# CONVERSION FROM DB TO DC PENSION AND ITS IMPLICATIONS FOR PENSION REGULATORS – CARIBBEAN PERSPECTIVE

MORNEAU SHEPELL

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International Organization of Pension Supervisors Conference
Friday, February 24, 2017

# Acknowledgements


- Audia Bacchas
- Jai Persaud
- Roger Pantin
- Marcia Tam-Marks

# Agenda

- Rationale for conversion from DB to DC
- Conversion scenarios
- Actuarial equivalence
- Impact of conversions
- Defined Contribution Plans-Caribbean, Bermuda, Cayman
- Plan Statistics – trend by plan type
- Regulatory concerns in approving conversions
- Treatment of conversion by selected regulators
- OSFI, FSCO & Jamaica - Requirements
- Considerations for Caribbean regulators
- Alternatives to conversions
- De-risking trends
- Highlights

# Rationale for conversions from DB to DC

| De-risking: Reduce risks through cost control (DC funding costs are more predictable) | Stringent funding rules imposed by pension regulators | Reduce Longevity risks |
|---|---|---|
| • Investment market volatility;<br>• Guarantee provided – only the plan sponsor bears / funds the risk | • Solvency funding – too short a time frame to amortize the deficit;<br>• Regulations /procedures – continuous changes | • individuals are living much longer today than before<br>• Results in increased cost to the Plan |

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# Conversion Scenarios

Close DB plan to new entrants; DC plan for new hires

Close DB plan and freeze benefits (hard or soft freeze ); all employees join the DC plan (future service & new hires)

Convert DB pension to DC account balances

# Actuarial Equivalence

- DC Plan Design v DB Plan Design (Minimum Statutory Requirements)
- 9% combined employee & employer contribution in a DC plan = 1% annual accrual in a DB plan
- Based on a final average 3-year earnings formula
- Payable at age 65 with 35 years of service
- Assumes no post-retirement indexing for inflation
- 12% combined employee & employer contribution if indexed

