Insight into Ontario's Pension Reform:

Implications of the Final Funding Rules (Part 3)

We wrote Part 2[1] of this series in May 2018; at the time permanent new pension plan funding rules had just come into effect in Ontario. The past 16 months have seen three significant developments:

1. The Financial Services Commission of Ontario ("FSCO", which has now been superseded by the Financial Services Regulatory Authority of Ontario or "FSRA") issued interpretations on the new funding rules;
2. Ontario's Ministry of Finance made additional changes to the Pensions Benefit Act ("Act") and Regulations ("Regulations"); and
3. The Toronto-Dominion Bank (TD) acquired Greystone Capital Management Inc., allowing for TD Asset Management ("TDAM") to provide insight on the new funding rules by leveraging the knowledge of both legacy managers.

This article will focus on the investment implications of point one and two above; and discuss how the regulatory environment may evolve further in the future.

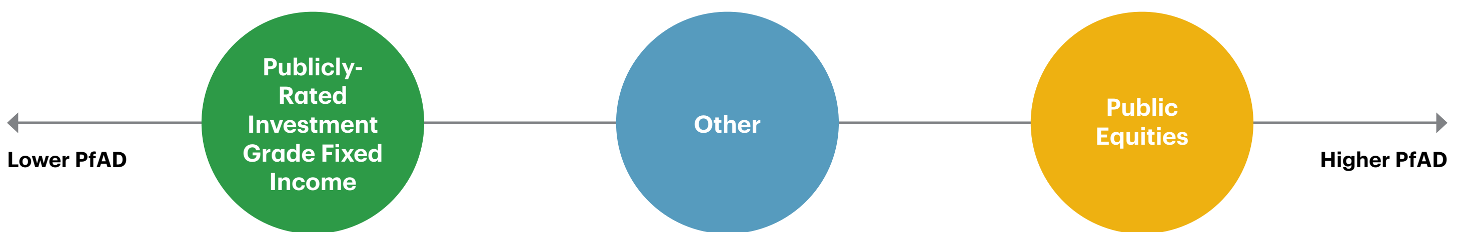
Rules that have been clarified since the Regulations were originally released

Clarified via new Regulations

As noted in Part 2 of this series, one of the aspects of the new pension funding rules that was unclear was the treatment of certain debt securities for Provision for Adverse Deviation (PfAD) purposes; namely high-yield bonds and privately rated bonds. That treatment has now been clarified with the release of *O. Reg. 105/19*[2], which amended the Regulations on May 21, 2019.

High-yield bonds and privately rated bonds of any quality are now treated as 50% fixed income for PfAD calculation purposes. This treatment is aligned with various forms of alternative investments and creates three clear classes of investments for PfAD purposes (**see Chart 1**):

Chart 1: PfAD Treatment, Based on Asset Class



For illustrative purposes only.

The new Regulations also eliminated a troublesome FSCO interpretation which we will refer to as 'Tainting'. Under the old regulation, tainting posited that holding any high-yield or privately rated bonds would have an outsized negative impact on the entire portfolio's PfAD treatment.

Clarified via FSCO Interpretation

Certain aspects of FSCO's interpretation of the new rules were superseded by recent changes to the Regulations mentioned above, so we will focus on the interpretations that we believe continue to be relevant to pension plan sponsors.

SIPP[3] Disclosures: While plan administrators have traditionally documented their target asset mix in their SIPPs based on a range of different asset class definitions, FSCO's interpretation requires that all plans document their asset mix using the 17 categories defined in the regulations.

Clarification on certain asset classes: FSCO has clarified the definition and treatment of various types of securities under their new regulations. Most notably, they clarified that indirectly investing in real estate and infrastructure, through listed securities, should be treated in a similar manner to investing in public equities for PfAD purposes. This contrasts with direct investments in real estate and infrastructure, which are treated as 50% fixed income for PfAD purposes.

Aspects of the Regulations that are still uncertain

One notable issue that remains unclear is the treatment of various derivative instruments under the new rules. Derivative instruments were not explicitly mentioned in the original regulation covering the PfAD rules; and this has not been clarified either through FSCO's interpretation or subsequent amendments to the Regulation.

The Canadian Association of Pension Supervisory Authorities ("CAPSA"), a national association of pension regulators, issued a communique in February of 2019 acknowledging that the use of derivatives is becoming more common for pension plans across Canada; and that further regulatory guidance may be needed[4].

As a result, we expect that this is an area where we will see further guidance, either from Ontario's Ministry of Finance or from FSRA, the successor organization to FSCO.

In Part 2 of this series of articles, we outlined a possible approach for reflecting derivatives in the PfAD calculation which had two key advantages:

1. It can produce consistent results, regardless of the amount of leverage used or how it is attained.
2. It can provide a limit on the extent to which leverage can be used to increase the going concern discount rate.

Given the Ontario Ministry of Finance's recent release of clarifying regulations, and the fact that the outcome of those regulations was to ensure a sensible and pragmatic result, we are confident that further legislation or regulatory guidance in this area will support a practical interpretation of the treatment of derivatives.

Another area where the rules remain unclear is the treatment of hedge funds. Since hedge funds vary greatly in their strategies and the underlying instruments they invest in, we would again suggest that the plan take a practical approach, consider the specific attributes of the hedge fund(s) in which they invest and remain internally consistent with the treatment of similar assets classes. We anticipate any future regulatory guidance would be supportive of such an approach.

