

# Special Communiqué

October 29, 2009

## Federal Pension Reform Proposals

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On October 27, 2009, the federal Department of Finance released a plan for pension reform. The proposed reforms primarily affect federally regulated pension plans though some of the measures would affect provincially regulated plans as well. Pension plans of all types are affected, including defined benefit (DB), defined contribution (DC) and multi-employer pension plans (MEPPs). Amendments will be required to the *Income Tax Act* (ITA) and the federal *Pension Benefits Standards Act, 1985* (PBSA) and regulations.

The reforms are the culmination of a consultation process that began when the Department of Finance released a discussion paper on pension reform in January 2009 and included public consultation meetings in March and April.

Some of the more significant proposed changes include:

- > Increasing the ITA surplus threshold preventing employers from contributing to a DB pension plan from 10% to 25% of plan liabilities;
- > Requiring DB plans to be fully funded on plan termination thereby creating an unsecured employer debt;
- > Eliminating partial plan terminations declared by plan sponsors;
- > Immediate vesting of pension benefits;
- > Imposing an additional restriction on contribution holidays;
- > Requiring solvency valuations to be performed using the market value of assets only, but with an averaging of solvency ratios over 3 years;
- > Requiring annual valuations;
- > Requiring that payments owed to the pension plan be remitted monthly rather than quarterly;
- > Establishing a workout scheme for distressed DB pension plans; and
- > Articulating specific governance measures for DC plans.

In this Special Communiqué, we summarize these proposed changes and comment on the potential impact on pension plan sponsors.

## Changes Affecting All Plans

Most of the proposed changes will affect only federally regulated pension plans, such as those offered by banks, telecommunications and transportation companies.

However, the following changes will affect all pension plans in Canada:

### *Income Tax Act Surplus Threshold*

The ITA currently requires employers to suspend contributions to a DB plan when surplus reaches a 10% threshold, or twice the estimated annual contributions, whichever is greater. The 10% surplus threshold will be increased to 25%. A 25% threshold will provide employers with more flexibility to retain surplus in DB plans, potentially increasing benefit security. The inability to overcontribute, however, has not been the main problem faced by plan sponsors. Plan sponsors, especially in the private sector, have balked at over-contributing to pension plans because the ongoing surplus asymmetry issue meant they would have very limited access to the resulting surpluses. That issue is not addressed in this reform proposal.

### *Federal Investment Rules*

It is proposed that the Federal Investment Rules would be amended. These rules, contained in the Regulations to the PBSA, have been incorporated into the legislation of all jurisdictions other than New Brunswick and Quebec. Proposed changes are as follows:

- > Removing the quantitative limits for resource and real property investments.
- > Amending the 10% concentration limit, to limit pension funds to investing a maximum of 10% of the market value of their assets (rather than the book value) in any one entity. An exception to this rule will apply for pooled investments over which the employer does not exercise direct control, such as mutual fund investments.
- > Prohibiting direct self-investment, so an employer would no longer be permitted to invest any portion of its pension fund in its own debt or shares (~~except indirectly via the financial markets~~) [See *News & Views* of December 11, 2009].

Some provinces, such as Ontario, Newfoundland and Labrador, and Nova Scotia, would need to amend their legislation to adopt the new Federal Investment Rules. Current pension legislation in Alberta, British Columbia, Manitoba and Saskatchewan would result in automatic adoption of the proposed changes to the Federal Investment Rules.

### *Multi-Jurisdictional Pension Plans Agreement*

Under the proposal, the federal Minister of Finance would be able to sign the new Multi-Jurisdictional Pension Plans Agreement, which was finalized by the Canadian Association of Pension Supervisory Authorities (CAPSA) earlier this year. This measure indicates that the implementation of the proposed Agreement is moving forward.

## Changes Affecting Federally Regulated Plans

The proposed changes to federal pension legislation are significant, covering funding, vesting, partial plan terminations, annual statements, and many administrative practices for DC plans and MEPPs.

