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Canada Post Task Force identifies pension deficit as key issue

In September 2016, the Canada Post Task Force issued its discussion paper, *Canada Post in the Digital Age*. The Task Force was set up in May 2016 by the Minister of Public Services, Judy Foote, to identify options to help put Canada Post on a sustainable long-term financial footing. Among other issues, the discussion paper identifies Canada Post's pension deficit as a key issue that needs to be dealt with in order to achieve financial sustainability. The discussion paper was released in preparation for a public consultation and is one of many sources that will be used to shape the future of Canada Post.

The discussion paper summarizes the main challenges specifically faced by Canada Post, but the options and conclusions would be applicable to many defined benefit pension plan sponsors in both the public and private sectors who are struggling with the long term sustainability of their defined benefit pension plans. The conclusions could also be helpful to governments in their efforts to make defined benefit pension plan sponsorship more sustainable for employers.

Financial position of the Canada Post pension plan

At December 31, 2015, the Canada Post pension plan, one of the largest in the country with more than $20 billion in assets and liabilities, was in a slight surplus position on a going-concern basis but had a huge **$5.9 billion** solvency deficit[1]. The going concern funded ratio was 106% and the solvency funded ratio was 78%. The solvency position of the plan has deteriorated in recent years mainly because of declining interest rates, and continued deteriorating this year, as the solvency deficit is estimated to have increased to **$8.1 billion** as of June 30, 2016.

In 2011, the Government provided all Crown corporations with temporary relief from the need to make solvency special payments and allowed them to utilize a special kind of "letter of credit" (whereby the government basically acts as a bank to guarantee the amount of the letter of credit), but with a limit of 15% of plan liabilities. Solvency funding relief was extended for Canada Post for an additional four years in February 2014. However, this relief is now scheduled to end in 2018.

According to the Task Force, the defined benefit pension plan puts significant pressure on Canada Post's financial situation. The solvency deficit may result in a significant need to increase borrowing requirements. The funding requirements tied to interest rate volatility put Canada Post at risk of being unable to sustain its business, including investing in capital assets.

Options available to Canada Post

The discussion paper summarizes the options available to Canada Post in the following table:

No.	Option	Effectiveness	Ease of implementation
1	Eliminate solvency valuation requirement	**High** No solvency funding required	**Medium** Government consent needed
2	Defer solvency valuation requirement or extend amortization period for making solvency payments	**Medium** Limitation of solvency funding	**Medium** Government consent needed
3	Amalgamate the pension plan with the federal government Public Service Pension Plan	**High** No solvency funding required	**Medium** Government consent needed
4	Exclude post-retirement indexing from solvency funding requirements (as is already done in Nova Scotia and Ontario)	**High** No solvency funding required	**Medium** Government consent needed
5	Convert pension plan to a shared risk model	**Medium** Limitation of solvency funding	**Low** Government and employee consent needed
6	Adjust inflation assumptions in the solvency valuation	**Medium** Limitation of solvency funding	**High** Management decision only
7	Amend plan design to reduce certain benefits	**Low** Limited reduction in solvency funding	**Low** Government and employee consent needed
8	Introduce a DC pension plan	**Low** Limited reduction in solvency funding	**Low** Government and employee consent needed
9	Improve investment management and asset to liability matching	**Low** Limited reduction in solvency funding	**High** Management decision only

1 A solvency valuation is based on the estimated cost of providing the pensions should the pension plan be terminated, which is more expensive than running a pension plan on an ongoing, or "going-concern", basis. A solvency valuation helps to protect plan members in case the employer were to become insolvent and thus leave members relying only on the plan's assets to receive their promised pension benefits. Solvency deficits are normally funded over 5 years, while going-concern deficits are funded over 15 years.

To illustrate the potential impact of certain options listed above, the Task Force estimated that Option 4 (i.e. excluding the value of indexing) could eliminate the solvency deficit completely, while Option 6 (i.e. adjusting the inflation assumption from 2% to 1.5%, for example) could reduce the solvency deficit by more than $1 billion.