# Impact of conversions

## Changes the fundamental nature of the plan

- Change of employment agreement
- Shifting of risks

## Plan Amendment- typically requires the approval of the regulator

- (Conversion not specifically addressed in legislation)- Guidelines

# DC Plans – Caribbean, Bermuda & Cayman

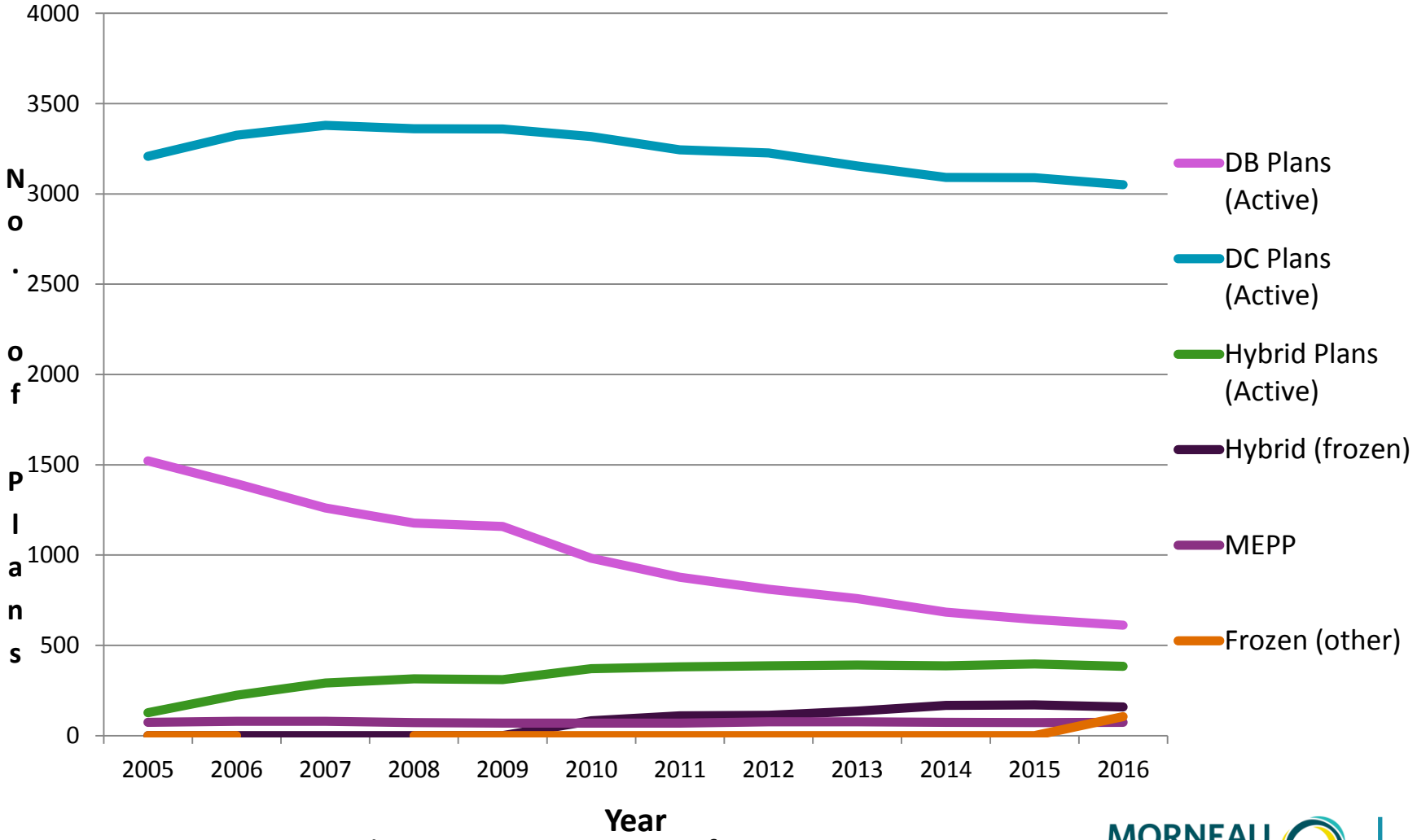
**Caribbean**

- Majority of plans in the Caribbean are not pure DC plans
- Typical 'DC plans'
  - Guaranteed or declared interest; few credit market yield
  - Pension benefits paid from the plan; some may annuitize
  - Investments are not member directed

**Bermuda & Cayman**

- Mandatory pension coverage required
- Conversions increased and DB plans were frozen
- Almost all plans are pure DC

# FSCO- trend by plan type




Source: Financial Services Commission of Ontario

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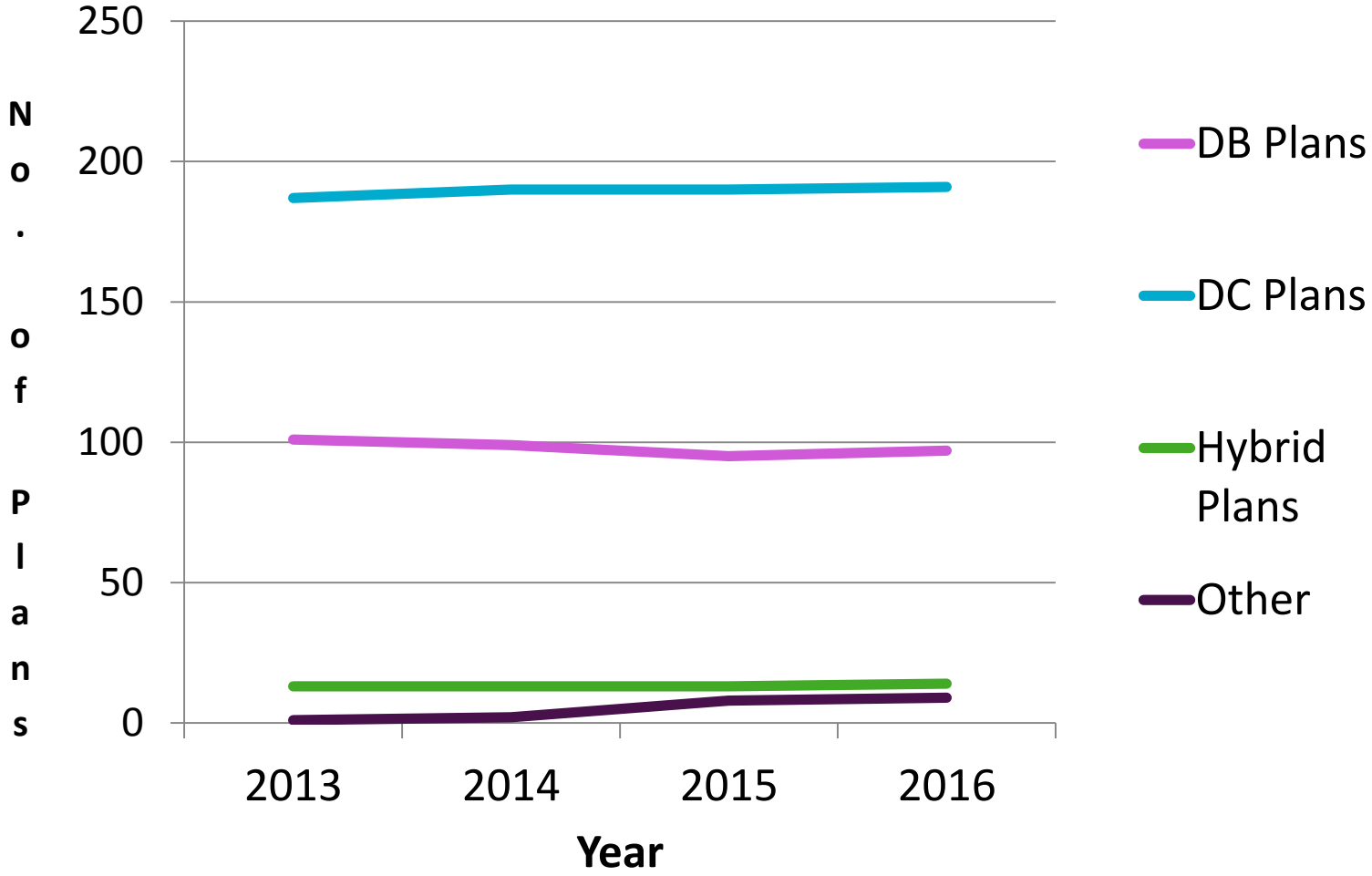
# FSC Barbados – trend by plan type




