July 13, 2020

Finance and Treasury Board
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**Subject: New Funding Framework for New Brunswick Defined Benefit Pension Plans**

The Canadian Institute of Actuaries (CIA) is pleased to offer the following comments on the proposed changes to the pension funding framework published by the New Brunswick government on June 29, 2020. The topic of solvency funding reform has been raised in recent consultations in other provinces, including Ontario, Québec, Manitoba, British Columbia, and Nova Scotia in 2018 and 2019, and the CIA responded in length to those proposals.

The CIA advocates for consistency whenever possible across Canada, and this is an opportunity to achieve greater uniformity in provincial legislation. Therefore, we would like to refer you to submissions we issued in 2016 and in 2018 in response to two of Ontario's consultations on a solvency funding framework. Many of our comments at that time are relevant to the issues that New Brunswick is trying to address with the proposed changes.

The CIA believes that defined benefit (DB) pension plans are the best means by which to provide secure and predictable retirement income. We also acknowledge that the large number of solvency special payments made by plan sponsors over the past 15 years have contributed to the modification and closure of many DB plans. The number of funding relief measures that have been introduced indicates the need for a change in funding regulations. To that end, the CIA supports a change to the pension funding regime that *replaces* the solvency funding framework with an enhanced going-concern framework, which would include provisions for adverse deviations (PfADs) and regulatory requirements regarding the determination of the PfADs.

However, we think that it is important to be transparent with pension plan members regarding the implications of the proposed new funding regime. While the proposed new funding regime will significantly lower the volatility of contributions, it will likely reduce the level of benefit security (except in the limited situation where the new rules prevent the insolvency of the employer.

**Pros and cons of solvency funding**

In arriving at this position, we considered the following pros and cons associated with solvency funding.

***Arguments for removing solvency funding requirements***

- 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 15 years indicates that the regime requires fundamental change.
- Many plan sponsors feel that solvency funding has resulted in unsustainable volatility in contributions.
- Solvency funding is pro-cyclical, asking plan sponsors to increase contributions once poor performance has already impacted the plan and at a time when they can least likely afford the contributions, rather than building a buffer before the risk of poor performance is realized.
- Some sponsors have difficulty budgeting for solvency funding requirements and managing the resulting level and volatility of contributions. This is often used to justify plan terminations and/or conversion to defined contribution plans.
- Solvency funding is based on the assumption that the plan will be terminated. Many employers feel that this is unreasonable given the remote possibility of wind-up for many plans.
- Solvency funding is also based on the assumption that stakeholders are willing to pay the price for the full security of benefits. As evidenced by the closing of many DB plans, many stakeholders are not willing to accept such a high price.
- Canada may be the only jurisdiction that uses such volatile measures, which produce significantly higher contributions than in other countries. For example, contributions are much lower and less volatile in the US. This may put Canadian businesses at a competitive disadvantage relative to their global peers.

***Arguments for keeping solvency funding requirements***

- Plan participants are likely to be better protected on plan wind-up if contributions are made on this basis.
- 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 reduced volatility of contributions; and
    - Implementing a solvency reserve account where excess solvency contributions can be refunded.

Relaxing solvency funding to a funded level that is below 100% is a public policy compromise between security and affordability and not rooted in actuarial principles.

## Proposed changes to the funding regime in New Brunswick

***Summary of our understanding of the proposed changes***

You will find below a summary of our understanding of the proposed changes found in the published regulation:

*Funding regime*

The proposed changes to the regulations would see the following happen:

- Establishment of an Enhanced Going Concern Funding Framework through the addition of a PfAD to the going-concern liability; combined with
- Reduced solvency funding requirements to a threshold of 85% (rather than 100%)

The PfAD is calculated using a one-dimensional table using the proportion of fixed income assets versus non-fixed income assets, with a lower PfAD for plans that have already been exempt from funding on a solvency basis (which remain exempt under the proposed regulation), which is similar to PfAD rules already adopted in Nova Scotia.

*Amortization periods*

New going-concern deficiencies are to be amortized over a shorter period of 10 years, while solvency deficiencies (up to the 85% threshold) continue to be amortized over 5 years.

*Effective date*

The implementation of the new rules would be retroactive to actuarial valuations effective on and after December 31, 2019.

*Contribution holiday*

Employer contribution holidays would only be permitted if plan assets are greater than 105% of both going concern and solvency liability.

*Use of letters of credit*

Letters of credit would be allowed for solvency funding purposes, up to 15% of the solvency liability.

*Governance policy*

Pension plan administrators would have to establish written governance policies in line with CAPSA Guideline No. 4, but such policies would not have to be filed with the regulator, except upon request.

***CIA commentary on the proposed changes***

We provide below our comments on some of the proposed changes:

*Funding regime*

We support the concept of requiring a PfAD if solvency funding requirements are reduced as proposed.

The CIA believes that the PfAD should reflect the inherent risk being taken by the plan by being linked to the degree of asset-liability mismatch. This can be accomplished using a two-dimensional grid based on the level of non-liability matching assets and the portion of interest rate risk being hedged.

