

Addressing the Pensions Dilemma in Canada

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Certified General
Accountants Association
of Canada

Addressing the Pensions Dilemma in Canada

BY THE CERTIFIED GENERAL ACCOUNTANTS
ASSOCIATION OF CANADA

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Foreword

Over recent times, we have heard much concern over the state of Canadian pension plans and the issues associated with pension plan management in this, and undoubtedly other countries. Like so many emerging issues, the subject has attracted the attention of various commentators and has been publicly deliberated in the spirit of informing and remedying actual and perceived problems of the regimes. Naturally, this exchange has served to inform. Concurrently, it has necessarily contributed to uneasiness for regulators, beneficiaries and administrators of those plans.

In response to emerging apprehension and in anticipation of growing concern, the Certified General Accountants Association of Canada has seen it timely to commission this paper. Undeniably complex, the purpose and goal of this CGA-Canada paper is to advance understanding of defined benefit (DB) pension plans along with inherent risks and imperfections, to impart a reasonable estimate of the standing of DB pension plans at December 31, 2003 and to explore potential remedies for consideration by stakeholders inclusive of legislators, regulators, standard setters, employers and members. In so doing, CGA-Canada would advocate for public policy which speaks to the interests of Canadians and responds to technical aspects of delineated challenges.

Towards these ends, the Association has recognized the appropriateness of securing the expertise of MERCER Human Resource Consulting in the research and presentation of findings. As a pension authority, MERCER has contributed its in-depth expertise on the subject and has afforded the empirical rigour from which conclusions may be drawn. They have also been invited to assist CGA-Canada in the definition of proposed avenues for change and the formulation of potential recommendations. As such, this paper represents an issuance of CGA-Canada which relies, in large part, on the indispensable contributions of MERCER Human Resource Consulting.

CGA-Canada is committed to making a meaningful contribution to the current debate on pension issues facing Canadians. We have opted to present our findings and recommendations under the three distinct headings of 'Funding', 'Accounting' and 'Public Policy' and trust that the design of this report shall effectively complement the collective efforts of other professional organizations, regulators, plan sponsors, members and their representatives.

Anthony Ariganello

President and Chief Executive Officer

The Certified General Accountants Association of Canada

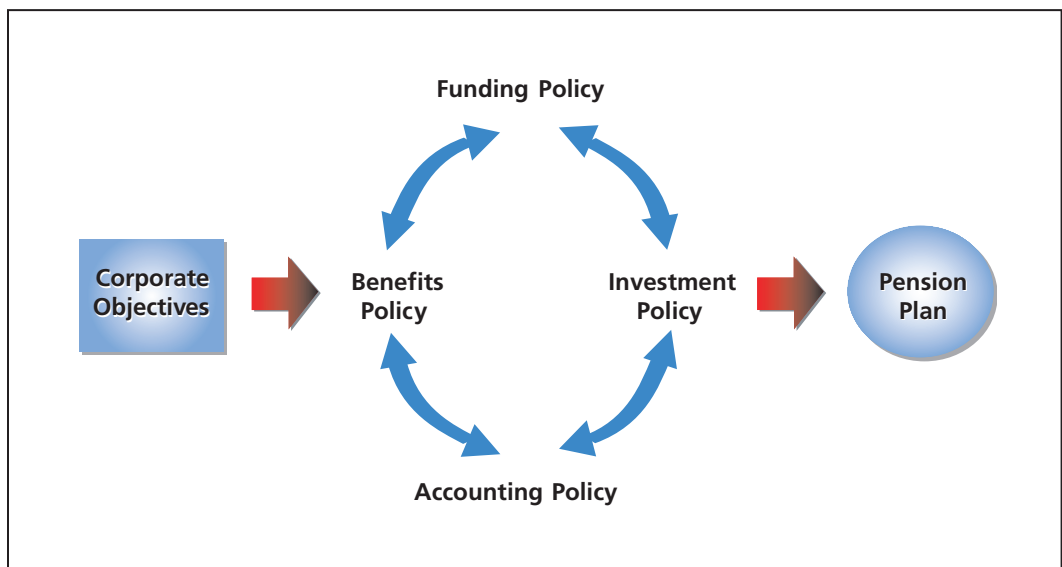
Introduction

The current economic and legislative environment within which pension plans are expected to function, including the recent performance of financial markets, has served to attract substantial concern and scrutiny. Increasingly, pension plan management has occupied prominent relevance on the agendas of organizations and their members. An important outcome of this emerging trend has been the public recognition that sound pension plan management is subject to rather complex factors which must be contemplated in the design of important decisions. Adding to this complexity, is the multitude of participants and stakeholders attracted to, and affected by, those decisions. While this may not be unique to pension plan administration, few topics demarcate as clearly the divergence of interests which can exist between the various participants.

In an attempt to better understand the decision making framework, it is useful to fragment plan considerations into four distinct policy components:

- Benefits policy: benefit entitlements of active members and pensioners;
- Funding policy: nature and timing of contributions;
- Investment policy: mix of investment vehicles and risk exposure; and,
- Accounting policy: measurement and financial statement treatment.

Depicted in graphic form below, these policies originate from corporate objectives of the sponsoring organisation and are in large part inter-related. With a view to preserving corporate and member expectations, competing policy considerations must be weighed so as to achieve a balanced regime.



The focus of this report is on important questions relating to the funding, accounting and policy aspects of defined benefit pension plan management. To a lesser extent, it will promote reflection also on the investment aspects which are inherently linked.

In the interest of clarity, all references to pension plans in this report shall relate specifically to defined benefit (DB) pension plans registered with a provincial or federal pension authority unless otherwise explicitly noted. This paper does not address defined contribution (DC) pension plans, supplementary employee retirement plans (SERP), defined benefit pension plans for Federal public employees (PSSA) or Quebec public employees (RREGOP). Focussing primarily on single employer pension plans, multi-employer pension plans which tend to attract different funding and accounting issues, have been excluded from findings and conclusions expressed herein.

Importantly, the analysis, findings and projections in this paper have been based upon the aggregate performance of 847 defined benefit pension plans. Serving as a representative sample from which to draw conclusions, these plans constitute approximately 30% of all such plans in Canada. As such, our approach has been to evaluate the combined performance of the 847 plans with which MERCER has a professional relationship and required composite knowledge.

In the following Key Findings, it is our goal to present major themes and findings. Throughout the succeeding text, we will build upon the highlighted concepts by introducing greater rigour, analysis and justification. Simultaneously, the Closing Comments section will highlight the more salient features and recommendations of this paper.

Executive Summary

At December 31, 2003, 59% of Canadian defined benefit pension plans continued to be in deficit. Assuming indexation of accrued benefits, it is expected that an additional \$160 billion is required to fully fund those deficits. Seeing that much of this funding level deterioration has occurred as a result of the poor equities market performance of 2001 and 2002 and that future prospects of equities market performance are relatively conservative, it is unlikely that stock market returns alone will correct the situation; at least in the short term. Consequently, it is fair to imagine that plan sponsors will have to make special payments in addition to their normal contributions if they wish to aggressively expunge pension deficits. While plan sponsors have not significantly modified their investment policies, a compelling argument can be made also to encourage greater reliance on risk budgeting processes which justify investment mix and provide a framework by which to monitor the risk embedded in selected and alternative investment portfolios.

Compounding these deficit concerns are regulatory implications which serve to undermine a sponsor's inclination to generously fund pension arrangements. Specifically, the ongoing debate around surplus ownership creates disincentive for plan sponsors in fear that surpluses will be apportioned to members while deficits are generally viewed as the sponsor's responsibility to correct. Regulators can naturally allow plan sponsors and plan members to negotiate their pension arrangements including also the provisions for the apportionment of surplus and deficit between them. Based upon current experience though, there is a concerted degree of pessimism that surplus and deficit disputes can be satisfactorily resolved by relying on goodwill alone. Rather, it seems reasonable that regulatory bodies predefine a fair and equitable approach to surplus distribution. Sponsors and members of contributory plans would be well served by a regulatory regime which articulates surplus attribution rules that are reflective of the respective contribution values of contributors. Alternatively, or taken in tandem, co-op and hybrid (a combination of defined benefit and defined contribution) pension plan models might also delineate a shared burden for deficits such that plan sponsors not assume sole exposure to uncontrollable market conditions.

Having the effect of further intensifying these and related concerns are the accounting standards utilized in the measurement of pension expenses and in the presentation of balance sheet positions. Current methodologies which permit the highly criticized concept of expected return on plan assets and various smoothing mechanisms are increasingly subject to scrutiny. In this light, accounting standard setting bodies are encouraged to further analyse alternatives in an international context with a view to modern economic principles that reflect fair value consideration.

As we make our way through the maze of pension plan controversy, we also come to realize the limitations of the current regulatory landscape which is seen as being unresponsive to a multitude of modern concerns. Within the national and various jurisdictional regimes lies an inherent opportunity to promote more proactive and harmonized measures to deal with the administrative, fiduciary and entitlement anxieties of stakeholders.

Entrenched within the above discussion is the desirability to empower pension plan members to attain increased understanding of their pension arrangements; intrinsic risks, entitlements and expectations; and the actions which they might pursue in planning for retirement. Towards this ends, pension arrangements need be well articulated and communicated with accentuation on the roles and responsibilities of the numerous participants. Pension advisory committees and pension committees, working in harmony with Human Resources departments, are likely the most suitable candidates to take up this duty and should be relied upon to promote understanding of the cost and value of this noteworthy compensation component.

As we forge forward in the investigation of these issues in the text which follows, we are heartened with the level of attention currently devoted to the subject of pension plans. Regrettably, market performance of the various investment devices which have hampered the health of pension funds coupled with low interest rates which have served to inflate pension liabilities have been cause for much attention when in fact there are deeper systemic problems which require redressing. Nevertheless, these market characteristics have sounded a wake-up call which can now be seen as overdue. In effect, the bad news has served to create a foundation from which to explore reform.

Canadians are encouraged to advocate for meaningful reform and are likewise encouraged to adopt best practices in pension plan management. Until such time as the system is perfected, or at least improved, the best policy is to prudently structure plan arrangements which consider and account for the imperfections of pension plan administration. Within a framework of cooperation, mutual stakeholder respect, increased awareness and enriched planning, participants can enjoin influence over pension plan design and sustainability.

Key Findings

Funding

1. THE FUNDING POSITION OF DEFINED BENEFIT PENSION PLANS IN CANADA IMPROVED SLIGHTLY IN 2003 (AS COMPARED TO THE POSITION A YEAR AGO) BUT A MAJORITY OF PENSION PLANS (59%) CONTINUE TO BE IN DEFICIT POSITION AS AT DECEMBER 31, 2003¹.

According to the study of the funding status of 847 defined benefit pension plans in Canada, it has been found that 59% of these plans are in deficit as at December 31, 2003 with an overall funding status (value of assets in relation to promised benefits) of 83% for those plans in deficit. This compares with 67% of plans which were in a deficit position as at December 31, 2002². Arguably modest, this improvement was realized as the result of a year of strong investment performance where Canadian equities experienced returns averaging 26.7%³ while the average pension fund generated a return of 14.0%³. Inopportunistly though, a strong Canadian dollar exchange has served to erode some of the gains made with U.S. investments.

In order to fully ascertain why the net funding situation has not improved further, we are compelled to examine the other side of the formula; specifically the value of the benefits promised or plan liabilities. In general, plan liabilities tend to behave like bonds and are therefore affected by movements in interest rates. The higher the interest rates, the lower the present value of the benefits promised in the future. In 2003, the strong investment returns were offset by a fall in long-term interest rates of about 40 basis points⁴ which accounted for an increase in plan liabilities of approximately 5% to 10%.

2. IT IS ESTIMATED THAT AN ADDITIONAL \$160 BILLION IS REQUIRED TO COVER PENSION PLANS' CURRENT DEFICITS AND TO PROVIDE FOR FUTURE INDEXATION OF ACCRUED BENEFITS.

Upon identification of these market characteristics, a logical question to pose relates to the actual magnitude of the unfunded position of Canadian pension plans. Based upon the premise that the pension plans included in this study represent approximately 30% of all defined benefit pension plans in Canada, it is estimated that if we do not allow for future indexation in benefits the total funding deficit of Canadian defined benefit pension plans at the end of 2003 would be about \$26 billion⁵. But if full indexation of benefits is accounted for, both before and after retirement, the funding gap would be about \$240 billion⁵. In reality, many plans do not adjust pension benefits after retirement and as well, not all pension plans provide for full indexing of benefits prior to retirement. Therefore, the real difference between the value of assets and plan liabilities can be approximated as lying somewhere between these two numbers; around \$160 billion⁵.

1 The funding deficits shown here have been calculated using risk free interest rates, plan assets valued at their fair market values and using no allowance for future salary increases or indexation of benefits.

2 Source: Study performed by MERCER Human Resource Consulting as at December 31, 2002.

3 Source: MERCER Survey of Canadian Institutional Pooled Funds.

4 Calculated as an average reduction in the yields on a blend of long-term government bonds and corporate bonds.

5 The basis of the calculation is provided in Section 4.

3. IT IS UNREALISTIC IN THE SHORT-TERM TO ASSUME THAT STOCK MARKET RETURNS ALONE WILL CORRECT THE SITUATION.

Without special payments to fund current deficits, a typical pension plan which is currently funded at a level of 80% (i.e. assets of the plan cover 80% of the plan liabilities) would need to generate an investment return of about 10% per annum for the next five years to eliminate the current deficit. For a plan which is only 70% funded, it would take more than eight years of double digit investment returns to remedy the current deficit. Considering that the long-term best estimate of future investment returns for a balanced pension fund can reasonably be estimated at around 6.5%⁶ per annum, net of investment and administrative expenses, it would be overly optimistic to rely on equity returns to correct the current situation.

However, the legislative framework for pension plans requires plan sponsors to fund going concern deficits with special payments (in addition to normal contributions) over fifteen years and solvency deficits with special payments over a period not exceeding five years⁷. Therefore, a combination of special payments and reasonable investment returns taken in tandem with a modest increase in the level of long-term interest rates could solve the situation for most pension plans.

For example, net investment returns of 8% per annum (i.e. 1.5% above the long term best estimate) combined with a 1% increase in the level of long-term interest rates and special payments made to the fund in accordance with the minimum funding requirements could correct the current deficit of the 70% funded plan in less than 3 years.

4. ON A SOLVENCY BASIS⁸, \$15 BILLION PER YEAR WILL NEED TO BE INJECTED INTO DEFINED BENEFIT PENSION PLANS IN CANADA OVER THE NEXT FIVE YEARS TO MAKE UP FOR THE INVESTMENT LOSSES PREDOMINANTLY INCURRED IN 2001 AND 2002.

According to an earlier MERCER study for pension plans currently in deficit position, an average special payment (in addition to the normal contribution) equivalent to 10% of the employers' payroll will need to be made by plan sponsors per annum for the next five years to fund current solvency deficits⁸. For the companies examined by MERCER, this represents additional or special contributions of about \$4.4 billion per year for the next five years. Extrapolating to the entire Canadian market, it is envisaged that these special payments can constitute an aggregate of \$15 billion per year for the next five years. In most cases, this would represent a significant drain on companies' cash resources, and at the very least, generate competition for resources which might preferably be deployed towards alternative pursuits.

6 Best estimate based on MERCER Portfolio Return Calculator for a plan invested 55% in equities and 45% in fixed income and assuming that expenses charged to the fund represent 0.5% of the value of the fund.

7 Going concern deficits are measured by focussing on the ability of the pension plan to meet its obligations under the assumption that the plan continues in existence. Solvency deficits, on the other hand, are measured on the assumption that the plan is terminated at the calculation date.

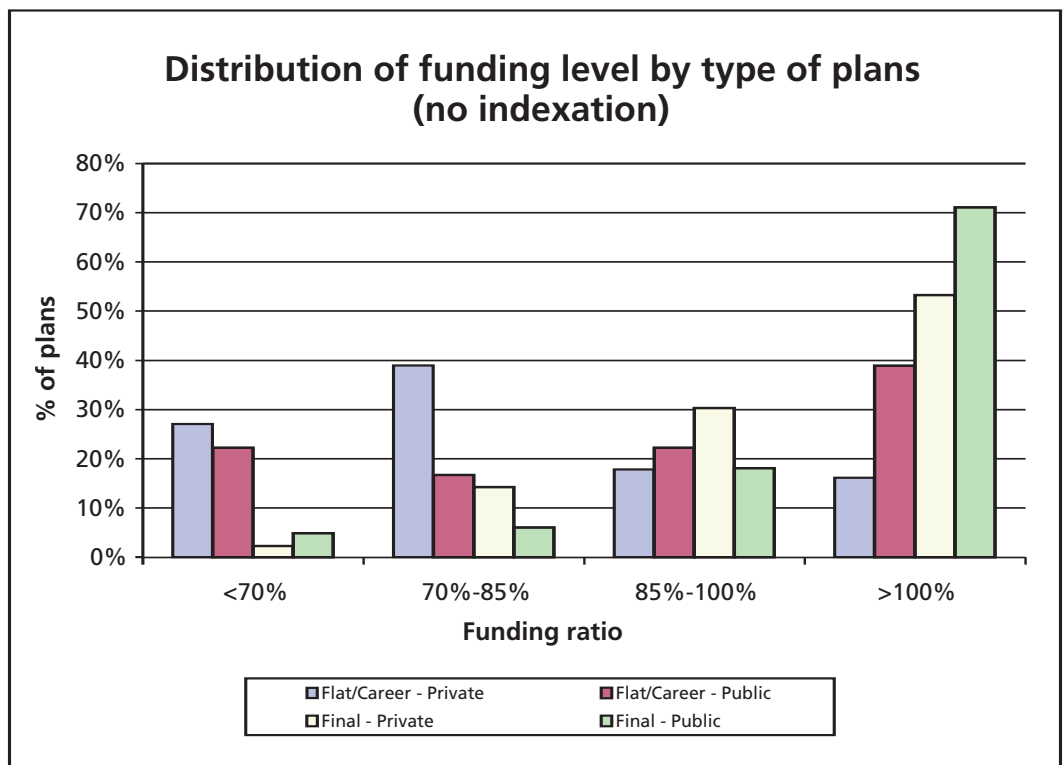
8 The solvency basis focuses on the ability of the plan to meet its obligations assuming that the plan is terminated at the calculation date. Solvency deficits are measured using actuarial methods and assumptions which are prescribed by pension standards legislation and which differ from the methods and assumptions used in our present study.

