Submission to the Department of Finance on the Pension Benefits Standards Act (Canada), 1985

The views and opinions expressed in this submission are those of bcIMC and its senior management team. They may or may not reflect the views of bcIMC's pension clients.

bcIMC
Investment
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Executive Summary

Occupational pension plans are an important pillar in Canada's retirement system. In fact, they provide the primary source of retirement income for many Canadian families. Occupational plans are also an important source of long-term capital and can help increase Canada's competitiveness in the global economy. As noted in the Department of Finance's discussion paper, in 2007 the assets in registered pension plans (RPPs) and Registered Retirement Savings Plans (RRSPs) amounted to almost $2 trillion and supported 44 percent of retirement income system payments received by seniors. The government has implemented some improvements over the past few years to encourage private retirement savings, including increasing RPP and RRSP contribution limits and increasing the maximum retirement age from 69 to 71.

Notwithstanding these improvements, Canada faces challenges from significant forecast growth in its retiree population and concerns that retired Canadians may not have sufficient retirement income. Within the RPP community, occupational plans are currently in decline, especially defined benefit pension plans. In particular, some private companies have closed their defined benefit plans to new entrants and a growing number of sponsors are contemplating taking similar actions.

These trends pose a number of social concerns. Key issues are as follows:

- **Reduced retirement income from occupational plans**- Defined Benefit (DB) pension plans provide some significant advantages over Defined Contribution (DC) pension plans and private savings. DB plans provide their members with higher and more predictable retirement income.[1] DB plans can mitigate or eliminate inflation and longevity risks.[2] DB plans also mitigate the risk of having to retire and purchase an annuity when asset values are depressed. DB plans are more "efficient" pension schemes in that they can provide greater retirement benefits for a given level of contribution. Even if every DB plan that closes is replaced by a new DC plan, aggregate retirement income paid from occupational pension plans will decline and more Canadian families will bear the risk that they will outlive their retirement money.

- **Potential demise of DB plans and loss of an important source of long-term investment capital**- DB plans have long investment time horizons and over the past 30 years have emerged as being an important source of capital for governments, companies, industrial development and infrastructure. As more private sector employers close their DB Plans, there will be increased pressure put on governments to follow suit and wind up the public sector DB plans (i.e., in order to "level the playing field" in terms of employee benefits).[3] Therefore, issues and concerns affecting private sector pension plans have broader social

[1] Waring and Siegel, Don't Kill the Golden Goose! Saving Pension Plans, *Financial Analysts Journal*, Volume 63, number 1

[2] Longevity risk is that the beneficiary will live longer than anticipated and outlive their savings.

[3] For example, in 2007 the Canadian Federation of Independent Business prepared a research paper entitled, *Canada's Pension Predicament: The widening gap between public and private sector retirement trends and pension plans* which argues this position.

implications. If DB plans are going to survive, it is important that decision-makers find solutions for the problems facing private sector sponsors. The demise of DB plans would represent a reduction in long-term capital and would decrease Canada's competitiveness in the global economy.

- **Increased reliance on income assistance from government-** Private individuals are not compensating for the decline in occupational pension plans with higher personal savings. In addition, retail investors face very high management fees and frequently lack the knowledge or expertise to choose appropriate investment strategies for their retirement savings. The decrease in occupational plans, and DB pension plans in particular, implies that future generations of Canadians will have lower and less secure retirement income than those of the past. Ultimately, this means that more individuals will become dependent upon government assistance during their retirement years.

The goal of this consultation by the federal government is to improve pension plan benefit security and ensure that the legislative and regulatory framework is balanced in its incentives to establish or maintain pension plans. The legislative and regulatory framework, together with accounting standards, affect the stability of a sponsor's contribution rates and the impact that changes in value in a pension plan's assets have upon a company's financial statements (e.g., balance sheet risks). These issues can affect the plan's investment strategies and the willingness of private sector employers to provide a DB plan. As such, the legislative, regulatory and accounting environment will play critical roles in determining both the long-term cost and sustainability of DB plans.

