Financial and
Consumer
Affairs Authority

The Pension Benefits Act, 1992

A Review of the Pension Funding Framework

For Single Employer Defined Benefit Plans

In the Private Sector

And Other Complementary Reform Measures Applicable to All Defined Benefit Plans

Consultation Paper

March 23, 2021

Table of Contents

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Introduction

Occupational pension plans are a key component of Canada's retirement income system. They serve to supplement the retirement income provided by universal government benefits and Canada Pension Plan. They help to provide income stability to retirees, and assist employers in the attraction and retention of workers.

Starting in about 2008, following the global recession, sponsors of defined benefit plans have faced significant funding pressures primarily due to persistently low long-term Government of Canada interest rates. Those rates are a significant determinant of the cost of defined benefit plans, as they are used to determine solvency liabilities. As those rates have declined, liabilities have increased faster than assets, resulting in increased costs to fund solvency deficits.

COVID-19 has brought another shock to defined benefit plans with further decreases to interest rates and uncertain equity markets. These factors bring additional uncertainty to funding requirements.

Funding pressures have led to some employers winding up their plans, or switching to less costly options, such as defined contribution plans. Due to the nature of defined contribution plans, they typically do not offer the same level of retirement income security as does a defined benefit plan.

To ease the funding burden and contribution volatility resulting from low interest rates, the Government of Saskatchewan amended *The Pension Benefits Regulations, 1993* (the Regulations) in 2009 to provide temporary solvency funding relief to all defined benefit plans who chose to elect it. In recognition of continued low interest rates, following the expiration of that initial temporary relief, the Government introduced further relief: permanent relief for public sector and publicly funded plans in 2013, temporary relief for limited liability plans in 2015, and then permanent relief for limited liability plans in 2017. Currently, only single employer private sector pension plans (SEPPP) must make contributions towards solvency deficiencies.

There are 36 SEPPPs[1] registered under *The Pension Benefits Act, 1992* (the Act).

In recognition that low interest rates persist and equity markets have experienced repeated shocks, the Financial and Consumer Affairs Authority (FCAA) is reviewing the current rules regarding the funding of solvency deficits for SEPPPs. As a reduction to the amount of solvency funding in a plan would increase risk to benefit security, the FCAA is also reviewing the addition of measures which would mitigate the risk to benefit security such as prescribed requirements for provisions for adverse deviations (PfAD) and restrictions on an employer's ability to take contribution holidays.

[1] This does not include pension plans that qualify as a designated pension plan under the *Income Tax Act*. Under the rules of the *Income Tax Act*, designated pension plans are not allowed to fund solvency deficiencies.

In addition to reviewing the degree to which solvency deficits must be amortized for SEPPPs, FCAA is reviewing other methods of providing funding relief to these plans: solvency reserve accounts and letters of credit.

Based on the feedback received, FCAA will consider making recommendations to the Government regarding amending the Act and the Regulations to change the solvency funding framework for SEPPPs.

The purpose of this paper is to seek feedback from all interested parties on whether to revise the solvency funding framework for SEPPPs, and if it is revised, how to structure the framework to better support the long-term sustainability and benefit security offered by those plans. A range of options will be identified in this paper.

This paper is also intended to seek feedback on two potential amendments which would affect all defined benefit plans registered under the Act: restrictions on contribution holidays and providing a discharge of liability on buyout annuity purchases.

Saskatchewan is not alone in examining the solvency funding rules. Several other Canadian jurisdictions have established or are pursuing solutions. In Quebec, effective January 1, 2016, solvency funding requirements were replaced with enhanced going concern requirements. Since then, Ontario, British Columbia, Manitoba, Nova Scotia and New Brunswick have either made or announced changes to their pension standards legislation so that solvency deficiencies need only be funded to ensure plans are 85% funded on a solvency basis, as opposed to the previous 100%. The federal government has announced that it is reviewing the funding rules in the federal pension standards legislation, and Alberta has issued a questionnaire regarding its funding rules.

Changes made to the solvency funding framework could require amendments to both the Act and the Regulations. It is likely that changes to contribution holidays and the addition of a discharge of liability on buyout annuity purchase would require Act amendments. As changes to the Act typically take more time to come into force than changes to the Regulations, it is possible that changes to the Regulations with respect to certain rules could precede changes to the Act.

