<u>A New Paradigm for the Wind-Up of Registered Pension Plans in Ontario</u>

We have read Ontario's consultation paper on potential revisions to the solvency funding requirements for registered pension plans in Ontario. While we believe some of the ideas presented in the paper would improve the regulation and sustainability of registered pension plans, we are concerned that the proposals do not adequately address some of our concerns with the current regulatory structure. In our view, **the current requirement to settle all benefits determined at wind-up on an immediate liquidation basis is extremely expensive (particularly given today's very low interest rate environment) and is therefore detrimental to most of the stakeholders in the pension industry.** This unilateral imposition of forced and immediate settlement of benefits on wind-up often leads to very poor outcomes for members, plan sponsors, regulators and the Pension Benefits Guarantee Fund '(PBGF'). In our view, current regulations favour appointed administrators and insurers rather than the plan members.

We suggest that the current wind-up regime be replaced by one that allows:

1. The continuation and maintenance of a long-term pension fund to pay benefits to members that are earned to the date of wind-up,
2. The administration of the wound-up pensions by qualified private or public third-party administrators,
3. The investment of pension fund assets by qualified third-parties (such as the Investment Management Corporation of Ontario) in accordance with investment mandates developed specifically for the benefits to be paid, including the commingling of assets of many pension funds by third party administrators to allow for the economies of scale, and
4. The application of the PBGF to the plan wind-up to provide funding for any guaranteed wind-up benefit <u>on an ongoing funding basis</u> at the date of wind-up and at regular prescribed intervals during the longer wind-up period.

In other words, we suggest that wound up pension plans be managed <u>on a going-concern basis</u> so that benefits provided to members are fixed at the date of wind-up but are then paid out over the normal period of benefit payout from a new independently managed pension plan fund. In this way, we avoid the excessive costs associated with current wind-up procedures and the immediate settlement of benefits on a liquidation basis. We also avoid the current imposed "opportunity cost" associated with the imposition of stringent and excessive solvency prefunding that would be reduced substantially for most pension plans.

To be clear, we are not suggesting that a pension plan sponsor not be allowed to wind up a pension plan and settle all benefits immediately at the plan sponsor's sole cost but rather that this requirement not be imposed upon any plan, whether benefits are frozen voluntarily or frozen as a result of the corporate reorganization of the plan sponsor. **Immediate settlement through insured annuities should be a choice, not a regulated minimum.**

The vast majority of pension plan members are well served through payment of benefits from well managed ongoing and long-term pension plan funds. The same could be provided to those members who find themselves "caught up" in a plan wind-up.

Problems Inherent in the Current Wind-Up Regime

The current regulatory framework was established more than thirty years ago when interest rates were considerably higher and annuity premiums were relatively inexpensive. Many, if not most, plans were solvent. At wind-up benefits were required to be settled immediately. Very few deferred pensioners existed in the pension plans at that time and, if there were deferred pensioners, they typically had only recently left the plan. Settling inactive members immediately was a reasonable expectation. Active members and pensioners were and remained easy to find. Settling benefits immediately was reasonable and many members were well served under the current wind-up regime.

Today, pensioners are faced with annuities that are not cheap. Plans often have many deferred pensioners who have lost touch with the plan administrator and are hard, or impossible, to find.

To settle benefits for pensioners an annuity must be purchased. Many pension experts believe or know that purchasing an annuity is very expensive today and should be avoided if possible. There is a very large opportunity cost associated with purchasing an annuity today at these high premiums. We strongly agree with this position but would go further; there is always a very large opportunity cost associated with purchasing an annuity. It is just, that when annuities are cheap, the smaller opportunity cost is ignored. Unfortunately, under the current regime, a pension plan sponsor or an appointed administrator is forced to purchase annuities on plan wind-up and suffer the associated prohibitive opportunity cost.

Annuities always have an opportunity cost for two reasons:

1. Insurance companies price annuities to make profits for their shareholders.
2. Insurance companies use suboptimal investment mandates (i.e. 100% fixed income portfolios) to virtually eliminate, not manage, the risk of investment loss.

As a result, pension plan administrators typically pay an additional amount for pensioners equal to approximately 25 percent of the annuity premium to life insurers over and above the amount needed to provide the pension benefit being insured had the pension benefit been paid out of a conservatively managed fund in today's environment. The additional amounts are even greater for deferred pensioners. This is not in the interest of the plan members.

In fairness to the insurance companies, they are in business to earn profits for their shareholders and the current regulatory framework imposed upon the insurer forces them to adopt suboptimal investment strategies.

