



# Research Advisory

Hewitt

Canadian Research Group

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## Highlights

Recently announced changes to the legislation governing federally regulated private pension plans will benefit both plans sponsors and members.

As well, *Income Tax Act* changes will increase the surplus threshold for all Canadian registered plans.

Finally, new investment rules will impact all federal and most provincially regulated plans.

The Hewitt Research Advisory is a regular Hewitt newsletter designed to provide a detailed overview of specific legislative and regulatory developments in Canada relating to human resources.

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## Federal Pension Initiatives Announced

### Introduction

In early January, the federal government published a Discussion Paper on strengthening the legislative and regulatory framework for private pension plans registered under the *Pension Benefits Standards Act, 1985* (PBSA). In March and April, public consultations were held across Canada and, on October 27, 2009, the resulting reform package was released by the Department of Finance. While the package of reforms is of primary importance for federally regulated pension plans, it will be of interest across the country because it contains broader investment initiatives and important changes to the *Income Tax Act* (ITA) that could affect all Canadian registered pension plans.

***Hewitt Comment:*** *It is important to note that federally registered pension plans represent only 7 per cent of all Canadian plans and 11 per cent of all plan members, primarily concentrated in a small number of industries (such as banking, telecommunications, airlines, and railroads).*

*These changes also represent the first attempt at reform following the conclusion of high profile expert commission processes in Ontario, Alberta, British Columbia and Nova Scotia, and could serve as a possible model for other jurisdictions contemplating reform of their pension legislation. As well, they could be a focus for efforts to harmonize pension regulation across Canada.*

## Increased ITA Surplus Threshold

One aspect of the federal government's reform package that could affect all Canadian registered pension plans is the proposal to increase the pension surplus threshold in the ITA, from 10 to 25 per cent for employer contributions relating to current service costs for 2010 and subsequent years. Currently, a plan sponsor is not permitted to make contributions to the pension plan if the surplus in the plan exceeds the minimum of (1) and (2) below:

- (1) the greater of:
  - (i) 10 per cent of the going concern liabilities or
  - (ii) two times current service cost;
- (2) 20 per cent of going concern liabilities.

**Hewitt Comment:** *The government has not commented on what will happen with the two times current service cost or 20 per cent threshold in this formula.*

*This change is designed to provide more funding flexibility, help plan sponsors maintain a surplus cushion and reduce the likelihood and future severity of funding deficiencies. The change would also replace the existing surplus tax rules for fixed-cost shared plans (also known as jointly-sponsored plans) and designated plans.*

*Many observers have commented that one reason for the current solvency crisis was the strict limits on employer contributions for plans in surplus. This is a welcome change as it will permit plans to build up a larger surplus than is currently the case, thereby insulating member benefits in the event of future significant market downturns. However, many others doubt that the change will encourage better funding, until plan sponsors have more certainty with respect to surplus ownership.*

*As well, it has been noted this change is too late for the current solvency funding crisis, as many plan sponsors are struggling to simply address deficiencies. In response to the current solvency funding crisis, many jurisdictions (including the federal jurisdiction) have implemented temporary solvency relief regulations to reduce the onerous funding requirements created by recent market turmoil.*

## Modernization of Pension Fund Investment Rules

Another aspect of the reform package that could have direct implications on the majority of Canadian registered plans is its proposal to "modernize" pension fund investment rules. Although contained in Schedule III to the PBSA, these rules have been adopted by reference within all jurisdictions except New Brunswick and Quebec. As proposed, changes to the pension investment rules would:

- remove the quantitative limits of between 5 and 25 per cent in respect of resource and real property investments;
- amend the 10 per cent concentration limit currently based on the fund's book value, so that it is based on market value, subject to an exception for pooled investments over which the employer exercises no direct control; and
- prohibit direct self investment, so that an employer would no longer be allowed to invest any amount of its pension fund in its own debt or shares.

**Hewitt Comment:** *This is a small and welcome step in aligning the investment regulations with market practices. For diversification rules to be meaningful, they should reference market value rather than book value. Quantitative rules for real estate and resource investing were overly prescriptive, given the prudent person context.*

*The prohibition on holding the plan sponsor's securities may have been a reaction to many large North American companies that were insolvent leaving their employees with no jobs and decimated retirement plans. The government will also need to clarify whether pooled funds containing the plan sponsor's own securities are acceptable (we certainly hope so). They will also need to confirm the implications for existing holdings of employer securities. While we would have preferred to see restrictions instead of an outright prohibition, the impact of this change on defined benefit and defined contribution pension plans is unclear at this point. However, we suspect that it will have a greater impact on defined contribution plans.*

*Some provinces will also need to legislate the adoption of these federal investment rules, whereas others will adopt them automatically based on the current wording of their regulations.*

## **Enhanced Protections for Plan Members**

As has already occurred in most other jurisdictions, sponsors of pension plans registered under the PBSA will be required to fully fund pension benefits on plan termination. Any solvency deficit that exists on termination will be amortized in equal payments over no more than five years, and the obligations of the employer determined following termination will be considered unsecured debt of the company.

