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MEPPs: To Solvency Fund Or Not?

By: H. Clare Pitcher

The most critical issue facing multi-employer **pension plans** (MEPPs) today is solvency funding. At best, it could mean a substantial reduction in **benefits**, even accrued **benefits**, including those of **pensioners**. At worst, it threatens their very existence. While solvency funding may be the most 'politically correct' and 'regulatory expedient' thing to do, it is clearly the very wrong thing to do!

Within the broad range of **pension** arrangements offered in Canada today, MEPPs are unique. It is that uniqueness which underlies the reasoning to not fund these types of plans on a solvency basis.

Let us first be clear on the types of plans to which we are referring. Essentially, we are including those types of **pension plans** which are "specified" as per the federal Income Tax Act – the socalled specified multi-employer **pension plans** (SMEPs). These plans have several participating employers and are typically union-negotiated/ collectively-bargained. They are either joint labour-management or 100 per cent union-trusteed. Employer contributions, typically cents per hour, are fixed as per the negotiated collective bargaining agreement (CBA) and go into the plan on a **Defined Contribution** basis. **Benefits** to members, typically flat **benefits**, are defined by a formula or a scale and come out of the plan on a **Defined Benefit** basis.

While DB plans define the benefits (with the contributions being variable) and DC plans define the contributions (with benefits being the variable), MEPPs define both the benefits and the contributions. This is the essence of their uniqueness.

The Canada Revenue Agency views these plans as DC, while the pension benefits acts of the various jurisdictions across Canada view them as DB plans. Clearly, they have elements of both. For greater certainty, we are not referring to the large public sector MEPPs, which are essentially DB plans.

In going-concern funding – which applies to all DB plans – the funding target is set assuming the plan will continue into the future indefinitely, actuarial assumptions are long-term, and unfunded liabilities are typically required to be funded over 15 years.

In solvency funding, the funding target is set assuming the plan will terminate immediately (as of the valuation date), actuarial assumptions are prescribed based on current settlement rates, and solvency deficiencies are typically required to be funded over five years. Its purpose is to protect the benefits in the event of plan wind-up, which makes sense in the case of single-employer pension plans because of the possibility of a single employer's insolvency.

Nature Of Underlying Pension Promise

There are a number of factors that differentiate MEPPs from the typical single-employer DB (SEDB) pension plan, the most fundamental of which is the nature of the underlying pension promise.

Very simply, in a MEPP, the basic pension promise is DC, or 'contingent DB.' It is contingent on there being enough assets to fund the benefits so that, even though the objective is DB or 'target' benefit, the promise in reality is DC. The employers' liability (other than in Quebec) is limited to the negotiated contributions. Therefore, as in the case of DC plans, the members are the ultimate bearers of the risk. They get what their employers pay for, through the negotiated fixed contributions. Effectively, then, the members are the owners, beneficiaries, and risk-takers of these plans. The members, through their representatives (the trustees), determine the (DB) benefit payouts. Furthermore, the trustees have a fiduciary responsibility to the members to ensure that the pension promise is kept.

Reduce The Benefits

In this context, solvency funding has no relevance. On plan wind-up, unlikely as that is, the liabilities of the plan are, by definition, equal to the assets. If the accumulated assets are less than the otherwise-applicable liabilities, the plan has the ability to legally reduce the benefits. Clear and full disclosure and communication to plan members about the nature of the promise and the inherent risks to members is, therefore, very relevant and critically important.

Most, if not all, regulators across Canada will tell you that the reason for solvency funding is to improve the security of the benefits. This is true in respect of single-employer plans (because additional contributions get put into the plan), but it is simply not true in the case of MEPPs.

The reality for MEPPs is that solvency funding does not improve the security of the benefits since, unlike single-employer plans, it does not result in more money being put into the plan (because the contributions are fixed by collective agreement). Solvency 'funding' is, therefore, a misnomer in the context of MEPPs. What it may do, of course, is force the benefits to be reduced. [Therefore, solvency 'reductions' is probably a better name for it.] On potential plan windup (the risk against which solvency funding is designed to protect), members simply end up with a higher percentage of a lower benefit, which is exactly equal to a lower percentage of a higher benefit. The illusion of enhanced benefit security simply means less adequate benefits.

So, solvency funding clearly does nothing positive for a MEPP plan member. Tragically, however, it can potentially and has historically, especially over the past few years, very seriously hurt these plans and their members.

Stability Of Contribution/ Benefit Rates

Rate stability – both contribution and benefit – is critical for MEPPs because of the DC/DB nature of these plans. Solvency funding, based on current 'point-in-time' long-term bond interest rates, is extremely volatile and, since contributions are fixed by collective agreement, can and will result in the benefits bouncing all over the map. In whose best interest is this?

Going-concern funding (based on longterm actuarial assumptions for the future) – not solvency funding – enhances the stability of these plans.

Unnecessary Reduction In Benefits

The primary practical mechanism in these plans to deal with a solvency deficiency (assuming the insufficiency of the existing contribution rates and any contingency reserve) is a reduction in the benefits. In the current environment of low interest rates, benefits get reduced. Then, current interest rates rise and the benefits are reinstated and perhaps even increased. This is the volatility referred to above.

Ultimately, the benefit levels will 'average out' based on the long-term experience of the plan. But, in the meantime, benefits – perhaps even the benefits of pensioners on fixed incomes – will have been reduced. Then, when they are reinstated, the pensioner may be dead. In whose best interest is this?

