

PROPOSALS FOR AMENDMENTS TO
THE PENSION BENEFITS ACT OF MANITOBA

THE PENSION COMMISSION OF MANITOBA

DECEMBER 2002

After a review of the Proposals I have decided to comment on three specific areas, which my opinion either need different amendments or clarification. These three areas are:

- Ancillary Benefits and Vesting of Benefits
- Division of Pension Benefits - Marriage Breakdown
- Tests for Solvency

The other areas of the Proposals I agree with but may have some concern about specific limits such as the shortened life expectancy being set at "two" years.

ANCILLARY BENEFITS AND VESTING OF BENEFITS

WHAT DOES THIS MEAN FOR TRANSFER VALUES AND SOLVENCY TESTING ?

The establishment of definitions of basic pension benefits and ancillary pension benefits and how these relate to termination and transfer to commuted values needs to be clarified.

The interpretation of the Pension Commission is that vesting applies to the basic benefits and vesting of ancillary benefits is based on the terms of the particular plan. The example given in the Proposals is that a member who does not satisfy the "Rule of 85" (age + employment service = 85) is not entitled to an unreduced pension.

What does this mean for purposes of a commuted value transfer upon termination of service? For example, if the member is age 54 and has completed 30 years of service (age 54 + 30 years = 84) at the date of termination the Rule of 85 is not satisfied.

1. Is the commuted value of the pension benefit based on a pension commencing at age 65 or a pension starting at age 55 (age 55 + 30 years = 85)?

2. What if the plan permits terminating members to choose a deferred pension and retire early under the same terms as member retiring directly from service?
3. Assume the plan permits a commuted value transfer as long as the pension has not commenced. Assume further, the member chooses not to transfer the pension benefit immediately but rather waits until he attains age 55 and then requests a transfer how then is the commuted value determined?
4. If the answer is that the commuted value would now reflect the early retirement ancillary benefit is there an obligation on the administrator to explain this to the terminating member?
5. For purposes of solvency testing, would the same interpretations apply? For example for the member who has attained age 54 and has completed 30 years of service (age 54 + 30 years = 84), is the solvency value based on a pension starting at age 65 or 55?

RECOMMENDATION – ANCILLARY BENEFITS AND VESTING

The Pension Commission should clarify how basic benefits and ancillary benefits are to be treated for:

- commuted value transfer purposes and
- solvency testing purposes.

DIVISION OF PENSION BENEFITS - MARRIAGE BREAKDOWN

DIVISION OF PENSION BENEFITS BEFORE RETIREMENT

The current method provides for a division of the pension or pension benefit via a lump sum settlement method (LSSM). Under this method, the 50/50 division of the pension benefit earned during the period of cohabitation is split on the assumption that the member has terminated from the plan and is therefore entitled to a termination benefit. This termination benefit is often the commuted value of the accrued pension commencing at the normal retirement age (usually age 65).

The main criticism of the current method is that it does not reflect the true value of the accrued pension that may come to be realized by the member, should the member continue to receive salary increases in the future and then retire at an early retirement age on a subsidized pension. The example given in the "Proposals for Amendments to The Pension Benefits Act of Manitoba" (the Proposals) expresses this quite well. A member with 30 years of credit in a pension plan has generated an accrued annual pension of \$30,000. The member separates after 10 years of marriage and therefore 10 years of pension accrual or \$10,000 of annual pension is to be split 50/50. The plan provides a subsidized unreduced early retirement pension upon the attainment of age 55 and the completion of 30 years of service. Since the member has not reached age 55, the early retirement ancillary benefit has not vested in the member at that point in time and therefore the commuted value of the spouse's share of the accrued annual pension (\$5,000) is based on the pension commencing at the normal retirement age of 65 and produces a lump sum value of \$22,300 per the current method.

However, if this same accrued annual pension of \$5,000 is adjusted for salary increases between age 50 and age 55 of the member and if the member is assumed to commence the pension at age 55, then the commuted value of the spouse's share of the pension becomes \$68,000 or three times greater than that produced by the current method.

