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PENSION ISSUES AROUND THE WORLD

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o The panel will describe recent developments and public discussions affecting pension benefits in Canada, Great Britain, Brazil, Japan and Australia, contrasting them with the United States. The discussion will include different attitudes toward pension surpluses and trends toward defined contribution versus defined benefit plans.

MR. MARK LEVINS O'REILLY: I am an international benefits consultant with Towers Perrin, based in San Francisco. I started my career as an actuary with the U.K. government and moved to International Benefits in 1981; since then I have worked in Germany and Britain.

Joining me is Dan Hoden, corporate manager of benefits of Occidental Petroleum. His background is in both domestic and international benefits. His first experience with international benefits was in 1972 when he moved to TRW. He continued being responsible for international and domestic benefits when he moved to Occidental in 1982. Josephine Wright is VP of International Benefits and Compensation at Bank of America. She is probably the most International of the four of us, having been born in China, educated in Japan, and having worked extensively in the U.K. and now for eight years in the U.S. And we have Peter Gorham, who is an actuary with MLH&A. He's been a consulting actuary since 1981.

I hope we'll give you a broad perspective on international benefits, and not only of the four countries we're dealing with. In Dan's case it's Brazil. Dan's main focus, rather like Josephine's, is going to be very much a corporate one -- in terms of their experience in putting in, managing and monitoring plans in the locations they're talking about. So there's a very much practical, nonactuarial angle which I think we'll all find very interesting. In Josephine's case it's going to be Japan.

I'm going to start out myself, talking about the U.K. and updating you on legislation there, and give you some background in case you're not aware of

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what I'm updating you on. The U.K. is an environment in which pensions are a very important benefit. Probably more so over recent years than in the U.S. The attention to retirement plans is probably more focused in the U.K., partly because the benefits such as medical and dental plans are less important. So when people talk about employee benefits in the U.K., 90% of the time they're talking about retirement pension plans. Pension plans have always been an important issue in labor negotiations, and are considered a valuable part of anybody's package. They have also tended to be a political football over the years.

This reached crisis proportions in the late 1960s and early 1970s until finally there was a political consensus under the Labor government in 1975, and they introduced what was known as the State Earning Related Pension Scheme (SERPS), up until which point there had only been flat rate state pensions. An important aspect of the legislation, however, was to allow existing pension schemes that provided at least equivalent benefit to contract out of SERPS. Many did so.

Now, this political consensus existed for eleven years, until our current conservative government started changing the rules. I'd say the only reason why it's no longer a political football is that there's only one team on the pitch: the conservative government -- the Labor party is somewhat in recession at the moment. The conservatives now have the power and definitely the inclination to alter the pension environment. They have changed the rules for contracting out of SERPS, and are introducing personal pensions that will come into effect in July of this year. They're also reducing the level of SERPS, though gradually over a period of time. They have shortened vesting periods. They have cut back on the pensions available to executives and they've also introduced legislation to curb surpluses in pension funds.

The motives of the government are worth covering briefly. The most laudable motive would be to reduce future social security cost. This is obviously one of the reasons given for cutting back on SERPS and encouraging more contracting out of SERPS so that more of this pension obligation is taken into the private sector. However, not many governments introduce legislation because it will have a beneficial effect in four or more years' time. So we have to look at the other reasons.

A major objective of the government is to create individual wealth, making the average member of the population more conservatively minded, and therefore more likely to vote conservative. One step was to sell off public sector housing at heavy discount. The other was to sell off public sector industries such as British Telecom, etc., at heavy discounts. The third thing they're doing now is selling off public sector pensions. And as we'll see the government will be doing that at a discount as well.

Let's look at the first issue, contracting out of SERPS. There are three ways of doing it. The original way was for an employer to provide a plan that gave a minimum level of defined benefits. That was the only way and it was fairly complicated. You not only had to guarantee that you would provide exactly what the person would have gotten from SERPS, but you also had to provide a minimum level of benefit which exceeded SERPS. The rules were simplified two years ago by removing that minimum level of benefits.

Legislation has gone much further now. In July you can contract out of SERPS by paying the money that you would have saved in social security contributions into a defined contribution pension plan. That money, incidentally, is 3.8% (in respect to the employer) and 2% (in respect to the employee) on earnings between about £2,000 pounds and £16,000 pounds a year.