Contribution holidays will only be permitted if the pension plan is more than fully funded by a solvency margin, which will be set at 5 per cent of solvency liabilities. A requirement that sponsors file their valuation report annually instead of every three years for a plan in surplus will lead to contribution holidays being taken based on a more recent picture of funded status.

**Hewitt Comment:** *The contribution holiday limitation is designed to provide some additional security to plan members, and follows similar legislation in Quebec. The*

*Ontario Expert Commission Report has also called for such measures and we believe many other provinces may follow suit.*

*Currently, the Office of the Superintendent of Financial Institutions (OSFI), the federal regulator, has authority to demand that administrators for any plan file valuation reports more frequently than triennially. Typically this authority is used for high-risk plans. A continuation of this regime would have been ideal, as the requirement for annual valuations will increase pension plan expenses unnecessarily for many pension plans, particularly smaller ones that may already be well-funded.*

The new federal regime will not permit a plan to incorporate an amendment if the funded ratio on a solvency basis is under 0.85 unless such amendment is fully funded on implementation.

Immediate vesting of benefits will be provided, instead of the current rule that allows for a maximum two-year period before accrued benefits can vest.

Sponsor-declared partial terminations will be eliminated, but the Superintendent will retain the ability to declare a termination in part.

Enhanced disclosure for annual member statements will be required, and the provision of disclosure electronically will be permitted on a positive consent basis.

***Hewitt Comment:*** *The immediate vesting initiative follows a similar move in Quebec several years ago, and is in line with comments made by various expert commissions. However, the result could be increased administrative expenses, particularly for defined benefit plans, which can outweigh the actual benefit value in many cases.*

*We also believe that there is minimal benefit to plan members in continuing to allow the Superintendent to declare a partial wind up, since there will be immediate vesting for all benefits. As well, the Federal Court of Appeal recently confirmed in the Marine Atlantic decision that there is no statutory right to surplus distribution on a partial termination. We believe it would have been more prudent to eliminate partial wind ups altogether, to reduce uncertainty and the additional expenses they entail.*

## **Reduced Funding Volatility for DB Plan Sponsors**

In addition to the increased ITA surplus threshold discussed above, measures to reduce funding volatility will include a provision that the average solvency position of a plan for funding purposes be defined as the average of the solvency ratios over three years, based on the market value of plan assets. Whenever a new solvency deficiency is revealed, past deficiencies will be consolidated and amortized over a five-year period for establishing solvency special payments (ie: a fresh start basis). The amortization

period for solvency deficiencies will remain at five years; and the going concern methodology and its 15-year amortization period will remain unchanged. Sponsors will be permitted to use letters of credit to satisfy solvency payments up to a limit of 15 per cent of plan assets.

***Hewitt Comment:*** *Using solvency ratios over three years is welcome and should help reduce solvency contribution volatility; certain provinces already allow for some similar form of smoothing. The consolidation of past deficiencies will also help reduce contribution variability, and should act as ongoing solvency funding relief should there be several consecutive years of losses. However, we fear that reduced volatility could be achieved at some expense to benefit security.*

*Using letters of credit is also welcome, follows the lead of other jurisdictions, and may give plan sponsors some additional funding flexibility when cash flow is an issue; but the predicament is that, for plan sponsors who are experiencing cash flow problems, securing a letter of credit could prove difficult.*

## **A New Framework for DC and Negotiated Contribution DB Plans**

A new framework will provide explicit guidance on the responsibilities and accountabilities applicable to employers, members, administrators and investment providers with respect to defined contribution plans. Pension plans will be able to permit members to receive Life Income Fund (LIF) style retirement benefit payments directly from a defined contribution pension fund. There will also be a separate framework in respect of negotiated contribution defined benefit plans.

***Hewitt Comment:*** *This new defined contribution framework responds to a frequent complaint that the PBSA only addresses defined benefit issues. It is important that the legislation be responsive to the unique features of defined contribution and negotiated contribution defined benefit plans as well.*

## **Other Pension Reform Measures**

The government's reform proposals include various additional measures that will:

- establish a workout scheme for pension plan sponsors with distressed plans where it is unlikely that contribution requirements will be met;
- allow the benefits of members who cannot be located on termination to be transferred to a central repository;
- amend 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 the older, original plan;

- clarify that an administrator shall comply with a court order or separation agreement related to pension entitlements that runs contrary to the PBSA's joint and survivor pension benefit provisions; and
- require that payments owed to pension plans be remitted monthly rather than quarterly.

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