The State of Defined Benefit Pension Plans in Canada: An Update

By the Certified General Accountants Association of Canada

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Electronic access to this report or its seminal predecessor titled *Addressing the Pensions Dilemma in Canada* can be obtained at www.cga-online.org

Certified General
Accountants Association
of Canada

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Foreword

In response to emerging apprehension and in anticipation of growing concern, the Certified General Accountants Association of Canada (CGA-Canada) issued a comprehensive paper on defined benefit pension plans in June of 2004. The goal of that CGA-Canada release titled *Addressing the Pensions Dilemma in Canada* was to advance understanding of defined benefit (DB) pension plans along with inherent risks and imperfections, to impart a reasonable estimate of the standing of DB pension plans at December 31, 2003 and to explore potential remedies for consideration by stakeholders.

In a large part motivated by a steady stream of media coverage focusing on pension plan shortfalls and a concern for the long-term viability of DB plans, CGA-Canada has advocated for reforms and sees fit also to update December 31, 2003 estimates with a December 31, 2004 assessment. As such, this report builds on CGA-Canada's June 2004 publication with the goal of further advancing public understanding. Serving as an update to the above noted seminal report, the reader can obtain background and increased context by referring to *Addressing the Pensions Dilemma in Canada* which can be found by visiting www.cga-online.org

Consistent with our initial findings, the issue of under-funded pension plans has become one of the most perplexing financial issues facing business executives, legislators and Canadian pensioners who are or will in the future be reliant on pension revenue as an important component of their overall retirement incomes. Importantly, we would continue to support an approach which corrects fundamental or structural imperfections or systemic influences such as surplus ownership and investment policy while anticipating the impacts that these changes have on outcomes or symptoms such as funding position.

While there are a number of examples of what happens when pension regimes become defective for workers, the current U.S. experience with United Airlines and the St. Anne-Nackawic Pulp Company event in Canada underscore that pension plan default can occur anywhere and within companies of any magnitude. Moreso, these occurrences demonstrate the need to better preserve pension plan solvency and member protection.

CGA-Canada remains committed to making a meaningful contribution to the ongoing debate on pension issues facing Canadians. We trust also that the content of this report effectively expands on our earlier works while complementing the collective efforts of other professional organizations, regulators, plan sponsors, members and their representatives.

Anthony Ariganello, FCGA, CPA (Delaware)
President and Chief Executive Officer
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Introduction

Health and financial well-being, in the broadest sense, have emerged as two of the most challenging issues facing Canadians in the new millennium. Beneath the optimistic veneer of recently published employment and job creation data sit the realities of "off-shoring" and "outsourcing." Traditional, financially viable jobs, especially in Canada's manufacturing sector have, at an alarming rate been lost to lower paying service and part-time/temporary work[1]. Coincidental with the complex socio-economic implications of continued globalization is the internal stress posed by Canada's large and aging population of baby boomers. The post retirement expectations and needs of the "boomer" generation, a group that will live longer than previous generations, will place enormous demands on the country's health and social support systems. The ability of Canadians to maintain a financially comfortable and healthy lifestyle after retirement has become one of this country's most vexing challenges and serves as the impetus of CGA-Canada's seminal report *Addressing the Pensions Dilemma in Canada* released in June of 2004.

For many Canadians, post-retirement health and well-being are increasingly and inextricably tied to Canada's pension system. Unfortunately, and the evidence is compelling, the pension system in this country has deteriorated significantly. There are problems related to under-funding, to allegations of archaic accounting practices and to sentiment of redundant legislation and public policy.

In some ways, the initial report on Canada's pension dilemma by CGA-Canada represents ground zero in what can hopefully contribute to a new pension paradigm for Canada. As an update to that work, the current paper serves to confirm the predicted risks and the proposed actions for transformation. As a minimum, we need to accept that in order to address the challenges before us; we need to acknowledge that the pension system is gravely imperfect. Only then, can key decision-makers and stakeholders focus on creating a sustainable pension 'system' that is financially viable and appropriately aligned with the retirement needs of affected Canadians.

In the interest of clarity, reference to pension plans in this paper shall relate specifically to defined benefit (DB) pension plans registered with a provincial or federal pension authority unless otherwise expressed. This paper does not address or represent the state of defined contribution (DC) pension plans, supplementary employee retirement plans (SERP), defined benefit pension plans for Federal public employees (PSSA) or Quebec public employees (RREGOP). Focusing primarily on single employer pension plans, multi-employer pension

1 "Restructuring of full time workers: A Case of Transitional Dislocation or Social Exclusion in Canada — lessons from the 1990s," by Susan Silver, John Shields and Sue Wilson, Ryerson University (paper to be published in 2005).

plans which tend to attract different funding and accounting issues, have been also excluded from findings and conclusions expressed herein.

Importantly, and in the interest of maintaining year-to-year data consistency, the analysis, findings, projections and comparisons in this paper have been based upon the aggregate performance of 847 DB plans reviewed as at December 31, 2003 and 784 DB plans reviewed as at December 31, 2004. Serving as representative samples from which to draw conclusions, these plans constitute approximately 30% of all such plans in Canada. As such, our approach has been to evaluate the combined performance of many of the plans with which MERCER Human Resource Consulting has a professional relationship and required composite knowledge. Consistent also with our earlier works, the Association has recognized the importance and appropriateness of retaining the expertise of MERCER Human Resources Consulting in the research and presentation of those findings. As a pension authority, MERCER has contributed its in-depth expertise on the subject and has afforded the empirical rigour from which conclusions may be drawn.

In the following pages, we will examine the nature of funding deficits while drawing a comparison between our 2003 and 2004 results. This is the predominant purpose of this paper, a “what it looks like one year later” account, if you will. We will not delve into the details of funding, investment and accounting policy, which while still relevant, are more appropriately covered in our initial report on the subject. In short, this paper is offered to the public as an update. We would encourage the reader to receive this report in concert with our sentinel *Addressing the Pensions Dilemma in Canada* paper which can afford the proper backdrop and context. Through the succeeding text, we will provide some narrative of current events and reflections.

This account was drawn from a variety of sources including contemporary media and journal articles, relevant academic research, interviews with key informants, and an analysis of position papers and speeches by knowledgeable and influential business, public service and labour leaders.

1 Executive Summary

Consistent with CGA-Canada's findings for the year ended December 31, 2003, 59% of Canadian defined benefit (DB) pension plans continue to be in deficit at December 31, 2004. If we provide for indexation of benefits, those numbers rise sharply to 95% and 96% respectively for the 2003 and 2004 years ending December 31.

Not only has the estimated number of deficit DB plans not improved; but the magnitude of the aggregate deficit has swelled significantly. With indexation of accrued benefits, it is estimated that the additional funding required to fully fund those deficit plans has grown from $160 billion at the end of 2003 to $190 billion at the end of 2004. When we ignore indexation, which is not particularly rational, we estimate that funding requirements distend from $26 billion at the end of 2003 to $29 billion at the end of 2004. Neither scenario is heartening to plan members.

The additional funding required to fully fund those deficit plans has grown from $160 billion at the end of 2003 to $190 billion at the end of 2004

If we isolate those plans in deficit forming part of our study, at December 31, 2003 and 2004 respectively, we can produce the results depicted in Table 1 below. In a large part, the table has been adapted from last year's study and then expanded to include 2004 findings. What is interesting is that it clearly demonstrates a weakening of the funding ratio of deficit plans between 2003 and 2004 and further corroborates last year's projections to 2008. So without being unnecessarily alarmist, results one year later are consistent with earlier prospects and are in fact inferior to the expected trajectory. Given a choice, it would have been preferable to have been wrong.

