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TOWERS PERRIN
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RENOVATE TO REJUVENATE: CANADIANS NEED A 21ST CENTURY PENSION PLAN

The sustainability of our three-legged retirement system in Canada is at stake. Much research has been published raising the alarm on whether or not Canadians living today and in the future will be able to afford any kind of retirement. In this paper, we propose a framework for the 21st century pension system.

WHITE PAPER

The sustainability of our three-legged retirement system in Canada is at stake. Defined benefit pension plans are making front-page news as they come under increasing pressure and scrutiny. Active and retired members are concerned about the security of their benefits — their fears exacerbated by virtually incomprehensible valuation and accounting systems. Sponsors are concerned about mounting costs. Regulators are concerned about enormous pension deficits at several major companies now on the brink of bankruptcy.

Much research has been published — by many different constituents from non-profit groups to banks, insurers, consultants and others — raising the alarm on whether or not Canadians living today and in the future will be able to afford any kind of retirement.

In the background, there is the ongoing doubt as to whether the DB model is really suitable for an era when neither employees nor employers are strongly committed to a career relationship. And, forward thinkers are warning that DB plans, as currently designed, offer no help in meeting Canada's expected labour shortage, and just might make that shortage worse.

Various underlying issues have prevented DB plans from evolving to keep pace with changes in our society. These barriers can, and should, be overcome. Canadians need pension plans that are secure, affordable, understandable, fair and flexible enough to accommodate a population that is living longer, healthier and more productive lives than ever imagined. The 20th century DB plan needs updating to meet the 21st century needs of employees, employers and society as a whole.

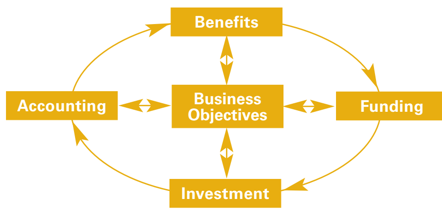
Fortunately, we are now in a climate in which change is possible. Unfortunately, there has been too much emphasis on highly technical remedial measures aimed specifically at current concerns about deficits. Towers Perrin feels the discussion should be significantly broadened. A group of senior Towers Perrin pension consultants from across Canada was asked to develop parameters for more wide-ranging consideration of what should be done to optimize the effectiveness of single-sponsor private sector defined benefit plans. This paper presents the issues and potential solutions they identified. We did not seek to create a model pension system for adoption on a turnkey basis, but rather a framework for all concerned to discuss and build upon. While we have not explicitly addressed the comparable issues with respect to public sector and multi-employer plans, we believe that much of this framework could be adapted to help improve the systems within which they operate.

We begin by lamenting Canada's cumbersome regulatory system — and cite a way to streamline it with due regard for the constitutional division of federal and provincial powers. We then address each of the four interrelated policies that govern the design and operation of a DB plan: benefits, funding, investment and accounting.

THE REGULATORY SYSTEM

There is a patchwork, piecemeal character to the way in which Ottawa and the provinces set minimum pension benefit standards and oversee the operation of plans. Eleven legislative bodies have authority, each with a different timetable and set of priorities. This increases the cost and administrative burden of providing pensions. It has also created a formidable barrier to change. In some cases, it has even compromised operational effectiveness for employers by impeding their ability to easily move employees between jurisdictions.

Officials from across Canada and securities industry representatives have now spent several years working on a way to place the country's capital markets under one regulator, virtual if not physical. They are blazing a trail that Canada's pension overseers should follow, leading to the creation of a clear, explicit and common set of rules enforced by one body with limited need to revert to the courts for interpretation. Further, this national body should hold scheduled reviews of the principles that underlie the pension system. These reviews, occurring every five to ten years, would be aimed at keeping plans and the related legislation in tune with the times and would limit the need for the ad hoc incremental changes that now make pension administration nightmarish. Achieving this would clearly require various jurisdictions to compromise in a number of deeply held philosophical positions that have emerged during the past 15 years.



