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In this issue

1 Draft Guideline for derivatives
3 Nova Scotia and New Brunswick: Temporary solvency funding relief
5 Travel insurance: Multiple coverage rules
6 Alberta releases dental fee guide
7 Tracking the funded status of pension plans as at August 31, 2017
8 Impact on pension expense under international accounting as at August 31, 2017

Draft Guideline for derivatives

On July 31, 2017, the Office of the Superintendent of Financial Institutions (OSFI) issued for comment a revised draft derivatives guideline titled *"Derivatives Sound Practices for Federally Regulated Private Pension Plans"* (the "Draft Guideline"), which will replace the 1997 guideline *"Derivatives Best Practices"*. The Draft Guideline reflects current practices with respect to the risk management of derivative activities and also sets out OSFI's expectations for plan administrators who invest indirectly in derivatives through various types of funds, including pooled funds and hedge funds. Derivatives include a wide assortment of financial or commodity contracts, including forwards, futures, swaps and options.

This Draft Guideline should encourage plan administrators to establish clear policies and procedures regarding derivative usage. It also highlights OSFI's recognition of the increase usage of derivatives in the investment schemes of pension plans as part of their risk management/return enhancement toolkit. Derivatives are often used to reduce risks associated with changes in exchange rates, interest rates, market indices and commodity prices, or for other purposes such as portfolio rebalancing or liquidity needs. A common example would be the use of derivatives to hedge interest rate risk through liability driven strategies.

When used prudently, derivatives can offer plan administrators efficient and effective methods for implementing risk management strategies. This Draft Guideline provides the perfect opportunity for plan administrators of federally regulated private pension plans in particular, but also for administrators of plans registered in other jurisdictions, to revisit their investment beliefs, investment policy and governance structure. The use of derivatives, particularly for risk management purposes, whether it is directly or indirectly, can be effective and entirely appropriate for a pension plan, as long as the activity is well monitored. By having clear policies and procedures governing the use of derivatives, in line with the "prudent person" standard, this can have a positive impact for the plan and provide peace of mind to plan administrators.

Impact for plan administrators of federally regulated private pension plans

The Draft Guideline outlines the factors that OSFI expects plan administrators to consider when developing policies and procedures for the sound risk management of derivative activities. As derivative strategies and investment portfolio compositions have become increasingly complex, more sophisticated risk management policies and procedures are required. The Draft Guideline encourages plan administrators to adopt more rigorous controls and standards in their plan's internal risk management framework, in order to have a better understanding of how derivative instruments can alter the risk and return profile of the pension plan.

As such, in addition to the pension plan's Statement of Investment Policies and Procedures (SIPP), the plan administrator should consider developing and documenting more detailed policies and procedures governing the use of derivatives as part of the pension plan's overall risk management framework. This should include the following:

- A description of authorized derivative investment strategies;
- Clearly defined roles and responsibilities for entering into derivatives transactions and overseeing the pension plan's derivative activities;
- Appropriate limits on derivatives risk taking that are consistent with the risk tolerance of the pension plan;
- Documented policies and procedures for identifying, monitoring and reporting the risks associated with derivative transactions, including stress testing and strategies for mitigating market, credit, liquidity and operational risk;
- Periodic review of the risk management framework to measure its effectiveness and to ensure that the framework remains consistent with the pension plan's investment objectives, financial position and risk tolerance, particularly in light of changing circumstances.

Plan administrators should consider how this Draft Guideline applies to their pension plan, keeping in mind the plan's investment objectives, risk tolerance and other relevant factors, and may wish to seek expert advice when establishing policies and procedures for derivatives risk management.

Additional information provided in the Draft Guideline

- The *Pension Benefits Standards Act, 1985* (PBSA) imposes a fiduciary standard of care on pension plan administrators when administering the pension plan. This "prudent person" standard requires the plan administrator to invest the assets of the pension fund in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund. It further provides that the administrator must use all relevant knowledge and skill that the administrator possesses or ought to possess.

- Plan administrators are expected to understand, monitor and mitigate the risks associated with derivative transactions. This includes making decisions based on proper analysis of adequate information and documenting the factors that were taken into account in making the decisions. The administrator must consider how the derivative fits within the plan's SIPP, its role in the plan's overall investment portfolio and strategy, and the plan's potential exposure to losses.
- The main risks associated with derivative transactions include market risk, counterparty credit risk, liquidity risk and operational risk. Best practices for mitigating each of these risks are provided in the Draft Guideline.
- When a pension plan gains indirect derivatives exposure via external managers, such as through pooled, investment or hedge funds, the plan administrator retains ultimate oversight responsibility over the plan's investment strategy and investments. The plan administrator should obtain sufficient information to determine the external manager's strategy with respect to the use of derivatives, the extent of investment by the manager in derivatives, and such other information as may be appropriate.