The philosophy behind the current annuity regulation is very short term and requires a "mark to market" mentality for the life insurance industry that leads to the suboptimal solution in the market place. The argument used is often, "invest in bonds because bond cash flows best match the underlying pension cash flows being insured".

In addition, active members are given a choice, elect a monthly pension and have it insured or elect a lump sum settlement that will be settled many months later (after regulatory approval) based on current market rates.

In our experience, the vast majority of the active members and certainly younger active members currently elect a lump sum settlement. Typically for two reasons. Their broker or advisor recommends a lump sum settlement and there is an immediate cash payment involved with the lump sum settlement.

As a result, the current regulations encourage settlements that remove assets from the pension system (i.e. cash payments) and the placement of settled funds in high-priced retail investment products. Both result in reduced expected benefits for the affected member during the member's retirement.

In fairness, the required minimum lump sum value paid on settlement to an active member in today's environment is based on the assumption that the member will attain investment returns of about 1.5% for ten years and 2.5% thereafter. Not a high required rate of return based on long-term averages, even after paying high retail investment fees and expenses. Any conservative balanced portfolio should be able to achieve these returns over the long-term.

Deferred pensioners are given the same options as active members, if they can be located. If they are not found, the administrator is forced to buy an annuity to settle the benefit. Such an annuity is extremely expensive, if one can be purchased at all. If an annuity cannot be purchased, there is no viable alternative.

Notwithstanding the low interest environment, the current regulatory framework is inefficient in and of itself. Specifically: settlement rates are liquidation based; expenses are very high; and settlement choices are often impractical.

It is not good public policy for legislators and regulators alike to continue such an inefficient system which causes direct harm to plan members. It is also very problematic when a regulator insists that a plan sponsor fund a pension plan based on a settlement scheme that the regulator knows, or should know, is inefficient.

Finally, the current regime requires the immediate settlement of benefits. This increases the administrative costs for the wind up of the plan substantially, especially if the wind up is caused by the bankruptcy of the plan sponsor.

A third-party administrator must be appointed from a short-list maintained by FSCO. The newly appointed administrator must collect a substantial amount of data with respect to the plan fund and plan members from existing providers. All plan members must be located. This process becomes very time consuming and expensive because the appointed administrator has no direct knowledge or experience with the plan being wound up. The affected members have no experience dealing with the newly appointed administrator.

Elaborate actuarial reports for both wind-up and PBGF purposes must be completed and filed multiple times. Pension benefits must be adjusted if the plan is underfunded. Regulatory approval at each step of the process is cumbersome and time consuming.

In our experience, the wind up ratio of the plan can be reduced substantially because of very large wind up expenses managed and approved (i.e. imposed) by FSCO when third party administrators are appointed. This is especially disconcerting because the additional expense is paid for by the members through reduced benefits and by the PBGF through increased claims.

In summary, the current regime is too expensive as it requires excessive costs to settle benefits and excessive costs to administer the pension plans during wind up. Any change to the current regime that would reduce settlement costs or administrative expenses should be examined.

<u>Proposed New Wind-Up Regime</u>

We recommend that the current wind-up regime be modified to not require immediate settlement of all benefits and to address the many inefficiencies in the current system.

Maintain a Pension Fund for Member Benefits Earned at Wind-Up

Many of the inefficiencies in the current regime are caused by forcing the pension plan benefits to be settled and the assets to be liquidated immediately.

We propose instead to maintain a pension fund on behalf of the affected members that will be invested using a mandate that is appropriate for the members of the terminated plan or, even better, for the commingled assets of many terminated plans.

Since most of the underlying benefits in the terminated pension plans would be pensions-in-pay or deferred pensions that become payable over the short term, we would expect the managers of the terminated plan assets to adopt a balanced target asset mix, for example of approximately 50% in fixed income and 50% in a well-diversified, high-quality, low-cost equity portfolio. The fixed-income portion of the resulting portfolio could include investments in real estate or infrastructure.

An investment mandate similar to the one described above is appropriate for a pension plan that consists primarily of pensions-in-pay. The fixed income part of the balanced portfolio is meant to support benefits to be paid within the short to medium term (i.e. up to ten years). The well-diversified equity portfolio would generate additional returns over the long-term to support long-term benefit requirements. This investment mandate requires slightly less equity exposure than mandates adopted for typical ongoing pension plans because the remaining obligations a somewhat shorter in nature.

