Canadian Institute of Actuaries
Institut canadien des actuaires

July 26, 2019

Linda F. Mezon, FCPA, FCA
Chair, Canadian Accounting Standards Board
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Re: Employee Future Benefits – Use of a Funding Valuation

Dear Ms. Mezon,

We are replying to the letters of February 14, 2019, and May 6, 2019, from the Canadian Accounting Standards Board (AcSB). The AcSB asked the Canadian Institute of Actuaries (CIA) for its opinion on the diversity in practice regarding the measurement of the defined benefit obligation (DBO) when a funding valuation is used to represent a pension plan's obligation under Section 3462, Employee Future Benefits, Part II of the *CPA Canada Handbook – Accounting*.

The following provides both a background on the issues raised in your February and May 2019 letters and the CIA's response to the AcSB's proposed course of action.

AcSB letter of February 14, 2019

On February 14, 2019, the AcSB sent a letter to the CIA regarding the use of a funding valuation. This letter advised the CIA that at the AcSB's December 2018 meeting, the AcSB discussed the use of a funding valuation in the measurement of a plan's DBO as referenced in Section 3462. You indicated that there was a concern regarding the diversity of practice that could arise, either:

- Directly as a private enterprise that applies Section 3462, Part II of the handbook,
- Via Section 3463, Reporting Employee Future Benefits by Not-For-Profit Organizations, in Part III of the handbook, or
- Via Section 4600, Pension Plans in Part IV of the handbook.

The diversity of practice was highlighted as a result of the changes to Ontario's pension funding rules in May 2018. These rules introduced a new component for funding a registered pension plan in Ontario. It is a reserve for unexpected poor experience and is referred to in the funding rules and within the actuarial community as a "provision for adverse deviations"

(PfAD). The changes to Ontario's funding rules followed a similar change to Québec's funding rules where the Québec regulator introduced the funding of a stabilization reserve in 2016, also to act as a buffer for unexpected poor experience.

The main question for the AcSB as a result of the introduction of these two reserves in Ontario and Québec was whether the reserve for a PfAD *should* or *should not* be included in the measurement of the DBO when an entity elects to use a funding valuation in accordance with Section 3462.

In your February 2019 letter, the AcSB reminded the CIA that the use of a funding valuation was an accommodation to eliminate the additional costs of preparing a separate accounting valuation under Section 3462. The AcSB stated that management's best estimate of a DBO is an accounting valuation and not a funding valuation. To be clear, you indicated that a funding valuation is prepared in accordance with legislation, regulatory, or contractual requirements and, even if the regulation stipulates separate calculations of the various components of the funding requirement, it is the aggregate of those components that makes up the funding valuation to be reflected in the financial statements. Therefore, if a PfAD or stabilization reserve is one of these components, then it would be included in the measurement of the DBO.

AcSB letter of May 2019

In May 2019, the AcSB sent a follow-up letter to the CIA regarding its decision on two points:

- Including Québec's stabilization reserve in a plan's DBO
- The diversity of practice for use of a PfAD in defined benefit plans with no funding valuation requirement, i.e., unfunded plans

You indicated that the matter of Québec's stabilization reserve had to be dealt with separately because prior to Ontario's introduction of a PfAD into its funding rules there had not been any questions on whether Québec's stabilization reserve should or should not be included even though a diversity of practice amongst practising actuaries may have existed.

Regarding Québec's stabilization reserve, the AcSB decided to take a standard-setting action and include it in the DBO calculation, but would send out an exposure draft to its membership to obtain feedback. The exposure draft is expected to be finalized by the fall of 2019.

Regarding the second point, the AcSB decided, based on subsection 3462.029C, that the same basis be used for defined benefit plans that have a statutory funding requirement and those that do not. Therefore, for plans without a statutory funding requirement, should include a PfAD or stabilization reserve, as the case may be. However, the AcSB was open to hearing the CIA's feedback on this decision.

CIA response

To summarize the reaction to the AcSB's decision on these matters, as outlined in the foregoing, the CIA canvassed pension actuarial accounting experts from five major pension actuarial consulting firms across Canada and the pension actuaries at each of the major accounting firms (Deloitte, EY, KPMG, and PwC). Overall, the actuaries at the pension consulting firms and the actuaries at the accounting firms understood how the AcSB came to its

conclusions; however, they expressed concern with the implications of these conclusions for various reasons. The actuaries at the consulting firms and accounting firms felt that the AcSB approach to include the PfAD or stabilization reserve was not the correct approach because it either did not fairly represent a valuation of the plan's liability or because the funding liability figures without the margins are now readily available and can be used easily.

With respect to the first point, the main reason for the concerns arose because the idea of including an explicit reserve for adverse experience through a PfAD or stabilization reserve appears contrary to the idea that the DBO for accounting purposes represents a valuation of the plan's liability (i.e., a present value of future cash flows). Many actuaries recognized that in the prior approach the going concern discount rate included an implicit margin that may have led to a similar result. However, in the prior approach only one funding value was available, so that value was used.

Under the current approaches in Ontario and Québec, the funding liability figures with and without the statutory reserves for adverse deviations are easily and readily available, consequently, many of the firms believe that the funding valuation figures without the margin are a better liability value to represent a plan's DBO for accounting purposes.

Using the funding liability without a reserve for adverse deviations is equally expedient since it involves no manipulation and it can easily be identified in an actuarial report by users who may not be familiar with actuarial communications.

