COMMUNIQUÉ

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Communicating information to and among PIAC Members

NEW GST/HST RULES APPLICABLE TO PENSION PLANS

By Robert Demers, Partner, Deloitte

On September 23, 2009, the Department of Finance of Canada published, through a Press Release, legislative proposals and explanatory notes applicable to pension plans. These legislative proposals follow consultations announced in January 2007. In so doing, Finance Canada has now legislated where before there was only an administrative policy of the Canada Revenue Agency ("CRA"), i.e., Technical Information Bulletin B-032R. These new rules have also substantially limited the scope of the case General Motors of Canada Ltd. v. The Queen[1].

B-032R

Technical Bulletin B-032R, in effect since June 1993, outlined the CRA's administrative policy on the application of the Goods and Services Tax (hereafter "GST") to supplies acquired in respect of the activities of registered pension plans for both the employers and pension plan trusts.

Essentially, under B-032R, pension plan expenses were either considered as "employer expenses" or "plan trust expenses". Employer expenses included the establishment or subsequent amendment of the pension plan or the plan trust as well as the administration of the collection of pension contributions and payment of pension benefits. Plan trust expenses included all expenses related to the plan trust assets such as investment advice regarding these assets and services relating to the acquisition, utilization or disposal of the plan trust assets.

Thus, notwithstanding the person that actually incurred the expense or the course of activities in which the expense was incurred, ITC entitlement was based on employer status for employer expenses and plan trust status for plan trust expenses. As a result, an employer engaged exclusively in commercial activities could claim ITCs on employer expenses, but ITCs could not be claimed when a plan trust was exclusively engaged in financial activities.

GENERAL MOTORS OF CANADA

On February 22, 2008, the Tax Court of Canada rendered a decision in the case *General Motors of Canada Ltd. v. The Queen*[2]. In this case, the judge had to decide whether General Motors of Canada Ltd. ("GM") was entitled to claim ITCs on the tax paid on expenses incurred for pension fund asset management services provided under investment management agreements entered into between GM and the managers.

In this particular case, GM was the administrator of two pension plans for its salaried and hourly employees. The two plans were funded by trusts that held the assets and the investments. Pursuant to a written agreement, the investment managers had to send their invoices to GM for approval, after which GM would request that the trusts pay these investment manager invoices.

The CRA argued that in the circumstances, GM failed to satisfy the three legislative[3] conditions for claiming ITCs in respect of the GST paid on the investment management services, i.e.:

A) to have acquired the services;
B) to be liable to pay the GST and;
C) to have acquired the services for consumption or use in the course of its commercial activities.

continued on page 2

IN THIS ISSUE

Call for Board Nominations.....................4
PIAC Asset & Return Survey 2009...........4
Pension Plan Subsidiaries.......................5
Stress Testing.......................................7

New GST/HST Rules Applicable to Pension Plans
continued from page 1

With respect to these three elements, the judge concluded that it was GM that had acquired the services, not the trustee of the plan trusts as argued by the CRA, that GM, as the recipient, was liable to pay the GST and lastly, that the services had been acquired for consumption or use in the course of GM's commercial activities, since "those services are part of its inputs toward its employee compensation program, which is a necessary adjunct of its infrastructure to making taxable sales."[4]

Accordingly, the Court ruled that GM was entitled to claim ITCs.

On April 16, 2009, the Federal Court of Appeal[5] upheld the Tax Court of Canada's ruling and the CRA decided not to appeal this decision.

PROPOSED RULES ISSUED ON SEPTEMBER 23, 2009[6,7]

The new rules state, in essence, that the distinction between employer expenses and plan trust expenses is a thing of the past and that pension plans will typically be entitled to a partial refund of 33% of the GST paid on any plan-related expenses. The new rules apply to the fiscal years of employers or to a *pension entity's*[8] rebate application period, starting on or after September 23, 2009.

The new rules apply to an employer that is a GST registrant and qualifies as a *participating employer*[9].

