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Employment, Labour and Pension Update

STIKEMAN ELLIOTT

# Ottawa takes a swing at pension reform

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On October 27, 2009, the Government of Canada announced its intention to reform the legislative framework applicable to federally-registered pension plans as well as the tax rules applicable to nearly all registered pension plans in Canada. The announcement follows the release in January 2009 of a discussion paper and consultation period on the federal pension rules and comes in the wake of numerous provincial attempts at pension reform. No timeline has been given for when formal amendments to the affected legislation and regulations will be forthcoming, and no opportunity to comment on the announcement was offered.

The purpose of the reforms does not appear to be so much to manage the effects of the current financial crisis, but rather to make fundamental changes to pension legislation that will lessen the impact of the next one. The stated dual objectives of the reforms are to enhance the benefit security of members and retirees while making pension plans easier to fund and manage for plan sponsors. Indeed, there are initiatives in the package aimed at each such objective; however after some consideration, it is not clear whether the proposed package of reforms strikes the right balance, or simply strikes out. Below is our assessment of the hits, the misses and the hard calls contained in the Minister of Finance's announcement.

## The hits (…not home runs, mind you)

***Increase to excess surplus***

For years, plan sponsors and member groups alike have called on Ottawa to increase the low surplus thresholds in the *Income Tax Act* (ITA) above which employers are not permitted to contribute to their defined benefit (DB) pension plans. Ottawa has now finally responded, signalling its plan to increase the meagre limit of 10% of a plan's going concern liabilities applicable to most registered pension plans in Canada to a more robust 25%. The hope is that employers will sock away more cash in their pension plans in order to save for a rainy day. The goal is a good one; however, given the recent deluge, it may be quite some time before this reform will have the desired effect, as the idea of plan surplus is a far-off notion for most plan sponsors today.

What prevents this reform from being a home run is that it is not coupled with an initiative to sort out the messy rules surrounding surplus ownership. We think it unlikely that most plan sponsors will want to plough surplus money into their pension plans where it is unlikely that they will be able to retrieve it, or even recognize it as an asset on their balance sheet when Canada moves shortly to the International Accounting Standards.

This newsletter was prepared by members of the Employment, Labour and Pension Group at Stikeman Elliott.

### *A nod to Defined Contribution (DC) and Negotiated Contribution (NC) pension plans*

That the federal *Pension Benefits Standards Act, 1985* (PBSA) was not set up to deal with DC or NC pension plans is also a decades-old complaint, echoed under many of the provincial regimes. While the existing provisions of the PBSA are workable, if awkward, with respect to DC plans, they often make little sense when it comes to multi-employer pension plans structured as NC plans. Ottawa intends all that to change with its planned addition of DC and NC-specific provisions to the PBSA.

On the DC side, the PBSA and regulations are to be amended to provide "explicit guidance on the responsibilities and accountabilities applicable to employers, members, administrators and investment providers" using the regulators' Capital Accumulation Plan Guidelines as the underlying framework. On NC plans, the reforms are more specific. Among them: employer liability is to be expressly curbed at the level negotiated; the board of trustees administering a NC plan is to have the express authority to reduce benefits where plan funding levels warrant *regardless of what the plan text might say*; and clear communication of the nature of a NC benefit is to be made to members of such plans.

Inasmuch as the above reforms should provide clarity to sponsors and members of DC and NC plans, they are a hit. Given the tide of conversions from DB to DC and the emphasis placed on NC plans of late (see the various 2008 provincial commission reports on pension reform), the addition of DC and NC-specific changes to the PBSA is timely and necessary. As the effect of these changes will be limited to federally-registered DC and NC plans, we hope the provinces take the cue.

