



Information Bulletin

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BC Proposes new DB Funding Rules – Consultation closes August 30, 2019

On August 2, 2019, the Director of Pensions in the BC Ministry of Finance published a report, *A Review of the Solvency Funding Framework*. It outlines new proposed Defined Benefit (DB) funding rules and the objectives and principles behind them.

The focus of the consultation is to assess whether a change in the DB funding framework would better support plan sustainability and benefit security over the long-term, balancing the interests of all pension stakeholders.

The proposed rules may be in place as soon as January 1, 2020. The key components changing from the current minimum funding rules to the proposed rules are as follows:

- Plans fund to a lower 85% solvency funded ratio (previously 100%) which will:
 - reduce or eliminate the large solvency contributions required for many plans over the past decade, improving contribution stability, and
 - still provide a level of benefit security for plan members.
- Plans fund to a minimum Going Concern Plus measure. The new measure includes an explicit Provision for Adverse Deviation (PfAD) which will:
 - be based primarily on the level of interest rates rather than plan specific factors,
 - improve contribution stability in changing interest rate environments, and
 - be applied to normal cost contributions only if the Going Concern Plus funded ratio is less than 105%.
- Funding for past service is simplified, because past deficits are consolidated at each valuation and amortized without interest, over 5 years for solvency deficits (up to 85%) and 10 years for unfunded Going-Concern Plus liabilities.

Impact on DB Pension Plans

In the short-term most DB pension plans will experience lower contribution requirements, as they will be able to significantly reduce or eliminate payments towards funding solvency deficits. For plans that have letters of credit in place, it is expected that these will also be able to be reduced or eliminated. Furthermore, many plans already have sizable going concern excesses, so no increase to the costs of funding future benefit accruals will be required, despite the new Going Concern Plus measure.

Over the long-term contributions are not expected to be as volatile. If interest rates rise, the normal cost for some plans may increase relative to what they would have been under the current rules. However, in many cases this will coincide with improved funded positions, thus may not directly impact contribution requirements.

Stakeholder Committee Process

A Stakeholder Advisory Committee (Committee) was established to provide input to ministry staff on how potential reforms might balance the divergent interests for stakeholders of DB pension plans.

An Actuarial Working Group (AWG) was formed to provide specialized expertise and feedback from BC pension actuaries to develop a funding buffer, or PfAD, under a Going Concern Plus funding framework.

In addition, Ministry staff met with many individual stakeholders and stakeholder groups to discuss the consultation paper, offering an opportunity to explore how the issues raised in the consultation affected them. The first consultation paper mentioned the potential to consider different rules for public sector and crown organizations, however the proposed rules are not different for this group.

Guiding Principles for DB Funding Framework

The following principles emerged from the consultation process for funding reform:

- Minimum funding requirements should reflect the long-term nature of these plans.
- The current funding requirements prioritize the small risk that any one employer may become insolvent. The resulting high and volatile contributions over the last 15 years has led to a reduction in DB pension coverage.
- A PfAD should be designed to help manage interest rate risk or long-term bond rate (LTBR) risk. This is the main long-term risk to contribution volatility which most DB pension plans face but cannot mitigate without immunizing.
- Investment risk is a shorter-term risk to contribution volatility that can be mitigated in other ways (such as asset smoothing).
- The application of funding requirements and minimum PfADs should be as simple as possible.
- Keeping some level of solvency funding along with enhanced going concern funding would prevent DB plans from becoming too underfunded.
- The primary risk to benefit security is employer insolvency; however, no practical way exists to implement different funding requirements based on the financial risk of a plan sponsor.

Going Concern Plus: Provision for Adverse Deviations (PfAD)

The going concern valuation will require that an explicit PfAD be added to the actuary's best estimate.

The proposed PfAD formula in most cases is **5 x LTBR** (5 x monthly long-term benchmark Government of Canada bond rate, CANSIM Series V122544). It will be lower for plans with low return-seeking asset allocations and will always be set to be at least 5%.

