Canadian
Association of
Pension
Supervisory
Authorities
CAPSA

Proposed Funding Principles for a Model Pension Law

A discussion paper by the
Canadian Association of Pension Supervisory Authorities
(CAPSA)

June 20, 2005

Association
Canadienne des
Organismes de contrôle des
Régimes de retraite
ACOR

Canadian Association of Pension Supervisory Authorities CAPSA

June 20, 2005

Dear Pension Industry Stakeholder:

RE: CAPSA Proposed Funding Principles for a Model Pension Law

On behalf of the Canadian Association of Pension Supervisory Authorities (CAPSA), we are pleased to announce the release of a consultation paper entitled *Proposed Funding Principles for a Model Pension Law* (the "funding principles") for review and comment by pension stakeholders. The paper is available in electronic form on the CAPSA website (www.capsa-acor.org) under "Consultation Papers". Paper copies are available upon request from the CAPSA Secretariat.

CAPSA is an inter-jurisdictional association of pension regulators whose mission is to facilitate an efficient and effective pension regulatory system in Canada. For the past five years, CAPSA has been working towards the development of a Model Pension Law that would form the basis of a harmonized and simplified model pension statute. Once drafted, the model law would serve as a model for federal and provincial governments to consider when they are making amendments to their pension legislation.

As a component of CAPSA's Model Law initiative, the funding principles that have been identified are intended to form the basis for harmonized model funding rules for defined benefit pension plans. Harmonized funding rules would contribute to the reduction of compliance costs and simplify the administration of multi-jurisdictional pension plans. The proposed funding principles should not be construed as the official position of any provincial or federal government or agency.

The consultation paper highlights the objectives and considerations that CAPSA has taken into account in the development of the funding principles, outlines 15 proposed funding principles for comment, identifies 3 additional principles for further deliberation, and sets out questions to guide this deliberation.

CAPSA welcomes the comments, suggestions and ideas of pension stakeholders regarding the proposed funding principles for a model pension law. Written submissions as well as any questions arising from this consultation paper should be forwarded to:

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CAPSA recognizes that several governments and organizations in the pension community are currently examining the issue of pension funding and is encouraged by the attention that this important topic is receiving at this time. Due to its own consultations currently underway in Québec, the Régie des rentes du Québec is not participating in this consultation.

Electronic copies of submissions and questions would be preferred. We look forward to receiving your submissions by November 30, 2005. As it is the intention of CAPSA to publicly release the submissions received in this consultation process, please indicate if you do not wish your submission to be made public.

Sincerely,

Debbie Lyon	Ellen Nygaard
Chair, CAPSA	Chair, CAPSA Funding Committee

Proposed Funding Principles for a Model Pension Law

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INTRODUCTION

This paper sets out the Canadian Association of Pension Supervisory Authorities' (CAPSA) proposals for funding principles for defined benefit pension plans, to be incorporated into the overall Model Pension Law that CAPSA is developing (see Appendix for the Funding Principles included in the *Proposed Regulatory Principles for a Model Pension Law*).

To guide the development of funding rule principles, CAPSA has developed a concise statement of objectives. Because these objectives cannot be viewed in isolation, but must be seen in the context of other policy considerations relevant in the current environment in which the employment pension system in Canada operates, this paper also discusses other considerations that affect policy-making.

When CAPSA embarked on the Model Law project, we stated clearly that it was not an exercise in picking a 'lowest common denominator' among existing and potential standards, but in identifying 'best practices' in pension regulation. Although most of the principles come from existing legislation in Canadian jurisdictions, it was recognized that new ground might have to be broken if the pension environment, as it currently exists and as we foresee it developing in future, indicates the need for it. The paper concludes by setting out a number of principles that require further deliberation and discussion, as they are not part of current pension standards legislation.

Funding rules must address the interests of three categories of stakeholder:

- plan members and former members as beneficiaries of the system and often as contributors to the financing of the system;
- plan sponsors as the parties bearing responsibility for financing the pension system; and,
- the general public and the pension regulators, who represent the public interest and bear the responsibility for implementing public policy.

