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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 Nova Scotia's Pension Funding Framework Review and other issues affecting pension plans

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TABLE OF CONTENTS

FOREWORD

ACPM (THE ASSOCIATION OF CANADIAN PENSION MANAGEMENT)

ACPM (The Association of Canadian Pension Management) is the leading advocate for plan sponsors and administrators in the pursuit of a balanced, effective and sustainable retirement income system in Canada. We represent plan sponsors, administrators, trustees and service providers and 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 workplace and individual savings arrangements ("Third Pillar") and mandatory public programs ("First and Second Pillar").

Empowering Choice in Coverage
Third Pillar arrangements should be encouraged and play a meaningful, ongoing role in Canada's retirement income system.

Adequacy, Security and Affordability
The components of Canada's retirement income system should ensure a healthy balance between these three objectives to enable Canadians to receive adequate and secure retirement incomes at a reasonable cost for members and employers.

Innovation in Plan Design
Canada's retirement income system should encourage and permit innovation in plan design in all three Pillars.

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 always strive for better harmonization.

Clarity and Transparency
Legislation, regulations and retirement income arrangements should be clearly defined and pension plan beneficiaries should be appropriately informed of risks, costs and benefits.

Good Governance
Excellence in governance and administration in the retirement income system.

Response to Nova Scotia's Pension Funding Framework Consultation

ACPM supports Nova Scotia 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.

Part 1: Funding Framework for Defined Benefit Pension Plans

The Consultation Paper sets out three possible options to consider:

1. maintain full solvency funding,
2. eliminate solvency funding and enhance going-concern funding, or
3. reduce solvency funding.

ACPM's preferred approach is option #2, because we do not believe that the changes to option #1 or the reduced #3 version, significantly remove the issues identified in the opening to the Consultation Paper. Option #1 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 Option #2 and strongly encourage its adoption – eliminating solvency funding and strengthening going concern funding.

That being said, for completeness, we provide some comments for each of the other two Options.

Option 1 – Maintain Full Solvency Funding

- Longer amortization periods: Lengthening the amortization period (and consolidating payment schedules) would help by reducing volatility. In order to have a material impact though, the period would need to be at least 15 years (or EARSL). A shorter period may be appropriate for a closed, very mature plan. That being said, a longer amortization period may simply delay and perpetuate the problem.

- Consolidation of Solvency Deficiencies: The approach suggested is consistent with the federal funding rules and we agree that this approach would help stabilize the funding requirements by avoiding multiple schedules of payments piling up on each other.

- Solvency Reserve Account: We agree that solvency reserve accounts would assist in reducing the asymmetry that currently exists in the defined benefit plan funding model. In this model, a plan sponsor who is having a good year, could conceivably feel more confident in accelerating contributions towards a solvency deficit if the employer had some assurance that a withdrawal of amounts from the solvency reserve account is possible when the solvency ratio meets the required conditions. We note that Reserve Accounts could also be utilized even where, in Option #2, a PfAD is required. In that scenario, it would be reasonable to have contributions towards a PfAD be recorded in the Plan's Reserve Account.

- Letters of Credit: A limit above 15% of liabilities could be helpful to those employers who can actually attain one. We believe there is no justification for limiting the amount of LC as a percentage of the plan's liabilities as the risk level is determined by the bank in terms of the financial capacity of the employer. Nevertheless if the regulator still wishes to impose a limit, it should be increased to at least 30%.

- Other: If full solvency funding is retained, grow-in and post-retirement escalation liabilities could be removed from funding requirements, except under a full or partial wind-up.

In conclusion, we believe that Option #2 should be pursued and only require full funding of solvency liabilities upon full or partial wind-up.

Option 2 – Eliminate Solvency Funding and Enhance Going-Concern Funding

- PfAD: ACPM agrees that a funding cushion through a Provision for Adverse Deviation (PfAD) is important to ensure that 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 PfAD defined in the legislation could be defined in a similar manner to the Québec, Alberta or British Columbia pension legislation, in that it should vary with the target asset allocation to risky assets and the interest rate risk hedging ratio.

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. (We have recommended below that buy-out annuities result in a full discharge of the plan sponsor's liability.)

However, we have 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 plan sponsors 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 service contributions.

The legislation should be clear that once the PfAD has been fully funded, the sponsor has a right to take a contribution holiday.

- Shortened Funding Period: We understand the rationale for shortening the going concern amortization period as a compromise for eliminating the five-year amortization of solvency deficits. Our preference would be to have the amortization period of 10 years, with a consolidation of the total unfunded liability (rather than the current approach of potentially multiple amortization schedules).

- Return on Investment Assumptions: As noted above, our preference is the use of an explicit PfAD rather than a MAD (Margin Against Adverse Deviation), and accordingly, actuarial assumptions should be best estimate.

