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OCCUPATIONAL PENSION PLANS: SELECTED POLICY ISSUES

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ABSTRACT

Statistics Canada data indicate that, at the beginning of 1988, the approximately 4.8 million Canadian workers participating in occupational pension plans represented 44.9% of all employed paid workers. Such plans constitute the second tier of the Canadian retirement income system. The first tier includes various government-operated sources of retirement income, such as Old Age Security and Guaranteed Income Supplement benefits, and payments from the Canada/Quebec Pension Plan. Individual retirement savings, through such mechanisms as Registered Retirement Savings Plans and home ownership, comprise the third tier.

This paper examines selected aspects of occupational pension plans, focusing on the jurisdictional and legal framework, the coverage of the labour force in terms of employees who may participate and various eligibility conditions, types of plans, and the vesting, locking-in and portability of pension credits. Also discussed are inflation protection and the related issue of pension surpluses, as well as survivor benefits.

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OCCUPATIONAL PENSION PLANS: SELECTED POLICY ISSUES

INTRODUCTION

Occupational pension plans represent the second tier of the Canadian retirement income system. The first tier includes various government-operated sources of retirement income such as Old Age Security and Guaranteed Income Supplement benefits and payments from the Canada/Quebec Pension Plan. Individual retirement savings, through such mechanisms as Registered Retired Savings Plans and home ownership, comprise the third tier.

Statistics Canada data indicate that, at the beginning of 1988, the approximately 4.8 million Canadian workers participating in occupational pension plans represented 44.9% of all employed paid workers. Of the 21,239 plans to which these workers belonged, the number of public sector pension plans accounted for 4.5%, but covered 44.8% of total plan participants. In comparison, the 20,276 private sector plans, covering 55.2% of total plan members, represented 95.5% of the total number of plans.

This paper will examine selected aspects of occupational pension plans, focusing on the jurisdictional and legal framework, the coverage of the labour force in terms of employees who may participate and eligibility conditions, types of plans, and the vesting, locking-in and portability of pension credits, as well as inflation protection and the related issues of pension surpluses and survivor benefits; some mention will also be made of female participation in occupational pension plans.

Unless otherwise indicated, all data are from the Statistics Canada publication, *Pension Plans in Canada 1988*.

THE LEGAL FRAMEWORK FOR OCCUPATIONAL PENSION PLANS

Partly because occupational pension plans are an integral component of the Canadian retirement income system for many labour force participants, the federal government and most provincial governments have implemented legislation to protect the rights of occupational pension plan members and to impose minimum standards for such issues as eligibility, vesting, locking-in and survivor benefits.

The regulation of pension standards is essentially through provincial legislation governing the pension plans applicable to employees who report for work in a specific province. Where an employer operates a plan in more than one province. Where an employer operates a plan in more than one province, the appropriate pension regulatory authorities have determined that the authority of the province where most plan members report for work will assume responsibility for both the registration of the plan and the supervision of compliance with all of the applicable legislative requirements.

Pension standard legislation was first enacted in Ontario, following the appointment of the Portable Pension Committee in 1963. At that time, the Ontario government's main concerns were to preserve pensions for mobile workers and to fulfil pension "promises." Similar legislation followed in several other provinces and in the federal jurisdiction, and was proclaimed in effect as follows:

Ontario — 1 January 1965
Quebec — 1 January 1966
Alberta — 1 January 1967
Federal — 1 October 1967
Saskatchewan — 1 January 1969
New Brunswick — 1 September 1973
Manitoba — 1 July 1976
Nova Scotia — 1 January 1977
Newfoundland — 1 January 1985.

Several jurisdictions have since amended their original pension standards legislation.

British Columbia alone has no legislation related to occupational pension plans. In Prince Edward Island, legislation received Royal Assent on 26 April 1990, but has yet to be proclaimed into force. The federal government has jurisdiction over the pension plans of federally regulated industries, including banking, interprovincial transportation, broadcasting and

telecommunications, as well as the plans of federal Crown corporations and of employees in the Yukon and Northwest Territories. Further, the federal government controls the maximum annual contributions to such plans that may be tax-sheltered.

COVERAGE

Although employers are not obliged to establish or maintain occupational pension plans for their employees, the documents establishing a plan define the categories of employees who may participate in it, and the conditions they must meet in order to become eligible; for example, in some instances, an employee must satisfy a service or an age requirement, or a combination of both. In 1988 in the public sector, 82.5% of the plans, covering 96.5% of plan members, provided for unrestricted membership. Comparable figures for private sector plans were 44.5% and 40.4%, respectively.