CAPSA has identified two primary objectives that broadly address the needs of stakeholders and a secondary objective relating to equity among plan beneficiaries in plans where funding rests wholly or partly on the shoulders of members.

Primary Objectives:

1. "*A funding requirement should provide appropriate assurance that sufficient plan assets are maintained to deliver the promised benefits in a defined benefit plan, particularly in the situation of employer bankruptcy*."

   This objective addresses the primary concern of pension regulators, because benefit security is essential if confidence and participation in the pension system are to be maintained. Of course, the underlying public policy objective is to create a stable, reliable retirement income system to enhance the independence and wellbeing of older citizens. Sponsors and members are also interested in this objective. If a pension plan is to be used by a plan sponsor as a tool for the attraction and retention of competent employees, current and prospective employees must have confidence that the benefits accrued in the pension plan are reasonably secure.

2. "*Encourage the fair allocation of responsibility for risk, and access to rewards, among plan sponsors and members.*"

   There must be clear rules regarding the responsibilities and entitlements of both plan sponsors and members. Funding rules should reflect an appropriate distribution of the responsibility and risk borne by members and sponsors. Issues such as the use of excess assets in on-going pension plans and possibility of benefit reductions in employer bankruptcy situations must be addressed. This objective addresses the underlying public policy goal of encouraging the establishment and maintenance of employment pension arrangements, since there is less incentive to maintain arrangements that are perceived to be unfair to either employers or plan members.

Secondary Objective:

"*Minimize inter-cohort and intergenerational inequity among groups of plan members.*"

Plan members will be willing to participate and will value their benefits in a defined benefit pension plan only if the members perceive that there is a fair value for their contribution or participation in the plan. If members perceive that their participation in a plan subsidizes benefits for another group, they will not regard the system as operating in their interests. This is particularly true for Negotiated Contribution Defined Benefit (single or multi-employer plans) and public sector plans. Funding rules must ensure that contributions to these types of plans do not unduly impose costs on one group of members, or members active in a plan during a particular period, and conversely, result in disproportionate gains for other groups.

Additionally, CAPSA has identified a number of other considerations that may limit or otherwise influence the extent and manner in which minimum funding rules are designed and applied to pension plans.

Other Considerations:

1. "*A minimum funding requirement should promote stability in the funded status of the plan while promoting stable contribution rates for plan sponsors*."

   In the long term, pension plans must be financially sustainable for plan sponsors and members. Year-to-year contribution rates resulting from the funding rules should be as stable and predictable as possible given the variability that will arise as a result of investment experience, interest rate changes, and other factors beyond the control of the plan sponsor. Contribution stability benefits the plan sponsor by enabling a reasonable assessment of the affordability of the benefit provided under the plan in order to properly budget the relevant costs. It is just as important to have stability in plans where contributions cannot be easily or quickly changed, such as plans established by collective agreement and employee-employer cost-shared plans. However, this concern must be balanced against the first primary objective. Rules based on that objective would deal with fluctuations in funded status by adjusting contribution levels to achieve some degree of stability in a plan's funded status.

Recognition must be given to the long-term nature of the pension plan and provisions for funding of the plan must reflect a pension plan's ability to deal with variations in the funded status over an extended timeframe. This must be achieved, however, without creating the potential for chronic underfunding of pension plans.

2. "*Maintain employment pensions as an integral part of Canada's retirement income system while recognizing the competitive pressures facing Canadian companies operating in a global environment*."

   In Canada's voluntary employment pension system, existing and potential plan sponsors will opt out if funding rules are so stringent that a plan sponsor's contribution requirement is too high. Private sector coverage by pension plans has been decreasing steadily. While diverse factors may have led to this decline, most of which do not relate to the existence of minimum funding standards, it must nonetheless be recognized that pension plan funding is a cost of doing business. It is a cost that employers have traditionally been willing to assume as an investment in attracting and maintaining a high-quality, stable workforce, but like all other costs of doing business, it must be perceived by corporate decision-makers as adding value.