Table 1: Funding Ratios for DC Plans in Deficit (with indexation)

Replicated from Table 11 of June 2004 Publication					
		Predicted Position at Dec. 31, 2008			
	Position as at Dec. 31, 2003[3]	Best Estimate	Pessimistic	Optimistic	Position as at Dec. 31, 2004[2]
Plan Assets at Market Value in $Bn	205.2	285.6	265.5	307.2	220.6
Funding Surplus/ (Deficit) in $Bn	(71.9)	(86.0)	(112.7)	(54.5)	(89.9)
Funding Ratio	74%	77%	70%	85%	71%

2 For 751 DB plans in deficit at December 31, 2004
3 For 802 DB plans in deficit as at December 31, 2003

While we can reasonably expect respectable investment returns as were witnessed in late 2003 and 2004, much ground needs be made up to compensate for low interest rates and the poor equities market performance of 2001 and 2002. Made all the more vulnerable by declining contributor to member participation ratios and the ongoing sensitivity of Canada's financial markets, CGA-Canada continues to advocate for proactive deficit funding strategies which do not rely solely on hopeful corrections in investment portfolios.

Under-funded pension plans will continue to be a major financial issue

Under-funded pension plans has become, and will continue to be, a major financial issue for business executives, legislators and Canadians who are now or will in future be dependent on pension income.

In its initial response to Canada's evolving 'pension dilemma' CGA-Canada focused on two key insights. First, under-funding is in and of itself a serious pension problem in Canada. Secondly, and perhaps of greater importance, the pension dilemma is systemic in nature. In other words, while pension under-funding is a challenge, it is more importantly a symptom of deeper problems rooted within the larger pension administration regime. There are deeper structural problems that will need to be corrected; some of which are being grappled with today. Actions to improve the state of under-funded pension plans will of course be necessary and beneficial. Nevertheless, unless the basic pension system is re-aligned to meet current and emerging socio-economic realities, these symptom fixes can be short-lived.

For a comprehensive review of CGA-Canada's policy recommendations, the reader is encouraged to refer to the sentinel report which delineates prescriptive findings and advice. For sake of convenience, these recommendations have been reproduced as "Appendix A" of this paper.

How the Funding Position of Pension Plans Was Measured

2

Difference Between Funding and Accounting

There is often confusion between the concepts of pension funding and pension accounting.

Simply stated, pension funding is the amount of cash that is set aside to secure the pension promises made by a plan sponsor to plan members. The amount of cash set aside in a particular year is the function of multiple factors such as the organisation's availability of cash, alternative investment opportunities as well as minimum and maximum funding requirements as respectively defined by provincial and federal pension standards legislation[4] and the Income Tax Act.

Pension accounting represents the cost of a pension plan as reported by an organisation in its financial statements. Pension accounting is not shaped by the factors that influence pension funding. Pension accounting is based on a set of principles and rules established by accounting standard setting bodies (e.g. Accounting Standards Board in Canada and the Financial Accounting Standards Board in the U.S.) to enhance comparability between different organisations' financial results.

Funding Requirements in Canada

As mentioned, an employer establishing a pension plan for Canadian employees must fund the plan at a pace which, at a minimum, meets the requirements of the pension standard legislation applicable to its pension plan[5]. The minimum funding requirements are determined from an actuarial valuation which must be carried out at least every three years. The actuarial valuation involves comparing the value of plan assets with the value of the benefits (also called plan liabilities) that the plan is expected to pay in the future. The ratio of the value of plan assets to the value of plan liabilities is often referred to as the funding ratio or funding level. For example, a plan with assets worth \$80 million and liabilities valued at \$100 million will be said to have a funding ratio or level of 80%.

When determining the minimum funding requirements, pension standards legislation requires an actuarial valuation be made under the following two bases:

1. A going-concern basis, which focuses on the ability of the plan to meet its obligations assuming that the plan continues in existence.

4 Each province has its own set of rules for pension funding. The federal government also has a set of pension funding rules for federally regulated companies.
5 Pension plans are registered in the province with the plurality of members.

2. A solvency basis, which focuses on the ability of the plan to meet its obligations assuming that the plan is terminated at the calculation date.

Both bases require the determination of several assumptions. Assumptions under the going-concern basis are normally left to the discretion of the Actuary based on the specifics of the pension plan to be valued. In the selection of appropriate assumptions, the Actuary is guided by actuarial standards of practice issued by the Canadian Institute of Actuaries. Commonly, the actuary will allow for future increases in benefits and will use a value of plan assets which may or may not fully reflect the fair market value of the assets. Deficits arising from application of the going-concern basis are to generally be made up over a period not exceeding fifteen years.

Assumptions under the solvency basis are largely prescribed by pension standards legislation, leaving little room for discretion, and are based on market interest rates at the date of the valuation. Generally, no allowance is made for future increases in benefits and the value of plan assets correspond to the fair market value. However, in some jurisdictions (e.g. Ontario), in order to reduce the volatility of the funding level and ultimately the contributions to the plan, it is permitted to average the interest rates used to value the plan liabilities and the plan assets over a period not exceeding five years. Deficits arising on the solvency basis are generally made up over a period not exceeding five years.

There is also a third way to measure the funding situation of a pension plan. Referred to as the wind-up basis, this approach is similar to the application of the solvency basis. With the proviso however that it does not allow for the exclusion of certain benefits payable upon termination of the plan as solvency valuations may permit, and requires the use of the fair market value of plan assets.

The Actuarial Basis Used in this Study

In measuring the funding situation of pension plans in Canada, we have chosen to use a basis which could be described as follows:

- It is a going-concern basis, i.e. it assumes that pension plans will continue in existence.
- It uses a risk free interest rate, i.e. a rate corresponding to the yields on long-term government bonds.
- It allows for future increases in benefits, before and after retirement.
- It assumes retirement assumptions in accordance with those used by the actuary who performed the original valuation.
- It assumes future mortality that recognizes future improvements in pensioners' longevity.
- It uses the fair market value of plan assets.

Table 2 below provides a summary of the main assumptions underlying the basis.

These assumptions are appropriate in comparing the funding position of various pension plans for the following reasons:

Table 2: Actuarial Assumptions (Risk Free Basis)

	December 31, 2003	December 31, 2004
Interest rate[6]	5.25%	5.00%
Indexation[7] - without indexation of benefits - with indexation of benefits	 0% 3.0%	 0% 3.25%
Mortality table[8]	UP94G	UP94G
Retirement Age	As per respective plan designs	As per respective plan designs

- It removes the inherent discretion in selecting assumptions for actuarial valuations performed on a going-concern basis, i.e. it allows for a common vision of future market conditions.
- It provides results on a risk free basis as it removes the influence of the investment policies in the selection of the actuarial assumptions.

But it should be noted that very few pension plans in the market place are currently funded using a similar basis. Typically, pension plans are funded using a higher than expected interest rate and a weaker mortality table which, if applied to this study, would show lower pension deficits or greater pension surpluses. In this way, the study can be seen as a conservative assessment of the current funding situation of pension plans in Canada.

6 Determined from the yields on long-term bonds of Government of Canada.
7 Represents a blended rate of pre-retirement indexation (based on wage increases) and post-retirement indexation (based on CPI increases).
8 UP94G stands for uninsured pensioners' mortality table 1994 generational. This table allows for expected future improvements in pensioner's mortality and is currently seen as a best-estimate mortality table.

