Enhancing the Supervision of Pension Plans under the Pension Benefits Standards Act, 1985

July 1996

Canada

ENHANCING THE SUPERVISION OF PENSION PLANS UNDER THE PENSION BENEFITS STANDARDS ACT, 1985

Changes to the prudential and supervisory framework for federally-regulated private pension plans

The Honourable Doug Peters
Secretary of State
(International Financial Institutions)

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Office of the Superintendent of Financial Institutions Canada

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1. Introduction

This paper sets out the government's proposals to improve the supervisory regime for pension plans regulated under the *Pension Benefits Standards Act, 1985* (*PBSA*). The proposed changes are designed to keep the supervision of federally-regulated pension plans responsive to the evolving environment in which they operate.

The *PBSA* governs private pension plans established in respect of employees engaged in a work, undertaking or business that is subject to federal jurisdiction, such as banking, inter-provincial transportation or telecommunications. All other private pension plans are governed by the laws of the province or provinces in which their members are employed. The Office of the Superintendent of Financial Institutions (OSFI) administers the *PBSA* and regulates some 1,100 of Canada's 16,000 pension plans, representing approximately 10 per cent of the asset value of all private pension plans in Canada.

Although the federal government is of the view that the *PBSA* framework is fundamentally sound, the supervisory/prudential regime for pensions included in the *PBSA* has not been revised since the Act was proclaimed almost a decade ago. As such, the government believes that it is prudent to review the *PBSA* at this time to ensure that the supervisory regime remains up to date and effective.

The proposed areas for change are designed to address supervisory and prudential issues for private pension plans. The federal government is one among many regulators of private pension plans. Rules in other jurisdictions were reviewed in order to benefit from experience in other jurisdictions and minimize any regulatory differences these proposals may cause. At the same time, further proposals for the harmonization of federal and provincial pension legislation are currently being addressed through separate exercises and the government would be prepared to examine any additional suggestions made in this regard.

2. Principles and Directions of Change

For the purposes of this paper, references to the employer include either a single employer or a group of employers (i.e., multi-employer) making contributions to a pension plan on behalf of a group of employees. References to the administrator reflect the current definition of administrator found in the *PBSA* and include: for a single employer plan, the employer; for a multi-employer plan or a plan established by collective agreement, a board of trustees or other similar body; and for multi-employer plans not established by collective agreement, a pension committee.

There are a number of principles and policy directions underlying the proposals for change:

- The pension regulatory and supervisory framework should contain the incentives and safeguards necessary to reduce the possibility that pension promises are not met.

- Private pension plans are supervised for the benefit of members, retirees and other beneficiaries. However, supervision cannot ensure that pension promises will always be met, nor can it be a substitute for good governance of plans by administrators. In some circumstances, remedial actions may be required and may be initiated voluntarily by the plan administrator or may be required through the supervisory process to reduce the risk of loss to members, retirees and other beneficiaries.

- Regulation and supervision must be cost-effective. The regulatory framework for private pension plans under the *PBSA* should not impose undue costs on existing plans or unduly inhibit the creation of new pension plans.

- Members of private pension plans should receive adequate information from the administrator concerning the financial condition of their plan.

- There must be appropriate accountability and transparency in the supervisory process.

The government's proposals have been developed within this framework.

3. Supervision under the *PBSA* and the OSFI Mandate

Pension plans regulated under the *PBSA* are generally established by trust agreement or insurance contract. To qualify for tax-sheltered status, a pension plan must also be registered under the *Income Tax Act*. Unlike financial institutions, pension plans do not generally draw all of their powers or attributes from their governing legislation. Instead, the terms and conditions not required by legislation are provided in the various legal agreements and other documents that establish the plan.

The *PBSA* establishes 16 standards for registration, which include: funding and investments; vesting, locking-in and portability of benefits; eligibility for membership; death benefits; and rights to information. Under the current legislation, failure to meet one or more standards, or failure to remedy the situation within a prescribed period, can only result in revocation of the plan's registration by the Superintendent. Within this framework, questions can arise concerning OSFI's role and responsibilities in regard to the supervision of pension plans. The government believes that it is important to be more precise about OSFI's mandate in this regard.

There are two focusses for pension plan supervision. One focus is on determining whether plans comply with the pension plan design aspects of pension law, such as vesting and portability, while a second focus is on the financial or solvency-related elements of plan supervision such as funding and investments. The evolving environment in which private pension plans operate suggests that the supervisory process should focus primarily on matters affecting the solvency or financial condition of plans. At the same time, it should be noted that, unlike financial institutions, pension plans are allowed to promise benefits beyond the level of their accumulated assets and this gap can continue for some time. This approach to funding, which is substantially consistent across jurisdictions, assumes that the employer will continue to contribute. This important distinction must be taken into account when considering the role that OSFI can play in respect to the financial supervision of pension plans.

It is recognized that an increased emphasis on solvency and funding matters and the application of additional requirements on plans may result in increased regulatory costs. At the same time, it is proposed that less supervisory emphasis be placed on actions which are more appropriately the responsibility of plan administrators.

