Knowledge & Insights

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In this issue

Pension funding: How solvency and going-concern funding have diverged since 2006

For many years now, Morneau Shepell has been tracking the funded status of pension plans on a month-by-month basis and reporting it in *News & Views*. At the end of each year, we reset the starting values to 100 in order to track the following year. It is instructive to take a step back periodically in order to see the longer-term evolution of pension funding in Canada. In particular, this enables us to understand more clearly why so many employers in the private sector have been closing their DB pension plans to new hires.

The chart on this page shows how the funding of a typical defined benefit pension plan would have evolved with market conditions over the last decade.

- The blue line shows how solvency funding has evolved. A DB plan that was fully funded at the end of 2006 on a solvency basis would be only **86 percent** funded at the end of 2016. (This assumes no special payments toward liquidating the deficit.)
- The orange line shows how going-concern funding produced an entirely different story. If the plan had been fully funded ten years ago, then today it would be **155 percent** funded!

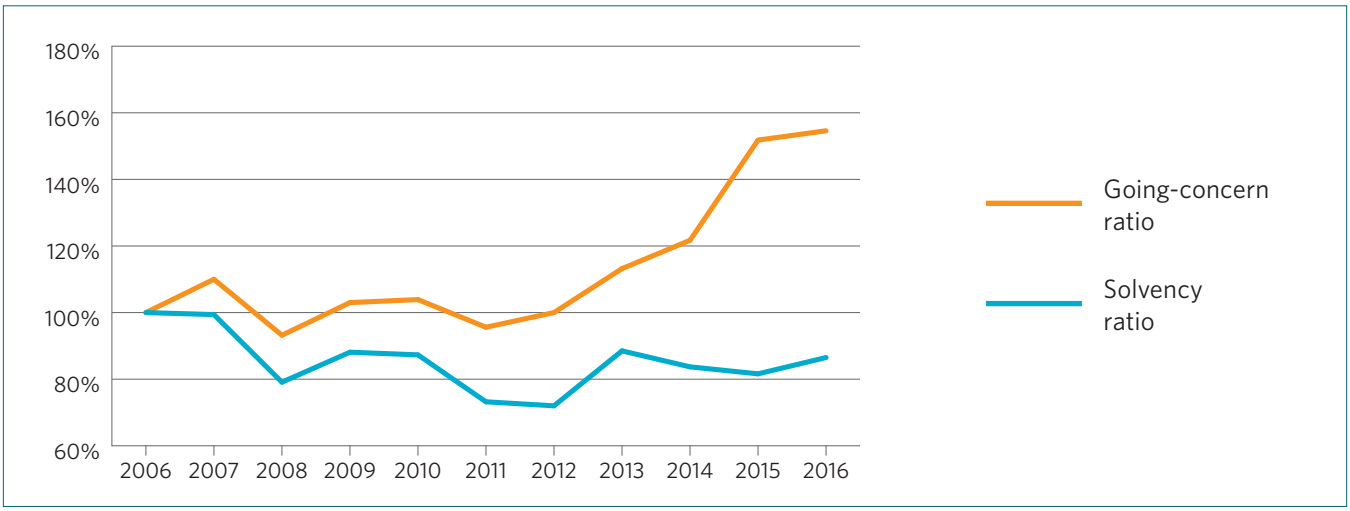
Funding on a going-concern basis improved so markedly because of excellent investment returns, mainly since the end of 2012, easily undoing the ravages of the 2008-2009 market debacle. The improvement is especially impressive given that the mortality assumption has been strengthened twice in the past ten years and even the going-concern valuation interest rate has been reduced to reflect lower future return expectations.

So when governments require plan sponsors and administrators to consider both bases in making decisions on funding DB promises and in managing the substantial financial risks involved, we can see the daunting challenges that result. Around the mid-1980s, when DB plans flourished, plan sponsors and actuaries had the luxury of focusing only on going-concern funding. Mark-to-market accounting did not exist yet and the regulators did not insist yet on solvency funding. Going-concern deficits were not a major problem then since they could be amortized over 15 years and besides, one could count on the bad years eventually being offset by good ones. Had the investment experience we have enjoyed in the last decade been combined with the funding and accounting rules as they existed in the 1980s, DB plans would now be enjoying a golden age. They would have continued to thrive, with plan stakeholders having plenty of opportunities to consider significant contribution holidays and benefit improvements.