The Funding Position of Pension Plans in Canada as at December 31, 2004

3

Limits of the Exercise

Readers are cautioned that the results presented in this section have a very short life span. The funding situation of pension plans is affected by a large number of factors (e.g. level of interest rates, stock market performance, inflation, improvements in longevity, etc.), with changes to these variables occurring frequently. Therefore, in assessing the financial health of pension plans, the date on which the calculations are performed affects greatly the resulting valuations. The results have been calculated as at December 31, 2003 and of December 31, 2004 respectively, and as such, should be seen as a snapshot of actuality at those precise points in time and be interpreted in this light.

Data

This study is based on data included in the MERCER Pension Database (MPD). The MPD contains information on the pension plans across Canada for which MERCER Human Resource Consulting provides actuarial and consulting services. The MPD includes information about plan design, plan membership, target asset mix, and the most recent actuarial valuation assumptions and results under the going-concern and solvency bases. The database is updated annually.

The samples studied contained some 847 plans covering 1,590,000 members for 2003 and some 784 plans covering 1,787,000 members for 2004. More plans were excluded from the 2004 analysis due to data defects contained in some plan profiles which arise as the result of incomplete information, incongruent solvency and funding valuation dates, or outdated valuation dates. However, the variation in sample size does not materially affect the overall results since most of the rejected plans are very or relatively small.

Overall, the pension plans included in this study represent roughly 30% of Canadian DB market. Furthermore, it is believed that the set of plans included in the MPD is representative of the overall Canadian market, with the exception of Multi Employer Pension Plans (MEPPs) which are under-represented.

Finally, the data on pension plans for federal public employees (PSSA) and Quebec public employees (RREGOP) is publicly available but has not been included in this study on the basis that they are not subject to the same funding issues/problems as other pension plans in Canada and inclusion would serve to bias comparability of results.

The Methodology

In this study, the results of the last funding valuation (assets and liabilities) were adjusted and subsequently projected to December 31, 2003 and December 31, 2004 respectively.

The projection of the plan assets was done on a market value basis based on the target asset mix of the plan and on the return of the corresponding index over the period. The indexes used were as follows:

- Canadian Equities: S&P/TSX Composite
- U.S. Equities: S&P 500 ($Cdn)
- International Equities: MSCI EAFE ($Cdn)
- Fixed-in Income: Scotia Capital Universe Bonds

The projected December 31, 2003 and December 31, 2004 plan liabilities were arrived at by extrapolating the going-concern liabilities from the last valuation and then adjusted. Cash flows on plan assets and liabilities in the extrapolation period (e.g. service cost, employee and employer contributions, benefit payments) were estimated based on the results of the last valuation of the plan.

The Overall Results of the 2003 and 2004 Studies

Table 3 (with no indexation) and Table 4 (with indexation) present overall positions of the 2003 and 2004 studies, comparing pension plans which were in a deficit position to those which were in a surplus position at the end of December of 2003 and of 2004. For each group of plans, these tables provide the number of plans studied, the value of plan assets and plan liabilities, the funding surplus or deficit and the funding ratio, i.e. the ratio of plan assets to plan liabilities, under the two bases of future indexation of benefits.

Table 3: Overall Funding Results *with no Indexation of Benefits*

December 31, 2003					
Status	**Number of Plans**	**Plan Assets Market Value ($Bn)**	**Plan Liabilities ($Bn)**	**Surplus/ (Deficit) ($Bn)**	**Funding Ratio**
Plans with Deficit	496	38.9	46.7	(7.8)	83%
Plans with Surplus	351	171.1	138.5	32.6	124%
Total	847	210.0	185.2	24.8	113%
December 31, 2004					
Status	**Number of Plans**	**Plan Assets Market Value ($Bn)**	**Plan Liabilities ($Bn)**	**Surplus/ (Deficit) ($Bn)**	**Funding Ratio**
Plans with Deficit	460	45.5	54.1	(8.6)	84%
Plans with Surplus	324	177.8	145.6	32.2	122%
Total	784	223.3	199.7	23.6	112%

Table 4: Overall Funding Results *with Indexation of Benefits*

December 31, 2003					
Status	**Number of Plans**	**Plan Assets Market Value ($Bn)**	**Plan Liabilities ($Bn)**	**Surplus/ (Deficit) ($Bn)**	**Funding Ratio**
Plans with Deficit	802	205.2	277.1	(71.9)	74%
Plans with Surplus	45	4.8	4.0	0.8	120%
Total	847	210.0	281.1	(71.1)	75%
December 31, 2004					
Status	**Number of Plans**	**Plan Assets Market Value ($Bn)**	**Plan Liabilities ($Bn)**	**Surplus/ (Deficit) ($Bn)**	**Funding Ratio**
Plans with Deficit	751	220.6	310.5	(89.9)	71%
Plans with Surplus	33	2.7	2.2	0.5	123%
Total	784	223.3	312.7	(89.4)	71%

The overall funding position "with no indexation of benefits" as at December 31, 2004 is very similar to that of the previous year. The solid investment returns in 2004 (about 9.5% for a typical asset mix[9]) and supplemental 2004 funding contributions have nevertheless been offset by a reduction (of about 0.25%) in the long-term bond yield of the Government of Canada. The percentage of plans in deficit position remained constant at 59%.

The overall funding position "with indexation of benefits" has slightly deteriorated, mainly due to the increase in the assumed long-term expected pension indexation[10] (from 3% to 3.25%). This reflects the anticipated increase in the long term inflation rate of the market. The percentage of pension plans in deficit is slightly higher than that of last year (96% versus 95%).

The percentage of plans in deficit position remained constant at 59%

Snapshot(s) of the Canadian Market

To illustrate the extent of the funding deficit situation of pension plans in Canada, the results of this study were extrapolated to the entire Canadian market as were those of our previous year's findings. Table 5 below summarizes the funding deficits of the years ended December 31, 2003 and 2004 respectively under the two bases (no indexation and with indexation).

Table 5: Snapshot(s) of the Canadian DB Market[11]

Bases	December 31, 2003 Funding Deficit[12] ($Bn)	December 31, 2004 Funding Deficit[13] ($Bn)	Change in Funding Deficit Over One Year Period	
			$Bn	%
No Indexation	26	29	3	11.5
With Indexation	240	300	60	25.0

Relying on the premise that the plans studied represent approximately 30% of the overall Canadian defined benefit pension plan market, we have projected that the funding position of the totality of DB plans in deficit has worsened regardless of the rate of indexation.

Under no indexation of benefits, the gap is $26 billion for 2003 year-end and $29 billion for 2004 year-end whereas if future indexation of benefits is considered, both before and after retirement, the funding gap is $240 billion and $300 billion for the 2003 and 2004 year ends. In reality, many plans do not adjust pension after retirement and not all pension plans provide for full

9 35% Canadian equities, 12% U.S. equities, 10% international equities, 40% fixed income and 3% money market.
10 This assumption reflects a blended rate of pre-retirement indexation (based on wage increases) and post-retirement indexation (based on CPI increases).
11 The subject DB pension plans studied by Mercer Human Resources Consulting and CGA-Canada are plans with which Mercer has a professional relationship and required composite knowledge and which collectively are deemed to constitute approximately 30% of the Canadian market.
12 (No indexation $7.8Bn/.3=$26Bn; With indexation $71.9Bn/.3=$240Bn)
13 (No indexation $8.6Bn/.3=$29Bn; With indexation $89.9Bn/.3=$300Bn)

indexing of benefits prior to retirement[14], therefore the real funding gap can be estimated to be somewhere between these two numbers.