Finally, we note that the new rules generally define the minimum quality rating for fixed income securities in line with the bond market's own definition; of which ratings are considered investment grade vs. high yield. The one exception is that the minimum ratings for the DBRS rating agency are one notch above the investment grade minimum rating (i.e. BBB instead of BBB (low)). While this difference is likely unintentional, we do not expect it to be corrected in the near future; as such pension plans should be careful in defining their own minimum rating criteria. For example, plans could look at the ratings of all the rating agencies and use a "highest of" criteria to determine which securities are considered investment grade.

Asset allocation considerations

Based on our analysis of the revised Ontario funding rules, in particular the PfAD treatment of various assets classes, we do not believe that the PfAD rules will have a material impact on the strategic mix of pension plans.

The PfAD treatment of private debt and common alternative assets classes is sufficiently benign to ensure they will continue to be used as portfolio diversifiers and yield enhancers. Also, the elimination of the "tainting rule" ensures that plans can continue to use "Core Plus / Bond Plus" funds as an efficient way to access multiple fixed income levers within a single mandate.

The one exception is that we expect Ontario pension plans will likely exhibit a clear preference for direct real estate and infrastructure exposure (treated as 50% fixed income for the PfAD calculation) vs. exchange-listed real estate and infrastructure investments (treated as 0% fixed income).

Do-it-yourself Annuities

Consistent within an overall trend of de-risking, buy-in annuities have grown in popularity in recent years. As mentioned in our 2017 article **"Two Paths, One Destination"**[5], the emergence of investment grade private debt pooled funds provides pension plans of all sizes with an attractive alternative to buy-in annuities, that is the option of building a portfolio that can significantly hedge interest rate risk and credit risk; at a much lower cost than an annuity purchase.

Given the uncertain treatment of private debt under the original Ontario legislation, the positive economics of this "do-it-yourself annuity" approach were under threat. With the recent changes in legislation, Ontario pension plans can once again choose the best de-risking solution for their circumstances, without undue interference from the PfAD rules.

Coping with Higher Ongoing Liquidity Needs

Based on discussions had with our clients, we observe that the new rules have achieved their objective of providing additional funding flexibility for plan sponsors. Generally, this has translated to a reduction in the amount of cash flowing into pension plans. At the same time, as closed defined benefit plans mature, the amount of cash flowing out of plans in the form of benefit payments continues to grow. As a result, a number of our Ontario clients have recently switched from being cash flow positive on a monthly basis, to being cash flow negative.

This has caused many clients to reframe how they view liquidity in their portfolio, from event-driven liquidity to ongoing liquidity.

Event-driven liquidity: Measuring liquidity based on the amount of liquid assets in their portfolio, that is, assets that could be sold on short notice with a minimal loss of value.

Ongoing liquidity: Measuring liquidity based on how much available cash flow is generated by the portfolio through fund distributions, coupon payments and maturing securities; without any selling required.

An important difference between these two definitions of liquidity applies to private fixed income and mortgages. These securities, which provide higher yields than public fixed income, have lower event-driven liquidity, but have similar or sometimes higher levels of ongoing liquidity. The table below illustrates various fixed income solutions to provide yield, interest rate hedging and liquidity to cover short term cash flows.

	Universe Bonds	Duration Matching Mix of Universe and Long Bonds	Buy-In Annuity	Duration Matching Mix of Public Bonds, Private Bonds and Mortgages
Portfolio Yield	2.35%	2.45%	2.75%	3.60%
Interest Rate Hedge Ratio	70%	100%	100%	100%
1 Year Cash Flow Coverage	45%	50%	100%	100%

Source: TDAM Internal. Data as of June 30, 2019.

Notes:
- DIY annuity portfolio is a tailored portfolio with allocation to investment grade private debt, commercial mortgages and public bonds
- Yield is annualized internal rate of return, rounded nearest 5bps
- 1 Year cash flow coverage based on projected asset cash flows / projected liability cash flows
- Interest rate hedge ratio calculated as asset duration / liability duration
- Buy-in annuity yield per Canadian Institute of Actuaries (CIA) annuity purchase guidance
- Based on indicative pension liability profile with duration 11 years

In Closing

Thus far, 2019 has been another year of surprises, with bond yields again falling despite many industry participants predicting the opposite. This suggests de-risking strategies would have performed very well. However, the unexpectedly strong performance of equity markets means that most pension plans, regardless of their investment strategy, are having a strong year of asset returns in the face of rising liabilities.

Now that the major concerns with the new funding rules have been resolved, we believe plans must revisit their investment objectives and strategies to ensure they are appropriately positioned to weather future macro-economic challenges.

TDAM takes a pragmatic and collaborative approach in customizing investment solutions based on each pension plan's overarching objective 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 the Ontario funding rules might mean for your plan and to create strategies to help you improve financial outcomes. ■

[1] Insight into Ontario's Pension Reform: Implications of the Final Fund Rules (Part 2), can be found here.
[2] O. Reg. 105/19: GENERAL: https://www.ontario.ca/laws/regulation/r19105
[3] SIPP: Statement of Investment Policies and Procedures
[4] Communique: Review of Leverage Use within Pension Plans: https://www.capsa-acor.org/Documents/View/628
[5] Two Paths, One Destination can be found here

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