5. SOME TYPES OF PENSION PLANS ARE MORE SERIOUSLY UNDER FUNDED THAN OTHERS, ESPECIALLY FLAT BENEFIT PLANS.

Study illustrates that flat and career benefit plans are typically more poorly funded than final average plans⁹. According to findings, 27% of flat and career benefit plans in the private sector have a funding level which is below 70%. Flat and career benefit plans are generally provided in unionised environments and tend to be improved regularly as part of the collective bargaining process. However, pension standards legislation does not require the funding of these future improvements until they are effective. And once the funding of these improvements is prompted, it is generally distributed over a number of years rather than over the duration of the collective agreement as permitted by way of paragraph 82 of Section 3461 of the CICA Handbook. Consequently, these plans have a propensity to continuously remain under funded. Comparatively, only 2% of final average plans have a funding level below 70% since the funding of these plans allows for future benefit improvements resulting from increases in salaries.

Chart 1 which follows depicts the distribution of the funding levels across types of plans at December 31, 2003 without future indexation of accrued benefits.

Chart 1 - Distribution of funding level by type of plans



⁹ Flat benefit plans provide a fixed dollar amount (e.g. \$40 per month) for each year of service at retirement. Career benefit plans provide a pension at retirement based on a percentage (e.g. 1.5%) of earnings over the entire period of employment. Final average plans provide a pension at retirement based on a percentage of earnings in the years before retirement (e.g. last or best 5 years of service).

6. SOME PLAN SPONSORS HAVING INADEQUATELY FUNDED PENSION PLANS MAY GO BANKRUPT AND MEMBERS' BENEFITS WOULD HAVE TO BE REDUCED.

The case of Jeffrey Mines in Québec is a recent and unfortunate example of what can transpire when things go wrong. In this case, the mine filed for bankruptcy and the pension plan had to be wound up while its funded level was at only 64%. In this instance, not only have the pensioners and plan members been deprived of a significant portion of their accumulated pension benefits but former employees who volunteered to be part of the pension committee are now being sued through formal litigation for millions of dollars on the alleged grounds of improper administration. In this particular case, the lawsuit extends also to fund managers and actuaries who advised the pension committee.

Other cases on the horizon include those of Air Canada and Stelco, which are currently going through restructuring with both companies having substantial pension deficits. Relying on media attention over recent months, Canadians have been made abundantly aware of some of the issues, concerns and potential consequences of restructuring inclusive of pension considerations which are a component of the broader restructuring landscape.

Having important commercial and social implications, these cases reinforce the fiduciary responsibility that rests on the shoulders of individuals involved in the administration of a pension plan; namely plan sponsors and members of pension committees and boards of directors.

7. MOST PLAN SPONSORS ACCEPT THE MISMATCH BETWEEN PLAN ASSETS AND LIABILITIES. THEREFORE, IN THE FUTURE, THERE WILL CONTINUE TO BE CYCLES OF SURPLUS AND DEFICIT.

While there are some variations in asset mix policy between plan sponsors, as of December 31, 2003 the average pension fund in Canada was invested 56% in equities, 37% in various types of bonds, 2% in real estate and 5% in other instruments. Conversely, plan liabilities (as measured on a solvency basis) tend to behave like bonds.

Most plan sponsors who invest pension assets in equities do so because they believe that this will reduce the long-term cost of the pension plan. But what is sometimes understated is the risk exposure that accompanies such an investment strategy. Therefore, the investment of a significant portion of the pension fund in equities will result in increased volatility of the funding position of the plan. Expectedly, future periods of high equity returns will result in surplus and periods of low equity returns will result in deficit. Therefore, future cycles of surplus/deficit in pension plans are inevitable given their correlation to stock market conditions.

Many factors influence the decision of the plan sponsor respecting the best asset mix but the sponsor's motivation seems to be the optimization of net returns on assets in the spirit of containing the volatility of pension contributions. While it perhaps should, the funding status of the pension plan seems to have much less influence in investment mix considerations. Actually and interestingly, few plan sponsors have changed the asset mix of their plans to reduce the equity component; even in light of the funding situation of their plans and the inherent risk of the equity component. Perhaps the justification lies in the confidence in capital markets recognizing that they are in fact cyclical and are reasonably expected to fare well in the long term.

8. FROM THE PLAN SPONSORS' POINT OF VIEW, THE CURRENT LEGISLATIVE FRAMEWORK DOES NOT PROVIDE THEM WITH AN INCENTIVE TO FUND THEIR PENSION PLANS IN EXCESS OF THE MINIMUM FUNDING REQUIREMENTS. FROM THE PLAN MEMBERS' POINT OF VIEW HOWEVER, THE CURRENT FUNDING SITUATION SHOULD TRIGGER LEGISLATIVE OR REGULATORY CHANGES TO BETTER PROTECT THEIR INTERESTS.

The uncertainty in the position of the regulators and the courts on the surplus ownership issue and their alleged bias towards plan members is a serious disincentive for plan sponsors. Compromising the future health of defined benefit pension plans, the recent case of Monsanto in Ontario serves as a good example. In this case, the court ordered the distribution of surplus to plan members upon the partial termination of the plan after a group of employees were laid-off despite the fact that such distribution would worsen the funding position of the plan and weaken benefit security. This case has sent a very negative message to plan sponsors, discouraging many of them from funding more than the statutory minimum in order to avoid generating surplus which may then be distributed to members rather than being returned to the company. While some arguments might be made that members of contributory plans should share in surplus circumstances and regulation would appear to favour members' rights, the distribution of surpluses to members has tended to be received by sponsors as punitive action. Especially given that plan deficits continue to be viewed as the obligation of the sponsor to remedy. The case has been appealed to the Supreme Court of Canada.

Another example of the uncertainty existing in the current system is in Québec, where since 1993 upon termination of a pension plan, an employer is required to obtain consent from members and pensioners on the distribution of the surplus. Interestingly, this provision applies even if the plan documents clearly provide that the plan surplus is owned by the employer.

Many experts in this country would suggest that the principles which speak to entitlement and equity are abdicated by current pension legislation. If in the view of sponsors, surplus is routinely appropriated by legislation, regulation or the courts, it stands to reason that there exists a real disincentive for plan sponsors to copiously fund their pension plans.

The current funding rules must be reviewed to encourage plan sponsors to fund defined benefit plans prudently:

- Some court cases strongly encourage employers to fund at a minimum. Pension legislation should be amended in light of the implications of these cases, and to protect plan sponsors' contributions which are in excess of the minimum.
- Pension legislation should allow sponsors and their members to define their own pension deals and to establish respective surplus and deficit sharing arrangements including also when and how benefits should be adjusted. To a minimum however, legislators should provide guidelines on fair and equitable allocations of any surplus or deficit.

Concurrently, the following activities could be considered by the regulators to better protect members of a pension plan with a funding deficit:

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- Promote communication to members on the nature and funding status of the plan and the related implications for members and pensioners;
 - Perform actuarial valuations more frequently than once every 3 years where, on a predefined basis, as incremental or extenuating circumstances might warrant;
 - Endorse closer monitoring mechanisms of investment policy requiring seriously under-funded plans to justify an investment policy which has excessive risk;
 - Apply greater scrutiny over benefit improvements within plans having large deficits and prioritizing the funding of benefits that are already promised; and,
 - Promote the establishment of Advisory Pension Committees to assist management in the administration of the pension plans including any risk identification and risk mitigation activities undertaken in those plans. As an illustration, we would refer to the rudimentary terms of reference of such a committee presented in Section 11.

9. FEW PLAN SPONSORS HAVE OPTED TO PROACTIVELY CONTRIBUTE IN EXCESS OF THE MINIMUM REQUIRED BY LEGISLATION IN ORDER TO CORRECT THE SITUATION.

But some have. The highest profile case is General Motors in the U.S. which borrowed \$18.5 billion through a special bond issue in order to fund its entire pension deficit. The move was well received by the market with the value of G.M. shares rising by about 26% after the move. Academically, it could be suggested that they have in effect simply replaced one form of debt by another. From the point of view of the plan members however, this special payment responsibly contributes to the security of their pension. Here in Canada, we have likewise witnessed some increased pension funding. Imperial Oil Ltd. contributed about \$500 million in 2003 (twice the minimum required) to reduce its pension deficit while Canadian Pacific Railways Ltd. also made a voluntary contribution of \$300 million to its pension plan to reduce its deficit. Encouraging as this is, there is little reason to believe that corporations will follow suit en masse in the absence of broader legislative reform.

Accounting

1. CURRENT CANADIAN ACCOUNTING RULES FOR PENSION PLANS ARE NOT SERVING THE INVESTMENT COMMUNITY WELL.

As far as pension plans are concerned, a key concern of investors and financial analysts are plans which have large deficits which do not appear on the corporate balance sheet. In particular, this situation requires these users to adjust the figures provided through GAAP¹⁰ financial statements in order to properly assess the value of a company and the financial risks inherent to pension plans. While the financial analysts who rely on these financial statements have the expertise to make the proper adjustments, an effort to render more transparent the financial results of corporations, would prove beneficial to all stakeholders.

The highly criticised concept of expected return on plan assets and the various smoothing mechanisms contribute to leaving billions of dollars worth of pension

¹⁰ GAAP = Generally Accepted Accounting Principles

deficits (and ultimately corporate debt) off-balance sheet. A study performed by National Bank Financial of 79 Canadian companies representing around 80% of the S&P/TSX market capitalization showed that at the end of 2002, off-balance sheet pension deficits amounted to \$21 billion. Recent studies suggest that these off-balance sheet liabilities have continued to increase through 2003.

However, some would argue that the current accounting rules serve a purpose by insulating plan sponsors' financial statements against external shocks in pension plan holdings. They suggest that a longer term view should be taken in assessing the cost of pension plans. It should be noted that financial analysts are also interested in future company contribution requirements. As future contributions are not known in advance, additional disclosure of management expectations would be appropriate.

2. IN THE FACE OF MUCH CRITICISM, NEW APPROACHES HAVE EMERGED.

In Canada and in the U.S., accounting standards boards decided in 2003 to leave unchanged the basic rules that define how the costs of pension plans are measured and recognised in a company's financial statements. They did decide to require additional disclosures about these pension costs in the notes to the financial statements. The objective is to increase transparency and to provide more information for readers to assess the market risks of plan assets and liabilities as well as future cash requirements. Although these new changes will help, it is doubtful that they alone will meet the requirements of investors and analysts.

In the United Kingdom (U.K.), a new pension accounting standard in the form of FRS 17 is to come into force in 2005. Meanwhile, the International Accounting Standards Board (IASB) has been talking about more closely aligning its pension accounting standard with that of the U.K. IASB's 2003 proposals are however on hold until such time as a tentative joint project with the Financial Accounting Standards Board (FASB) in the U.S. to harmonize pension accounting rules has been concluded. Nevertheless the IASB has issued a proposal to include the option of recognizing full gains and losses in the year which they occur, albeit recognized outside of the main profit figures (as does the FRS in the U.K.).

3. THE APPROACH FAVOURED BY THE U.K. AND IASB WILL HAVE A SIGNIFICANT IMPACT ON THE WAY PENSION COSTS ARE MEASURED AND RECOGNISED ON COMPANIES FINANCIAL STATEMENTS AS WELL AS ON THE CONTINUED EXISTENCE OF DEFINED BENEFIT PENSION PLANS.

- It will make financial statements more transparent by depicting the real picture.
- It will result in more meaningful balance sheets, as the asset or liability recorded on the balance sheet will actually represent the value of the pension plan for the company (generally equal to the plan surplus or deficit).
- It will make pension costs much more volatile (unless 100% of assets are invested in fixed income securities to immunize against changes in liabilities resulting from changes in interest rates), as actuarial gains and losses will be fully recognised as they occur. Investors will have to understand the source of the volatility in order to make appropriate assessments of companies.

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- It could conceivably encourage plan sponsors to close or modify their pension plans as experienced in the U.K. and as suggested by a recent survey of the Committee on Investment of Employee Benefit Assets (CIEBA), an association which represents some of the largest private sector pension plans in the U.S.

4. MOVING FROM CURRENT CANADIAN AND U.S. ACCOUNTING RULES TO THOSE FAVOURED BY THE U.K. AND IASB REPRESENTS A SHIFT FROM ONE END OF THE RANGE TO THE OTHER.

Current Canadian and U.S. accounting rules allow for smoothing of asset variations which serve to defer costs in times of poor investment returns. The rules allow for investment and actuarial gains and losses to be amortized over long periods. In the case of actuarial losses, the amortization period could extend beyond the period over which they must be funded. These smoothing and deferral mechanisms are generally viewed by investors and analysts and as being too lenient. Nevertheless, a change to immediate recognition of gains/losses is perhaps too radical since a plan is long term in nature and funding of a plan occurs over time.

With respect to plan amendments or improvements which increase past service costs, Canadian and U.S. accounting rules require that these costs be amortized over the average remaining service period of active members on the premise that the employer will receive a benefit from having made the plan improvement. This premise certainly has merit for certain plan improvements, but perhaps not for others. For example, one could argue that ad hoc pension benefit increases or negotiated improvements to flat benefit plans should be recognized over a much shorter period of time (e.g. coinciding with the expiration of the collective agreement).

5. THERE IS AN EXPECTATION THAT ACCOUNTING STANDARDS WILL EXPERIENCE INCREASED CONVERGENCE IN THE NEAR FUTURE.

While substantial change in pension accounting has been brought forward in Canada in recent years through the issuance of Section 3461 of the Handbook as well as in the U.S. by way of SFAS 132, there continues to be substantial interest to participate in the design of global converged standards. Currently in Canada, the Accounting Standards Board (AcSB) is awaiting the outcome of the joint meetings of the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB).

Of particular interest to Canadians, reliance on expected returns (anticipating earning a risk premium on plan assets) is under serious scrutiny. The fact is that the resulting anticipated spread between the expected return on pension plan assets and the liability discount rate (risk free yield) can be recognized as a component of earned income. For example, if we were to assume a return on plan assets of 8.5 percent and a liability discount rate (high quality debt instrument) of 6.0 percent, the resulting spread of 2.5 percent or \$25 million per annum for each \$1 billion of pension assets is booked to profit. Importantly, actual experience which differs from the assumed or expected prediction must eventually be recognized. But recognition can be stretched over extended periods of time and serves to understate reported balance sheet deficits. Seen by many

as a problematic misstatement of actual financial performance, there may be significant divergence between reported results and the real mark-to-market (market value) performance. While greatly expanded disclosure rules have been introduced, Canada and the U.S. have nevertheless identified this area as an opportunity for reflection and potential change.

It is too soon to predict the outcome of ongoing deliberations but it is encouraging to note the willingness of participants and decision-makers to take part in meaningful dialogue. It should be noted that not one existing system seems to universally represent a panacea for outstanding issues. In response to criticism of the current pension accounting rules expressed to International, U.S. and Canadian accounting standard setting bodies, it is expected that accounting revisions will seek to eliminate mismatch and associated distortions to the extent possible. Consistent with earlier pronouncements of CGA-Canada, convergence and harmonization of accounting standards, including those on pension accounting, should be pursued.

6. SOME WILL CONTINUE TO SEEK MORE RADICAL CHANGES TO ACCOUNTING STANDARDS.

Based upon our previous discussion, it would appear that a compelling argument can be made to depart from current accounting practice in Canada. That is, intuitive reaction to the preceding discussion naturally invokes a level of discontentment with participants who would seemingly permit distortion of financial results. The real fact of the matter however is that it is difficult to strike a balance which embraces the inherently attractive features of either of the alternatives (expected return vs. market value) and the treatments afforded by “smoothing” and “mark-to-market” methodologies. Without expanding on the various technical aspects, we will generalize that the current model does not report the real cost of the plan; at least in the shorter term. Conversely, mark-to-market or actual current experience does not adequately reflect the optimism which might be expected in future periods resulting from decisions of earlier periods.

At the heart of the accounting and reporting dilemma, is the question of fair and accurate representation. Tied to it, is the question of the audiences making use of the reported information. Naturally, not all are equally served by alternative accounting treatments. But ignoring the divergence of information preferences, we should look at the overall best way to report results on the premise that accuracy is the optimal outcome. Thus, the real question is what represents accuracy to readers of financial statements? Obviously, the jury is out and the reason is as follows. Mark-to-market promotes the utilization of actual or real financial market performance measurement whereas the current actuarial and accounting landscape looks to amortize occurring results over the longer term. Reasonably, the argument can be made that the long term characteristics of a pension plan are such that long term matching is most appropriate. Each has merit but the utilization of expected yields and associated smoothing mechanisms better respond to the fundamentals and constructs of accounting. It is important to acknowledge that the accounting profession has been grappling with the issue for some time and has certainly not chosen to willingly mislead users of financial statements. Rather, it is a fundamental limitation which surfaces when taken in a broader societal context. Inadvertently, the significant market losses of 2001 and 2002 and the increased order

of magnitude (on an absolute basis and as a function of total assets) of pension plans have served to underscore those limitations.

