Recommendations
Funding of Benefits for Plans Other than Defined Contribution Plans

February 2019

Introduction

Over the last several years sponsors of defined benefit (DB) pension plans have faced many challenges that negatively affected the sustainability of these plans. Of these, a fundamental issue relates to legislated funding requirements for DB pension plans. Moreover, market volatility, increased longevity, low interest rates, and plan maturation have made it difficult for plan sponsors to offer a DB pension plan at a reasonable, predictable and sustainable cost without compromising their business operations.

Governments across the country have responded to the issue of increased funding costs in a variety of ways. These included multiple rounds of solvency funding relief as temporary measures and longer-term responses such as allowing new plan designs that provide for more innovative and flexible approaches, including new funding regimes.

Through reforms introduced in 2015, Québec was the first province to eliminate solvency funding for its private sector registered pension plans. In May 2018, Ontario introduced amendments to support implementation of a new funding framework; employers now only need to fund a solvency deficiency up to an 85 per cent funded ratio. Saskatchewan had previously reformed its legislation, removing solvency funding requirements for public sector and publicly funded plans. Manitoba and Nova Scotia have completed their stakeholder consultation on the funding regimes in those provinces, and British Columbia released a consultation paper in October 2018.

While the focus of funding reform has been on stabilizing contribution requirements, the need to provide security of benefits must be recognized, considered and incorporated into any recommendation for funding reform.

The goal of CAPSA is to harmonize, to the extent possible, the regulatory processes related to multi-jurisdictional pension plans. CAPSA finds that legislation appears to be diverging as jurisdictions take different approaches to revising their funding goals.

While this paper is to be made public, the primary audience is the policy makers across Canada. We believe that a more common standard and set of funding rules would mitigate the concerns of sponsors and members of multi-jurisdictional pension plans.

Purpose

In keeping with its mandate “to further the coordination and harmonization of pension regulation across Canada”, CAPSA set up the Funding Review Committee (the Committee) to develop recommendations for best practices related to the funding of benefits under the current environment, where some governments are considering options other than full solvency funding. The Committee set up an Industry Working Group (IWG) to recruit industry expertise and to provide their input on how these recommendations may impact members, retirees, sponsors and administrators.

The Committee, with the input of the IWG, recommends options that policy makers and governments should consider in order to promote new, consistent funding rules, to the extent possible. While the Committee acknowledges that solvency rules are aimed at safeguarding pension benefits, it poses severe funding challenges that contribute to the on-going decline in DB coverage. In developing these recommendations, the Committee's overarching focus was how best to balance the health and sustainability of pension plans with the need for security of benefits for plan beneficiaries.

The Canadian Federation of Pensioners (CFP) was invited to participate in the IWG and expressed strong support for establishing a Guarantee Fund; whether national or specific to a jurisdiction. Their rationale was that employer contribution reductions (through the elimination of solvency) could be directed into a fund to protect pensioners better, if the plan sponsor became insolvent and the plan was underfunded on termination.

The Committee does not believe that recommending a Guarantee Fund can be a viable proposal for every jurisdiction. Consideration of any form of a Guarantee Fund would need to be reviewed, and decided on, by policy makers.

The Committee concluded that there were several elements from the new funding frameworks in Québec and Ontario, which could be amalgamated to promote a harmonized framework across Canadian jurisdictions. Both provinces conducted extensive research and public consultations to develop their models and the Committee agrees that it could leverage certain features from each of these frameworks, to make their recommendations.

Ideally, the options put forward here, along with other innovative solutions, would also encourage plan sponsors to maintain and even introduce new DB pension arrangements or other new plan designs, as may be permitted in different jurisdictions.

Recommendations Regarding the Funding of Plans

The options described below may be adopted as stand-alone items or as part of a larger reform package. CAPSA recommends that policymakers consult with not only stakeholders, but that they also work closely with the regulatory body (Regulator) in their jurisdiction when considering any or all of the proposals described below.

1. Modify solvency funding rules with a caveat

The modification of solvency funding rules could significantly reduce the financial strain affecting plan sponsors, in particular the high level of volatility in cash contributions. However, depending on the existence of any other provisions that safeguard benefit security, the Committee recommends that jurisdictions could require funding on a solvency basis if a plan's funded status falls below a prescribed threshold.