The government is proposing to extend OSFI's mandate, contained in the *OSFI Act*, to help clarify its supervisory role in regard to pension plans. This extension would emphasize the core role of OSFI in monitoring the financial condition of pension plans and in taking steps -- or requiring that steps be taken -- to deal with deficiencies.

The Superintendent has specific responsibilities assigned under the *PBSA* which are generally carried out for the benefit of plan members and beneficiaries. At the same time, OSFI's role does not, and cannot, extend to ensuring that pension plan benefit promises will always be met by employers. The proposed amendments to the OSFI mandate would recognize that a reasonable balance must exist between the expectations of plan members and beneficiaries that obligations will be met and the role of the regulator in assessing whether such promises can be met and taking appropriate action, or causing such action to be taken, if they cannot be met. As indicated above, the mandate would acknowledge OSFI's role in monitoring the solvency of the pension plans that it regulates, in promoting policies that are designed to monitor and control risk, and in taking steps -- or requiring that steps be taken -- to deal promptly with problem plans. In some cases, this may mean that a plan has to be terminated or other steps taken to reduce the potential loss to the plan members.

The amendments to the OSFI mandate would also help clarify that it is the plan administrator's responsibility to ensure continuing compliance with the *PBSA* and regulations, to oversee the operation of the plan and to deal with problems that may emerge.

4. Types of Pension Plans Subject to the *PBSA*

Pension plans can be set up to require contributions by the employer and the member or to require that funding be provided solely by the employer. Also, most plans fall into one of two categories -- defined benefit (DB) plans or defined contribution (DC) plans (also known as "money purchase" plans).

DB plans promise a specified pension based on various factors, such as number of years of service and salary at retirement. The employee contribution is often a fixed percentage of salary, up to a maximum. Contributions required from the employer are usually determined by actuarial calculations and may be subject to fluctuation caused by market and experience risk. If, however, the plan is terminated, pursuant to the *PBSA*, the employer is responsible only for those funding payments which are due at the time of termination and is not required to fund any shortfalls on wind-up.

DC plans, on the other hand, simply accumulate and invest pre-defined contributions, using the accumulated value of the assets at retirement to purchase individual annuities for retiring employees. Accordingly, employees bear the market risk and, provided that contributions are remitted in a timely fashion, DC plans are, by definition, always fully funded.

Plans in which the contributions made by the employer are negotiated pursuant to collective bargaining are referred to as negotiated contribution (NC) plans. These plans cover members of one or more bargaining units and, where more than one unit is involved, are often referred to as "multi-employer" plans.

Most NC plans subject to the *PBSA* provide for defined benefits while contributions required of the employers are negotiated with the union. Based on the negotiated level of contributions and actuarial advice, the administrator (usually a board of trustees composed of employer and union representatives) determines the level of benefits to be provided by the plan.

Additional background on the size and attributes of plans supervised under the *PBSA* is included in Annex 1.

5. The Environment in which Private Pension Plans Operate

As indicated earlier, funding regulations of all jurisdictions allow plans to promise benefits beyond the value of their accumulated assets, and to fund the shortfall over several years. Employers may, in most cases, terminate a plan when they wish, with the exception of plans established pursuant to collective agreement or a pension obligation pursuant to an employment contract (for example, an executive pension plan). The *PBSA* does not require an employer to make additional contributions to the lan if there are insufficient assets to pay promised benefits at the plan termination date. Therefore, the security of unfunded pension benefits depends on the financial strength of the employer and the employer's commitment to maintain a pension plan.

Since the coming into force of the *PBSA* in 1987, some federally-regulated plans have had solvency concerns, and a very few plans have been wound up without sufficient assets to pay all the promised benefits. In these situations, the employer, whether a single employer or a group of employers within one industry, was experiencing financial difficulty. Many pension plans made substantial improvements to pension benefits in the 1980s, with the expectation that employers would always be able to fund them. In some cases the contributions required to fund these improvements were not made. Factors such as maturation of the workforce and downsizing have also made pension funding relatively more expensive. (Higher contributions are usually required for employees who are close to retirement age because these employees usually earn comparatively higher salaries than younger employees and, more importantly, there is less time to earn investment income on contributions made on their behalf.) The assumption that employers will always contribute more money to fund pension promises is challenged by the fact that some pension plans have been wound up without sufficient assets to pay all the promised benefits.

Whereas the vast majority of plans supervised under the *PBSA* are fully funded, those that are not must take prudent steps to protect plan benefits. However, additional financial pressures on many pension plans will continue and some plan terminations, voluntary or involuntary, cannot be ruled out. In this environment, the government believes that it would be desirable to make changes to:

- enhance plan governance measures, placing more emphasis on the importance of the duties and responsibilities of plan administrators and allowing employees more access to the administration of their plan;

- require the administrator to provide more information to plan members on the financial condition of the plan;

- provide additional supervisory powers for the Superintendent;

- clarify certain requirements in respect of investment policies and propose alternatives for enhancing funding requirements; and

- make some technical changes to clarify and facilitate the administration of legislative requirements.

