TD Asset Management

Investment Implications of Ontario's Proposed Funding Rules: Part 1

January 2018

In 2008, two significant events took place with respect to the Ontario defined benefit (DB) pension regulatory environment:

1) The release of the Report of the Expert Commission on Pensions, which recommended significant changes to Ontario pension plan legislation to promote safe and affordable pension plans for many years to come; and

2) The introduction of what would be the first of successive rounds of "temporary" solvency relief.

Both events put into question the appropriateness of the solvency funding rules which had been brought in as part of the Pension Benefits Act, 1987 and accompanying regulations. In 2018, temporary relief will be replaced with a more permanent relaxation of the funding rules. Ontario's Ministry of Finance released details of the proposed new funding rules for DB pension plans on December 14, 2017 and are accepting feedback on the proposed rules until January 29, 2018. Final Regulations will be released thereafter.

In this article, TD Asset Management Inc. ("we") will focus on providing our perspective on the investment implications of these proposed funding rules, as well as what we would hope to see in the final regulations.

Altered liability risk profiles

Previously, funding for many DB pension plans in Ontario was driven by the solvency basis. Based on the proposed funding rules, plans must only prefund 85% of their solvency liabilities. However, the going concern funding basis has been strengthened with the reduction in the period over which going concern deficits must be funded, from 15 to 10 years, and with the added requirements to fund a reserve, called a Provision for Adverse Deviations (PfAD).

The size of the PfAD will vary based on three factors:

1) Whether the plan is open or closed to new DB members;

2) What percent of the assets are invested in return-seeking assets; and

3) Whether and to what degree the plan's going concern discount rate exceeds a benchmark discount rate (BDR), to be defined in the regulation.

Under the proposed 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 proposed rules may help plans focused on longer-term outcomes, and they incentivize risk reduction efforts (albeit to a limited 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 cautious 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 increased focus on 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 the proposed rules will vary based on whether a plan is open or closed, the plan's maturity and the plan's overarching objectives.

Given the driving factors mentioned above, and the complexity of proposed rules, plan sponsors should be careful about jumping to conclusions without detailed analysis. That said, there are certain outcomes that are likely to be observed in aggregate:

i. Preference for return-seeking assets

While the PfAD provision appears to favour risk reduction, on a net basis increasing the allocation to return-seeking assets (e.g., equities and alternatives) should lead to lower minimum contributions. We believe this to be true even for closed plans, except at the highest allocations of return-seeking assets.

This can be observed in the tables below, which show the relationship between the going concern liabilities and the allocation to return-seeking assets (assumed to be 2/3rd public equities and 1/3rd alternatives) for a typical open and closed plan, respectively.

Table 1: Effect of PfAD for a typical open plan

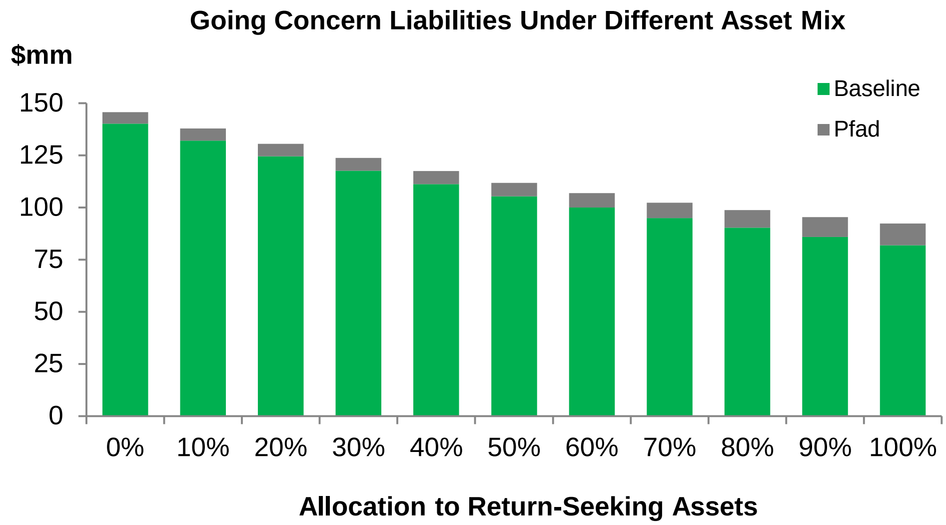
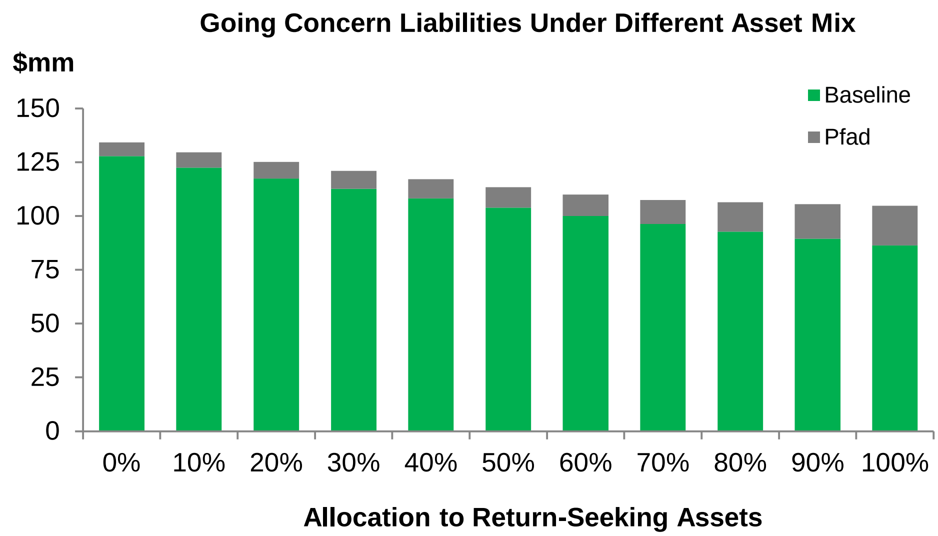


