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15 January 2019

Subject: Enhancing Retirement Income Security for Canadians: Consultation Document

Dear Mr. Schaan,

We are pleased to provide our response to the above-noted Consultation Document.

Most defined benefit pension plan members enjoy a significant level of retirement income security because they are sheltered from longevity risk, equity risk and interest rate risk; these risks are borne by the pension plan sponsor. However, these plan participants remain exposed to one risk: insolvency of the plan sponsor. Though sponsor insolvency prevalence is limited, those that are impacted can suffer a material reduction in their lifetime income and it is often seniors, who have limited opportunity to generate additional income, that are the most impacted.

We thank the Federal Government for undertaking the consultation, and furthermore support the stated intent to take a balanced, principled and evidence-based approach to the retirement income security issue.

The Consultation Document outlines various Options for Stakeholder Comment. We will focus on the pension specific options as these fall under our area of expertise.

In addition, we suggest an option that is not expressly considered in the Consultation Document: the Pooled Insolvency Fund, which we feel would significantly improve the retirement income outcome in many insolvency cases.

Throughout this letter we use the term “sponsor insolvency” to refer to situations where a plan sponsor is insolvent and sponsors a pension plan with a windup deficit.

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Pension Options

1) Solvency Reserve Accounts (SRA's)

We are fully supportive of SRA's as defined in the Consultation Document and as enacted in pension standards legislation of Alberta, British Columbia and, to a limited extent, Québec. SRA's would help mitigate a systemic funding disincentive that arises from potential surplus ownership disputes and provide some incentive for sponsors to maintain their defined benefit pension plans.

Minimum solvency funding requirements can cause a plan to have a large surplus on a going concern basis. This surplus can become "stranded" and be at least partially unavailable as an economic benefit to the plan sponsor. Apart from the long term inefficient use of company resources, this can have an immediate adverse impact on corporate balance sheets, even those with underfunded plans, due to the impaired asset provisions in Canadian and International financial reporting standards (notably IAS19 and IFRIC14 under the international standards). As a result, plan sponsors have an incentive to fund only the minimum amount required under legislation.

SRA's lessen this funding disincentive. With SRA's as a funding option, some currently profitable plan sponsors could choose to make larger funding contributions than they would otherwise make. To the extent these sponsors later suffer a downturn that leads to insolvency (as may be expected in some cyclical industries), the SRA mechanism will have improved retirement income security. However, SRA's are not likely to improve retirement income security for systemically distressed sponsors that can be expected to fund the minimum amount allowed by legislation regardless of the SRA mechanism.

Even if SRA's did not entice sponsors to make larger contributions, they would still improve retirement income security by removing one of the problems sponsors have with defined benefit plans: risk asymmetry. Defined benefit plan sponsors generally bear all the plan's downside risk in that they are responsible for any deficit funding, but they do not fully benefit from the upside, due to the potential for stranded surplus described above. SRA's reduce the likelihood of surplus being stranded and, as a result, make defined benefit plans more attractive to plan sponsors.

SRA's entail some administrative requirements for plan sponsors. Depending on the legislation, they may require establishing a separate account which in turn results in additional reporting and administration. Questions arise regarding whether investment management and administrative expenses can be paid from

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SRA funds, and under what conditions funds can be transferred out of an SRA to the main plan fund. Clear legislation and regulatory guidance would help to lessen these difficulties¹.

2) Pension Funding Relief Criteria

The Consultation Document suggests that employers seeking special funding relief (i.e. under the Distressed Pension Plan Workout Scheme, or “DPPWS” provisions of the Act and Regulations) could be required to agree to certain specified conditions such as a temporary prohibition of dividend payments.

