# A Review of the Solvency Funding Framework under the *Pension Benefits Standards Act*: A Consultation Paper

**October 2018**

Ministry of Finance

## Foreword from Deputy Minister Lori Wanamaker

Pensions are an important part of our retirement income system. They help provide employees with income stability in retirement, and assist employers in attracting and retaining talent.

The purpose of this review is to seek input from all pension stakeholders to identify whether changes to B.C.'s *Pension Benefits Standards Act* (PBSA) might better support long-term plan sustainability and benefit security, so that defined benefit (DB) pension plans continue to provide lifetime pensions to plan members and other beneficiaries. An important objective of the review is to support the continuation of existing DB pension plans and the creation of new DB pension plans, whether they are single employer plans or industry-wide multi-employer plans that are collectively bargained.

Since the global financial crisis in 2008, DB pension plans have faced funding pressures associated with years of low long-term Government of Canada interest rates, aggravated by volatility in those rates and in investment returns.

According to the Superintendent of Pensions, the aggregate funding ratio for solvency valuations of B.C.-registered DB pension plans has shown a decline from 99 per cent in 2013 to 92 per cent in 2017. While the solvency funding ratio has stayed relatively constant since 2015, the total amount of solvency deficit that must be funded by plans has increased by $1.02 billion during that time. On a going concern funding basis, these plans have seen a significant increase in the funding ratio, from 104.6 per cent in 2013 to 114 per cent in 2017.

The focus of this consultation is to review the solvency funding framework for DB pension plans that are required to fund on a solvency basis and to consider reforms that support both plan sustainability and benefit security. The consultation is primarily intended to address the funding issues experienced by single-employer DB plans. Many of these employers continue to face difficulties stemming from their solvency funding obligations under the PBSA. Funding pressures have led to some employers winding up their plans or switching to less costly options, such as defined contribution, that offer little or no retirement income security for plan members. While these obligations can be a substantial challenge in today's economic environment, they are intended to ensure that the plan can fulfill the DB pension promise to plan members on an ongoing basis.

Solvency funding requirements have a different impact on DB pension plans that are negotiated with unions representing plan members working in multiple workplaces across a single industry. These plans typically require benefits to be reduced when fixed contributions fall short of meeting funding requirements. Of note, in 2015, a framework for target benefit pension plans was established, and most multi-employer negotiated cost plans previously registered as DB plans have converted to target benefit multi-employer plans, effectively making the temporary solvency funding exemptions provided to them since 2008 permanent. However,

multi-employer negotiated cost plans that did not convert to target benefit are now required to fund according to the same solvency funding rules generally applicable to B.C.-registered DB plans.

B.C. has attempted to alleviate the funding pressures on DB pension plans by making the following solvency relief available: the use of letters of credit to fund solvency deficiencies, Superintendent of Pensions' extensions to deadlines and, in 2016, the use of a one-time extension to the solvency amortization period from five years to 10 years.

In the meantime, interest rates have remained low.

The need for solvency relief in B.C. and other Canadian jurisdictions since 2008 and the recent solvency funding reforms in Quebec and Ontario suggest a review of the solvency funding framework under the PBSA is timely. A review will evaluate whether the rules for the funding of DB pension plans are appropriate in a continuing environment of low interest rates.

The broad range of options proposed in this Consultation Paper is intended to elicit discussion, and do not represent government policy.

Comments are welcome from all interested individuals on the options and questions set out in the Consultation Paper or any other issue that relates to B.C.'s solvency funding framework. Ministry staff will review the submissions and may follow up with stakeholders for further information.

As part of the solvency funding review, the Ministry is in the process of establishing a Stakeholder Advisory Committee, to ensure that any reforms to the existing solvency funding rules are balanced and informed by a wide range of stakeholder opinions. In addition, the review will include focused consultation with specific stakeholder groups, including employers that sponsor DB pension plans, unions representing multi-employer negotiated cost DB pension plans, plan members and pension industry advisors (actuaries, lawyers, accountants and professional administrators).

Thank you, in advance, for your participation in this important review.