In the past four years, the LTBR has been between 1.6% and 2.6% and is currently at 1.7%. Therefore, the PfAD would currently be less than 10%. For plans that already have an implicit margin in their going concern valuation assumptions, in many cases their going concern liabilities will not increase much, or not at all, due to this proposed minimum PfAD.

For plans with low return-seeking (non-fixed income) asset allocations, the formula that would apply to determining the PfAD is **Maximum [5%, 5 x LTBR x (Minimum (30%; Non-Fixed Income Allocation) / 30%)]**. The "5x" multiple in the PfAD formula will be reduced on a pro-rata basis for plans with less than a 30% allocation to return-seeking assets. For example, plans with less than 15% return-seeking assets would currently have a PfAD of only 5%.

Plans must fund at least the sum of the best estimate going concern liability plus the PfAD (Going Concern Plus). If a plan's Going Concern Plus funded ratio is less than 105%, then a PfAD must also be added to the best estimate normal cost to fund benefit accruals. However, for plans with a funded ratio of more than 105%, the only going concern funding required will be the best estimate normal cost. Therefore, most plans will not see an increase in normal cost contributions.

The rationale provided in the report for the proposed PfAD formula is summarized below:

- The PfAD is intended to mitigate contribution volatility, not to enhance benefit security.
- It varies based on economic scenarios rather than short-term market fluctuations. Therefore, the PfAD is only based on interest rate risk.
- A PfAD based on market risk could unduly influence investment strategy and does not mitigate contribution volatility because if markets have a downturn the PfAD is unchanged.
- As interest rates rise, typically plan positions improve. As interest rates fall, typically plan positions deteriorate.
- It is reasonable to put aside a portion of gains (or release a portion of losses) as interest rates change.
- Plans may be exposed to numerous other risks, such as market risk, equity risk, duration mismatch risk, fixed income default risk, and liquidity risk. Trying to develop factors for a PfAD that account for all these risks would be unwieldy. In addition, many plan sponsors would adopt innovative and possibly counter productive investment strategies to avoid higher PfADs.

PfAD Reserve Account

Contributions to fund the PfAD can be remitted to a single reserve account for accumulating both solvency and PfAD payments. This helps clarify entitlement to these surplus funds and lessens the risk of stranded surplus. Reserve account withdrawals will be permitted above a 105% funded ratio on a Going Concern Plus basis, provided the plan's solvency position will not reduce to below 100%. Superintendent's consent is not required.

Contribution Holidays

Contribution holidays rules will be like the current provisions but based on a Going Concern Plus basis. Effectively implicit margins employed currently by most plans will be replaced by the minimum prescribed PfAD for the test on funded position.

Benefit Improvements

The current BC PBSA provides that the Superintendent can refuse an amendment that decreases the solvency ratio below 90%. There will be no changes to this except under the proposed rules, the 90% threshold will be lowered to 85%.

What's Next?

Comments on the Ministry of Finance report may be made by the public until **August 30, 2019**, and should be directed in electronic format to PBSA.SolvencyReview@gov.bc.ca or mailed in paper format to Financial and Corporate Sector Policy Branch, Ministry of Finance, PO Box 9418 Stun Prov Govt, Victoria BC V8W 9V1

Ultimately, any proposed changes to the minimum funding requirements for ongoing DB pension plans would be subject to consideration and approval by the Minister of Finance and Cabinet, and, for any amendments to the PBSA, the approval of the Legislature of British Columbia. It is possible the government may aim to implement these proposed changes as early as this fall so they are in place for January 1, 2020. Changes to the PBSA for how lump sum values are calculated are still under consideration and would not be expected to be in place for at least another year.

Your Aon consultant will be reaching out to you to discuss these changes in more detail. We can help you understand how the changes will impact your plans and funding requirements, as well as help you prepare any response to the consultation report. We can also help you determine if it will be advantageous to file an early valuation once the new rules are in place.

Contact Information

Should you wish additional information on this topic, please contact your local Aon consultant, or send an email to canada.retirement@aon.com.

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