Knowledge & Insights

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CPP expansion: Legislative changes and chief actuary's valuation

Following up on the finance ministers' agreement to expand the Canada Pension Plan (CPP) on June 20, 2016 (see our *Special Commmuniqué* of June 2016), and the assent of all provinces other than Quebec, the federal government introduced Bill C-26 on October 6, 2016. Bill C-26 amends the Canada Pension Plan, the *Canada Pension Plan Investment Board Act* and the *Income Tax Act* (ITA) in order to provide for the agreed-upon CPP expansion to be implemented gradually from 2019 to 2025.

CPP amendments

The current definition of the Year's Maximum Pensionable Earnings (YMPE) will be retained. A new definition of Year's Additional Maximum Pensionable Earnings (YAMPE) will be added to the CPP. The YAMPE will be 107% of the YMPE in 2024 and 114% of the YMPE thereafter.

This change is very significant. If the new, higher limit had been named the YMPE, then pension plans that are integrated with the CPP would have adjusted their benefits downward automatically. Instead, each plan will have to take action to make the change happen and to avoid providing overly generous benefits.

The new contribution levels will be termed "first additional contributions", in respect of the increased contributions for earnings up to the YMPE, and "second additional contributions", in respect of new contributions above the YMPE (collectively, the "additional contributions").

Retirement, survivor and disability pensions will be increased as a result of the additional contributions, subject to the amount of additional contributions made and the number of years over which these additional contributions are made.

The additional contributions will be held within the CPP in a separate account named the Additional Canada Pension Plan Account. These will be accounted for and valued separately, although they will form a part of the CPP. Pursuant to the legislative requirement that benefit enhancements should be fully funded, the additional contributions are intended to be sufficient to fully fund the new tier of benefits. If the Chief Actuary reports a shortfall, the CPP provides required contributions may be increased or the inflation adjustments may be decreased. It remains to be seen what impact this objective will have on the investments of the Additional Canada Pension Plan Account.

ITA Amendments

As previously announced, the first and second additional contributions will be fully tax deductible for all employees. The current level of contributions will continue to be subject to a tax credit based on the lowest tax rate, instead of being deductible from income.

The amendments to the Income Tax Act also implement increases to the Working Income Tax Benefit (WITB) starting in 2019. The WITB is a refundable tax credit intended to provide tax relief for eligible low income workers. The expansion of the WITB is meant to help them offset the impact of increased CPP contributions.

Chief Actuary's Report

On October 26, 2016, the Chief Actuary, Jean-Claude Ménard, presented the 28th Actuarial Report on the CPP, concluding that the projected contributions are expected to be sufficient to sustain the expanded CPP. It is expected that a separate, slightly less risky investment policy will be developed for the new tier of the CPP. Due to the funding approach of the additional CPP tier, in the long term investment income will become the major source of funding for the additional CPP tier. There is a small buffer built into the contribution rates for the additional CPP tier.

It is interesting to note that, in the very long term, once the current generation of younger workers retires and receives the full impact of the gradual benefit phase-in, the assets of the additional CPP tier will exceed the assets in the base CPP. This is a result of the requirement that the additional CPP tier be fully funded, as opposed to partial funding of the base CPP.

Conclusion

Bill C-26 is expected to be passed by the federal government in the near term. In the meantime, the Quebec consultation on expanding the Quebec Pension Plan has been delayed and may take place next year.

The Chief Actuary's report notes the importance of investment returns in ensuring the additional CPP tier is financially sustainable. This means that contribution rates for the additional CPP tier could be more sensitive to investment results. If the projected real rates of return are not achieved on the additional CPP tier assets, Canadians in the future might need to contribute more into the expanded CPP or receive less than full indexing on those benefits.

Federally regulated plans: Legislation introduced for target benefits and buy-out annuities

On October 19, 2016, the federal government introduced Bill C-27, which will permit the establishment of target benefit plans (TBPs) by federally regulated employers, for both single and multi-employer pension plans. Bill C-27 follows the 2014 consultation on target benefits for federal plans, as discussed in our *Special Communiqué* of April 2014.

