Ontario budget:
Pension announcements

On April 27, 2017, Ontario released its 2017 Budget. The Budget includes a number of important announcements of future changes to Ontario pension legislation and regulation. The government also introduced Bill 127, which would implement some of the measures announced in the Budget.

Solvency funding framework

The government intends to announce the guiding principles of the new solvency funding framework later this spring, with draft regulations released for public consultation this Fall. Measures to support transition to the new framework should also be implemented this spring.
Target benefit MEPP framework

The government intends to announce its proposed target benefit multi-employer pension plan (MEPP) framework for Specified Ontario Multi-Employer Pension Plans (SOMEPPs) later this spring. It intends to release draft regulations for public consultation this Fall. The new framework will provide a transition period for plans to make necessary adjustments.

The government will also continue to explore options for a target benefit MEPP framework for plans that do not currently meet the SOMEPP criteria. SOMEPPs are typically unionized pension plans in the private sector in which contributions are made pursuant to collective agreement.

DC plan rules

The government intends to develop regulations later this spring to facilitate the implementation of variable benefits from defined contribution (DC) pension plans. Variable benefits allow retired members to withdraw retirement income directly from the DC pension plan, rather than transferring their benefits to a Life Income Fund or purchasing an annuity. A DC pension plan would not be required to permit variable benefit accounts.

Bill 127 includes a number of measures to facilitate variable benefit accounts. A spouse’s consent will be required to establish a variable benefit account, and the spouse at the time of account establishment would be entitled to receive the balance of the account upon the member’s death, subject to waiver by the spouse. Valuation and transfer rules upon marriage breakdown are also set out.

The government will engage DC plan sponsors, the financial services industry and pension experts on potential changes to the annual statements that could help DC plan members prepare more effectively for retirement, such as requiring projected retirement income. The government will also explore other options to enhance transparency that would modernize member communications and create regulatory efficiencies.

More broadly, Ontario will examine new approaches to managing the payout phase in retirement, often referred to as the “decumulation phase,” when retirees are drawing down their savings in order to produce retirement income. Ontario will engage the federal government, the financial services industry and pension experts to explore new avenues for plan members to manage investment and longevity risk. These would include new tools for members to draw down their savings in an efficient and cost-effective manner during the decumulation phase of their retirement.

The government will also explore other options to strengthen DC participation and performance.

New powers for the Ontario Superintendent

Legislation to permit administrative monetary penalties was passed in late 2016. Regulations required to implement administrative monetary penalties will be posted this Spring for public consultation. This will allow penalties to be levied on plan administrators and others without requiring a prosecution and conviction for a provincial offence.

Additional amendments are introduced in Bill 127 to further enhance the powers of the Superintendent of Financial Services. These amendments will give the Superintendent the authority to direct a plan administrator to provide plan beneficiaries with information specified by the Superintendent, and to hold a meeting with the Superintendent and anyone else designated by the Superintendent to discuss matters specified by the Superintendent.

Missing plan beneficiaries

The government will instruct the Superintendent to develop a policy to provide direction to administrators on steps they should take to locate beneficiaries. Since some individuals may be difficult to locate, which can mean both increased cost and the risk of privacy violations, Bill 127 includes amendments to the Pension Benefits Act providing authority to the Superintendent to waive the requirement of providing periodic pension
statements in situations where a plan administrator can demonstrate that the inactive member or retired member should be considered missing.

The government will consider further changes to assist employers in dealing with missing beneficiaries and help individuals in locating pension benefits. These changes may include, for example, a registry where employers or administrators could post information regarding missing beneficiaries and individuals could search for missing benefits. The government will also explore options to allow the wind-up of pension plans in cases where missing beneficiaries remain, while continuing to protect the benefits of those who are missing.

OHIP+ is the first program of its kind in Canada and would be provided without an earnings test to reflect the Ontario government’s commitment to ensure equal access for all families requiring drugs for their children to be healthy and to thrive. A successful introduction of OHIP+ may pave the way for Universal Pharmacare in Ontario, with those aged 25 to 65 as the remaining, yet significant, gap in coverage.

If approved, OHIP+ would be effective January 1, 2018, and would provide coverage for the 4,400+ medications covered under the Ontario Drug Benefit (ODB) program, which includes treatment for acute and chronic illness, as well as certain pediatric cancers. There would be no out-of-pocket expense for drugs covered under the ODB, meaning that no deductible or co-payment would apply.

