Insight into Ontario's Pension Reform: Implications of the Final Funding Rules (Part 2)

May 2018

On April 20th, 2018, the Ontario Ministry of Finance (the "Ministry") released regulation *O.Reg 250/18*, altering the province's Pension Benefits Act and permanently changing the funding rules applicable to single employer pension plans in Ontario, effective May 1st, 2018.

This regulatory change was subsequent to the release of a list of proposed new funding rules, which occurred on December 14th, 2017 for which TD Asset Management (TDAM) provided a detailed response to the Ministry. In our submission to the Ministry, TDAM provided our perspective on the treatment of certain investments that are increasingly common in the investment portfolios of Ontario pension plans. Our thoughts were also published in a January 2018 article entitled "Investment Implications of Ontario's Proposed Funding Rules: Part 1".

As an investment management firm, TDAM believes that the overall investment strategy of a plan should be aligned with its long and short term objectives, with a tolerance for risk being kept in mind. In the short term, the funding requirements of a plan will be impacted by the new rules. Nevertheless, the cost of delivering a pension is dependent on the actual return earned on its investment and is independent of initiatives, such as the Provision for Adverse Deviation (PfAD). Hence, TDAM believes that a prudent and practical interpretation of the regulations should be applied. In light of the finalized regulations being enacted, this paper is the part two (2) to our initial article and will:

I. Highlight where the finalized regulations provide clarity and where ambiguity remains;
II. Provide insight into the relationship between the Provision for Adverse Deviation (PfAD) and the plan's investments.

What is the Provision for Adverse Deviation (PfAD)?

The *Provision for Adverse Deviation (PfAD)* is a prescribed margin requirement by which a pension plan will fund a reserve to protect against a future negative plan experience. The PfAD is determined based on the status (closed or open) of a plan, its target asset mix and the going concern discount rate. Plans deemed higher risk will require a higher reserve[1].

What has been clarified under the new rules?

The following changes have been confirmed:

1. Plans are only required to prefund 85% of their solvency liabilities;

[1] The size of the PfAD reserve is dependent on three factors, **(i)** Whether the plan is open or closed to new defined benefit members, **(ii)** What percent of the assets are invested in non-fixed income assets; and **(iii)** Whether and to what degree the plan's going concern discount rate exceeds a Benchmark Discount Rate (BDR) as defined in the regulation.

2. The time frame to fund going concern deficits has been reduced from 15 year to 10 years; and
3. The treatment of certain investments, as follows:

Investment	Treatment
Investments that qualify for 100% fixed income treatment.	To get 100% fixed income treatment, money market, domestic and foreign bond securities must be rated "investment grade" (i.e. R2 (mid) or BBB low or higher, respectively) by a credit rating agency recognized by a competent authority.
Specified investments receiving dual 50% treatment.	The list of specified investments which receive dual treatment (i.e., 50% between fixed income and equity) has been broadened by including a catch-all "Other" category.
Treatment of pooled funds.	The proportion of a pooled fund that is considered fixed income, dual or equity is based on a look-though to the underlying target mix of the fund. This new provision captures all mutual, pooled and segregated funds, including balanced funds, core plus bond funds and bond overlay funds.

For a pension plan that only invests in traditional asset classes (i.e. investment grade rated fixed income and public market equities), the effects of the new rules are straightforward. However, for plans that are more diversified, have exposure to alternative investments, use derivatives, or utilize a liability hedging-strategy, there remains some uncertainty as well as some new dynamics to consider.

What remains unclear under the new rules?

There remains some ambiguity on how different asset classes are treated. Some early conclusions were:

- Getting 100% fixed income treatment is the most favorable PfAD treatment;
- The final rules need to provide more guidance on the treatment of derivatives; and
- Interest rate hedging is not rewarded under the going concern funding rules.

As we continue to analyze the impact of the new rules, we are identifying nuances that challenge the validity of these early conclusions. In the next section, TDAM shares our insights on four (4) key aspects of the new rules.