Although well-intended, changes made by some other jurisdictions have had some unintended consequences and have exacerbated the problems facing DB plans and their sponsors. For example, rather than helping DB plans to survive, regulatory and accounting changes made in the UK have had the opposite effect and accelerated their demise. These changes have also had a detrimental effect on the UK's capital markets by creating excess demand for long-dated bonds. Arguably, these accounting and regulatory changes have not helped to increase the transparency of DB plans but rather reflect misplaced confidence in the accuracy and precision of actuarial valuations. Given the adverse consequences experienced in some other jurisdictions, the British Columbia Investment Management Corporation ("bcIMC") applauds the decision by the federal government to seek input on the most appropriate means of enhancing the legislative and regulatory framework for registered pension plans subject to the *Pension Benefits Standards Act, 1985* (the Act).

The specific impact on bcIMC and its pension plan clients of amendments to the Act will be limited to the permitted investments rules under Schedule III of the *Pension Benefits Standards Regulations, 1985* (Schedule III). Pursuant to section 38 of *Pension Benefits Standards Regulation* (BC Reg 433/93), British Columbia pension plan assets must be invested in accordance with the permitted investment rules in Schedule III. As a result, our submission will focus primarily on investment issues and the related *Income Tax Act* requirements. However, because the investment framework is relevant to the broader societal issues and the impact may be significant, our submission will touch on the societal impacts of future enhancements to the Act. bcIMC believes that a modern approach to permitted investments will assist not only the administrators of RPPs but also the government to achieve secure retirement income for members of occupational pension plans, avoid a significant reduction in long-term capital that could decrease Canada's competitiveness in the global economy and reduce the potential reliance on government income assistance programs that will result from a loss of long-term investment capital.

In regard to the regulation of pension plan investments, bcIMC is pleased to provide the following submission. We have made five general recommendations. They are as follows:

> **Recommendation # 1: The regulatory framework should encourage the establishment and maintenance of well-funded final salary DB pension plans. This is because these plans provide the greatest benefits, both for the members and for society.**
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> **Recommendation # 2: Larger pension plans face lower costs and have increased investment opportunities. Employers/sponsors should be encouraged to join multi-employer plans rather than managing their DB plans on a separate basis**.
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> **Recommendation # 3: Capital markets are very dynamic and opportunities and risks are constantly evolving and changing. As such, the rules governing the pension investments should be based on principles rather than historical restrictions.**
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> **Recommendation # 4: The federal government should be encouraged to modify the *Income Tax Act,* particularly section 149 with respect to tax-exempt entities, to mirror any changes made to the PBSA 1985.**
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> **Recommendation # 5: The federal government should be encouraged to modify the *Income Tax Act* to encourage sponsors to hold larger asset cushions, reflecting the uncertainty as to future costs.**

Background material supporting the above recommendations is included in the text of this submission. If desired, bcIMC would be pleased to follow-up with a presentation during the national consultation meetings.

<u>Background</u>

The British Columbia Investment Management Corporation (bcIMC) manages assets on behalf of 11 public sector pension plans. As at March 31, 2008 bcIMC had approximately $85 billion under its administration, $65 billion of which is administered on behalf of pension funds and $20 billion on behalf of various trust funds and other clients. This makes bcIMC the largest pension fund manager in Western Canada.

bcIMC's pension clients offer final salary defined benefit (DB) pension plans to their members. DB pension plans are facing some significant challenges and appear to be approaching a crossroad. Specifically, some private sector employers have closed their DB plans to new entrants and considerably more are considering taking similar actions. The decline in DB plans is not only happening in Canada but has also occurred in other jurisdictions, such as the US and the UK. DB plans have been an important pillar in Canada's retirement system. Therefore, the current trend raises some obvious social concerns.

In response to the above issues and concerns, the federal government and several provinces, including British Columbia, have conducted public reviews seeking recommendations to help sustain private occupational pension plans.

