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The Management and Regulation of Occupational Pension Plans in Canada

by

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Introduction

The purpose of this study is to examine the management of occupational pension plans[1] in Canada and, in particular, the legal structures that have been put in place to regulate their administration and financing. The study consists of five sections:

- The first section discusses the framework for the regulation of occupational pension plans. It describes the complementary roles played by the tax authorities and by the government agencies that oversee occupational pension plans.

- The second section examines the statutory provisions through which the framework described in the first section is implemented. It summarizes the requirements of the laws[2] regulating occupational pension plans as those laws relate to the administration, funding and investments of the plans. It also summarizes the relevant requirements of the *Income Tax Act*.

- The third section looks at non-statutory mechanisms for improving the management of occupational pension plans. These include the governance guidelines of the Canadian Association of Pension Supervisory Authorities and the training and information initiatives of the Régie des rentes du Québec.

- The fourth section analyzes the financial difficulties that many defined benefit pension plans in Canada face, the underlying causes of those difficulties, and the solutions that have been proposed to resolve them, including pension benefit guarantee funds.

- The fifth section summarizes the principal conclusions that can be drawn from the descriptions and the analyses in the study.

The framework for the regulation of occupational pension plans

The first formal step to regulate occupational pension plans in Canada was taken in 1946 when the Department of National Revenue, which at the time was the agency of the federal government responsible for the administration of the *Income Tax Act*, issued guidelines to determine whether a plan qualified for the preferential tax treatment offered under the Act. Since 1917 this preferential tax treatment had allowed employers to deduct contributions to occupational pension plans as a business expense when calculating income subject to income tax, and since 1942 the *Income Tax Act* had allowed employees similarly to deduct their contributions. The policy objective sought through this preferential tax treatment was to encourage savings for retirement. However, in the absence of specific legal provisions regarding pension plans, the Department of National Revenue had no clear basis for determining if contributions were being made for the intended purpose or simply as a means of avoiding taxation. In particular, the Department was concerned that contributions to pension plans could be used as a means of bypassing the wage freeze and the excess profit tax that had been imposed during the Second World War [Albert 2006; Whiston and Gottlieb 2005]. The purpose of the 1946 guidelines was to fill the legal gap.

The federal tax authorities, now known as the Canada Revenue Agency (CRA), continue to this day to play an important role in the regulation of occupational pension plans. Although the policy objective for giving such plans preferential tax treatment – encouraging savings for retirement – remains unchanged, the focus of the CRA's involvement has evolved since 1946 and consists of two related goals. The first is to make certain that pension plans are legitimate vehicles for providing retirement income, and not devices to avoid tax on savings in general. The second is to ensure that the contributions eligible for deduction are in amounts that the government considers as reasonable [Albert 2006; Whiston and Gottlieb 2005].

The total value of the tax which is foregone[3] because of the preferential tax treatment given to occupational pension plans is large and explains the ongoing role of the tax authorities in regulating such plans. According to estimates by the federal Department of Finance, the deductibility of contributions to occupational pension plans will result in foregone taxes of $10,000 million[4] in 2006. The exemption from taxation of the investment income of pension plans will result in further foregone taxes of $10,670 million. These two amounts, however, are partially offset by the tax that is collected on the benefits paid by occupational pension plans. This tax is estimated as $8,340 million, leaving a net cost to the federal treasury in 2006 of $12,330 million [Finance 2005a]. In addition to the cost to the federal treasury, the provincial treasuries also forego taxes because of the preferential tax treatment given to occupational pension plans. This can be estimated as a little less than half of the costs to the federal treasury, or about $6,000 million.

While the federal tax authorities have historically played, and continue to play, an important part in regulating occupational pension plans, their role is limited under the Canadian Constitution to issues related to taxation. It became increasingly clear in the 1960s, when occupational pension plans expanded rapidly in Canada, that there was a need for regulation which extended beyond issues of taxation. In particular, there was a need for laws to protect the interests of plan members by regulating the key terms and conditions of occupational pension plans as well as the administration of the plans, their funding and their investments.

This additional, and from the perspective of plan members unquestionably more important, role in the regulation of occupational pension plans is played by the agencies of the federal and provincial governments which have been mandated to apply the respective federal and provincial laws governing pension benefits.[5]

Pension benefit laws in Canada have evolved over the past 40 years. In the first stage of their evolution, which took place primarily in the mid and late 1960s and the early 1970s, the first pension benefit laws were enacted in most provinces as well as at the federal level. Those laws established minimum standards regarding various aspects of occupational pension plans. In the second stage, which occurred in the 1980s and early 1990s, the minimum standards were improved and strengthened. The emphasis was on broadening membership in occupational pension plans (in particular to include part-time workers), enhancing the rights of members (for example, by shortening the length of the period of service needed to acquire the right to a pension on reaching pensionable age), and expanding benefits (for instance, requiring survivors pensions). Finally, in the third stage of the evolution of pension benefit laws, which began around 2000 and continues to this day, attention has been focussed on the governance of occupational pension plans and strengthening their funding.

In order to qualify for the preferential tax treatment offered under the *Income Tax Act*, a pension plan must be registered with the Canada Revenue Agency. One of the conditions for obtaining this registration is that the plan also be registered with the provincial or federal agency responsible for the pension benefit law applicable to the plan, thus ensuring that occupational pension plans comply with all the requirements of the regulatory framework under both the tax and the pension benefit laws.[6] This reflects the complementary roles played, on the one hand, by the federal tax authorities and, on the other hand, by the provincial and federal regulatory agencies.

Statutory provisions regarding the administration, funding and investments of occupational pension plans

To understand how the regulatory framework described in the previous section is applied in practice, it is necessary to examine several specific aspects of the laws applicable to occupational pension plans: the designation of the plan administrator and the plan trustee, the obligation to provide sufficient funding, the rules regarding the investment of the assets of a plan, the process for registering a plan and ongoing reporting requirements, and the requirements for communicating with plan members.

Nine provinces of Canada as well as the federal government have implemented pension benefit laws.[7] To simplify analysis, this study only discusses the laws in three jurisdictions – at the federal level and in the provinces of Quebec and Ontario. Two-thirds (66 percent) of the occupational pension plans in Canada with almost three-fifths (58 percent) of all plan members are registered in these three jurisdictions [Statistics Canada 2006]. The titles of the relevant pension benefit laws and of the agencies responsible for overseeing their application are shown in Table 1.

Designation of the plan administrator and the plan trustee

The plan administrator is the person, group or entity responsible for managing the affairs of an occupational pension plan. The plan text, which is the document setting out the plan's terms and conditions, must specify the plan administrator and, if the administrator is a committee or board of trustees, the method of selecting the members.

Table 1
Pension benefit laws

Jurisdiction	Title of the law	Regulatory agency
Federal	*Pension Benefits Standards Act, 1985*	Office of the Superintendent of Financial Institutions (OSFI)
Quebec	*Supplemental Pension Plans Act*	Régie des rentes du Québec (RRQ)
Ontario	*Pension Benefits Act*	Financial Services Commission of Ontario (FSCO)

For occupational pension plans under federal jurisdiction or the jurisdiction of the province of Ontario, the plan administrator can be the employer, a pension committee established for this purpose (usually consisting of representatives of the employer, although representatives of members can also be included) or the financial institution or insurance company guaranteeing benefits under the plan (if there is one). In the case of multi-employer plans, the plan administrator must usually be a board of trustees.[8]

In Quebec, the plan administrator must be a pension committee whose members are appointed in accordance with the plan text.[9] The committee must have at least three members. One of the members must be a representative of the active members of the plan (those paying contributions to the plan or on whose behalf contributions are being paid) and another must be a representative of the non-active members (for example, persons receiving a pension from the plan). There must also be a third member of the pension committee who is independent of both the members and the employer. The Quebec law does not set a limit on how many other members may be appointed to the pension committee nor does it prescribe the criteria for selecting those other members (except that the criteria must be contained in the plan text). Therefore, representatives of the employer can, and usually do, form a majority of the committee.

The Quebec law is the only one in Canada which requires, in all instances, that the administrator of an occupational pension plan be a pension committee and that members of the plan be represented on the committee. Under the federal and Ontario laws, a pension committee can be the plan administrator, but, as noted above, other options are also allowed. However, under the federal law, if the plan administrator is a pension committee, both the active members and the retired members each have the right to be represented on the committee if a majority of them so request.

In addition to designating the administrator, the pension benefit laws require that there be a plan trustee responsible for holding the assets of the plan. The employer cannot be the trustee. Under the federal and Ontario laws, the trustee can be a financial institution (generally speaking, an insurance or trust company) or a board of trustees established for this purpose. If the trustee is a board, the Ontario law requires that there be at least three members and that at least one of them be independent of the employer. In Quebec, the pension committee serves as the trustee unless the plan is one under which benefits are insured by a life insurance company (in which case that company is the trustee).