Some plans specifically exclude certain categories of workers, such as seasonal or part-time employees. In certain jurisdictions, however, recent legislative changes stipulate that, where an occupational pension plan exists, part-time workers must be eligible, subject to certain earning and tenure conditions. The inclusion of part-time workers in a plan may lead to higher costs for the employer, given the administrative expense of providing small benefits to a group of workers characterised as having high turnover. Further, in the absence of participation in a pension plan, these employees may have received other compensation in lieu of a pension.

Participation in a pension plan may or may not be a condition of employment. With non-contributory plans, where all pension contributions are made by the employer, all employees who fulfil eligibility requirements automatically participate, as a general rule. Choice in participation is more often available with contributory plans, where both the employer and the employee make pension plan contributions. In 1988, 43% of contributory plans provided for compulsory membership and 55% allowed voluntary employee participation. Voluntary plans covered fewer than 11% of all contributory plan members, while compulsory membership contributory plans covered 86% of all such members. Participation is compulsory in most of the larger contributory plans.

As well, eligibility conditions determine the earliest date on which an employee may begin participation in an occupational pension plan. Generally, an employee must complete

a minimum period of service prior to participation, with the legislation in several jurisdictions permitting participation after no more than two years of service, regardless of age. In 1988, 38.0% of plans, covering 44.3% of plan members, had no eligibility conditions; such was the case for 27.0% of public sector, and for 38.5% of private sector, plans. Further, a lack of eligibility conditions was more usual in non-contributory, than in contributory, plans. In 1988, almost 61% of all non-contributory plans had no service or age requirements, compared with 18% of contributory plans; 12% of all plans imposed some type of age restriction, either alone or in combination with a service requirement, while 48% of plans required only some period of service.

Although higher coverage could be achieved by legislating both the establishment of pension plans by all employers and employee participation in such plans, governments have instead imposed more stringent limitations on the exclusion of classes of workers, for example part-time workers, from participation in an existing plan.

DEFINED BENEFIT AND DEFINED CONTRIBUTION PLANS

Occupational pension plans can be of two types: defined benefit or defined contribution.

A. Defined Benefit Plans

Defined benefit plans guarantee a specific level of pension benefits, based on a predetermined formula reflecting the number of years of service, or a percentage of earnings, or both. For each additional year that an individual works, he or she typically experiences not only a wage increase, but also an increment in pension benefits.

These plans are either unit benefit, where benefits are usually based on final earnings averaged over a number of years or over the employee’s career, or flat benefit, where a fixed benefit is provided under a formula that usually does not account for the level of earnings, and may disregard the number of years of plan participation. In 1988, 84% of all unit benefit plan members had the earnings of years close to retirement as their earning base, while the base for the remaining 16% of members was career average earnings. Further, in 1988, 78.8% of all

unit benefit plan members were entitled to a pension credit of 2% or more of earnings for each year of credited service with the employer.

In defined benefit plans there is no fixed maximum limit on employer and employee contributions, and employers are generally thought to bear the most risk, since a fixed level of benefit is guaranteed to the employees and the employers are responsible for any deficiency in the plan. Employer contributions are not specified, but depend on the cost of ensuring that the pension fund is actuarially sound and can provide the promised benefits. The contributions must be made as determined by an actuary and as set out in the actuarial report. Generally, the contribution rate must be re-established at least every three years and each time the cost of the plan is affected by a plan amendment.

In some sense, plan members may bear the limited risks of employer bankruptcy and/or inadequate funding. As a response, at least in part, to concerns about the solvency of pension funds in cases of bankruptcy and the inability to recover overdue employer contributions from the bankrupt employer, the timing requirements for employer contributions have been shortened in a number of jurisdictions. Shorter payment periods could contribute to greater plan solvency by reducing the level of outstanding contributions. Ontario also provides some protection through its Pension Benefit Guaranteed Fund, as discussed below. Further, defined benefit plan members may bear some risk if their plans are not fully funded; members of defined contribution plans do not have this risk since their plans are, by definition, fully funded.

In general, plans in the public sector were superior to those in the private sector in 1988; more than 94% of the members of public sector plans were in schemes where pension credits were based on earnings in years close to retirement, generally the period of the employee's highest earnings. In the private sector, 32% of all plan members had this provision. Further, 98.6% of public sector members of unit benefit plans were entitled to a benefit rate of 2% or more of earnings per year of credited service, while such was the case for 47.6% of members in private sector unit benefit plans. Finally, flat benefit plans were more prevalent in the private sector, where more than 36% of all members were covered by such a scheme at the beginning of 1988. These plans are frequently non-contributory, with 90% of flat benefit plans, covering 85% of the members, not requiring employee contributions in 1988.

B. Defined Contribution Plans

Under defined contribution, or money purchase, plans, the benefits paid to retired employees are based on accumulated employer, and in some instances employee, contributions and their investment earnings. Usually contributions are a fixed percentage of employee earnings, a fixed dollar amount, or a specified number of cents per hour worked. With these plans, employees bear the risk of uncertain benefits, since the long-term rate of return determining them is unspecified, and the employer has no obligation to ensure that a specific benefit is received.