3. *"Other laws, rules and policies affect pension plans and their sponsors, and may impose constraints on or otherwise affect funding rules."*

   Pension plans exist in a very complicated legal and quasi-legal environment. Other laws, rules and policies may constrain or otherwise influence the setting of minimum funding standards:
   - the federal *Income Tax Act*, which sets upper limits on pension plan funding, contributions and benefits;
   - actuarial standards of practice affect the valuation and reporting of pension liabilities and pension fund assets – funding rules have traditionally been designed with explicit recognition of and reliance on these standards;

- the standards of the accounting and auditing profession govern financial reporting on pensions, not only with respect to the pension plan as a financial entity, but more broadly in the context of corporate financial reporting;
- labour law governing collective agreements, and laws and rules governing investment instruments may also directly or indirectly affect the successful setting and application of funding standards; and,
- the Courts, through interpreting statutes and making common law, have been gradually defining the 'pension deal', thereby influencing the behaviour and choices of the parties to the deal – plan sponsors and beneficiaries.

Recognizing the stated objectives and these considerations, CAPSA is proposing the funding principles that follow and asks for comments on additional issues, with the aim to maintain a realistic and consistent funding regime for employment pension plans.

PROPOSED PRINCIPLES

Below are listed principles that CAPSA is proposing to guide the development of pension funding rules. Comments on these principles are welcomed:

1. **Employer (and Employee) current service contributions - remittance deadlines**

   Contributions covering normal costs must be remitted to the plan fund within 30 days from the end of the month for which they apply.

2. **Employer special payments for unfunded liabilities – remittance deadlines, amortization**

   Contributions covering unfunded liabilities must be remitted to the plan fund in equal monthly amounts no later than 30 days after the end of the month to which they apply. The amortization period would be up to 15 years. (Issues related to the amortization period for unfunded liabilities are addressed under 'Principles Requiring Further Deliberation'.)

3. **Employer special payments for solvency deficiencies – remittance deadlines, amortization**

   Contributions covering solvency deficiencies must be remitted to the plan fund in equal monthly amounts no later than 30 days after the end of the month to which they apply. The amortization period would be up to 5 years.

4. **Separate funding of each solvency deficiency and unfunded liability**

   Each unfunded liability and solvency deficiency must be funded separately. Each deficiency is funded with an amortization schedule beginning on the date it was established and that schedule, subject to the maximum amortization periods noted above, is maintained for the duration of the time the deficiency exists.

5. **Requirement to calculate solvency position**

   All actuarial valuations must include a solvency valuation, including valuations reporting the impact of an amendment that increases solvency liabilities. The solvency position of the plan must be stated – it is not sufficient for the actuary to opine that the solvency ratio is greater than one or that the impact of an amendment will not render the plan less than fully solvent.

6. **Application of actuarial gains**

   If a valuation reveals an actuarial gain on the going concern and/or the solvency position of a pension plan, those gains must be applied to existing unfunded liabilities or solvency deficiencies respectively, starting with the earliest established liability or deficiency, as the case may be.

Only after experience gains are realized would an actuary be permitted to advise that either the special payment levels be maintained, thereby effectively reducing the amortization period, or that the special payment be recalculated such that the original amortization period of the remaining liability or deficiency is maintained.

7. Acceleration of amortization schedule

If amortization of unfunded liabilities and solvency deficiencies is accelerated by increasing the amount of special payments, making special payments prior to their due date, or adding extra payments, subsequent special payments may be reduced as long as the outstanding balance of the unfunded liability or solvency deficiency is not, at any time, greater than it would have been under the original schedule. A revised cost certificate must be filed to support any subsequent reduction in special payments.