Conceptually, we agree it would be reasonable for the Minister to have the power to impose additional constraints in the event that a sponsor wishes to deviate from the general funding regulations. Those constraints could include, for example:

- restrictions on dividend payments,
- provision for extra funding if a certain threshold of free cash flow is available
- a carried interest provision
- extra reporting of corporate events that may impact the viability of the plans (such as the notifiable events regime in the U.K.², the reportable events regime in the U.S. or the disclosable event regime that the Ontario government announced before the last Ontario election)

However, we note that the DPPWS rules require that the funding scheme be approved by the plan members via their qualified court appointed representatives. Consideration should be given to where the additional constraints fit into the member negotiation and approval process.

¹ A more efficient solution than SRA's would entail legislative clarification of employer surplus ownership so that sponsors have an incentive to fund more than the minimum required. However, such a solution would be contentious, and SRA's are likely a more practical approach.

² The UK government is currently considering expanding its Notifiable Events regime to include items such as sale of a significant portion of the business (perhaps leaving a legacy business with disproportionate pensioner liabilities), business activities that render the sponsor less viable, issuance of secured debt, restructuring of the board of directors, breach of banking covenant, etc..

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3) Clarify Benefit Entitlement

We believe that plan sponsors and members should have the flexibility to agree to plan designs that can lead to variations in benefits, particularly ancillary benefits, under certain circumstances such as wind-up. The implications of any potentially adverse design changes should be communicated clearly to plan members, and where members are not represented by a union, a consent mechanism could be set out in the regulations.

We also believe that, in the event of sponsor insolvency, some benefits warrant more protection than others. For example, the lifetime pension should perhaps have higher priority to fund assets than ancillary benefits such as indexation and subsidized early retirement benefits. Similar frameworks can be found in the Ontario PBGF coverage rules and in the Multi Jurisdiction Pension Plan Agreement.

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4) Transfers to self-managed accounts

We agree that the forced annuitization of pension obligations on sponsor insolvency leads to permanently reduced benefits. This reduction is a function of transferring money from a vehicle that has some risk (an employer sponsored pension plan that at times is dependent on the solvency of the plan sponsor) to one that has virtually zero risk (an annuity provided by an insurance company, backed by very conservative investments). It is expensive to eliminate all risk. The outcome is particularly frustrating when a pension plan is fully funded on a going concern basis, but is underfunded on a wind-up basis: these plans could be maintained as a going concern and have a high likelihood of paying out 100% of each members' pensions, but if an annuity purchase is forced, the members are certain to receive a reduced benefit. Accordingly, we agree with the Consultation Document's concept that an alternative to annuitization could improve outcomes following insolvency.

However, we have significant concerns regarding self-managed accounts.

Defined benefit pension plans work very well for most plan members because they offer the following characteristics:

- strong regulatory and governance structures to prevent fraud and ill informed decision making
- economies of scale (which results in much lower fees and general efficiency)
- expert investment advice
- access to a wide variety of investments, providing greater diversification and risk/return profiles
- longevity risk pooling (defined benefit plans provide insurance against outliving ones' savings)

Self-managed accounts lack all of the above characteristics and would result in a reduction in overall retirement income security. This is why most pension plans do not offer portability to members on retirement. Accordingly we do not recommend individual vehicles as a solution.

We believe that a new pooled vehicle should be made available for plan members who face pension reductions due to sponsor insolvency. We believe this solution, which we have titled Pooled Insolvency Fund for this letter, would make a material difference to retirement income security. Please see the following Pooled Insolvency Fund section of this letter for further discussion.

Pooled Insolvency Fund

Mercer recommends creation of a regime expanded from that adopted in Québec, or informed by that used for Stelco in Ontario, wherein, on sponsor insolvency, affected members may elect to transfer the value of their pension to a centralized third party administrator that invests the pooled money on a prudent, going concern basis. This approach provides the members with a higher expected pension and all the previously listed benefits of defined benefit plans that would be lost.

The Pooled Insolvency Fund would be invested on a long term, going concern basis, with a less conservative asset mix than insurance companies are currently allowed to use when backing a group annuity. The higher expected return would provide a higher level of expected pension than can be afforded when crystallizing the pension plan's losses with an annuity purchase.