How to Participate

There are questions posed throughout the paper. However, any feedback is welcome.

Feedback on this paper can be submitted to pensions@gov.sk.ca with the subject line “Solvency Funding Review”.

Submissions must be received by June 11**,** 2021.

The Financial and Consumer Affairs Authority of Saskatchewan may make public some or all of the submissions received, including personal information, the name of the organization associated with a particular submission, and the name of any individual submitting on behalf of the organization. By providing a submission, you are consenting to us publishing it in full without any redaction, except if you request that it or any portion of it be kept confidential. Submissions received through this consultation are subject to *The Freedom of Information and Protection of Privacy Act* (the FOIP Act). As such, all submissions may be subject to disclosure when a person makes an access to information request under the FOIP Act.

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Current Environment for SEPPPs

At the end of 2019, there were 36 SEPPPs[2] registered under the Act. These plans have 17,938 members (total of active, deferred and retired members).

The solvency ratio of a pension plan is determined by dividing the assets of the pension plan fund by the liabilities as measured on a plan termination basis. The solvency ratio indicates whether or not a pension plan would have enough money to cover plan members' accrued benefits if the plan were to terminate at the date of the most recently filed actuarial valuation report. An actuarial valuation report for a defined benefit plan must be filed at least every three years. One purpose of the actuarial valuation report is to determine the solvency ratio of the plan. If a SEPPP has a solvency ratio of less than 1.00, then payments must be made over no longer than a five-year period to pay off the deficit.

As of the last filed actuarial valuation reports, two of the SEPPPs had a solvency ratio less than 0.85, 16 had a solvency ratio between 0.85 and 0.99, and 18 had a solvency ratio of 1.00 or greater. The average solvency ratio for all of the SEPPPs is 1.03. The total amount of solvency deficit that is currently being funded by the 18 plans with a solvency ratio less than 1.0 is $68 million.

The combined total annual required payments towards the $68 million solvency deficit was $30 million in 2020. The annual payment of $30 million includes payments towards solvency deficiencies that may have been established in a prior valuation.

Several SEPPPs have been terminated by the plan sponsor over the past decade. There are many factors that have contributed to these terminations: the 2008 recession, prolonged low interest rates, volatile asset returns, increased longevity and maturing plans. As a result of all of these pressures, solvency funding has come under increased scrutiny. Several jurisdictions in Canada have changed or have announced changes to their solvency funding rules. The most common method of providing relief is to reduce the solvency funding requirement from 100% to 85%. Each jurisdiction which has made changes to the solvency funding requirement has made other changes which are intended to mitigate the risk to plan members of decreasing the amount of solvency funding.

[2] This does not include pension plans that qualify as a designated pension plan under the *Income Tax Act*. Under the rules of the *Income Tax Act*, designated pension plans are not allowed to fund solvency deficiencies.

Current Funding Requirements for SEPPPs

The Act sets out the minimum funding requirements for pension plans registered in Saskatchewan. These requirements are intended to ensure that plans have adequate assets to meet the pension promise on an ongoing basis and to protect benefits that have accrued if a plan should terminate.

The Act requires employers to remit contributions to a defined benefit plan on the basis of an actuarial valuation report prepared by the plan's actuary. The Act requires the actuary to prepare both a going concern valuation and a solvency valuation.

Going concern valuations are based on the plan continuing, are longer term in focus, and may use techniques that smooth losses. Actuarial standards provide actuaries with discretion in determining the assumptions to use in the going concern valuation. The actuary, in consultation with the plan administrator, will select best estimate assumptions based on the plan's past experience, adjusted to reflect the actuary's judgement about what will happen in the future. The interest rate assumption, which is the most important assumption in a valuation, is usually based on the assumed long-term average rate of return of the pension fund. The Act requires that any going concern deficiency for a SEPPP must be amortized over no more than a 15-year period.

Solvency valuations use assumptions consistent with the plan being terminated, and are based on current financial market conditions. As the solvency valuation is intended to be an objective assessment of the ability of the plan to meet all of its obligations at a specific point in time, the actuary has very little discretion in determining the assumptions for the solvency valuation. The interest rate assumption is prescribed by the Canadian Institute of Actuaries, and is based on long-term bond yields. The Act requires that any solvency deficiency for a SEPPP must be amortized over no more than a five-year period.

