Ontario: renewed solvency relief

On June 3, 2016, the Ontario Government adopted regulations under the Ontario Pension Benefits Act, which will extend for an additional three years the temporary solvency funding relief measures previously provided to private sector defined benefit (DB) pension plan sponsors in 2009 and 2012. The draft regulations were originally released on May 6, 2016. The Ontario Government first announced this extension in the 2015 Fall Economic Statement and again in the 2016 Ontario Budget.
At the same time, the regulations impose additional restrictions on contribution holidays for DB plans registered in Ontario, identical to those in place from 2010 to 2013.

**Temporary solvency relief extension**

This additional round of solvency funding relief will apply to the first actuarial valuation report with a valuation date on or after December 31, 2015, and prior to December 31, 2018. Eligible plan sponsors may benefit from the following two options:

- consolidate existing solvency payment schedules into a new five-year payment schedule; and
- extend the solvency payment schedule to a maximum of ten years (from the current maximum of five years) for any new solvency deficiency determined in the applicable valuation report, subject to the consent of plan members and beneficiaries.

These options are essentially identical to the options previously offered to eligible plan sponsors under the 2009 and 2012 relief measures. The same requirements for notice and consent to a solvency amortization schedule extension apply under the new relief measures.

**Temporary restrictions on contribution holidays**

The regulations also provide that previous temporary restrictions on contribution holidays will be reintroduced for plan fiscal years ending after June 29, 2017, and before January 1, 2020. DB pension plans (other than designated plans and individual pension plans) will not be permitted to use actuarial surplus to reduce normal cost contributions to the plan, unless an actuarial cost certificate is filed confirming the plan was in a surplus position at the beginning of the fiscal year.

According to the Ontario Government, this restriction is intended to provide a more "balanced relief package".

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**Conclusion**

Sponsors of DB plans registered in Ontario with solvency funding deficits will welcome the temporary solvency relief measures, but those in a surplus position may question the link between restrictions on contribution holidays and solvency funding relief.

Other news may be expected soon regarding the consultation announced previously for more fundamental changes to the solvency regime.

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**Revised multi-jurisdictional pension plan agreement**

On June 2, 2016, the Canadian Association of Pension Supervisory Authorities (CAPSA) announced that representatives of the governments of British Columbia, Nova Scotia, Ontario, Quebec and Saskatchewan have signed a new interim Agreement Respecting Multi-Jurisdictional Pension Plans, which is intended to come into effect for these jurisdictions on July 1, 2016 (the “2016 MJPP Agreement”).

The 2016 MJPP Agreement is intended to replace the multi-jurisdictional agreement previously signed by Ontario and Quebec effective July 1, 2011 (the “2011 MJPP Agreement”), along with the Memorandum of Reciprocal Agreement signed by all provincial pension jurisdictions (except for Prince Edward Island, which has no pension legislation in force) in 1968 (the “1968 Memorandum”). The other provinces and the Federal jurisdiction did not sign the 2011 version, although some of them passed legislation authorizing their governments to do so. In the meantime, the 1968 Memorandum will remain in effect for those provinces which have not signed the 2016 MJPP Agreement, and all similar bilateral federal-provincial agreements will continue in effect.
This 2016 MJPP Agreement will be effective in these jurisdictions until a further revised version is released by CAPSA sometime after 2018, and then signed by applicable Canadian pension jurisdictions. According to CAPSA, the 2016 MJPP Agreement was negotiated as an interim measure while CAPSA coordinates amendments to the agreement that will address the changing solvency funding regimes across Canadian pension jurisdictions. After CAPSA conducts a public consultation, Canadian pension jurisdictions are expected to enter into a further revised agreement.

2016 MJPP Agreement

The 2016 MJPP Agreement will replace both the 1968 Memorandum and the 2011 MJPP Agreement for those jurisdictions that sign it, and is largely identical to the 2011 MJPP Agreement, with the following differences:

- **Deemed solvency funding requirement for certain asset allocation purposes:** The 2011 MJPP Agreement set out a methodology for allocating pension plan assets among multiple jurisdictions where specific plan events occur (such as an asset transfer, an employer withdrawal, or a partial wind up of the plan). This allocation is completed according to four levels of priority, giving a higher level of priority to liabilities and benefits that are required by applicable pension legislation to be funded on a solvency basis. In order to recognize any pension legislation that permanently removes the solvency funding requirement for certain plans (such as Quebec under Bill 57), the 2016 MJPP Agreement provides that any liabilities and benefits earned prior to the effective date of such change are deemed to be funded on a solvency basis for purposes of this asset allocation process.