Obligation to provide sufficient funding

Under federal and provincial pension benefit laws, an occupational pension plan, at any given time, should have sufficient assets – accumulated through contributions and the income derived from investing past contributions – to enable it to pay the pensions and other benefits which current and past members (including retirees) have earned to date. This is often referred to as 'advance funding'.

A defined contribution pension plan is, by definition, always sufficiently funded because the benefits that are due to a member are only determined at the time that he/she qualifies for a pension, and they are based exclusively on the total amount credited to the member at that time and the annuity which that amount can purchase.

In the case of a defined benefit pension plan, on the other hand, it is much more complicated to determine if the scheme is sufficiently funded. The benefits due to a member are determined according to a formula given in the plan text. The formula is based on factors which cannot be determined with certainty until the benefits start to be paid. These factors can include the member's total length of service and future earnings. Equally, the sufficiency of the contributions that have been made to date will depend on factors that cannot be precisely known – for example, future rates of inflation, future long-term interest rates, and the income that will be derived from investing the plan's funds.

In order to determine whether a defined benefit occupational pension plan is sufficiently funded, an actuarial valuation of the plan's assets and liabilities is required. Under federal and provincial pension benefit laws, such an evaluation must be conducted at least every three years. The valuation must be done on two bases: a solvency basis and an ongoing basis. Whiston and Gottlieb [2006: 190-191] describe these as follows:

> An ongoing valuation focuses on the ability of the plan to meet its obligations, assuming that it continues to operate. For example, in a final average earnings plan, the valuation on an ongoing basis views the plan as if members will continue to accrue benefits and receive pay increases, in accordance with the plan terms and assumptions used in the valuation respectively. The ongoing valuation attempts to show whether the funding of the plan is on course …
>
> A solvency valuation focuses on the ability of the plan to meet its obligations if it is terminated as at the review date. At first glance, it may seem more likely that a plan will be fully funded on a solvency basis simply because members cease to accrue benefits. However, the plan terms or [applicable pension benefit law] may result in the plan having additional liabilities on termination that it does not have if it continues on an ongoing basis. The solvency of the plan is determined as the aggregate of the market value of the plan assets and the present value of future special payments, over the liabilities of the plan where the liabilities are determined on a plan termination basis. If liabilities exceed assets, the plan has a solvency deficiency, and if assets exceed liabilities, the plan has a solvency excess.

In accordance with the terms and conditions set out in the plan text, employees may be required to make 'current service' contributions to finance part of the cost of the future benefits that are related to service during a year.[10] However, whether or not this is the case, the federal and provincial pension benefit laws obligate the employer to bear the ultimate responsibility for providing sufficient funding to ensure the payment of the benefits promised by a defined benefit plan.[11] Any shortfall in funding that is revealed in an actuarial valuation of the plan is the responsibility of the employer and must be paid (amortized) within a prescribed period of time.

The prescribed period for amortizing an unfunded liability depends whether the liability is determined on an ongoing basis or on a solvency basis. Funding shortfalls on an ongoing basis must usually be amortized over a period of not more than 15 years. Funding shortfalls on a solvency basis, on the other hand, must be amortized over a shorter period. Until recently, this period under federal, Quebec and Ontario laws was not more than five years. However, in response to the funding problems that many defined benefit plans in Canada have encountered in recent years (discussed further in the fourth section of this study) both the federal and Quebec governments have extended that period to as much as ten years.[12]

In the case of Quebec, a plan must meet one of two alternative conditions in order to qualify for an extension to ten years. The first alternative is that the pension plan "obtain a suitable guarantee to cover the difference between the value of the amortization payments that would have been required under [the rules previously in effect (i.e. over five years)] and the value of the payments actually made after taking advantage of the relaxed amortization requirements for solvency deficits." The guarantee must be from a source outside the pension fund. The second alternative is to "obtain the consent of the active members as well as of the non-active members and beneficiaries (including retirees) with less than 30% opposition within each of the two groups" [RRQ 2005: 69].

In the Budget brought down in April 2006, the federal government announced its intention to take measures similar to those of Quebec and to extend the amortization period for solvency deficits to ten years [Finance 2006a]. For occupational pension plans subject to the federal pension benefit law, an extension to ten years is not allowed if one third (33 1/3 percent) or more of the active members or of the non-active members and beneficiaries object [Finance 2006b].

Ensuring that defined benefit occupational pension plans are sufficiently funded is one of the primary objectives of the federal and provincial pension benefit laws. One means of accomplishing this goal would be to encourage employers with defined benefit plans to maintain surpluses in their plans in order to provide a cushion that would absorb at least part of the impact of unforeseen negative micro- and macro-economic developments such as a decline in the profitability of the employer or a drop in equity markets. However, this raises a concern for the tax authorities: employers might try to defer the tax on their profits by putting them into the pension plan even if the pension plan is already in surplus and does not require additional contributions. This would mean that the profits, to the extent they are contributed to the pension plan, would be deductible from the employer's income subject to income tax. It would also mean that the income derived from investing those profits would be exempt from taxation as long as it remains in the plan.

In response to these concerns, the *Income Tax Act* sets a limit on the amount that employers can contribute to an occupational pension plan. Generally speaking, an employer's contributions in a year cannot exceed an amount that would bring the surplus of the plan to a level greater than ten percent of the plan's liabilities, as determined by the plan's most recent actuarial valuation. As will be seen in the fourth section of this study, this 'ten percent' limit has been the subject of considerable debate. Along with several court decisions regarding the ownership of surpluses in defined benefit pension plans,[13] the limit, in the view of many, effectively discourages employers from taking measures that would protect their defined benefit plans from unforeseen economic developments that could adversely affect the plans and the security of their benefits.

Rules regarding the investment of the assets of a plan

The overriding objectives of pension benefit laws are to protect the interests of plan members and, in particular, to ensure that the plans will be able to pay the promised benefits when the pensions become due. One of the ways in which pension benefit laws meet these objectives is to prescribe rules for the investment of the assets of a pension plan, especially in the case of defined benefit plans. As well, given the concern of the tax authorities that the preferential tax treatment given to pension plans be used to further the goal of providing income in retirement and not simply as a means of avoiding taxation, the *Income Tax Act* also has rules regarding the investment of plan assets.

The rules set out in the *Income Tax Act* are straightforward. First, an occupational pension plan cannot invest in the shares or bonds of the employer unless the shares are publicly traded on a recognized stock exchange (in which case both the employer's shares and bonds are permissible investments). Second, the plan's investments must conform to the requirements of the federal or provincial pension benefit law to which the plan is subject.

Until 2005, the *Income Tax Act* placed an upper limit on the amount of a plan's assets that could be invested outside Canada. This restriction, which had been 30 percent of the plan's assets, was eliminated in 2005 [Finance 2005b]. The rationale for eliminating the limit on foreign investment was, in part, that financial markets in Canada make up only a small fraction of worldwide markets, so allowing occupational pension plans unlimited access to out-of-country markets permits greater diversification and, therefore, can result in lower investment risk. However, as a greater portion of a plan's assets are invested outside Canada, its currency-exchange risk increases since benefits are almost always denoted in Canadian dollars [Whiston and Gottlieb 2005: 445].

The most significant rules regarding the investment of the assets of an occupational pension plan are found in the federal and provincial pension benefit laws. These rules are based on three considerations: the 'prudent person' or 'reasonable person' principle, the need for diversification in the investment of the assets of the plan, and the requirement for a written investment policy.

The 'prudent person' principle is found in the pension and trust laws of many countries, especially those with legal traditions derived from the United Kingdom. An example of its wording can be found in article 8 of the federal pension benefit law:

> (4) In the administration of the pension plan and pension fund, the administrator shall exercise the degree of care that a person of ordinary prudence would exercise in dealing with the property of another person.
>
> (4.1) The administrator shall invest the assets of a pension fund in accordance with the regulations and in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund.
>
> (5) Without limiting the generality of subsection (4), an administrator who in fact possesses, or by reason of profession or business ought to possess, a particular level of knowledge or skill relevant to the administration of a pension plan or pension fund shall employ that particular level of knowledge or skill in the administration of the pension plan or pension fund.

Quebec's pension benefit law is based on the 'reasonable person' principle. Article 151 of the law states this principle as follows:

> The pension committee shall exercise the prudence, diligence and skill that a reasonable person would exercise in similar circumstances; it must also act with honesty and loyalty in the best interest of the members or beneficiaries.
>
> The members of the pension committee shall use in the administration of the pension plan all relevant knowledge or skill that they possess or, by reason of their profession or business, ought to possess.