Pros of Solvency Funding

Solvency funding rules are intended to provide a high degree of financial security for members who participate in a defined benefit pension plan, and for former members who will receive or are receiving a pension from a plan. While solvency funding does not guarantee that a plan will be fully funded if the employer chooses to terminate the plan or becomes insolvent, it does ensure that more money is contributed to the fund while a plan is in a solvency deficit than if solvency funding were not required. The impact on plan members, including retired members, could be significant if a plan in an underfunded position is to terminate.

If an employer chooses to terminate a pension plan while it is not fully funded on a solvency basis, the Act does require that certain amounts be contributed to the plan, but this will not necessarily result in accrued benefits being fully funded.[3] This makes solvency funding of particular importance, and this paper will propose specific rules which will mitigate the risk of this outcome. In other Canadian jurisdictions, an employer who chooses to terminate their pension plan must fully fund the benefits. Note, however, that even if the Act were to require full funding of benefits on plan termination, this full funding may not occur if there is an employer bankruptcy.

[3] Although the rules in the Act do not necessarily result in benefits being fully funded, the terms of the plan may require full funding of benefits on plan termination.

Cons of Solvency Funding

Contribution Volatility

Solvency funding can result in volatile contribution requirements because solvency valuations are based on long-term interest rates that change independent of equity returns. Unpredictable contribution amounts make it difficult for employers to prepare their budgets, which is a disincentive from them maintaining defined benefit plans. Employees would also be affected by the volatile nature of solvency funding, if the terms of their plan require plan members to contribute to funding a solvency deficit.

Procyclical Contribution Requirements

An environment of low interest rates and poor investment returns will typically result in higher solvency deficiencies. During that environment, businesses are more likely to suffer from depressed economic activity and have reduced cash flow.

High Cost of Benefit Security

Solvency funding is based on the premise that a pension plan will terminate at the date of an actuarial valuation report, which is required at least every three years. However, defined benefit plans are established for the long-term and typically have lifespans of several decades. Employers question why plans must be funded as if the plan will be terminating, as large pension contributions divert capital that could otherwise be used for business operations.

Surplus Issues

Large amounts of solvency funding can lead to surpluses in later years when the economic environment changes. This could motivate employers to terminate their plan or make no more than the minimum required contributions.

Objectives of the Review

Adequate Benefit Security

The funding requirements of the Act exist so that people who have accrued benefits while working have a level of benefit security. A benefit is fully secure if the pension fund has sufficient assets to ensure that benefits will be paid, both on an ongoing basis and if the plan should terminate.

Plans That Are Affordable and Sustainable

A pension plan is sustainable if, over the long term, it has enough assets to meet its benefit obligations as they come due. A funding framework should be designed to make contributions affordable. If contributions are affordable, there is a greater likelihood that an employer will maintain the plan over the long term.

Stable Contribution Rates

Any changes that are made to the funding rules should decrease contribution volatility.

Balanced Stakeholder Interests

Stakeholders have competing interests: Employers are interested in reducing the cost of the plan, plan members and unions are concerned with the plan's ability to provide the promised benefits, and retirees and deferred members are focused on having a financially strong and viable plan which will provide pensions that maintain their purchasing power. Any changes to the funding framework must provide an appropriate balance between these competing interests.

Transparent Rules

Plan sponsors should be able to understand their obligations, and plan beneficiaries should be able to understand the financial state of their pension plan.

Pension Coverage

Workplace pension plans are an important source of retirement income, and they contribute to the economic and social well-being of Saskatchewan. Furthermore, defined benefit plans typically provide a higher degree of retirement security than do other types of pension plans. The options presented in the paper recognize that maintaining pension coverage through voluntary plans requires consideration of the competing objectives of benefit security and plan affordability.

Options for Reform

There are different ways to approach changing the solvency funding rules. In this section, two main approaches to changing the solvency funding requirements are identified: (1) change the way in which solvency deficiencies are funded; or (2) eliminate solvency funding, or require partial solvency funding, and enhance going concern funding. Following these two main approaches, we will propose some additional changes which could be made regardless of which of the two main approaches are implemented.

