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Are pension funds considering filing early valuations to lock in pre-coronavirus funded ratios?

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With coronavirus causing market volatility and an increase in the size of solvency liabilities, pension plans are feeling the impact.

One potential way for plan sponsors to ease the pain is by performing an early actuarial valuation to capture year-end 2019 numbers.

Most Canadian jurisdictions require plans to file valuations every three years, however a valuation may be required more often if there is some sort of solvency issue.

“Early valuations have been practiced for a long time and people do strategically sometimes choose when to do a valuation within the three-year cycle and don’t necessarily wait the full three years to do one,” notes Jason Vary, president at Actuarial Solutions Inc.

Special payments

If a plan sponsor files a valuation and is underfunded on a solvency basis, it must make special payments into the pension plan.

The threshold for special payments in Ontario, for example, is 85 per cent. “If you’re over 85 per cent funded then a) no special payments on a solvency basis and b) your next valuation is due three years from now,” notes Vary. “But if you’re below 85 per cent, then you have to make solvency special payments over five years to get yourself back up to 85 per cent and you also need to do annual valuations.”

In Ontario, specifically, many plan sponsors filed their last valuation at the end of 2017 because that’s the year the funding regulations changed, allowing them to lock in lower contributions under the new rules, says Andrew Whale, a principal in the wealth business at Mercer Canada. As such, many of these plans’ three-year cycles are scheduled to end at the close of 2020.

“We’ve been talking to many of our clients in that position to say, you don’t have to file until the end of 2020, but if you wait, you risk being in a much lower position than if you were to file early, which you are allowed to do under the regulations. If you file early at the end of 2019, when most plans are very strong and then you lock in a contribution schedule that won’t have to be reset at that point until the end of 2022.”

Wait and see

With the markets very volatile, it's too soon to say what's in store for the rest of 2020. "It's too early to tell yet, but we've been thinking here that there is a chance that some of our clients may choose to do valuations early," says Vary.

In most jurisdictions, pension plan sponsors have to file their valuations within nine months of the valuation date, which means the latest valuations are generally due to be filed with regulators in September.

"Especially if, in the summer time, things are still looking bad and [it's] uncertain if equity markets will recover . . . then some clients may want to hedge a bit to do an early valuation and just lock things in for three years," Vary says. "I think that's a very real possibility."

However, he also notes this may be a non-issue, depending on how a pension plan is invested. "If a pension plan has already moved to a fairly de-risked investment strategy with long bonds and what not, then this volatility may not worry them at all."

Nichola Peterson, a partner at Morneau Shepell Ltd., notes plan sponsors can conduct sensitivity testing to help determine whether to file early. "Some plans doing a Dec. 31, 2019 valuation might still find that they have higher required contributions as a result of that valuation. But if they do some sensitivity testing, maybe they'll find that they'd rather go with that valuation date, rather than chancing it at Dec. 31, 2020. If you do some sensitivity analysis, you might find that your contributions are potentially going to be much higher. So it may be better to take a half-bad solution rather than a really bad solution."

Pension plan sponsors that choose to go down this route will want to consider their governance policies, Peterson adds. "Some plans may have a funding policy which might lay out for them under what circumstances they might consider filing an off-cycle valuation. So you'd want to make sure that, from a governance perspective, you feel you have the flexibility to strategically file a valuation."

As well, filing early does potentially pose the risk that the market recovers and brings a "perfect world instead of the perfect storm," Peterson says. In this situation, plan sponsors can consider another off-cycle valuation. "There's nothing to stop you from then doing a Dec. 31, 2020 valuation in order to . . . reduce your contribution requirements, but the loss would be any additional contributions you had to make during 2019."

Overall, she highlights the importance of regular, quarterly monitoring. "Just so that they're monitoring the way the plan's financial position is moving and that there aren't any bad surprises at the end of the year."

Transfer ratios

The solvency funding ratio determined in a valuation is also significant because, when an employee terminates membership in a DB plan and is eligible for a lump sum, the transfer ratio is usually equal to the solvency ratio, Vary adds. If a plan is less than 100 per cent funded, but employees are taking out 100 cents on the dollar, this can be problematic for the members left in the plan.

A transfer ratio is usually based on the last valuation. However, in Ontario, if a plan sponsor knows or ought to know that the funding ratio has dropped by 10 per cent or more, the pension plan will have a mini-valuation to reset the transfer ratio, Vary says.

"It's not a full valuation. It's not going to change the contribution requirements. It's not going to reset the three-year clock or anything like that. The only purpose for that mini-valuation is to come up with a new transfer ratio."

In this situation, pension plan sponsors must seek approval from the Financial Services Regulatory Authority of Ontario to pay out the transfer.

In other jurisdictions, such as Alberta or B.C., there aren't strict "know or ought to know" rules. However, in those provinces, administrators are responsible not to pay out a commuted value if it will harm the benefit security of the plan. "It's a looser kind of rule, but the intention is the same. They don't want a whole bunch of people to leave, get all of their money and the people who stay behind are harmed."

According to Vary, this is one of the reasons the Office of the Superintendent of Financial Institutions introduced the blanket rule that pension plans can't pay out commuted-value transfers for the time being unless they receive permission.

That said, the OSFI requires federally regulated plans to file annual valuations, as opposed to the three years in most other jurisdictions. "OSFI's transfer ratios don't usually get too far out of date because the worst they could be is a year old," he says. "So presumably, once [federal] plans do a valuation at Dec. 31, 2020 and reset their transfer ratio down to a new lower number — assuming that's what happens — . . . presumably, at that point, OSFI may allow transfers to be paid out again because it's going to reflect that new lower number."

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