Canadian Institute of Actuaries / Institut canadien des actuaires

September 6, 2019

Financial and Corporate Sector Policy Branch
Ministry of Finance
PO Box 9418, Stn. Prov. Govt.
Victoria, BC V8W 9V1
PBSA.SolvencyReview@gov.bc.ca

Subject: A Review of the Solvency Funding Framework under the Pension Benefits Standards Act: Report on Stakeholder Committee Process

The Canadian Institute of Actuaries (CIA) is pleased to offer the following comments on the aforementioned consultation paper. These comments are in addition to our response provided in January of this year.

Going-concern plus

The CIA is generally supportive of the move towards a going-concern plus regime like the BC Ministry of Finance is proposing, as long as the implications are clearly understood by all stakeholders. A going-concern plus regime will significantly reduce contribution volatility, which has been a primary reason for the closure and freezing of defined benefit (DB) plans. We believe that DB plans are a very effective way to provide retirement security to Canadians, and therefore we are supportive of policy actions encouraging the maintenance of such plans.

However, it is important for all stakeholders to recognize that the proposed change in funding regime will, in almost all circumstances, result in lower benefit security for DB plan members. We advise that there be transparency in how this change is communicated. No one should presume that the new funding regime will result in better benefit security for DB plan members. Wind-up funded positions of pension plans will generally be materially lower under the new funding regime vs. the status quo, and will improve more slowly if they deteriorate (all else being equal). Consequently, if benefit cutbacks are required under an employer insolvency scenario, they are likely to be more severe.

Structure of Provisions for Adverse Deviation (PfAD) and actuarial excess usage

We have the following comments regarding the proposed structure of the PfAD and actuarial excess usage:

1. By definition, a PfAD is meant to protect against adverse experience. In a pension plan context, the primary sources of risk are asset returns and interest rates. A PfAD which is based solely on the absolute level of interest rates does not fully protect against either of these sources of risk. In our view, if something is going to be called a PfAD, it should be linked to the level of asset-liability mismatch.

   We note that revised actuarial standards of practice will soon require that valuation reports disclose the potential impact on the plan's funded status and contributions of plausible adverse scenarios. Those scenarios are intended to highlight the investment market risk and the interest rate risk faced by the plan, this latter risk taking into account both assets and liabilities. These new disclosures will illustrate how the proposed PfAD will provide a much smaller buffer against adverse experience for plans with bigger asset-liability mismatches than those with smaller asset-liability mismatches.

2. A going-concern plus regime allowing asset smoothing and 10-year amortization of deficits will result in much lower contribution volatility than the current regime in which solvency deficits have to be funded over five years. Contributions may still be volatile for plans which are below or close to an 85% solvency ratio, but even under that scenario, they will be much more stable than under the current regime. Consequently, we question whether it is necessary for the PfAD to be solely focused on reducing contribution volatility. Rather we think the PfAD should be designed to also promote other policy objectives such as encouraging prudent investment and funding policies.

3. The PfAD proposed by the BC Ministry of Finance could be very effective in maintaining contribution stability under a particular economic scenario (i.e., when interest rates rise and asset returns are acceptable), but could actually be counter-productive under other economic scenarios (e.g., where both interest rates rise and equity returns are very poor, which occurred in the 1970s).

   If the BC Ministry of Finance wants to further increase contribution stability, this would be more directly accomplished by defining a wider funding range in which the plan sponsor would be required to make current service contributions, rather than through the design of the PfAD.

4. The proposed PfAD structure could create some anomalous results:

   - If interest rates were to rise significantly, the PfADs could become inappropriately high (e.g., if interest rates were to rise to 8%, a 40% PfAD seems excessive). Under these scenarios, particularly if assets have performed well, plan sponsors and members could reasonably argue that the PfAD inappropriately restricts their ability to utilize surplus to fund contribution holidays and/or benefit improvements.

   - The PfAD will not help contribution stability if long-term bond rates fall significantly below 1%. A very low interest rate environment is a real possibility – long-term interest rates in Canada are at historic lows and we have witnessed prolonged very low or even negative yields on the sovereign longer-term debt of some developed countries (Japan, Switzerland, Germany etc.). If long-term interest rates were to fall to 1% or lower, the proposed minimum PfAD of 5% seems very low (even if it is applied to higher liabilities), given the level of risk being taken in pension plans.

We believe that a funding regime should be robust enough to function effectively under a broad range of plausible economic scenarios. In our view, the proposed PfAD structure could work effectively under some economic scenarios but could be counter-productive under other economic scenarios.

5. The paper cites a rationale for the PfAD not being linked to the asset mix, so as not to influence investment policy. In our view, the proposed structure of the PfAD is likely to have a significant influence on investment policy.

   There are indications that, in Ontario and Québec, the move away from a solvency funding to a going-concern plus funding regime has resulted in many plan sponsors choosing to suspend or delay further de-risking activities. In some cases, sponsors have opted to take on more investment risk. This is because contributions have become much more stable under the new funding regimes, allowing sponsors to take on a higher level of investment risk without increasing contribution volatility. A higher risk asset mix would generally allow the use of a higher going-concern discount rate, which in turn results in lower minimum funding requirements. While Ontario and Québec both have a PfAD which increases as investment risk increases, the net impact of increasing investment risk is to lower minimum funding requirements. The PfAD proposed by the BC Ministry of Finance does not increase when investment risk increases – consequently, we expect that the incentive to suspend de-risking activities or increase investment risk will be greater than it is in Ontario and Québec.