The employer will be deemed to have made supplies to the pension entity in the following circumstances[10]:

1) the employer acquires a property or service with the intention of supplying it to a pension entity of a pension plan for consumption or supply in the course of pension activities in respect of the pension plan;

2) the employer consumes or uses an employer resource for the purpose of making a supply of a property or a service to a pension entity of a pension plan for consumption, use or supply by the pension entity in the course of pension activities in respect of the pension plan;

3) the employer consumes or uses an employer resource in the course of pension activities.

The employer is thus deemed to have made taxable supplies to the pension entity on the last day of its fiscal year. The employer is also deemed to have collected the tax at that time and is required to remit it. The new rules say nothing about the employer's right to claim an ITC in respect of property and services acquired in order to be "deemed" as supplied to the pension entity. Consequently, the general ITC rules should apply and because the property or service was acquired by the employer in order to make a taxable supply, the employer may claim an ITC with respect to the GST paid on the acquired property or service.

The pension entity is deemed to have paid the GST on the deemed supply received from the employer and may apply a rebate equal to 33% of the GST that is not otherwise recoverable, either through an ITC or another rebate.

It should also be noted that a pension entity may only file a rebate application if it qualifies as a *"qualifying pension entity."*[11]

Obviously, any GST paid directly to suppliers by the qualifying pension entity will also be eligible for the 33% rebate.

REBATE SHARING

Under the new rules, employers and the pension entity may make a joint election to "transfer" the new rebate from the pension entity to the employers.

The sharing of the rebate applies differently depending on whether:

- The employer is engaged exclusively in commercial activities;
- The employer is not exclusively engaged in commercial activities;
- The pension entity is not a qualifying pension entity.

Where the employer is engaged exclusively in commercial activities, the employer and the pension entity may make an election to share all or part of the rebate.

Where the employer is not exclusively engaged in commercial activities, an election to share may also be made but the sharing must take into account the employer's tax recovery rate and the employer's actual contribution in the plan.

Lastly, in the case of a non-qualifying pension entity, although the pension entity is not eligible to the 33% rebate, each employer which makes an election with the pension entity will be entitled to deduct in its net tax a percentage of the 33% of GST paid (or deemed paid) by the pension entity, which will be calculated based on its tax recovery rate and its actual contribution in the plan.

continued on page 3

New GST/HST Rules Applicable to Pension Plans
continued from page 2

REBATE FOR QUALIFYING PENSION ENTITIES

Note that a pension entity must file a rebate application within the following time limit:

- if the entity is a registrant, within two years of the deadline for filing its GST return for the period;
- otherwise, within two years of the end of the claim period[12].

It should also be noted that only one rebate claim may be filed by the pension entity per claim period[13].

INFORMATION TO BE PROVIDED TO THE PENSION ENTITY

Where the deemed supply provisions apply, the employer is required to report information in such form and on the terms and conditions as determined by the minister. This will require administrative follow-up of the deemed supplies, which will increase the employer's administrative burden.

QUEBEC SALES TAX

Quebec has decided to harmonize the QST regime with the new proposed GST rules mentioned above. Hence, similar deeming rules between the employer and the pension entity will be applicable. However, since financial services are zero-rated in the QST regime (as opposed to exempt in the GST regime), pension entities will normally be eligible to a 100% rebate. However, the QST rebate will be adjusted to reflect the case where the participating employers are public service bodies (the rebate will be limited to either 88% or 77% of the QST paid depending on the percentage of contributions made by public service bodies and their entitlement (or not) to QST rebates).

CONCLUSION

These new rules are complex and are worth being analysed in detail when applied to a particular case. In addition, as they are still only proposed rules, they may be further modified.

Most importantly, the deeming rules mentioned above apply to all employers who have set up a pension plan for their employees, even if the pension entity does not qualify for the 33% rebate (or full rebate in the case of the QST). So everybody should feel concerned.

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1 2008 TCC 117, February 22, 2008, Diane Campbell J. (hereafter "General Motors of Canada"), upheld 2009 FCA 114, April 16, 2009, Desjardins J.

2 2008 TCC 117, February 22, 2008, Diane Campbell J.

3 Subsection 169(1) ETA.

4 General Motors of Canada, supra, par. 67.

5 2009 FCA 114, April 16, 2009, Desjardins J.

