
SEDAP Conference:

PRIVATE PENSIONS AND INCOME SECURITY IN OLD AGE

**Reforming Pension Funding:
Why is it so Hard to Make Improvements?**

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PENSION FUNDING: REFORM IS IN THE EYE OF THE BEHOLDER

Canadian Institute of Actuaries (CIA) Standards of Practice: Pension Plans

“The objectives of funding a plan in accordance with accepted actuarial practice (AAP) are:

the systematic accumulation over time of dedicated assets which, without recourse to the employer’s assets, secure the plan’s benefits in respect of members’ service already rendered, and

the orderly and rational allocation of contributions among time periods”.

Other Funding Objectives

- Benefit security
- Inter-generational equity
- Fair allocation and disclosure of risk
- Stability of contributions
- Affordability

PENSION FUNDING: REFORM IS IN THE EYE OF THE BEHOLDER

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Stakeholders in the Funding Debate

Funding rules must address the interests of various stakeholders:

- ✎ Plan members and former members as beneficiaries of the system and often as contributors to the financing of the system;
- ✎ Plan sponsors as the parties bearing responsibility for financing the pension system; and,
- ✎ Citizens and pension regulators who administer pension standards legislation passed by Legislatures in the public interest.

The existence of many different sets of rules in different jurisdictions makes reform more difficult.

Lack of harmonization among jurisdictions can put pressures on legislators to adopt the weakest or strongest standards, depending on the interest group. For example, when funding provisions are being eased in other jurisdictions, plan sponsors and their representatives will lobby for similar reforms in their jurisdiction.

Question / Challenge

Is the goal of reform to strengthen funding rules and thereby improve benefit security, or to provide funding relief since arguably benefit security depends to a significant degree on the long term financial health of the plan sponsor, or some combination of the two?

FUNDING VALUATION STANDARDS: WHO IS RESPONSIBLE?

Responsibility for actuarial standards used in funding valuations is shared between the actuarial profession and governments.

In the case of the actuarial profession, standards take the form of AAP (both written and unwritten). Most pension legislation requires that funding valuations be prepared in accordance with AAP.

- ✎ However, pension standards legislation frequently permits significant departures from AAP. Examples include the exclusion of certain benefits from funding standards (e.g. inflation protection) and the exclusion of entire plans from certain funding requirements (e.g. solvency funding).
- ✎ In addition, there are significant gaps in AAP such as going concern funding standards and assumptions (e.g. discount rates, appropriate mortality tables), acceptable asset smoothing procedures.

Government standards take the form of statutes / regulations in pension benefits standards legislation.

- ✎ For example, deadlines and deficit amortization periods / methods are generally established by legislation / regulation.

Issues:

- ✎ Blurred responsibility for failures associated with windups with inadequate funding.
- ✎ If, for example, the actuarial value of plan assets exceeds the market value of plan assets by a large margin in a funding valuation, is this properly a matter for AAP, the courts, pension standards legislation or regulations, the exercise of discretion by pension regulators or some combination of the above to address?

Question / Challenge

How can we arrange for governments, pension regulators and the actuarial profession to work together on clear funding standards in a timely manner?

LEADING BY EXAMPLE

The term “private pension plans” is a misnomer.

- ✎ According to Statistics Canada, there were about 14,800 pension plans in Canada in 2004 with a total membership of 5.6 million, of which about 1,300 were public sector plans. However, 47% of all pension plan members (2.6 million) were employed in the public sector.
- ✎ Statistics Canada reports that in 2003, the “total accumulated assets” of pension plans backed by “Government Consolidated Revenue Funds” (i.e. plans which are funded from the general government revenues and have little to no marketable assets) exceeded \$163 billion. Most governments have now discontinued this approach.

Pension benefits standards legislation in most jurisdictions does not bind the Crown, or if it does there are frequently significant exemptions for public sector plans (most notably in the area of funding).

Not surprisingly, private sector employers suggest that governments acting in their capacity as employers or transfer agents to public sector employers are unwilling to apply the funding standards which are applied to private pension plans to themselves. Interest groups often argue for similar treatment to public sector plans.

There is no question that public sector employers are unlikely to become insolvent and seldom wind up their pension plans. Nevertheless, the obligations of public sector pension plans are not unlike the public debt and concerns have been expressed that public sector pension costs are frequently passed on to future generations of taxpayers and plan members.

Question / Challenge

Is reform of pension plan funding possible without addressing the issue of the rules which govern the funding of public sector pension plans and the merits of the case for differences between the two sectors?

PENSION PLANS ARE VOLUNTARY

Because provision of a pension plan to employees is desirable to governments, but voluntary on the part of employers, governments must balance the rules so as not to discourage employers from offering them.

Many would argue, however, that pension benefits legislation – designed largely to ensure that accrued benefits will be paid – is increasingly serving to discourage the provision of pension plans, particularly DB plans.

- ✎ This is particularly true of defined benefit (DB) plans, which are desirable for employees, and yet complex and risky for employers, particularly given the economic environment in recent years.
- ✎ If employees do not voluntarily save for retirement, they may become dependent on income-tested income security programs such as the Guaranteed Income Supplement and provincial top ups and pressure would increase to expand other government programs such as Old Age Security and the CPP/QPP.

