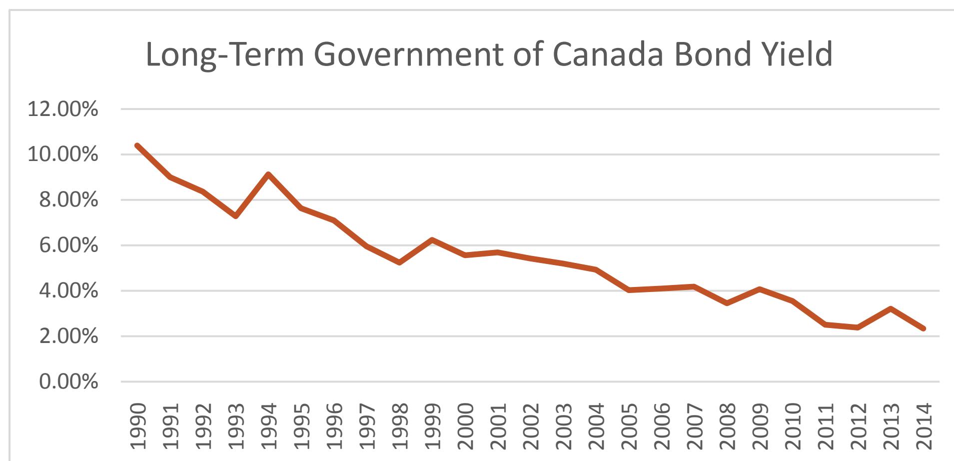
# New Funding Rules for Target Benefit Plans: Hits and Misses

Trustees of multiemployer pension plans (MEPPs) have waited a long time for new pension funding rules. The new B.C. *Pension Benefits Standards Regulation*, released in May, puts the 2012 B.C. *Pension Benefits Standards Act* rules into effect, has some good points and some bad points.

## Some History

B.C.'s current funding rules have applied since January 1, 1993 when B.C. implemented its first pension standards legislation. The funding rules include the infamous solvency test which has required many MEPPs to reduce benefits. As is well known, the root of the solvency problem is the requirement to calculate liabilities using a discount rate based on long-term bonds. As the following graph shows, long-term interest rates have declined consistently since 1990, raising solvency liabilities. The problem became dire with actuarial valuations in 2002 and 2003, following the bursting of the tech bubble in 2002, when lower asset values and higher solvency liabilities caused many pension plans to have to reduce benefits.




In 2007, the B.C. and Alberta governments established the Joint Expert Panel on Pension Standards (JEPPS) composed of pension experts to review the pension system. The panel invited submissions, which led to their fine report in 2008, *Getting Our Acts Together*[1].

Amongst the panel's recommendations was to specifically recognize the pension plan design used by many industry trades as Target Benefit Plans (TBPs). These plans provide benefits at a level recommended by their actuary that could be afforded by the negotiated contributions made to the plan. Benefits could be increased if the plan experience was favourable, and reduced to the level that was supportable by the plan assets if the plan experience was unfavourable.

[1] http://www.fin.gov.bc.ca/tbs/tp/JEPPS_Final_Report_Dec1-08.pdf

Importantly, the JEPPS panel advocated a "principles-based" approach to regulation of these plans rather than a "rules-based" approach so that, in theory, the Trustees of TBPs could develop their own rules, setting out when to increase or decrease benefits.

The JEPPS report led to a re-write of the legislation. The re-write was extensive; both provinces introduced legislation in 2012, but the legislation wasn't effective until new regulations were put in place - Alberta in 2014 and B.C. in 2015.

## The New Rules in Action

All sets of funding rules (going concern, solvency, solvency-relief, TBP) describe the circumstances that may allow or require action:

I. When past benefits must be reduced
II. When past benefits may be increased
III. When future benefits must be reduced
IV. When future benefits may be increased

There is some good news with the new TBP rules: in situation I (when past benefits must be reduced), benefits will have to be reduced only if the assets[2] are less than the going concern liabilities and the contributions are insufficient to pay off the deficit. Because going concern liabilities are much lower than solvency liabilities (how much being dependent on a number of plan-specific factors), the requirement to reduce benefits will not be as stringent as with the solvency rules.