Conclusion

The Draft Guideline will apply to administrators of federally regulated pension plans that invest, directly or indirectly, in derivatives, and once finalized, will set out OSFI's expectations applicable to such plan administrators. In addition, the Draft Guideline may assist administrators of plans registered in other jurisdictions in understanding and applying best practices for derivative investments.

Public comments should be provided by **September 29, 2017**.

Nova Scotia and New Brunswick: Temporary solvency funding relief

Nova Scotia has adopted temporary solvency funding relief regulations for defined benefit (DB) pension plans registered in those provinces. At the same time, New Brunswick has proposed temporary solvency funding relief regulations, but only for multi-jurisdictional DB plans registered in that province.

Nova Scotia

The Nova Scotia *Pension Benefits Regulations* have been amended to allow for temporary solvency relief for DB pension plans registered in Nova Scotia. Effective August 8, 2017, plan administrators have the one-time option to fund eligible solvency deficiencies over a period of up to 15 years, as opposed to the standard 5-year period. Solvency relief must be elected in a valuation report dated from December 30, 2016 to January 2, 2019 inclusive. The extension can apply to both new solvency deficiencies and pre-existing solvency deficiencies being funded over a 5-year period. Pre-existing solvency deficiencies that were already being funded over an extended period are not eligible for the new extension.

In order to qualify for solvency relief the administrator is required to have made all normal cost contributions and remitted all employee contributions. The solvency relief report submitted to the Superintendent must include:

- A statement that the administrator proposes to make an extension to the amortization period;
- The special payments that will be required after the election to extend is made; and
- The special payments that would have been required if the election to extend were not made.

Further, a plan administrator must notify plan members (active, former and retired members, as well as any collective bargaining agents that represent them) if solvency relief is being sought.

LATEST NEWS:

Nova Scotia launches consultation on solvency reform

On September 6, 2017, Nova Scotia has announced a DB pension plan funding consultation. This comes on the heels of its latest solvency relief measures. Broadly speaking, the three options under consideration are:

1. maintain full solvency funding with measures to help reduce funding volatility;
2. eliminate solvency funding and enhance going concern funding; and
3. require only partial funding of solvency liabilities.

The consultation paper also asks for input on target benefit pension plans, buy-out annuities and investment regulations.

Comments can be submitted until **November 10, 2017**.

Alberta

On September 11, 2017, Alberta's Superintendent of Pension extended the deadline to file valuation reports as at December 31, 2016, for six months to March 31, 2018, for all pension plans except collectively bargained pension plans. A six month extension is also granted for valuation reports due to be filed between September 27, 2017 to December 31, 2017.

The extension will allow the Superintendent's office to undertake research, analysis and stakeholder engagement in the development of options regarding private sector pension plan funding relief.

Contributions must continue in the amounts specified under the prior actuarial valuation until the new actuarial valuation report is filed.

If a DB pension plan has already filed an actuarial valuation report as at December 31, 2016, the Superintendent requests that the plan administrator contact the Superintendent's office directly to discuss options.

The proposals will be discussed in greater detail in the next edition of *News and Views*.

If at least one-third of these members object, then the administrator may not obtain temporary solvency relief. The collective bargaining agent may object on behalf of the members it represents.

Nova Scotia has previously provided solvency relief measures in 2013 (an extension to 15 years), and in 2009 (an extension to 10 years). Nova Scotia university and municipal pension plans already benefit from a permanent solvency exemption.

New Brunswick

The New Brunswick Government has released draft amendments to the *Pension Benefits Regulations* (the "Draft Regulations") to provide temporary solvency funding relief to multi-jurisdictional DB pension plans. A multi-jurisdictional pension plan is defined as a pension plan subject to the New Brunswick pension legislation and to the pension legislation of at least one other jurisdiction. The Draft Regulations would permit a solvency funding extension from 5 to 10 years, and would furthermore permit consolidation of previous solvency deficiencies into the new solvency funding deficiency. Temporary solvency funding relief would apply to a single valuation report with a review date between December 31, 2016 and December 31, 2018, both dates inclusive.

