Pension Investment
Association of Canada
Association canadienne des
gestionnaires de caisses de retraite

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Dear Mr. Sauvé,

OSFI Revised Instruction Guide for the Preparation of Actuarial Reports for Defined Benefit Pension Plans

The purpose of this letter is to provide comments from the Pension Investment Association of Canada ("PIAC") on the draft Instruction Guide for the Preparation of Actuarial Reports for Defined Benefit Pension Plans (the "Guide") released for consultation by OSFI in December, 2019.

PIAC has been the voice for Canadian pension funds since 1977 in matters related to pension investment and governance. PIAC's members manage over $2 trillion of assets on behalf of millions of Canadians. Our mission is to promote sound investment practices and good governance for the benefit of plan sponsors and beneficiaries..

Our main comments on the Guide concern the proposed changes to the guidance around the determination of liability values using the replicating portfolio approach, and the supervisory cap on the going concern discount rate. These issues have raised considerable concern among our federally-regulated member plans.

Alternative Settlement Method – Replicating Portfolio

We note first that the timing for the proposed changes is highly problematic. While we appreciate that the draft Guide was developed prior to onset of the COVID-19 crisis, a procyclical tightening of pension funding requirements in the midst of a deep recession and record low interest rates is the wrong policy for the moment. Federal policy since the start of the recession has generally aimed at bridging income shortfalls and finding avenues for companies to defer tax and regulatory expenditures to support ongoing operations and contribute to the economic recovery. Implementation of the proposed changes is expected to increase solvency deficits for federal plans and therefore moves in the opposite direction to broader federal policy. Moreover, as the replicating portfolio approach is generally used by larger plan sponsors, which tend to be financially stronger than average, the proposed changes would have an additional adverse effect of tightening policy for those sponsors that least need increased regulatory attention and that can best use what financial flexibility they can maintain to contribute to the economic recovery.

The stated intent of the revisions is to ensure that the liability quantum calculated under the replicating portfolio approach is similar to that which would be achieved under a group annuity purchase, which is a reasonable objective in a solvency context. Our members however are of the view that this objective is already achieved under the current implementation. We understand that most federal plan sponsors using the replicating approach target very high probabilities of full pension payment, with modest (i.e. low single-digit) shortfalls in the scenarios where full payment is not realized. This provides overall coverage at a very high degree of conservatism, in particular given that the credit quality restrictions on the replicating portfolio construct likely result in a lower yield than a plan sponsor would actually earn from a prudently constructed matching fixed income portfolio. As such, the addition of Amounts C and D to the liability will likely cause over-funding of plans over the long-run which is an unattractive option for plan sponsors, in particular for those sponsors where access to plan surplus is uncertain.

On the question of Amount E, we are encouraged that OSFI is prepared to recognize the strength of a financial sponsor as an input into regulatory funding requirements. However, we have two concerns with the proposed guidance. First, we do not think actuaries are best placed to opine on sponsor strength, perhaps with the exception of public sector agencies where one could default to a view of negligible default risk under most conceivable economic scenarios. Second, by requiring an opinion on future long-term financial strength under a large number of long-term future scenario, the Guide goes beyond what can reasonably be expected by any financial analysis. The guidance as drafted therefore likely precludes any private sector plans from utilizing an Amount E offset in practice. While we acknowledge that it is challenging to assess sponsor strength for many smaller, private plans, we would assert that there are a number of federal plan sponsors who are demonstrably in strong financial condition today based on a variety of independent metrics (e.g. size, credit rating, capital market access) and the standards should be drafted such that Amount E is accessible for such sponsors.

Going Concern Valuation

We question the rationale for a supervisory cap on the going concern discount rate and would suggest that OSFI use its discretion to intervene on a case by case basis if it is concerned about individual plans taking an overly aggressive approach. We believe that the proposed 5.75% cap represents a bottoms-up view of what is achievable from a traditional "60/40" asset mix in the current asset pricing environment. While this may be reasonable, we see no reason that plans which aim to achieve higher returns should be capped on the discount rate in cases where they can logically support a higher expected return. Further, if a plan can reasonably justify a higher going concern discount rate, the arbitrary cap may result in increased normal cost and increased cash contributions. As stated above, the timing of this change is problematic by putting further pressure on cash resources at a time that the cash could be reinvested in businesses and the economic recovery.

We also recommend that actuaries be permitted to use net of fees return estimates at the asset class level as an input to building the expected portfolio return. We think that expected returns at the asset class level have an inherent conservative bias and the imposition of a standard "passive" fee loading on all asset classes may unduly discount returns from higher fee asset classes such as real estate or infrastructure. In our experience, investors and fund managers understand that returns net of fees is the ultimate objective and price assets accordingly. Moreover, pension funds will not participate over the long-term in alternative asset classes which do not meet return targets net of fees and expenses.

Conclusion

We close by re-iterating the urgent need to reform pension funding rules at the federal level. PIAC has sought regulatory solutions to the problems with solvency funding rules for defined benefit plans for many years and the record low interest rates and weak growth outlook due to COVID-19 is only exacerbating pressures on plan sponsors. We therefore urge the federal government to move in the same direction as the larger provinces by moving to a single going-concern funding regime.

Yours sincerely,

Simon Fréchet
Chair

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