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November 7, 2007

Mr. Harry Arthurs
Ontario Expert Commission on Pensions
777 Bay Street
P.O. Box 102
Toronto, Ontario M5G 2C8

VIA EMAIL

RE: The Future of Defined Benefit Pensions in Ontario

Dear Mr. Arthurs:

Introduction

I am grateful for the opportunity to submit to you this presentation in respect of your review of the security, viability, and sustainability of the pension system in Ontario.

At the outset, I wish to confirm that the ideas and opinions presented in this paper are mine and may not represent the opinions of my employer, my colleagues or any other association for which I serve as a volunteer.

Given the great number of submissions that the Expert Commission is expected to receive, this submission will not address in detail many issues which will likely receive full attention in other submissions as well as through the research being conducted directly by the Expert Commission.

This presentation is divided into the following sections:

- ✓ Biography
- ✓ Social Policy
- ✓ The Future of the Defined Benefit Plan
- ✓ Fixing the System
- ✓ Recommended Solution

Biography

I was educated in mathematics at the University of Waterloo between 1985 and 1988. I wrote my first actuarial exam in 1986 and commenced my first employment as an actuarial student for the Province of Ontario in that same year. From December, 1988 through April, 1995 I worked at Mercer in Toronto following which I spent three years at a small insurance brokerage and consulting firm.

In 1997 I qualified as a Fellow of the Canadian Institute of Actuaries. In 1998 I co-founded Actuarial Solutions Inc. (ASI) which is a boutique firm with offices in Windsor and Oakville.

The core business of ASI is providing consulting, actuarial, and administrative services to sponsors of defined benefit registered pension plans. The majority of my clients over the past twenty years have been small and mid-sized employers with fewer than 500 active employees. It is the perspective of these small and mid-sized employers that shapes my thinking with respect to pension plans in Canada.

Social Policy

There are a number of policy questions that the Expert Commission needs to consider which revolve around whether defined benefit pension plans are a useful social tool. **In my opinion, pension plans in general serve to defer income from a working lifetime through to retirement.** The deferral of income is an important outcome in our society as the model whereby family members and community organizations marshal the necessary resources to care for society's elderly is no longer viable.

In the absence of an effective system for deferring income will lead to two possible outcomes. The first possible outcome is the inability for Canadians to afford retirement, requiring them to either continue working for longer periods or retiring in relative discomfort. The second possible outcome is for a transfer of wealth from workers to retirees to provide retirees with adequate support. In my opinion, this second approach represents a looming disaster as the demographics of the country shift with the aging of the population. Wealth transfer as a solution is affordable in a young and growing population. In an aging population, the affordability of the wealth transfer strategy will erode until it reaches a breaking point where the workers become unwilling to provide for the retirees. The architects of the Canada Pension Plan and the architects of "unfunded" retiree health programs have both come to see the difficulty of making promises to one generation while passing the cost to another generation.

Social policy may seek the end result of deferring income through encouragement of defined benefit plans, defined contribution plans, the Canada Pension Plan or a number of other mechanisms. There are merits to each approach and it is highly likely that a system which blends all three approaches will be found to be optimal.

Both the Canada Pension Plan and defined contribution pension plans offer a mechanism for current workers to defer income to their retirement. It is possible, that retirement savings can be achieved through these vehicles alone and ‘saving’ defined benefit plans may not be a necessary agenda for our governments.

With this said, I believe that defined benefit registered pension plans have a significant advantage over the now popular defined contribution approach due to risk pooling. I do not intend to enter the debate on the merits of expanded CPP coverage.

The Future of Defined Benefit Plans

Defined benefit plans allow for the sharing of costs – or the sharing of risks – among plan participants relating to mortality. In addition, employers can support adequate pensions through the implementation of a long-term investment strategy while using corporate assets to buffer cashflow requirements arising from variations in investment performance.

In contrast, defined contribution plans pass the entire investment risk and mortality risk to participants with the balancing features becoming the level of income that can be provided and the possible early retirement date (or necessary late retirement date). Defined contribution plans also introduce the new risk of an uncertain date when retirement income ceases due to an exhaustion of pre-retirement savings. Defined contribution programs generally only succeed in providing for an adequate retirement by encouraging ‘over saving’ to protect against contingencies that are unmanageable on an individual basis but which can be diversified through group participation (defined benefit plan) and the asset backing of a plan sponsor.

