Canadian Institute of Actuaries / Institut canadien des actuaires

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Subject: Pension Funding Framework Review and Other Issues Affecting Pension Plans

The Canadian Institute of Actuaries (CIA) is the national, bilingual organization and voice of the actuarial profession in Canada. Its members are dedicated to providing actuarial services and advice of the highest quality. The Institute holds the duty of the profession to the public above the needs of the profession and its members.

We are pleased to offer the following comments on your recent consultation, Pension Funding Framework Review And other issues affecting pension plans. We have provided comments on similar initiatives from other provinces, and our responses below draw from those submissions. Most of our responses correspond with specific sections in your consultation paper, and we have attempted to use consistent section headings.

The CIA believes that defined benefit (DB)-type plan designs are the best vehicles to provide secure and predictable retirement income. In order to slow down the decline of DB coverage, or potentially increase it, the CIA would support a policy decision by the Nova Scotia government to change the funding regime by replacing the solvency funding framework with an enhanced going concern funding framework, provided that the going concern framework would appropriately include regulated provisions for adverse deviations (PfADs).

The CIA supports greater consistency in pension regulation across Canada; hence, the content of this submission will be very similar to the responses we provided to a consultation issued by the province of Ontario in 2016.

Pros and Cons of Removing Solvency Funding

We note that there are several pros and cons associated with removing solvency funding. Arguments in favour of this include the following:

- While solvency funding has served to increase the pool of assets dedicated to fund DB pension plans, the need for repeated relief measures over the last 10 years indicates that the regime requires fundamental change.
- It has resulted in unsustainable volatility in contributions, as it is based on market interest rates, notwithstanding the smoothing mechanisms available.
- It is procyclical, and asks plan sponsors to increase contributions once poor performance has already impacted the plan, and at a time when they likely can't afford the contributions, rather than building a buffer before the impact of poor performance is realized.

- For some sponsors, solvency funding requirements and the resulting level and volatility of contributions are difficult for them to budget and manage and are used to justify plan terminations and/or conversion to defined contribution (DC) plans.
- It is based on the assumption that the plan will be terminated. Plan terminations on an unfunded basis with an insolvent employer are rare and not the primary focus of the plan sponsor in the context of funding.
- It is also based on the assumption that stakeholders are willing to pay the price for the full security of benefits. Many are not willing to accept such a high price.

Arguments in favour of keeping solvency funding requirements include the following:

- Plan participants will be better protected on plan wind-up if contributions are made on this basis. Furthermore, participants need to be informed of the wind-up position of the plan in order to be aware of the risk.
- Sponsors' concerns can be partially addressed through the following:
  - Additional temporary relief during unfavourable economic circumstances;
  - Increasing the amortization period resulting in lower levels and volatility of contributions; and
  - Implementing a solvency reserve account where excess solvency contributions can be refunded.

Option 1 – Maintain Full Solvency Funding

The paper presents a series of options should full solvency funding be maintained.

Longer Funding Period

A longer amortization period for solvency deficiencies would represent a certain compromise between security and affordability, as contributions would be significantly reduced, but does not remove the basic problem of solvency variability.

Consolidate Solvency Deficiencies

The consolidation of all past deficits at each valuation date is effectively the approach adopted under the federal solvency regime and would also serve to lengthen the amortization period for solvency deficiencies. The CIA would support this approach if solvency funding was maintained, though the period should be chosen so as to target the desired funding level within a reasonable time frame.

Solvency Reserve Accounts

The CIA strongly supports the concept of a solvency reserve account, which we would more broadly refer to as a flexible funding account (FFA). FFAs should be enabled whether or not the policy decision is made to uphold or remove solvency funding requirements; in fact, we believe that the concept should be extended to the going concern funding requirement as well (although this would be under a different name).

The CIA has long been an advocate of FFAs, either achieved through a separate account or within the plan; for example, through a "banker's clause" as in Québec. As surplus asymmetry

represents an issue for the long-term sustainability of DB pension plans, we recognize that allowing employers to draw from excess surplus would be a positive step for them.

Plan sponsors are very concerned that they are required to make large solvency payments, especially in the current low interest rate environment. A significant increase in interest rates may by itself eliminate current solvency deficits. Under that scenario, those solvency payments would only contribute to a surplus. Often, the utilization of a surplus is a contentious issue; furthermore, on plan wind-up, it is often subject to litigation.

The CIA has suggested that these payments be accumulated in a special account and that the account be refunded to the entity that has made those payments if all accrued benefits are fully secured. In particular, on plan wind-up, if all accumulated benefits have been settled, the part of the remaining surplus attributable to those payments could be refunded.

Letters of Credit

The CIA supports allowing the use of letters of credit (LOCs), and does not see a reason to impose a low limit on their use, given the high quality of these instruments. The threshold allowed remains a government policy decision, as 15 percent or any other limit is not the result of any actuarial analysis.

The market will find a natural limit for letters of credit, since banks will not offer them and sponsors will not buy them to any greater extent than justified (because they are expensive and reduce the sponsor's ability to obtain lines of credit for other business purposes). We note that Alberta, BC, and Manitoba have no such limit.

Option 2 – Eliminate Solvency Funding and Enhance Going Concern Funding

The CIA supports the concept of enhanced going concern funding if solvency funding requirements are removed.

Requiring a Funding Reserve

In our response to Ontario, we discussed a number of options. One of these options included the requirement to have a funding cushion, otherwise known as a provision for adverse deviation (PfAD). Including a new PfAD in future going concern valuations is a good way to address the risks involved. The PfAD should reflect the risks by being linked to the degree of asset liability mismatch and potentially other factors.

