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of Financial Institutions Canada

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PBSA Update

Issue No. 11

PBSA Update is issued by the Pension Benefits Division, Office of the Superintendent of Financial Institutions. The Office administers the *Pension Benefits Standards Act, 1985* (PBSA).

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Contents

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1. Amendments to the Pension Benefits Standards Regulations, 1985

… recently approved

- The amendments to the Pension Benefits Standards Regulations, 1985 (Regulations) described in the previous issue of *PBSA Update* were approved on May 26, 1994. The Office announced this in a memorandum to plan administrators dated June 6, and the amendments were published in the *Canada Gazette,* Part II, on June 15.

Canada

... for the future

- Amendment to section 6 – the Office is recommending an amendment to section 6 of the Regulations dealing with the holding of pension plan assets by financial institutions. The part of the current regulation dealing with the safekeeping of assets of pension plans allows that the assets be held “in the name of a bank, trust company or other financial institution in accordance with an agreement that clearly indicates that the investment is held in trust for the plan…” However, trust companies are the only financial institutions that can enter into this type of agreement.

  The proposed amendment will allow other financial institutions (as defined by the regulation) to hold the assets of pension plans through a custodial agreement.

  This section of the Regulations was last amended in December 1991, to allow pension plan investments to be held “in the name of the Canadian Depository for Securities Limited (CDS) or a nominee thereof.” The recommended amendment will direct that the use of CDS be in accordance with a custodial or trust agreement.

  The recommended amendment dictates specific terms and conditions of the custodial agreement which are designed to ensure that if a custodian were wound up, pension plan assets will be reserved for the pension plan, and not used to satisfy other claims against the custodian. An English and French copy of the draft regulation is attached. Comments should be sent by September 30, 1994 and directed to Johanne Prévost, in the Policy Division of the Office, at the address on page 8.

In addition, the Office will:

- Recommend an amendment to subsection 11(3) of the Regulations to allow the filing of an actuarial report that conforms with the latest standards developed by the Canadian Institute of Actuaries, when applying for registration under the PBSA. Subsection 11(3) is the only reference in the PBSA or Regulations to a specific set of standards for the valuation of pension plans. The Office continues to look to current standards of the Canadian Institute of Actuaries as generally accepted actuarial practice for pension plan valuations other than those required by 11(3). The most recent set of standards is Standards of Practice for Valuation of Pension Plans, dated January 1994.

- Recommend changes to funding regulations, described in the article below, Changes to Funding Regulations.

- Recommend a change to subsection 28.5 of the Regulations to confirm that supplemental plans set up strictly to provide members with benefits above

Revenue Canada limits are exempt from the PBSA even if the employer does not contribute to the supplemental pension plan.

- Recommend a change to the Regulations that will exempt from most of the standards for registration certain small pension plans, perhaps those covering only connected persons as defined in subsection 8500(3) of the Income Tax Regulations. There would be no exemption, however, from standards protecting spousal benefits.

2. Changes to Funding Regulations

Several PBSA plans have recently run into difficulty as their membership declined in response to economic conditions. The plans had unfunded liabilities resulting from benefit improvements made when the economic outlook was better or made to induce workers to retire. As the workforce supporting the plans diminished, the burden of funding the liabilities arising from the benefit improvements became unsupportable. Although negotiated contribution multi-employer plans are particularly vulnerable to this risk, single employer plans may also be affected.

The Office is considering recommending changes to the solvency funding rules. They include:

- requiring the funding of solvency deficiencies within three years, rather than the current five and excluding from solvency assets special payments payable more than three years after the valuation, and

- requiring immediate funding of new solvency deficiencies created by improvements to plans that have a solvency ratio less than 100 per cent.

The Directives of the Superintendent would also be changed to require the annual filing of valuations for plans that have been established for more than five years and that reported a solvency ratio of less than one at the last valuation.

Most pension plans subject to the PBSA are fully solvent and would be unaffected by these changes. Transitional provisions would ensure that the Regulations do not hit plans with a sudden funding burden.