The requirements set out in pension benefit laws regarding diversification in the investment of the assets of a pension plan define, to some extent, how a prudent or a reasonable person is expected to act in making investment decisions. These requirements prescribe quantitative limits on certain types of investments and, in the case of Quebec, an explicit statement regarding diversification. By way of illustration, article 171.1 of Quebec's pension benefit law states the following regarding the investment of the assets of an occupational pension plan:

> Unless it is reasonable in the circumstances to act otherwise, the pension committee must endeavour to constitute a diversified portfolio so as to minimize the risk of major losses.

In addition, the Quebec law sets out two quantitative limits: the assets of a pension plan cannot be invested, directly or indirectly, in securities controlled by the employer in a proportion greater than 10 percent of the total book value of those assets; and the assets of a pension plan cannot be invested, directly or indirectly, in shares carrying more than 30 percent of the voting rights of all the shares of a company taken together.

The federal and Ontario pension benefit laws contain considerably more quantitative limits than the Quebec law. Under the federal law, for example, a pension plan cannot invest more than 10 percent of its assets in any one company or in two or more related companies. Various limits are also placed on the investments that can be made in real property, such as land and buildings, and in resource properties, such as oil and gas fields.

The third important part of the rules regarding investments found in pension benefit laws is the requirement that a plan have a written statement of its investment policy and procedures. The development of such a policy requires the administrator of a pension plan to consider the various factors that need to be taken into account in investing the assets of the plan. The policy provides guidance to the plan administrator in making investment decisions.

As an example of what an investment policy should contain, the federal law requires the following:

- categories of investments and loans, including derivatives, options and futures;
- diversification of the investment portfolio;
- asset mix and rate of return expectations;
- liquidity of investments;
- the lending of cash or securities;
- the retention or delegation of voting rights acquired through plan investments; and
- the method of, and basis for, the valuation of investments that are not regularly traded at a public exchange.

The three-part regulatory structure just described governing the investment of the assets of pension plans – the 'prudent person' or 'reasonable person' principle, the requirement for diversification in investments along with quantitative limits, and the requirement for each plan to have a written investment policy – is intended to balance the need for oversight by public regulatory agencies and the desirability of allowing plan administrators with broad discretion in making investment decisions. Measured by its results to the present time – that is, the ability of occupational defined benefit pension plans to pay the promised benefits – the regulatory structure has been successful. There have been no significant defaults by pension plans in Canada. However, the financial difficulties currently faced by many defined benefit pension plans in Canada (discussed in the fourth section of this study) demonstrate weaknesses in the structure that require attention.

Registering a pension plan and ongoing reporting requirements

As was noted earlier in this study, an occupational pension plan must be registered with the Canada Revenue Agency (CRA) as well as with a federal or provincial agency regulating such plans. In both cases, the registration process involves submitting various documents and information that will allow the two agencies to determine whether the plan meets the requirements set out in the laws which they administer. Among the most important of these documents is the plan text, which sets out the plan's terms and conditions. In the case of a defined benefit plan, pension benefit laws also require that an actuarial report be submitted either as part of the registration process or within a short period following the establishment of the plan.

Any modification to an existing occupational pension plan must be submitted in writing to the CRA and to the agency regulating the plan. Before a modification can enter into effect, it must be accepted for registration by the CRA and the regulatory agency.

The *Income Tax Act* and the federal and provincial pension benefit laws set out specific requirements for ongoing reporting that all the occupational pension plans must meet. An occupational pension plan must submit an annual report to the CRA and to its regulatory agency which contains various types of information such as the composition of the membership of the plan and the contributions that have been paid.

In addition, at least once every three years a defined benefit plan must submit an actuarial valuation. The regulatory agency may require a plan to submit actuarial valuations more frequently then every three years if a previous valuation shows a funding deficit on a solvency basis. Under the Ontario law, for example, if a plan's actuarial valuation shows a deficit on a solvency basis that is more than 10 percent of the plan's estimated liabilities and if the amount of the deficit exceeds $5 million, or if the deficit is more than 20 percent of the plan's liabilities irrespective of the dollar amount of the deficit, another actuarial valuation must be conducted and submitted to the regulatory agency within one year. Through these kinds of provisions in pension benefit laws, the regulatory agencies are able to monitor the funding status of all occupational pension plans and to direct particular attention to those plans whose funding gives reason for concern.

In addition to the regular requirements for ongoing reporting, the federal and provincial regulatory agencies have broad authority to require a plan to submit additional information on the plan's financing if they have reason to believe that the plan's funding is insufficient or not in accordance with the applicable pension benefit law. As well, the regulatory agencies have developed tests that allow them to identify plans which are at a greater risk of funding shortfalls and, therefore, which require a higher degree of oversight.

Communicating with plan members

Pension benefit laws set minimum requirements regarding the information that an employer with a pension plan or the plan administrator must provide to members about the plan in general and about each member's individual accrued rights under the plan. These are as follows [Albert 2006: 141; Whiston and Gottlieb 2005: 410]:

- a written description of the plan;
- an annual personal statement;
- a personal statement when an employee ends membership in a pension plan; and
- access to information, including key documents related to the plan.

Every employee must be given a written description of the pension plan when he or she becomes eligible for membership in the plan. Members must also be given a written description of any modification to the plan. These descriptions usually take the form of a brochure or a booklet summarizing the plan's terms and conditions as well as the members' rights and responsibilities. Quebec's pension benefit law specifically requires that the actual plan text be provided to each member in addition to a summary. The federal law requires that the description of the plan and of any modification also be provided to the spouses and common-law partners of plan members so they will be aware of the survivors benefits to which they can be entitled in the event of the death of the member.

Every active member of a pension plan must be given an annual personal statement that shows:

- the total amount of contributions paid to the plan by the member and, in the case of a defined contribution plan, by the employer on behalf of the member;
- the member's total period of service to date on which a pension will be based;
- the earliest date on which the member will qualify for a pension; and,
- in the case of a defined benefit plan, the estimated amount of the future pension based on service, contributions and earnings to date.

The federal and Quebec pension benefit laws also require that a member's annual personal statement indicate if the pension plan has a solvency deficit and, if it does, the measures being taken to eliminate the deficit. Under the federal and Ontario laws, the annual personal statements must usually be issued within six months of the end of the plan's financial year; the Quebec law provides for a longer period of nine months. Under the Quebec law, both active and non-active members (for example, former employees who now work for a different employer) must receive an annual personal statement. Under the federal law, the spouse or common-law partner of a member must be sent a copy of the member's statement.

When an employee ceases to be a member of an occupational pension plan (for example, on changing jobs or when retiring), he or she must be given a statement containing much the same information as the annual personal statement just described. In particular, the statement must show the member's total accrued pension rights, the earliest date to which he/she will be entitled to a regular retirement pension, the estimated amount of that pension, and any rights the member may have to an early pension. The statement must usually be issued within 30 days of ceasing membership. The federal law requires that a copy of the statement be given to the member's spouse or common-law partner. In the event of the death of a member, a statement must be sent to the spouse or common-law partner of the member describing any survivor benefits payable under the plan.

Finally, every plan member has the right to see various documents related to the plan. These include the plan text, the actuarial reports on the plan, the annual information statements the plan files with its regulatory agency and the plan's financial statement.

In addition to the minimum requirements set out in pension benefit laws, many plans provide further information, including financial counselling, for plan members. This can be particularly important in the case of defined contribution plans in which members can make choices regarding the investment of the funds credited to their accounts.

Non-statutory mechanisms for strengthening the management of occupational pension plans

The statutory provisions described in the preceding section set legally binding conditions that must be observed in the management of occupational pension plans. However there has been another development in recent years in Canada regarding the management of such plans that warrants discussion. It involves a non-statutory mechanism: voluntary guidelines for pension plan governance.

The issue of the governance of business enterprises has been given increased attention during the past fifteen years in many countries around the world. In Canada, a number of factors, including court decisions involving the management of pension plans, have led to specific attention being given to the governance of pension plans [Whiston and Gottlieb 2005].

The term 'governance' has many possible meanings. In regard to a pension plan, it can be defined as "the structure and processes for overseeing, managing and administering a plan to ensure the fiduciary and other obligations of the plan are met" [CAPSA 2004: 10].

In 1998 the Office of the Superintendent of Financial Institutions, which regulates pension plans under federal jurisdiction, issued a guideline for the governance of the plans for which it is responsible [OSFI 1998]. The guideline was the first of its kind in Canada and likely in any country. It was, and remains, voluntary. The guideline describes the considerations that should be taken into account in properly governing a pension plan.