### *DB Plan Funding Changes*

Plan sponsors will be required to fully fund DB benefits on plan termination. Currently, Saskatchewan and the federal government are the only remaining pension jurisdictions that do not require a solvent employer to fully fund DB benefits upon plan termination. The obligations of the employer following a plan termination will be considered unsecured debt of the company.

Employer contribution holidays will be permitted only if the pension plan has assets equal to at least 105% of solvency liabilities. (Quebec legislation will also require the calculation of a margin effective 2010, although the mechanics differ from those in the Federal proposal).

The Regulations to the PBSA will restrict benefit improvements by a plan that has or would lead it to have a solvency ratio of 0.85 or less. In planning for certain benefit improvements a plan sponsor might have to consider funding a benefit improvement up front, so as not to lower the solvency ratio below 0.85.

Sponsor-declared partial plan terminations will be eliminated (as is currently the case under Quebec pension legislation). Without partial terminations, a member whose employment is terminated as part of a large corporate restructuring would have the same status in pension legislation as a member who leaves employment voluntarily. The Superintendent, however, will retain the ability to declare a partial termination.

The proposals will require annual actuarial valuations. A new standard will apply for establishing minimum funding requirements on a solvency basis that will use average – rather than current – solvency ratios. The average solvency position of the plan will be defined as the average of the solvency ratios over three years (i.e., the current and previous two years). The three solvency ratios used in the determination of the average will be based on the market value of plan assets. Past deficiencies will be consolidated and amortized over five years for the purpose of establishing solvency special payments. A new five-year amortization schedule will be re-established each year. The changes in the basis for determining minimum solvency funding requirements will lead to less volatility in contribution requirements.

DB plan sponsors will be permitted to use properly structured letters of credit to satisfy solvency payments up to a limit of 15% of plan assets.

The methodology for calculating the going concern unfunded liability and the amortization payments over 15 years will remain unchanged.

### *Remittance of Contributions*

The PBSA will require that payments owed to pension plans be remitted monthly rather than quarterly. The custodian will be required to notify the Superintendent of the monetary amount and lapsed time of late remittances.

### *Immediate Vesting*

Under the proposed plan, an individual's pension benefits will vest immediately upon becoming a plan member (as currently applies under Quebec legislation). Current legislation allows for up to a two-year period before accrued benefits vest. The requirement for locking-in of vested pensions would continue to be two years of plan membership.

There are no new rules governing the waiting period before an employee can join a plan. Therefore, federally regulated employers may wish to reconsider their waiting period in light of the new immediate vesting requirement.

### *Annual Statements*

Former members and retirees will be entitled to receive annual member statements (this is a current requirement under Quebec legislation). Information that must be provided in annual member statements will be expanded to include:

- > The date of the solvency ratio reported in the annual statement along with the date of the next required valuation report;
- > The total assets and liabilities of the plan;
- > A summary of the plan's investment allocation and 10 largest investment holdings;
- > A statement regarding members' right to examine the plan's Statement of Investment Policy & Procedures; and
- > Total employer contributions made for the reporting year.

### *Electronic Documents*

Electronic member statements and other disclosures will be permitted with member consent, giving more flexibility to plan sponsors and administrators. This is a positive step forward.

### *Workout Scheme for Distressed DB Plans*

A workout scheme for distressed pension plans will be established when a particular plan sponsor cannot meet near-term funding requirements. The workout scheme will allow sponsors, plan members and retirees of a distressed pension plan to negotiate funding

arrangements not in conformity with existing pension regulations to facilitate a plan restructuring (such as the 2009 Air Canada revised funding agreement). To facilitate expedient entry into the scheme, a declaration by the board of directors that the sponsor does not anticipate being able to meet its upcoming special payment will be required.

Within the scheme, the sponsor will be eligible for a short moratorium on special payments. The parties would then be at liberty to negotiate changes to their pension arrangements, including the schedule of special payments, with representation provided for plan members, deferred vested members and retirees. Where a workplace is unionized, the bargaining agent would provide representation, while in non-unionized environments and for retirees and other beneficiaries, the legislation would provide that a representative would be appointed for these groups. Member and retiree consent would be required. The negotiated workout arrangement would also be subject to Ministerial approval.

