FTR Now

A Roadmap to Federal Pension Reform

Date: April 4, 2011

On April 1, 2011, amendments to the *Pension Benefits Standards Regulations* ("*PBSR*") came into effect that alter the rules regarding the funding and operation of pension plans governed by the *Pension Benefits Standards Act, 1985* ("*PBSA*"). Since 2009, the Federal Government has taken a number of steps to reform the *PBSA* and the *PBSR*.

This *FTR Now* is intended to provide a high level roadmap of the reforms to help you identify necessary and desirable changes to your plans. We review the changes made over the past year as a result of amendments to the *PBSR*, and amendments to the *PBSA* contained in Bill C-9, *Jobs and Economic Growth Act*, and Bill C-47, *Sustaining Canada's Economic Recovery Act*, which received Royal Assent on July 12, 2010 and December 15, 2010 respectively. We also highlight those changes not yet in force that will be of interest to plan sponsors and administrators. Virtually all federally regulated pension plans will need to be amended as a result of the reforms. The extent to which your plans will need to be amended will depend on their existing terms.

EFFECTIVE APRIL 1, 2011 – AMENDMENTS TO THE *PBSR*

FULL FUNDING ON PLAN TERMINATION

Consistent with almost all other Canadian jurisdictions with pension standards legislation (except Saskatchewan), the *PBSR* has been amended to require a pension plan to be fully funded upon plan termination. Prior to April 1, 2011, an employer's funding obligation in the event of a full plan termination was limited to the normal cost of benefits accrued to the termination date, any special payments accrued to the termination date, and any employee contributions deducted from payroll but not yet remitted to the pension fund. Bill C-9 requires that a plan sponsor must fully fund benefits upon full plan termination (unless the plan is a multi-employer pension plan).

The amendments to the *PBSR* require employers to calculate and amortize any termination deficiency with equal annual payments over a period not longer than five years from the date the plan is terminated. New solvency funding rules that now permit an annual consolidation of payments schedules and an average solvency ratio method of determining solvency payments will not apply where a termination deficiency is being amortized. Annual actuarial reports and contributions following the plan termination will be required until all promised benefits are funded in full. In addition, the deemed trust provisions of the *PBSA* will continue to apply until that time.

LETTERS OF CREDIT

In response to recent pension funding crises, the Government enacted temporary solvency funding relief that permits sponsors to fund their pension plans using letters of credit. As of April 1, 2011, the *PBSA* and *PBSR* permit the use of letters of credit on a permanent basis. The amendments to the *PBSR* allow plan sponsors to satisfy solvency payments up to a limit of 15 percent of plan assets. Such letters of credit must be held by a trustee, rather than the employer or plan administrator.

Letters of credit can be reduced by a plan sponsor upon a return to fully funded status, provided the plan retains a five percent solvency margin (i.e., 105% funded). If the plan returns to full funding plus the solvency margin without factoring in the value of any letters of credit, any outstanding letters of credit will be permitted to expire.

The *PBSR* also sets out the conditions that must be satisfied in order for letters of credit to be considered solvency funding

assets. These conditions include: (1) limiting the entity (i.e., banks and cooperative credit societies) that can issue a qualifying letter of credit; and (2) the requirement to “call” on the letter of credit in certain circumstances, such as insolvency.

VOID AMENDMENTS

The *PBSA* has long contained a provision that voids any plan amendment if the solvency ratio of the pension plan is or would fall below a prescribed solvency ratio level set out in the *PBSR*. However, until now the *PBSR* did not prescribe a solvency ratio for the purpose of this provision. As of April 1, 2011, the *PBSR* prescribes that the solvency ratio level shall be 85 percent. The *PBSR* provides that the sponsor can avoid the void amendment result if it funds the benefit up front such that the amendment would not have the effect of lowering the solvency ratio of the plan. Employers should be conscious of this restriction when amending their pension plans or negotiating with bargaining agents. Amendments agreed to in collective bargaining should be made conditional on there being no requirement for lump sum funding.

