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

June 19, 2019

Finance and Treasury Board
Pension Regulation Division
PO Box 2531
Halifax, NS B3J 3N5

Via email: pensionreg@novascotia.ca

To Whom It May Concern:

Re: Our Comments on the Improved Funding Framework for Nova Scotia Pension Plans (the Road Forward)

ACPM 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 millions of plan members.

We thank you for the opportunity to provide these comments on the proposed changes to the pension funding framework for Nova Scotia Pension Plans. We will address each of the specific questions identified in your request for feedback on technical aspects of the new framework.

First though, we note that the optional approach to adopting a lower solvency funding floor (85% in lieu of 100%) in combination with required PfADs on going-concern funding is inconsistent with other jurisdictions who have introduced similar modernizations of their pension funding rules. We believe that the model of enhanced going-concern funding reduces the need for a 100% solvency ratio funding floor. Under the theory that the new model has been crafted to improve the sustainability and stability of required employer funding (a component of sustainability), it would make sense to use the new funding model for all private sector plans without requiring an election and objection process.

The approach taken by Ontario, being a smaller PfAD and 85% solvency ratio funding floor is a reasonable alternative to the Quebec model which relied on larger PfADs and no solvency ratio funding floor. Accordingly, we do not believe it makes sense to impose the PfADs on top of a 100% solvency funding model. If the government believes it must provide an opportunity for plan beneficiaries to object to reducing the solvency ratio funding floor, then the two choices should be:

- 100% solvency funding without mandated PfADs on the going-concern valuation (current funding rules); or
- 85% solvency funding with mandated PfADs in the going-concern valuation (new funding rules).

1. **Types of Employer Contributions that Should be Permitted to be Paid into a Reserve Account**
   We believe that any special payment towards a solvency deficiency or going-concern deficiency, a mandated PfAD or indeed any payment beyond current service cost, could be paid into the Reserve Account. This is based on the premise of symmetry, being that if a sponsor pays additional amounts beyond current service cost amounts towards a deficiency, then the sponsor would normally expect to have the benefit of surplus generated from such excess contributions.

   We note that, in other jurisdictions, allowances are made for access to the reserve account while a plan is ongoing, provided prescribed conditions are met (certain specified funded ratio and going-concern ratios). We are concerned that the absence of this provision will be a deterrent to excess funding by a plan sponsor (contributions beyond minimum payments under the regulations), which would not be in the best interest of plan beneficiaries.

2. **Approach to Defining the Going-Concern Provisions for Adverse Deviation**
   (a) Preference of option 1 over option 2 for Prescribed PfAD Calculation

   While many factors could and should be considered by Plan sponsors and administrators in selecting an appropriate PfAD for the Plan, for the purpose of defining a minimum standard in regulations, we believe it makes sense to focus on the two most important factors that affects the probability of maintaining a fully funded state in unfavourable scenarios, namely:

   - <u>The variability of assets that do not correlate with the liabilities:</u> Generally speaking, this may include equities, real assets and other alternative investment strategies. That being said, in some cases, namely real assets, there can be moderate correlation with liabilities, due to the greater dependence on the discounting of fairly predictable cash flows (rent, tolls, and other income from such real assets). Accordingly, the PfAD required on these special types of variable assets might be reduced to reflect the expectation of lower variability and moderate correlations with the liabilities.
   - <u>The change in liabilities due to a change in the discount rate</u>: Investments in bonds and other fixed income investments will often correlate highly with the liabilities. For example, if a Plan invested 100% of its assets in fixed income assets that closely mirrored the characteristics of the liabilities, you might expect very little deviation in funded status between valuations. The suggested approach using the ratio of the duration of assets to the duration of liabilities is a simple and reasonable approach to defining that aspect of a prescribed PfAD.

   On this logic, we believe Option 1 best addresses these two primary reasons for deviations in the funded status.

   We note that it should be clear that the discount rate used in the going-concern valuation should be determined on a best estimates basis by the Plan actuary, *i.e.*, it should not include a Margin Against Adverse Deviation (MAD). The advantage of the PfAD approach over the MAD is that it provides a transparent measure of the margin or contingency built into the funding model.

(b) Other options that should be considered

A pension plan sponsor or administrator should be able to use its own determined PfAD if it can demonstrate using stochastic modelling that there is at least an 85% probability that the plan will retain or improve its current funding level over a three-year period. We note that the Canadian Institute of Actuaries (CIA) has conducted and published studies on PfADs using such modelling to assess the likelihood of maintaining a certain funding level. In addition, the CIA has recently introduced guidance on the disclosure of stochastic models for the purpose of specified going concern funding models. This latest guidance could be used by the regulator in evaluating the stochastic analysis before granting an exemption to the normal PfAD calculation table in the pension regulations. It could also be useful in assessing whether a New Brunswick Shared Risk Plan's funding model is consistent with the going-concern funding model in Nova Scotia (but obviously not addressing the potential reduction in benefits under such regulations).

(c) Whether there should be a different PfAD for solvency exempt or public sector plans

First, we note the current funding model would seem to imply that such organizations by their very nature do not require solvency funding in order to ensure a high degree of probability that the promised benefits will be delivered. (There is perhaps an inherent expectation that such organizations will never fail, so the plan can be assumed to be maintained forever.)

