Comments of the

Canadian Federation of Pensioners

regarding

Pension Funding Framework Review

Nova Scotia

(September 2017)

10 November 2017

Introduction

The Canadian Federation of Pensioners (CFP) is pleased to provide its comments regarding Nova Scotia's Pension Funding Framework Review. CFP is an organization dedicated to improving the security of Defined Benefit pension plans in Canada. Each of CFP's member organizations advocates for the interests of the active and retired members of a workplace DB pension plan. Collectively, the CFP member organizations represent the interests of more than 250,000 individuals across Canada.

The consultation paper notes that the pension framework in many Canadian jurisdictions has been recently changed, or change is under active consideration. The paper notes that in May of this year, the Ontario government proposed, in broad strokes, a number of initiatives that may form the basis for a revamped Ontario DB pension framework. CFP has participated in Ontario's consultation process since its inception, and continues to advocate for measures that will strengthen the security of pensions earned in Ontario and elsewhere in Canada.

The Nova Scotia consultation paper raises many of the same issues canvassed in the course of the Ontario consultation regarding its own pension framework. CFP believes that the recommendations that it has made to Ontario to improve pension security in that province would prove to be of mutual benefit to pensioners and employers in all Canadian jurisdictions, including Nova Scotia.

In section A, CFP presents a summary of its proposal for pension framework reform. It is a novel solution to two persistent problems. At least in recent years, many employers with defined benefit plans have chafed at the cost of fulfilling the defined benefit pension commitments that they have made to their current and former employees. At the same time, pensioners have come to realize that those commitments may not be honoured. Pensioners losing part of their pensions when their former employer falters is all too common. Even a cursory examination of funding statistics demonstrates that a significant proportion of pensioners are in plans that are underfunded, leaving those pensioners at risk to losses should the employer become bankrupt. CFP's proposed framework addresses both of these issues. If the pension framework is changed as CFP proposes, then employers will realize significant savings as the costs to maintain their DB plans are reduced, and pensioners will be assured that the pensions they have earned will be paid as promised. The proposal is not only fair in that it honours the commitments that have been made, it is also economically efficient in that it delivers better outcomes at a reduced cost.

In section B, CFP addresses each of the discussion questions posed in the consultation paper. The questions canvass issues that are interrelated. So that CFP can properly address these interrelated issues in a comprehensive fashion, it first sets out in section A a description of the pension policy framework it proposes. In most instances, the brief answers provided in section B are elaborated on in section A. The answers to the discussion questions must be read within the context of the framework proposal presented in section A.

A. CFP Pension Framework Proposal

Pension security is critically important to all Canadians. The benefits of security, and conversely the harm arising from the lack of security, are felt by the individual. Aggregate statistics on pension plan

funding, by way of example, mean little to the individual whose plan is being wound-up and who is facing a sharp reduction in his or her pension payments. Each individual hopes and trusts that his or her government has put in place pension rules that will protect the pension that has been earned during a lifetime of work.

From the policy maker's perspective, however, aggregate statistics may be indicative of systemic problems that must be addressed. The most recent report of the Superintendent of Pensions reveals that pensioner security in Nova Scotia continues to be an elusive goal.[1] One out of every three members is in a plan that is not "fully funded"; 22% of members are in plans with a "solvency deficit" of at least 20%.[2] The potential harm for pensioners is even worse than these statistics imply. The definition of "full funding" and "solvency deficit" underlying these figures excludes indexation. For plans that provide for indexation, the true deficit can be 25 or 30 percentage points higher.

These aggregate statistics demonstrate that a significant proportion of Nova Scotia's DB pensioners is at risk of material pension reductions should their plans be forced to wind up. This level of DB plan funding, and hence DB pensioner risk, has persisted under the pension framework that requires employers to fund to a solvency target of 100%. All else equal, if the funding obligations are relaxed, say by lowering that funding target or by eliminating it altogether, then pensioner risk will increase. Pensioners will come to even more harm should their plan wind up, because it can be expected to be even more poorly funded than it is today.

CFP concludes that the current Nova Scotia pension framework is not up to the task of protecting the pensions that have been earned. Reform is required. Reform that contemplates only the relaxation of funding obligations will increase pensioner risk; outcomes for pensioners will be worsened, not improved.

