Valuations In The Time Of COVID

BY: **DEAN NEWELL**

For sponsors of defined benefit pension plans, the first half of 2020 has been interesting. When the COVID-19 pandemic first started to spread through North America, the financial markets experienced a sharp and significant decline while bond yields also declined. As a result, the typical unhedged pension plan would have seen its funded status, as determined on a hypothetical wind-up basis, deteriorate by around 10 per cent to 15 per cent from the end of 2019 to the end of March. Since those dark days in March, the financial markets have recovered rather nicely. Nevertheless, at June 30, 2020, the funded status for a typical unhedged pension plan was still down around five per cent to 10 per cent for the year.

Plan sponsors and pension regulators have responded in various ways to the COVID-19 pandemic. Some of the key responses have been regulators freezing or updating their policies with respect to commuted value payouts, providing various levels of funding moratoriums or deadline extensions for various regulatory filings, and requesting increased risk disclosures in regulatory reporting. Many plan sponsors have initiated special reviews of their asset mix, investment strategies, DB exit strategies, and are performing unscheduled valuations at a date prior to the pandemic. This article will explore two of these responses in greater detail.

Unscheduled Valuations

In light of the market volatility in 2020, many plan sponsors who were not scheduled to perform funding valuations in 2020 are now contemplating the merits of doing an early valuation as at January 1, 2020. In considering this option, plan sponsors are weighing the following factors:

- The risk of increased contributions when preparing a future valuation – which is largely dependent on the future outcomes in the financial markets and the investment risk inherent in a plan's investment policy.
- The funded status of the plan as at January 1, 2020. Most pension plans were reasonably well-funded at January 1, 2020, and plan sponsors may wish to 'lock-in' their funding requirements based on a valuation performed at that date.
- When considering the merits of performing an off-cycle valuation, plan sponsors are wise to consider their fiduciary obligations to plan

members and are well-advised to document the process they followed in making their decision.

- Other transactions such as a plan amendment, plan wind-up, or another event scheduled for the near future may also factor into the plan sponsor's decision to do an early valuation.

For Ontario registered pension plans, valuations performed at January 1, 2020 (including 'off-cycle' valuations performed at this date), would normally need to be filed by September 30, 2020 – but the regulations have recently been updated to allow January 1, 2020, valuations to be filed as late as December 31, 2020.

Many plan sponsors have already decided to prepare early valuations at January 1, 2020, for their plans and some plan sponsors are still weighing this option, but they better act quickly to ensure that this work can be completed before the filing deadline expires on December 31, 2020.

Risk Analysis In Valuation Reports

Earlier this year, the Financial Services Regulatory Authority of Ontario (FSRA) caused a bit of a stir in the actuarial community with its guidance on the contents of an actuarial valuation report in light of the COVID-19 pandemic. Specifically, FSRA is expecting valuation reports prepared as at December 31, 2019, (and thereafter) to include sensitivity disclosures that go above and beyond the minimum reporting requirements that are currently outlined in actuarial standards of practice. While FSRA's guidance will need to be considered by plan sponsors and actuaries as they prepare valuation reports this year, the actuarial profession at large, and the Actuarial Standards Board in particular, will need to consider if actuarial standards need to be updated yet again to provide additional, and arguably more meaningful, risk analysis in the funding valuation report.

The question that should be asked is: what is an appropriate minimum standard for disclosures in a funding valuation report? Is the purpose of a valuation report simply to illustrate how the minimum and maximum contribution requirements were derived? Or is the purpose of the valuation report to also provide readers with a deeper understanding of the risks inherent in the plan?

In recent years, the actuarial profession in Canada has been moving from the former to the latter and increasing the amount of sensitivity analysis that is required to be disclosed in a valuation report. The most recent iteration of updates to the standards, made effective March 1, 2019, required the disclosure of the effects of "plausible adverse scenarios" on the going concern valuation results, whereby "plausible adverse scenarios" are "scenarios of adverse but plausible assumptions, relative to the best estimate assumptions selected for the valuation, to which the plan's financial condition is sensitive."

Interestingly, at the time this new standard was implemented – which, at March 1, 2019, was not that long ago – the actuarial profession purposefully limited this "plausible adverse scenario" analysis to only the going-concern valuation results. Specifically, this analysis did not extend to the solvency, wind-up, or contribution requirement results. This limitation was, in part, a compromise to enhance its practicality and because many elements of these additional disclosures could be extrapolated to the solvency/wind-up valuation results by interested users.

While more risk analysis and disclosures in a valuation report is nice to have, there is a cost/benefit analysis that needs to be weighed.

Consulting Exercise

While some may argue that a risk analysis is a consulting exercise that needs to be performed outside of the regulatory valuation report, others argue that a valuation report is semi-public document and provides an opportunity for both plan members and regulators to obtain a better understanding of the risks inherent in a pension plan. No matter the argument, consideration needs to be given to the complexity of the calculations, the perceived value of the additional information provided, and the cost to prepare the analysis.

In my opinion, the current version of the "plausible adverse scenarios" in the actuarial standards provides useful information. However, I tend to agree with FSRA that there is a net-positive to extend the analysis of the "plausible adverse scenarios" to the solvency, wind-up, and contribution requirement disclosures in a valuation report.

With that said, one of the biggest threats to a pension plan's financial condition is the ability of the plan sponsor to continue making contributions. This is contemplated in FSRA's guidance, as it notes it may be appropriate for the "plausible adverse scenarios" to consider the financial stresses to the plan sponsor that may affect its ability to make required contributions when due. Unfortunately, measuring this risk is not something an actuary can do easily; and as such, requiring any additional disclosure on the ability of the plan sponsor to continue making contributions should not, in my opinion, be an additional disclosure in a valuation report.

With its new guidance, FSRA is effectively stating that it is now expecting valuation reports to extend the "plausible adverse scenarios" analysis to include their impact on the solvency, wind-up, and special payments calculations. As such, actuaries and plan sponsors preparing valuations in 2020 and beyond will need to consider if they will include the additional sensitivity information requested by FSRA in their valuation reports. If they decide against including this additional information, it appears that FSRA may come looking for it after the fact.

In the meantime, the actuarial profession and, in particular, the Actuarial Standards Board will need to consider FSRA's comments and determine if it is now time to make these enhanced disclosures a minimum requirement in actuarial standards of practice. Co-incidently, the Actuarial Standards Board had already started the process of reviewing its pension standards, so now is a great time to be having this debate.

However, since FSRA released its guidance on this topic in advance of any changes to the actuarial standards of practice, many actuaries and plan sponsors may wish to consider updating their valuation reports with these additional disclosures sooner rather than later. **BPM**

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