To a great extent, the changes introduced by way of Section 3461 of the current Canadian accounting standards seek to bridge the information gap. Specifically, the revised issuance of March 2004 calls for improved disclosures and augmented transparency. In short, the new principles extend a construct which provide reconciliation between the GAAP compliant financial statements (with limitations discussed above) and the “real” pension cost position. Conceivably viewed by some as a stop-gap measure, CGA-Canada applauds the work of the Accounting Standards Board while simultaneously supporting ongoing examination under the anticipated harmonization conditions which have been set. By virtue of paragraphs 69 and 70 of the ‘Background Information and Basis for Conclusions’ of Section 3461 of the Handbook, CGA-Canada is satisfied that the Accounting Standards Board has seen fit to continue the debate on measurement and recognition and is also amicable to discussion within an international framework.

Tempting as it may be to do away entirely with expectations-based returns and smoothing provisions, we would caution that the impacts of doing so must be fully understood before taking action. Importantly, it must be determined if the appetite to assume increased volatility exists, and if so, whether or not it better serve financial statement users and the markets they serve. Cognitively, we can agree that real values ought to be more accurate and thus more valuable. On a more theoretical level, we question whether greater protection is afforded given that going concern pension plans are measured over the long term and are subject to cyclical market behaviours which contain self-correcting features over time. As previously suggested, this debate must occur if the ultimate goal is to enhance confidence.

Public Policy

1. THE CURRENT LEGAL FRAMEWORK FOR PENSION PLANS IS NOT SERVING PLAN SPONSORS OR PLANS MEMBERS WELL.

Uncertainty related to surplus ownership is a main driver for apprehension. Until the system is seen as having been corrected, Canadians can expect to continue to see resistance from employers in sponsoring defined benefit plans. Based upon past experience, it is unlikely that sponsors will deliberately aim to enrich surplus protection for plan members. Consequently, legislators might wish to revisit the manner in which any surpluses and deficits are allocated between sponsors and members in pursuit of equitable distribution which reflects time-weighted contribution values of the contributors.

A compelling case can be made to unify or to harmonize pension legislation across provincial jurisdictions; especially for those sponsors having multi-jurisdictional plans. Given that these plans must comply with legislative requirements of various jurisdictions, the standards which they are subject to tend to become unwieldy, duplicative and potentially contradictory.

2. PENSION REGULATORS MUST TAKE A MORE PROACTIVE APPROACH AND MONITOR MORE CLOSELY THOSE PENSION PLANS WHICH ARE IN A DEFICIT POSITION.

This monitoring may involve:

- Requiring more frequent actuarial valuations based upon graduated solvency ratios (on a predefined basis, as incremental or extenuating circumstances might warrant);
- Placing constraints on the level of investment risks taken by the pension fund;
- Making additional requirements for plan sponsors who despite funding deficits wish to improve the benefits of the plan; and,
- Requiring more targeted communication on the funded status of the plan to members.

3. AS PENSION PLANS MATURE AND BECOME MORE IMPORTANT RELATIVE TO THE SIZE OF THE ORGANISATION, PENSION ISSUES SHOULD BE ELEVATED AND IN SOME CASES SHOULD BE MONITORED MORE CLOSELY BY THE BOARD OF DIRECTORS. IN THIS RESPECT, AN ADVISORY PENSION COMMITTEE MIGHT BE USEFUL.

Within the current legislative framework, each plan sponsor is responsible to establish its own pension governance structure which includes the mechanisms to be adopted in the design and supervision of funding and investment policies.

In some cases, especially for mature organizations with a significant number of pensioners and with pension deficits, there should be a significant role for the Board of Directors. For example, the Board may want to confirm the investment policy (e.g. how much risk should be taken as measured by the % of assets invested in equities) and the funding policy (e.g. contribution amounts in light of regulatory requirements and potential vulnerability). In the development of its pension plan mandate, the Board of Directors is encouraged to concentrate on such salient policy matters while relying on management and/or an internal Pension Committee to carry out operational functions.

A MERCER survey on pension governance conducted in 2001 revealed that 61% of private sector defined benefit plan sponsors relied on either the Board of Directors or Board sub-committee to approve the funding policy. However, 57% of the same survey respondents indicated that they did not have a formal written funding policy. Not necessarily conclusive in itself, there is reason to suspect that the information does not always flow to those ultimately responsible and that pension related policy is often not predefined or well understood.

4. FEATURES OF THE PENSION PLAN NEED TO BE BETTER UNDERSTOOD BY MEMBERS.

Plan members need to understand better how their pensions are provided for and how they could be affected by the funding status of the plan. Supported by legislative changes, employers should take the lead and explain to plan members how fund surpluses/deficits relate to member costs/benefits. It has been the finding of MERCER that pension committees can be helpful and contribute to increased awareness among plan members.

5. THE TREND TOWARDS DEFINED CONTRIBUTION PENSION PLANS IS EXPECTED TO CONTINUE.

Pension plans have become one of the compensation features adopted by corporations to enhance long-term competitiveness in the marketplace for talent. They are inherent to recruitment and retention strategies of many organizations and as such have rightfully become viewed as part of the total compensation package. Therefore, if pension plans are not meeting these above objectives, compensation practices are possibly not congruent with the enhancement of long-term competitiveness and are failing to achieve the desired or optimal outcome. In those cases, additional and special attention should be directed to the evaluation of those plans and consideration should be given to more responsive plan design(s).

Each type of plan, defined benefit (DB) and defined contribution (DC) has its merits. DC is simpler to administer and lets employees control their pension assets. DB, on the other hand, allows the employer to invest the pension assets in a more efficient way (on the premise of better information and access to superior investment vehicles) and carries with it an apparent guarantee to a certain level of retirement income. DC plans, whilst addressing employer concerns over costs and volatility of costs, create other challenges such as transferring significant risks to individual employees who may be ill prepared to assume those risks or to make effective financial decisions. Furthermore, benefits may end up being inadequate, either through insufficient contribution or from poor investment returns.

There is a global trend; U.S., U.K. and Australia are moving much faster toward defined contribution plans. Employers are increasingly concerned about the supposed value or utility added by being involved in the retirement planning of their employees. Increasingly, new generations of workers are generally better educated and more aware of the issues relating to financial planning for retirement. Instinctively, worker preference to play a more active role in this respect has emerged and is expected to persist. From the shareholder perspective, this furnishes an opportunity for management to concentrate on operational business issues and to leave pension issues to employees who can steward their retirement planning in keeping with respective personal agendas. Therefore, it is expected that Canadian employers will continue to move gradually towards DC plans for the reasons previously cited. Time will tell as to how fast they will move and whether they will all gravitate to a DC position. The ultimate corporate decision to adopt DC, DB or a hybrid regime will of course be influenced by motivation, or lack thereof, to assume the bearing of responsibility.

6. WITH BABY BOOMERS RETIRING, SHORTAGE OF LABOUR HAS BECOME A LOOMING FACT OF LIFE. IN THIS CONTEXT, COSTLY EARLY RETIREMENT SUBSIDIES CURRENTLY PROVIDED THROUGH PENSION ARRANGEMENTS MAY NO LONGER SERVE THE INTEREST OF PLAN SPONSORS AND SOCIETY.

It has been a common feature of many pension plans to provide generous early retirement benefits. For example, in the forest and paper sector, a common feature is to permit unreduced pensions for employees having 58 years of age with 20 years of service despite the normal retirement age being set at 65. In addition, generous additional

benefits are payable between the ages of 58 and 65 years. These early retirement benefits can often represent a cost which is double that which might otherwise be incurred if the employee was to retire under the normal conditions at age 65.

Many now question the logic of these early retirement incentives as the rate of growth in the labour force begins to decline. According to recent projections of the Conference Board, the annual growth in labour force will shift from the current 1.9% to 1.2% by 2010, 0.5% by 2015 and 0.2% per annum by 2020.

7. INFLATION PROTECTION HAS NOT GENERALLY BEEN ENTRENCHED IN CANADIAN PENSION PLANS.

The issue of inflation protection, whether it is after retirement or during the period between termination of employment and date of retirement, has been around for a long time.

After retirement, it is difficult to argue that employers should be forced to provide indexation. Recognizing that registered pension plans are a voluntary exercise in Canada (in fact only 40% of the Canadian labour force belongs to one), employers are not forced to provide a plan nor are they mandated to achieve any particular benefit level.

Between termination and retirement, some would argue that indexing should be required for final average plans or perhaps for all plans since termination benefits from defined benefit pension plans at younger ages are often less than that which would have accumulated under typical defined contribution plans. Defined benefit plans not possessing the characteristic of indexation in the deferral period reward long service older employees at the expense of shorter service younger employees.

Some jurisdictions (e.g. Ontario) adopted automatic indexation as a feature of their pension reform in the late 1980s but this provision has not come into effect. Québec, with the introduction of Bill 102 in 2001, introduced mandatory indexation during deferral period, i.e. between the termination of employment and the date of eligibility for retirement, to protect more mobile workers from the negative effects of inflation on defined benefit plans.

But despite these efforts, there does not seem to be a general trend toward the provision of automatic indexation in defined benefit plans in Canada. As per MERCER's Pension Database, only 17% of pension plans currently provide for automatic indexation of pension payments. Arguably, indexation would become part of private pension deals if sponsors recognized a demonstrated value in doing so.

It is conceivable that the issue of inflation protection is best dealt with through negotiated agreement between plan sponsors and plan members rather than through mandatory indexation in pension legislation. Currently, the notion of indexation has proven simpler to introduce in unionised environments but the framework should be changed so as to encourage greater indexation in both unionized and exempt environments.

3

How the funding situation of pension plans in Canada was measured

Difference between funding and accounting

There is often confusion between the concepts of pension funding and pension accounting. The meaning of each concept is explained below.

Simply stated, pension funding is the amount of cash that is set aside to secure the pension promises made by a plan sponsor to plan members. The amount of cash set aside in a particular year is the function of multiple factors such as the organisation's availability of cash, alternative investment opportunities as well as minimum and maximum funding requirements as respectively defined by provincial and federal pension standards legislation¹¹ and the Income Tax Act.

Pension accounting represents the cost of a pension plan as reported by an organisation in its financial statements. Pension accounting is not dictated by the factors that influence pension funding. Pension accounting is based on a set of principles and rules established by accounting standard setting bodies (e.g. Accounting Standards Board in Canada and the Financial Accounting Standards Board in the U.S.) to enhance comparability between different organisations' financial results.

Funding requirements in Canada

As mentioned above, an employer establishing a pension plan for Canadian employees must fund the plan at a pace which, at a minimum, meets the requirements of the pension standard legislation applicable to its pension plan¹². The minimum funding requirements are determined from an actuarial valuation which must be carried out at least every three years. The actuarial valuation involves comparing the value of plan assets with the value of the benefits (also called plan liabilities) that the plan is expected to pay in the future. The ratio of the value of plan assets to the value of plan liabilities is often referred to as the funding ratio or funding level. For example, a plan with assets worth \$80 million and liabilities valued at \$100 million will be said to have a funding ratio or level of 80%.

When determining the minimum funding requirements, pension standards legislation requires an actuarial valuation be made under the following two bases:

1. A going-concern basis, which focuses on the ability of the plan to meet its obligations assuming that the plan continues in existence, and
2. A solvency basis, which focuses on the ability of the plan to meet its obligations assuming that the plan is terminated at the calculation date.

¹¹ Each province has its own set of rules for pension funding. The federal government also has a set of pension funding rules for federally regulated companies.

¹² Pension plans are registered in the province with the plurality of members.

Both bases require the determination of several assumptions. Assumptions under the going-concern basis are normally left to the discretion of the Actuary based on the specifics of the pension plan to be valued. In the selection of appropriate assumptions, the Actuary is guided by actuarial standards of practice issued by the Canadian Institute of Actuaries. Commonly, the actuary will allow for future increases in benefits and will use a value of plan assets which may or may not fully reflect the fair market value of the assets. Deficits arising from application of the going-concern basis are to generally be made up over a period not exceeding fifteen years.

Assumptions under the solvency basis are largely prescribed by pension standard legislation, leaving little room for discretion, and are based on market interest rates at the date of the valuation. Generally, no allowance is made for future increases in benefits and the value of plan assets correspond to the fair market value. However in some jurisdictions, (e.g. Ontario), in order to reduce the volatility of the funding level and ultimately the contributions to the plan, it is permitted to average the interest rates used to value the plan liabilities and the plan assets over a period not exceeding five years. Deficits arising on the solvency basis are generally made up over a period not exceeding five years.

There is also a third way to measure the funding situation of a pension plan. Referred to as the wind-up basis, this approach is similar to the application of the solvency basis with the proviso however that it does not allow for the exclusion of certain benefits payable upon termination of the plan as solvency valuations may permit, and require the use of the fair market value of plan assets.

The actuarial basis to be used in this study

In measuring the funding situation of pension plans in Canada, we have chosen to use a basis which could be described as follows:

- It is a going-concern basis, i.e. it assumes that pension plans will continue in existence;
- It uses a risk free interest rate, i.e. a rate corresponding to the yields on long-term government bonds;
- It allows for future increases in benefits, before and after retirement;
- It assumes retirement assumptions in accordance with those used by the actuary who performed the original valuation;
- It assumes future mortality that recognises future improvements in pensioners' longevity; and,
- It uses the fair market value of plan assets.

Table 1 below provides a summary of the main assumptions underlying the basis:

Table 1 — Actuarial basis

| | Without indexation of benefits | With indexation of benefits |
|--|---------------------------------------|------------------------------------|
| Interest rate | 5.25% ¹³ | 5.25% ¹³ |
| Indexation (before and after retirement) | 0% | 3% |
| Mortality table | UP94G ¹⁴ | UP94G ¹⁴ |

These assumptions are appropriate in comparing the funding position of various pension plans for the following reasons:

- It removes the inherent discretion in selecting assumptions for actuarial valuations performed on a going-concern basis, i.e. it allows for a common vision of future market conditions; and
- It provides results on a risk free basis as it removes the influence of the investment policies in the selection of the actuarial assumptions.

But it should be noted that very few pension plans in the market place are currently funded using a similar basis. Typically, pension plans are funded using a higher expected interest rate and a weaker mortality table which, if applied to this study, would show lower pension deficits or greater pension surpluses. In this way, the study can be seen as a conservative assessment of the current funding situation of pension plans in Canada.

¹³ Determined from the yields on long-term bonds of Government of Canada at the end of December 2003.

¹⁴ UP94G stands for uninsured pensioner mortality table 1994 generational. This table allows for expected future improvements in pensioners' mortality and is currently seen as a best-estimate mortality table.

4

The funding situation of pension plans in Canada as at December 31, 2003

Limits of the exercise

Readers of this study are cautioned that the results presented in this section have a very short life span. The funding situation of pension plans is affected by a large number of factors (e.g. level of interest rates, stock market performance, inflation, improvements in mortality, etc.), with some of these variables changing on a daily basis. Therefore, in assessing the financial health of pension plans, the date on which the calculations are performed affects greatly the resulting valuation. The results relied upon in this study have been calculated as at December 31, 2003, and as such, should be seen as a snapshot of actuality at that precise point in time and be interpreted in this light.

Data

This study is based on data included in the MERCER Pension Database.

MERCER Pension Database (“MPD”) contains information on the pension plans across Canada for which MERCER Human Resource Consulting provides actuarial and consulting services. The MPD includes information about plan design, plan membership, target asset mix, and the most recent actuarial valuation assumptions and results under the going-concern and solvency bases. The database is updated annually.

The MPD used for this study includes information on actuarial valuations performed between January 1, 2000 and October 31, 2003. Containing some 900 plans, some plans were excluded from the analysis due to data defects contained in some plan profiles which arise as the result of incomplete information, incongruent solvency and funding valuation dates, or outdated valuation dates.

As a result, 847 pension plans were included in this study. These plans cover 1,590,000 members and have total assets of \$187 billion at market value as of the last valuation date (estimated average valuation date of February 2002).

Table 2 below provides a comparison of the assets of pension plans used in this study with the asset base of all defined benefit pension plans in Canada (Registered Pension Plans “RPP” only), as reported by Statistics Canada.

Table 2 — Asset base comparison

| | Market value of assets as at the last valuation date (\$ Billion) | Statistics Canada at December 31, 2000 ¹⁵ (\$ Billion) |
|----------------|--|--|
| Public Sector | \$112 | \$374 |
| Private Sector | \$75 | \$254 |
| Total | \$187 | \$628 |

¹⁵ From Catalogue no. 74-507-XIE, Canada’s Retirement Income Programs: A statistical Overview (1990-2000). Figures shown above exclude assets in governments’ consolidated revenue funds and Defined Contribution assets

Overall, the plans included in this study represent roughly 30% of Canadian RPP market. It should be noted however that the above asset data are not valuated at the same date; Statistics Canada data being at generated as at December 31, 2000 and the MPD data being produced from an *average* February 2002 date.

Furthermore, it is believed that the set of plans included in the MPD is representative of the overall Canadian market, with the exception of Multi Employer Pension Plans (MEPPs) which are under-represented.

Finally, the data on pension plans for Federal public employees (PSSA) and Quebec public employees (RREGOP) is publicly available but has not been included in this study on the basis that they are not subject to the same funding issues/problems as other pension plans in Canada and inclusion would serve to bias comparability of results.

The methodology

In this study, the results of the last valuation (assets and liabilities) were defined and subsequently projected to December 31, 2003.

