

January 29, 2018

Funding Rules for Defined Benefit Pension Plans
Pension Policy Branch
Ministry of Finance
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Subject: Reform of Ontario's Funding Rules for Defined Benefit Pension Plans: Description of New Funding Rules – Comments by the Canadian Institute of Actuaries

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.

On December 14, 2017, the government of Ontario released two proposals on the reform of the defined benefit funding rules for pension plans registered in Ontario. The [first document](#) outlines funding rules and provides details on new solvency and going concern funding requirements, including the introduction of a provision for adverse deviation (PfAD). The proposal also addresses provisions on contribution holidays and benefit improvements, disclosure requirements, and transition rules. The [second document](#) outlines the possible discharge of plan sponsor obligations pursuant to annuity purchases and gives details on funding and notice requirements related to the discharge.

For your information, the CIA previously provided [input](#) on the [consultation process on solvency funding](#) issued July 2016.

We are pleased to offer the following commentary on both proposals.

General Comments

First, please note that the CIA accepts the six principles on which the December 2017 document is based, and that the CIA supports the benchmark discount rate (BDR) approach, subject to amendments as further noted in the next sections of this letter.

Second, while the concept of PfAD is addressed, the document does not explain how the level of PfAD was established. We encourage the Ministry of Finance to provide stakeholders with additional information on how the PfADs were established, in order to properly comment on whether they are appropriate.

Third, we notice that the first document does not include the concept of a special account in which contributions paid above minimum current service cost are tracked separately and can be used at the discretion of the plan sponsor, potentially as a contribution holiday, and returned to the employer on plan wind-up after all liabilities are settled. Such a credit could be

treated in a similar manner to the current prior year credit balance (PYCB) mechanism. We would like to emphasize that the CIA has supported the concept of such a special account (or PYCB) in order to improve the funding of pension plans and to address the issue of surplus asymmetry. Please note that other provincial regulators in Alberta, British Columbia, and Québec (for both solvency and going concern payments) have adopted such accounts as funding options for plan sponsors. We note that in Québec, the accounts have been easy to administer.

Fourth, there is a proposed requirement to fund on a solvency basis if needed to improve the plan's funded status to 85 percent on a solvency basis. As the proposed government policy decision is to accept a minimum solvency funding target that could be lower than 100 percent, the CIA supports targeting a minimum solvency ratio, such as 85 percent, as a reasonable compromise between security and affordability. This 15 percent decrease in solvency funding requirement is somewhat made up by the enhanced going concern funding as a reasonable trade-off.

Fifth, as part of the PfAD requirements, we suggest that the following concepts be more clearly defined:

a) Open vs. closed plans

From an actuarial perspective, the open/closed characteristic of a plan is not an accurate proxy for the risk inherent to the plan. We surmise that the distinction could be a policy decision to provide an incentive for plan sponsors to keep their plan open to new members. As noted in a prior position discussed with the Québec Government, we encourage the continuance or creation of DB plans, and it might therefore be preferable to offer a less restrictive funding regime to those sponsors that provide further DB accruals; however, we do not think that this small incentive will significantly affect the behaviour of plan sponsors. Regardless, the open/closed definitions should be further clarified as they could be subject to interpretation and possible abuse. We are concerned that the difficulties of properly defining a closed vs. open plan might overcome the small advantages of incenting DB plans to remain open.

As an example, the treatment of a plan that would be open to 25 percent of the workforce while closed to 75 percent of the employees could raise issues.

b) Alternative investments

We are concerned that treatment of alternative investments (whether alternatives are 50 percent non-fixed income) might not have been thoroughly researched. We encourage the Ministry of Finance to hire experts on that matter to define alternative investments and how these should affect the PfAD.

Specific Comments

Please find detailed comments on the proposal, broken down by page in the first proposal:

Page 1

1) Shortening the amortization period from 15 years to 10 years for funding a going concern shortfall in the plan.

The CIA expresses no comment, as the 10-year period is not based on actuarial grounds.

2) Consolidating going concern special payment requirements into a single schedule when a new report is filed.

The CIA agrees with this approach and recognizes that it is consistent with previously announced solvency funding relief measures. We support this approach as it is being used in other jurisdictions. However, the implications of this measure entail that the funding of deficiencies is always being pushed forward with new 10-year amortization periods, and in the absence of experience gains, funding deficiencies or any targeted funding level is unlikely to be achieved within 10 years.

