

CARPENTRY WORKERS' PENSION PLAN OF B.C.

STATEMENT OF FUNDING POLICY

October 2003

Approved by the Board of Trustees

Chair

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I—BACKGROUND

The Plan is a multi-employer negotiated cost pension plan that is registered under the British Columbia *Pension Benefits Standards Act* (the “PBSA”). Benefits are funded by contributions from participating employers, who pay a contribution for every hour worked by members that is fixed by negotiation. Participating employers have no other financial obligation to the Plan.

The PBSA requires the Trustees to file an actuarial valuation report with the Superintendent of Pensions at least once every three years. If the valuation indicates that the Plan has developed a deficit that cannot be liquidated in accordance with the PBSA requirements by future contributions at the negotiated level, then benefits must be reduced.

The Trustees have three primary goals:

1. to achieve the largest amount of benefits for the Plan’s members and beneficiaries over the long term that is possible and consistent with prudent management of financial risks;
2. to manage the risks to provide a high level of security of benefits; and
3. to comply at all times with the funding and solvency standards in the PBSA.

The first of these goals requires that part of the investment portfolio be invested in equities to achieve the incremental rate of investment return needed to improve benefits over the long term, while the second and third goals require that well thought-out investment and funding policies be in place to help manage the risks, including volatility of returns, associated with equity investments and the uncertainties of actuarial estimates. The Plan’s funding policy is therefore inextricably linked to the Trustees’ benefit objectives and to the investment policy.

This document summarizes the principal elements of the funding policy. The Appendix contains a more detailed explanation for the development of the policy.

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II—BENEFIT TARGETS

The Trustees have one shorter-term and two longer-term objectives with respect to the level of the Plan's benefits. Each will have to wait until funds are available, in accordance with the funding thresholds described below.

A—Shorter-Term Benefit Objective

The shorter-term benefit objective is to restore a portion of the “across-the-board” pension reductions implemented in 2003 for older retired members and beneficiaries. The specific target is to restore a portion of the “across-the-board” reduction for each member who was born on or before July 1, 1931 as indicated in the following table.

Date of Birth	Portion Restored
Before July 1, 1927	50%
July 1, 1927 to June 30, 1928	40%
July 1, 1928 to June 30, 1929	30%
July 1, 1929 to June 30, 1930	20%
July 1, 1930 to June 30, 1931	10%

B—Longer-Term Objectives

The first of the longer-term benefit objectives is to restore the full amount of the “across-the-board” pension reductions implemented in 2003 for all members.

The second longer-term benefit objective is to provide increases in both accrued benefits and future benefit accruals so that, over the longer term, benefit amounts keep pace with price inflation and the “real value” of the Plan's benefits is maintained. The specific target is to provide increases in the pension accrual rate payable at retirement that are in line with increases in average wages, and to increase pensions in payment in line with increases in the Consumer Price Index (Canada, all items, seasonally adjusted). This target presumes that contribution rates to the Plan will increase on average at the same rate as future wages.

To avoid putting further pressure on funding and solvency of the Plan, these periodic increases will be targeted and systematically pre-funded but not actually promised or provided until or unless the financial experience of the Plan so permits based on the funding thresholds described below. Thus there will always be a larger target benefit and a smaller promised benefit.

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In future, apart from the first benefit objective noted above, the focus of Plan improvements will be on Plan features that apply to most or all members and beneficiaries rather than favouring a minority.

Retired members at July 1, 2003 who do not participate in the shorter-term benefit objective noted above will participate in the longer-term benefit objectives. Restoration of pension reductions, included in the benefit objectives, relate only to the “across-the-board” reductions and not to the removal of early retirement pension subsidies.

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III—INVESTMENT POLICY

The Trustees have established an investment policy which calls for investment of the Plan assets in a diversified portfolio of equities and equity-equivalent investments (including stocks, real estate and high yield bonds) and debt (high quality bonds and mortgages), with a target asset mix of 45% equities (including equity-equivalent investments) and 55% debt. This policy includes a number of controls to limit investment and funding risks, including the matching of the duration of the debt securities to the duration of the Plan's liabilities and diversification of the equity portion of the portfolio. Despite these controls, and in order to achieve the desired level of investment returns over the long term, the investment policies entail some of the normal risks associated with such investments, including unpredictable returns in any time period, and volatility of returns from time period to time period.