### *Governance Framework for DC Plans*

Measures specifically pertaining to defined contribution arrangements will be clearly articulated. The legislation will provide guidance on the governance responsibilities of employers, members, administrators and investment-providers. The framework will consider Joint Forum of Financial Market Regulators' 2004 Capital Accumulation Plan (CAP) Guidelines. The measures will eliminate the requirement for a Statement of Investment Policy and Procedures for a DC plan.

DC pension plans will have the option to permit members to receive Life Income Fund (LIF) style retirement benefit payments directly from the pension fund rather than having to transfer the monies out of the fund following termination or retirement. Permitting the payment of LIF-style benefits would allow members to continue to have their pension savings managed by the plan. These LIF-style benefits are currently allowed in the pension legislation of the four western provinces.

### *Negotiated Contribution Pension Plans*

The legislation will amend the framework for negotiated contribution DB plans, which are common in MEPP arrangements, by adding the following measures:

- > Creating a formal definition in the Act specifying for these plans that employer contributions are limited to the level negotiated in the collectively bargained agreement.
- > Establishing criteria for the composition of the Board of Trustees of the plan to ensure that all stakeholder interests (i.e., employer, employee and retiree) are represented.
- > Specifying that the Board of Trustees has the authority to amend the plan to reduce accrued benefits, subject to the amendment being authorized by the Superintendent. This authority of the Board of Trustees will override any terms to the contrary in the plan text.
- > Enhancing information disclosure to members and retirees to clearly communicate the nature of the pension arrangement, including that benefits may be reduced if negotiated contributions are insufficient to meet funding requirements.
- > Providing that if a valuation shows the pension plan is not meeting minimum funding requirements, the valuation report must include options that the Board of Trustees are considering to resolve the funding shortfall.

### *Other Changes*

In addition to the above-noted reforms, the following other changes are proposed:

- > At the time of a plan termination, a plan sponsor will be permitted to transfer the benefits of members who cannot be located to a central repository.

- > The Office of the Superintendent of Financial Institutions (OSFI) will be given additional powers to intervene when there are concerns about the work of a plan actuary.
- > Annuity purchases for an ongoing plan will be restricted if the plan is underfunded (to be consistent with the treatment of transfers of lump sum benefits).
- > The definition of plan termination will be amended to avoid capturing situations where the plan is not necessarily terminated, and to clarify the timing and content of information provided to plan beneficiaries following a termination.
- > The requirement that pension plans report to the Superintendent on inflation adjustments made to the pension benefits will be eliminated.
- > The definition of “former member” will be amended so plan members transferred to a new plan cannot influence future surplus distributions from their previous plan.
- > Where accrued benefits are small, they can be paid as a lump sum at retirement. This change would be consistent with the treatment applied when a member otherwise ceases membership or dies.
- > The administrator will have to comply with a court order or separation agreement related to pension entitlements in situations that are contrary to the legislated requirement for a joint and survivor pension benefit.

## Conclusion

The proposed changes are extensive and significant. However, the vast majority of pension plans in Canada are provincially regulated. The day following the federal announcement on pension reform, Ontario’s Minister of Finance announced that the first of two phases of Ontario’s pension reforms will be introduced in November. Ontario’s second phase of pension reforms will follow in 2010. Alberta, British Columbia and Nova Scotia engaged in significant pension reform consultations, but have yet to introduce related legislation.

The federal reforms are likely to receive a mixed reception from plan sponsors. Federal DB plan sponsors likely will appreciate changes in some areas such as the new solvency funding calculation, investment flexibility, electronic documents, and elimination of employer-sponsored partial plan terminations. However, the requirements for annual valuations, the new restrictions on contribution holidays, immediate vesting, enhanced disclosure requirements, monthly contributions and new governance requirements for DC plans will not be universally welcomed. The ability to contribute up to a 25% surplus threshold would have been seen as positive if the surplus asymmetry issue had been resolved.

Larger public policy issues, such as declining pension coverage and the growing inequity between private-sector and public-sector pensions, have not been addressed.