Another important development is that Bill C-27 will also allow federally regulated defined benefit (DB) plans to purchase buy-out annuities to fully satisfy some or all of their liabilities under the plan and thereby fully extinguish their liability to members. This would be another tool allowing plan sponsors to manage risks.

Introduction to TBP

A TBP is a pension plan that allows for some or all of the plan benefits to be adjusted upwards or downwards based on the financial performance of the plan. Because of the risk to members, comprehensive target benefit legislation requires increased disclosure, governance and risk management that do not apply to a typical DB plan. There is general consensus that pooling of pension risks by groups of members can lead to a more efficient and effective pension delivery model, particularly for those who do not possess a deep knowledge of financial markets.

The Federal government chose a comprehensive risk management framework as the basis for the TBP legislation. The general framework is similar in many respects to the legislation introduced in New Brunswick in 2012 for Shared Risk Plans (SRPs). It is less similar to the approach taken to TBPs in Alberta and British Columbia.

The Target Benefit Plan model as written in the legislation could be described as "outcome-based", with the plan being expected to meet certain stability goals, based on actuarial modelling, at the date of establishment. The stability goals will be restricted by rules that will be prescribed in the upcoming regulations.

Establishment and conversion to TBP

According to the proposed rules, a TBP must be a newly established plan and may not include a defined contribution provision or regular defined benefits.

Defined benefits earned for service to date under a DB provision may only be transferred to a TBP with the consent of members, former members and survivors, as applicable. Consent is to be provided at an individual level, except that in a unionized workplace the union may consent on behalf of active members. Disclosure requirements to obtain consent will be prescribed in the regulations and must be approved by the Superintendent of Pensions. This differs from the approach used for SRPs in New Brunswick where conversion of past DB benefits is allowed under a prescribed high standard for benefit stability goals.

Bill C-27 imposes on TBPs requirements that resemble those applicable to existing Multi-employer Pension Plans (MEPPs) or to SRPs in New Brunswick, as shown in the following table:

Requirements for Target Benefit Plans

	Similar to existing MEPPs	Similar to New Brunswick 2012 SRP legislation
A target benefit plan must be administered by a board of trustees or other similar body.	✓	✓
The board of trustees or other similar body must include at least one individual chosen jointly by active members and employees eligible to join the plan and, if the number of former members and survivors exceeds a prescribed threshold, at least one individual chosen by former members and survivors.	✓	✓
A governance policy that complies with the requirements prescribed by regulations is required.	NEW	NEW
A funding policy that includes the objectives of the plan with respect to pension benefit stability, a deficit recovery plan and a surplus utilization plan must be adopted.	NEW	✓
Actuarial modeling is required before the target benefit plan is established and at prescribed intervals.	NEW	✓
Plan amendments may not amend the target benefit plan's objectives with respect to pension benefit stability.	NEW	✓
Plan amendments may not reduce previously accrued benefits unless the amendment results from the plan's funding policy.	NEW	✓
Plans terminated within 5 years of establishment will be subject to DB distribution rules for converted benefits.	NEW	✓
Transfer values to be established by regulations.	NEW	✓
Annual actuarial valuation reports are required.	NEW	✓

In comparison to the SRP rules in New Brunswick, the major difference in the administration of an ongoing federal TBP seems to be the requirement of adopting a formal governance policy. The proposed federal rules do not track the TBP rules in Alberta and British Columbia, which require governance and funding policies (as would apply to any defined benefit plan), but otherwise do not impose the same levels of actuarial analysis and specificity with respect to funding objectives, pension benefit stability and the circumstances in which benefits will be reduced.

Buy-out annuity purchase

Bill C-27 also permits DB pension plans to extinguish their liability to members through the purchase of a buy-out annuity. The annuity must be purchased from a life insurer or another issuer approved by the Superintendent. The plan must authorize the annuity purchase and the annuity must replicate the benefits under the plan.

Notice requirements will be prescribed by regulations.

Comments

The introduction of target benefit plans at the Federal level is a positive step that could boost the development of these types of plans across the country, offering a new middle-ground approach between DB and DC.

The ability for DB plan sponsors to extinguish liabilities through the purchase of buy-out annuities will help federally regulated DB employers implement de-risking initiatives and possibly remove pension liabilities from their financial statements.