Sincerely,

Lori Wanamaker, FCPA, FCA
Deputy Minister
Ministry of Finance

# How to Participate

This Consultation Paper is provided for public discussion and comment.

The deadline of December 14, 2018 for comments has been extended.

Comments may be made until the end of the day, **January 31, 2019**, and should be directed in electronic format to **PBSA.SolvencyReview@gov.bc.ca** or mailed in paper format to:

Financial and Corporate Sector Policy Branch
Ministry of Finance
PO Box 9418 Stn Prov Govt
Victoria BC V8W 9V1

The Ministry of Finance will share comments it receives with the Office of the Superintendent of Pensions and others involved in this review. The information received may also be summarized and disclosed in a manner that does not disclose the source. Even if confidentiality is specifically requested, freedom of information legislation may require that records containing comments be made available to members of the public who request access.

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# A Review of the Solvency Funding Framework under the *Pension Benefits Standards Act*

# Background

## Current Environment for Defined Benefit (DB) Pension Plans

Workplace pension plans, and DB pension plans in particular, are an integral part of Canada's retirement income system. They provide employers with a way to attract and retain talent and give employees a valuable and stable source of retirement income. At the end of 2017, 155 DB plans with 820,000 members were registered in B.C., according to the Office of the Superintendent of Pensions. The term "member" is used here and throughout the Consultation Paper to refer to all categories of plan members (active, deferred and retired) and other plan beneficiaries.

The years of low interest rates coupled with volatility in those rates and in investment returns since the 2008 global recession, along with improvements in longevity, have created financial difficulties for DB pension plans.

In particular, the following concerns have been raised:

1. **Contribution volatility:** Solvency funding can result in volatile contribution obligations because solvency valuations are based on long-term interest rates that change independently of equity returns. Unpredictable contribution amounts make it difficult for employers that sponsor DB pension plans to prepare their budgets and business plans, creating a disincentive to sponsoring this type of pension plan. Employees who are members of DB plans that are sponsored jointly by employers and members are also required to contribute to solvency funding and are negatively impacted when their contribution obligations become volatile.

2. **Procyclical contribution requirements:** Employers that sponsor DB pension plans are experiencing greater unpredictability in their contribution requirements. In recent years, they have been required to make larger solvency contributions during periods of low interest rates and investment returns, when their businesses are more likely to suffer from depressed economic activity and have a reduced cash flow. The same issue affects employees making solvency payments to jointly-sponsored DB plans, as wages are less likely to keep up with inflation during these economic periods.

3. **Short-term funding rules for long-term pension commitment:** Solvency funding assumes that a DB pension plan will wind up on the date of the plan's valuation. But DB pension plans tend to be perceived as a long-term investment. Employers that sponsor DB plans therefore question the need for large solvency contributions that reduce the amount they can invest in their business. Unions who represent members of negotiated cost plans question the need to reduce benefits to meet short-term funding rules, which undermines long-term retirement income security if those reductions affect pensions currently being paid.

4. **Excess funding:** Large solvency contributions can lead to excess solvency funding when interest rates increase. Sponsoring employers who are unable to withdraw a solvency excess may be motivated to make no more than the minimum required solvency payments, or to close their plans to new members.

## British Columbia's DB Pension Plan Funding Rules

The PBSA sets out minimum requirements for pension plans registered in B.C., including funding requirements. These minimum requirements do not require employers to offer pensions to their employees. Workplace pension plans are offered at the sole discretion of the employer, who also has the authority to change or wind up the plan, subject to legal restrictions.

To determine whether a DB pension plan is sufficiently funded, two types of funding valuations are required under the PBSA.

**Going concern funding** assumes that the pension plan continues indefinitely. The cost of the benefits earned under the plan in the year following the valuation date (commonly referred to as the plan's normal cost) is calculated on a going concern basis. Any going concern funding shortfalls must be eliminated within 15 years.

To calculate going concern funding requirements, the actuary for the plan chooses best estimate assumptions, with input from the sponsoring employer. Assumptions are based on the plan's experience with adjustments to reflect anticipated future events and trends.