The proposed method is to still split the pension accrued during the period of cohabitation on a 50/50 basis but to wait until the member retires or terminates (DSM).

I have the following observations about the current method compared to the proposed method:

1. The current LSSM provides the spouse with a fair value of the share of the accrued benefit if the member terminates from the pension plan within a short period following the marriage breakdown date.

This would also occur under the proposed DSM.

2. The current LSSM also provides the spouse with a fair value of the share of the accrued benefit if the member's plan provides that a member who terminates service may receive the same early retirement benefits as a member retiring directly from service, upon the member reaching the early retirement age. When these conditions exist, the

spouse may actually receive a greater value under the current LSSM than under the proposed DSM.

The proposed DSM may or may not produce a comparable value of the spouse's share of the accrued benefit. For example, if the member decides to retire at age 65 and receives no or modest increases in salary the spouse would receive less under the proposed DSM.

3. The current LSSM does not provide the spouse with a fair share of the accrued benefit if the member continues to participate in the plan, receive salary increases and subsequently retire on a subsidized early retirement pension (in most cases but not always).

The proposed DSM would help alleviate this problem.

4. The current LSSM permits the spouse to receive an immediate lump sum settlement and is no longer tied to the former member spouse.

The proposed DSM does not permit the spouse to receive a benefit immediately and ties the ultimate benefit to the member based on the member's decision as to when to retire or terminate. It seems that while we are disconnecting the spouse from the member when it comes to sharing post-retirement pensions we are reconnecting them when it comes to pre-retirement benefits.

5. The current LSSM is reasonably easy to administer. Lump-sum benefits are determined and usually transferred to a locked in retirement account of the spouse.

The proposed DSM would require the establishment of "notional" member records and the locating of these notional members when the member becomes entitled to a benefit. Some of these notional members will undoubtedly not be able to be located and thus may end up forfeiting a benefit.

RECOMMENDATION – MARRIAGE BREAKDOWN BEFORE RETIREMENT

The proposed change to the DSM be provided as an option to the current LSSM. The spouse would be informed of the potential differences in value.

DIVISION OF PENSION BENEFITS AFTER RETIREMENT

The current method of tying the spouse's ultimate benefits to the member by splitting the pension but retaining the original form of pension can impose hardships on the former spouse. It is logical to have both the member and the spouse receive completely separate pensions independent of each other provided this is done on an actuarially equivalent basis.

We fully endorse this change to the marriage breakdown rules.

TESTS FOR SOLVENCY

The current rules for solvency testing of pension plans are:

1. non-uniform across jurisdictions,
2. produce volatile results,
3. utilize a maximum cost approach,
4. require funding that is front end loaded and
5. are inappropriate for MEPPS.

1. NON UNIFORM SOLVENCY RULES ACROSS JURISDICTIONS

Some jurisdictions allow smoothing of assets, some allow certain benefits to be ignored, some allow the present value of certain contributions to be counted as an asset and one requires the smoothing of the solvency discount rate if assets are being smoothed.

2. SOLVENCY TEST RESULTS ARE VOLATILE

The current solvency legislation in Manitoba results in solvency test results that are volatile depending on the valuation date. A change in the valuation date by as little as two or three months can cause the test to go from a solvency surplus to a solvency deficiency or vice versa. For example, a valuation with a date of March, 1999 would have had a solvency discount rate of 5.75%, yet a valuation with a date of October, 1999 (7 months later) would have had a solvency discount rate of 7.00%. This type of swing in the discount rate can cause the liabilities to decrease by as much as 25%.

The argument often given to justify this type of volatility is that there should be a corresponding reduction in the value of the assets. This simply does not happen. The value of a plan's bond portfolio would not decrease by this much because the duration of the typical bond portfolio is normally lower than the benchmark long Canadas which underlie the basis for the solvency discount rates. In addition, the typical plan will have other assets besides bonds and in particular equities. This category of assets does not react in tandem with changes in the bond markets and some would argue it reacts in the opposite direction.

