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British Columbia's pension funding reform

To help plan sponsors better address the pressures of low interest rates and volatile investment returns, while supporting the long-term sustainability and benefit security of pension plans in the province, British Columbia has *announced* major changes to the funding requirements for defined benefit pension plans effective December 31, 2019. While there are some notable differences, like the legislation in Quebec, Ontario and elsewhere, the changes strengthen going concern funding requirements while reducing solvency funding requirements.

Also of note is a new option for single employers who wish to offer a target benefit pension plan to their employees. Previously, this option was only available to multi-employer plans.

Our *Special Notice Preview,* released on December 19, 2019, provided brief highlights of the changes. This *Special Notice* reviews the changes in more depth, including the impact for plan sponsors, trustees and members.

Funding rules for defined benefit plans

Changes to the funding rules for defined benefit plans take effect for actuarial valuations on or after December 31, 2019, and include the following:

Solvency funding requirements are reduced and simplified

Funding of solvency deficits will only be required if the plan's solvency ratio is below 85%. The monthly contribution requirements will be calculated on a "fresh start" basis, by dividing the amount of any deficit below the 85% threshold by 60.

Previously, the same five-year period applied for funding solvency deficits, but funding was required up to a solvency ratio of 100%, and monthly payments were calculated to amortize both principal and interest on the declining deficit balance. Amortization schedules were previously established for fixed five-year periods at each valuation date, whereas the new rules no longer require tracking of remaining payment schedules from previous valuations.

Commentary: These measures will provide relief to plan sponsors who are currently funding solvency deficiencies, despite having considerable surpluses on a going concern basis. Easing the burden on plan sponsors, however, comes at the cost of a reduction in the security of members' benefits if the sponsor were no longer able support the plan.

While other provinces have gone further, B.C. has now reached the same balance point between the competing objectives as Ontario, being the 85% solvency funding target. Quebec eliminated solvency funding targets entirely for plans with Quebec members only, and adopted a 75% solvency funding target for multi-jurisdictional plans effective January 1, 2019.

By simplifying the amortization calculation, the changes recognize that there is an element of spurious accuracy in fixed-term funding towards a volatile measure of the plan's hypothetical wind-up position at periodic valuation dates. Most jurisdictions continue to allow for interest in the amortization calculation and do not adopt a fresh start approach; as such, the B.C. changes further exacerbate the different funding requirements applied across Canada for defined benefit pension plans.

B.C. had previously introduced temporary solvency relief measures to allow plans to consolidate solvency deficiencies and fund them over 10 years rather than five. These measures have now been removed and plans currently relying on them will no longer be able to do so following their first actuarial valuation carried out under the new funding rules. In addition, the BC Financial Services Authority has stated that they are unlikely to approve any special requests to extend the timeframe to pay solvency deficiencies going forward.

Going concern funding targets are increased

The going concern funding target now includes a prescribed margin intended to reduce long-term interest rate risk.

The margin, known as a “provision for adverse deviation” or “PfAD,” is calculated as the greater of 5% or five times a long-term Government of Canada bond rate (CANSIM Series V122544).

For valuations with an effective date of December 31, 2019, the PfAD is 8.35% (assuming non-fixed income allocation is over 30%).

Unlike Quebec and Ontario, the margin required in B.C. does not depend on the plan’s investment strategy or maturity, as long as the plan’s non-fixed income allocation is over 30%. Where the non-fixed income allocation is below 30%, the PfAD is proportionately reduced but still subject to the floor of 5%. The PfAD does not apply to any portion of a plan’s liabilities that have been insured by the purchase of annuities.

The PfAD must also be included in the normal cost (i.e., contributions towards benefits being earned in the current year), unless the going concern funded ratio, including the PfAD, exceeds 105%.

Commentary: When interest rates are lower, liabilities are generally higher, but a lower margin percentage will be applied than at times when interest rates are higher. The total liabilities plus margin is therefore expected to be more stable in the face of changes in interest rates.