BENEFITS POLICY

The defined benefit pension plan was born in an era when members could reasonably be expected to spend a full career with one employer, retire at 65 and then collect a pension for a relatively short period. This era is no more. Let's consider the three aspects of the traditional DB scenario — mobility, retirement age, and a relatively short payout period:

- Mobility: While many individuals may still accrue long service and then retire on the pensions they were promised all along, many others will not. These people may quit, be laid-off or lose their jobs if the company fails. The value of DB pension credits is deferred compensation; each employee foregoes cash compensation today in exchange for pension benefits payable in the future. This is rooted in design provisions that were forged long ago when career employment was the norm and pension benefits were viewed as a way to retain staff or reward long service. These provisions mean, however, that the value of such benefits from a typical plan may drop significantly if employment is terminated prior to retirement eligibility. So, the dollar of cash compensation foregone by the employee who turns out to be a long-timer will invariably buy more pension than the dollar foregone by one who leaves earlier — willingly or unwillingly. Also, the dollar of cash compensation foregone by the employee who works his or her last 10 years at the company and qualifies for early retirement will buy far more pension than that of employees who work their first 10 years at the company and then leave. This creates an asymmetric risk-reward tradeoff.

At present, the termination benefit for a pre-retirement departure does not commonly include the value of the early retirement subsidy often built into DB plans. Nor does it factor in the projected wage growth that will substantially benefit the long-timers when average earnings for their final or best years are applied to every year of service. The 21st century pension plan needs fair, effective vesting so that pension accrued for a given year retains its value even on pre-retirement termination. If we assume that compensation is an appropriate measure of an employee's economic value to the organization, this change would properly reflect the contributions made by those who leave before retirement. Some might suggest that long-service employees should be entitled to extra pension value as a reward for loyalty, but this tontine ignores the fact that many departures are due to forces outside the employee's control. In addition, by fully recognizing the value of the service that mobile employees accrue, this change would make DB plans fair to those who do not desire a career-long relationship.

We recognize that this approach to vesting of pension benefits will significantly change the value delivery spectrum and force plan sponsors either to reallocate economic value between groups of employees or accept a higher level of cost. Reallocating economic value would shift benefit from those who retire from the organization toward those who leave prior to retirement. But this shift would not be as pronounced as moving to the typical defined contribution plan. In today's environment, we suspect that few employers would be prepared to accept a higher level of ultimate cost for their plans. Implementing some of the other recommendations in this paper could alleviate this concern. At the end of the day, we believe this change would be an equitable trade in the overall rebalancing of the risk/reward relationship that must ultimately occur if we are to solve some of the other fundamental asymmetries that exist — particularly, the ownership of surplus and deficit.

- Retirement Age — Normal Retirement: The typical DB plan currently has a normal retirement age of 65, but the reality is that most employees retire well before then. Heavily subsidized early retirement benefits entrenched in many pension plans strongly encourage employees to retire long before their productive potential career has been realized.

We must recognize that Canada faces a labour and skills shortage as the baby boom generation moves into the prime retirement years. Older employees — especially

those doing mental as opposed to physical work — might be able to cover much of that gap by extending their careers. Indeed, recent court challenges of the mandatory retirement provisions of pension plans and employment standards legislation suggest that many individuals are now thinking of extending their participation in the work force. But the 20th century pension plan and the tax regulations that govern it discourage this. Early retirement benefits in many plans are so generous that the employee who opts to keep working does not earn enough marginal after-tax pay to make the effort worthwhile; in many cases, it is akin to working for free. This requires employers to offer other incentives to retain employees with key skills.

The system must be made more neutral across the full spectrum of possible retirement ages. Postponed and phased-in retirement provisions merit more attention — from those responsible for government pension plans as well as those overseeing and running employer-sponsored plans. Employees who remain on the job should be able to customize their work/retirement program to maintain total net consumable income. It should be reasonable for employees to reduce the hours they work, but still maintain their overall income levels through a mixture of pay and pension income. Employees should continue to accrue pension to the extent they are working regardless of age — even beyond age 69 — and regardless of whether they are using a portion of their pension income to top-up their total earnings. Similarly, individuals who are still actively working should not be forced to begin receiving payments from their RRSP until they truly cease employment. This too would better reflect the fact that the value of pension accruals are a form of deferred compensation; those who continue to work continue to receive full compensation.

