Knowledge & Insights

MORNEAU SHEPELL

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Pension Commuted Values: new rules expected in 2018

The Canadian Institute of Actuaries (CIA) has provided an update regarding a review of their Commuted Value, or "CV", Standard. This standard is used to determine the lump sum value of pension benefits payable from Registered Pension Plans. For a typical defined benefit pension plan, the new approach being considered remains similar, although the changes recommended would reduce the lump sums paid to members by as much as 5%. This would lead to lower solvency liabilities and could reduce contribution requirements.

For multi-employer plans, the impact is far more significant. The proposed changes would modify how lump sum payments for these members are calculated, so that they would receive their "proportionate share" of the plan assets on the same basis as used for funding purposes.

Impact for defined benefit plans

- The current approach determines a value based on current yields of Government of Canada Bonds with a fixed spread of 0.9% added to the interest rates. As the yield of Government of Canada Bonds has dropped significantly over the past few years, the commuted value placed on pension benefits has increased dramatically.
- The CIA is now expected to recommend that the yields of provincial bonds and corporate bonds, in addition to Government of Canada bonds, be taken into account when calculating lump sums. The proposed approach would lead to a reduction of lump sum amounts by up to 5%, based on current market conditions.
- For plans whose investment policy reduced risk by attempting to immunize a portion of the assets to replicate the value of solvency liabilities, this change could lead to revisions in the investment policy, but the new rules could facilitate such immunization strategies.

Impact for Multi-employer plans

- Currently, the same CV rules as for other defined benefit plans apply to multi-employer plans. Some provinces allow, if provided by the plan text, to pay out a lump sum that takes in consideration the funded status of the plan. The proposed changes would have such plans paying the members their proportionate share of the plan assets. This would be calculated as the liabilities for the members' pension on the plan's funding basis, either increased or decreased depending on whether the plan has a surplus or deficit.
- This could significantly reduce the lump sums, possibly by as much as 50% of the current levels, although the exact level will vary a lot for different plans.

Conclusion

The updated Commuted Value standard is not expected to come into force until the **spring of 2018** at the earliest, following consultation on the proposals.

Ontario confirms new temporary solvency funding relief

As promised in the solvency funding reform measures that were announced on May 19, 2017 (see our *News & Views* of June 2017), the Government of Ontario released interim funding relief measures on June 29, 2017. An administrator will be permitted to elect a two year deferral of funding for any new solvency deficiency revealed in the first solvency valuation with a valuation date on or after December 31, 2016 and before December 31, 2017. This provides an additional deferral above and beyond the one year already permitted, but only in respect of a new deficiency revealed in the solvency relief report.

A pension plan that takes advantage of this deferral is not permitted to elect the extension of solvency funding period from 5 to 10 years in the same valuation report. The funding extension was made available last year in the first solvency valuation with a valuation date on or after December 31, 2015 and before December 31, 2018. The two forms of relief could apparently be combined only if the extension was elected in a previous report filed with a valuation date on or after December 31, 2015, and prior to December 31, 2016.

Written notice of the election would have to be provided to plan members in the same format as other solvency funding relief notices. Member consent is not required.

The deferral is not available to specified Ontario multi-employer pension plans or to public sector plans that have taken advantage of the special public sector funding relief measures that have been provided to certain public sector plans by regulation.

The announcement will be welcome to defined benefit pension plan sponsors in Ontario, but it is important to note that the measures only apply to new solvency deficiencies disclosed in a valuation report, and not to pre-existing solvency deficiencies.

Conclusion

The interim solvency funding relief provisions came into force on July 1, 2017. The details of the permanent solvency reform measures are expected to be released in the **Fall of 2017**.

Ontario announces target benefit framework for collectively bargained multi-employer pension plans

On June 29, 2017, the government of Ontario announced a target benefit framework for collectively bargained Ontario multi-employer pension plans (MEPPs). The target benefit framework will apply to all MEPPs, as opposed to the current time-limited solvency funding exemption applicable to specified Ontario Multi-Employer Pension Plans (SOMEPPs). A SOMEPP is a MEPP that meets certain criteria, including unionization.

The announcement follows the release of a discussion paper in July 2015 and subsequent public consultation (see our *News and Views* of August 2015).

The new target benefit framework would set out the following rules:

- a permanent exemption from solvency funding;
- a requirement to fund a reserve called a Provision for Adverse Deviation (PfAD) to help manage future risk and help ensure benefits are secure;
- going concern funding deficiencies to be amortized over 15 years;
- a new basis for calculating benefits paid when a member terminates participation in a plan or when a plan is wound up; and
- procedures to ensure that plan benefits are appropriately reduced when funding requirements are not met.