While there are some notable structural differences between public and private DB plans, public sector fiduciaries face many of the same issues and concerns as their private sector counterparts. More importantly, bcIMC believes that the survival of public sector plans is ultimately dependent on resolving the challenges facing private sponsors. Specifically, if the private sector abandons the DB model, it will become increasingly difficult for government to justify providing DB plans for public sector workers. It seems unlikely that, over the long-term, public sector workers will be given a retirement benefit that, however wrongly, is perceived to be unaffordable by the private sector.

bcIMC strongly believes that the DB model is the most appropriate vehicle to provide secure retirement income to all pension plan members, both private and public sector. It also has the most potential to reduce potential reliance on government income assistance programs. Finally, the large pools of long-term investment capital generated through DB plans are a significant source of Canadian economic competitiveness. bcIMC's submission focuses on two key areas:

- Regulatory, accounting and legal changes/approaches that are needed to help address structural problems facing DB plans. Overall, bcIMC believes the primary goal of pension legislation should be to create incentives for employers to establish and maintain well funded occupational pension plans (Recommendations 1 and 2).

- Legislative and regulatory changes to enhance investment performance and reduce the long-term cost facing DB plans. Pension plans have two sources of income: contributions and investment returns. Enhancing investment returns reduces long-term costs, which benefit both the plan's stakeholders and the broader society (Recommendations 3 to 5).

Recommendations

Recommendation #1: The goal of the regulatory framework should be to encourage the establishment and maintenance of well-funded final salary DB pension plans. This is because these plans provide the greatest benefits, both for the members and for society.

Empirical studies indicate that DB pension plans earn higher and more stable rates of return than DC plans.[4] As such, DB plans are a more efficient pension scheme and can provide a higher level of retirement income for a given level of contribution. Stronger returns not only benefit the stakeholders but also reflect that the plan's assets are being invested more effectively and are generating stronger income and dividend streams. As such, stronger returns imply a better deployment of the pension capital, which is another social benefit of DB plans.

The advantages of DB over DC, however, do not stop with superior investment performance. DC plans generally have lower contribution rates than DB plans, which will also reduce the level of retirement benefits.[5] DC plans typically invest in mutual fund products and face higher management fees. Therefore, more of DC plan's proceeds are paid to financial intermediaries versus providing retirement benefits.

A greater concern is that many individuals are not knowledgeable in investment issues or principles. As a result, they frequently do not select appropriate investment strategies for their circumstances. Significantly, a recent US study concluded that: "…more than half of the participants in 401(k) plans do not follow the prudent investment strategy of diversifying their holdings."[6] A key advantage of DB plans is that they tend to be managed by investment professionals.

From a plan member's perspective, a key advantage of DB over DC plans is that the former provides the beneficiaries more stable and predictable retirement income. In addition, DB plans reduce longevity risks by providing benefits until the member's death.[7] DB plans also mitigate the risk of having to retire and purchase an annuity when asset values are depressed.

There are, of course, many challenges associated with providing a DB plan. At this time, it suffices to say that from a societal perspective:

- It is better to have a DC pension plan than no occupational plan; and

- DB plans are preferred to DC plans as they are a more efficient source of providing retirement income.

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[4] Munnell, Soto, Libby, and Prizivalli, Investment Returns: Defined Benefit vs. 401(k) Plans, Center for Retirement Research at Boston College, September 2006, number 52

[5] Waring and Siegel, Don't Kill the Golden Goose! Saving Pension Plans, *Financial Analysts Journal*, Volume 63, number 1 p. 31

[6] Munnell, Soto, Libby, and Prizivalli, Investment Returns: Defined Benefit vs. 401(k) Plans, Center for Retirement Research at Boston College, September 2006, number 52, page1.

[7] Longevity risk is that the beneficiary will live longer than anticipated and outlive their savings.

Final salary DB plans are complex financial arrangements and no regulatory framework can resolve all of the financial, structural, or intergenerational challenges that are inherent in these schemes. The regulatory framework can, however, eliminate barriers to the establishment and maintenance of DB plans. The focus on solvency over going concern funding requirements, small asset cushions and the pressure to eliminate smoothing techniques are examples of regulatory disincentives.