Source: Financial Services Commission Barbados

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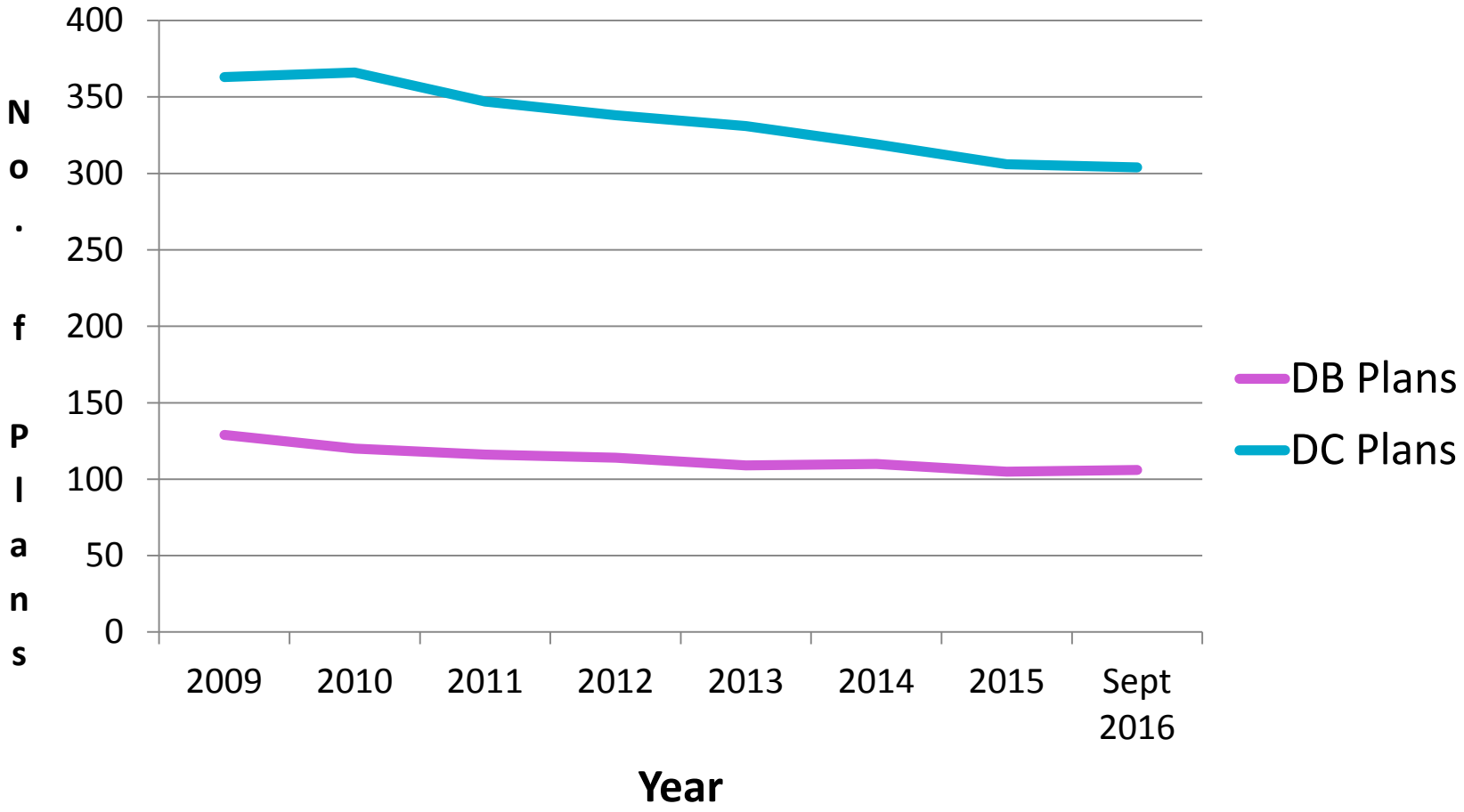
# FSC Jamaica – trend by plan type