In 1988, although defined benefit plans represented 39.1% of all occupational pension plans, they accounted for 91.4% of all plan members. In that year, 7.6% of all plan members belonged to defined contribution plans, which represented 59.8% of all pension plans.

The implementation of stricter pension standards in some jurisdictions, with resulting cost increases, has led increasing numbers of employers to institute defined contribution, rather than defined benefit plans. In particular, small employers, if they offer a plan at all, may prefer the administrative simplicity and controlled costs of defined contribution plans. One analyst has suggested that stricter standards could be particularly onerous for small employers with low profit margins and labour-intensive operations. Coverage is already thought to be particularly low among these producers, who are often less capable of paying the administrative and contributory expense of pension plans, even without the expense of stricter pension standards.(1)

CONTRIBUTORY AND NON-CONTRIBUTORY PLANS

At the beginning of 1988, 53.7% of all occupational pension plans, covering 69.8% of all plan members, were contributory. Contributory plans were much more prevalent in the public sector than in the private, and in that year made up 94.3% of all public sector plans, covering 99.6% of all public sector plan members. In the private sector, contributory plans at that time were 51.8% of all plans, and covered 45.5% of workers. Of the non-contributory plans

(1) National Council of Welfare, *Pension Reform*, Department of Supply and Services, Ottawa, 1984, p. 21, 38.

in operation at the beginning of 1988, 99.4%, covering 99.4% of all members in such plans, were in the private sector.

At the beginning of 1988, 45.8% of all contributory plan members were required to contribute at a rate of 7% or more of salary, and virtually all of these members were in the public sector, where generally, contribution rates are higher than in the private sector. In 1988, 70.7% of members of public sector contributory plans were required to contribute 7% or more of their salary to their plan, compared to 1.6% of members in private sector contributory plans.

VESTING, LOCKING-IN AND THE PORTABILITY OF PENSION CREDITS

A. Vesting and Locking-In

Vesting is the employee's right, on termination of employment before retirement, to all or part of employer pension contributions made on his or her behalf, generally in the form of a deferred pension. The qualification for vesting is usually the completion of a period of employment or plan membership. If employees terminate employment prior to vesting, they are entitled to the value of their own contributions, if any, with interest, although in the past pension standards legislation did not prescribe minimum interest rates to be applied to employee contributions, various jurisdictions have recently done so.

Locking-in refers to a situation where plan members who terminate employment after meeting certain conditions regarding the period of employment, or plan membership, or age, or a combination of these, cannot withdraw the vested contributions of the employer, and employee contributions if any, in cash; the plan member will be provided with a deferred pension at retirement age. Locking-in prevents the use of retirement savings for purposes other than retirement. The principle of locking-in may be supported by the argument that since the government provides tax assistance for pension plan contributions, it should ensure that funds are used for the intended purpose. If this principle is adopted, however, certain questions arise. To what extent should the government restrict employees in spending what they regard as their own money? Is it unduly paternalistic for government to force employees to save for their retirement when they may have other priorities?

When pension standards legislation was first introduced, most pension plans had better vesting conditions than the then newly mandated age 45 and ten years of service

requirement. Currently, the pension standards legislation in some jurisdictions requires that vesting and locking-in occur after no more than two years of plan participation, although two years of service may be required before the employee is able to participate in the pension plan. In other jurisdictions, the requirement is after no more than five years of service or plan participation.

These enhanced vesting and locking-in provisions need not be retroactive, and can apply only to the contributions made after the effective date of revisions to the relevant Acts. Most jurisdictions have elected to retain their former vesting provisions for benefits accrued prior to the recent amendments, while others, usually for administrative simplicity, have adopted the new vesting provisions for all plan members.

At the beginning of 1988, 36.4% of all occupational pension plans, covering 6.5% of plan members, had provision for immediate vesting of pension credits, while 0.2% of all plans, covering about 0.2% of plan members, had no vesting provisions. Further, 43.6% of plans, covering 50.0% of plan members, provided no vesting provisions beyond those required by pension standards legislation. For 85.0% of plans, covering 76.5% of plan members, the years of service or participation required for vesting was no more than five years in 1988, an increase from 53% in 1986 as a result of legislative changes. Prior to 1988, members of contributory plans generally had shorter vesting periods than did non-contributory plans, although recent legislative amendments have virtually eliminated these differences.

Finally, in 1988, there was little difference between public and private sector plans in terms of the five-year vesting requirement. In that year, 78% of private sector, and 74% of public sector, plan members were in plans that provided for vesting after no more than five years of service or participation.