### *Benefit improvements linked to solvency ratio*

In a move to be applauded, Ottawa intends to restrict the ability of a plan sponsor to improve benefits under its plan where the solvency ratio of the plan is 0.85 or less, unless the benefit improvement is funded upfront. This will have two positive effects. First, it will effectively save employers from granting benefit increases they cannot afford. Second – and probably most worthwhile – is that the cost of any benefit improvement will have to be fully assessed prior to implementation to determine if it is permissible. This will require the price tag of benefit improvements to be truly understood upfront. In a unionized environment, where benefit increases are often negotiated now to be paid for later, this reform will improve the likelihood that promised benefits will actually be delivered.

## The misses (…some worse than others)

### *Partial terminations made worse*

One definite "miss" is the proposal to eliminate *sponsor-declared* partial terminations from the PBSA, but to leave the regulator alone the authority to declare a partial plan termination. The impetus for this measure is confusing. Under what circumstances would the Superintendent have the authority to declare a partial termination? Where such an event did occur, would there be a requirement to inform the Superintendent? Would the Superintendent be able to declare a partial termination many years after the fact?

What is clear is that the sponsor would no longer be able to control when a partial termination is declared in its plan. It is very difficult to see how this benefits stakeholders. Given that one of the other proposed reforms is to provide immediate vesting to all plan members, we see no reason not to wipe the concept of partial terminations right off the books.

### *Contribution holidays cut short*

As the legislation currently stands, an employer may take a contribution holiday so long as the pension plan shows that it has a surplus sufficient to support such contribution holiday, i.e. so long as there are at least 100 cents of assets for every dollar of liability per the last valuation report. Under the proposed reforms, plan sponsors would be prohibited from taking contribution holidays where the pension plan did not have at least 105 cents of assets for every dollar of liabilities, or assets that exceed its liabilities by 5% measured on a solvency basis.

The Department of Finance's stated rationale for such reform is that this new 5% cushion would enhance benefit protection, by reducing the likelihood that the plan would become underfunded as a result of fluctuating asset and liability values. However, the evolution of plan deficits in Canada has generally been far more closely linked to poor investment fund performance and declining interest rates than to contribution holidays. Moreover, one other effect is that sponsors will be required to pay more into their plans than they otherwise would have, maintaining a surplus

that, as noted above, will be fought over on the plan's eventual termination and will suffer the accounting treatment noted above. Because it is not coupled with clear and fair surplus ownership rules, this reform is a "miss".

## The hard calls

### *"Modernization" of investment rules*

Under the heading of "modernization", Ottawa announced that it will be amending the pension fund investment rules in Schedule III to the *Pension Benefits Standards Regulations, 1985* to (1) remove the quantitative limits in respect of resource and real property investments (currently there are total and individual limits on the amount of plan assets that may be invested in parcels of real and resource property), (2) change the measure of the limit on a plan investing more than 10% of its assets in any one investment from book value to market value (with an exception for certain pooled investments) and (3) prohibit holding employer shares even where acquired on the market. Because Schedule III is incorporated by reference into the pension regulations of Alberta, British Columbia, Manitoba, Ontario and Saskatchewan, these amendments will affect both federal plans and plans registered in those provinces.

In and of itself, change (1) would be a "hit", as many of the larger plans are bumping up against the current arbitrary limits on the amount of plan assets that can be invested in real estate. However, changes (2) and (3) could prove difficult to manage. First, market values fluctuate (as we have seen), so keeping an eye on those values will be a near daily event where investment levels creep up near the 10% threshold. Second, employer shares are not an inherently bad investment – the regular standards of prudence and fair dealing should be enough of a constraint where they are concerned.

These concerns aside, the shortcomings of (2) and (3) could have been overlooked had a larger problem with Schedule III – the 30% ownership limit on the voting securities of an entity – been addressed. This limit was ripe for relaxation or even repeal, at least for those big and sophisticated plans for which this rule now acts as a barrier to efficiency. True modernization would have entailed a recognition of the wealth and the wealth of knowledge that exists within the big plans and to allow them to opt out of certain rules where appropriate.