DISTRESSED PENSION WORKOUT SCHEME

Bill C-9 contained amendments to the *PBSA* that introduce a new “workout scheme” for distressed pension plans. Distressed pension plans are considered to be those with significant funding deficits, which the employer will not likely be able to fund without jeopardizing the employer’s continuing operations. Workout schemes are intended to provide a framework for parties of a distressed pension plan to negotiate an alternative funding schedule for the plan in order to provide an opportunity for the restructuring of the employer, the plan or both.

The amendments to the *PBSR* provide the necessary detail to support the *PBSA* provisions introducing the workout schemes. To trigger entry into the distressed pension plan workout scheme, the plan sponsor’s board of directors must make a declaration that the plan sponsor does not anticipate being able to meet its upcoming special payments. Upon entry into the scheme, the plan sponsor will be eligible for a short moratorium on special payments of up to nine months after the filing of the declaration.

The plan sponsor will then be at liberty to negotiate changes to its pension arrangements, including the schedule of special payments, with representatives of the plan members, deferred vested members and retirees. Where a workplace is unionized, the bargaining agent will provide representation, while in non-unionized environments and for retirees and other beneficiaries, the *PBSA* provides that a representative will be appointed for these groups by the appropriate court, on the consent of the members and retirees.

The employer and the member representatives can negotiate a revised funding schedule with deficits amortized over a period up to 10 years. The workout scheme must then be submitted to the Minister of Finance for approval, with input and guidance from the Office of the Superintendent of Financial Institutions.

While the workout scheme presents an opportunity for sponsors to restructure their payment obligations, it is only available to distressed pension plans. It does not apply to plans that do not meet the definition of a distressed pension plan nor does it apply if the employer has been assigned into bankruptcy, liquidated or becomes bankrupt under the *Bankruptcy and Insolvency Act*.

EFFECTIVE JANUARY 2011 – MONTHLY CONTRIBUTIONS

Effective January 1, 2011, employers are required to make monthly contributions for normal cost contributions and any special payments. Previously, employers were permitted to make contributions on a quarterly basis. All federally regulated plan sponsors should ensure that they are complying with the new contribution schedule.

EFFECTIVE DECEMBER 2010 – SMALL BENEFIT UNLOCKING

Bill C-47 amended the *PBSA* to increase the small benefit unlocking threshold from 4 percent to 20 percent of the Year's Maximum Pensionable Earnings. Although plans are not required to reflect this unlocking rule, most plans contain the existing rule and plan sponsors will likely wish to take advantage of the higher threshold in order to reduce the costs of administering small pensions.

EFFECTIVE JULY 2010 – CHANGES TO FUNDING AND MINIMUM STANDARDS

Bill C-9 received Royal Assent on July 12, 2010, bringing a number of changes to *PBSA* minimum standards into force. In addition, the Government released amendments to the *PBSR*, effective July 1, 2010, which made significant changes to plan funding rules.

NEW SOLVENCY FUNDING STANDARD TO REDUCE DEFINED BENEFIT FUNDING VOLATILITY

Effective July 1, 2010, one of the most significant changes to the funding rules was the introduction of a new standard for calculating solvency deficiencies. The purpose of the new standard is to reduce funding volatility for sponsors of defined benefit pension plans. Valuation reports are now required to be filed on an annual basis (regardless of the plan's funded status) and solvency funding is determined based upon a three-year average of the funded ratios. Each valuation establishes a new payment schedule of equal annual payments required to fund the plan based on the average solvency ratio, with the deficit being consolidated annually. This change will likely increase plan administration expenses, as prior to July 1, 2010 plan valuations could be prepared and filed once every three years if the plan was well funded. This new methodology is intended to provide plans with some relief from fluctuations in the markets and interest rates.

INTRODUCTION OF A SOLVENCY MARGIN

A solvency margin concept has been introduced for federally regulated pension plans. The solvency margin effectively restricts an employer's ability to take a contribution holiday unless the plan is 105 percent or more funded on a solvency basis.

CHANGES TO THE INVESTMENT REGULATIONS

Amendments to the *PBSR* also made certain changes to Schedule III, which sets out the regulations governing the investment of pension plans. These amendments eliminated certain quantitative limits on the investment of pension assets in natural resources and real estate. These changes were long sought by much of the pension industry.

POWER TO ORDER FULL WIND UP

The Superintendent now has the authority to declare a full plan wind up if benefits cease to be credited to plan members.