Conclusion

The problem with DB plans has not been poor investment performance; it has been the impact of ever-lower interest rates on solvency liabilities (as well as accounting liabilities), combined with burdensome solvency rules aimed at theoretically safeguarding the tragic but rare events of plan wind-ups following the insolvency of the employer. The strict rigidity of DB plan promises, long considered to be a strength of the defined benefit model, has ultimately proven to be its greatest failing. This one chart alone shows that the time has come for substantial changes in pension legislation, such as solvency reform (already implemented in Quebec and discussed in Ontario) as well as new plan designs like shared risk or target benefit plans (already implemented in New Brunswick and proposed for Federal employers and for multi-employer plans in a few provinces).

The funding divergence in DB plans since 2006



Recommendation to increase retirement age under public plans

The government-appointed Advisory Council on Economic Growth has recommended that the age of eligibility for OAS, CPP and GIS be increased to "meet the reality of an ageing society and a considerably longer life expectancy". The Advisory Council is a 14-member body that was handpicked by Finance Minister Bill Morneau back in March 2016, to suggest options to overcome the challenges posed by an aging population and improve economic growth. In their report, they point out that the workforce participation rate of Canadians over 55 is just 54 percent. By comparison, it is 62 percent for the top-performing OECD countries, including the US, Japan, Sweden and New Zealand.

It will be remembered that the Harper government had planned to increase the retirement age for OAS and GIS benefits from 65 to 67. One of the first actions taken by the Trudeau government was to cancel this change and preserve the status quo. So it was no surprise that Social Development Minister Jean-Yves Duclos was quick to reject that idea. Nevertheless, this latest report represents one more voice that could eventually put it back on the table, and the discussion then might be expanded to encompass the CPP.

Curiously, the Advisory Council made no mention of raising the eligibility age for pensions under workplace pension plans. The majority of workplace defined benefit plans allow for unreduced early retirement pensions from age 60 or 62 and sometimes as early as 55. As for reduced early retirement pensions, all workplace plans by law are required to allow commencement by age 55 and many allow an even earlier start date.

In some private sector workplace plans – and most public sector plans – a supplementary pension is also paid until C/QPP pensions become payable in full (at 65). If those plans are left unchanged, millions of their participants could be buffered from the effects of any change in retirement age under CPP. Then it could be mainly workers without workplace pension coverage who would be adversely affected by an increase in the eligibility age for OAS, GIS and CPP.

The Advisory Council also suggested to explore ways to make deferrals beyond age 65 more attractive, pointing out that allowing deferrals beyond age 70 could encourage some workers to continue working longer.

Conclusion

It is still early days for such changes, but they have also been suggested by others. We may see very soon in the next federal budget whether the government intends to focus on other ways to encourage older workers to keep working longer.

Taxation of employer health and dental plans

In recent months, there has been speculation that the federal government might be considering a major change in tax rules in the next federal budget that would make employer contributions to extended health and dental plans taxable to employees, similar to the current practice in the province of Quebec. Such a concept is not new and has been contemplated by the Department of Finance for about a decade; however, the attention on this subject has been highlighted due to greater media awareness and lobbying efforts within the insurance industry.

It may be assumed the main intent of introducing such a tax rule would be to generate additional tax revenue, which is estimated to be in the range of $3 billion; however, opponents have argued the tax would affect lower and middle income Canadians the most and potentially result in employers reducing or eliminating healthcare programs altogether. Another possible consequence could be greater employee awareness of the cost of health and dental benefits, resulting in higher overall claims (and premiums) due to behavioral changes of employees. Such behaviour would be comparable to disability plans where incidence and claims costs tend to be higher when employees pay premiums for those plans.

The taxation of employer-paid healthcare plans could also cause unintended cost shifting if it brings a greater number of uninsured workers to rely on provincial plans, at a time when provinces can ill afford it. And since the provincial plans do not provide extensive coverage of prescription drugs to those workers, this could increase public pressure on the federal government to fund a national drug plan.