1. Be aware of the BDR

There has been discussion within the industry about whether some assets classes are being given preferential PfAD treatment over others. We believe an important factor, which is often overlooked, is the impact of a plan's asset mix on the Benchmark Discount Rate (BDR). The BDR formula is based on the marked-to-market level of long-term government bond yields plus a maximum allowable risk premium based on the plan's asset mix:

Asset Class:	Fixed Income	Specified Investments which receive dual 50% treatment	Equity
Risk Premiums:	1.50%	3.25%	5.00%

If the going concern discount rate exceeds the BDR, the PfAD increases such that the BDR effectively sets a floor on the going concern funding target. Hence, the higher the BDR, the lower the funding target floor[2].

Given that the final rules place a broad grouping of investments in each of the three risk premium categories, consideration for how much immediate credit one can get for taking investment risk should be kept in mind. For example, real assets (like resource properties or venture capital) have the same allowable 3.25% risk premium as real estate debt and a lower premium than equities at 5%. Similarly, all investment grade rated fixed income is treated equally, so whether you invest in less risky government bonds or corporate bonds, the maximum allowable risk premium remains 1.5%. As a result, when anticipating the PfAD impact for a target asset mix, it is insufficient to solely consider the percentage allocated to non-fixed income as the weighted average risk premium allowable in the BDR versus the actuary's best estimate also impacts the funding target floor.

In the next section, we explore this trade-off further using an example of the treatment of private debt.