The current pension frameworks in Ontario and Nova Scotia are not identical. However, the similarities are extensive; there are far more similarities than there are differences. CFP recommends to Nova Scotia the same reforms that CFP has recommended to Ontario. For ease of reference, CFP has attached its September 2016 submission to the Ontario consultation on pension framework reform. That submission discusses at length the rationale for the recommendations contained therein.

The following paragraphs describe the overall objectives underlying the recommendations, and the main features of the pension framework recommended by CFP.

A.1 Objectives for the Reform of the Pension Framework in Nova Scotia

The objectives are twofold:

1. Provide pensioners with a guarantee that the DB pension they earned through their working lives will be delivered to them in their retirement years. That is, the pension commitments that have been made will be honoured.

[1] "Report of the Superintendent of Pensions on the Administration of the *Pension Benefits Act* for the year ending March 31,2016", Thirty-Ninth Annual Report. Found at www.novascotia.ca/finance/pensions/docs/Annual-Report-March-31-2016.pdf.

[2] Thirty-Ninth Annual Report, page 10

2. Provide DB employers with a pension framework that is less costly, and significantly so, than the current pension framework.

CFP understands that the conventional wisdom is that greater pension security comes with a greater cost to employers, and conversely that a less financially burdensome pension framework for employers comes at the cost of reduced pension security for pensioners and employees. However, this need not be the case, and is not the case for the framework recommended by CFP.

A.2 Features of the CFP Pension Framework

As noted above, the attached September 2016 submission to Ontario canvasses many facets of the pension framework. In the paragraphs below CFP focuses on the main features of its recommended framework.

A.2.1 Changing the Paradigm for Pensioner Protection

Underlying the CFP framework is a change in the paradigm for pension security that is embodied in current pension rules.

Current rules require that two funding standards be met. The first is the going-concern funding requirement, meaning that plan administrator is to ensure that a plan's assets at least match its going concern liabilities. By doing so, as long as the employer is a going concern and its pension plan is earning returns in the market, there will be sufficient plan assets to pay pensions going forward. If the plan is ever in a deficit relative to this standard, then a fairly lengthy time – 15 years – is allowed for the employer to make the plan whole.

The second funding standard is that the administrator is to ensure that a plan's assets at least match its solvency liabilities. That is, at least conceptually[3], the assets would be sufficient to cover all pension commitments going forward even if the plan were forced to wind up. Once a plan winds up, contributions from the employer and employees cease, and the plan no longer earns returns in the market. Essentially, this rule requires that each employer must set aside, in its pension plan, enough money to honour all pension commitments under the assumption that the employer ceases to operate. To put it another way, the solvency funding standard is a requirement that each employer insure its pension plan against the eventuality that the employer will fail.

Any solvency deficit must be made good over a five year period, typically. However, upon condition, the period over which the deficit is allowed to persist can be increased to ten years. If the employer should falter and enter bankruptcy proceedings, say, before the pension plan is made whole, then the inevitable outcome for pensioners is a cut in pension payments.[4]

---

[3] The term "conceptually" is used here because the solvency funding requirement in Nova Scotia permits exclusions in the calculation of the solvency liabilities for funding purposes. A plan that is just "fully funded" according to the solvency calculation is insufficiently funded to cover all plan provisions. The permitted exclusions are, in effect, a built-in plan deficit. This built-in deficit exists, but is not recognized in the reported statistics.
[4] Though pension plans may be able to recover some of the amounts owed to them through bankruptcy proceedings, the usual outcome is that pensions are reduced by the amount of underfunding at the time the employer enters the proceedings.

Employers' complaints about solvency funding requirements are not uncommon. One can understand that a requirement to insure against failure may annoy those who cannot, or will not, envision the possibility of their own failure. In fact, most who say "My company will not fail" are correct – at least for a long period of time. It is also a fact that some <u>will</u> fail at some point. Just which ones will fail, and when, is not possible to predict.

The current paradigm, then, is to require all employers to self-insure their pension plan against their own failure, because it is known with certainty that some will fail, at some point.

From the pensioner perspective, at least in theory, this makes sense. Theoretically, if this self-insurance is in place, then pension reductions should not be a threat, because the pension plan should be well enough funded even if the employer fails. Practice, however, is different than theory.

The self-insurance paradigm is not fool proof for several reasons. Because employers are given time to make their plans whole, and because the solvency funding requirement builds in a plan deficit for some plans, and because employers can fail before the plan is made whole, and because insolvency legislation provides almost no contribution towards unfunded liabilities, pensioners get harmed when plans wind up.

