Knowledge & Insights

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In this issue

Quebec: Regulation on funding policies and annuity purchases

A draft regulation to amend the *Supplemental Pension Plans (SPP) Regulation* was published on July 12, 2017 in the *Gazette officielle du Québec*.

This draft regulation covers some of the same material as the draft regulation published July 20, 2016 (see our August 2016 *News & Views*) and adds new elements, in particular provisions regarding funding policies and annuity purchasing policies.

The following is a summary of the draft regulation.

1. Actuarial valuation report and letters of credit

The draft regulation makes some changes to the content of the actuarial valuation report and to letters of credit.

2. Funding policy

The funding policy required by the SPP Act must:

- indicate that its purpose is to establish the principles related to plan funding that must guide the pension committee in the performance of its duties;
- describe the main characteristics of the employer and the market trends observed in the employer's sector that could affect plan funding;
- describe the type of pension plan, its main provisions and the demographic characteristics that could affect plan funding;
- describe the funding objectives of the pension plan with regard to variations in and the level of contributions and benefits;
- identify the main risks related to funding of the pension plan and the employer's and active members' level of tolerance thereto.

The funding policy may also provide specifications with regard to any question related to the pension plan's funding goals, particularly with regard to:

- the determination of the value of the liabilities and the determination of the value of the assets for, among other things, the smoothing of assets, or the use of an implicit margin in the interest rate assumption;
- the circumstances giving rise to the reduction of a letter of credit;
- the frequency of actuarial valuations not required under the SPP Act; and
- the measures that could be used to quantify and manage the risks related to plan funding.

The funding policy must be established no later than one year after the regulation comes into force. Note that the funding policy must be adopted by the person or body who may amend the plan.

3. Annuity purchase policy

When an annuity purchase policy is established, to permit the plan to discharge its obligations, it must indicate:

- that it has been established by the person or body who may amend the pension plan;
- the rules regarding its revision;
- the frequency at which and the circumstances under which annuity purchases may be made from an insurer;
- whether the benefits of members and beneficiaries may be paid in part and the special conditions that apply to such a payment;
- the funding requirements with respect to maintaining the degree of solvency of the plan and for making the special annuity purchasing payment to the pension fund;
- the obligation to obtain the written consent of the employer with regard to making the special annuity purchasing payment;
- the criteria for selecting the annuities to be purchased from an insurer;
- the requirements regarding the characteristics that the annuity purchased from an insurer must have and the conditions under which the characteristics of the pension may be replaced, in particular regarding the written consent of the member or beneficiary with regard to replacing the characteristics of his or her pension;
- the information that must be provided to each member and beneficiary regarding the purchase of his or her annuity, such as the amount and the characteristics of the annuity purchased, the name and contact information of the insurer and the rules provided for in the SPP Act regarding, upon plan termination, the retention of status as a

member or beneficiary for three years for certain purposes under the plan (with respect to the allocation of surplus assets or the reduction of benefits following the employer's bankruptcy or insolvency);

- the process and the criteria for choosing the insurer;
- the effective date of the annuity purchase policy.

In addition to addressing the content of the annuity purchase policy, the draft regulation also provides the following requirements:

- The annuity purchased from an insurer must have the same characteristics as the pension payable under the plan.
- If no annuity of the type to which the member or beneficiary is entitled is available on the market due to its nature, in order to have an insurer guarantee the pension, the characteristics of the annuity that make it unavailable on the market may be replaced by similar characteristics of equal value. In such a case, for the purchase of the annuity to be considered final payment of benefits, the member or beneficiary must, within 30 days of the date on which the notice is sent, consent in writing to the replacement of the characteristics of his or her pension.
- Insured annuities held by a plan may be paid in accordance with the annuity purchase policy of the pension plan by subrogating the member or beneficiary of the annuity in the rights of the pension fund as regards the contract entered into with the insurer.
- The payment of benefits under an annuity purchase policy is subject to funding requirements including:
  - An actuarial valuation must be performed as at the annuity purchase date;
  - Where the actuarial valuation shows that the degree of solvency of the plan is less than 100%, a special annuity purchasing payment must be paid to maintain the degree of solvency of the plan at the level established before the annuity purchase.
  - Where the degree of solvency is greater than or equal to 100%, the payment of benefits must not cause the degree of solvency of the plan to be less than 100%. Otherwise, a special annuity purchasing payment must be paid into the pension fund to maintain the degree of solvency at 100%.

Note that the provisions concerning the annuity purchase policy do not apply to municipal and university sector pension plans. Currently, a municipal or university sector pension plan may purchase annuities, but such purchase does not release the plan from its obligations to the members for whom these annuities were purchased.

