

Pension Funding Framework Review

And other
issues affecting
pension plans

September 2017



Introduction

Employer sponsored pension plans play a key role in helping individuals save for their retirement. The majority of pension plans in Nova Scotia are defined benefit or defined contribution. In addition, multi-employer pension plans are common among the trades and the Pension Benefits Act that came into force on June 1, 2015 provides for jointly sponsored pension plans. Target benefit plans are envisioned under the legislation but a regulatory framework has not yet been developed.

Part I of this paper focuses on the funding framework for defined benefit plans. Part II focuses on regulatory issues that affect various types of pension plans. Discussion questions are identified throughout the paper and are summarized at the end, but feedback from individuals and organizations on any of the issues raised in the paper is welcome.

Part I: Funding Framework for Defined Benefit Pension Plans

Like most Canadian jurisdictions, Nova Scotia requires that defined benefit pension plans value and fund their plans on two different bases:

1. On a going concern basis: assuming the pension plan operates indefinitely.
2. On a solvency basis: assuming the pension plan is terminated or wound up, and all its obligations must be settled at a specific point in time (the valuation date).

Solvency funding is required to help ensure that a pension plan, on wind-up, is able to fulfill the pension promises made under the plan. This is particularly important in the event that the employer that sponsored the plan becomes insolvent or bankrupt and no further funds are available to pay into the pension plan. Even with solvency funding rules, there is no guarantee that a plan will be fully funded when bankruptcy is declared as there may be solvency funding deficiencies that have not been fully resolved. Nonetheless, solvency funding rules are intended to provide a high degree of financial security for members who participate in a pension plan.

Providing a high degree of financial security to those who participate in pension plans is an important goal. Pension plans, and particularly defined benefit pension plans, are an important means of ensuring that individuals and families have sufficient income throughout retirement to maintain a reasonable standard of living. However, market and demographic conditions over the past decade have presented some practical challenges to companies offering this type of pension plan.

Following an abrupt market downturn in 2007–2008, temporary solvency funding relief was provided to permit pension plans to elect to fund solvency deficiencies over longer time frames than the five years typically required in Nova Scotia. In 2009, pension plans with solvency deficiencies identified in a valuation report between December 30, 2008 and January 2, 2011 could be funded over 10 years instead of 5 years, subject to certain conditions. In 2013, another round of temporary solvency relief was provided and pension plans with solvency deficiencies identified in a valuation report dated between January 3, 2011 and January 2, 2014 were permitted to fund the deficiency over 15 years instead of 5, again, subject to certain conditions.

In addition, many pension plans in the broader public sector, including those of universities and municipalities, were permanently exempt from solvency funding in 2012–2013. Specified multi-employer pension plans were also exempt from solvency funding.

Nova Scotia's new Pension Benefits Act and Regulations came into force on June 1, 2015. The new legislation contained some measures to address concerns about solvency funding requirements with the aim of easing the burden on employers by allowing them to better manage funding volatility and meet the full solvency funding standard:

- New special payments identified in a valuation report may be deferred for up to 12 months following a valuation date.
- The ability to smooth the solvency interest rate over a number of years, to a maximum of five years, was added.
- Letters of credit of up to 15% of solvency liabilities may now be used to satisfy a solvency deficiency.

While market conditions have made a significant recovery since 2007–2008, long term interest rates have fallen and remain low. This poses challenges for some defined benefit plans as it weakens their solvency position. Changing demographic trends (retired workers living longer, workers entering the workforce later and/or retiring earlier) further challenge these plans.

About 40% of private sector single employer defined benefit pension plans¹ elected to take solvency funding relief at least one of the two times it was available in the past. About half of these plans remain open to new membership. The average solvency ratio of plans that have elected relief in the past is just over 80%. In contrast, those plans that did not elect solvency funding relief are, on average, 100% funded on a solvency basis. Approximately half of the plans that did not take solvency relief remain open to new members.

In response to some companies' ongoing struggle with meeting solvency funding obligations, three jurisdictions, British Columbia, Manitoba, and Ontario, have implemented a recent round of temporary solvency funding relief. Pension plans that identify a new solvency deficiency within a specified time period may consolidate at least some existing solvency deficiencies with the new deficiency and fund the consolidated deficiency over a longer period of time than the standard five years.

Nova Scotia has followed suit and, in August 2017, implemented a further round of solvency funding relief. Defined benefit pension plans filing valuation reports with valuation dates from December 30, 2016 to January 2, 2019 may elect to fund new solvency deficiencies over a 15-year period. Existing solvency deficiencies that are being funded over a 5-year period may be consolidated with new solvency deficiencies and funded over a 15-year period. This third round of temporary solvency funding relief raises the question of whether a more permanent adjustment to funding rules is required to avoid the need for repeated rounds of funding relief.

