Comments on Public Sector Accounting Proposals

MARCH 2018

About OPTrust

With net assets of over $20 billion, OPTrust invests and manages one of Canada's largest pension funds and administers the OPSEU Pension Plan, a defined benefit plan with over 92,000 members and retirees. OPTrust was established to give plan members and the Government of Ontario an equal voice in the administration of the Plan and the investment of its assets through joint trusteeship. OPTrust is governed by a 10-member Board of Trustees, five of whom are appointed by OPSEU and five by the Government of Ontario.

Employment Benefits: Discount Rate Guidance in Section PS 3250

A review of the discount rate guidance in RETIREMENT BENEFITS, Section PS 3250, issued by the Public Sector Accounting Board (PSAB)

Objective of financial statements:

The OPSEU Pension Plan is a jointly sponsored pension plan (JSPP) that allows for the sharing of risk between employers and members of the Plan. We have a long tradition of joint governance and managing our Plan through challenging economic times. As a result, our Plan is viewed as a model of efficiently and sustainability. In this regard, we note that the Ontario government and other Canadian jurisdictions are encouraging single-employer pension plans in the broader public sector to amalgamate and transition to a jointly-sponsored structure that has separation of control and authority from the sponsor(s) to the fiduciary to set a discount rate and a funding policy.

As JSPPs, our members and employers jointly share the funding risks of our plans. There is no recourse to employers, the Government or the pension benefit guarantee fund in the unlikely event, given our structure, of a plan wind-up and deficiency. Accurately costing and forecasting our liabilities, along with preserving and growing fund assets, is of paramount importance to JSPPs in ensuring our pension benefits remain secure and sustainable for the lifetime of our members and their survivors. One of the goals of our respective funding polices is to strive for equity amongst generations of members and distinct groups.

We believe that determination of the appropriate discount rate for accounting purposes should be based on the objectives of financial statements. A private sector accounting objective is to allow investors to have confidence in company financial statements. An investor in the USA or Germany can make informed decisions about investing their capital in a Canadian company if the Canadian financial statements are based on standards comparable to their own standards. Chart 2 in paragraph .048 illustrates that private sector accounting standards have converged and now use a discount rate based on the market yields of high-quality debt instruments at the reporting date. This method, uniform across the globe, serves international investors well.

We believe the objective of public sector accounting is not global in nature compared to that of private sector accounting. A taxpayer in Germany has less interest in Canadian public sector accounting than does a Canadian taxpayer. Taxpayers are not as mobile as capital is. We believe the primary external user of Canadian public sector accounting to be Canadian taxpayers. We also suspect their major concern is their level of taxation. A change in Canadian public sector accounting standards that increases Canadian taxes will not be welcomed by Canadian taxpayers.

Question 1. Do you agree that PSAB needs to consider whether the discount rate guidance in RETIREMENT BENEFITS, Section PS 3250, is appropriate and sufficient?

Reply: We agree that PSAB needs to consider the discount rate guidance. With the move to market yields on quality debt in the private sector, many are suggesting public sector accounting should also adopt this market-based method. We hope that after careful consideration the current method will be retained, but that as a result of the review PSAB will have greater confidence in the method.

Question 2. What challenges do you have, if any, in applying the discount rate guidance in Section PS 3250?

Reply: We have adopted the 'expected return on plan assets' to set our discount rate. Included in this analysis is a determination of future yields of asset classes. Our challenge with determining the yields on good quality debt is that the very thin market for these investments in Canada makes reviewing past experience difficult. This thin market for good quality debt also applies to the private sector and the solution has been for the Canadian Institute of Actuaries to develop a method for determining these yields.

Our challenge for setting yields for asset classes other than bonds is the changing economic environment. Real return on assets has been decreasing and we have adjusted our discount rate assumption accordingly. We expect that as economic conditions change, we will again change our discount rate.

Question 6. Which of the discount rate bases identified in paragraphs .052-.092 is most appropriate for estimating the fulfillment value of the accrued benefit obligation? Please identify any guidance that may need to be considered.

Reply: We believe the 'expected return on plan assets' is most appropriate as it is founded on the same basis as the funding valuations – the difference being the inclusion of provision for adverse deviation in the funding return. Both the existing plan asset method and the funding valuation method produce pension expenses that are less volatile than those produced by the private sector bond market-based method.

A discount rate based on good quality bonds does not serve taxpayer interests. If we look at private sector experience, the move to a market-based discount rate introduced a great deal of volatility in the pension expense and the non-pension benefit expense. To counteract this volatility the private sector has been closing defined benefit plans to new members, replacing defined benefit plans with defined contribution plans, or simply closing defined benefit plans altogether. For example, since the introduction of private sector accounting for other post-employment benefits, many private sector entities have terminated their post-retirement medical/health plans.