The trend towards closing defined benefit plan to new entrants, converting defined benefit plans to defined contributions plans, changing final average plans to career average, moving toward combined defined benefit /defined contribution plans is very evident in the U.S. and the U.K. (less so in Canada).

In Canada, pension coverage has declined somewhat but not as much as in the U.S. Statistics Canada reports that since 1977, the RPP coverage rate for the private sector has been steadily decreasing, from 35% in 1977 to about 27% in 2003. In 2003, over 86% of public sector workers were covered by an RPP. Public sector RPP coverage increased from 1977 to 1991, but has since been declining.

Employers are “voting with their feet” – leaving DB plans behind either gradually or immediately. Such moves appear to be more acceptable than they were in the past, drawing limited comment. Because employers are generally required to fund any deficit at plan wind up, a risk going forward is that employers will shift out of DB plans when/if their existing shortfalls are eliminated (either through increased contributions or actuarial gains).

Question / Challenge

What can or should be done to encourage employers to establish and maintain pension plans without undermining benefit security?

“AD HOC” SOLUTIONS AND CASE LAW

Where comprehensive pension reform does not occur, a system of special exemptions and regulations and “ad hoc” solutions may result (e.g. Air Canada, Algoma Steel). While this approach can and does solve particular problems, the larger problem may remain unaddressed.

In addition, fundamental pension policy is often decided by the courts when legislation is ambiguous or silent (statute law is increasingly replaced by case law).

Examples:

- ✎ *Schmidt, etc v. Air Products* (Supreme Court of Canada, June 1994) – required funds in a trust to be treated according to classic trust principles, confirmed ability to take contribution holidays.
- ✎ *Monsanto v. Ontario Superintendent of Financial Services* (Supreme Court of Canada, July 2004) – required distribution of plan surplus on partial plan wind up, restricting use of surplus for other purposes.
- ✎ *ING v. Transamerica* (Supreme Court of Canada, July 2004) – SCC refused leave for appeal, so the Court of Appeal decision stands – Court disallowed use of surplus in one part of a merged plan for the deficit in another part.
- ✎ *Kerry Canada v. Ontario Superintendent of Financial Services* (Ontario Divisional Court, March 2006 – being appealed) – Court indicated that plan expenses cannot be paid out of a pension fund unless provided for, and surplus from a DB plan cannot be used to fund DC components of a plan.

“AD HOC” SOLUTIONS AND CASE LAW

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When plan sponsors with under-funded pension plans face insolvency, many parties may be adversely affected. Governments are often asked to intervene.

In these instances, governments may be blamed both for the weak funding rules that contributed to the funding shortfall and for the onerous funding requirements that lead to the sponsor’s demise.

In Ontario, the government may be called upon to loan funds to the Pension Benefits Guarantee Fund (PBGF), although there is no legal obligation for it to do so.

Question / Challenge

A move away from ad hoc solutions and a reliance on courts and toward more comprehensive reform is supported by most stakeholders, but progress requires compromise. How can this best be achieved?

THE SEARCH FOR COMPROMISE

Particularly with respect to pension plan funding and entitlements, plan participants (members/pensioners) generally have directly opposing views to employers/sponsors;

With the exception of jointly sponsored pension plans in which plan members and employers share responsibility for deficits (most of which are multi-employer plans in the public sector), employers are responsible for deficits in most single employer plans.

While virtually all public sector plans are contributory (97%), only about one half of private sector pension plans are contributory (51%).

It is not always understood that increased pension costs for employers have an impact on the total compensation package for plan members.

In many cases there are disagreements between active members and retirees from the same plan (i.e. contribution holidays vs. benefit improvements).

When employers face financial challenges, there is a strong incentive to focus collective bargaining on improvements to pensions which can be amortized over time instead of wage increases which must be paid immediately. If the pension plan is already under funded, the result is to “dig the hole deeper”.

Question / Challenge

Legislative reform generally implements stakeholder compromises which are consistent with the public interest. Are compromises among stakeholders possible and, if so how can they be arranged?

CHALLENGES TO LONG-TERM PENSION REFORM

For the most part, pension issues are long term in nature.

When governments change frequently and minority governments are common, it may be more difficult to tackle complex issues that require extensive consultation and debate.

Governments want to get re-elected, so they may be reluctant to deal with issues likely to antagonize labour, management or pensioners, particularly when there is little middle ground on which to base a compromise.

In addition, the consequences of inaction are often long term and uncertain and government actions often draw more criticism than the failure to address a problem or issue.

Viable solutions often require compromise on the part of all stakeholders. This is easier said than done and there is a risk that short term compromises (e.g. weakening funding standards in the midst of a recession) may put the pension system at risk in the long term.

Question / Challenge

How can we design comprehensive reforms which will endure for the long term?

CONCLUSION

Clear objectives are critical. If you do not know where you want to go, you are unlikely to arrive at your destination.

Governments, pension regulators and the actuarial profession must work together to develop funding standards for defined benefit pension plans and timely action is critical.

Governments must lead by example. Differences in funding standards between public and private sector pension plans must be based upon a compelling rationale. Otherwise reforms to the standards which apply to private sector plans will be difficult to achieve.

Compromises among stakeholders including plan members, pensioners and employers will be essential if enduring comprehensive reforms are to be achieved.

Ad hoc reforms to address particular situations and reliance on courts to decide the direction of pension policy in the absence of action by Legislatures is likely to lead to sub-optimal outcomes.