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

# Brief of the Pension Investment Association of Canada ("PIAC")

Submitted to the Committee on Public Finance
Special consultations on the report entitled "Innovating for a Sustainable Retirement System"

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**Submission from PIAC**

The Pension Investment Association of Canada ("PIAC") has been the national voice of pension funds in matters of investments since 1977. Senior investment professionals employed by PIAC's member funds manage over $1 trillion in assets for more than 130 private and public pension funds 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 believes that defined benefit pension plans are an important and effective delivery vehicle for pensions in Canada, providing the best opportunity for secure retirement savings for Canadians. However, we are gravely concerned with their significant reduction throughout Canada. PIAC submitted its views in August 2012 on the future of pension plans in Québec, as part of the proceedings of the Committee on the future of supplemental pension plans. PIAC recommended, among other things:

- easing solvency funding requirements
- rectifying the risk/reward asymmetry between plan sponsors and beneficiaries
- allowing existing plans to purchase annuities and to transfer the entire liability to the insurer
- implementing voluntary retirement savings plans ("VRSP") without delay and promoting VRSPs in other jurisdiction throughout Canada, and at the same time encouraging harmonization

PIAC thanks the Public Finance Committee for allowing it to comment on the important report entitled "Innovating for a Sustainable Retirement System" (the "Report").

PIAC's mission is focused on investment related issues of managing pensions. A pension plan's investment policy, however, is not developed in a vacuum. The pension plan's risk management is based not only on such policy, but also on the funding policy associated with its ability to pay. Thus PIAC's comments reflect this belief.

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**Comments**

*Values and principles*

PIAC ascribes to the values of intergenerational equity, transparency and accountability and to the four (4) underlying principles of the Report, namely, to ensure funding reflects actual costs, to protect the diversity of retirement income sources, to apply a flexible legal framework and to encourage risk pooling.

It should be noted that unless the sponsors and the beneficiaries first reach an agreement on such values and principles, laying the foundations for a major renewal, as suggested in the report, will not allow the construction of a new social contract that is sustainable.

*Longevity Pension at age 75 (Recommendation number 1)*

PIAC applauds this initiative which will allow all Québec workers to have access to a defined benefit pension at age 75, and strongly supports the recommendation that this pension would be fully capitalized. This measure would reduce the costs of defined benefit pension plans by transferring part of their longevity risk and will enable longevity risk pooling among Québec workers. Harmonizing this measure with other provinces is important for employers with employees based in provinces other than Québec.

*The "enhanced funding" method (Recommendations number 3 and 4)*

PIAC believes that this funding method is a reasonable *compromise* between funding deficiencies over a 15 year period on a capitalized value basis and funding deficiencies over a 5 year period on a solvency basis. We support the suggested length for the transition period for the reduction in the amortization period of the deficiencies (from 15 years to 10 years), as well as the ability to evaluate the assets on a smoothed value basis over a 3 year period. In order to reduce the volatility of the plans and of the resulting contributions, PIAC believes that not only should smoothed assets be permitted, but also that allowing a smoothed funding ratio should be considered as an alternative.

As shown in the Report (pages 158 to 162), compared to the other valuation methods, the impact of this measure on different pension plans will vary widely. Thus, in the examples used, the current service cost increases and the impact on the contributions towards eliminating the deficiencies varies significantly, increasing for some plans and decreasing for others.

PIAC understands that applying the "enhanced funding" basis to plans under the supervision of the Régie des rentes du Québec which are currently exempted from solvency rules since the end of 2006, such as the plans of the universities and municipalities, with regards both to past and future contributions, would result in significantly larger deficits for many of those plans and, often, in unsustainable increases in contributions. In view of such major changes to funding rules, it is essential that transition measures be implemented. Accordingly, various measures should be considered, such as extending the deficit amortization period and/or providing that the new funding method will apply only after the expiration of a sufficiently long period of time to allow, if possible, the restructuring of benefits.