The projection of the plan assets was done on a market value basis based on the target asset mix of the plan and on the return of the corresponding index over the period. The indexes used were as follows:

- Canadian Equities: S&P/TSX Composite
- US equities: S&P 500 (\$Cdn)
- International equities: MSCI EAFE (\$Cdn)
- Fixed income: Scotia Capital Universe Bonds

The projected December 31, 2003 plan liabilities were arrived at by extrapolating the going-concern liabilities from the last valuation and then adjusted by way of the basis described in Section 3.

Cash flows on plan assets and liabilities in the extrapolation period (e.g. service cost, employee and employer contributions, benefit payments) were estimated based on the results of the last valuation of the plan.

The final results were then broken down by type of plan and sponsorship (private or public), by industry and by work environment.

The results of the study

OVERALL RESULTS

Table 3 (with no indexation) and Table 4 (with indexation) present overall results of the study, comparing pension plans which were in a deficit position to those which were in a surplus position at the end of December 2003. For each group of plans, these tables provide the number of plans studied, the value of plan assets and plan liabilities, the funding surplus or deficit and the funding ratio, i.e. the ratio of plan assets to plan liabilities, under the two bases of future indexation of benefits.

With no indexation of benefits

Table 3 — Overall funding results

| Status | Number of plans | Plan assets market value (\$Bn) | Plan liabilities (\$Bn) | Surplus/ (Deficit) (\$Bn) | Funding ratio |
|--------------------|-----------------|---------------------------------|-------------------------|---------------------------|---------------|
| Plans with deficit | 496 | 38.9 | 46.7 | (7.8) | 83% |
| Plans with surplus | 351 | 171.1 | 138.5 | 32.6 | 124% |
| Total | 847 | 210.0 | 185.2 | 24.8 | 113% |

With indexation of benefits

Table 4 — Overall funding results

| Status | Number of plans | Plan assets market value (\$Bn) | Plan liabilities (\$Bn) | Surplus/ (Deficit) (\$Bn) | Funding ratio |
|--------------------|-----------------|---------------------------------|-------------------------|---------------------------|---------------|
| Plans with deficit | 802 | 205.2 | 277.1 | (71.9) | 74% |
| Plans with surplus | 45 | 4.8 | 4.0 | 0.8 | 120% |
| Total | 847 | 210.0 | 281.1 | (71.1) | 75% |

BY TYPE OF PLAN

Table 5 below presents funding results by type of plan, i.e. flat benefit/career average plans, and final average plans. Flat benefit plans and career average plans are combined as they tend to have similar funding patterns and both are normally funded without allowing for future increases in benefits. Final average plans are based on salaries at retirement and their funding normally allows for future increases in salaries up to retirement. The two types of plans are further categorised by whether they are sponsored by private or public organisations.

Table 5 — Funding results by type of plans

| Type of plan | Number of plans | Plan assets market value (\$Bn) | Funding ratio (no indexation) | Funding ratio (with indexation) |
|-------------------------|-----------------|---------------------------------|-------------------------------|---------------------------------|
| Flat/career – private | 303 | 10.3 | 87% | 57% |
| Flat/career – public | 18 | 4.5 | 106% | 67% |
| Final average – private | 443 | 71.7 | 107% | 72% |
| Final average – public | 83 | 123.5 | 121% | 79% |

BY INDUSTRY

Table 6 below presents funding results by selected industry to determine whether funding results vary by industry.

Table 6 — Funding results by industry

| Type of industry | Number of plans | Plan assets market value (\$Bn) | Funding ratio (no indexation) | Funding ratio (with indexation) |
|-------------------------|-----------------|---------------------------------|-------------------------------|---------------------------------|
| Manufacturing | 379 | 7.6 | 96% | 61% |
| Paper & Forest | 100 | 6.6 | 81% | 55% |
| Other natural resources | 94 | 9.8 | 92% | 64% |
| Financial services | 50 | 17.3 | 105% | 67% |
| Other services | 88 | 52.5 | 115% | 79% |
| Other | 136 | 116.2 | 121% | 78% |

BY WORK ENVIRONMENT (FOR PRIVATE SECTOR ONLY)

Table 7 below presents, for the private sector only, the funding results by work environment, i.e. by whether the employees covered by the pension plans are unionised or not. Some plans cover both unionised and non-unionised employees. Only the private sector is presented as inclusion of some very large public sector plans would unreasonably skew the analysis.

Table 7 — Funding results by work environment

| Work environment | Number of plans | Plan assets market value (\$Bn) | Funding ratio (no indexation) | Funding ratio (with indexation) |
|------------------|-----------------|---------------------------------|-------------------------------|---------------------------------|
| Non-Unionised | 432 | 36.2 | 104% | 69% |
| Unionised | 256 | 23.2 | 93% | 63% |
| Both | 58 | 22.6 | 116% | 80% |

An illustration for the Canadian market

To illustrate the extent of the funding situation of pension plans in Canada, the results of this study were extrapolated to the entire Canadian market. Table 8 below provides funding deficit under two bases, i.e. no indexation and with indexation.

Table 8 — Illustration for the Canadian market

| Bases | Funding deficit (\$Bn) |
|-----------------|------------------------|
| No indexation | 26 |
| With indexation | 240 |

Really, how much money is the funding deficit then? Under no indexation of benefits, the gap is \$26 billion whereas if future indexation of benefits is considered, both before and after retirement, the funding gap is \$240 billion. In reality, many plans do not adjust pension after retirement and not all pension plans provide for full indexing of benefits prior to retirement¹⁶, therefore the real funding gap is somewhere in between these two numbers.

With the assistance of MERCER, it is estimated that the current funding gap of defined benefit plans in Canada is about \$160 billion. This number was arrived at relying on the assumption that all pension plans, regardless of their type, would be fully indexed one way or another before retirement. In so far as providing for indexation after retirement, it was assumed that pension plans which currently provide automatic indexation (e.g. 17% of all plans) would continue to do so in the future and that all others would provide an average indexation of 1% per annum.

Comments on the results

BY TYPE OF PLAN

It is not surprising to observe that flat and career benefit plans are more poorly funded than final average plans. Looking at the private sector only, the average funding level of flat and career benefit plans is 87% without future indexation of benefits and 57% with indexation. This compares with funding levels of 107% and 72% for final average plans. A similar conclusion is discovered when we look at the public sector alone. Why is this so? Even though flat and career benefit plans are improved regularly, the minimum funding requirements of pension standards legislation do not require the funding of these future improvements until they are effective. And once the funding of these improvements starts, it is generally spread over many years (5 to 15 years). Therefore, these plans are continuously under funded. In contrast, final average plans are funded by allowing for future increases in salaries which result in a more gradual funding of these plans.

It should be noted that 82 of the flat and career benefit plans in the private sector (i.e. 27% of them) have a funding level below 70%. Table 9 below shows a distribution of the funding level as of December 31, 2003 by type of plans without future indexation of benefits.

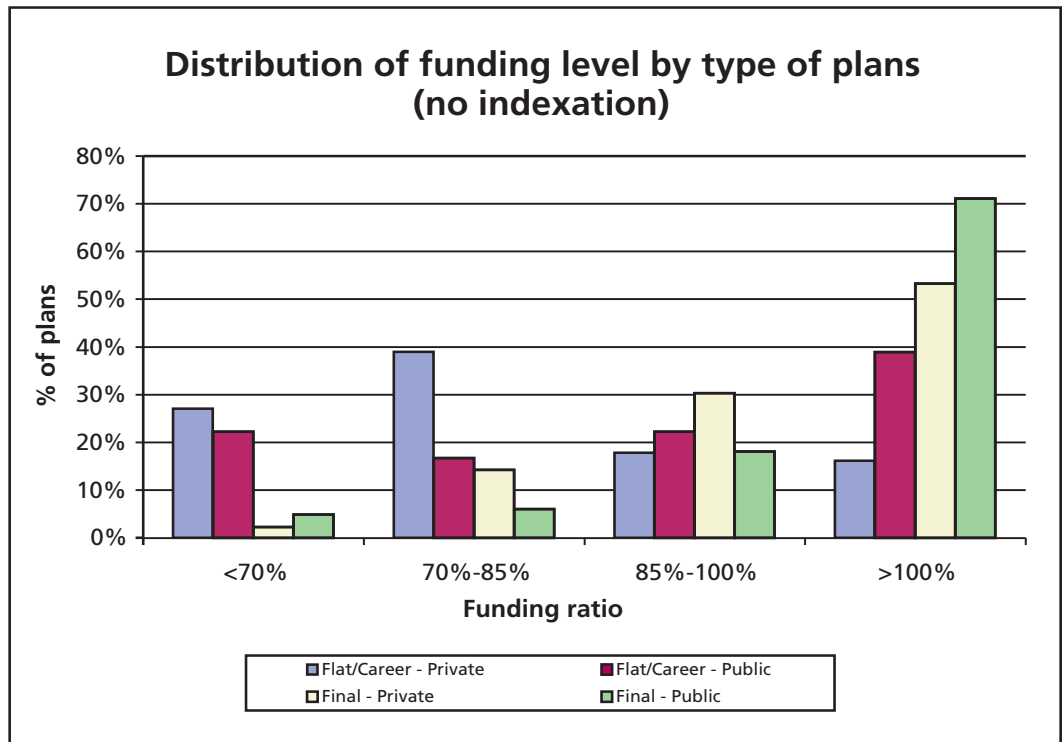
Table 9 — Distribution of funding level

| Type of plans | Number of plans | | | | |
|-------------------------|-----------------|---|-------------------|--------------------|----------------|
| | Total | Number of plans with funding level without indexation | | | |
| | | Less than 70% | Between 70% - 85% | Between 85% - 100% | More than 100% |
| Flat/career – private | 303 | 82 | 118 | 54 | 49 |
| Flat/career — public | 18 | 4 | 3 | 4 | 7 |
| Final average – private | 443 | 10 | 63 | 134 | 236 |
| Final average – public | 83 | 4 | 5 | 15 | 59 |

¹⁶ Final average plans allows for full indexing of benefits up to retirement while flat and career plans will tend to be improved on an ad-hoc basis which might or might not allow for full indexing of benefits up to retirement.

Chart 2 below presents the same results in the form of a graph.

Chart 2 - Distribution of funding level



BY INDUSTRY

The main industries considered in this study are manufacturing, natural resources (showing separately the paper & forest sector) and service (showing separately the financial service sector). All pension plans which did not fall into one of these categories were classified as “other”.

As at December 31, 2003, pension plans in the service industry were much better funded than pension plans in the manufacturing or natural resource industries. This can be explained by the fact that the manufacturing and natural resource industries have a higher concentration of flat and career benefit plans while the service industry is dominated by final average plans. The paper & forest sector is particularly under funded compared to other sectors.

BY WORK ENVIRONMENT (FOR PRIVATE SECTOR ONLY)

Three categorizations of plans were reviewed, plans covering only unionised employees, plans covering only non-unionised employees, and plans covering both unionised and non-unionised employees. As at December 31, 2003, non-unionised plans were generally better funded than unionised plans. Once again, part of the explanation is that there is a higher concentration of flat and career benefit plans in unionised environments and as mentioned earlier these plans tend to be more poorly funded than final average plans. On the other hand, it is also possible that the bargaining process of recent years may have led to benefit improvements which depleted available surpluses or increased deficits.

5

How the funding situation can be expected to evolve in the next 5 years

Introduction

Addressing this issue for the economy as a whole is a difficult exercise as no two pension plans are exactly identical and each will respond differently to external factors affecting them such as movement in interest rates or stock market performance. Nevertheless, we have attempted to portray the projected funding position of the pension plans included in the study to the end of the next 5-year period. The approach has been to present conclusions under the three different economic scenarios which are described in the methodology section below.

In complementary fashion we have also presented, for typical pension plans, the following:

- The return that should be generated by pension funds in the next 5 years to correct the current deficits; and
- The increase required in the level of long-term interest rates to eliminate the current deficits.

The methodology

The identical methodology as that described in Section 4 has been used in projecting the funding position of pension plans over next 5-year period except that financial and economic variables were projected under three different economic scenarios; best estimate, pessimistic and optimistic (pessimistic and optimistic being interpreted in the context of a pension plan). Projected variables include inflation, interest rates and investment return for each asset class. These variables were first projected over the 5-year period as per the best estimate scenario and then alternative scenarios were derived in keeping with the following definitions:

BEST ESTIMATE SCENARIO

The best estimate scenario is characterised by low and stable inflation (i.e. remaining at its current level) and moderate economic growth. The average annual return over the projection period is assumed to be 8.15%¹⁷ on the equity portion of the fund and 4.36%¹⁸ on the bond portion of the fund. The long-term bond yield at the end of the projection period is assumed to be 5.1% net of investment and administrative expenses.

¹⁷ The assumed investment return of 8.15% on the equity portion of the fund is the sum of a risk free return of 5.25% (based on the yields on long-term bonds from the Government of Canada) and an equity risk premium of 2.90%.

¹⁸ The assumed investment return of 4.36% on the bond portion of the fund is based on the expected return on a portfolio of corporate and government bonds of various maturities. The average returns over the 5-year period being 3.70% for short-term bonds, 4.34% for medium-term bonds and 5.55% for long-term bonds.

PESSIMISTIC SCENARIO

The pessimistic scenario is characterised by lower inflation, lower interest rates and lower equity returns. The annual return over the projection period is assumed to be 3.60% on the equity portion of the fund and 4.90% on the bond portion of the fund. The long-term bond yield at the end of the projection period is assumed to be 4.4% net of investment and administrative expenses.

OPTIMISTIC SCENARIO

The optimistic scenario is characterised by higher inflation, higher interest rates and higher equity returns. The annual return over the projection period is assumed to be 13.20% on the equity portion of the fund and 3.70% on the bond portion of the fund. The long-term bond yield at the end of the projection period is assumed to be 6.1% net of investment and administrative expenses.

The results of the study

MACRO LEVEL

The plans that are currently in deficit position, their funding position at the end of the 5-year projection period under the three different economic scenarios described above, and the two basis of future indexation of benefits described in Section 3, are presented below: With no indexation of benefits

Table 10 — Funding position as at December 31, 2008

| | Position as at December 31, 2003 ¹⁹ | Position as at December 31, 2008 | | |
|------------------------------------|--|----------------------------------|-------------|------------|
| | | Best estimate | Pessimistic | Optimistic |
| Plan assets at market value (\$Bn) | 38.9 | 58.0 | 53.8 | 61.5 |
| Funding surplus/ (deficit) (\$Bn) | (7.8) | (0.3) | (9.4) | 8.7 |
| Funding ratio | 83% | 100% | 85% | 117% |

With indexation of benefits

Table 11 — Funding position as at December 31, 2008

| | Position as at December 31, 2003 ²⁰ | Position as at December 31, 2008 | | |
|------------------------------------|--|----------------------------------|-------------|------------|
| | | Best estimate | Pessimistic | Optimistic |
| Plan assets at market value (\$Bn) | 205.2 | 285.6 | 265.5 | 307.2 |
| Funding surplus/ (deficit) (\$Bn) | (71.9) | (86.0) | (112.7) | (54.5) |
| Funding ratio | 74% | 77% | 70% | 85% |

¹⁹ For 496 pension plans in deficit as at December 31, 2003

²⁰ For 802 pension plans in deficit as at December 31, 2003

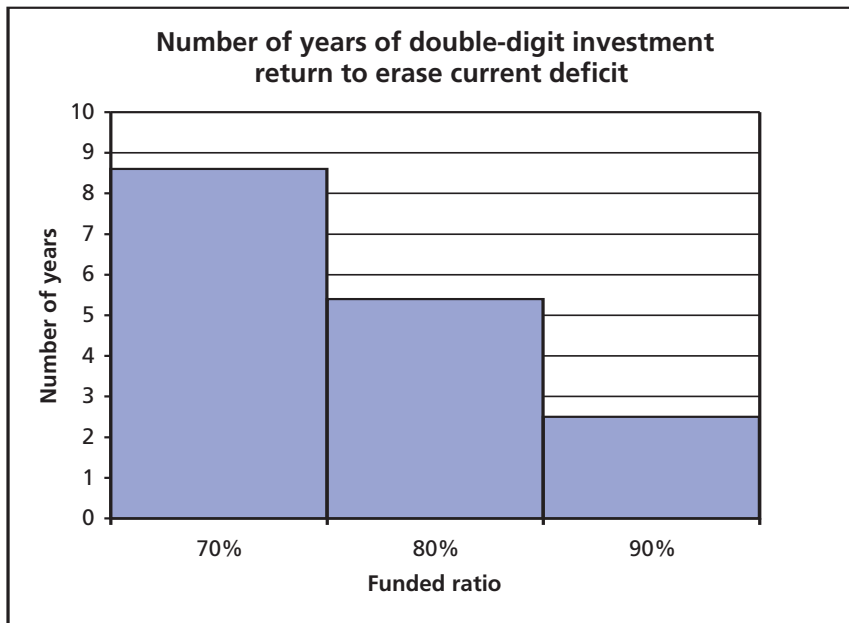
Table 10 depicts that for pension plans which are currently in a deficit position, assuming that the experience of the next five years goes in accordance with our best estimate scenario, these plans would be fully funded at the end of the 5-year period. This, however, assumes that no indexation of benefits would be provided beyond the 5-year period. This conclusion is consistent with current minimum funding rules which require the funding of deficits on a solvency basis over a period not exceeding five years.

However, even in a favourable environment, when future indexation of benefits beyond the 5-year period is considered, the pension plans in general would still be inadequately funded at the end of the 5-year period, as evidenced by the 85% funding level under the optimistic scenario in Table 11.