The most important assumption is the interest rate assumption. For a going concern valuation, the interest rate is generally based on the long-term average return assumed for the pension fund.

**Solvency funding** is intended to calculate the funding required to pay for benefits if the plan were to wind up immediately, on the valuation date. The rules are designed for annuities to be purchased for members upon plan wind-up in accordance with the provisions of the plan.

However, solvency funding does not guarantee that the plan would be fully funded if the employer sponsoring the plan becomes insolvent. While the likelihood of employer insolvency while the plan is not fully funded is low, the impact on plan members of receiving less than the promised benefit would be significant, and could be severe.

Any solvency shortfall must be paid within five years. To determine solvency funding requirements, the plan's actuary must use a discount rate based on long-term interest rates. A solvency valuation is considered to be a more objective assessment of the level of benefit security provided by a pension plan on the valuation date than a going concern valuation. Therefore, the requirement to fund on a solvency basis adds rigour to pension plan financing.

Pension plans registered in B.C. were first required to meet solvency funding requirements in 1993, with the first PBSA. Solvency funding is intended mainly to provide an early warning sign of potential funding shortfalls that could place the security of members' benefits at risk.

Solvency valuations and going concern valuations tend to alternate over time as the main driver of pension plan costs. Solvency funding valuations were low in the 1990s when higher interest rates and investment returns were common. If going concern valuations had not been in place, plans would have had smaller contribution requirements and been in worse shape after interest rates dropped significantly and remained low. The requirement for two types of valuations may explain why DB plans in Canada have performed better than their counterparts in other countries.

The pension funding rules under the PBSA are of general application to private and public sector plans.

B.C.'s four large public sector pension plans have been exempt from the solvency funding rules since their establishment. These multi-employer plans are governed by the *Public Sector Pension Plans Act*. The exempt status of these four plans is based on several factors which differentiate them from other plans in the public and private sectors, including the plans' joint funding and governance structures which ensure a joint fiduciary duty to all plan members, the greater opportunity for risk-sharing owing to their larger scale and the assumption that the sponsoring employers are less likely to become insolvent.

However, other DB plans in the public sector are required to fund on a solvency basis and the same funding challenges faced by private sector employers are placing substantial pressure on the employers sponsoring these plans. As a result, the temporary solvency relief measures introduced in 2016 were equally available to these plans. These plans are sponsored by the following employers:

- British Columbia Hydro and Power Authority;
- British Columbia Lottery Corporation;
- Insurance Corporation of British Columbia;
- Simon Fraser University;
- University of Victoria;
- WorkSafeBC.

Steps have been taken to ease the impact of solvency funding requirements for B.C.-registered DB pension plans, to help maintain the long-term sustainability of DB plans while protecting members' benefits.

Sponsors of single-employer plans and non-collectively bargained multi-employer plans are permitted to use letters of credit (LOCs) obtained from a financial institution to cover payments toward a solvency shortfall. An LOC is a promise from a financial institution to pay the fund an agreed amount in certain circumstances, such as if the employer fails to renew the LOC prior to its expiration date or fund a solvency shortfall on plan wind-up.

LOCs, while expensive to obtain, balance stakeholder interests by addressing employer concerns regarding large contribution requirements while maintaining the benefit security for plan members provided by solvency funding. Once an employer's contributions are made to the plan, they cannot be withdrawn unless the plan is at least fully funded on both a going

concern and solvency basis. LOCs help maintain the viability of DB plans by providing sponsoring employers the flexibility of using LOCs to meet their funding obligations without committing funds that may be unrecoverable or may never be needed.

The PBSA was repealed and replaced in September 2015 to reflect recommendations in the 2008 Report of the Alberta – British Columbia Joint Expert Panel on Pension Standards, *Getting Our Acts Together* (the JEPPS Report).

The importance of solvency funding was recognized in the JEPPS Report. In particular, the Report recommended that, "Pension standards should continue to require both solvency and going-concern valuations, with reasonable requirements that protect benefit security while not being overly onerous for sponsors…" (Recommendation 8.1.1). The introduction of solvency reserve accounts, described below, is an example of such a reasonable requirement. However, the Report was written prior to the global recession in 2008 and should be considered in light of the changed economic conditions experienced since its release.