3. Change in Financial Reporting

In a March 1994 notice to pension plan administrators, the Director General, Pension Benefits Division, announced a change to the exemptions that allow a plan administrator to file certified financial statements instead of audited financial statements. Previously, we required pension plans administered by individual trustees, plans funded through pension fund societies and those that did not meet other criteria (explained in a February 1990 memorandum) to file audited financial statements regardless of where the funds were deposited. Now, individual trusteed pension plans whose funds are invested according to items (a), (b) or (c) on the first page of the February 1990 memorandum may file certified financial statements if at least one trustee certifies that the statements are a complete and accurate representation of the financial position of the plan. Other changes to the reporting requirements are still being considered. We enclose a copy of the notice and a memorandum describing the previous policy.

4. Benefits Subject to Consent

In Issue No. 7 of *PBSA Update*, we announced the Office's policy that benefits subject to the consent of the employer need not be included in liabilities for solvency valuations. Recent experience has shown us that it is sometimes extremely difficult or even impossible for an employer to deny consent for a benefit, no matter what the plan text says. For example, if the plan administrator has consistently granted such a benefit to all eligible members who apply for it, if employees have been told that they were entitled to the benefit, or if there is nothing in the employee booklet reminding members that a benefit is subject to consent, employees may see their right to this benefit as irrevocable. In these situations, the administrator may find it morally or even legally impossible to deny the benefit even in case of plan termination.

Further, when the sponsors of pension plans run into difficulty, the reaction of some plan administrators has been to encourage retirement through generous early retirement benefits. Unfortunately, the cost of providing these early retirement benefits can drain a pension fund, perhaps to the point that the plan can no longer be funded according to the Regulations. To cut pension expense, the employers may eventually decide to deny consent for these benefits. However, employee expectations may force employers to announce in advance their intention to deny consent. If a large portion of eligible members take advantage of this last chance for early retirement benefits, the funding problem becomes even more serious, perhaps leading to the termination of the plan. While the plan text may not state that the benefits subject to consent are available at termination, they are nonetheless payable in the final months of the plan.

The Office's policy allows the exclusion from solvency liabilities of benefits genuinely subject to consent. Before deciding to exclude all or part of a benefit, the actuary should establish the degree to which consent to this benefit may be denied. To do this, the actuary should discuss the matter with the plan administrator and consider past administrative practices, employee booklets and other communications to members, the intentions of the plan administrator and collective agreements. If benefits are excluded from the solvency liability because they are subject to consent, the actuary should indicate it in the valuation report.

5. Expenses Charged to the Pension Fund Must Be Reasonable

In recent months, we have discovered that the trustees and administrators of some negotiated contribution pension plans are charging expenses to their pension funds that, in the view of the Office, are not legitimate. This violates subsection 8.(4) of the PBSA, which requires that plan administrators "exercise the degree of care that a person of ordinary prudence would exercise in dealing with the property of another person."

The unreasonable expenses that have been charged to pension funds include the attendance at distant conferences of people with no responsibility for administering pensions, unjustified travel expenses, the purchase of capital equipment that is not used primarily for the administration of the pension plans, donations and the use of pension funds for union business. In one recent case, uncovered by an on-site examination, the Office insisted that the trustees reimburse the excessive charges to the pension fund.

The trustees of pension plans should have controls in place to ensure that expenses charged to pension funds are reasonable and in line with the requirements of subsections 8.(3) and 8.(4) of the PBSA. Also, they should be prepared to justify all their expenses to the Office and to plan members.

6. Investment Information Return

We have been asked to clarify the requirements of the Investment Information Return. Question 1 asks whether the pension plan is fully insured, either through government annuities or annuity contracts issued by an insurance company. Administrators may find a definition of "insured plan" in subsection 2(1) of the Regulations. The key word in Question 1 is "all." Many plans use annuities to cover benefits for retired members or former members with deferred vested pensions, but do not purchase annuities each year to provide benefits accruing to active members. These plans are not insured plans. Only if annuities are purchased to provide all benefits accrued to all beneficiaries is a plan fully insured. Few plans are fully insured.