Key points made by the Task Force are as follows:

- The elimination or further deferral of solvency funding requirements would be a significant benefit to Canada Post and of high effectiveness. The federal government's consent would be required and it is possible that such a solvency exemption would be seen as a precedent for other crown corporations. It should be noted that some public service pension plans in Canada, including the federal Public Service Pension Plans (PSPP), are already exempt from solvency funding requirements, as the possibility of plan termination is considered quite low and the possibility of plan sponsor insolvency is non-existent.
- The Canada Post assets and liabilities could be reabsorbed into the federal PSPP from which it originated. This would be another way of providing a solvency funding exemption, given that the PSPP is not subject to solvency funding requirements. The Task Force notes that reverting assets and liabilities to the PSPP may be viewed unfavorably by the competitive marketplace, as it could be seen as an unfair competitive advantage for Canada Post. However, it also notes that the legacy of the PSPP design is a burden on Canada Post that private sector competitors do not have to bear.
- Subject to legislative changes, another alternative would be the conversion to a Shared Risk model. This would allow greater flexibility in funding and potentially adjusting benefit levels or ancillaries such as indexing. Within the Shared Risk framework, for example, Canada Post could continue to provide a guaranteed base pension to employees but only provide indexing conditional on investment performance. The prior federal government had proposed a target benefit model in April 2014 (see our *Special Communiqué*), but it is now unclear if and when the new government intends to consider such possible rule changes.
- The impact of changes to benefit design, including the introduction of a defined contribution pension plan, is minimal in the near term as design changes are generally limited to changes to future service accruals, thus not impacting the current solvency deficiency but limiting the growth of solvency deficiency in the long term.

Comments

The Canada Post Task Force seems to point to the elimination of solvency funding, either through legislative reform or through merger with the federal Public Service Pension Plan as one of the most effective options for putting Canada Post's pension arrangements on a sustainable long term footing. We note that these options would not be an option for most private sector organizations in Canada at this time. The possibility of converting the plan to a shared risk model should be a viable alternative to consider at Canada Post and other public and private sector organizations wrestling with pension sustainability issues. This model could potentially provide a balanced sharing of risk between employers and employees, and could help manage both legacy costs and the cost of future benefits. However, legislative reform would be required in order to help make this model a reality. So far only New Brunswick, Alberta and British Columbia have taken significant steps in this regard.

Consultation

The Task Force report represents Phase 1 of the Minister's review; Phase 2 is a public consultation being held by a Parliamentary Committee in cross-country meetings between September 26 and October 7, while on-line comments may be submitted until **October 21**.

Ontario to permit appointment of replacement administrator if employer is restructuring

On September 13, 2016, the Ontario government proposed regulations that would allow the Superintendent of Financial Services to appoint or act as the administrator of an Ontario-registered pension plan in prescribed circumstances. In 2010, Ontario passed amendments to the *Pension Benefits Act* to permit such regulations, but the amendments to the *Pension Benefits Act* have not yet been proclaimed.

Ontario legislation already permits the appointment of a replacement administrator to wind up a pension plan. The proposed regulations would permit the Superintendent to appoint a replacement administrator without the requirement for the plan to be wound up if the employer is bankrupt, in receivership or in restructuring under the *Bankruptcy and Insolvency Act* or the *Companies' Creditors Arrangement Act*. In such circumstances, appointment of an administrator may help limit conflicts of interest and protect benefits of members, retirees and other plan beneficiaries. The Supreme Court of Canada commented on such potential conflicts of interest in the 2013 case, *Sun Indalex Finance, LLC v. United Steelworkers*, and suggested that a replacement administrator could be one method of addressing potential conflicts of interest when a bankrupt or insolvent employer administers a pension plan.

Comments could be submitted by **September 22, 2016.**

Medications: Private insurance plans can contain costs

With the arrival in 2010 of the generic forms of Lipitor and Crestor, some group insurance plan sponsors stopped worrying about the costs of treating hypercholesterolemia, commonly referred to as high cholesterol.