There are many available investment managers in both the public and private sectors who could establish and manage such a mandate. Many large public sector plans such as OMERS or the Ontario Teachers Plan could likely take on this mandate. Solutions would also be available in the private sector. The newly established Investment Management Company of Ontario (IMCO) would seem to be very well placed to work with a plan Administrator to fulfil this investment mandate since its existing investment mandates would be very similar, if not identical, to this investment mandate.

This portfolio could be conservatively expected to produce a net annual return of at least 5% per annum over the long-term (a net annual real return of 3.5% for the adjusted investment mandate for full indexation pension plans) which is substantially more than assumed by insurers of annuities.

Pensioners would continue to receive their pensions from an ongoing pension fund – the 'new pension fund'. The amount of pension would be determined based on the funded status of the Plan at the date of wind-up. Wind-up liabilities would be determined using the new wind-up regime methods. Since under the new wind-up regime, the pension fund remains ongoing for the pensioners, the pensioner liability will be determined using that as a settlement basis. In other words, the liability would be determined, for example, using a 5% discount rate (or a 3.5% real discount rate) since that is the expected long-term return for the ongoing fund under the new wind-up regime.

To be clear, a date of determination would need to be declared (similar to the current date of plan wind-up). A determination of all benefits earned to that date and a valuation of those benefits would then be conducted. The results of this valuation would determine the benefits that are owed to each of the members of the pension plan that has been terminated. This would be based both on the funded status of the terminated pension plan and the application of the PBGF at that date.

Once the benefits owed to each member is determined, then the funding to support those benefits would be transferred to the 'new pension fund' to be managed by a third party that has the appropriate expertise and governance such as IMCO over the long-term.

The "fixed" benefits could be managed on a target basis from that point forward if that is agreed or mandated. Making the benefits owed at the date of termination "target benefits" after transfer to the subsequent fund will eliminate many subsequent risk management issues. This approach would allow for improvement to benefits (inflation protection) should future plan experience warrant the increase. The increases could be managed for this plan just like for any other target benefit plan. A large single plan for all "orphaned" benefits could be very effective if managed in this way. A target benefit approach would also make commingling assets for many plans much simpler to administer. **A target benefit approach would eliminate the need for future recourse to the PBGF.**

This "new wind-up liability" may be higher than the current ongoing funding liability under the pension plan for these members but should be substantially less than the current solvency liability for these members. As a result, the "new wind-up funded ratio" should be higher than the current wind-up funded ratio, all else being equal. The pensioner will often receive a pension that is higher than the monthly pension the pensioner would have received under the current wind-up regime. The pension would be the same if the plan was fully funded on wind-up under both the current and new wind-up regimes.

The 5% discount rate assumption could be adjusted in the future for changing market conditions. For example, if fixed income returns are 5% in the future, then the new investment return expectation would be higher (e.g. 6.5% per annum) using typical actuarial methods.

Active members would continue to be given a choice, a pension or a lump sum. If they elect a pension, then it will be paid from the new pension fund. The lump sum would be mandated to be the amount eligible to be transferred to the subsequent pension plan. This would not be the same method as is currently mandated for any other member who terminates from a pension plan since the CIA minimum transfer value is mandated. The replacement of the current CIA minimum transfer value with the amounts described above with a mandated transfer value based on the same assumptions used for determining the pensioner wind-up liability under the new regime should be considered.

If this new wind-up regime is adopted across Canada, then we would favour a mandated minimum lump sum transfer based on the same assumptions used for determining the pensioner wind-up liability under the new regime. Again, the liability would likely be intermediate to the current ongoing funding liability for the plan and the Solvency Liability for the plan under the current regime resulting in higher benefits.

Deferred pensioners will have the same options as active members when they come forward. If they are not found, they will have their pensions managed through the new pension fund.

The liability on wind-up becomes the ongoing liability. We have just changed the methods for managing the benefits after the date of determination.

The PBGF pays any shortfall under the normal rules based on this new determination of the wind-up liability which will result in lower deficits. That is, the PBGF would continue to provide coverage up to a recognized dollar level for eligible members. This should result in significantly lower payments from the PBGF at this time because actual deficits would be lower under this wind-up paradigm. As a result, there would be room to improve coverage under the PBGF, either by increasing the maximum coverage (e.g. $1,000 per month) or by improving coverage for those active members and deferred pensioners who elect the "pension from the fund" option (i.e. an active member is given the choice of a lump sum based on a solvency ratio assuming all active members receive a lump sum or a pension from the fund based on the assumption that all active members remain in the fund).

If the transferred amounts are managed as minimum amounts owing to the affected members, then the PBGF should also apply to future losses that emerge in the subsequent fund. These deficits could be managed in a manner similar to deficits that emerge under an ongoing pension plan (e.g. amortization of deficits over a fifteen year period).

