TD Asset Management

Investment Implications of Quebec's Bill 57

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The past decade has been a difficult reality check for defined benefit ("DB") pension plans. Not only did longevity increase, but interest rates declined, which caused the liabilities to increase, and equity markets experienced wide swings. Combined, these factors led to a number of pension plans being severely underfunded. However, these challenges also led to a better understanding of the economic risks pension plans must be cognizant of, and they prompted authorities to reconsider pension plan legislation so that it more easily allows plans to achieve sustainable funding.

One example of this pension legislation reform is Quebec's Bill 57, which establishes a new funding method and a stabilization provision for private sector DB pension plans. Much has been written about the specifics of Bill 57, so in this article, TD Asset Management Inc. ("we") will focus on providing our perspective on its investment implications.

Altered liability risk profiles

Previously, funding for many private sector DB pension plans in Quebec was driven by the solvency basis. Following the adoption of Bill 57, contributions will be determined under an amended going-concern basis where an explicit buffer is required to cover market and interest rate risk.

Under the new rules, plan obligations will remain a relatively predictable set of cash flows and plan financials will continue to depend on the interaction between asset and liability performance. However, the nature of the interaction is changing.

The new rules may help plans focused on longer-term outcomes, and they incentivize risk reduction efforts to some extent. However, they do allow for an early recognition of the potential benefits from adopting more liberal investment strategies. As a result, it will be important for plan sponsors to understand the assumptions that are being used, be wary when they deviate from economic fundamentals or from what is being priced in the market, and be cognizant of the implications should these assumptions prove to be overly optimistic.

Nuanced investment implications

At first glance, the return toward a going-concern approach seems logical for pension plans – after all, the assumption is that pension plans are genuine long-term investors. However, the reality is more nuanced, and the implications of Bill 57 will vary based on a plan's maturity, overarching objectives and ability to harvest different risk premia over time. In the following examples, we look at some of the investment implications for two very different types of plans.

Case #1: Open plan with long time horizon

For less mature plans with long time horizons, Bill 57 may provide an opportunity to revise investment strategies to achieve improved outcomes (e.g., lower and/or more stable contributions over time).

- With respect to the expected level of contributions, the interplay between the investment return assumptions and the stabilization provision will be a critical factor
- The volatility of contributions will depend on the asset mix chosen plus a myriad of other factors, such as plan profile, whether/how smoothing is applied and how quickly the going-concern discount rate is updated to reflect prevailing market conditions

Given the driving factors mentioned above, plan sponsors should be careful about jumping to conclusions quickly. That said, there are certain outcomes that are likely to be observed in aggregate:

Allocation between liability hedging vs. return-seeking assets (relative to pre-Bill 57 rules)

Return-seeking	+	While the stabilization provision favours risk reduction, on a net basis return-seeking assets should lead to lower contributions.
Liability hedging	–	The allowance for smoothing assets should make higher allocations to return-seeking assets more attractive than pre-Bill 57.

Impact on liability-hedging assets (vs. Canadian government bonds)

Fixed income overlay strategies[1]	++	■ Could increase discount rate if (a portion of) maturity term premium is recognized; and ■ Can support lower stabilization provision (through duration hedging benefit[1]) and/or free up capital to invest in return-seeking assets
Investment grade corporate bonds & mortgages	++/+	■ Increased discount rate; and ■ Treated as favourably as Canadian government bonds for stabilization provision[1] NB: Stabilization provision rules do not penalize securities outside Canada[1]. This will help promote better diversification across countries, sectors, issuers and possibly currencies.

