QUEBEC SHAKES UP PENSION LANDSCAPE WITH SHIFT TO GOING-CONCERN FUNDING

By ***Yaldaz Sadakova***

In a move that has drawn significant attention in the pension community, Quebec has introduced a potential solution to a major conundrum for employers: how to keep their costly defined-benefit pension plans sustainable in the long run.

Under the new legislation, the province no longer requires defined-benefit plans to fund themselves based on short-term assumptions about their own finances and market volatility. Instead, they now need to fund themselves based only on long-term, less conservative assumptions. The law, which aims to reduce contribution volatility for employers and thus make defined-benefit plans more sustainable, is the first of its kind in Canada.

"It will not necessarily encourage employers to shift back to defined-benefit plans but it will curb the shift from defined-benefit plans to defined-contribution plans or at least slow it," says Julien Ranger, a Montreal-based partner at Osler Hoskin & Harcourt LLP.

Solvency requirement removed

Bill 57, which took effect on Jan. 1, removes the requirement to fund private defined-benefit pension plans on a solvency basis. A valuation on the basis of solvency assumes the plan folds suddenly and looks at whether or not it holds enough assets to pay out all obligations accumulated until that time immediately.

Even before the change, Quebec's public sector plans were for the most part exempt from the solvency-funding requirement. While certain pension plans in other parts of the country are also exempt from funding their solvency deficits, Quebec was the first province to introduce that exemption across the board.

Because the solvency valuation relies on current market conditions, when interest rates are low and markets are volatile — the way they've been recently —

it has the effect of increasing plan liabilities and deficits.

Under the new rules, employers will have to fund their plans on a going-concern basis. A going-concern valuation assumes the plan will exist indefinitely and therefore lessens the impact of short-term market fluctuations on its funded status.

The new law is a positive development because it "will allow sponsors to use less conservative, more realistic long-term assumptions when they're determining how much money to put in their plan," says Ranger.

Cushion for bad times

As a trade-off for eliminating the need for solvency funding, employers will have to put money in a reserve even when they've fully funded their plans on a going-concern basis. The requirement is the law's so-called stabilization provision aimed at helping pension plans withstand financial shocks.

"This reserve should provide a reasonable level of security even though we're eliminating solvency," says Ranger.

The size of the reserve will depend on each pension plan's investment strategy. "The riskier your assets are, the larger the margin of the provision will be," says Jason Malone, a Montreal-based partner at Aon Hewitt.

Other factors, such as the degree to which a plan's assets and liabilities match, may also play a role in determining the reserve's size, says Malone, noting more details will emerge soon.

Funding the reserve will increase costs for employers; however, according to Malone, the rationale behind the bill was never to trim expenses but rather to reduce the volatility of contributions.

The stabilization provision was a response to union concerns, says Malone. "The bill was a collaboration between the unions and the employers. The employers did not want the solvency [requirement] anymore, but the unions wanted protection as well."

While the new law aims to reduce volatility, it may lead to higher employer contributions in some cases, says Malone. For example, a plan that isn't fully funded on a going-concern basis may see an increase in contributions this year while a plan with a low solvency ratio but relatively high funding on a going-concern basis may see a decrease in contributions.

Lower employer contributions do present potential risks, however. If the employer goes bankrupt for some reason, there could potentially be less money in the plan than there would have been under the old rules, says Gavin Benjamin, senior consulting actuary at Willis Towers Watson.

"In other words, [if] the employer isn't there to fund the deficit, then you're looking at members potentially receiving reduced benefits," says Benjamin, something he admits is a remote possibility.

Less frequent valuations

The new development also eliminates, at least in certain instances, the need for annual actuarial valuations.

If a plan is at least 90% funded on a going-concern basis on the date of the valuation, that appraisal will be good for three years, says Marco Dickner, a Montreal-based senior consultant and retirement practice leader at Willis Towers Watson. If the funded ratio is less than that, the plan sponsor will still have to file a valuation the following year.

The change gives sponsors more certainty because each time they get a new valuation, they're subject to new employer contributions, says Dickner.

More surplus clarity

Another change introduced by the new law is a clarification of who has access to surplus funds resulting from excess employer contributions in the case of a plan windup.

The old law didn't stipulate whether the employer or employees should get the surplus, meaning the issue could end up in court, says Dickner.

"The most likely scenario [was] that you would have to share the surplus with the employees. Employers had no incentive to put too much money because if something was to happen and they were to terminate their plan, access to that surplus was really uncertain."

Now, employers will have easier access the surplus if the plan folds and the text allows for it, says Dickner.

When plans have a surplus on an ongoing basis, employers have the option of taking a break from making contributions, says Dickner. That was also true under the old rules.

Lower payouts to members

The new law also affects the minimum rights employees have when they leave their jobs and, therefore, their pension plans.

When employees leave the plan, they can choose to receive a lump sum reflecting the value they've accrued. Plan sponsors now have the option to pay the transfer value based on the solvency ratio of the plan. As a result, they no longer have to provide a 100% payout if the plan isn't fully funded on a solvency basis, says Dickner. For example, if the plan is at 90% funding on a solvency basis, the employee will receive 90% of the commuted value.

That aspect of the law will affect even employers with plans registered outside of Quebec but that have some plan members in that province. That's because the province of employment dictates minimum payout rights while the province of registration stipulates solvency funding rules, says Dickner.

Will other provinces follow suit?

As Quebec's employers deal with the new law, Ontario is considering changes to its own pension rules.

The Ministry of Finance recently announced on its website that it "will initiate, on an expedited basis, a review of the current solvency funding rules for defined benefit pension plans, focusing on plan sustainability, affordability and benefit security. To provide private-sector sponsors with immediate assistance in the face of persistently low interest rates, the government intends to offer temporary solvency funding relief."

But whether Ontario will follow Quebec's lead and when that might happen is hard to predict, says Dickner. BC

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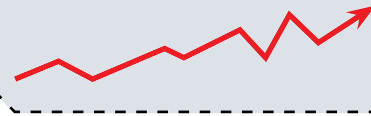
IMPACT ON INVESTING

The reduced contribution volatility that will result from Quebec's new law will have an impact on investing, says Jason Malone, a Montreal-based partner at Aon Hewitt. Under the old rules, plans adopted many investment strategies to reduce volatility, but now that a portion of that uncertainty has lessened, they may have to change their approach to investing, he notes.



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