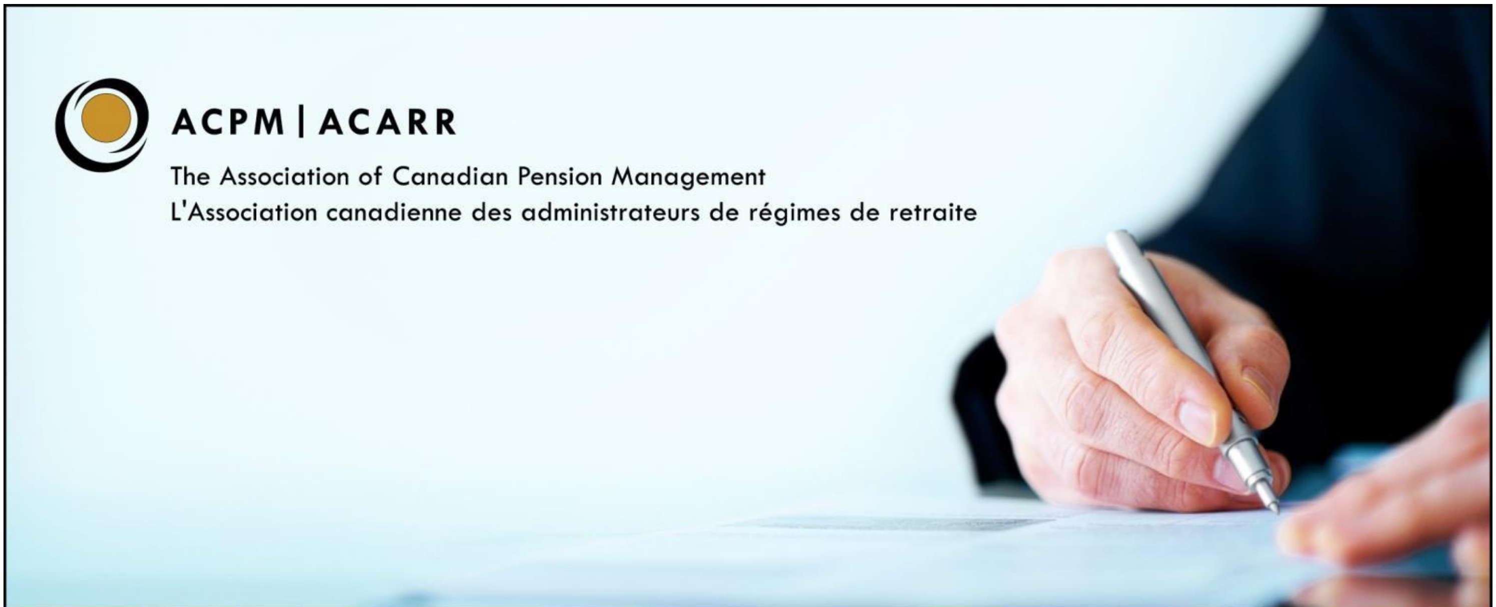

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ACPM Response to British Columbia's Consultation Paper: A Review of the Solvency Funding Framework under the *Pension Benefits Standards Act*

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FOREWORD

ACPM (THE ASSOCIATION OF CANADIAN PENSION MANAGEMENT)

ACPM (The Association of Canadian Pension Management) is the leading advocate for plan sponsors and administrators in the pursuit of a balanced, effective and sustainable retirement income system in Canada. We represent plan sponsors, administrators, trustees and service providers and our membership represents over 400 companies and retirement income plans that cover more than 3 million plan members.

ACPM believes in the following principles as the basis for its policy development in support of an effective and sustainable Canadian retirement income system:

Diversification through Voluntary / Mandatory and Public / Private Options
Canada's retirement income system should be comprised of an appropriate mix of voluntary workplace and individual savings arrangements ("Third Pillar") and mandatory public programs ("First and Second Pillar").

Empowering Choice in Coverage
Third Pillar arrangements should be encouraged and play a meaningful, ongoing role in Canada's retirement income system.

Adequacy, Security and Affordability
The components of Canada's retirement income system should ensure a healthy balance between these three objectives to enable Canadians to receive adequate and secure retirement incomes at a reasonable cost for members and employers.