In 2004, the Canadian Association of Pension Supervisory Authorities (CAPSA), which is made up of the federal and provincial agencies responsible for the regulation of pension plans, issued guidelines on governance which are applicable to all pension plans in Canada. Entitled *Pension Plan Governance Guidelines*, they set out eleven principles that should form the basis for the governance of a pension plan. The guidelines also describe in general terms how those principles should be applied. The eleven principles are the following [CAPSA 2004]:

Fiduciary responsibility: The plan administrator has fiduciary and other responsibilities to plan members and beneficiaries. The plan administrator may also have fiduciary and other responsibilities to other stakeholders.

Governance objectives: The plan administrator should establish governance objectives for the oversight, management, and administration of the plan.

Roles and responsibilities: The plan administrator should clearly describe and document the roles, responsibilities and accountability of all participants in the pension plan governance process.

Performance measures: The plan administrator should provide for the establishment of performance measures and for monitoring the performance of participants who have decision-making authority in the governance process.

Knowledge and skills: The plan administrator, directly or with delegates, has a duty to apply the knowledge and skills needed to meet governance responsibilities.

Access to information: The plan administrator and, as necessary, any delegate should have access to relevant, timely and accurate information.

Risk management: The plan administrator should provide for the establishment of an internal control framework, commensurate with the plan's circumstances, which addresses the pension plan's risks.

Oversight and compliance: The plan administrator should provide for the establishment of appropriate mechanisms to oversee and ensure compliance with the legislative requirements and pension plan documents and administrative policies.

Transparency and accountability: The plan administrator should provide for the communication of the governance process to plan members, beneficiaries and other stakeholders to facilitate transparency and accountability.

Code of conduct and conflict of interest: The plan administrator should provide for the establishment of a code of conduct and a policy to address conflict of interest.

Governance review: The plan administrator should conduct a regular review of its plan governance.

The CAPSA guidelines are general in their wording because they are intended to apply to all occupational pension plans. The variations among such plans, in terms of their type, size, terms and complexity, make it very difficult – some argue virtually impossible – for a single detailed set of guidelines to be developed that could apply to all plans. For much the same reason, the guidelines have not been included in pension benefit laws themselves, although some of the provisions of the guidelines are closely related to the provisions of those laws (for example, the fiduciary obligation of the plan administrator). To assist plan administrators to apply the guidelines, CAPSA has developed a questionnaire administrators are urged to complete in order both to identify the measures that are already in place in their plans and the measures still needed. As well, CAPSA has produced, and regularly updates, a 'frequently asked questions' section on its website that provides additional guidance on various issues related to the guidelines that have been brought up by plan administrators [CAPSA 2006].

Although the CAPSA guidelines are voluntary, this does not mean that they have no legal significance. As Whiston and Gottlieb [2005: 433-434] have pointed out, "Should a plan administrator ever be subject to litigation, the reasonableness of the administrator's actions will depend in good part on the degree of compliance with best practices, which in turn will largely reflect the CAPSA … Guidelines."

In addition to the CAPSA guidelines, another non-statutory mechanism for strengthening the management of occupational pension plans are the training and information initiatives of Quebec's regulatory agency, the Régie des rentes du Québec (RRQ), directed to the members of pension committees.

It will be recalled that the Quebec pension benefit law requires that the plan administrator be a pension committee. The law further requires that at least one member of the committee be a representative of the active members of the plan, and that another member be a representative of past members (including those receiving benefits). As a result of these latter provisions in particular, some members of a pension committee may be persons who have had little or no formal experience in managing a pension plan, and they may have not have the full range of knowledge required to carry out their duties.

To respond to this situation, the RRQ has developed publications, written in non-technical language, that assist members of pension committees to carry out their responsibilities. One of these is the *Guide for Pension Committee Members* which explains the role, rights and responsibilities of committee members. Another is a series of publications entitled *Administering a Pension Plan Well* which contains sections on sound administration, the role and responsibility of a pension committee, and how a pension plan operates. All of these documents are available on the RRQ's website *www.rrq.gouv.qc.ca*.

In addition to its publications, the RRQ also gives training courses for members of pension committees. The course of greatest relevance to strengthening the management of a pension plan is an orientation course for new committee members.

The financial difficulties of many defined benefit pension plans

In the past five years, many defined benefit pension plans in Canada have experienced substantial solvency deficits. Although there have always been some plans with such deficits, the problem was not widespread until 2001, when pension plans were severely affected by a sharp decline in equity markets that began in late 2000 and that occurred at the same time as a decline in long-term interest rates, which play a key role in actuarial valuations on a solvency basis. At first many experts thought that when equity markets recovered, the solvency deficits would be largely erased. Equity markets did recover in 2003, and deficits were reduced, but they nonetheless remained, and continue to remain, substantial. A few statistics will illustrate the magnitude of the problem:

- The Office of the Superintendent of Financial Institutions, the agency that regulates pension plans under federal jurisdiction, estimates that 78 percent of all the defined benefit plans it oversees had a solvency deficit on 31 December 2005 [OSFI 2006].

- In Quebec, the Régie des rentes du Québec estimates that 70 percent of the plans it oversees had a solvency deficit in December 2002, and that for one plan in five the deficit was more than 20 percent of its total liabilities [RRQ 2005].

- In Ontario, the Financial Services Commission estimates that about 75 percent of the plans it oversees has a solvency deficit, and that the median funding level of occupational pension plans in the province of Ontario is 87 percent of their liabilities [FSCO 2006].

A significant part of the funding shortfall of defined benefit pension plans in Canada would be resolved if long-term interest rates were to increase. However, this is unlikely to happen in the foreseeable future. Moreover, a growing number of experts believe that there are underlying causes of the funding problems of defined benefit plans that must be addressed.

The obvious solution to the funding problem is for employers with defined benefit plans having solvency deficits to make additional contributions, as required under the federal and provincial pension benefit laws, in order to amortize the deficits over a prescribed period. But for many employers, the cost of doing this is high. In the case of companies experiencing general financial difficulties, the added pension costs can be hard for them to absorb in the short term, and might even result in some declaring bankruptcy. Even enterprises that are financially sound will see their profits decline and, as a result, the price of their stock shares. This could make some companies terminate their defined benefit plans and convert them to defined contribution schemes in order to reduce future liabilities.

The challenge that governments and pension regulators face is to find a means for reducing the solvency deficits of defined benefit plans while, at the same time, taking into account the circumstances of companies experiencing general financial difficulties and not accelerating the shift among these and other companies from defined benefit to defined contribution schemes. As discussed earlier in this study, Quebec's interim solution has been to extend to ten years from five the period for amortizing solvency deficits, and the federal government has done the same. However, both Quebec and the federal government have said that extending the amortization period, by itself, is not a long-term solution for ensuring sufficient funding for defined benefit plans. Other measures are also required.

To understand the measures that have been proposed – in particular, amendments to Quebec's pension benefit law which are currently before the province's National Assembly (the provincial legislature) – it is necessary to examine issues related to the use and ownership of the surplus of an occupational pension plan (when a surplus arises) as well as the question of matching assets and liabilities. The issue of pension benefit guarantee funds also needs to be considered.

Use and ownership of pension plan surpluses

It may seem contradictory to discuss the use and ownership of the surplus of a pension plan when the issue under consideration is the insufficient funding of defined benefit plans. However, some observers argue that the existing legal provisions regarding the use and ownership of plan surpluses have discouraged employers from building reserves in their pension plans that could cushion those plans from adverse developments such as declines in long-term interest rates. Combined with court decisions in cases involving the ownership of plan surpluses, these observers argue, the result has been that defined benefit plans are less well funded than would otherwise be the case. While there is not unanimity in favour of these arguments – in fact, there are well-informed observers who disagree strongly with such a conclusion – the arguments have many proponents and warrant consideration.

One fact is incontrovertible. In the same way that economic and other developments can adversely affect the financing of a defined benefit pension plan and result in a solvency deficit, these developments can also positively affect a plan and lead to a surplus. This was the case for many pension plans in the period from 1990 to 2000 when stock markets in Canada rose sharply and, with them, the value of the assets of pension plans, a significant proportion of which are invested in equities.[14]

The federal and provincial pension benefit laws generally do not allow employers to withdraw surpluses from a pension plan unless this is specifically permitted under the plan text and, even then, subject to prescribed conditions. In Quebec, the withdrawal of a surplus from an ongoing plan is entirely prohibited. An employer whose defined benefit pension plan has a surplus has three options: leave the surplus in the plan; use the surplus to improve benefits; or, unless it is specifically prohibited in the plan text, reduce the amount of contributions.[15] These options are not mutually exclusive.

