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Client Advisory

Pension reform in British Columbia: New defined benefit funding rules and introduction of single employer target benefit plans

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Summary

The British Columbia (BC) government has finalized changes to its defined benefit (DB) pension plan funding framework. Similar to recent changes in Ontario, BC plans will only be required to fund to 85% on a solvency basis, whereas the going concern funding requirements are being enhanced. In addition, while the prior reform measures introduced in BC included the ability for multi-employer plans to offer "target benefits", the new legislation now permits single employer plans to also become target benefit plans. The new rules are effective on December 31, 2019, and will have a significant impact on the funding and design of many pension plans registered in BC.

This Client Advisory will be of interest to sponsors and administrators of defined benefit pension plans registered in BC, and others interested in the development of funding requirements and the evolution of pension plan design options in Canadian jurisdictions.

The new funding rules for BC-registered DB pension plans are set out in B.C. Reg. 264/2019, amending the *Pension Benefits Standards Regulation* (PBSR). These changes include a decrease in the solvency funding threshold to 85% of solvency liabilities, and the introduction of a provision for adverse deviation for going concern funding. They follow stakeholder consultations last year (see our Client Advisory dated November 5, 2018) and will apply on a DB plan's first review date on or after December 31, 2019. Although not included in last year's consultations, single employers will also be able to offer target benefit plans, effective December 31, 2019. The BC Financial Services Authority (BCFSA) has released PENS 19-004, a bulletin outlining both sets of amendments, and is expected to release a bulletin with further guidance in January.

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New funding framework

The following are the main aspects of BC's new funding framework.

Solvency funding

Employers will only be required to fund a solvency deficiency up to 85% of solvency liabilities (a decrease from the previous 100% funding threshold). The period to amortize a solvency shortfall will continue to be five years; however, the method of calculating the deficit payments will change from the prior legislation in two ways:

- The amount of the deficiency will be consolidated and reported as a single amount at each review date, with a single series of payments required (fresh start). This differs from the previous legislation, where each new deficiency created a new series of payments and previously established amortization schedules continued until they were funded or expired.
- The monthly amount of special payments until the next review date will be the portion of any solvency deficit below the 85% threshold, divided by 60. Under the previous rules, the amortization payment was determined using a five-year present value annuity factor rather than dividing by a simple factor of 60.

The new funding rules will continue to permit the use of a Letter of Credit (LOC) in lieu of remitting cash contributions toward the solvency deficit, and LOCs implemented in lieu of cash contributions can be reduced or eliminated if the plan's solvency ratio remains at 85% or more after the reduction. In addition, plan sponsors can continue to remit solvency deficit contributions to a Solvency Reserve Account (SRA).

However, no changes have been made to the rules with respect to accessing funds in the SRA and excess assets in the SRA can only be refunded, in accordance with the prescribed formula, to the plan sponsor if the plan is 100% funded on a solvency basis.

Note that, although the solvency ratio is not used to determine the contribution requirements if the solvency ratio is above 85%, the actuarial valuation report must continue to disclose the plan's solvency ratio.

Enhanced going concern funding

The amortization period for any going concern deficits will be decreased from 15 years to 10 years. Consistent with the deficit funding changes for the solvency valuation:

- The amount of the deficiency will be consolidated and reported as a single amount at each review date, with a single series of payments required (fresh start). This is different from the previous legislation, where each new deficiency created a new series of payments and previously established amortization schedules continued until they were funded or expired.
- The monthly amount of special payments until the next review date will be the determined as the deficit amount divided by 120. Under the previous rules, the amortization payment was determined using a 15-year present value annuity factor.

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Provision for Adverse Deviations

The PBSR amendments include the introduction of an explicit margin, called a provision for adverse deviation (PfAD), for DB plans which will be added to both the going concern liabilities and the annual normal cost when determining minimum contribution requirements. The explicit margin will replace any existing margins previously included in the going concern funding valuation (such as an implicit margin in the going concern discount rate assumption) and will be calculated as the greater of 5% or five times the long-term bond rate (defined as CANSIM Series V122544 as published by the Bank of Canada on the plan's review date). The PfAD for plans that have less than 30% of the plan's portfolio invested in non-fixed income assets will be decreased on a proportionate basis; however, the PfAD will never be less than 5%. Note that any liabilities secured by buy-in annuities are excluded from both the explicit PfAD requirement as well as the asset mix calculation for the reduced PfAD.

The approach for determining the explicit PfAD for DB plans (described above) differs from the approach adopted in recent Ontario and Quebec pension reforms, and also differs from how the PfAD is determined for BC-registered target benefit plans, where the size of the PfAD is more closely linked to the plan's asset mix. Below are some of the reasons that BC decided to link the PfAD with Government of Canada long-term bonds as opposed to asset allocation:

- A simplified approach should be adopted that avoids influencing investment strategy.
- The PfAD should be based on the interest rate risk, over which plan sponsors have little to no control. Market risk can be managed elsewhere.
- The intended purpose of the PfAD is to mitigate contribution volatility, and not specifically to enhance benefit security. A PfAD based on market risk does not help mitigate contribution volatility.