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IV—FUNDING POLICY

A—Purpose of Funding Policy

The purpose of this funding policy is to establish a framework for the sound financial management of the Plan that, in conjunction with the Trustees' investment policy, will provide benefits to members and beneficiaries in a reasonable and fair manner over time, minimize the risk of having to reduce the Plan's benefits from time to time, and provide a realistic expectation for periodic benefit improvements.

More specifically, the objectives of this policy are to:

1. Identify the Plan's exposure to funding risks (both short-term and long-term).
2. Establish the combination of measures to be used to protect the Plan's funded position against these risks.
3. Establish the Plan's target funding margins.
4. Define the funding thresholds that will determine the permitted level of benefit improvements and the required level of any future benefit reductions.
5. Document the Trustees' long-term benefit targets and their priorities for implementing benefit improvements.

B—Exposure to Funding Risks

The Plan's funded status is subject to a variety of risks that can be grouped into the following principal categories:

- The risk that the Plan may develop funding deficits as a result of the assets and liabilities not being fully matched;
- The risk that the number of active Plan participants will continue to decline, resulting in further erosion of the contributory hours base;
- Volatility in the contribution rate required to fund deficits, particularly solvency deficits, due to the liabilities being very large relative to the size of the contributory hours base;
- The risk that the Plan's economic and/or demographic experience will be unfavourable relative to the assumptions employed in the actuarial valuation; and
- Deterioration in the Plan's solvency position as a result of the Plan's solvency liabilities not including any provision for early retirement subsidies which, although provided under the Plan, do not apply in the event of Plan wind-up.

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Given that contributions are fixed through collective bargaining, the Plan is especially vulnerable to factors that result in unexpected increases in the required contribution rate.

C—Funding Policy

In order to protect the Plan's funded position against the foregoing risks, the Trustees have adopted the following policies. A detailed explanation of the development of the policy positions is contained in the Appendix.

1. Protective Measures

The protective measures relate to the actuarial methods and assumptions to be used in actuarial valuations of the Plan's funded position.

Asset Valuation Method

Actuarial valuations (both funding and solvency) will use smoothed asset values. Currently, these values are based on 4-year smoothing of investment gains (losses) on all assets. Note: the asset valuation method may be changed to market value for fixed income assets and 5-year smoothing of gains (losses) on all other assets.

Valuation Cost Method and Assumptions

Liabilities and normal actuarial costs will be measured using the actuarial cost method known as the "accrued benefit cost method". A specific provision for adverse deviations will be made in the actuarial valuation by discounting future benefit costs for interest at a rate that is below the best estimate of the future return on the Plan's assets (see target funding margins below). Assumptions with respect to each of the other economic and demographic factors should be justified based on the Plan's experience and should also include adequate provision for expected future changes in those factors.

Target Funding Margins – Going-Concern Position

The target funding margins on the going-concern basis are comprised of two parts: the excess of the Plan's funded ratio over 100% and the margin by which the Plan's projected contribution income exceeds the sum of the cost of future pension accruals and the allowance for expenses (the "contribution margin").

The Plan's target funding margins, determined on a going-concern basis, are the greater of 1. and 2. below:

1. A *target funded ratio* of 115% and a *target contribution margin* of 20%, both determined by applying to the valuation of the promised benefit a discount rate that contains a margin of 0.5% per annum relative to the best-estimate long-term return on the Plan's assets, subject to a maximum discount rate of 6.0% per annum.
2. A *target funded ratio* of 100% and a *target contribution margin* of 0%, both determined by applying to the valuation of the promised benefit a discount rate that contains a margin relative to the best-estimate long-term return on the Plan's assets equal to the assumed rate of future increases in the CPI.

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Target Funding Margins – Solvency Position

The Plan's target margin on the solvency basis is a solvency ratio of 115% determined using a solvency valuation interest rate equal to the prescribed rate minus 0.5% per annum, subject to a maximum solvency interest rate of 6.0% per annum.

For the purpose of determining the solvency ratio, the solvency liabilities include the cost of early retirement subsidies determined on the basis of the going-concern retirement rates.

