



Pension Investment
Association of Canada

Association canadienne des
gestionnaires de caisses de retraite

September 17, 2017

Actuarial Standards Board
Designated Group
Canadian Institute of Actuaries

Attention: Gavin Benjamin

Via email: gavin.benjamin@towerswatson.com

Dear Mr. Benjamin,

Re: Amendments to Section 3500 of the Practice-Specific Standards for Pension Plans – Pension Commuted Values

The Pension Investment Association of Canada (PIAC) is pleased to respond to the Exposure Draft released by the Actuarial Standards Board in July 2017 regarding proposed Amendments to Section 3500 of the Practice-Specific Standards for Pension Plans – Pension Commuted 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 \$1.8 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 provided commentary on the Notice of Intent in our correspondence dated December 17, 2015 (attached) - specifically, we responded to questions #1, 2, 3, 4, 5, and 7. Our commentary on questions 4, 5 and 7 are relatively consistent with the Designated Group's (DG) conclusions. However, we would like to reiterate our position on some of the issues as well as to provide additional commentary on the Exposure Draft related to questions 1, 2 and 3.

It is critical that pension legislation policy makers, i.e., governments, state their position on the priority for optional commuted value (CV) transfers on termination of plan membership, and on what a CV should represent and the related rationale.

Also, pension plan design is continuously evolving. An environment with purely traditional defined benefit (DB) and defined contribution (DC) plans no longer exists. Consider the expanding number of risk-shared, target-benefit arrangements (including various plans with benefits that are provided on a conditional basis – typically based on the plan’s ability to pay for such benefits at any given point in time).

We must also consider the trend away from solvency funding of DB pension arrangements in various provinces. PIAC is fully supportive of this trend. Providing CVs based on a solvency basis when the plan is being funded on a going concern basis necessarily results in cross-subsidization whereby ongoing plan members are supporting those who choose to leave the plan.

As a result, we recommend government policy makers determine whether the “current” CV approach or the going concern approach under 3570 is appropriate for a particular pension plan.

These notions are further discussed below:

1. What should a Commuted Value (CV) represent?

As noted in our 2015 submission, with the evolution of plan design, DB benefits are not 100% guaranteed and should be regarded as follows:

- a high level of benefit security, and not “a 100% guarantee”;
- pragmatic funding ability of sponsors (including both active plan members and employers); and
- the understanding that pension plans exist to provide lifetime retirement income at retirement and not to provide CV transfer rights that effectively try to replicate, for an individual in the retail-marketplace, what an institutional pool of assets can achieve over the very long term.

We continue to hold the view that an optional CV transfer value should be based on the amount consistent with a plan sponsor’s going concern funding assumptions, where those assumptions are structured to ensure the probability of achieving a high level of benefit security. The plan member would always have the choice of receiving a pension from the plan. In cases of plan termination, where plan assets must be wound up, a rationale based on the economic value of the pension plan obligation should be applied. As noted in the Exposure Draft, a going concern approach allows for the CV basis to “be cost neutral to the plan sponsor from an ongoing funding perspective”.

The Exposure Draft comments that “others also indicated that the economic value approach allows for the use of consistent assumptions across all plans, which is not the case for the going concern approach”. Our view is that the individual plan design, risk factors, funding approach, etc. should be key factors in the CV determination and that treating all plans as being the same is not desirable nor defensible.

Finally, page 3 of the Exposure Draft notes that the economic value approach “strikes a reasonable balance between terminating plan members, non-terminating plan members,

plan sponsors, and other affected parties”. As noted above, in a number of cases, it is clear cross-subsidization is occurring based on individual plan circumstances, which is less than desirable.

2. Multi-Employer Pension Plans and Target Benefit Pension Plans:

Per our 2015 submission, given MEPPs, TBPs and JSPPs are effectively funded on a going concern basis, CV transfer values should be based on the amount consistent with the plan’s going concern funding assumptions. We are therefore generally supportive of the DG’s addition of subsection 3570.

The DG requests additional feedback on whether a cap on the funded ratio should be employed. We support a cap of 100% and agree that amounts in excess of 100% could result in the distribution of surplus assets to former members which may not be equitable for remaining plan members and plan sponsors. In addition, as noted, the plan member can always choose to receive a pension from the plan and, therefore, should not be unduly rewarded for choosing to elect a CV.

Regarding JSPPs, your paper correctly recognizes that unlike MEPPs and TBPs, benefits cannot be reduced while the JSPP remains ongoing, however as a JSPP, members and employers share the cost and funding risks of the plan and members can only rely on the plan fund to meet their future benefit commitments (there is no recourse to the employer or government if there is a deficiency). And while it is true that the “promise” of such plans is as strong, if not stronger, than traditional single employer plans, the use of a going concern measure or a CV multiplied by the lesser of 1.00 and the transfer ratio is appropriate because of the shared funding risk. Where the JSPP is exempt from solvency funding, any payout that uses a solvency standard to determine the CV can result in a loss to the JSPP and a cross-subsidization by active members in respect of those that terminate and choose to take a payment from the JSPP.

