August 5, 2022

Via email: andrew.donelle@fin.gc.ca

Andrew Donelle
Director, Deferred Income Plans
Tax Legislation Division
Department of Finance
140 O'Connor St
Ottawa, ON K1A 0G5

Dear Mr. Donelle:

Re: Registered Pension Plan Borrowing Restrictions

The Canadian Bar Association Pension and Benefits Law Section (CBA Section) is pleased to comment on draft changes to the borrowing restrictions applicable to registered pension plans under section 8502(i) of the *Income Tax Regulations* (ITR).

The CBA is a national association of over 37,000 members, including lawyers, notaries, academics and students across Canada, with a mandate to seek improvements in the law and the administration of justice. The CBA Section contributes to national policy, reviews developing pensions and benefits legislation and promotes harmonization. Our members are involved in all aspects of pensions and benefits law and include counsel who advise pension and benefit plan administrators, employers, unions, employees and employee groups, trust and insurance companies, pension and benefit consultants, and investment managers and advisors.

I. BACKGROUND

On September 16, 2021, the CBA Section prepared submissions in response to your request for our views on the approach to amend the borrowing restrictions under section 8502(i) of the ITR. Our September 2021 letter[1] followed a July 16, 2021 discussion between members of a CBA Section Working Group, you and your colleague Zahra Haji.

Based on our July 2021 discussion, our September 2021 letter indicates our understanding that the new rules would be less restrictive than the current ones and would not prohibit or restrict any

[1] See CBA Section Submission (September 16, 2021).

borrowings not currently prohibited or restricted. We understood that the intent for the new rules was to give plan administrators greater borrowing flexibility while imposing a workable and reasonable cap on the amount of money that can be borrowed by a registered pension plan.

On January 28, 2022, as part of the annual meeting of the CBA Section Executive and Finance Canada, we discussed the proposed changes to section 8502(i) of the ITR. At that time, while you were still considering our September 2021 letter, we understood that Finance Canada still intended that the new rules would be more flexible than the current ones.

The *Notice of Ways and Means Motion to Amend the Income Tax Act and Other Legislation* released with the federal budget on April 7, 2022 included the draft changes to section 8502 of the ITR.

On April 21, 2022, our Working Group met with you and your colleague Paul Taylor to discuss the draft legislation. We conveyed our initial thoughts, including concerns with the incorporation of a plan liabilities-based test in new section 8502(i.2)(ii) of the ITR, which had not been contemplated in our prior discussions or submissions. At the conclusion of that meeting, we undertook to send you further submissions on the draft legislation.

II. OVERVIEW

We commend Finance Canada's efforts to make the borrowing rules more flexible for defined benefit (DB) plans. As recognized in draft guidance by the Canadian Association of Pension Supervisory Authorities (CAPSA), leverage is an important element in pension plan investment and risk management. Increased flexibility to borrow money would give pension plans a wider array of tools to invest plan assets and manage plan risks.[2]

That said, we wish to comment on two aspects of the proposed new rule that undermine the objective of granting additional flexibility and could instead impose unnecessary burdens:

(i) The funded status of a plan is not well correlated with whether it would be appropriate or helpful for a plan to borrow to meet investment or liquidity objectives. Imposing a liabilities-based test on the amount a plan can borrow, in particular a "sliding scale" test, does not recognize the value of borrowing to a plan's long-term health regardless of funded status and will undermine the flexibility granted because of the relative uncertainty and administrative burden associated with it; and

(ii) Removing the current 90-day borrowing rule exception in conjunction with adding the liabilities test makes the new borrowing rule less flexible for DB plans near or at a 125% funded status.

We believe that removing the liabilities test in its entirety (and relying on the 20% of net assets limit on borrowing) best aligns with Finance Canada's stated objectives, without undermining any desire to cap the accumulation of surplus in a pension plan.

Alternatively, if Finance Canada wished to retain a version of the liabilities test, we recommend removing the "sliding scale" test, which decreases the amount a plan can borrow as it approaches 125% funding and replace it with a hard limit when a plan becomes 125% funded, not before. This is

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[2] For example, see consultation draft guideline Leverage and the Effective Management of Associated Risks, published by the Canadian Association of Pension Supervisory Authorities (CAPSA) on June 9, 2022.

similar to the treatment of the employer contribution rules under section 147.2 of the *Income Tax Act* (ITA). This approach would give plans greater certainty for investment planning from year to year, reducing the potential for unintended consequences.