As a result, a relatively small move in the valuation date can cause a substantial change in the solvency position, yet no material change has taken place with respect to the going concern position. This is at least, in part, the rationale behind Ontario's solvency legislation which requires averaging of the discount rate if averaging of the assets is being used.

RECOMMENDATION – VOLATILITY

If the current approach of prescribing the discount rate is to be continued in conjunction with the ability to smooth assets over a period of no longer than 5 years, the legislation should be amended to permit the actuary to average the discount rate over the same period as the period used for smoothing the assets.

3. MAXIMUM COST APPROACH

The solvency testing requires the actuary to value benefits that in all probability will never be received. For example, the maximum early retirement benefits will not be paid to every member.

RECOMMENDATION – MAXIMUM COST APPROACH

The current legislation should be clarified so that for purposes of solvency testing if a member has not satisfied all the criteria for a subsidized pension, the pension should be valued as a pension available at the normal retirement age. A subsidized pension is a pension which is not actuarially reduced to an equivalent amount to compensate for the earlier commencement of that pension prior to the normal retirement age.

4. FRONT END LOADED

The current regulations for funding solvency deficiencies is 5 years. After the 5-year period, the funding requirements decrease significantly.

RECOMMENDATION – FRONT END LOADING

The current legislation should be amended to permit the funding of solvency deficiencies over 10 years provided a set of criteria are satisfied. For example, the criteria might include but not be limited to:

- Any improvements in past service benefits must be funded over 10 years and must be funded out of new contributions but utilize no more than, say, 75% of new contributions until the solvency deficiency is eliminated.
- Any improvements in future service benefits must be funded out of new contributions but utilize no more than, say, 75% of new contributions until the solvency deficiency is eliminated. In no event should the combined improvements for past service and future service utilize more than 75% of new contributions until the solvency deficiency is eliminated.
- Unfunded liabilities would continue to be funded over the required maximum period of 15 years.

5. INAPPROPRIATE FOR MEPPS

By definition a MEPP is a pension plan generally established by a union or association in conjunction with employers in the industry. A MEPP has unique characteristics including:

- Contributions are negotiated between the union and the employers, the trustees have no power to increase in contributions.
- There are usually many employers, with collective agreements requiring different rates of contributions.
- Movement of employees between employers occurs.
- Depending on the industry and the cycle of the economy participation can be sporadic.
- The Board of Trustees is usually made up of labour and management trustees but not always.
- Even when it is possible to negotiate increased contributions to deal with funding deficits the process can take some time.
- The pension benefit is usually a flat benefit not contingent on salary increases.

A simplified example may help illustrate why the consequences of applying solvency funding rules to MEPPs are significant. Because contribution rates are fixed, the variable factor is the benefit amount. With solvency funding, the trustees must limit the pension promise to the amount that can be provided on wind-up (including expected contributions in the next five years). Consider a plan that can comfortably afford a \$600 pension on a going concern basis and a \$500 pension on a solvency basis. With solvency funding, the benefit is \$500 both in the likely event (plan continuation) and the unlikely event (wind-up). Without solvency funding, the benefit is \$600 in the likely event and is still \$500 in the unlikely one.

Thus today's members are short \$100 every month from what could prudently be provided, solely so that their expectations will be met in the unlikely event of wind-up. There is no current improvement in the wind-up benefit by holding the promised benefit down.

RECOMMENDATION – MEPPS

- i) The actuary perform the solvency test in accordance with the prescribed rules, disclose the results clearly but not be required to initiate any solvency special payments in addition to the going concern special payments.
- ii) Appropriate provisions in the going concern assumptions must be made and disclosed.

- iii) For the going concern basis, the actuary must opine that the going concern funding requirements can be met.
- iv) If the going concern funding requirements cannot be met, the actuary must indicate:
 - a) the increase in contributions that would be required,
 - b) the reduction in benefits that would be required,
 - c) recommended different solutions to the funding deficiency including:
 - (A) possible different reductions to different classes of members such as reducing benefits for active members but not retired members,
 - (B) reducing future benefit accruals without reducing accrued benefits, and/or
 - (C) changing the plan features such as the normal form, or early retirement ancillary benefits.
- v) The trustees should have a formal funding policy document that clearly articulates contingency reserves, objectives, the trustees intended approach to benefit enhancements, and how they will handle a situation in the event of inadequate funds.