Conclusion

On February 1st, Prime Minister Justin Trudeau ended all speculation by announcing his government would not change tax rules for employer paid extended health and dental care benefits. He stated during question period: "we are committed to protecting the middle class from increased taxes and that is why we will not be raising [those] taxes". So ends the need, for the present, of lobby efforts fueled primarily by life and health insurers. While the Prime Minister's announcement is related to this year's federal budget, it remains uncertain whether such a tax change may be introduced in the future.

Review of public sector accounting of retirement and post-employment benefits

In 2014, the Public Sector Accounting Board (PSAB) identified, as part of a survey, the review of Section 3250 (Retirement Benefits) and Section 3255 (Post-employment Benefits) as one of the top priorities in its agenda. Given past revisions to accounting rules for other types of employers, as well as the introduction of new types of pension plans in Canada, it is a good opportunity to review the provisions of PS 3250 and PS 3255 and determine if changes are required. PSAB established the *Employee Benefits Task Force* ("Task Force") in 2015 to undertake the project. The Task Force decided to split the review process into two phases:

1. Phase One will address the deferral of experience gains and losses and the determination of the discount rate assumption, which could lead to amendments to the current standards.
2. Phase Two will focus on how to account for new types of pension plans in Canada (shared risk plans, target benefit plans), multi-employer defined benefit pension plans and vested sick leave benefits. This phase will ultimately lead to the replacement of the existing PS 3250 and PS 3255 sections with a completely new comprehensive section.

Public sector entities can currently defer the recognition of actuarial gains and losses to future years, with gains and losses being amortized over the estimated average remaining service life (EARSL) of active members of the plan. In addition, an entity can use a market-related approach when valuing the plan assets, which essentially smooths the investment gains and losses over a period not to exceed five years. However, other accounting standards bodies have decided in the last few years to eliminate such deferral provisions, mostly because many feel that the net pension liability (or asset) reported in the balance sheet does not fairly represent the obligation (or asset) of the entity when actuarial gains and losses are not immediately recognized. Furthermore, combining amounts arising from the activities of the current period with the amortization of gains and losses of prior periods in the determination of the plan expense can be difficult to understand.

There are valid arguments to justify eliminating the deferral of gains and losses approach, the most obvious of which are full transparency of financial statements and enhanced comparability between public sector entities. Nonetheless, the Task Force is also cognizant of the environment in which these entities operate, namely that many of them are required to have a balanced budget in every reporting period and that any additional volatility in the surplus/deficit will be difficult to budget for, due to the size of th liability and expense. Also, the general consensus is that public sector entities are different from those in the private sector, because in many cases of their power to tax and low risk of default,

which may suggest that it is less imperative to report the gains and losses in the period in which they arise.

PSAB is using a "components approach" when looking at the various types of actuarial gains and losses. They include changes in the actuarial assumptions (economic and demographic), experience adjustments, and unexpected investment return. The nature of each component of the changes in the defined benefit obligation and the value of plan assets needs to be understood, before evaluating which recognition treatment is the most appropriate. PSAB identified three recognition options:

- *Immediate recognition* in the annual surplus/deficit as it arises;
- *No recognition* in the annual surplus/deficit when it arises or in subsequent periods (no recycling); or
- *Deferred recognition* in the annual surplus/deficit in subsequent periods (recycling).

It is important to note that PSAB has not yet established a preliminary view on the most appropriate financial reporting model, which is one of the main reasons why the ITC is seeking stakeholder input. Therefore, the recognition options are not limited to those listed above.

Conclusion

The effective date of any potential amendment to the standards will likely be a few years away as a result of PSAB's due process. It will be interesting to see in the coming months how the stakeholders will respond to the ITC and how the various public sector entities will reconcile the practical nature of employee benefits reporting with the need for full transparency and comparability of financial statements.

The Task Force published the first *Invitation to comment* (ITC) in November 2016, which is focused on the deferral provisions of the standards. Stakeholders may send their comments until **March 3, 2017**. The second *Invitation to Comment*, which will focus on the discount rate assumption, is scheduled for **later in 2017**.

