A Review of the Solvency Funding Framework under the *Pension Benefits Standards Act*: Report on Stakeholder Committee Process

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BRITISH COLUMBIA | Ministry of Finance

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Background

Solvency Funding Review

The Ministry of Finance is currently undertaking a review of solvency funding requirements for defined benefit (DB) pension plans under the *Pension Benefits Standards Act* (PBSA). The scope of the review is restricted to funding requirements for plans while they are ongoing and does not include funding requirements applicable to plan termination and wind-up.

The PBSA sets out minimum requirements for pension plans registered in BC. Workplace pension plans are offered at the sole discretion of the employer, who has the authority to change or wind up the plan, subject to legal restrictions.

On October 22, 2018, the Government of British Columbia released its consultation paper seeking input from pension stakeholders to identify whether changes to the PBSA might better support long-term plan sustainability and benefit security, so that DB pension plans can continue to provide lifetime pensions to plan members and their beneficiaries. The public was invited to comment on a full range of potential reform options for solvency funding rules for DB pension plans. The paper presented options for changing or replacing solvency funding requirements and for adjusting the commuted value of benefits for employees who choose to transfer benefits from a DB pension plan when they terminate employment with an employer participating in the plan. The consultation paper is available at gov.bc.ca/solvencyfundingconsultation.

The period for comments on the consultation paper closed on January 31, 2019. More than 45 submissions were received from various stakeholders, including sponsoring employers, actuarial firms, member associations, members, unions and other pension sector associations.

In addition, consultations with stakeholders have been conducted in a variety of ways.

A Stakeholder Advisory Committee (Committee) was established to provide input on how potential reforms might balance the divergent stakeholder interests involved in private sector DB pension plans, including potential insolvency of a sponsoring employer.

An Actuarial Working Group (AWG) was established to provide specialized expertise and feedback from BC pension actuaries to inform the potential development of a funding buffer, or provision for adverse deviation (PfAD), under an enhanced going concern funding framework, and related issues.

Ministry of Finance staff met with numerous stakeholders to discuss the consultation paper. Focused consultation meetings with separate stakeholder groups involved in DB pension plans offered these groups a forum to explore how the issues raised in the consultation affect them. One-on-one meetings with stakeholders were also held, upon request.

The Committee met from November to March to discuss the full range of potential reform options put forward in the consultation paper and their relevant impacts on the different plans and groups represented on the Committee (sponsoring employers, members and unions). To support its analysis, the Committee included members with actuarial and legal expertise. A consensus was reached on the principles and high-level requirements that should be reflected in a new ongoing funding framework for DB pension plans.

The results of the Committee's work were presented to the AWG for further development of enhanced going concern funding rules involving a PfAD, and related issues. During meetings in April, May and June, the AWG discussed the results of the Committee's work as well as individual proposals from AWG members on potential approaches to a PfAD. Consensus was reached by members on a proposal for minimum ongoing funding requirements for DB pension plans, which is substantively consistent with the Committee's work.

In June 2019, the Committee reconvened to discuss the AWG proposal and to conclude its work. Potential implementation of the proposed reforms was also addressed. The Committee recommended that the proposal be implemented by regulation so that new funding rules would be available to DB pension plans preparing valuation reports as at the end of 2019. As a result, the Committee recommended that potential reforms for any issues that would require amendments to the PBSA be deferred. These include the additional complementary reform measure raised in the consultation paper, whether to modify the method of calculating commuted value transfer values, and whether to provide for PfAD payments to a reserve account. The Committee noted that, regarding the commuted value transfer value issue, relevant changes to actuarial standards have not yet been approved by the Canadian Institute of Actuaries.

Objectives of Review

The overall objective of this review, as identified in the consultation paper, is to assess whether British Columbia'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.

As expressed in the consultation paper, benefit security is considered to exist if a 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.

A pension plan was described as being sustainable if, over the long-term, it has enough assets to meet its benefit obligations. Contribution predictability was identified as an important element of sustainability, as if an employer considers contribution requirements to be unaffordable, the plan may not be sustainable as the employer may decide to wind it up. 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.

The continuation of existing DB pension plans, and the creation of new DB pension plans, were identified as another important objective of this review. The consultation paper recognized 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.