These changes are outlined in the following section.

6. Major Elements of the Policy Package

i) Plan Governance

Pension plan governance refers to the system used to organize the roles and responsibilities of all persons in respect of a pension plan. In general, good governance promotes the timely and cost-effective delivery of benefits and, at the same time, promotes the administration of the plan in the best interests of the plan members and beneficiaries. Good pension plan governance requires processes with appropriate control mechanisms that encourage good decision making, proper and timely execution and regular review and assessment. While the government recognizes that good plan governance will not, in and of itself, guarantee good performance, it does contribute to the success of a plan.

Further, good plan governance may reduce ongoing administration expenses, overall funding costs and potential liability for the administrator, employer and associated advisors. Good plan governance demands a clear accountability for every decision made with respect to a pension plan. This accountability leads to better plan administration.

Currently, the *PBSA* contains few corporate governance requirements. The government proposes that the following steps be taken to enhance plan governance:

- That OSFI develop, in consultation with interested parties, a "best practices" guideline for the composition, duties and responsibilities of plan administrators and individual trustees. Plans supervised under the *PBSA* would be expected to adopt these practices over time. Monitoring the adherence to the concepts described would become part of the monitoring and examination process.

- That there be a legislative mechanism to require the administrator to organize a meeting, with plan auditors and actuaries in attendance, on behalf of the membership, if a minimum percentage or number of members wish to meet. The proposed thresholds are the lesser of 5 per cent of the membership or 100 members. The number of meetings would be restricted to a maximum of one each year.

- That -- for multi-employer pension plans established pursuant to collective agreement -- at least half of the board of trustees must be composed of representatives of the members chosen by the members. For multi-employer plans not established pursuant to collective agreement, at least half of the pension committee be composed of representatives of the members chosen by the members. The method for selecting member representatives will be prescribed by regulation and will reflect the current regulations relating to pension committees, which outline appropriate procedures for nomination and posting and disclosure of voting time and location, etc. This proposal reflects the existing situations of many boards of trustees and pension committees and is similar to rules applied by other jurisdictions.

- That the *PBSA* be amended to provide the option for the employer of a single employer plan established pursuant to a collective agreement to be the plan administrator.

- That -- to allow the Superintendent, in appropriate circumstances, to discuss concerns with the administrator -- the Superintendent be empowered to attend meetings of the board of trustees and to call a meeting with the administrator, at the Superintendent's discretion.

Coincident with the above proposed plan governance enhancements, the government is proposing to introduce the legislative framework to allow development of a "simplified pension plan" for pension plans supervised under the *PBSA* below certain size thresholds (for example, 250 members). The low rate of pension plan participation of employees of small businesses suggests that traditional pension plans do not adequately meet the needs and expectations of the small employer. Characteristics of a "simplified pension plan" would be the introduction of a standard pension contract containing both general and specific provisions prepared by OSFI and delegation of administrative responsibilities to a financial institution.

ii) Powers and Duties of the Superintendent

Directions of Compliance

It is proposed that, in line with the federal financial institutions statutes, the *PBSA* be amended to provide the Superintendent with the authority to issue formal directions to plans where, in the opinion of the Superintendent, imprudent or unsafe practices exist. Such legally enforceable directions could be used to require that a pension plan or a person in a position of influence to a pension plan (for example, employer, administrator or individual trustee) *stop* practices considered imprudent, or unsafe, or take action to remedy an unsatisfactory situation. These directions could apply, for example, to situations where a breach of one or more of the *Standards of Registration* exist and, thus, would allow the Superintendent to direct specific actions to be taken with respect to the plan without necessarily taking steps leading towards the revocation of a plan's registration. This flexibility could also be used in other situations, such as matters related to the administration of the plan (for example, inadequate record keeping or failure to provide adequate internal controls).

Also in line with the financial institutions statutes, there would be an appropriate appeal process during which directions would continue to be in effect.

The government proposes that non-compliance with a direction could result in a fine being levied against the person, persons or entity to which the direction was given. Continued non-compliance would result in the revocation of a plan's registration.

Provide for the removal of an administrator and appointment of a replacement administrator when a plan is being wound up

In situations where a plan has been terminated either voluntarily or involuntarily and is in the process of being wound up, the administrator may not always continue to act in the best interests of the members (for example, in some circumstances the administrator may not act expeditiously, or may incur excessive costs). While the *PBSA* allows for the appointment of an agent (which can be, for example, an administrator or professional advisor) for the purposes of distributing pension benefits and credits, it does not specifically provide the authority to require the resignation of the incumbent administrator.

In addition, a situation may occur where it would be appropriate to appoint an alternative administrator if a pension plan is <u>about</u> to be wound up. For example, in a situation where an employer, who also acts as plan administrator, has filed for bankruptcy and the pension plan is to be terminated, the employer or trustee in bankruptcy may not be in a position to focus efforts on the distribution of the pension plan assets.