Two Main Approaches

1. Change the Way in Which Solvency Deficiencies Are Funded

Under this approach, the method of funding solvency deficiencies would change, while the current rules for funding a going concern deficit would remain the same. Going concern deficiencies must currently be funded over 15 years, and a new amortization schedule must be established for each deficiency. The following are options, which are not mutually exclusive, to change the method of funding solvency deficiencies.

i. Lengthen the Amortization Period for Funding Solvency Deficiencies

The Act currently requires that solvency deficiencies be amortized over five years. This period of time could be lengthened to a longer period. Lengthening the amortization period would decrease the solvency payments and reduce contribution volatility.

ii. Re-Amortization of Solvency Deficiencies

Currently the Act requires that, if a solvency deficiency is established in a filed actuarial valuation report, a five-year schedule of payments is established to amortize that deficiency. If a subsequently filed actuarial valuation report reveals a solvency deficiency, then another five-year schedule is established. The rules could be changed so that, rather than having different schedules of solvency payments, the solvency deficiencies are consolidated and re-amortized at each valuation. This change could decrease the solvency payments and reduce contribution volatility.

iii. Solvency Reserve Accounts (SRA)

All contributions to a defined benefit plan, including solvency payments, are held in the same fund. Solvency funding protects against the short-term risk of an underfunded plan winding up, usually because an employer becomes insolvent. A SRA would address employers' concerns over large surpluses, referred to as "trapped capital", which can result from high solvency contribution requirements. SRA's would balance stakeholder interests by addressing employers' concerns while maintaining the benefit security provided by solvency funding. A SRA would be a separate account within a pension fund which is established to hold payments made in respect of solvency deficiencies. It would not be mandatory for a plan to have a SRA. The rules could be structured such that, if solvency payments made into that account are no longer needed because of favourable plan experience, the sponsor could withdraw some of the payments. However, before withdrawals could be made, a sufficient level of solvency surplus would be needed to mitigate the effect of future experience losses. Alternatively, the rules could be structured such that solvency payments to the SRA can only be withdrawn if the plan terminates in a surplus position. Consent of the Superintendent could be required before a withdrawal is allowed.

iv. Letters of Credit (LOC)

A LOC is a promise from a financial institution to pay the pension fund an agreed sum of money towards a solvency deficit in certain circumstances, most notably when there is a deficit on plan wind up. The LOC would be used to cover solvency payments for up to a certain percentage or for the full amount of solvency liabilities. Similar to SRAs, LOCs balance the interests of plan sponsors by addressing the large payment requirements, and of plan beneficiaries by addressing benefit security. LOCs may impact minimum funding requirements on accounting disclosures for those sponsors who prepare financial statements in accordance with international accounting standards.

Discussion Questions – Change the Way in Which Solvency Deficiencies Are Funded

1. If the solution is to modify solvency funding, which of the above options or combination of options do you feel provides the right balance between benefit security and affordability?
2. Are there other methods of modifying solvency funding which you feel should be considered?
3. If the period of time for funding solvency deficiencies is lengthened, what is the appropriate new time period?
4. If SRAs are allowed, under what circumstances should the employer be allowed to withdraw payments that have been made into the account?
5. If LOCs are allowed, should the amount be limited to a certain percentage of liabilities?

2. Partial Solvency Funding or No Solvency Funding, with Enhanced Going Concern Funding

Currently, a solvency deficiency must be fully amortized over five years. Rather than requiring amortization of the full deficit, the rules could be changed so that only the portion of the deficit above a certain threshold needs to be funded. Any solvency payments which are required would be amortized over five years. For example, in some jurisdictions, if a plan is funded at or above 85% on a solvency basis, no solvency deficiency payments are required. Alternatively, solvency funding could be eliminated completely. Partial solvency funding or no solvency funding would decrease the cost of the pension plan in the current economic environment, in some cases significantly so.

Under this approach, solvency funding would be reduced or eliminated but going concern funding would be enhanced. As going concern funding does not represent the true cost required to pay the promised benefits to plan beneficiaries at a given time, it is important to enhance going concern funding if solvency funding is reduced or eliminated. The solvency deficiency would continue to be determined, as it provides information about benefit security, and could continue to be used in determining how much to hold back from commuted value payments when plan members terminate membership and transfer their money out of the plan.