6 These rules are still "legislative proposals" and are subject to Parliament approval.

7 The legislative proposals contain many definitions and the reader is advised to refer to them.

8 A pension entity of a pension plan is defined as the trust governed by the pension plan, or a corporation that administers the pension plan.

9 A participating employer of a pension plan is defined as an employer that has made, or is required to make, contributions to the pension plan in respect of the employer's employees or former employees, or payments under the pension plan in respect of the employees or former employees.

10 Proposed subsections 172.1 (5) to (7) of the ETA

11 A qualifying pension entity is defined as a pension entity of a pension plan, other than a pension plan in respect of which listed financial institutions, within the meaning of the Act, made 10% or more of the total pension contributions to the pension plan or in respect of which it can reasonably be expected that listed financial institutions will make 10% or more of the total pension contributions to the pension plan in the next calendar year in which pension contributions will be required to be made to the pension plan.

12 "Claim period" is defined in subsection 261.01(1) ETA by reference to subsection 259(1) ETA. If the entity is not a registrant, the claim periods are the first and second fiscal quarters and the third and fourth fiscal quarters of a fiscal year of the entity.

13 Subsection 261.01(4) ETA.

CALL FOR BOARD NOMINATIONS

The PIAC Governance and Nominating Committee annually invites members to suggest names or to volunteer to be considered for PIAC's Board of Directors. The Governance and Nominating Committee is charged with recommending candidates for the Board to the Membership and requests that any names be submitted to Gayle McDade, Chair of the Governance and Nominating Committee by July 1, 2010. Gayle can be reached at 780-415-1108 or gayle.mcdade@aimco.alberta.ca

The term of office for Directors is three years, with a maximum of two three year terms, except in the case of Directors who are serving as Officers, in which case they may be elected for additional terms in order to fulfill their responsibilities as Officers. There are normally four Board meetings per year. Two of those meetings are generally two hours in length and held via conference call. The other two meetings are half day meetings held immediately prior to the opening dinners of PIAC's Spring and Fall conferences. Participation in these meetings is very important. In addition, every Director is expected to serve on at least one PIAC Committee in order to participate fully in the life of the Association.

The Governance and Nominating Committee shall review the nominees submitted through the call for nominations together with the candidates the Committee itself has identified and shall prepare a list of nominees which it determines best reflects the demographic and geographic composition of PIAC and achieves an optimum mix of the abilities of nominees.

After determining that all the candidates being proposed for the list are prepared to stand, the Committee will contact the other candidates to explain the decision of the Committee, to encourage their participation in other ways in PIAC and to let them know that they may still stand for election, although they will not be on the recommended list.

In the event that there are still more nominees than vacancies on the Board, a ballot shall be sent to Members with a report presenting the list of nominees recommended by the Governance and Nominating Committee pursuant to the criteria above together with a list of the additional nominees. A biographical outline (maximum 100 words) of each candidate will be provided to the Members along with the ballot not later than 60 days prior to the Annual Member Meeting with a deadline for return not more than 30 days later. The results of the ballot will be announced at the Annual Member Meeting and publicized in Communiqué.

In the event that a ballot is not required, the Chair of the Governance and Nominating Committee shall present a report to the Annual Meeting setting out the list of candidates for nomination as Director and request a motion to elect those persons named in the report as Directors of the Association.

For additional details on the responsibilities of the Board as well as PIAC's Committees, please see the PIAC web site under Board/Committees.

PIAC Asset & Returns Survey 2009

Collection of data for the 2009 Asset & Returns Survey is underway! On March 5, 2010 all Regular Members from PIAC Member Funds were sent an email and link to access the online presentation of the 2009 Asset & Returns Survey.

Please note that only Regular Members from each Member Fund were sent the email notice, with the survey link and log-in information. If that member is not the person that completes the survey we ask that the email be forwarded to the appropriate person.

As you know, the Asset and Returns Survey is a vital and highly valued service to PIAC Members. Please note that it is a requirement of membership that the Asset Survey be completed annually. While the Returns portion of the survey is optional, the vast majority of members complete it and the important information included is only available to those who participate.

This year we are asking that the benchmarking section of the survey be completed, as there will be a new confidential report created using that data.