Thus, the government proposes amending the legislation to clarify that, for plans that have terminated, are in the process of being wound up or are about to be wound up, the Superintendent has the authority to replace the incumbent administrator if the administrator is bankrupt (where the administrator is the employer) or is not acting in the best interests of plan members in regard to the plan wind-up. The costs of doing so would be charged to the plan. There would be an appropriate appeal process, during which time a replacement administrator appointed by the Superintendent would remain in place.

Power of the Superintendent to obtain independent actuarial, accounting or other professional advice at the expense of the plan

At present, the *PBSA* authorizes the Superintendent to appoint persons to undertake examinations or audits of plan documents and of investments. At present, however, the cost of an independent review is borne by all pension plans through the annual assessment of supervisory costs.

The government proposes that the legislation be amended to allow costs associated with work performed at the direction of the Superintendent to be charged directly to the plan.

Guide to Intervention for Federally-regulated Pension Plans

The *PBSA* and related documents and processes include a range of supervisory measures that may be taken by OSFI in respect of the pension plans it supervises. This package contemplates an extension of these measures and also proposes that OSFI develop a *Guide to Intervention for Federally-regulated Pension Plans*. This guide would describe in general terms what supervisory activities or range of activities OSFI may take if and as the financial condition of a pension plan deteriorates. The guide would also promote awareness by administrators, members and retirees of OSFI's involvement in pension plan supervision and enhance the transparency of the supervisory system.

iii) Disclosure to Plan Members

The *PBSA* currently requires that, on an annual basis, a member and a member's spouse receive a statement outlining the member's individual contributions, the benefit to which the member is entitled, the funded ratio of the plan (i.e., the ratio of the assets of the plan to its liabilities on a "going concern" basis) where applicable and other prescribed information. In addition, members have authority under the *PBSA* to see the administrator's copy of certain regulatory information filed with OSFI. However, the *PBSA* does not require the administrator to provide members with any information with respect to whether the plan is fully funded on a "solvency" or "termination" basis.

Pension plan solvency is not comparable to the solvency of a financial institution. As previously noted, the pension regulatory system accepts the premise that a pension plan may promise benefits to members even though those benefits may not always be fully funded. What constitutes "full funding" depends upon whether one uses a "going concern" test or a "termination" test. These two tests yield different results because there are differences in what assets and liabilities are included as well as the values assigned to them. In particular, projections of salaries or probabilities of termination of membership are included in the "going concern" test but are usually not included in the "termination test." Also, where the market value of an asset, such as real estate, is not readily available, an estimate of the value if an immediate sale were to occur ("termination" value) could be different than the value of the property if a sale were to occur over a longer period ("going concern" value).

Although it should be recognized that the solvency ratio (i.e., ratio of assets to liabilities on a "termination" basis) is not a foolproof predictor of a plan's long term viability, it is one measure of the security of plan benefits, as it attempts to capture the proportion of benefits of the plan that could be expected to be paid out if a plan was terminated immediately. The government believes that disclosure of the solvency ratio would be of interest to plan members and should be provided by plan administrators. Along with the disclosure of the actual ratio it is proposed that a definition and interpretation of the ratio also be disclosed. For plans with a solvency ratio of less than 1.0, the disclosure would also include a description of the measures the administrator has implemented to bring the plan into a fully-funded status.

In conjunction with this proposed solvency disclosure, the government believes that plan members should receive annual information which provides an overview of their plan including the investment policies of the plan, financial statements and investment summaries. This requirement would not involve the preparation of substantially different information than is currently being prepared with respect to regulatory filings pursuant to the *PBSA*.

The *PBSA* requires that members be advised of any amendment made to their plan within six months of the amendment becoming effective. The *PBSA* also provides that accrued pension benefits cannot be *reduced* without permission of the Superintendent. The government believes that additional disclosure is warranted with respect to plan amendments which would result in a reduction of pension benefits accruing *subsequent* to the effective date of the amendment, or which may have an adverse effect on the future rights of a member or former member. The government proposes that plan administrators be required to advise members and retirees of such proposed amendments prior to implementation. Prior disclosure of such amendments would permit members to communicate concerns with the amendment to the administrator. This, in turn, could effect a change in the proposed amendment or cause it to be withdrawn. This proposal, when considered together with the requirement that an administrator organize meetings at the request of plan members, is an important element of increasing member involvement in plan governance.

Consultation with the industry will take place to identify realistic time frames for implementation of this additional disclosure. The government is also prepared to consider suggestions from interested parties concerning additional disclosure requirements.

iv) Funding Standards and Investment Policies

Funding Standards

Approximately 90 per cent of employees in pension plans subject to the *PBSA* have been promised defined benefits. A plan-specific formula is used to calculate monthly pension at retirement. The DB plan does not require employees to make decisions regarding what funds must be set aside for a specific retirement income and how it must be invested. Employees believe that as long as the plan continues the employer will contribute what is necessary to pay for the promised benefits. Funding rules require employers to contribute at a rate that provides a reasonable protection for members from losses should the plan be wound up.

