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The Association of Canadian Pension Management
L'Association canadienne des administrateurs de régimes de retraite

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ACPM Response to Ontario's Solvency Funding Framework for Defined Benefit Pension Plans

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FOREWORD

ACPM (THE ASSOCIATION OF CANADIAN PENSION MANAGEMENT)

ACPM (The Association of Canadian Pension Management) is a national, non-profit organization acting as the informed voice of plan sponsors, administrators and their service providers in advocating for improvement to the Canadian retirement income system. Our membership represents over 400 companies and retirement income plans that cover more than 3 million plan members.

ACPM believes in the following principles as the basis for its policy development in support of an effective and sustainable Canadian retirement income system:

Diversification through Voluntary / Mandatory and Public / Private Options
Canada's retirement income system should be comprised of an appropriate mix of voluntary Third Pillar and mandatory First and Second Pillar components.

Third Pillar Coverage
Third Pillar retirement income plan coverage should be encouraged and play a meaningful ongoing role in Canada's retirement income system.

Adequacy and Security
The components of Canada's retirement income system should collectively enable Canadians to receive adequate and secure retirement incomes.

Affordability
The components of Canada's retirement income system should be affordable for both employers and employees.

Innovation in Plan Design
Canada's retirement income system should encourage and permit innovation in Third Pillar plan design.

Adaptability
Canada's retirement income system should be able to adapt to changing circumstances without the need for comprehensive legislative change.

Harmonization
Canada's pension legislation should be harmonized.

Response to Ontario Solvency Funding Consultation

ACPM supports Ontario reviewing its funding rules in order to address the current circumstances and improve the sustainability of defined benefit (DB) pension plans for the long-term. We are pleased that the framework set out in the Consultation Paper recognizes the issues of prolonged low interest rates, contribution volatility, pro-cyclicality, complexity and surplus asymmetry that were similarly laid out in our DB Pension Plan Funding paper dated May 13, 2014 (*DB Pension Plan Funding: Sustainability Requires a New Model*).

Our May 2014 paper had four objectives that we recommend be adhered to when the government makes its decisions. The new model:

- Should be clear to all stakeholders,
- Should not increase the cost burden on plan sponsors,
- Should be based on sound funding and risk management principles, and
- Should be reflective of the long-term nature of DB plans.

We understand that a balance between benefit security and affordability/sustainability requires compromises and this response sets out our preferred approach and provides commentary on the options presented with that in mind.

A note on Jointly Sponsored Pension Plans (JSPPs)

At the outset, we would highlight that the Consultation Paper notes that certain existing JSPPs are exempt from solvency funding and have been since 2010. This follows the Ontario Expert Commission Report and is in recognition that the existing going concern funding rules were best suited for such JSPPs given their joint governance, funding responsibility that is shared among members and employers, ability to reduce benefits on plan windup, and the need to ensure intergenerational equity. We would strongly recommend against any changes that adds to existing going concern funding rules for such JSPPs. This is because any such changes would only serve to: increase member and employer costs with no corresponding increase in sustainability; fail to respect the joint governance structure of those JSPPs, i.e., those that own the risk (members and employers), through their representatives' set contributions and other funding assumptions as appropriate for their risk tolerance; and impair intergenerational equity. It may be that the approach chosen through this consultation process would be appropriate for single-employer DB plans that convert to JSPPs in the future.

Our comments and recommendation on the two Approaches

The Consultation Paper sets out two approaches:

A. Fund on both going concern and solvency bases, and reduce required solvency funding.
B. Eliminate solvency funding requirements and require enhanced going concern funding.

It should be acknowledged that Approach A, in several respects, has elements of the existing Federal, Alberta and British Columbia funding regimes, while Approach B is largely the new Québec funding regime. We believe that the Québec legislation should be the model to adopt either in its entirety or at least in major elements, with appropriate modifications only to address circumstances specific to Ontario such as the existence of the PBGF and perhaps the pace of transition from existing rules.