It is timely to undertake a review of the funding framework for defined benefit pension plans. Nova Scotia is not alone in examining this issue. Several other jurisdictions have either established or are actively pursuing solutions. In 2013, New Brunswick enabled defined benefit pension plans, subject to certain criteria, to convert their pension plans to shared risk target benefit plans. Doing so would alleviate the need for employers to bear the full cost of a worsening solvency funding position. In Quebec, effective January 1, 2016, solvency funding requirements were replaced with enhanced going concern funding requirements.

Ontario conducted a significant review of its funding rules and announced reforms in May 2017. Going concern rules are being enhanced, including shortening the amortization period from 15 years to 10 years for funding a shortfall in the plan. A funding reserve within the plan, a Provision for Adverse Deviation (PfAD), will be required. Plans will be required to fund on the enhanced going concern basis only, unless the plan's solvency funded status falls below 85%, in which case solvency funding would be required as well.

In addition, Ontario will be increasing the monthly guarantee provided by its unique Pension Benefits Guarantee Fund for a worker's monthly pension from \$1,000 to \$1,500. These reforms are intended to help ensure retirement income security for workers and retirees is protected while helping keep workplace pension plans affordable, enabling Ontario business to grow and compete.

¹ Excludes Individual Pension Plans and pension plans exempt from solvency funding requirements

Options to Consider

Three options are being considered in terms of a funding framework for defined benefit pension plans going forward:

1. **Maintain Full Solvency Funding:** Maintain the current solvency funding standard (fund 100% of solvency liabilities) but introduce measures to help reduce the volatility and variability of funding payments
2. **Eliminate Solvency Funding and Enhance Going Concern Funding:** Eliminate the current solvency funding rules, but enhance going concern funding requirements
3. **Reduce Solvency Funding:** Modify the solvency funding standard so that solvency liabilities need only be partially funded. Measures to help reduce volatility and variability of funding payments and/or implement enhanced going concern funding requirements could also be introduced.

1. Maintain Full Solvency Funding

If the full solvency funding standard, which requires solvency liabilities to be 100% funded, is to be maintained, there are some ways the underlying requirements could be adjusted to help reduce funding volatility and address other issues of concern. These include:

Longer Funding Period

The maximum period of time over which a solvency deficiency may be funded could be permanently lengthened from 5 years to a longer period (for example, 7 or 10 years).

Lengthening the maximum funding period has, as discussed above, been used in Nova Scotia on a temporary basis twice in the past and is currently being used once again. Doing so on a permanent basis may help reduce the size of solvency payments and may help reduce funding volatility.

Consolidate Solvency Deficiencies

If a plan has a solvency deficiency at a valuation date, a schedule is established to fund the deficiency over five years. At the next valuation date (typically one or three years later), if another solvency deficiency is identified, another five-year schedule is established. Instead of requiring different schedules for each solvency deficiency, deficiencies could be consolidated and a single 5-year schedule produced at each valuation date.

Solvency Reserve Accounts (SRA)

An SRA is a separate account within a pension plan fund established to hold payments made in respect of a solvency deficiency. Employer withdrawals from an SRA could be made up to a certain maximum if the solvency ratio was 100% or greater. Greater certainty is provided to employers that money paid in respect of a solvency deficiency can be returned to the employer if the pension plan returns to a solvency excess funded position. This type of account may be established in other provinces, such as Alberta and British Columbia.

Letters of Credit (LOC)

LOCs obtained from a financial institution can be used to cover solvency special payments for up to 15% of solvency liabilities. A higher limit on the use of LOCs could be considered.

Discussion Questions

1. Do you believe that full (100%) solvency funding should be maintained?
2. If full solvency funding were to be maintained, what adjustments, if any, to the specific solvency funding requirements discussed above should be implemented?
3. Are there changes to solvency funding requirements not identified in this paper that should be considered?