The concept of a solvency threshold is intrinsically linked to the inclusion of a funding margin via a Provision for Adverse Deviation (discussed further in Section 3. below). It is important to balance the interaction between funding margins and solvency thresholds. For example, the margins in Ontario which requires solvency funding only where the solvency ratio is less than 85 per cent, are less conservative than those in Quebec, which does not require solvency funding.

Both Ontario and Quebec include consideration of benefit security – Ontario has done this through the requirement for solvency funding if the solvency ratio is less than 85 per cent, and Quebec through more conservatism in the PfAD, thus increasing contribution requirements despite the absence of solvency funding rules.

The prospect of modified solvency funding may motivate plan sponsors to make lump sum contributions (in lieu of the solvency amortization payments they would have made under prior funding regimes) to increase the funded ratio above this threshold, thereby improving benefit security for plan members over the long term.

2. Strengthen going concern funding regime

It is important to recognize the inherent long-term nature of DB pension plans and as a direct result of this, funding should focus on the going concern valuation basis.

In the absence of solvency funding, or if solvency funding is reduced, going concern funding rules must be particularly robust and defensible with a strong emphasis on ensuring sustainability of the DB arrangement and protection of benefit security for members.

The goal of reducing financial strain on plan sponsors and reducing unpredictability and volatility of contributions should be accompanied by measures that not only provide benefit security through increased plan assets but should also include consideration of intergenerational equity.

3. Provision for Adverse Deviation (PfAD)

The Committee recommends inclusion of a funding margin through a PfAD, to protect the plan against unexpected negative situations. The PfAD could be incorporated implicitly into the funding of the past service liability and current service cost; and should reflect as much as possible, the characteristics of the pension plan, which would enable the Regulators to assess the appropriateness of the margin on a plan-by-plan basis. A demonstration of the derivation of the PfAD may be set out in the valuation report.

The addition of a PfAD also contributes to benefit security for plan members since it is an "add-on" to the required funding amounts and results in additional assets to the benefit of the plan and its beneficiaries.

Alternatively, the proposed regime could include specific PfADs or margins that may be funded by experience gains where the plan is fully funded or through additional employer contributions.

The PfAD should be prescribed and Regulators and policymakers may consider a number of factors in determining how to calculate a PfAD in their jurisdiction. To minimize additional costs imposed by this requirement, the number of factors should be limited to three or four, and may include:

- the probability of the plan being funded to a prescribed threshold within a prescribed period;
- whether and how the PfAD should be adjusted dynamically to reflect actual plan experience;
- the plan's benefit provisions. For example, a plan which offers indexation or generous early retirement benefits may require a larger PfAD; and
- the plan maturity, status and demographics. Considerations may include, among other things:
    - whether the plan is closed to new members;
    - the duration of the plan liabilities**:** although factoring in whether a plan is closed or open to new members is a possible approach, given the potential for significant differences in plan demographics, we are supportive of a more robust approach of focusing on the duration; and
    - the expected remaining service life of active employees.
- The plan's asset mix:
    - how the plan considers major risks such as the percentage of assets allocated to variable-yield. This portion of the PfAD could be determined in accordance with prescribed rules using the target allocation of investments set out in a plan's statement of investment policy and procedures, as is the case in Ontario, Quebec, Alberta and British Columbia. Again, this would take into consideration the plan demographics given that a very young plan with primarily active members is able to take on more investment risk than a very mature plan with primarily retired members;
    - the extent to which assets and liabilities are matched versus simply focusing on the allocation to fixed income assets alone. Like the point above, plan sponsors should be considering plan member characteristics when establishing their investment strategy;
    - the treatment of alternatives and bonds in determining the PfAD; that is, to what extent do these investments add to or mitigate risk; and
- the discount rate assumption that the plan is using, as compared to a Benchmark Discount Rate determined in accordance with prescribed methodology as an upper

bound. The Benchmark Discount Rate could be compared to a best estimate discount rate without margins.

4. Amortization period

For going concern funding

Should policy makers decide to modify solvency funding, the Committee recommends that the amortization period for funding going concern deficits should be no longer than a 10-year period and each valuation should allow for a fresh start; that is, all unfunded liabilities should be combined into a single amount and re-amortized over a period not greater than 10 years from the valuation date. This may contribute towards greater stability in contribution levels while also contributing to benefit security, as a shorter amortization period results in increased payments to eliminate the deficiency.

