NEEDED: a true balance

Do the numerous governmental and regulatory proposals on the table concerning the health of defined benefit plans balance sponsors' and members' needs?

By Gary Nachshen

Two years after the onset of the defined benefit (DB) pension plan funding crisis, Canada's regulators and legislators have sprung fitfully into action with a series of consultations and proposals designed to address plan deficits and shaky employer finances.

Starting with the federal government, recent months have seen two pension-related initiatives from Ottawa. First, the federal Department of Finance released a consultation paper in May 2005 entitled *Strengthening the Legislative and Regulatory Framework for Defined Benefit Pension Plans Registered under the Pension Benefits Standards Act, 1985.*

Second came the June 2005 introduction of Bill C-55, a massive overhaul of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act, which includes numerous proposed changes relating to pension plans.

Quebec was also busy this past spring. The National Assembly adopted a series of "temporary" measures on DB pension funding in Bill 102. Meanwhile, the Régie des rentes du Québec released its own consultation paper, *Toward Better Funding of Defined Benefit Pension Plans*, containing an ambitious series of more fundamental reforms proposed to be phased in over the next several years.

Finally, the Canadian Association of Pension Supervisory Authorities (CAPSA) issued a discussion paper in June 2005, setting out several proposed principles which would underpin the DB funding rules in the long-anticipated model pension law.

An examination of the federal, Quebec, and CAPSA papers reveals several common threads and, this being Canada, a number of potentially divergent paths for the various jurisdictions' future rules on pension funding. The federal Department of Finance's consultation paper comments on challenges faced by plan sponsors relating to both surpluses and deficits. It asks for views by Sept. 15, 2005 on a number of issues and possible changes in legislative direction.

One surplus-related question it asks arises directly out of the Supreme Court of Canada's decision in the Monsanto case last year. The question is whether federal pension legislation should continue to recognize the concept of partial terminations and, if so, whether there should be a requirement to distribute surplus in the event of a partial termination.

The consultation paper notes that the partial termination concept disappeared from Quebec's pension legislation with that province's move to immediate vesting in 2001, leaving the distinct impression that the same change may be coming at the federal level. It can be strongly argued that immediate vesting ought to be a perfectly acceptable trade-off for the elimination of mandatory surplus distribution prior to full plan wind-up, at least from a sponsor's perspective.

On deficits, the Finance Department has asked for views on the parameters for an across-the-board extension of the maximum solvency deficit funding period from five years to 10 years. It has also asked for views on the possible use of letters of credit to secure a portion of a plan's solvency liabilities, on whether the federal legislation should be aligned with most provincial pension statutes to require full funding on plan termination, and on the advisability of establishing a federal pension benefits guarantee fund like Ontario's.

Given the dramatic and unexpected decline since 2001 in long-term interest rates and the corresponding spike in plans' solvency liabilities, extending the solvency amortization period to 10 years seems like an eminently sensible reform. Unfortunately, the consultation paper somewhat prejudges the outcome of the consultation process by asserting that any extension "must" have conditions attached to "recognize the potential increase in risk." So what the government may give to hard-pressed plan sponsors with one hand, it may take away with the other.

At first blush, the posting of letters of credit (L/Cs) in lieu of cash contributions seems like it would be an attractive alternative for plan sponsors trying to plug solvency gaps without cutting unduly into capital spending. Indeed, L/Cs have recently become something of a flavour of the month as a potential fix to solvency funding concerns.

However, the experience to date with L/Cs in the retirement compensation arrangement (RCA) context suggests that it might be tricky to nail down the events of default which would trigger the calling of the L/C. And it is precisely those events of default which are the key to ensuring the benefit security the L/C would be designed to provide.

It is also not obvious who would be charged with determining that an event of default had in fact occurred in any particular situation. The plan custodian? Most trust companies and insurance companies are extremely reluctant to exercise discretion on much less contentious matters, let alone make decisions of this magnitude. The regulator? In all likelihood, neither sponsor nor regulator would be enthusiastic about that alternative.

In other words, it might be wise to proceed with extreme caution, if at all, with the L/C "quick fix."

Similarly, full funding of any deficit existing as of the date of plan termination is an idea that might seem more attractive at first blush than on closer scrutiny. When the federal government floated a similar idea midway through Air Canada's 2003 restructuring, creditors reacted negatively. Other lenders could have the same reaction to what would constitute a fundamental new threat to the interests of those extending credit to DB plan sponsors. It is not difficult to foresee what those lenders might then do, meaning that this reform might ultimately backfire on the plan members it would ostensibly be designed to assist.

Moreover, in light of recent court decisions like Monsanto, there is something of a "Heads I win, tails you lose" flavour to this suggestion. That is, as the courts award plan members ever more of the DB plan upside in the form of surplus distributions and restrictions on sponsor flexibility in the use of plan assets, legislators should be loathe to give those same members additional protection on the downside.

To put it another way, the nature of the DB "bargain" has been transformed by the courts into one giving members much more than the simple defined benefits which were all most employers ever thought they had promised. So it is only right that the newly-enriched members should be prepared to bear some of the DB risk, too.

The possibility of establishing a federal pension benefits guarantee fund is a dreadful idea. The vast majority of benefits paid out of federally-registered pension plans are funded by a handful of sponsors. The fund would effectively have to be financed by taxpayers. Given the windfall which this generation of DB plan members has already enjoyed, there can be no public policy justification to have taxpayers further backstop one small group's good fortune.

It is interesting that the federal and Quebec papers both begin with an express affirmation of the importance of ensuring "balance" between the interests of DB plan sponsors and members. The CAPSA paper starts from the same premise, although framed somewhat differently.

All three papers, however, move inexorably in the direction of greater protection of members' benefits at the expense of sponsors' interests. This is not surprising, for any number of reasons. Ultimately, however, the continuing absence of true balance does not augur well for the long-term health of DB plans in Canada. **BC**

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What are the consultation papers recommending?

	Federal govt.	Quebec govt.	CAPSA
Surplus	• Seeking views on possible changes to the framework of surplus distribution. • Seeking possible improvements for dispute settlement mechanisms.	• Surplus payments to the employer during a plan's existence are prohibited in Quebec. • A contribution holiday can only be taken if the pension fund has a surplus.	• Surpluses may be used for benefit increases, left in the plan as reserves, used by the sponsor for a contribution holiday, or withdrawn from the plan subject to the relevant model law withdrawal rules.
Solvency/Funding	• Permit letters of credit to be recognized as pension assets in solvency valuations. • Extend solvency-funding period from five to 10 years.	• Solvency valuations should establish provisions for adverse deviations. • An easing of the amortization rules for solvency deficits could help get plans through a difficult period.	• A pension plan that winds up with a deficit would be required to amortize the deficit within five years of the wind up. This provision would not apply in cases of employer bankruptcy.
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