Retirement Age — Early Retirement: The early retirement provisions in most pension plans were introduced during the 1960s, ’70s or early ’80s. In some cases, provisions such as the “30 and out” pension eligibility threshold were intended to recognize the reasonable working lifetime that existed for individuals in physically demanding industries such as mining or automotive assembly plants. In other cases, these provisions were introduced to allow employers to better manage their workforce needs at a time when pension programs were used to help with labour cost management. Although some jobs continue to be sufficiently demanding that productive careers are finite, these early retirement provisions have become less essential due to huge ergonomic improvements in working conditions and the inclusion in most labour contracts of seniority provisions that often permit long-service employees to work in less physically demanding jobs. Recent experience in many of these industries has shown that employees are electing to work long past the earliest unreduced retirement age.

The overall system should allow flexibility for both the employer and the employee to deal with their needs. Employers must be better able to adjust pension plan early retirement provisions to reflect the changes in employment needs. Employees should be able to plan their careers around their own lifestyle options, reflecting their retirement age choices and health issues. Similarly, employers should be able to reasonably retain employees who possess essential skills and gracefully retire those who are no longer willing or able to meet the demands of their jobs.

This calls for two fundamental changes. The first change would be the removal of the heavy early retirement subsidies now entrenched in pension plans, except in cases when the physical demands of the work still significantly limit an employee’s productive career. The second change would be the inclusion of a voluntary contribution arrangement that permits an employee to purchase the option to retire early. In addition, the removal of the current barriers to offering voluntary and involuntary early retirement windows is a key element of this process as it would make it possible for employers to provide employees with cost- and tax-effective severance packages. Changes of this sort would also help alleviate the cost/value trade-off issue raised in the earlier discussion on mobility.

- Longevity: Life expectancy for today’s 65-year-old man is 17% longer than it was when his father turned 65 in the early 1970s, according to Statistics Canada’s most recent data. And, this man has a 14%

chance of celebrating his 90th birthday. Life expectancy for a 65-year-old woman is up 14% from the early ’70s, and she has a 29% chance of reaching 90. Further mortality gains are expected. The combination of early retirement and increased longevity means many baby boomers can reasonably expect to be retirees for as long as they were full-time workers, if not longer. The architects of the 20th century pension plan did not contemplate this scenario. The 21st century pension plan must provide for it, both through secure funding and provisions that remove the disincentive for employees to extend their careers.

Other problems arise from attempting to enshrine severance provisions in pension plans — such as statutory grow-in requirements in Ontario and Nova Scotia and special plant closure benefits in certain union-negotiated plans. Movement toward fair, effective vesting will remove the need for statutory grow-in requirements. Plant closure benefits should no longer be included in pension plans. Rather, these should be provided as severance benefits with increased ability for plan members to shelter any form of severance benefit through the pension plan.

Communications may not explicitly be part of benefits policy, but are integral to its success. Employers have spent large amounts of money to provide pension benefits, but communication programs have been sadly deficient. As a result, many — maybe most — employees do not understand what they have, how the deal is intended to work and the degree to which their benefits are or are not subject to risk. It is vital that the system be made as transparent as possible to ensure that Canadians clearly understand the deal and have confidence in it. Sponsors of 21st century pension plans should clarify the true elements of the deal, such as:

- The plan's true accrual pattern if the termination benefit differs from the retirement benefit
- The funding policy — both the target level of assets and the contribution strategy to get there
- Who owns the surplus and in what ways it may be used
- Who is responsible for a deficit, and to what extent do members share this risk by facing higher employee contributions, lower future benefits or other measures.

FUNDING POLICY

Plan sponsors, many of whom had become accustomed to pension plans having little immediate cost, now face cash calls to cover deficits. This change has caused many to re-evaluate the entire role that pensions play in their compensation program.

The current run of pension deficits is routinely attributed to the bear stock market and declining long-term interest rates. Relatively small swings in interest rates can create a large swing in employer contributions due to the heavy weight of retiree obligations in the total plan and the mismatch between the nature of the liabilities and the behaviour of the asset portfolio. While the unusual confluence of falling stocks and falling interest rates was the direct cause of today's deficits, two underlying factors set the stage — and, unless addressed, will likely make deficits more common in the future. Those factors are the ongoing issue of surplus ownership and the development over the past 15 years of very strict minimum funding rules.