While Bill C-27 will not affect employers who are not federally regulated, the introduction of outcome based and risk managed TBPs at the federal level may give additional encouragement for other jurisdictions to enable the establishment of TBPs. So far, only New Brunswick has a similar framework. Alberta and British Columbia also permit target benefit plans to be established, although Alberta currently does not allow conversion of accrued benefits. There is currently unproclaimed legislation in Nova Scotia and Ontario permitting target benefit plans to be established. Ontario is expected to move toward target benefit for MEPPs as a first step before single employer TBPs.

NOTE: Morneau Shepell played a key role in the development and implementation of outcome based and risk managed SRPs in the New Brunswick 2012 legislation, for the New Brunswick Teachers' Pension Plan reform of 2014 and for the reform of public service pension plans in PEI. Morneau Shepell has also participated in the conversion of British Columbia DB plans into TBPs.

VRSP: The deadline is fast approaching

For any Quebec employer that had 20 or more employees as at June 30, 2016, the deadline for setting up a Voluntary Retirement Savings Plan (VRSP) or other type of retirement plan that involves pay deductions is December 31, 2016. There are only a few weeks left for these employers to comply with VRSP legislation.

Here is some important information for these employers:

- Retraite Québec has confirmed that the deadline applies to the date on which the contract comes into force. Since contracts normally take effect 30 days after the notice is sent out to employees, employers must join a VRSP **by the end of November**.
- The Commission des normes, de l'équité et de la santé du travail (CNESST) is responsible for overseeing employers' compliance with the requirement to offer a retirement savings plan. Before imposing penalties ranging from $500 to $10,000 on employers that fail to comply, the CNESST will first try to make them aware of and encourage them to meet their obligations. Also, it will only intervene if employees complain that their employer has not complied with this provision of the Act.
- Even though the risk of being penalized in early 2017 is low, it is recommended that employers provide a retirement plan.
- Employers who already offer their employees a pension plan must ensure that all employees are eligible to join that plan. If some classes of employees are not eligible, they must be given the opportunity to participate in a retirement plan. In such cases, employers must decide whether to make them eligible to join the existing plan, or set up another plan. If an employer has 20 or more employees, and even only one employee is not eligible, the employer must still set up a plan by the end of 2016. Only the single employee in question will be able to participate in the VRSP. Even if other employees wish to join the VRSP, they are not entitled to do so.
- Employers may choose among a number of retirement savings vehicles, including an RRSP, DPSP, SPP, RPP, TFSA and VRSP. Each vehicle has its own features, administrative requirements and employer obligations. It is important to review each type of plan before making a decision. There has been a certain negative response to the VRSP because of its administrative requirements, to the point where some employers have refused to even consider it. However, employers should be aware that other retirement savings vehicles also have administrative and fiduciary requirements.

NOTE: Morneau Shepell is a VRSP provider approved by Retraite Québec.

Drug plans can benefit from biosimilars

In the last 10 years, there have been intensive pressures on drug costs coming from the development of new biologic drugs. A biologic drug is a medicinal product that is more than a simple combination of chemical compounds and in which the active ingredient is a biological substance. Claims of such drugs are increasing at a pace of about 15% per year and the average cost of such drug are very high (± $30,000).

There is good news for sponsors of health benefit plans – biosimilars are entering the market.

A biosimilar is a type of drug that is approved by Health Canada and is highly similar to an already approved biologic drug. It is also called Subsequent-Entry Biologic (SEB). Is it important to note that they are similar but not identical, which means that they are not the same as generic drugs.

Due to the complex nature of biologics and the high cost of R&D and clinical trials, biosimilar development comes with a higher price tag compared to the much lower cost of developing generics. The price of these biosimilar drugs are expected to be 20-30% lower than the brand name versions, whereas generic drugs can be 65-80% cheaper than their brand name counterparts.

Inflectra® (infliximab), the biosimilar of Remicade®, is already available on the market. Remicade is mainly used to treat rheumatoid arthritis but also other diseases (psoriasis, Crohn's disease). Because of its very high cost, Remicade is one of the highest cost drugs paid for by private health insurance programs, although the incidence of claims is quite low. About $1B of Remicade is sold in Canada annually.