Because of the limits prescribed in the *Income Tax Act* on the preferential tax treatment given to an employer's contributions if a plan's surplus exceeds 10 percent of its liabilities (see the section above titled 'Obligation to provide sufficient funding'), an employer will not make further contributions when the surplus exceeds 10 percent of liabilities. In such a circumstance, the employer will either increase the pension plan's liabilities (through improvements to benefits) or, unless prohibited under the plan text, decrease contributions (including, depending on the circumstances, ceasing contributions entirely) until the surplus is reduced to the allowable limit.

The limits regarding surpluses prescribed by the *Income Tax Act* have been criticized by the association representing Canada's largest pension funds (the Association of Canadian Pension Management, or ACPM) and others. The ACPM has written that "the limit [on plan surpluses] is arbitrary and may be too low. It can interfere with the rational management of [defined benefit] plan funding" [ACPM 2005: 18]. The Governor of the Bank of Canada has expressed the view that the limit "has certainly added to the bias against sponsors allowing surpluses to build up in their pension plans" [Dodge 2005]. The Quebec regulatory agency, the Régie des rentes du Québec, has concluded that "the taxation ceilings on accumulated surplus assets … encourage minimum funding since they make it impossible to constitute an adequate, explicit provision for adverse deviations" [RRQ 2005: 43].

There is another factor which has made employers reluctant to maintain surpluses in pension plans: the provisions of pension benefit laws, and several court rulings, regarding the ownership of such surpluses in the event that a plan is terminated. The issues involved are complex. However, the practical outcome can generally be summarized as follows: an employer will only receive, at most, a portion of the surplus of a plan that is terminated, even if the surplus is primarily or entirely the result of the contributions the employer has made in the past.

There has been much debate in Canada over the use and ownership of the surplus of occupational pension plans – both in the case of ongoing plans and in the event of plan termination. Many (likely most) employers argue that it is unfair that they usually have to bear the full responsibility for deficits in a plan but that they have access, at most, to only part of any surplus, and this generally only on plan termination. This situation is often described as the asymmetrical treatment of surplus assets and deficits. Members of pension plan, on the other hand, have a different perspective. They usually feel that pension plans have been established for the benefit of the members, and that surpluses therefore should primarily belong to them. This view is held particularly by those who see pension plans as a form of deferred compensation. The case in favour of the ownership of surpluses by plan members is often linked to the fact that, in most pension plans, benefits are only increased partially or on an ad hoc basis to rises in the cost of living. Surpluses, when they arise, provide a means of adjusting pensions in payment.

There are many other arguments both for and against the claim that there is unfair asymmetrical treatment of surplus assets and deficits. What is important from the perspective of the present analysis is the practical result. This is summed up in the discussion paper of the Quebec pension regulatory agency as follows [RRQ 2005: 42]:

> … many employers see little advantage in making a provision for adverse deviations in a plan since any additional contribution that could result in [a plan surplus] could eventually be lost, at least in part. The funding rules provided by law require high contribution payments when deficits appear and in a way,

> when surplus assets appear, encourage their use for benefit increases and contribution holidays. Thus, plan sponsors are not much encouraged to provide more than minimum funding.

Matching assets and liabilities

In an ideal world, the future income from the investment of the funds of a defined benefit pension plan (including, as required, the sale of assets from the fund) would exactly equal, at any given point in time, the future pensions that must be paid from those funds. This would be a perfect matching of assets and liabilities.

In the real world, such a perfect matching is impossible to achieve because of the many different factors affecting both investment income and future pensions – factors that cannot be predicted with certainty. Some of the most important factors have been described earlier in this study in the section titled 'Obligation to provide sufficient funding'. In practical terms, the closest matching of assets and liabilities would be achieved by investing the funds of a defined benefit plan entirely in fixed-income securities (e.g. bonds) whose interest payments and maturity coincide with the best possible projections of the future pensions to be paid by the plan.

Over the long term, the rate of return from investing in fixed-income securities is almost always lower than the rate of return from investing in variable-income securities such as equities and in other asset classes such as real property. The difference in the rates of return – the 'risk premium' – reflects the fact that there is generally more volatility, and less certainty, in the return from asset classes such as equities and real property than there is from fixed-income securities.

The rate of return from investments is a key factor in determining the cost of a defined benefit plan. As a result, a substantial part of the funds of all defined benefit plans are invested in asset classes such as equities that pay a risk premium. This has kept the cost of defined benefit plans lower than if their funds were invested exclusively in fixed-income securities. It as also brought benefits to the Canadian economy as a whole, as noted by the Governor of the Bank of Canada [Dodge 2005]:

> The managers of defined-benefit pension plans have both the ability and desire to invest in the kinds of assets that the average individual investor might not normally consider. Pension managers have superior knowledge of financial markets and of the associated risks that makes them willing to invest in alternative asset classes and to engage in arbitrage between markets. All of these activities make financial markets more complete and, so, enhance their efficiency.

However, investing in asset classes such as equities and real property make it much more difficult to match the assets of a defined benefit pension plan and its liabilities. Income from such investments can vary substantially over time depending on market conditions. If the assets need to be sold at some time in the future in order to pay pensions, the income that will be realized will depend on markets at that time. If markets are depressed, the price of the assets will likely also be depressed.

Over the past five years, several commentators have written about the 'mismatch' between the assets and liabilities of most defined benefit plans in Canada and the consequences for the plans' financing. Ambachtsheer has argued that a large part of the funding problems encountered by defined benefit plans since 2000 has been due to the mismatch of assets and liabilities. He has advocated that "asset-liability mismatch risk in defined benefit plans should be measured and disclosed regularly" [Ambachtsheer 2004: 9]. Robson has stressed the need for "closer attention by sponsors and regulators to asset-liability mismatches" [Robson 2005: 3] . The agency regulating occupational pension plans in Quebec, the Régie des rentes du Québec, has noted that "among the financial risks facing pension plans are the risk that pension fund yields will be less than the actuarial assumptions and the risk of inadequate matching of assets and liabilities. In recent years, we have noted that some plans are in a precarious situation because of excessive exposure to such risks and if they had to be terminated, there could be a major loss of benefits for many members and beneficiaries" [RRQ 2005: 47].

Pension benefit guarantee programs

In order to provide greater security of benefits from defined benefit pension plans, several countries and jurisdictions have established publicly administered pension benefit guarantee programs. These programs insure part or all of the benefits to which members have acquired rights in the event that a defined benefit pension plan is insufficiently funded and the employer is unable to provide the needed additional financing. The programs are usually financed by mandatory contributions from employers with defined benefit pension plans and, as required and as permitted by the applicable laws, by government subsidies or loans.

In Canada, the only such program is in the province of Ontario. Known as the Pension Benefits Guarantee Fund (PBGF), it was introduced in 1980, at a time when the consequences of the closure of the manufacturing plants of several large industrial companies in the province, in particular the possible failure of those companies' defined benefit pension plans, were issues of serious concern [Stewart 2006].

Subject to prescribed limits and exceptions, the PBGF protects the retirement pensions of the members of a defined benefit pension plan in the event that the plan is terminated. It also protects the benefits payable to members' survivors. The PBGF applies only to a pension (or the part of a pension) based on employment in the province of Ontario. The maximum amount of benefit guaranteed by the PBGF is $1,000 a month.[16] Benefits under a plan which has been in operation less than three years are not insured by the PBGF, nor are any improvements to benefits made in the three years before the plan is terminated (e.g. new types of benefits or increases to existing benefits).

Under the legal provisions applicable to the PBGF, payments from the fund are allowed *only* if a defined benefit pension plan has been terminated because of the bankruptcy (insolvency) of the employer. In all other instances, the employer remains legally responsible for funding any deficit in a plan if the employer decides to terminate the plan. These provisions are intended to avoid situations in which an employer could voluntarily terminate an underfunded plan and expect the PBGF to assume the liabilities.

When payments under the PBGF are required, the Ontario agency regulating pension plans, the Financial Services Commission of Ontario, becomes responsible, in effect, for the administration of the plan and appoints a plan administrator.

The PBGF is financed primarily through contributions paid by employers with defined benefit pension plans. The amount of an employer's annual contribution is based on the number of members of the pension plan and on the plan's unfunded liabilities (if any). Every employer in Ontario with a defined benefit plan, irrespective whether the plan is in surplus or deficit according to the plan's last actuarial valuation, is required to contribute $1.00 a year to the PBGF for each plan member. In addition, a plan with an unfunded liability is required to pay an addition annual contribution which is calculated as a percentage of the liability. The additional contribution is determined using a sliding scale based on the proportion of the plan's total liabilities represented by the unfunded liability The higher the proportion, the higher the required contribution.[17] The rationale for basing part of the contribution on a plan's unfunded liability is to link the amount that an employer has to pay to the PABG with the risk (degree of possibility) that benefits under the employer's plan will require protection under the PABG.

