Intelligence MEMOS

From: Barry Gros

To: Ontario's Pension Policy Branch

Date: May 19, 2023

Re: **Target Benefit Pension Plan Sustainability: Determining the Optimal Role and Magnitude of PfADs**

The Ontario Ministry of Finance released a consultation document on target benefit pension (TBP) regulation, with a June 30 feedback deadline. I evaluated its proposals in two recent Intelligence Memos. The second focused on achieving sustainability in these plans. This memo digs deeper into the technical aspects of sustainability and concludes with specific recommendations.

First, a few words on Provision for Adverse Deviation (PfAD), a key concept from the Canadian Institute of Actuaries Standards of Practice and used in pension plan funding. It is a cushion added to a calculation made using best estimate assumptions (i.e., that have a 50-percent chance of occurring) to provide a buffer against potential risks such as unfavourable economic conditions or poor investment performance. It is typically expressed as a percentage of a plan's liabilities or service cost (the annual cost of benefits being earned) and is meant to ensure sufficient assets to meet obligations in adverse scenarios.

For the purpose of this discussion, I focus on key decisions a TBP board of trustees must make, and the role of PfADs in informing those decisions. These include:

Determining the future benefit level to match future fixed contributions. It is common practice to establish a PfAD to act as a buffer between contribution levels and the costs of the benefit. PfAD size is critical because it directly affects the size of the benefit earned and its income adequacy for members, which is a primary measure of pension plan quality. This differs from how PfADs operate in defined benefit plans, where the PfAD is a complete add-on to the service cost and has no direct impact on benefit size.

Many TBPs aim for benefit stability, which requires a relatively predictable and stable PfAD over time. The British Columbia PfAD working group, of which I was a member, concluded that the PfAD applied against contributions should be easy to determine and communicate to plan members. However, the contribution sufficiency test in Ontario's consultation document works against this stability objective by proposing a PfAD that changes with every valuation cycle. In contrast, BC implemented a minimum PfAD at a flat rate of 7.5 percent of the service cost, leaving each TBP to specify an additional specific PfAD as needed.

It is important to note that for mature TBPs with a significant retiree population, a PfAD requirement on the service cost has negligible effect on benefit security.

Assessing when and how benefits earned to date can be improved or reduced. The board of trustees typically makes critical decisions about benefit levels by assessing a plan's funded status. Benefit improvements are generally determined by setting funded status thresholds (e.g, a funded ratio of at least 110 percent) while benefit reductions would likely be required if the funded status dips below 100 percent. Funded status thresholds exist as an actionable metric. While some jurisdictions require a minimum PfAD on the plan funded status for benefit improvements, none have any requirement to fund this target. There is no need for PfAD requirements to be identical with respect to their application against a plan's service cost and their incorporation into thresholds for decision making on benefit improvements. Different needs should be met in different ways.

Ontario's consultation document falls short in stating "the proposed framework would allow benefit improvements regardless of the Plan's funded level," with the requirement that "any increase in going concern liabilities and PfAD on this increase would be required to be funded over 10 years." This is very concerning, especially since I would expect that benefit improvements would be deferred until a board believed the plan was well enough funded to provide for those benefits and could sustain them over the long term. It seems counter to the concept of TBPs to allow benefit improvements that cannot be justified by existing assets. Furthermore, it is highly unlikely that plan contributions would have any room for the amortization payments suggested, in any event.

PfADs should align with the plan's objectives and not be regulated in a way that is disconnected from those objectives. Ontario's document could benefit from a clearer definition of the PfAD role – and its proper magnitude – in creating plan sustainability.

Finally, moving forward: I suggest the following four changes to realign the consultation document:

1. Grant plans the flexibility to choose their own methodology for determining and assessing benefit sustainability. Many plans already employ multiple tests and actuarial methods based on specific circumstances, so regulatory imposition on the methodology should be avoided.
2. Establish a minimum PfAD level, similar to that adopted in BC, which would apply regardless of the actuarial methodology used to assess sustainability.
3. Mandate comprehensive disclosure of sustainability testing in filed actuarial valuation reports, encompassing methodologies, assumptions, and conducted stress tests. This would allow the provincial pension regulator, FSRA, to assess its own comfort level with the analysis.
4. Impose a standardized financial reporting methodology for all plans, such as employing the unit credit going concern funding method. This would enable FSRA to compare all plans using a common platform. This reporting exercise would solely serve as a means of disclosure and would not impact separate plan assessments regarding sustainability.

Barry Gros is a retired actuary and Chair, Pension Board, University of British Columbia Staff Pension Plan.

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