Québec's new rules prescribe a relatively simple two-dimensional grid. We believe that such a grid is a step in the right direction and hope to see a slightly more refined approach in the near future. Others have suggested determining a PfAD by reference to the valuation interest rate assumption, but that is not the best approach, as it poorly reflects the asset-liability mismatch. Suggestions to reflect certain plan provisions or the financial strength of the plan sponsor may be relevant to assess certain risks, but we consider them too difficult to implement in a practical manner. Other factors such as plan maturity and demographics are taken into account by Québec's new approach. The suggestion to take into account the level of funded PfAD in determining the possibility to use surplus is appropriate, as is the suggestion to take into account the level of funded PfAD to determine the frequency of valuations.

The CIA is not in favour of removing solvency funding without implementing a PfAD. We believe the level of security targeted with a PfAD is a policy decision, and should be prescribed through legislation or regulatory policy. The CIA would be willing to offer assistance in developing appropriate guidelines, as we have done with other jurisdictions.

Shortened Funding Period

In our response to Ontario, we discussed the considerations surrounding the amortization period, and the impact of reducing that period. Though 15 years or another fixed amortization period have no underlying actuarial principles, the CIA considers 15 years a reasonable compromise between affordability, stability, and security. Should solvency funding be removed, we reiterate that a 15-year amortization period should be applied with a PfAD.

One of a typical plan's key funding objectives is stability of contribution requirements. Allowing a plan the ability to fund going concern unfunded liabilities over a 15-year period is important in being able to achieve that objective, and is no less so in the absence of solvency funding. There appears to be no strong actuarial rationale upon which to base a reduction in the amortization period.

Furthermore, a maximum amortization period of 15 years is a minimum requirement which means that, based on the needs of a particular plan—and its balancing of key funding objectives (adequacy, affordability, security, stability, and equity)—it can fund deficiencies over any time frame from immediately up to 15 years. This would then provide a plan with flexibility by allowing up to 15 years, thereby promoting stability of contribution requirements. Lowering the allowable amortization period would simply limit a plan sponsor's flexibility and the plan stakeholders' ability to decide the relative priority of its key funding objectives.

Restrictions on Return on Investment Assumptions

The CIA understands why regulatory oversight of actuarial assumptions may be desirable. The suggestion to set a maximum interest rate assumption would be acceptable provided such a maximum can be adjusted to reflect each plan's investment policy. This would tie in well with the earlier suggestion to determine a PfAD that reflects a plan's asset-liability mismatch and other relevant factors.

We would also suggest that the current approach of reflecting the actuary's best estimate expectations be maintained, without any regulatory requirement or expectation that an implicit margin in or offset from the discount rate be reflected. The more direct and appropriate way to accomplish the objective is through regulated PfADs.

CIA members are guided by our actuarial Standards of Practice, so it would be desirable for any regulations to be coordinated with these standards.

Solvency Trigger for Enhanced Funding

The consultation paper suggests that solvency could continue to play a role by referring to a plan's solvency position as a trigger to determine whether additional funding is needed or if the plan would be allowed to take an action that would weaken its funded position (as examples: requiring additional funding or restricting benefit improvements if a plan falls below a certain

solvency level). Implicit in this approach is that, regardless of the funding method, a specific level of benefit security on a solvency basis is required.

The CIA stresses that the level of the trigger is effectively a policy decision. Any level below 100 percent is a public policy compromise, and not rooted in actuarial principles. Our submission to Ontario stated that a level of 80 percent would constitute a reasonable compromise between security and affordability. However, requiring a lump sum contribution would create a potentially onerous pension funding cliff for plan sponsors in particularly challenging economic climates. Therefore, both the level of the trigger and the resulting funding requirements when triggered would need to consider this issue. We observe that this approach would therefore be most effective when combined with some of the solvency modifiers discussed above (e.g., lengthened amortization periods, LOCs, FFAs).

Part 2 – Target Benefit Plans

We would support regulations that would allow for the enactment of target benefit legislation in Nova Scotia. Having the option of the target benefit model would be helpful and has many advantages over the defined contribution model, with which many defined benefit plans are being replaced.

The Alberta and British Columbia models for target benefit plans should be reasonably simple and easy to administer and regulate. If the enhanced funding framework model were implemented, then it would be a relatively simple matter of linking the target benefit funding model to the enhanced going concern funding model. For example, a target benefit plan could be restricted from enhancing benefits from surplus below the prescribed PfAD, and may require additional measures (enhanced contributions, benefit accrual reduction, or benefit reductions) in the case where the going concern ratio falls below 100 percent or some other prescribed ratio (e.g., 90 percent).

We see no actuarial reason to restrict target benefit plans to unionized environments, but understand that in a non-unionized environment it may be preferable to either provide for employee representation in the governance model or at the very least require the establishment of a pension advisory committee to ensure there is employee input into the administration and communications about the plan.

Conversion of past service would also be a contributing factor to the success of target benefit plans. The report from our Task Force on Target Benefit Plans addressed this issue and offered some suggestions. At the very least, it would be reasonable to allow individual members and beneficiaries to elect a conversion of their past benefits into a target benefit model. The current option exists for conversions from DB to DC.

Additional Comments – Transfer Values

An issue not raised in the consultation paper is transfer values. If the enhanced going concern model is adopted, then it may be appropriate to revisit the calculation of transfer values. As pension plans would no longer be expected to be fully funded on a solvency basis in a five-year time horizon, it may not be logical to provide a commuted value assuming a 100 percent transfer ratio.

A potential solution would be to pay the commuted value times the most recently determined transfer ratio (and not to provide the unfunded portion of the commuted value in five years). Terminated members always have the option of selecting the deferred pension, and potentially could be offered the commuted value option periodically, say every five years, as the transfer ratio might improve in future years.

Conclusion

Thank you for taking the time to review our submission. We trust that the comments provided will be helpful.

Yours truly,

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