Adjustment for Contribution Margin

The Plan's funded and solvency ratios will be adjusted to reflect the difference between the Plan's actual and target contribution margin. The capitalized value of the excess (shortfall) in the contribution margin for the next 5 years will be added to (deducted from) the value of the Plan's assets for the purpose of determining the Plan's funded ratio. In the case of the solvency position, the adjustment for any excess (shortfall) in the contribution margin will be determined on the basis of target #1 for the going-concern basis.

Based on simulations of expected future investment returns and the Plan's asset mix policy, the probability that the target margins will not prove sufficient to avoid the necessity for benefit reductions at the next actuarial valuation is less than 5%. The target funding margins are sufficient to enable the Plan to withstand three consecutive years in which the Plan assets earn a rate of return 5% per annum below the return on a long bond portfolio without the necessity for benefit reductions at the next triennial valuation. For example, if long bonds generated a return of 6.0% per annum over a 3-year inter-valuation period, the target margins would be sufficient to withstand a return on the Plan's total assets as low as 1.0% per annum over the same period.

Based on historical experience (from 1928 to 2002), there have been only three 3-year periods in which a portfolio with the Plan's asset mix and returns on each asset class corresponding to the market index return would have under-performed to this extent (1929–1931, 1930–1932 and 2000–2002). Except for the period of the Great Depression, such a portfolio has never under-performed a long bond portfolio by more than 3.7% per annum over a 6-year period.

2. Funding thresholds for benefit increases and decreases

Along with the technical protective measures, the Trustees have adopted the following funding thresholds to be met before a benefit increase or decrease is considered.

- No benefit increases will be implemented until the funded ratio and solvency ratio both exceed 110%. Similarly, if either the funded ratio or solvency ratio falls below 110%, no benefit increases may be implemented until both ratios once again exceed 110%.
- Benefit increases may be granted after the funded and solvency ratios exceed 110% and before the target funded and solvency ratio margins are reached, provided the additional liability created by such increases does not utilize more than 50% of the improvement in the funded ratio since the previous actuarial valuation and does not reduce such ratios below 110%.
- Once the target funded and solvency ratios have been reached, benefit increases may utilize up to 100% of the excess ratios.

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- If the funded ratio and solvency ratio are both in excess of 120%, the Trustees will improve benefits such that the target ratios are reduced to between 115% and 120%.
- Benefits will not be reduced while there are any margins in place, unless and to the extent required to comply with the PBSA.
- If benefits have to be reduced, the reductions must be sufficient to establish a *minimum margin* that is expected to withstand three consecutive years in which the Plan earns a rate of return 1.5% per annum below the return on a long bond portfolio without necessity for further reduction of benefits at the next triennial valuation.

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V—POLICY REVIEW

Compliance with this funding policy will be reviewed annually. The policy will be reviewed at least once every three years and either confirmed or amended in accordance with the Trustees' governance standards. A review of the funding policy will occur whenever changes are made to the Plan's investment policy.

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VI—APPENDIX—EXPLANATION OF FUNDING POLICY DEVELOPMENT

A—Investment Policy

The Trustees' investment policy is designed to achieve two objectives - protection against funding risks and the potential for growth in asset values that will permit the Plan to enhance benefits over the long term. These two aspects of the investment policy are described below.

1. Protection against funding risks

The ultimate target asset mix provides for the portion of the assets invested in fixed income securities (50% bonds and 5% mortgages) to have a duration approximately equal to the duration of the solvency liabilities and somewhat shorter than the duration of the liabilities determined on a going concern basis.

This structure approximately immunizes one-half of the assets and liabilities against the effects of changes in long-term interest rates. By matching this portion of the assets and liabilities, the need for margins in the funding basis is diminished.

2. Potential for growth in asset values

The balance of the assets is invested in a diversified mix of different asset categories including Canadian equities, U.S. equities, other foreign equities, individual real estate properties, pooled real estate funds and high yield bonds.

This portion of the assets is not matched to the liabilities and therefore exposes the Plan to the risk of an adverse change in the relationship between the value of these assets and the corresponding liabilities.

Counterbalancing this risk to some degree is the variety of different investment categories included in this portion of the Plan assets. As compared to a pure equity portfolio, this combination of investment categories is expected to result in lower investment return volatility with some reduction in the expected investment return over the long term.

B—Funding Policy

1. Protective Measures

To protect the Plan against funding risks, there are four measures employed by the Trustees. Each of these measures and their contribution to the protection of the Plan's funded position are summarized below.