Question 2 asks whether the pension plan invests all its funds in the unallocated general fund of a life insurance company. These are funds subject to the prudent person investment rules for life insurance companies. They do not include segregated funds. Plan administrators should verify with the issuing insurance company whether specific contracts are backed by the company's general unallocated funds.

Some administrators have read into the Investment Information Return the implication that administrators of some types of pension plans need not prepare investment policies. This is incorrect. The Regulations require the administrator of any pension plan, insured or not, to prepare an investment policy. Plans that are insured, or that invest all their funds in the unallocated general funds of an insurance company, are exempted from answering several questions on the new investment return.

As previously announced in *PBSA Update,* the Office is planning to change the Annual Information Return (AIR). The revised AIR will incorporate the Investment Information Return.

7. Life Income Funds (LIFs)

We receive inquiries regularly asking when transfers to LIFs will be permitted under the PBSA. The PBSA and Regulations require members to use credits transferred from pension plans to purchase a life annuity either directly or through a locked-in RRSP. Tax rules for registered retirement vehicles generally require that benefit payments begin by the year the holder attains age 71. Therefore, former members who transfer pension benefit credits out of their plans must purchase an annuity by the year in which they attain 71. LIFs are registered vehicles that allow retired members to manage their funds even after payments begin and do not force the purchase of an annuity before age 80.

The process for amending the PBSA is lengthy. Be assured that the Department of Finance, which is responsible for amendments to the PBSA, is aware of the interest in this option.

8. Pension plans With Members in British Columbia

The *Pension Benefits Standards Act* of British Columbia was enacted on January 1, 1993. Consequently, during 1993, the Office gathered detailed membership information from pension plans with British Columbia members that are currently supervised by the Office. About 40 per cent of the 300 plans with members residing in British Columbia responded to our request. Only 10 responses showed that both the federal and provincial legislation applies. Of these, we understand that two or three will register with British Columbia once a reciprocal agreement is signed. The Office and the Superintendent of Pensions in British Columbia are currently drafting the agreement.

We have reviewed the list of plans that did not respond to our request, and it appears that they are probably all subject exclusively to the federal pension standards. The onus is on plan administrators, however, to ensure that their pension plan is filed with the correct supervisory authority.

9. Provision for Expenses in Actuarial Valuations

The Office has recently seen multi-employer plans for which important recurring expenses of operations, relative to the normal cost, were not adequately provided for in the funding recommendations. Because the administrator of a plan was unable to recover the expenses from employers, contributions to the plan were inadequate to cover both the cost of accruing benefits and expenses. Surplus disappeared and a deficit emerged.

While the problem is likely most serious for negotiated contribution plans, expenses of operation should be discussed in all valuation reports. Investment expenses should be treated separately from other expenses. The report should indicate whether the normal cost includes these expenses, and if not, how these expenses will be paid. There must be an adequate provision for expenses.

In Issue No. 6 of *PBSA Update*, we confirmed that solvency valuations must include an assumption for expenses of winding up the plan. Recently, some solvency valuation reports filed with the Office did not include an assumption for estimated expenses of plan wind-up, and we have requested that they be resubmitted.

10. Records Retention

On occasion, during a pension plan examination at the office of the plan administrator, our examiners' work is frustrated by the fact that certain records have been destroyed, e.g., benefit calculations for a terminated member. Clearly, the Office requires this information to fulfill its obligations under the PBSA. Also, destruction of records may place the administrator in a difficult position if, in the example cited, the benefit calculation is challenged by the former member.

While the PBSA does not explicitly provide for the retention of records, the Office considers the requirements in subsections 8(4) and 8(5), that administrators exercise care and prudence in administering the plan and fund, to be broad enough to include the requirement that key records should not be destroyed before a reasonable length of time has passed. Also, section 38 provides that it is an offence to destroy records in certain circumstances.