MICRO LEVEL

Assuming that interest rates stay at their current level and only normal contributions are made to the funds, the pension plans with funding levels of 70%, 80% and 90%, the calculated number of years of double-digit investment returns (e.g. 10% per annum, net of investment and administrative expenses) needed to eliminate current deficits are presented in Chart 3 below.

Chart 3 - Distribution of funding level



Therefore, without special payments to fund current deficits, a typical pension plan which is currently funded at a level of 80% (i.e. assets of the plan cover 80% of the plan liabilities) would need to generate an investment return of 10% per annum, net of investment and administrative expenses, for the next five years to expunge the current deficit. For a plan which is only 70% funded, it would take about eight years of double digit investment returns to eliminate the current deficit.

Considering that the long-term best estimate of future investment returns for a balance pension fund is around 6.5%²¹ per annum, net of investment and administrative expenses, it would be exceedingly optimistic to rely only upon equity returns to correct the current situation.

However, the legislative framework for pension plans requires plan sponsors to fund going-concern deficits²² with special payments over fifteen years and solvency deficits²³ with special payments over a period not exceeding five years. Therefore, a combination of special payments and reasonable investment returns coupled with a modest increase in the level of interest rates could solve the situation for most pension plans.

For example, net investment returns for the entire fund of 8% per annum (i.e. 1.5% above the long-term best estimate) combined with a 1% increase in the level of long-term interest rates and special payments made to the fund in accordance with the minimum funding requirements would correct the current deficit of the 70% funded plan over less than 3 years.

21 Best estimate based on MERCER Portfolio Return Calculator for a plan invested 55% in equities and 45% in fixed income and assuming that expenses charged to the fund represent 0.5% of the value of the fund. The assumed return on the equity portion of the fund includes an equity risk premium of 2.90%.

22 Going-concern deficits are measured by focusing on the ability of the pension plan to meet its obligations assuming that the plan continues in existence. Assumptions and methods are determined by the Actuary based on the specifics of the plan.

23 Solvency deficits are measured by focusing on the ability of the pension plan to meet its obligations assuming that the plan is terminated at the calculation date. Assumptions and methods are prescribed by pension standards legislations.

6

The current measures to redress the situation for plans in deficit and their financial consequences

Current regulatory requirements

The requirements to eliminate current pension deficits are defined in provincial pension standards legislation for provincially regulated companies, and the federal pension standards legislation for federally regulated companies. Each of these respective legislative structures has its own sets of rules defining the pace at which deficits occurring over time will be funded. While these rules are fairly complex, they do revolve around the same basic principles. Specifically that deficits occurring on a going-concern basis (i.e. assuming that the plan remain in existence) must be made up over a period of fifteen years whereas deficits occurring on a solvency basis (i.e. assuming that the plan terminates at the date of the valuation) have to be made up over a period not exceeding five years.

As previously explained, solvency deficits are affected by changes in the level of long-term interest rates and by the performance of the stock market. Over the four year period from the end of 1999 to the end of 2003, long-term interest rates (as measured by the yields on long-term Government of Canada bonds) declined by more than one percent (from 6.25% to 5.14%) while at the same time the Canadian stock market performed poorly, generating an annual return of 1% over the period (as measured by the performance of the S&P/TSX composite index). What this has meant is that pension plans which were in a surplus position four years ago are now in a deficit position. Triggering the need for plan sponsors to now make special payments in addition to their normal contributions, many are now required to set aside a significant portion of their payrolls in order to eliminate these deficits over a period not exceeding five years.

The fiduciary role of the plan sponsors

In addition to pension standards legislation which aims to protect pension plan members, plan sponsors have a fiduciary role in the management of pension plans.

In many jurisdictions, the plan sponsor is also the plan administrator and to that effect is required to manage the plan with care, diligence and skill that a person of ordinary prudence would exercise in dealing with property of others.

Among the most important tasks that a plan sponsor deals with is the establishment of funding and investment policy for the administration of a pension plan. In doing so, plan sponsors have a duty to establish policies which on the one hand make the pension plan affordable and on the other hand provide for a reasonable level of security of plan members' promised benefits.

The role of the Pension Benefits Guarantee Fund (PBGF)

Ontario is the only jurisdiction in Canada having a fund that guarantees benefits to Ontario members whose pension plan is terminated and the plan sponsor is insolvent.

Albeit perhaps modest, the Guarantee Fund provides a level of benefits up to \$1,000 per month. Financed with a special levy collected from plan sponsors on the basis of their pension plan's funding level on a solvency basis, the better is the funding level of the plan the lower is the levy.

This fund has been in place in Ontario for more than 20 years and one might wonder why other provinces have not implemented similar funds. Financially healthy sponsors often have well funded pension plans and see PBGF levies as an additional tax while less healthy sponsors might see it as an insurance policy and could be tempted to provide benefits that could not otherwise be afforded. But more importantly, the effect of a single large bankruptcy on the financials of the Fund could be devastating.

A case in point is the current Stelco situation (where the company is in bankruptcy protection and the deficit of the pension plan is three to four times the size of the Guarantee Fund) will tell the story. Should Stelco not weather the storm and should members be compelled to claim under the Guarantee Fund which itself cannot absorb the obligations (even at reduced and capped levels); we must ask ourselves where the difference is to come from. Naturally, as an obligation of the government, it would in fact have to be subsidized by Ontario taxpayers. Therefore, although this kind of guarantee fund adds to the security of pension benefits for members, it does extend the risks to unrelated parties.

It is interesting to note that the U.S. has a similar guarantee fund in the form of a federal act which guarantees part of the benefits related to terminated plans in deficit.

The role of the actuary

Actuaries have an important role to play in the funding of pension plans. They normally select the methods and assumptions used to set the level of contributions needed to fund the promised benefits. In selecting these methods and assumptions, the actuary will be guided by standards of practice with consideration to the funding policy established by the plan sponsor. Actuaries normally advise plan sponsors in the establishment of funding policy recognizing that funding policy will vary between sponsors and will by in large be dictated by their respective levels of motivation to preserve stability in contribution levels or a desire to minimise (reduce) or maximise (enrich) the contribution levels. In practice, most private sector sponsors tend to contribute the minimum level required.

Avenues available to plan sponsors

Having experienced deficits, plan sponsors have pursued various strategies to remedy the situation. Presented below are potential strategies, ordered from the least to the most intrusive to plan members.

1. CONTRIBUTE THE MINIMUM REQUIRED, AND HOPE FOR SOLID STOCK MARKET PERFORMANCE IN THE COMING YEARS

The majority of plan sponsors have followed this strategy. For many of them, it seemed

to be the most sensible option considering the state of the current legislative framework for pension plans which discourage plan sponsors to fund their pension plans in excess of the minimum funding requirements. The uncertainty in the position of the regulators and the courts on surplus ownership and their perceived bias towards plan members has become a serious disincentive for plan sponsors.

2. INCREASE THE LEVEL OF EMPLOYER CONTRIBUTIONS IN LINE WITH MORE UP TO DATE REALITIES

According to Statistics Canada, plan sponsors contributed \$12.6 billion in 2002, up from \$7.3 billion in 2000. It is hard to determine how much of this amount has been due to revised minimum funding requirements following an actuarial valuation and how much has been initiated voluntarily by plan sponsors. Nevertheless, some plan sponsors have taken the bull by the horns and contributed in excess of the minimum funding requirements. The highest profile case is General Motors in the U.S. which borrowed \$18.5 billion through a special bond issue in order to fund its entire pension deficit. While, the move was well received by the market with G.M. shares rising by about 26% after the move, it in fact, simply replaced one form of debt by another. From the plan members' point of view, this special contribution makes their pensions more secure. In Canada, there is evidence of increased pension funding as well. For example, Imperial Oil Ltd contributed around \$500 million in 2003 (twice the minimum required) to reduce its pension deficit and Canadian Pacific Railways Ltd. also made a voluntary contribution of \$300 million to its pension plan to reduce its deficit.

3. CHANGE THE INVESTMENT POLICY

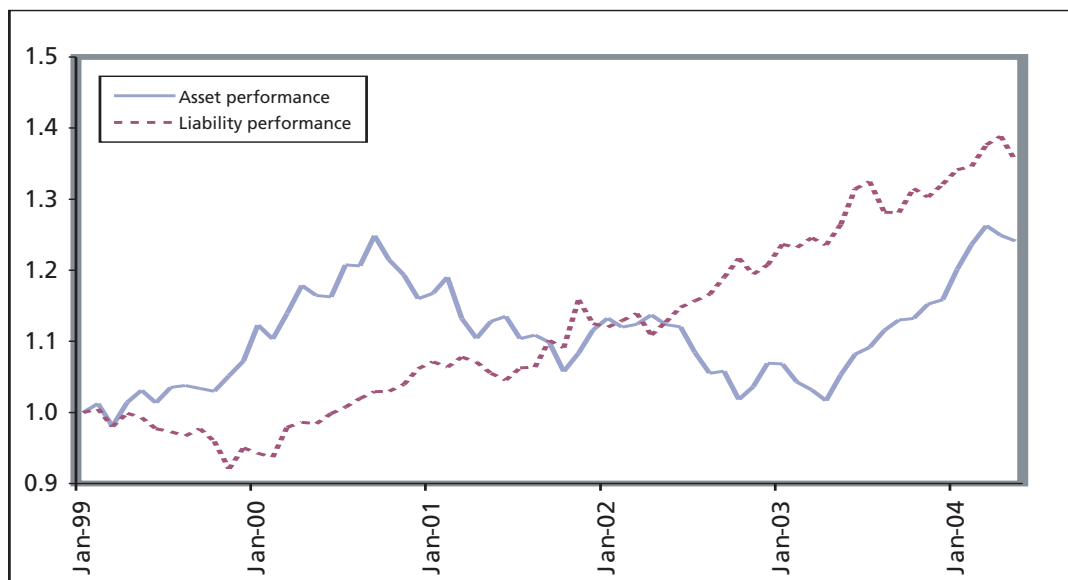
Any significant change in pension plans' investment policy has not surfaced in the conduct of this study. Of the 847 pension plans studied, the target equity content of these pension plans has been seen to decrease only slightly from 56.8% to 55.6% during the one year period from December 31, 2002 to December 31, 2003.

Admittedly, change in investment policy does not immediately impact the funding position of a pension plan but it reasonably does limit the potential volatility of future funding levels. While most financial institutions such as banks and insurance companies expend a great deal of effort to try to match their assets and liabilities, most plan sponsors accept the mismatch that exists between them.

As of December 31, 2003, the average pension fund in Canada was invested 56% in equities, 37% in various types of bonds, 2% in real estate and 5% in other instruments; but there are some variations in asset mix policy between plan sponsors.

In general, plan liabilities (as measured on a solvency basis) tend to behave more like bonds, therefore the investment of a significant portion of the pension fund in equities will result in increased volatility of the funding position of the plan. Future periods of high equity returns will result in surplus, and periods of low equity returns will result in deficit. Therefore, future cycles of surplus/deficit in pension plans are inevitable as much as cycles in the stock market are. This phenomenon is illustrated in Chart 4.

Chart 4 - Illustration of the mismatch of plan assets and liabilities



The chart shows the movement of plan assets and liabilities for a typical pension plan over the last five years assuming that both were equal at the beginning of the period. One can see that while the plan liabilities steadily increased over the period, the plan asset behaved more erratically, as did the stock market. Therefore, because of the mismatch of plan assets and liabilities generally occurring in the first half of the 5-year period, a typical pension plan was in surplus position, while the inverse produces itself in the second half of the period with plan liabilities clearly exceeding plan assets.

4. ASK THE EMPLOYEES TO CONTRIBUTE TO THE PLAN IF THEY ARE NOT CONTRIBUTING, OR IF THEY ARE ALREADY CONTRIBUTING, TO INCREASE THE LEVEL OF EMPLOYEE CONTRIBUTIONS

With pension contributions reaching levels unseen before, some plan sponsors are tempted to share the bill with plan members. Some plan sponsors have succeeded but there is no evidence of a widespread trend. The Ontario public sector pension plans could serve as a model as the practice in these plans is that both sponsor and member contributions fluctuate in good times and in bad times on an equally shared 50/50 basis. It is considered unlikely at this time that many private sector pension plans would adopt a similar cost sharing model.

5. MAKE SUBSTANTIAL CHANGES TO THE CURRENT BENEFIT PROMISES

Pension standards legislation generally protects benefits accrued up to a certain date, that is benefits that have been accumulated based on current salary and service. However, a plan sponsor can change the defined benefit formula in respect to future years of service. Here are two examples:

- a) Change the early retirement conditions for those who have not yet qualified

It would have an immediate impact on the plan's funded level and would also reduce future contribution levels.

b) Reduce pension formula for future service

It would not have an immediate impact on the plan's funded level but would reduce future contribution levels.

6. INTRODUCE DEFINED CONTRIBUTION ELEMENTS TO THE PENSION FORMULA

Pension plans are one of the tools available to organizations to enhance long-term competitiveness in the marketplace. As such, they are a part of talent recruitment and retention strategies and represent part of the total compensation package. If pension plans are not meeting these above objectives, they are not congruent with the enhancement of long-term competitiveness and should attract special attention from management so as to correct, or where necessary, make changes to the current plans or regimes.

Each type of plan, defined benefit (DB) vs. defined contribution (DC), has its own merit. DC is simpler to administer and lets employees control their pension assets. DB, on the other hand, allows the employer to invest the pension assets in a more efficient way and can guarantee a certain level of income replacement at retirement.

Also, factors such as increased costs due to increased longevity after retirement, volatility of costs, as well as the current status of pension legislations and court cases, encourage plan sponsors to move toward defined contribution plans.

The following five examples illustrate the potential means of introducing such a plan:

a) Restrict the membership in the defined pension plan to existing employees only.

Here, a plan sponsor would close the defined benefit (DB) plan to new employees while allowing existing members to continue to accrue benefits in the DB plans and enrol new employees only in a defined contribution (DC) plan.

The idea is to limit future financial risks by shifting new employees to a defined contribution plan. About a dozen plan sponsors have done it and more are contemplating it. There are a few high profile cases such as Bell Canada and more recently Air Canada, where one of the conditions proposed by the new or potential investor was the ability to change the design of the pension plan for future employees.

It should be noted that the company pension plans are one of the key sources of retirement income of employees. Because of the fiduciary responsibility of employers accruing under defined contribution plans, they should provide employees with access to third-party advisors who can provide financial orientation and planning.

As an illustration, financial education might include:

- Information about investing in equities and bonds;
- Information regarding expected risk and return associated with options;
- Information about investing in mutual funds and income trusts, etc.;
- Information about recognition of spending habits;
- Information about the asset allocation mix for the long-term; and
- Glossary of terms used in the investment industry.

b) Cease future accrual of benefits under the defined benefit plan for existing members and convert future service accrual to a defined contribution formula.

Here, a closed DB plan is run next to a DC plan. We have not seen many of these in Canada but we know of a few plan sponsors who have gone that route in the United Kingdom in the aftermath of their new “marked to market” pension accounting standard (FRS 17).

c) Convert the defined benefit plan into a defined contribution plan for both accrued and future benefits.

This is a radical change in philosophy and happens with plan sponsors which are no longer prepared to support the financial risks that go with defined benefit plans. As one might imagine, a plan conversion can be a very contentious and complex exercise. There is very little evidence of recent cases of complete conversion from DB to DC.

d) There is a hybrid plan that has a Defined Benefit component and a Defined Contribution component. This type of hybrid plan attempts to strike a deliberate balance between advantages and disadvantages associated with either type of plan. Hybrid plans can resemble the following example.

Where a company:

- under a defined benefit plan might, at retirement, provide a pension amount of 2% of the salary per year of service for a total contribution of 6% annually of an employee’s salary and in turn collects contributions from the employee in the same amount,
or
for the defined contribution plan, might contribute 6% annually with the employee matching the contribution with the company having no obligation to provide a fixed amount of pension benefit at retirement,
- **under the hybrid plan, could:**
 - For the defined benefit component might provide a pension amount of 1% of the salary per year of service for a total contribution of 3% annually of an employee’s salary and in turn collect employee contributions in the same amount; and

-
- For the defined contribution component, might contribute 3% annually and require the employee to likewise contribute 3% annually but the company would be under no obligation to provide a fixed amount of pension at retirement for this component.

e) To meet its long-term objectives, a company might offer all three types of plans with option to move between plans. Under this scenario, the employees would get best of the both worlds and the company would continue to meet its long-term objectives relating to competitiveness and workforce retention. Because of the options, the cost would naturally be higher for the company.

7. WIND-UP THE PENSION PLAN

This is the ultimate change to a pension plan and involves the distribution of all assets of the plan. Total wind-ups are rather rare other than in bankruptcy situations.

The financial consequences

For those plan sponsors who decide to follow the first approach, i.e. to contribute the minimum required and hope for solid stock market performance in the coming years, we illustrate below how much money would need to be put in pension plans in the near future.

HOW MUCH TO CONTRIBUTE IN 2004

As mentioned earlier in the report, an actuarial valuation is normally required every three years for most pension plans. For a pension plan for which the last actuarial valuation was carried out as at January 1, 2002, a new valuation will be required as at January 1, 2005. It is highly likely that the financial situation of such a plan would have deteriorated over the period. According to the MERCER Health Index, a pension plan which was 100% funded on a solvency basis as at January 1, 2002 will probably have a funded ratio of around 90% as at January 1, 2004.

The question for plan sponsors having had a January 1, 2002 valuation becomes whether they should contribute more in 2004 to reduce the anticipated solvency deficit at the next valuation date or should they continue contributing in keeping with the schedule of contributions set in 2002 and hope that market returns and interest rates in 2004 are such that the deficit will correct itself, at least partially, in 2004.