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Protective Measure	Purpose/Effect of Measure
Asset Valuation Method	<ul style="list-style-type: none"> • An asset valuation method that smoothes fluctuations in the value of the Plan assets reduces the possibility of temporary aberrations in the Plan's funded position. • The extent to which asset values are smoothed is a determining factor in setting the margins in the funding basis.
Funded Ratio/ Solvency Ratio	<ul style="list-style-type: none"> • A funded/solvency ratio in excess of 100% is the first line of defense against adverse financial experience in the short term. • The target level for the funded/solvency ratio is dependent mostly on the investment policy, the asset valuation method and the provision for pre-funding of the target benefit increases.
Contribution Margin	<ul style="list-style-type: none"> • If adverse short-term financial experience causes the funded/solvency ratio to drop below 100%, contribution margins are the Plan's second line of defense • If not required to fund deficits, contribution margins improve the Plan's funded position and are a source of financing for Plan improvements
Margin in Valuation Assumptions	<ul style="list-style-type: none"> • Margins in assumptions serve two purposes: <ul style="list-style-type: none"> — they provide protection in periods when the Plan's experience is adverse relative to the long-term expectations — over the long term, they are expected to produce gains in the Plan's funded position that will be available to improve benefits

While all four items provide protection for the Plan's funded position, only the last two provide a source of funding for Plan improvements.

Each of the protective measures and the development of the Trustees' policy with respect to each measure is reviewed below.

2. Asset Valuation Method

Protection against the effect of short-term fluctuations in asset values on the Plan's funded position is provided by the method used to value the Plan's assets for actuarial valuation purposes.

The asset valuation method adopted for the actuarial valuation at June 30, 2002 smoothes the effect of fluctuations in the Plan's investment returns. This is achieved by spreading the difference between the Plan's actual investment income each year and the investment income expected on the basis of the valuation interest rate over that year and the following three years. The smoothed asset value is used for both the going-concern and solvency valuations. Consideration may be given at the next actuarial valuation to changing the method of valuation to market value for the fixed income portfolio and a 5-year smoothed value for the balance of the Plan assets.

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In order to ensure that the smoothed asset value does not deviate too far from market value, the smoothed value is limited to a corridor of 92.5% to 107.5% of market value. A 10% corridor is the maximum acceptable to the Pension Standards Branch. *(Note – if the asset valuation method moves to market value for fixed income securities and smoothed value for equities and real estate, a 110% ceiling relative to market value would be appropriate for equities and real estate.)*

3. Funded Ratio/Solvency Ratio

A funded ratio and solvency ratio in excess of 100% means that the Plan's assets are more than sufficient to cover the Plan's accrued liabilities determined on a going concern or solvency basis. The excess over 100% (or surplus) is the Plan's first line of defense against adverse experience in the short term. If this is not sufficient, the Plan falls back on its contribution margin to finance any deficits.

Solvency liabilities in the valuation prepared for regulatory purposes do not include the cost of early retirement subsidies since these subsidies are not provided on Plan wind-up. Exclusion of any provision for the cost of early retirement subsidies means that the Plan's solvency position deteriorates each year as Plan members retire with subsidized early retirement pensions.

Wherever the term "solvency ratio" is used in this funding policy, it means the ratio of the solvency liabilities (including the cost of early retirement subsidies determined on the basis of the going-concern retirement rates) to the smoothed value of the Plan assets.

The target levels for the funded ratio and solvency ratio are developed in the next section.

4. Contribution Margin

Contributions are applied first to cover the cost of pension accruals for future service and non-investment expenses. The balance of the contributions received by the Plan (the contribution margin) is available to improve the Plan's financial position or pay down any funding deficits.

A margin in the contributions is required to protect the Plan from:

- an increase in the cost of future pension accruals as a result of the aging of the active membership or changes in the assumptions used to determine those costs;
- future increases in the level of non-investment expenses due to inflation and other factors.

The minimum level of margin considered necessary to provide adequate protection against these contingencies is 20% of the contribution income.

