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

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Comments on Québec Bill 57: An Act to amend the Supplemental Pension Plans Act with respect to the funding of defined benefit pension plans

ACPM CONTACT INFORMATION

Mr. Bryan Hocking
Chief Executive Officer
Association of Canadian Pension Management
1255 Bay Street, Suite 304 Toronto ON M5R 2A9
Tel: 416-964-1260 ext. 225
Fax: 416-964-0567
Email: bryan.hocking@acpm.com
Web: www.acpm-acarr.com

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FOREWORD

THE ASSOCIATION OF CANADIAN PENSION MANAGEMENT

The Association of Canadian Pension Management (ACPM) 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.

INTRODUCTION

ACPM is grateful for the opportunity it has been given to present its comments to the Government of Québec. ACPM has submitted numerous documents to Canadian federal and provincial governments with the goal of improving the retirement income system, including a position paper to the Public Finance Committee after the report on the future of the Québec retirement system was tabled by the D'Amours Commission in 2013.

ACPM is pleased to present its remarks and comments on Bill 57. These remarks and comments are the fruit of analyses and discussion by the ACPM Québec Regional Council and the ACPM National Policy Committee. In August 2015, we also organized a breakfast conference in Montréal to sound out industry stakeholders and validate certain elements.

ACPM views the bill positively overall. The purpose of this position paper is to propose certain amendments and clarifications in order to support the maintenance of defined benefit pension plans and to ensure that the bill's objectives are achieved coherently for the range of pension plan situations.

Among the amendments and clarifications, we wish to highlight the following four aspects which we believe to be the most important:

- The scale for calculating the stabilization provision should reflect significant factors such as asset/liability matching and alternative investments; moreover, there should be an option for a plan, through its actuary, to propose a level of stabilization provision that reflects the risk management specific to that plan.

- The stabilization provision for the current service contribution should be the same as for the stabilization amortization payment, rather than being 5% higher than the latter.

- The limit on use of surplus assets during the life of a plan should be increased to 50% instead of 20%.

- The ownership confirmation process for surplus assets should be optional rather than mandatory within a given time frame.

Our detailed comments have been broken down into three parts:

- Funding Rules
- Use of Surplus Assets
- Other Provisions

FUNDING RULES

1) Solvency valuation

We support the elimination of the solvency valuation as a means of determining the contributions payable to pension plans. Use of the solvency valuation leads to highly volatile contributions and does not reflect the long-term nature of pension plans, and its elimination is in line with the recommendations of the D'Amours Commission report and ACPM's national orientation.

2) Determination of contributions

Under Bill 57, the plan sponsor must contribute the following amounts:

- The current service contribution, i.e., the cost of one year of current service
- The current service stabilization contribution
- The technical amortization payment, i.e., amortization of the funding deficit
- The stabilization amortization payment, i.e., amortization of the stabilization provision for past service. The target stabilization provision is reduced by a margin of 5% of the funding liabilities for the purpose of calculating this contribution.
- The improvement amortization payment, i.e., amortization of the additional liabilities arising from an amendment to the pension plan

The introduction of mandatory contributions to create a stabilization provision is a major change to the funding rules. If long-term interest rates, currently at an all-time low in Canada, increase to their historical averages, contributions established under the new law may be significantly higher for many plan sponsors than the level required under current solvency rules.

We believe this is an impediment to the sustainability of defined benefit (DB) pension plans, as it may lead plan sponsors to terminate their plans in favour of defined contribution (DC) pension plans. Note that there is no such obligation to create provisions in other countries with funding rules based on long-term funding valuation (as opposed to solvency valuation), like the United States and the United Kingdom.

The situation is particularly problematic for the current service contribution, as current solvency does not apply to the cost of current service. The obligation to contribute the full stabilization provision for the current service contribution will lead plan sponsors to reconsider maintaining these plans. For plans to which employees contribute, the leverage effect may mean employer contributions that are 20% or 25% higher [1].

1 - For example, consider a plan where the cost of current service is 12% of wages, where the employee pays a fixed contribution of 5% of wages (and the employer, 7% of wages), for which the stabilization provision is set at 15% of the cost of current service. The cost of current service is thus 15% higher, now at 13.8% of wages in total and 8.8% of wages for the employer. Consequently, the employer's cost will have risen from 7.0% to 8.8% of wages, up 25.7%, which is far higher than the 15% stabilization provision.

