Canada's Pension Plans – Current Problems, Future Solutions

Notes for a Speech on Pension Regulation,

Delivered by Nick Le Pan, Superintendent of Financial Institutions

To the

National Press Club of Canada Newsmaker Breakfast, Ottawa, Ontario, May 21, 2003

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Context

We have all been reading about the problems facing private pensions. Recent headlines about private sector pensions would seem to bear this out.

There are problems out there. Three years of falling equity values have had a significant impact on the investment performance of private pension plans. In some cases, the companies that sponsor pension plans are experiencing serious problems as well.

What I am here to talk about is solutions.

Clearly, as a pension regulator, I can't wave a wand and reverse the decline in the equity markets, or fix problems in some sectors that have led some sponsoring companies to experience problems, making it difficult for them to fund plans.

But there are things that can be done – and that are being done – to deal with the current set of events.

Before getting into that, let me explain the role of a pension supervisor, and what we can and cannot do.

We cannot guarantee that benefits will be met in all cases. Employers and employees establish pension plans voluntarily. They set benefit levels and promise to fund them accordingly.

We can work to ensure that pension funds remain in a secure separate account, that funds are invested according to the rules, that appropriate disclosure takes place, that plan administrators provide information to us when they are supposed to, that shortfalls are identified on a timely basis and that action is taken to deal with them.

Within this context, let me describe what we can all do to cope with the current and future events.

What Plan Sponsors and Members Can Do

First, what can plan sponsors and members do?

Let's take the biggest problem – under-funded pension plans. When shortfalls are identified, OSFI's job is to ensure that this gets recognized by the various parties involved, and gets dealt with.

But there is no silver bullet for dealing with shortfalls. There are only two ways for sponsors and members to deal with a shortfall: fund it (and the rules allow the deficit to be funded over time given the long-term nature of pension obligations), or restructure the plan so that it becomes more affordable.

Not all deficits are bad. They depend on the parties' ability to pay them off in a reasonable period. But where deficits are very large, or where other factors cut into ability to pay, employers and employees need to take some difficult decisions.

Looking back, it is clear that plan sponsors, unions and others have to be very careful about enhancing benefits unless they are sure they can pay for them. The current environment calls for a lot of caution when enhancing benefits, and for a focus on what is affordable.

In 1998, OSFI fought hard for a new legislative provision that would void enhancements to pensions if the pension fund could not afford them. We succeeded in getting the change, but its implementation depends on passing a regulation. At that time, there was virtually no support for proceeding with a regulation from plan sponsors and unions. People thought that such a power would unreasonably constrain the ability to negotiate increases in benefits. But I think that the time has come for all stakeholders to embrace such a regulatory change, as we have seen that benefit enhancements must be affordable.

What can boards of directors do? I think it is important that board members and senior management of companies that are sponsoring pension plans be aware of the financial position of their pension plans. For a number of years, pension plans were not front and centre. They need to be.

What can plan members themselves do? Plan members should not hesitate to exercise their right to obtain information from the plan administrator. This is a fundamental right that flows from the way these plans are set up and the way in which they are regulated.

What can employers do? A number of companies with deficits in their plans are starting to voluntarily address deficits that exist, including by putting more money in, without being pushed by my Office.

What OSFI can do?

Of the 1,200 pension plans we oversee – which is 10% of the system -- approximately 370 are defined benefit plans. This is where our efforts are concentrated. About 60 of these 370 plans are on our watch list.

At the same time, we have not lost sight of Defined Contribution plans. They, too, can be affected by such things as non-remittance of contributions, in particular where plan sponsors are facing financial difficulty, and OSFI is staying on top of that.

Looking at our 1,200 plans, OSFI is taking action in a number of areas.

Pension plans file Valuation Reports every three years and more frequently if the Valuation Reports reveal a funding deficit. A few years ago we started annual stress testing of plans – even those plans that had shown a healthy surplus on their last report. This was timely given the downturn in markets. Estimating the impact of changes in key variables such as investment returns and interest rates has paid off, in helping us identify problem plans earlier.