In either case, we believe it would also be helpful to include the current 90-day borrowing rule exception in any new rule. This would ensure plans avoid inadvertently exceeding (including in some cases due to events beyond their control) either an asset based or liabilities-based limit.

We suggest improvements to the borrowing rules for Finance Canada's consideration below.

III. PROPOSED RULES

The Ways and Means Motion proposed several changes to the ITR's borrowing of money by registered pension plans sections.

In particular, the Ways and Means Motion introduces amendments to section 8502 of the ITR that change the conditions under which DB plans may borrow money. Under the proposed amendments (section 8502(i.2)(i)), borrowing money is permitted to acquire income producing real property, which is unchanged from the existing sections on borrowing. Borrowing money is also permitted provided a plan does not exceed a percentage of assets tests (Formula A), or a test based on the percentage by which plan assets exceed its liabilities (Formula B), whichever is lower, as set out in the draft provision below:

> (i.2) in the case of a defined benefit provision of the plan (other than an individual pension plan), a trustee or other person who holds property in connection with the provision does not borrow money for the purposes of the defined benefit provision, except
> […]
>
> (ii) in any other case, at any time that an amount is borrowed, if the total of that amount and the amount of any other outstanding borrowings in respect of the provision (other than those described in subparagraph (i)) does not exceed the lesser of the following amounts:
>
> (A) the amount determined by the formula 0.20 (A − B) where
>
> > A is the value of the plan assets in respect of the provision on the first day of the fiscal period of the plan in which the amount is borrowed, and
> >
> > B is the amount of outstanding borrowings in respect of the provision, determined on the first day of the fiscal period in which the amount is borrowed, and
>
> (B) the amount determined by the formula 1.25 × C − (D − E) where
>
> > C is the amount of actuarial liabilities in respect of the provision, determined on the effective date of the plan's most recent actuarial report,
> >
> > D is the amount determined for A in clause (A), and
> >
> > E is the amount determined for B in clause (A)

The proposed amendment to the ITR for DB plans removes the provision that previously permitted pension plans to borrow for a short term (up to 90 days), provided the borrowing is not part of a series of loans and plan property is not used as security for the loan except to avoid a distressed sale in certain circumstances (i.e., the "90-day rule").

Formula B of the amendment permitting borrowing under certain asset thresholds is a test based on the amount by which 125% of the plan's actuarial liabilities exceeds the value of the plan's assets net of outstanding borrowing (the "liabilities-based test"). As noted above, this type of test was not considered in our previous submission.

The effect of the liabilities-based test (Formula B) is to progressively limit a DB pension plan's ability to borrow money (i.e., to reduce the amount of borrowing room available to it under the asset test) once the plan reaches a funded status that exceeds 105% (i.e., assets exceed liabilities by approximately 5% or more). Between a funded status of 105% and 125%, a plan's borrowing room is progressively reduced on a sliding scale from 20% of assets to 0% of assets (net of outstanding borrowing).

We understand that the liabilities-based test is intended to function similarly to the excess surplus rule under section 147.2(2) of the ITA, where an employer is prohibited from contributing to a DB plan once the plan is more than 125% funded. Where a plan is more than 125% funded, an employer must take a contribution holiday or benefits must be improved under the plan to bring assets below the 125% level. In other words, the goal is to prevent a build up of assets in the plan beyond what is necessary to fund liabilities plus a 25% funding cushion.

IV. CONCERNS WITH PROPOSED NEW RULES

A. Liabilities-Based Test Unnecessary and Potential Impediment to Reasonable Borrowing Activity

Leverage is an important element in pension plan investment and risk management. Increased flexibility to borrow money would give pension plans a wider array of tools to invest plan assets and manage plan risks.

The investment purposes for which a DB plan may wish to borrow money include implementing liability-driven investment strategies (where plans increase exposure to assets that behave like their liabilities), increasing exposure to return seeking assets, or seeking investment opportunities and efficiencies available by accessing additional assets (e.g., greater diversification or ability to take larger positions in low volatility asset classes).

These investment purposes allow plans to reduce risk in their portfolios by allowing for greater access to lower risk assets (among other strategies). The benefit of reducing risk does not change based on the funded status of the plan. Borrowing could also help manage investment liquidity or to hedge and mitigate specific investment risks.