That is why we are proposing the following changes:

- Apply an adjustment reduced by 5% to the current service stabilization contribution, as is the case for the stabilization amortization payment.

- Where there is a collective agreement, delay the application of the current service stabilization contribution to the end of the collective agreement, not to exceed a period of five years. Adding a current service stabilization contribution will be a considerable change and should be part of the discussion platform when negotiating collective agreements.

- Reflect the appropriate factors when calculating the stabilization provision (see next item).

3) Calculation of the stabilization provision

Bill 57 provides for the creation of a stabilization provision whose calculation will be determined by regulation. The stabilization provision would be a function of the target distribution between fixed- and variable-income securities.

We agree with the concept of recognizing a plan's risk level in establishing the stabilization provision. However, a more sophisticated approach is necessary. The following example shows that a scale with a single variable or aspect is too simplistic: a plan would be able to invest 100% of its pension fund in the money market, thereby meeting the scale of the smallest stabilization provision (100% fixed income) yet exposing the plan to a very high degree of risk should long-term interest rates decline. What's more, the provision for adverse deviations (PfAD) introduced a number of years ago factored in more than one variable or aspect. We therefore suggest a two-dimensional scale to take into account asset/liability matching (or the duration of the fixed-income portfolio) in addition to the fixed- and variable-income portions.

We also suggest that the following elements be considered in the regulations for implementation:

- The bill is silent on implicit margins in the valuation assumptions. The assumptions should be based on the best estimates (i.e., without an implicit margin), except if the funding policy determines otherwise. There should be no requirement for an implicit margin in the valuation assumptions, as there will now be a stabilization provision with explicit margins.

- There are investments like real estate and infrastructure that are not directly assigned to the fixed-income and variable-income categories.

- Not all investment policies have a single target for fixed- and variable-income allocations. Sometimes a policy stipulates a range (e.g., 40% to 60% for variable-income securities) that can be fairly broad.

- The portion of liabilities that would have been the object of an annuity buy-in should be excluded when calculating the stabilization provision, since the risk has been transferred to an insurer.

Finally, we propose that plans be given the option to show, through their actuary, the level of stabilization provision necessary to achieve the stabilization objective. In this way, plans that use more sophisticated risk management methods can adapt stabilization provision targets to better suit their situation.

4) Amortization period

Bill 57 stipulates that the deficit will be amortized over an initial period of 15 years, reducing gradually to 10 years over a 5-year period. Additionally, it provides for consolidation of deficits and re-amortization at each valuation. We support these provisions of the bill.

When an improvement is made to a pension plan, the plan sponsor must fund the past service obligation plus the full amount of the stabilization provision. If the funding level is less than 90%, the plan sponsor must immediately pay the total amount; otherwise, it can be amortized over five years. We are proposing the following changes:

- Specify that only the amount required to achieve 90% of funding must be paid immediately and the remainder can be amortized over five years.

- The stabilization provision should be 5% less than the target and payable over 10 years, as is the case with other past service liabilities.

5) Frequency of actuarial valuations

We support the requirement for submitting an actuarial valuation every three years instead of every year. Contributions will be less volatile than with solvency valuations; as a result, conducting a full valuation every year is neither useful nor necessary. Furthermore, three-year valuations are better for managing contribution volatility, particularly for plan sponsors with several plans, as the valuation dates can alternate.

Under the bill, the solvency test must be carried out annually and a valuation must be submitted if the annual test shows a solvency of less than 85%. We agree that more frequent valuations be required if the plan shows weak funding. However, the proposed rule will be an impediment to maintaining defined benefit plans by preventing plan sponsors from planning contribution amounts in the medium term.

We propose that the bill be amended so that the decision as to whether the next valuation is in three years or one year be made at the time of the actuarial valuation (and not every year) based on the plan's financial position at the time of the actuarial valuation. This rule would be consistent with the Ontario rule: if the degree of solvency is over 85%, the next valuation will be in three years, otherwise, it must be in one year.

6) Use of letters of credit

Bill 57 provides for the use of letters of credit for stabilization amortization payments, to a maximum of 15% of funding liabilities. Letters of credit are useful to plan sponsors as liquidity management instruments. For plan members, letters of credit provide the same security as a cash contribution.

Use of letters of credit should be permitted for the current service stabilization contribution as well as for any past service contribution:

- amortization payment;
- stabilization amortization payment;
- mandatory contribution further to an improvement (as is currently the case), and not just for the stabilization provision.