More recently, Brenzys®, a biosimilar of Enbrel®, was authorized in Canada. Enbrel treats many of the same diseases as Remicade. About $400M of Enbrel is sold in Canada annually.

As mentioned, biosimilars are not generic drugs so they cannot be substituted by the pharmacist. It requires a therapeutic substitution that can only be authorized by physicians.

As it is expected that many others biosimilars will enter the market in the coming years, plan sponsors may wish to take advantage of such opportunities to control the cost of their drug plan. One way to adapt their insurance program is to force plan members to try biosimilars before using the brand drug, where biosimilars are available. This process is called "step therapy" and requires good communication to participants in order to limit the frustration of having the original prescription refused at the pharmacy in some cases.

Most insurers are able to manage "step therapy" but as with any plan change, there must be careful consideration of the pros and cons and how best to communicate the change to plan members. Step therapy is increasingly being utilized not just for biologics, but for many different kinds of drugs.

Premiums to provincial medical plans: Changes in BC and Quebec in 2017

In September 2016, the British Columbia government announced that the planned 4% increase to Medical Services Plan (MSP) premiums for 2017 has been cancelled. Premiums for those eligible for premium assistance will also be reduced by 4%.

The remaining changes to MSP premiums announced in the 2016 provincial budget (see our *News & Views* of March 2016) will be implemented effective January 1, 2017. These changes include no longer considering the number of children in a family in the calculation of MSP premiums, increasing the couple premium to twice the premium for singles, and increasing the income thresholds for premium assistance.

BC is one of only three provinces (the others are Ontario and Quebec) that currently requires health care premium payments from individuals and the only one of those three not to collect premiums through income or payroll tax. The government has suggested that further changes to MSP premiums will be made in the future.

Quebec announced in a late October 2016 economic update that the health contribution would be eliminated effective January 1, 2017. Employers in the province deduct the health contribution from employees' payroll. The government had previously announced that the health contribution would be gradually reduced and eliminated in future years. Employer contributions to the health services fund will continue.

OSFI issues instruction guides on disclosure requirements for DB and DC pension plans

In October 2016, the Office of the Superintendent of Financial Institutions (OSFI) released two Instruction Guides on disclosure requirements for defined benefit (DB) and defined contribution (DC) pension plans, respectively. The Instruction Guides replace a 1998 guide that was applicable to both DB and DC pension plans. Although for the most part the Instruction Guides summarize the requirements of pension legislation applicable to federally regulated pension plans, they provide useful guidance on OSFI's expectations of how plan administrators can meet legislative requirements and what should be provided to members at all stages of plan membership.

General principles

OSFI references an administrator's fiduciary responsibilities and states "the disclosure of information should be carried out in a manner that is consistent with the disclosure requirements of the legislation and with the administrator's fiduciary responsibilities and applicable standard of care".

The Guides say that administrators should aim to make disclosure of information timely, easily understood and accurate. Furthermore, any document provided to a member should give the name, address and telephone number for a contact person who can answer any follow-up questions.

Plan booklets

Although the federal pension legislation does not provide a list of topics to be included in the plan booklet or summary that is provided to members, the Instruction Guides includes a list of topics that OSFI expects to be addressed in the plan booklets provided to members. The main headings are as follows:

1. Description of the plan
2. Eligibility to join the plan
3. Contribution information
4. Investment options (DC)/investment of the pension fund (DB)
5. Plan expenses and fees
6. Benefits at retirement
7. Benefits on cessation of membership before retirement
8. Death benefits before retirement
9. Non-assignment/commutation of pension benefits
10. Marriage or common-law partnership breakdown
11. Termination of the plan
12. Additional information available on request

It should be noted that there are a number of specific requirements with respect to each heading. Although OSFI's previous disclosure guide included a number of specific requirements, the list of requirements has been significantly expanded. A federally regulated plan administrator should review the plan booklet or summary for accuracy and should ensure that the plan booklet meets OSFI's expectations.

