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Federal Government Tweaks Pension Solvency Funding Rules And Investment Limits

By Mark Newton

On May 3, 2010 the federal department of finance introduced draft regulatory amendments to the federal Pension Benefits Standards Act (1985), concerning solvency funding requirements and quantitative investment limits.

The changes to the solvency funding requirements would affect federally-registered Defined Benefit pension plans, namely, those pension plans whose funding is subject to the federal PBSA. The changes to the investment limits would affect most registered pension plans in Canada, the reason being that the pension legislation in most provincial jurisdictions has adopted the federal PBSA investment rules.

Solvency Funding Changes

The primary proposal by the government is to introduce a form of solvency averaging so as to reduce volatility inherent in the current rules, attributed to market conditions and changes in interest rates. Under the proposed rules, solvency funding would be calculated based upon a three-year average solvency deficiency. In this manner, the impact of a spike in a solvency deficiency in a particular year will be smoothed.

In addition, the government has proposed the use of a five per cent solvency margin before a plan sponsor would be entitled to take a contribution holiday. This means that a plan's solvency ratio, or the ratio of a plan's market value of assets to its solvency deficiency, would have to be at least 1.05 in order for a plan sponsor to discontinue its current service contributions.

Investment Limit Changes

The investment regulations under the federal *PBSA* contain a number of quantitative limits, viewed by most in the pension investment community as outmoded and unnecessary. There are five such investment limits on the investment of a pension fund's assets:

- 30 per cent of the shares of an entity that may be used to elect the directors
- 10 per cent of the book value of the pension fund's assets in any one entity five per cent of the book value of the pension fund's assets in a single parcel of real estate or Canadian resource property
- 15 per cent of the aggregate book value of the pension fund's assets in Canadian resource properties
- 25 per cent of the aggregate book value of the pension fund's assets in real estate and Canadian resource properties.

The government is proposing to eliminate only the five per cent, 15 per cent, and 25 per cent limits. The 30 per cent and 10 per cent limits would remain. While the government announced that it intends to propose further modifications to the 10 per cent rule, it confirmed that it will not be changing the 30 per cent limit. According to the government's impact analysis statement, the 30 per cent rule "remains appropriate at this time for prudential reasons."

Significant Concern

The proposed changes to the solvency funding rules, through the smoothing of solvency deficiencies, are salutary. A significant concern with the current regime has been the volatile nature of the solvency funding requirements, as market returns and prevailing interest rates go up and down.

The government considered extending the five-year funding of solvency deficiencies to 10 years, but decided that this would not fairly balance the interests of plan members and plan sponsors. In the government's view, the three-year smoothing would represent a better balancing of interests, which is always a challenge with pension plan regulation.

The requirement for a five per cent 'solvency cushion' in order to permit plan sponsors to take contribution holidays is not unlike other jurisdictions' concept of a provision for adverse deviation. The five per cent cushion would not have to be factored into solvency funding requirements. A plan sponsor with a pension plan whose solvency ratio of at least 1.00 but less than 1.05 would still be required to make current service contributions.

With regard to the pension investment limits, the proposed changes are disappointing. The quantitative limits are outmoded in a modern investment regime that places more weight on fiduciary duties and the prudent person standard. While many in the pension investment community had hoped that all of the quantitative limits would be eliminated, this was perhaps too much to hope for in this round of regulatory changes. ■

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