The federal funding regulations are fundamentally sound and are similar to those of other jurisdictions. As indicated earlier, all Canadian jurisdictions allow plans to operate with assets that have a lower value than liabilities for promised benefits, and to fund the shortfall in assets over several years. This remains an appropriate approach. However, although the government believes that supervision cannot ensure that pension promises will always be kept, it is important to ensure that funding regulations reduce the potential for loss to members.

Possible improvements to funding regulations are outlined in Annex 2. They include:

- the ability to improve plan benefits being dependent on plan solvency. Plan benefit improvements would be prohibited if, prior to and immediately after granting these benefits, the plan would fail to meet prescribed tests for solvency;

- the use of sensitivity testing as an essential part of good governance of pension plans; and

- technical changes for making solvency valuations more objective, including: a more precise definition of market value; use of consistent economic assumptions for valuing assets and liabilities; elimination of the use of average market value; clarification that wind-up expenses be deducted from assets; and a requirement that benefits subject to consent be included in solvency liabilities.

These proposals will be the subject of consultation with interested parties prior to finalizing the changes to legislation and regulations.

Investment Policies

Another area that is important to the well-being of a pension plan is its investment policy. The *PBSA* provides that an administrator exercise the degree of care that a person of ordinary prudence would exercise in dealing with the property of another person. Federal financial institutions legislation, however, applies a "prudent portfolio" approach that requires a portfolio to contain an appropriate investment mix. In 1993, the pension regulations were amended to embrace this concept; however, the *PBSA* currently requires that *each investment* as well as the portfolio be assessed on a prudential basis. Accordingly, the government proposes that the *PBSA* be amended to include the prudent *portfolio* approach.

The government recognizes that the prudent portfolio approach allows significant latitude in the development of investment policies and significant variation among the investment policies of various pension plans. While this flexibility is a positive attribute, the government believes that it would be useful to provide additional guidance to pension plan administrators concerning the key desirable elements of an investment policy. As such, it is proposed that OSFI develop a "best practices" guideline concerning the development of investment policies by federally-regulated pension plans. The guideline would address factors similar to those found in the *"Prudent Person Approach"* guideline issued by OSFI for federal financial institutions and would outline factors that OSFI would expect the administrator of a pension plan to consider in establishing investment policies (for example, limits for exposures to particular industries and geographic areas and asset/liability matching). The guideline would also recognize that the size of a plan may have an impact on its capacity to engage sophisticated investment advisors. It would be meant to serve as a guide which would be adapted by each pension plan to reflect the attributes of its membership mix. The government also proposes to clearly state in legislation that administrators are required to invest in accordance with the plan's investment policies.

v) Other Proposed Changes

Fines and Penalties

The current $10,000 maximum fine in the *PBSA* does not sufficiently deter non-compliance with the statute, nor is it in keeping with the federal financial institutions statutes.

The government is proposing to bring the level of sanctions of the *PBSA* up to the level provided in the federal financial institutions statutes. Natural persons could be subject to a fine of up to $100,000, or to imprisonment for up to 12 months, or both. In the case of an entity other than a natural person, the maximum fine would be $500,000. Where a person is convicted of an offence related to the failure to submit or make payment to a pension fund, the court may, in addition to any fines imposed, assess the amount not submitted or paid and order the payment to the fund. Penalties for other regulatory offenses (for example, for late filings) will also be implemented.

Authorize the Superintendent to specify exceptions from generally accepted accounting principles and actuarial practice

The *PBSA* requires that actuarial reports be prepared "in accordance with generally accepted actuarial principles." The *PBSA* also provides that actuarial methods or assumptions used must be adequate and appropriate or the Superintendent can direct an actuarial report to be revised. However, this provision is plan-specific. The authority to specify the use of an actuarial assumption or method for all plans is not clearly stated in the *PBSA*. The government proposes that the Superintendent's authority to specify exceptions from the use of generally accepted actuarial practice on a general basis be included in the legislation.

Similarly, while most pension plan financial statements are prepared using principles which closely reflect generally accepted accounting principles, there is no specific requirement in the *PBSA* legislation to do so. It is often assumed by the readers of financial statements that the statements do follow generally accepted accounting principles. A requirement to comply with a consistent set of principles would accommodate comparison between different companies and funds. The government is proposing to require that financial statements be prepared in accordance with generally accepted accounting principles. In addition, in parallel to the treatment of actuarial reporting, the Superintendent would be given authority to specify exceptions on a general basis from the use of generally accepted accounting principles.

It should be noted that the primary intent of these two proposals is not that the Superintendent instruct pension plans to circumvent the principles or practices of professional associations, but rather to allow more specificity to be added to the principles or practices when appropriate, especially in respect of matters of prudential concern.

Impose certain administrative requirements relating to documentation

The *PBSA* does not impose any specific administrative requirements relating to pension plan documentation and, at times, OSFI's attempts to obtain documentation relevant to a plan have been frustrated. Certain documentation is required to assist the Superintendent's analysis of the plan's compliance with the standards of registration and matters relating to its solvency.

