Funding of Québec Pension Plans: Draft Regulation With Respect to Bill No. 57

On April 6, 2016, the Québec government published the Regulation to amend the Regulation respecting supplemental pension plans (Draft Regulation) following the adoption of Bill No. 57 An Act to amend the Supplemental Pension Plans Act mainly with respect to the funding of defined benefit pension plans, SQ 2015, chapter 29 (Act).

Sponsors of pension plans registered in Québec have eagerly awaited this Draft Regulation, given that the Act has been in force since January 1, 2016. Until now, several implementation provisions have been uncertain or unknown, including those related to the funding measures for private sector pension plans.

Interested parties have 30 days to comment on the Draft Regulation.
Scale setting the target level of the stabilization provision

Pursuant to the Act, there is no longer a requirement to fund solvency deficiencies. On the other hand, the going concern approach must include a stabilization provision.

After several months of waiting, the scale setting the target level of the stabilization provision has finally been unveiled. This scale is the cornerstone of the funding reform for private sector pension plans. It is worth noting that the Comité consultatif du travail et de la main d’œuvre had been entrusted to make recommendations with respect to this scale. Employer and union groups represented on this committee were able to reach a consensus and submitted recommendations to the Québec government. We can only assume that the scale set out in the Draft Regulation and the associated rules is largely based on those recommendations.

The scale proposed in the Draft Regulation is as follows:

<table>
<thead>
<tr>
<th>Assets allocated to variable income securities</th>
<th>Duration of the assets/duration of the liabilities</th>
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<tbody>
<tr>
<td></td>
<td>0%</td>
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<tr>
<td>0%</td>
<td>12%</td>
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<tr>
<td>20%</td>
<td>14%</td>
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<td>40%</td>
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<td>50%</td>
<td>17%</td>
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<td>60%</td>
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<tr>
<td>70%</td>
<td>22%</td>
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<tr>
<td>80%</td>
<td>24%</td>
</tr>
<tr>
<td>100%</td>
<td>27%</td>
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</table>

Prior to this Draft Regulation, little was known about the proposed nature of this scale. There was some indication that it might be inspired by the scale proposed by the new target benefit pension plan legislation in Alberta. In addition, during a press briefing, a Retraite Québec representative indicated that the level of the stabilization provision of a typical plan would be 15%.

If we were to define a typical plan as one where 50% of its assets are invested in “universe bonds” and the other 50% are allocated to variable-income securities, we would then obtain a “duration of assets/duration of liabilities” ratio of 25%. For such a ratio and such an allocation in variable-income securities, the size of the stabilization provision is in line with what had been previously indicated; i.e., 15%.

The proposed scale refers to the two variables that are most likely to influence a plan’s financial position; i.e., the market risk (as measured by the allocation to variable-income securities) and the interest rate risk (as measured by the ratio of the duration of assets over the duration of liabilities).

The scale should favour the stabilization of contributions, since it would take a major change to the investment policy to induce a significant variation in the level of the stabilization provision. In this regard, it answers one of the major criticisms made by pension plan sponsors in respect of the old funding rules.

On the other hand, does it encourage good risk management?

What is mean by “duration”?  

The term “duration” in the scale is commonly used to quantify the sensitivity of a bond portfolio or a pension liability to interest rate variations. As a reference, the duration of a typical plan is around 15, the duration of a Canadian universe bond portfolio is about 7, and the duration of a long-term bond portfolio is about 14. The Draft Regulation provides that the duration of the assets be calculated for each fixed-income security, weighted on the basis of the investment policy target allocation.

What is meant by “variable-income securities”?

Variable-income securities are any investment type that is not:  
- cash on hand;  
- quality money market securities;  
- bond market securities whose rating is equal to or better than BBB;  
- first or second mortgages, subject to certain limits; or  
- 50% of the assets invested directly in infrastructure or real estate, excluding those which are traded on a stock exchange. Their duration will be limited, however, to 6.
Overview of the impact on the current service contribution

The chart below demonstrates the effect of different variations in the investment policy on the current service contribution. The lighter the colour, the less the current service contribution will be.