The rules applicable in situation II (when past benefits may be increased) are disappointing. The new regulations introduced a concept called a Provision for Adverse Deviation (PfAD), which is "actuarial-speak" for extra assets that are required to protect the plan's benefits against future poor experience. The calculation is complex – plans that have as much as 60% equities could expect a PfAD of as much as 25% of the liabilities. For a plan to improve benefits, a plan must have sufficient assets to fund the plan's going concern liabilities plus the PfAD, plus the **entire** cost of any improvements plus the PfAD on the benefit improvement[3]. So if the PfAD is 25%, then the plan must have assets of at least 125% of the liabilities **including** the cost of the benefit improvement.

Perhaps the most negative consequence of the new rules arises in situation III (when future benefits must be reduced). Contributions must be sufficient to fund the cost of current service plus the PfAD on the cost of current service. If the PfAD is as high as 25%, the contribution rate must be at least 125% of the current service cost. There is some short-term relief – the requirement will be phased in over three years, but then it may become a problem for some plans. Under the old rules, a plan with a substantial going concern surplus could use the surplus to fund any deficiency between the cost of its current

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[2] In this context, "assets" includes excess contributions over the cost of benefits for the following 10 years
[3] The actual calculation is a bit more complex: current service and past service are combined in the calculation. To the extent that past service liabilities are much larger than current service liabilities (the usual case), this description is approximately accurate.

service benefits and incoming contributions; under the new rules, a plan with a funded ratio even as high as 200% would not be able to use any of that excess to fund the contribution shortfall.

Situation IV (when future benefits may be increased), will be more challenging in the future than it was in the past. Future benefits could potentially be increased independently of the funded position of past service benefits, but there will still be the requirement for a PfAD, again as much as 25% on the current service cost, including the cost of the benefit improvement.

## The Flaws

There are a number of criticisms of the new rules. Perhaps the most significant one is that instead of the recommended principles-based approach recommended by the JEPPS expert panel, the regulations include prescribed rules, some of which are flawed.

The most problematic new rule is the requirement that contributions must be sufficient to fund the current service cost plus PfAD. The apparent rationale for this rule is the belief that to maintain equity between different groups of members over time, contributions each and every year must be sufficient to fund the benefits earned in that year. Historically many pension plans generated surpluses, so the Trustees were able to apply a portion of the surplus to fund any contribution shortfall. And why not? Presumably the designers of the new funding rules argue that members with accrued benefits (including retirees) own the surplus, and shouldn't be required to subsidize the cost of future service. But the counterargument is that a central objective of a TBP is to provide a sustainable benefit over time and over generations by spreading risks. Indeed, there are many risks in a TBP that can be spread – and it should be the Trustees' decision as to how to share or spread the risk. This flaw in the new regulations could easily be remedied by allowing Trustees to apply any surplus, in accordance with their funding policy, to the cost of future benefits.

A second criticism is the size and volatility of the PfAD. The PfAD is based on two components – an asset mix component and an interest rate-related component[4]. For funds with large equity components, the PfAD will be at least 15%. The PfAD will also be very volatile depending on the particular asset mix for the plan and the actuary's discount rate assumption – our research has found that the PfAD could easily range between 15% and 30% over a period as short as 12-24 months.

The logic in requiring a PfAD is that a pension fund should hold sufficient assets to support the plan's benefits, and surplus (in the form of a PfAD) is needed to protect existing benefits in case future plan experience is poor. But a very large PfAD arbitrarily sequesters surplus that cannot be used for benefit improvements – it was the same problem with the solvency rules. Furthermore, the sensitivity of the actuarial valuation results and benefit levels to long-term bond yields on the valuation date is the solvency problem all over again. A more sensible approach is to simply pick a reasonable PfAD percentage, based on advice from the actuary using projections and models, that will protect most of the plan's benefits most of the time, and stick with it.

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[4] Details of the calculation of the PfAD can be found on page 3 of FICOM's Bulletin PENS 15-003 and in the *Regulation* itself http://www.fic.gov.bc.ca/pdf/Pensions/bulletins/PENS-15-003.pdf

## A Missed Opportunity

There was much hope when the JEPPS review was announced in 2007. The JEPPS panel prepared an excellent report. The new TBP funding rules reflect some of their recommendations, but not all. Time will tell as to whether these new rules accomplish the expected goals of the JEPPS review.