A number of recommendations in the JEPPS Report that were adopted in the new PBSA address issues related to solvency funding.

**Solvency reserve accounts** were introduced to respond to concerns expressed by employers that sponsor DB pension plans about overfunding that could result from high solvency contribution requirements. Solvency funding protects against the short-term risk of an underfunded plan winding up with an insolvent employer. If the solvency contributions that were made to reduce this risk are no longer needed when plan funding improves, the employer may withdraw some of the excess through the use of a solvency reserve account, subject to certain restrictions.

A solvency reserve account is a separate account that an employer may establish within the fund of a DB pension plan to hold payments toward a solvency funding shortfall. It is not mandatory. This account makes it easier for an employer that sponsors a DB pension plan to track and withdraw excess funds. Before such withdrawals are permitted, a sufficient level of excess funds is needed so that future experience losses are less likely to put member's benefits at risk. When the solvency asset value exceeds 105 per cent of the solvency liability value, employer withdrawals up to a prescribed maximum may be made from the account with the consent of the Superintendent of Pensions. Only 20 per cent of the accessible solvency excess may be withdrawn each year.

Under the new PBSA, all pension plans are required to establish a **governance policy** and a **funding policy**. In addition to promoting benefit security by requiring a disciplined approach to funding, these policies must be disclosed to plan members upon request, supporting member education about the governance and operation of their plan.

The new PBSA provides a **statutory discharge from liability for annuity purchases** that meet the specified requirements. By purchasing annuities, DB pension plans are able to transfer the responsibility to pay pensions to an insurance company. A one-time payment is made from the plan to the insurance company to purchase annuities that will provide deferred or retired members with the same benefits they would have received from the plan.

Providing a discharge supports strategies to transfer funding risks associated with interest rates and investment returns to insurance companies. This reduces the overall risk of a pension plan.

Annuities provided by insurance companies provide greater benefit security for plan members. Insurance companies have more stringent capital requirements than pension plans. By the nature of their business, they are better focused on managing risk. Annuity insurance, through Assuris, provides specified levels of protection against loss of benefits due to the financial failure of an insurance company.

More recently, in 2016, temporary, one-time solvency funding relief was provided to DB pension plans. Plan administrators were able to elect an extension to the solvency payment period from five years to 10 years for actuarial valuations prepared as of a date between December 31, 2015 and December 31, 2017.

# Objectives of the Review

The overall objective of this review is to assess whether B.C.'s solvency funding framework for DB pension plans should be changed so that it better supports plan sustainability and benefit security over the long-term, in a way that balances the interests of all pension stakeholders. The objectives set out in this section should also be balanced against each other for the purposes of this review.

## Benefit Security

DB pension plans are an important element of members' retirement incomes. Benefits are considered secure if the plan has enough assets to ensure payment of benefits while the plan is ongoing, and if the plan is wound up due to events other than the sponsoring employer's insolvency. Funding requirements play an important role in providing a level of benefit security to members who have accumulated benefits during their employment. Solvency funding is an effective way to protect benefit security.

## Contribution Predictability and Plan Sustainability

From the perspective of the sponsoring employer, the pension plan can be considered unaffordable if the required contributions place significant financial pressure on the business. Such pressure can weaken the employer's commitment to continuing the pension plan for its employees.

The cost of a pension plan depends on the benefits provided by the plan, the investment and administrative expenses paid by the plan, and the investment income earned on the plan's assets. Costs may only be reduced by lowering benefit levels or plan expenses or increasing contributions or investment income. A single-employer DB pension plan may be amended to reduce future benefit entitlements but benefits already earned by members must not be reduced.

A pension plan is sustainable if, over the long-term, it has enough assets to meet its benefit obligations. If an employer considers contribution requirements to be unaffordable, the plan may not be sustainable as the employer may decide to wind it up.

## Pension Coverage

Workplace pension plans are an important source of retirement income for British Columbians. An important objective of this review is to support the continuation of existing DB pension plans and the creation of new DB pension plans.