8. Effect of plan amendments on amortization schedules

New amortization periods, and the establishment of an unfunded liability or solvency deficiency, would commence on the effective date of the amendment that necessitated the new or revised valuation. The actuary must either update an existing actuarial valuation or file a new one.

9. Rules for specific types of plans – Negotiated Contribution Defined Benefit (NCDB) plans

Actuarial valuations for NCDB plans must demonstrate that the negotiated contribution rate is sufficient to provide for the normal cost, special payments, and (if applicable), administrative expenses of the plan.

If the valuation cannot demonstrate contribution sufficiency, the plan sponsor must provide the pension regulator with an action plan addressing the issue within 120 days of filing the valuation. Contribution insufficiency may be addressed through reduction to future accruals, reduction to ancillary benefits subject to vesting rules, increase in contributions, etc. If remedial actions fail to solve the problem, the pension regulator may, as a last resort, permit the plan to reduce accrued benefits.

10. Rules for specific types of plans – Plans for Specified Individuals (PSIs or Designated Plans)

Plans for Specified Individuals are for connected persons (owners of the plan sponsor) and/or high-income earners (earn 2.5 x Canada/Quebec Pension Plan

Year's Maximum Pensionable Earnings per year). The *Income Tax Act* (ITA) may limit the extent to which benefits provided by the PSIs may be funded.

11. Definition of solvency deficiency – rules for determining assets and liabilities

A "solvency deficiency" is the amount by which the solvency liabilities exceed solvency assets as defined below.

Solvency assets are the market value of assets (MVA) plus receivables less termination expenses, adjusted to include the actuarial present value of 5 years' worth of going concern and solvency special payments. The actuarial present value of 5 years of these special payments is an adjustment to the MVA and is not an asset of the plan.

Solvency liabilities are all liabilities accrued in respect of plan members as of the review date, based on a hypothetical termination of the plan at that date.

For reporting purposes, the plan must disclose the solvency ratio of the plan as set out below. For funding purposes, the actuary would be permitted to smooth the value of assets subject to the following:

- value of smoothed assets cannot exceed MVA by more than 10%, unless otherwise permitted by the pension regulator;
- smoothing can be based on no more than a 5 year average of the last MVAs;
- smoothing must be applied consistently over at least 10 years;
- smoothing of solvency interest rate and liabilities would not be permitted; and,
- the pension regulator would retain the right to request a solvency valuation completed without the use of smoothed assets.

12. Definition of going concern and solvency ratio

Going Concern Ratio = Going Concern Assets divided by the Going Concern Liabilities

Solvency Ratio = Market Value of Assets less termination expenses divided by Solvency Liabilities as described above.

13. Permitted use of excess assets of an ongoing plan

Plans that exhibit no solvency deficiencies or unfunded liabilities may have "excess assets". These "excess assets" (i.e.: the lower of going concern surplus and solvency surplus) may be used for benefit increases, left in the plan as reserves, used by the sponsor for a contribution holiday, or withdrawn from the plan subject to satisfying the relevant model law withdrawal rules, (yet to be finalized).

Sponsors wishing to suspend or reduce contributions (a contribution holiday) may do so if the practice is not specifically prohibited under the plan. The use of a contribution holiday is restricted: either the plan must maintain going concern and solvency funded ratios of at least 105% OR the plan must amortize the total excess assets over a five-year period.

14. Frequency of filing actuarial valuation reports

Actuarial valuations should be filed on a triennial basis, within 9 months of the date of the actuarial review of the plan.

The pension regulator may, however, require annual valuations in circumstances established by the Superintendent, to be filed within 9 months of the date of the actuarial review of the plan.

The pension regulator may also require valuations at any time at its discretion.

15. Amortization of solvency deficiency on plan termination

A pension plan that winds up with a deficit would be required to amortize the deficit within 5 years of the windup. This provision would not apply in cases of employer bankruptcy or to NCDB plans.

If a participating employer in a multi-unit (multi-employer but not NCDB) plan withdraws from the plan, that employer is responsible for the amortization of any solvency deficiencies relating to that employer’s members.