With the assistance of Mercer, it was estimated that the funding gap of defined benefit plans in deficit in Canada could reasonably be pegged at $160 billion at the end of 2003 and $190 billion at the end of 2004. These numbers have been arrived at based on the assumption that all pension plans, regardless of their type, would be indexed somewhat one way or another before retirement. In so far as providing for indexation after retirement, it was assumed that pension plans which currently provide automatic indexation (e.g. 17% of all 2003 plans) would continue to do so in the future and that all others would provide an average indexation of 1% per annum.

14 Final average plans allows for full indexing of benefits up to retirement while flat and career plans will tend to be improved on an ad-hoc basis which might or might not allow for full indexing of benefits up to retirement.

Funding Implications

4

Estimated Funding Contributions in 2005

Based on each plan's actual funding basis, Table 6 presents a comparison of estimated funding contributions to be made in 2004 and 2005 respectively. That is, 2004 estimates[15] are based on 2003 results relating to the 847 plans under consideration and 2005 estimates are based on 2004 results relating to the 784 plans under consideration.

Table 6: Estimated Funding Contributions[16]

Plan Status	Employee Contributions		Employer Current Service		Employer Special Payments		Total	
	$ Mn	% of Payroll	$ Mn	% of Payroll	$ Mn	% of Payroll	$ Mn	% of Payroll
2004 Estimates								
Solvency Deficits at Dec. 31, 2003 (603 plans)	1,600	4%	3,854	10%	4,536	11%	9,990	25%
Solvency Surpluses at Dec. 31, 2003 (244 plans)	258	3%	349	4%	24	0%	631	7%
Total (847 plans)	1,858	3.8%	4,203	8.9%	4,560	9.1%	10,621	21.9%
2005 Estimates								
Solvency Deficits at Dec. 31, 2004 (572 plans)	1,825	4%	3,454	8%	5,216	12%	10,495	24%
Solvency Surpluses at Dec. 31, 2004 (212 plans)	159	2%	269	4%	34	1%	462	6%
Total (784 plans)	1,984	3.7%	3,723	7.5%	5,250	10.3%	10,957	21.3%

An important limitation of the above calculations is that the format would suggest that contributions can and will be made at one precise point in time or interval. In practice though, the real or actual timing of sponsor contributions will manifest themselves very differently depending on a number of inter-active factors. These factors can include, but are not limited to, such actualities as legitimate smoothing mechanisms for going-concern position,

15 Based on MERCER Pension Database (MPD) representing approximately 30% of the Canadian Defined Benefit Pension Plan market.
16 The methodology used by MERCER to estimate funding contributions is very complex and embodies a number of necessary assumptions too numerous to transmit effectively.

use of aggregate actuarial methods for large plans, solvency smoothing for Ontario plans, staggered filing dates of actuarial valuations, contribution holidays or the use of certified special payment schedules relying on outdated or renewed estimates.

Observations

In comparing estimated funding contributions to be made in 2005 by members and employers (broken down between solvent and insolvent plans), a review of Table 6 reveals that expected special payments in 2005 ($5.2 billion) would be higher than the previous year's expected ($4.5 billion), whereas the expected employer service costs would be decreased from $4.2 billion to $3.7 billion. Further review of the data contained in the MPD exposes that these resulting variations are in large part explained by changes in the results of a few very large plans.

It should be recognized that funding contributions to a pension plan comprise employee required contributions, if any, and employer contributions which include current service costs and special payments which may be required to fund going-concern and/or solvency deficits. As outlined in CGA-Canada's 2004 report, the cost of pension plans has greatly escalated over recent times as may be evidenced by the amount of money represented in Table 6 and the correlating percentages as a function of payroll. The order of magnitude can in itself be alarming to an unfamiliar reader but all the more so if we consider that the collection of plans having funding deficits can attract up to a 25% surcharge on payroll costs. While much can be deduced from the information provided in the above table, one very significant observation is that pension cost is a considerable driver in the determination of employer compensation costs and there does not seem to be any real or anticipated relief on the immediate horizon.

5

The Nature of the Pension Controversy in Canada

Since the publication of *Addressing the Pensions Dilemma in Canada* in 2004, there has been a noticeable increase in media coverage related to the issues of retirement, pension plan solvency and sustainability. While much has been said about the problem of 'under-funding' per se, further analysis has revealed that pension plan administration is unduly complex and is plagued by 'pension system' shortcomings. Drawing on the findings of our initial review, CGA-Canada asserted that "Regrettably, market performance of the various investment devices which have hampered the health of pension funds coupled with low interest rates which have served to inflate pension liabilities have been cause for much attention when in fact there are deeper systemic problems which require redressing."

Research by the Wharton School's Pension Research Council[17] readily supports the assertion that post retirement in Canada is a 'systemic' problem and has explicitly identified two important trends in the configuration of Canada's private pension system that were somewhat predictable a couple of years back:

1. The decline in the relative importance of pension plans covered by pension legislation (i.e. Registered Pension Plans — RPPs) in favour of group savings vehicles (i.e. Registered Retirement Savings Plans — RRSPs) that are not covered by these laws.
2. Complementary to the first trend is the shift away from Defined Benefit (DB) pension plans to Defined Contribution (DC) plans, plus the additional realization that the growth of DC plans has been most pronounced outside of the pension regulatory framework.

The once vaunted Ontario Teachers' Pension Plan (OTPP) represents a real world example of the 'system versus symptom' pension debate. In terms of symptoms, a recent article in *The Globe and Mail* characterized the OTPP problem as follows: "despite a top-notch investment record, the Pension fund is facing a shortfall in funds."[18]

On the surface (i.e. symptomatically), the problem with the OTPP plan is a deficit that has ballooned to over $19 billion. Obviously there is a crisis brewing with the plan. However, to quote Pension Plan CEO Claude Lamoureaux, the deeper issue is that "there are too many teachers in retirement and too few teachers in the classroom." For example, in 1990, the active teacher to retiree ratio was 4:1. This ratio has further deteriorated to 1.6:1 in 2004 and is

17 Pozzechon, Silvana. 2004. "The Future of Pensions in Canada" The Pension Research Council, The Wharton School, University of Pennsylvania.
18 Church, Elizabeth and Willis Andrew. June 27, 2005. "Teachers' big problem: How to find $19.4 billion" *The Globe and Mail*, Pension Funds.

projected to decline further to 1.3:1 by 2014. Mr. Lamoureux's near term strategy will be to match future indexing with plan assets. In other words his plan to re-establish the overall integrity of the OTPP includes a better balance of assets to liabilities, which in turn is closely related to the ratio of working teachers to retirees.

> "the Lamoureaux strategy will be keenly watched — the fund is ahead of the demographic boom, and before long its woes will be felt by other retirement plans."[19]

In a broader context, the OTPP reflects a problem which extends beyond Ontario teachers. For years the OTPP has been the benchmark of pension solvency and sustainability. That it now finds itself in a serious deficit situation serves as a barometer of things to come for the larger Canadian pension system.

It seems obvious from the OTPP example that, while very often the presenting issue with pensions is funding deficits, there are in fact deeper structural problems that need correcting, including, for example, the funding of deficits, the ownership of surpluses, issues of relevancy with respect to pension legislation as well as concerns related to contentious accounting and actuarial practices.