To minimize these concerns the government proposes the legislation of minimum administrative requirements relating to documentation.

- Pension plan records, or copies, should be accessible in Canada;

- Pension plan records should be segregated and maintained separate from all other business records of the employer or of the union; and

- Plan member information should be kept for the life of the member, and beneficiary information should be kept for the life of the beneficiary. (This is especially important where, for example, an error has occurred over a long period and which may require a fund distribution to prior members, or where a pension plan is terminated and a surplus is distributed to past members or beneficiaries.)

Pension Surplus

Another area where the government may consider legislative revisions (and invites comments from interested parties) is in respect to the scope for employers of defined benefit plans with substantial financial surplus (i.e., above a prudent estimate of what is needed to meet promised levels of benefits) to withdraw a portion of that surplus. Although the current *PBSA* framework permits surplus withdrawals with the consent of the Superintendent and subject to conditions set out in the regulations, the scope to give such consent is subject to plan text and other plan documents, including trust agreements, clearly permitting surplus withdrawals. In some cases it is not clear whether all such documents, taken together, provide such entitlements. While surplus withdrawals should remain subject to agreements entered into by the employer and employees, there may be scope to revise the *PBSA* framework to provide more certainty concerning entitlement to surplus in certain circumstances. Any explicit legislative provision could involve conditions such as agreement by a substantial majority of employees and a requirement that part of the available surplus be used to improve benefit levels.

vi) Amendments which Clarify Existing Legislation

As the *PBSA* was written more than a decade ago, the government acknowledges that additional technical changes are required to clarify and expand upon the interpretation of existing legislation. These are proposed as follows:

- The existing Ministerial authority to enter into agreements with other provincial authorities regarding the administration of pension legislation will be enhanced to allow OSFI to participate in the proposed multilateral agreement being developed through the *Canadian Association of Pension Supervisory Authorities* (CAPSA). This agreement, if implemented, would allow a lead regulator (i.e., the regulator of the jurisdiction in which most members either reside or, in the case of the federal government, are engaged in a federal undertaking) to supervise a plan on behalf of other jurisdictions, using the legislative requirements of the lead regulator.

- Regulations respecting the distribution of assets of a pension plan on wind-up will be developed.

- The *PBSA* provides that any interested person may apply to a court to have an administrator or member of the board of trustees removed for conflict of interest reasons. The *PBSA* will be amended to specifically identify the Superintendent as "an interested person." This amendment would also provide the Superintendent with specific standing to seek injunctive relief.

- To clarify that the Superintendent's duty with respect to examinations of pension plans does not include an "audit" requirement.

- To grant more extensive examination powers to the Superintendent.

- The *PBSA* will be amended to clarify that an administrator is required to produce copies of plan documents and records related to the plan as requested by the Superintendent.

- To require that the holder of the assets of a pension fund notify OSFI if the employer is not remitting required contributions to the plan.

- To ensure that the *PBSA* reflects that, for defined contribution plans, a survivor, in the event of the death of the plan member prior to pensionable age but after becoming eligible for early retirement, is entitled to 100 per cent of the contributions made by and on behalf of a member.

- To allow for assignment of the spousal pre-retirement death benefit to a dependent as defined pursuant to the *Income Tax Act*.

- The "cash out" rule will be prescribed by regulation, and set initially at 4 per cent. The *PBSA* provides that a member on ceasing membership in a plan (or a spouse of a deceased member) may withdraw the pension benefit credit in a one time lump sum payment (referred to as a "cash out") if the annual pension that would be provided by this credit is less than 2 per cent of the year's maximum pensionable earnings as defined by the Canada Pension Plan. Strict application of this provision would currently require the annual pension to be less than $1,000 per year. As such, compliance with the *PBSA* is difficult, because annuities which pay less than $1,000 per year are not readily available.

7. Consultation Process and Next Steps

The government invites interested parties to provide written comments on the range of proposals identified in this paper. Comments should be directed to the Policy Initiatives Division, Office of the Superintendent of Financial Institutions Canada, 255 Albert Street, Ottawa, K1A 0H2, by September 27, 1996.

Annex 1. Data on *PBSA* Plans

Location of Plans

At March 31, 1995, OSFI supervised 1,112 pension plans representing some 10 per cent of pension plan assets in Canada. The following table illustrates the geographic distribution of plan administrators and membership subject to the *PBSA* and supervised by OSFI at that time.

	# of plans	**# of members**
Alberta	91	19,381
British Columbia	187	56,603
Manitoba	144	10,998
New Brunswick	28	7,893
Newfoundland	14	3,460
Nova Scotia	36	11,986
Ontario	310	179,071
Quebec	150	204,715
Saskatchewan	86	7,957
Other	66	4,952
Total	**1,112**	**507,016**

Note: In this table, "other" refers to the Yukon and Northwest Territories, Prince Edward Island and outside Canada.