But Repatha and Praluent—two new cholesterol-lowering drugs known as PCSK9 inhibitors—may just get them to start paying attention again. The cost of these new drugs is estimated at around $7,500 per year, or about 15 times the cost of conventional medications (statins).

In Quebec, PCSK9 inhibitors are covered as an exceptional medication under the public drug insurance plan, and plan members must meet certain criteria before the drug is reimbursed. According to INESSS[1], approximately 10% of patients with familial hypercholesterolemia will be eligible for coverage. Based on these data alone, drug plan costs would climb 1% to 2%.

Elsewhere in Canada, governments are very reluctant to include PCSK9 inhibitors in their provincial formularies. A number of insurers have introduced prior authorization rules when permitted under the contract.

But the story doesn't end there. The huge market potential of these drugs—a fact not lost on pharmaceutical companies—means that the latter will be promoting the real benefits of these drugs not only to doctors, but also to the public. According to TELUS Health Solutions, the potential sales of PCSK9 inhibitors in Canada could grow to over $2.5 billion by 2026, which is more than the cost of statins. Therefore, for this drug alone, plans that have open access provisions pertaining to covered drugs can expect to see a 3% to 5% increase in the longer term.

This should hammer home to plan sponsors the importance of containing their health plan costs. Insurers have introduced a number of measures to limit access to expensive drugs or control costs. Sponsors are sometimes reluctant to implement such measures as they want their employees to appreciate their plan.

One solution is pre-authorization, which is an approach that restricts access to costly drugs only to plan members who meet specific criteria.

1 INESSS: Institut national d'excellence en santé et en services sociaux (in Quebec)

Sponsors must understand that this is a more cumbersome process that interferes with the doctor-patient relationship. This option, which sometimes requires union approval if the plan is subject to bargaining, must be well explained and communicated to members. Its implementation can be facilitated if insurers provide plan members with tools for real-time access to information about which drugs are covered and which ones have restrictions; this would help encourage informed, open discussions in the doctor's office, when the physician is prescribing the medication. In the case of PCSK9 inhibitors, this is the approach taken by the Quebec public plan and offered by some insurers.

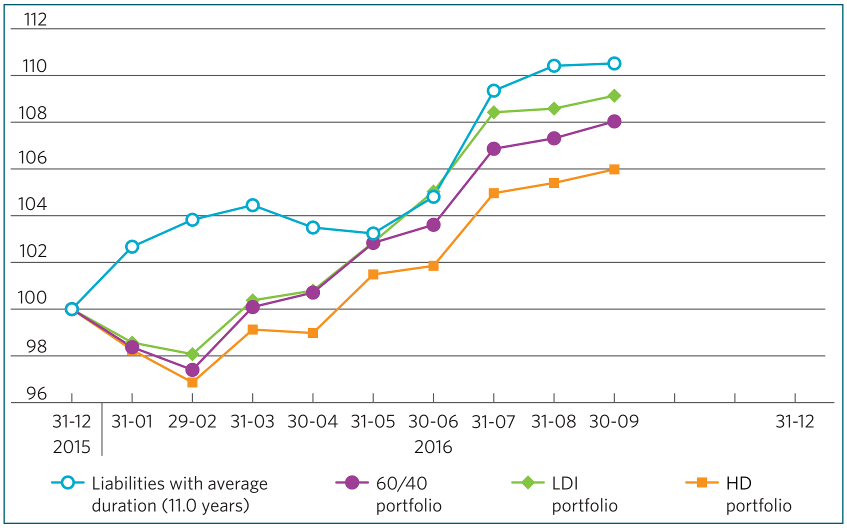
Given the mass influx of expensive drugs, it is well worth taking the time to have meaningful discussions with the various stakeholders involved in order to understand the issues surrounding the plan's sustainability, determine whether policy clauses need to be changed, strengthen cost control mechanisms as needed, examine which prevention techniques to use and their ROI, review risk pooling measures, focus on establishing clear communication with employees and align premium-sharing arrangements with the organization's overall compensation strategy, among other things.