The second, more radical, step is to say not only can companies set up these defined contribution plans but individuals can set up their own personal pension plan, and instead of paying the extra social security contribution direct that money into the personal plan. The employer is obliged to pay its 3.8% of pay into the personal pension plan of the individual.

Now how is the government going to make this all happen? What are the heavy discounts it's offering in order to encourage people to follow this route? First of all, to enable this thing to work they have to make all pension plans voluntary. It's no longer lawful to require an employee to be a member of a pension plan as a condition of employment. That came into effect January this year. Secondly, instead of the employer having to pay contributions into each individual plan that his employees request, the Department of Health and Social Security, which collects social security contributions, will actually take the full amount from the employer and employee and divert the portion relating to SERPS into their personal pension. That relieves the employer of a lot of the administration. Thirdly, it's offering a 2% incentive (or what the pension industry has called a 2% bribe). This is 2% of earnings between £2,000 and £16,000 a year, which will be paid by the government as an additional amount into plans which contract out now. That amount will be paid for a period of five years. For people who take out personal pensions now, the period is six years. This is a substantial amount of money both for employers who want to set up contracted out plans now and for individuals who want to move to personal pensions. One attached condition is that the employee has not been contracted out for more than the last two years.

Part and parcel of this change in legislation has been a reduction in vesting. For a long time we've had five-year "cliff" vesting; now it's down to two years. You can imagine how this fits in with the whole framework: U.K. plans are normally contributory, and nonvested terminees can get a contribution refund with only a 10% tax withholding, despite a full tax deduction on the money when paid in. So vesting is a way of locking people into plans.

It's interesting that the government should have cut back on the opportunities for executives to set up very generous pension plans. But it also fits in with the (if you like) Thatcherite philosophy of government which is a conservative one, a right wing one, but not one which favors the rich and powerful. Margaret Thatcher does not believe that the captains of industry should enjoy excessive pensions at the taxpayers' benefit. So two steps were taken: one is to reduce free lump sums from plans to a maximum of £150,000. Secondly, a two-thirds of final-pay pension cannot be acquired through a pension scheme in less than 20 years. Up until now you join a company at age 55, retire at 65 and that company could have given you a two-thirds of final pay pension. Many companies will be affected by this. There are still a lot of such generous executive plans, particularly in financial services. I have to add a condition: the changes only apply to people joining plans from now on. They will not affect the existing members of plans.

My final item is pension plan surpluses. British actuaries tend to be very conservative in their actuarial assumptions. Over the last five to ten years we've seen tremendous stock market growth coupled with relatively low inflation. Continued conservative assumptions by actuaries have produced some enormous surpluses. Up until relatively recently it's been difficult to get that surplus out. You could not do as you can do in the U.S., just close the plan and buy annuities. If you did that then the Inland Revenue has the discretionary power to prevent you ever setting up an approved pension plan again. The result was a lot of plans with enormous surpluses, and a lot of public criticism about it.

In his 1986 budget speech, the Chancellor announced what was considered to be a very far-reaching piece of legislation. Any plan that was over 105% funded had to take either one or a combination of three types of actions. Either lower its contribution rate for up to five years, increase benefits to make up the surplus or actually refund money to the employer. If you did refund, however, you were taxed 40% of it.

There was an immediate outcry from the pensions industry that this was far too stiff. The Institute of Actuaries campaigned for the 105% to be increased to 120%, and the runoff of contributions to be over ten years. They didn't succeed, but what they did succeed in was influencing the Government Actuary to adopt a very conservative basis for measuring the actuarial liability against which you measure the assets. And in fact, a conservative basis for measuring the assets. Liabilities are measured at 8.5% interest, salary increases of 7% plus a promotional scale that could add another 1% to salaries. So you end up with 8.5% and 8%. You can also value pension increases even if they're not guaranteed. You just take an average of your last three years' pension increases. You end up with a conservative liability, and you measure assets using a discounted future cash flow basis, assuming 8.5% interest and 3.5% dividend growth. At the time this was introduced, this meant that the actuarial value of assets came in at 80% of the market value. The two have gotten closer since last October. But the net result is, that although this surplus test might have seemed exacting at first, through the conservative nature of the assumptions few plans have had to take drastic action. Many have had to lower their contribution rates, but few have been obliged to take the refund of surplus.