Ideally, the regulatory environment should encourage sponsors to join multi-employer DB plans. To the extent that multi-employer plans are permitted to maintain funding on a going concern rather than a solvency basis, the disincentive for single employers to provide a DB plan is mitigated, but participating in a larger portfolio also provides ancillary financial benefits for the plan (e.g., lower unit costs, expanded investment options).[8] In addition, pension sponsors should be encouraged to hold larger asset cushions, to mitigate solvency risk and to reflect the uncertainty as to future growth of the assets and liabilities. Finally, some of the solvency risk may need to borne by the plan members and there should be clear rules and guidelines on how benefits are administered and will be adjusted in the event that the sponsor goes bankrupt and there appears to be insufficient money to meet all of the plan's future obligations. Employees are more likely to want to participate in a DB plan because of the reduced risk that employer insolvency will leave them with no or dramatically reduced pension benefits.

Asset and liability smoothing also mitigates short-term funding problems and helps fiduciaries adopt a longer-term perspective in terms of the plan's investment policy and risk appetite. Smoothing enhances the ability of the sponsor to reduce pension costs with higher investment returns. Asset and liability smoothing does not affect a plan's long-term results or its long-term funding status. Rather, smoothing decreases contribution rate volatility. There is growing pressure on governments and regulators to eliminate asset and liability smoothing and force DB sponsors to value their asset and liabilities on mark-to-market basis. bcIMC disputes both the logic and value of this initiative. The approach places undue confidence in the accuracy of actuarial forecasts and encourages pension fiduciaries to adopt lower risk investment strategies to manage their balance sheet risks. Over the long-term, decreasing the level of risk and return will be counterproductive and will increase the long-term costs to the sponsor. The best way to address the argument that smoothed values do not provide a true representation of a plan's funding status is not by removing smoothing, but by increasing asset surplus cushions. Smoothing reduces short-term balance sheet risk to plan sponsors and enables sponsors to pursue investment strategies that target long-term growth by seeking higher risk-adjusted returns. Eliminating smoothing provides an incentive to sponsors to weight investments to lower return fixed income vehicles to reduce volatility. Smoothing is a valuable part of an overall strategy of pursuing investments that will allow more of the pension promise to be met by increased investment returns rather than employer contributions.

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[8] This issue is examined further under recommendation #2.

The pressure to eliminate smoothing is another factor in the current regulatory climate that discourages the establishment and maintenance of well-funded final salary DB pension plans.

Recommendation #2: Larger pension plans face lower costs and have increased investment opportunities. Employers/sponsors should be encouraged to join multi-employer plans, rather than managing their DB plans on a separate basis.

In 1989, Don Ezra, a Senior Vice President with the Frank Russell Company, undertook a research project to review the relative importance of contributions and investments in the provision of DB benefits. The following is a synopsis of Mr. Ezra's Research Commentary:

> *In a defined benefit pension plan, how many cents in each dollar of benefit come from contributions and how many cents from investment return? No the answer is not 60/40. This commentary shows that 80 cents or more comes from investment returns; contributions account for the remaining 20 cents of each benefit dollar. This points to the dominance of investment policy when considering the finances of a pension plan.*[9]

The proposition that investments provides over 80% of a DB plan's funding was estimated based on the assumption that its investment return would exceed the members' annual salary growth by 3% per annum. Obviously a plan's actual results will vary from this assumption and its funding status will be influenced by plan specific factors (e.g., future hiring, mortality and withdrawal rates, investment policy and risk appetite, etc.). Regardless of the exact proportion of a DB plan's funding that comes from investment returns, the above illustrates two fundamental principles in the management of occupational pension plans. These are as follows:

- Pension plans only have two sources of funding: contributions and investment returns. The higher the plan's long-term investment return, the lower contributions that will be needed for a given level of benefits; and,

- Investment return is the most important source of income for a DB plan and strong returns will reduce the long-term cost of the pension promise to the plan sponsor(s). Conversely, pursuing a low risk/low return investment strategy will result in much higher costs/contribution rates to the sponsor.