As a consequence, the self-insurance pension framework of today is working for neither the employer nor the pensioner. The employer sees it as an unnecessary expense; the pensioner sees it as making sense in theory, but not in practice. And it is the practice that matters to pensioners; the practical effect of current rules is that many pensioners are harmed when their plans wind up.

The CFP proposal would change the paradigm. Rather than requiring each employer to self-insure fully, CFP proposes instead a hybrid that retains self-insurance for a portion of the plan's liabilities, and introduces a collective insurance scheme for the remaining portion. All DB employers should be required to support an insurance pool which is capable of making good on any unfunded windup liability for any plan that winds up involuntarily.

For example, assume the solvency funding target is lowered to 90%. This means that each employer would be required to fund 90% of the solvency liabilities of its own plan. Across all Nova Scotia DB plans, every year there would be substantial savings for employers from being relieved of funding 10% of total solvency liabilities. But the 10% of total solvency liabilities are not left unprotected. Rather, that amount is protected by the insurance pool. The insurance pool, funded by employers, need only cover the unfunded liabilities <u>for just those DB plans that windup involuntarily</u>. By contrast, today's funding rules require each employer to cover that 10% of solvency liabilities of its own plan, whether the plan is winding up or not. Because plan windup is relatively rare, funding the insurance pool is a far less expensive proposition than fully funding every DB plan.

The paradigm changes from each DB employer being required to self-insure fully against its own failure, to a hybrid insurance model. The hybrid insurance model would require each employer to self-insure, say, 90% of its own plan, and to insure the remaining 10% of its solvency liabilities through a collective insurance pool.

The effects are two-fold. First, pensioners would be better protected than they are today. In particular, the harm that befalls pensioners when their plan winds up before it is made whole would be avoided, because the insurance pool would cover the unfunded amount. Second, employers would realize

significant savings from the combined effects of lowering the funding target and introducing fees for the insurance pool. Costs are reduced, outcomes are improved.

A.2.2 Implementing the Paradigm Shift

The main features of the proposed framework are:

Change the Going Concern funding target

A provision for adverse deviation (PfAD) should be included in the going concern funding target. A PfAD is not a replacement for or equivalent to solvency funding. Rather, it enhances the benefit security objective of the going concern funding obligation. A PfAD provides protection against a plan failing to meet its going concern funding objectives. It allows the pension plan to more gracefully accommodate the swings in economic conditions that affect the plan's assets and liabilities.

CFP recommends that a default PfAD of 25% be set.

Change the solvency funding target

As discussed above, lowering the solvency funding target can deliver significant savings to employers. As long as a Pension Guarantee Fund is introduced at the same time, and the Guarantee Fund is designed and funded, through employer fees, so that it can backstop any unfunded wind up liabilities for plans winding up involuntarily, then pensioners will not be harmed by relaxing the funding obligations.

The level of the new solvency funding target will be of great interest. Clearly, the greater the reduction, the greater will be the savings for employers, and the greater will be the reliance on the Pension Guarantee Fund to protect pensioners. CFP has recommended 90% to Ontario in the course of its consultation. Ontario has indicated that it intends to establish the level at 85%. As long as the Guarantee Fund is capable of making good on any unfunded liabilities, the level of the funding target is of secondary concern.

Introduce a Pension Guarantee Fund

The rationale for this measure is given above. The Guarantee Fund is critical to achieving a new pension framework that delivers savings to employers and increased security to pensioners. It is paramount that the Guarantee Fund is properly funded, that is, that it is capable of making good on any unfunded wind up liabilities for plans that wind up involuntarily. That means that there must be no exceptions in its coverage. All DB plans must be covered, and all plan provisions must be considered in the calculation of the plans' liabilities, and no cap would be placed on the coverage of the Guarantee Fund.

Nova Scotia will know that Ontario has had a Pension Guarantee Fund since 1980, and that the government's announcement in May indicated the intention to increase its "coverage" from $1000/month to $1500/month[5]. Though a somewhat positive move, this change would still leave pensioners exposed to the harm of funding shortfalls for pensions in excess of $18000/year. To be clear, CFP is strongly recommending to Nova Scotia, as it is still recommending to Ontario, that no cap be

[5] Regarding "coverage", Ontario describes its Pension Benefits Guarantee Fund (PBGF) as guaranteeing the first $1000/month. That means that a plan with a 40% deficit would receive $400/month from the PBGF to make up for the 40% loss on the first $1000. Any pension payment in excess of $1000 would feel the full brunt of the 40% shortfall.

included in the Pension Guarantee Fund. The new paradigm works for employers and pensioners alike only if the Guarantee Fund makes good on any unfunded windup liabilities.