   As the objective of the funding review is to improve the ability of employers to continue to voluntarily operate their plans, perhaps this is an acceptable outcome for policymakers. However, it is important to recognize that if pension plan sponsors take more investment risk, the chances of significant deteriorations in wind-up status and adverse impacts on member benefit security will increase. Consequently, we believe it is important to have some mechanism in the funding regime to discourage extreme risk taking behaviour.

   A PfAD which is linked to the level of risk being taken in the pension plan would have a positive impact on benefit security (vs. a PfAD which is not linked to the level of risk) because it would require plans which are exposed to more risk to build bigger buffers before contribution holidays are taken.

Consistency across jurisdictions

The CIA has for many years called for greater consistency across jurisdictions when it comes to pension regulation. We also note that CAPSA has established a Funding Review Committee to develop recommendations for best practices related to the funding of benefits for DB pension plans. Quoting from the committee's recommendations, we note that "regulators and policymakers may consider a number of factors in determining how to calculate a PFAD in their jurisdiction." The factors subsequently listed differ from what has been proposed by the BC Ministry of Finance.

We also note that consistency across provinces is appropriate to the extent that each jurisdiction has similar goals for the use of a PfAD.

Other comments

We are generally supportive of the 85% solvency floor. As noted above, we believe that it is useful for members' security to have some mechanism to ensure solvency positions do not get too low. However, there needs to be recognition that lowering the solvency floor will result in a greater likelihood and severity of benefit reductions in a bankruptcy scenario.

We believe that, when calculating deficiency payments, division by 60 or 120 is overly simplistic. Under this approach, the rate at which a deficit gets liquidated would be very different when interest rates are high vs. when they are low. The current formula that takes interest rates into account should be maintained, as in every other province.

Recommendations and conclusion

Based on the above, we offer the following recommendations:

1. Given the stated objectives of the PfAD, it should be renamed "stabilization provision" or something similar.
2. Under a going-concern plus regime, the most effective way to maintain contribution stability is through the management of deficits and excesses, rather than through the design of the PfAD. We note that under the proposed legislation, sponsors will need to contribute the service cost from the point at which the going-concern funded ratio is 100% until the point that both the going-concern funded ratio (including PfAD) is 105% and the solvency ratio exceeds 100%. An effective way to enhance contribution stability would be to widen this range. For example, the legislation could establish a broad range beginning at or slightly below a 100% going-concern funded ratio and ending at a higher going-concern funded ratio (e.g., 120%), in which current service contributions would be required to be made. In order to recognize the fact that funded status volatility depends on the investment strategy, the size of the range would ideally be based on the size of the asset-liability mismatch. However, simpler alternatives where the range is based on the level of investment risk or even a fixed range would be more effective than the proposed PfAD design in maintaining contribution stability under a broad range of scenarios.

   A variation of this approach is to have a corridor or buffer zone beyond the PfAD which does not require funding but which restricts utilization of excess assets. We could refer to this as a “wait-and-see” zone that gives some leeway to markets to adjust a bit without affecting contributions. The proposed regime includes such a buffer of 5% above the target PfAD, which helps in this sense, whereas Québec chose to apply a buffer of plus and minus 5%, i.e., on each side of the target PfAD, which can be more effective in reducing volatility.

3. The PfAD structure should be fundamentally changed. The proposed PfAD structure would only be effective in accomplishing its stated objective of contribution stability under some economic scenarios. It could actually be counter-productive to this objective under other economic scenarios. Furthermore, we believe that the objective of the PfAD should be broader than just contribution stability – in particular, it should discourage very aggressive funding and investment policies. In our view, the PfAD should ideally be based on the asset-liability mismatch (as in Québec). If this is deemed too complex, then it should be based on the level of investment risk (as in Ontario). Either of these approaches would be more robust than the proposed approach.

4. If the BC Ministry of Finance chooses to maintain the proposed approach of calculating the PfAD based on a multiple of nominal interest rates, further modifications should be made to reflect the level of risk being taken in the pension plan. The current proposal allows for lower PfADs for plans that hold more than 70% in fixed income assets (to a minimum PfAD of 5%). This approach should be extended.

   We believe that the proposed PfAD was derived for a sample plan that holds 50% in fixed income assets. The PfAD could be adjusted based on a given plan’s fixed income holdings relative to 50%. For example, there could be a simple scale that decreases the target PfAD by up to 50% for plans that have 100% in fixed income and increases it by up to 50% for plans that have 0% in fixed income. Under this example, if the reference bond yield is 2% and the desired PfAD is thus 10% for a sample plan with 50% in fixed income assets, then a plan with 80% in fixed income assets would have its PfAD decreased by 30% to 7% while a plan with 20% in fixed income assets would have its PfAD increased by 30% to 13%. Other variations which achieve the objectives while still being very simple to apply can be derived. If this approach is of interest, further analysis should be performed to develop appropriate adjustment factors that best meet the policy objectives.

5. Regardless of the approach taken, we recommend that the BC Ministry of Finance provide more time to allow for development, testing and consultation of changes to the funding regime. These changes are too significant and too important to be implemented in such a short timeframe. In our view, the time allowed for this consultation is far too short to allow for adequate testing of the proposal. We believe that the BC Ministry of Finance should carefully consider the feedback received, and regardless of the policy direction chosen, provide additional time for stakeholders to test and provide feedback on this proposal or a revised one.

The CIA appreciates the opportunity to provide feedback on these issues, and we would welcome further discussion with you throughout this process.

If you have any questions, 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

The Canadian Institute of Actuaries (CIA) is the national, bilingual organization and voice of the actuarial profession in Canada. Our 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.