Additionally, using the proposed AcSB approach creates practical complications as discussed in the sections below.

The CIA recommends that the AcSB consider modifying its conclusions for funded versus unfunded plans, and we would be happy to support the AcSB in analyzing the implications of alternatives.

Statutorily funded plans

For funded plans with a legislative, regulatory, or contractual funding requirement, the CIA understands the rationale for the AcSB's decision for including a PfAD or stabilization reserve in the funding liability calculation based on the AcSB's reasoning in its February 2019 letter. However, it would be the CIA's preference that the AcSB not include such reserves because a plan's DBO would be more appropriately or accurately represented by its obligation without including a reserve for a PfAD or a stabilization reserve.

The AcSB considered the treatment of Ontario's PfAD and Québec's stabilization reserve separately in the February and May letters. However, as they both conceptually represent a reserve against poor experience, the CIA would like the AcSB to treat the two equivalently in any future decisions. As a clarification, a PfAD or stabilization reserve represents an additional amount based on various factors, as follows:

- A plan's market risk. This market risk is assessed using a funded plan's target asset mix as shown in its investment policy document. Plans with a higher proportion of their assets invested in fixed-income securities will be deemed to have less market risk than plans that are more invested in variable-income securities (like equities).

- For Québec-registered plans, a plan's interest-rate risk. The interest-rate risk is determined based on a plan's hedge ratio, that is, the ratio of a plan's investment duration to its liability duration.
- For Ontario-registered plans, whether the defined benefit component of the plan is considered open or closed.
- For Ontario-registered plans, whether the plan's going concern discount rate is higher than a benchmark discount rate established in Ontario's funding rules.

Most, if not all, pension actuaries would agree that the funding liability calculation for Ontario- and Québec-registered plans consists of the true funding liability calculation (the actuarial present value of future benefits) and an additional component for poor experience (a percentage of which is determined based on a plan's market risk and other elements as outlined above). Therefore, to include the PfAD or stabilization reserve in the funding liability for accounting purposes represents a liability which is higher than the plan's actual funding liability and not a true estimate of the obligation for the benefits that are promised to be paid. This is especially relevant given that the actuary has the funding valuation without the PfAD or stabilization reserve readily available, with no incremental effort required to generate this liability measure.

Defined benefit plans without a funding valuation requirement

Another result that arises from including the PfAD or stabilization reserve in the funding valuation is that the expense for the plan is skewed under Section 3462. By including these reserves, additional gains are created in the plan's annual expense via gains on the plan's obligations. Every dollar of benefit paid releases a dollar of liability plus PfAD resulting in a re-measurement gain on the plan's obligation. This creates some unexpected outcomes for mature plans reporting under ASPE where a plan could have a pension income instead of expense due to the release of liabilities from the PfAD component.

An example and unintended result of the AcSB's decision for such plans would be a plan sponsor with a small registered pension plan for only its executives and a much larger unfunded OPEB plan for all employees, or an unfunded LTD plan. In such a situation, applying the PfAD under the registered plan to the OPEB could be extremely significant in terms of its impact on the sponsor's expense and balance sheet and would bring into question the reasons for this approach.

The CIA strongly recommends that the AcSB reconsider its conclusion to include some sort of PfAD or stabilization reserve in the DBO calculation for defined benefit plans without a funding requirement. To apply the PfAD or stabilization percentage, whose value is determined based on the nature of the plan investments (and other factors outlined above), to plans that have no investments does not seem appropriate. For partially funded plans, the lack of a tax-advantaged funding mechanism could lead to very different investments than the corresponding statutorily funded plan.

In addition, the prior practice of using the same discount rate for unfunded plans as funded plans was more of a convenience and, with the change to the funding requirements to include a PfAD or stabilization reserve, this prior approach arguably no longer makes sense going

forward. Some actuaries would even dispute that this prior approach was sensible in the first place. As mentioned, it was most likely assumed as a convenience in completing the work due to materiality considerations. This could also raise practical issues for some non-pension actuaries who perform OPEB valuations to identify within a pension plan funding report a provision or reserve percentage that they may not be aware of. For instance, non-pension actuaries performing a valuation for post-retirement benefits may easily find information on assumptions to value their benefits under a funding approach but may not be familiar with funding requirements for a PfAD or reserve within a different section of the pension plan report as they may not be familiar with these aspects.

If the AcSB is trying to discourage sponsors from using the funding valuation expedient for such plans, the CIA feels it should consider a revision to the applicable standards. Therefore, it would be the CIA's strong preference that no PfAD or stabilization reserve be included for such plans. Instead, actuaries would be supported by guidance material to be developed by either the CPA or CIA on how to determine the DBO for such plans when a plan sponsor elects to use a funding valuation for arrangements for which such valuations are required.

Next steps

We appreciate the AcSB reaching out to the CIA to discuss these questions on the use of a funding valuation and we trust that the discussion will help the AcSB arrive at a solution that will still provide for an accommodation while also using an actuarial basis that is appropriate.

The CIA would be happy to assist further in the AcSB's process, and we look forward to addressing any questions you have on our response. Please contact Chris Fievoli, CIA Staff Actuary, Communications and Public Affairs, at 613-656-1927.

Sincerely,

[original signature on file]

Marc Tardif, FCIA
President, Canadian Institute of Actuaries

cc.

Nancy Estey, Kelly Khalilieh (AcSB)
Chris Fievoli, Conrad Ferguson, Michel Simard (CIA)