Ontario also stated in May its intention to consider the establishment of a third party administrator to be accountable for the continued operation of plans that would otherwise wind up in an underfunded state. Doing so would have the potential that the plan would continue to earn in the markets, rather than crystallizing any unfunded liabilities at the time of wind up. This could have the effect of relieving some of the pressure on the Guarantee Fund. CFP supports Ontario's stated intention, and commends it to Nova Scotia's consideration.

A.3 Impact of CFP's Proposed Pension Framework

It is clear today that the current pension framework is not working for pensioners; pension losses when plans wind up are all too common. As discussed above, a new model is possible: a model that finally gives pension security to pensioners at the same time as delivering savings to employers.

The data that would permit an estimation of the savings that Nova Scotia employers would enjoy are not available to CFP. The Superintendent of Pensions may well have the requisite data to hand.

CFP has been able to estimate employer savings, using aggregate data pertaining to Ontario's private sector DB plans. CFP has conservatively estimated that DB employers in Ontario will save in the order of $1.4B/year, and that the increase in fees to support Ontario's Guarantee Fund would amount to approximately 5% of this amount. Nova Scotia's corresponding figures will, of course, differ. However, the evidence is compelling, and the same factors at play in Ontario are at play in Nova Scotia. CFP expects that its proposal will net significant savings for Nova Scotia employers, and the offsetting cost of establishing a Guarantee Fund would be only a small fraction of those savings.

B. Discussion Questions

As noted above, the answers to these questions must be read within the context of the discussion in section A, which elaborates on the issues canvassed by the questions.

Q1 Do you believe that full (100%) solvency should be maintained?

A1

The 100% solvency funding target is intended, at least in theory, to ensure that a DB plan will be funded sufficiently to cover all pension commitments, even if the employer were to cease making contributions to the plan, say in the event of bankruptcy. For the reasons noted in section A, and as evidenced by the statistics cited in the Report of the Superintendent of Pensions, Nova Scotia's pensioners cannot be assured that this theoretical intent will be met. Indeed, it is clear that today's funding rules fall well short of providing that protection.

The 100% solvency funding target need not be maintained, but any relaxation of the funding target must be conditional upon the establishment and operation of a Pension Guarantee Fund that is capable of making good on the unfunded wind up liabilities for any DB plan that winds up involuntarily.

Q2 If full solvency funding were to be maintained, what adjustments, if any, to the specific solvency funding requirements discussed above should be implemented?

A2

Exclusions should not be permitted in the quantification of a plan's liabilities. Currently, Nova Scotia permits the exclusion of certain plan provisions, such as indexation. Consequently, a plan that appears to be 100% funded, according to Nova Scotia's regulations, is in reality underfunded. That is, it would not be capable of honouring the commitments made in respect of those provisions that have been excluded from the calculations. No matter what solvency funding target is chosen, regulations must insist that all plan provisions be included in the quantification of a plan's solvency liabilities.

Whether the funding target is set at 100% or some lower figure, pensioners should be protected by a Pension Benefits Guarantee Fund. The lower the target, the greater the need for a Guarantee Fund. Even at 100%, as has been the case in Nova Scotia, a significant proportion of plan members is in plans that are underfunded. Should these plans wind up before they are fully funded to cover all plan provisions, pensioners will be hurt as their pension payments are reduced.

If there is no Guarantee Fund, then the solvency funding target should include a provision for adverse deviation (PfAD). The Report of the Superintendent makes it clear that even a target of 100% leaves many plan members exposed to the risk of pension reductions.

Q3 Are there changes to solvency funding requirements not identified in this paper that should be considered?

A3

Yes. Incremental changes to solvency funding requirements will not be enough to protect pensioners. Further, the relaxation of solvency funding requirements without additional measures to enhance pension security will place even greater risk on pensioners. What is required is a change to the paradigm for pensioner security, as discussed in section A. That change will not only enhance pensioner security, but will also reduce the costs of DB plans for employers.

Q4 If the current 100% solvency funding threshold is discontinued, are 'enhanced' going concern funding requirements sufficient to ensure benefit security?