Source: OSFI records

Distribution of plans and membership by plan type

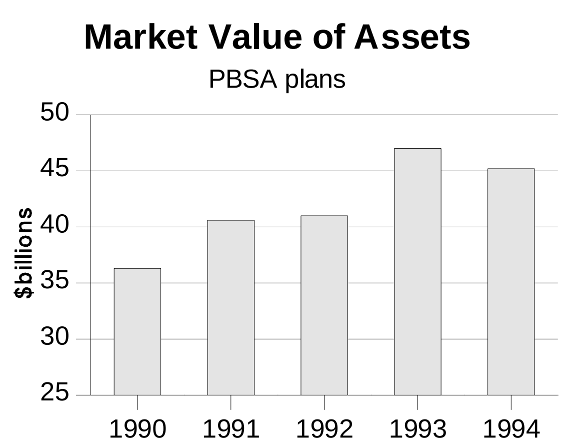
While most plans (58 per cent) supervised by OSFI are of the defined contribution (money purchase) type, participants in defined benefit plans account for almost 90 per cent of the total membership of the 1,112 *PBSA* plans at March 31, 1995.

Distribution of Plans and Membership by Plan Type

	# of plans	%	# of members	%
Defined Benefit				
Average best earnings	214		293,205	
Final average earnings	108		77,167	
Career average earnings	94		27,073	
Flat benefit	26		17,949	
Negotiated contribution	30		38,763	
	472	**42**	**454,157**	**90**
Defined Contribution (Money Purchase)	**640**	**58**	**52,859**	**10**
TOTAL	**1,112**		**507,016**	

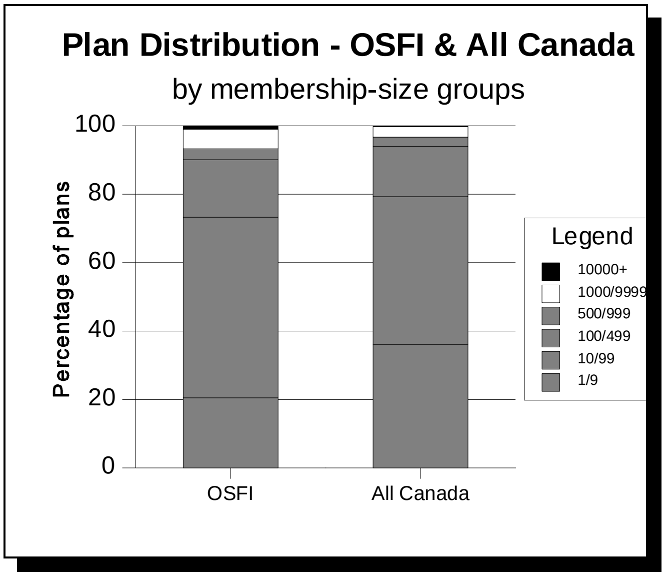
Market value of assets over the years

The market value of the assets of pension plans supervised by OSFI as at December 31, 1994 was estimated at $45.2 billion. While this was down about 4 per cent from the previous year, the assets of these plans have grown by more than 25 per cent over the past five years.



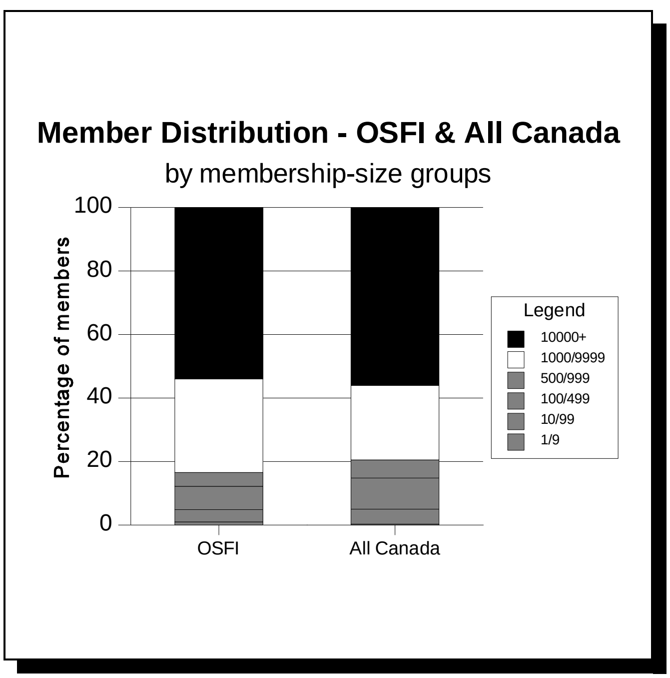
Source: OSFI records

Membership of Plans



More plans are in the 10 to 99 member range than any other range, both for plans supervised by OSFI (53%) and for all Canada (43%).

Fewer than 1 per cent of plans supervised by OSFI have more than 10,000 members; for all Canada the corresponding proportion is 0.3 per cent.



The majority of plan members are in plans with more than 10,000 members, both in OSFI supervised plans (55 per cent) and in all Canada (56 per cent).