THE EXTENT OF THE CONTRIBUTION REQUIREMENTS

Assume a medium sized employer with a total payroll of \$40 million. Let's say it sponsors a pension plan with \$80 million in assets and a degree of solvency of 80% at the date of the last actuarial valuation. The deficit is therefore \$20 million. According to pension standards legislation, this deficit must be funded over a period of five years. This represents annual special payments of \$4.6 million per annum²⁴ or 11.5% of the total payroll, which must supplement the normal contribution in respect of current benefit accrual of say 6% of payroll per annum.

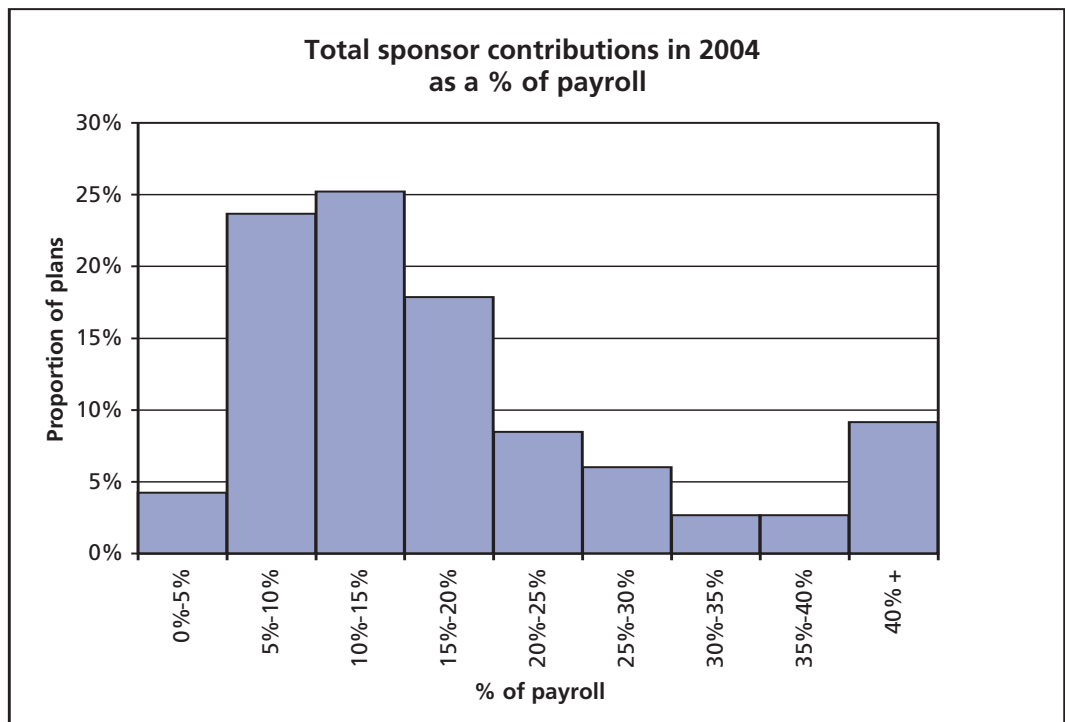
²⁴ Assume an interest rate of 6% per annum.

For a large plan with a fund equal to four times the size of the employers' payroll, the annual special payments could represent as much as 23% of the payroll. Needless to say, this is a huge increase considering that many of these plan sponsors enjoyed contribution holidays in the late 1990s.

According to a MERCER study for pension plans currently in deficit, an average special contribution of 10% of the employers' payroll per annum would need to be made by plan sponsors for the next five years to fund current solvency deficits. For the companies studied by MERCER, it represents additional contributions of about \$4.4 billion per annum for each of the next five years. For the entire Canadian market, it is estimated that an additional contribution of \$15 billion per year will be needed for each of the next five years. This could be a significant strain on companies' cash.

Chart 5 below shows a distribution of the total contributions required from plan sponsors in 2004, i.e. the sum of the normal contribution to fund current benefit accrual and the special contribution to correct funding deficits, as a percentage of the employers' payroll for the pension plans studied by MERCER.

Chart 5 - Distribution of sponsor contributions



As pension plans mature, their inclination and ability to bear risk declines. The recent bear market is a wake-up call for the pension system. Pension plans with assets representing more than four times payroll are now common. When these plans lose 5% return in a year, this represents a loss of 20% of the employers' payroll which will need to be made up at some point by the plan sponsors. This could be very significant cash drain for many of these sponsors and this is part of the reason why the management of pension plans is taking an increasingly prominent place on many employers' agendas.

7

What else can be done to limit the risk of under-funding of defined benefit pension plans in the future

The current funding situation may trigger legislative changes to protect plan members but the legislators should also change the framework to better promote the maintenance of defined benefit plans by employers.

Some court cases strongly encourage employers to fund at a minimum. The legislation should be amended in light of the implications of these cases and potentially protect an employer's contribution that is in excess of the minimum from distribution to plan members. At the least, legislation should allow the employer and the members to define their own pension deal and to agree on how to share surpluses and deficits, including defining how benefits should be adjusted.

A series of measures that could be considered to limit the risk of future under funding for pension plans in Canada could appear as follows:

Increase the role of regulators

Pension regulators should monitor more closely those pension plans which are in a deficit position or which have only a small surplus. The regulators should be granted more power to act when the situation warrants a remedial action.

Increase the frequency of actuarial valuations

Currently, the requirement is to produce actuarial valuations every three years except in certain provinces if the solvency of the plan is below a certain level. In those cases, valuations are required every year. Requiring more frequent actuarial valuations for poorly funded plans would promote timely monitoring of the financial health of the pension plan and for those sponsors seeking to take contribution holidays, this would serve to help justify their actions.

Better control of investment policy

Place constraints on the level of investment risks taken by the pension fund and exercise closer monitoring of the investment policy. Under-funded plans would need to justify an investment policy with significant risks.

Better inform plan members

Promote more targeted communication on the funded status of the plan to members and enhance communication to members on the funding status of the plan and its consequences.

Constrain benefits improvement within plans in deficit

Make additional requirements for plan sponsors who despite deficits wish to improve the benefits of the plan. The priority should be given to fund the current benefit promise rather than to improve the benefits as any member gains are likely to be made at the expense of resulting plan security exposure.

Reduce generous early retirement provisions

It has been a common feature of many pension plans to provide generous early retirement benefits. For example, in the forest and paper products industry, a common feature is to allow unreduced retirement at age 58 with 20 years of service despite having a normal retirement age set at 65. In addition, generous additional benefits are payable between 58 and 65. In terms of value, these early retirement benefits often cost twice the amount it would otherwise cost if the employee was retiring under the normal conditions at age 65.

Many now question the wisdom of early retirement incentives as the rate of growth in the labour force begins to decline. According to the Conference Board's recent projections the annual growth in labour force will move from 1.9% presently to 1.2% by 2010, 0.5% by 2015 and 0.2% per annum by 2020.

Move toward Defined Contribution

Factors such as increased costs due to lower return expectation and increased longevity after retirement, volatility of costs as well as the current status of pension legislation and court cases encourage plan sponsors to move toward defined contribution plans.

Defined contribution pension plans address sponsors' main concerns related to volatility of costs and the risk of future pension deficits. However, they create other problems as they transfer significant risks to the plan members who may be ill prepared to take on those risks, or to make the necessary financial decisions.

8

Problems identified with the current pension accounting standards

The Canadian pension accounting rules

Often referred to as CICA No. 3461, the current Canadian pension accounting rules are defined in Section 3461 of the Canadian Institute of Chartered Accountants (CICA) Handbook. Borrowing some of the rationale from its counterpart in the U.S. by way of Financial Accounting Standards Nos. 132 and 87, CICA No. 3461 and its predecessor (CICA No. 3460) originated in the mid-1980s. These standards were put in place to require companies to recognise the cost of pension plans in a more systematic and rationale way, to enhance comparability between organisations and to increase consistency between different reporting periods. Prior to issuance of these standards, companies were often recording pension cost as being that amount equal to the contribution they had made to their plan in a given year.

The current standards allow for an array of smoothing mechanisms (expected vs. actual return on plan assets, smoothed plan asset value, amortisation schedules, etc.) which have attracted much criticism in the past few years. These smoothing mechanisms were introduced mainly to insulate a company's financial statements against financial shocks in its pension plan assets. They tended to work conservatively as things were going well, but not so well when things started to go poorly with the sustained bear market of the early 2000s; precisely the time when conservatism would have been most useful. In effect, these mechanisms were designed to reflect that a longer term view should be taken in assessing the costs of pension plans and to limit the impact of short-term volatility which is unavoidable in pension plan valuation as it is impossible to accurately predict future events that will have an effect on the financial position of these plans.

Let's analyse the impact of each of these smoothing mechanisms on the results reported by plan sponsors in their financial statements.

The expected return on plan assets

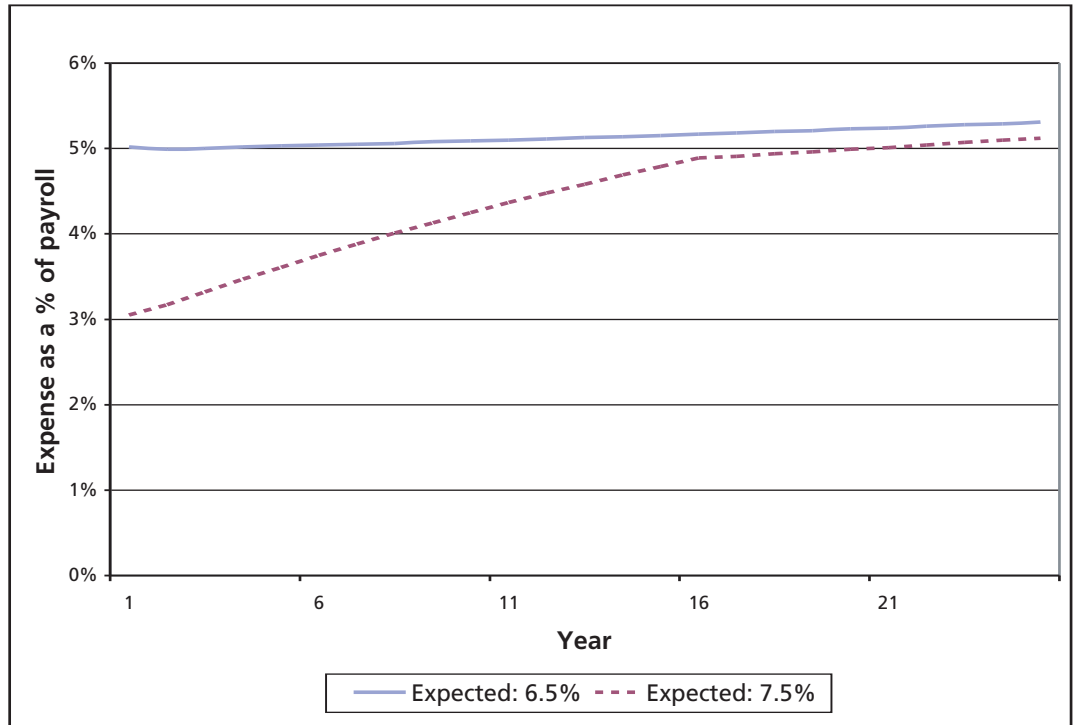
This is the area of pension accounting which has attracted the most criticism in recent years. Basically, a company selects at the beginning of the period the rate of return it expects to earn in this period on its pension assets. It then records this expected return as an offset to the pension expense and therefore a credit to the net profit for the year, regardless of what the actual return on the fund will be in the period. In other words, from the Company's point of view, you are one day into the year and you know that you will generate an income equal to the expected return on assets, regardless of what happens in the next 364 days. It is in effect booking a budgeted figure with no requirement to adjust it in the current reporting period even if the experience differs from the budgeted figure.

So what happens then to the difference between the expected return and the actual return on the assets of the pension fund? It is spread over several years and thereby impacts the company's profit gradually overtime. Does this shifting of costs to future years

really distort? Let's illustrate the issue by comparing two hypothetical companies sponsoring identical pension plans with identical investment policies.

Chart 6 shows the pension expense as % of payroll over a 25-year period for two companies sponsoring identical pension plans with identical investment policies. Company A is using an expected rate of return on plan assets of 6.5% per annum and Company B is more optimistic and uses a rate of 7.5%. Assuming the actual return over the 25 year period is 6.5% per annum.

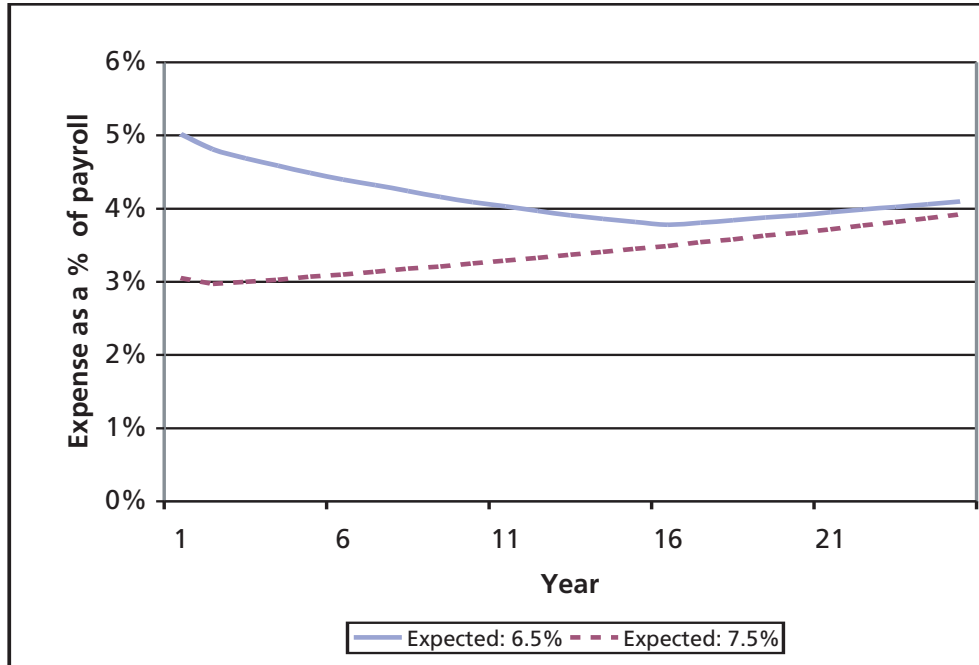
Chart 6 - Expense as a % of payroll



It clearly shows that Company A which selected a more realistic rate of return, is penalised with the recognition of a higher pension expense than Company B over the 25-year period. Higher pension expense means lower profits and lower profits generally equates to a lower stock price. Is this an accurate representation of respective company values? Probably not.

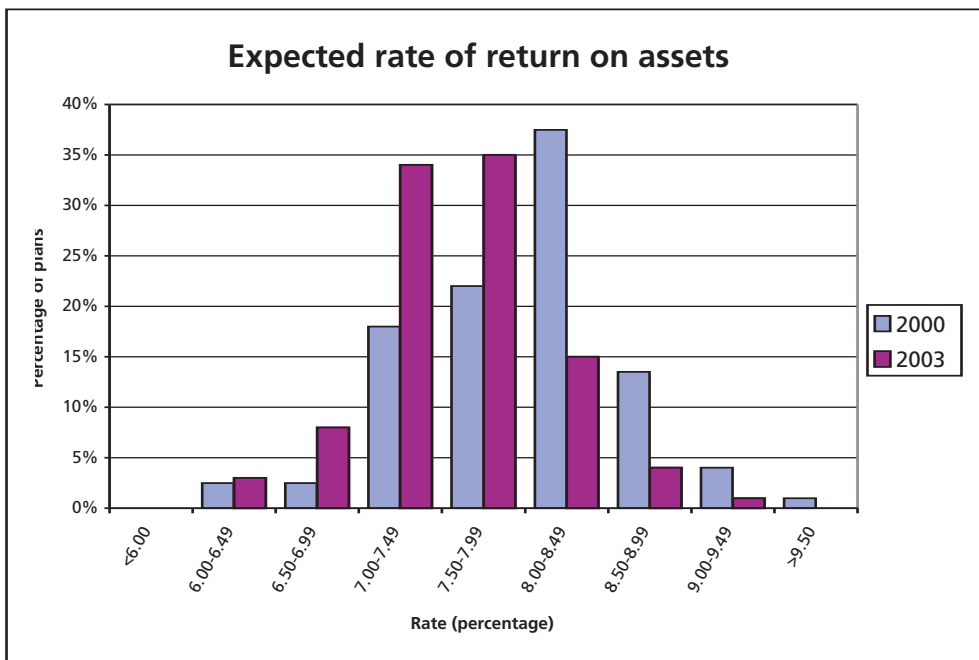
But how would the picture look if Company B was right and investment returns over the 25-year period were 7.5% per annum? Chart 7 shows the pension expense as a % of payroll under this scenario. Again Company A will have reported a much higher pension expense over the 25 year period than Company B.

Chart 7 - Expense as a % of payroll



The conclusion of the above illustrations is that allowing management to predict future investment returns creates a serious lack of comparability between the financial statements of different companies. According to a MERCER survey, the expected rate of return on plan assets used by Canadian companies for their fiscal year ending in 2003 varied from 6.0% to 9.5%. Chart 8 below shows a distribution of these rates for 2003 and compares the rates used by the MPD companies for the year 2000.

