Special Notice

December 17, 2019

Changes to pension plan funding rules: Quebec releases its final regulation

Quebec's final regulation to amend the *Regulation respecting supplemental pension plans* includes a new stabilization provision scale and the full-matching benefits of fixed-income investments

On November 20, 2019, the government of Quebec published the *final regulation* (Regulation) amending the *Regulation respecting supplemental pension plans*. The Regulation is almost identical in all respects to the draft regulation published on July 3, 2019. The most impactful change included in the Regulation is the introduction of a new scale used to determine target levels of the stabilization provision applicable to private-sector pension plans. Additionally, when determining a plan's exposure to interest rates, the Regulation now allows for the recognition of the full matching benefits provided by fixed-income investments, including that of private debts. In this *Special Notice*, we reiterate the relevant information that was provided in our July 16 *Special Notice*, *Lower rewards for managing interest rate risk*.

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Target levels of stabilization provisions

The most significant change proposed by the Regulation is the revision of the scale used to determine the target level of the stabilization provision that must be established and funded, when applicable, by the payment of stabilization contributions. The target level of the stabilization provision is determined in the manner prescribed by regulation and is based on the long-term asset mix targets set out in the pension plan's investment policy. The charts below illustrate the current and new scales, and outline the differences:

CURRENT SCALE

Assets allocated to variable-yield investments (%)	Duration of the assets / Duration of the liabilities (%)				
	0	25	50	75	100
0	12	10	8	6	5
20	14	12	10	8	6
40	16	14	12	10	8
50	17	15	13	11	9
60	19	17	15	13	11
70	22	20	18	16	14
80	24	22	20	18	16
100	27	25	23	21	20

NEW SCALE

Assets allocated to variable-yield investments (%)	Duration of the assets / Duration of the liabilities (%)				
	0	25	50	75	100
0	10	8	7	6	5
20	12	10	9	8	7
40	15	13	12	11	11
50	17	15	14	13	13
60	20	18	17	17	17
70	24	22	22	22	22
80	27	26	26	26	26
100	33	32	32	32	32

DIFFERENCES BETWEEN SCALES

Assets allocated to variable-yield investments (%)	Duration of the assets / Duration of the liabilities (%)				
	0	25	50	75	100
0	-2	-2	-1	0	0
20	-2	-2	-1	0	1
40	-1	-1	0	1	3
50	0	0	1	2	4
60	1	1	2	4	6
70	2	2	4	6	8
80	3	4	6	8	10
100	6	7	9	11	12

Eckler's opinion

The current scale has allowed – when compared to the previous funding rules as they read before January 1, 2016 – plan sponsors and administrators to turn their focus to establishing long-term integrated investment and funding policies that reflected a plan's characteristics and aligned with the long-term funding objectives of the plan sponsors. As a result, some plans have improved their match between assets and liabilities, or increased their exposure to return-seeking investments to improve long-term expected returns.

The new scale will not have a significant impact on typical plans, i.e., plans with 40% to 60% of their assets invested in fixed-income investments and a ratio of durations between 25% and 50%, with the target level of the stabilization provision changing by -1% to +2%.

The new scale, however, will penalize plans for taking on more variable-yielding investments over the long term, especially plans where assets are matched to liabilities using derivative products. For example, a plan with a 60% allocation to variable-yielding investments that has fully matched its liabilities using derivatives would see its stabilization provision target level increase from 11% to 17%, which represents a 55% increase. This change alone would result in a significant increase in required contributions for the plan.

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Allowance for consideration of unquoted private debts

The Regulation also allows for unquoted private debts to be considered, up to 10% of a plan's assets, as fixed-income investments under certain conditions for the determination of the target level of the stabilization provision. This is a welcome change for plan sponsors, as it will allow for a better diversification of the fixed-income portfolio of the plan and result in the reduction of the target level of the stabilization provision.

Determination of the interest rate risk exposure

The target level of the stabilization provision is determined in the manner prescribed by regulation and aims at providing additional protection against two specific risks under a pension plan:

- The market risk; and
- The interest rate risk.

The Regulation now allows for a better separation of these two risks for fixed-income investments. For purposes of determining the **market risk**, the following investments are now accounted for as fixed-income investments:

- Cash on hand;
- Money market securities with a rating higher than the minimum required under the Regulation;
- Bond market securities with a rating higher than the minimum required under the Regulation;
- First or second mortgages;
- Up to 50% of the assets invested in direct infrastructure or real estate; and
- Unquoted private debts with a rating higher than the minimum required under the Regulation.

Under the current Regulation, the **interest rate risk** is represented as the ratio of the sensitivity of assets to interest rates and the sensitivity of liabilities to interest rates. While under the current Regulation the assets used to determine the sensitivity of assets to interest rates would only include the fixed-income investments described above, the Regulation now provides that all fixed-income investments with interest rate sensitivity, regardless of minimum ratings or upper limits prescribed for the determination of the exposure to market risk, will be used.

Eckler's opinion

In today's very low interest rate environment, a growing number of plan administrators and plan sponsors are seeking additional yield by moving a portion of their traditional bonds investments to alternative investments, such as real estate, infrastructure, private debts, and high-yield bonds. The change included in the Regulation was required to better reflect the intrinsic nature of these newer investment classes, i.e., investments that are sensitive to market risk but that also offer important hedging benefits for a pension plan against the sensitivity of its liabilities to interest rates.

Limits on fees associated with annual information returns and other filings

The Regulation also increases the upper limit of fees required when filing annual information returns, registering a pension plan, or filing a termination report from $100,000 to $150,000 effective December 31, 2019, and indexed annually thereafter. Plans with significant numbers of members may see increased fees as a result of this adjustment.

Relief regarding content of partial valuations and fees for document filing

The Regulation includes various reliefs with respect to the content of partial valuations related to amendments and annuity purchases for private-sector pension plans. Furthermore, additional fees payable for delays in filing reports in certain situations have been eliminated.

Next steps

The new scale for determining the level of the stabilization provision and the revised methodology to determine the market risk and interest rate risk components will apply to actuarial valuations with an effective date on or after December 31, 2019. After three years under the new funding regime, which took effect on January 1, 2016, the recent changes introduced by the Regulation may be a good opportunity for plan sponsors to review their investment strategies and optimize them with their funding objectives documented in the funding policies, considering the recent changes introduced by the Regulation.

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