The impact on any particular plan will depend on whether this buffer is more or less than any existing margins. For example, many plans already have an implicit margin built into their going concern liabilities, through a reduction in the discount rate below the actuary’s best estimate of future investment returns. It may be appropriate to review plans’ funding policies and reduce or remove existing implicit margins given the introduction of an explicit margin (the PfAD).

Going concern deficits are consolidated and contributions are simplified

As with solvency deficits, following the changes to regulations, any going concern deficit is considered on a fresh start basis at each valuation. Under the old rules, any existing amortization contribution schedules were carried forward, and a new schedule was added for contributions towards any new deficit.

The consolidated going concern deficit, calculated with the margin added to the liabilities, will need to be funded over 10 years rather than 15 years. The monthly payments due will be calculated by dividing the going concern deficit by 120.

Commentary: The fresh start approach will generally lengthen the period over which deficiencies are funded.

The combined impact of shortening the payment period from 15 years to 10 years and simplifying the calculation by removing interest will depend on how deficit contributions are currently calculated.

For example:

- Under the new rules, monthly contributions per $1 million of deficit are around $8,300 ($1 million divided by 120).
- If, under the old rules, Plan A calculated its going concern deficit contributions as a flat amount per month, using a discount rate of 6%, this also resulted in monthly contributions of around $8,300 per $1 million of deficit (paid over 15 years with interest, rather than 10 years without interest). Plan A would, therefore, see no material change in the starting amount of monthly contributions.
- If, under the old rules, Plan B calculated its going concern deficit contributions over 15 years as a percentage of active members' salaries, assuming a discount rate of 6%, annual salary growth of 3%, and a stable population of active members, this would have resulted in monthly contributions of around $6,800 per $1 million of deficit initially, with later payments expected to rise in line with salaries. Plan B would, therefore, see an increase of over 20% in the starting amount of monthly contributions.
- Where further unfunded liabilities arise at future valuations, generally the total payment requirements will be lower under the fresh start approach.

Restrictions on use of surplus are updated

Restrictions on benefit improvements, contribution holidays, and refunds of surplus to the plan sponsor are updated to reflect the new funding requirements.

In particular:

- The Superintendent may refuse to register a plan amendment if it would reduce the plan's solvency ratio below 85% (previously 90%).
- The funding thresholds for contribution holidays and refunds of surplus to the plan sponsor stay the same at 105% for going concern and 100% for solvency, although the going concern funded ratio must now include the PfAD. Note that solvency funding must be at 100% for a contribution holiday, despite the reduction in solvency funding to a target of 85%.
- The conditions applying to solvency reserve accounts are unchanged.

Target benefit plans extended to single employers

Target benefit pension plans provide cost certainty for plan sponsors, while targeting a defined level of pension for retired members. Since contributions are fixed, pensions may be reduced in hard times or increased in better times.

British Columbia introduced legislation in 2016 that allowed multi-employer plans to convert existing defined benefit arrangements into target benefit plans, which are exempt from solvency funding altogether.

The changes, effective from December 31, 2019, allow single employers to offer new target benefit pension plans to their employees, although there is no mechanism for single employers to convert existing defined benefit plans to target benefit.

Commentary: Despite the welcome changes to funding rules for defined benefit plans, the risk remains of significant and unexpected cash contributions being required. The option to offer target benefit plans will be welcomed by plan sponsors who wish to offer their employees greater certainty about their future retirement income than can be offered by a defined contribution plan or RRSP, but without the burden of defined benefit funding requirements. In the absence of a mechanism to convert existing single-employer defined benefit plans to target benefit, however, the change may have limited impact.

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Vancouver
604-682-1381

Winnipeg
204-988-1586

Toronto
416-429-3330

Montreal
514-395-1188

Quebec City
418-780-1366

Halifax
902-492-2822

Barbados
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