B. The Potential Benefits of Earlier Vesting

Certain benefits would likely result from earlier vesting provisions. One potential benefit concerns greater labour mobility, with its associated positive effects on economic growth. Currently, employees often remain with employers solely because of the period of service required before pension rights are vested, and this practice may hamper labour mobility. Without earlier vesting provisions, some pension plan members who have contributed to pension

plans for a number of years may receive only a limited amount of retirement income because they have changed jobs too frequently to acquire the right to vested pension benefits.

Further, occupational pension plan benefits are generally viewed as deferred compensation to which employees have a right and over which they should have total control. From this point of view, employees should perhaps acquire the right to these benefits at the point when contributions are made. This practice would lead to the immediate vesting that characterises the Canada/Quebec Pension Plan.

As well, provisions for earlier vesting of pension credits could lead to increased levels of retirement income and thus reduced expenditures under the Guaranteed Income Supplement (GIS) program. Currently, the income-tested GIS program is designed to guarantee low-income Old Age Security pension recipients a certain minimum income. If such individuals are able to increase their retirement income through higher retirement benefits from earlier vesting, then they may become ineligible for GIS payments, and thus there will by reduced federal expenditures on this program.

C. The Potential Costs of Earlier Vesting

Earlier vesting periods could, however, have negative effects. A requirement for earlier vesting of pension credits could lead some employers either to terminate existing plans or to forgo their implementation. Such might be the case, for example, where employers had established vesting requirements so as to minimise job turnover and retain valued employees. As well, employers could experience higher costs with earlier vesting. If they are unable to use vesting to limit turnover, employers may implement alternative mechanisms to limit labour mobility, including steeper service-related wage grids, with lower initial wages and higher wages with increasing seniority.(2) Finally, under deferred vesting, employers may assume the costs of upgrading general or transferable skills of their workers, as well as providing on-the-job training. With earlier vesting, however, employees may be less willing to remain with the employer until the firm's training costs have bee recouped, and thus may find themselves assuming these costs in the form of lower starting wages. The net result could be reduced investment in employee education and training.

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(2) Ontario Economic Council, *Pensions Today and Tomorrow : An Ontario Economic Council Position Paper*, Ontario Economic Council, 1983, Toronto, p. 37.

D. The Potential Benefits of Enhanced Portability

Portability is an employee's ability to transfer pension credits earned during service with one employer to some other retirement savings vehicle. Portability of pension credits has several potential benefits. As mentioned above, a mobile labour force is important to Canada's economic growth, and pension plan provisions that allow the movement of pension credits will facilitate labour mobility and thus lead to a better matching of jobs and worker, and greater labour market efficiency.

Further, if it is assumed that occupational pension plan benefits are a form of deferred compensation over which employees should have total control, an employee who leaves an employer prior to retirement should have the option of transferring vested pension credits to a new employer's pension plan or to another locked-in retirement savings vehicle.

As well, there is often a fear that company bankruptcies or closures may cause employees to lose vested benefits. Portability of vested pension credits would permit former employees to move their pension credits to what they considered to be a more secure environment, thereby perhaps lessening their risk of benefit loss, in whole or in part, through financial insolvency or closure by former employers.

As a supplement to, or as a substitute for, enhanced portability provisions, some analysts have proposed a pension plan termination insurance scheme, similar to the bank deposit insurance offered through the Canada Deposit Insurance Corporation. They argue that the absence of such insurance requires pension plan beneficiaries to bear the risk of plan termination and possible loss of retirement income.(3) A termination insurance scheme, however, could put the greatest burden on the majority of firms, who do have financially sound pension plans.(4) Finally, should neither enhanced portability provisions nor a termination insurance scheme be adopted, beneficiaries in a pension plan in a deficit position at termination might perhaps have a higher priority call on the employer's assets.

The Ontario government alone-introduced mandatory pension benefit insurance, with the creation of the Pension Benefits Guarantee Fund, effective 4 December 1980. The Fund was established to increase the statutory protection offered to pension plans members in the

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(3) Jihad Nader, "Seven Steps to Pension Policy, " *Policy Options*, September 1988, p. 31.

(4) House of Commons, *Report of the Parliamentary Task Force on Pension Reform*, Department of Supply and Services, Ottawa, 1983, p. 57.

event of plan termination, in whole or in part, particularly through bankruptcy or plant closure. The Fund's purpose is to guarantee payment of certain pension benefits, within limits, in such circumstances. Since 4 August 1983, employers making contributions to defined benefit plans have been required to pay annual assessments to finance the Fund.