If the benefits are managed on a target basis, the PBGF coverage should end with funding associated with any shortfall determined at the date of determination. In addition, excess investment returns in the fund may provide a pool that could support increased pensions in pay under certain circumstances. Much like ad hoc increases to pensions-in-pay offered by some ongoing pension plans.

The key to risk management in the subsequent plan fund is to commingle assets and liabilities so that large pools can be obtained and costs can be minimized. Benefits from all terminated pension plans would need to be administered on a consistent basis.

Administration of Plan Benefits by Qualified Third-Parties

Administration of the pension plan on wind-up could be conducted in two stages.

In the first stage, the management of the wind-up could be quite similar to the process followed today. The main difference would be that immediate settlement of the benefits would not be strictly necessary thereby eliminating much of the current work.

There would be no need to purchase annuities. There would be no need to do more than a preliminary search for any members who have not been located since the administration of the plan benefits will be maintained for them in a new fund for the foreseeable future. Any member not located will be able to contact the administrator, whose identity will be published, when the member is ready to start a monthly pension.

The Plan will still have to be wound-up. Benefits at the date of wind-up will have to be determined and certified by an actuary. Any adjustments to the accrued benefits would be determined at that time. Any payments from the PBGF will need to be determined and paid into the fund. Any surplus amounts would need to be settled in a separate application.

In the second stage, the benefits payable on wind-up, which would include all adjusted pensions-in-pay and all deferred pensions for those electing a payment from the fund, would be transferred to a qualified third-party for administration during the payout period. The funds associated with these benefits would be transferred at that time.

Most of the work for this third-party administrator would principally involve administering monthly payments for pensions-in-pay much like an insurance company manages the administration of insured pensions. The administrator would adjust payments on death of the pensioner, would adjust pensions for indexation, would file the necessary tax reports/forms and would respond to other pensioner inquiries.

The administrator would start payments when a deferred pensioner decides to begin payments. This would include providing a deferred pensioner optional forms of benefit at that time.

All of these administrative functions are very familiar to current pension plan administrators. There should be many administrators who would be willing and able to provide this service.

Since all of the benefits will be fixed in each wound-up pension plan, there would be an opportunity to manage the benefits for many plans together by the same administrator using the same system. There would be no need to reinvent the wheel by establishing new administration protocols for each wound-up pension plan. The commingling of benefits in this way should result in substantial administrative savings during the expanded payout period.

Investment of Pension Fund Assets by Qualified Third-Parties

Placing the assets of a pension fund after the date of wind up into a stand-alone investment fund would be impractical over a long-term payout period. If the single employer pension plan fund is maintained separately, then the amount of assets under management would necessarily decline over time and the cost of investing the remaining assets would become prohibitive on a relative basis.

We would therefore establish a limited number of funds (or even a single fund) to manage the assets for all pension plans that have been wound up under the new wind-up regime together. Since the pension benefits for the wound up pension plans would be predominately pensions-in-pay, the investment mandate for the various individual pension plans should not vary materially.

As a result, one investment mandate and one qualified third-party manager for all of the wound-up plan assets would be optimal. This would avoid the problem of an investment fund running down over time and would also allow for a larger fund with all the economies of scale that would be inherent in such a solution. There could be a steady flow of new assets as pension plans are wound up under the regime. Even if pension plan wind-ups decrease in the future, the management of the decline of one large fund would be more cost effective than the management of the decline of numerous smaller funds.

More than one fund could be used since more than one third-party manager could be qualified to provide the necessary investment services. It may also be important to operate more than one fund given that some pension plans promise automatic inflation protection while pensions are being paid whereas other pension plans do not. It may be better to have two distinct segregated funds – one with an investment mandate for pensions that are inflation protected and the other with an investment mandate for pensions that are not inflation protected.

The newly established Investment Management Corporation of Ontario would seem to be a logical choice to manage this investment mandate but other providers in the public or private sector could also be considered to provide these services.

The keys to success would be that the selected managers be able to deliver on the investment mandate established for this fund, that they be able to deliver on this mandate without being unduly distracted by competing investment mandates established for their other clients and that they be able to provide this investment service at a very low relative and absolute cost.

Application of the Pension Benefits Guarantee Fund

The application of the PBGF to the plan wind-up would continue as in the past.

The cost of settling benefits for those who remain in the ongoing pension fund should, however, be substantially reduced as described above. This will result in a reduction in PBGF claims at the time of plan wind-up. This should also result in higher member benefits being maintained as a result of the Plan wind up.