Stakeholders need to correct deeper structural problems in addressing the challenges of Canada's pension system

And as the example of the OTPP reflects, issues related to demographics, traditional and perhaps outdated retiree expectations and paternalism only serve to exacerbate structural challenges. The solvency and long-term sustainability of Canada's pension system will undoubtedly depend on how well stakeholders understand, anticipate, and act "systemically" in addressing those challenges.

A Pensions Paradox

In updating the information contained in *Addressing the Pensions Dilemma in Canada*, it became obvious to CGA-Canada that while much of the complexity of Canada's pension system resides in its administrative, regulatory and financial structures, it is equally clear that the dilemma being posed by pensions involves and is affected by the expectations, perceptions, passion and emotions of its many and varied stakeholders.

The global consulting firm Watson Wyatt[20] reported in June 2005 that approximately 11% of large companies that offer traditional pension plans either terminated them or froze benefits in 2004. More importantly the report goes on to state that four of these major employers with falling profits and big pension problems (i.e. Ford, General Motors, United Airlines and Continental Airlines) "gave their top executives huge retirement payments." Paradoxically, whereas unfunded pension obligations at Ford (U.S.) have risen to $12.3 billion, Ford Chief Executive William Clay Ford Jr., has collected $53 million over

19 Church, Elizabeth and Willis, Andrew. June 27, 2005. "Teachers' big problem: How to find $19.4 billion" *The Globe and Mail*, Pension Funds.
20 Watson Wyatt Consulting. June 24, 2005. "Study says more large companies end pensions" reported on AccountingWEB.com.

the past 3 years. General Motors followed a similar pattern awarding CEO Richard Waggoner $40.7 million over the same period within which a pension shortfall of $7.5 billion has amassed.

In the face of these revelations, it's not hard to understand the hard-line position that Canadian Auto Workers (CAW) negotiators have taken on wage and benefit demands as they head into the current round of bargaining with Ford, General Motors and Daimler Chrysler in Canada.

Funding, Accounting and Legislation 6

As the so-called pension paradox suggests, there are fundamental structural problems at the core of Canada's pension dilemma. That is not to suggest that specific issues like under-funding, alleged out-dated accounting rules and practices and inflexible pension regulations in and of themselves are not problematic. Symptoms are also problems. Funding, accounting, investment and benefit policy are key elements in the structure of the pension system. Individually, interactively and collectively, they have a significant impact on the overall integrity of the system.

Funding and Investment Policy Update

CGA-Canada's report, *Addressing the Pensions Dilemma in Canada*, established that funding has become a serious issue with many of Canada's defined pension plans. At December 31, 2003, 59% of Canadian defined pension plans were in deficit. Assuming indexation of accrued benefits, this translated into the need for an additional $160 billion to fully fund those deficits. One year later, again based on data furnished by MERCER Human Resource Consulting, that amount has been recast at $190 billion.

Canadian pension plans are likely in the worst shape in two years

And as of December 31, 2003, the average pension fund in Canada was invested 56% in equities, 37% in various types of bonds, 2% in real estate and 5% in other instruments.

It had been predicted that future cycles of surplus/deficit in pension plans would be inevitable given the tendency for most plan sponsors to heavily invest plan assets in equities. Interestingly, equities still comprise 57% of the investment portfolio. This has proven advantageous albeit relatively more risky.

In July 2005, an article appearing in *The Globe and Mail* reported that "Canadian pension plans are likely in the worst shape in two years."[21] Relatively consistent with CGA-Canada's findings, the article explains that the assets of a typical pension plan were only 79% of what was needed as of the end of June, compared to 120% in the fall of 2000 and 84% six months earlier. The reason for the "backsliding" is said to be declining interest rates.

Most recently and on a very positive note, significant stock market recovery was reported in the month of July 2005. According to *Globe and Mail* journalist David Parkinson, "It's raining earnings. And investors are singing in the rain."[22] Parkinson goes on to state that the S&P/TSX composite surged 132.78 points to 10,500.67 and the S&P/TSX 60 rose 8.04 points to 591.23 — new 57 month closes for both.

21 Durbin, Dee-Ann. July 18, 2005. "Big Three, CAW launch contract talks" *The Globe and Mail*, Automotive.
22 Parkinson, David. July 28, 2005. "Profit Picture gives Investors Something to Dance About" *The Globe and Mail*.

In considering estimated funding contributions to be made in 2005 by members and sponsors (broken down between solvent and insolvent plans), the MERCER data also reveals that anticipated "special payments" of $5.2 billion are higher than the expected $4.5 billion calculated one year earlier, whereas the expected employer service cost has decreased from $4.2 billion to $3.7 billion. MERCER further suggests that these variations are largely explained by changes in the results of a few very large plans.

In a similarly positive vein, the majority of CFOs surveyed by Watson Wyatt[23] expect that 2004 long-term bond yields will be the same or higher than they were at the end of 2003. This, if correct, will be good news for pension plans because long-term bond yields are a major driver of pension expense (for financial statement purposes) and the state of pension plan solvency.

However, in the face of these more optimistic perspectives are the continuing economic woes of major Canadian employers including, for example Stelco, Ford, General Motors and Daimler Chrysler. All four contend that burgeoning employee benefit costs are a major cause of their economic problems. Emotion and rhetoric aside, it is sobering to think that Stelco's pension liabilities alone (which are in excess of $1 billion) far exceed the approximately $300 million in funds that are available through Ontario's Pension Guarantee Fund.

And even in the face of strong investment returns on pension coffers, how do we explain the events currently transpiring with United Airlines. In the spring of 2005, a bankruptcy judge approved a deal between the airline and government that allowed the carrier to terminate its pension plans in what could potentially be the largest corporate pension default in U.S. history. In essence, the deal consists of eliminating pension plans covering 120,000 members as part of a restructuring effort to realign its costs and attract the requisite financing needed to step out from court protection. The four pension plans are under-funded to the tune of $10 billion U.S. and the government will guarantee $6.6 billion U.S. through the Pension Benefit Guarantee Corporation (PBGC) which is itself running at $23 billion U.S. deficit. This leaves a $3.4 billion variance which will translate into deep and permanent cuts in retirement benefits to members, while downloading increased burden onto the American public. This whole issue has been the subject of the first ever 'Online Congressional Hearing' which took place over the summer months of this year.

And what of the St. Anne-Nackawic pulp mill in New Brunswick. The mill closed without warning approximately one year ago putting some 400 employees out of work. The mill filed for bankruptcy and a firm was appointed by the province to administer the pension fund for the mill workers. After the dust had settled, it was determined that the company's two plans were under-funded by about $30 million making it unclear as to whether mill employees would get the pension they are owed. By December, 2004, it had

23 Reed, G. Edward, Markham, Ian, Watson Wyatt Worldwide and Financial Executives International, November, 2004. "Is There a Pension Plan Crisis? The Perspectives, Reactions and Strategies of Canadian CFOs" Conference Board of Canada.

been determined that workers under the age of 55 years would receive no pension benefits.

Now, while an argument could be made that these concerns do not result from funding and investment policy per se but could be attributable to regulation and enforcement, they are intrinsically linked. Some might also suggest that member protections are afforded in the long term by regulation, but experience tells us that in economic downturn, all bets are off. The long and the short of it is that plan insolvency is problematic and companies are by definition constructs of the law which have a finite life. So, otherwise financially viable plans can and will eventually wind down; sometimes with devastating effects. The true answer lies in recognizing pension benefits as deferred compensation which is contractually and legitimately owed to the worker, and as such, should be managed and preserved for that sole purpose.