Key Characteristics of the Pooled Insolvency Fund:

- Pension benefits would initially be reduced to a level that has a strong probability of being payable without further reduction, given an appropriate asset mix.
 - The appropriate asset mix and resulting pension benefit level would be determined based on a typical stochastic asset/liability analysis such as those used periodically by most Canadian pension plans and routinely for target benefit plans and for valuing solvency liabilities using a replicating portfolio as currently permitted by OSFI. For example, a plan that is 80% funded on a solvency basis might be 100% funded on the plan's going concern basis. Rather than requiring a 20% reduction in pension provided by an insurance company, the pension might be initially reduced by 15%, with funds invested so that there is an 80% probability that the pension will not need to be reduced by the full 20%. These figures are purely illustrative: actual pension reduction and probabilities would be determined by stochastic analysis.
- Pension benefits would be adjustable to reflect investment performance and mortality experience, with the objective and expectation that members will ultimately receive a higher pension than if they had locked in their underfunded reduced pension with an insurer. However, pensions may have to be reduced in the event of sustained investment losses or mortality experience losses.
- In the event the pool becomes fully funded on a solvency basis (i.e. assets eventually equal the annuity purchase cost), the pensions would be secured via an annuity purchase.
- It would be most effective if all members of a particular plan affected by insolvency elect as a group to move to the Pooled Insolvency Fund. Group transfers enhance the benefits of risk pooling and eliminate anti-selection problems that may adversely impact annuity pricing. However, the ideal of transferring the entire plan's population to the Pooled Insolvency Fund is probably not obtainable, and

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it will probably be necessary to allow individuals to choose between the Pooled Insolvency Fund and other vehicles (i.e. annuity purchase or commuted value transfer for non-retirees).

- The Pooled Insolvency Fund would offer only basic ancillary benefits (actuarially reduced early retirement benefits, no bridge benefits, no indexation or else adjustable indexation conditional on funded status), to reduce administrative complexity and pricing risk, and to increase the core lifetime pension that is payable.

Overview of Québec Model

The following is paraphrased from Retraite Québec's April 2016 Supplemental Pension Plans Newsletter:

The Supplemental Pension Plans Act ("SPPA") provides an option for members to have their pensions administered by Retraite Québec, where the pension is reduced due to the insolvency of the employer, upon the employer's withdrawal or on termination of the plan. Only members whose pension was already being paid on the date of withdrawal or termination can take advantage of this option. Members are not allowed to have the value of their pension transferred to a life income fund: they are only offered the options of purchasing an annuity from an insurer or having their pension administered by Retraite Québec.

The Québec government previously guaranteed pension amounts for a period of time, but no longer provides that guarantee. The amount of a pension initially paid depends on the pension fund's assets. In the event of insufficient assets, the pension amount could be reduced.

Sections 230.0.0.1 through 230.0.0.11 of the SPPA set out the applicable provisions.

The Pooled Insolvency Fund that we propose would differ from the Retraite structure in the following key ways:

- The Pooled Insolvency Fund might take on greater investment risk than the Retraite structure, in order to increase the likelihood of improving the members' pensions; the appropriate amount of risk would be determined by the stochastic analysis described previously.
- The Retraite administers its solution. The Canadian Government need not administer the Pooled Insolvency Fund (though that would be an option).
- The Pooled Insolvency Fund could allow non—retirees to participate as well as retirees.

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Overview of Stelco Model

Stelco pension plans are administered by a third party and assets are invested with a sizeable allocation to growth assets. Should the solvency ratio of the plan drop below 85% of the initial solvency ratio, the Superintendent of the Financial Services Commission of Ontario would wind-up the plan (resulting in a reduction of benefits). Stelco differs from most insolvency cases however, because there is some fixed residual deficit funding being made.

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Non-Pension Options

The Consultation Document presents several non-pension options that are generally outside of our main area of expertise, so we explore them only briefly.

We suggest a guiding principle for the discussion: any changes made to enhance retirement income security should be designed carefully so as not to further discourage plan sponsors from maintaining their defined benefit pension plans.