Warning: This chart is theoretical. It is only used to illustrate the potential impact on the current service contribution of a change in the investment policy. Pension committees should assess the impact of an investment policy change not only on the current service contributions, but also on the amortization payments. This chart shows some hypothetical and unrealistic scenarios. In particular, it is unlikely that a plan will be 100% invested in fixed income securities with a very short duration. It would also be very difficult to implement an investment policy with a 100% allocation to variable-income securities, while having 100% hedge against interest rate risk.

Impact on risk management

With the elimination of funding on a solvency basis, the Act significantly reduces the impact of the interest rate risk on the volatility of contributions which, one might assume, could lead some plan sponsors to manage this risk less. On the other hand, it seems that the proposed scale encourages better management of the interest rate risk. Using various investment strategies (namely investments in a long-term bond portfolio or a bond overlay portfolio), a plan can target a duration of assets while retaining the same allocation in variable-income securities. The scale recognizes this increased protection against the interest rate risk by setting a lower level of stabilization provision. In some cases, depending on the investment strategy used, it may even result in a higher discount rate, which also reduces the value of the plan liabilities (moving from point A to point B on the chart).

The net effect is better risk management with a reduction in funding liabilities (which corresponds to the sum of the going-concern liabilities and the stabilization provision) and a reduction in contributions.

In respect of the market risk, the answer is less obvious. If we look again at the typical plan and increase the proportion in variable-income securities from 50% to 70%, the size of the stabilization provision will increase by 5%, from 15% to 20%. On the other hand, such an investment policy allows for a higher discount rate (which represents the expected long-term return of the fund). Based on preliminary analysis, a higher market risk (moving from point A to point C in the chart) would generally lead to a reduction in plan funding.

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1 Bond overlay: An investment strategy that uses leverage to invest in bonds, and thus improves hedging of the interest rate risk. For more information, please contact us to receive our recent “Investment Insights” publication on the use of this type of strategy.
**The importance of the investment policy**

Pursuant to the new funding rules, the investment policy plays an essential role. In addition to impacting the discount rate, the investment policy will now also have an impact on the level of the stabilization provision. In turn, these two components allow for determining the current service contribution and, where appropriate, the amortization payments for funding the deficiencies. According to the funding rules that applied prior to January 1, 2016, deficiencies were usually determined according to solvency liabilities, whose value was not impacted by the investment policy. The new playing field will require that pension committees review their investment policy in light of the SPP Act and their fiduciary duties. It is also highly likely that the implementation of the new funding rules and the use of this scale will result in increasing discrepancies between one investment policy to another. We believe that each plan’s characteristics (maturity level, open vs. closed, funding level, etc.) will further contribute to the development of investment policies which are adapted to the objectives of each plan.

**Another aspect**

The Draft Regulation also clarifies the requirements applicable to the content of the opinion regarding the funded position of the plan when no actuarial valuation is required.

**Another upcoming draft regulation**

We understand that another draft regulation will soon be published with respect to additional requirements under Bill No. 57, including:

- Funding policy
- Annuity purchase policy
- The use of letters of credit
- Elimination of the additional benefit
- Payment of variable benefits (based on the terms of a life income fund) from a defined contribution component
- Consultation process regarding changes to the allocation of surplus assets
- Pension committee by-laws and quantification of risks
- Employer withdrawal from a multi-employer plan
- Administration of pensions paid by Retraite Québec

**Comments**

After the 30-day comment period, the Québec government will publish the final regulation. Consequently, plan sponsors will not know their 2016 contributions with certainty for a number of weeks. The Québec government is aware of the urgent need to approve these new funding rules, and has decided to proceed with an expedited publication process.

In the interim, sponsors who have not yet done so can focus on the important decisions concerning the possibility of paying transfer values prorated according to the solvency ratio and the possibility of eliminating the additional benefit (or the indexation of the deferred pension, as applicable).

**Don’t miss our webcast (in French) on Thursday, April 14, from 10:00 to 11:00, on the Draft Regulation, where we will have an in-depth look at pension plan funding.**

To register, just simply [click here](#) and you will be directed to the invitation.

It’s an opportunity you won’t want to miss!
Contact Information

Should you wish additional information on this topic, please contact your local Aon Hewitt Consultant, or send an email to info@aonhewitt.com.

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