4. Subjects on the agenda of the annual meeting

In addition to the subjects required under the SPP Act, the following subjects must be on the agenda of the annual meeting:

- the main risks related to plan funding identified in the funding policy;
- the measures taken, in the course of a fiscal year of the plan, to manage the main risks related to the plan's funding;
- in the case of a pension plan that has adopted an annuity purchase policy, since the previous annual meeting, the number of annuities purchased and the premium required by the insurer for each annuity purchased and, if applicable, the amount of the employer's special annuity purchasing payment.

5. Statements

New content has been added to member statements, in particular:

- Annual statements: information about the degree of solvency, the stabilization provision and the banker's clause;
- Annual statements for non-active members and beneficiaries: information when the plan's annuity purchase policy is applied to final payment of benefits.

Annual statements for a fiscal year ended before December 31, 2017 may simply comply with the current provisions of the regulations (i.e., those in effect on the date prior to the effective date of this regulation).

6. Variable benefits under a DC plan

Where a pension plan provides for the payment, as a life income, of variable benefits under a defined contribution (DC) provision, the following rules apply:

- for each fiscal year, the member or spouse sets the income to be received as variable benefits;
- the minimum income paid is that prescribed for a registered retirement income fund (RRIF) by the *Income Tax Regulations;*
- the maximum income paid is set in accordance with the rules applicable to the life income fund (LIF), which apply with the necessary modifications.

Furthermore, where a pension plan provides for the payment of variable benefits as temporary income, special rules apply depending on whether the member is at least 55 years of age but less than 65 years of age, or where the member is less than 55 years of age.

The plan administrator shall, at the beginning of each year, provide the member with a statement that indicates the information prescribed for a LIF, with the necessary modifications.

7. Transfer of benefits between spouses

For the purposes of provisions with respect to the transfer of benefits between spouses, the definition of "pension benefits" is amended to eliminate any reference to the additional pension benefit. The method of determining total benefits is also amended, in particular by the elimination of any reference to the additional pension benefit.

Where there is a transfer of benefits from the member to the member's spouse due to the member's partition of benefits, the payment is no longer subject to the rules governing payment in proportion to the degree of solvency.

The provisions with respect to the transfer of benefits between spouses will apply to transfers executed as of the third month following the final publication date of the regulation.

Comments

Comments are solicited within 45 days of the publication of this draft regulation. The regulation will come into force on the 15th day after final publication in the *Gazette officielle du Québec*.

Quebec: Amendments to the funding of municipal and university pension plans

A draft regulation to amend the *Regulation respecting the funding of pension plans of the municipal and university sectors* was published on August 2, 2017 in the *Gazette officielle du Québec*.

The purpose of the draft regulation is to exclude the stabilization contributions paid by a member from the 50% rule. The draft regulation however states that such stabilization contributions must be taken into account for the purposes of the 100% rule.

The draft regulation also provides that the report on an actuarial valuation taking into account the stabilization contributions paid by a member and sent to Retraite Québec before August 2, 2017 may be revised or replaced, subject to certain conditions.

Comments

Comments are solicited within 15 days of the publication of this draft regulation. The regulation will come into force on the 15th day after final publication in the *Gazette officielle du Québec*. In some cases, provisions regarding actuarial valuation reports may be applied retroactively.

2017 Survey: Economic assumptions for accounting

Recently, Morneau Shepell issued its 17th annual survey on the economic assumptions used by Canadian public companies to account for the costs of their defined benefit plans. The data was gathered from audited financial statements as at December 31, 2016.

Here are a few highlights of the survey:

- Discount rates at December 31, 2016 have decreased when compared to the prior year. The median discount rate was 3.80% as at December 31, 2016 compared to 4.00% a year earlier. The discount rates used for non-pension benefits are similar to those used for pension benefits.
- More than three quarters of the companies surveyed used a compensation increase assumption between 2.50% and 3.50% (median of 3.00%, which is identical to last year's median).
- Companies surveyed showed a 93% overall ratio of pension assets to defined benefit obligation for accounting purposes.
- The median assumption for the short-term medical cost trend rate was 6.20%, while the median ultimate trend rate was 4.50%. Those rates are identical to last year.

For complete details of the survey, please refer to the document available on the Morneau Shepell website.

CAPSA: Consultation on funding and asset allocation in multi-jurisdictional pension plans

On July 13, 2017, the Canadian Association of Pension Supervisory Authorities (CAPSA) released a consultation paper with options for funding and asset allocation in defined benefit (DB) multi-jurisdictional pension plans. The consultation paper is meant to address the move away from solvency funding in certain jurisdictions, such as the 2016 funding reform in Quebec and the pending changes to the Ontario funding framework.