The deadline for completion of the survey is April 2, 2010, so that the final Asset & Returns Reports can be made available prior to the Spring Conference.

Pension Investment
Association of Canada

Association canadienne des
gestionnaires de caisses de retraite

SPRING CONFERENCE

May 5 – 7, 2010

Chicago, Illinois

HANDS ACROSS THE BORDER

Full program and registration details at **piacweb.org**

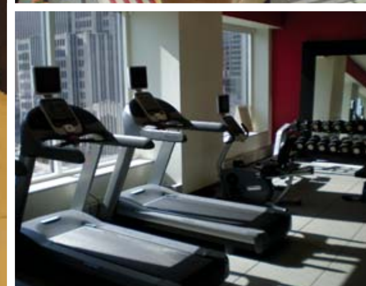
Embassy Suites Chicago Downtown/Lakefront

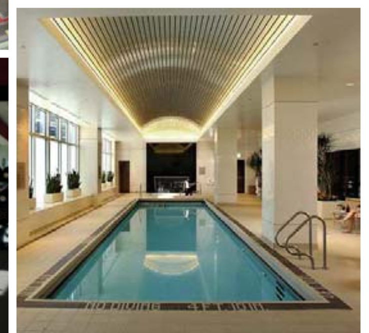
511 North Columbus Drive
Chicago, Illinois

The Embassy Suites Chicago Downtown/Lakefront hotel is the ideal choice for Chicago hotels. Experience the stunning architecture, comfortable suites, and convenient location. Just two blocks away from Navy Pier and the Magnificent Mile, the hotel offers the perfect location for Chicago attractions. This upscale sophisticated downtown Chicago hotel is loaded with all the amenities today's traveler expects in an unbeatable location.

PASSPORT REQUIREMENT

The Western Hemisphere Travel Initiative (WHTI) is a US law that requires all travelers, including US and Canadian citizens, to present a valid passport when entering the United States.





Conference Program

Wednesday May 5, 2010

12:30 – 6:00 PM **Registration**

1:15 – 4:00 PM **Managed Futures Session at Chicago Board of Trade (Members Only)**
The Chicago Board of Trade has opened its doors to welcome PIAC members for a tour of their visitors' gallery and trading floor. This session will include a guest speaker and a question and answer period on the topic of Managed Futures. Round trip transportation from the Embassy Suites Chicago Downtown/Lakefront hotel will be provided to registered participants.

6:00 – 7:00 PM **Welcome Reception**

7:00 – 9:30 PM **Welcome Dinner and Keynote Presentation**

Nudge: Improving Decisions about Health, Wealth and Happiness
Richard Thaler, Chicago Booth School of Business

Thursday May 6, 2010

7:30 – 8:30 AM **Breakfast**

8:30 – 8:35 AM **Opening Remarks**
Conference Chair: Gretchen Van Riesen

8:35 – 10:00 AM **The Future of Canada's Pension System**
Moderator: Leo de Bever, Alberta Investment Management Corporation
Don Ezra, Russell Investments
Malcolm Hamilton, Mercer (Canada) Limited
Jack Mintz, School of Public Policy, University of Calgary

10:00 – 10:15 AM **Networking Break**

10:15 – 11:15 AM **Financial Market Regulations**
Joseph Dear, California Public Employees' Retirement System

11:15 – 12:15 PM **What Will Work for Canadian Pension Investing THIS Decade?**
Don Coxe, Coxe Advisors LLC

12:15 – 2:00 PM **Lunch and Keynote Speaker**

After the Crisis and the Future of the Global Financial and Political Order
Madeleine Albright, Albright Capital Management LLC & Albright Stonebridge Group

2:00 – 3:00 PM **Insight into the Financial Landscape: Past, Present, and Future**
Robert P. Kelly, BNY Mellon

3:00 – 3:15 PM **Networking Break**

3:15 – 5:00 PM **Liquidity**
Moderator: Philip Falls
David Marshall, Federal Reserve Bank of Chicago
Bruce Zimmerman, University of Texas Investment Management Corporation

6:00 – 10:00 PM **Reception, Dinner & Entertainment aboard the Odyssey**
Take in Chicago's glittering skyline while enjoying the ultimate dining cruise indulgence aboard the Odyssey, which sails from Navy Pier.