In 2004, the assets of the PBGF became insufficient to cover its liabilities, due primarily to the partial termination of the defined benefit pension plan of a major manufacturer. In order to allow the PBGF to continue to operate, the province of Ontario made a loan of $330 million to the PBGF. The loan was interest-free, and has a term of 30 years. The most recent financial statement of the PBGF indicates a deficit of $237 million, taking into account the remaining outstanding portion of the province's loan [FSCO 2005].

There have been discussions whether pension benefit guarantee funds should be established in other jurisdictions in Canada. For example, in a consultation paper on possible changes to the federal pension benefit law issued in 2005, the federal Department of Finance asked for views on the establishment of a guarantee fund for defined benefit plans in federal jurisdiction. The paper summarized the principal arguments for and against such a fund as follows [Finance 2005c: 14]:

> The attraction of a PBGF is that it provides pension compensation to employees, retirees, and beneficiaries if an employer becomes bankrupt or insolvent and its pension plan is under-funded. A PBGF may also reduce the propensity of employees from leaving companies experiencing financial difficulty because employees have greater confidence that the PBGF will provide them with benefits in the event that their employer becomes bankrupt.
>
> While there are potentially a number of benefits to a PBGF, there are also potential draw-backs. One major consideration is that a PBGF could provide a disincentive for employers in financial difficulty to properly manage their pension plans to control risks if their pension liabilities will be covered. It may also be difficult to efficiently spread the insurance risk in a PBGF at the federal level because federally registered pension plans account for only 10 per

> cent of pension plan assets in Canada, with 10 plans accounting for about 63 per cent of the assets. Moreover, there would be an increase in cost to plan sponsors through insurance premiums. This additional cost could contribute to the shift to defined contribution plans. There is also a risk the PBGF has insufficient funds to cover its pension liabilities. This could lead to pressure for government funding, the extent of which could have broader implications for government policies and the economy. Indeed, the PBGFs in Ontario and the U.S. are experiencing significant deficits.

Not surprisingly, different views were expressed regarding the establishment of a federal pension benefit guarantee fund. Most respondents either opposed establishing such a fund or urged further study before a decision is taken. For example, the association representing the largest pension plans argued as follows [ACPM 2005: 21-22]:

> … All of the existing guarantee funds are insolvent if their assets and liabilities are properly measured …
>
> Those with the greatest need for protection (financially troubled companies with poorly funded pension plans) are also those least able to pay for it. Events causing plan sponsor insolvencies also tend to affect certain industries … disproportionately. Consequently, guarantee funds subsidize poor risks and overcharge good ones.

Some respondents, especially those from the trade union sector, were in favour of the creation of a guarantee fund at the federal level. However, even among these respondents, caution was urged. For example, the largest federation of trade unions in Canada, the Canadian Labour Congress, which "has promoted the idea of pension insurance for many years", noted that "there are clearly potential problems of moral hazard and adverse selection" [Finance 2005d].

It appears unlikely at the present time that pension benefit guarantee funds will be established either by the federal government or by any of the provinces. This conclusion is based on the widely shared (although not unanimous) opinion in Canada that such funds do not, overall, significantly strengthen the security of benefits under defined benefit pension plans and that their potential disadvantages outweigh their potential advantages.

Proposed amendments to Quebec's pension benefit law

Quebec is the first jurisdiction in Canada that has proposed a comprehensive set of amendments to its pension benefit law, the *Supplemental Pension Plans Act*, to address the financial difficulties currently facing defined benefit pension plans. The amendments are the result of a consultative process that began in 2005 with the release of a discussion paper by the province's regulatory agency, the Régie des rentes du Québec (RRQ). The paper analyzed the situation of defined benefit plans and made a number of preliminary proposals for changes to the pension benefit law [RRQ: 2005]. Based on the reaction to those preliminary proposals and on alternatives put forward in the course of the consultation process, the Quebec government developed its definitive proposals for amending the province's pension benefit law. These are contained in Bill 30 [Quebec 2006] which has been examined by the Social Affairs Committee of the province's National Assembly and is awaiting final approval by the National Assembly itself.[18]

Quebec's proposed amendments affect many aspects of the financing and governance of pension plans [RRQ 2006a, 2006b]. Three are of particular significance to this study:[19] the requirement for a provision for adverse deviations, the right of future pensioners to have their pensions guaranteed by an insurer, and the introduction of the principle of equity in determining how a plan's surplus can be used to improve the plan.

Under the proposed amendments, all pension plans regulated in Quebec will be required to create a ***provision for adverse deviations***. The purpose of the provision will be to cover the risks associated with fluctuations in the economy. The level of the provision (i.e. the amount of the provision expressed as a percentage of a plan's liabilities) will vary from one plan to another and will be primarily based on the risk inherent in a plan's investment policy. The greater the risk, the higher the required level of the provision. The exact formula to be used to determine the level of the provision will be set out in regulations to be adopted by the RRQ after the amendments enter into force. Preliminary estimates from the RRQ indicate that a provision equal to 15 percent of a plan's liabilities (on a solvency basis) would be sufficient for most plans [RRQ 2005: 56].

The provision for adverse deviations will be built up from the surplus, if any, in a plan and by contributions from the employer. If a plan is in surplus, the employer will not be allowed to take a 'contribution holiday' (i.e. reduce the amount of contributions by the amount of the surplus) until the required level of the provision is achieved. As well, until the level is achieved, the employer will not be allowed to make any improvements to the plan (for example, by increasing benefits) unless these are entirely financed by additional contributions. If a plan is in deficit and the employer is making contributions to amortize the deficit, the employer will be required to continue making those contributions even after the deficit has been eliminated until such time as the level of the provision for adverse deviations has been achieved.

Members of a pension plan who retire after 2009 will have the ***right to request that their pensions be guaranteed by an insurer***. In most instances, the practical effect will be that, if a member exercises this right, the pension plan will have to purchase an annuity contract from an insurance company. The initial amount of the annuity will be equal to the amount of the pension to which the member would otherwise have been entitled from the pension plan. Once the pension plan has purchased the annuity contract, the member's ties with the plan will have been severed since future payments will be paid exclusively under the annuity contract. Therefore, if in the future the pension plan is terminated with a solvency deficit and the employer is unable to amortize the deficit because of bankruptcy, the member's benefits will not be affected.

If a defined benefit plan has a surplus, and if the plan meets the new requirement just described regarding a provision for adverse deviations, one possible use of the surplus is to improve benefits under the plan. If this option is taken, the proposed amendments to Quebec's pension benefit law will require that the ***principle of equity be used to determine the improvements that will be***

made to the plan's benefits. The objective of introducing the principle of equity is to ensure fair treatment for both active members (current employees) and non-active members (persons receiving benefits). The criteria that will be used to apply the principle of equity will include: the evolution of the pension plan, any amendments made to it and the circumstances in which those amendments were made, the origin of the surplus assets concerned, the use made in the past of any surplus assets, the characteristics of the benefits provided for under the plan and the characteristics of the pensions being paid out.

The Social Affairs Committee of Quebec's National Assembly which studied the changes proposed in Bill 30 received submissions from many interested organizations and individuals. These included organizations representing the key stakeholders in the pension system, such as employers (the Conseil du Patronat du Québec, or CPQ), trade unions (the Confédération des syndicats nationaux, or CSN), pensioners (the Association québécoise de défense des droits des personnes retraitées et préretraitées, or AQDR), pension plan administrators and sponsors (the Association of Canadian Pension Management, or ACPM), and actuaries (the Canadian Institute of Actuaries, or CIA).[20] An analysis of the submissions from these groups demonstrates their different and sometimes opposing positions regarding the proposed amendments.

All the principal stakeholders that appeared before the Committee agreed in principle with the fundamental objectives which the government of Quebec is seeking to accomplish in Bill 30. The explanatory notes to the bill give these objectives as: "to improve the funding of pension funds in order to protect the pension benefits of plan members and beneficiaries [and] to enhance the governance of pension plans and better define the scope of the responsibilities of pension committee members and other persons involved in the administration of pension plans" [Quebec 2006]. However, the stakeholders had very different views about the approach proposed in the bill as a whole and about the specific measures it contains.