While some of these purposes may have the effect of increasing plan assets (net of borrowing), others do not. Moreover, even those borrowing purposes that make more assets available for investment do not necessarily result in an increased funded status over time because:

- increased borrowing will not necessarily translate into increased returns beyond those available under other investment strategies that do not involve borrowing (e.g., a "lower risk" investment strategy incorporating borrowing may achieve the same return as the "higher risk" strategy – but with less risk);

- the employer contribution rules under section 147.2 of the ITA prevent an employer from contributing to the plan when the plan is in an “excess surplus” position (i.e., it is more than 125% funded), until such time as excess surplus is eliminated; and
- plans have various means of managing surplus, such as benefit improvements and contribution reductions. Plans often have funding policies (or other documentation) addressing asset-liability management, including managing surplus typically well below the level of excess surplus set out under section 147.2 of the ITA.

Further, under the proposed new rules, the 20% asset limit (Formula A) will itself act as a limit on borrowing that should prevent accumulation of excess surplus.

For plans wishing to borrow to diversify and seek better returns from a lower risk portfolio, overly limiting the amount a plan can borrow could result in changes to portfolio construction that could lead to higher risk taking for the same target return.

Moreover, a plan’s funded status is not necessarily well correlated to a plan’s liquidity. Plans may wish to borrow whether or not their most recent actuarial valuation discloses a more than fully funded status to allow them to achieve investment objectives at a lower risk than other permissible investment strategies. In addition, in our experience, even well funded plans may occasionally need to borrow to meet short term liquidity demands (see examples below).

Based on these considerations, we believe that including a liabilities-based test in the borrowing rule is unnecessary and could impede prudent use of borrowing to achieve reasonable investment objectives.

B. Liabilities-Based Test Cumbersome to Administer

The liabilities-based test requires a plan administrator to determine liabilities based on the effective date of the plan’s most recent actuarial report. Actuarial reports are typically prepared by plans every year or every three years, in accordance with the requirements of pension standards legislation. Their primary function is to determine the financial health of a pension plan (via its funded status) and an employer’s contribution obligations to the plan.

Using actuarial reports to determine liabilities for purposes of an investment-type test is unusual (it is not required for purposes of any other investment rule) and strays from the core purpose of an actuarial valuation. This use of an actuarial report in the new borrowing rules may not be in the best interests of pension plan stakeholders as it creates potentially contrary incentives by using liabilities to determine contributions to the plan and borrowing room (i.e., an actuarial valuation prepared for the purposes of the liabilities borrowing test could, under pension standards legislation, result in employers having to pay additional contributions or in benefit cuts for some types of plans).

Further, under Formula A (percentage of assets test), assets are determined as of the end of the most recent fiscal year and, under Formula B (liabilities-based test), the liabilities are determined as of the effective date of the most recent actuarial report and the assets are determined as in Formula A. This could create a mismatch between the date on which assets and liabilities are determined for many plans because:

- actuarial reports are not prepared annually by most plans, and
- even where they are prepared annually, an actuarial report is typically finalized and issued months after its (typically December 31 or January 1) effective date.

Plans that seek to determine their liabilities more frequently than otherwise required by pension standards legislation would be subject to additional costs and the administrative burden of preparing an actuarial valuation.

Further, given the potential for fluctuations in a plan's funded status year over year, it would be difficult to forecast the amount of a surplus position, and as a result, the potential impact of the decrease in borrowing room when a plan is over 105% funded. Therefore, pension plans may not be able to forecast and consider any borrowing room when establishing their long-term investment strategy and may be required to incorporate higher risk investment strategies to meet required returns. Removing the sliding scale imposed by the liabilities test, as discussed below, would mitigate concerns about forecasting for long-term investment purposes.

Overall, eliminating the liabilities-based test would create a simpler and administratively less burdensome test without significantly increasing the risk that DB plans would accumulate excess assets.

C. Proposed Rules Not Parallel to Excess Surplus Rule

Our understating is that the formula in proposed section 8502(i.2)(ii)(B) (Formula B) of the ITR (i.e., the liabilities-based test) was introduced to parallel the excess contribution rules in section 147.2(2) of the ITA such that, in circumstances where an employer would be prevented under section 147.2(2) of the ITA from making additional contributions to a DB plan as a result of being more than 125% funded, the plan would be prevented from borrowing money.

However, Formula B is more restrictive than the rules in section 147.2(2) of the ITA. Under section 147.2(2), an employer is not prevented from making additional contributions until the plan is 125% funded.

Under proposed section 8502(i.2)(ii), there are two formulas:

> Formula A, essentially 20% of the excess of the value of plan assets over outstanding non-real estate borrowings of the plan (Net Value of Plan Assets); and
>
> Formula B, essentially 125% of actuarial liabilities less Net Value of Plan Assets.