MS. JOSEPHINE B. WRIGHT: I should like to start with a brief word on Bank of America's operation in Japan. The bank celebrated its 40th anniversary last year. Since traditionally the turnover in Japan is very, very low we have an aging work force and we now have seven retirees. In the last few months the newspapers and television in Japan as well as in this country have been carrying numerous articles on Japan's aging population and concerns about the strain that it places on Japanese social security. I was asked to comment on how we as a multinational corporation adapted to the local employment environment and have been making provisions for retirement. Since there's not much time to go into any great detail, my comments will be very, very limited.

There's no mandatory retirement age in Japan. However, the labor regulations stipulate an age limit for employment. This is as a result of the Japanese concept of lifetime employment. Until recently the age limit was 55, however, with the labor and social pressures it gradually went up to 60 and last year the government passed a law that required this. And that 60 applies to male as well as female.

Just a brief background of the pension plans in Japan. They can be classified into three categories: public, corporate and individual. The public pension plans are administered by the government, such as the social security in this country. Contributions currently run at 10.6% of pay, shared equally by the employer and employee. However, as the case may be in many of the western countries, social security as I mentioned earlier is facing serious difficulty, and it is envisioned that contributions will rise as high as 34.9% by year 2025. Corporate pension plans consist of basically two types: qualified pensions and adjusted pensions or, as they call it, the welfare pension plan. Since the late 1940's Japanese companies have been setting up internal book reserves to finance their retirement obligations, retaining the money in that company for business operations just as they do in Germany. However, in the early 1960s, the government introduced the concept of a tax-favored qualified pension plan, modeled after the one in the U.S., to encourage externally funded plans. In 1966, they introduced the adjusted pension plan, or the welfare plan as it is known, and the adjusted pension plan was a means by which the corporation could set up an approved welfare plan within the corporation to supplement the social security.

The incentive for establishing these plans rather than continuing on a pay-as-you-go book reserve type of program was a needed tax relief available to the employer. Ever since establishment of these two plans, however, the tax relief available gradually reduced from 100% now down to 40%. Recent statistics show about 80% of major Japanese and multinational corporations have either a qualified pension plan or a qualified adjusted pension plan.

The third type is, as you have in the U.S., an individual retirement plan offered by the various financial institutions, insurance companies, banks and the post office.

In Bank of America, until a few years ago we funded retirement obligations by the book reserve method. This was common practice. However, with erosion of the tax relief on the book reserve we had to seriously consider alternatives. Decision was reached a few years ago to set up a tax-qualified pension plan and invest the funds externally. One of the requirements of a tax-qualified pension plan is that the benefits must be offered in the form of an annuity, although they can be commuted to a lump sum. Under corporate tax law only life insurance companies and/or trust banks can be designated as trustee of qualified pension plans. There are no other institutions that can handle it.

We reviewed insurance companies versus trust banks, investment method, strategies, the understanding of the U.S. accounting requirements, providing timely and accurate information, and so on, and we chose to go the insurance route. Although our preference was to place the retirement funds with a single insurance carrier, Japan has a unique system in which you place it with a group of insurance companies: this is known as the general management system. Since the final rates are subject to Ministry of Finance approval there's not much difference in the returns. You have a lead insurer managing your funds.

As mentioned in the beginning, Bank of America passed the 40th anniversary last year, so you can imagine the size of the portfolio going across to the insurance company. In Japan a transfer of funds from book reserves to a qualified pension plan can be handled in three ways: either a total transfer, or partial transfer, or you can set up an additional transfer. Total meaning you just turn everything over to the insurance company, the partial, as it says, just keep part in house and part externally. The third method would be the top up method. The bank chose to do a total transfer. Corporate tax laws in Japan permit amortization of your retirement reserves over a 7-year period, offsetting the negative impact of paying out pension premiums in the initial seven years. So it does have some major tax benefit.

As is the case in U.K., Japan also permits contracting out of the Japanese social security system. However, the criteria are that only employers with more than 700 employees are permitted to contract out of a pension system. However, that situation is currently under review. There is a proposal by the Ministry on Welfare that the situation be revisited. What is also under review by the Ministry of Welfare is a change in how pension funds are being invested and managed. Currently only trust banks and insurance companies can handle these funds.

