Canadian Institute of Actuaries' Prescription for Canada's Ailing Pension System

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Defined Benefit pension plans are in crisis

Healthy Defined Benefit pension plans are a key element of the financial security of Canadians. However, most workers in the private sector do not have the opportunity to participate in a Defined Benefit pension plan. According to Statistics Canada, only 21% of private sector workers were covered by Defined Benefit plans in 2003, down from 29% in 1992. Pension plan sponsors in many industries are turning away from Defined Benefit plans and turning instead to Defined Contribution plans, with many large marquee name companies among those curtailing Defined Benefit plans or switching to Defined Contribution plans.

The Canadian pension system is built on four pillars:

- Universal government plans (Old Age Security, Guaranteed Income Supplement);
- Employment-related government plans (Canada Pension Plan/Quebec Pension Plan);
- Other employment-related pensions (e.g., employer or industry-sponsored plans, including workplace Defined Benefit and Defined Contribution plans); and
- Personal savings.

Weakness in any one of these pillars puts pressure on the other three.

Right now, weaknesses in private sector Defined Benefit plans threaten both the adequacy and security of Canadians' retirement income. Canada's patchwork of regulations, legal decisions, tax rules and changes in accounting standards has created problems. These problems have been compounded over the past several years by:

- Low interest rates;
- Increasing longevity;
- Volatile market yields;
- Rising pension costs; and
- Uncertainty regarding contribution holidays and plan surplus ownership.

Because of the critical importance of Defined Benefit plans in the overall pension system in Canada, the Canadian Institute of Actuaries (Institute) chooses to concentrate its prescription on Defined Benefit plans.

Saving and improving Defined Benefit pension plans is a better choice for Canadians than allowing their steady erosion

Defined Benefit plans are in the best interests of Canadians for many reasons:

1. ***Greater predictability for plan members.*** Defined Benefit plan members have a good sense of what they will receive in retirement, making future planning easier and reducing uncertainty. A strong Defined Benefit plan system also means less uncertainty for governments.
2. ***More security and less risk to plan members.*** Individuals in an ongoing Defined Benefit plan face lower risks related to low interest rates, longer-than-expected longevity and volatility of market returns.
3. ***Better workforce management***. Defined Benefit plans help employers retain good employees and they can be a tool to help employers to better manage their workforce (e.g., enhance early retirement).
4. ***Higher investment return.*** By having larger pools of money to invest and longer investment time horizons, a more aggressive, diversified and informed investment strategy with lower management fees can be used. The higher yields and lower administration costs result in greater value for dollars invested in Defined Benefit plans compared to Defined Contribution plans over the long run.
5. ***Greater economic benefit to society and the economy***. Bank of Canada Governor David Dodge supports Defined Benefit pension plans. He believes that they promote economic efficiency by allowing better allocation of savings and that they contribute efficiency gains for financial markets. He has stated that managers of Defined Benefit plans have both the ability and desire to invest in the kinds of assets which the average individual investor might not normally consider. They have a superior knowledge of financial markets and of the associated risks that make them willing to invest in alternative asset classes, and that plans invest over very long time horizons so they can finance large investment projects at competitive rates of return. An example would be investment in critical infrastructure to support Canada's future production capacity.
6. ***Better pension coverage for employees in all sectors.*** If the decline in private sector Defined Benefit plans continues unabated, in a few years the only working Canadians with a Defined Benefit plan will be in the public sector. This is a situation that private sector employers and workers would be increasingly unwilling to support.

Ten recommendations to heal Defined Benefit pension plans

The Institute believes that bold policy measures combined with plan sponsor and plan member leadership are needed now to ensure adequate retirement conditions for those who will leave the workforce in 10 years and beyond.

Saving Defined Benefit plans is an important part of the solution. The Institute's 10-point prescription aims to secure Defined Benefit plan benefits for participants and create an environment conducive to maintaining and strengthening Defined Benefit plans for plan sponsors.

Introduce innovative ways to meet funding requirements

Employers would be more likely to fund more conservatively a Defined Benefit plan if they knew they could get back surpluses that might arise from their contributions. This would assure maintenance of existing Defined Benefit plans and the creation of new Defined Benefit plans. Recommendations 1 and 2 are intended to address this reality.