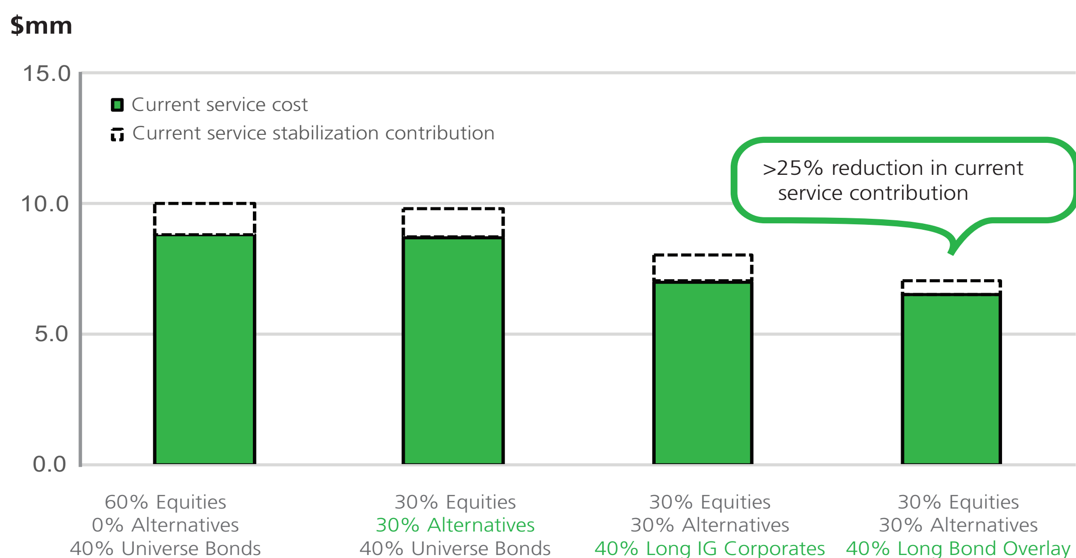
Impact on return-seeking assets (vs. equities)

Real estate & infrastructure	+	■ Impact on discount rate will vary; but ■ Treated more favourably than equities under stabilization provision[1]
Other	Varied	■ Impact on discount rate will vary ■ Treated like equities under stabilization provision

[1] Provided it meets the definition of fixed income

Under reasonable investment return assumptions, the traditional asset allocation split of 60% equities, 40% universe bonds (which led to significant volatility in contributions pre-Bill 57) is unlikely to be an attractive proposition:

Current service contributions for sample plan[2]



As of June 30, 2016. Source: TD Asset Management

Case #2: Mature plan on its way to fully de-risking

For a late-stage plan that has full de-risking in sight, ignoring solvency-based concept measures could lead to unfortunate outcomes. We recommend plan sponsors consider the following when it comes to their investment strategy:

Interest rate risk: A key de-risking cost driver is the level of interest rates. Plan sponsors should remember that (i) the interest rate sensitivity of current market-based liability measures is different from that of the going-concern liabilities, and (ii) while it may be tempting to invest in shorter-term assets to benefit from potential increases in rates, this could increase any shortfall if rates decline and might also involve giving up yield in the interim.

Liquidity: Full de-risking could necessitate the sale of assets on short notice and within a compressed timeframe. This may favour certain assets, and emphasis should be placed on mitigating execution risk throughout the process.

Enhancing yield/return: Many plans will target higher investment returns to support part of the de-risking cost. Forming realistic expectations on the potential range of outcomes and diversifying sources of risk premia will be important. Strategies that deliver similar returns with lower volatility (e.g., low volatility equities) or that limit downside risk (e.g., using derivatives) may also lead to improved outcomes.

Collaboration will help improve outcomes

Moving forward, we do not expect much relief from challenging conditions for investors. Global economic growth remains subpar, and foreign exchange and government/fiscal policy distortions may prevent its acceleration. Inflation remains stubbornly low, weighing on bond yields and creating fears of deflation. In addition, debt is high in both the developed and emerging worlds, and our research indicates we are in the late stage of the credit cycle, which has historically coincided with weak equity returns.

Given this backdrop and the changes that will occur under Bill 57, it is no surprise that some pension plans are questioning the appropriateness of de-risking strategies. We believe plans must revisit their investment objectives and strategies to ensure they are appropriately positioned to weather future macro-economic challenges and take advantage of the new rules.

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[2] Based on liability stream with duration of 20 years (discounted at Provincial bond curve) and prevailing interest rates and credit spreads. Assumes risk premium of 4% on return-seeking assets, 25bps margin on corporate bonds and 50bps of return on the portion of overlay bonds.

We take a pragmatic and collaborative approach to customizing investment solutions based on each pension plan's overarching objectives and specific constraints. We work continuously with our clients and their consultants to help them adapt their investment strategies so they can take advantage of investment opportunities in light of the regulatory and macro-economic backdrops. We would be delighted to discuss what Bill 57 might mean for your plan and to create strategies to help you achieve improved financial outcomes. Please contact your Relationship Manager for more information. ■

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