2. Eliminate Solvency Funding and Enhance Going Concern Funding

Solvency funding could be eliminated and going concern funding requirements enhanced. Going concern funding assumes a pension plan will continue indefinitely. However, the going concern liability does not represent the real cost of paying out the promised benefits for plan beneficiaries at a given time. Consideration should be given to one or more of the following features to enhance going concern funding requirements, particularly if solvency funding will be eliminated in whole or in part:

- A. Require a Funding Reserve (provision for adverse deviation or PfAD): require an amount in excess of a plan's liabilities that must be funded before the plan may take an action (for example, benefit improvements) that could weaken the plan's funded position.
- B. Shortened Funding Period: currently, going concern deficiencies must be funded within a 15-year period. A shorter maximum funding period would increase benefit security.
- C. Return on Investment Assumptions: the interest rate is typically the most significant assumption in determining the liabilities in a going concern valuation. Ensuring that interest rates are not unrealistically high would help to ensure liabilities are being valued conservatively. The maximum allowed interest rate for use in going concern valuations could be required to be based on high-quality long term corporate bonds.
- D. Solvency 'Trigger' for Enhanced Funding: use a plan's solvency position to determine whether additional funding is needed or if the plan would be allowed to take an action that would weaken its funded position. For example, if a plan fell below a certain threshold of solvency funding (for example, 85%), then a requirement to pay an additional lump sum could be triggered.

3. Reduce Solvency Funding

Reduce solvency funding to require only partial funding of, for example, 85% of solvency liabilities. This reduced solvency funding approach could be combined with elements of the other two options described above. Changes to the underlying requirements could be considered, as in Option 1. In addition, going concern funding requirements could be enhanced per Option 2.

Discussion Questions

4. If the current 100% solvency funding threshold is discontinued, are 'enhanced' going concern funding requirements sufficient to ensure benefit security?
5. What features should enhanced going concern funding rules include?
6. If the current 100% solvency funding threshold is reduced to require only partial solvency funding, is a threshold of 85% appropriate? What other changes to funding requirements should be made?
7. Are there any other reforms to the funding framework for defined benefit pension plans that should be considered?

Part 2: Regulatory Issues

Target Benefit Plans

Target benefit plans refer to a type of pension plan that establishes contribution requirements of employers and employees. Benefits are not defined as a guarantee and are dependent on the plan's financial performance. If contributions are not sufficient to maintain benefits, then contribution rates may be adjusted and benefits may be reduced (future accruals, and in certain circumstances, past benefits).

In 2012, New Brunswick amended its pension law to permit shared risk target benefit plans. Several other provinces have since permitted target benefit plans to be established, and in some circumstances permit conversion of defined benefits to target benefits. In fall 2016, the federal government introduced amendments that would permit target benefit plans. Nova Scotia's pension legislation contains provisions that have not been proclaimed into force that would permit target benefit plans to be established in unionized settings. This is similar to the approach adopted in Ontario's (also unproclaimed) legislation.

Discussion Questions

8. Should Nova Scotia proceed with developing a regulatory framework for target benefit pension plans?
9. Should target benefit pension plans be restricted to unionized environments?
10. Should defined benefit plans be permitted to convert to target benefit plans, including benefits earned in the past?

Annuity Discharge

At present, a pension plan pursuing a strategy to reduce risk by purchasing annuities (typically from life insurance companies) to 'buy-out' its pension obligations retains ultimate responsibility for the liability associated with those pension obligations. Annuity buy-outs may be particularly attractive to employers who have closed their defined benefit pension plans to new members and are seeking to gradually remove its pension obligations. Some jurisdictions have granted a statutory discharge of the liability, providing certain conditions have been met, recognizing that the obligation to pay the pension has been shifted from the pension plan to a regulated life insurance company. Doing so makes this strategy more likely to be utilized.

Discussion Questions

11. Should a statutory discharge of liability for the pension plan be granted where annuity buy-outs occur, and if so what conditions should be met in order to qualify for the discharge?

Permitted Investment Rules

Rules and requirements pertaining to permitted investments in Nova Scotia's Pension Benefits Regulations are generally highly harmonized with those federal Pension Benefits Standards Regulations, and are set out in Schedule I: Permitted Investments. In 2015, the federal government modernized its investment regulations. In particular, the federal rules were amended so that the 10% limit on investing pension plan assets in a single entity is based on the current value or "market value" of a pension plan's assets rather than the "book value". While these changes took effect automatically in several provinces that have incorporated by reference the federal investment regulations, Nova Scotia has not yet adopted any of the 2015 reforms.

Discussion Questions

12. Should Nova Scotia's permitted investment rules mirror those established federally? Are there situations where it would be important to have different rules for Nova Scotia pension plans?
13. Should the current Schedule 1: Permitted Investments of the Pension Benefits Regulations be replaced by incorporating by reference the federal investment regulations?

How to Submit Feedback

Responses to Discussion Questions raised in this paper, and any other comments relevant to the funding framework for pension plans and other regulatory issues are welcome.

To ensure your views are considered, please submit your feedback by **Friday, November 10, 2017**.

Feedback may be submitted by email at:
pensionreg@novascotia.ca

Or by mail at:
Finance and Treasury Board
Pension Regulation Division
PO Box 2531
Halifax, NS B3J 3N5