A quick review of the needs of those expected to be covered can be categorized in the following stages and most likely prescription drug needs, which we believe to be well represented under the ODB formulary:

- For the early years: diaper rash and oral thrush, ear infections and viral infections, probably the most common reasons to seek medical attention;
- For elementary school ages: asthma, ADD/ADHD, and seizure control, likely the most prevalent in the elementary school ages;
- For high school ages: acne, allergy medications, birth control, antibiotics;
- For young adults: muscle relaxants, NSAIDS, antidepressants, anxiety drugs.

Most group health benefit programs define a dependent child as someone who is under age 21, or under age 25 if in full-time attendance at an accredited institution, and the implementation of OHIP+ could mean significantly reduced drug claims under these programs. Prescription drugs typically represent the lion’s share of costs for these plans and it is anticipated they will act as a supplementary plan to the first-payor OHIP+ if it is implemented.

**Conclusion**

The Budget indicates an ambitious agenda to adopt solvency funding and target benefit MEPP frameworks in the near future, while promoting DC pension plan efficiencies and developing new decumulation options. Measures to facilitate the payment of benefits to inactive members will also be welcome.

The introduction of variable benefit accounts will be of interest to some DC plan sponsors who may wish to offer retirement income options to former plan members, including multi-jurisdictional plans which have been waiting for Ontario to move forward on such regulations.

**Ontario budget: Children and Youth Pharmacare**

Under the heading “Helping Parents”, the 2017 Ontario Budget has introduced OHIP+: Children and Youth Pharmacare (OHIP+), proposing free prescription drug coverage for four million children and youth aged 24 and under in Ontario.
Cancer treatment and medication provided in-hospital are currently covered by OHIP, with private group health benefits programs, including employer-sponsored plans, typically providing coverage for at-home cancer therapies. It is uncertain at this point if additional cancer treatments would be available under OHIP+ and further clarification is required to determine if OHIP+ will mitigate the continuing and significant increases in charges for individual high amount pooling under group health benefits programs, driven by costly specialty drugs including cancer therapies in the past.

It also remains to be seen what coverage would still be deemed necessary for Student Health Plans or other such type of plans outside of OHIP+.

What is also uncertain is how the insurance industry will respond to these changes as the Provincial Health Department staff could not give any indication of the commitment from the insurance industry, and how the ODB benefits payments would be coordinated with private plans. Plan sponsors can expect savings from this new coverage under the ODB formulary, probably with any renewal period on or after January 1, 2018.

The availability of specific data for each of plan sponsor’s experience is paramount to ensure that reduction on ongoing costs as well as post-employment benefits liabilities, be passed onto them. Further analytics to identify key cost drivers for plan sponsors may help inform them of modifiable risk behaviours and determine targeted wellness intervention to help better stave off health cost increases. More details should become available in the near future.

New mortality improvement scale

On April 28, 2017, the Canadian Institute of Actuaries (CIA) issued the draft Task Force Report on Mortality Improvement. The purpose of the task force was to construct “a mortality projection scale for the purpose of reflecting future mortality improvement in Canadian actuarial work.” The task force was composed not only of pension plan experts, but also actuaries from other practice areas, such as insurance.

The task force work led to the construction of a new two-dimensional mortality improvement scale, MI-2017. This scale assumes that historical mortality improvement rates will transition smoothly to an assumed long-term mortality improvement rate over a 10–20 year period, varying by age. The new scale is based on data up to 2015; the CPM-B, currently the most commonly used scale for pension plan valuations, is based on data up to 2007. The long-term mortality improvement rate was thus established taking more recent historical averages into consideration, but also using a long-term rate that is basically an average of the projection rates used for public plans in Canada, the United States and the United Kingdom. The CPM-B scale was based primarily on projections for the Canada Pension Plan.

Establishing an assumption for the mortality improvement rate requires a considerable amount of judgment. It must take into account a number of unknown variables, such as future technological and medical advances that will have an impact on the longevity of Canadian citizens. The uncertainty is even greater for the oldest ages (90 and up), for which little data is available.

Impact on life expectancy and the value of pension plan commitments

As shown in the table below, assumed life expectancy with this new scale combined with the base mortality table CPM2014 is about 1% - 1.5%
higher than the life expectancy calculated using the more common CPM-B scale, for both males and females.