The defined benefit pension plan was conceived as a contractual relationship. The employer promised a definable pension, assumed responsibility for ensuring that this promise was adequately secured through its funding program, and had full access to surplus that developed if the pension fund did better than expected. But the 1980s and ’90s brought substantive change as judges and regulators re-characterized the deal as a trust relationship. In most cases, employers remain fully responsible for covering any deficit, but often must share surplus with plan members. Rules that have evolved around recovering surplus are now extremely difficult for all concerned. (In some cases, employees may indirectly share the pension deficit risk as their companies squeeze operational budgets to fund increased pension contributions and

consider plan redesign to remove some of the corporate deficit risk in the future. Of course, employers doing this run the risk of hurting morale and labour market competitiveness.)

Just as employees can face an asymmetric risk-reward tradeoff in the calculation of termination benefits, full ownership of a deficit but only partial ownership of a surplus creates an asymmetric risk-reward tradeoff for employers. *Both need fixing.*

During the 1970s — the last time when pension plans suffered this type of massive funding impact — many employers responded by significantly increasing the level of their funding. This money ultimately contributed to the surplus that emerged with the stock market recovery and decreasing interest rates beginning in 1982. Since then, efforts to make pension plans more secure have ironically made them less stable, with lower levels of funding and higher levels of investment risk than might otherwise have occurred. That's because the erosion of employer access to surplus discourages sponsors from contributing any more than they absolutely have to.

As corporations have adopted minimum funding policies, regulators have generally reacted by enforcing even stricter minimum funding rules. This spiral has led sponsors to search for ways to reduce those requirements. Increasingly, funding policy is concentrating on avoiding having to make contributions — both by directing increasing proportions of a plan's investment portfolio to mismatched categories that have historically provided higher long-term returns and by deferring cost through pre-recognizing the expected higher returns from equity investments in the discount rate used to determine the plan's liability.

The 21st century pension plan should be returned to its roots as a contractual relationship, with the pension fund operating like a sinking fund. For plans that provide effective vesting of the termination benefit, surplus control should be enshrined with the sponsor, with these provisos:

- The sponsor may use surplus for contribution holidays. This could be conditional on the maintenance of a minimum cushion to protect against adverse events. The explicit right to contribution holidays would make it easier — if not advisable — for companies to bolster their pension plan coffers during strong parts of their business cycle, when they can readily afford to do so. Contributions above minimum requirements would be considered advance payments and covered by explicit rules on their separation and use.
- Surplus reverts to the sponsor on full plan termination. Reversion may occur before then only if there is a very large surplus — to be defined — or if members consent. Requirements for member communication and consent would be clearly detailed. This provision would allow, for example, the use of funds that are truly excess to provide windfalls for both employer and plan members — cash for the sponsor and improved benefits for the members.
- Transitional provisions would permit the continuation of back-loaded plan designs (such as those with significant early retirement subsidies that are not included in the termination benefit), but with greater restrictions on surplus usage. Contribution holidays would be allowed, subject to any minimum margin requirement. There would be no ability to pay out surplus prior to full plan termination, but there would be the ability to amend the plan's <u>benefit</u> provisions under all circumstances, including partial plan wind-up. Such amendments could increase the benefits earned in the past or increase (or reduce) the benefits to be earned in the future. Surplus distribution on full plan termination would be based on a settlement between the employer and plan members or their union.

It is crucial that plan sponsors be encouraged to make decisions regarding pension contributions in an appropriate economic framework, based on efficient use of capital for the best interests of the company's shareholders. Sponsors need certainty on surplus/deficit issues at the time a contribution is being considered — not just once a surplus or deficit has emerged. With that in mind, the 21st century

pension plan would require a sea change in the philosophy behind minimum funding requirements. As the name implies, these requirements should reflect minimum standards, not target objectives. Standards predicated on the sponsor becoming bankrupt tend to result in over-funded plans. Although the protection of the employee's promised benefit is crucially important in the event of bankruptcy, it is clearly an inefficient use of capital for the majority of organizations where the probability of bankruptcy is relatively small.

The minimum funding standard should reflect the level of assets that provides most of the promised benefit all of the time, and all of the promised benefit most of the time. For example, contributions over the next five years might be set so that, with current plan assets, there is a high probability (to be defined) that the plan will be 100% funded for the termination benefit. This approach has two conceptual strengths:

- It deals directly with any asset-liability mismatch, addressing concerns raised by financial economists. At a given current funding level, a plan with a larger equity allocation would typically require higher contributions due to the greater uncertainty about future funding levels.
- It sets the funding target in a comparable fashion for all jurisdictions.