  In order to manage the risk of overly aggressive actuarial assumptions, you could define through a guidance note, the reference maximum discount rate (as defined in Québec, BC and Alberta, this can be a weighted average of the reference rates for the liability matching portfolio and the growth portfolio), and require (as in British Columbia and Alberta) an additional PfAD when the discount rate exceeds the reference maximum discount rate defined in the guidance note.

- Solvency Trigger: We understand that Ontario is considering a solvency level threshold which would require additional funding beyond the proposed enhanced going-concern framework. We can understand the concern given the Pension Benefit Guarantee Fund that is unique to Ontario. We believe a well-constructed enhanced going-concern funding framework in Nova Scotia should not require a secondary solvency funding test.

Option 3 – Reduce Solvency Funding

While we believe the enhanced going-concern framework should be sufficient by itself, we can see the merit in a compromise of establishing a threshold level of solvency funding below which certain extra measures could be taken, including requiring extra funding. However, as mentioned above, this is not as relevant in Nova Scotia as it is in Ontario, given the existence of their Pension Benefits Guarantee Fund. If Nova Scotia does introduce a secondary solvency test, this should reduce the PfAD that would otherwise be required without the secondary test.

Part 2: Regulatory Issues

A) Target Benefit Plans

We believe that regulations should be developed in order to allow the enactment of the target benefit legislation in the Pension Benefits Act. Having the option of the target benefit model would be helpful and in our view has many advantages over the defined contribution model, with which many defined benefit plans are being replaced.

In our view, the Alberta and British Columbia models for target benefit plans are much simpler and easier to administer and regulate, than the New Brunswick model. If the enhanced funding framework model were implemented, then it would be a relatively simple matter of linking the target benefit funding model to the enhanced going-concern funding model. For example, a target benefit plan could be restricted from enhancing benefits from surplus below the prescribed PfAD, and may require additional measures (enhanced contributions, benefit accrual reduction, or benefit reductions) in the case where the funded ratio falls below 100% of the going-concern funded ratio.

We do not believe target benefit plans should be restricted to unionized environments, but agree that in a non-unionized environment, it may be ideal to either provide for employee representation in the governance model, or at the very least require the establishment of a pension advisory committee to ensure there is employee input into the administration and communications about the plan.

As recommended by the Canadian Institute of Actuaries and in the ACPM target benefit position papers, we believe that plans should have the option of converting past benefits. A possible model would be to allow for the vote of the membership (including deferred members and beneficiaries) and to only allow past service conversion if less than one-third of the plan members and beneficiaries vote against past service conversion. In this scenario, we would envisage that unions would vote on behalf of their members. At worst, individuals should have the right to elect to convert their own past service. This would encourage plan sponsors and stakeholders to work together to provide a basis for conversion which would be palatable for most participants.

It would be reasonable to negate and reverse any past service conversion for any plan which is wound up within a prescribed period, say 5 years, after the conversion. At the very least, voluntary conversion of past service should be available at the individual level, as is done for conversion of past service to a DC. (In a very real sense, a target benefit model is a really a special case of a pooled DC model.)

B) Annuity Discharge

ACPM 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 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.

C) Permitted Investment Rules

ACPM supports the replacement of the current Schedule 1: Permitted Investments of the Pension Benefits Regulations with a reference to the federal investment regulations. We can see no advantage or rationale for adopting a different set of rules for Nova Scotia pension plans.

Other Comments

Annual Valuations

If the enhanced funding framework is adopted, the contribution requirements will become much more stable and, accordingly, annual actuarial valuations for all plans would result in an unnecessary expense. Triennial valuations of well-funded pension plans have served the pension industry well for many decades 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, for example a going-concern funded ratio of less than 90%.

Commuted Values

An issue not raised in the Consultation Paper is commuted values. If the enhanced going-concern model is adopted, then it would be appropriate to revisit the calculation of transfer values. As pension plans would no longer be expected to be fully funded on a solvency basis in a five year time horizon, it would not be appropriate to provide a commuted value assuming a 100% transfer ratio.

A simple solution would be to adopt the approach used in Québec, namely to pay the commuted value times the most recently determined transfer ratio (and not to provide the unfunded portion of the commuted value in five years). Terminated members always have the option of selecting the deferred pension, and potentially could be offered the commuted value option periodically, say every 5 years, as the transfer ratio might improve in future years.

Solvency Exempt Plans

We note that certain plans, like municipal and university plans are currently exempt from solvency funding. We would caution against imposing any drastic changes to the funding requirements of such pension plans.

That being said, the enhanced going-concern funding framework could be a good model for such pension plans, provided a reasonable adjustment period is provided. For example, the funding requirements could be the lesser of that under the current model and the new model for a five year period, and then either immediately or gradually change to the new model.

If the enhanced going-concern funding model includes a loading on current service cost equal to the PfAD until the PfAD is fully funded (as is the case in the Québec model), you could specifically exempt municipalities and universities of this requirement under the presumption that those entities are supported by some extent by a government or government authority and have a lower likelihood of failure.

Thank you for the opportunity to provide our input on this consultation and we are available if you require any further assistance.