The impact on pension values would be about 0.5% (compounded by the application of any stabilization provision). Using the new scale would result in a similar increase in the value of plan liabilities.

**Impact for actuarial valuations of pension plans**

The report suggests that the new scale should be considered for most actuarial work in Canada (for actuarial valuation of defined benefits plans, but also for other actuarial work such as establishing insurers’ reserves). This means that sponsors of pension plans that are not fully funded on a going-concern basis could see an increase in their amortization payments and in their current service contributions. A similar impact could also be expected on liabilities and current service cost for accounting purposes if the new scale is also considered the best estimate on that basis.

It is important to point out that for the time being, the new scale would not be used to calculate transfer values payable upon member termination, since the assumptions used for these calculations are prescribed and based on CIA recommendations.

The same is true for the calculation of liabilities on a solvency basis for members assumed to receive transfer-value payments (members who have not retired).

Lastly, note that the report does not present results varying by population segments for which little data exists (socio-economic level, gender, smoker or non-smoker, etc.). However, the task force did conduct a literature review, which tended to indicate that the mortality improvement rate could vary by population segment. Although the report acknowledges that this could be reflected in certain circumstances, it argues that for most actuarial work in Canada, the proposed MI-2017 scale is a reasonable estimate of the mortality improvement rate.

**Comments**

CIA members have until **June 30, 2017** to comment on the draft report. Depending on the outcome of the consultation, the results and impact on the value of pension plan liabilities could change in the final version of the report. The CIA might then revise its recommendations on transfer values to reflect this new scale.
Quebec: New rules for member-funded pension plans

A draft Regulation was published in the Gazette officielle du Québec on April 12, 2017 to amend some of the rules for Member-Funded Pension Plans (MFPP).

The amendments mainly introduce a solvency funding exemption and easing of pension indexation rules.

**Funding**

Like other defined benefit pension plans in Quebec, the MFPP will no longer be required to fund solvency deficiencies. The solvency ratio will, however, continue to be calculated and reported for the purpose of calculating transfer values upon termination of membership or utilization of surplus assets. Furthermore, the funding of an MFPP on a going-concern basis will no longer need to include the stabilization provision required of private defined benefit pension plans, since the funding of non-guaranteed indexation already provides a margin to mitigate future fluctuations stemming from plan experience. In addition, the plan will no longer require a solvency surplus before pension indexation will be permitted.

The draft regulation also specifies that a funding deficiency that gives rise to amortization payments is based on plan commitments, excluding any assumed future indexation.

Lastly, to simplify things, any variation in the contribution established by the plan’s actuarial valuation will take effect on the first day of the fiscal year following the one for which the contribution is calculated.

These new rules could permit more frequent pension indexation, which is good news for members of this type of plan. On the other hand, if the funding level, taking into account future indexation, is below 100%, this additional flexibility will reduce the implicit margin equal to the cost of the indexation. However, given that future indexation is not guaranteed, the margin level remains significant.

**Indexation**

As noted above, indexation of pension benefits is not automatic, but depends on the financial position of the MFPP. When the MFPP was introduced in 2007, benefits could only be indexed if, after indexation, the plan was still solvent and funded (taking into account the provision for future indexation). The draft regulation now considerably eases these rules, since indexation may be granted if the plan remains funded after the indexation (without taking into account the provision for future indexation). Furthermore, indexation may now be granted without regard to the plan’s solvency ratio.

**Additional pension benefit**

In an MFPP, the additional pension benefit (representing indexation of 50% of assumed

The following is a summary of the main proposed measures:

<table>
<thead>
<tr>
<th>Application Date</th>
<th>• Retroactive to December 31, 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funding</td>
<td>• Elimination of solvency funding</td>
</tr>
<tr>
<td></td>
<td>• Changes to the contribution rate apply at the beginning of the next fiscal year</td>
</tr>
<tr>
<td>Indexation</td>
<td>• Elimination of the rule requiring that the plan be solvent before pensions can be indexed</td>
</tr>
<tr>
<td></td>
<td>• The plan must now be funded without taking future indexation into account</td>
</tr>
<tr>
<td>Improvement (other than the indexation provided by regulation)</td>
<td>• No change, so still permitted if:</td>
</tr>
<tr>
<td></td>
<td>- the plan remains solvent</td>
</tr>
<tr>
<td></td>
<td>- the plan remains funded, taking future indexation into account</td>
</tr>
<tr>
<td>Additional pension benefit</td>
<td>• The value of the additional pension benefit is no longer included in transfer-value payouts</td>
</tr>
<tr>
<td>Additional pension funded by voluntary contributions or transfers from a prior plan</td>
<td>• Must be determined based on funding assumptions rather than solvency assumptions</td>
</tr>
<tr>
<td>Multi-employer plans</td>
<td>• Mandatory withdrawal of an employer that has not had active members for 12 months</td>
</tr>
</tbody>
</table>
Background to the MFPP

Special rules for MFPP were introduced in 2007 for unionized workers in Quebec. With few exceptions, an MFPP must be maintained in accordance with a collective agreement and cannot include workers from another province. It may be a multi-employer or a single employer plan.

The MFPP is exempt from several provisions of the Quebec Supplemental Pension Plans Act (SPP Act), but is governed by specific rules established by regulation. The MFPP is a defined benefit pension plan, since each participating worker accrues pension benefits calculated in accordance with plan provisions. However, the plan cannot be a “best-average-earning” or “final-average-earnings” plan; it must be a “career earnings” or “flat benefit” plan. Also, automatic pension indexing is not permitted.

What distinguishes an MFPP from a traditional defined benefit plan is that the employer’s financial obligation is fixed. The financial risk is assumed by plan members, but unlike in a defined contribution plan, it is a collective risk. This makes an MFPP closer to a target benefit plan, with prescribed funding rules and mechanisms to protect pensions.

Since members assume the risks, the funding rules incorporate security margins. An MFPP actuarial valuation on a funding basis must assume that pensions will be indexed to the increase in the Consumer Price Index, even though such indexation is not guaranteed. The purpose of this measure is to create an implicit security margin equal to the cost of indexation.

Pension indexing is only granted if the plan’s financial position permits. If assets are higher than the amount required to fund indexation, the surplus may be used to increase benefits or modify contributions.

If the MFPP has a funding deficiency, plan members must make amortization payments, without taking future indexation into account. Until the draft regulation was tabled on April 12, 2017, solvency deficiencies also had to be funded.

Conclusion

The proposed changes, especially the solvency funding exemption and easing of pension indexing rules, could increase the popularity of MFPPs. Even though this type of plan has been an option for 10 years, it is still very rare and occurs primarily as a multi-employer plan. But for the most part the plans that do exist are in a good financial position.

Given the decline in defined benefit pension plans, the MFPP and target benefit pension plans could provide employers with another way to help their employees save for retirement. It would be interesting if access to an MFPP were more formally extended to non-union employees.

The draft regulation is scheduled to come into force on May 27, 2017, but takes effect as of December 31, 2016.
Letter of credit limits for federally regulated DB plans

On April 29, 2017, the Federal government posted draft regulations to amend the Pension Benefits Standards Regulations 1985 (the “PBSR”). The amendments will 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, as determined at the last actuarial valuation. They also make some minor updates to the unlocking rules for federally regulated locked-in accounts held at financial institutions.

Letter of credit amendments

Currently, sponsors of federally regulated DB plans may use a letter of credit to replace solvency special payments, up to an aggregate limit of 15% of the market value of the DB plan assets, as determined at the most recent plan year end.

The proposed amendments to the PBSR would change the aggregate limit to 15% of the solvency liabilities of the DB plan as at the valuation date of the most recently filed valuation report. Changing the basis for the aggregate limits from assets to liabilities could grant plan sponsors additional opportunities to use letters of credit and permit them to take greater solvency payment reductions.

Locked-in account amendments

The proposed amendments would also clarify unlocking and transfer rules for life income funds, restricted life income funds and locked-in registered retirement savings plans (collectively termed “locked-in accounts”). These proposed changes include provisions that:

- clarify that funds in locked-in accounts may be transferred to pension plans that are provincially regulated and pooled registered pension plans; and

- provide that a locked-in account must permit owners to unlock benefits in situations where life expectancy is considerably shortened, as opposed to making it an option that financial institutions may offer.

Conclusion

The proposed changes will be helpful to federally regulated DB pension plan sponsors who wish to maximize the amount of their letters of credit.