Another topic under discussion is the protection of benefits. Although the Japanese looked across the waters to the U.S. in 1962 to develop their tax-qualified pension plan, it was too early to conceive a protection of pension benefits in the event of bankruptcy. This is now proposed regulation under consideration: the Japanese version of PBGC, which will have some not insignificant cost impact to employers. They've had time to review the situation not only in this country but also in Germany.

You will be interested to know that actuaries will not escape attention. They will be getting more attention in the proposed legislation. Currently actuaries servicing contracted-out pension plans need only be members of the Japanese actuarial society which comes under the guidance of the Ministry of Finance. What is proposed is that they be enrolled with the Ministry of Welfare.

In conclusion I would like to say that the introduction of the proposed legislation by the Ministry of Welfare will take some time. There are a number of issues, which many interested parties will find controversial and undoubtedly which will involve other government agencies as well. The tradition in Japan where the children take responsibility for their parents' old age security is eroding. And those currently working and nearing retirement are putting pressures not only on their employers but also on the government. So it should be interesting to watch the developments, especially as aging of the Japanese population is receiving tremendous attention, not only in government circles but also in the public press.

MR. O'REILLY: As Josephine has indicated, the development, the progress of pensions in Japan has enormous consequences, not only for Japan but also probably for the world economy partly because of the aging of the Japanese population. As Josephine mentioned, this move from book reserving to funded plans is still a process carrying on since 1962 and it's obviously going to have very important financial consequences. Also the liberalization of the investment for pension funds. There's some fundamental issues there which are not peculiar to Japan, in particular the concept of book reserving on a tax-deductible basis. And it's also very common in Germany. In fact, Germany still relies on that system.

Now, another difficult pension environment, as I mentioned earlier: Brazil. Just to put this in context, South America does not have a pension plan culture at all. Most of the countries there have what we call a termination indemnity culture. Termination indemnities really take the place of pensions when you combine them with the high levels of social security that are offered there. In other words, when a employee leaves the company he gets a lump sum; you add that to social security, and that's considered adequate retirement benefit. Among those countries perhaps Brazil has the most sophisticated retirement pension system, although still a great majority of the companies down there do not have pension plans. And hence the difficulty in setting up a pension plan because legislators themselves are not sure in which direction they want to go. You also have to combine this with the problems of operating a funded plan, because we are talking now about a hyperinflation environment. So with those caveats I ask Dan to give you his experiences of what it was like, two years ago at least, to attempt to set up a Brazilian pension plan.

MR. DANIEL M. HODEN: Pensions are a relatively a new development in Brazil. Our pressure came from management. Management kept talking about a plan. There have been plans that have been developed and the government has approved. We studied it for two or three years. It's something we look at a lot. The major reasons we do this is to replenish our work force. And in a lot of cases we really want to take care of upper management. But the major reasons in Brazil, as people have furnished us with studies and surveys, have been for higher salary people and the replacement of their older workers. We probably went a little further.

I'm sure you're all aware that not only does Brazil have social security but they also have very rich termination benefits. And in 1967, they started to cut those termination benefits back. This has had a significant effect, and it's had a significant reduction in what those benefits would provide for people who terminate because of retirement. As you can see it's now about one-half month's pay for a year of service. Where previously I think it was two months. That's quite a cutback. And the further we get from 1967, that becomes more of a problem. Social security provides anywhere from 6% of pay replacement for the executive up to 75% for the lower paid. You can see that the indemnity is now going to provide about 10%. So we're looking at people receiving from 16% to 85% pay replacement under the social system.

We then looked at our target objectives. What do we want, where do we want our people to be? And depending upon whether you want them to retire with 50%, 60% or 70% pay replacement, those are where you need the supplementations under the private plan.

Now you might ask yourself, what's the rationale? Why have a formal plan, if you're going to end up not supplementing too many people -- why not just go with the pay-as-you-go? You have that alternative. We looked at prefunding through a closed entity; the thing we liked at that time was the tax advantage. Under pay-as-you-go you don't get a tax advantage when you accrue the liability.