Pension plans are a deferred compensation which is contractually and legitimately owed to the worker

The complexity of the pension system is further reflected in a recent article published by the Canadian Labour Congress (CLC) wherein the CLC suggests that there are two false myths circulating with respect to pensions[24]:

1. that there is excess regulation; and
2. that risk asymmetry (i.e. sponsors bearing total cost of under-funding but having to share surpluses on partial windups, etc.) is distorted.

The CLC contends the asymmetry claim is totally inconsistent with employers taking contribution holidays and asking plan members to restrain other wage and benefit demands in order to pay off pension deficits.

In the opinion of Joe Hornyak, executive editor of Benefits and Pensions Monitor[25] the whole issue of funding/deficits asymmetry is merely an accounting or actuarial number. In his opinion a better way to measure pension plans is to know if sponsors are meeting current retiree needs. He proceeds to explain that current accounting/actuarial targets relative to future funding obligations put companies at financial risk, which is unfair and ill-advised. In his opinion the use of market value is a fair and more accurate measure of a plan's status.

Accounting and Actuarial Update

In *Addressing the Pensions Dilemma in Canada*, CGA-Canada expressed the concern that accounting rules for pension plans are not serving the investment community well. For example, plans with large deficits can legitimately defer recognition of obligations in such a way that they do not appear on corporate balance sheets. According to a study by National Bank Financial, off balance sheet deficits of 79 Canadian companies (representing approx. 80% of S&P/TSX market capitalization) at the end of 2002 amounted to $21 billion. While a richer discussion on accounting and actuarial issues (including

24 Georgetti, Ken, president, Canadian Labour Congress. March 17, 2005. "Workplace Pensions: Current Difficulties and Going Forward".
25 Hornyak, Joe, executive editor. June 27, 2005 interview "the current status of DB pensions in Canada: issues, opportunities" Benefits and Pensions Monitor, PowerShift Communications Inc.

reliance on the expected rate of return on plan assets, amortization of gains and losses, amortization of past service costs and smoothing of plan assets) can be found in *Addressing the Pensions Dilemma in Canada*, an elementary scan of recent events reveals that:

1. The International Accounting Standards Board (IASB) and the United States Financial Accounting Standards Board (FASB) have agreed to work to better harmonize pension accounting rules, however there is no indication at this time as to progress made to date in particular respect to pension accounting standards.
2. While there had been some passive hope that the IASB would adopt a standard similar to that of United Kingdom's Financial Reporting Standard No. 17 (FRS17) and at the same time eliminating the controversial 'expected return on plan assets' component of pension expense, the IASB has provided only optional guidance. That is, the IASB has modified its standard to allow employers to recognize pension cost on a market basis (instead of deploying smoothing constructs available through amortization mechanisms) but has made it optional rather than compulsory.
3. In the absence of any real accord or impetus on the parts of American and International fronts, it is unlikely that the Canadian Accounting Standards Board (AcSB) will be compelled to further investigate Handbook Section 3461 (employee future benefits) while so many important pressures are concurrently bearing down on the standard-setting industry.
4. Effective February 2005, commuted values (or transfer values) under registered pension plans have to be calculated under a new valuation basis. This new basis better reflects market linkage between economic assumptions and recognition of mortality improvements over more than 20 years. The good news is that this represents responsible policy and more realistic modelling. The bad news: this change can be expected to intensify solvency liabilities by 3% to 5% on average.

Legislation and Public Policy Update

Pension regulators must uniformly apply common rules

Addressing the Pensions Dilemma in Canada recommends that pension legislation should be harmonized across provincial jurisdictions. In other words, pension regulators must uniformly apply common rules, which in and of themselves should collectively take a more proactive approach and monitor more closely those pension plans that are in a deficit position, including for example:

1. requiring more frequent actuarial valuations where conditions warrant;
2. placing constraints on the level of investment risks taken by the pension fund;
3. adding plan requirements for sponsors who wish to improve benefits of plans which are already in deficit;

4. an untainted enforcing of regulation;
5. requiring targeted communications to plan members; and
6. ensuring that pension plans attract strong vigilance by Boards of Directors as well as ensuring that Board members are qualified or otherwise independently guided to act on pension issues.

Regrettably, some of the rules have been relaxed rather than tightened. For example, it has been noted that some pension regulators have started to review their solvency funding requirements for DB pension plans in favour of loosening current or pre-existing requirements. For example:

- Changes to federal pension legislation will provide relief to companies entering a creditor protection process. As a result, a company such as Air Canada was permitted to amortize existing pension deficiencies over a 10-year period instead of the traditional 5-year provided for by law.
- New Brunswick has amended legislation such that the Superintendent can approve requests for extensions to the amortization period for solvency deficiencies.
- Nova Scotia has amended legislation to exclude solvency liability from "grow-in" provisions.
- Manitoba's Pension Commission has recently invited submissions for changes related to solvency requirements.
- Quebec has introduced temporary measures providing for funding relief. Quebec is also holding public consultations on various pension issues.

More encouraging to solvent plan members and following the Ontario Court of Appeal's recent decision in the case of Transamerica, the Financial Services Commission of Ontario (FSCO) published a new position on pension asset transfers. The main impact of this decision is a reduced flexibility in the merging of pension plans or the transference of pension assets between plans. Some can legitimately argue that this new directive will impede the popularity of DB plans in their restructuring but one has to wonder if blending of solvent plans with weak or insolvent ones really accommodates anyone in the long term.

On July 29, 2004 the Supreme Court of Canada released its landmark judgement requiring that surplus attributable to a partial wind-up group be distributed at the time of the partial wind-up and not at a subsequent date. Even though the judgement is directly relevant to Ontario legislation, the expectation is that other jurisdictions with similar statutory wording will likewise be affected. While there are supporters and non-supporters of this decision, CGA-Canada continues to believe that neither extreme is in the best interest of any or all parties. Rather, the position taken has been one of consensus and equity wherein reliance could be placed on time-weighted formulas which take into account the respective contribution values of members and sponsors. Such a formula was put forward by CGA-Canada in the fall of 2004 and can be found by visiting www.cga-online.org/canada.

In contrast to serious pension funding issues that have surfaced within the private sector, the proposed new OMERS governance model[26] Bill 206 "An Act to Revise the Ontario Municipal Employees Retirement System Act" received first reading on June 1, 2005. This legislation, if passed would give municipal employers and employees greater control of the Ontario Municipal Employees Retirement System (OMERS). The new governance model would include a Sponsors Corporation consisting of employer and employee representatives as well as an administrative corporation continuing in the role of the current OMERS Board. The new model would give different member groups the ability to tailor plans to meet unique group needs (e.g. police forces, etc). The model would also include a formal dispute resolution mechanism with mediation and arbitration similar to that of the Ontario Teachers' plan. Government intends to have the new bill in place in early 2006.

With regards to the decision in February's federal budget to lift the cap on pension investment in foreign equities, the expectation is that Canadian pension funds will, on average, raise their foreign content to about 33% from the current average of about 26% (*Globe and Mail*, Pension Funds, June 27, 2005).

26 Canadian NewsWire. June 1, 2005. "Ontario Government proposes new OMERS governance model" (Bill 206).

7 Inputs from Others

From the perspective of Canada's Labour Unions, Ken Georgetti, president of the Canadian Labour Congress, suggests Canadians have reason to worry about their pensions: "Poll after poll tells us 3 out of 4 Canadians worry about having enough to live on when they retire — these are the hard realities the budget failed to address.[27]"

According to Mr. Georgetti, the pension problem could have been, but was not, addressed in the February 2005 federal budget. The Canadian pension issue is made more prominent, in Mr. Georgetti's opinion, by virtue of the fact that from 1992, for the first time in decades, the percentage of employed people who belong to workplace pensions started to decline.