Summaries of plan amendments

OSFI considers an amendment to a plan to be made as of the date that the decision regarding the amendment is properly adopted in accordance with the governance procedures for that plan.

OSFI expects plan administrators to apply the legislative requirement to provide notice of amendments broadly. OSFI assumes that most amendments to a plan could be considered applicable to all members of the plan. For example, while a particular amendment may not directly affect the benefit level of a particular class of members, it may have an impact on the funding of the plan. This may effectively require notice of nearly every DB plan amendment to all plan members, including former members.

CAPSA guidelines for DC plans

Although not legislatively required, OSFI recommends that CAPSA Guideline No. 8 – *Defined Contribution Pension Plans Guideline* and CAPSA Guideline No. 3 – *Guidelines for Capital Accumulation Plans* (the CAP Guidelines) should be followed by administrators of all DC pension plans. OSFI expects the plan administrator to provide the information recommended by CAPSA regarding topics such as decision-making tools, fees and expenses, transfer options and performance reports.

Portability

In addition to the prescribed information for statements, statements provided to members or survivors who are offered portability should also:

- Include a recommendation that members or survivors should seek independent financial advice before deciding on available portability options;
- State whether the administrator permits portability in the situations where notification is received after the expiration of the notification period given on the statement and if a re-calculation of the transfer amount (pension benefit credit) is possible in that circumstance (DB plans only);
- State that members or survivors who do not elect to take portability should file any future changes of address with the plan administrator.

Other information

In addition to the information described above, the Instruction Guides also summarize disclosure requirements relating to electronic communications, investment information, annual statements to members and former members (including spouses and common-law partners), termination/retirement/death statements, variable benefits (DC only), phased retirement (DB only), and plan termination. They also include checklists for annual member and former member statements for both types of plans.

Conclusion

The Instruction Guides provide a useful, comprehensive summary of the information disclosure requirements for federally regulated pension plans. Furthermore, they provide valuable insight into OSFI's expectations for communications and disclosure, which in some cases go above and beyond the strict legislative requirements.

Ontario adopts three regulations proposed earlier

On October 31, 2016, the Ontario government adopted three regulations which were previously discussed in *News & Views* this year.

Pension advisory committees

The Ontario government has adopted regulations for establishing pension advisory committees. The new rules on pension advisory committees will come into force on January 1, 2017.

There are no changes from the most recent draft regulations, issued on August 22, 2016 (see our *News & Views* of September 2016).

Superintendent's right to appoint replacement administrator

The Ontario government also filed regulations that allow the Superintendent of Financial Services to appoint or act as the administrator of an Ontario-registered pension plan in prescribed circumstances. These prescribed circumstances include the employer being in receivership, bankruptcy or restructuring. The new rules came into force on October 31, 2016 (see our *News & Views* of October 2016).

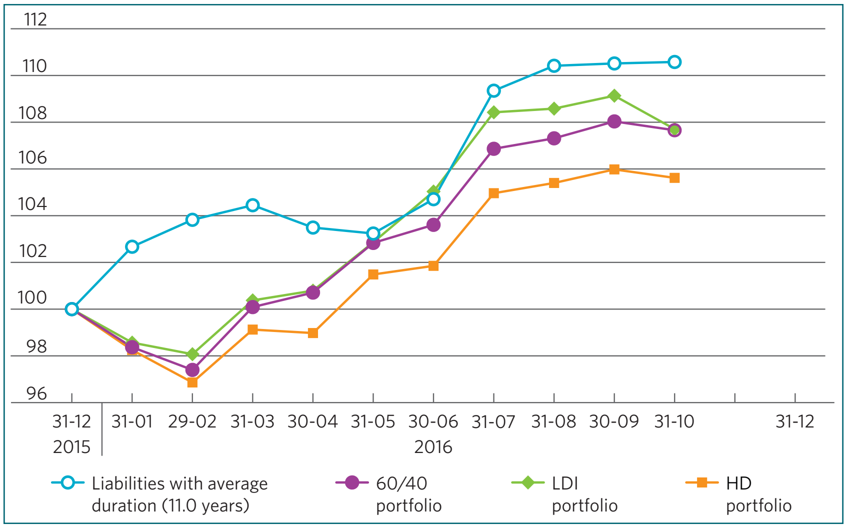
Additional solvency funding relief for the broader public sector

Finally, the Ontario government adopted regulations implementing additional solvency funding relief measures for pension plans in the broader public sector (see our *News & Views* of August 2016). The final version of the regulations modifies the solvency deficit that needs to be funded based on a quarter of the difference between 100% and the solvency ratio (instead of half as proposed originally).