Source: Financial Services Commission Jamaica

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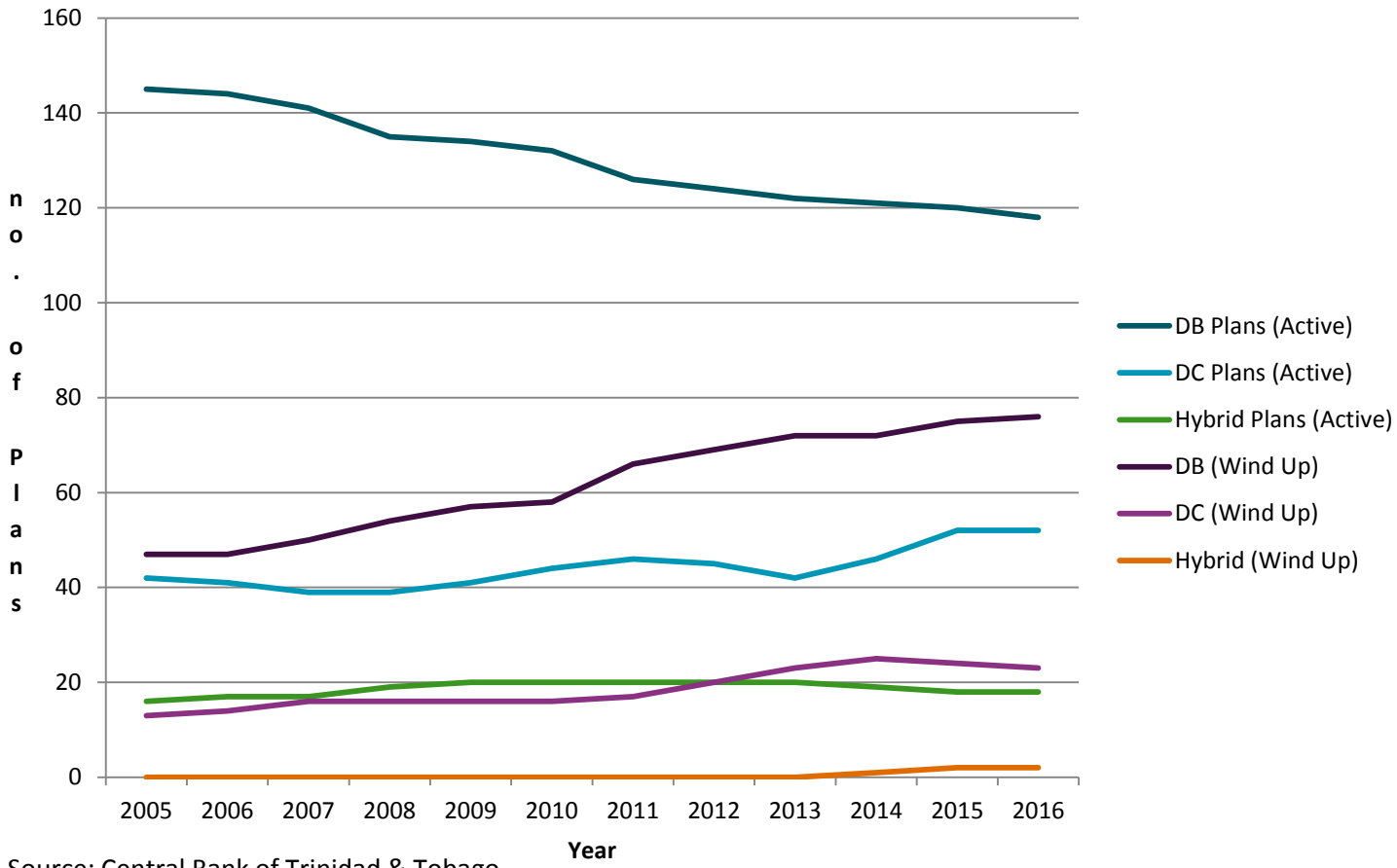
# CB Trinidad & Tobago- trend by plan type