Finally, the consultation paper emphasized that to be effective, any reforms resulting from this review must balance the interests of affected stakeholders.

The primary stakeholder groups in relation to the overall objectives of this review were identified as being sponsoring employers, plan members, with specific reference to members of jointly sponsored plans, and unions, with specific reference to negotiated cost plans.

Results of Stakeholder Committee Process

Guiding Principles

The following principles emerged from the stakeholder committee process as the principles that should guide minimum ongoing funding requirements for DB pension plans:

- Funding requirements for DB pension plans should reflect the long-term nature of these plans; even most closed plans will continue to be managed over the long-term.
- The current solvency funding requirements prioritize the very small risk that any one private sector employer may become insolvent over the sustainability of all DB plans, even though solvency funding has not been effective in preventing loss of benefits in insolvency. This prioritization has led to a reduction in pension coverage as many plans have wound up due to the contribution volatility and high costs associated with solvency funding requirements.
- A PfAD should be based on the main risk that most DB pension plans are exposed to but cannot control, which is interest rate risk. As this is reflected in long-term bond rate (LTBR) risk, a PfAD should become larger as the LTBR and its associated risks increase and smaller as the LTBR and its associated risks decrease.
- Investment risk is a shorter-term risk that can be mitigated through other means (such as smoothing). Further, basing PfAD requirements on investment mix inappropriately influences investment decisions, raising fiduciary issues. For the same reason, a PfAD should not include a benchmark discount rate.
- The formula for a PfAD should reflect a typical pension fund's sensitivity to changes in the LTBR. These changes affect the entire plan liability but only affect the fixed income portion of plan assets. The multiplier should reflect a combination of both.
- Plans should not have to carry out stochastic modelling to be able to comply with funding requirements.
- A required floor for solvency funding (85% is proposed), in conjunction with enhanced going concern funding, would prevent DB pension plans from becoming so underfunded that it becomes overly difficult to return to a fully funded solvency position for plan wind-up. At the same time, it would mitigate the problems of trapped capital and contribution stability and improve intergenerational equity for cost-shared plans.
- The primary risk to benefit security is employer insolvency; however, no practical mechanism exists to impose different funding requirements based on the financial risk of a plan sponsor. Attempting to use credit ratings would likely have the counter-productive outcome of negatively affecting a company's credit rating.

Consensus on Proposed Funding Requirements

The stakeholder committee process resulted in a consensus among committee members that minimum ongoing funding requirements for DB pension plans should consist of the following requirements:

1. Plans should be required to fund a PfAD in addition to the usual going concern funding requirements:

    a. The size of the PfAD should be determined based on the long-term Government of Canada benchmark bond yield, CANSIM V122544, (referred to as LTBR) as at the date of the valuation. For example, possible approaches include:

    - multiplying the LTBR by a factor that reflects the interest rate risk of the plan fund (for example, LTBR x 5);
    - setting bands for PfADs within certain LTBR ranges, for example,

LTBR less than 1%	PfAD 5%
LTBR 1% or more and less than 2%	PfAD 10%, etc.

    b. The PfAD should be calculated on both the going concern liabilities and the normal cost.

    c. Plans that are more than 105% funded with PfAD on a going concern basis should not be required to include the PfAD for current service contributions, i.e. the normal cost PfAD should be funded from surplus.

    d. Going concern unfunded liability should be calculated on a consolidated (fresh start) basis and amortized over 10 years.

2. Plans with a solvency ratio of less than 85% should continue to be required to fund up to 85% on a solvency basis:

    a. Solvency deficiencies should be calculated on a fresh start basis and amortized over 5 years.

    b. 100% solvency funding should no longer be required.

The use of smoothed asset values or an average interest rate for solvency valuations was not supported during the stakeholder committee process.