11. Reporting of Forfeiture Amounts

Some insurance companies do not report the amounts deposited in forfeiture accounts on the financial statements of money purchase pension plans. Forfeiture amounts are part of the pension fund and must always appear in the fund totals. They may be held under a different account but they have to be reported in the financial statements as part of the assets of the fund. The financial statements should show how much of the forfeitures, if any, were used to cover current service costs as a separate item from employer contributions. For example, the annual information return may show that the employer used $1,000 forfeitures for part of the $3,000 current service costs; however, the financial statement only specifies a $3,000 company contribution deposit. It appears from the financial statement that $3,000 “new” assets went to the plan but in fact only $2,000 was deposited, while $1,000 came from a forfeiture account, which should be considered part of the pension fund.

Comments?

OSFI welcomes readers' comments on any matter covered in *PBSA Update* or related to OSFI's supervision of pension plans. If you have any suggestions that you think would improve communications between our Office and the pension industry or on other matters about the legislation, please write to:

PBSA Update
Pension Benefits Division
Office of the Superintendent of Financial Institutions
255 Albert Street
Ottawa, Ontario
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You may fax the Pension Benefits Standards Division at (613) 990-7394 or e-mail us at penben@osfi-bsif.gc.ca.

Attachments (4)

March 1994

TO ALL PENSION PLAN ADMINISTRATORS

In response to representations made by plan administrators, we have made a change to the exemptions that allow certified financial statements to be filed in lieu of audited financial statements.

Our existing policy is described in the attached memorandum; however, please note that the following change is effective immediately:

- Plans whose funds are invested according to items (a), (b) or (c) and have individual trustees may file certified financial statements, provided that at least one trustee certifies that the financial statements are a complete and accurate representation of the financial position of the plan. This trustee certification is in addition to the financial institution certification which is still required.

Other changes are being considered but are not finalized at this time.

Pension plans that do not meet the criteria described in the attached memorandum including the above change, must continue to file audited financial statements.

Mars 1994

AUX ADMINISTRATEURS DE REGIMES DE RETRAITE

À la suite des observations que nous avons reçues des administrateurs des régimes de retraite, le Bureau a modifié les exemptions permettant aux régimes de déposer des états financiers certifiés au lieu d'états financiers vérifiés.

La politique présentement en vigueur est décrite dans la note de service ci jointe; veuillez noter que la modification qui suit est, dès maintenant, applicable:

- Les régimes dont les fonds sont placés selon les articles (a), (b) ou (c) et qui comprennent des individus agissant à titre de fiduciaires peuvent déposer des états financiers certifiés, pourvu que l'un des fiduciaires atteste que les états financiers déposés représentent entièrement et fidèlement la situation financière du régime. Cette certification s'ajoute à celle, toujours requise, provenant de l'institution financière.

D'autres modifications, non encore menées à bonne fin, sont présentement à l'étude.

Comme par le passé, les régimes de retraite qui ne satisfont pas aux critères nooncés dans la note de service ci-jointe, y compris la modification précédemment décrite, doivent déposer des états financiers vérifiés.

Mark Fowler
Directeur General/le directeur général
Pension Benefits Division/Division des régimes de retraite

Revised February 1990

MEMORANDUM TO ALL PENSION PLAN SPONSORS

In accordance with the *Pension Benefits Standards Act*, *1985* and the Regulations and Directives issued under the authority of the Act, pension plans, other than insured plans, are required to submit annually audited financial statements.

It is recognized that this change in reporting requirements has created some difficulty for plans that formerly filed an unaudited financial statement on a triennial basis. In order to assist plans, that might face difficulty in complying with the new requirements, the office has followed the practice of accepting a certified financial statement for certain plans. This practice was applied during the period 1987 to 1989 and has worked reasonably well. The study of pension plan financial statements is on-going and may result in further changes to the office's administration practice in this area. For the purposes of complying with the filing requirements, plans meeting the criteria listed below may continue to submit a certified financial statement. This policy will remain in effect until further notice.

Pension plans which may file certified financial statements in lieu of audited financial statements are those whose funds are deposited as follows:

(a) where all funds are held and managed by an insurance company – any type of account;

(b) where all funds are held in the *pooled funds* of, and managed by, a trust company; and

(c) where all funds are managed by a trust company but are held outside the pooled funds in some other funding arrangement and *both* of the following conditions are met:

   (ii) there are fewer than 100 members;

   (iii) there is less than $1,000,000 in total assets (market value).