As noted above, employees could potentially contribute to several occupational pension plans over the course of their careers. If pension credits were non-portable, and were vested with each employer, then upon retirement an employee could receive deferred benefits from several pension plans. For each employer, there would be a certain administrative cost associated with locating the employee and issuing the benefit cheque. With portability, however, the employee could transfer vested credits to each new employer, so that at retirement the last employer could issue a single pension benefit cheque on behalf of both its own pension plan and that of all previous employers. Administrative efficiency would result as the cost of the disbursement of benefit cheques would be undertaken by a single employer, rather than by several.

Finally, enhanced portability provisions could lead to increased retirement income and decreased demands for such payments as the GIS, as discussed above. Without such provisions, a significant number of employees may not receive an "adequate" pension upon retirement because of their high level of job mobility and loss of pension credits with each job change.

E. The Potential Costs of Enhanced Portability

Despite these potential benefits, however, enhanced pension credit portability could entail some costs. For example, it could frustrate the employer's goals in his establishment of the pension plan, lead some employers either to refrain from offering a plan or to terminate an existing plan, entail certain administrative problems for employers and legislative problems for the two levels of government, and jeopardise the financial viability of, and high rates of return to, some pension plans. Employers often design their pension plans to encourage valued employees to remain with them, and full portability provisions may not be totally compatible with this aim.[5] Deferred compensation measures like pensions are often preferred by employers both

(5) *Ibid.*, p. 51.

because they create an incentive for employees to work diligently in order to keep their jobs and have access to these deferred payments, and because they reduce turnover. Employees, for their part, may find such deferred compensation schemes not undesirable, provided that their wages are sufficiently high to compensate for some deferral and hence some uncertainty about receipt, and that they are given adequate guarantees that the deferred compensation will in fact be paid by the employer at some future date. Pension credit portability and/or the pension plan termination insurance scheme discussed earlier may provide such guarantees.

The development of occupational pension plans on a sufficiently uniform basis to allow reciprocal transfers of pension credits between employers would certainly facilitate the portability of pension credits. The large number of occupational pension plans, however, as well as substantial differences in their structure and benefits, make the development of such reciprocal arrangements difficult, if not impossible. Reciprocal arrangements between employers in the same industry might be possible, but would not benefit those mobile workers who move from one industry to another. The problems associated with the negotiation of such reciprocal arrangements could lead some employers simply to terminate their plans. Since occupational pension plans are regulated by the provincial government in some cases, and by the federal government in others, the federal and provincial governments would have to adopt universal legislation with regard to portability requirements in order to achieve full portability across employers and across provinces. Obtaining the necessary consensus among all jurisdictions could be a formidable task.

Finally, portability would allow a terminating employee to withdraw pension credits from a former employer's pension plan. There has been some concern that the viability of the pension plan and the interests of remaining plan members could be at risk if a significant number of plan members terminated and transferred the value of their vested credits in unison.[6] As well, portability of pension credits could increase pension plan liquidity requirements, with a larger proportion of the plan's assets held in liquid securities in order to accommodate the requests for transfers of credits from an uncertain number of terminating employees. Such securities generally have a lower rate of return and, as a result, the plan's rate of return, and ultimately perhaps the level of benefits, could be lower.

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(6) *Ibid.*, p.52.

INFLATION PROTECTION

Since relatively few pension plans provide for automatic cost-of-living increases to pension benefits after an employee retires, these benefits are often eroded by inflation. Nevertheless, some employers do, from time to time, make *ad hoc* increases to benefit levels which partly offset the effects of inflation, though there is no guarantee that future increases will be given. Such increases are more prevalent in the private, than in the public, sector, and may consist of a certain percentage or a flat dollar amount, depending on the needs of retired employees and the employer's ability to finance such increases.

According to a 1987 survey of 284 Canadian companies, while the cumulative inflation rate between 1976 and 1986 was 110%, the cumulative average paid out in extra pension benefits over this period totally 29%.(7) As well, a national survey of large pension plans in the private sector found that, while 80% of the plans had received *ad hoc* adjustments for inflation over the 1971-75 period, these adjustments averaged 66% of the increase in the cost of living during that time.(8) Further, with an inflation rate of 4% per year, pensioners lose approximately 30% of their purchasing power in ten years, assuming their pensions have no inflation protection.(9) Inflation affects the value of pensions paid in retirement; it also affects the value of pension credits earned prior to retirement, although "final average earnings" plans do provide some inflation protection by calculating pension benefits on the basis of earnings in years closest to retirement.

In 1988, 6.1% of all occupational pension plans, covering 34.3% of all plan members, provided for the automatic cost-of-living escalation of pension benefits either in whole or in part; 88% of these members were in the public sector. In that year, 12.9% of public sector plans, covering 67.3% of all public sector plan members, had some form, either full or partial, of indexing. These figures compare with the 5.8% of plans, covering 7.5% of plan members, with full or partial indexing, in the private sector in that year. These data, however, do not reflect the

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(7) Ann Finlayson, "Whose Money Is It, Anyway?" Report on Business Magazine, The Globe and Mail, *January 1989, p. 60.*

(8) National Council of Welfare, *A Pension Primer*, Department of Supply and Services, Ottawa, 1984, p. 53.