Innovation in Plan Design
Canada's retirement income system should encourage and permit innovation in plan design in all three Pillars.

Adaptability
Canada's retirement income system should be able to adapt to changing circumstances without the need for comprehensive legislative change.

Harmonization
Canada's pension legislation should always strive for better harmonization.

Clarity and Transparency
Legislation, regulations and retirement income arrangements should be clearly defined, and pension plan beneficiaries should be appropriately informed of risks, costs and benefits.

Good Governance
Excellence in governance and administration in the retirement income system.

Introduction

ACPM supports the British Columbia review of its pension funding rules in order to address the current circumstances and improve the sustainability of defined benefit (DB) pension plans for the long-term. We are pleased that the considerations highlighted in the Consultation Paper recognize the issues of prolonged low interest rates, contribution volatility, pro-cyclicality, and complexity that were similarly laid out in our DB Pension Plan Funding paper dated May 13, 2014, (*DB Pension Plan Funding: Sustainability Requires a New Model*).

Our May 2014 paper had four objectives that we recommend be adhered to when the government makes its decisions.

The new model:

1. Should be clear to all stakeholders,
2. Should not increase the cost burden on plan sponsors,
3. Should be based on sound funding and risk management principles, and
4. Should be reflective of the long-term nature of DB plans.

We understand that the consultation paper deliberately did not propose one solution, rather it lays out a number of options for pension funding reform with an overall objective to assess whether B.C.'s 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.

We also understand that a balance between benefit security and affordability/sustainability requires compromises and this submission provides commentary on the options presented with that in mind.

Funding Framework for Defined Benefit Pension Plans

The Consultation Paper sets out two general options to consider:

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.

ACPM prefers Approach B, because we do not believe that the changes under Approach A significantly remove the issues identified in the background and introduction to the Consultation Paper. Approach A starts with the existing solvency rules and attempts to address the cost, volatility and asymmetric risk issues to the plan sponsor with options that will reduce, smooth or eliminate contributions that would otherwise be required. With all these modifications, one must therefore question the very rationale behind the solvency liability as a measure of the pension benefit to be funded in the first place. It is preferable to start with the ongoing measure of the pension obligation and then strengthen those funding rules to improve benefit security. Therefore, we agree with Approach B and strongly encourage its adoption – eliminating solvency funding and strengthening going concern funding.

In this submission, we provide comments on each of the approaches (and options within each approach) as well as providing responses to the specific questions posed in the consultation paper.

Approach A – Maintain Solvency Funding with Modifications

Option 1. Lengthened amortization period: Lengthening the amortization period (and consolidating payment schedules) would help by reducing volatility of special payments required to amortize solvency deficiencies. In order to have a material impact, the period would need to be at least 10 years. A shorter period may be appropriate for a closed, very mature plan. That being said, a longer amortization period may simply delay and perpetuate any problems.

While a corporate sponsor might want to negotiate a longer amortization period (beyond 10 years) on an exception basis, we are mindful of the recent high-profile wind-up of the Sears Canada pension plan and the impact on those former employees and pensioners. If there will be some accommodation for special situations (beyond the normal amortization rules) to be negotiated between a corporate sponsor and the ministry, more deliberation will be required to develop rules under which the minister can exercise discretion to allow it, potentially including restrictions on increasing dividends or executive compensation during the distressed workout period.

Option 2. Consolidation of Solvency Deficiencies: The approach suggested is consistent with the federal funding rules and we agree that this approach would help stabilize the funding requirements by avoiding multiple schedules of payments piling up on each other.

Option 3. Basing Solvency Funding on Smoothed Asset Values: If the 5-year amortization period is applied instead of a longer period, ACPM would support some smoothing of asset values for solvency funding purposes if the smoothing was applied consistently over several valuation cycles and if the smoothed values were controlled within a corridor. However, we feel that smoothing assets in solvency valuations decreases transparency and may result in more complicated communication. If Options 1 and 2 are implemented, the potential benefit of smoothing assets is not clear. Additionally, smoothing techniques can differ among practitioners, which may make it difficult for the regulator to assess relative plan solvency positions.

