



Pension Investment
Association of Canada

Association canadienne des
gestionnaires de caisses de retraite

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Re: CIA Consultation with Regulators on Solvency Funding

This submission is made by the Pension Investment Association of Canada (PIAC) in support of a letter submitted by the Canadian Institute of Actuaries (CIA) to Canadian federal and provincial regulators on October 30, 2014 (attached). The CIA submission was developed based on the understanding that several Canadian jurisdictions are contemplating a review of pension funding regulation and calculation of transfer values.

PIAC has been the national voice for Canadian private and public pension funds since 1977 in matters related to pension investment and governance. Senior investment professionals employed by PIAC's member funds are responsible for the oversight and management of over \$1.3 trillion in assets on behalf of millions of Canadians. PIAC's mission is to promote sound investment practices and good governance for the benefit of pension plan sponsors and beneficiaries.

PIAC supports the CIA in its proactive engagement on the issues related to pension reform, and generally supports the stated views and suggestions in its letter. Canadian governments have the ability to alter the policy underpinnings of the pension regime and thereby alleviate some of the funding and regulatory challenges that plan sponsors and administrators are facing.

It is clear to PIAC that the current minimum funding rules utilized across Canada are simply not working. Our observations are:

- Minimum solvency funding rules are having an ongoing detrimental effect on the viability of defined benefit pension plans.
- Sponsors of plans not being wound up are struggling with their commitment to their business and pension plan sustainability, necessitating repeated rounds of temporary regulatory solvency relief.
- As defined benefit pension plans mature in a low interest rate environment, plan sponsors are still struggling with the large financial burden solvency funding creates; a burden that is clearly worse than expected due to the extraordinary economic circumstances.

Clearly, the repeated temporary relief measures that have been implemented by numerous jurisdictions over the last several years represent an acknowledgement that the minimum solvency funding requirements are not working. PIAC believes Canada needs a more fundamental solution to defined benefit pension plan funding rather than serial "temporary relief programs". We need to seek a better long-term funding model and we need to come up with a new and more effective valuation and funding methodology.

PIAC is convinced that now is the time for the reform of long-term, minimum funding rules. We believe Canadian pension jurisdictions need one funding rule, as opposed to one going-concern funding rule and one plan termination funding rule. This one funding rule can be properly designed to meet the needs of beneficiaries and plan sponsors to balance the need for benefit security and plan sustainability. It is our hope that new rules can be developed with jurisdictions across Canada to promote the efficiencies of harmonization.

We strongly encourage Canadian federal and provincial regulators to pursue the ideas and initiatives, and to accept the CIA's offer of assistance in the review and creation of a revised regulatory framework for pension funding and transfer values. PIAC's membership has considerable experience with many of the intricacies and challenges associated with these issues, and we would be very pleased to provide assistance on this important initiative.

Respectfully submitted on behalf of the members of the Pension Investment Association of Canada.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Michael Keenan". The signature is fluid and cursive, with a small flourish at the end.

Michael Keenan
Chair

enclosure: CIA October 30, 2014 letter to regulators
cc. Canadian Institute of Actuaries

October 30, 2014

This letter was sent to federal and provincial regulators.

The Canadian Institute of Actuaries (CIA) is the national organization of the actuarial profession. The CIA establishes the Rules of Professional Conduct, guiding principles, and monitoring and discipline processes for qualified actuaries. All members must adhere to the profession's Standards of Practice. The CIA follows its Guiding Principles, including Principle 1, which holds the duty of the profession to the public above the needs of the profession and its members. The CIA also assists the Actuarial Standards Board (ASB) in developing standards of practice applicable to actuaries working in Canada.

The CIA understands that several Canadian jurisdictions are currently contemplating how the funding of pension plans should be regulated and how transfer values should be calculated. Due to the importance to the public of how pensions are funded and the values transferred by individuals from pension plans are determined, and due to the actuarial nature of these calculations, the CIA would like to share with Canadian legislators and regulators its views on these subjects and other related topics, such as solvency funding requirements. We would also like to offer our assistance with creating new frameworks for pension funding and transfer values.

Rule 1 of the CIA notes that our duty is to the public interest, and it is in this vein that the Institute created a task force on pension funding and transfer values. Based on our preliminary analysis, we suggest that:

1. There are methods other than the current solvency funding rules that can provide some protection for members' benefits, while maintaining pension plans that continue to offer the most important defined benefit elements;
2. Consideration should be given to amending legislation to allow indexed pension plans to assume that a pension plan's variable indexing provision is substituted with one that is fixed on plan wind-up; and
3. Legislators should consider reducing the transfer values payable from certain pension plans if the plan is less than 100 percent funded.

We expand on these suggestions below.

1. The Appropriate Funding Basis

The current solvency funding requirements were implemented as a tool to accelerate contributions to pension plans so that plan members' benefits would be more secure if their employer became bankrupt and was no longer available to fund members' pensions. We share the same concern as many other stakeholders, in that the security of pension plan benefits is of significant importance. However, we offer a caution that current solvency funding measures do not guarantee this security.