Notice to members, former members and other persons entitled to payments under the pension plan would be required, but member consent would not be required. Plans would be required to file annual valuations until fully funded or the 10-year period expires. Furthermore, amendments to improve benefits are not permitted during the 10-year period unless fully funded by the employer or no special payments are required with respect to the consolidated existing solvency deficiencies.

Conclusion

In introducing temporary solvency funding relief measures for private sector pension plans, New Brunswick and Nova Scotia join British Columbia, Manitoba, and Ontario, which have also provided broad-based temporary solvency relief measures in the past two years. In addition, Ontario is currently reviewing permanent changes to its funding rules, while Quebec permanently removed solvency funding and updated its funding rules in 2016.

The New Brunswick Draft Regulations are unique in that they only apply to multi-jurisdictional DB pension plans registered in the province. The rationale appears to be that pension plans with solely New Brunswick members have the option of becoming shared risk pension plans, an option that is foreclosed to pension plans with members in other provinces.

Public comments in New Brunswick were requested by **August 18, 2017**.

Travel insurance: Multiple coverage rules

Changes are occurring in some travel insurance contracts regarding which policy should pay first when there is multiple coverage.

Travelers are often insured under more than one plan. Coverage may be included within an plan member's group insurance plan, a spouse's group insurance plan, credit card insurance coverage, an individual policy, or may be purchased separately through a travel agent.

Traditionally, the insurer who is contacted first in the event of an emergency situation processes the claim. The insurer manages the provincial plan recoveries, reimburses the claimant or service provider for their eligible expenses up to their plan maximum, and then shares the costs with the other insurers as appropriate.

It has been generally accepted that when a plan member is covered by more than one travel insurance policy, the plan member's group insurance plan will reimburse the claim first. They are referred to as the "primary" or "first" payer. If the policy limit is reached, a spouse's group plan will pay next, and if applicable, followed by the other insurers.

Recently, some group insurers have added a provision in their travel insurance policies stating that they will only pay for expenses that are not covered by the plan member's other travel insurance policies; this is referred to as an "excess coverage clause". In other words, they become the last payer when the plan member has group or individual travel coverage under more than one plan. Plans without a similar provision are at a disadvantage, requiring them to cover the bulk of the expenses claimed. It can be expected that more travel insurance providers will implement an excess coverage clause, which could add some confusion to the claim payment process.

Impact on claimants: The claimant experience will not be impacted and the claimant will not see a change in the coverage provided. The administration and payment of eligible travel claims will be coordinated behind the scenes and will remain seamless to the claimant, although insurers would likely require information on other coverage the claimant is entitled to.

For Plan Sponsors: Implementing an excess coverage clause can be expected to eventually reduce the cost of travel insurance included in group benefit plans.

Employees working abroad

Even if a group benefit plan includes travel insurance, it may be recommended that employees sent abroad for business purposes be appropriately covered. Some plan members may be exempted from coverage because they are covered under their spouse's benefits plan, but it may not include travel insurance. When an employee travels for business purposes, the employer would generally be deemed responsible for the costs related to an unforeseen sickness or accident.

It is prudent to proactively inform plan members that they should first utilize their benefit program travel insurance in the event of a claim, unless they have made alternative arrangements. If the benefit program has implemented an excess coverage clause, then claims will be spread between different providers so that each available source shares part of the cost.

Alberta releases dental fee guide

In mid-August, the Alberta Dental Association and College (ADAC) released a dental fee guide, effective September 1, 2017. After 20 years without a provincial dental fee guide, the newly released document has been criticized for only including a minor two to three percent decrease in fees compared to what Alberta dentists typically charged earlier in 2017. In a statement, Canadian Life and Health Insurance Association President and CEO Stephen Frank said "more work needs to be done to bring fees down to reasonable levels, given that dental fees in Alberta are 26 to 32 per cent higher than elsewhere in the country". The Alberta Minister of Health has been in contact with ADAC since the fee guide was released and discussions are ongoing regarding further revisions and cost reductions.

Every other Canadian provincial dental association publishes a fee guide which is updated annually. The Alberta Dental Association discontinued publishing a provincial dental fee guide in 1997. At the time, the fee guide was criticized as 'price fixing' and it was suggested that it limited competition amongst dental providers. Since then, insurers processing claims have created their own fee guides for Alberta to use as the basis for reimbursement. For example, Manulife's dental reimbursement values are based on its block of Alberta claims data and are designed so that approximately 70% of submitted claims are eligible for full reimbursement.