Option 4. Basing Solvency Funding on an Average Interest Rate*:* Similarly to the comments above, ACPM would support the use of an average interest rate if other options are not already applied to manage cost levels and the contribution volatility of solvency funding. We would caution that introducing this averaging in a period of increasing interest rates (as we are going into now) will mean that the average rate will likely be lower than the current single rate basis, increasing costs initially.

Option 5. Funding a Percentage of the Solvency Liability: If a percentage less than 100% of solvency funding is required, we would support using 85% like Ontario (in order not to further exacerbate the lack of harmonization across the country). That said, we are concerned that if a plan incorporated this lower percentage in conjunction with all or several of the other options above, there could be a significant impact on member benefit security. Alternatively, a minimum solvency ratio funding target like 85% could be superimposed on other funding rules that might otherwise result in an even lower solvency ratio in a five-year period. (For example, if the new funding requirements were not expected to reach an 85% solvency ratio on a market value basis within 5 years, an additional temporary funding schedule could be imposed until the 85% solvency ratio is achieved.)

If solvency funding rules are retained, with some or all of the above modifications, we would also want to ensure retention of the existing rules relating to letters of credit and solvency reserve accounts.

Questions related to Approach A:

1. **Do you agree or disagree with the approach of maintaining current solvency funding requirements with one or more of the above modifications?**

   ACPM recommends the elimination of solvency funding rules and strengthening the going concern funding rules rather than implementing modifications to the existing solvency funding rules. We do not believe that the proposed modifications significantly remove the issues identified in the Consultation Paper background and introduction. Approach A starts with the existing solvency rules and attempts to address the cost, volatility and asymmetric risk issues to the plan sponsor with options that will reduce, smooth or eliminate contributions that would otherwise be required. We believe it is preferable to start with the ongoing measure of the pension obligation and then strengthen those funding rules to improve benefit security.

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?**

   While options 1 and 2 (and perhaps 3 and 4) could reduce the volatility of funding requirements, without an overriding provision such as a minimum accelerated solvency funding requirement when the solvency ratio drops below some threshold, member benefit security could be compromised.

   Our preferred approach would be to consider Approach B as the primary funding mechanism with an overriding minimum funding requirement if and when the solvency ratio on a market value falls below a specified minimum threshold. In our view, this approach would balance the desire of stabilizing funding requirements and benefit security by 1) imposing a risk-adjusted funding provision and; 2) a minimum accelerated funding requirement if the solvency ratio drops below the threshold level.

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?**

   As noted above, we feel that Option 3 (and Option 4) may not be necessary if the other Approach A options are implemented by a plan. Smoothing of asset values can decrease transparency and may result in more complex calculations and communication. In addition, smoothing methodologies may differ between plans which may make it difficult for the regulator to evaluate plan risk. If smoothing of asset values is allowed, the smoothing approach must be adopted for a specified number of subsequent future valuations (to avoid flip-flopping at each valuation in pursuit of the absolute minimum funding requirement) and the maximum period for deferring investment gains or losses should be 5 years.

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?**

   This option may not be required at all if the plan is already using the extended amortization period and consolidating past deficiencies which provide some smoothing already. We also note that implementing average interest rates when rates are rising (as may be expected in the near future) will result in lower rates (and higher liabilities/costs) than the current methodology. We also recommend that if a plan uses average interest rates, they must continue to do so for a specified number of subsequent future valuations rather than switching back and forth between static and average interest rates.

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?**

   A target of less than 100% solvency ratio could be used in conjunction with other measures that reduce the volatility of funding requirements. As noted in our response to Question 2, this would be preferable if Approach B were used as the primary funding mechanism. If a level less than 100% is incorporated, using Ontario's 85% level would result in a measure of harmonization.

Approach B – Eliminate Solvency Funding and Enhance Going Concern Funding

An approach similar to the going concern funding rules recently introduced in Québec and Ontario would reduce the volatility of DB plan funding requirements, although in many cases, the total funding obligations could be higher than under the current funding model.

We do not recommend incorporating the Provision for Adverse Deviation (PfADs) that is prescribed under the current target benefit funding regulations in the BC Pension Benefits Standards Act (PBSA or "the Act"). Simply using these provisions in lieu of solvency funding requirements could increase funding requirements well beyond those under the new Québec or Ontario funding models.