We can expect the introduction of a bond market-based discount rate into the public sector to create more volatility and we expect government response will be the same as that experienced in the private sector. Government will react to taxpayer concern about volatile taxes. If PSAB adopts a market-based method then the Board is not just measuring liabilities – it is creating volatility with a predictable result of government curtailing defined benefits to control that volatility.

Paragraph .099 highlights the problem with volatility. Benefits are paid out over a very long time. Any method based on a point-in-time measure of yields will miss these very long time periods. Any of the investments analysed for their yield will not have the same time horizon as a pension benefit.

In paragraph .060 concerns are raised that "entities may use more aggressive investment return assumptions to present lower accrued benefit obligation." We do share this concern that the determination of the future asset class returns is open to aggressive assumptions. While the use of a single asset class such as the bond market solves this problem, it will create additional problems.

Another of our concerns is that introducing a bond market-based discount rate will remove an incentive for funded plans to invest in alternative asset classes. The only sources of funding for these plans are tax dollars and investment income. If the amount of investment income is decreased, the amount needed to pay for the benefits must come from the taxpayer. While accounting standards can soften the impact by averaging and deferring recognition, the basic premise that benefits must be costed on a bond yield could increase the ultimate cost of pension/benefits.

One solution to aggressive assumptions for the other asset classes might be to encourage the Canadian Institute of Actuaries to develop a standard for setting the rate of return on alternative asset classes. The private sector was faced with the problem of determining the return on bonds, as there were various methods. The private sector asked the CIA to develop a method to determine the bond yields to be used for accounting valuations. The CIA method was developed after consultation with the CIA membership and reflected their best estimate of how bond yields could be determined for a discount rate assumption for accounting valuations. It is not unrealistic to expect that they could also develop a standard for setting a return for the other asset classes.

We suggest that a CIA method for setting the prospective rates would a solution to the problem outlined in paragraph .105. We agree that subjectivity should be discouraged, but suspect that some subjectivity will always be present, if not inherent in the development of a CIA method. In addition, no method will cover all investment possibilities, and subjectivity will be needed to implement the CIA methods.

Question 7. Which of the discount rate views identified in paragraphs .093-.106 is most appropriate for estimating the fulfillment value of the accrued benefit obligation? Please identify any guidance that may need to be considered.

Reply: We note that paragraph .095 defines current rate as "a current rate reflects the current expectations about the periods over which the benefit payments are expected to be made." We do not view the 'projected view' as referenced in paragraph .093 as that much different than your definition of 'current rate' in paragraph .095. The expected return on plan assets is based on 'current expectations,' the same as your definition of 'current rate.' The difference is who is determining current expectations. By 'current rate' we assume that the broad market is determining expectations at a point in time as opposed to the government entity determining expectations based on several factors, including the current point-in- time expectations.

We note in paragraph .103 reference is made to "They do not believe that historical experience is a reliable predictor of the future." It is ironic that given the very small market of good quality corporate bonds in the Canadian market the CIA had to rely upon their judgement to determine the recommended method for determining yields for good quality Canadian bonds. In the CIA Educational Note Supplement *Accounting Discount Rate Assumption – Calculating Spread Above Provincial Yields* there is the statement: "Finally, in the educational note, the task force acknowledges that the suggested approach includes a number of simplifications and a judgmental estimate."

http://www.cia-ica.ca/docs/default-source/2013/213063e.pdf?sfvrsn=2http://www.cia-ica.ca/docs/default-source/2013/213063e.pdf?sfvrsn=2

We do not disagree with the method used by the CIA, but only point out that judgement implies historical experience, and thus historical experience has some impact on the setting of the private sector discount rate.

Paragraph .100 refers to the information value of a point-in-time liability as it reflects risks. We see a difference between information value and the value of using these results in a financial statement. This is not dissimilar to the issue of regulators using solvency valuations to monitor the risks of a funded pension plan. The solvency valuations have provided useful information but have been ineffective as a funding strategy. Pension regulators have begun to accept that disclosure of solvency results is more important than requiring restrictive solvency funding. We would support accounting standards that recognize the information value of a point-in-time measurement but require recognition in financial statements with a less volatile method. If 'disclosure but not funding' was the message ultimately heard by pension regulators, we would hope that PSAB hears 'disclosure but not accrual.'

Signed

Dani Goraichy, FSA, FCIA

Vice-President, Actuarial Services and Plan Policy