

ABOUT US

Westcoast Actuaries Inc. (WAI) is a Vancouver based independent actuarial consulting firm. WAI consults on individual pension plans for business owners and executives as well as multi-employer and single-employer pension plans for employees.

RESPONSE TO BC SOLVENCY FUNDING CONSULTATION

WAI supports the BC Ministry of Finance in seeking to identify changes to BC's *Pension Benefits Standards Act* (PBSA) that will better support long-term sustainability and benefit security of defined benefit pension programs that provide lifetime pensions to plan members and other beneficiaries.

The Solvency Funding Framework Review objectives are:

- I. Benefit Security**
- II. Contribution Predictability and Plan Sustainability**
- III. Pension Coverage**
- IV. Balancing Stakeholder Interests**

A balanced approach is required to meet the review objectives. We recognize the decline in defined benefit (DB) pension coverage in Canada is due to a risk bias against employers that discourages DB pension coverage. Pension risk has transferred to private sector employees through the use of capital accumulation plans (CAP). The fundamental risks to pension programs are:

- **Mortality Risk**
- **Equity Risk**
- **Interest Rate Risk**

In our view, employers are better able to manage these risks than their employees, especially after retirement, and there exists a public need for DB pension coverage. To encourage the long term sustainability of DB pensions there need to be legislation in place that has a long term focus. Current solvency legislation does not align well with DB funding over the long term.

Mortality Risk

A PfAD will help address this risk for long duration plans. Most plans experience the same mortality risk and so a constant PfAD may be appropriate.

DB Plans with short durations can manage mortality risk more effectively using the mark-to-market modified solvency approach.

Equity Risk

A PfAD should not be used to address equity risk. Equities are expected to be the best performing asset class over the long term. Employers that invest in equities are choosing to accept volatility in contributions over the short term because they believe it is their optimal long term pension fund investment strategy. Over the long term, there is no negative bias in a plan's funded position due to equity exposure.

Equity linked PfADs discourage equity investment. Legislation focusing on long term DB pension sustainability should not discourage investment in equities as they are expected to be the best performing asset class in the long term. However, DB plans with short liability durations are subject to funded position bias due to short term equity volatility. The mark-to-market modified solvency approach is more appropriate to fund pension plans with short liability durations. An equity linked PfAD should be avoided for the reasons described above.

Interest Rate Risk

A PfAD that reflects current interest rate conditions is appropriate for long duration DB plans. We feel the PfAD should be directly related to interest rate risk. In periods of high interest rates it would be appropriate to increase the PfAD, and in periods of low interest rates we would expect a smaller PfAD. Linking the interest rate risk PfAD to a plan's liability duration may be appropriate.

DB Plans with short durations can manage interest rate risk more effectively using the mark-to-market modified solvency approach.

APPROACHES TO LONG-TERM SUSTAINABILITY AND BENEFIT SECURITY OF DB PLANS

The Review sets out two approaches:

- I. Approach A: Modifications to Current Solvency Funding Rules**
- II. Approach B: Replace Solvency Funding Rules with Enhanced Going Concern Funding Rules**

Approach A retains the most conservative measure of market value. This approach may be appropriate for plans that are closed, exhibit short liability duration or if the plan's funding policy is to fund the plan using the most conservative measure of liabilities. Certainly this approach would provide benefit security for plans that are close to winding-up. However, such conservatism does not encourage long-term sustainability of DB pension plans. Experience has shown that employers prefer to offer DC benefits to employees over DB benefits that must be funded using conservative mark-to-market valuation methods.

Approach B using a PfAD derived from mortality and interest rate risks (but not equity risk) will reduce the cost, volatility and asymmetric risks borne by plan sponsors of DB programs with long duration liabilities. We see this approach satisfying both long-term sustainability and benefit security for DB plans that are open and have a long liability duration. This approach however, will not provide benefit security for short duration or closed plans described above.

RECOMMENDATION

We feel that both approaches, modified solvency and enhanced going concern, should be in the legislation.

1. For DB plans that have long liability durations it would be appropriate to apply enhanced going concern with a PfAD based on mortality and interest rate risk (but not on equity holdings). PfADs should be reviewed periodically and updated as necessary.
2. For DB plans that have short liability durations it would be appropriate to apply the modified solvency funding rules described in Approach A.
3. A further improvement to the legislation would allow plans with long durations the option to fund according to the modified solvency rules. Certain long duration plans may elect to fund on a modified solvency basis if they have short term funding objectives.

RESPONSES TO QUESTIONS FOR COMMENT

Approach A: Modifications to Current Solvency Funding Rules

1. **Do you agree or disagree with the approach of maintaining current solvency funding requirements with one or more of the above modifications?**
Yes, but only for plans with short duration liabilities.
2. **Would an option or a combination of options under this approach effectively balance the interests of the primary stakeholder groups listed on page 7? Why or why not?**
Funding short duration plans using a modified solvency approach with a combination of consolidation of deficiencies and a 10 year amortization (options 1 & 2) would be an adequate balance.
3. **With regard to Option 3, should smoothed asset values be allowed for solvency valuations? If so, what should be the maximum period over which recognition of investment-related gains or losses may be deferred?**
No.
4. **With regard to Option 4, should the use of an average interest rate be allowed for solvency valuations? If so, what should be the maximum averaging period?**
No.

5. **With regard to Option 5, should solvency funding requirements be reduced to a level less than 100 per cent? If so, what would be an appropriate level?**

No.

Approach B: Replace Solvency Funding Rules with Enhanced Going Concern Funding Rules

1. **What are the advantages and disadvantages of eliminating solvency funding requirements in favour of enhanced going concern funding requirements?**

Permitting plans with long duration liabilities to fund using enhanced going concern will reduce the cost, volatility and asymmetric risks borne by plan sponsors of DB programs. This approach however, will not provide benefit security for short duration or closed plans.

2. **Which combination of the options described under this approach would best balance benefit security and contribution volatility?**

Option 2 - PfAD

3. **With regard to Option 2, if a PfAD were required, what factor or factors should be used to determine the PfAD? For example, should they be linked to the plan's investment policy or the level of plan maturity?**

A PfAD derived from mortality and interest rate risks (but not equity risk).

4. **Are there other measures to enhance going concern requirements that should be considered in the absence of solvency funding requirements?**

Enhanced going concern should be available only to DB Plans that have long liability durations.

Modifying Commuted Value Transfer Rules

1. **Would the modification to the commuted value rules described above be appropriate? If so, what increase in interest rates should be used to calculate the commuted values?**

An adjustment to the calculation of commuted values would be appropriate for long duration plans that are funded using enhanced going concern. We do not believe an adjustment for the spread between the commuted value rates and enhanced going concern discount rate is the best solution.

2. **Are there other, more appropriate, methods that could be applied to modify the commuted value calculation?**

Members who elect to leave a long duration plan should receive the commuted value times the most recently determined transfer ratio (the approach used in Quebec).

3. **What other measures, if any, could be considered that would complement Approach A or Approach B or both approaches?**

Members who elect to leave plans of any duration could receive the commuted value times the most recently determined transfer ratio. Members can elect a deferred pension and retain the option to take a commuted value prior to retirement if their position becomes more favourable.