Background

In 2016, an interim Multi-Jurisdictional Pension Plans Agreement (MJPPA) was adopted by British Columbia, Nova Scotia, Ontario, Quebec and Saskatchewan. The MJPPA sets out rules for the administration and funding of pension plans with members in multiple Canadian jurisdictions. The 2016 MJPPA was explicitly stated to be an interim measure while a future agreement covering all Canadian jurisdictions is developed.

The concern of regulators is that, if different jurisdictions in Canada have significantly different funding rules, a pension plan member in a particular province could have his or her benefits differently funded depending on where the pension plan is registered. For example, a member located in a jurisdiction requiring full solvency funding would have less protection if the pension plan was registered in a jurisdiction without solvency funding. Additional funding is contemplated in order to protect the interest of such members.

Option 1 – Continue current rules

The first option would essentially be a continuation of the current funding model under the MJPPA. The funding rules of the pension plan's jurisdiction (the Major Authority) would apply. However, if the funding rules of a member's jurisdiction (the Minor Authority) require a particular benefit to be funded that is not required to be funded in the Major Authority, then the benefit would have to be funded. The benefit would be funded in accordance with the Major Authority's rules.

Upon plan wind-up, the benefits that are funded would be allocated pro-rata to the plan's defined benefit liabilities in each applicable jurisdiction.

Option 2 – Additional funding requirements

Option 2 would also incorporate the rule requiring Minor Authority benefits to be funded, as set out

under Option 1. In addition, if the Major Authority did not require solvency funding but the Minor Authority did, an additional liability would be calculated in respect of members in the Minor Authority. The amount of the additional liability would be calculated to account for the difference between solvency funding under the Minor Authority's funding requirements and the Major Authority's funding requirements. The grossed up amount related to the Minor Authority's DB liabilities would then be funded in accordance with the Major Authority's legislation.

This requirement for an additional liability could be limited to certain circumstances, such as when the plan is funded at less than 95% on a solvency basis (with no asset smoothing), or when the amount of the additional liabilities would equal at least 10% of the plan's total DB liabilities calculated on a solvency basis.

Upon plan wind-up, there would be an adjustment upwards for members in the Minor Authority if any additional funding was required in respect of that Minor Authority in the last 10 years, roughly in proportion to the amount of additional funding that was required.

Conclusion

Public comments are requested by **August 31, 2017**. CAPSA did not provide a timeline for adoption of a final MJPPA.

Letter of credit limits for federally regulated DB plans: Increase now in force

Further to the release of draft regulations on April 29, 2017, the Federal government has adopted regulations to amend the *Pension Benefits Standards Regulations 1985* (the "PBSR"), to change the maximum amount of a letter of credit for a federally regulated defined benefit (DB) pension plan from 15% of assets to 15% of solvency liabilities.

There are no significant changes between the final amendments adopted and the proposed amendments (see the May 2017 edition of our *News and Views*).

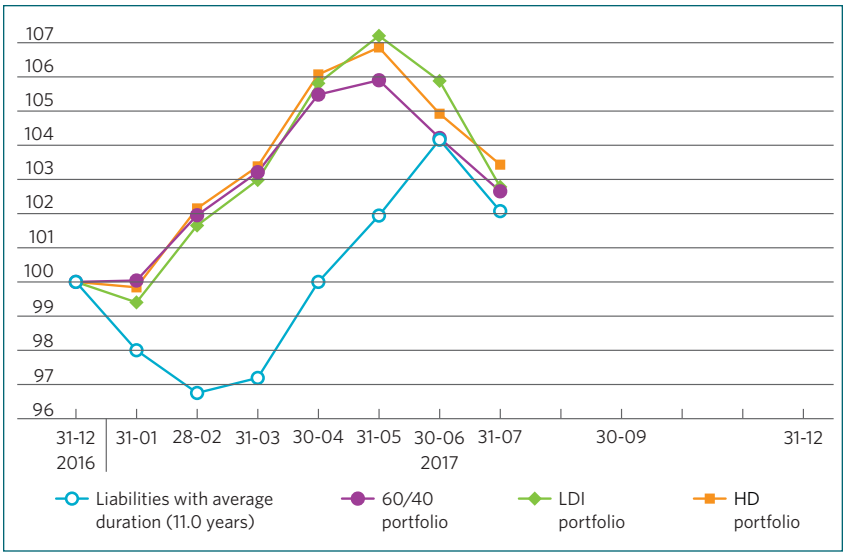
The other changes included in the draft regulations, regarding locked-in accounts, were also adopted without significant modifications.

