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New rules for federally regulated pension plans

The first set of draft regulations for the Pension Benefits Standards Act (PBSA) were released on May 3, 2010. The new regulations follow up on previous announcements by the Minister of Finance related to federal pension reform and apply to private plans that are subject to federal pension regulations (such as banks, transportation companies and telecommunications companies).

The government announced a long list of intended changes in October 2009 to federally regulated pension plans. However, the newly released draft regulations cover only those changes related to funding and investments rules. We expect final regulations in early June. Changes to other pension benefit rules (which, unlike the recently released regulations, will also apply to pension plans that have employees in the Northwest Territories, Nunavut and Yukon) have been included in government omnibus Bill C-9, which passed second reading in the House of Commons on April 19, 2010. It is unlikely, however, that these changes will come into force before fall, and many will require companion regulations.

The main changes covered in the recently released regulations and Bill C-9 are described below. For simplicity, we have grouped them into four basic categories: funding, investment, benefits and plan administration.

Changes to funding rules

The most significant changes in the new regulations relate to funding rules. An entirely new method of calculating solvency payments – different from anywhere else in Canada – has been created.

New minimum funding standard

There is a new method for measuring the solvency position of an ongoing DB plan. Solvency special payments will now be based on the three-year average of solvency ratios (the current year and the previous two years) instead of the current solvency ratio only, where the solvency ratio is defined as the ratio of the solvency assets to the solvency liabilities, and can be greater than 100%. The three solvency ratios used to determine the average must be based on the market value of plan assets for each of the respective years. Smoothing of assets will no longer be permitted under the averaging method and past deficiencies must be consolidated annually (which means a “fresh start” each valuation). The amortization period for solvency deficiencies will remain at five years; however, the calculation of the solvency special payment for the next plan year is being simplified (it is now equal to one-fifth of the solvency deficiency, calculated using the average solvency ratio, less the annual amount of special payments being made to liquidate any going concern unfunded liability).

(cont'd)

An example of how the new standard works is shown below. The example assumes the plan has going concern special payments of \$200,000.

	Year end (all amounts in millions)		
	2007	2008	2009
Market value of assets (A)	\$8.8	\$7.0	\$9.0
Solvency liabilities (B)	\$8.0	\$10.0	\$12.0
Solvency ratio = (A)/(B)	110%	70%	75%
At the end of 2009:			
Average solvency ratio = $(110\% + 70\% + 75\%) \div 3$			85%
Adjusted solvency assets = 85% of \$12.0			\$10.2
Solvency liabilities			\$12.0
Solvency deficiency = $\$12.0 - \10.2			\$1.8
Going concern special payment in 2010			\$0.20
Solvency special payment in 2010 = $(\$1.8 \div 5) - \0.20			\$0.16

The above example is for a basic calculation. The regulations provide for various adjustments to the calculation; for example, to reflect special payments or plan amendments made in the last two years.

The main objective of the solvency smoothing mechanism is to mitigate short-term fluctuations in the value of plan assets and liabilities, providing for more stable contribution rates. Solvency smoothing takes the place of adjustments based on asset smoothing (which is no longer allowed). In the event of a large experience loss, the increase in required special payments will, initially, be less than under current solvency funding rules. Similarly, when a plan's funding position improves, solvency special payments will decline more gradually, further strengthening the financial position of the plan. There may even be cases where a plan that is fully funded as of the valuation date is still required to make special payments - because the average solvency ratio is less than 100%. However, it also means that the recognition of large losses or gains will no longer be immediate but will be spread over several years.

Effective date

The federal government is expected to make the new funding rules effective in early June. This means the new funding rules will apply to plan years ending December 31, 2009 if a valuation report is due June 30, 2010. Based on the recent bulletin published by the Office of the Superintendent of Financial Institutions (OSFI), the filing deadline will likely be extended past June 30th.

Transitional rules

The new regulations also contain transitional rules, including special requirements for sponsors who are subject to the temporary Solvency Funding Relief Regulations issued in 2006 and 2009. Special payments determined under the temporary measures will continue unchanged for the balance of the amortization period. Furthermore, if a plan solvency ratio was not calculated in either of the two prior plan years, the current solvency ratio may be used.

Annual valuations

The new minimum funding standard assumes that plan assets and liabilities will be valued each plan year. As a result, valuation reports must be filed at least annually for most plans, or more frequently if requested by OSFI. To enable this change, OSFI has already released a draft amendment to the Directives of the Superintendent dealing with frequency of actuarial reports. Based on that amendment:

- DB plans with a solvency deficit reported with a valuation date after December 30, 2008 and before December 31, 2009 must file a valuation report as of the end of the plan year beginning in 2009. This just confirms the old rule that plans whose last report before December 31, 2009 revealed a solvency ratio less than one must file another valuation report one year later.
- Except as provided in the following two points, a plan must file a valuation report annually, starting with the first plan year-end after December 31, 2009.
- Only designated plans and those plans that reported a solvency ratio of at least 125% on or after December 31, 2009 are exempt from annual filing and can continue to file on a triennial basis.