Tracking the funded status of pension plans as at October 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 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

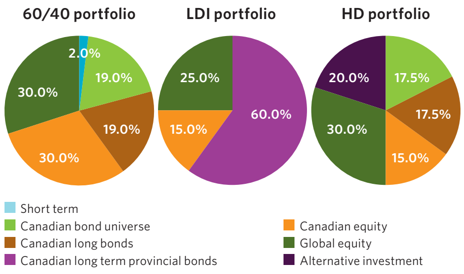


During the month of October, Canadian universe bonds, Canadian long term bonds and Canadian long-term provincial bonds showed negative returns while Canadian and global equity markets (in C$) as well as alternative investments showed positive returns. With a return of -0.3%, the 60/40 portfolio and the highly diversified portfolio (HD) outperformed the low volatility portfolio (LDI) (-1.3%). The underperformance of the low volatility portfolio (LDI) is explained by higher allocation in Canadian bonds. Annuity purchase rates decreased while the rates used in the calculation of solvency liabilities increased 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 decrease. 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 October 31, 2016 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	97.4%	97.4%	95.5%
90%	87.6%	87.7%	86.0%
80%	77.9%	77.9%	76.4%
70%	68.2%	68.2%	66.9%
60%	58.4%	58.4%	57.3%

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 7.7%, 7.7% and 5.6% respectively. The solvency liabilities increased over that same period between 9.9% and 10.8% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at October 31, 2016 stands between -4.5% and -1.6%.

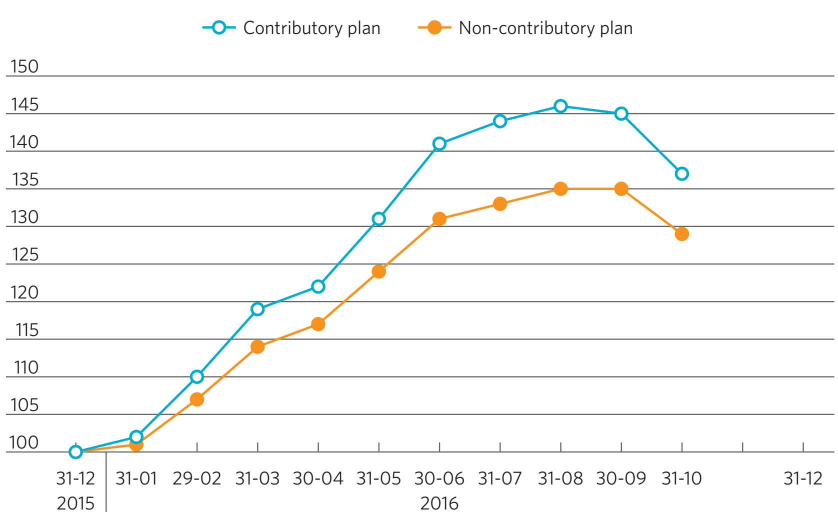
Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.

Impact on pension expense under international accounting as at October 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



Discount rate (%)	4.0	4.0	3.9	3.7	3.6	3.4	3.2	3.1	3.1	3.1	3.3
Return on assets (60% equities) (%)	0.0	-1.6	-1.0	2.8	0.6	2.1	0.8	3.1	0.4	0.7	-0.4

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	October 2016	Change in 2016
11	3.71%	3.09%	-62 bps
14	3.91%	3.23%	-68 bps
17	4.04%	3.30%	-74 bps
20	4.12%	3.35%	-77 bps

Since the beginning of the year, the pension expense has increased by 37% (for a contributory plan) due to the decrease in the discount rate. However, the pension expense has decreased slightly since last month. This decrease is due to the increase in the discount rate over the last month.

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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