The bill limits the total amount of all letters of credit that can be considered in the plan's assets to 15% of funding liabilities. We propose that this limit be increased to recognize all existing letters of credit, should these exceed the 15% limit. This situation might occur for a pension plan that has already reached the 15% limit for solvency liabilities. Our proposal is based on the fact that if an event triggers payment of the letters of credit, all of the letters would be payable, without limitation.

Moreover, for a more suitable solution in the long term, we propose increasing the limit, which would enhance flexibility and reflect the fact that the reference amount is the funding liabilities rather than the solvency liabilities.

USE OF SURPLUS ASSETS

1) Sums accrued under the banker's clause and ownership of these sums upon plan termination

We support the introduction of the employer contributions account ("banker's clause") set out in section 42.2 (new) of the Act. This concept is similar to the solvency reserve accounts introduced in Alberta and British Columbia. However, we propose that the sums accrued be permitted to include, in addition to technical amortization payments and stabilization amortization payments, the following contributions:

- Any employer contribution paid in excess of the minimum required by the Act, to encourage respondents to better fund pension plans;
- Improvement amortization payments, including the mandatory lump sum when the degree of funding is less than 90%, since it concerns funding for past service obligations like technical amortization; and
- Current service stabilization contributions, as these are additional amounts intended to improve stabilization.

Furthermore, we propose that the Act stipulate that when a plan is terminated, the surplus assets remaining after payment of all accrued benefits, to a maximum of the sums accrued under the banker's clause, belong to the employer.

The Act should also provide that plan members be able to make contributions towards their own banker's clauses, particularly for cost-sharing plans.

2) Amount of surplus assets available for use during the life of a plan

Under Bill 57, the amount of surplus assets available for use during the life of a plan is equal to the lesser of:

- The amount in excess of the stabilization provision target plus 5%; or
- The amount in excess of 105% of the solvency liabilities.

The surplus assets available for use, if used, must first be applied to provide a one-year employer contribution holiday, provided the sums accrued under the banker's clause so permit. Thereafter, the amount of excess surplus assets available for use, where applicable, is limited to 20% per year and may, in accordance with plan provisions, be used to fund an improvement to the plan or be transferred to the employer.

The 20% limit considerably reduces the employer's ability to benefit from a contribution holiday. It is a significant change with respect to the current situation and may represent a substantial short-term increase in contributions for certain employers whose plans currently have surplus assets. In addition, employers will be concerned by their ability to fully benefit from favourable economic situations should the available excess surplus be limited to 20%.

We believe that benefit security is sufficiently protected by the stabilization provision target and the 105% of solvency liabilities and that the plan sponsor should therefore be able to use 50% of the excess surplus assets.

For plans presenting a limited risk level (e.g., with asset/liability matching), the degree of solvency required before contribution holidays are permitted should be reduced to less than 105%.

3) Rules governing the use of surplus assets

Bill 57 proposes to abrogate the principle of equity among plan member groups for use of surplus assets. We support the elimination of this obligation, which was both restrictive and ambiguous and made it difficult to obtain approval for improvements.

Use while a plan is ongoing

Under Bill 57, rules governing use must be confirmed by January 1, 2017, and submitted to plan members for approval. Where no agreement can be reached, 50% of the surplus assets would be used to improve benefits.

Applying a default solution would change the nature of the plan and further increase asymmetry, i.e., the employer is responsible for funding deficits but plan members benefit from 50% of the surplus. Moreover, the deadline of January 1, 2017, is too short for appropriate consultation of plan members. Finally, it should be recognized that certain plan sponsors have already obtained such approval from plan members.

The process of confirming or amending the rules on use of surplus assets should be optional rather than mandatory, as elected by the entity that has the authority to amend the plan's provisions. This entity may choose to maintain the provisions currently in force.

We propose instead that the following rules be applied:

1) The amount of surplus assets can be used for a contribution holiday to a maximum of the sums accrued under the banker's clause, regardless of the provisions on ownership of the surplus assets stipulated by the plan.

2) For assets greater than the sums accrued under the banker's clause:

    a) If the entity that has the authority to amend the plan's provisions decides not to amend or confirm the provisions, the surplus assets are available for a contribution holiday, insofar as current provisions permit. The equity rules under section 146.3 are abrogated;

    b) If the entity decides to amend or confirm the provisions, use of the surplus assets will be subject to the consultation process set out in the bill with the following amendments:

        - The plan members of a defined contribution component have no right in this regard.