Technical Details

The members of the AWG reached a consensus on the following technical details to support the full development of an approach to minimum ongoing funding requirements for DB pension plans:

1. **Going Concern Valuation**

   a. Plans should be required to disclose the funded status of the plan on a going concern best-estimate basis.
      - This is a somewhat new requirement. Currently, plans are required to disclose the going concern position with the assumptions including an implicit margin.
      - No margins (implicit or explicit) would be required to be included in this valuation.

   b. The going concern liability under the Going Concern Valuation should be determined based on the advice of the actuary.
      - There should be no benchmark discount rate.
      - The regulator would have the usual power to challenge / reject best-estimate assumptions that are considered inappropriate.

   c. Asset smoothing should be permitted.
      - The funded status should be disclosed both before and after asset smoothing.

   d. Asset smoothing would be subject to the requirements in the Canadian Institute of Actuary's (CIA's) Educational Note on asset smoothing and the current regulatory constraints. No new regulatory / legislative constraints should apply.

   e. The normal actuarial cost under the Going Concern Valuation should also be disclosed.

2. **Going Concern Plus Valuation**

   a. Plans should be required to disclose the funded status of the plan on the basis of a valuation on a going concern basis including a PfAD (Going Concern Plus Valuation).

   b. The liability under the Going Concern Plus Valuation should be determined as the liability under the Going Concern Valuation plus an explicit PfAD (as defined in paragraph 3, below).

   c. Asset smoothing should be permitted.
      - The funded status should be disclosed both before and after asset smoothing.

   d. Asset smoothing would be subject to the requirements of the CIA's Educational Note on asset smoothing and the current regulatory constraints. No new regulatory/ legislative constraints should apply.

   e. The normal actuarial cost under the Going Concern Plus Valuation should also be disclosed.

3. PfAD

a. The PfAD should be formula-based; the unadjusted PfAD should be equal to the monthly long-term benchmark Government of Canada bond yield, Series V122544 (referred to as LTBR), as at the valuation date, with no rounding or averaging, multiplied by 5.

- For example, if the LTBR is 2%, the PfAD would be 10%.

b. The chances of the LTBR growing to a large percentage (say above 6%) is so slim that no cap should be placed on the PfAD, but even if the LTBR were to increase to 6%, a PfAD of 30% would be appropriate.

c. If a plan has less than 30% exposure to asset classes other than traditional fixed income investments (Non-Fixed Income Allocation), the PfAD should be adjusted (see formula in paragraph g).

d. "Non-Fixed Income Allocation" would be determined based on the plan's target asset allocation in the Statement of Investment Policy and Procedures, as at the valuation date, to asset classes other than traditional fixed income investments (cash, investment-grade bonds, money market funds and the corresponding portion of pooled funds).

e. It is important that the PfAD be defined based on exposure to asset classes other than fixed income. A PfAD should neither reward nor penalize plans for innovative investment strategies that appear to increase fixed income allocation but retain market risk.

f. In determining the plan's Non-Fixed Income Allocation and PfAD, the value of any buy-in or buy-out annuities should be excluded.

- For example, for a LTBR of 3%, a plan with $300 million backed by buy-in annuities, $100 million of non-annuitized liabilities and 40% traditional fixed income backing non-annuitized liabilities would have a PfAD of $15 million (3% x 5 x $100 million).

g. The PfAD formula should be:

Maximum [5%, 5 x LTBR x (Minimum (30%; Non-Fixed Income Allocation) / 30%)].

4. Going Concern Past Service Funding

a. Plans should be required to fund to the liability under the Going Concern Plus Valuation.

- There should be no relief from this requirement based on solvency funding.

b. Any unfunded liability under the Going Concern Plus Valuation should be funded on a simplified basis:

- Fresh start approach at each valuation;
- Divide the unfunded liability by 120 to determine monthly special payments until the next valuation.

c. No letter of credit alternative to funding by special payments should be provided.

5. Going Concern Future Service Funding

a. If the funded ratio under the Going Concern Plus Valuation is 105% or less, plans should be required to fund the normal actuarial cost under the Going Concern Plus Valuation.

b. If the funded status under the Going Concern Plus Valuation is above 105%, plans should be permitted to apply any excess surplus under the Going Concern Plus Valuation to offset the PfAD portion of the normal actuarial cost.

- All or a portion of the excess surplus should be available for use immediately.

c. This would be independent of the solvency ratio.

d. The concept is that the PfAD on the normal cost is not required if the plan is funded at above 105% on a Going Concern Plus Valuation basis.