In addition, pension plans contribute to the economic and social well-being of the province by investing their funds. For example, a report commissioned by the British Columbia Pension Corporation in 2015 showed that the spending associated with the $3.245 billion paid to BC residents from the four large B.C. public sector plans generated $1.662 billion provincial Gross

Domestic Product, 31,099 jobs, and $310 million in total government tax revenue.[1] Workplace pension plans also reduce reliance on taxpayer-funded income replacements.

However, options that may maintain or increase pension coverage must be assessed for their effect on benefit security. The options presented in this Consultation Paper recognize that maintaining pension coverage through voluntary workplace pension plans requires consideration of the competing objectives of providing secure benefits for plan members and affordable and predictable funding costs for sponsoring employers.

## Balancing Stakeholder Interests

Finally, to be effective, any reforms resulting from this review must balance the interests of affected stakeholders. The concerns of the primary stakeholder groups in relation to the overall objectives of this review are summarized below:

- **Sponsoring employers** are concerned about the predictability of their required contributions as well as plan sustainability. They want to provide benefits that will allow them to recruit and keep the workers they need, while keeping their business financially viable.

- **Unions** representing negotiated cost DB pension plans are concerned about benefit security and plan sustainability. They want to avoid benefit reductions for their members who participate in these plans, particularly when reductions affect pensions that are being paid.

- **Active members** are concerned about benefit security and plan sustainability. They want to remain in pensionable employment, be able to transfer benefits to another pension plan upon changing employment, and receive adequate income when they retire.

  Active members of jointly-sponsored DB plans are also concerned about the predictability of solvency contributions they must pay into the plan.

- **Retired and deferred members** are concerned about benefit security and plan sustainability. They want to receive the pensions to which they are entitled and be assured of the financial health of their former employer and their plan.

Other pension stakeholders, including actuaries, lawyers, accountants and professional plan administrators, have an interest in the regulatory regime within which they practice. Input from these groups is important to enable options to be evaluated from an actuarial, accounting and legal perspective.

This consultation is intended to encourage stakeholders to comment on how these interests may be balanced in arriving at an option or combination of options that might best address them as a whole.

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[1] Urban Futures, *Assessing the Economic Impacts of Pension-Income Spending in British Columbia* (July 2015), p. 1. https://mpp.pensionsbc.ca/documents/391208/1207079/%28PDF%29+Assessing+the+Economic+Impacts+of+Pension-Income+Spending+in+British+Columbia/76df9fc2-ed66-4e70-b562-8b54a4574952

# Options for Reform

A reform of B.C.'s solvency funding framework could follow one of two general approaches:

A. Keep the current solvency funding requirements but modify them to achieve the objectives of the review;

B. Replace the current solvency funding requirements with enhanced going concern funding requirements.

Each approach could involve one or more general options. This section suggests how each option set out below might address the objectives of the review. Options may be combined under each approach or from both approaches, and are not intended to be mutually exclusive.

This review is intended to solicit comments on the two general approaches and the various options or combinations of options without indicating a preferred approach or option(s).

Additional options also exist that complement either Approach A or Approach B. One such option is presented at the end of this section, which could be implemented along with any of the options presented.

## Approach A: Modifications to Current Solvency Funding Rules

Approach A presents options for changes to existing solvency funding requirements to address the varied interests of stakeholder groups.

### Option 1: Lengthened Amortization Period

The PBSA currently requires solvency shortfalls to be paid within five years. The period of time over which solvency shortfalls must be paid could be lengthened (e.g., to 10 years).

Increasing the payment period would address both the volatility and size of solvency payments for underfunded pension plans.

### Option 2: Consolidation of Solvency Deficiencies

Under the PBSA, if a plan has a solvency shortfall at a valuation date, the shortfall must be paid based on a five-year amortization schedule. If another solvency shortfall is identified in the next valuation, a new five-year amortization schedule is established for the required payments.

Instead of requiring a successive series of solvency payments to be made, solvency shortfalls could be consolidated and paid based on a new amortization schedule established at each valuation date (i.e., a "fresh start" approach).