RELATED ISSUES TO SOLVENCY TESTING

The following two related issues to solvency testing need to be addressed. These are:

- the treatment of estimated expenses in the solvency ratio calculation and
- the treatment of payment to pensioners when a plan winds-up and there is a wind-up deficiency.

6. ESTIMATED WIND-UP EXPENSES

The current legislation requires the estimated expenses of wind-up be included with the wind-up liabilities. The alternative approach is to reduce the wind-up assets by the appropriate allowance for expenses.

The problem with the current method of including the estimated expenses in the wind-up liabilities is that the wind-up ratio spreads the assets over all liabilities including the wind-up expenses. For example, if the estimated wind-up expenses are \$100,000 and the wind-up ratio is 65% then only 65% of the liabilities can be paid immediately including the estimated expenses. In other words only \$65,000 in theory can be paid for doing the wind-up work.

The Canadian Institute of Actuaries recommends in its valuation technique paper for wind-up valuations that expenses be deducted from the wind-up assets.

RECOMMENDATION – WIND-UP EXPENSES

The current legislation should be changed so that the estimated expenses of wind-up are deducted from the wind-up assets in determining the wind-up ratio.

7. PAYMENTS TO PENSIONERS AFTER WIND-UP

The current policy of the Pension Commission is to not allow the “topping up” of pensions in payment, during the amortization period of a wind-up deficiency, to compensate for the reduction in benefits that has been incurred due to a plan wind-up deficiency.

This policy is different than what is allowed in other jurisdictions where the practice of topping up the pension on a pay-as-you go method is permitted. It is understood that if the plan sponsor is unable to make all of the required special payments to amortize the wind-up deficiency then the subsequent distribution of the assets to pensioners takes into account the top ups they have already received.

Each special payment made by the employer is made on behalf of all members in a proportionate manner. Each payment consists of:

- the amount necessary to cover the current reduction in pensioners’ payments,
- the amount necessary to cover the reduction in pensioners’ payments beyond the 5-year amortization period and
- the amount necessary to cover the reduction in benefits to non-pensioners who received a lump-sum benefit.

As a result at any point in time during the amortization period, if special payments stop, all categories will receive their fair share. No class or group of members will benefit at the expense of another class.

A simplified example may help illustrate. For a plan with \$1,000,000 in wind-up liabilities (75% related to pensioners) and a wind-up ratio of 65% (deficiency of 35%), the amortization payments would be \$6,700 per month. The employer commences special payments to amortize the deficiency and a portion of each payment is used to top up the pensions to pensioners to their original level, but then the special payments cease half way through the amortization schedule. The final settlement of benefits would be as follows:

- Non-pensioners would recover approximately 18.75% of their lost benefit and in total would receive 83.75% (65% + 18.75%) of their original benefit. This is the same proportion had no top up been made to pensioners during the first 2½ years.
- Pensioners would receive 13.68% of their lost benefit and on a go forward basis and in total receive 78.68% (65% + 13.68%). Pensioners receive less than non-pensioners on a go forward basis because they already received a 35% top up in the first 2½ years of the

amortization period. Pensioners would always receive something on a go forward basis perhaps.

Had the 35% top up not been made to the pensioners, they would be able to receive 23.15% of their lost benefit for a total of 88.15% on a go forward basis. To put this another way, payments of 65% for 2½ years and 88.15% thereafter are equivalent to payments of 100% for 2½ years and 78.68% thereafter.

RECOMMENDATION – PAYMENTS TO PENSIONERS AFTER WIND-UP DEFICIENCY

The Pension Commission should adopt a policy which permits a “top up” of pensions to pensioners after a wind-up deficiency has reduced their pensions provided:

- special payments are made per the scheduled payments to amortize the deficiency over 5 years or less and
- in the event the employer is not able to make all the required special payments no class of members gains to the detriment of other members.