Given what I believe is a clear case for a social policy for effective means of accumulating retirement savings and an equally clear case for the effectiveness of defined benefit plans, it might be tempting to assume that defined benefit plans are flourishing. Unfortunately, this is not the case. Defined benefit pension plans are declining in popularity and use. The commonly agreed upon reasons for this decline include the unpredictability of costs, the unfairness of the current rules regarding surplus assets, and the complexity and uncertainty of plan administration.

Defined benefit plans remain somewhat prevalent in the public service as well as in unionized environments. These programs also remain intact at some of the countries largest private employers although this latter group is seeing erosion in their commitment to these programs. What should be perfectly clear is that for small and mid-size employers, the exodus from defined benefit plans continues and it is unlikely to end short of the complete elimination of defined benefits for all but the executive class.



Fixing the System

In order for the defined benefit plan to return to a place of usefulness in our society, the system requires repair. Below is a brief outline of what I believe are the key ingredients to ‘fixing’ the system.

Without a doubt, developments over the past twenty years in accounting standards combined with the rise of the ‘marked to market’ approach of the solvency valuation has destroyed any measure of cost predictability. Employers will not return to sponsor defined benefit plans until this single most important aspect of plan design is resolved.

Some actuaries will argue that the ‘old school’ approach of ‘smoothing’ market fluctuations has hidden the true cost of pensions from sponsors – and that had the true cost been exposed in decades past, the exodus would have commenced much earlier. This criticism is partly valid, but partly misdirected.

In the early days of pensions, in addition to actuarial techniques to smooth results, smoothing was inherent in plan design (e.g. career average plans with updates based upon available surplus), in the belief that over-funding could be countered by surplus withdrawals, and in a less volatile investment market. It is my argument that the defined benefit plans of yesterday worked in their time – but times have changed and these programs and the regulatory regime has not changed alongside.

Given the realities of market value fluctuations, we are left with three choices:

1. Abandon defined benefits; or
2. Establish a system that provides benefit security though ‘overfunding’ with the necessary mechanism to return excess assets to contributors; or
3. Establish a system that allows for predictable levels of contributions by employers and allow the security of benefits to vary with market fluctuations.

For many existing pension plans, surplus rules are embedded in trust law as well as ancient verbal and written promises. Fixing the rules for plans currently in existence may not be possible and will certainly not be easy. It is possible however, for a future system to clearly define surplus ownership and place it in the hands of the party being asked to make and fund the promises of the plan.

This however is not the only solution and in fact I believe option 3 above will be considered a superior approach. In the system of defined contribution plans, plan members take all of the risk of underfunding, whether a result of investment performance, mortality (or lack thereof) or any other factor. It is therefore puzzling to me that society will not accept a defined benefit system which transfers some of these risks to sponsors while leaving some of the risk with plan members.



Recommended Solution

It is my recommendation that a three-stage approach be taken to revitalizing defined benefit plans. These are:

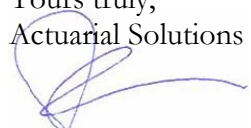
1. Develop a framework for a 'new era' of defined benefit plans and implement this system for sponsors that wish to establish new programs.
2. Develop appropriate rules for transitioning the existing defined benefit plans to the new system.
3. Simplify the existing rules for defined benefit plans that cannot be transitioned to the new system.

Steps 2 and 3 above are beyond the scope of this presentation. Given the 'outside the box' nature of my recommended solution, I will not spend the time to make a detailed explanation. The key features of in Step 1 above to my proposal are as follows:

- ✓ Clearly define that the actuary's duty in setting contribution rates is to plan beneficiaries and that the contributions to the pension fund should be expected to be 'reasonably adequate' to fund benefits over the plan's lifetime.
- ✓ **Limit sponsor liability for funding benefits to required contributions as set out in the each actuarial report – that is, sponsors should not have a balance sheet liability for future contribution requirements.**
- ✓ Allow for plan assets to rest within a corridor around the wind-up liability. That is, don't force modest unfunded liabilities to be immediately funded – allow for the 'rationale and orderly accumulation of assets'.
- ✓ Require that surplus utilization for 'contribution holidays' be appropriately amortized over future contribution periods. That is, don't allow 'temporary surplus' to be rapidly eroded.
- ✓ Provide for a regime of minimum benefit rules and administrative requirements that are identical across all provinces.

I look forward to attending the public hearing in Windsor on November 15, 2007. I would be pleased to answer any questions that you may have either in advance or at the hearing. Thank you for considering my submission.

Yours truly,
Actuarial Solutions Inc.


Joseph F. Nunes, FCIA
President

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