Similar to Option 1, a "fresh start" would address both the volatility and size of solvency payments for underfunded pension plans.

## Option 3: Basing Solvency Funding on Smoothed Asset Values

The PBSA requires solvency funding shortfalls to be determined based on the market value of plan assets. However, short-term fluctuations in market values result in volatile solvency funding requirements. An asset valuation method that "smooths" the recognition of investment-related gains or losses over a specified period could be used to moderate the volatility of solvency funding costs. The period should not be longer than the typical length of an economic cycle.

This option would moderate the volatility of solvency funding costs by deferring the recognition of investment gains and losses.

## Option 4: Basing Solvency Funding on an Average Interest Rate

Interest rates used in a solvency valuation are those recommended by the Canadian Institute of Actuaries (CIA) as the basis for a hypothetical wind-up valuation. The solvency liability for benefits in a single-employer DB pension plan that are expected to be settled by an annuity purchase (typically, pensions) is calculated as the cost of replacing the pension obligation with a life annuity from an insurance company. The solvency liability for benefits that are expected to be settled by a lump-sum transfer is calculated on the commuted value basis. Both are based on interest rates and mortality assumptions established by the CIA from time to time.

The interest rate assumption used to calculate solvency liabilities for pension obligations could be replaced by one based on the average of the CIA interest rates over a specified period before the valuation date. The period should be long enough to be effective in dampening the volatility of solvency funding requirements, without being overly long so that the impact of changing interest rates may be inappropriately delayed.

This option would moderate the volatility and high level of solvency funding payments or, in the case of negotiated cost plans, benefit reductions, by mitigating the impact of falling or rising interest rates on solvency funding requirements.

## Option 5: Funding a Percentage of the Solvency Liability

The required level of solvency funding could be reduced from 100 per cent to a lesser percentage of the solvency liabilities, reducing solvency payments.

This option would address sponsoring employers' concerns about high solvency payments, while continuing to provide benefit security to a specified solvency funding level. Given that few employers are at risk of insolvency at a particular time, this option may adequately protect benefit security while moderating employer contributions.

## Questions for Comment

1. Do you agree or disagree with the approach of maintaining current solvency funding requirements with one or more of the above modifications?
2. Would an option or a combination of options under this approach effectively balance the interests of the primary stakeholder groups listed on page 7? Why or why not?
3. With regard to Option 3, should smoothed asset values be allowed for solvency valuations? If so, what should be the maximum period over which recognition of investment-related gains or losses may be deferred?
4. With regard to Option 4, should the use of an average interest rate be allowed for solvency valuations? If so, what should be the maximum averaging period?
5. With regard to Option 5, should solvency funding requirements be reduced to a level less than 100 per cent? If so, what would be an appropriate level?

## Approach B: Replace Solvency Funding Rules with Enhanced Going Concern Funding Rules

Some pension stakeholders have expressed concerns with the premise of solvency funding; that is, to fund a pension plan assuming the pension plan will wind up on the valuation date. DB pension plans are often viewed as a long-term investment in the employees in a particular workplace or industry. Going concern funding assumes a pension plan will continue indefinitely and some see going concern funding as a more appropriate funding approach. In addition, stakeholders have expressed concern with the volatile and procyclical characteristics of solvency funding.

Going concern funding is based on accepted actuarial practice. But it can be a confusing concept and is frequently misunderstood. Statements such as "a plan is fully funded on a going concern basis" can create a misconception among plan members that the members' benefits are fully secured in the circumstances of plan wind-up, or even the sponsoring employer's insolvency. The going concern liability does not represent the true cost required to pay the promised benefits for plan members at a given time. For these reasons, a decision to eliminate solvency funding requirements should be accompanied by a move to enhanced going concern funding requirements.

Approach B considers enhanced going concern funding requirements for DB pension plans as the basis for establishing contributions requirements. An enhanced going concern approach to funding would still meet the objectives of reducing the financial burden on many employers that sponsor single-employer DB pension plans and making contribution amounts more stable and predictable. To the extent that employers are closing these plans due to concerns about high costs and funding volatility, an enhanced going concern approach may encourage the continuation of existing DB pension plans.