(9) National Council of Welfare, *A Pension Primer*, Department of Supply and Services, Ottawa, 1989, p. 44.

periodic *ad hoc* increases sometimes made to pension payments. Of greater significance, perhaps, was the 93.9% of plans, covering 65.7% of plan members, that contained no automatic provision for the indexing of pension benefits in 1988.

Most employers are opposed to mandatory inflation protection, noting that pension plans are a voluntary undertaking by them. Nevertheless, according to one analyst, most jurisdictions are considering a requirement for a t least "part" of all pensions and deferred pensions earned after 1 January 1991 to be adjusted annually by 75% of the increase in the Consumer Price Index, minus 1%. That "part" to be adjusted is the portion of the pension earned each year that does not exceed 2% of the Year's Maximum Pensionable Earnings as specified under the Canada/Quebec Pension Plan.(10) Ontario is committed to mandatory inflation protection, a commitment recently reinforced by Premier Bob Rae when he indicated that forthcoming pension legislation would deal with indexation, as well as with the ownership of pension surpluses.

Although there has been much interest in the concept of the automatic escalation of pension benefits to reflect cost-of-living increases, the substantial costs of such a proposal have also been discussed. One analyst has suggested that employees would have to share in such costs, by receiving either a lower starting pension, or less than full indexing, or a combination of both. Many employers feel that they cannot be expected to assume an open-ended cost; the alternative would be either capped inflation indexing or some other approach, perhaps using surplus pension funds.(11) There is an expectation that if employers are to provide enhanced pension benefits, perhaps through inflation protection, then, net of any productivity-enhancing effects, employers will receive an equal concession in terms of reduced current wages, a reduction in some other part of the compensation package, higher prices from consumers, or some combination of these.

Further, such income-tested programs as the GIS may provide a disincentive to acquire pension benefits that are protected against inflation, since indexed public pensions can be substituted for the declining real value of occupational pension plan benefits in retirement. In

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(10) L. Jacques Pelletier, "Pension Reform — Have We Seen the End?" *CMA Magazine*, November 1989, p. 24.

(11) Frank Speed, "The Disappointments From a Decade of Pension Reform," *Canadian Speeches*, February 1988, p. 8

fact, low-income workers and/or workers for whom saving has a low priority, may prefer not to reduce current income in order to make pension contributions. As well, a slight decline in the real purchasing power of pensions may be optimal since consumption is generally thought to decline with age. Finally, pensioners may be able to hedge against inflation in the context of their overall retirement portfolio.

Should the government actively promote inflation protection for occupational pension plan benefits? It might be that benefit indexation should not be of concern to policy-makers if, in its absence, employees receive higher current wages and/or larger basic pension entitlements than would otherwise be the case. One analyst has suggested that the preferred solution to the problem of the erosion of pension benefits by inflation may be fiscal and monetary policies designed to reduce the rate of inflation to the point where indexing is no longer an issue.(12)

PENSION FUND SURPLUSES

A. The Ownership Question

The high interest rates of the late 1970s and the early 1980s led many pension funds to earn significantly higher investment returns than actuaries had estimated when establishing contribution levels. Thus, many pension plans found themselves in a position of surplus, with the actuarial value of plan assets exceeding the actuarial liabilities for accrued benefits. In many instances, these "excess interest" surpluses were augmented when pension fund liabilities declined as a result of work force reductions and a slowdown in the rate of wage increases, as well as wage cuts and freezes. The high interest rates also led to relatively low purchase costs for the annuities for retirees. Further, with declining nominal interest rates in the mid-1980s, rising equity values led to additional increases in pension plan income. The result of these factors is that many defined benefit plans have accumulated more assets than actuaries predict will be needed to pay the stated level of benefits.

In an ongoing pension plan, the surplus at any particular date is an estimate, and can vary substantially depending on the actuarial methods used to value assets and to determine

(12) James Pesando, "Indexing of Private Pensions: An Exchange," *Canadian Public Policy*, Summer 1979, p. 428.

the liability for accrued benefits. Legislation in some jurisdictions stipulates certain valuation assumptions.

