January 29, 2018

Funding Rules for Defined Benefit Pension Plans,
Pension Policy Branch
Ministry of Finance
7 Queen's Park Crescent
5th Floor, Frost Building South
Toronto, Ontario
M7A 1Y7

Email: pension.feedback@ontario.ca

Dear Sirs and Mesdames:

Re: Reform of Ontario's Funding Rules for Defined Benefit Pension Plans: Description of New Funding Rules

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The Portfolio Management Association of Canada[1] (**PMAC**), through its Industry, Regulation & Tax Committee's sub-committee on pensions, is pleased to have the opportunity to participate in the Ministry of Finance's (**Ministry**) consultation with respect to the Reform of Ontario's Funding Rules for Defined Benefit Pension Plans: Description of New Funding Rules (**Consultation**).

Overview

As background, PMAC represents over 240 investment management firms registered to do business in Canada as portfolio managers. PMAC members manage investment portfolios for, among others, private individuals, foundations, universities and pension plans.

PMAC is supportive of Ontario's goal of seeking stakeholder feedback on amendments to the defined benefit pension plan (**Plan**) funding rules. PMAC supports efforts to ensure that Plans' solvency funding approaches are appropriate and that pension legislation encourages the establishment and maintenance of workplace Plans that ensure secure retirement benefits for their beneficiaries.

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[1] PMAC was established in 1952 and represents firms that manage total assets in excess of $1.4 trillion. Our mission is to advocate the highest standards of unbiased portfolio management in the interest of the investors served by Members. For more information about PMAC and our mandate, please visit our website at www.portfoliomanagement.org.

Defined benefit plans are an integral part of Canadians' retirement income savings, even as increasingly fewer of us are covered by such Plans as a result of increased complexities and expenses in funding them.

We thank the Ontario government for its continuing work to review the regulatory framework for pension funding aimed at strengthening the province's retirement income system.

<u>General Comments</u>

PMAC's members are attuned to the funding pressures facing Plans as a result of a relatively low interest rate environment. The temporary solvency funding relief provided by the Ontario government in 2009, which was extended in 2012 and again in 2016, was a constructive and practical solution to address the impact of the global recession of 2008. We applaud the Ministry for recognizing the importance of, and need to, assess appropriate amendments with respect to the Plan solvency funding issue longer term.

In reviewing the Consultation, PMAC members raised concerns with two aspects of the provision for adverse deviations (**PfAD**) calculation. The first concern relates to the need to reflect differences between types of fixed income assets to incentivize desired investment behavior, and the second concern relates to the need for greater distinction between specified alternative investments to distinguish between those that have better liability hedging characteristics from those that do not. Members also expressed their strong preference for harmonized pension legislation across all Canadian jurisdictions. Our comments on these issues are set out in detail below.

Provision for Adverse Deviations

a) Differentiation between fixed income assets

PMAC notes that one part of the PfAD component is dependent on the Plan's asset mix. The Consultation notes that this is designed to encourage investments appropriate for long-term pension obligations and that the PfAD increases as the Plan's allocation to non-fixed income assets increases.

In order to encourage best investment practice, PMAC believes that the component of the PfAD calculation that is dependent on the asset mix in the Plan should increase as the asset versus liability mismatch increases. We believe that the PfAD calculation, as currently proposed, does not fully account for this since it treats all fixed-income assets equally, regardless of their duration characteristics.

For example, there are some fixed income assets, such a T-bills, which may pose a greater risk for Plans, as opposed to long-term bonds which are likely to be more suitable investments for Plans. Consider a fully funded open Plan with a liability duration of 15 years and assets consisting of 40% 90-day T-bills (duration of 0.25 years) and 60% equities would be hedging less than 1% of its liabilities interest rate exposure. Another Plan with the same characteristics in all respects, except for an investment in long term bonds (duration of 15 years) rather than 90-day T-bills, would be hedging upwards of 40% of its liabilities interest rate exposure, however, both Plans would have the same PfAD obligation.

As a result, PMAC believes that the lack of differentiation between the types of fixed income assets in a Plan used to calculate the PfAD, may inadvertently undermine the best investment strategies for these Plans and, more importantly, their beneficiaries.

Subject to PMAC's comment below encouraging harmonization of pension legislation, were the Ministry to implement the amendments in the Consultation, we strongly urge that this aspect of the PfAD calculation be enhanced to include a component which takes into account the Plan's interest rate hedge ratio.

PMAC members have suggested that the hedge ratio should be a calculation of the dollar duration of fixed income assets, divided by the dollar duration of the liabilities, to create a hedge ratio between 0% and 100%. Based on this new measurement, the PfAD would decrease as the hedge ratio increases, since a higher hedge ratio can help insulate a Plan from interest rate movements.

The result of the Ministry implementing such an enhancement to the PfAD would not be dissimilar to the calculation of the stabilization provision under the recent Quebec solvency funding rules where one dimension of the Quebec calculation reflects the percentage of non-fixed income assets in the Plan and the other reflects the interest rate hedge ratio.

PMAC is cognizant that this suggested amendment would add to the complexity of the PfAD calculation, but we believe that the benefits of reflecting this important nuance would outweigh the costs. We believe not only that Plans will appreciate the funding flexibility and that if higher interest rate hedge ratios were to result in lower PfADs, Plans will be incentivized to invest to more closely hedge their obligations.

b) Distinguish liability hedging characteristics of specified alternative investments

Members also raised concerns about the aspect of the PfAD calculation which stipulates that 50% of specified investments that are alternative investments would be considered non-fixed income assets. The Consultation states that this is intended to reflect that these investments have both fixed and non-fixed income characteristics. Members believe that specified alternative investments should be distinguished between those with poor liability hedging characteristics (e.g., equity long/short hedge fund) and those with better liability hedging characteristics (e.g., long dated infrastructure debt fund). Consequently, PMAC recommends that the Ministry exclude assets representing equity ownership from the definition of specified alternative investments for the purpose of this 50% cap in the PfAD calculation since these assets may not provide better liability hedging. These assets should instead be included in the percentage of non-fixed income assets.

We ultimately believe that these two amendments will more closely align Plans' investment objectives with the best interest of investors.

Harmonization

PMAC advocates for harmonized pension regulation across Canada so that investors benefit from the same level of protection as well reductions in underlying plan complexity and compliance costs, no matter their jurisdiction of residence.

As such, PMAC would prefer that the Ministry conform its approach on Plan funding to the amendments recently undertaken by other Canadian jurisdictions which have undergone similar consultative processes. Alternatively, to the extent that the Ministry has strenuous objections to the approach adopted in Quebec, for example, PMAC urges the Ministry to reach out to its provincial and territorial counterparts in an effort to moderate a nation-wide review of Plan solvency funding frameworks with a view to a national debate and a harmonized outcome.

Conclusion

PMAC believes that seeking balanced solutions that promote effective investment policies whilst ensuring that Plans have the ability to pay out accrued benefits to members over the long-term are essential to the well-being of the economy and investors. We would like to once again thank the Ministry for engaging in on-going consultation and assessment of Plan funding issues.

If you have any questions regarding this submission, please do not hesitate to contact Katie Walmsley (kwalmsley@portfoliomanagement.org) at (416) 504-7018.

Yours truly;

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