Solvency valuations could continue to play a role with respect to filings and disclosure, as such valuations provide valuable information about benefit security to the plan, plan members and the Superintendent of Pensions. Plans could continue to be required to provide solvency valuations and disclose solvency ratios in all filed valuation reports and include solvency ratios in disclosure statements to plan members.

The following measures could be considered to enhance going concern funding requirements. As noted previously, changes that balance the objectives of benefit security, contribution predictability and plan sustainability and the concerns of the primary stakeholder groups may involve a combination of the options in one or both approaches.

## Option 1: Shortened Amortization Period

To compensate for the impact of eliminating solvency funding rules, going concern funding rules could be enhanced by shortening the required amortization period. Special payments to fund any going concern funding shortfall could be amortized over a period shorter than the current 15 years.

A shortened amortization period would increase contribution requirements, which would help address benefit security.

## Option 2: Requiring a Funding Buffer (Provision for Adverse Deviation)

Another way to strengthen going concern funding is to require the build-up of a funding buffer, referred to as a Provision for Adverse Deviation (PfAD).

A plan could be required to fund to a level that is greater than the sum of a PfAD plus the plan's liabilities calculated using best estimate assumptions before allowing any action that could weaken the plan's funded position (e.g., reduce contributions, increase benefits, or withdraw excess).

A PfAD is not a replacement for or equivalent to solvency funding, but does help to reduce the risk of a plan being underfunded upon wind-up.

The PfAD could be determined based on the extent to which a plan's investment policy is inconsistent with its demographic profile, linking a plan's funding requirements to the investment risk to which it is exposed. For example, a mature plan with a large proportion of retirees and greater equity exposure would exhibit a high degree of asset/liability mismatch and therefore require a greater PfAD.

Other factors for determining a PfAD could include:

- Interest rate risk associated with plans that link the best estimate interest rate to interest rates for government or corporate bonds (e.g., a higher PfAD could be required when rates increase);
- Plan maturity and demographics;
- The benefit provisions (e.g., a plan with generous early retirement benefits may require a larger PfAD than one with modest early retirement benefits);
- The financial strength of the sponsoring employer.

In the absence of solvency funding, a PfAD can help to improve benefit security by increasing the assets accumulated in a pension plan, mitigating the risk associated with benefit reductions on plan wind-up due to employer insolvency. Currently, under the PBSA, such risks are managed through solvency funding requirements.

A PfAD can also help to protect plan members against the risks to the plan associated with investment strategy, interest rate changes and decisions to increase benefits.

### Questions for Comment

1. What are the advantages and disadvantages of eliminating solvency funding requirements in favour of enhanced going concern funding requirements?
2. Which combination of the options described under this approach would best balance benefit security and contribution volatility?
3. With regard to Option 2, if a PfAD were required, what factor or factors should be used to determine the PfAD? For example, should they be linked to the plan's investment policy or the level of plan maturity?
4. Are there other measures to enhance going concern requirements that should be considered in the absence of solvency funding requirements?

## Additional Complementary Reform Measures

As noted earlier, additional options also exist that complement either Approach A or B described above. One such approach is to modify the method of calculating commuted values for members of DB pension plans who are eligible to elect to transfer their benefits out of the plan as a lump sum.

### Modifying Commuted Value Transfer Rules

The commuted value of a member's benefit is the amount of money that needs to be provided today, using current interest rates, in exchange for the benefit to which the member is entitled under the pension plan. Standards established by the CIA prescribe the actuarial methods and assumptions for calculating an individual's commuted value, including the interest rate and mortality assumptions used in the calculation.

When an individual terminates employment with an employer, they may, if eligible, elect to transfer the commuted value of their benefits from the pension plan to a locked-in Registered Retirement Savings Plan or other permitted financial instrument instead of leaving their benefits in the plan. The PBSA requires 100 per cent of the commuted value to be transferred if the plan is fully funded on a solvency basis. In the current environment of persistently low interest rates, commuted values are high, as a greater amount of money is required to be set aside to pay for the individual's future pension. This creates a financial risk for pension plans, as it is typically now more expensive for a plan to pay commuted values than to pay pensions as they fall due.