The fact that the contributions to fund any going concern deficits start one year after the valuation date and continue for one year past the next valuation date raises a minor technical issue: the value of the next 12 months of pre-scheduled contributions should be reflected upon establishment of funded status of the plan. Here is an example to illustrate the issue:

- Assume a January 1, 2018 valuation shows a going concern deficit;
- This deficit would be amortized over 10 years, with payments scheduled for 2019, 2020, and 2021 (reflecting the one-year deferral);
- The next valuation is as at January 1, 2021 and will specify that any deficit must be re-amortized over 10 years and payments scheduled for 2022, 2023, and 2024; therefore
- As the deficit as at January 1, 2021 is being calculated, treatment/credit given for the contributions already scheduled for 2021 based on the January 1, 2018 valuation should be clarified.

3) Requiring the funding of a reserve within the plan, called a Provision for Adverse Deviations (PfAD).

Please see comments below (related to pages 5, 6, and 7 of the proposal).

4) Requiring funding on a solvency basis if needed to improve the plan's funded status to 85 percent on a solvency basis.

Any level below 100 percent is a public policy compromise, and not rooted in actuarial principles. As noted in our previous comments, we believe that a level of 85 percent would constitute a reasonable compromise between security and affordability.

5) Increasing the guarantee provided by the Pension Benefits Guarantee Fund (PBGF) from \$1,000 per month to \$1,500 per month.

The PBGF should be subject to more rigorous actuarial analysis. It is incumbent on the government to ensure that the premiums paid reflect the risk of the various plans. Rather than simply increasing the premiums across the board, we suggest that additional sophistication of the PBGF assessment is warranted if the PBGF is to continue. Actuarial input on setting the appropriate premiums would be warranted and the CIA

would be pleased to assist. We will provide further input on the consultation process specific to the PBGF.

6) Providing funding rules for benefit improvements and restricting contribution holidays to improve benefit security.

Please see comments below on page 6.

Page 2

Determination of Solvency Special Payments

The CIA wishes to ensure that the solvency assets adjustment includes the six years (i.e., five years from the solvency schedule plus the one-year deferral) of special payments from the enhanced going concern funding, including the funding toward the PfAD.

Solvency Excess and Transition

The CIA agrees with this approach.

Page 3

Previous Solvency Funding Relief

The CIA has no comment on this section.

Temporary Solvency Funding Relief for Public Sector Plans (Regulation. 178/11)

The CIA has no comment on this section.

Page 4

Letters of Credit (LOC)

Under the proposal, the LOC limit remains at 15 percent of solvency liabilities and the lower solvency funding target of 85 percent will become the threshold for the reduction of existing LOCs. LOCs used instead of cash contributions could be reduced if the plan's solvency ratio remains at 85 percent or more after the reduction.

Existing solvency LOCs as well as new LOCs should be available for use to fund the new PfAD. It seems that the current proposal does not recognize existing LOCs. In terms of security, note that LOCs are comparable to bank deposits.

We also recommend that letters of credit (LOCs), existing and newly issued, should be allowed toward PfAD funding. A LOC properly guaranteed by a financial institution can be used to provide security, and there is no actuarial justification for the 15 percent limit.

Going Concern Funding Deficiencies

The CIA agrees with the proposed approach.

Funding for Indexation

Although the CIA understands that indexing could technically be excluded from solvency (for consistency with the prior regime approach), on a going concern basis there is an

inconsistency with the treatment of pre-retirement indexing and pre-retirement salary increases, where PfAD is required on the latter but not on the former. The CIA wishes to emphasize that there are no actuarial grounds for treating indexing differently from other inflation-related benefits either on the PfAD or on funding.

Pages 5, 6, and 7

The topics on these pages outline the main element of the new framework: the determination of the PfAD.

The document does not explain how the level of PfAD was established. We encourage the Ministry of Finance to provide stakeholders with additional information on how the PfADs were established, in order to properly comment on whether they are appropriate.

The objective should be to find a simple but appropriate proxy for the risks in order to establish the PfAD. The calculation of the PfAD should not significantly increase the cost of actuarial valuations and should not provide incentives to establish inappropriate investment or funding policies. Please note that the current proposed factors (fixed-income securities (FIS) vs. non-FIS, open plans vs. closed plans) are suboptimal as they lack recognition of the plan liabilities and possible mismatch with assets. The asset/liability mismatch risk can be mitigated through duration matching of assets and liabilities, and this is not reflected in the proposal. Adding a duration component to PfAD would not add much administrative complexity for plan administrators, in addition to giving consideration to interest rate risk.