Source: Central Bank of Trinidad & Tobago

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# Regulatory concerns in approving conversions

**Treatment of the DB portion**

- Ensure preservation of accrued defined benefits
- Funding of deficits before conversion
- Disclosure of future normal cost if soft freeze. Costs can escalate if no new entrants.

**Managing the Conversion**

- Are members given adequate options in the process?
- Are members given adequate notice?
- Is member consent required?
- Are members adequately informed about their rights and risks involved in the conversion?
- Are members informed about the change in benefits?

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# Regulatory concerns in approving conversions (Continued)

- Structure of new DC plan
  - Does the new DC plan meet regulatory and other requirements?
  - Is the Plan a pure DC plan or does the employer have contingent liabilities e.g. pensions paid from the plan and guaranteed interest
- Education / Communication to members
  - Are the options given to members clearly communicated?
  - Are the roles of members under the DC Plan clearly stated?
  - Manage employees expectations as it relates to benefits and risks under the DC Plan.
  - Are member booklets updated?
  - Annual member benefit statements (not legislated in many Caribbean countries)

# Treatment of conversion from a DB to DC by selected regulators

| Regulator | Approval required | Amendment | Guidelines | Options to Members | Benefit Statement | Actuarial bases specified/ prescribed | Employer to Fund Deficit | Filing | Notiuce to Members |
|---|---|---|---|---|---|---|---|---|---|
| OSFI (Canada) | √ | √ | √ | √ | √ | √ | √ | √ | √ |
| FSCO (Canada) | √ | √ | √ | √ | √ | √ | √ | √ | √ |
| Jamaica | √ | √ | √ | No | No | Not specified | Not specified | √ | √ |
| Barbados | √ | √ | No (few references in legislation) | No | No | Not specified | Not specified | Not specified | √ |
| Trinidad & Tobago | √ | √ | No | No | No | Not specified | Not specified | As for amendment | √ |

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# OSFI – Requirements (Options to Members)

## Retain accrued benefits as defined benefits

- Maintain a pension plan for the defined benefits (possibly based on projected salary); or
- Purchase annuities
  - Provide substantially the same benefits available under the terms of the Plan
  - Based on projection of salaries including reasonable termination rates, recognizing that not all members will reach normal retirement age

## Transfer the lump sum of equivalent value of the accrued benefits to a DC plan

- All benefits provided under the terms of the Plan should be recognized

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# OSFI - Requirements

- Minimum Value of Converted Benefits- based on Canadian Institute of Actuaries' Recommendations for the Minimum Transfer Values of Pensions.
- Actuarial Basis- guidance provided on assumptions to be used
- Funding of Employer Current Service Costs from surplus is allowed (providing provisions in both the DB and the new DC plan permit contribution holidays)
- Underfunded Plans-shortfall should be funded in full from corporate resources or amortized over a five year period.