For example, a recent study that reviewed the wind-up funded status of Ontario registered pension plans of bankrupt employers between January 1, 2000, and December 31, 2013, revealed that 47 percent of those plans were less than 70 percent funded—showing that members' benefits have not had full security (if we ignore possible Pension Benefits Guaranteed Fund (PBGF) protection) when needed the most under current solvency funding rules. In addition, the economic environment has changed since solvency legislation was introduced 25 years ago, and we note that both life insurance companies and banks in Canada now operate under updated solvency rules for the current environment.

We also note that solvency relief measures have been adopted in most Canadian jurisdictions in recent years. Therefore, governments understand that there is often a trade-off between the security of benefits and the pressure on particular employers and business in general to provide affordable contributions.

We also note that it should be understood that if a plan has a mismatch between the assets and liabilities (as is typical practice in Canada), then a downward movement in equity markets or bond yields creates a deficit in what, until that point, had been considered a fully solvent plan.

While solvency funding requirements at this time represent a more conservative actuarial basis than going concern funding requirements—and thus produce higher contributions that should, all else being equal, provide higher benefit security for plan members—they do give rise to other challenges.

More specifically, lower interest rates in recent years, improved longevity of pensioners, and the maturity of many plans (more pensioners vs. active members) have led to greatly increased contribution requirements that may make plans unsustainable from the plan sponsor's perspective and impose a burden on businesses generally that may impact their competitiveness. This has contributed to a move away from defined benefit-type pension plans, and therefore away from the pension plans which many believe are in the best interest of Canadians.

The decision on minimum funding requirements ultimately rests with legislators. In our view, removing solvency funding requirements should result in additional actions being taken to maintain a reasonably high level of benefit security, and one that reflects the appropriate trade-off between security and affordability.

If a legislator elects to eliminate solvency funding requirements, we recommend that:

1. Going concern valuations should be required to include a margin (otherwise referred to as a provision for adverse deviation, or PfAD) in the valuation, either as an embedded adjustment in the assumptions or as an explicit supplement representing a certain percentage of the result, with such a PfAD being determined in a manner that reflects the risks involved, and the way in which they are to be taken into account.
2. Communications to members should be enhanced, in order to explain the risks involved, the PfAD taken into account, and to what extent the PfAD may be expected to address the risks.
3. Risk management should be paramount within the governance of pension plans, including documentation that describes the risks involved and how the parties may expect to be affected by them and deal with them.

Margins

The level of PfAD that would be required is very dependent, among other things, upon the level of benefit security deemed acceptable by the legislator. The requirement of a PfAD for going concern valuations will directly increase the level of funding, which will improve benefit security in comparison to the current going concern approach in the absence of solvency funding. The PfAD in itself will not offset all the risks that currently exist in traditional defined benefit plans owing particularly to the effect of assets that are mismatched to liabilities. A more comprehensive approach may be required to better align all stakeholder interests and to determine a new PfAD range to help mitigate these current risk sharing issues.

The CIA has previously published studies regarding the level of PfADs for both going concern and solvency valuations, considering a plan's investment policy and the maturity of the plan. We would be interested in working with legislators to expand that study and create a PfAD framework that would move towards the type of benefit security and ease of use legislators are looking for.

Communications

The CIA believes that communications to plan stakeholders need to change. If a pension plan is subject to a significant mismatch between assets and liabilities, then plan members need to be informed that their benefits may not be well secured by such mismatched assets, and may be dependent upon the strength of the plan sponsor at some unknown and unpredictable future date. Plan members should be apprised of what the most recent wind-up position of the plan is, what the wind-up deficit and asset mismatch represent, to what extent the wind-up deficit may be funded by extra contributions from the PfAD or other margins, how the asset mismatch can be expected to produce variations in the wind-up deficit, and what could happen in the event of employer bankruptcy. These items would also need to be communicated in a fashion that the plan member would be able to understand.

Finally, the CIA supports disclosures that present a range of valuation results as opposed to point estimates (subject to cost/benefit analysis). This recognizes that actuarial valuation results are estimates, and a range of estimates would provide additional helpful information. Additionally, stakeholders should be able to see the consequences of alternative decisions through the range of results.

Risk Management

One could argue that solvency funding is just one of the tools currently used to mitigate the risk of benefits not being provided to members. We recommend that stronger risk management regimes be in place to ensure robust governance of pension plans. Actuaries have many risk analysis tools at their disposal now compared to 25 years ago and are more comfortable speaking to plan sponsors and pension committees about the risks inherent in pension plans. We would be pleased to explore this further with you.

Funding Bases for Public-Sector vs. Private-Sector Plans

It is appropriate to consider adopting funding rules that differ between (a) plans where benefits are subject to reduction either while a plan is ongoing or on wind-up, e.g., multi-employer plans in many jurisdictions, and jointly sponsored plans (“self-funding plans”), and (b) traditional single-employer pension plans (SEPPs) where the employer is required to fund all benefits even in the event of plan wind-up, as is currently in effect for some types of plans in some jurisdictions. Under SEPPs, plan members are subject to benefit loss only in the event the employer becomes insolvent and thereby is unable to fulfil the funding obligations.