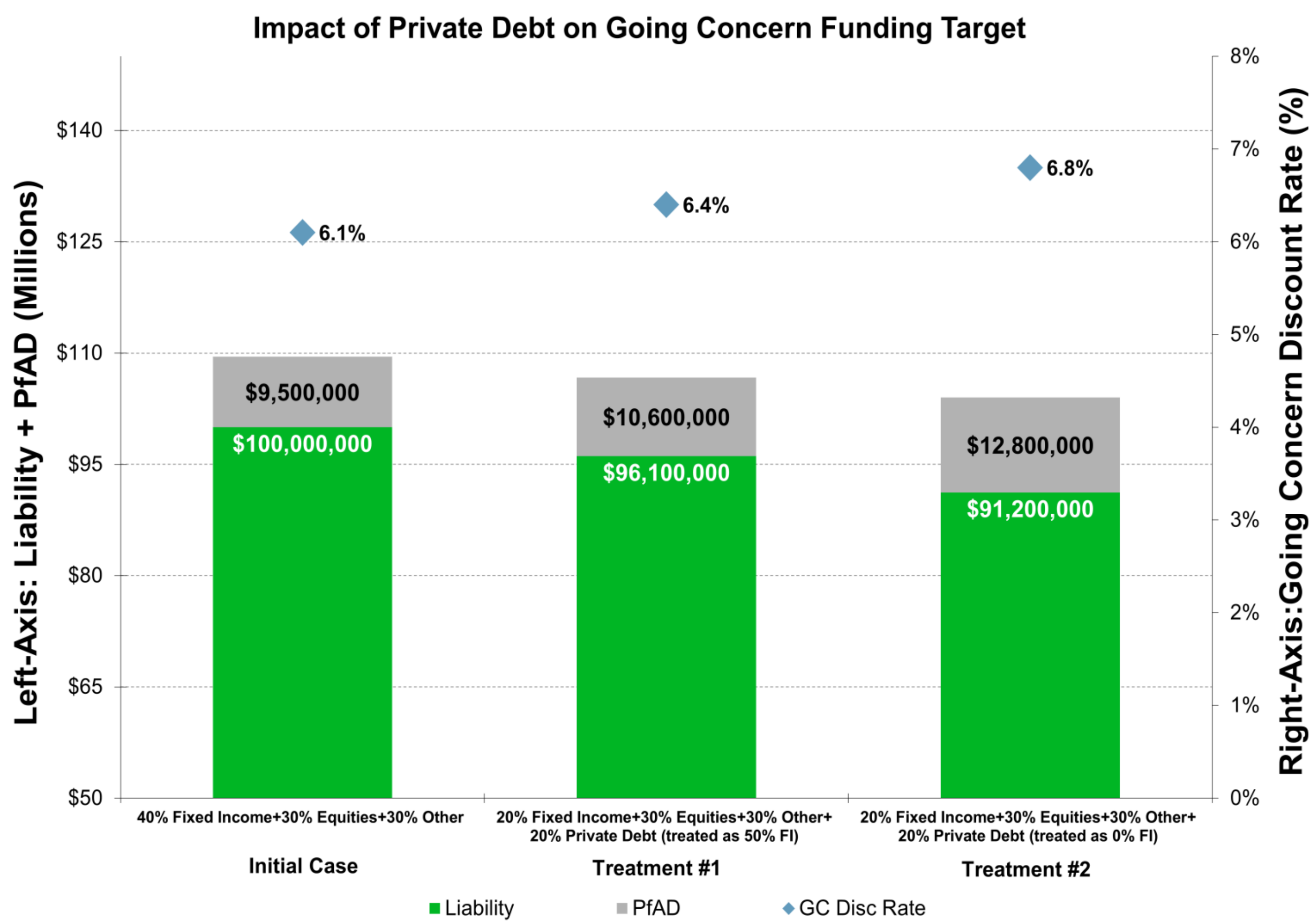
2. Guidance on specific debt securities

For debt instruments, such as high-yield bonds or privately rated debt, the classification is unclear – are they in the all-encompassing "other" category or categorized as "equity" for the purposes of the PfAD? Our analysis shows that whether they receive a dual treatment (i.e. 3.25% risk premium) or equity treatment (i.e. 5% risk premium), there may not be a material difference.

For example, consider a plan initially invested in 30% equities, 30% alternatives and 40% in investment grade rated fixed income. Assuming that the going concern discount rate is equal to the BDR, the funding target will hit a floor of $100 million plus a PfAD of $9.5 million (*initial case*). If the plan then diversifies its fixed income holdings by allocating 20% to investment grade private debt, would the resulting funding outcome be favourable for the plan sponsor?

The following chart illustrates the initial case and the outcome under two treatment scenarios. As shown, the allocation to private debt is favourable. In both treatment scenarios, the going concern funding target is lower than the initial case (even after reflecting the increased PfAD) because the maximum allowable risk premium increases from 1.5% to 3.25% (and at the extreme interpretation, possibly even 5%), properly reflecting the illiquidity premium in private versus public debt.

[2] Please note that this ignores the effect on the normal actuarial cost, which may not be exactly offsetting.