While it may be preferable to implement a prescribed PfAD calculation in line with other provinces so as not to further exacerbate the lack of harmonization among pension jurisdictions, we believe that plan sponsors should have the option to develop a custom PfAD for their plan, along with providing sufficient actuarial justification that adopted funding and investment policies will result in at least an 85% chance that a fully funded plan will remain fully funded by the next actuarial valuation.

Option 1. Shortened Amortization Period – ACPM understands the rationale for shortening the going concern amortization period as a compromise for eliminating the amortization of solvency deficits. Our preference would be to have an amortization period of 10 years, with a consolidation of the total unfunded liabilities, i.e., a "fresh start" at each valuation rather than tracking and managing multiple amortization schedules.

Option 2. Requiring a Funding Buffer (Provision for Adverse Deviation or PfAD) – We agree that a funding cushion through a PfAD is important to provide a buffer to safeguard member security, particularly in poorer economic environments. We recommend best estimate actuarial assumptions with an explicit PfAD, and that liabilities covered through annuities or a longevity swap should be excluded. The PfAD could be prescribed in a similar manner to the Québec legislation (or to a modified version of the existing BC target benefit funding rules) in that it should vary with certain factors including target allocation to risky assets, duration of the liabilities, etc., but the plan sponsor should have the option to develop a plan-specific PfAD by providing sufficient information and analysis to satisfy the superintendent that the plan's policies will provide a high probability of maintaining or improving benefit security (such as discussed above).

As noted above, we have concerns with increasing the costs for plan sponsors that already apply appropriate governance and risk management principles to their plans and are currently in a going concern surplus situation. Consideration should be given to allowing the PfAD for plan sponsors with a going concern funded ratio of at least 100% to fund the rest of the PfAD through actuarial gains rather than an increase in current service contributions.

As under the new Québec pension legislation, there should be a special account where PfAD contributions are accumulated to enhance benefit security when the plan is below a threshold surplus level and may only be reduced by taking a contribution holiday or withdrawn by the employer once the plan exceeds a threshold surplus level. This is similar to the current solvency reserve account and a plan's going concern PfAD reserve account could start with any balance in the plan's solvency reserve account at the point the funding rules transition from solvency funding to enhanced going concern funding. If there are any superimposed minimum solvency funding requirements such as in Ontario, then those contributions would also be allocated to this special reserve account. Once the PfAD has been fully funded and the plan has a solvency ratio above 105% on a market value basis, then the employer would be permitted to take a contribution holiday or withdraw up to 20% of the excess (smaller of the two measures) from the reserve account. It should be clear that, upon plan wind-up, any portion of the account not needed to provide promised benefits would be returned to the plan sponsor.

ACPM does not recommend that Option 1 (shortened amortization period) be implemented on its own (without the PfAD in Option 2). We do not believe that best estimate discount rate assumptions are appropriate for long term sustainable pension plan funding, and there are currently no other applicable rules (including professional actuarial standards) which require a buffer in the going concern funding basis.

Questions related to Approach B:

1. **What are the advantages and disadvantages of eliminating solvency funding requirements in favour of enhanced going concern funding requirements?**

   We have addressed these to some extent in the commentary above, but below is a summary of the advantages and disadvantages:

Advantages	Disadvantages
Funding requirements should be much more stable. Increased predictability and clarity on contribution holidays may reduce the number of DB Plan sponsors who might otherwise have considered terminating their Plans.	May increase minimum funding obligations for plans currently 100% funded on going concern basis and/or those funding solvency requirements through letters of credit
Some harmonization with recent reforms in other jurisdictions (Québec and Ontario).	The prescribed PfAD basis in the target benefit plan funding rules is not recommended as it is too restrictive and could produce high and volatile contribution requirements. A PfAD approach consistent with those recently implemented in Ontario or Quebec would be preferable, along with a provision to allow plan sponsors the flexibility to create plan-specific PfADs under certain conditions.
Long term focus with added buffer to address member benefit security strives to balance stakeholder interests.	May not address member benefit security to the extent solvency funding rules would unless PfADs are managed to be consistent with market costs of settling liabilities or there is an overriding minimum solvency funding mechanism in the event the plan falls below a certain threshold.