At this time we did see the advantages for prefunding. And there were tax advantages for the employee on lump sum benefits. Employee contributions are tax deductible. This is the approach we came up with, with the advice of actuaries. We used prefunding within the closed entity. A closed entity is like a trustee arrangement as we understand in this country. It does a lot more things down there and it's a little more formal. But just think of it as an arrangement, the open entity being more of an insurance concept than annuities. But we wanted to minimize cash flow, we wanted as little cash requirement as possible, we wanted to maximize the tax advantages.

What did we come up with? We had the same concern with investment risk, and the volatility down there of everything you can invest in. What the mixes of the investments can be. What investment returns you're going to get. And our goal was to minimize that by minimizing the amount of pension assets we were going to have. But what did we do? We funded with the most liberal actuarial assumptions. For accounting, a more realistic approach. Bring contributions to the lowest level. And maximize the book reserving to the extent we could.

But first of all I better show you what the plan design is. We took a good hard look at defined benefit versus defined contribution. I don't know if you know it, but domestically Occidental Petroleum has a defined contribution plan. Keep in mind in Brazil when you have a defined benefit plan there's readjustment and indexing after retirement. It's a major problem. We're seeing that there are some defined contribution plans coming in, though by percentage it's not that great. It's probably a little better than what we have in this country. Defined contribution plans as a basic pension plan are not the prevalent practices we know.

Brazil is generally a noncontributory country. What we came up with was a combination of a defined benefit/defined contribution plan. I'll give you those specifications later on. But in setting the actuarial method for the defined benefit plan keep in mind we were trying to have as few pension assets as possible. And we were trying to maximize the amount of book reserve that we would take in conjunction with it. We put up the basic plan, the basic pension plan and a supplementary defined contribution plan. Those are the general specifications.

In our plan, 2,258 people are at the very low end. They're not going to be getting a pay replacement from the defined benefit plan. That replacement is from the defined contribution plan. And it does require employee contributions. The real benefit of the plan starts at 17 to 20 "minimum salaries" and going up from there and there are very few people in those categories. The major argument against this plan is: which of those people below 17 minimum salaries are going to be able to have discretionary income? Even contribute to a plan?

Here is the supplemental defined contribution plan. 3% of pay up to 34 minimum salaries, and it's a 50% company match. Some doubling up for past service if they want to do it. And you don't really have the defined benefit starting until roughly 25 minimum salaries. And then it really pays off for the higher paid. I would say if those people who are trying to figure out what they're going to do in Brazil, whether they're going to have a strong social system, or a private system, if they saw something like this, it would probably inclining them to have a stronger social system. I'm not too sure that the legislature is too happy with all the benefits going to the higher paid. I don't know if that's good or bad, that's just my observation.

We put this plan to the government, I think at the beginning of 1986; as yet they haven't approved it. The information that we got back relates that it isn't that there's anything wrong with the plan, it's that they're in a turmoil down there as to what the government wants to do, and what direction they want to go with private versus social.

MR. O'REILLY: I've got two technical points to add to that which doesn't affect the actual design of Don's plan: just changes in the legislation down there. The termination indemnity system has gone to defined contribution, as opposed to being one month per year of services. Also, new plans cannot set up book reserves. So essentially the focus is now on funded plans. As Don was saying, obviously there is a problem with funding in Brazil because of the high-level inflation. But there are investment instruments you can use which match inflation.

So far, we've given you a good cross section of three very different types of pension environment. We're now moving on to Canada, so I'll pass you over to Peter.

MR. PETER GORHAM: There is currently an awful lot going on in Canada in the pension area. I think that it would be best to begin with a very brief summary of some of the differences between Canada and the U.S. affecting pensions. As is the case in many areas, there are a lot of similarities between the two countries' approaches to pensions.

The Canadian parallel to OASDI is a combination of two programs: Old Age Security (OAS) is a universal program funded out of general tax revenues and the Canada Pension Plan (CPP) is a pay-related program funded equally by employees and employers.

Canada provides medicare and drug benefits to all senior citizens, also funded out of general tax revenues. Also, all Canadians under 65 are covered by a government hospital and medical plan. Individual premium rates are nominal with the government funding the bulk of the costs.

On the regulatory side, Canada has pension benefits legislation at the provincial level. These acts are essentially aimed at protecting employee rights and providing security through funding and prudent investing. This contrasts with the U.S. legislation which could be said to have similar goals, but which seems to be primarily concerned with preventing discrimination and excessive tax deferrals.