Table 2: Effect of PfAD for a typical closed plan



Source: TD Asset Management. For illustrative purposes only.

ii. Preference for specified alternative investments

The special treatment given to specified alternative investments (i.e. only 50% treated as return-seeking assets) means that allocating to these investments, especially those with an equity-like return profile, should lead to lower minimum contributions.

iii. Preference for investment grade corporate bonds

Although the definition of what constitutes fixed income is not well defined under the proposed rules, it is reasonable to expect that all investment grade fixed income securities will be considered fixed income for the purpose of the PfAD. Investing in investment grade corporate bonds rather than government bonds should typically lead to a higher discount rate and therefore, lower minimum contributions.

Special considerations for a well-funded closed plan

For a late-stage plan that is over 85% funded on a solvency basis, 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. Return-seeking 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.

Our wish list for the final regulations

TD Asset Management Inc. is the largest manager of Liability Driven Investment mandates in Canada[2]. The comments below reflect our over 20 years of experience in implementing customized investment solutions for pension plans and insurance companies who wish to manage the volatility of their assets relative to their liabilities.

Given the length of the consultation process up to this point, we expect that the framework outlined in the proposed funding rules is unlikely to change materially in the final regulations. Therefore, with one exception, we will focus our aspirations on the aspects of the new funding rules which are not well defined under the proposed rules.

Recognition of fixed income duration for closed plans: The interest rate risk of a pension plan is based on the difference in interest rate sensitivity between the plan's liabilities and its assets. Because the proposed PfAD rules do not take into account the duration of the fixed income assets, they do not differentiate between a plan whose interest rate risk is fully hedged and one whose is exposed to significant interest rate risk. For open or less mature plans, managing long term affordability may be more important that managing interest rate risk. However, for mature, closed plans, interest rate risk may be the single greatest threat to that plan's ability to fully pay the promised benefits. By definition, the PfAD provides a margin for future risks, therefore, at least for closed plans; it should be designed to vary with the level of interest rate risk.

Treatment of overlays: Many pension plans use derivatives to achieve synthetic exposure to fixed income or equities in addition to their physical exposure. We would like to see clarity in the final regulations regarding how overlay positions are treated in the PfAD rules. We would note that a plan can achieve the same economic exposure by investing in physical equities with a bond overlay, or by investing in physical bonds with an equity overlay. The PfAD rules should be defined in such a way that both these portfolios, which have comparable risk, have the same PfAD.

Definition of fixed income assets for PfAD purposes: For both insurance companies and pension plans, there are many situations where asset portfolios have been designed to substantially hedge the risks associated with future expected cash flows. Traditionally for pension plans, this consisted of public investment grade bonds. For insurance companies this consisted of a mix of public and private investment grade bonds and mortgages. In recent years there has been growing interest and adoption among pension plans of the hedging instruments and techniques used by insurance companies, supported through better availability of pooled fund vehicles. We believe this is a positive development in that it will generally improve the affordability of pension plans without increasing the level of risk.

We believe these private investment grade bonds and mortgages should be considered fixed income assets and, correspondingly, any lower quality bonds should not constitute fixed income assets. In addition, given the limitations of the Canadian bond market, we believe the definition of fixed income assets should not be restricted to Canadian bonds. This will help promote better diversification across countries, sectors, and issuers.

Collaboration will help improve outcomes

Moving forward, we expect challenging conditions for pension plan 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, equity valuations are high 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 the proposed new funding rules, 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.

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 the proposed new Ontario funding rules might mean for your plan and to create strategies to help you improve financial outcomes. Please contact your Relationship Manager for more information.

[1] The Top 40 Money Managers (as of June 30, 2017) Benefits Canada, November 2017