ELIMINATION OF EMPLOYER-DECLARED PARTIAL WIND UPS

Employers are no longer permitted to declare partial wind ups of their plans. Only the Superintendent can declare a partial wind up of a pension plan.

Employers who sell a part of their business should consider the potential effect this new restriction will have on members, as the *PBSA* sale of business provisions deem transferred employees' membership in the employer's plan not to have ceased and require such members to continue to accrue service in the plan for the purpose of vesting and benefit entitlements. If the transferring employer and the purchaser do not agree to a transfer of assets and benefit liabilities, the employer will not be permitted to declare a partial wind up to distribute benefits to transferred employees.

RESTRICTIONS ON ANNUITY PURCHASES FROM AN UNDERFUNDED PLAN

The *PBSA* currently requires a plan administrator to obtain the Superintendent's consent to commuted value transfers where the Superintendent is of the view that the transfer would impair the solvency of the pension fund. Bill C-9 expanded this rule to also apply to the purchase of immediate and deferred annuity purchases.

CLARIFYING MARRIAGE BREAKDOWN RULES

The *PBSA* now allows plans to provide for an adjustment to the form of payment of a member's pension if no part of the member's pension benefit is divided for the purpose of the marriage breakdown. The member's pension may be adjusted to become payable in the normal form instead of as a joint and survivor pension. Bill C-9 also amended the *PBSA* to clarify that an administrator has a duty not only to distribute, but also to administer, the pension benefits in accordance with an agreement or court order between former spouses that divides their family property on marriage breakdown.

Plan sponsors can elect to amend their plans to provide the new options available under the *PBSA*. Administrators should also ensure that they are administering all spouses' shares in accordance with the court order or agreement, as well as in compliance with the *PBSA*.

POWER TO REPLACE ACTUARY

Bill C-9 amended the *PBSA* to give the Superintendent the authority to designate an actuary to prepare an actuarial report or termination report in respect of a plan where the Superintendent believes that this is in the best interests of plan beneficiaries. The administrator will be entitled to review a draft of the designated actuary's report and will have the opportunity to provide comments. Once finalized, the plan administrator will be required to fund the plan in accordance with the designated actuary's report.

Bill C-9 also provides that the administrator must pay the reasonable fees and expenses of the designated actuary associated with preparation of the Superintendent-commissioned actuarial report out of the pension fund, which may be intended to override plan or trust language that would otherwise prohibit the payment of administrative expenses from a pension fund.

SIGNIFICANT CHANGES STILL TO COME

"SAFE HARBOUR" RULES

Bill C-47 contains a number of rules specific to defined contribution ("DC") pension plans which have not yet come into force. First and foremost, the *PBSA* will expressly permit members, former members and their beneficiaries to direct the investment of their individual DC accounts. The *PBSA* is currently silent with respect to member-directed investments (which are offered under most DC plans).

The amendments to the *PBSA* will also require that if a plan administrator provides members with individual investment choices, it must provide choices with "varying degrees of risk" and expected investment returns that would allow a reasonable and prudent investor to create a portfolio adapted to his or her particular retirement needs. If the plan administrator makes a prudent range of individual investment options available to members, it will be deemed to have complied with the statutory prudent investor rule. These provisions will provide the plan administrator with a limited version of what is commonly called a "safe harbour" defence, which exists for plan administrators in the U.S. under *ERISA* (the *Employee Retirement Income Security Act*). A "safe harbour" defence prevents members from suing the plan administrator for investment performance when the administrator has (demonstrably) met its standard of prudence in investment selection.

While positive for plan administrators, these new investment rules will be subject to further requirements in future regulations that have not yet been published. It is possible that the regulations, once published, will define what would be "prudent" in

certain circumstances. It is even possible that the regulations will adopt a rules-based approach with specific quantitative requirements for investment options. This would provide more concrete “rules-based” guidance and would generally be preferred by administrators.

Although they will legally apply only to federally regulated plans, any investment requirements in the federal regulations may provide guidance to sponsors of provincially regulated plans and for other self-directed retirement plans.