The various provinces have, over the past few years, gone their own separate ways in amending their acts. Recently, they all got together and agreed on a uniform set of provisions. Unfortunately, they all seem to have their own definition of uniform. Thus, Canadian plans covering employees across the country need a lot of special situations for each of the provinces.

Canadian plans are also subject to the Income Tax Act and the rules and regulations issued by Revenue Canada. You may think that we have a relatively easy time when I mention that at present, the bulk of these rules are set out in a 25-page document. But things are about to change due to tax reform.

Four of the more important differences between the countries are that in Canada the following apply: (1) Employee contributions are tax deductible. (2) The restrictions on integration with OAS and CPP are easy to apply. (3) The maximum pension permitted from Canadian tax sheltered plans is $60,000, as opposed to the $94,000 from U.S. plans, and our $60,000 will remain unchanged until 1995. (4) Pensions must be paid as a lifetime annuity. Lump Sum Distributions are not permitted. This partly explains the greater problems we are facing in conforming to the requirement for both unisex contributions and unisex benefits on money purchase plans.

The last difference to mention is in the area of individual tax assisted savings. The Canadian equivalent of the IRA is called an RRSP -- Registered Retirement Savings Plan. In the past, individuals could contribute up to $5,500 to an

RRSP. Like many of the statutory provisions, these RRSP contribution limits are being revised, and will move upwards for many people, and down for some.

A few weeks ago, the federal government finally got around to releasing draft legislation to effect the pension aspects of tax reform. The basic ideas have been public knowledge for many years, but it has taken until now to figure out how to put them into legislation.

A goal of this tax reform is to treat the three broad types of pension arrangements equally. These three types are Money Purchase plans, Defined Benefit plans and RRSPs (which are admittedly an individual money purchase plan). In the past all three types have been treated unequally in terms of Revenue Canada maximums for contributions and benefits.

The most interesting aspect of this reform is the method of comparing a defined benefit plan to a money purchase arrangement. A defined benefit plan is deemed to cost \$9.00 for every \$1.00 of annual pension. This is known as the PA or Pension Adjustment. It is expressed as a formula:

$$PA = 9 \times \text{Pension Benefit} - \$600$$

Thus, a person earning \$45,000 in a 2% plan (regardless of whether it be career or final earnings) gets a pension benefit of \$900, and a PA of \$7,500. In other words, his benefit is deemed to be equivalent to a money purchase contribution of \$7,500. And this is regardless of the employee's age.
All of this is done as a means to determine how much a person may contribute to an RRSP. The RRSP contribution room is simply the maximum less the PA. The overall maximum is 18% of pay or \$15,500.

Now, you may wonder, why the \$600? I will admit to being cynical, but it seems that this was the only way to get the formula to produce \$2,000 of RRSP contributions for government employees. This \$2,000 contribution would seem to be a strategic target of the government. A client of mine had the gall to suggest to me that the \$600 was the actuary's fee.

The government recognizes that this 9 times factor is arbitrary. But it is stated to be the average cost of a fully loaded defined benefit plan over an employee's career.

A very interesting feature is that the PA is not affected by ancillary benefits. The maximum permitted benefit is 2% of final average earnings, considered equivalent to 18% of pay -- the money Purchase maximum. But there are some benefits deemed to be "free": (1) survivor benefits -- before and after retirement; (2) disability benefits; (3) bridge supplements; (4) salary updates on career plans; (5) benefit updates on flat benefit plans (up to CPI increases); and (6) indexing to CPI increases.

All of these are socially "good" benefits which will presumably reduce the risk of a beneficiary becoming dependent on government social assistance programs in the future.

There are two possible major consequences of these tax reforms worth mentioning: (1) The 9 times factor favors money purchase plans at younger ages and defined benefit plans at older ages if there are a lot of ancillary benefits. So we could see some plans switching to a new type of hybrid plan, say money purchase up to age 45 and defined benefit thereafter. Of course, this results in larger termination benefits at younger ages than a pure defined benefit plan. (2) With the encouragement of ancillary benefits, plans may reduce the pension formula and increase the ancillary benefits, keeping the plans cost to the company the same, but increasing the individual's contribution room to his own RRSP.