As illustrated in the following example, Formula B becomes the limiting factor with respect to plan borrowing once the Net Value of Plan Assets exceed 105% of actuarial liabilities, as opposed to only when a plan is 125% funded (as the test applies in section 147.2(2)):

> Assume that a DB plan's Net Value of Plan Assets is 105 and actuarial liabilities equal 100 (i.e., the Net Value of Plan Assets is 105% of the actuarial liabilities). In this example, Formula A will produce borrowing room of 21 where Formula B will produce borrowing room of 20 (125-105).
>
> The plan's borrowing room continues to be reduced under Formula B as its Net Value of Plan Assets increases. If the plan's actuarial liabilities remain at 100 but its Net Value of Assets increases to 110 (i.e., the Net Value of Plan Assets is 110% of the actuarial liabilities), Formula A will produce borrowing room of 22 whereas Formula B will only produce borrowing room of 15. In both these scenarios, the plan's borrowing room has been limited to less than 20% of the value of the plan's assets even though the plan is less than 125% funded.

Therefore, the result of the proposed amendment is more restrictive than the result achieved by section 147.2(2) since Formula B becomes a limiting factor on a plan's ability to borrow once the plan becomes more than 105% funded, whereas the limitation on plan contributions under subsection 147.2(2) does not become effective until the plan becomes more than 125% funded. As noted above, this result is unnecessarily restrictive in the circumstances and undermines the ability of plans to reasonably take advantage of the borrowing room afforded by the rule.

If the liabilities-based test were to remain at all, the borrowing rule and the contribution restriction under section 147.2(2) should apply symmetrically such that Formula B would not limit a plan's ability to borrow until it is 125% funded. This would give additional flexibility to plans and assist them in investment planning because it would reduce the risk of potentially significant changes in the room available for borrowing over time.

If Finance Canada does not wish to remove the liabilities test in its entirety, we recommend that Formula B be amended to apply symmetrically to the excess surplus rule in section 147.2(2) (i.e., we recommend that the sliding scale be replaced with a limit that only comes into effect when a plan is at 125% funding, not before).

D. Proposed Rules Less Flexible Than Current Rules in Certain Circumstances

Pension plans sometimes need to borrow money temporarily because of unanticipated events that can result in the plan needing temporary liquidity. Under the current regulations, DB plans can rely on the 90-day rule to allow this temporary borrowing irrespective of the plan's funded status. Under the proposed regulations, DB plans could not rely on the 90-day rule and DB plans with a surplus of 25% or more would be offside the borrowing test as a result of an unanticipated temporary borrowing of the nature described above.

We set out two examples below.

Settlement Failures

A situation where a plan may need to borrow money regardless of funded status relates to cash advances to cover the knock-on impact on a plan's liquidity of certain ordinary course capital markets events.

The day on which cash or securities are *exchanged* in a capital markets trade is typically not the day on which the trade is *agreed* (trade date). Usually, settlement occurs in the days following (settlement date). Sometimes this date is a market convention (e.g., publicly traded shares in Canada and the U.S. settle two days after their trade date, or "T+2"). In other cases, the settlement date can be agreed on between market players.

It is not uncommon for a counterparty to be unable to deliver securities on a given settlement date. When a counterparty fails to deliver securities (or cash) as agreed, it is referred to as a *settlement failure.* If the trade is settled on a delivery-vs-payment basis (DVP), as most are, a party who sold securities but fails to deliver them will not receive the cash until it delivers the securities.

Failed trades impact liquidity. As a simplified example, on a Monday a pension plan may agree to:

- Sell 100 shares of Walmart for $150 USD per share;
- Exchange $15,000 USD for $19,000 CAD with a financial institution; and
- Buy 132 shares of CIBC for $143 CAD per share.

Typically, the share trades would settle T+2 by convention, meaning the pension plan would have agreed to a T+2 settlement date with the financial institution for its currency exchange trade, for liquidity management purposes. If on Wednesday any of the legs of these trades fail, the pension plan's cash flow will be impacted. For example, if any of the USD is not paid, the pension plan will not deliver the Walmart shares accordingly. The knock-on effect would be that the pension plan is short USD for its currency exchange trade, and further, short CAD for its CIBC share purchase.