Some people have asked, is annual stress testing enough? Given what our tests showed earlier this year, we are changing our processes so as to conduct these tests every six months. Could we do it more frequently? The answer is yes, once we complete a current project to move to electronic filing -- which will allow manipulation of numbers far more readily.

We are vigorously pursuing problem plans we identify. This environment forces us to be much more activist and interventionist. Before we act, we verify the plan's situation with administrators and determine if they have a reasonable plan of action to deal with it. Where concerns exist, we require more detailed information about the investments in the plan. In addition, when plan administrators submit their annual filings, they are required to attest to their compliance with the investment rules outlined in pension regulations, including the requirement not to invest more than 10% of the plan assets in the shares of a single company.

Stress testing that OSFI undertook using December 2002 figures produced a list of 177 plans that were not fully funded (almost half of the defined benefit plans OSFI supervises). Of the 177 plans, there were 12 that were taking contribution holidays and that were not scheduled to file formal valuation reports for several months.

We acted. My Office sent letters to these 12 plan administrators indicating that, while the law allows contribution holidays (when valuation reports indicate that the plans are fully funded and have excess cash), our estimates suggested that these 12 plans had moved into a deficit position. Consequently, we said that we wanted the employers to resume making contributions to their plans immediately.

We also said that each plan administrator should inform plan members and other beneficiaries of the current estimated financial position of their pension plan and of the company's decision with respect to contribution holidays.

Can more be done?

For a pension plan supervisor like OSFI, the most difficult areas in which to operate are when the best available information tells you that the plans are operating just above, or just below, the fully funded line. We have assessed our tolerance levels here and the current environment suggests less tolerance is prudent.

We recognize that balance and judgement are required, given that these are voluntary arrangements between employers and employees. We do not want to be so onerous as to discourage the creation of pension plans to begin with, or to cause employers to terminate plans. We are not here to damage businesses or to hamper the proper development of companies that are creating and sustaining jobs. But I think that, on balance, some change in tolerance is called for.

So, for any plans that are operating close to the margin, OSFI will now require advance notification to us of intentions to take contribution holidays. This would also have to be disclosed to members, because some people have suggested that they were not aware that their employer was taking a contribution holiday.

If plans are just under the wire, we will require disclosure plus a board resolution to continue to take contribution holidays. This will increase accountability and awareness at the board level.

We will also routinely require annual valuation reports for all plans that we believe are operating just short of the line, as this can prove to be the wrong strategy when downturns hit.

Aside from this, there are things that have been in the works and that are being moved forward. We had previously consulted on the desirability of a new regulation that would stipulate that when a Defined Benefit plan fully terminates, the employer must pay into the plan the amount necessary to fund the full benefits promised to plan members at the date of termination. This would require that there be full funding of deficits if plans are terminated. This is going through the regulatory process now.

We will also continue to resist attempts to remove the current 10% limit on investments by a pension plan in any single company. We resisted this when it was proposed a few years ago at the height of the stock market bubble, but some continue to push for it. If this rule had been changed, I would venture to say that we would be facing even bigger problems today.

Finally, while setting accounting rules for companies that offer pension plans is not OSFI's responsibility, we do play a role through our participation on the Accounting

Standards Oversight Committee, or AcSOC.   I think we need more disclosure and more transparency here. This will be discussed at an upcoming meeting – which is open to the public – and I look forward to that.

<u>Conclusion</u>

I have talked about the role of a pension supervisor like OSFI, what we are doing, and what plan sponsors, their boards, and members can do.

As a supervisor, there is nothing more concerning than the plight of a retiree, or employee who is about to retire, who learns that their pension benefits are at risk due to the financial condition of their plan.   For this reason, OSFI will continue to pursue our mandate with vigour, and to talk about what we think all stakeholders can do.

I would be pleased to respond to your questions.