To illustrate this, suppose a pension plan was 80% funded under the current wind-up requirements but would be 100% funded under the proposed wind-up regime (not an unreasonable assumption given the cost of settling benefits immediately today). As a result, there would be PBGF costs today but they would be eliminated under the new regime.

Members who have pensions of $1,000 per month or less would be unaffected since their entire pensions are guaranteed under the PBGF. A member entitled to more than $1,000 per month in pension payments, however, would have their pension paid in full under the new regime rather than suffering a 20% reduction in the amount of pension in excess of $1,000 per month. For example, a member entitled to an accrued pension of $2,000 per month would receive $2,000 from the ongoing fund under the new regime rather than $1,800 per month (i.e. $1,000 plus 80% of $1,000) from an insurance company under the current regime.

Future PBGF fees could potentially be based on wind-up liabilities using the new wind-up regime, resulting in lower fees. While protection would remain, the likelihood of a pension plan being underfunded at wind-up would be reduced and the amount of underfunding would be reduced.

The comingled wound-up pension benefits being managed on an ongoing basis could be subject to potential future losses. If a plan becomes sufficiently underfunded, then the PBGF should make supplemental payments to ensure benefits are paid using guidelines that are agreed to in advance. Establishing a relatively conservative ongoing liability (e.g. one based on a 5% per annum discount rate today) should reduce substantially, but not eliminate, the possibility of supplementary payments being required from the PBGF. The payment should be required for the commingled fund as a whole.

Solvency Valuation Requirements

The solvency liability would be defined as the wind-up liability under the new rules. This would result in a solvency basis being adopted that is similar to a relatively conservative “ongoing funding” basis in today’s environment.

For active members who may elect a lump sum settlement, the solvency liability would remain at the minimum CIA transfer value. A member eligible to retire immediately could be valued using a lump sum settlement technique or using a wind-up calculation under the new rules.

All other current solvency rules for Ontario pension plans, including voluntary exclusion of certain benefits, could remain the same but do not have to remain the same under the new rules.

This should result in reduced solvency liabilities, increased transfer ratios and reduced fees.

Some plans may wish to, at their own discretion, adopt the new solvency requirements for the ongoing funding valuation of their plan, recognizing that this method does build in some margins and would result in higher immediate funding in today's environment.

<u>Effect of New Wind-Up Paradigm on Stakeholders</u>

For pensioners, there should be a maintenance or improvement in pensions paid on wind-up as compared to the current wind-up regime. For some pensioners, there may appear to be a reduced guarantee with respect to part of their pension-in-pay. Would a pensioner rather have a reduced but guaranteed (i.e. insured) pension or a pension at current levels that is very likely to be paid in full? We think most would readily elect to receive their current pension benefits in full with the understanding that a future reduction may be necessary.

For active members, they will have choice. They can still elect a lump sum settlement. If they elect a pension, then their position is the same as the pensioners.

For plan sponsors, there is a more stable funding environment. There should also be lower ultimate costs because the additional cost of insuring a benefit has been removed. There will also be lower current minimum contributions required for plan funding.

The funding and management of the PBGF becomes less volatile under this new wind-up framework.

<u>Other Collateral Benefits</u>

The new commingled fund could be opened up to sponsors of ongoing plans as well, not just to pension plans that have been wound up. For a payment of assets into the commingled fund, the administrator of the commingled fund could accept the liability for pensions-in-pay from an ongoing pension plan. That is, the administrator of the ongoing pension plan could accept a transfer under the normal "wind-up" rules for pensions being paid from a fund that is not being wound up in the normal sense. This would be equivalent to "purchasing an annuity" under the current rules. This would be especially helpful to smaller private pension plans who would then be able to routinely "get the liabilities off their books". Of course, an ongoing plan may elect to retain the pensions-in-pay or to purchase an annuity to settle those benefits.

We could also allow members of a defined contribution plan the right to "purchase" lifetime payments from the comingled fund (similar to purchasing an annuity) using the normal wind-up liability calculation rules. In this way, the members would be offered an affordable option that would provide a relatively reliable lifetime pension similar to that enjoyed by members of defined contribution pension plans.

Self- employed members could be offered this option through their personal RRSPs. In this way there is access to better pensions for everyone.

In our view, these changes to the current regulation of pension plans in Ontario would improve pension coverage in Ontario more than the proposed ORPP would have and more than the expanded CPP will.

A new regulatory framework would also be needed to protect the interests of the affected members who become involved this new process and to provide protection to the providers of services to the subsequent long-term pension funds.