

Research Project # 4: Funding Regimes in Comparative Context

Research Paper: Comparative Funding Regimes

Researcher: Colin J. Pugh

Date: October 2007

SECTION 1 - INTRODUCTION

Scope of Report

This research paper is prepared for the Expert Commission on Pensions that has been established by the Government of Ontario to review the security, viability and sustainability of the pension system in Ontario. Among the guiding principles, those of particular relevance to this particular paper are “the importance of maintaining and encouraging the system of defined benefit pension plans” – an objective strongly supported by the author – and “the importance of maintaining the affordability of defined benefit plans for both members and sponsors”.

More specifically, the primary objective of this paper is to summarize funding regulations in selected countries where DB plans have been (and to a large extent, still are) a dominant force in the occupational pensions scene. Particular attention will be paid to the significant changes in funding regulations that have been made in several jurisdictions in recent years, and to make comparisons with the current funding regulations and the current debate in Ontario. This paper should then provide a mechanism for the Expert Commission to assess whether the reasons for the changes in these other countries and the exact nature of their latest funding regulations provide useful guidance regarding the challenges facing the provision of occupational defined benefit pensions in Ontario.

The **six countries** selected for detailed analysis provide quite different perspectives on the direction of funding regulations, thus proving the obvious, namely that there is no perfect or one-size-fits-all solution. For example, two countries (Ireland and the Netherlands) reacted quickly to the difficult funding problems of 2001-2003 by going in opposite directions. **Ireland**, in a similar manner to Quebec, provided temporary funding relief by extending its standard amortization period for experience deficiencies from 3 years to 10 years if the reason for the deficit was investment-related. It has since cemented these temporary rules into more long-lasting regulations and broadened the range of allowed reasons. For example, Ireland’s tiger economy has meant large salary increases that have significantly strained the funded position of traditional final-average earnings DB plans, and this cause is now also eligible for 10-year amortization. In contrast, the **Netherlands** continued to tighten its funding requirements, requiring 105% funding virtually all the time and further requiring the accumulation of contingency

reserves that bring the ultimate funding requirement for the average plan to about 130% of liabilities.

As regards the **USA**, one can argue that (overall) they tightened their regulations, but the prior regulations arguably had been the least demanding in the world, and they were also long-overdue for change. The **UK** moved in another direction altogether, abolishing virtually all prescriptive minimum funding regulations and demanding plan trustees, in consultation with the plan sponsor, to establish plan-specific funding objectives. This is coupled with the plan sponsor's "covenant" covering its desire and its financial ability to keep the plan on a sound financial footing. The regulator places great weight on this covenant, which can be supplemented by additional guarantees from, for example, the parent company and by additional financial guarantees such as letters of credit and assigned assets. As one would expect, risk-based supervision is paramount.

Switzerland prides itself on infrequent, but well-debated changes in regulations. The only major change in recent years has been to adopt the "corridor" approach and only require funding to 90% of accrued liabilities. Swiss authorities also encourage, but do not prescribe, the establishment and maintenance of investment fluctuation reserves. Finally, **Portugal** appears to be the only country (other than Canada, and the USA prior to the 2006 changes) that prescribes separate minimum funding requirements on both a wind-up type basis and a going concern valuation basis. Several other countries were surveyed by the author in the preparation of earlier papers, and some will be mentioned in this paper, but none of them have (or no longer have) the dual funding requirements.

The core part of this paper will be divided into four sections, and the basic thrust of each such section now will be identified. The starting point will be the regulation of conventional single employer defined benefit pension plans financed through autonomous pension funds. Where applicable, the different treatment of the funding regulation of multi-employer plans and (at the other extreme) significant shareholder plans and other small plans will be identified.

Terminology

Wherever possible, this report will use terminology that is consistent with words and phrases used in Ontario pension legislation and by the Canadian actuarial profession. To the extent it can facilitate easier reference with local legislation and better communication with local regulators, the local terminology occasionally will be shown in brackets. One exception is the Canadian phrase "jointly sponsored pension plans", a category into which only some multi-employer plans fall. The phrase is used in some other countries, especially where equal representation of employees and employers on the board of trustees, the board of foundation or equivalent body administering a single employer plan is dominant, and where these bodies often have more powers than the plan sponsor – but this does not necessarily imply the same infrastructure as a Canadian plan of the same

name. Instead, the phrases “multi-employer pension plans” or, where appropriate, “industry-wide plans/funds” will be used.

Actuarial Costing Methods

Those readers requiring an introduction to actuarial costing methods, and especially the basic categorization into “families of methods”, should refer to **Section 2**. This material may also be useful to other readers requiring a simple reference point for the various actuarial methods mentioned throughout this paper. **Experts on actuarial matters do not need to read Section 2.**

FOUR MAIN SECTIONS OF THIS PAPER

Section 3 identifies and addresses the core funding issues common to the large majority of countries – minimum funding requirements; benefits that can be excluded from calculation of the minimum funding requirements; benefits that must be restricted due to poor funding levels; extra-statutory guidelines; maximum funding limits; and treatment of different types of plans (e.g. multiemployer and significant shareholder plans).

Section 4 identifies and addresses related actuarial matters such as - customary funding practices; further details on actuarial costing methods and actuarial assumptions; valuation of assets; roles of “provisions for adverse deviation” (PfADs or contingency reserves); alternative forms of contributions; frequency of actuarial valuations and interim actuarial reports; and other funding information requirements.

Section 5 focuses on ownership and application of funding excesses within an ongoing plan, withdrawal of surplus assets from an ongoing plan, and related issues.

Section 6 concentrates on issues relating to the termination of overfunded and underfunded plans, whether through a voluntary plan termination or insolvency of the plan sponsor. Only a brief mention will be made of PBGF-type insolvency guarantee funds, as this is the subject of a separate research paper. For completeness, each country profile will simply identify whether such an arrangement exists in that country.

Each sub-section in these Sections will describe the issue itself in general terms and then continue with highlights of practices in selected countries, especially where those approaches are different from Ontario practices or reinforce key messages. Considerably more detail will be found in the individual country Appendices at the end of this report.

Limitations on Comparisons with Ontario funding rules

Each country appendix will start with a comment on the potential limitations of interpreting or applying that country’s pension legislation in the environment of Ontario

pension laws and regulations. Among the countries reviewed in this report, only Ireland, the UK and the USA are common law countries with trust law. However, given that the primary focus of this report is actuarial funding requirements, this does not of itself automatically diminish the validity of the funding regulations to be found in the other selected countries – Netherlands and Switzerland, where occupational pensions are financed through pension foundations, and Portugal, where occupational pensions are financed through pension fund management companies.