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Statement by Julie Dickson,
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Office of the Superintendent of Financial Institutions Canada

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Good afternoon and thank you for joining us today. As you know, the Office of the Superintendent of Financial Institutions, or OSFI, is Canada's primary prudential regulator of financial institutions, which includes banks, insurance companies and federally regulated private pension plans. We regulate and supervise about ten per cent of all pension plans in Canada, representing about 20% of total pension assets.

Canadians are concerned about the health of their pension plans. In my time today, I want to briefly outline OSFI's perspective on the state of the pension industry, some of the trends and developments and share with you our expectations for the months ahead.

In OSFI's 2004-05 Annual Report, we provided information on the health of pension plans. That information was based largely on the situation as we saw it in the spring of 2005. Overall, we characterized the environment as stable but fragile. We spoke about the strong equity market returns in 2004, which improved pension plan health, offset by a continuing decline in long term interest rates (which had the opposite impact). As well, at that time, a common sentiment in pension circles and among economic forecasters, was that long-term interest rates would be higher in 2005, with helpful implications for plan solvency.

So what has happened in the last six months? Instead of rising, long-term rates have remained at historical lows, and even declined further. Further, new actuarial rules have come into effect, which have had a negative impact on the reported numbers pertaining to plan health.

The impact is reflected in our latest solvency testing results, which is what I want to share with you today. OSFI's primary rationale for running solvency tests is to detect problems and challenges early so that we can, working with the pension plans, take steps to safeguard members' benefits. Conducted using June 2005 values, the results show a marked deterioration in the average estimated solvency ratio, or ESR, of federal plans.

As you may know, pension regulations do not require defined benefit pension plans to be fully funded at all times. But, where the ratio of assets to liabilities on a solvency, or liquidation, basis is less than one, the plan must fund the deficiency over no more than five years.

OSFI's latest test shows that the average ESR fell from 1.00 in December 2004 to 0.91 in June 2005. The results also show that an estimated 72 per cent of federal defined benefit plans were less than fully funded as at June 2005, compared to 53 per cent in December

2004. Although this estimated number is high, it is important not to overreact. While 72 per cent of defined benefit plans were under funded, on average the funding shortfall is less than 10%. Thus, the situation can still be described as stable but fragile, but with heightened vigilance being warranted, especially in cases where the funding shortfall is significantly more than ten per cent.

The June 2005 ESR results also show that the estimated aggregate solvency deficit of all federal plans in a deficit position is approximately $12 billion -- up from an estimated $4 billion in December 2004. Though actual funding requirements will depend on final results reported as at each pension plan's next valuation report, OSFI's June 2005 results suggest that many defined benefit pension plans will face, and need to prepare for, higher solvency funding requirements in 2006.

These results will have an impact on OSFI's watch list going forward. Pension plans that give rise to serious concern, due to their financial condition or for other reasons, are placed on the watch list and are actively monitored.

There are currently 83 pension plans on the watch list; 50 defined benefit plans and 33 defined contribution. This is only slightly different from six months ago, but we will likely see a number of new plans added to the watch list in the coming months.

Given there are almost 1,300 federally registered private pension plans in Canada, it should not come as a surprise that several plans are added to and removed from the watch list on a regular basis. The primary value to OSFI in maintaining the watch list is not so much to track how many plans are on the list at any given time. Rather, the list serves as a tool for focussing our supervisory attention and activities on plans that pose the greatest risk and identifying the actions that need to be taken to safeguard benefits.

What is driving OSFI's ESR results?

The 9-percentage point drop in the ESR between December of last year and June 2005 was the combination of three main factors:

1. Lower long-term interest rates lowered the average ESR by approximately <u>five</u> percentage points.
2. Strong equity market performance made a positive contribution of about <u>three</u> percentage points.
3. A change in actuarial methods introduced by the actuarial profession in February 2005 lowered the average by approximately <u>seven</u> percentage points. The change in actuarial methods adopted by the Canadian Institute of Actuaries, changes how solvency liabilities are calculated. Among other things, the new standard makes the calculation of those liabilities more sensitive to prevailing market interest rates versus using rates more in line with historical norms. The standard also incorporates up-dated mortality tables reflecting increased life expectancy of plan beneficiaries.

Excluding the impact of the new actuarial standard for a moment, the results point to a slight deterioration in the solvency position of federal defined benefit pension plans as a whole. This is consistent with the kind of narrow movement we've seen for the last couple of years.

But the impact of the new actuarial standard – which adds seven percentage points to the deterioration -- cannot be ignored. It will have a very real impact on individual plans' solvency ratios going forward.

The expected deterioration in many plans' financial position brought on by changes in financial and economic variables is something that requires heightened vigilance. In this regard, OSFI has six key points for stakeholders to consider:

1. Pension plans need to focus on the impact of the low interest rate environment and new actuarial standards, which reflect market rates as well as the fact that mortality studies show that people are living longer.
2. Funding requirements are very sensitive to changes in economic conditions (an increase in long-term interest rates or a very strong equity market could go a long way to alleviate the situation). But don't bet on such favourable outcomes.
3. In this environment, disclosure to members, and member awareness regarding the health of their plan, is key.
4. A plan facing a very large increase in funding is not necessarily considered by OSFI to be a high-risk plan – it depends on the health of the sponsor, number of active members paying into the plan, etc.
5. OSFI will continue to exercise its authority to ensure compliance with pension legislation and regulations. We will also continue to identify under funded pension plans, in respect of which contribution holidays are being taken, and take action, ranging from strongly encouraging plan sponsors to cease contribution holidays, to requiring enhanced notification to members and/or requesting early valuation reports.
6. OSFI is prepared to continue working with plan sponsors and members to find reasonable solutions. This could involve plan restructurings to make them more affordable and approving benefit reductions, where this is better for plan members than the alternative of plan termination.