In designing these reforms, the government has stated their goal is to provide tax-assisted retirement savings on earnings up to twice the average industrial wage in Canada. When the phase-in period is over in 1994, this will result in tax-assisted savings on earnings up to $86,000. (Using a 5% salary factor, that is equivalent to $64,000 today.) As we creep towards 1994, more and more employees will find themselves affected by the maximums.

Since most plans in Canada do not provide the maximum benefit of either 18% of pay to a money purchase plan or 2% of final average earnings to a defined benefit plan the salary level at which the maximums will kick in will vary upwards from this $86,000 level.

The government did not forget the high earners -- it just will not offer tax assistance on these "top hat" pensions. But it has set up an interesting mechanism for funding these plans. All contributions, whether employee or employer, are tax deductible in the year made. The trust fund, however, pays a 50% tax on net cash flows -- contributions and all forms of investment income. Taxes paid are refunded when benefits are paid out of the trust. The net effect of this is that it works just like a regular pension plan except that 50% of the plan's assets are invested with the government at zero interest.

It will be some time yet before we see how much use will be made of this funding arrangement. The government has ensured some use for these Retirement Compensation Arrangements (RCA) by enacting legislation to require that they be the only acceptable vehicle for funding nonregistered plans. With the increase in numbers of employees likely to be covered by top hat benefits, we expect the use of these RCAs will grow.

Moving to the provincial scene, we are experiencing a major set of reforms gradually spreading across the country. These reforms include the following:

1. Faster vesting and locking-in of contributions -- this occurs after two years of plan membership. (Locking in means that cash refunds are prohibited. Only a lifetime annuity may be paid to the employee at retirement.)

2. Minimum death benefits equal to the commuted value of the benefits.

3. Minimum level of funding from the company, known as the 50% rule.

4. Portability. On termination, employees must be permitted to transfer the value of their benefits to an RRSP rather than be forced to accept a deferred pension.

5. Benefits and contributions may not vary by sex.

6. Pensions must now be taken into account in splitting assets on divorce in a few provinces.

7. A new minimum funding standard is based on a plan wind-up scenario. Any deficit must be funded over five years.

8. Employees may now require that a Pension Advisory Committee be set up to monitor the operation of the plan. This committee may include company representatives, but must have a majority of employees. As part of their mandate, the committee may examine fund performance and offer their comments.

The major result of these reforms is an increasing burden on defined benefit plans, both administratively and financially. In other words, Canada seems to be moving towards the example set in the U.S. While additional burdens have been created for money purchase plans, they are beginning to look more attractive than defined benefit arrangements. At least a lot of consultants are saying so. To date, there has not been the type of predicted activity of companies switching from defined benefit to money purchase. I, for one, do not expect to see much switching either.

The province of Ontario has decided that uniformity of legislation is a nice idea, but because 70% of the pension plans in Canada are registered in Ontario, they can determine what uniformity is. As a result, even though other provinces did not feel it was the right time to do so, the Ontario government announced that pensions must be indexed. Pensions must be indexed during active service, retirement and the deferred vested period. The law says we must index, but a formula has not been developed yet.

This indexing requirement is in response to a lot of retiree pressure exhibited during the innumerable task forces and other committee hearings of the past decade which were set up to review what reforms were needed to pensions. Shortly before the last election, the Ontario government announced that it was committed to indexing.

As background, most public sector employees in Canada have pensions fully indexed to the CPI. Recent union negotiations have focused on indexed benefits with the United Auto Workers (UAW) and the big three automakers agreeing on a six-year term of automatic indexing. A similar agreement was reached following a short strike by the Air Canada ground workers.

Throughout all of the debate, the corporate position has focused on costs and competitiveness. The automakers determined that the cost of a new car would increase $500 if full indexing were granted.

Out of all this came a report from the Friedland Task Force. This was a task force set up to recommend to the government how to implement indexing. Its recommendations included the following:

1. An indexing formula of 75% of CPI - 1%, capped at 6.5% indexing (based on a 10% CPI increase).

2. Mandatory indexing should apply only to the future accruals, since costs were lower initially and, the Task Force claimed, there was less variability in cost increases between companies. However, a number of "inducements" were put forward to encourage extending the increases to all prior service benefits.

3. No surplus refunds to the plan sponsor would be permitted unless indexing was extended to prior service.

4. For money purchase plans, it would be mandatory for the plan to offer an optional form of pension which provided the indexing benefit. Thus, money purchase plan sponsors could escape with no added costs, but defined benefit sponsors would have to pay more to the extent they could not pass the increase on to employees.

