January 31, 2019

Financial and Corporate Sector Policy Branch
Ministry of Finance
PO Box 9418, Stn. Prov. Govt.
Victoria, BC V8W 9V1
PBSA.SolvencyReview@gov.bc.ca

Subject: A Review of the Solvency Funding Framework under the *Pension Benefits Standards Act*: A Consultation Paper

The Canadian Institute of Actuaries (CIA) is the national, bilingual organization and voice of the actuarial profession in Canada. Its members are dedicated to providing actuarial services and advice of the highest quality. The Institute holds the duty of the profession to the public above the needs of the profession and its members.

We are pleased to offer the following comments on the consultation paper. The topic of solvency funding reform has been raised in recent consultations in other provinces, including Ontario, Québec, Nova Scotia, and Manitoba, and the CIA responded in length to those proposals.

The CIA believes that defined benefit (DB) pension plans are the best means by which to provide secure and predictable retirement income. We note that one of the objectives of the British Columbia (BC) Ministry of Finance is to encourage the continuation and growth of DB plans; we assume that this objective will be a key criterion in evaluating the solvency reform proposals. We also acknowledge that the large number of solvency special payments made by plan sponsors over the past decade have contributed to the modification and closure of many DB plans. The number of funding relief measures that have been introduced indicates the need for a change in funding regulations. To that end, the CIA supports a change to the pension funding regime that replaces the solvency funding framework with an enhanced going-concern framework, which would include provisions for adverse deviations (PfADs) and regulatory requirements regarding the determination of the PfADs.

Pros and Cons of Solvency Funding

In arriving at this position, we considered the following pros and cons associated with solvency funding.

1740-360 Albert, Ottawa, ON K1R 7X7 ✆ 613-236-8196 🖷 613-233-4552
head.office@cia-ica.ca / siege.social@cia-ica.ca **cia-ica.ca**

Arguments for removing solvency funding requirements:

- While solvency funding has served to increase the pool of assets dedicated to fund DB pension plans, the need for repeated relief measures over the last 10 years indicates that the regime requires fundamental change.
- Solvency funding has resulted in unsustainable volatility in contributions, as it is based on market interest rates, notwithstanding the smoothing mechanisms available.
- Solvency funding is procyclical, asking plan sponsors to increase contributions once poor performance has already impacted the plan and at a time when they can least likely afford the contributions, rather than building a buffer before the risk of poor performance is realized.
- Some sponsors have difficulty budgeting for solvency funding requirements and managing the resulting level and volatility of contributions. This is often used to justify plan terminations and/or conversion to defined contribution plans.
- Solvency funding is based on the assumption that the plan will be terminated.
- Solvency funding is also based on the assumption that stakeholders are willing to pay the price for the full security of benefits. As evidenced by the closing of many DB plans, many stakeholders are not willing to accept such a high price.
- Canada may be the only jurisdiction that uses such volatile measures, which produce significantly higher contributions than in other countries. For example, contributions are much lower and less volatile in the U.S.

Arguments for keeping solvency funding requirements:

- Plan participants might be better protected on plan wind-up if contributions are made on this basis. But participants need to be informed of the wind-up position of the plan to be aware of the risk.
- Sponsors' concerns can be partially addressed through the following:
  - Additional temporary relief during unfavourable economic circumstances;
  - Increasing the amortization period, resulting in lower levels and reduced volatility of contributions; and
  - Implementing a solvency reserve account where excess solvency contributions can be refunded.

Replacement of Solvency Funding (Approach B)

In light of these advantages/disadvantages, we offer the following opinions on the two options presented under approach B (Replace Solvency Funding Rules with Enhanced Going Concern Funding Rules).

Option 1: Shortened Amortization Period

The paper proposes a reduced period for the amortization of funding deficiencies, replacing the current 15-year period. The CIA considers a 15-year period a reasonable compromise between affordability, stability, and security, while noting that the choice of a fixed amortization period is not based on any underlying actuarial principles.

One of a typical plan's key funding objectives is stability of contribution requirements. Allowing a plan the ability to fund going-concern unfunded liabilities over a 15-year period is important in helping to achieve that objective and is no less so in the absence of solvency funding.

Furthermore, a maximum amortization period of 15 years is a minimum requirement which means that, based on the needs of a particular plan—and its balancing of key funding objectives (adequacy, affordability, security, stability, and equity)—it can fund deficiencies over any time frame from immediately up to 15 years. This would then provide a plan with flexibility by allowing up to 15 years, and thereby promoting stability of contribution requirements. Lowering the allowable amortization period would limit a plan sponsor's flexibility and the plan stakeholders' ability to decide the relative priority of the plan's key funding objectives.

From that perspective, we do not see the value of a shortened amortization period.

Option 2: Requiring a Funding Buffer (Provision for Adverse Deviations)

The CIA believes that including a funding buffer, or PfAD, in future going-concern valuations is a better way to address the risks involved in a DB plan. The PfAD should reflect the inherent risks by being linked to the degree of asset-liability mismatch and potentially other factors. We would like to draw your attention to Québec's new rules, which are intended to reflect this option, but in a simplified manner that prescribes a relatively simple two-dimensional grid.

