments, ie those with acceptable risk adjusted returns.
- 4.7 More education and public information can only lead to better-informed pension constituents.
- 4.8 Joint administration mechanisms do not reduce risk. They also do not improve the quality of decisions made.

V Underfunding and overfunding

- 5.1 The existing definitions of DB plan solvency are not realistic.
- 5.2 The consequences of overfunding are not properly understood. In many case the courts and arbitrators have unfairly adjudicated them.
- 5.3 Over and Underfunding are essentially the same concept. They result from formulas and should be treated symmetrically with recognition of their transitory character.
- 5.4 We support greater discretion for the pension regulator to adjudicate upon unusual circumstances, so long as this “philosopher king” is free from short-term political influences. Expediency in the short term does not resolve long dated issues.

5.5 There could be different rules for different types of plans to determine Pension Benefit Guarantee Fund (PBGF) premiums. They could take account of the quality of the plan assets, the nature of the plan liabilities and the credit of the plan sponsor.

5.6 & 5.7 Solvency funding relief should be considered for plan sponsors with recognized credit capacity and credit agency ratings to justify such extensions. The overall objective of minimizing risk on the ultimate benefit payments can be achieved while giving relief to DB plan sponsors with obvious credit strength.

5.8 Conceptually, funding relief could be made available to employers through:

- Letters of credit
- Insolvency filings
- Benefit reductions
- Plan windup

VI Ensuring solvency in a viable economy

6.1 FEI Canada would support such an initiative as described.

6.2 FEI Canada would support such greater latitude provided plan members do not have recourse to any resulting transitory plan surplus. Benefit reduction, though difficult, may be the only viable solution for a severely impaired DB plan.

6.3 As we understand the proposal, earmarked contingency reserves would be contrary to GAAP, as its offset would have an arbitrary effect on income. The current regulations provide such a reserve in the PBGF.

6.4 Employment of risky investment strategies to deal with solvency concerns under normal circumstances could be associated with increased volatility on the value of plan assets and consequently the magnitude of any resulting deficit (surplus). As such action would increase the probability of a claim on the PBGF, we support a risk rating of PBGF premiums, accelerated reporting requirements, and introduction of independent trustees to monitor the risk assumption.

6.5 The depth and breadth of the capital markets in Ontario has increased significantly over the last 25 years. Changes in DB plan sponsors' investment strategies will likely have little impact if they are administered in a disciplined investment manner in accordance with a statement of policy and procedures.

VII The Pension Benefit Guarantee Fund

7.1 We note that the PBGF is not an insurance fund as the guarantees it offers are not an insurable risk. There are no assets available to fund the associated obligation. The credit is that of the fund and the Ontario general revenue account. As noted earlier FEI Canada supports risk adjusted premiums.

7.2 & 7.3 The PBGF funding adequacy is complex and broadly based. We believe a strong and productive Ontario economy supported by a balanced federal monetary policy and encouraged by both federal and provincial fiscal policies is the best form of credit enhancement for the PBGF.

7.4 FEIC supports the idea of placing the PBGF administration under a regulatory body other than that of pensions. Another division of FSCO/FST would be appropriate. The majority of PBGF's directors and or trustees should be independent.

7.5 The above changes have the common theme of risk rating the premiums. It makes sense to charge more to those engaged in higher risk activities.

VIII Wind-ups, splits, mergers and insolvencies

8.1 – 8.3 Qualified actuaries should provide fair and consistent calculations to determine the respective interests in such situations. The regulator currently has sufficient powers and authority to deal with transition cases.

8.4 We cannot comment without examining the text of the PBA amendments to determine their impact.

8.5 The current Ontario provisions are punitive. As noted elsewhere above we recommend the Quebec style elimination of partial wind-ups in part to offset the Supreme Court's recent decision and the elimination of grow-in rights in solvency calculations.

8.6 A financially viable plan sponsor together with a well-funded pension plan provides the best assurance or protection of plan members and their rights to pensions.

IX Regulating the pension system

9.1 FEI Canada does not see the need for such a change. What is important to national employers is inter provincial consistency in regulations.

9.2 Yes. It should be clear that the law of contract governs pension matters. Case law continues to provide guidance. The recent Kerry decision contains meaningful guidance across a wide range of pension issues.



9.3 It would be constructive to better inform DB plan sponsors and members on the complexities of DB plan economics, assumptions as well as the macro-economic backdrop.

9.4 With an appropriate shift in priorities, FSCO, FST and Superintendent of Financial Services appear to be adequate to undertake the mandate.

9.5 & 9.6 A multi-disciplinary advisory committee would be helpful to FSCO in its assessment of its administrative priorities.

We hope that our comments are helpful and remain available for further consultation at your convenience.

Yours truly,

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