Given the above, the best way to control the costs of a final salary DB plan is to build a regulatory framework that allows the fiduciaries to enhance their investment results.

There are significant financial benefits associated with managing larger investment portfolios and this is a key advantage of encouraging sponsors to join multi-employer plans. There are economies of scale in investment management and, as such, larger institutional investors will pay much lower administrative and management fees than

[9] Don Ezra, **A Model of Pension Fund Growth**, Russell Research Commentary, June 1989 p. 2

their smaller counterparts. Larger funds are more inclined to manage assets internally, which further reduces costs. Larger funds have expanded investment opportunities and can build a more diversified portfolio by increasing their exposure to less liquid asset classes (real estate, mortgages, infrastructure, and private placements). Greater economies of scale and reduced management fees permit larger plans to spend more money on their management platform and infrastructure, such as risk management systems. Larger plans have a greater influence and impact on issues such as corporate governance and corporate policies and practices, where best practices can have a positive effect on financial performance. Finally, larger plans generate significant long-term capital investment in Canada enabling government and corporate industrial development and infrastructure spending.

Recommendation # 3: Capital markets are very dynamic and opportunities and risks are constantly evolving and changing. As such, the rules governing the pension investments should be based on principles rather than historical restrictions.

The legislation governing pension plan investments was introduced many years ago when the economy and investment opportunities were much simpler and slow to change. In the new economy, pension plans have a range of investment options that simply did not exist when Schedule III came into effect. Capital markets are becoming increasingly complex and dynamic, especially with the proliferation in investment opportunities (e.g., infrastructure), instruments and products (e.g., derivatives), and strategies (e.g., hedge funds, short-selling). Pension fiduciaries can no longer define their market risk by the weightings of equities in their asset mix nor can they afford to adopt a passive approach in managing the plan's assets. Rather, pension fiduciaries must become active market participants, in order to protect their pension capital and enhance the plan's long-term investment performance.

Schedule III needs to be updated and modernized to reflect the new environment. It is cumbersome legislation, difficult to interpret, and focuses on rules rather than principles. In particular, Schedule III somewhat arbitrarily restricts pension plans from investing:

- More than 5% of their book value in a single parcel of real estate or Canadian resource property;
- More than 10% of their book value in any one entity;
- More than 15% of their book value in all Canadian resource properties; and
- More than 25% of their book value in all real estate and Canadian resource properties.

These rules were introduced to ensure pension plans hold a diversified portfolio but do not reflect current realities. They have long since been overtaken by modern approaches to investing and accounting, including a shift away from the use of book value as a standard. Instead of being bound by legislated diversification thresholds, plan administrators should be able to rely on the high level of expert investment and financial advice available today to decide what constitutes an appropriate level of diversification.

Especially burdensome and illogical, however, is the rule that a pension plan cannot invest in securities of a corporation that carry more than 30% of the votes to elect directors unless the corporation qualifies as:

- a real estate or resource corporation (which limits its activities to acquiring, holding, maintaining, improving, leasing or managing real or resource property), or
- an investment corporation (which limits its investments to those permitted to a pension plan and cannot therefore itself invest in securities of a corporation that carry more than 30% of the votes to elect directors).

This rule should, in bcIMC's view, be eliminated immediately, regardless of what action is taken in respect of the 5%,10%, 15% and 25% limitations listed above.

First, this rule, unlike the other numerical rules, has no value in requiring pension plans to diversify exposure and spread risk. It seems merely to be aimed at reducing the influence of pension plans in the economy.

Second, this rule effectively penalizes multi-employer pension plans. As argued elsewhere in this submission, multi-employer pension plans are to be encouraged for the superior protection against risk they offer to pension plan beneficiaries. However, the 30% rule has the illogical effect of stating that four single employers with four single pension plans can collectively own 100% of the voting shares of an enterprise, but if those four employers join together in one pension plan, that joint pension plan can only own 30% of the same enterprise.