To help institutional investors with this issue, all custodians offer margin on custody accounts (similar conceptually to "overdraft" protection an individual may have on a chequing account). If the client (i.e., the pension plan) is short cash at the close of business, the custodian covers the shortfall, and charges the client a fee for doing so. The cash shortfall is typically repaid in the next day or two.

Custodial/trust agreements often include arrangements for the trustee/custodian to lend money to the pension plan to facilitate transactions (e.g., liquidity issue arising from a failed transaction as discussed above). In some cases, when opening the account, the trustee/custodian may seek security over plan assets for these loans, which can put the pension plan to great expense to negotiate and avoid secured short-term borrowing. In turn, a pension plan may find it challenging to retain an otherwise preferred custodian/broker who could offer reliable and efficient custody and trade execution.

Unforeseen Market Events

Market events causing sudden downturns can also put temporary pressure on pension plans to manage liquidity needs without selling assets at declining prices. The unpredictable nature of a market stress period causes liquidity issues for plans. In particular, liquidity could be needed for increased and unexpected capital or market calls.

In a period of market stress, plans cannot typically capture any temporary associated decline in funded status in a new funding valuation, nor would it be reasonable for them to do so. Accordingly, a well-funded and well-managed plan may have to sell assets at a loss to satisfy the plan's temporary liquidity needs rather than borrowing temporarily to satisfy those same liquidity needs.

The fact that plans may need to borrow money at times of market stress was recognized by Finance Canada in the temporary COVID relief (section 8502(i.1) of the ITR) applying to loans (or series of loans) repaid no later than April 30, 2022.

We reiterate our understanding that the proposed regulations were meant to offer greater flexibility than the current regulations. Therefore, we recommend that, as a minimum, the 90-day rule be reinstated for DB plans. This recommendation applies whether or not Finance Canada removes or amends the liabilities-based test.

V. SUMMARY OF RECOMMENDATIONS

We recommend the following revisions to proposed section 8502(i.2) of the ITR, in order of preference:

1. **Amend clause (ii) by removing the liabilities-based test (Formula B) because the liabilities-based test is not appropriate or necessary.**

If this recommendation is adopted, the borrowing room for DB plan borrowing (other than real-estate related borrowing) would be set solely by current Formula A. This change would give desirable flexibility to plans, reduce administrative burdens and uncertainty for plans and maintain a workable cap on borrowing.

2. **If recommendation 1 is not adopted, revise the liabilities-based test (Formula B) to remove the gradual reduction in borrowing room and replace it with a limit that only comes into effect when a plan is 125% funded, not before.**

Prior to a plan reaching 125% funding, its borrowing room (other than in respect of real-estate borrowing) would be limited by Formula A. The proposed modification to the 125% threshold would make the operation of contribution and borrowing prohibitions consistent: both would be triggered at the same threshold, namely, where the plan is 125% funded. It would also give plans the ability to better forecast borrowing room for long-term investment planning.

3. **In either case – even if Recommendation 1 or2 is adopted but in particular if neither recommendation is adopted – reinstate the 90-day rule for DB plans.**

By reinstating the 90-day rule, DB plans would retain the benefit of this “safety valve” currently available to address, among other things, involuntary borrowing arising from ordinary course settlement failures and temporary liquidity needs related to market downturns. This would ensure the new rules are no less flexible than the current ones.

In addition, we recommend two changes to improve the current and proposed borrowing rules:

4. **If the 90-day rule is maintained, current subparagraph 8502(i)(iii) should be removed to update and improve the 90-day rule.**

DB plans that need to borrow money for purposes other than to avoid a distressed sale of assets are often asked as part of standard commercial documentation to grant security over plan property – given the short-term nature of the borrowing and that this is a risk management tool frequently sought by blue chip custodians/brokers, the requirement for the short-term borrowing to generally be unsecured should be eliminated.

5. **Section 8502(i.2)(ii) should be revised to clarify that the renewal of existing borrowing should not be considered “new” borrowing for purposes of the proposed formulaic DB plan borrowing rule.**

Plans may need to refinance existing borrowing when they are at or have exceeded the borrowing limit and should have certainty that they would not be considered offside the rule if they do so. Alternatively, this clarification could be addressed through technical notes or guidance from the Canada Revenue Agency.

VI. CONCLUSION

The CBA Section appreciates the opportunity to offer these comments. We trust they are helpful, and we would appreciate an opportunity to meet with you to elaborate further or to answer any questions that you may have.

Yours truly,

(original letter signed by Marc-André O'Rourke for Level Chan)

Level Chan
Chair, CBA Pensions and Benefits Law Section