# OSFI - Requirements (Cont'd)

## Post conversion monitoring

- Where a deficit remains after the conversion -the solvency ratio of the DB portion must equal at least the plan's solvency ratio prior to the conversion;
- Hybrid Plans
  - Any deficit in the DB plan should not affect the DC portion
  - The DC portion must be fully funded no later than 5 years after the conversion date through special payments

## Conversion Report

- Treatment of terminations, retirements, death, wind-up within 5 years after the conversion date, where the initial DC plan is not fully funded.
- Disclosure of interest rate to be applied between the date of conversion and transfer

# OSFI- Requirements (Cont'd)

Treatment of Accrued Benefits (Conversion Report)

- Benefits retained as defined benefits
  - Changes in contribution rates to be addressed
  - Actuarial valuations required at the usual 3 years intervals
- Unchanged accrued benefits fully guaranteed through the purchase of annuities
  - certification that benefits are unchanged and fully guaranteed;
  - the treatment of surplus

# OSFI- Requirements (Cont'd)

Treatment of Accrued Benefits (Conversion Report)

- Converted accrued benefits guaranteed to be no less at retirement, than what would have been received under the DB formula
  - Address changes in contribution rates and show liabilities for DB and DC portions;
  - Actuarial valuations required at the usual 3 years intervals (exception; guarantees are not significant)
- Accrued benefits guaranteed through annuity purchase based on projected salaries or benefits are substantially altered
  - members should be offered an equivalent lump sum; and
  - assumptions and methods supporting that the lump sum is equivalent to the accrued benefit in its original form is described

# FSCO – Requirements (Options to Members)

**Preserve accrued benefits in the form of defined benefits**

- Purchase an annuity (the sponsor may elect) (comply with provisions of the PBA, early retirement, transfer rights and pre-retirement death benefits
- (Default- DB benefits will be retained if no election is made)

**Transfer the lumps sum of equivalent value of the accrued benefits to a DC plan**

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# FSCO- Requirements

- Minimum Commuted Value is to be determined in accordance with the legislation;
- Amounts in excess of the Income Tax limit- refund to member;
- Vesting- vesting rules in the DB will continue to apply in the DC plan. The member must be advised. (Ontario-immediate vesting effective July 1, 2012);
- Funding
  - the sponsor is required to contribute the shortfall in underfunded plans by way of a lump sum.
  - Ongoing-the sponsor should ensure that the solvency ratio of the remaining DB component does not fall below 1
- Conversion report is filed simultaneously with the plan amendment

# JAMAICA - Requirements

Members' approval required for prescribed amendments-e.g. changes to the fundamental nature or design of the plan

Disclosure requirements:

- The basis used to value defined benefits;
- The value of ancillary benefits;
- The rate of interest applied to commuted values between the conversion date and payment date;
- Notification to members regarding the proposed treatment of surplus/deficits;
- Confirmation that the proposed amendment conforms with requirements of other relevant documents such as collective agreements

# Considerations for Caribbean Regulators

Members given the option to purchase an annuity with accrued benefits vs. the approach selected by the employer/sponsor

If DB benefits are retained; whether hard freeze or soft freeze will be allowed.

Should the employer continue to fund the DB component at a fully funded level in the ongoing plan?

# Considerations for Caribbean Regulators

Should Actuarial bases be specified at conversion?

- Minimum Transfer Values
- Assumptions

Should actuarial valuation reports be required for DC Plans?

How should underfunded plans be treated?

- should employers contribute the shortfall in a lump sum payment or over a period or at all?

Should vesting rights earned under the DB continue to accrue under the DC?

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## Considerations for Caribbean Regulators

- How should pension values in excess of Income Tax limits be treated?
- Should the regulator allow for refunds & under what circumstances?
- Should notices to the Regulator and members & timelines, be required to provide transparency in the process?
- What relevant information should be requested to assess the conversion?
- Should consent of members be required?
- Should option forms be given to members and should the format and content be prescribed to minimize deficient information?

# Considerations for Caribbean Regulators

**Governance Considerations for DC Plan**

- Employee bears the investment risk; but other parties make the investment decisions (if no member choice)
- Choice of asset allocation; typically other parties
- Who designs the default investment fund if no member choice

## Regulator's role

- Monitor investment managers who are not licensed
- Monitor expense levels e.g. Fees
- Monitor asset allocations/ restructure
- Specify minimum disclosure requirements
- Utilize tender process to select annuity providers

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# Considerations for Caribbean Regulators

**DC Design – Decumulation / Payout Phase Options**

- Purchase annuities
- Drawdowns
- Pay directly from the Plan
- Lump sums

## Regulator's role

- Consider local environment
- Protection against longevity risks – annuity purchase
- Promote flexibility – lump sums, draw downs
- Assess the availability of insurance products- Is there an annuity market?
- Is the insurance industry adequately capitalized?