The DG also requests additional feedback on defining which pension plans fall under subsection 3570. The view that the value of a pension “should primarily depend on whether a reduction in accrued benefits...to manage the risk associated with the plan as an ongoing entity” is somewhat narrow given the many other elements at play – some of which are noted above. In addition, would the reduction of ancillary benefits in relation to past service be considered or does the “reduction in accrued benefits” solely relate to the core benefit accrual? For example, plans with conditional inflation protection could be argued to allow for a reduction in accrued benefits given that, when retirement benefits are eventually paid, it is possible that no (or little) inflation protection may be provided.

As noted in our opening comments, pension plan design is continuously evolving. We therefore recommend that whether the “current” CV approach or the going concern approach under 3570 is appropriate for a particular pension plan is a question that should be deferred to the government policy makers. Section 3570.01 could be less specific and speak to a “reduction to the accrued pensions of plan members” as one particular example (rather than the only example) of the type of plan that would be subject to 3570.

Regarding the draft subsection 3570, we have questions / comments on the following:

- .05 – What is the rationale for excluding margins for adverse deviations?
- .06 – It is common in plan design to provide for an actuarial equivalent adjustment upon termination prior to being eligible for immediate pension commencement. Using a valuation approach appropriate for “performing an actuarial valuation of a pension plan consisting only of deferred pensioner members” would therefore likely be towards the low end of potential values. Is this not inconsistent with the DG’s view to not revisit the “greatest value” approach?

3. Discount Rate Spread:

Per our 2015 submission, we agree an adjustment for liquidity is warranted and the liquidity premium should be market-based versus fixed. Therefore, we support the DG’s recommendation on the Discount Rate Spread. That said, concerns others have noted regarding a market-based approach being too difficult to achieve or implement are justified. As such, the reference information used to determine the spread should be readily accessible, reliable and relatively straight-forward to interpret.

8. Assuming the Option that Results in the Greatest Value:

Although our 2015 submission did not comment on this particular question, we acknowledge that a member selecting the option with the greatest value is biased in their favour. We recommend the DG reconsider maintaining the current approach until it can explore other potential options, such as blending values at the earliest unreduced retirement date and the earliest reduced retirement date to the extent plan terms permit early retirement on a subsidized basis.

Thank you for this opportunity to respond to the consultation document. We would be happy to clarify any of our response as required.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Kevin Fahey". The signature is fluid and cursive, with a large, stylized "F" at the end.

Kevin Fahey
Chair

cc. Chris Fievoli, CIA at chris.fievoli@cia-ica.ca

encl. December 17, 2015 letter to ASB



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Dear Mr. Benjamin,

Re: Amendments to Section 3500 of the Practice-Specific Standards for Pension Plans – Pension Commuted Values

The Pension Investment Association of Canada (PIAC) is pleased to respond to the consultation paper released by the Actuarial Standards Board on October 15, 2015 on the Notice of Intent – Amendments to Section 3500 of the Practice-Specific Standards for Pension Plans – Pension Commuted 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 \$1.5 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.

The consultation document released by the Designated Group (DG) set out a number of different questions for which they are seeking input. PIAC's responses to several of those questions (#1,2,3,4, 5, and 7) are set out below.

1. What should a Commuted Value (CV) represent?

- i. What should a CV represent?*
- ii. What is the rationale for the response to i. above?*
- iii. Should the value of a CV differ depending on whether an individual has the*

option of electing the CV (e.g., in the case of a regular termination of plan membership) or the individual is forced to receive the CV (e.g., in the case of a person employed in the province of Quebec whose pension entitlement is paid in the form of a CV upon plan wind up)?

In PIAC's view, there was no robust discussion of what a CV should represent and the rationale for that when the CV transfer standards were first requested by the regulators from the CIA in 1986. Nor has there been a sufficiently thorough discussion of what a CV should represent since then. Over the past three decades, the rationale has been affected by an evolving perception by a number of stakeholders that DB benefits are 100% guaranteed in all cases. That is an incorrect perception. There is a need to re-focus this discussion on:

- a high level of benefit security, and not “a 100% guarantee”;
- pragmatic funding ability of sponsors (including both active plan members and employers); and
- the understanding that pension plans are there to provide life-time retirement income at retirement and not to provide CV transfer rights that effectively try to replicate, for an individual in the retail-market-place, what an institutional pool of assets can achieve over the very long term.

It is critical that the pension legislation policy makers, i.e., the governments, state their position on the priority for optional CV transfers on termination of plan membership, and on what a CV should represent and the related rationale. The pension sector, including the CIA, is engaging governments on this matter.