While shortening the amortization period would increase benefit security and will reduce the probability of a solvency ratio lower than the established threshold, it is recognized that the fresh start may have an impact on the time needed for the plan to become fully funded.

For solvency funding

To the extent that solvency amortization payments are required (due to the ratio being lower than a threshold) the deficiency should be funded over a period of no more than five years and could allow for a fresh start each valuation.

5. Incorporate a banker’s clause/side-car fund

Policy makers should consider the creation of a “side-car fund” as has been promoted by stakeholders and incorporated into the legislation of Alberta, British Columbia and Québec, where it is referred to as a “banker’s clause”. For ease of reference, we will use the term “side-car fund’.

Such a fund would be a sub-account, either real or notional, created to receive and hold specific employer contributions to the fund (for example, solvency payments or contributions other than current service cost and unfunded liability payments). These employer contributions may be recovered by the employer, if certain conditions are satisfied. There would be no requirement for segregation of funds (i.e. no separate trust).

The sustainability of pension plans is supported by contributions being made to fund members’ benefit entitlements. If employers are permitted to recover assets that exceed the required funding level, the ‘trapped capital’ issue is eliminated. The side-car fund may be seen as a solution to the asymmetry of risk; that is, the risk employers bear of funding shortfalls with little or no possibility of recovering assets in excess of the sum of all actuarial liabilities. It could also serve as a powerful tool as employers could also take contribution holidays in leaner years, lessening cash flow strain.

The assets allocated to the side-car fund may be:

- retained in the fund;
- used to reduce or eliminate employer-required contributions (contribution holiday [more detail provided below]), subject to prescribed conditions; or
- returned to the employer, subject to prescribed conditions.

6. Refund to the employer from the side-car fund

Legislation may set out the conditions under which an employer may apply to recover excess assets from the side car fund. Any application for recovery of assets would be subject to consent from the Regulator.

Such conditions may include requirements such as:

- assets are in excess of a prescribed threshold of the plan's liabilities;
- return of assets to the employer may be made only where the superintendent consents;
- refunds may be made
    - o without restriction; or
    - o subject to a prescribed annual limit, either dollar or percentage value of the available excess;
- return of assets to the employer may not result in a deficit in the plan;
- return of assets to the employer must be disclosed to plan beneficiaries receiving annual disclosure statements;
- the sufficiency of assets is subject to annual confirmation through the filing of actuarial certification of the plan's funded status and continued existence of assets in excess of the threshold.

In addition, it is recommended that policymakers give the Regulator discretion to order a cessation of such withdrawals and a repayment, where circumstances warrant. An example of such circumstances would be a significant market event, such as occurred in 2008.

7. Using/taking contribution holiday(s)

Legislation may set out the conditions under which either a contribution holiday, other than a contribution holiday required by federal tax law, may be taken or the employer may apply to recover excess funds. The conditions for a contribution holiday are largely similar to those relating to the withdrawal of assets from a side car fund and could include requirements such as:

- assets are in excess of a prescribed threshold of the plan's liabilities;
- contribution holidays may be taken:
  - without restriction; or
  - subject to a prescribed annual limit, either dollar or percentage value of the available excess;
- contribution holidays may not result in a deficit in the plan;
- contribution holidays would have to be disclosed to the superintendent and to plan beneficiaries receiving periodic disclosure statements;
- continuation of the contribution holiday is subject to annual confirmation through the filing of actuarial certification of the plan's funded status filed with the Regulator; and
- the Superintendent may order a cessation of the contribution holiday, where circumstances warrant.

In a plan where members are required to make contributions with respect to past service, a contribution holiday may be shared through a reduction of employee-required contributions.

8. Letter of credit

In the context of pension plans and funds, a letter of credit is a financial instrument issued by a financial institution to the plan fund-holder, in trust for the plan, which serves as a guarantee for payments to be made to the plan fund, under specified conditions.

In many jurisdictions, a plan sponsor may use a letter of credit to secure solvency payments rather than contributing solvency payments as required by legislation. In most instances, the fees for issuing a letter of credit will be significantly less than the solvency payments established by the most recent valuation filed with the Regulator. This would reduce capital requirements for funding a pension plan without impairing the security of benefits.