If a solvency deficit does not have to be fully funded, or does not have to be funded at all, then going concern funding could be enhanced by the addition of a PfAD. A PfAD is not a replacement for or equivalent to solvency funding, but does help to reduce the risk of a plan being underfunded upon wind up.

A PfAD is a buffer, in excess of a plan's going concern liabilities, which is added to a going concern valuation. A PfAD would be expressed as a percentage of a plan's going concern liabilities, and could also be required on current service cost payments. A minimum level of PfAD could be required in every SEPPP. A PfAD can increase benefit security by increasing the assets accumulated in a pension plan, thereby mitigating the risk of benefit reductions on plan wind up. PfADs can also protect against the risk of experience losses and benefit improvements.

The PfAD could be calculated on both the going concern liabilities and on the current service cost. There could be a threshold above which a PfAD on the current service cost is not required to be funded. For example, if a plan is more than 105% funded with a PfAD on a going concern basis, contributions to PfAD on the current service cost would not be required; rather, that PfAD would be funded from surplus. The level of funded PfAD could have a bearing on whether the plan can take certain actions, such as benefit improvements.

There are different types of risk which could be addressed through a PfAD: risk to the funded position of the plan (due to level of variable income securities in asset mix, changes in interest rates, or aggressive discount rates), or risk of contribution volatility.

There are different methods of designing PfAD requirements to address those risks. For example, one or a combination of the following methods could be used:

1. The PfAD could be tied to the plan's asset mix.
2. The plan's discount rate assumption could be compared to a benchmark.
3. The PfAD could be based on the plan's asset/liability mismatch.
4. The level of PfAD could be tied to the long-term bond rate.

It is noted that there is a wide range of PfAD models which have been introduced in other Canadian jurisdictions. FCAA is interested in receiving feedback on the main risk(s) which should be mitigated by a PfAD, and a practical model which would best address that risk.

Another way to enhance benefit security if solvency funding is reduced or eliminated is to require that going concern deficiencies be amortized over a shorter period of time. Currently, going concern deficiencies must be funded over no more than 15 years.

Discussion Questions – Partial Solvency Funding or No Solvency Funding

1. If the current solvency funding threshold of 100% is reduced to require only partial solvency funding, is a threshold of 85% appropriate?
2. What is the main risk(s) that a PfAD should mitigate?
3. What do you feel is the best method of determining the level of PfAD?
4. Should the method of determining PfAD be different if there is no solvency funding required than if there is a certain level of solvency funding required?
5. Should the PfAD have to be funded on current service contributions, even if the plan is in a going concern surplus?
6. If the period of time for amortizing going concern deficiencies is shortened, what is the appropriate period?
7. Are there other methods of enhancing going concern funding which should be considered?
8. Are there any other features to the funding rules which should be considered, such as consolidation of unfunded liabilities?
9. Are there any options from the previous section (**Change the Way in Which Solvency Deficiencies Are Funded**) which should be incorporated if only partial solvency funding is required, or if it is eliminated completely? In particular, would solvency reserve accounts and letters of credit be useful mechanisms if a solvency deficiency has to be funded only to a certain level?

Additional Change Applicable to SEPPPs

Full funding on plan termination

For plans registered in Saskatchewan, there is a higher risk (as compared to plans registered in other jurisdictions) that plan beneficiaries will not receive the full value of their pension if the plan sponsor chooses to terminate their pension plan. This is because, although the Act does require that certain amounts be contributed to a plan upon plan termination, those contributions will not necessarily be enough to result in accrued benefits being fully funded.[4] In other jurisdictions, for plans that are similar in nature to our SEPPPs, legislation requires that contributions have to be made to plans to ensure that beneficiaries receive the full value of their accrued benefits when a plan is terminated.

Solvency funding is usually seen as the best way to bring a high level of certainty to plan members that there will be enough money in the plan to fully cover benefits when a plan is terminated. However, solvency funding is not a perfect solution because the true cost of the benefits provided by a pension plan can only be determined when a plan is terminated.

Although solvency funding may be the best way to achieve benefit security, it does come with a high cost. This consultation is intended to seek feedback on methods of reducing cost, while achieving the right balance of stakeholder interests.