- As a transition, plans that reported a solvency ratio of 100% or more before December 31, 2009 do not need to file annually until after their next required triennial valuation.

The annual filing requirement will result in additional compliance costs for plan sponsors.

Monthly remittances

The current requirement for quarterly remittances of required contributions and special payments will be repealed by the end of this year. Starting January 1, 2011, all required payments must be paid in equal instalments on a monthly (or more frequent) basis and no later than 30 days after the end of the contribution/instalment period. Late payments must include interest for the period of delay.

Contribution holidays

The new regulations introduce a new “solvency margin.” This margin – which is equal to 5% of solvency liabilities – will not have to be explicitly funded. Solvency funding requirements would still be based on bringing the average solvency ratio of the plan to 100%.

Reductions to “normal cost” contributions will be permitted only if the current solvency ratio exceeds 105%. Where the current solvency ratio exceeds 100%, but is less than 105%, the employer will have to continue making normal cost contributions. Given that solvency special payments are based on the average solvency ratio and contribution holidays are based on the current solvency ratio, there may be instances where a plan sponsor is permitted to take a contribution holiday for the normal cost because the current solvency ratio is above 105%, yet have to make special payments because the average solvency ratio is below 100%.

Bill C-9 amends the Income Tax Act to permit actuarial surpluses of up to 25% of liabilities before employer contributions must be stopped. The previous limit on actuarial surplus was equal to the greater of: a) 10% of liabilities, or b) twice the current service cost (limited to 20% of liabilities).

Letters of credit

A new rule to be introduced to the PBSA once Bill C-9 becomes law will allow plan sponsors to use letters of credit to satisfy solvency funding obligations up to 15% of the plan’s assets. This means an employer would be able to use a mix of cash and letters of credit to satisfy solvency payments in a given year. The regulations needed to support this change have yet to be published, so letters of credit are unlikely to be an option for funding solvency payments in 2010.

Funding of benefit improvements

Unless authorized by the Superintendent, plan amendments that increase pension benefits or credits will not be permitted if:

- a plan’s solvency ratio is below a yet-to-be prescribed level, or
- the amendment would reduce the solvency ratio of the pension plan below the prescribed level.

It’s expected that the prescribed solvency level will be set at 85% (as announced in October 2009). OSFI has clarified that benefit improvements may be authorized for plans that have a solvency ratio below 85% provided the employer funds any corresponding increase in liabilities based on the solvency ratio immediately prior to the amendments. For example, if a plan had an 80% solvency ratio, the plan sponsor must immediately fund 80% of the cost of any benefit improvement.

Termination funding

To date, full funding on plan termination is required in all jurisdictions in Canada – except in Saskatchewan and for federally regulated plans. Under Bill C-9, this will change for federally regulated plans (with the exception of multi-employer plans). Solvent employers will be required to fully fund all promised benefits upon plan termination – in instalments, over a five-year period.

Wind-ups and terminations

Once Bill C-9 takes effect, partial terminations by sponsoring employers will no longer be permitted. Only the Superintendent will have the right to declare a plan partially terminated. As a result, partial terminations and partial wind-ups will be eliminated from the federal pension framework – reflecting a similar proposal in Ontario.

Under Bill C-9, the whole plan can be terminated or wound up – not only by the plan administrator, but also by the sponsoring employer. However, the Superintendent must be notified in writing 60 to 180 days before the date of termination/wind-up.

Changes to investment rules

In addition to the new funding rules, the new regulations make important changes to investment rules for pension plans. In particular, the new regulations will eliminate existing limits set for investment in real estate and resource properties. Under the current rules, plans can invest no more than:

- 5% of the book value of plan assets in any one parcel of real estate or Canadian resource property;
- 15% of the book value of plan assets in Canadian resource properties; or
- 25% of the book value of plan assets in real estate and Canadian resource properties.

Elimination of the limits will have an impact in other jurisdictions as well since the federal investment rules have been adopted by most of the provinces. Alberta, British Columbia, Saskatchewan and Manitoba have adopted the federal investment rules “as amended from time to time.” This means, removal of the limits will apply automatically to plans in these provinces. Other provinces, including Ontario, do not have automatic harmonization with the federal rules and will need to amend their regulations to remain in sync.

The government intends to propose further changes with regards to investment rules that prohibit pension funds from investing more than 10% of their assets in a single investment or investing in shares of the plan’s sponsoring employer. However, no changes are contemplated to the 30% rule (where a plan may not own more than 30% of a single entity).

Changes to pension benefits rules

A number of the changes provided for in Bill C-9 will require amended regulations (still to be released). It’s safe to say, however, that the minimum standards applicable to member benefits will be significantly different once Bill C-9 becomes law. The main changes to benefit provisions are as follows.