Table 7: Percentage of Canadians in Workplace Pension Plans (11)

Year	% of Canadians in workplace pension plans	% of those Canadians in DB plans
1992	49%	90%
2002	44%	83%

Recently published research by the Wharton School, Pension Research Council confirms that "future challenges to both the public and the private pillars of the Canadian retirement system will require regulatory reform in the medium term." In supporting their conclusion the Wharton researchers state that from 1986 to 1996 annual contributions to the Canada Pension Plan (CPP) increased by 0.2%, reaching 5.6% of maximum contributory earnings in 1996. In 1997 the funding crisis resulted in an increase in contributions to 2003 of 9.9% where they are projected to remain for some years. These premiums are sufficiently high to accumulate surpluses until 2021 (McNaughton, 2004, as quoted in the Wharton paper).

The "pension system" perspective advocated by CGA-Canada gives substance to a recent "warning" from Michael Robinet, vice president of global forecasting for the Michigan-based automotive consulting firm CSM Worldwide. Mr. Robinet recently stated that "Canadian automotive plants will become less competitive with rival factories in parts of South America and Asia — where workers earn less — if they keep winning big wage and benefit increases."[28]

And yet in stark contrast and seemingly undaunted by the prospect of

27 Canadian Labour Congress. March 1, 2005. "Retirement Income: Canadians' Worries Ignored" as posted to CLC web site.
28 Vander Doelen, Chris. June 8, 2005. "Canadian GM workers won't escape cuts" Financial Post.

reduced competitiveness, CAW president Buzz Hargrove announced recently that because “the CAW has earned its benefits,” there will be no relief in benefit demands during the current round of contract negotiations with Canada’s domestic auto manufacturers.

In *Addressing the Pensions Dilemma in Canada* it is suggested that entrenched in the pension funding dilemma is the desirability to empower pension plan members to attain increased understanding of their pension arrangements; intrinsic risks, entitlements and expectations; and the actions they might pursue in planning for retirement. With the one exception noted below, it does not appear that employers have taken any significant initiative to “empower pension plan members.”

The notable exception to an absence of employee empowerment comes out of a recent survey of Canadian CFOs by Watson Wyatt. The CFO survey report states that “most companies have made changes to the amount of education made available to plan members (for both DB and DC plans).” However, while the survey of CFOs refers to a greater amount of education, we have found no information to date on how effective this education has been.

On a related note Joe Hornyak, executive editor of Benefits and Pensions Monitor offers the opinion that “Judges don’t understand pensions.” Whereas the position of the Ontario courts was to insist on the distribution of pension assets in the Monsanto case, parts of Europe and Quebec have dropped the “partial wind-up” process. And issues of fairness, solvency and sustainability aside, the approximately 200 partial wind-up reports sitting with no action in Ontario hints to an additional problem of legislative paralysis.

According to Mr. Hornyak, most people today use RRSPs to defer taxes. In fact, he goes on to say that tax deferment as opposed to post-retirement income planning is promoted by both employers and the banks.

Researchers at the University of Pennsylvania’s Wharton School have identified a number of important concerns related to Canada’s evolving pension system including:

1. Increasing public pension demands competes for other tax dollars within Canada’s already ailing public health care system.
2. The Association of Canadian Pension Management (ACPM) suggests that Canada’s transfer payments to the elderly are too generous.
3. The dependency ratio (i.e. inactive people over 55 relative to the active labour force 15 years and older) for Canada is projected to double between the year 2000 and 2030.
4. The current tax system penalizes Canadians who gradually withdraw from the labour force.
5. Demographically, Canadians 65 and over constituted 8% of the population in 1971, 13% in 2001, is projected to be 15% in 2011, 19% by 2021 and 21% by 2026.

Despite their general optimism, as reflected in Tables 8, 9 and 10[29], the CFOs surveyed by Watson Wyatt expect the current funding crisis to have a substantial impact on the pension environment (see Table 11). On the other hand the majority of CFOs consider the crisis to be cyclical.

"Nearly 75% of the CFOs expect current conditions to result in a number of DB plans being closed to new members. Eighty-two percent foresee various DB plans being replaced by DC plans. Thirty-four percent predict that some organizations will pay cash in lieu of pension benefits."

82% of CFOs expect various DB plans will be replaced by DC plans

Table 8: Number of Pension Plans Sponsored

Number of Pension Plans Sponsored in Canada	Respondents (%)
1	31
2	20
3-5	28
6-10	13
>11	8

Source: The Conference Board of Canada

Table 9: CFO Perspectives on Crisis Severity

Perspective	Respondents (%)
Problem is isolated/limited	29
Problem is widespread but cyclical	39
Problem is severe/will linger	20

Source: The Conference Board of Canada

Table 10: Expectations for Long-Term Bond Yields

Direction of Change	Respondents (%)
Higher	32
About the same	50
Lower	18

Source: The Conference Board of Canada

As an overall response to the pension issues as reported by CFOs, the following behaviours have been observed:

1. The most typical reaction to under-funding has been a review of their funding, investment and accounting policies.

29 As replicated from The Conference Board of Canada. November 2004. "Is There a Pension Plan Crisis?

2. Only 39% plan to contribute above minimum required, 41% reported no planned changes, 20% plan to reduce their contributions to minimum contributions.
3. Fifty percent are assessing the skill sets of and styles of their investment managers to better match them with their liability structure. However, that said, 82% do not plan to modify their investment strategy.
4. Ninety percent are not considering eliminating smoothing or amortization practices; which is “interesting in view of the general move in accounting circles to a ‘mark to market’ approach in all aspects of the income statement and balance sheet”.
5. Sixty-seven percent are not contemplating any changes to pension risk sharing even though this might help preserve DB plans.
6. Most companies have made changes to amount of education made available to plan members (for both DB and DC plans).

8

Summary of Key Findings Identified During the Process

- Employers have continued the trend of restructuring and/or replacing defined benefit pension plans with less financially onerous retirement arrangements. For example, employed Canadians in workplace pension plans dropped by 5% between 1992 and 2002 (see Table 7). As Table 11 below indicates, 82% of CFOs surveyed recently foresee defined benefit plans being replaced with defined contribution plans.

Table 11: Impact of Current Situation on Pension Plans

Impact	Respondents (%)
Many DB plans will be closed to new members	75
Many corporations will replace DB plans with DC plans	82
Many corporations will pay cash in lieu of pension benefits	34

Source: The Conference Board of Canada

- Although there are examples of significant investments to under-funded plans, generally plan deficits continue to be a major symptom of what CGA-Canada refers to as the current Canadian pension system 'dilemma'.

- The Wharton School's Pension Research Council convincingly argues that a serious issue for Canada's pension system is the growth of defined contribution plans <u>outside</u> <u>of</u> the pension regulatory framework.

- Demographics including most particularly Canada's aging population further exacerbates the already tenuous state of the DB pension system. For example, the dependency ratio (i.e. in-actives over 55 relative to active labour force participants 15 years and up) will double between 2000 and 2030.

- There is no indication as yet that legislators are considering alternate methods for distributing pension surpluses in the case of partial wind-ups.

- There has been a noticeable increase in the perceived need to improve the amount of education and communication provided to retirees and pension plan members.