To protect the benefits of the members remaining in the plan, the calculation of commuted values could be modified to provide a transfer value that balances the interests of remaining members with the right to transfer benefits from the plan.

For example, the calculation of commuted values could be modified to pay members who elect to leave the plan an amount that is more reflective of the underlying risk associated with the benefit in the plan. This could be accomplished by appropriately increasing the interest rate used to calculate the commuted value.

Modifying the commuted value transfer rules would have a direct impact on plan costs and could support benefit security and plan sustainability. This option could also help balance the interests of members who choose to transfer a commuted value from the plan upon termination of employment and members who remain in the plan.

## Questions for Comment

1. Would the modification to the commuted value rules described above be appropriate? If so, what increase in interest rates should be used to calculate the commuted values?
2. Are there other, more appropriate, methods that could be applied to modify the commuted value calculation?
3. What other measures, if any, could be considered that would complement Approach A or Approach B or both approaches?

## Next Steps

This Consultation Paper solicits written feedback from stakeholders, but is not intended to be the only mechanism of consultation.

Consultations with the Stakeholder Advisory Committee, other stakeholders and subject matter experts will occur throughout the fall and continue after the comment period closes.

# Glossary

## Actuarial going concern excess

Plans are considered to have an excess level of funding on an ongoing basis if they have more assets than required to meet their anticipated obligations on a going concern basis, based on actuarial valuation reports.

## Actuarial valuation report

A report prepared by an actuary that determines the financial status of a pension plan at a certain date of calculation and the required contributions for a period of time after the date of calculation. DB pension plans are required to file a valuation report with the Superintendent of Pensions at least once every three years.

## Commuted value

The commuted value of a benefit is the amount of money that needs to be provided today, using current interest rates, in exchange for a member's benefit entitlement, as specified by regulation. The commuted value of a member's benefits is calculated according to standards set by the Canadian Institute of Actuaries.

## Defined benefit (DB) pension plan

A pension plan that provides its members with a pension on retirement based on a formula, usually based on a flat dollar amount per year of service or a percentage of salary and length of service.

## Defined contribution pension plan

A pension plan in which members accumulate savings in investment accounts that are later used to provide income during the member's retirement. The monthly amount is unspecified.

## Going concern funding

This method of valuation for a defined benefit pension plan assumes the plan will continue indefinitely, and determines the amount of assets required to pay benefits as they come due in the future. Any going concern shortfall must be paid off within 15 years.

## Multi-employer plan

A pension plan to which two or more non-affiliated employers make contributions. Members are employed by one of the participating employers, which are usually in the same industry sector.

## Negotiated cost plan

A pension plan that is established under a collective agreement, if contributions to the plan are determined by that collective agreement.

## Pension Benefits Standards Act (PBSA)

The B.C. legislation that establishes minimum standards for pension plans registered in B.C.

## Provision for adverse deviation (PfAD)

A provision corresponding to the funding buffer that a DB pension plan is required to reach in order to enhance the benefit security or stabilize benefits and/or contributions.

## Single-employer pension plan

A pension plan covering workers employed by a single employer or by employers that are affiliated.

## Solvency funding

This method of valuation for a DB pension plan assumes the plan is being wound up as of the valuation date so that its assets will have to be used immediately to meet its existing liabilities. Any solvency shortfall must be paid off within five years.

## Solvency excess

An ongoing DB pension plan is considered to have a solvency excess if it has more assets than required to meet its anticipated obligations on a solvency basis, based on actuarial assumptions set out in a solvency valuation. The amount of excess remains hypothetical until a plan is actually wound up, at which time, a surplus, if any, is crystallized.

## Target benefit pension plan

A pension plan with the goal of providing its members with a target monthly pension during retirement. Contributions of the sponsoring employer are limited to those specified in the plan or other supporting document. Funding shortfalls may be addressed by reducing benefits, including benefits that have already been earned.