There is, however, a practical weakness in this proposed minimum funding standard: the degree of subjectivity that may be introduced when modeling assets and liabilities. This raises many of the issues now being debated with respect to the accounting return on assets assumption. The Canadian Institute of Actuaries would have to address this. It is an area in which Towers Perrin and other consulting firms could collaborate.

The probability-based funding standard we propose is potentially lower than that in current legislation. But it would not necessarily increase benefit risk in the event of bankruptcy. Less onerous minimum targets and more certain surplus ownership would enable sponsors to better fit their contribution patterns to the company's business pattern. DB plans would no doubt be in better funding positions today had their sponsors been able to contribute more during stronger parts of the business cycle. With this in mind, it would also be advisable for the Income Tax Act to provide greater flexibility for employers who wish to build a security margin into their pension funds. These companies should be able to continue making contributions even if the plan is already in a surplus position.

Plan members would also be better protected than now if the new system acknowledges that the value of pension benefits is a form of deferred compensation and ranks them with unpaid wages in bankruptcy proceedings. To avoid abuse, a limit could be placed on the benefits entitled to this higher level of protection. For example, the higher priority might not apply to obligations attributable to plan amendments made in the three years prior to bankruptcy or benefits in excess of some threshold dollar level.

Another key issue stems from the 28-year federal freeze on tax deferral limits for retirement savings through Registered Pension Plans. The pension cap was reasonable in 1976 when it affected only senior executives. Now, even with increases scheduled under the 2003 Federal Budget, it unreasonably affects growing numbers of mid-level employees. As a result, many ordinary Canadians are accruing substantial supplementary pension benefits that are not funded. Worse yet, many of these people are not aware of the extent to which this retirement income is at risk. We welcome Ottawa's intention to index the pension cap to average wage growth starting in 2006, but the system needs more of a catch-up adjustment than the government has set out. This would permit employers to provide substantially more of the pension promise from the registered plan. That would provide employees with added security and be more effective for employers who are now discouraged from pre-funding supplementary obligations due to onerous tax costs imposed by the Retirement Compensation Arrangement rules.

We realize that the recommendation to increase the maximum benefit amount will have an impact on the timing of government tax revenues. So will other recommendations such as the increased ability to shelter severance through pension plans and additional flexibility to make contributions to plans in surplus. The extent of any change in tax revenues (or any simplification of the PA structure) will need to be determined by the government in conjunction with its overall financial management initiatives.

INVESTMENT POLICY

Any change to the current pension framework must recognize that there is a financial interdependence between capital markets and pension plans. Corporations depend on institutional investors, such as pension plans, to provide capital for business development. Meanwhile, as we noted in discussing funding policy, stringent funding requirements encourage pension plans to rely on the higher returns potentially available from equities to lower the expected cost of their contributions over time.

The bear market heated up an ongoing debate over the extent to which pension funds should make equity investments. In arguing against equities, financial economists attack the use of securities whose future value is unknown to secure long-term liabilities whose amounts are known. This, they say, creates an asset-liability mismatch that unfairly exposes shareholders to risk beyond the business risk of the enterprise in which they have invested. Those favouring the predominant or exclusive use of bonds also cite tax considerations related to the inability of tax-deferred pension plans to take advantage of the favourable tax treatment accorded capital gains and dividends.

The asset-liability mismatch risk cited above is not explicitly recognized or clearly understood in the current environment, due in large part to the widespread use of smoothing allowed in both funding and accounting rules. The revised minimum funding and pension accounting methodologies in our 21st century framework would clarify the issue of mismatch risk and would provide a base from which plan sponsors would explicitly choose the risks that they are prepared to accept.