Reduction of benefits in multi-employer plans

Bill C-9 spells out the rules for plan funding and plan amendments as they apply to MEPPs. In the past, the Act was silent on the following points:

- Employer contributions set by statute, regulations, collective agreement, or an agreement between participating employers are limited to the set amount. In other words, participating employers are not liable for any funding deficit.
- Although MEPPs are subject to the same solvency test as other plans, they have the option to amend the plan to reduce benefits – so that they reduce liabilities and satisfy the test.
- MEPPs are exempt from the requirement to ensure the plan is fully funded upon termination.

MEPPs will also be prohibited from the use of letters of credit in solvency funding.

Immediate vesting

Once Bill C-9 is enacted, all DB and defined contribution (DC) plans covered by the PBSA will need to provide for immediate vesting of benefits for all service. Currently, benefits earned since January 1, 1987 are vested after two years of plan membership. Immediate vesting means all terminating members will have the right to a deferred pension (although the PBSA still allows pension plans to force vested members to transfer the value of their pension out of the plan if the annual benefit is less than 10% of the YMPE). Pension benefits will continue to be locked-in after two years of plan membership and the right to unlock up to 25% of pre-1987 benefits will be removed.

Introducing immediate vesting will increase both funding and administrative cost for federally regulated pension plans. One possible remedy to mitigate costs related to immediate vesting is to amend the plan (and potentially employment contracts) to introduce a two-year waiting period for plan membership.

Minimum pension credit

For DB plans, the 50% cost-sharing rule will apply to pension benefits accrued for all service (not just service earned since January 1, 1987). The excess contributions, if any, will continue to be payable at the time of termination, retirement or death and will remain locked-in. For a contributory DB plan, this change may result in increased benefits for members and, therefore, increased costs to the plan.

Plans that provide annual indexing for deferred pensions up to the day pension payments begin (within prescribed limits) will continue to be exempt from the 50% cost-sharing rule.

Variable benefits

Under Bill C-9, DC pension plans will be able to provide variable benefit payments – directly from the plan – to members who have reached early retirement age. Variable payments would be similar to the payments prescribed under a Life Income Fund (LIF). Currently, when a member retires, the money in their DC account is used to purchase a life annuity from a financial institution or is transferred to an external LIF provider. The proposed change would allow members (or a surviving spouse) to keep his or her DC account in the plan and receive pension income.

If a DC plan is amended to provide variable benefits, the retiree must be given the opportunity – at least once a year – to transfer the balance of his or her DC account out of the plan to purchase a life annuity or move it to a LIF. A more detailed description of how variable benefits will work should be provided in the future regulations.

Pre-retirement death benefits

Bill C-9 simplifies the rules for benefits on death before retirement. Benefits will no longer depend on whether the deceased member was eligible for immediate retirement. The surviving spouse, beneficiary or estate will receive the commuted value of the late member's pension benefit for all service, calculated as if the member terminated employment on the date of death. Currently, survivors of members who die after they are eligible to retire would receive an immediate survivor pension from the plan.

Division of benefits due to marriage breakdown

If a court order or separation agreement does not require the payment of a survivor pension to a former spouse for service accrued during the marriage period, then the plan can provide the member with the normal form of pension for single members. This could include reversing any actuarial reduction applied to calculate a member's joint and survivor pension benefit.

Changes to plan administration rules

Plan-to-plan transfers

Pension asset transfers between DC plans will no longer require the consent of the Superintendent. The exemption will apply to DC accounts in DC plans, as well as in DC/DB combination or hybrid plans. The current requirement for Superintendent consent as it applies to the transfer of DB assets will remain in force.

Distressed pension plan workout schemes

Bill C-9 sets out a new process for plan sponsors and plan members to negotiate a deficit funding arrangement outside the PBSA.

To start, the sponsoring employer must declare in writing that it is unable to make the required contributions to the pension plan. That declaration must be filed with the Superintendent and the Minister of Finance along with additional documents. Plan members must also be notified. The declaration will trigger a moratorium on special payments, allowing the parties to negotiate.

This is a brand new approach to plan funding – one that is based on experience with Air Canada's pension plans. The entire process is to be prescribed in detail in future regulations.

Superintendent powers

Bill C-9 provides the Superintendent with extended powers to remove and replace a plan administrator if:

- the administrator is unable to act,
- the administrator is insolvent, or
- the Superintendent feels it's in the best interests of members.

The pension fund will be required to pay the expenses and fees of the new administrator.

The Superintendent has the same authority with respect to the plan's actuary. If the Superintendent determines it's in the best interest of members, OSFI can appoint an actuary to value the plan and to prepare actuarial reports. The plan administrator, in turn, will be required to:

- pay the expenses of the OFSI-appointed actuary (as they relate to the actuary's report); and
- fund the plan in accordance with the report.

Furthermore, the Superintendent can decide to terminate a plan if there is "a cessation of crediting of benefits to the plan members." This could mean frozen plans will be required to wind up and purchase annuities for members.

Enhanced disclosure

Bill C-9 expands the list of information that needs to be disclosed to plan members and other plan beneficiaries. For example, detailed information on the plan's funding status must be included not only in annual statements to members, but also in annual statements to deferred vested members, retirees and their spouses, as well as any survivors receiving benefits from the plan.

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