COMMUNIQUÉ

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PROPOSED FUNDING RULES FOR PRIVATE SECTOR PENSION PLANS IN QUEBEC

On 11 June 2015, the Quebec Minister of Labour, Employment and Social Solidarity presented to the Quebec National Assembly Bill 57, *An Act to amend the Supplemental Pension Plans Act mainly with respect to the funding of defined benefit pension plans*. The Bill aims primarily to amend funding rules applicable to registered pension plans in the private sector in Quebec, effective 1 January 2016. The minister has announced that consultations will take place on the Bill.

The Bill reflects the work done by the "Comité Consultatif du Travail et de la Main-d'oeuvre" (CCTM) in the wake of the Expert Committee report (the D'Amours report) pertaining to the future of the Québec retirement system. This committee included representatives of employer associations, large unions and a youth association. The changes to funding rules are designed to make defined benefit pension plans more sustainable from the perspectives of these groups. The Bill also makes significant changes to the rules for appropriating and allocating surplus assets.

This Communiqué summarizes the main elements of the Bill. Some details will be defined in a future regulation.

General principles

For an ongoing pension plan, funding of the solvency deficit will no longer apply. Instead, funding will be based on a strengthened going-concern valuation, which will include a stabilization provision. The stabilization provision will be funded by special amortization and current service contributions, and by actuarial gains. The stabilization provision objective will be a function of the pension plan's investment policy.

Contribution holidays and the use of surplus to fund plan improvements would be dependent on the level of funding of the plan. Even though funding of the solvency deficit would no longer be required, the solvency valuation would still need to be performed and reported, and the solvency financial position could have an impact on the frequency of actuarial valuations in addition to having an impact on the use of surplus while the plan is ongoing.

The Bill provides that existing surplus allocation and appropriation rules applicable during the life of the plan and at plan termination must be amended or confirmed. Failing such amendment or confirmation by January 1, 2017 or a later date authorized by the Régie des rentes du Québec, default provisions will apply.

The obligation for the plan sponsor to fund any deficit remaining at plan termination remains.

The stabilization provision and required contributions

The stabilization provision objective will vary according to the target asset allocation in the plan's investment policy, according to a scale to be established by regulation.
Stabilization contributions may be required in respect of past service and current service. The funding requirements will include six types of contributions, as follows:

- ***Basic current service contributions*** are required according to the usual principles;
- ***Current service stabilization contributions*** are required and would represent the stabilization fund objective multiplied by the total current service cost;
- ***Technical amortization payments*** would be required to amortize going-concern deficits (i.e. when total assets are less than going-concern liabilities) over **10 years**, subject to transition rules;
- ***Stabilization amortization payments*** would be required if the level of the stabilization fund as a percentage of going-concern liabilities is more than 5% below its objective, the shortfall compared to the objective less 5% being amortized over **10 years**, with actuarial gains to fund the remainder;
- ***Improvement amortization payments*** intended to amortize unfunded liabilities due to plan improvements over 5 years, including the related stabilization provision;
- ***Special improvement payments*** equal to the value of the improvements including the related stabilization provision, required at the time of a plan amendment when the plan's funding level is below 90%.

In the course of its analysis, the CCTM referred to work performed by the Canadian Institute of Actuaries in relation to the introduction of a scale for similar purposes under the new Alberta pension legislation. Therefore, the scale for the stabilization provision and its effects could be expected to reflect the following parameters:

Percentage invested in non fixed income assets	Stabilization provision objective	Stabilization provision level **below which stabilization amortization payments are required**	Stabilization provision level **above which surplus utilization measures may apply**
0%	5%	0%	10%
20%	10%	5%	15%
40%	13%	8%	18%
50%	15%	10%	20%
60%	17%	12%	22%
80%	20%	15%	25%
100%	25%	20%	30%

The technical amortization payments and stabilization amortization payments mentioned earlier will be redetermined at each valuation.

Actuarial valuations will generally be required every three years. However, if the degree of solvency is below 85%, or if surplus assets are used for the payment of employer contributions, an annual valuation will be required. In order to confirm that an annual valuation is not required, it will be necessary to send a notice to the Régie des rentes du Québec in respect of the financial position of the plan at the end of the prior year no later than April 30.

For example, for a plan with a target asset allocation of 50% in equities, the following could apply (ignoring any plan amendment):

	Level of funding on going-concern basis			
	Under 100%	100% - 110%	110% - 120%	120% or more
Basic current service contributions	Regular current service cost	Regular current service cost	Regular current service cost	In accordance with surplus utilization measures
Current service stabilization contributions	15% of total current service cost	15% of total current service cost	15% of total current service cost	In accordance with surplus utilization measures
Technical amortization payments	Deficit over 10 years	-	-	-
Stabilization amortization payments	10% of liabilities amortized over 10 years	Shortfall compared to 110% of liabilities, amortized over 10 years	-	-

Only stabilization amortization payments may be replaced by letters of credit, up to 15% of the plan's going-concern liabilities. These letters of credit (as well as existing letters of credit upon transition from existing rules) will be considered in the determination of the going-concern financial position.

A notional accounting (special monitoring) will be maintained in respect of the technical amortization payments and stabilization amortization payments made by the employer, accumulated with interest. During the life of the plan, the employer could make use of these amounts to take contribution holidays, irrespective of plan rules, if allowed by the surplus utilization rules described below.

Transition rules

An actuarial valuation will be required for all plans as at December 31, 2015.