Thus far, the bonds-or-stocks investment policy debate has not adequately addressed the aforementioned interdependence between capital markets and pension plans. First, Canada's bond market — with little growth in government debt issuance over the past five years — would have serious difficulty in the short term in meeting the demand created if pension plans made a huge shift from equities to bonds. While corporations may find it attractive to provide new debt to the marketplace — particularly if the imbalance between supply and demand for bonds drives down yields substantially — securities analysts generally encourage them to control debt issuance and reduce the leverage on their balance sheets. Second, while our proposals would make it easier to design a portfolio with bonds matched to liabilities, we do not expect this portfolio to actually become the investment policy. Rather it would serve as a benchmark for use in asset mix creation. By identifying the mix required for the plan to meet its obligations at minimal risk, the matched portfolio provides a gauge for measuring whether the plan sponsor is being adequately compensated for the additional financial risk they are accepting by moving away from the matched portfolio. It is also important to recognize that the risk-minimizing portfolio cannot be a risk-eliminating portfolio, as there are not asset categories available to immunize against all of the uncertainty that exists within the liability calculation, such as demographic risks.

Asset classes would be divided into two categories. “Financially non-risky” assets would be those that behave like some or all of the plan’s liabilities and “financially risky” assets would be those that do not. Implementation strategies then become more important as plan sponsors attempt to better diversify the mismatch risk incorporated in the financially risky portion of their portfolios. Diversification across different markets — whether defined by industry exposure or country exposure — would become increasingly important.

Instead of the current focus on tracking error and risk relative to an asset-only index, investment manager structures would focus on further reducing systematic risk inherent within and between markets. Alternative ways of investing that provide less direct relationship to the equity markets would become more attractive to plan sponsors. The goal of the game would be to protect the sponsor from the financial impact of the mismatch risk during those periods when the business is experiencing difficult times. Yet again, there is an underlying intent to increase security and stability for plan members by better relating the sponsor's funding commitment to its business cycle.

ACCOUNTING POLICY

In the midst of the bear market, the public was appalled when it learned that company income statements were still recognizing profit from pension plans even though the value of fund assets had fallen below the liabilities. Explanations of smoothing methodology were met with scepticism and demands for more transparency. Now, the accounting profession is moving toward a regime in which plan assets and liabilities will be marked to market each year with little or no smoothing or deferral.

While transparency should be a key feature of the 21st century pension plan, the prospect of mark-to-market reporting raises concerns that have not yet been addressed. For example:

- The DB pension promise amounts to employer-issued debt that is held by the employees. Standards under consideration would mark to market liabilities based on current AA corporate bond yields. This is inconsistent with the manner in which the corporation's regular long-term debt is held, typically at face value. The pension liabilities may thus appear to be more volatile than the corporation's borrowings even though both are long-term debt.
- While pension plan liabilities would be marked to market at each measurement date, proposed standards do not require the concurrent updating of the plan’s inflation assumption. This disparity would create a time horizon disconnect and produce a potentially misleading view, particularly if one assumes that the return on nominal bonds includes the market's best estimate of future inflation. Consider that a strategy that matches the plan's liabilities with nominal bonds may seem prudent in the short term, but is highly vulnerable to unexpected inflation in the future. If the long-term inflation expectation is regularly updated, the plan's liabilities would more resemble some combination of nominal and real return bonds, not solely the nominal bond portfolio that previously seemed to work.
- The return on assets assumption has been a rallying point for critics of the current pension accounting system, with cries of corporate abuse appearing in the media on a regular basis. While this assumption does not directly affect the balance sheet, an overly optimistic assumption can reduce pension expense or increase income, thus deferring cost recognition into the future. The return on assets assumption should be determined on a forward-looking basis and be reasonably consistent with yields currently available on bonds, the best estimate of future long-term returns. Any equity risk premium assumed must also be reasonable.
- Though smoothing has taken on a bad name, some degree of amortization is needed to recognize the pension plan’s function as a long-term funding vehicle. While the marketplace assumes that the liability can be accurately determined at any point in time, it is important to recognize that precision and accuracy are not synonymous. There are many aspects of the liability calculation that defy accurate calculation, with the result that the figure shown could easily be more than 10% different from the “true” liability. The true liability can only be calculated at the point when the obligations crystallize — typically at plan windup. Similarly, although the

capital markets provide the best possible pricing of the assets held by the fund, the market is notoriously prone to overshoot the "real" value during bull runs and undershoot the real value during downturns. The lack of explicit recognition of these facts could unduly distort corporate financial statements given the large size of many plans relative to the size of their sponsors.