PRINCIPLES REQUIRING FURTHER DELIBERATION

Further to the principles outlined above, CAPSA would like to propose for discussion the three issues that follow. In this section we ask whether existing rules are adequate to meet the challenges of the future, and suggest some potential alternatives. Respondents are encouraged to provide comment and perspective on these issues, with particular consideration of the questions posed at the end of the section.

1. Strengthening funding rules

As a general statement, we believe that if funding rules are to move in any direction, it should be toward strengthening them and thereby improving the benefit security, as was identified as our prime objective. The following are some alternatives to consider.

a) Amortization period for unfunded liabilities

There are several factors influencing the debate regarding the appropriate amortization period for liquidating going concern unfunded liabilities (UFLs). As defined benefit pension plans mature, there is an increasing concern that the current amortization period of 15 years is too long. Initially, the use of a 15-year amortization period permitted defined benefit plans to amortize past service benefits granted at the inception of the plan in an affordable manner, and allowed benefit improvements to be made in the early years of the plan and paid for before the benefits became payable. However, as plan membership matures, there is less and less time available to fund UFLs in a plan given the declining accrual period remaining for active members.

Stronger minimum funding standards may be necessary also in view of pressures that are working against the funding of plans beyond minimum requirements. Shorter amortization periods, for example, would counter recent funding practices emerging in reaction to sponsor concerns about risk/reward imbalances: some sponsors are choosing to fund at statutory minimums due to reluctance to generate surpluses.

The issue at hand is to determine what an appropriate amortization period is for UFLs arising in increasingly mature pension plans given the objectives and other considerations set out in this paper.

b) Constraints to benefit improvements

Many plan sponsors, especially sponsors of NCDB and jointly funded public sector plans, face pressure to increase the level of benefits any time contributions to the plan increase. In under-funded pension plans, this may exacerbate the funding issue, and in extreme cases, jeopardize the plan itself.

One solution is to constrain benefit improvements unless plans meet certain requirements. For example, a plan with a funded or solvency ratio of less than 85% would not be permitted to increase benefits until the plan exceeded that ratio, unless the plan sponsor funded the benefit increase to a point where the solvency ratio is not reduced by the increase.

c) Requirement to establish a Provision for Adverse Deviation (PfAD)

A PfAD is an explicitly stated adjustment to liabilities. It is the difference between the liabilities including margins for conservatism, and the liabilities as determined using best estimate assumptions. The Canadian Institute of Actuaries has raised the concept in their current review of its standards of practice for reporting on pension plan funding.

This provision may be used in conjunction with either a solvency (or wind-up) or going-concern valuation of liabilities. It is the actuary's estimate of how much needs to be set aside to enhance the protection of benefits if the actuary's "best estimates" assumptions are not met and the plan's financial status is worse than predicted.

The CIA has suggested that the actuary and the plan sponsor would decide whether an actuarial report would include a PfAD and how that PfAD would be determined, having regard to the sponsor's funding policy. If that is eventually adopted as an actuarial standard of practice, the effect could be that some funding valuations would be filed that lacked any PfAD. In that case, minimum legislated standards for PfADs could also be introduced to ensure that at least some conservatism is always included in funding valuations filed with the pension regulator.

2. Requirement for Plan Funding Policy

Funding decisions have an immediate and significant impact on the stakeholders of a pension plan. These decisions potentially impact employer costs, the security of member benefits, and the soundness of the plan itself. Such decisions should not be made on an ad hoc basis. Decision-making should be consistent with the goals and purposes of pension plan and be related to a long-term policy. Development of a funding policy by sponsors would support decision-making processes.

Below is a list of possible topics that could be covered in a funding policy. This is not an exhaustive list, but illustrates possible elements of a funding policy:

- Benefit improvements: a funding policy might address the instances when a benefit improvement is appropriate and establish guidelines as to what impact is acceptable to the funded status of a plan as a result of improvements.