Clearly, the security of the benefits has been compromised. The regulators ' primary overall objective is benefit security, which in single- employer plans they hope to achieve through solvency funding. Ironically, in the case of MEPPs, solvency funding has exactly the reverse impact and the objective will not be achieved.

Intergenerational Equity

As discussed above, volatile solvency funding results in volatile benefit patterns. Volatile benefit patterns, in turn, result in the effective transfer of monies from one generation of members/ beneficiaries to another.

For example, if the plan has to over-fund currently because of solvency funding requirements, current benefits will be set too low, unfairly resulting in the effective transfer of monies from the current generation to future generations.

Focus On Long-term Best Interest

MEPPs' funding focus and philosophy is normally on the long-term – as represented by a going-concern funding valuation – plan continuation scenario. Solvency funding would impose an immediate short-term (wind-up) focus, at the expense of the long-term best interest of the plan and its members.

Stated a different way, 'Members prefer a 99.9 per cent probability of a higher benefit rather than a 100 per cent guarantee of a lower benefit.' Who is the government – the politicians and the regulators – to tell them (all the major stakeholders – unions, employers, and trustees) otherwise? Clearly, the broader long-term best interest of the plan and its members must not be sacrificed for the narrow focus and short-term perspective of many regulators and, particularly, in respect of an event (plan wind-up) that is virtually never going to happen.

As an analogy, the legislated speed limit on Highway 401 in Ontario is currently 100 kilometres/hour. Reducing it to 20 kilometres/hour would clearly save lives, yet we don't impose that because it's deemed not to be worth it (the 'cost' in terms of the 'few' lives lost). So solvency funding is not worth it (the 'cost' in terms of members' potential, but unlikely, loss of benefits). The difference, however, is that while reducing the speed limit to 20 kilometres/hour would save lives and clearly be a positive result from that perspective, imposing solvency funding on MEPPs clearly has a detrimental impact on the plan and its members.

Unlikelihood Of Plan Wind-up

While I do not consider the fact that MEPPs are highly unlikely to windup to be a primary reason to exempt MEPPs from solvency funding, it is certainly a reality that leads to the same conclusion. The fact of the matter is that, in Ontario for example, there have been only two wind-ups (with a relatively small number of members) of these types of plans in the last 50 years.

Unlike the situation in respect of single-employer plans – whose future continuance is contingent on the continuing viability of a single employer – a MEPP's continuance is not dependent on the fortunes of any single employer, but rather on an entire industry (for example, construction). Therefore, there is not the same 'need' for solvency funding for MEPPs as there is for other (single-employer) plans. Furthermore, if an employer does withdraw, the affected members will typically move to another employer in the industry/plan.

Legal Situation

While the fundamental issue we have been dealing with is whether or not solvency funding should be required for MEPPs, the next question is whether or not it is required in the various jurisdictions across Canada. This is a legal, rather than actuarial, issue.

The legal requirement to fund (or not to fund) solvency deficiencies varies by jurisdiction across Canada. Solvency funding is clearly required in B.C., Alberta (with a three-year moratorium), Saskatchewan, Manitoba, Quebec, Newfoundland, and the federal government. It is not required in Nova Scotia, New Brunswick, and PEI (no legislation). The U.S. has long recognized the differences between MEPPs and single-employer plans and has not imposed the solvency funding requirements applicable to single-employer plans on them. This position has recently been reaffirmed by its new Pension Protection Act.

Meanwhile, in Ontario, the regulator, the Financial Services Commission of Ontario, would lead one to believe that solvency funding is legally required, the reality is that it is not, nor was it ever intended to be. After all, why are MEPPs not covered by the Pension Benefits Guarantee Fund? That was not an accident.

Unfortunately, however, FSCO's interpretation of the law is to require solvency funding. Clarification is, therefore, necessary to clearly exempt MEPPs from solvency funding and avoid the continued debate. Currently, a joint task force of industry (MEBCO) and government (political, policy, and regulatory levels) personnel is working together to define a new funding framework for MEPPs. I am confident that this framework will not involve any form of solvency funding (although the plan's wind-up position will still be calculated and disclosed, as it should be). It will, however, require strengthened member disclosure and communication, improved plan governance based on the Canadian Association of Pension Supervisory Authorities (CAPSA) model (including a formal funding policy), possible restrictions on plan improvements, and benefit reductions if, on the going-concern basis, the contributions are insufficient.

Once Ontario clearly takes the position – and follows it up with legislative clarification – that solvency funding is not required for MEPPs, it is hoped that other jurisdictions in Canada and CAPSA will follow Ontario's lead and provide an environment across Canada in which MEPPs can thrive and continue to benefit the Canadian economy. Solvency funding of MEPPs results in:

- No improvement in the security of benefits
- Unstable contribution/benefit rates
- Intergenerational inequity

Not only does solvency funding not serve any useful purpose in the case of MEPPs, it actually does harm to the plan and its members. Solvency funding is clearly not in the best interest of the plan and its members, causing potentially unnecessary benefit reductions. Most importantly, it could very well drive the plan to the point of wind-up, which is exactly what solvency funding is designed to protect against in the case of single-employer plans!

Finally, it is hoped that CAPSA will support this initiative and the legislators/ regulators of the various jurisdictions in Canada, based on a clear understanding of the situation and a clear recognition of the plans'/members' best interest, will exempt MEPPs from solvency funding requirements and will make those changes as soon as possible. ■

H. Clare Pitcher is a principal and consulting actuary in the Toronto office of ACS/ Buck Consultants.