Third, this is a rule against owning voting control – not against investment exposure. It does not prohibit a pension plan from having a right to 100% of the returns from a corporation. It merely prevents a pension plan from exercising a control over that corporation commensurate with its economic exposure. The 30% rule, therefore, is by implication a rule against the alignment of voting control and economic exposure.

Fourth, technical compliance with the 30% rule has not been matched in the pension industry by substantial compliance. Investors have evolved legal structures to comply with the technical requirements of the rules while in fact circumventing them. All that is effectively achieved is the imposition of the unnecessary structuring, excessive expenses and creation of legal risks associated with nominal compliance with this rule.

Fifth, the restrictions are inequitable as it may be easier and less costly for larger pension managers to establish structures to circumvent the rules.

Sixth, the complexity and interpretive difficulty of these rules are a source of a considerable amount of legal uncertainty. It should be emphasized that it is almost impossible to get definitive legal guidance on the interpretation of these rules. Unlike the similar rules set forth in the *Income Tax Act*, neither advance rulings nor interpretation bulletins can be obtained to help in the interpretation of Schedule III, even though these rules are similar in nature to those in the *Income Tax Act*. The ambiguity of these rules, the difficulties of their interpretation and the inability to obtain definitive guidance in respect of them are particularly unreasonable burdens for pension plan investors.

Seventh, these rules imply that an investment corporation must limit its own investments to those permitted to a pension plan as though the corporation were itself a pension plan. This means, for example, that in order to meet a Canada Revenue Agency interpretation, an investment corporation must simultaneously make at least ten initial investments so as to comply with the rule that it can invest no more than 10% of its book value in any one entity. This in itself is one of the ambiguities of Schedule III but, if true, this means that pension plans lack the ability to do indirectly what they can do directly, i.e. invest 10% of the fund in an investment through a single investment corporation. This means that pension plans must expose themselves directly to certain investment risks, without the benefit of a corporate liability shield, to achieve certain investment goals.

Eighth and most important, the primary concern of the regulatory framework for pension plan investment should focus on enabling pension investors to find investments that will earn sufficient returns and an acceptable degree of market risk to satisfy long-term funding obligations. Since these latter rules narrow the field of possible investments unnecessarily, they run counter to this primary consideration.

Pension fiduciaries are required to act in accordance with the prudent person standard. In British Columbia that standard is set out in the *Pension Benefits Standards Act* and the *Trustee Act,* but the prudent person standard applies throughout Canada. In exercising their responsibility to comply with the quantitative and qualitative standards in Schedule III, pension fiduciaries may not be acting prudently if they are creating or increasing compliance risk. If pension fiduciaries comply with the restrictions, more pension plan assets must be invested in vehicles that cannot take advantage of the limited liability available in a corporate framework. In addition to reducing the field of possible investments, this may increase the liability risk to the plan assets and potentially creates a benefit risk for plan beneficiaries.

With the abolition of the foreign property rule, the requirement that no more than 30% of pension fund assets could be invested outside of Canada, the quantitative rules in Schedule III may unintentionally lead to a reduction in investment in Canadian resources. With a global market in which to seek competitive investment opportunities, factors that add to the cost and complexity of an investment will reduce its attractiveness to pension fund investors.

The rules for pension plan investment should be modernized adopting a principle based approach, as Quebec has already done. If the federal government makes no other changes to Schedule III, it is critical that the quantitative rules, particularly the 30% rule, in Schedule III be removed at least insofar as they apply to investment corporations that invest pension funds for pension plans. This is an urgently needed reform.

The static rules in Schedule III fail to reflect the dynamic nature of capital markets and investment structures. More importantly, an amended Schedule III that replaces one set of restrictive rules with another, more current set of restrictive rules will quickly become out-of-date. Most of the necessary principles are already stated in sections 8(4), (4.1) and (5) of the *Pension Benefits Standards Act,* 1985 and sections 6 to 7.2 of the *Pension Benefits Standards Regulations,* 1985. These principles might usefully be supplemented by additional principles related to use of leverage and other borrowing rules and conflict of interest and related party rules.