- Pension liabilities, which have continued to increase for a large number of Canadian employers, are still not fully accounted for on the organizations' balance sheet.

- The recently tabled OMERS governance model (via Bill 206) will improve plan flexibility and give municipal employees and employers greater control over the management of the assets.

- Globalization creates another level of complexity and concern for pension system stakeholders. Outsourcing and off-shoring have helped to improve near term employer competitiveness. However, new evidence shows that these productivity gains have been at the cost of significant job loss for many Canadian workers, especially those in the manufacturing sector.

Closing Comments

9

The current economic and legislative environment within which pension plans are expected to function is complex. Increasingly, pension plan management has occupied prominent relevance on the agendas of organizations and their members. Adding to this complexity and the acute attention directed at the matter, is the multitude of participants and stakeholders attracted to, and affected by, those decisions. Fraught with competing benefit, funding, investment and accounting policy decisions, few topics demarcate as clearly the divergence of interests which can exist between the various participants and the emphasis or importance directed to the matter by these stakeholders.

Within such a complex model, and as we have witnessed, it would be idealistic to simply expect all stakeholders to be reasonable over pension rights and obligations; it is really not that straightforward. On the one hand, employers, governments and the courts need to recognize that pensions are a form of deferred compensation which is fittingly owed to the members. On the other hand, members, bargaining units and unions must appreciate the external impacts which cripple otherwise well-intended sponsor intentions and the economic realities of today's markets and demographics. If some compromise is not reached between these stakeholders, participation in DB plans will merely decline or altogether disappear. In fact, it is already happening and the current conflict emphatically serves to accelerate its demise. Nowhere is this more evident than in Canada's private sector.

Participation in DB plans will decline or altogether disappear

Interestingly, last year's recommendations (as reproduced as Appendix A) continue to be relevant today. Some progress has been made in several regards but, for the large part, it is our view that those who had predicted sponsor exodus from the DB plan marketplace had accurately foretold the inescapable outcome. What is less obvious is why stakeholders have not compromised.

The heart of the true debate lies within the two conflicting views of the pension "deal":

- the accounting/economic view where pension assets and liabilities are corporate assets and liabilities; where plan members are secured creditors to whom pensions are owed; and where experience gains and losses accrue to shareholders; and

- the judicial/legislative view where pension assets are legally distinct from corporate assets; where pension funds are managed by fiduciaries for the benefit of plan members, not shareholders, and where shareholders are responsible for deficits while the ownership of surplus remains in dispute.

Surely, an argument may be made for either. That is, if we continue to ignore that pension and retirement benefits, are in reality, a form of deferred compensation. If we accept that pensions are a component of compensation, we are hard pressed to accept the first view. As a form of compensation, we can not discount the notion that pension benefits accrued are in fact a future promise for services rendered today. An employer should no sooner be capable of abdicating itself from its promised pension obligations than any other form of contractual undertaking.

Having said that, plan sponsors should not be penalized for effective plan management (i.e. surplus), given that members have entrusted the sponsor to satisfy the pension obligation accruing from that trust. In other words, members should not seek to receive a premium over and above the pledged amount. Special circumstances of surplus emanating from plan restructuring or plan wind-down (partial or otherwise) could however be subject to other special rules which rely on time-weighted, contribution-rated formulas as that produced by CGA-Canada in late 2004. Our reasoning for this caveat is that, the term of plan obligations towards individual members or groups of members is mitigated by the fact that benefit security for those members has been infringed and the collective member stake has been abridged.

Defined benefit pension plans have lost their appeal

At this juncture, many would agree that defined benefit pension plans have lost their appeal; mostly due to all of the contentious issues and events that have transpired. We can not reasonably expect a resurgence of those plans but we can moderate the pace of decline of enduring plans while providing a framework which better enables the creation of new or redesigned plans. Otherwise, we can expect to experience continued diminishment of member interests; especially in the competitive private sector where the risks and costs can not, and should not, be disregarded. This report has not spoken to it, but the very imbalance in DB plan participation which is now mounting between in the public and private sectors will bring about a whole new multitude of human capital issues for Canada.

If we are to assure sustainability and confidence in DB pension plans, it will be necessary to address these fundamental challenges and to seek out meaningful compromises which promote greater plan certainty, credibility, viability and longevity.

Appendix A

10

Addressing the Pension Dilemma in Canada: June 2004 Recommendations

- Pension fund administrators, relying on risk budgeting processes, could be required to better justify their choice of investment mix and should also disclose how anticipated risk is to be measured, managed and otherwise mitigated where actual experience fares poorly.

- Securities regulators could decree a greater degree of disclosure and/or the rating of pension-related risk being carried by publicly traded companies.

- Given the imperfections cited throughout this report related to pension plan administration, members' growing reliance of pension benefits and the weakened confidence in pension fund performance, greater emphasis should be placed on the design and sustainability of pension plans. While advocating for possible change, stakeholders should strengthen their planning and policy development activities, taking into account all the pension related issues.

- Regulators will need to address the question of pension surplus ownership if sponsors are to be held accountable. Within the current landscape, surplus distribution is simply not seen as fair and equitable to plan sponsors. When determining the attribution of pension plan surpluses, there may be an opportunity to establish time-weighted formulas which take into account the respective contribution values of members and sponsors.

- Workplace pension arrangements and the roles, responsibilities and obligations of the various participants involved in the management of those pension plans should be fully articulated and communicated to all key stakeholders.

- While reliance on pension advisory committees and pension committees should be fostered, the regulatory and legal framework should provide greater protection against litigation to those who would agree to serve in an agency relationship. Consideration should also be given to including provisions for errors and omissions insurance coverage for those who serve in such capacities.

- Regulators could require actuarial valuations more frequently than once every three years where deterioration of solvency ratios (on a predefined basis) may warrant; especially where plan asset returns have fared less favourably than earlier communicated predictions.

- Accounting and actuarial standard setting bodies should be encouraged to analyse and report back on alternative reporting standards with particular attention being devoted to the practicality of adopting modern economic principles based on fair value.

- Regulators should continue to explore harmonization of jurisdictional provisions in the spirit of simplifying administration and conformance.

- Regulators should develop common provisions for a plan sponsor which has operations in multiple provinces (e.g. Hudson's Bay Company), and in the absence of harmonized regulations or uniform law, should examine allowing the sponsor to be regulated by one agency.

- In the face of growing obligations and the shrinking labour force entry rates, sponsors and bargaining units should revisit early retirement schemes adopted under circumstances which substantially differ from current-day realities.

- Given the growing order of magnitude of pension plan assets and obligations, boards of directors, CEOs and CFOs should be encouraged to pursue and adopt constantly evolving best practices as they relate to pension plan management.

- Further study into other models such as co-op and hybrid pension models vs. the current captive insurance company model (pledged benefit as a function of contribution and sponsor diligence) should be commissioned. At the heart of such a study, the benefits/costs/limitations of the alternatives would undoubtedly shed light on any improvements in pension plan clarity and identify disproportionate assumption of risks between participants. In short, these alternative models promote risk-sharing and enjoin greater member participation and self-reliance in retirement planning.

- The Department of Finance Canada should revisit the 10% cap (disallowance of surplus amounts which exceed liabilities by 10% or more) historically placed on DB balance sheet surpluses in favour of elevating the limit, to say 30%, or discarding the provision altogether. Retrospectively and prospectively, we can expect that the 10% rule does in some instances force a sponsor to take contribution holidays when the sponsor may not otherwise do so.

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