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Rethinking plan design & funding: pension innovation in Canada

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Pension plan design possibilities are evolving in various jurisdictions across the country. This is happening at a time when many plan sponsors have been considering pension risk management and recognizing plan design as a key risk management tool.

Over the past several years, single-employer defined benefit (DB) plans have become increasingly unpopular among private sector employers as their sponsors respond to funding, investment, longevity and other risks associated with the traditional DB model. In view of these risks, legislatures across Canada have made some changes to facilitate pension design changes and innovation. This article will summarize some of these recent legislative changes.

Changes around funding

Alberta and British Columbia introduced Solvency Reserve Account (SRA) rules. SRAs are designed to help address plan sponsor concerns around "trapped capital" acting as a disincentive to maintaining DB plans. SRAs hold solvency deficiency payments made under the DB component of a pension plan, and are designed to remove the disincentive to fully fund plans by making it easier for plan sponsors to withdraw excess funds (surplus) in the SRA. In particular, certain excess assets may be withdrawn, subject to approval by the superintendent and compliance with the regulatory regime. The enhanced flexibility fostered by SRAs should prove beneficial to both plan sponsors and members.

In Québec significant changes to the funding rules for DB pension plans came into effect January 1, 2016 with the passage of Bill 57, *An Act to amend the Supplemental Pension Plans Act*. The most significant feature of Québec's overhaul is the elimination of the solvency funding requirement, which will be replaced by a stabilization provision. A stabilization provision is a reserve account funded by actuarial gains, additional current service contributions and special amortization payments. The target level will be prescribed by regulation, based upon the level of investment risk posed by the asset mix in the plan's investment policy. While stabilization contributions may increase plan current service costs, such costs could be offset by the removal of solvency contributions. These changes are expected to help reduce funding volatility for plan sponsors.

Certain other Canadian jurisdictions are in the process of evaluating the solvency funding framework. In Ontario, the intent to consider this framework was first announced in the 2015 *Ontario Economic Outlook and Fiscal Review*. The Ontario Ministry of Finance has since released a Consultation Paper in July 2016 (the Consultation Paper) which identifies a number of options for solvency funding reform, grouped under the following two general approaches: (1) maintain the requirement for a pension plan to be funded on both a going concern and solvency basis, but modify the solvency funding requirements; and (2) eliminate solvency funding requirements with corresponding enhancements to going concern funding

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requirements. The Consultation Paper communicates an expectation that any proposed funding reforms will be made available for public feedback in the fall of 2016.

Changes to facilitate different plan designs

Target benefit plans (TBPs) continue to garner attention across Canada. As discussed in previous blog posts, TBPs are like DB plans in that they pool longevity and investment risks, but are also like money purchase (DC) plans in that contributions are fixed or variable within a narrow range. Ultimately, TBPs are designed to deliver a targeted benefit while giving administrators the flexibility to adjust benefits in response to the plan's funded position.

New Brunswick was the Canadian TBP trailblazer, introducing its comprehensive shared risk regime in 2012. Québec has also introduced a limited TBP regime that applies only to the pulp and paper sector. Both Alberta and B.C. have also implemented a comprehensive TBP regime, with rules relating to the TBP regime folded into the new pension standards legislation that came into force in these provinces on September 1, 2014 and September 30, 2015, respectively. Similar to New Brunswick, target benefits in Alberta are another design option for union or non-union plans, both single employer and multi-employer. Target benefits in Alberta, however, are available for future service only (i.e., accrued benefits cannot be converted). B.C. currently limits its target benefit regime to multi-employer plans and only negotiated cost, multi-employer plans are permitted to convert accrued benefits, subject to consent by the applicable union. Saskatchewan regulators take the position that no amendments are required to the applicable pension standards legislation to accommodate TBPs.

At this point, Ontario and Nova Scotia have passed legislation (not yet in force) permitting TBPs in particular circumstances (e.g., collectively bargained or multi-employer plans). Ontario's Ministry of Finance has also delivered a consultation paper addressing prospective regulatory reform. Released in July 2015, the paper explores potential reforms for target benefit multi-employer pension plans in Ontario.

The status of TBPs in the other provinces and at the federal level is less certain, as TBP regulatory frameworks do not yet exist.

One of the most significant impediments to pension plan design innovation remains the *Income Tax Act* (the ITA) (Canada) and the regulations thereunder (collectively the Tax Rules). As registered pension plans are subject to the federal tax regime, pension plans must fit within the existing rules applicable to DB plans, DC plans or specified multi-employer plans (SMEPs). SMEPs are multi-employer plans that satisfy certain conditions under the Tax Rules. In order to qualify as a SMEP, the employers must participate in the plan under a collective agreement and there must be either (i) at least 15 employers contributing to the plan, or (ii) at least 10% of the plan members are employed by more than one participating employer. Another pre-condition to SMEP status is that contributions must be made under a negotiated contribution formula and such contributions cannot vary by reference to the plan's financial experience.

As you can imagine, the current tax regime is not one that easily accommodates new plan designs. Essentially, if a pension plan is not a SMEP or money purchase, it will be treated as defined benefit for tax purposes. Depending on the plan design, this tax treatment may be far from ideal.

The federal government's April 2015 budget committed to considering amendments to the Tax Rules "to appropriately accommodate Target Benefit Plans within the system of rules and limits for Registered Pension Plans." Thus far, no such amendments have been introduced.

While tax changes to appropriately accommodate single employer target benefit plans are needed and welcome, more significant changes are arguably needed to overhaul the tax regime regarding registered pension plans to better facilitate and accommodate design innovation.