Recommendation # 4: The federal government should be encouraged to modify the *Income Tax Act,* particularly section 149 with respect to tax-exempt entities, to mirror any changes made to the Act or to defer to the Act.

For pension plans to be able to benefit from amendments to the Act to implement a principle based approach to investment requirements, it will be necessary for parallel changes to be made to the *Income Tax Act* ("ITA"), as both the ITA and the Act attempt to define and limit pension plan investment vehicles.

Pension plans are generally exempt from taxation under the ITA and employ a variety of investment vehicles to maximize returns. Investments through corporations may be preferred but not all corporate investment vehicles employed by pension plans will be recognized as tax-exempt under the ITA. Section 149 of the ITA identifies a number of tax-exempt entities, including section 149(1)(o.2) with respect to real estate, resource and investment corporations. The rules and interpretations applicable to these corporations add significant complexity to pension plan investment practices and do not cleanly align with the rules and interpretations of permissible investments under the Act.

The purpose of section 149(1)(o.2) is to allow pension plans to establish corporations to achieve investment goals. When the investment corporation rules limit that ability, it reduces the ability of pension plans to achieve the investment goals.
Granting tax-exempt status to a broader category of corporate investment vehicles for pension plans is consistent with the overall tax policy with respect to pension plans. The tax-exempt status of pension plans is more accurately characterized as tax deferral since taxes will be paid on the pension funds by the pension plan members when they receive their pension benefits.

While amendments to the ITA are outside the mandate of the Department of Finance in the context of its review of the Act, pension plan fiduciaries must comply with both federal statutes. That requirement is most easily met if the Act and the ITA are consistent. The simplest way to ensure consistency is for section 149(1)(o.2) of the ITA to provides that entities that comply with the applicable provision of Schedule III are tax-exempt.

Recommendation # 5: The federal government should be encouraged to modify the *Income Tax Act* to encourage sponsors to hold larger asset cushions, reflecting the uncertainty as to future costs.

A significant impediment to building stronger pension plans is the ITA restrictions that are placed on the accumulation of pension surplus. Again, while this issue is somewhat outside the mandate of the Department of Finance in the context of its review of the Act, pension plans are affected by both federal statutes.

Traditionally, the ITA has effectively prohibited contributions to registered pension plans if the plan's assets are deemed to exceed its liabilities by 10% or more.[10] As a result, many plans were compelled to take contribution holidays during the 1990s when their investment returns were strong. As evidenced by the equity market correction of 2001-2003, 10% is a very small asset cushion and a plan's funding status can be quickly eroded if the plan's investment returns are weaker than anticipated. The current market collapse will be even more devastating to DB plans and their funding status.

As noted with respect to the pressure to eliminate asset and liability smoothing and adopt mark-to-market valuations of assets and liabilities, the underlying problem stems from decision-makers having undue confidence in the accuracy of the actuarial valuation. An asset cushion helps the sponsor deal with the uncertainty of capital markets and the future cost of the pension promise. It can also reduce solvency risks by strengthening the ability of the plan to meet its payment obligations, independent of the future financial health of sponsor. It should be noted that some jurisdictions approach this issue fundamentally differently and encourage their DB plans to maintain large asset cushions to fund their pension liabilities. For example, the Netherlands requires that DB sponsors maintain assets that, on average, are at least equal to 130% of their liabilities.[11]

Obviously, pension issues and challenges are inter-related. For example, sponsors will not be willing to hold larger asset cushions in their DB plans unless authorities address the legal problem of the asymmetrical distribution of funding risks and rewards. The health of the pension system depends largely upon its ability to withstand adverse events. This would be facilitated if plans had larger asset cushions.

[10] The contribution rate rule was modified in 2003 and was increased to a maximum of 25% for DB plans that qualify as "shared-cost plans." Other plans are still subject to the 10% rule.
[11] Blome, s. et al (2007) "Pension Fund Regulation and Risk Management: Results from an ALM Optimisation Exercise", OECD Working Papers on Insurance and Private Pensions, No.8 OCED Publishing.