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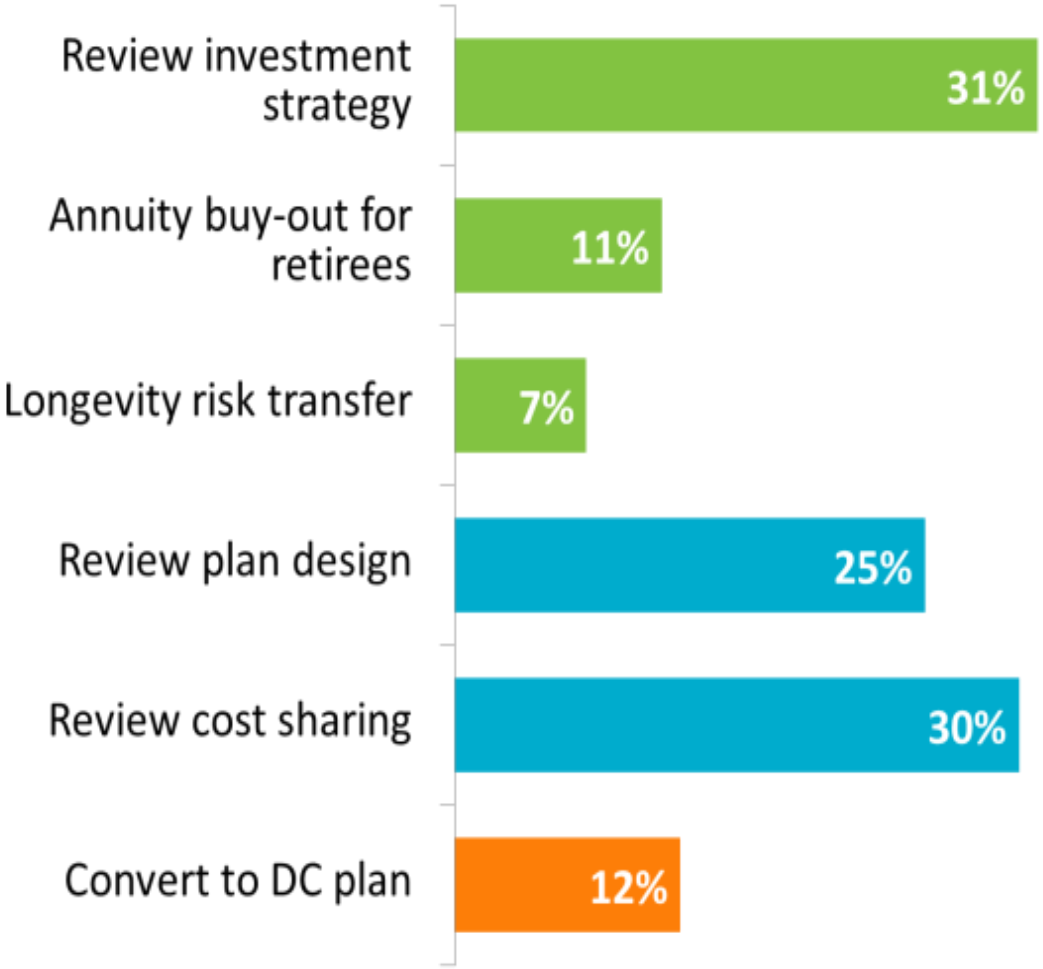
# Alternatives to conversion

- Plan Termination
- Settlements: Buy-ins, Buy-outs / terminal funding

Buy-in: is an investment option where the plan trust is the policy holder and the policy is a pension plan asset. The insurance company will pay the covered benefits via the pension plan.

Buy-out: the insurance company issues individual policies to the members and their liabilities are effectively transferred out of the pension plan to the insurance company. The insurance company will pay the covered benefits to the members.

# De-risking trends – Canada 2017 survey




Source: Morneau Shepell's Human Resources Trends for 2017

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# Highlights

- Request relevant information (at conversion and on an ongoing basis)in order to effectively manage the process;
- Members should be given adequate information to make informed decisions;
- The benefits and risks associated with the DC plan should be explained to members; Disclosure of funding risks for closed DB plans
- Consider provisions /guidelines that will protect accrued benefits

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# THANK YOU

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