To ease the transition to the new funding rules, for purposes of determining the technical amortization payments and the stabilization amortization payments, the 10-year amortization period described above would be set at 15 years on December 31, 2015, decreasing gradually each year over a 5-year period to attain 10 years on December 31, 2020. Also, if the total annual contribution required from the employer, excluding the base current service contributions, in 2016, 2017 or 2018 exceeds the amount which would have been required in 2016 in accordance with

the rules that existed on December 31, 2015, only 1/3 of the difference would need to be contributed in 2017, and 2/3 in 2018.

Use of surplus

Use of surplus in an ongoing plan will only be possible if the stabilization provision has attained its objective increased by 5% and the degree of solvency is at least 105%.

If the above conditions are met and continue to be met after any use of surplus:

- the employer could take a contribution holiday up to the amount of the employer contributions subject to the special monitoring described earlier, irrespective of plan terms,
- an amount of up to 20% of the excess remaining after considering the above contribution holiday could be applied, as provided by the plan terms, either to improve benefits or be remitted to the employer.

The provisions in respect of appropriation and allocation of surplus assets during the life of the plan or at plan termination (excluding the use of the employer contributions subject to the special monitoring during the life of the plan, which is governed by the legislation) must be amended or the existing provisions confirmed by January 1, 2017 or a later date authorized by the Régie des rentes du Québec. For this purpose, a notice will be sent to plan members and beneficiaries, and the amendment or confirmation will apply if less than 30% of members and beneficiaries oppose.

In the absence of an amendment or confirmation, the plan will be deemed to include the following default provisions:

- in the event of plan termination, surplus assets are distributed equally among the employer and members and beneficiaries, and the share attributed to members and beneficiaries is distributed among them proportionately to the value of their benefits;
- during the life of the plan, if a portion of the surplus is remitted to the employer or used for the payment of employer contributions, an equal portion must be used to provide additional benefits to plan members and beneficiaries proportionately to the value of their benefits.

However, if the plan already provides for the allocation of a surplus share to plan members and beneficiaries in excess of 50%, the existing plan provisions to that effect are deemed to be confirmed.

The existing rules in respect of surplus sharing agreements and arbitration will thus cease to apply.

Valuation basis

The going-concern valuation must be based on appropriate methods and assumptions. The Bill does not address whether the going-concern discount rate should include or exclude a margin for adverse deviations.

Also, for purposes of the going-concern valuation, it would be possible to use a smoothed asset value.

Policies

The entity which has the power to amend the plan will need to establish a written funding policy.

An annuity purchase policy may also be implemented. For a plan that has established a satisfactory annuity purchase policy, it will be possible to purchase annuities during the life of the plan with a discharge of obligations in respect of the members and beneficiaries affected by the purchase without obtaining their individual consent. In this case, affected members and beneficiaries would retain their right to participate in an eventual surplus attribution upon plan termination for a period of three years.

Other measures

The legislation does not change the basis for computation of commuted values. However, in the event of cessation of active membership, rights will be settled in proportion to the degree of solvency, without any residual entitlement. An exception applies for members who do not have the option of leaving their entitlements in the plan. Also, if the degree of solvency exceeds 100%, the entitlements will be limited to 100% of the commuted value unless the plan is amended to provide that the 100% ceiling does not apply.

The additional benefit (previously prescribed benefit providing partial indexation from the date of termination of employment to age 55) can be eliminated for past and future service if the plan is amended to this effect prior to January 1, 2017.

The 50% (excess contribution) rule continues to apply. In the case of a member who contributes toward amortization payments, the test allows to distinguish these contributions. The test also maintains the requirement that a member's current service contributions cannot account for more than 50% of the value of benefits.

Different provisions apply in respect of multi-employer plans.

Comment

The draft legislation includes innovative proposals, and the removal of the requirement to fund on a solvency basis is a significant development. Since the proposals were drawn from discussions between representatives of employer and union groups, we expect that they will be generally well received.

However, some provisions may be controversial, such as those in respect of surplus appropriation and allocation, whether during the life of the plan or at plan termination. The requirement to confirm or agree on new provisions prior to January 1, 2017 irrespective of existing provisions may be problematic. Furthermore, the ownership of the employer contributions subject to special monitoring in the event of plan termination has not been confirmed. Also, certain technical issues such as the maximum amount of contribution holidays, the types of employer contributions included in the special monitoring, the modulation of the current service stabilization contributions and the limitations on the use of letters of credit appear to limit the flexibility provided by the legislation. The position of the Régie des rentes du Québec in respect of the use of margins for adverse deviations in the going-concern discount rate in addition to the constitution of the

stabilization provision could result in potentially significant increases in contributions for some pension plans.

Mercer participated in the discussions at the CCTM and has assisted employers in this process. We believe that the proposed changes represent a meaningful development as they address many of the concerns of the groups who participated in the discussions to ensure the sustainability of existing defined benefit plans. However certain important elements needed to ensure the viability of plans are not included in the legislation.

Although the proposals depart from recent pension reform initiatives in other jurisdictions, there are a few common themes, namely the special monitoring of some employer contributions which resemble to some extent the solvency reserve accounts in Alberta and British Columbia, and the possibility to purchase annuities with a discharge of obligations as is now the case in British Columbia.

The new rules will result in a reassessment of risk management measures. We expect that given the significant levels of the stabilization provision, and the fact that contributions will be less sensitive to movements in interest rates, many plans will review their investment policy.

The Bill is a step in the right direction but adjustments are needed. Mercer will make a submission in the course of the consultation process.

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