Chart 8 - Distribution of rate of return



The other major concern with dependence on expected return on plan assets is with the inclusion of an equity risk premium (reward in excess of risk free return) in the selection of the expected rate of return. We do not deny the fact that such equity risk premium exists in the marketplace, but its inclusion in a company's financial statements may persuade shareholders that the company is actually receiving a magnified added value from investing part of the pension fund in equities. It is in effect recognising an additional potential return in advance, i.e. prior to that return actually being realized, without recognising the added risk that goes with such an investment, i.e. a form of double counting.

The amortisation of gains and losses

Under current accounting rules, the recognition in a company's financial statements of the difference between the expected return and the actual return on plan assets can be spread over several years effectively keeping them off-balance sheet for a long time. The same approach also applies for experienced gains or losses occurring over time on the valuation of the plan liabilities. This practice may create bizarre situations where, for example, a company will show an asset on its balance sheet in respect to the pension plan while this same plan is actually in deficit position.

In addition, these mechanisms contribute to leaving billions of dollars worth of corporate debt off-balance sheet. A study performed by National Bank Financial of 79 Canadian companies representing around 80% of the S&P/TSX market capitalization showed that at the end of 2002, off-balance sheet pension liabilities amounted to \$21 billion. These accumulated losses which are kept off-balance sheet represent, unless reversed by future experience gains, the potential charge to future companies' profits.

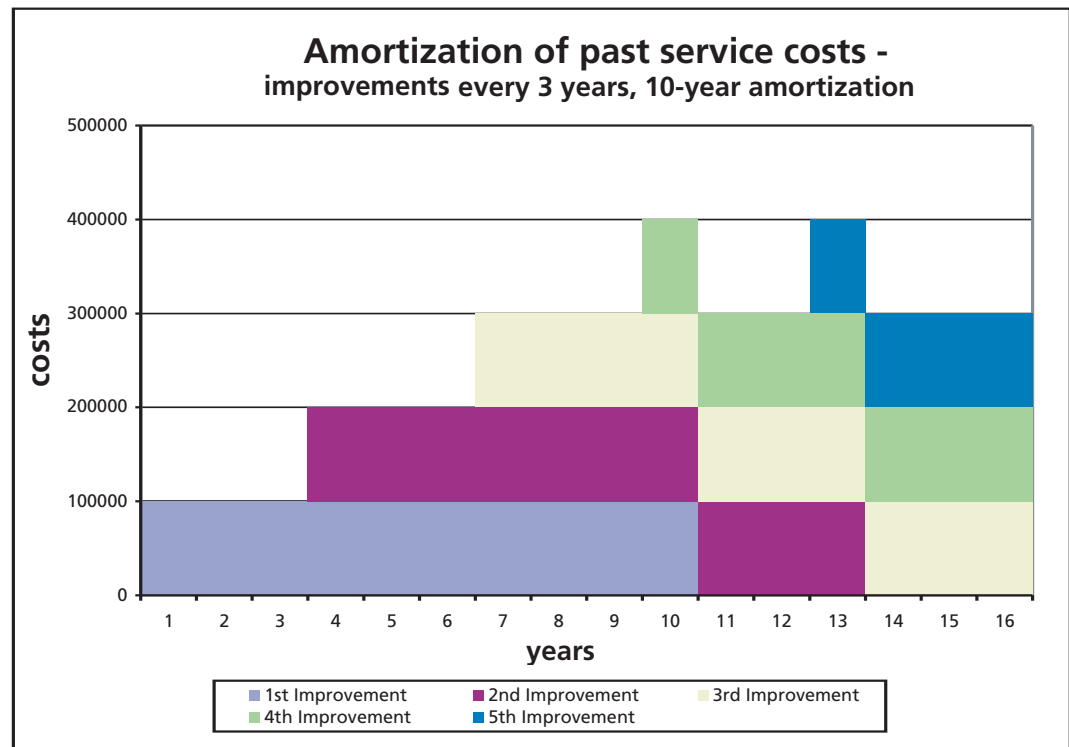
The amortisation of past service costs

Similar to experienced gains and losses, past service costs, i.e. the cost of benefit improvements in respect to years of service already rendered by employees, are also spread over several years. The mechanism is based on the principle that the increased benefits are granted in exchange for future service and that an economic value will flow to the company for as long as the employees continue to work with the company. Therefore such costs are amortised over the average remaining service period of active members which will typically be between 10 to 15 years.

The current rules also provide for a faster recognition of these costs when the economic value to flow to the company is not expected to last for that long, e.g. for ad hoc pension increases or negotiated increases to flat benefit plans. However, in practice, very few companies recognise the costs of benefit improvements over a shorter period. For example, for flat benefit pension plans which are upgraded every three or four years (through collective bargaining), a common practice is to amortise the cost of the benefit improvement over the average remaining service period of the active members. In contrast, we encourage the alternative afforded by Canadian accounting standards to amortize over the term of the collective agreement.

The current practice creates situations where the past service cost recognised by a company in its financial statements in a particular year includes a portion of the cost of several different benefit improvements, which makes the understanding of reported figures and the assessment of future earnings more difficult. Chart 9 which illustrates the various layers of past service costs which are recognised over time assuming that a pension plan is improved every three years and the costs of these improvements are spread over a 10 year period. Needless to say this makes for a very complex portrait.

Chart 9 - Layers of past service costs



The smoothing of plan assets

CICA Section 4100 deals with financial reporting of pension funds, i.e. reporting on the pension plans. Under this section, when pension obligations are measured not using fair value of the assets, the actuarial asset values should be used, that is, the asset values are adjusted. This asset value can be adjusted in many ways but a common feature is to recognise recent investment experience on a gradual basis. Typically, investment gains and losses are recognised on a straight-line basis over five years. This is another way to reduce the impact of short-term volatility.

Using a simple example, let's assume a company with \$100 pension asset with a net cash flow of zero. The company assumes a return of 7% on its pension asset in 2002 but the asset eventually loses say 10%. At the beginning of 2003, the asset is worth \$90 but in calculating its expected return for the year, the company would use a value of \$103.60, thereby inflating the expected return for the coming year and therefore profits for the

year. Why \$103.60? The company expected a 7% return on the asset but it actually generated a negative return of 10%, contributing to a net loss of 17%. Using a typical method to calculate the adjusted asset value, only 20% (one fifth) of this loss of 17% (or \$17) would be recognised, with 80% left for recognition in future years. The fair market value of \$90 would therefore be marked up by \$13.60 (80% of 17\$). This is a simple example, but in real life applications, it is not an easy task for a normal investor to make any sense of the reported values.

A standard that does not meet the needs of users

Because of the smoothing mechanisms, users of companies' financial statements, namely investment managers, financial analysts and rating agencies, are struggling to find their way through the pension accounting jungle. The many options available to the reporting entity lead to inconsistency in assumptions and accounting practices between companies and hence render difficult the comparison of financial results from company to company.

For these reasons, users have pushed for changes to the current rules to make the pension numbers more transparent and to allow them to better assess the financial risks associated with pension plans.

The next section discusses two avenues that have been proposed recently to address current issues with pension accounting. But until the proposed solutions are fully implemented, financial statement users will continue to make adjustments to the numbers provided by companies about pension costs in order to meet their needs. A classic example is Standard & Poor's which introduced the concept of core earnings a few years ago and elected to look only at specific components of the pension expense, thereby removing most of the smoothing effects on pension numbers.

9

The changes that can be made to these standards to improve quality, clarity and transparency of plan sponsors' financial statements

In the face of much criticism of current pension accounting rules, two different approaches have emerged.

A North-American approach

On this side of the Atlantic Ocean, accounting standard setters have decided, for the time being, to leave unchanged the basic rules that define how the cost of a pension plan is measured and recognised in a company's financial statements but to require additional disclosures about these pension costs. The objective is to increase transparency and provide more information for readers to assess the market risks of plan assets and liabilities, as well as the amount and timing of future cash flows to and from the pension plan.

A global trend to more transparent pension accounting standards

A new approach to pension accounting has emerged in the United Kingdom (U.K.) and Continental Europe. The basic principle consists of recognising the cost of a pension plan at its fair market value. Therefore, there would be no more smoothing mechanisms to defer the recognition of costs to future periods. While Financial Reporting Standard No. 17 (FRS17) in the U.K. has retained the controversial concept of expected return on plan assets, a proposal from the International Accounting Standards Board (IASB) developed in 2003 purports to eliminate the expected return on asset component of the pension expense. Instead, all changes in the value of plan assets would be recorded as one item on a redesigned income statement. This means that a company's assumed rate of return on the funds invested to support the defined benefit liabilities would no longer impact the main income figures. However, this proposal was recently put on hold as the IASB is considering embarking on a joint project with FASB in the U.S. to harmonize pension accounting rules. Forging forward, the IASB has also recently issued a proposal to add an option within its existing standard to recognise full gains and losses in the year which they occur, albeit outside the main profit figures (as does FRS17 in the U.K.). We can expect these proposals to influence the outcome of any joint projects.

By removing the possibility to defer the recognition of costs to future periods, the proposed avenue will result in companies having balance sheets which more accurately reflect the value of the pension plan to the company sponsoring it. This means that a company should recognise as an asset, the right it has to benefit from a plan surplus and as a liability, the obligation to fund a plan deficit. Therefore, in practice a company would record a liability on its balance sheet for a pension plan in deficit and an asset for a pension plan in surplus.

In short, this approach eliminates the option of spreading investment gains and losses over a period of time. This would also apply equally to other experienced gains or losses. Companies would report such gains or losses directly on a redesigned income statement which has not yet been completed but which should present each component of the pension expense in a way that makes understanding the financial results of public companies more relevant to investors.

The approach favoured by the U.K. and IASB will have a significant impact on the way pension costs are measured and recognised and will have the following consequences on companies' financial statements.

- It will make financial statements more transparent by showing the real picture;
- It will result in more meaningful balance sheets, as the asset or liability recorded on a company's balance sheet will actually represent the value of the pension plan for the company (generally equal to the plan surplus or deficit);
- But it will make pension costs a lot more volatile, as actuarial gains and losses which are unavoidable, will be fully recognised as they occur. Investors will have to understand where the volatility comes from to make the appropriate assessment of the companies in which they invest;
- It may lead to changes in investment policies to reduce the volatility of pension costs (e.g. by investing a significant portion of the fund in fixed income securities to immunize against changes in plan liabilities resulting from changes in interest rates) although there is no strong evidence of this from recent experience in the U.K.; and
- It could encourage plan sponsors to close or modify their pension plans as evidenced by the experience in the UK and as suggested by a recent survey from the Committee on Investment of Employee Benefit Assets (CIEBA), an association which represents some of the largest private sector pension plans in the US.

By eliminating smoothing, corridors and amortization, these standards will help make more visible the actualities that shareholders bear. And by recognising these attributes, companies and investors will comprehend more fully the assumption of large investment risks, the relationships between pension costs and pension obligations, the composite level of employee compensation, and the immediate implications of deficiently funded plans.

A different approach to internal delegation

More transparent accounting will force companies to focus on the compensation and financial elements of pension expense separately.

- The HR department would be accountable for the compensation element of pension expense which would be determined by plan design, the composition of the workforce and real and nominal interest rates. Compensation costs would not be affected by investment results, funding decisions or the existence of surplus.
- The finance department would be responsible for the financial elements of pension expense and would be able to influence this element through funding and investment decisions. If the company decides, for financial reasons, to fund conservatively and to invest aggressively, any gains or losses flowing from this decision would be reserved for shareholders, not credited to employees as an adjustment to the cost of their compensation. No longer would shareholders be told that employee compensation is under control on the premise that the stock market went up.

These changes would affect corporate financial results and share prices

Investors' concern

The current situation for pension plans is a concern for investors as they need to assess the full obligation of the company in which they invest. For companies sponsoring defined benefit plans, this obligation can be substantial. Investors need to know how this obligation will be funded and how this will affect future growth.

Financial analysts, as specialists in the assessment of companies' values are certainly interested in the pension numbers. Their assessment can positively or negatively impact the share price of a company when they raise questions or concerns about pension plan management.

A MERCER survey conducted with directors of research and portfolio managers at nine leading investment companies in the U.S. looked at the approaches used in analysing pension finance issues by these firms. Key findings include that:

- Most of the firms interviewed now explicitly incorporate pension-related financial information in their company valuations;
- All agree that the profile of the issue has increased significantly in their research process over recent years;
- More than half of the firms adjust company value for pension surplus or deficit, and of those, some do their own forecasts of pension surplus and funding requirements and some in considerable detail;
- Many penalize companies with lower valuations for pension assumptions they consider out of line, especially aggressive expected rate-of-return on plan asset assumptions;
- Several research directors noted that companies that make pension financial information easily accessible will win points from buy-side analysts and investors. Providing only the minimum required disclosure may cost the firm credibility with this audience.

Who has the most exposure to pension funding issues?

A study produced by National Bank Financial²⁵, published in June 2003, looked at exposure to pension plan financials for the largest companies in Canada. In studying the 79 companies under consideration, they used various measures of exposure such as:

- Size of the deficit as a percentage of the company's market capitalization in relation to shareholder's equity;
- Size of the plan liabilities as a percentage of the company's market capitalization and shareholder's equity;
- Pension expense as a percentage of net income; and
- Pension expense as a percentage of operating cash flow.

²⁵ Roberge, Martin, et. al. Canadian Pension Fund Deficit, One Year After Our Yellow Flag

An extract of the study revealed that:

- 13% of the companies studied have a pension deficit greater than 20% of the market capitalization of the company at the end of 2002. In other words, for these companies, the pension plan could have a claim of one-fifth of the company's market value.
- Several companies (24 out of 79) have plan liabilities greater than 50% of the shareholders' equity at the end of 2002.
- 14 companies reported pension income in 2002 despite heavy losses on the stock market.
- The average pension expense as percentage of net income was around 11% in 2002.
- 14 companies have pension expense in excess of 10% of their operating cash flows in 2002.

These results demonstrate that several companies are particularly vulnerable to financial shock to their pension plan. For these companies, a sudden increase in the value of the plan liabilities or a sudden decrease in the value of the plan assets which support those liabilities could seriously affect profit measures or balance sheet health and therefore affect equity valuations, debt covenants and credit ratings.

The value of transparent accounting

We can expect more rather than less scrutiny on pension financials as pension plan exposure becomes increasingly important. The cash requirement of pension plans and the relation between the actuarial assumptions underlying the pension numbers reported in companies' financial statements and the investment strategy of the pension fund will continue to attract attention of financial analysts.

The new disclosure requirements implemented in Canada and in the U.S will improve the clarity of reported pension numbers but there are still many aspects of pension accounting that continue to blur the pension numbers. And from the MERCER study referred to above, it seems that the lack of clarity contributes to what is called an "accounting risk discount" which seems to become increasingly applied in equity valuation. If the pension plan financials are well understood, it is more likely that their implications will be properly reflected in equity analysis. For this reason, it is believed that companies should disclose the most useful information they have in respect to their pension plans. Audit committees are certainly starting to ask more questions about pension accounting.

The different stakeholders of the current pension system and their respective roles

In looking at the various stakeholders to the current pension system, this study focused on single employer pension plans, as opposed to multi-employer pension plans.

| | |
|--------------------------------|--|
| Plan sponsor | <ul style="list-style-type: none"> • Often referred to as the party who sets up the pension plan and who is ultimately responsible for its costs • The employer acting through its Board of directors is the plan sponsor for most pension plans |
| Board of Directors | <ul style="list-style-type: none"> • Approves the defined benefit plan and its governance structure • Approves strategic decisions on design, funding and investments |
| Shareholders | <ul style="list-style-type: none"> • Support the volatility of the cost of the Plan |
| Legal Administrator | <ul style="list-style-type: none"> • Could be a pension committee²⁶ or a Board of trustees • Ultimately responsible for the administration of the plan • Should act in the best interest of plan participants |
| Management of the plan sponsor | <ul style="list-style-type: none"> • Implements all pension decisions approved by the Board of Directors or the administrator • Selects service providers |
| Plan members | <ul style="list-style-type: none"> • Employees and retirees • Select options, if available • Need to be informed • If applicable, contribute to the Plan |
| Union or Bargaining Unit | <ul style="list-style-type: none"> • Represents the employees in negotiating level of benefits/contributions |
| Pension regulator(s) | <ul style="list-style-type: none"> • Implements provisions of pension legislation • Registers pension plans and enforces compliance or maximum benefits, funding requirements, communications and investments |
| Tax authority | <ul style="list-style-type: none"> • Registers pension plan • Sets limits on deductibility of contributions and maximum benefits • Sets limits on investments |

²⁶ Québec has mandated the formation of pension committees to serve as legal administrator but in almost all cases, private sector pension plans have delegated the performance of the relevant administrative functions (e.g. funding and investment) to the plan sponsor.

| | |
|--------------------------------------|---|
| Courts | <ul style="list-style-type: none"> • Resolve conflicts on interpretation of plan rules, fiduciary responsibilities, and surplus ownership |
| Other Professional Service Providers | <ul style="list-style-type: none"> • Actuaries <ul style="list-style-type: none"> – Evaluate financial position of plan, advise in plan funding matters and provide general support to plan sponsor and administrator • Auditors <ul style="list-style-type: none"> – Attest to accuracy of financial statements and notes to financial statements inclusive of pension fund components • Custodians <ul style="list-style-type: none"> – Hold pension assets – Collect investment income – Pay benefits • Fund managers <ul style="list-style-type: none"> – Select investments and trade securities |

Comments on the current roles of stakeholders

- The roles of these stakeholders have not changed significantly in the last few years. These roles are not different to comparable roles in the U.S. and the U.K. although, in the U.K., the administrator (i.e. the trustees) generally has a more important and visible role.
- It is expected that the Board of Directors will play a more significant role in pension issues. This is due to the increased importance of pensions, the public scrutiny on governance and the responsibility related to deficit.
- The roles related to the sponsorship of the plan vs. the roles related to the administration of the plan need to be better articulated, particularly, in the area of funding and investment. The laws need to clarify the role of the decision maker and whose interests (sponsors or members) they are representing. This is especially true in Québec where pension committees are ultimately responsible for the administration of pension plans. They have a fiduciary duty to act in the best interest of plan members but in practice this role is very hard to reconcile with that of a plan sponsor which prefers to contribute only the minimum required to the pension fund. While resultant deficit positions expose pension committee members to personal financial risks (as is the case of Jeffrey Mines), we should recognize that these risks can be mitigated as suggested later in this section and that there is good cause to do so given the demonstrated value in relying on pension committees.
- In practice, pension issues are managed by both finance and human resource staff. There are variations to delegated assignments within the various environments.