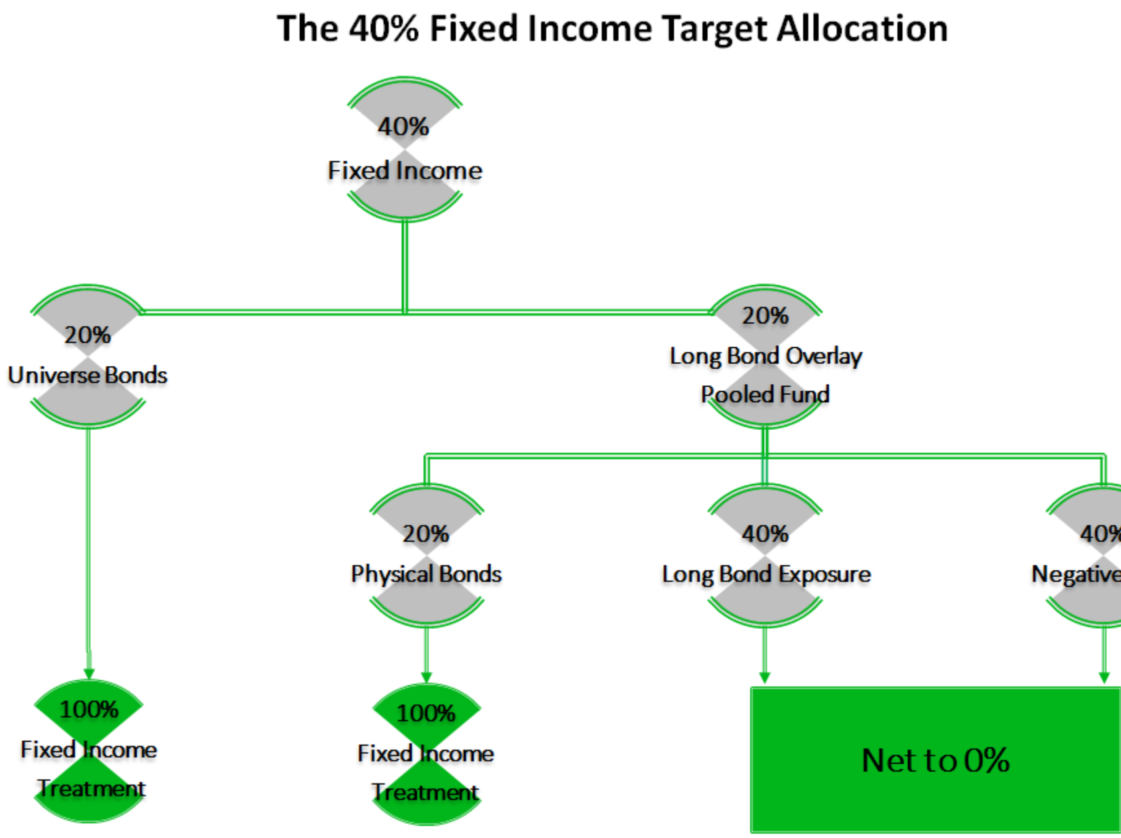
Source: TD Asset Management. This chart is for illustrative purposes only.
Please Note:
This chart assumes a closed plan, with the going concern discount rate being equal to the benchmark discount rate.
A long government bond yielding 2.5% and a going concern duration of 14 years was also assumed.

3. Guidance on derivatives

The treatment of derivatives is not explicitly covered in the final regulations. However, TDAM believes the most appropriate interpretation should reflect the ultimate economic exposure the derivatives provide.

In applying the aforementioned principle, all long positions should be considered separately from short positions and financing costs should be recognized as negative cash on hand.

For example, consider bond overlay in a pooled fund format. A "look through" is required to determine the underlying holdings. Assuming the pooled fund target allocation is a mix of physical bonds and bond repurchase agreements, it can be viewed as providing additional exposure to long bonds offset by a financing cost equivalent to a negative cash position. Since all parts of the target allocations are investment grade rated instruments or cash, all should receive 100% fixed income treatment under the PfAD rules.



In utilizing the stated approach, two outcomes can be realized:

I. It produces consistent results, regardless of the amount of leverage used or how it is attained;
II. The 40% allocation has a 1.5% risk premium for BDR purposes so there is a cap on the extent to which leverage increases the discount rate.

For other derivative strategies, including equity derivatives, similar principles may be applied.

4. Hedging interest rate risk still has merits

The reduction in the solvency funding target from 100% to 85% will be welcomed by pension plan sponsors as it provides more flexibility in funding requirements and recognizes a longer investment horizon by focusing on going concern funding. While solvency is a market-based liability measure, going concern is based on long term expected returns with various tools available to smooth the asset and liabilities of the plan, thus managing any volatility ensuing from its funded status.

For plans with significant solvency deficits or shorter time horizons (i.e., risk of closing or annuity purchase), liability hedging solutions are still effective to manage funded status volatility. In addition, we described earlier the BDR and resulting funding target floor are marked-to-market with the prevailing long bond yields. As a plan's discount rate approaches the BDR, the going concern liabilities become more market-based, making them both more likely volatile and easier to hedge using market instruments.

Closing Thoughts

We anticipate that the industry and actuaries will continue to seek clarity from the regulator as the practical applications of the new rules are still being understood. Furthermore, as new investment strategies are brought to market, understanding how said strategies will align with the prevailing regulatory framework will be of the utmost importance. The Ontario pension regulator may provide guidance over time. However, in the interim, the prudence of industry practitioners, their interpretation of the regulations and actions that makes economic sense should be favored. Overall, we support the regulator's desire to provide long term sustainability for defined benefit pension plans and the spirit of the new rules.

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