2. **Which combination of the options described under this approach would best balance benefit security and contribution volatility?**

   Benefit security and contribution volatility are only balanced by incorporating BOTH a shorter amortization period and PfAD, i.e., both proposed options.

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?**

   The factors that should be considered include duration of liabilities, asset mix, investment policy and plan maturity. Other plan specific provisions which can drive higher or lower volatility (e.g. indexing) could be included in a plan-specific PfAD provision. It is important that any regulation or guidance on the PfAD calculation not be so onerous that it would prevent the plan sponsor from pursuing a reasonable allocation of risk for fear of increasing its immediate funding requirements.

   While regulations and guidance from the Superintendent are necessary to determine the default PfAD for a given DB pension plan, a plan sponsor should have the ability to opt out of this default PfAD calculation by providing the Superintendent sufficient analysis to demonstrate that its own PfAD, funding policy and investment policies are expected to have a high probability of preserving or maintaining a similar or better funded position over the intervaluation period.

4. **Are there other measures to enhance going concern requirements that should be considered in the absence of solvency funding requirements?**

   If there is a move to an enhanced going concern funding regime, including an overall minimum solvency ratio target (like the 85% implemented by Ontario) could provide additional comfort for member benefit security. It would be informative to first understand the potential funding implications of this supplemental measure on plans with different demographics, duration, and plan characteristics as well as under different economic environments.

   In any event, benefit improvements should result in additional funding requirements if the plan is not already fully funded on both a going concern and solvency funding basis. For example, additional funding requirements could be imposed such that the plan would achieve an 85% solvency ratio and a 90% going concern ratio within five years. In this case, the additional contributions would have to be made until the ratios are achieved and not consolidated with other special payments.

   Contribution holidays should be restricted or prohibited unless the plan is fully funded on a going concern basis (including the PfAD) and has a solvency ratio above 105%.

Additional Complementary Reform Measures - Modifying Commuted Value Transfer Rules

The consultation paper proposes that, 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. It notes that the CV calculations 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 by increasing the interest rate used to calculate the commuted value.

We agree with the paper's comment that modified lump sum transfer rules would have a direct impact on plan costs and could support benefit security and plan sustainability and 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?**

   If the enhanced going-concern model is adopted, then it would be appropriate to revisit the calculation of transfer values. As pension plans would no longer be expected to be fully funded on a solvency basis in a five-year time horizon, it would not be appropriate to provide a commuted value assuming a 100% transfer ratio. However, we do not believe that a simple increase in the interest rates provides an appropriate adjustment, and that it would make more sense to tie the adjustment to the funded ratio of the plan to ensure that the risk premium for departing members is more consistent with that of remaining members.

   We do note that the Canadian Institute of Actuaries has recently released a draft revision to the Commuted Value calculation rules. It retains its position that the calculation of commuted values should be independent of the funded status of the plan (other than in a couple of specific circumstances) but does recommend a change to the CV discount rates by adjusting the interest rate spreads to be based on a time-varying, market-linked estimator which would be more consistent with a marked-to-market assessment of the economic value of the pension payable from the pension plan that the former member is foregoing by receiving a CV.

2. **Are there other, more appropriate, methods that could be applied to modify the commuted value calculation?**

   A simple solution would be to adopt the approach used in Québec, namely to pay the commuted value times the most recently determined transfer ratio (and not to provide the unfunded portion of the commuted value in five years). Terminated members always have the option of selecting the deferred pension, and potentially could be offered the commuted value option periodically, say every 5 years, as the transfer ratio might improve in future years.

3. **What other measures, if any, could be considered that would complement Approach A or Approach B or both approaches?**

   As noted above, if Approach B is implemented, an overall minimum solvency ratio target (like the 85% implemented by Ontario) could provide some additional measure of member benefit security. It would be informative to first understand the potential funding implications of this supplemental measure on plans with different demographics, duration, and plan characteristics as well as under different economic environments.

Thank you for the opportunity to provide our input on this consultation and we are available if you require any further assistance.