Friday May 7, 2010

7:30 – 8:30 AM **Breakfast**

8:30 – 10:00 AM **Selecting Your Money Managers: Is There a Right Way and a Wrong Way?**
Moderator: Gretchen Van Riesen
Richard Ennis, Ennis, Knupp & Associates
Éric Fontaine, Brockhouse & Cooper Inc.
Janet Rabovsky, Watson Wyatt
Peter Wright, bfinance Canada Inc.

10:00 – 10:15 AM **Networking Break**

10:15– 11:30 AM **Is Securities Lending Dead?**
Moderator: Gayle McDade
Virgilio "Bo" Abesamis, Callan Associates Inc.
John Osborne, Alberta Investment Management Corporation
James Slater, CIBC Mellon

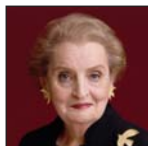
11:30 – 12:30 PM **Pot Pourri (Members Only)**
Moderator: Philip Falls

12:30 PM **Farewell Luncheon**

* Program and presenters subject to change

Conference Faculty

VIRGILIO “BO” ABESAMIS
Senior Vice-President & Manager of the Master Trust, Global Custody & Securities Lending Group
Callan Associates Inc.



MADELEINE K. ALBRIGHT
Chair and Principal, Albright Capital Management LLC
Chair, Albright Stonebridge Group
Former U.S. Secretary of State

DON COXE
Strategy Advisor, BMO Nesbitt Burns and BMO Capital Markets
Chairman, Coxe Advisors LLC

LEO DE BEVER
Chief Executive Officer
Alberta Investment Management Corporation

JOSEPH DEAR
Chief Investment Officer
California Public Employees' Retirement System

RICHARD ENNIS
Principal
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DON EZRA
Co-Chair, Global Consulting
Russell Investments

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Executive Vice-President, Advisory Services
Brockhouse & Cooper Inc.

MALCOLM HAMILTON
Worldwide Partner
Mercer (Canada) Limited

ROBERT P. KELLY
Chairman and Chief Executive Officer
BNY Mellon

DAVID MARSHALL
Senior Vice President
Federal Reserve Bank of Chicago

JACK MINTZ
Director and Palmer Chair in Public Policy
School of Public Policy, University of Calgary

JOHN OSBORNE
Chief Risk Officer
Alberta Investment Management Corporation

JANET RABOVSKY
Senior Investment Consultant
Watson Wyatt

JAMES E.R. SLATER
Senior Vice President, Capital Markets
CIBC Mellon

RICHARD THALER
Professor of Behavioural Science and Economics
Chicago Booth School of Business

PETER WRIGHT
Director, Canada
bfinance Canada Inc.

BRUCE ZIMMERMAN
Chief Executive Officer / Chief Investment Officer
University of Texas Investment Management Corporation

PENSION PLAN SUBSIDIARIES – TRIPS AND TRAPS

By Dan Hayhurst, Partner, Gowling Lafleur Henderson LLP

Defined benefit registered pension plans (**"Plans"**) commonly invest, directly or through pooled vehicles, in alternative investments such as real estate, private equity, infrastructure, timberlands, resource properties and hedge funds. Where these investments are made directly, the various commercial agreements that govern the transaction impose legal obligations, and potential liability, on the Plan investor. Where these investments are made through pooled vehicles, the most common investment vehicle used by third-party managers is the limited partnership. By their very nature, limited partnerships afford passive investors a high degree of protection from liability. However, this protection is not absolute. For example, certain rights granted to a limited partner under the limited partnership agreement (**"LPA"**) or a side letter could give rise to concerns about whether the limited partner is participating in the business of the partnership, possibly jeopardizing its limited liability. Investing through a subsidiary corporation (commonly referred to as a "blocker corporation") adds an additional layer of limited liability and is a cheap insurance policy for the Plan investor. Investing through a subsidiary generally also affords additional Canadian and foreign tax protections by isolating tax risk.