- **Coming into force:** The 2016 MJPP Agreement provides that the agreement comes into force on July 1, 2016, in respect of British Columbia, Nova Scotia, Ontario, Quebec or Saskatchewan. For other parties that sign after July 1, 2016, the effective date must be unanimously agreed to by the existing MJPP Agreement parties.

- **Withdrawal from MJPP Agreement:** Under the 2016 MJPP Agreement, a party to the MJPP Agreement can only withdraw from the agreement by giving written notice to all other parties on or after January 1, 2019 and before April 1, 2019, with effect on July 1, 2019. This effectively means that there is a three-year moratorium on withdrawing from the 2016 MJPP Agreement.

Federal consultation on the 30% investment rule for pension plans

On June 3, 2016, the Federal Department of Finance launched a consultation to assess the usefulness of the investment rule which currently restricts federally regulated pension plans from holding more than 30 per cent of the voting shares of a company (“the 30% rule”). The 30% rule also affects plans under provincial jurisdiction, as provincial rules incorporate the federal investment rules by reference, except in New Brunswick and Quebec. The consultation paper identifies and invites comments on three considerations.

Conclusion

The 2016 MJPP Agreement will come into effect for multi-jurisdictional pension plans where: (i) the pension plan is registered in British Columbia, Nova Scotia, Ontario, Quebec or Saskatchewan; and (ii) the plan has members subject to the pension legislation of two or more of these jurisdictions.

Another revised MJPP Agreement is expected to be released by CAPSA for public consultation by 2018, which, if signed by every pension jurisdiction, would mean that a uniform agreement may be in force across Canada shortly thereafter.
1. Prudential considerations
The prudent person standard requires the administrator to invest the assets of the pension plan in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension plan. One of the consequences of the 30% rule is that pension plans owning more than 30% of the equity in a business may search for complex governance structures to retain control of their investments. In addition, stakeholders have argued that elimination of the 30% rule would allow for more effective risk management by pension plans by giving them the ability to elect directors. The consultation requests feedback on the benefits and risks of pension plans taking on a dual role of providing benefits to members and taking an active role in the operations of a business, and whether additional rules in addition to the prudent person level should be adopted when pension plan investments exceed a certain standard.

2. Investment performance
The consultation paper notes the view that precluding plans from taking controlling stakes in Canada could negatively affect capital market efficiency by reducing liquidity, the availability of patient capital, and capital for large-scale projects. It asks whether the 30% rule impedes pension administrators from obtaining appropriate investment returns and imposes additional costs.

3. Tax avoidance
The consultation paper states pension plan control of operating businesses may give rise to certain concerns about tax fairness and efficiency. Pension plans may be able to restructure their investments in these businesses so as to shift taxable income from the business entity to the pension plan, with the result of avoiding federal and provincial corporate income taxes on business income. The consultation paper asks if these tax policy concerns are material. It also asks if the government should consider implementing tax measures to limit the ability of pension plans to undertake tax planning strategies to reduce or eliminate corporate income tax.

Conclusion
The potential abolition or amendment of the 30% rule will have an impact primarily on large pension plans that have the ability to take controlling stakes in businesses, but it could also have an impact on the investment products available to smaller pension plans. Stakeholder submissions are requested by the government on or before September 16, 2016.
Tracking the funded status of pension plans as at May 31, 2016

This graph shows the changes in the financial position of a typical defined benefit plan with an average duration since December 31, 2015. For this illustration, assets and liabilities of the plan were each arbitrarily set at $100 million as at December 31, 2015. The estimate of the solvency liabilities reflects the new CIA guidance published in April 2016 for valuations effective March 31, 2016 or later. The following graph shows the impact of three typical portfolios on plan assets and the effect of interest rate changes on solvency liabilities of medium duration.

The evolution of the financial situation of pension plans since December 31, 2015

During the month of May, Canadian long term bonds, Canadian long-term provincial bonds, Canadian universe bonds, global equity markets, Canadian equity markets and alternative investments showed positive returns. With a return of 2.5%, the highly diversified portfolio (HD) outperformed the 60/40 portfolio (2.1%) and the low volatility portfolio (LDI) (2.1%). The outperformance of the HD portfolio is explained by a larger weight in alternative investments. Annuity purchase rates decreased while the rates used in the calculation of solvency liabilities increased, decreasing the solvency liabilities by 0.2% for a medium duration plan. In all cases, the combined effect increased the solvency ratio.