We note that the application of the table can result in a reduction of contributions as the percentage of non-FIS increases. We would prefer that the table provide no such incentive. As a principle, the PfAD structure, in isolation, should not have the potential of encouraging plan sponsors to increase the equity component of the pension fund so that they may benefit from a decrease in required contributions.

Our support of the PfAD approach is based on the understanding that the PfAD would be applied to a liability based upon best estimate assumptions that do not include any implicit margins in the assumptions. It would be helpful for this to be made clear in the final regulations.

We understand that non-FIS include equities. FIS include bonds, cash, term deposits, short-term notes and treasury bills, GICs, and insured contracts (including annuities held as plan assets). It is our opinion that no PfAD should be applied to liabilities directly supported by purchased annuities. Also, FIS would need to be of a certain quality to support pension liabilities and the regulations should detail certain characteristics of bonds of lesser quality that will not be considered fixed-income assets. We stress that the government will need to clarify the classification of FIS versus non-FIS for plans with more complex asset strategies.

The CIA agrees with the application of an additional PfAD if the going concern discount rate is above a formula-based benchmark rate which depends on the plan's asset mix and the level of long-term government bond yields.

In setting the BDR, the government proposes that risk premiums be set at 1.5 percent for FIS and 5 percent for non-FIS. It further proposes that 50 percent of specified investments that are

alternative investments be considered non-fixed income assets. We presume that this is intended to reflect an upper bound of a reasonable range of assumptions. The CIA agrees with the 5 percent maximum non-FIS risk premium and with the 1.5 percent maximum for FIS.

Specifically on the BDR:

- 1) We suggest using the daily rate given by CANSIM V39056 (Government of Canada long bond yield on the day of the valuation date), rather than the monthly rate given by CANSIM V122544.
- 2) We are concerned that these assumed risk premiums might become the default option in selecting actuarial assumptions for many plans. We suggest that funding policies define objectives and criteria, as done in other jurisdictions.
- 3) A note on passive vs. active investing: The proposal seems to penalize plans with active management compared to those with passive management, as the PfAD would be increased by the duration of the plan's going concern liabilities multiplied by the difference between the plan's best estimate discount rate, gross of all expenses, and the BDR. An approach better aligned with CIA guidelines would be to base the calculation on best estimate net (rather than gross) of investment expenses, as the CIA allows, to recognize additional return due to active management, limited up to the investment management expense level. Regardless, the treatment of active vs. passive returns, and expenses, should be clarified as it relates to comparing a plan's discount rate to the BDR.
- 4) We suggest that if a plan chooses also to include an implicit margin in the discount rate assumption, then it should be taken into account in determining the BDR.
- 5) As stated earlier, we encourage Ontario to consult with investment experts to refine how alternative assets are treated. More detailed guidance will be required to determine which alternative investments have fixed-income elements. Furthermore, many alternative investments should be considered as 100 percent fixed income (not 50/50). As an example, mortgage loans of sufficient quality should be considered as 100 percent FIS. Another example is private debt of sufficient quality, which in many cases should be considered 100 percent fixed income. On the other hand, private equity should be considered as 0 percent FIS.

Bottom of Page 7

Adjusting Going Concern Special Payment Schedules

The CIA agrees with this approach.

Page 8

Benefit Improvements

Benefit improvements are proposed to only be allowed if the solvency ratio of the plan after the improvement is at least 85 percent and the going concern ratio (without PfAD) is 90 percent. Where necessary, a lump sum contribution can be remitted to satisfy these requirements. The cost of benefit improvements on a going concern basis will have to be funded over five years beginning on the effective date of the amendment and cannot be consolidated with other going concern amortization schedules.

The new requirement of the going concern funded ratio of 90 percent on top of a solvency funded ratio of 85 percent is significant. As benefit security is more a concern on plan wind-up, there are limited actuarial grounds for imposing an additional threshold on the going concern funded ratio. The impact is also increased due to the immediate funding requirement of the improvements. If accelerated funding of improvements is required, it is difficult to define the purpose of the 90 percent threshold. Plan sponsors may be reluctant to improve benefits as a result, though it is understood that benefit improvements are unlikely in the current context.