1. Introduce legislation that allows employers to set up 100% employer-funded Pension Security Trusts that would be separate from but complementary to the regular Defined Benefit pension funds. The contributions arising from going concern valuations would go into the regular pension fund, while additional contributions (including those required to fund solvency deficiencies) could be made to the Pension Security Trusts. Money in the Pension Security Trusts could be released back to the employer if a subsequent solvency valuation shows that it is not needed for the Defined Benefit plan. Amounts contributed into the Pension Security Trusts would be tax deductible, while amounts withdrawn would be taxable.
2. Introduce legislation that allows the use of irrevocable Letters of Credit to secure solvency deficiencies, as some provinces and the federal government have done.

Improve the transparency of plan funding

Many plan sponsors do not have a formal funding policy for their Defined Benefit plans. Recommendations 3 and 4 are intended to rectify this situation and encourage better governance and communication.

3. Introduce legislation that would require plan sponsors to establish a written funding policy for Defined Benefit plans in order to promote clear objectives and transparency.
4. Expand the required annual disclosure by plan administrators to plan members, to include the key elements of the funding policy, investment policy and current funded status.

Change pension benefits laws and the Income Tax Act to enable improvement of Defined Benefit plans' funded status

Recommendations 5, 6 and 7 are intended to require a higher level of funding using approaches that make it more attractive for plan sponsors to develop and maintain a surplus within their Defined Benefit plans. Higher funding levels will enhance the security of members' pensions.

5. Introduce legislation that would require each Defined Benefit plan to have a Target Solvency Margin related to the risks in the Defined Benefit plan's asset mix and funded by a Pension Security Trust, a Letter of Credit or the regular pension fund. Contribution holidays would not be permitted if the plan's surplus was less than the Target Solvency Margin. For example, a particular plan might have a Target Solvency Margin of 10%, so that the plan sponsor would have to make contributions, as long as the plan assets were less than 110% of the solvency liabilities.
6. Establish a task force with representation from the Canadian Institute of Actuaries and pension regulators to develop guidance on the required levels of Target Solvency Margins. The Target Solvency Margin for a particular plan should take into account the risks faced by the plan, reflecting its member demographics and investment policy.
7. Change the tax rules to allow Defined Benefit plans to develop surpluses that are the greater of two times the Target Solvency Margin on a solvency valuation, or 25% of the going concern liability.

Other measures

The remaining recommendations are intended to enhance the security of Defined Benefit plan members' pensions.

8. Introduce legislation to protect underfunded pension benefits by according them treatment similar to that of unpaid pension plan contributions in bankruptcy and restructuring proceedings.
9. Amend legislation where required so that pension matters fall within the authority of the Ministers of Finance throughout the country to allow for pensions to be included on the national agenda and to promote consistency of pension legislation among jurisdictions.
10. Explore the feasibility of alternate ways of handling underfunded plan wind-ups for insolvent employers, such as establishing new pension insolvency insurance vehicles.

Conclusion

Time is of the essence. If all parties act on our prescription now, it will dramatically improve the health of the Canadian pension system.

APPENDIX

Why actuaries are involved in finding solutions to the Defined Benefit plan crisis

The Canadian Institute of Actuaries sees the shrinkage of Defined Benefit plans and coverage as a threat to Canadians' future financial security.

We believe that a healthy Defined Benefit pension plan environment is in the best interests of Canada and Canadians. Actuaries have long been involved in the country's pension plan system and can play an even more vital role in crafting improvements because of our unique qualifications:

- The first Guiding Principle of the Canadian Institute of Actuaries is: "In carrying on its activities and programs, the Institute holds the duty of the profession to the public above the needs of the profession and its members."
- Actuaries are the experts in the pension field as evidenced by the unique role given to them by the federal and provincial governments in assessing the cost of the pension promises made to plan members.
- Almost half of all actuaries working in Canada are involved in pension plan work and have therefore developed a unique and extensive expertise. They regularly assess and report on the funding status and future costs of Defined Benefit plans and advise pension plan stakeholders on the risks and costs inherent in alternative courses of action.