ADDITIONAL AMENDMENTS TO THE INVESTMENT REGULATIONS

The Government announced in late 2009 that it intends to amend a quantitative limit that prevents pension plans investing more than 10 percent of its portfolio in a single investment, subject to certain exceptions where the administrator does not control the allocation of pooled investments.

The Government also announced in late 2009 that Schedule III of the *PBSR* will be amended to prohibit the direct investment of any assets of a pension plan in the stock or shares of the employer. When this restriction is enacted, all plan administrators will be required to ensure that their pension investments comply with the new limits.

VESTING AND LOCKING-IN

Currently, vesting occurs after two years of plan membership. Bill C-9 amends the *PBSA* to require all members’ benefits to vest immediately upon enrolment in the pension plan for all service, whether accrued before or after January 1, 1987. Locking-in will continue to occur after two years of plan membership.

While not yet in effect, plan sponsors may wish to consider the eligibility provisions of their pension plans in light of the change to immediate vesting. Extending the waiting period before employees become eligible to participate in the pension plan may minimize the costs associated with enrolling and eliminating short service employees. The maximum waiting period continues to be 24 months of continuous employment. Plan sponsors will need to consider whether there are any restrictions on their ability to lengthen the waiting period under their plan (i.e., due to the terms of a collective agreement).

SPOUSAL CONSENT TO TRANSFERS

The *PBSA* will also be amended by Bill C-47 to require a member to obtain his or her spouse’s consent prior to a transfer of the member’s commuted value to a prescribed retirement savings plan. This change will result in increased administrative requirements and administrators will need to ensure that they have received the necessary prescribed consent forms prior to processing a transfer.

PRE-RETIREMENT DEATH BENEFITS

Bill C-9 amends the provisions applicable in the event that a member dies before retirement. The commuted value of the benefit of the deceased member or former member (or account balance, in the case of a DC plan) for all service will be payable to the member’s surviving spouse, calculated as though the member had terminated employment on the date of death. The *PBSA* will also be amended to clarify that if there is no surviving spouse, the death benefit is payable first to the designated beneficiary or, if there is no beneficiary, to the estate of the member or former member. The key change is that pre-retirement death benefits will no longer differentiate on the basis of whether the member was eligible for an immediate pension at the time of death.

ENHANCED DISCLOSURE OBLIGATIONS

Bill C-9 introduces a number of enhanced disclosure obligations to increase transparency for members, former members, and their spouses. Once the changes are in effect, plan administrators will be required, within six months of the plan’s year end,

to send annual statements to deferred vested members, retirees, and their spouses setting out the funded level of the pension plan. These statements may also be required to include other information that will be contained in future regulations.

Members and former members will also be permitted to request copies of additional actuarial- and funding-related documents, such as any documents relating to letters of credit used to fund the plan, or documents relating to a distressed pension plan workout scheme. The *PBSA* is also amended to clarify the obligation to provide statements after a member's death.

Finally, a new requirement has been introduced regarding the provision of information on the termination of a pension plan. Where a plan is terminated, an administrator will be required to provide 30 day advance notice of the plan termination to each member, former member and his or her spouse and inform them that they are entitled to receive a statement of benefits within 120 days of the plan termination.

ELECTRONIC COMMUNICATIONS

For those plan administrators looking to ease their administrative burden by replacing paper with electronic plan communications, Bill C-47 provides for the disclosure of plan information electronically, including annual statements. An administrator will satisfy any requirement under the *PBSA* to provide members and other persons with information by providing the information electronically if the member or person has consented to it and has designated an information system (i.e., an email account) for the receipt of the electronic document. Although the relevant provisions of the *PBSA* are not yet in force, plan administrators may wish to consider whether to implement an electronic communication system to fulfill their pension plan disclosure obligations and develop a strategy to obtain the required consents from plan members and other persons entitled to the information. The process of advising members of their rights with respect to electronic communication and obtaining their consent can take some time. Bill C-47 also provides that any requirement under the *PBSA* for a signature will be satisfied in relation to an electronic document if certain conditions are met. For example, the signature must result from a technology or process that ensures that the signature is unique to the person signing.

"DEEMED TRUST" PROVISIONS

The *PBSA* "deemed trust" provisions deem certain amounts to be held in trust by an employer for the benefit of pension plan beneficiaries and are intended to provide priority to these beneficiaries over an employer's other creditors. Currently, the deemed trust applies to: (1) moneys in a pension fund; (2) the aggregate amount of required payments that have accrued to date; and (3) all amounts deducted from members' remuneration or that are due to the pension fund by the employer.