Interested persons may make representations concerning the proposed amendments to the PBSR by May 29, 2017.

Alberta: Draft guideline on governance, investment and funding policies

On March 28, 2017, the Alberta Treasury Board and Finance (the “regulator”) released a new draft of Interpretive Guideline #12 – Governance, Investment and Funding Policies (“IG-12”). The proposed revision to IG-12 provides more information than the previous draft about the regulator’s expectations for the content of governance, funding and investment policies, as well as the triennial assessment of plan administration. The previous draft was discussed in our July 2015 News and Views.

The revised IG-12 includes the following new guidance:

- A plan administrator can satisfy the obligation to establish a code of conduct and conflict of interest by incorporating references to or extracts from the organization’s code of conduct and conflict of interest policy into the governance policy.

- Plan administrators should consider addressing expenses incurred by trustees (if there are trustees) and how such expenses are reimbursed and disclosed.

- The governance policy should define the skills sets and expertise that third party service providers should possess, including prudence and standards of care.
• The governance policy should define response actions to be taken if decision makers in the governance structure do not acquire required skills in accordance with pre-determined timelines.

• Plan assessments that are required no less than every three years under the Alberta Employment Pension Plans Act may be conducted using Canadian Association of Pension Supervisory Authorities Guideline No. 4: Pension Plan Administrator Governance Self-Assessment Questionnaire, which was most recently updated on December 20, 2016 and discussed in our February 2017 News and Views.

It should be noted that governance policies were already required to be in place for Alberta-registered pension plans by December 31, 2016. The first assessment of plan administration is due by December 31, 2017.

Comments
The regulator has requested public comments on the draft revised IG-12 by June 30, 2017.
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.

Tracking the funded status of pension plans as at April 30, 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 March 31, 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 April, Canadian universe bonds, Canadian long term bonds, Canadian long-term provincial bonds, alternative investments as well as Canadian and global equity markets showed positive returns. With a return of 2.8%, the low volatility portfolio (LDI) outperformed the highly diversified portfolio (HD) (2.6%) and the 60/40 portfolio (2.2%). The outperformance of the LDI portfolio is explained by a larger weight in Canadian long-term provincial bonds. The prescribed CIA rates used in the calculation of solvency liabilities decreased during the month, increasing the solvency liabilities by 2.9% 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 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 the global equity markets, the 60/40 portfolio, the LDI portfolio and the HD portfolio returned 5.5%, 5.8% and 6.1% respectively. The solvency liabilities fluctuated over that same period by 0.1% to 0.2% depending on the duration of the group of retirees. The variation in the plan’s solvency ratio as at April 30, 2017 stands between 3.4% and 6.1%.

Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.
Impact on pension expense under international accounting as at April 30, 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

<table>
<thead>
<tr>
<th>Date</th>
<th>Discount rate (%)</th>
<th>Return on assets (55% equities) (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>31-12</td>
<td>3.8</td>
<td>0.0</td>
</tr>
<tr>
<td>31-01</td>
<td>3.9</td>
<td>0.0</td>
</tr>
<tr>
<td>28-02</td>
<td>3.8</td>
<td>1.9</td>
</tr>
<tr>
<td>31-03</td>
<td>3.8</td>
<td>1.2</td>
</tr>
<tr>
<td>30-04</td>
<td>3.8</td>
<td>2.2</td>
</tr>
<tr>
<td>30-06</td>
<td>3.5</td>
<td>2.2</td>
</tr>
</tbody>
</table>

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

Discount rate

<table>
<thead>
<tr>
<th>Duration</th>
<th>December 2016</th>
<th>April 2017</th>
<th>Change in 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>3.66%</td>
<td>3.31%</td>
<td>-35 bps</td>
</tr>
<tr>
<td>14</td>
<td>3.81%</td>
<td>3.48%</td>
<td>-33 bps</td>
</tr>
<tr>
<td>17</td>
<td>3.90%</td>
<td>3.59%</td>
<td>-31 bps</td>
</tr>
<tr>
<td>20</td>
<td>3.96%</td>
<td>3.66%</td>
<td>-30 bps</td>
</tr>
</tbody>
</table>

Since the beginning of the year, the pension expense has increased by 11% (for a contributory plan) due to the decrease in the discount rates despite the good returns (relative to 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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