In addition, the target benefit framework will include the following measures to help protect plan beneficiaries:

- a requirement to develop policies on funding and governance;
- opportunities for retirees to participate in plan governance; and
- enhanced disclosure to plan members on the status of their pension plan.

The government will be consulting with stakeholders on the details of the above framework, including how plans transition to the new requirements. The government proposes to introduce legislation in the Fall of 2017, followed by regulations in 2018 to implement the new framework. The government will also continue to explore options for a framework for non-collectively bargained MEPPs.

Temporary funding relief extension for SOMEPPs

As an interim step, while working on the target benefit framework for MEPPs, the government has extended the temporary solvency funding exemption currently in place for SOMEPPs by one year to August 2018.

Ontario update: expansion of superintendent powers and creation of FSRA

Ontario Bill 127, which includes several pension measures, has received royal assent. Bill 127 was discussed as part of our summary of the 2017 Ontario Budget (see our *News & Views* of May 2017).

As a result of the passage of Bill 127, the following provisions are now in force:

(a) the Superintendent of Financial Services (the "Superintendent") may order the administrator of a pension plan and others involved in plan administration to participate in meetings with the Superintendent and anyone else named by the Superintendent,

(b) the Superintendent may order the plan administrator to provide specified information to members and others with an entitlement from the pension fund, and

(c) the Superintendent may waive the requirement to provide statements to former and retired members if there are reasonable grounds to believe the members are missing.

The powers of the Superintendent will be exercised by the Financial Services Commission of Ontario for now and soon by the new Financial Services Regulatory Authority (FSRA). Legislation establishing the FSRA is now partly in force (see our *News & Views* of December 2016) and the first board of directors has been appointed. The government expects to introduce legislative amendments regarding FSRA's mandate and governance structure, as well as the structure and powers of the Financial Services Tribunal, by the end of 2017.

Update on variable benefit accounts

Bill 127 also includes measures relating to variable benefit accounts in defined contribution pension plans, but these measures will come into force upon proclamation. Additional regulations will be required to implement variable benefit accounts.

US accounting rules: new disclosure requirements

The Financial Accounting Standards Board (FASB) issued in March 2017 an update to *Accounting Standards Codification 715 – Compensation – Retirement Benefits* (ASC-715), titled "*Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*". This update has no impact on the way the costs are calculated for pension and other postretirement benefits, but rather in the presentation of these costs in the financial statements.

The update requires that the "service cost "component be reported separately from the other components of net benefit cost in the income statement. The "service cost" component must be reported together with other compensation costs arising from services rendered during the period. The update allows only the "service cost" component to be eligible for capitalization as part of an asset such as inventory.

Effective dates and transition requirements

- **Public business entities**: annual periods beginning after December 15, 2017 (including interim periods within those annual periods)
- **All other entities**: annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019

Early adoption is also permitted as of the beginning of an annual period for which financial statements have not been issued, or within the first interim period if an employer issues interim financial statements.

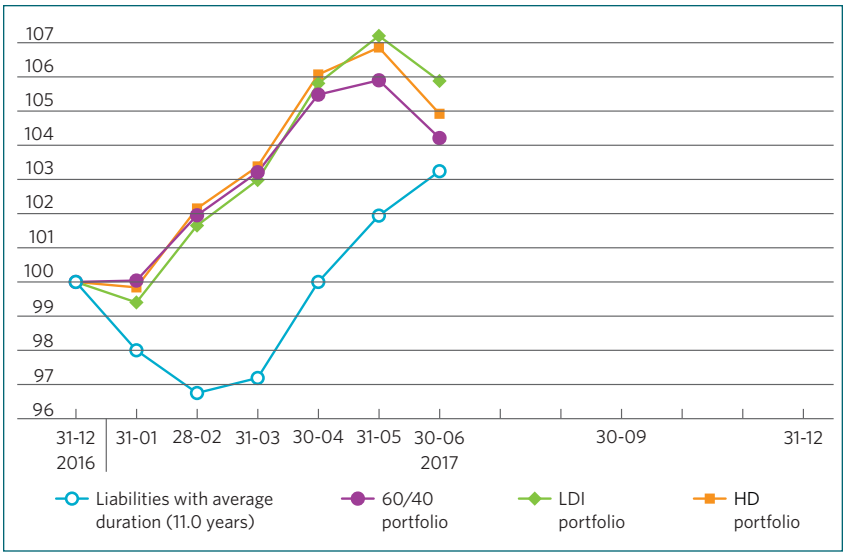
For the presentation of the "service cost" component, this change should be applied **retrospectively**. As a practical expedient, the employer can use the amounts disclosed in its pension and other postretirement benefits plan note for the prior comparative periods as the estimation basis for applying the retrospective presentation requirements.