The pensioners' organization was the most positive among the stakeholder groups about the approach reflected in the bill, agreeing with almost all the proposed changes [ADQR 2006]. The organizations representing trade unions, pension plan administrators and actuaries supported the general approach taken in the bill, but expressed concern about, or outright opposition to, some of the specific measures [CSN 2006, ACPM 2006, CIA 2006]. At the other end of the spectrum of opinions, the organization representing employers believed that the entire approach embodied in the bill is wrong. Their submission stated: "This bill, which seeks to strengthen the financial security of current and future pensioners, is, in our view, a pure work of fiction … It is clear that this bill will result in the end of [defined benefit pension plans] in the private sector. The costs and the accrued risks associated with such plans for companies will lead those companies to offer their new employees defined contribution plans, where the risks are assumed by employees" [CPQ 2006: 1,9].[21]

Other stakeholders also expressed concern that some provisions of Bill 30, if implemented, would hasten the shift from defined benefit to defined contribution plans in the private sector. The association representing pension plan administrators expressed the view that "some new provisions …, if they are retained, would cause irreparable harm to defined benefit pension plans … and would precipitate a flight towards defined contribution plans, as shown by the experience of other countries that have over-regulated defined benefit plans" [ACPM 2006: 2]. The trade union confederation stated the view that "despite the fact that the adoption of the bill could give greater security to current members of defined benefit pension plans, we firmly believe that, in the long term, workers will be the big losers. Many will find themselves in defined contribution plans in which they will entirely have to bear the financial risk" [CSN 2006: 9]. The actuaries' association warned that "[Some of the proposed measures] represent major issues that could lead a number of sponsors of [defined benefit pension plans] to terminate their plans" [CIA 2006: 3].

Turning to the specific changes proposed in Bill 30, there was a general consensus among most stakeholders that a mandatory provision for adverse deviations would strengthen the security of defined benefit pension plans and should be adopted. However, the trade union confederation wanted to see the bill amended to include specific measures for determining the level of the provision rather than only the principle that the level will be linked to a plan's investment policy. The employers' organization also criticized the absence of wording specifying precisely how the level of the provision will be determined, and expressed the fear that, in the absence of precise wording, the government will continually change the requirements. The actuaries' association, on the other hand, implicitly endorsed the flexibility of the wording of the bill (i.e. the absence of detailed rules in the law itself for setting the level of the provision for adverse deviations), stressing that "the emphasis should be on the rule's simplicity rather than its theoretical precision" [CIA 2006: 9].

The organizations representing employers and pension plan administrators opposed the proposal that would require employers who are making contributions amortizing the deficits in their defined benefit plans to continue making those contributions even after the deficit has been eliminated, until the required provision for adverse deviations has been established. The employers' organization argued that this measure "is unfair because it would have the effect of treating differently [the pension plans of] two employers having the same degree of funding" [CPQ 2006: 5]. The employers' organization further argued that the measure "accentuates the problem of asymmetry under which the employer is responsible for deficits while, in practice, not owning surpluses" [CPQ 2006 : 3]. The organization representing pension plan administrators argued in the same vein, expressing the view that the proposed measure is "excessive and all the more unacceptable from the fact that the bill contains no measure seeking to correct the asymmetrical treatment of surpluses and deficits" [ACPM 2006: 3].

The pensioners' organization took a different position on the proposed provision for adverse deviation from that of the other major stakeholders. It advocated the creation of a pension guarantee fund, stating "we consider the creation of a provision for adverse deviations, as proposed in the bill, to be a timid step. In fact, this measure … offers at first glance few guarantees for the protection of benefits in the short and medium term" [AQDR 2006: 3].

Equally strong opinions were expressed regarding the proposal to give persons retiring after 2009 the right to request that their pensions be guaranteed by an insurer. The pensioners' organization welcomed the measure, but believed that it should be extended to all pensioners, including those who are already receiving benefits, and not just to future pensioners. In a similar vein, the actuaries' association expressed concern about treating pensioners differently solely on the basis of when they retire. Their submission stated that "members, be they active or non-active, should be treated the same in the event of an insolvent plan being terminated, irrespective of the date they retire (before or after 2010)" [CIA 2006: 3].

In addition to their concern about treating different groups of pensioners differently, the actuaries' association also warned about the cost of the proposed guarantee. The same concern regarding cost was expressed by the organizations representing employers and pension plan administrators.

The actuaries' submission noted that "the option given to pensioners to have their pension guaranteed is retroactive in scope. Indeed, employers will need to assume the additional costs associated with the payment of these pensioners' benefits through lump sum transfers to insurers, while the plans have been funded on the assumption that the payment would be spread over the life of the pensioners and funded from the pension fund" [CIA 2006: 7]. In the opinion of the organization representing pension plan administrators, if the guarantee option is adopted, "the effects would be disastrous" [ACPM 2006: 4].

The trade union confederation supported the *principle* of a guarantee. Its submission states that "we believe that permitting the purchase of annuities from insurance companies would not only enhance the security of pensioners, but would reduce in the long term the level of risk and of volatility of pension plans" [CSN 2006: 15]. However, the confederation was opposed to the measures being proposed to implement that principle, expressing the view that these measures will have a negative effect on the financing of defined benefit pension plans. The confederation argued that "it would be useful to evaluate this measure and its consequences during the coming years in order to find a solution that is adequate and acceptable to everyone" [CSN 2006: 17].

Finally, regarding the measure requiring that the principle of equity between active and non-active members be applied in deciding on improvements to a plan's benefits, all the stakeholders except the pensioners' organization were, for varying reasons, opposed. The pensioners' organization, on the other hand, which has advocated such a principle for many years, warmly welcomed the proposed measure, arguing that it finally recognizes the rights of non-active members (pensioners and other beneficiaries) who, in the opinion of the organization, have been forgotten in the past.

The organization representing pension plan administrators stated its opposition to the proposed principle of equity as follows: "Equity is a highly subjective concept. But one thing is for sure: The plan sponsor will always be the loser because the sponsor alone continues to be responsible for deficits and because the sponsor's contractual right to modify the plan by using a surplus becomes open to all manner of contestation and submitted to binding arbitration. Of all the measures in the bill, this is the one that will cause the greatest harm to registered pension plans in Quebec, in that it will be retroactive, litigious and discriminatory in the eyes of pension plan sponsors both actual and possible." [ACPM 2006: 4-5].

The employers' organization stressed the difficulty of reaching consensus among different stakeholders, in particular between active and non-active members, about what would be equitable. It also expressed concern regarding the implications of the proposed change for collective bargaining between employers and employees. Their submission noted "as an example, it could be difficult for retired members to understand that an improvement granted or negotiated to the future retirement benefits of active members was the result of a smaller salary increase, of an increase in the contributions that these members will pay in the future, of a change favourable to the employer in one or more conditions of work, or of provisions of the collective agreement … On the other hand, active members might be opposed to a partial indexation of pensions, arguing that they pay more today in contributions than their seniors paid during their period of employment" [CPQ 2006: 6-7].

The trade union confederation shared the concern of the employers about reaching consensus among stakeholders. After an analysis of the implications, the confederation concluded that it "is in agreement with the principle of equity. However, we believe that the proposed measures are entirely inadequate. Inadequate because they will entail substantial administrative costs, because they will give rise to divisions between generations of workers, because they will confer a right of veto to all members, and because they will establish the relationships between different stakeholders by judicial means. [The confederation] is strongly opposed to the introduction of such a measure in the [*Supplemental Pension Plans Act*]" [CSN 2006: 20].

The examples just cited – and there are a great many more that could be given – demonstrate the challenges in trying to find solutions to the financing problems facing defined benefit pension plans in Canada that are acceptable to all the stakeholders.

Conclusions

The regulation of occupational pension plans is inherently complex, in large part because the plans themselves are complex. The complexity of regulating pension plans is made all the greater by the need to find a balance between protecting the security of the benefits promised to plan members, on the one hand, and allowing plan administrators sufficient leeway to make legitimate management and financing decisions, on the other hand. A further element of complexity arises from the need for public authorities to ensure that occupational pension plans, which qualify for preferential tax treatment, are not abused by employers and/or workers and simply turned into vehicles for evading taxes on income or profits.

In Canada there are two additional factors contributing to the complexity of regulating occupational pension plans. The first is the fact that such plans are voluntary. The second is that responsibility for regulating pension plans is shared by the federal and the provincial governments.

Because occupational pension plans are voluntary, over-regulation could induce employers with plans to terminate those plans altogether or to convert defined benefit plans (which are generally seen to be advantageous from the perspective of workers) to defined contribution plans (which usually entail lower, and certainly more predictable, costs for employers, although they are often seen as less advantageous for employees).