Due to the decline in the number of active members and the substantial growth in the Plan's liabilities for accrued benefits, the margin in the contributions is small relative to the size of the liabilities. The annual margin in the contributions after the benefit reductions in 2003 is \$1.75 million per annum. While the margin is considered sufficient to provide reasonable protection for the Plan against the contingencies described above, it is sufficient to finance a solvency deficit of only 4% of the solvency liabilities within the maximum 5-year amortization period.

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Accordingly, in setting the target funded/solvency ratio and managing the Plan's funding in relation to this target, it is the Trustees' policy not to include any credit for the margin available in the contributions.

5. Margin in Valuation Assumptions

Protection against a deterioration in the Plan's funded position over the long term is provided by including an explicit provision for adverse experience in the assumptions used to determine the Plan's accrued liabilities and the cost of pension accruals for future service.

For the purposes of establishing the Trustees' policy with respect to these margins, the valuation assumptions can be separated into economic assumptions (i.e. the rate of discount for interest, the projected level of future contributions and the allowance for administration expenses) and demographic assumptions (i.e. rates of mortality, retirement, termination and disability).

The policy adopted for the Plan's valuation is currently one that provides a relatively small margin of conservatism in the economic assumptions but no specific margin in the demographic assumptions.

Economic Assumption at June 30,2002	Best Estimate Projection at June 30, 2002	Margin at June 30, 2002
Discount rate <ul style="list-style-type: none"> • going-concern: 6.75% • solvency: 6.0%–6.5% 	<ul style="list-style-type: none"> • long-term returns are projected to be: <ul style="list-style-type: none"> — fixed income: 5.5% to 6.0% — other assets: 8.0% to 8.5% • investment management fees are assumed to be covered by the additional return earned through active management • based on the 50/50 target asset mix, the best estimate long term return is projected to be 7.0% p.a. 	<ul style="list-style-type: none"> • the margin in the discount rate is considered to be: <ul style="list-style-type: none"> — 0.25% p.a. (going-concern) — 0.25%–0.75% p.a. (solvency)
Expense allowance <ul style="list-style-type: none"> • \$1 million p.a. 	<ul style="list-style-type: none"> • non-investment expenses have been at very high levels (above the allowance) in the last two years • it is expected that these expenses will progressively reduce to more normal levels for a pension plan of this size • the long term estimate of expenses is no more than \$750,000 p.a. 	<ul style="list-style-type: none"> • the long-term margin in the expense allowance is at least \$250,000 p.a.

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Although a margin is considered to exist in the discount rate, the margin is small and does not provide much protection against the possibility that the best estimate of long-term investment returns is overstated. The current margin on a going-concern basis (0.25%) is viewed as a minimum and compares to the Trustees' target margin of 0.5%. As the Plan's funded position permits, the margin will be increased to the target level.

Similarly, for the purpose of determining the Plan's position relative to the solvency funding target, the solvency liabilities will be discounted using an interest rate 0.5% below the prescribed rates.

As the operating expenses reduce and it becomes clearer as to what the Plan's ongoing expenses will be, it is expected that the margin in the expense allowance will be reduced.

C—Target Funded Ratio/Solvency Ratio

Setting the target funded ratio and solvency ratio involves balancing two competing considerations:

- the need to establish adequate protection against future benefit reductions; and
- the desire to restore some of the benefits cut in 2003 and provide ongoing inflation-related benefit increases.

By setting the ratios at a higher level, the protection against future reductions is increased, but the extent to which benefit cuts are restored or benefits are enhanced is further delayed, and *vice versa*.

To balance these two considerations, two levels of target ratios have been established, an intermediate target (110%) at which limited benefit increases may commence and the long term target (115%) at which less restricted benefit increases may commence.

1. Target Ratios—Protective Measure

A funded ratio/solvency ratio in excess of 100% is the Plan's primary defense against the risk that the Plan's funded position deteriorates as a result of the investment return on the Plan's assets being lower than the change in the value of the Plan's liabilities. Since changes in the value of the Plan's liabilities match changes in the value of a portfolio of long bonds with the same duration, the risk of a deterioration in the Plan's funded position can be measured by comparing the expected returns from the Plan's investment portfolio with those from a portfolio of long bonds.

Simulations of expected future returns show that the probability that a portfolio based on the Plan's target asset mix will under-perform a portfolio of long bonds over a 3-year period is as follows.