ACPM's preferred approach is B because we do not believe that the changes to approach A significantly remove the issues identified in the opening to the Consultation Paper. Approach A starts with the existing solvency rules and attempts to address the cost, volatility and asymmetric risk issues to the plan sponsor with options that will reduce, smooth or eliminate contributions that would otherwise be required. With all these modifications, one must therefore question the very rationale behind the solvency liability as a measure of the pension benefit to be funded in the first place. It is preferable to start with the ongoing measure of the pension obligation and then strengthen those funding rules to improve benefit security. Therefore, we agree with Approach B and strongly encourage its adoption – eliminating solvency funding and strengthening going concern funding.

Comments on Approach A

- As mentioned, while most of the options in approach A reduce the cost or volatility burden on plan sponsors, they do not remove the issues with the measurement of solvency liabilities.

    - Liabilities will be calculated on an overly conservative measure of market value. It is artificial to require funding based on the assumption that a plan will have to be immediately wound up when in reality DB plans can, and should, maintain a long-term investment focus to better secure benefits assuming the plan is ongoing.

    - The solvency deficit remains a volatile measure because of its reliance on current market interest rates and companies will still have difficulty budgeting for their resulting special payments.

    - Approach A will not address the pro-cyclicality of solvency funding, i.e., instead of funding in good times for poor economic environments, requiring funding in bad times when plan sponsors are already under stress corporately.

- Averaging solvency ratios can be similarly volatile, especially when the calculation drops off a good year for a bad year in the three-year average. We note that the calculation is not straightforward and will not be clear to most stakeholders how the mechanism works.

- Lengthening the amortization period and consolidating payment schedules would help by reducing volatility and would need to be at least 15 years (or EARSL), unless a closed mature plan.

- Funding a percentage of the liability or only certain benefits could be seen as similar to what Ontario has today - i.e., not funding "excluded benefits" like indexing. Pension plans already only fund a percentage of the windup liability and this option may just continue the same issues we are faced with today. There is no sound risk management principle to fund a percentage of the liability and can be seen as arbitrary and ripe for pressure to change.

- Solvency reserve accounts and letters of credit (where a plan sponsor can obtain one) are helpful under a solvency funding regime, but our preference is to remove solvency funding altogether. Solvency reserve accounts could also be utilized even where, in Approach B, a PfAD is required.

Comments on Approach B

ACPM agrees that the first option under approach B, that is including a funding cushion through a Provision for Adverse Deviation (PfAD), is important to ensure there is a buffer for poorer economic environments to safeguard member security. As under Québec legislation, there should be a special account where employer contributions for the PfAD are accumulated to enhance benefit security when the plan is below a threshold surplus level, and may only be reduced by taking a contribution holiday or withdrawn by the employer once the plan exceeds a threshold surplus level.

The level of the PfAD should reflect the amount needed to protect the funding position of the Plan against adverse deviations, in particular in connection with the uncertainty of future returns of equities and alternative investments, and with the mismatch of assets and liabilities.

The factors proposed in the Consultation Paper are all strong principles that could be considered in developing an appropriate PfAD. The Government should establish the objectives and principles that should be followed in calculating the level of the reserve, for example, a probability of maintaining the current funding position over the next few years. The Government should provide for a simple way to calculate the level of the reserve according to different asset mixes and degree of interest rate mismatch.

However, a plan sponsor and its actuary should have the option to calculate the level of the reserve reflecting the characteristics of the Plan. The actuary would have to demonstrate that the level meets the regulated principle.

We have, however, concerns with increasing the costs for plan sponsors that already apply appropriate governance and risk management principles to their plans and are currently in a going concern surplus situation.

Consideration should be given to allowing the PfAD for companies with a going concern funded ratio of at least 100% to fund the rest of the PfAD through actuarial gains rather than an increase in current contributions.