6. Rationale for PfAD

a. The PfAD is intended to mitigate contribution volatility, not to enhance benefit security.

b. The PfAD should vary based on economic scenarios rather than short term market fluctuations.

c. A PfAD based on market risk does nothing to mitigate contribution volatility. If markets have a downturn of 20%, the PfAD is unchanged.

d. The PfAD should only be based on interest rate risk.

e. The PfAD should be simplified to avoid influencing investment strategy.

f. Sample durations (i.e. % change in liabilities due to a 1% change in interest rates) of typical open pension plans are:

- Flat dollar / non-indexed plans = 15;
- Final average earnings / non-indexed plans = 18;
- Final average earnings / indexed plans = 21.

g. The interest rate risk associated with these open plans varies depending on the sensitivity of the benefits to changes in inflation and salaries and may be approximated by:

- Flat dollar / non-indexed plans = 100%;
- Final average earnings / non-indexed plans = 80%;
- Final average earnings / indexed plans = 60%.

h. Based on the above, the interest rate risk (based on a 1% change in rates) may be:

- Flat dollar / non-indexed plans = 15% (15 x 100%);
- Final average earnings / non-indexed plans = 14.4% (18 x 80%);
- Final average earnings / indexed plans = 12.6% (21 x 60%).

i. All types of open plans may be assumed to have roughly 12% to 15% interest rate risk.

j. Typically, about one-third of plan assets are in fixed income, so about one-third of this volatility is offset by asset volatility (depending on plan characteristics and asset strategy).

- This implies that typical plans may have about 10% gains (losses) due to a 1% increase (decrease) in long-term interest rates.

k. Requiring a PfAD of 5% for each 1% change in the LTBR would require a plan to put aside approximately half of the gains due to increasing interest rates in the form of a higher PfAD.

l. It is appropriate to only put aside a portion of gains (or release a portion of losses).
   - The best-estimate going concern discount rate will likely be somewhat sticky. If the LTBR increased by 1% in a given year, then stayed constant, it may take 3 to 4 years for the best-estimate going concern discount rate to ultimately increase by 1%.
   - Only 30% to 40% of the gains due to increases in the LTBR may appear in the first year, with the rest developing over time.
   - It would not be appropriate for the PfAD to increase by more than the gains experienced due to the increase in the best-estimate going concern discount rate.
   - Similarly, in a decreasing interest rate environment, the PfAD should not be released faster than the decrease in the best-estimate going concern discount rate.

m. Plans may choose to take on numerous risks other than interest rate risk, such as market risk, equity risk, duration mismatch risk, fixed income default risk, and liquidity risk. Trying to develop factors for a PfAD that take into account these risks would be unwieldy.

n. In addition, many plan sponsors would adopt innovative investment strategies to avoid PfAD funding requirements.

7. Solvency / Hypothetical Wind-up Valuation

a. The funded status of the plan on a solvency / hypothetical wind-up basis should be disclosed.
   - There should be no difference between a solvency and hypothetical wind-up basis.
   - There should be no ability to smooth assets or liabilities in determining the solvency funded status.
   - The CIA Standards already require disclosure of the funded status on a hypothetical wind-up basis.

b. In accordance with CIA requirements, the solvency incremental cost should be disclosed.

c. The requirements of this section are identical to existing legislation / regulation.

8. Solvency Funding

a. Plans should be required to be funded to a level equal to 85% of the solvency liability.

b. Any solvency deficit below the 85% threshold should be funded on a simplified basis:
   - Fresh start approach at each valuation;
   - Divide the solvency deficit by 60 to determine monthly special payments until the next valuation;
   - If unfunded liability payments are required, the amount of each monthly solvency payment should be reduced by the amount of each monthly unfunded liability payment:

     Monthly solvency payment = Maximum ($nil, solvency deficit / 60 – monthly unfunded liability payment).

c. All special payments related to any solvency deficit (i.e. whether required to meet a minimum 85% solvency funding requirement or beyond minimum requirements) should continue to be eligible:
   - to be deposited in a solvency reserve account, and
   - to be secured by a letter of credit.

d. Funding relief from the requirement to fund to a solvency ratio of 85% should not be provided except in exceptional circumstances on a plan-specific basis.