Q5 What features should enhanced going concern funding rules include?

A4-5

The going concern funding requirement can be enhanced, from the pensioners' perspective, by a number of measures. For instance:

- Include a PfAD in the going concern funding target;
- Reduce the amount of time allowed to retire any going concern deficit; and

- Require the use of assumed rates of return that fall within a conservative and narrow range, prescribed by regulation.

The larger the PfAD, or the shorter the amortization period for deficits, or the smaller the assumed rate of return, the lower would be the risk to pensioners. However, the purpose of the going concern funding requirement should remain unchanged: its goal should be to ensure that the pension plan is sufficiently funded assuming the employer continues indefinitely. CFP does not favour a regulatory approach that attempts to achieve, through going concern funding requirements, what can directly be achieved through other measures. In particular, one should not attempt to mimic a solvency funding requirement by fudging the parameters of the going concern funding requirements. Consequently, CFP recommends that a PfAD be incorporated in the going concern funding requirement that is large enough to protect against the unexpected fluctuations in market performance, say 25%. It should not be chosen in an attempt to mimic the funding outcomes of a solvency funding regime. Rather, if 100% solvency funding is a goal, then regulations should continue to insist on solvency funding.

Benefit security should be the goal of the pension legislation and regulations. The best way to achieve the goal is to change the paradigm for pensioner protection, as presented in section A. That model rightly relies on three measures to achieve benefit security: going concern funding requirements, solvency funding requirements, and a pension guarantee fund.

Q6 If the current solvency funding threshold is reduced to require only partial solvency, is a threshold of 85% appropriate? What other changes to funding requirements should be made?

Q7 Are there any other reforms to the funding framework for defined benefit pension plans that should be considered?

A6-7

If a Guarantee Fund as described in section A is not introduced, then lowering the solvency funding threshold below 100% is not appropriate. Indeed, a PfAD should be added to the solvency funding threshold of 100% to mitigate the harm that the current solvency funding threshold is causing, and all plan provisions should be included in the quantification of solvency liabilities. See A2. See also A4-5.

The needed changes go beyond consideration of funding requirements. The most important of these changes is the establishment of a guarantee fund that is capable of covering the unfunded wind up liabilities of any plan that winds up involuntarily.

See also the Attachment, pages 13-17.

Q8 Should Nova Scotia proceed with developing a regulatory framework for target benefit pension plans?

A8

Target benefit pension plans may be a useful addition to the range of pension plans permitted to be offered in Nova Scotia. They may be of interest to some employers who wish to provide a form of pension, but who are not prepared to undertake the provision of a defined benefit plan.

Q9 Should target benefit plans be restricted to unionized environments?

A9

CFP sees no reason why such restriction is necessary or desirable.

Q10 Should defined benefit plans be permitted to convert to target benefit plans, including benefits earned in the past?

A10

Employers today are permitted to terminate their DB plans, upon condition. CFP would prefer to see a target benefit plan offered in the workplace where the DB plan had been terminated than see no plan offered at all. If an employer wishes to change its plan from a DB plan to a target benefit plan, then it should terminate its DB plan, meeting the funding obligations that pertain to termination.

The conversion of DB benefits earned in the past should not be permitted. Those benefits were earned as deferred wages, where it was understood by the employee and employer alike that the defined benefits would be delivered to the pensioner at the conclusion of his or her working life. With the exception of employer bankruptcy or restructuring, the risk of ensuring the DB benefits is carried by the employer. The risk proposition for target benefit plans is very different, where the risk is shared by the employer and the employee/pensioner. The certain pension earned under a defined benefit plan becomes an uncertain pension under a target benefit plan.

Conversion should not be permitted. The commitment made under a defined benefit plan is not honoured under a target benefit pension plan.

However, if Nova Scotia nevertheless decides that conversion of earned DB benefits will be allowed, conversion should proceed only upon condition. The condition is that the individual whose benefits are to be converted must give informed and explicit consent to the conversion before the conversion proceeds. CFP notes that this condition is embodied in Bill C-27, the proposed legislation that would allow for target benefit pension plans to be offered by federally regulated employers.

Q11 Should a statutory discharge of liability for the pension plan be granted where annuity buy-outs occur, and if so what conditions should be met in order to qualify for the discharge?

A11

See pages 17 and 18 of the Attachment, “Buyout Annuities”.