Under the pension benefits standards laws of all Canadian jurisdictions (**"Pension Law"**), a Plan is prohibited from acquiring shares of a corporation to which are attached more than 30% of the votes to elect directors (in Quebec, the restriction applies to voting shares generally) unless the corporation qualifies as an "investment corporation", a "real estate corporation" or a "resource corporation". Where such a corporation meets certain requirements, it will be exempt from income tax under the *Income Tax Act* (Canada) (the **"ITA"**) in the same manner as its pension fund shareholder. The ITA requirements relate to equity ownership and activity tests. Under most Pension Laws, the Plan administrator must cause the corporation to file a prescribed form of undertaking with the pension regulator prior to acquiring shares in excess of the 30% maximum. Among other things, the undertaking contains restrictions on the number of "layers" of subsidiary corporations.

This article focuses on investment corporations and real estate corporations, being the most commonly used Plan subsidiaries.

The equity ownership test under the ITA, which applies to all three types of corporation, must be met at all times since November 16, 1978 or the date of incorporation. The basic rule is that all of the shares, and all of the rights to acquire shares, of the corporation must be owned by, or by a combination of, one or more Plans, one or more trusts all of the beneficiaries of which are Plans, other such corporations, and certain other prescribed persons. If the corporation goes "offside" the equity ownership requirements, it loses its tax-exempt status - forever. Typical "trips and traps" to watch out for include:

- the issuance of incorporator or director qualifying shares;
- tag-along provisions in a shareholder agreement that may give rights to a non-qualifying person to acquire shares;
- default or termination provisions in an LPA giving non-qualified limited partners the right to acquire the shares of the corporate limited partner in prescribed circumstances.

If such a corporation has more than one shareholder, the corporation will lose its tax exempt status if any one of the shareholders loses its qualified status. Therefore, a Plan should consider what representations, warranties and covenants are given by the other shareholders concerning their status as qualified investors, and what due diligence has been and will be done to ensure that any prospective or other change is brought to its attention on a timely basis.

The activity test under the ITA varies by category of corporation. For an investment corporation it is seemingly straightforward:

- The corporation can only make investments that a Plan can make under "the Pension Benefits Standards Act, 1985 or a similar law of a province";
- The assets of the corporation must be comprised of at least 98% cash and investments;
- The corporation cannot issue "debt obligations";
- The corporation must derive at least 98% of its income from, or from the disposition of, investments.

continued on page 6

Pension Plan Subsidiaries - Trips and Traps
continued from page 5

How difficult can this be? Consider the following "trips and traps":

- While pension regulators such as OSFI only apply the quantitative rules for investment at the Plan level, the Canada Revenue Agency (**"CRA"**) has adopted the opposite view with regard to ITA compliance. For example, in connection with the federal (Schedule III) 10% rule, OSFI would see no compliance issue per se if a federal Plan used an investment corporation to hold a single investment, as long as the Plan itself remains on-side this rule. In contrast, CRA has stated that this is permissible only if the investment corporation itself complies with the 10% rule, which it will not in most cases. Fortunately, the 10% rule under the Supplemental Pension Plans Act (Quebec) (a "similar law of a province") is less restrictive such that, in many cases, the federal Plan could rely on Quebec Pension Law to achieve income tax compliance.
- For ITA purposes, strictly speaking a "debt obligation" arises any time there is a legal obligation to pay an amount to another person. Fortunately, CRA recognizes that this should not apply to mere payables (e.g., an accounting bill), otherwise the prohibition on issuing debt obligations would trip up most investment corporations. The prohibition likely includes a prohibition on issuing guarantees and certain other types of financial assistance. But there may be more subtle "traps". For example, LPAs often contain provisions under which limited partners commit to making payments beyond the mere promise to contribute capital and such provisions could throw an investment corporation offside.
- The 98% investment income requirement seems straightforward. However, many LPAs allow fee income otherwise payable to the general partner to be paid to the limited partners directly in certain circumstances, and such a payment might throw the investment corporation offside.
- Similar compliance issues can arise with the 98% test relating to assets if the LPA allows the general partner to distribute the partnership assets to investors.

The rules relating to real estate corporations have their own "trips and traps".