For the capitalization of the "service cost" component in assets, this change should be applied **prospectively**, on and after the effective date.

Tracking the funded status of pension plans as at June 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



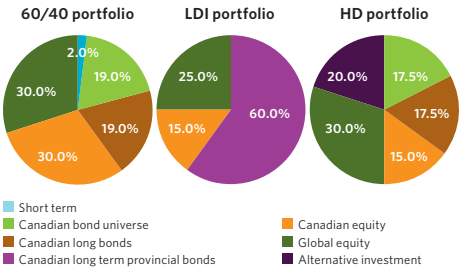
During the month of June, Canadian universe bonds, Canadian long term bonds, Canadian long-term provincial bonds, alternative investments (CAD), the Canadian equity market as well as global equity markets (CAD) showed negative returns. With a return of -1.2%, the low volatility portfolio (LDI[1]) outperformed the 60/40 portfolio (-1.6%) and the highly diversified portfolio (HD) (-1.8%). The relative outperformance of the LDI portfolio is explained by a smaller weight in global equities and no exposure to alternative investments. The prescribed CIA annuity purchase rates increased during the month, while the rates used in the calculation of solvency liabilities decreased during the month, increasing the solvency liabilities by 1.3% 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.

Initial solvency ratio as at December 31, 2016	Evolution of the solvency ratio as at June 30, 2017 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	100.9%	102.6%	101.6%
90%	90.9%	92.3%	91.5%
80%	80.8%	82.0%	81.3%
70%	70.7%	71.8%	71.1%
60%	60.6%	61.5%	61.0%

[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 Canadian long term bonds, global equity markets as well as the alternative investments, the 60/40 portfolio, the LDI portfolio and the HD portfolio returned 4.2%, 5.9% and 4.9% respectively. The solvency liabilities increased over that same period between 3.2% and 3.4% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at June 30, 2017 stands between 0.6% and 2.6%.

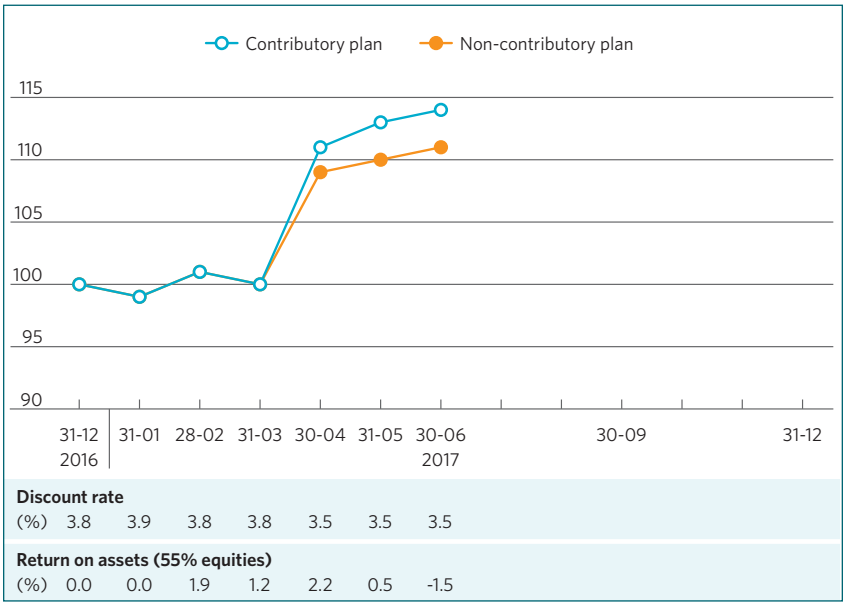
Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.

Impact on pension expense under international accounting as at June 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



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	June 2017	Change in 2017
11	3.66%	3.37%	-29 bps
14	3.81%	3.51%	-30 bps
17	3.90%	3.59%	-31 bps
20	3.96%	3.64%	-32 bps

Since the beginning of the year, the pension expense has increased by 14% (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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Contributing editors

Sébastien Rannaud, FSA, FCIA
Retirement Consulting

Maria Zaharia, FSA, FCIA
Retirement Consulting

Andrew Zur, LL.B.
Pension Legislation

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