With the removal or reduction of solvency funding, less money will generally be contributed to plans over the lifespan of the pension plan. This is not always the case, as there will be periods of time when plans will not have a solvency deficiency. To counteract the risk that is placed on the financial position of plans with an easing of the solvency funding requirements, this paper earlier discussed PfAD requirements and other means of adding benefit security.

There is another means of adding benefit security which we would like to hear from you about. Given the heightened risk in Saskatchewan of benefit reductions upon plan termination, we are interested in hearing from you about structuring changes to the funding framework so that solvency funding relief would be by election. If a plan administrator elects to fund under the new framework, they would then have to fully fund all accrued benefits if the plan is terminated. This would be similar to a prior amendment to the Regulations. In 2009, the Regulations were amended to allow plan administrators to elect temporary relief from making solvency deficiency payments. A condition was added such that, if temporary relief was elected and the plan was terminated during the relief period, then any deficiency identified in the termination report would have to be funded either in one lump sum or over a period not exceeding five years. If a plan is wound up as a result of employer insolvency, then the rules of the *Bankruptcy and Insolvency Act* would apply.

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[4] Although the rules in the Act do not necessarily result in benefits being fully funded, the terms of the plan may require full funding of benefits on plan termination

The full funding condition could be a requirement only if the new funding regime involves an elimination of solvency funding, or a rule that a plan has to be funded only to a certain level. If the new funding regime consists only of more conservative relief such as re-amortization of solvency deficiencies, then the change may not be enough to warrant a full funding requirement.

Discussion Questions – Full Funding on Plan Termination

1. Assuming the solvency funding framework is changed, are there any types of SEPPPs for which an employer should not have to fully fund a deficit if the plan is voluntarily terminated? For example, if members are required to contribute towards a solvency deficit, the framework could be structured so that only a portion of the deficit has to be funded by the employer if the plan is wound up.
2. Are there any options presented in “Two Main Approaches” which should not require the full funding condition, if the Regulations are amended to include only that option? For example, if the only change made to the Act or Regulations is to allow a longer period of time for amortizing a solvency deficiency, should full funding on plan termination still be a condition for electing the option?

Additional Changes Applicable to All Defined Benefit Plans

1. Restrictions on Contribution Holidays

Currently contribution holidays are allowed if a plan has surplus assets, as long as three conditions are met: (1) the plan permits the use of surplus assets; (2) the employer's intention to take a contribution holiday is disclosed to members and former members in a prescribed manner; and (3) the Superintendent has approved it. To determine if a plan can take a contribution holiday, surplus assets must be considered on both a going concern and a solvency basis. A contribution holiday cannot take either the going concern funded ratio or the solvency ratio below 100%.

Any solvency funding relief warrants a review of the rules respecting contribution holidays. In addition to the existing conditions, the following conditions, which are not mutually exclusive, should be considered:

- A plan would have to be funded above 100% (for example, 105%) on a solvency basis before a contribution holiday could be taken.
- A plan would have to be funded above 100% (for example, 105%) on a going concern basis before a contribution holiday could be taken.
- A margin above the required PfAD could be required before a contribution holiday could be taken.

Discussion Questions – Restrictions on Contribution Holidays

1. Should contribution holidays be restricted further than they are currently? If so, which method best protects member benefits?
2. If a plan is required to be funded at a higher level than 100% on a solvency basis and/or a going concern basis before taking a contribution holiday, what is the appropriate level?
3. Should the ability to take a contribution holiday be determined on an annual basis, whereby a cost certificate would have to be filed each year to determine whether the plan remains in a surplus position?

2. Annuity Discharge

A statutory discharge of liability could be provided for plans that purchase annuities from an insurance company to buy out pension obligations. A number of conditions could be required, including:

- Benefits provided under the annuity must be equivalent to those provided under the plan.
- If the plan is wound up within a certain number of years after a buyout, any former member's entitlement to surplus will remain for those who were affected by the buyout.
- The buyout cannot adversely impact the funded position of the plan.

- Affected retirees and deferred members must be given notice prior to the purchase of the annuities or prior to the discharge taking effect.

Discussion Questions – Annuity Discharge

1. If annuity discharge provisions are added to the Act, what are the appropriate conditions that a plan should have to meet in order to be eligible to qualify?