- For non-real estate investments held by a real estate corporation, the real estate corporation can only make investments permitted by a Pension Law. Once again, thank goodness for Quebec Pension Law as it relates to the 10% rule.
- Real estate investments are restricted to real estate that is "capital property". So if there is any intention to sell the real estate, the corporation will lose its tax exempt status. This includes a changed intent, and possibly a secondary intent.
- Borrowing is permitted, but solely for the purpose of earning income from real property. This can raise a host of issues, including the use of borrowed monies to repay capital, to pay dividends, to replace existing debt or to advance to a subsidiary corporation or limited partnership (which in turn owns real estate). Only some of these are permitted.
- The ITA expressly contemplates that a real estate corporation could have, as its sole asset, an investment in a partnership that itself meets certain requirements (all real estate related). But most Pension Laws contemplate that a real estate corporation will hold real estate directly, and that partnerships are separate entities. If Pension Laws contemplate that a corporation that does not hold real estate directly is an investment corporation, not a real estate corporation, it begs the question as to which set of rules will apply (if not both).

To top it all off, if a Plan's subsidiary has been tripped or trapped by the ITA activity tests, the shares of the subsidiary may become a non-compliant investment for the Plan under applicable Pension Law. That, in turn, would result in the Plan becoming a "revocable plan" under the ITA such that at CRA's discretion, the Plan's tax-exempt status under ITA could be revoked.

Rules that seem simple sometimes are. In this case, if you are not careful, they can trip you or trap you.

PIAC Member Value Survey 2010

PIAC will be distributing a Member Value Survey to all PIAC Members in late May using Survey Monkey. The last Member Value Survey was done in April 2006. The Member Value Survey, built by members for members, is a very important tool for the Board and all the committees, as it provides a wealth of information that assists them in improving the services that are offered to members.

STRESS TESTING DEFINED BENEFIT PENSION PLANS

By **Rob Corkum,** Principal and **Lisa Buccella,** Senior Associate, Mercer

Not surprisingly after the events of 2008, pension regulators and plan sponsors are becoming more concerned about the risks inherent in defined benefit pension plans and are taking a more forward-looking approach as a result. OSFI, in typical proactive fashion, has been encouraging regular stress testing as a means of identifying and managing risk in defined benefit pension plans, as evidenced by their survey last fall of plan sponsors' stress testing practices. In the absence of specific guidance, sponsors are left wondering what practices would be appropriate in OSFI's view. Fortunately, OSFI has recently provided an indication of the direction they intend to take from a supervisory standpoint; also, there are several established stress testing techniques already used in practice. In this article, we address both prevailing practice and our understanding of OSFI's intentions.

OSFI intends to develop formal stress testing guidance for pension plan sponsors and will take into consideration its stress testing guidance for financial institutions, Guideline E-18 (released in December 2009 on OSFI's website). Guideline E-18 deals with enterprise wide stress testing, but provides many concepts that should have application to pension plans. The Guideline defines stress testing as a "risk management technique used to evaluate the potential effects on an institution's financial condition, of a set of specified changes in risk factors, corresponding to exceptional but plausible events. Stress testing includes scenario testing and sensitivity testing." It further describes scenario testing as using a hypothetical future state to define changes in related risk factors (such as inflation, discount rates and fund returns) over a long term time horizon. Sensitivity testing involves an incremental change in a risk factor over a shorter time horizon, including an instantaneous shock. Sensitivity testing is less sophisticated than scenario testing and usually requires fewer resources.

We have categorized prevailing stress testing practices under OSFI's definitions of scenario testing and sensitivity testing, as follows:

The most typical sensitivity test is a measurement of the impact on the plan funded status of a one-percent change in the discount rate, or, if the plan is indexed or the benefit is earnings related, the annual inflation rate. This is a simple, but important test. Another straight forward test is to determine the impact of a ten-percent variation in annual fund return compared to a baseline expected return. These tests can be simplified further by assuming instantaneous shocks to the system. As an example, in practice, we have used sensitivity tests to demonstrate both the risks on transition to international accounting standards and the characteristics of the accounting policy options under those standards.