CAPSA: Revised Governance Guideline

On December 22, 2016, the Canadian Association of Pension Supervisory Authorities ("CAPSA"), consisting of Canada's pension regulators, published revised *Guideline No. 4: Pension Plan Governance Guideline*, along with the related *Self-Assessment Questionnaire and FAQ Document* (together, the "Governance Guideline"), in final form following industry consultation. The previous version of the Governance Guideline was released in October 2004 and this revision was released in draft on March 11, 2016 (see our *News & Views* of April 2016).

The revised Governance Guideline includes a number of revisions and additions, including the following:

- Expanded explanations of fiduciary duties, including situations when a fiduciary relationship exists and the responsibilities that flow from that relationship;
- Guidance for creating a governance framework, including a suggestion that an administrator can create an electronic governance "binder" that stores plan-related material under various folders;
- Guidance for documenting various plan administration roles and responsibilities, including a sample tool for documenting roles and responsibilities;
- Clarifying an administrator's duty to monitor and document plan administration;
- Guidance on how to develop an appropriate level of knowledge and skills for the parties involved in pension plan administration (such as pension committee members and the employer's finance and human resources departments);
- Examples of risks faced by pension plans, such as funding, investment, and operational risks;
- Guidance on methods and substance of communications with members;
- Guidance with respect to conducting a governance review.

The Governance Guideline maintains the eleven Governance Principles contained in the original 2004 Governance Guideline. The Self-Assessment Questionnaire has been changed to add additional questions (there are now 28 questions rather than the initial 21), and the FAQ Document has been significantly expanded and revised.

In general, the Governance Guideline has been revised to emphasize that governance and administrative practices need to be documented, and to make it easier for plan administrators to review their compliance with the Governance Principles.

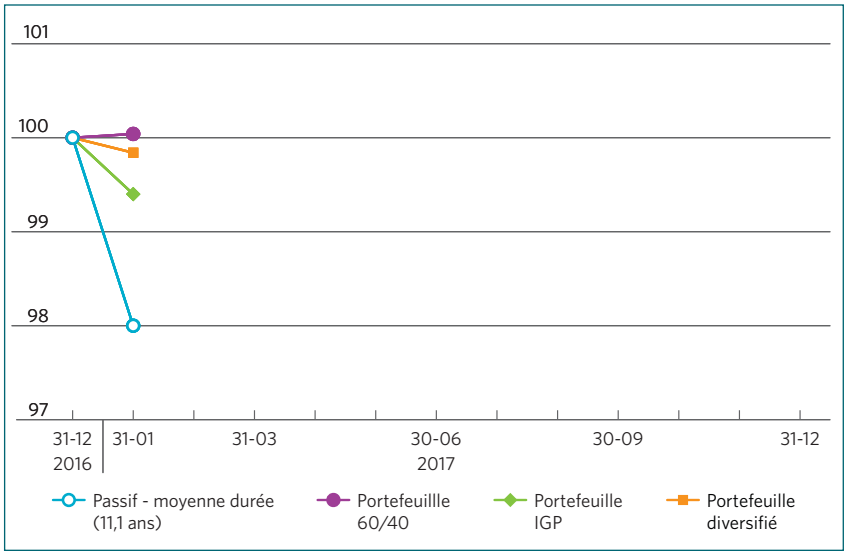
Conclusion

The Governance Guideline (along with other guidelines released by CAPSA) has been increasingly referred to by Canadian pension regulators to help pension plan administrators understand their duties and obligations with respect to plan administration and governance. Pension plan administrators should periodically review their compliance with the Governance Guideline, and can expect that regulators will consider the administrator's compliance with the Governance Guideline as part of an examination or audit.

Tracking the funded status of pension plans as at January 31, 2017

This graph shows the changes in the financial position of a typical defined benefit plan with an average duration since December 31, 2016. For this illustration, assets and liabilities of the plan were each arbitrarily set at $100 million as at December 31, 2016. The estimate of the solvency liabilities reflects the newest CIA guidance. 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, 2016



During the month of January, Canadian universe bonds, Canadian long term bonds, Canadian long-term provincial bonds, global equities and alternative investments obtained negative returns, while Canadian equity markets showed positive returns. With a return of 0.0%, the 60/40 portfolio outperformed the highly diversified portfolio (HD) (-0.2%) and the low volatility portfolio (LDI[1]) (-0.6%). The underperformance of the low volatility portfolio (LDI) is explained by higher allocation in Canadian bonds. The prescribed CIA rates used in the calculation of solvency liabilities increased during the month, decreasing the solvency liabilities by 2.0% for a medium duration plan. For this type of plan, an investment in either of the 60/40, the LDI or the HD portfolio resulted in a solvency ratio increase.