Currently, an area of increasing concern is the ownership of these surpluses. Several questions arise: should employers be able to recover these surplus assets for their own use, given that the terms of some plans do not entitle plan members to claim anything more, or anything less, than the promised benefit levels? Should the surpluses be used to protect or improve the pension benefits of plan members, since they have earned, as deferred compensation, whatever is contributed to the plan and are therefore entitled to the full returns of those contributions?(13)

Some employers argue that the surplus funds resulting from "excess interest" returns belong to them, noting that because they are liable for any fund shortfalls, they should receive any surpluses as a return for the risk they bear, as long as the payment of promised pension benefits is not endangered. They suggest that they should be able to periodic contributions to the pension funds. Further, in defined benefit plans employers essentially make "educated guesses" as to the contributions necessary to guarantee future benefit payments. If the "guess" is too low, then the employer is responsible for any shortfall. If the "guess" is too high, however, and employers are unable to have "excess" contributions returned, they may limit their contributions in order to minimise the size of any surplus; as a result, pensions may be less secure.(14)

Alternatively, others propose that excess interest returns should be used for benefit enrichment, for inflation protection, for reduced employee contributions, for a contingency reserve against unfavourable financial trends in the future, or for any other purpose that will benefit employees, since these returns belong to those plan members. This view is consistent with the assumption that pension plans are a form of deferred compensation, with any surpluses realised on pension funds being part of this compensation package. Further, one analyst suggests that not all plan risk is borne by the employer, since employees risk that the real value of promised benefits will decline between the time when the pension promise is made and

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(13) Bernard Adell, "Pension Plan Surpluses and the Law: Finding a Path for Reform," *Ontario Task Force on Inflation Protection for Employment Pension Plans Report*, 1988,p. 211.

(14) Speed (1988), p.7.

the benefits are paid. Those market factors especially inflation, that are largely responsible for plan surpluses are also those that erode the real value of promised benefits before they are paid.[15] Finally, in contributory plans, there may be an implicit agreement between the employer and employees to share in the cost of the pension plan. In such situations, employees may have a moral entitlement to a portion of any surplus. This moral claim may also exist where employer contributions to a pension plan are made in exchange for a smaller wage increase or other forms of compensation, and where the employees "contributed" in the expectation of benefits whose real value would not decline greatly over time.

The treatment and uses of plan surplus are generally determined by the terms of the pension plan, trust documents related to the plan, collective agreements, communications to employees, legislation and court interpretations of all of these. Often, plan documents are silent or ambiguous on the issue of surplus ownership and its legitimate use, since many of these were created at a time when surplus was not an issue. However, several jurisdictions require, as a condition of plan registration, that the plan text include information on the treatment of surplus, both while the plan is ongoing and on plan termination. The pension standards legislation in some jurisdictions requires that employers may not receive any plan surplus unless the plan expressly permits them to do so; other legislation provides that the employer may withdraw surplus from an ongoing plan if the appropriate regulatory authority is otherwise satisfied of the employer's entitlement. Plan surplus may be received by an employer either through a "contribution holiday" or through a withdrawal of funds. Although these two circumstances have the same effect in the long run, since in either case the surplus is reduced by a certain amount, which the employer then has available for other purposes, their practical and symbolic effects may be different, with contribution holidays usually viewed somewhat more favourably.[16]

B. Contribution Holidays

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(15) Adell (1988), p. 234.

(16) *Ibid.*, p. 242.

Although all pension legislation in Canada allows employers to use surplus funds to reduce the contributions they otherwise would have to make, the specific requirements and limitations vary. The most common practice in these circumstances is the "contribution holiday," in which surplus is credited toward the employer's contributions payable for current service costs, in place of actual payments.

C. Withdrawals

Legislative controls on surplus withdrawal by the employer exist to protect both the solvency of the plan and the potential or actual rights of employees to the surplus. Many jurisdictions require that if a withdrawal is made by an employer from an ongoing plan, a portion of the surplus must be left in the plan. Further, employees are generally given the right to be notified of the employer's application to withdraw surplus. Typically, legislation places the onus on the employer to demonstrate its entitlement to withdraw surplus, and even where surplus withdrawal is provided for in the plan text, there may be questions about its validity. The courts may be called upon to determine the ownership of any pension plan surplus by interpreting plan documents and the legal relationships they create.

Where withdrawals are permitted and these amounts are to be credited to the fund over a certain period of time, certain questions arise. Should these "loans" be available at an interest rate below the market rate of return? Should some sort of "business necessity" criterion be met prior to a withdrawal? Should employers be allowed to "borrow" for purposes for which loans could not be obtained on the capital market?[17]

It is likely that the future growth of pension fund surpluses will be limited by legislated requirements for improved pension benefits and the possibility of future stock market corrections. Also to be considered are the ageing of the labour force and the probability that its growth will slow; thus, a higher proportion of employees will have high incomes on which benefits are based, more of them will be reaching retirement age, and there will be a smaller proportion of younger employees to contribute to pension plans. It might be possible to permit surplus withdrawals only if assets exceeded liabilities by a certain margin and after the contributions for a certain period of time had been taken out of excess moneys, and to ensure that

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(17) *Ibid.*, p. 240-241.

withdrawals were used for reducing the company's debt, or that the money was used in some other "acceptable" manner.