Bill C-9 provides that additional amounts will be subject to the *PBSA* deemed trust provisions. These amounts would include: (1) payments that have accrued to date under a workout scheme for a distressed pension plan; (2) an amount equal to the face value of the letter of credit, if an issuer of a letter of credit has failed to honour a trustee's demand for payment; and (3) any payments the employer is required pay to amortize a termination deficiency that are due but not paid.

POWER TO REPLACE PLAN ADMINISTRATOR

Once the applicable provision is in effect, Bill C-9 will give the Superintendent broad authority to remove and replace a plan administrator where the administrator is: (1) insolvent; (2) unable to act; or (3) the Superintendent is of the opinion that it would be in the plan beneficiaries' best interests to do so. The reasonable fees and expenses of the replacement administrator would be payable from the pension fund. Currently, the Superintendent does not have the express authority to replace an administrator.

CLARIFYING MULTI-EMPLOYER PENSION PLAN (MEPP) ISSUES

Bill C-9 will amend the *PBSA* to provide greater clarity regarding the application of certain rules and minimum standards for

federally regulated MEPP's. The definition of a MEPP will be amended to clarify that MEPPs can be established pursuant to: (1) a collective agreement; (2) an agreement between participating employers; (3) statute; or (4) regulation.

Federally regulated MEPPs remain subject to the same solvency funding requirements applicable to single employer pension plans ("SEPPs"), but Bill C-9 will amend the *PBSA* to clearly provide that participating employers are required to pay into the pension fund only those contributions that they are required to pay under the collective agreement, agreement between participating employers, statute or regulation, as the case may be. In addition, the *PBSA* is amended to expressly permit the administrator of a MEPP to amend the plan to reduce accrued pension benefits, notwithstanding any language in the plan text to the contrary that would purportedly limit the ability to reduce benefits. An amendment that reduces benefits will continue to require the approval of the Superintendent. These modifications to the federal MEPP rules are beneficial to employers who participate in these plans since they provide clarity regarding employers' obligations vis-à-vis their employees' benefits provided under MEPPs.

PAYMENT OF VARIABLE BENEFITS FROM A DC PLAN

Bill C-9 will amend the *PBSA* to permit DC pension plans to pay benefits to retired members directly from the pension plan. In order to receive a variable benefit, the member must have at least reached early retirement age at his or her date of termination. The amount of the variable payment is to be determined/adjusted on an annual basis. New rules regarding minimum and maximum annual pension payments will also apply.

The election to receive the pension in the form of a variable benefit is only available with spousal consent, if applicable, as the variable benefit is not required to be paid in joint and survivor form. However, the spouse is entitled to receive the balance remaining in the member's DC account on the date of death. If there is no spouse, the remaining DC account balance is paid to a designated beneficiary or the member's estate. An election can be made from year to year whether to continue to maintain the account in the pension plan or to take any of the traditional portability options available to DC plan members.

If an employer wishes to provide variable benefits, its pension plan would need to be amended and the administrator would need to consider the governance, communication, and administrative cost implications associated with allowing terminated employees and retirees to retain their investments within the pension fund.

NEXT STEPS

It has been a very busy year of reform for federally regulated pension plans, with more changes yet to come. We will provide additional updates when further amendments to the *PBSR* are released and more details regarding the pending changes are available.

Now that parts of Bill C-9 and Bill C-47, as well as changes to the *PBSR*, have come into force, sponsors and administrators of federally registered pension plans should carefully assess the implications of these significant pieces of legislation for their businesses and pension plans.

In virtually all cases, Bill C-9 and Bill C-47 require significant changes to a pension plan text, an organization's pension administration practices and its pension governance processes. This reform presents challenges as well as opportunities from a workforce management perspective. In all cases, the impact this will have on your organization and your pension plans will depend on the existing terms of your pension plan and your workforce characteristics.

In the meantime, if you have any questions with respect to the amendments to the *PBSA* and *PBSR*, please contact a member of our Pension & Benefits Practice Group.

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