That being said we suspect that many solvency exempt plans or public sector plans already have either a PfAD or a MAD built into the discount rate. The imposition of a higher (equivalent) PfAD may have a material impact on the sponsor of such plans unless a reasonable transition period is allowed for gradually increasing the PfAD. A transition period of at least five years may be necessary for such entities.

An alternative approach, analogous to the current solvency funding exemption, would be to exempt such plans from actually funding the PfAD, but still retain the concept of the PfAD for other considerations such as contribution holidays.

(d) Use of an additional PfAD to apply for pension plans using aggressive discount rates

We believe that the regulator should normally be able to rely on an actuary's certification of best estimate assumption. Prescribed maximum discount rate methodology is prone to simplistic approximations which won't be able to anticipate every type of investment strategy or future market conditions that influence actuarial opinions.

That being said, we acknowledge that there may be instances where an actuary might use a discount rate deemed to be too high to the regulator. We suggest instead to continue to allow the Superintendent discretion over approving actuarial assumptions for a particular plan. Guidance on the discount rate could be published and periodically updated by the Superintendent's office in lieu of imposing a prescribed calculation that may become stale with changing economic conditions or innovation into new investment vehicles. By allowing Superintendent discretion over the discount rate, the Superintendent could either disallow a discount rate or impose an additional PfAD that would be equivalent to the upper limit that the Superintendent believes is reasonable in the circumstances.

(e) Definition of variable income securities

We caution the government in how it defines these terms as they can be elusive to define and future innovation can create new investment securities or strategies which may fall in between liability matching and variable income securities. An alternative approach would be to provide a high level definition of such asset categories and allow the regulator to define, within published guidelines, the list of such assets and strategies and the application of the variable asset definition. For example, you might consider the following thoughts based on an aggregate of other existing regulations in Canada (QC, AB, BC, and Ontario):

- Fixed Income (or liability matching): These assets would normally include investment grade debt issued by federal, provincial, municipal, or corporate entities, but they may also include other securities like mortgages and private debt, provided the cash flows are predictable and they are expected to have a similar level of security as investment grade debt. These other types of assets may include, for example, a buy-in annuity from an insurance company whose debt is well rated by credit rating agencies or privately traded bonds with covenants and other features which an investment manager would deem to have security equivalent to investment grade debt (as opposed to more speculative private debt such as mezzanine or leveraged buyout debt).
- Partial liability matching assets: It can be argued that some variable assets have highly predictable cash flows and liability matching characteristics. For example, core or core-plus real estate and infrastructure assets would fall into this category. While not perfect, we find the approach taken by other jurisdictions of assigning half of such allocations to the liability matching category and half to the variable asset category to be reasonable.
- Variable assets: This would include equity (both publicly and privately traded) as well as high yield bonds and other higher risk fixed income strategies, hedge funds, and a portion of the partially liability matching assets as noted above. We note that the definitions that Ontario used in its regulations cause confusion as any below investment grade debt or non-rated debt taints all bonds as equity rather than allowing one to separate the proportion of the portfolio in investment grade and high quality private debt into the liability matching bucket and the non-investment grade debt / speculative debt into the equity bucket. We suggest caution in the actual definitions used in documenting the PfAD calculation.

3. Transition Period for Pension Plans that Must Pay Increased Contributions under the New Rules

For the first aspect in the transition, we recommend a fresh start to amortization of existing going-concern unfunded liability schedules. From there, we would recommend a 5-year transition period from the fresh start unfunded liability payments over 15-years to the new funding requirements over 10-year amortization periods.

We have concern that a three-year period to move from a 15-year schedule to 10-year schedule at the same time one is increasing funding to the prescribed PfAD could result in a significant increase in funding requirements, especially for plans which may be well funded on a solvency basis.

4. Proposed Contribution Holiday Threshold

In order to promote uniformity with other jurisdictions, we recommend that the government adopt a 5% margin above the required PfAD and a 105% solvency ratio, rather than the proposed 110% of going-concern and solvency ratios. Given the PfAD already gives a high probability of a Plan maintaining its fully funded status, a 5% buffer should be more than sufficient in most cases to ensure a very high degree of fully funded status and a reasonably high probability of maintaining the PfAD. We point out that, in some cases, 110% requirement above the PfAD could lead to a violation of the Income Tax Act and render the plan revocable.

Once the thresholds have been achieved (going concern ratio above 100%+PfAD+5%, and solvency ratio above 105%), then contribution holidays should be allowed until the dollar amount of contribution holidays equals the lesser dollar excess above the two thresholds. That being said, we believe the sponsor should have access to the reserve account while it is ongoing. One approach would be to allow contribution holidays from the reserve account provided the PfAD is funded and the plan has a 100% solvency ratio.

Thank you once again for inviting our comments. We would welcome the opportunity to meet with you and discuss any questions you may have on this feedback. In the meantime, please feel free to contact us if we can be of further assistance.

Sincerely,

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Chief Executive Officer
ACPM

Todd Saulnier
Chair, National Policy Committee
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