Source: Statistics Canada, as at December 31, 1993.

Distribution of OSFI Supervised Plans by Selected Groupings of Plans

Distribution of OSFI Supervised Plans by Selected Groupings of Plans

(as at October 31, 1995)

	Plans		Members		
Groupings	**Number**	**%**	**Number**	**%**	**% (cum.)**
Plans with 10,000+ members	10	0.9	259,500	51.8	51.8
Other plans with 1,001 to 9,999 members	60	5.4	159,750	31.9	83.7
Other plans with 51 to 1,000 members	283	25.6	61,450	12.2	95.9
Indian Band plans	360	32.7	16,750	3.3	99.2
Other plans with 2 to 50 members	344	31.2	4,204	0.8	100.0
. . . . Other plans with 1 member	46	4.2	46	(0 .1)	100.0
Total	1,103	100.0	501,700	100.0	100.0

Source: OSFI records

Over 51 per cent of the membership of pension plans that are supervised by OSFI are in less than 1 per cent of the some 1,100 plans at October 31, 1995.

Annex 2. Funding Options

The following range of measures for strengthening the funding rules are being considered.

A. Rights to improve benefits dependent on solvency

Many plans that have encountered financial difficulties have granted benefit improvements before funding them. The regulations allow several years to fund the liabilities that arise from benefit improvements; however, the employer may not always make the required contributions. In some cases employers went bankrupt. In other cases, the contributions to a negotiated contribution plan were reduced as an industry declined.

It is proposed that the *PBSA* funding regulations be changed to prohibit improvements to benefits or the granting of new benefits for past service if, prior to and immediately after the granting of these benefits, the plan would fail to meet prescribed tests for solvency. It is proposed that plans would be required to demonstrate a prescribed minimum solvency ratio after the benefits are granted. For example, this minimum ratio could increase gradually and steadily to 105 per cent in the year 2012, from an initial value that is the greater of 80 per cent or the last solvency ratio for the plan reported to the Superintendent before 1996. Special arrangements could be made to avoid disrupting contracts negotiated by collective bargaining before the change to the *PBSA*, and the Superintendent may consider special rules for newly established plans.

B. Establishment of accepted actuarial practice for pension plans -- especially in the choice of economic assumptions

To strengthen the funding of pension plans, it is proposed that the Superintendent use the proposed new authority, described earlier, to specify exceptions to accepted actuarial practice for pension plans. Among other purposes, this authority could be used to narrow the range of assumptions and methods, such as the interest rates used to discount the value of obligations.

C. Sensitivity testing

Good governance of pension plans requires administrators to look at the sensitivity of the balance sheet and contributions to a range of economic, demographic and business possibilities. The Superintendent expects administrators to conduct sensitivity or scenario testing to foresee and manage important risks facing their plans. To encourage this aspect of governance, OSFI could issue a best practices guideline on sensitivity testing. From time to time, the Superintendent could require the administrators of plans that appear particularly vulnerable to economic or demographic risks to file the results of tests. Elaborate testing would not be necessary for plans with very strong balance sheets. Moreover, the sophistication of the studies should bear a reasonable relation to the size of the plan. If this approach is adopted, OSFI would endeavour to work with the *Canadian Institute of Actuaries* (CIA) in developing guidance for its members.

D. Technical changes for solvency valuations and the calculation of the solvency ratio

To make solvency valuations more objective (and the results of these valuations more useful) some technical changes are being considered:

i. A more precise definition of the term "market value," requiring an estimate of what would be realized from the disposition of illiquid assets within one year.

ii. A requirement that solvency liabilities be calculated using the methods and assumptions prescribed by the *"Recommendations for the Computation of Transfer Values from Registered Pension Plans"* issued by the CIA, effective September 1, 1993, with an important exception. To allow a rapid payment of transfer values, the recommendations require actuaries to use economic assumptions that are based on bond indices issued by the Bank of Canada as at the end of the second month preceding the termination of a member's participation. The mismatch of economic assumptions for liability and asset values at market as at the valuation date has tended to increase the volatility of solvency balance sheets and to reduce the usefulness of the solvency ratio as a measure of a plan's ability to pay accrued benefits. Therefore it is proposed that interest rates and price indices be based on bond indices issued by the Bank of Canada as at the end of the month of the valuation date.

iii. The elimination of the option to use average market value in the solvency balance sheet. Current regulations allow the actuary a choice between assets at market value and an average of market values over a maximum of five years. Liabilities are calculated using current market rates. It is proposed that assets be valued consistently.

iv. Clarification that expenses of winding up must be deducted from the value of assets on the solvency balance sheet and from the calculation of the solvency ratio.

v. A requirement that benefits subject to consent be included in solvency liabilities, unless the plan text explicitly states that they are not payable at termination and the administrator has demonstrated that consent has been denied. These benefits may be an enormous liability which is not currently contemplated in solvency funding. Pension plans would be permitted to revise plan texts to state that benefits subject to consent are not payable at termination.