Scenario testing is a more holistic approach that produces a number of deterministic or stochastic projections of a plan's funded status based on a variety of economic scenarios. The economic variables in a given scenario are generally chosen to be internally consistent. Internally consistent scenarios may be constructed in terms of a period of recession, stagflation, market correction or volatile equity returns, for example. The specific scenario being modelled then determines the appropriate economic assumptions.

Scenario testing can form part of a more robust risk analysis, such as a short term Value at Risk (VaR) analysis or a long term asset liability study. For short term VaR analysis, at Mercer, we use a relatively simple model (the Annual Pension Risk Profile), in which liabilities are treated as a negative allocation to an asset class, which can then produce a VaR measure of the plan's funded status through the year.

From a stress testing standpoint, the 5th percentile funded position one year after the most recent valuation date is a useful reference. Caution must be used with such VaR analysis, however, as plausible outcomes in the tail of the distribution may be intolerable to the plan sponsor, yet may not be obvious from the analysis. On the other hand the 5th percentile funded position may be sufficiently disconcerting to trigger a reaction from management; for example, a client recently extended their bond portfolio duration as a result of discomfort with the 5th percentile results shown by the APRP.

Many readers will be familiar with asset/liability stochastic modeling (ALM), which provides perhaps the most in-depth form of scenario testing. ALM analyzes risks and rewards by focusing on the interaction of assets and liabilities and generates expected values and downside risk measures for a number of variables such as plan surplus and present value of contributions. The time horizon for such models typically ranges from 5 to 20 years.

continued on page 8

Stress Testing Defined Benefit Pension Plans

continued from page 7

The above techniques deal with economic risks, but OSFI has also indicated interest in demographic stress testing. Demographic changes tend to be gradual; consequently, this variety of stress testing is not as common for traditional defined benefit plans. However, many plans would benefit from the modelling of their future membership, costs as percentage of earnings, mortality improvements and exposure to plan design cliffs (i.e. abrupt eligibility for generous early retirement benefits). Negotiated Contribution Defined Benefit Plans are particularly exposed to declines in active membership so are more likely to model demographic fluctuations.

Guideline E-18 is useful in that it indicates stress testing program characteristics that presumably will be appealing at least from OSFI's perspective. These include:

- a formal, documented program (versus ad-hoc testing);
- scenarios that are consistent with the entity's risk appetite, as defined by senior management;
- scenarios that include severe shocks, periods of severe and sustained downturn and episodes of market turbulence;
- consideration of interrelations between risk factors;
- frequency and timing of tests that are sufficient to support timely management action;
- reverse stress tests, which start with a specified outcome that challenges the viability of the entity, then work backward to identify scenarios that would lead to that outcome;
- envisaged responses to test results that would be realistically available in a period of stress. For example, a severe economic downturn may significantly increase funding requirements at the same time that the sponsor can least afford to increase contributions.

In designing a stress testing program, plan sponsors should first consider their own objectives and the characteristics of their particular pension plans. A well designed program that meets the sponsor's needs is likely to meet OSFI's needs as well. Such a program can be a useful part of pension risk management and can assist in developing appropriate investment, funding and accounting policies as well as plan design. Satisfying OSFI should then be a happy by-product of the program.

PIAC CALENDAR

May 5 – 7, 2010
Spring Conference
Embassy Suites
Chicago - Downtown/Lakefront
Chicago, Illinois, USA

September 29 – October 1, 2010
Fall Conference
Delta Victoria
Ocean Pointe
Victoria, BC

May 11 – 13, 2011
Spring Conference
Toronto Marriott
Bloor Yorkville
Toronto, ON

September 28 – 30, 2011
Fall Conference
Hilton Lac Leamy
Gatineau, QC

People on the Move

NEW MEMBERS

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Jean Michel	Air Canada Pension Investments
Paul Schneider	Ontario Teachers' Pension Plan
Grace Wong	Canada Post Corporation

2010 International Corporate Governance Network (ICGN) Annual Conference and AGM

Please mark your calendars for the 2010 ICGN Annual Conference and AGM - The Changing Global Balances, being held in Toronto, Canada, June 7-9, 2010, at the Royal York Fairmont Hotel. The conference is being hosted by the Ontario Teachers' Pension Fund and the Canada Pension Plan Investment Board. PIAC is a partner of the ICGN.

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