### *Full funding on plan termination*

Ottawa has finally made good on its on-again-off-again intention (threat?) to require that federally-registered pension plans be fully funded on plan termination, announcing that the PBSA will be amended to require that any deficit existing on plan termination must be funded and amortized over no more than 5 years post-termination. This reform aligns the federal regime with that of the pension legislation of every other Canadian jurisdiction (save Saskatchewan).

The announcement states clearly that a deficit remaining on plan termination will be an *unsecured* debt of the employer, thus putting an end to speculation that a priority in bankruptcy was to be instituted with respect to deficits remaining on plan termination. This may raise the ire of plan members and retirees (especially those marching on Parliament Hill over the past few weeks). However, it will come as a relief to DB plan sponsors in need of any sort of financing, as it is unlikely that any financial institution would lend money on workable terms where a pension plan deficit could outrank such financing in a liquidation scenario.

### *Liability smoothing and an annual "fresh start"*

Sponsors will always be required to file a valuation report annually, instead of only once every three years as is often currently required. Annual filings will keep closer tabs on a plan's financial position, whether it be in surplus or deficit. In order to curb the volatility associated with annual snapshots, Ottawa has proposed that solvency liabilities be smoothed over a 3-year period, and that each year, the solvency deficit will be measured without reference to the amortization of previous years' deficit payments – as if it were a fresh start. Also, the 5-year and 15-year amortization periods for solvency and going-concern deficits remain unchanged. Notably absent from this proposal is any rethinking of the basis on which solvency liabilities are computed in the first place, e.g. whether long-term government bonds remain the sole appropriate yardstick for solvency discount rates.

***Enhanced disclosure requirements***

The reforms will also cause the content of annual member statements to be expanded to include information that will provide members with a better picture of the plan's financial status. Among the new requirements, member statements will have to include the total assets and liabilities of the plan, a summary of the plan's investments and its 10 largest investment holdings. It is not really clear to us how this additional information will truly help members – but we doubt it will hurt, either.

***Grab bag***

The reform package includes a host of other proposed technical amendments to the PBSA and its regulations to better align the legislative framework with its current interpretation and administration. Among them, the major one is the creation of a repository to which employers may transfer the benefits of members who cannot be located. Others include granting additional powers to the federal pension plan regulator to intervene where there are concerns about the work of a plan's actuary and amending the definition of former member to ensure that plan members who have transferred to a new plan do not have a say in future surplus distributions in an older, original plan.

## Knocked out of the park

In a proposal strikingly similar to the process and regime put in place for Air Canada and its pension plans this past summer, Ottawa has proposed that the stakeholders in distressed plans be permitted to negotiate plan-specific solutions where a plan sponsor is unable to meet the ordinary funding requirements.

These measures are intended to be used in very limited circumstances for a plan sponsor in critical need, and must be initiated by a declaration from the employer's board indicating that it is unable to make an upcoming special payment (i.e. deficit reduction contribution). Such a sponsor would immediately be granted a temporary moratorium on special payments until an alternate funding arrangement could be negotiated. In reality, we see this relief as being part of a distressed employer's larger corporate restructuring, whether under bankruptcy protection proceedings or otherwise, as the news that the employer cannot make its pension contributions would undoubtedly have an effect on its ability to seek and maintain credit and carry on business generally.

Having had front row seats in the Air Canada funding relief process, we applaud the Minister of Finance for seeking to codify a clear process, transparent to all stakeholders, and to allow access to relief where the existing funding requirements imposed by the current framework are ill-suited to a particular circumstance.

It is true that in their small way, many of the proposed reforms will be useful for those DB plans that survive. It is also true that such reforms will not fix the problems inherent with DB plans. For this, more would be required than the minor tweaking of the system delivered by the Minister of Finance last week. Canada's pension system is in need of a fundamental overhaul. Sadly, that is not what has been delivered.

For further information, please contact your Stikeman Elliott representative, the author listed above or any member of our Employment, Labour and Pension Group listed at www.stikeman.com

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