The tables below shows the impact of past returns on plan assets and the effect of interest rate changes on solvency liabilities, based on the plan’s initial solvency ratio as at December 31, 2015, as well as the asset allocation of the three typical portfolios.

<table>
<thead>
<tr>
<th>Initial solvency ratio as at December 31, 2015</th>
<th>Evolution of the solvency ratio as at May 31, 2016 for three different portfolios</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>60/40 portfolio</td>
</tr>
<tr>
<td>100%</td>
<td>99.6%</td>
</tr>
<tr>
<td>90%</td>
<td>89.6%</td>
</tr>
<tr>
<td>80%</td>
<td>79.7%</td>
</tr>
<tr>
<td>70%</td>
<td>69.7%</td>
</tr>
<tr>
<td>60%</td>
<td>59.8%</td>
</tr>
</tbody>
</table>

Since the beginning of the year, driven by strong returns within the Canadian equity and the Canadian fixed income markets, the 60/40 portfolio, the LDI portfolio and the HD portfolio returned 2.8%, 2.9% and 1.5% respectively. The solvency liabilities increased over that same period between 2.8% and 3.3% depending on the duration of the group of retirees. The decrease in the plan’s solvency ratio as at May 31, 2016 depends on the plan’s initial ratio, but stands between 0.2% and 1.7%.

Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.

Comments
1. No consideration has been made for contributions paid to the plan or for benefits paid out of the plan.
2. Solvency liabilities are projected using the rates prescribed by the Canadian Institute of Actuaries (CIA) for the purpose of determining pension commuted values.
3. The underlying typical defined benefit plan is a final average plan with no pension indexing, including active and inactive participants representing 60% and 40% of liabilities, respectively.
4. Assets are shown at full market value. Returns on assets are based on three typical benchmark portfolios.
Impact on pension expense under international accounting as at May 31, 2016

Every year, companies must establish an expense for their defined benefit pension plans.

The graph shows the expense impact for a typical pension plan that starts the year at an arbitrary value of 100 (expense index). The expense is influenced by changes in the discount rate based on high quality corporate and provincial (adjusted) bonds and the median return of pension fund assets.

**Expense Index from December 31, 2015**

<table>
<thead>
<tr>
<th>Date</th>
<th>Discount rate (%)</th>
<th>Return on assets (60% equities) (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>31-12-2015</td>
<td>4.0</td>
<td>0.0</td>
</tr>
<tr>
<td>31-01-2016</td>
<td>4.0</td>
<td>-1.6</td>
</tr>
<tr>
<td>31-02-2016</td>
<td>3.9</td>
<td>-1.0</td>
</tr>
<tr>
<td>31-03-2016</td>
<td>3.7</td>
<td>2.8</td>
</tr>
<tr>
<td>31-04-2016</td>
<td>3.6</td>
<td>0.6</td>
</tr>
<tr>
<td>31-05-2016</td>
<td>3.4</td>
<td>2.1</td>
</tr>
</tbody>
</table>

The table below shows the discount rates for varying durations and the change since the beginning of the year. A plan’s duration generally varies between 10 (mature plan) and 20 (young plan).

**Discount rate**

<table>
<thead>
<tr>
<th>Duration</th>
<th>December 2015</th>
<th>May 2016</th>
<th>Change in 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>3.71%</td>
<td>3.25%</td>
<td>-46 bps</td>
</tr>
<tr>
<td>14</td>
<td>3.91%</td>
<td>3.38%</td>
<td>-53 bps</td>
</tr>
<tr>
<td>17</td>
<td>4.04%</td>
<td>3.45%</td>
<td>-59 bps</td>
</tr>
<tr>
<td>20</td>
<td>4.12%</td>
<td>3.49%</td>
<td>-63 bps</td>
</tr>
</tbody>
</table>

Since the beginning of the year, the pension expense has increased by 31% (for a contributory plan) due to the decrease in the discount rate.

**Comments**

1. The expense is established as at December 31, 2015, based on the average financial position of the pension plans used in our 2015 Survey of Economic Assumptions in Accounting for Pensions and Other Post-Retirement Benefits report (i.e. a ratio of assets to obligation value of 91% as at December 31, 2014).

2. The return on assets corresponds to the return on the Morneau Shepell benchmark portfolio (60% equities and 40% fixed income).

3. The actuarial obligation is that of a final average earnings plan, without indexing (two scenarios: with and without employee contributions).

Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.
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