- 1) Amending insolvency legislation to ensure that unfunded pension liabilities are paid ahead of the claims of secured creditors.

Giving pension deficits a super-priority over secured creditors would seem to be a more compassionate regime than the current structure. However, such a change could have a significant adverse impact on the ability of defined benefit plan sponsors to raise capital at competitive rates; this in turn would penalize defined benefit sponsors and provide another headwind against defined benefit plans. Paradoxically, such a measure may reduce overall retirement income security in Canada.

If priority changes are to be made, it would be less disruptive to take a graduated approach, wherein only a portion of unfunded liabilities, for extremely poorly funded plans are given a higher priority.

We direct your attention to a potential reference: INSOL (the International Association of Restructuring, Insolvency & Bankruptcy Professionals) conducted an informative and comprehensive 2015 survey on Pensions and Insolvency that sets out the pension insolvency environment in 21 countries. How each country prioritizes pensions in insolvency is explicitly addressed in the survey.

- 2) Restrictions on corporate behaviour

The Consultation Document contemplates restricting dividend payments, share redemptions and executive compensation where a company has a large pension deficit. Our guiding principle applies here: any such restrictions would penalize the defined benefit sponsor and may have unintended adverse effects. For example, a restriction on executive compensation would deter a talented leader from taking a position at (or staying with) a company with a large pension deficit; such a company (and its pension plan members) will have better outcomes if they are able to attract talented leadership.

A better approach would be to provide incentives for good corporate behaviour, though how that might be achieved is beyond the scope of this letter.

- 3) Increased corporate reporting and disclosure requirements

We are not in a position to comment on this topic.

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- 4) Enhanced “look-back” period for setting aside dividends, share redemptions and reviewable transactions:

This option is outside of our area of expertise, but we will note that executive bonuses and compensation increases are generally much smaller than the pension deficit in the type of insolvency situations being contemplated. So while retroactive clawbacks of inappropriate compensation may be appropriate in some cases and may act as a deterrent against imprudent corporate behaviour, earmarking such clawbacks for funding pension obligations will not have a material impact on plan funded statuses or retirement income security.

- 5) Enhanced transparency in the CCAA process

This option is outside of our area of expertise, but we do concur that pensioner and non-unionized workforce representation during CCAA proceedings could be improved.

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Final Thoughts

In conclusion, we reiterate that defined benefit arrangements provide better retirement income security than other designs, so long as the plan is either well funded, or is sponsored by a financially strong entity. The objective of providing retirement income security to Canadians can be furthered by measures that encourage sponsors to maintain sustainable defined benefit plans. Target benefit designs were not raised in the Consultation Document, but we continue to endorse the design as a sustainable variation on the traditional defined benefit plan.

We thank the Canadian Government for undertaking this Consultation and for its commitment to a balanced, evidence-based approach. We would be happy to discuss our submission further, should you have any questions.

Sincerely,



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Principal



Luc Girard, FSA, FCIA
Partner

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Appendix: Additional References:

We note the following references that may be useful.

The UK government is undertaking a similar review of retirement income security. They issued a broad-based Protecting Defined Benefit Pension Schemes white paper in March of 2018:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/693655/protecting-defined-benefit-pension-schemes.pdf

They then issued a narrower consultation on regulatory powers which proposes to broaden the notifiable events framework. The Notifiable event material starts on page 8:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/719779/protecting-defined-benefit-pension-schemes.pdf

Mercer responded to the UK consultation in the following document:

<http://content.mercer.com/Wealth%20UK/Protecting%20Defined%20Benefit%20Pension%20Schemes%20-%20a%20Stronger%20Pensions%20Regulator.pdf>

INSOL (the International Association of Restructuring, Insolvency & Bankruptcy Professionals) conducted an informative and comprehensive 2015 survey on Pensions and Insolvency that sets out the pension insolvency environment in 21 countries. Copies can be ordered from INSOL.

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