Sponsors have their work cut out for them, and they will need courage to deal with these challenges. The most successful companies will be those that consult and collaborate with the various stakeholders to make the most informed choices.

Tracking the funded status of pension plans as at September 30, 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 August 2016 for valuations effective June 30, 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



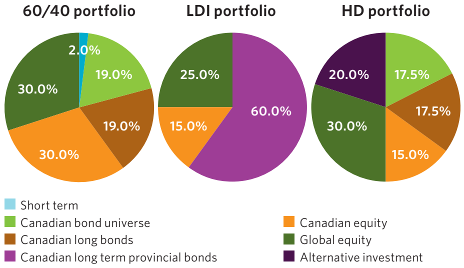
During the month of September, Canadian universe bonds, Canadian long term bonds, Canadian long-term provincial bonds, Canadian and global equity markets as well as alternative investments showed positive returns. With a return of 0.7%, the 60/40 portfolio outperformed the highly diversified portfolio (HD) (0.6%) and the low volatility portfolio (LDI) (0.5%). The outperformance of the 60/40 portfolio is explained by higher allocation in Canadian equities. Annuity purchase rates slightly increased, while the rates used in the calculation of solvency liabilities remained stable during the month, increasing the solvency liabilities by 0.1% 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 tables below 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, 2015 as well as the asset allocation of the three typical portfolios.

Initial solvency ratio as at December 31, 2015	Evolution of the solvency ratio as at September 30, 2016 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	97.8%	98.8%	95.9%
90%	88.0%	88.9%	86.3%
80%	78.2%	79.0%	76.7%
70%	68.4%	69.1%	67.1%
60%	58.7%	59.3%	57.5%

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.



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 8.0%, 9.1% and 6.0% respectively. The solvency liabilities increased over that same period between 9.7% and 10.9% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at September 30, 2016 stands between -4.1% and -0.7%.

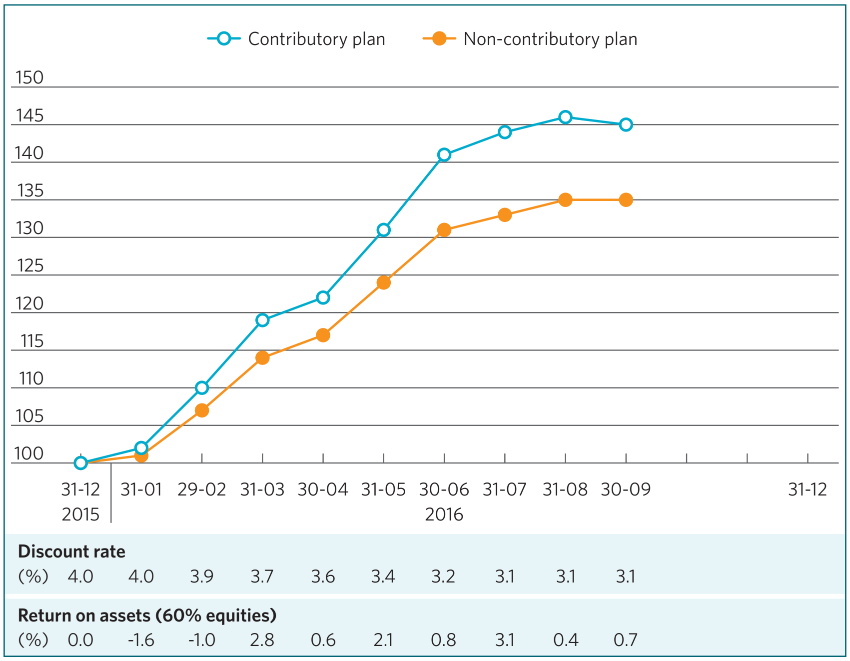
Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.

Impact on pension expense under international accounting as at September 30, 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



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 2015	September 2016	Change in 2016
11	3.71%	2.91%	-80 bps
14	3.91%	3.04%	-87 bps
17	4.04%	3.11%	-93 bps
20	4.12%	3.16%	-96 bps

Since the beginning of the year, the pension expense has increased by 45% (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).

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