-
- Members are increasingly concerned about the sustainability and security of their benefits entitlements. It is difficult to obtain an accurate account of member interests in these matters; in particular from the pensioners.
 - The structure of our pension legislation needs to be rebuilt. It is too complicated, is not uniform across Canada, and is ineffective in resolving the surplus ownership issue. The law is also seen as inadequate for pension deals needing to be restructured.

Reviewing this list, we can identify three key participants whose roles should be explored further. The first relates to the role of the Board of Directors, the second relates to the potential role of a Pension Committee and the third is around regulation.

The role of the Board of Directors

What should the Board of Directors make of all this? Divert more money to pension plans? Try to reduce their financial risks? Or close the pension plan?

As pension plans mature and become more important relative to the size of the organisation, pension issues should be elevated, and in some cases, should be monitored more closely by the Board of Directors. Each plan sponsor is responsible to establish its own pension governance structure including how funding and investment policies are to be selected and monitored.

In some cases, especially for mature organizations with a significant number of pensioners and with pension deficits, there should be a significant role reserved for the Board of Directors. For example, the Board may want to confirm the investment policy (e.g. how much risk should be taken, as measured by the % invested in equities) and the funding policy (e.g. whether or not to contribute more than the minimum acceptable to the regulators).

A MERCER survey about pension governance, carried out in 2001, found that for 61% of private sector defined benefit plan sponsors, either the Board of Directors or a sub-committee of it approve the funding policy. However, 57% of survey respondents indicated that they did not have a formal written funding policy accentuating the lack of hard evidence that the information flows up to those ultimately responsible.

A potential role for an Advisory Pension/ Post Employment Benefits Committee

Over time, the assets and liabilities in pension plans generally grow to large amounts resulting in significant financial impacts on plan sponsors' cash flows and on the lives of plan members (active and retired). In the spirit of devoting adequate energy to such important pension issues and encouraging greater dissemination of information, CGA-Canada proposes that greater reliance be placed on advisory pension committees and pension committees. At one end of the governance scale, an Advisory Pension Committee should at minimum be established. At the other end of the governance scale, a major stakeholder Pension Committee might be more appropriate for some organizations such as large unionized environments. For yet other organizations, a blended model might be more appropriate.

The roles and responsibilities of an Advisory Pension Committee are discussed next and following this discussion, the additional responsibilities of a Pension Committee are presented. Represented as a blended model, a third alternative is to selectively pick and choose from both models as appropriate for the circumstances.

Predominantly mandated to assist management in the operation of the pension plan(s), we see well also the express responsibility to more effectively communicate with active members and pensioners. An Advisory Pension Committee would advise the Board and raise concerns of employees (active and retired) and of management.

The role of the Advisory Pension Committee could typically include surveying members concerning pension and retirement related issues, determining their preferences and priorities, and examining options to improve pensions and retirement or separation benefits (i.e. medical, dental, vision care, long-and short-term disability income, severance, salary continuation, job training, etc.). Importantly, the committee could be responsible to make recommendations related to resolution of issues pertaining to modifications arising from any curtailment or termination of pension plans and allocation of any surpluses and deficits. Members should stay abreast of, and adhere to, various legislations including pronouncements of tax authorities, relevant court cases and fund status and regularly communicate pension issues and concerns to all active and retired members of the plan.

Comprising of members having the requisite level of expertise and/or representation, the committee should, at minimum, be composed of members designated by both plan members and by the employer, a senior management representative having composite knowledge of pension plan matters, a Board representative and at least one external member or consultant to provide independent and objective insight.

The Committee:

- should meet at least four times per year;
- should review the risk management policies of each plan;
- should establish procedures/mechanism(s) to seek and receive input from plan members (active and retired) where required; and,
- at least twice a year, should:
 - issue communication-briefs of potential interest to respective plan members including investment policies, and the identification, management, and mitigation of risk management decisions taken during the year; and
 - provide a mechanism by which concerns and questions can be addressed and resolved in a timely manner.
- or the administrator, annually, should send a written statement containing the prescribed information in respect of the pension plan, the member's pension benefits and any ancillary benefits.
- annually hold a general meeting of the pension plan members to report on the status of the plan(s).

As mentioned previously, for some organizations, the establishment of a major stakeholders model of a Pension Committee might be right. Under this model, a Pension Committee would have some specific guiding principles and responsibilities in addition to the roles

and responsibilities mentioned under the Advisory Pension Committee.

The guiding principle for the Pension Committee should be that all provisions in the pension by-laws and any changes in the pension plans are based on expressed principles of equity in keeping with implicit intentions of the by-laws. Any changes in the plans that benefit only a minority of the members should be made under special circumstances and for reasons that are compelling to the majority of the members.

The additional roles and responsibilities of the Pension Committee are to:

- administer/monitor the operation of the pension plan;
- oversee proper application of the accounting standards and of applicable regulations;
- establish, recommend and monitor pension plan policies;
- endorse pension plan by-laws of all plans; and,
- review and improve investment and risk management policies of each plan.

The independent external member of the Pension Committee might also be commissioned to mediate conflicts, disclose declared or reported conflicts of interests, and serve as adjudicator where the Board might approve. Management and Committee members should be made very aware of the role and the authority of the pension consultant and should typically participate in the selection of a joint designate who shall not exert undue influence on fellow participants.

Given the liability that fiduciary participants seem to be attracting of late, we would make a call for increased debate around the relationships between Boards of Directors and Pension Advisory Committees or Pension Committees. To a great extent, these committees can be seen as an extension of the legal entities' decision-making capacity and should typically attract greater recognition in this agency relationship. At a minimum, errors and omissions insurance coverage should be afforded to committee members on the premise that a delegation of responsibility (and exposure to liability) has occurred.

A potential role for Uniform Law

Established in 1974, the Canadian Association of Pension Supervisory Authorities (CAPSA) has served as a federal-provincial forum to facilitate the discussion and resolution of common issues faced by the various federal and provincial pension plan supervisory authorities. Having broad representation, the CAPSA membership has been active in development of principles for sound governance of pension plans and in reviewing areas of the investment regulations.

Currently, CAPSA has renewed discussions respecting the pronouncement of a 'Model Law' in recognition that there are approximately 2,784 multi-jurisdictional plans (out of 13,861 plans) and that of those plans 1,000 of them (covering over 1 million members) represent members in 5 or more provinces. Admittedly, the compliance standards which those sponsors must attain are unwieldy and duplicative given that these plans must comply with the different legislative requirements of various jurisdictions.

Intended to promote efficient administration and reduce cost of legislative compliance, such an approach would naturally entail the simplification of pension regulations, the alleviation of administrative complexity and create a more favourable environment for the adoption and maintenance of pension plans in Canada.

Earlier this year, CAPSA released principles for consultation and met with national stakeholder groups with consultations taking place across Canada during the months of April and May. Upon finalization of regulatory principles, the desire would be to draft a model pension law for submission to governments when they are contemplating amendments to their pension legislation.

While admirable, it is the view of CGA-Canada that the model law initiative does not go far enough in unifying or harmonizing pension law. Possibly received as a stop-gap measure, which may well introduce significant improvement, it shall be subject to individual discretionary acceptance by the distinct authorities, in full or in part. As such, the optimal benefits are likely never to be realized. That is not to say that there are no benefits in the deliverables envisioned by the model law initiative. Rather, the pronouncement and adoption of one uniform or harmonized pension law dealing with core principles and standards and allowing for jurisdictional uniqueness on a predetermined basis would fare more effectively in achievement of the stated objectives.

The current legal environment is influencing the funding of pension plans

An alleged one sided deal

Defined benefit pension plans are not served well by the current legislative framework for pension plans and this is seriously jeopardising their future.

At the heart of the problem is the asymmetry of the funding deal, where deficits arising from a pension plan need to be paid by plan sponsors over five years, while surpluses arising from special contributions, i.e. in addition to normal contribution, can be legally challenged on plan windup or in other business transactions.

This uncertainty in the ownership of the surplus arising from the special contribution is one of the major reasons why a plan sponsor would not aim at building a surplus to protect plan members. Until the system is mended, it is fair to say that the marketplace will continue to witness resistance from employers in sponsoring defined benefit plans, and for those existing plans, sponsors may continue to contribute the minimum required.

If surplus is routinely seen as being confiscated by legislation, regulation or the courts, where is the sponsor incentive to properly or abundantly fund a pension plan?

Plan sponsors are concerned by recent court decisions

Plan sponsors cannot take comfort in the recent efforts and pronouncements of the courts, regulators and governments.

In 2002, Bill 198 (Ontario) which attempted to address surplus ownership was abandoned in the absence of political penchant.

There is a growing wave of class action suits involving pension plans; Jeffrey Mines, the Participating Coops of Ontario, Telus, Noranda, and BC Rail are a few of the organisations fighting class action suits over pensions.

Then there is the Monsanto case which revolves around surplus ownership. More specifically, it is about the distribution of surplus on the partial termination of a pension plan, i.e. in Monsanto's case after a group of employees were laid-off. The latest court decision upheld that Monsanto was required to distribute surplus to affected members despite the fact that its pension plan funding status would likely no longer be in surplus position and that such distribution would worsen the funding position of the plan while weakening also the benefit security of remaining plan members. The case has discouraged many plan sponsors from funding more than the statutory minimum to avoid generating surplus which might then be subject to distribution or allocation to members. The case has been appealed to the Supreme Court of Canada.

There is another case – Transamerica. The case is about the ability of plan sponsors to merge two or more defined benefit pension plans, an option that plan sponsors sometimes favour on a sound business rationale. The latest court decision found that, resulting from an undertaking made by the buyer, because the plan documents of one of the merged

plans containing certain language about exclusiveness of benefit²⁷, the merger should not have taken place. The court's decision raises doubt about plan sponsors' ability to merge pension plans and has the effect of discouraging the merger of pension plans that also have "exclusive benefit" trust language thereby impeding once more the flexibility in managing pension plans. Following this decision, the pension regulator (in this case, the Financial Services Commission of Ontario) imposed a moratorium on all asset transfers involving pension trusts. An application for leave to appeal has been filed with the Supreme Court.

Two conflicting views of the current legal system

At the heart of our pension system are two conflicting views of the pension "deal":

- the accounting/economic view where pension assets and liabilities are corporate assets and liabilities; where plan members are secured creditors to whom pensions are owed; and where experience gains and losses accrue to shareholders; and
- the judicial/legislative view where pension assets are legally distinct from corporate assets; where pension funds are managed by fiduciaries for the benefit of plan members, not shareholders and where shareholders are responsible for deficits while the ownership of surplus remains in dispute.

Because of these conflicting views and in the absence of perceived or real balance and responsiveness in the legislative framework, there is little inclination to make meaningful decisions about the governance, funding or investment of pension funds.

Unless politicians and regulators decide to create and maintain an environment where defined benefit pension plans can represent a good deal for both plan sponsors and plan members, interest in extending defined benefit pension plans will wither; possibly to the point of extinction.

²⁷ The Court stated that the terms of one of the plan's trust precluded any part of that fund from being diverted to any purpose other than the exclusive benefit of the beneficiaries of that trust.

Pension plan participants can be better informed about pension issues

Currently, pension plan members have access to various pieces of information in order to understand the functioning of their pension plans. Many are required by pension standards legislation and include at a minimum such things as:

- the official plan rules or a summary of the main plan provisions (e.g. booklet);
- latest actuarial report and the pension fund's statements; and,
- a personal statement produced on an annual basis showing the benefit entitlement of the member.

Many plan sponsors are exceeding these minimum standards and are trying to better inform plan members of the full value of their pension plans and of variables which may potentially enhance comprehension, especially in this time of escalating costs.

However, these efforts by many plan sponsors have frequently produced disappointing results. With the exception of those approaching retirement, there is a sense that most plan members remain uninterested in pension issues, are not well informed about their pension benefits, and appear to be unwilling to devote additional effort in improving understanding.

There is generally little need to justify an increase in regulatory requirements for additional information, except perhaps, in the area relating to the consequences of funding deficits on plan members and pensioners. The promotion of the understanding of pension plans should be left to the plan sponsor and the members who might jointly elect to adopt deliberate mechanisms (such as the use of Pension Committees and regular newsletters, etc.). At minimum, we can expect that:

- Employers facing escalating costs would want to ensure that employees are better informed of their plan and its cost to the business so that they may consequently appreciate the existence of such a plan and its value.
- The aging of the population will encourage a labor force to be generally more interested in pension issues than they are now.

It is possible to make communication of pension issues relevant to employees:

- Employers should stress that the role and obligation of employees to be involved in retirement planning is increasingly important and that the employer will reasonably support those who are prepared to make a conscious effort to enhance self-reliance.
 - Technology will make the communication of complex pension issues simpler, especially if the information can be tailor-made in response to the explicit needs of collective or individual plan members.
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Closing Comments

Stemming from the findings of this study, it is the view of CGA-Canada that there are concrete actions which can be taken in the immediate future to improve pension plan management:

- Pension fund administrators, relying on risk budgeting processes, could be required to better justify their choice of investment mix and should also disclose how anticipated risk is to be measured, managed and otherwise mitigated where actual experience fares poorly.
- Securities regulators could decree a greater degree of disclosure and/or the rating of pension-related risk being carried by publicly traded companies.
- Given the imperfections cited throughout this report related to pension plan administration, members' growing reliance of pension benefits and the weakened confidence in pension fund performance, greater emphasis should be placed on the design and sustainability of pension plans. While advocating for possible change, stakeholders should strengthen their planning and policy development activities, taking into account all the current pension related issues.
- Regulators will need to address the question of pension surplus ownership if sponsors are to be held accountable. Within the current landscape, surplus distribution is simply not seen as fair and equitable to plan sponsors. When determining the attribution of pension plan surpluses, there may be an opportunity to establish time-weighted formulas which take into account the respective contribution values of members and sponsors.
- Workplace pension arrangements and the roles, responsibilities and obligations of the various participants involved in the management of those pension plans should be fully articulated and communicated to all key stakeholders.
- While reliance on pension advisory committees and pension committees should be fostered, the regulatory and legal framework should provide greater protection against litigation to those who would agree to serve in an agency relationship. Consideration should also be given to including provisions for errors and omissions insurance coverage for those who serve in such capacities.
- Regulators could require actuarial valuations more frequently than once every three years where deterioration of solvency ratios (on a predefined basis) may warrant; especially where plan asset returns have fared less favourably than earlier communicated predictions.

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- Accounting and actuarial standard setting bodies should be encouraged to analyse and report back on alternative reporting standards with particular attention being devoted to the practicality of adopting modern economic principles based on fair value.
 - Regulators should continue to explore harmonization of jurisdictional provisions in the spirit of simplifying administration and conformance.
 - Regulators should develop common provisions for a plan sponsor which has operations in multiple provinces (e.g. Hudson's Bay Company), and in the absence of harmonized regulations or uniform law, should examine allowing the sponsor to be regulated by one agency.
 - In the face of growing obligations and the shrinking labour force entry rates, sponsors and bargaining units should revisit early retirement schemes adopted under circumstances which substantially differ from current-day realities.
 - Given the growing order of magnitude of pension plan assets and obligations, boards of directors, CEOs and CFOs should be encouraged to pursue and adopt constantly evolving best practices as they relate to pension plan management.

In the generation of this report, we have encountered other opportunities for change. While we do not outline these subjects in the text and will not speak to all of them in these closing remarks, we are nevertheless compelled to identify 2 further recommendations which merit additional consideration on the grounds that they can contribute to improved health and sustainability of pension plans in Canada. Specifically that,

- Further study into other models such as co-op and hybrid pension models vs. the current captive insurance company model (pledged benefit as a function of contribution and sponsor diligence) should be commissioned. At the heart of such a study, the benefits/costs/limitations of the alternatives would undoubtedly shed light on any improvements in pension plan clarity and identify disproportionate assumption of risks between participants. In short, these alternative models promote risk-sharing and enjoin greater member participation and self-reliance in retirement planning.
- The Department of Finance Canada should revisit the 10% cap (disallowance of surplus amounts which exceed liabilities by 10% or more) historically placed on DB balance sheet surpluses in favour of elevating the limit, to say 30%, or discarding the provision altogether. Retrospectively and prospectively, we can expect that the 10% rule does in some instances force a sponsor to take contribution holidays when the sponsor may not otherwise do so.

As with any subject, the presented dilemmas can be seen as opportunities for meaningful reform. Amidst the fears of balance sheet deficits, surplus disputes, asset-based investment models, ill-defined pension arrangements, disputed actuarial and accounting practices,

unresponsive governance and management processes and poorly integrated regulatory models lies the current alarm over the status and sustainability of defined benefit pension plans in Canada.

If we are to assure sustainability and confidence, it will be necessary to address these fundamental problems and look to affecting meaningful change which produces greater certainty and credibility.