Use of surplus and contribution holidays

The rules for contribution holidays remain unchanged under the new funding measures, with the exception that the accessible going concern excess calculation includes the explicit PfAD. In other words, a contribution holiday will be permissible if the plan is at least 105% funded on a going concern basis, including the explicit PfAD, and at least 100% funded on a solvency basis.

In addition, if the plan has accessible going concern excess (i.e., is at least 105% funded on a going concern basis, including the PfAD) at the review date, there will be no requirement to fund an explicit PfAD on the normal cost.

Benefit improvements

The threshold for the Superintendent to approve benefit improvements will be reduced from a solvency ratio of at least 90%, after the improvement, to a solvency ratio of at least 85%, after the improvement. The amended PBSR do not include an additional threshold for the going concern

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PfAD. The financial effects of a benefit improvement will be disclosed when they are effective and will be funded in the same manner as any other unfunded liabilities or solvency deficits.

Transition

A DB pension plan will be subject to the new funding requirements on the review date of the first actuarial valuation report, filed with the Superintendent for funding purposes, prepared as at December 31, 2019 or later. Prior to that review date, the current funding requirements continue to apply.

Temporary and discretionary funding relief

Temporary relief under Schedule 8 of the PBSR will not be permitted on or after December 31, 2019, and any existing temporary relief will end on the first review date on or after December 31, 2019. Schedule 8 was added earlier this year and applies in relation to plans with a review date between December 31, 2018 and December 31, 2020, inclusive (see our Client Advisory dated March 8, 2019).

BCFSA staff will also no longer recommend that the Superintendent approve any applications for extensions to the time period required for solvency payments.

Commuted values and disclosure requirements for DB plans

Although last year's consultation included a request for comments on the use of alternate measures to determine commuted value amounts, such as going concern funding assumptions, no changes to this effect were included in the PBSR amendments.

Under the new rules, as with the old rules, if a DB plan is less than 100% funded on a solvency basis and a member elects a commuted value transfer, a plan sponsor must continue either to fund the transfer deficiency up to the 100% solvency ratio to permit a full settlement, or defer the payment of the unfunded portion of the commuted value payment by up to five years.

Unlike recent pension reforms in Ontario and Quebec, BC has not changed the member disclosure provisions (i.e., annual statements, retirement statements, termination statements, marriage breakdown statements, etc.)

Single employer target benefit plans

When the *Pension Benefits Standards Act* (new PBSA) was passed in 2012, it introduced target benefit plans in British Columbia. However, in 2015 when the PBSR was released to support implementation of the new PBSA, its target benefit provisions were only made available for multi-employer pension plans. Effective December 31, 2019, single employers can also establish target benefit plans. Key features of the target benefit plan framework in BC include:

- Introducing a PfAD on the normal cost, which increases the more the fund is invested in equities and the higher the going concern discount rate used. Unfunded liabilities are amortized over the lesser of 15 years or the expected average remaining service lifetime of the active members

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- Introducing requirements to reduce benefits, increase contributions and prohibit benefit improvements for plans that are insufficiently funded
- Basing commuted value transfers on going concern assumptions and the target benefit funded ratio from the last filed actuarial valuation report
- Requiring stress testing on material risk factors

Target benefit plans, like DB pension plans, must establish, but not file, a funding policy.

Conclusion

BC's new funding framework will materially change the contribution levels for many DB plan sponsors. For plans between 85% and 100% funded on a solvency basis, solvency payments will no longer be required, as long as the plan maintains the 85% funding threshold. Although solvency payments will still be required for plans that are funded below 85%, such payments will likely be reduced. There will be no solvency impact on plans that are fully funded or that remain temporarily exempt from solvency funding.

However, any elimination or reduction of solvency payments could be partially offset by increased going concern funding requirements, such as the introduction of a new PfAD requirement and a shorter amortization period for plans with a going concern shortfall. In any event, plan sponsors should be proactive in estimating their plans' solvency and going concern funding positions as at their fiscal year end as soon as possible to identify opportunities to remit timely cash contributions and avoid solvency deficit contributions and/or PfAD contributions on the normal cost.

For any particular plan, the impact of these funding rule changes will depend on the plan's relative solvency and going concern funded positions. This new legislation creates an opportunity for sponsors of BC-registered DB plans to reassess their appetite for risk taking within their pension plans. For example, those with exit strategies might want to revisit the merits of risk transfer transactions, such as annuity purchases, against running down the plan's liabilities over a longer period.

The various features of target benefit plans position them between traditional DB and defined contribution (DC) plans, and therefore provide plan sponsors with additional plan design options from which to choose. Of particular appeal to some employers may be the fact that the employer contribution rate to a target benefit plan is fixed. This means that, for accounting purposes, the employer can treat its participation in the plan like a DC plan in the absence of actions that create a constructive obligation for further contributions. Target benefit plans could therefore complement some plan sponsors' benefits or financing strategies. However, because they permit the reduction of accrued benefits under specific circumstances, target benefit plans could have negative implications for employee attraction and retention.

For more information

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