Contribution Holidays

It is proposed that surplus can be applied towards required contributions of an employer or members provided that the plan is fully funded on a going concern basis (including the PfAD) and maintains a transfer ratio of at least 105 percent (including indexation if applicable). However, no more than 20 percent of available surplus may be used to take a contribution holiday in a given year. We realize that limiting contribution holidays to 20 percent of the available amount is a security measure that may be considered as a policy decision compromise for permanent relief of solvency funding. We would like to express that there is no actuarial foundation supporting the 20 percent number itself. Also, should the government decide to implement the special accounts (recommended in our introduction), our opinion is that such accounts should not be subject to this 20 percent limit, as in Québec.

The requirement to attain a 105 percent transfer ratio (TR) and maintain the 105 percent TR after the contribution holiday seems inconsistent with the 85 percent minimum solvency level requirement. As an example, if a plan sponsor uses a LOC while being above 85 percent, it can eliminate the LOC at will. On the other hand, if a plan sponsor remitted contributions above the 85 percent threshold, this effectively results in a 20 percent corridor (105 percent to 85 percent) of unavailable funds. We suggest that the 105 percent transfer ratio requirement be reduced to 100 percent.

Upon wind-up or for contribution holidays, if surplus emerges as a result of PfAD contributions, this should be treated differently compared to regular surplus—this can be addressed through the special account mentioned in our introduction.

Page 9

Filing of cost certificate

The proposal states that a contribution holiday could be taken only if an actuarial cost certificate is filed with the Superintendent within the first 90 days of the plan's fiscal year. It would be helpful to extend this time frame to 120 days.

Also, when a full valuation report is being prepared, there should be no requirement to file a cost certificate between April 30 and September 30 when a full valuation report is about to be filed.

On the topic of contribution holidays and cost certificates, we would like to suggest an exemption for plans that have "excess surplus" under the Income Tax Act—this causes issues,

as the Canada Revenue Agency prohibits contributions, but the Financial Services Commission of Ontario requires contributions to resume unless a cost certificate is filed.

Page 10

Transitional Funding Rules

The CIA agrees with the proposed change; however, we suggest that the reduction from 15 to 10 years in the amortization period could be made gradually, similar to the Québec approach.

Disclosure Requirements

The CIA agrees with the proposed approach.

Consequential Amendments regarding Surplus

The CIA agrees with the proposed approach.

Comments on Annuity Purchases

The annuity proposal details were generally in line with CIA expectations. After the annuity is purchased, the plan's solvency ratio must at least equal the greater of the solvency ratio immediately before the purchase and 100 percent. The 100 percent target will decrease to 85 percent when the revised solvency funding rules are in place. While we agree with the notion that no annuity purchase should be made at the expense of remaining plan members, it is our opinion that the plan's solvency ratio after the purchase should at least be equal to the solvency ratio immediately before the purchase, not the greater of the solvency ratio immediately before the purchase and 100 percent. In our opinion, adding the 100 percent requirement does nothing to address whether the remaining plan beneficiaries are negatively affected. As an example, if a plan was 105 percent solvent before the purchase, it should be enough to remain at 100 percent after the purchase (or 85 percent as is targeted after reform). On the other hand, if a plan was 75 percent solvent before the purchase, then the target should be to remain at 75 percent after the purchase (not raise the level to 85 percent).

In addition, the employer must remit any contributions needed to meet this requirement within 30 days of the annuity purchase. This time frame of 30 days is very short and may not give enough time for the actuary to determine the required contributions. We suggest that 90 or 120 days be granted to provide enough time.

Also, purchasing an equivalent annuity where the original form is not available on the market should be permitted, where the approval of the form of the purchased annuity could be based either on member consent, pursuant to finding reasonably priced annuities (i.e., to not force a plan sponsor to proceed if member consent is obtained, but the annuities are too expensive) or by the Superintendent. As an example, such a situation could occur in instances where complex contractual indexing formulas exist in the plan.

On entitlement to surplus on annuity purchases, a limit of three to five years (or other statute of limitation) should be implemented for any surplus distributions pursuant to annuity purchases. Significant administrative complexities will emerge from having no time limitation on right to surplus for annuity purchases.

We would like to raise the issue of a discharge when purchasing annuities for active members with frozen DB benefits. The proposals clearly contemplate a discharge only for deferred and retired members, but active members with frozen DB benefits are often (but not always) identical to deferred members.

Additional Remark

The government should consider the Québec approach of paying lump sum values on the basis of the solvency ratio.

As always, the CIA stands ready to assist in the work ahead.

Thank you for taking the time to consider our comments. If you have any questions, please feel free to contact Joseph Gabriel, CIA staff actuary, education, by telephone at 613-236-8196 ext. 150, or by e-mail at joseph.gabriel@cia-ica.ca.

Yours truly,

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