9. Contribution Holidays

a. Contribution holiday rules should be similar to the current rules under the PBSA, but based on the Going Concern Plus Valuation.

b. Plans should be permitted to take a contribution holiday if the plan has:
   - a funded ratio of greater than 105% on a Going Concern Plus Valuation basis (i.e. the amount by which going concern assets exceed 105% of the sum of going concern liabilities plus the PfAD on going concern liabilities), and
   - a solvency ratio of greater than 100% before and after the contribution holiday (even with 85% minimum solvency funding).

c. Most going concern valuations now include implicit margins that are similar to the explicit margins being proposed in today’s economic environment, so a loosening of the 105% would be inappropriate. Plans should continue to be encouraged to be fully funded on a solvency basis, so contribution holidays should not be permitted if they would result in the solvency ratio dropping below 100%.

d. Any excess on a Going Concern Plus Valuation basis above 105% should be able to be used to reduce or eliminate contributions based on the existing rules, which include:
   - Prior notice to the Superintendent, who may direct that use ceases;
   - Funded ratios determined on the basis of a valuation report as at a date not more than one year before the contribution holiday starts;
   - Use limited to 20% per year for up to three fiscal years;
   - Contribution holiday ends before a new valuation report is, or must be, submitted;
   - Disclosure to members in the annual statement; and
   - Contribution holiday not permitted if plan documents prohibit them.

10. Benefit Improvements

a. There should be no restrictions on benefit improvements other than the current restrictions in the PBSA, which provide that the Superintendent can refuse an amendment that results in the solvency ratio declining below 90%.
   - The 90% threshold should be replaced by an 85% threshold.

b. The financial effects of any benefit improvements would be disclosed when they are effective and would be funded in the same manner as any unfunded liabilities or solvency deficits (below 85%).

11. PfAD Reserve Account

a. Consideration should be given to enabling use of a single reserve account for solvency payments and PfAD payments. No distinction should be made between PfAD payments on normal cost or past service.

b. It is anticipated that plan sponsors would be more amenable to stronger going concern funding requirements if payments could be remitted to a reserve account, thereby clarifying entitlement to the funds and lessening the risk of stranded surplus.

c. Plans should be permitted to withdraw going concern excess from a reserve account if the plan has:

   - a funded ratio of greater than 105% on a Going Concern Plus Valuation basis (i.e. the amount by which going concern assets exceed 105% of the sum of going concern liabilities plus the PfAD on going concern liabilities), and
   - a solvency ratio of greater than 100% before and after the withdrawal (even with 85% minimum solvency funding).

d. Superintendent's consent should not be required for any reserve account withdrawal.

e. Additional rules should apply consistent with the current rules under the PBSA for solvency reserve accounts, which include:

   - Funded ratios determined on the basis of a valuation report as at a date not more than one year before withdrawal starts;
   - Withdrawal limited to 20% per year for up to three fiscal years;
   - Withdrawals completed before a new valuation report is, or must be, submitted;
   - Disclosure to members in the annual statement.

f. Plans should have the option of using an amount eligible for withdrawal from a reserve account to reduce or eliminate contributions, instead of having to withdraw it before using it to pay contributions.

g. Legislation should be clear that a notional account in the plan's pension fund is all that is required to set up a reserve account, to clarify that plans are not required to set up a new trust account.

Next Steps

Role of Stakeholder Participation

Input from stakeholders is an important component of the solvency funding review.

The consultation paper, the stakeholder committee process and meetings with Ministry of Finance staff provided an opportunity for stakeholders to comment during the early stages of the review process, prior to the development of policy options.

Comments are welcome from all interested individuals on the principles and proposals from the stakeholder committee process set out in this report.

All input received from stakeholders will be used to help inform the analysis of solvency funding review issues and the development of policy options by Ministry of Finance staff. This work is currently underway.

Ultimately, any proposed changes to the minimum ongoing funding requirements for DB pension plans would be subject to consideration and approval by the Minister of Finance and Cabinet, and, in the case of amendments to the PBSA, the approval of the Legislature of British Columbia.

How to Participate

This report on the stakeholder committee process is provided for public discussion and comment.

Comments may be made until the end of the day, **August 30, 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 may 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.