There is no information available to explain how the level of PfAD found in the proposed regulation was established. We encourage government 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) 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 would like to draw your attention to Québec's recent rules, which are intended to reflect this option, but in a manner that prescribes a relatively simple two-dimensional grid, rather than the one-dimensional grid proposed in the regulation. Factors such as plan maturity and demographics are taken into account by Québec's recent approach.

We note that the application of the proposed PfAD 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. The PfAD structures in other jurisdictions have created an incentive for plan sponsors to increase investment risk in order to reduce their contribution requirements

Our support of the PfAD approach is based on the understanding that the PfAD would be applied to a liability that has been calculated 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 noted that the PfAD is only added to the going-concern liability but not to the current service cost. It would be internally consistent to require the PfAD to apply to both the liability and service cost, and also consistent with the approach taken by most of the other jurisdictions requiring PfADs.

We understand that the primary purpose of the PfAD is to enhance benefit security. Consequently, to the extent that benefit security is not a concern or a lower concern for certain plans, such as municipal or university sector pension plans which have already been exempt from solvency funding in New Brunswick, a strong argument can be made that they should not be forced to reflect a PfAD that is as high as for other plans. We understand that this is what is currently being proposed and agree with such treatment.

*Amortization period*

The regulation proposes a reduced period for the amortization of funding deficiencies, replacing the current 15-year period with a 10-year period.

The CIA recognizes that one of the key objectives of the current reform is to reduce the volatility of funding contributions to pension plans. This is largely achieved through the reduction in solvency funding requirements.

The CIA considers a 10-year period a reasonable compromise between affordability, stability, and security, while noting that the choice of a fixed amortization period is not based on any underlying actuarial principles.

*Effective date*

We noted that there were no transition rules under the proposed regulation. First of all, we are surprised that the rules are proposed to apply retroactively to December 31, 2019 for all plans. Although immediate application of the new rules may be preferred by some plan administrators, the new rules may cause hardships for other plan administrators if the new rules will end up in additional funding requirements. This can be expected to be the case for plans which have a solvency ratio above 100% or which have already been exempted from funding on a solvency basis (and remain exempt under the new rules). For those plans, the additional PfAD is likely to require additional funding on a going-concern basis, without the offsetting reduction in solvency funding. The additional funding required by the addition of a PfAD (and shortening of the amortization period, if maintained) could be phased in over a period of three to five years.

*Contribution holiday*

It is proposed that surplus, presumably calculated after application of the PfAD, can be applied towards required contributions of an employer or members provided that the plan’s assets are greater than 105% of both going-concern liability (excluding PfAD) and solvency liability.

There appears to be an inconsistency between the calculation of the “surplus”, which includes the PfAD, and the going-concern ratio of 105%, which would not include the PfAD, based on the proposed definition. To ensure consistency, we suggest that both those calculations should include the PfAD.

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

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 use of special accounts mentioned below.

*Use of letters of credit*

The CIA supports allowing the use of 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% 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.

*Governance policy*

Having a formal governance policy is a good practice and is supported by the CIA.

## Other comments

***Special accounts***

We noticed that the proposed regulation 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. We would like to emphasize that the CIA has supported the concept of such special accounts 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 and British Columbia (for solvency payment), 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.

***Modifications to commuted value calculations***

We note that while the proposed reforms would relax solvency funding, terminating members would still be offered lump sum commuted value settlements upon termination that are calculated using assumptions similar to those used in solvency valuation.

This may create an equity issue between continuing and terminating members as the value of benefits paid out to terminating members are higher than the funding being set aside to pay for the benefit of other members. In order to address this equity issue, other provincial consultations have also referenced possible changes to the commuted value (CV) calculations. The actuarial profession has developed standards of practice to determine the commuted value as the "fair value" of a pension benefit under financial economic principles. The CV does not attempt to adjust the value to reflect the risk inherent in each pension plan. The issue of how much a pension plan should pay to terminating members who elect a lump sum settlement is a public policy decision. The range of answers includes (but is not limited to) the following:

- Commuted value, as currently defined;
- Some adjustment to the commuted value based on the funded status of the plan; and
- Some measure related to the plan's funding reserve.

Some consultation papers suggest scenarios whereby terminating plan members would have the option to receive a lump sum value that could be lower than the CV. If such members do not agree with this approach, the deferred pension option remains available to them, albeit not fully funded on a solvency basis, should solvency funding be reduced.

We would like to point out that New Brunswick has already implemented such a policy decision for its shared risk plans, whereby only the funded portion of a termination value is payable to a former member as a lump sum. This concept could be adapted to traditional defined benefit plans as discussed above.

Thank you for taking the time to review our submission. We would like to note that the timeframe to provide comments was very short and we kindly advise that a review period of at least six to eight weeks would be appreciated by all stakeholders to ensure a thorough analysis of all the proposed changes.

If you have any questions, please contact Chris Fievoli, CIA Staff Actuary, Communications and Public Affairs, at 613-656-1927 or chris.fievoli@cia-ica.ca.

Sincerely,

[original signature on file]

Michel St-Germain, FCIA
President, Canadian Institute of Actuaries

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