In addition, we recommend that actuarial assumptions should be best estimate and not include other margins if there is an explicit PfAD that is required to be applied. Further, liabilities that are covered through annuities or a longevity swap should be excluded from a PfAD, or allow a reduced PfAD on these liabilities, since all, or at least a portion, of the risk has been transferred to an insurer and they already have established their own capital requirements to cover the risk. (We have recommended below that buy-out annuities result in a full discharge of the plan sponsor's liability.)

We understand the rationale for shortening the going concern amortization period as noted in Option 2 as a compromise for eliminating the five-year amortization of solvency deficits. Our preference would be to have the amortization period as the greater of 10 years and the plan's expected average remaining service lifetime (EARSL), so that plans with a greater concentration of active employees can fund over their service lifetime.

We do not support Option 3, either the setting of a regulated maximum discount rate or following the accounting discount rate, neither of which reflect the investment policy choices made by the pension plan. Rather, we believe that a PfAD which is established at a level that serves to offset otherwise aggressive discount rates would serve a similar purpose.

As proposed in Option 4, we can see merit in establishing a threshold level of solvency funding below which certain extra measures should be taken, including requiring extra funding.

There should be transition rules, like in Québec, for those plans experiencing an increased cost.

Additional Complementary Reform Measures:

In response to the additional complementary reform measures which are discussed in the Consultation Paper as potentially being introduced along with either Approach A or B, we would like to provide the following comments:

1. Requiring Annual Valuations

We believe that requiring annual actuarial valuations for all plans is an unnecessary expense. Triennial valuations of well-funded pension plans have served the pension industry well for many decades now and are already a balancing of what is a very long term commitment with a need to ensure that plans are monitored on a regular basis. We suggest that annual valuations, if used, should be conducted when specific funding thresholds are not met. This is consistent with the current approach in Ontario.

However, we do see some merit in requiring a certain level of annual update reporting if a plan is taking contribution holidays during the triennial period. A plan may be required to show at annual interim periods that the plan is still fully solvent and all reserves are funded to continue to take a contribution holiday during the subsequent annual period.

2. Requiring written governance and funding policies to be established and filed with FSCO

CAPSA has recommended in its consultation on revisions to the pension plan governance guideline No. 4 that a governance framework be documented:

"The plan administrator should establish and document a governance framework for the administration of the plan.

The governance framework should:

i. identify the duties and functions that need to be performed for the plan administrator to meet its fiduciary and other responsibilities; and
ii. determine and demonstrate on an on-going basis how the plan administrator will meet such fiduciary and other responsibilities."

That governance document could properly deal with both governance and funding policies. The CAPSA guidelines have functioned for more than a decade as a best practice. The best practice offers a principle-based approach to pension plan governance which we believe should be continued as it provides greater flexibility, recognizing the wide variety, both as to size and sophistication, of voluntary pension plans in Ontario. We think this provides sufficient governance and funding guidelines such that prescribing written governance and funding policies to be established and filed with FSCO is not necessary and is adverse to the establishment and encouragement of voluntary pension plans in the province.

3. Commuted Values

The Consultation Paper suggested that commuted value calculations could be modified to pay individuals electing to leave the plan an amount which is "more reflective of the underlying risk associated with the pension benefit" and that this could be accomplished by increasing the interest rate used to calculate the commuted value.

As ACPM has noted in the past when pension portability was introduced, it was never the intent to provide terminating and transferring members a premium over the long-term cost of keeping the deferred pension in the plan. ACPM prefers the portability provisions of the New Brunswick shared-risk pension plan that put the two features of portability and plan cost back in balance. Section 18 of the New Brunswick Shared Risk Plans Regulation provides that a terminating employee is paid their share of the actuarial reserve based on the funded status of the plan at the date of calculation. Should the member not like the portability "deal", the member is free to keep the entire value of the deferred pension within the plan and commence the pension at retirement. Under this regime, the ACPM would also be open to allowing portability during the deferral period so a member can access their funds if a plan becomes better funded. We believe that this solution, or some similar restriction on portability, provides a fair balance between the interests of departing and remaining members.