In Quebec, under Bill 57, this matter has been addressed in a revised and thoughtful manner. Optional CV transfers are permitted but only to the extent of the funded ratio. If a plan member does not want a transfer that is less than 100% of the funded ratio, then that plan member can elect to receive a pension from the plan at retirement. Similar changes have occurred in New Brunswick for risk-shared, target-benefit plans. In these jurisdictions, the rationale has been reviewed and re-thought and legislative provisions enacted or proposed. By so doing, such regulators and policy makers have made an effective distinction between the value ascribed to the benefit and the amount by which a member can receive in terms of an optional lump-sum payment of such amount.

A further complicating factor at this time is the high level of quantitative easing implemented by central banks and governments resulting in artificially low interest rates. This in turn results in extremely low discount rates for CV values and high transfer costs for plans.

If government policy makers articulate a rationale for the CV to represent the economic value of a guaranteed obligation discharged by the pension plan, then the ASB should set the CV standards accordingly. However, that rationale is undergoing a rethink by policy makers, e.g., Quebec. Accordingly, if the ASB is charged with determining the methodology for determining a CV on the assumption that it represents the economic value of a guaranteed obligation, it should be clear in promoting its standards that this is only a measure. The right to a CV payout and the amount of such payout is a different

question that must be answered by legislation and that policy makers having regard to the legislative intentions and/or funding standards in that jurisdiction.

PIAC would argue that an optional CV transfer value should be based on the amount consistent with a plan sponsor's going concern funding assumptions, where those assumptions are structured to ensure the probability of achieving a high level of benefit security. The plan member would always have the choice of receiving a pension from the plan. In cases of plan termination, where plan assets must be wound up, a rationale based on the economic value of the pension plan obligation should be applied.

2. Multi-Employer Pension Plans and Target Benefit Pension Plans:

- i. *Should MEPPs and/or TBPs fall within the scope of section 3500?*
- ii. *Should the methods and assumptions used to calculate CVs differ between single employer DB plans, MEPPs and/or TBPs? If they should differ, what should the differences be (including whether the standards should permit more judgement when selecting the CV assumptions for MEPPs and/or TBPs)?*
- iii. *Some pension plans, such as jointly sponsored pension plans (JSPP), share certain characteristics of both single employer DB plans and MEPPs and TBPs. For example, accrued benefits under an Ontario JSPP cannot be reduced while the plan is ongoing, but benefits can be reduced upon plan windup if the plan is underfunded. How should CVs be calculated for JSPPs and other types of pension plans that are neither single employer DB plans, MEPPs, nor TBPs?*

Section 3500 should not apply, as currently structured, to MEPPs, TBPs and, we would add for the reasons noted below, JSPPs. Effectively, these types of plans are funded on a going concern basis and thus CV transfer values - to be consistent with the funding standards of such plans - should be based on the amount consistent with the plan's going concern funding assumptions. The plan member would always have the choice of receiving a pension from the plan. Another alternative would be to recognize the shared funding risk associated with such plans and use the same economic value standard but multiply it by the lesser of the plan's transfer ratio and 1.00. In this way there is no cross subsidization between remaining and terminating members.

In cases of plan termination, where plan assets must be wound up, all benefits, including CV transfers would be based on the funded status of the plan and its plan wind up asset allocation provisions.

Regarding JSPPs, your paper correctly recognizes that unlike MEPPs and TBPs, benefits cannot be reduced while the JSPP remains ongoing, however as a JSPP members and employers share in the cost and funding risks of the plan and members can only rely on the plan fund to meet their future benefit commitments (there is no recourse to the employer or government if there is a deficiency). And while it is true that the "promise" of such plans is as strong, if not stronger, than traditional single employer plans, the use of a going concern measure or a CV multiplied by the lesser of 1.00 and the transfer ratio is appropriate because of the shared funding risk. Where the JSPP is exempt from solvency funding, any payout that uses a solvency standard to determine the CV results in a loss to

the JSPP and a cross-subsidization by active members in respect of those that terminate and choose to take a payment from the JSPP.

3. Discount Rate Spread:

- i. Is it appropriate to include an adjustment for liquidity in CV discount rates? If it is appropriate, is the 90 bps adjustment still appropriate or should a different adjustment be used? If a different adjustment should be used, what should the adjustment be and what is the justification for the magnitude of the adjustment?*
- ii. Should the adjustment for liquidity be market based or fixed? If a fixed adjustment is applied, should it be promulgated i.e. able to be updated from time to time without a review of the full standard of practice?*
- iii. Should the adjustment for liquidity differ between pensions that are indexed and pensions that are not indexed?*
- iv. Should the discount rates include adjustments for other factors, such as credit risk and / or expenses? If other adjustments are appropriate, what should be the magnitude of these adjustments?*

As noted in the answer to Question 1, PIAC believes that an optional CV transfer value should be based on an amount consistent with a plan sponsor's going concern funding assumptions, where those assumptions are structured to ensure the probability of achieving a high level of benefit security. As per the Notice of Intent, "Given the various uses of CV calculations, the basis for calculating CVs should be as fair as possible to terminating plan members, non-terminating plan members, plan sponsors and other affected parties". Members remaining in the plan should not be in the position of cross-subsidizing those who choose to leave and elect a lump sum (which is the case given current market rates).