The Report does not contain any indication that the Pension Committee's ability to develop its investment policy freely could be reduced. In PIAC's opinion, it is essential that the Pension Committee retains its discretion, and retains the freedom to innovate. Accordingly, even if the interest rate applicable to the funding of the pension component of liabilities was prescribed and based on a corporate bond index, it would not be advisable that the Pension Committee be prevented from investing the assets of the plan in a diversified manner. PIAC notes that the use of a funding basis that relies, in part, on investment grade corporate bond rates instead of federal bond rates (as is presently the case with funding on a solvency basis) could lead certain pension plans to reduce their exposure to long term federal bonds and to replace those with investment grade corporate bonds with similar maturities. Although it is difficult to evaluate the extent of such potential substitution, and still more difficult to measure its actual impact on interest rates, the possibility that it could push corporate bond yields down must be acknowledged. The impact of the new funding basis on the investment programs and the management of these plans are unknown at this time and we would support a periodic review to ensure any unintended consequences are understood and managed.

With regards to the annual consolidation of the deficits and resulting amortization payments, this method should allow for the recognition of both the gains and losses, and should apply equally in a surplus or a deficit situation. This will help reduce asymmetry built into the current structure. PIAC also believes that deficit reductions resulting from higher returns than anticipated, for example, should translate into payment schedule reductions instead of a build up in the provision for adverse deviation. Finally, believing that the cost of funding a pension should be similar whether the pension fund is public or private, PIAC is of the opinion that the new funding rules should equally applied to government pension funds like the RREGOP as well as pension funds of the private sector, municipalities and universities.

*A new method for calculating transfer values (Recommendation number 6)*

PIAC agrees with Recommendation number 6, since it better reflects the reality of the markets. Actually, the effect of the proposed method for calculating minimum transfer values would be to increase the discount rate on the value of benefits and, accordingly, to reduce the monetary value that is transferred.

*A better understanding of risk levels, their disclosure and their management (Recommendation number 8)*

PIAC is entirely in agreement with the fact that the employer be required to adopt a funding policy. PIAC also agrees with the fact that risk levels should be quantified regularly. Such analysis will assist plans in designing investment programs with the appropriate risk appetite. PIAC submits that there should be a variety of methodologies acceptable to conduct such assessments; not only stochastic analysis, which can be costly for small plans, but also utilizing other methods which could be developed internally. Those other methods could be similar to internal models used for calculating capital adequacy to cover the financial risks of financial institutions, as provided in the Basel Accords.

*Rectifying the asymmetry between risks and benefits (Recommendations number 9, 10, 11 and 12)*

Recommendations number 9, 10, 11 and 12 address this concern of PIAC articulated at the beginning of this submission.

However, if a plan is silent regarding the division of surplus assets and the employer assumes the entire costs related to the deficiencies, PIAC suggests that Recommendation number 10 specify that such surplus assets should be the property of the employer (subject to the conditions provided in Recommendation number 5) since the employer bears the whole investment risk.

With regards to Recommendation number 11, PIAC understands that the act will contain the criteria applicable to the selection of insurers for the purchase of annuities. PIAC also understands that the purpose of this recommendation, as requested by PIAC, is for plans to transfer the liability under the plan with respect to retirees and beneficiaries, while at the same time relieving the Pension Committee and the pension plan administrator from responsibility with respect to these plan members. This will enable plan sponsors to use annuities to improve the risk management of the Plan.

*Letters of credit*

The Report is silent regarding the use of letters of credit, which are currently permitted. PIAC recommends maintaining the possibility of using letters of credit in the next revision of the Supplemental Pension Plans Act of Québec.

*Harmonization of pension plan legislation across Canada*

The D'Amours report makes no mention of harmonizing regulations across Canada. In the application of measures such as the longevity pension and VRSPs, uniform legal provisions would facilitate worker mobility between provinces and simplify implementation for employers with employees located in other provinces than Québec.

*Allowing DC plans to pay variable benefits, using the same model as for life income funds (Recommendations 18 and 19)*

PIAC is delighted with this measure which allows plans to reduce the inherent costs associated with such a transaction and, accordingly, to maximize the benefits that will be paid to the retiree. By allowing participants to a defined contribution plan to leave their accumulated balances in their plan at the time of retirement in order to receive variable benefits, using the same model as for life income funds, will ensure continuity in the management of investments and significantly reduce management fees.

**Conclusion**

Québec pension plans and others around the world are facing major challenges. PIAC believes that the Report, with the adjustments suggested by PIAC, lays the proper foundation in order to reinforce the financial security of Quebecers. We know that many other jurisdictions in Canada will be very interested by the evolution of this report in which the government of Québec could play a leading role by acknowledging that the status quo cannot be maintained.