This has come under strong attack. The Task Force Chairman recently stated that maybe defined benefit plans should have mandatory indexing imposed through optional annuity forms. In my opinion, this looks like creating an opening for the government to escape from a potentially very troublesome problem with some measure of face saving.

I mentioned how many public sector employees already enjoy fully indexed pensions. The indexed part of their pensions is usually funded by a 1% employee contribution matched by the employer. A recent task force headed by Laurence Coward examined the funding status of some of these plans in Ontario and concluded that massive increases in funds are needed. So we are faced with the government attempting to require the private sector to institute indexing at the same time as they try to figure out how to get the money to correct their own funding problems.

The indexing issue is ensured to be a political one, since the formula and other rules regarding its operation must be debated in the legislature. In my opinion, a solution that does not give indexing to prior service will not be politically acceptable. I believe we will either see all plans being mandated to offer indexing as an add-on (in most cases, paid for by surplus and the employer) or as an optional annuity (in most cases, paid for by the employee).

This now brings us to the questions of surpluses. A few years ago, Canadian pension plans operated on the basis of what made sense. If there was a surplus in the plan, unless the plan text stated that it could not revert to the sponsor under any circumstances, it was generally considered to belong to the sponsor. Of course, nobody bothered to ask for the opinion of the employees, so it is possible for me to make this generalization.

Many successful surplus refunds and a few court cases later, it is very difficult to get surplus out of a pension plan. Quebec has specifically forbidden surplus refunds from ongoing plans for many years now. Ontario has instituted a moratorium on almost all refunds until they can decide what to do. All other jurisdictions are being extremely careful.

Part of the current situation is due to the rather casual attitude taken to pension plans in the past. Employers seemed prepared to do whatever seemed reasonable in order to get the tax deductions. The provincial funding requirements resulted in conservative funding which has now caught up with us.

It has come as a rude shock to the pension industry that pension plans are subject to trust law. Plans were set up without regard to the possibility that monies would be deemed irrevocable once made to the trust, unless otherwise provided. It was unthinkable in the 1960s and 1970s that surpluses would exist.

Part of what is contributing to the question of ownership are three items:

1. Deferred Wages: More and more people are beginning to look at pensions as deferred wages. In particular, where pensions are subject to bargaining, many negotiations get into discussions like, "Those pension increases are worth 30 cents. Do you want it in wages or pensions?" In my opinion, this would imply that much of the surplus arising from the 30 cents belongs to the members.

2. Employee Contributions: The widespread use of employee contributions clouds the whole issue. Many people feel that excess investment earnings on the employee contributions should, at least partly, belong to the employees. If this were the only issue, all we would have to do is somehow separate the surplus arising from employee contributions from the rest of the surplus. Things are not that easy.

3. Funding Deficits: This argument is getting a little tired, but no one seems to have a good rebuttal for it yet. If the sponsor has accepted the risks of funding deficits, then surely he should get the benefit of surpluses.

There is one way still available to get the use of surpluses. The plan sponsor can take a contribution holiday to the extent that surplus is sufficient. This has been approved by the courts in at least one case. Contribution holidays are not surplus refunds. The sponsor is only obligated to contribute the funds required in excess of the employee money. Therefore, as long as there is sufficient money in the trust fund, the sponsor does not need to contribute.

One consequence of this debate is the likelihood of funding assumptions becoming more aggressive. After all, why would a sponsor knowingly contribute what will likely be excess monies if he cannot recover them? A showdown with the provincial regulators is likely to come.

Another probable outcome (on which Ontario is about to release a position paper) will be the requirement that surplus funds be tracked as employee groups are split off, merged in or otherwise transferred between plans. This could easily develop into a situation in which there are many groups of members in a plan, each one entitled to differing portions of the surplus funds. We are hoping that, somehow, sanity will prevail and plans can continue to operate in an environment of trust and reasonableness.

This concludes our whirlwind tour of Current Issues in Canada. Some of these you recognized as imports to Canada from America, but the underlying differences in pensions put a few new twists on them. Two items I would recommend you keep your eyes on are the development of the surplus ownership question and mandatory indexing. These could become Canadian exports under the Free Trade agreement between our countries.