The amendments to the PBSR became effective on June 23, 2017.

Tracking the funded status of pension plans as at July 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 new CIA guidance for valuations effective June 30, 2017 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, 2016



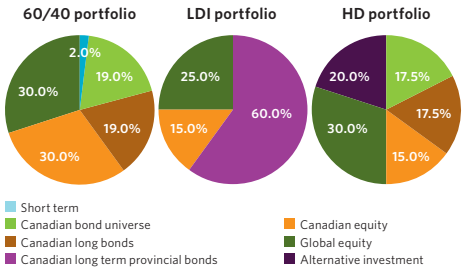
During the month of July, Canadian universe bonds, Canadian long term bonds, Canadian long-term provincial bonds, alternative investments (CAD), the Canadian equity market as well as global equity markets (CAD) showed negative returns. With a return of -1.4%, the highly diversified portfolio (HD) outperformed the low volatility portfolio (LDI[1]) (-2.9%) and the 60/40 portfolio (-1.5%). The relative outperformance of the highly diversified portfolio is explained by a smaller weight in Canadian long term bonds and no exposure to Canadian long-term provincial bonds. The prescribed CIA annuity purchase rates and the 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 the 60/40 or the HD portfolio resulted in a solvency ratio increase while an investment in the LDI portfolio resulted in a solvency ratio decrease.

Initial solvency ratio as at December 31, 2016	Evolution of the solvency ratio as at July 31, 2017 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	100.6%	100.7%	101.3%
90%	90.5%	90.6%	91.2%
80%	80.5%	80.6%	81.1%
70%	70.4%	70.5%	70.9%
60%	60.3%	60.4%	60.8%

[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.



The table shows the impact of past returns on plan assets and the effect of interest rate changes on solvency liabilities of a medium duration plan, based on the plan's initial solvency ratio as at December 31, 2016 as well as the asset allocation of the three typical portfolios. Since the beginning of the year, driven by strong returns in global equity markets as well as the alternative investments, the 60/40 portfolio, the LDI portfolio and the HD portfolio returned 2.6%, 2.8% and 3.4% respectively. The solvency liabilities increased over that same period from 1.9% to 2.1% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at July 31, 2017 stands between 0.3% and 1.3%.

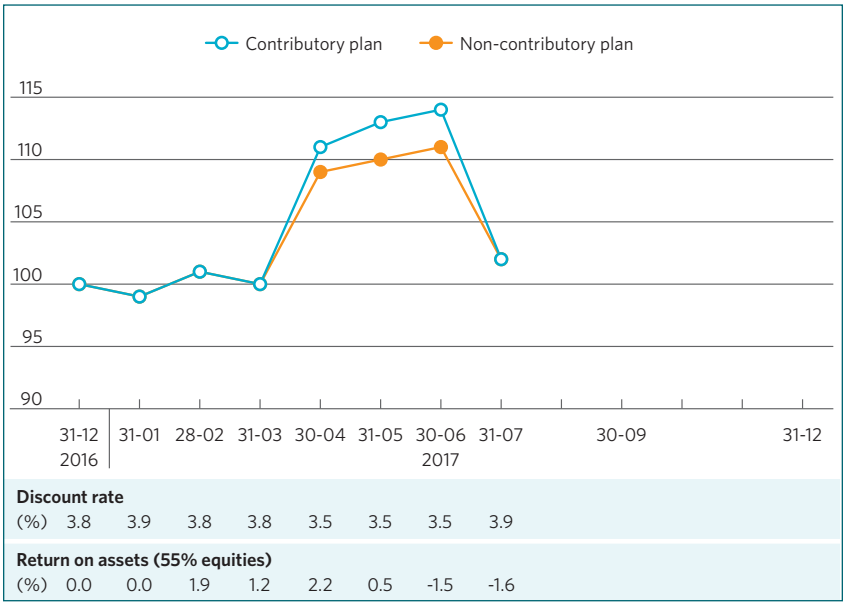
Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.

Impact on pension expense under international accounting as at July 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	July 2017	Change in 2017
11	3.66%	3.70%	+4 bps
14	3.81%	3.84%	+3 bps
17	3.90%	3.92%	+2 bps
20	3.96%	3.98%	+2 bps

The discount rate has increased in the last month, resulting in a reduced expense, despite poor returns (relative to the discount rate). Since the beginning of the year, the slight increase in the discount rate combined with returns slightly above expectations (relative to the discount rate) has resulted in the pension expense returning almost to its level at the beginning of the year.

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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