SURVIVORS BENEFITS

Prior to recent amendments to pension standards legislation, there was no requirement for occupational pension plans to provide survivor benefits, other than a return of member contributions, if the plan member died before retiring. Pension standard legislation in some jurisdictions, however, now requires that the surviving spouse of a plan member who dies after meeting the vesting requirements must receive either part or all of the commuted value of the deterred pension earned after the effective date of the legislation. This value must be received in the form of an immediate or a deferred annuity. Such a provision need not apply if a survivor pension has been refused in writing by both spouses.

In 1988, 6.0% of occupational pension plans, covering 14.5% of plan members, provided for no survivor's benefits or for only the return of employee contributions in the event of a member's death before retirement. Further, 46.0% of all plans made provision for the refund of employer contributions. Finally, 7.2% of plans in that year made provision for a spouse's pension in the event of the death of the plan member prior to retirement. It is of some note that more than 66% of public sector plan members were provided with an automatic spouse's pension on the death of the plan member before retirement, compared with 26% of private sector plan members. Further, while three public sector pension plans covering 87 plan members provided no death benefit at all, the same was true of 295 plans, covering 4% of plan members, in the private sector.

Similarly, in 1988, upon the death of a retired employee, most pension plans provided some form of survivor benefit, generally depending on the normal type of annuity used for payment of retirement benefits under the plan. Pension standards legislation in many jurisdictions requires that a joint and survivor pension, actuarially equivalent to the normal form of pension, is mandatory for plan members, but this type of pension can be waived.

In 1988, 8.4% of occupational pension plans, covering 13.4% of plan members, provided for a life annuity for the plan member only, whereas 77.9% of plans, covering 33.1% of plan members, provided for a life annuity for the member with a specified guarantee period for

payments to be made for a certain number of years in any event. Under this latter type of plan, the beneficiary of a retired employee who died within the guarantee period would receive pension payments for the remainder of the guarantee period. Nearly 71% of the plan members with such a provision had a five-year guarantee period in 1988, while 27% of plan members had a guarantee period of ten years. Also, in 1988, 8.2% of plans, covering 46.9% of plan members, and including many of the largest plans in both the public and the private sectors, made provision for a spouse's pension. Most of these plans entitled the beneficiary to one-half of the retired employee's pension. Finally, for 1.6% of the plans, covering 4.9% of plan members, the death benefit was in the form of a lump sum payment of employer, and in some instances employee, contributions, less pension payments made to the date of death.

Again, in 1988, great differences existed between public sector plans and private sector plans in terms of death after retirement, especially with respect to a spouse's pension. In that year, nearly 72% of all public sector plan members were provided with a spouse's pension, compared with 26% of private sector plan member. Further, more than 50% of private sector plan members and 12% of public sector plan members were provided with life pensions with a minimum guarantee period.

Discussions of survivor benefits often include references to the particular situation of women. How women will be affected in the even of their spouse's death is a key issue, given that women, on average, live longer than men and may have only limited retirement income in their own right. Further, the pension benefits received by female workers may be smaller than those received by male workers, given the formers higher level of job mobility and the current vesting and portability provisions. As well, women are more likely to be employed in those jobs, businesses and industries that do not offer occupational pension plans as part of the total compensation package. Nevertheless, in 1988 females constituted 36.4% of pension plan members; the proportion was higher in public sector plans, at 46.5% of all plan members, and lower in private sector plans, at 28.2% of all plan member. Women's participation in occupational pension plans has grown over time, and represented approximately 80% of the 15.5% increase in total plan membership over the 1978-88 period. Further, the coverage of female workers by pension plans may be enhanced by recent changes to the participation of part-time workers in such schemes, as discussed above. These changes should be particularly beneficial to women, since they represent 71.6% of all part-time workers in 1989.

CONCLUSION

Through participation in an occupational pension plan, many Canadian workers attempt to make some provision for their retirement. Potential retirement benefits are, however, often limited by plan or legislative provisions, regarding vesting, portability, inflation protection and the treatment of pension plan surpluses. Further, the retirement income of surviving spouses of plan members is limited by legislated and plan provisions.

Currently, there is some concern about the financial solvency of the Canada Pension Plan, which is included in the first tier of the retirement income system. Further, for many Canadians home ownership, a source of retirement income included in the third tier, is not affordable. If the first and third tiers of the retirement income system become less reliable as a source of retirement income, then occupational pension plans may become increasingly important. Such issues as vesting, portability, inflation protection, the use and ownership of pension fund surpluses, and survivor benefits would then become areas of even greater interest to policy-makers.

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