        - An agreement with the union is deemed an agreement by the plan members represented by the union.

        - If no agreement is confirmed, the current provisions are maintained.

        - The deadline should be later than January 1, 2017. For example, the date of January 1, 2019 (three years), would allow the parties to better analyze the situation, or within one year after the end of the collective agreement for pension plans that are subject to collective agreements.

Use upon plan termination

As with use while a plan is ongoing, the possibility of amending provisions on surplus assets when a plan terminates should be an option rather than an obligation. If the option is exercised, the consultation process prescribed in the bill (with the suggested amendments) applies. If the option is not applied or if the agreement is refused, the current wording of the plan's provisions and in the Act should apply by default.

Information to plan members for contribution holiday

Under section 156.91.1 of Bill 57, the pension committee must inform plan members when surplus assets are used for a contribution holiday or when any amount of surplus assets is transferred to the employer. This requirement would make plan administration more burdensome. The Act already stipulates that the annual statement for plan members must show contributions by plan members as well as by the employer. This statement could also inform plan members that surplus assets have been used for a contribution holiday or been transferred to the employer.

Mandatory actuarial valuation for a contribution holiday

Under Bill 57, an annual actuarial valuation is required when a contribution holiday is taken. We believe that one valuation every three years is sufficient to support potential contribution holidays for the following three years, along with an annual certification by the actuary that the degree of solvency respects the mandatory minimum.

OTHER PROVISIONS

1) Purchase of annuities

Bill 57 provides that a plan with an annuity purchase policy can purchase annuities from an insurance company and that this constitutes full and final settlement of benefits. We support this provision. The purchase of annuities from an insurance company is a key risk management tool, which is in the interest of plan members. We suggest that the wording of this section of the Act be clarified to ensure that the annuity purchase will truly release both the plan and the plan sponsor of any and all obligations with respect to the plan members.

We propose certain provisions for the regulations that will apply to the annuity purchase:

- Flexibility must be maintained for the purchase of annuities by increment, either for a certain subgroup or over a given period rather than all at once, in order to benefit from opportunities in the annuities market and for this to be available to large plans.

- The Act should allow applying the concept of final payment of benefits to annuity purchases made in past years, as elected by the entity responsible for amending the plan. In this case, if the plan is in a deficit situation, the employer will have to pay the amount that would have been required to maintain the degree of solvency at the same level before and after the annuity purchase. Moreover, the three-year period for participation in the surplus in the event of plan termination would begin at the effective date of the conversion of insured annuities into full and final settlements.

- We propose that the decision to buy annuities, and adoption of the relevant policy, fall to the entity responsible for amending the plan provisions. This entity would instruct the pension committee to purchase the annuities.

2) Payment of transfer value

Bill 57 stipulates that, in the event of employment termination, the transfer value be prorated to the degree of solvency if less than 100%, except if a deferred annuity is unavailable to the plan member, in which case the total value must be paid. We agree with this provision as it prevents plan members who choose to take their transfer value from reducing the solvency for the remaining plan members.

We suggest that the plan's degree of solvency be tracked at least once every 12 months, or more frequently at the administrator's option, to ensure that the degree of solvency applied is recent. Furthermore, we suggest that plans be permitted to pay 100% regardless of the degree of solvency if a plan sponsor so wishes, subject to amending the plan to allow for this and subject to payment of the missing amount if the degree of solvency is less than 100% (if the objective is to avoid reducing solvency for the remaining plan members).

3) Additional benefit

Bill 57 proposes to eliminate the additional benefit, that is, indexation of the benefit in the event of employment termination, up to 50% of inflation until age 55. Retroactive elimination is also possible if the change is made before January 1, 2017.

We agree with this provision of the bill, as the additional benefit is unique to Québec, of little use and complex. It should also be eliminated from pension plans that are subject to collective agreements, even when this indexation is explicitly described in the plan's provisions. Also, we find the proposed one-year period too short; we propose that the period be three years (January 1, 2019).

4) Funding policy

Bill 57 stipulates that a funding policy be established by the entity that has the authority to amend the pension plan provisions. We agree with this requirement as it allows for clarification of the methodologies and assumptions used for actuarial valuations, particularly in the new system where the going-concern funding valuations determine all contributions. We suggest clarifying that the funding policy should be established by the entity that has the authority to amend the plan's provisions, to avoid any confusion.

ACPM is available to discuss this paper in order to provide any assistance to the Québec government.