That being said, if government policy makers determine that the current approach to determining CVs is appropriate, we agree that including an adjustment for liquidity is warranted. Ideally, the liquidity premium would be market based versus fixed. The DG's view is that pension promises are secure but illiquid. We question how truly secure the promise is and suggest further adjustments beyond the liquidity premium should be taken into consideration. As an example, the funded status of the pension plan could be taken into consideration.

4. Discount Rate Structure:

- i. Should a full yield curve or a simplified approach be used to establish the CV discount rate assumption?*
- ii. If a simplified approach remains appropriate, should there be changes to the current structure? For example, should there be an ultimate rate that is fixed (i.e., the rate does not vary based on changes in GoC bond yields)?*

A full yield curve would be an appealing approach to introduce further robustness to the process, however, administrative costs and complexities must be taken into consideration. We therefore agree with the DG's view of maintaining the current simplified two-tiered structure. Furthermore, we believe the ultimate rate should continue to vary based on changes in the GoC bond yields vs. adopting a fixed rate approach however we recognize that this would complicate hedging strategies.

5. Basis for Inflation Assumption:

- i. Is the BEIR an appropriate measure of price inflation for purposes of calculating CVs?*
- ii. If use of the BEIR is not appropriate, what approach should be used? For example, should other inputs, such as the expectation of experts, be reflected in the assumption?*
- iii. Is the material difference between the premium for an indexed group annuity and the CV for the same pensions an issue that needs to be addressed? If this is an issue that needs to be addressed, what changes to section 3500 would be appropriate?*

We agree that the “break-even inflation rate” (BEIR) is subject to distortions over certain time periods due to supply / demand imbalances in the market for long-term GoC indexed bonds. That being said, although various alternatives could be considered, using the BEIR is defensible and appealing given it is observable. Therefore, we agree with the DG that the BEIR is an appropriate measure of inflation. Premiums for indexed annuities purchased from insurance companies are materially larger than what the CV would be, however this is reflective of a variety of factors including insurance company profit loads. Our belief is that CVs are not meant to represent the cost required to replicate the benefit from an insurance company. Although the gap in values can be material, we do not believe it is a relevant consideration for the appropriate determination of a CV nor an issue that needs to be addressed.

7. Complex Indexing Approaches:

- i. Should the standards of practice be more specific with respect to the valuation of certain complex indexing approaches? If yes, in what way should the standards be modified?*
- ii. Is it appropriate in certain circumstances to use stochastic simulations to calculate the expected indexing resulting from an excess interest or other complex indexing approach?*
- iii. Is it ever appropriate for the CV calculation to reflect the funded status of the pension plan at the valuations date?*

We believe that the standards, as written, provide sufficient guidance for valuing the indexation component of the CV for traditional approaches to plan design. That being said, pension plan design is continuously evolving. Creative arrangements exist today that provide various benefit promises (including the level of indexation provided) that are conditional upon the funded status of the pension plan. The design of such arrangements typically focus on ensuring the long-term sustainability of the arrangement. The probability of such benefits being provided to members in the future should be taken into consideration in the determination of the CV. It would be important to recognize the distinction between plan terms that are *conditional* versus *discretionary*. In terms of conditional indexing in particular, stochastic forecasting would be ideal, however, plan size, administrative costs and complexities should also be taken into consideration. Robust, stochastic forecasting may not be a viable option for all plan sponsors / administrators. However, guidelines (without being overly prescriptive) for a simplified deterministic forecast approach could be provided by the standards. Forecasting

approaches / policies should take into consideration the current funded position of the plan, future expectations of the funded position, funding policies, frequency of updating the forecast, etc... Regardless of the approach taken, the actuary should be prepared to justify their adopted methodology as well as the related underlying assumptions. We believe that Section 3520.01 should be updated to allow for the funded position of the plan to be taken into consideration where the underlying benefits are conditional upon the plan's ability to pay. That being said, for pension plans *without* conditional benefits, we support the current premise that the funded position of the plan should be *excluded* as a factor in determining the CV.

Thank you for this opportunity to respond to the consultation document. We would be happy to clarify any of our response as required.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Dan Goguen', with a long horizontal flourish extending to the right.

Dan Goguen
Chair

cc. Chris Fievoli at chris.fievoli@cia-ica.ca.