For all other plans, we will require an audited financial statement regardless of where funds are deposited. These plans include:

(a) all plans administered by individual trustees;

(b) all plans funded through Pension Fund Societies; and

(c) all plans that do not meet the criteria of (c) above.

We have prepared a list of what we consider the minimum requirements for a certified financial statement. Please refer to the addendum. Your cooperation in supplying the necessary information will be appreciated.

Mark Fowler
Director General
Pension Benefits Division
(613) 990-8124

ADDENDUM

Certified Financial Statements

Certified Financial Statements should include, as a minimum, the following information:

(a) Statement of financial position (net assets), indicating the following elements for the current period and the immediate prior period:

- (i) amounts held in cash;
- (ii) receivables (employee and employer contributions shown separately);
- (iii) accrued investment income;
- (iv) investments at cost and market, by classes of investments;
- (v) payables.

(b) Statement of changes in pension fund net assets indicating the following elements for the current period and immediate prior period:

- (i) balance of net assets at beginning of period;
- (ii) additions to the pension fund including:
  - contributions for the period (employee and employer shown separately);
  - net investment income;
  - net profit, if any, on sale of investments;
- (iii) deductions from the pension fund including:
  - pension, annuities and termination benefits paid;
  - net loss, if any, on sale of investments;
  - administration expenses if paid from the fund;
- (iv) balance of net assets at end of period.

(c) Certification by original signature of an Officer of the trust or insurance company attesting to the fact that the attached statements are an accurate representation of the plan's financial position.

DRAFT DOCUMENT

SCHEDULE

1. Subsection 2(1) of the Pension Benefits Standards Regulations, 1985 is amended by adding the following thereto:

   "financial institution" means

   (a) a bank;

   (b) a body corporate to which the *Trust and Loan Companies Act* applies;

   (c) a cooperative credit society to which the *Cooperative Credit Associations Act* applies;

   (d) an insurance company to which the *Insurance Companies Act* applies;

   (e) a trust, loan or insurance corporation incorporated by or under an Act of the legislature of a province;

   (f) a cooperative credit society incorporated and regulated by or under an Act of the legislature of a province;

   (g) an entity that is incorporated or formed by or under an Act of Parliament or of the legislature of a province and that is primarily engaged in dealing in securities, including portfolio management and investment counselling; and

   (h) a foreign institution.

2. Subsection 2(1) of the said Regulations is further amended by adding the following thereto:

   "foreign institution" means an entity that is:

   (a) engaged in the business of banking, the trust, loan or insurance business the business of a cooperative credit society or the business of dealing in securities or is otherwise engaged primarily in the business of providing financial services; and

   (b) incorporated or formed otherwise than by or under an Act of Parliament or of the legislature of a province.

3. Section 6 of the Pension Benefits Standards Regulations, 1985 is revoked and the following substituted therefor:

   6. Every pension plan shall provide that the moneys of a pension fund are to be:

(a) invested in accordance with Schedule III; and

(b) invested:

(i) in a name that clearly indicates that the investment is held in trust for the pension plan, and where the investment is capable of being registered it shall be registered in that name;

(ii) in the name of a financial institution or a nominee thereof, pursuant to a custodial agreement or a trust agreement entered into on behalf of the pension fund with a financial institution that clearly indicates that the investment is held for the pension plan; or

(iv) in the name of the Canadian Depository for Securities Limited or a nominee thereof in accordance with a custodial agreement or trust agreement entered into on behalf of the pension fund with a financial institution that clearly indicates that the investment is held for the pension plan.

4. The above-mentioned Regulations are further amended by adding the following:

6.1 For the purpose of section 6 a “custodial agreement” shall mean an agreement which includes terms and conditions to the effect that an investment made or held pursuant to the agreement:

(a) is made or held on behalf of the pension plan and constitutes part of the pension fund;

(b) shall be held or invested in such a manner that adequate records shall be maintained so that, at any time, the ownership of any investment can be traced to the pension plan; and

(c) shall not at any time constitute an asset of the custodian or nominee.