Because both the federal and the provincial governments are involved in the regulation of pension plans, there are multiple pension benefit laws as well as agencies to oversee the application of those laws. While the federal and provincial laws are broadly similar in terms of the aspects of occupational plans that are subject to regulation and the parameters for that regulation, there are nonetheless significant differences between them. This situation can, and often does, create challenges for employers operating in two or more jurisdictions in Canada.

This study has tried to summarize the principal features of Canada's approach to the management and regulation of occupational pension plans. Based on experience, the Canadian approach has been successful to the present time. There have been no significant failures among occupational pension plans in Canada. The share of the income of Canada's seniors coming from such plans had increased significantly over the past 25 years. The shift from defined benefit to defined contribution plans, which has been very marked in countries such as the United States and the United Kingdom, has also been happening in Canada but, so far, at a much slower pace [Tamagno 2006].

However, in the past six years years, many – in fact, most—defined benefit pension plans in the private sector in Canada have experienced serious financing problems. The problems have many causes, perhaps the most important being the continued low level of long-term interest rates.

The financing problems defined benefit pension plans have encountered has caused governments, both federal and provincial, to examine ways in which to strengthen the security of occupational pension plans. The province of Quebec was the first in Canada to propose specific changes to its pension benefit law. As this study has shown, Quebec's proposed changes have drawn very different reactions from various key stakeholders in the pension system such as employers, trade unions, pension plan administrators, actuaries and pensioners. More recently, the province of Ontario created an 'Expert Commission on Pensions' with a mandate to study a wide range of issues related to occupational pension plans, especially defined benefit schemes, and to make recommendation to the provincial government [OECP 2006]. The Ontario Commission is expected to give its final report in late 2007 or early 2008.

Given the critical role that occupational pension plans play in Canada's overall retirement income system, the regulation of those plans will continue to be a major subject of study and analysis in Canada for many years to come.

Endnotes

1. These plans are sometimes referred to as employer-sponsored pension plans, workplace pension plans, private pension plans, or, in Canada, registered pension plans.

2. When references are made in this study to laws, they include the regulations made in accordance with the laws as well as the laws themselves. Regulations are statutory instruments which are authorized by a law and which are approved by the cabinet (council of ministers) or a designated agency of the government concerned.

3. The term 'forgone tax' means the tax that would have been paid if a deduction, exemption or tax credit did not exist.

4. Whenever the dollar sign ($) and the word 'dollar' are used in this study, they refer to Canadian dollars (CAD).

5. The federal pension benefit law (the *Pension Benefits Standards Act, 1985*) applies to the occupational pension plans of private-sector companies in Canada engaged in fields of economic activity within the constitutional jurisdiction of the federal government. These include banking, international and inter-provincial transportation and communications. The federal law also applies to the occupational pension plans of all private-sector companies in Canada's three northern territories. Provincial pension benefit laws (for example, in Quebec, the *Supplemental Pension Plans Act*, and in Ontario, the *Pension Benefits Act*) apply to the occupational pension plans of all other private-sector companies in Canada. The generic term 'pension benefit law(s)' is used throughout this study to refer to the federal and provincial laws. To reduce the regulatory burden on companies operating in two or more provinces or territories, the federal and provincial laws contain provisions under which the occupational pension plan of such a company only needs to be registered in the jurisdiction (province or territory) in which it has the largest number of members. That jurisdiction is then responsible for the oversight of the plan. Under these provisions, the rights, duties and responsibilities of one jurisdiction's pension regulatory agency are delegated to the pension regulatory agency of another jurisdiction (i.e., another province or the federal government). However, the standards in force in the first jurisdiction (the one delegating its regulatory authority) are not replaced by the standards in force in the second jurisdiction (the one to which regulatory authority has been delegated). Thus, an occupational pension plan operating in more than one province or territory must meet the standards prescribed in the pension benefit law of the jurisdiction in which it is registered in respect of plan members working in that jurisdiction, and it must also meet the standards prescribed in the pension benefit law of any other jurisdiction in which it has members in respect of plan members working in that other jurisdiction.

6. The requirement for registration with a federal or provincial agency regulating occupational pension plans does not apply to plans which are established under a specific law of the federal Parliament or of a provincial legislature which exempts them from such registration. Such plans are almost all in the public sector. In 2004, there were 253 occupational pension plans in Canada exempted from registration with a pension regulatory agency. They covered about 20 percent of all the members of occupational pension plans in Canada [Statistics Canada 2006].

7. One province, Prince Edward Island, has enacted a law but has not yet brought it into force. In 2004 there were 66 occupational pension plans with 12,100 members in Prince Edward Island [Statistics Canada 2006].

8. Multi-employer pension plans are schemes that cover the employees of two or more separate employers, each of which contributes to the plan. Such plans are generally found in industries such as construction and forestry where employees move frequently from one employer to another. Multi-employer plans ensure that employees will accrue rights to a pension which will be based on their periods of service with all the participating employers. Such plans are usually the result of collective bargaining (negotiations between trade unions and employers). In 2004, multi-employer pension plans made up 3.2 percent of the occupational pension plans in Canada and covered 20.2 percent of all the members of occupational plans taken together [Statistics Canada 2006].

9. For very small plans with less than 26 members the employer can be the plan administrator.

10. If members are required to contribute to a plan, the plan is referred to as contributory. In 2004, 55 percent of all occupational pension plans in Canada, having among them 75 percent of all the members of such plans, were contributory [Statistics Canada 2006].

11. There is an exception if, under the plan text, members (which can include persons already receiving pensions) are required to assume part of the cost of a funding shortfall, either in the form of reduced benefits or increased contributions. At the present time, there are few occupational pension plans with such terms.

12. In both cases, the extension of the amortization period from five to ten years is on a temporary basis, to allow time for comprehensive proposals for strengthening the funding of defined benefit pension plans to be legislated.

13. One of the court decisions that has been of particular significance is that of the Supreme Court of Canada in the case of *Monsanto Canada Inc. v. Ontario (Superintendent of Financial Services)* [SCC 2004].

14. The Régie des rentes du Québec estimates that, on average, over 50 percent of the assets of the plans it oversees were invested in stock shares in 2002 [RRQ 2005: 36].

15. This is referred to as a 'contributions holiday'.

16. In general terms, in the event of the termination of a defined benefit pension plan insured under the PBGF, a member who is entitled to a monthly pension of $1,000 or less from the plan is guaranteed the full pension from the PBGF. A member who is entitled to a monthly pension greater than $1,000 is guaranteed the first $1,000 of the pension from the PBGF. In addition, he/she will receive the portion of the remaining part of the pension that can be paid from the assets of the terminated pension plan. For example, if the assets are sufficient to pay 70 percent of the total benefits earned under the plan by all members (active and inactive, including retirees), the member will receive 70 percent of the remaining part of his/her pension. The legal provisions setting the terms and conditions under which benefits are guaranteed are complex. For a full description of these provisions, see FSCO 1996.

17. For a plan with a solvency deficit, the part of the contribution related to the plan's deficit is calculated as follows: 0.5 percent for the unfunded liability representing up to 10 percent of the plan's total liabilities; for additional unfunded liabilities (if any) representing up to 20 percent of total liabilities, one percent; and for any unfunded liabilities above 20 percent of total liabilities, 1.5 percent [Stewart 2006: 18].

18. The Social Affairs Committee heard submissions on Bill 30 at various sittings between 20 September and 1 November 2006. On 28 November the Committee finished its clause-by-clause examination of Bill 30. It submitted its report to the National Assembly on 29 November. The final stage is for Bill 30 to be debated and voted upon by the National Assembly.

19. In addition to the three measures discussed in this study, Bill 30 contains several other important changes to Quebec's pension benefit law. These include: allowing a plan with a solvency deficiency to finance the amortization payments through the use of letters of credit, up to 15 percent of the value of the liabilities of the plan; requiring annual actuarial valuations of all plans with a solvency or going-concern deficit; requiring that any improvements to a plan which would bring the plan's degree of solvency to less than 90 percent be fully and immediately financed by contributions from the plan sponsor; requiring all the providers of services to a plan (e.g., the plan's actuary, accountants, financial advisors, etc.) to act in the best interest of the plan's members; and providing that, in the event of a conflict between the wording of the plan text and the by-laws adopted by the plan's pension committee, the by-laws would prevail.

20. Altogether, some 40 organizations and individuals made written submissions to the Social Affairs Committee regarding Bill 30. All the submissions are available on the Commission's website at *http://www.assnat.qc.ca/fra/37legislature2/commissions/cas/depot-pl30.html*. The five submissions examined in this study are from major organizations that represent the principal stakeholders in the pension system.

21. All of the submissions examined for this study, with the exception of the one from the Canadian Institute of Actuaries, were in French only. Translations of the portions cited are those of the author.

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