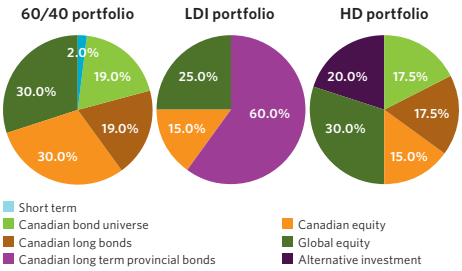
The table below shows the impact of past returns on plan assets as well as the effect of interest rate changes on solvency liabilities, based on the plan's initial solvency ratio as at December 31, 2016.

Initial solvency ratio as at December 31, 2016	Evolution of the solvency ratio as at January 31, 2017 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	102.1%	101.4%	101.9%
90%	91.9%	91.3%	91.7%
80%	81.7%	81.1%	81.5%
70%	71.5%	71.0%	71.3%
60%	61.2%	60.9%	61.1%

[1] Liability driven investment

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.



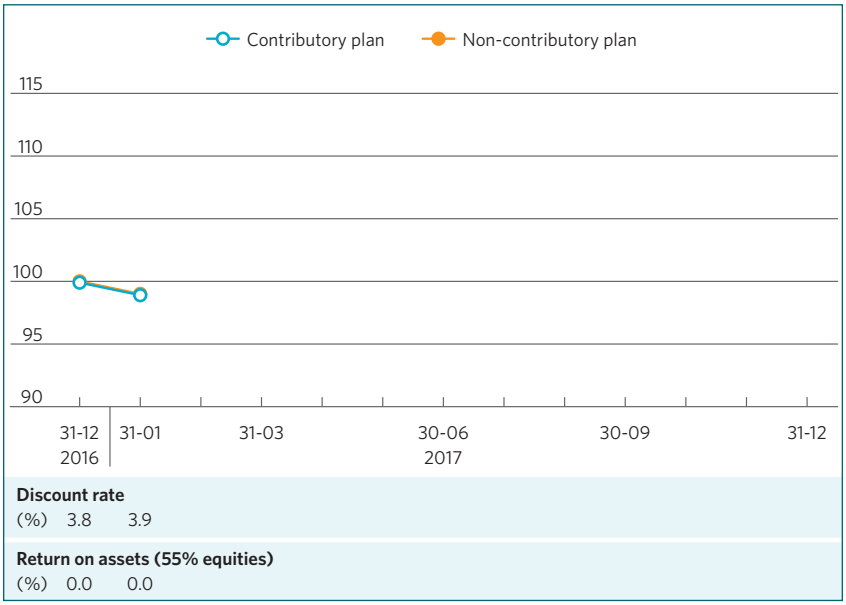
Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.

Impact on pension expense under international accounting as at January 31, 2017

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, 2016



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

Duration	December 2016	January 2017	Change in 2017
11	3.66%	3.63%	-3 bps
14	3.81%	3.81%	0 bps
17	3.90%	3.92%	+2 bps
20	3.96%	3.99%	+3 bps

Since the beginning of the year, the pension expense has decreased by 1% (for a contributory plan) due to the increase in the discount rate.

Comments

1. The expense is established as at December 31, 2016, based on the average financial position of the pension plans used in our *2016 Survey of Economic Assumptions in Accounting for Pensions and Other Post-Retirement Benefits* report (i.e. a ratio of assets to obligation value of 94% as at December 31, 2015).
2. The return on assets corresponds to the return on the Morneau Shepell benchmark portfolio (55% equities and 45% fixed income), which reflects the average asset mix in our *2016 Survey*.
3. The actuarial obligation is that of a final average earnings plan, without indexing (two scenarios: with and without employee contributions.

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