We have seen suggestions that the PfAD should be determined by reference to the valuation interest rate assumption, but we believe that is not the best approach, as it poorly reflects the asset-liability mismatch. Other suggestions to reflect certain plan provisions or the financial strength of the plan sponsor may be relevant to assess certain risks, but we consider them too difficult to reflect in the PfAD in a practical manner. Other factors such as plan maturity and demographics are taken into account by Québec's new approach. The suggestion to take into account the level of funded PfAD in determining the possibility to use surplus is appropriate, as is the suggestion to take into account the level of funded PfAD to determine the frequency of valuations.

We support the concept of requiring a PfAD if solvency funding requirements are removed. However, we should state that we are not in favour of removing solvency funding without implementing a PfAD. Since BC rules already require that plan administrators establish a funding policy that reflects the management of risks specific to that plan, we believe the new rules should allow a plan administrator to include in the plan's funding policy the determination of a PfAD that takes into consideration certain relevant factors that could be prescribed. Alternatively, a plan administrator could choose to use a PfAD that is prescribed for use by default, based on a simple grid that reflects one or two relevant factors (similar to the Québec approach). We would be pleased to assist the BC Ministry of Finance in determining those relevant factors or default grid if such an approach is to be implemented.

Modifications to Current Solvency Rules

Although the removal of solvency funding in combination with the introduction of enhanced going-concern funding with a PfAD is our preferred approach, we would also like to offer the following comments on the options included within approach A (Modifications to Current Solvency Funding Rules).

Option 1: Lengthened Amortization Period

The paper proposes a period as long as 10 years for the amortization of solvency deficiencies, replacing the current five-year period which results in high and volatile contributions. This represents a certain compromise between security and affordability, as contributions would be significantly reduced, but does not remove the basic problem of solvency variability. The CIA would support this option if approach A were adopted.

Option 2: Consolidation of Solvency Deficiencies

Consolidating all past deficits at each valuation date is effectively the approach adopted under the federal solvency regime and would serve to lengthen the amortization period for solvency deficiencies. The CIA would support this option if approach A were adopted.

Option 3: Basing Solvency Funding on Smoothed Asset Values

Asset smoothing helps reduce the volatility of solvency contributions but deviates from the solvency measure and thus may produce a false sense of security. Due to the complexity for stakeholders to understand such an approach and the resulting disconnect from market values, we do not support this option.

Option 4: Basing Solvency Funding on an Average Interest Rate

Liability smoothing from averaging interest rates helps to reduce the volatility of solvency contributions but deviates from the solvency measure and thus may produce a false sense of security. Due to the complexity for stakeholders to understand such an approach and the resulting disconnect from market values, we do not support this option.

Option 5: Funding a Percentage of the Solvency Liability

The actuarial profession has developed standards of practice to determine the wind-up valuation basis. If a government policy decision is made to establish a minimum solvency funding target that would be lower than 100 percent, the CIA could support targeting such a solvency ratio (e.g., 80 percent) as a reasonable compromise between security and affordability.

Modifications to Commuted Value Calculations

Other provincial consultations have also referenced possible changes to the commuted value (CV) calculation. The actuarial profession has developed standards of practice to determine the commuted value as the “fair value’’ of a pension benefit under financial economic principles. The CV does not attempt to adjust the value to reflect the risk inherent in each pension plan. Please note that the CIA and the Actuarial Standards Board have initiated a review of CV standards. An exposure draft was released in July 2017, and recently an updated exposure draft was released in November 2018.

The issue of how much a pension plan should pay to terminating members who elect a lump sum settlement is a public policy decision. The range of answers includes (but is not limited to) the following:

- Commuted value, as currently defined;
- Some adjustment to the commuted value based on the funded status of the plan; and
- Some measure related to the plan's funding reserve.

The consultation paper suggests scenarios whereby terminating plan members would have the option to receive a lump sum value that could be lower than the CV. If such members do not agree with this approach, the deferred pension option remains available to them, albeit not fully funded on a solvency basis, should solvency funding be removed.

It is our opinion that the decision to allow a reduced value (instead of the CV) is a government policy decision: the decision to pay a benefit that is less than the amount determined in accordance with CIA standards rests with the government. We believe that legislation should not alter or adjust the calculation of the CV; but if for public policy reasons the government wishes to allow the payment of an alternative (e.g., lower) amount, then this can be provided for separately (either by allowing the payment of a fraction of the commuted value in plans with deficits or by referencing an alternative measure such as the funding reserve). However, the definition of CV itself should not change. Clear information on the implications of this option should be provided to terminating members. In the interest of increased transparency, members should also be informed about this impact. We would like to point out that there could be inconsistency between members who terminate before a plan winds up (they lose the unfunded portion of their CV) and plan members at the time of wind-up where the employer is solvent (such members would receive their full CV). This would create a potential for disputes.

Thank you for taking the time to review our submission.

If you have any questions, please contact Chris Fievoli, CIA Staff Actuary, Communications and Public Affairs, at 613-656-1927 or chris.fievoli@cia-ica.ca.

Sincerely,

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John Dark, FCIA
President, Canadian Institute of Actuaries