- Funding deficiencies: the policy could provide guidance on how to deal with situations when a valuation reveals a funding deficiency. The funding policy would have to reflect at least the statutory requirements, but could require accelerated funding of the deficiency beyond the statutory requirements.

- Setting of economic assumptions and costing methods to be used in valuations, and frequency of valuations.

- Use of adjustments, if any, to assets or liabilities, such as asset smoothing.

- Policy to guide the use of surplus and contribution holidays.

- Links to statements of investment policies and procedures: a funding policy should be closely linked to the Statement of Investment Policy & Procedures (SIP&P) and the plan investment strategies.

Similar to the requirement of many jurisdictions for plans to establish an SIP&P, the establishment of a funding policy could be required, without requiring that the policy be filed with the pension regulator (although the regulator could demand a copy as necessary).

3. NCDB Plans: A Case for Separate Funding Rules?

Negotiated Contribution Defined Benefit plans are unlike other employer-sponsored plans in many ways. In multi-employer NCDB plans the financial health of one employer does not necessarily impact the viability of these plans and employers are only obligated to make negotiated contributions. In the case of single-employer NCDB plans, the plan has the same risk of a business failure by the employer as a regular employer-sponsored plan, and has the added constraint on funding that is imposed by collective bargaining.

In recognition of these and other differences, a specific funding regime for this type of plan may be appropriate. The risks faced by this type of plan are different than those for single employer plans, and the challenges facing them stem from different issues than the challenges faced by the other plans.

Funding rules for NCDBs need to address these differences but should not disadvantage this type of plan. There is a need to address the special vulnerabilities of these plans, and also to recognize that voluntary termination by the plan sponsor is very unlikely.

QUESTIONS REGARDING THE PRINCIPLES FOR FURTHER DELIBERATION

The following questions have been set out to focus the discussion on the foregoing Principles for Further Deliberation. Of course, additional comments are welcome.

1. Is there a need to strengthen funding rules for defined benefit pension plans?
    a. If so, what is your view of the effectiveness of the alternatives posed?
    b. Are there other alternatives that should be considered?

2. Should a funding policy be mandatory?
    a. If so, should it be required to be filed with the pension regulator?
    b. What elements would be important?

3. Should NCDB plans have different funding rules?
    a. If so, what should the differences be?

4. Are there other distinct categories of defined benefit pension plans (eg. Public Sector Plans) that should have different rules?
    a. If so, why should these categories of plans have different funding rules?
    b. What should the differences be?

APPENDIX

The *Proposed Regulatory Principles for a Model Pension Law* consultation paper released by CAPSA in January 2004, included a high-level principle related to the funding of pension plans. The relevant section of the consultation paper is reproduced below.

Funding of Pension Plans

- The employer must make contributions to the pension fund of a pension plan sufficient to pay for all of the benefits payable under the plan, in the prescribed manner and within the prescribed period of time, and in accordance with the prescribed funding and solvency requirements.
- The employer must make contributions to the pension fund of a pension plan with a defined benefit provision in accordance with the most recent actuarial valuation report respecting the plan filed by the plan administrator with the regulatory authority.
- If the regulatory authority is of the opinion that an actuarial valuation report does not meet the prescribed requirements, the regulatory authority shall notify the administrator of the plan and direct the administrator to amend the report in order to comply with the prescribed requirements.
- The employer may take a contribution holiday in accordance with the terms of the pension plan and the prescribed requirements.
- The administrator of a pension plan shall ensure that all required contributions are paid into the pension fund within the prescribed time. Except where the administrator is a pension committee or a board of trustees of a multi-employer pension plan, the administrator will provide the *fundholder* with an annual summary of contributions within the prescribed time, which sets out the estimated amounts to be remitted, and the expected date of the remittance. Where actual contributions remitted to the fund do not match the amounts in the summary of contributions and no satisfactory explanation is provided for the variation, the fundholder is required to notify the regulatory authority of the funding deficiency within the prescribed time.