4. Restrictions on Contribution Holidays and Benefit Improvements

The Consultation Paper includes a statement, picking up on prior government proposals, that contribution holidays would be permitted only if a PfAD (on a going concern or solvency basis) is fully funded. Further, it states that administrators would be required to file annual statements confirming that eligibility continue as the contribution holiday continues.

ACPM has previously stated that the idea of avoiding well-funded pension plans taking steps that could lead to underfunding is based on the Report of the Expert Commission on Pensions (October 31, 2008) (the "OECP") and is laudable - in some respects, it needs to be aligned with the significant changes in funding rules since the OECP report was released; in particular, there are many variations of solvency funding relief which, when compared to the contribution rules, provide funding relief to sponsors of underfunded plans while the proposed change to the contribution holiday rules will provide additional limits applicable only to well-funded plans.

It is important that any restrictions on contribution holidays retain elements of flexibility, smoothing and cost-effectiveness and that this matter should be carefully analyzed in the context of the suggested funding changes.

As ACPM has said previously, governments may want to impose some methods of restriction on benefit improvements unless the plan has sufficient assets to cover the full cost. Alternatively, improvements could be allowed with a requirement to achieve full funding of the incremental benefit over a relatively short period of time (e.g. 3 to 5 years, or a collective bargaining contract period) or in a "side-car" funding vehicle, like letters of credit or the solvency reserve account in British Columbia and Alberta, such that the incremental funding shortfall created by the benefit improvement does not affect the benefit security of the benefits before the improvements.

5. Administrator Discharge for Annuity Buyouts

ACPM has stated previously that it believes that a buy-out annuity should no longer be an asset of an active pension plan and that the administrator and the plan sponsor be discharged of the pension liability for the following reasons:

i. Legislative protections for the prospective annuitants and the remaining plan members are already in place in the form of the top up payment and/or approval of the relevant regulator;

ii. Life annuities are already recognized within pension statutes as a portability option for plan members because of their benefit security features;

iii. It is the expectation of plan sponsors that the plan be discharged in respect of the liability because of the top up payment and the expectation of annuitants that their benefits are not subject to reduction as a result of the subsequent wind up of a plan in deficit. Since the annuity obligation is in the name of the annuitant, and not the plan, this expectation is reasonable. It is also not typical for the certificates issued to annuitants to make provision for benefit reduction in the event of the wind up of the pension plan;

iv. The need to make provision for a possible liquidity event would lead to an increase, likely small, in the cost of annuities; and

v. Harmonization with other jurisdictions. Québec, British Columbia and Alberta have recently introduced amendments to their respective pension legislation that include a discharge for the administrator and the employer, subject to prescribed but as yet to be published conditions.

6. The PBGF

The Consultation Paper states that changes to PBGF coverage could be pursued regardless of the option approach chosen.

We believe that changes to the PBGF must be carefully considered. The Consultation Draft appears to consider both increasing the PBGF assessments because of the additional risk resulting from the elimination of solvency funding or reduction in solvency funding requirements. We are concerned as to the cost that may be incurred by voluntary pension plans and believe that this matter should be carefully considered. The consideration of how to increase the assessment based on factors such as the plan's investment portfolio, the demographics of the plan, and the plan sponsors financial position ought to be fully considered. There should be consultation with all stakeholders when details of the proposed PBGF changes are determined and prior to any decision being made in this matter. It is key to the promotion of voluntary pension plans in the province that the cost of the PBGF not become unmanageable.

As all the other provinces have managed a pension system without a guaranteed fund, the very existence of the guarantee fund must be considered. Québec has clearly moved forward with solvency funding elimination without a guarantee fund.

In addition, the Consultation Paper appears to suggest increasing the level of the PBGF pension benefit guarantee from the current $1,000 per month. Again, the cost of such an increase should be fully discussed with stakeholders prior to any decision being made for the reasons noted above.

Should there be a further clarification of this content of this paper required, please feel free to contact us and we would be glad to accommodate. As is always the case, we would also be more than pleased to meet with Ministry officials at any time to discuss this subject further.