Because of self-funding plans’ ability to adjust accrued benefits, they do not share the risk of employer bankruptcy and an unfulfilled guarantee by a single employer. Thus, whether the self-funded plan is in the public or private sector, we see no need to differentiate their funding rules.

For SEPPs where a government effectively guarantees the pension promises, the traditional view has been that the risk of benefit reductions was low because the risk of wind-up of the plan was also low and therefore funding could be lower than in private sector. However, there is a risk of intergenerational inequity (both taxpayers and members) and possibly other benefit risks on an ongoing basis even if no bankruptcy occurs. Taken from a public interest perspective, at a minimum all costs must be properly assessed for financial reporting purposes, thereby recognizing the value of the government’s guarantee. The rules must also consider reducing the risk of inappropriate transfers of costs between generations of taxpayers and plan members. As for funding, proper consideration of all risks and not just the wind-up risk should form the basis of the funding regime accompanied by clear communications of the implications of the funding decisions.

2. The Valuation Basis for Indexed Plans

Within the context of current legislation, the CIA publishes regular guidance for actuaries regarding assumptions to be used for hypothetical wind-up and solvency valuations, including those for indexed plans. While such guidance is regularly reviewed and refined, no major changes can be expected under the current regulatory regime, other than those that may be required on a periodic basis to reflect the evolving market for insured annuities.

For various reasons, the insured annuity market for pensions indexed with the Consumer Price Index (CPI) is very limited, which leads to high prices for purchasing such indexed pensions. Legislators should consider amending pension legislation to explicitly permit the substitution of fixed percentage indexing for CPI indexing when annuities are purchased on plan wind-up. The determination of the fixed percentage must be fair to plan members and must not be expected to provide a lower average indexation.

3. Potential Changes to Transfer Value Bases

The current transfer value bases are set out in the Standards of Practice adopted by the ASB and published by the CIA. The legislation in all Canadian jurisdictions requires the use of these bases when a member elects to transfer their entitlement out of a pension plan as permitted by the legislation. The CIA is pleased that these bases apply across Canada, and believes such consistency is important and ought to be preserved.

The current transfer value basis is based on a principle of “equivalent market value” and on the premise that the pension entitlement would otherwise be paid from the plan without reduction. The interest rates used in this calculation reflect recent yields on Government of Canada bonds, which are considered to have no risk, plus an adjustment of 0.9 percent to reflect a liquidity premium. Under this context, no consideration is given to the possibility that pensions might be reduced in the event of employer bankruptcy and no consideration is given to potential future investment risk. The basis is uniform for all plans, regardless of the financial strength of different plan sponsors.

The ASB currently has two projects related to the transfer value standard:

1. A review of the mortality assumptions in light of the recent publication of new Canadian pension mortality tables by the CIA. Adoption of new mortality tables will likely result in higher transfer values, resulting in higher costs to pension plans and sponsors and higher benefits for terminated members who transfer out their entitlements from pension plans.
2. A general review of the transfer value standard, potentially including reconsideration of the economic assumptions and the views of stakeholders. This project has only recently commenced.

For self-funding plans, benefits are subject to adjustment based on available funding either on an ongoing basis and/or on plan wind-up. In this situation, it is generally appropriate to reflect the funded status of the plan in the amount to be transferred, e.g., the transfer value calculation (on the same basis as the funded ratio being used) reduced to the extent that the plan is less than fully funded at the time of payment, so that the transfer value payable in a lump sum reflects the appropriate share of the assets for the terminated member. This approach still needs to be incorporated into the relevant legislation where appropriate, as has already occurred for some types of plans in some jurisdictions.

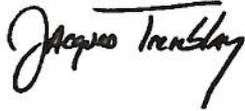
For SEPPs, if solvency funding requirements are removed, one potential argument is that a terminated member should receive a lump sum that reflects how his pension has been funded, rather than on a principle of “equivalent market value”. We expect that the second ASB project will consider the merits of this argument.

It is the responsibility of the legislator to establish the minimum benefit payable to those who elect a lump sum on termination of employment. If the legislator decides that such lump sum should not correspond to the “equivalent market value” but to a pro rata share of assets available, then the CIA would be pleased to assist the legislator in determining how this can be addressed. It is important to note that it is not the intent of the CIA to propose different calculations for different jurisdictions.

Conclusion

The CIA looks forward to participating in the discussions happening within various governments and regulators and we would appreciate if we could meet with you in person to discuss the above issues. Please contact me at the address below so we can arrange an in-person meeting at your earliest convenience.

The Canadian Institute of Actuaries trusts that the comments provided above will be of value. We thank you for offering us the opportunity to respond.

A handwritten signature in black ink that reads "Jacques Tremblay". The signature is written in a cursive style with a horizontal line above the first few letters.

Jacques Tremblay, CIA President

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