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Level of Under-performance (% p.a.)	Probability of Occurrence
-1.0%	25%
-3.3%	10%
-4.8%	5%

The Trustees wish to set a target funded ratio/solvency ratio that reduces the risk of reducing benefits at the next valuation to a probability of less than 5%. This means that the target funding margins should be sufficient to withstand investment returns that are approximately 4.8% per annum below the corresponding returns generated by a long bond portfolio over the 3-year inter-valuation period.

A funded ratio of 115%, combined with a contribution margin of 20%, is expected to be sufficient to withstand investment returns that are 5% per annum below the yields on long bonds for a 3-year period. Accordingly, a target funded ratio/solvency ratio of 115% is considered appropriate given the Trustees' risk tolerance.

2. Target Ratios—Provision for Target Benefit Increases

The Trustees wish to make provision in the Plan's funding for increases in benefits over the long term that result in benefits maintaining their "real" value. Accordingly, at each actuarial valuation, the Plan's ability to provide the target benefit increases will be measured by performing a separate going-concern valuation in which the liabilities will be adjusted to include provision for inflationary increases in both accrued benefits and future benefit accruals. This adjustment will be made by discounting the liabilities and future accruals for interest at a rate that is equal to the "best-estimate" return on the Plan's assets reduced by the assumed rate of future increases in the CPI.

Based on this adjusted discount rate, the target funded ratio is 100% and the target contribution margin is 0%.

D—Funding Thresholds for Benefit Improvements/Reductions

Since the contributions paid to the Plan are fixed by negotiation, the only factors that have a material effect on the Plan's funded position over which the Trustees exercise control are the investment policy and the level of the Plan's benefits. The greater the degree of mismatching between the assets and the liabilities permitted under the investment policy and funding policy, the greater the likelihood that the Trustees may have to adjust benefits to maintain the Plan's funding margins within acceptable thresholds.

1. Benefit Improvements

The Trustees will grant benefit improvements only if an actuarial valuation discloses that the Plan's funded ratio and solvency ratio are both in excess of 110%. If the funded margin is above 110% but below the target level of 115%, benefits may be improved provided the resulting

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additional liability does not utilize more than 50% of the improvement in the funded ratio since the last valuation.

If both the funded ratio and the solvency ratio exceed 120%, the Trustees will be obligated to grant benefit improvements that reduce the funded and solvency ratios to less than 120 but not below 115%. If both the funded and solvency ratios exceed 115% and one of these ratios is below 120%, the Trustees may grant benefit improvements provided neither ratio is reduced below 115%.

2. Benefit Reductions

Reductions in accrued pension benefits are permitted under the PBSA only if the Plan is unable to comply with the minimum funded standards prescribed by the legislation. If benefit reductions become necessary, they will be made at a level that is sufficient to restore the Plan's funded position to a point at which it is able to withstand a 3-year period in which investment returns average approximately 1.5% below the corresponding returns on a long bond portfolio. The likelihood of this occurring is less than 25%, based on a simulation of expected future investment returns and is even lower immediately following a period in which the target margin is eroded. This minimum protection is achieved if the aggregate of all of the Plan's funding margins is at least 8% of the Plan's liabilities. For this purpose, the annual margins in the contribution income and the valuation assumptions will be capitalized over a period of five (5) years.

E—Benefit Improvements—Priority Considerations

Benefit reductions implemented in 2003 resulted in substantial and immediate reductions for retired Plan members. As a result of the structuring of the benefit reductions in 2003, the Trustees have established certain principles and priorities for the determination of benefit improvements when these are permitted under the funding policy.

- The first (shorter-term) priority will be to restore a portion of the “across-the-board” benefit reductions for older retired members for whom the opportunity to benefit from Plan improvements is the most limited.
- The second (longer-term) priority will be to restore the balance of the “across-the-board” benefit reductions.
- The final longer-term objective will be to provide benefit increases over the long term, including increases in benefit accruals for both past and future service, in line with changes in the Consumer Price Index so that the real value of Plan benefits is maintained.
- Benefit improvements will be focussed on features of the Plan that apply universally to all members or at least to a broad proportion of the membership, and will not be allocated to create preferential treatment for a minority of members.
- Benefit increases for members who retired on or prior to April 1, 2003 with very large pension subsidies and whose benefit reductions were limited by the 45% cap may be deferred or limited to reflect the advantage they derived from the application of the cap.