The Committee recommends that a letter of credit should be available to plan sponsors for plan funding, with a specified limit based on the size of the plan's liability.

9. Transfer rules

The value of benefits eligible for transfer on termination of membership, retirement (where transfer is permitted on retirement) and pre-retirement death should not disadvantage members remaining in the plan, nor should it unduly benefit those who elect to transfer.

Policymakers should engage with the Actuarial Standards Board and Regulators to determine an appropriate methodology for both the determination and circumstances for the transfer of funds by eligible members that balances the interests of those who remain in the plan and those electing a transfer.

The transfer should neither lead to a deterioration in the funded status of the plan nor unduly benefit those who elect to make a transfer, when eligible.

For example, a potential approach is to allow a member who terminates and is eligible for a lump sum transfer under the provisions of legislation and the terms of the plan may elect to:

- immediately transfer the product of their commuted value and the transfer ratio, with no future claims on the plan fund; or
- leave the amount in the plan fund, but with the right to transfer funds should the plan’s funded ratio improve.

Where plan rules require a member to make a transfer, the full commuted value must be made available for transfer. This means that the employer may be required to make contributions to the plan to ensure that the full amount is available without possibility of reducing the funded ratio of the pension fund.

Other Recommendations

1. Encourage new plan designs

Cost Shared Plans subject to Enhanced Funding Regime

These plans would include variable member contributions. In jurisdictions where such plans have been introduced, in addition to the base amount of member- required contributions to pay the current service costs of benefits accruing under the plan, employee-required contributions would be adjusted based on the most recent actuarial valuation report. Where a plan has losses in the inter-valuation period, contributions would increase. Similarly, where a plan has gains and/or an excess of assets over liabilities, contributions may decrease.

Contributions are generally adjusted based on the results of each valuation filed with the Regulator. This option is similar to approach currently available in Ontario, Alberta and BC for jointly sponsored plans.

Generally, member contributions allocated to fund a deficiency are not included in the calculation of the maximum funding rule (often referred to as the 50 per cent funding rule), which normally requires that member contributions cannot pay for more than half the benefit earned.

Target Benefit provisions should be made available to all plan sponsors

Subject to amendments and/or policy guidance relating to tax reporting (e.g. pension adjustments, past service pension adjustments and pension adjustment reversals) from Finance Canada and/or the Canada Revenue Agency, and where necessary, amendments to pension legislation, target benefit provisions should be made available to all pension plan sponsors, including plans sponsored by a single employer.

Under a target benefit provision, the sponsor, and active members where the plan is contributory, make(s) fixed contributions to a pension plan. Through a benefit formula provision, the plan text document establishes an aspirational target benefit that a retired member will receive. The target benefit framework would promote plan sustainability and intergenerational equity through the plan's ability to adjust benefits and contributions to help ensure that the target benefit is met, and to deal with surplus or deficit situations.

A going-concern funding regime which includes a PfAD could be developed and applied to target benefit provisions as has been done in Alberta and British Columbia.

2. Enhanced Governance Requirements

Pension plan governance refers to the structure and processes in place for the effective administration and oversight of the pension plan to ensure the fiduciary and other responsibilities of the plan administrator are met. If plan members and beneficiaries are to receive the benefits they are entitled to, good pension plan governance is essential in order to enhance benefit security.

The objective of good pension plan governance is to enable the plan administrator to deliver on the pension promise consistent with the pension plan documents and pension legislation. Pension legislation defines the pension plan administrator as the body responsible for the governance of the pension plan.

The Committee recommends that legislation be amended to specifically require that all pension plans establish and monitor a governance policy. The policy must also be available to the Regulator, upon request. While there may be no prescribed requirement to file the governance policy with the Regulator, the Committee recommends that plan administrators should be strongly urged to do so.

For consistency and harmonization across jurisdictions, the Committee recommends that the governance policy be modeled on CAPSA's Guideline No. 4 Pension Plan Governance and Self-Assessment Questionnaire.

Where new or alternative plan designs are incorporated into legislation (see Other Recommendations #1), the Committee recommends that a funding and/or benefits policy be required, to provide administrators with a framework based on leading practices that will guide their plan administration activities.

Similar to the requirement for a governance policy, the funding and/or benefits policy should be available to the Regulator upon request, and although there may not be a prescribed requirement to file it with the Regulator, plan administrators should be strongly urged to do so.