With these issues in mind, we recommend that the new accounting standards:

- Require both the discount rate and the expectation of future inflation to be marked to market at each measurement date, recognizing that there is an implicit linkage between them
- Require the fair value of assets to be used in determining pension expense
- Remove the current corridor from the amortization of experience gains or losses, requiring amortization of the entire gain or loss
- Spread recognition of each year's liability gains/losses over five years
- Spread recognition of each year's investment gains/losses relative to the discount rate over five years
- Provide separate treatment for operating cost, which reflects service cost and prior service costs related to plan improvements. Operating cost should be recognized as part of operating income — separate from financing costs that would be recognized as a non-operating item together with the organization's other financing costs.
- Recognize the cost of benefit improvements over a period consistent with their value recognition. Improvements granted in collective bargaining should be recognized over the length of the agreement, while other improvements are recognized over a reasonably short period such as five years.

It is also very important that all users of financial statements be educated on the true nature of pension plan obligations. In particular, it should be made clear that liabilities can be calculated with great precision at any point, but are based on assumptions that are only educated guesstimates. The true obligation is crystallized only when the benefits are actually paid.

A FINAL THOUGHT

There are many parties to the pension system, and each one's actions over the years have generally reflected its own set of principles and interests. It will be very difficult for the system to function efficiently unless these parties achieve a more holistic understanding and agree on a comprehensive action plan that properly aligns everyone's interests. To work properly, it is essential that the system be made transparent to all participants and that these parties share a common vision of how the deal is intended to work. Canadians need a 21st century pension plan. We are confident that, collectively, those working in the system can deliver it. Towers Perrin welcomes your comments.

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27 Steps to Build Canada's 21st Century Pension System

PENSION AND TAX REGULATORS

- Create one national pension regulator, virtual or physical
- Review system principles at set intervals to limit/avoid ad hoc change
- Require effective vesting (e.g., include early retirement subsidies in termination benefits)
- Remove barriers to offering voluntary and involuntary early retirement windows
- Remove barriers to postponed and phased-in retirement
- Make the pension plan a contractual (not trust) arrangement between employer and employee
- Enshrine control over surplus with employer, subject to conditions:
  — Minimum cushion earmarked for adverse events
  — Surplus above cushion available for contribution holidays
  — Surplus at plan termination reverts to sponsor
  — Very large surplus — to be defined — may qualify for non-windup reversion if members consent
  — Continuation of back-loaded plans but with greater restrictions on surplus usage
- Ease minimum funding standards to recognize that most companies are at very low risk of bankruptcy. Replace 100% funding with a probability-based model
- Eliminate statutory grow-in provisions
- Substantially increase Income Tax Act pension limit to make up for 28-year freeze, enabling employers to pre-fund more pension on a tax-deferred basis
- Increase the amount of surplus that may be held in a plan prior to requiring contribution holidays

CANADIAN INSTITUTE OF ACTUARIES

- Develop a probability based model for plan funding
- Impress upon all that, no matter how precise, pension liability measures are still rough estimates and crystallize only when a plan is wound up

PLAN SPONSORS

- Recognize pension value as deferred compensation
- Alter vesting provisions to include early retirement subsidies, wage growth, etc.
- Alter retirement provisions to provide more flexibility
- Remove plant closure provisions from pension plans
- Clarify the pension deal in employee communications
- Explicitly recognize the asset-liability mismatch that occurs when securities whose future value is unknown are used to fund liabilities whose future value is known
- Categorize asset classes according to how much they behave like plan liabilities. Identify a matched portfolio with minimal risk and use it as a benchmark in measuring the risk-reward tradeoffs in other asset mixes
- Focus investment management not on relative performance, but on ability to match funding commitments to the sponsor's business cycle

ACCOUNTING STANDARD SETTERS

- Mark to market the plan's long-term inflation assumption as well as its liabilities
- Require fair value of assets to be used in pension expense
- Require five-year amortization in recognizing liability gains/losses as well as investment gains/losses relative to the discount rate
- Separate operating cost from financing costs
- Recognize cost of benefit improvements over period consistent with its value recognition

OTHER

- Provide pension beneficiaries with priority claim in bankruptcy proceedings, subject to specified limits.

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About Towers Perrin

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