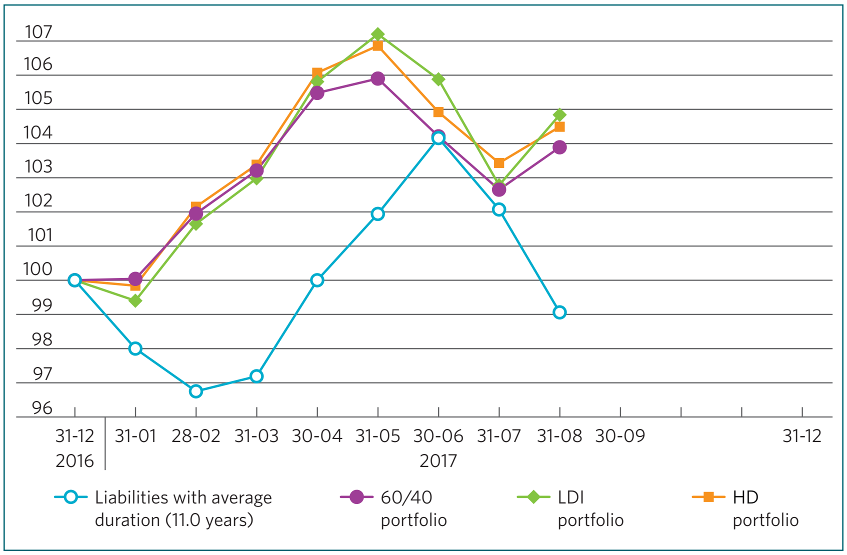
While a dental fee guide being established in Alberta is generally good news for plan sponsors, this first edition will result in negligible savings at best. Insurers are expected to base Alberta dental claim reimbursements on the new fee guide effective September 1, 2017. Most group benefits contracts stipulate that reimbursements are made according to the current year's dental fee guide, though some plan sponsors may have other contractual arrangements.

It remains to be seen when more significant reductions to the Alberta dental fee guide will take place. For the time being, plan sponsors with Alberta employees should expect dental costs to remain above the level in other provinces. It is important to note that fee guides are recommendations and dental offices are not obligated to follow the suggested fees.

Tracking the funded status of pension plans as at August 31, 2017

This graph shows the changes in the financial position of a typical defined benefit plan with an average duration since December 31, 2016. For this illustration, assets and liabilities of the plan were each arbitrarily set at $100 million as at December 31, 2016. The estimate of the solvency liabilities reflects the new CIA guidance for valuations effective June 30, 2017 or later. The following graph shows the impact of three typical portfolios on plan assets and the effect of interest rate changes on solvency liabilities of medium duration.

The evolution of the financial situation of pension plans since December 31, 2016



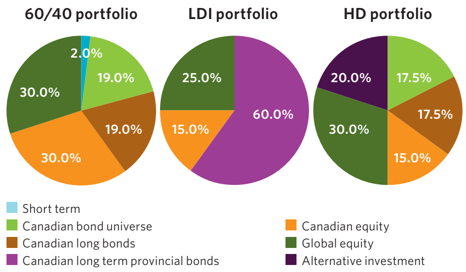
During the month of August, Canadian universe bonds, Canadian long term bonds, Canadian long-term provincial bonds, the Canadian equity market as well as global equity markets (CAD) showed positive returns. However, certain alternative investments (CAD) registered negative returns. With a return of 2.0%, the low volatility portfolio (LDI[1]) outperformed the 60/40 portfolio (1.2%) and the highly diversified portfolio (HD) (1.0%). The relative outperformance of the low volatility portfolio is mainly due to its allocation to Canadian long-term provincial bonds. The prescribed CIA Annuity purchase rates decreased during the month; however, the commuted value rates used in the calculation of solvency liabilities increased. As a result, the solvency liabilities decreased by 2.9% for a medium duration plan. For this type of plan, an investment in the 60/40, LDI portfolio or the HD portfolio resulted in a solvency ratio increase.

Initial solvency ratio as at December 31, 2016	Evolution of the solvency ratio as at August 31, 2017 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	104.9%	105.8%	105.5%
90%	94.4%	95.2%	94.9%
80%	83.9%	84.7%	84.4%
70%	73.4%	74.1%	73.8%
60%	62.9%	63.5%	63.3%

[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 the Canadian bond market and in the global equity markets, the 60/40 portfolio, the LDI portfolio and the HD portfolio returned 3.9%, 4.8% and 4.5% respectively. The solvency liabilities changed over that same period between -1.1% and -0.8% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at August 31, 2017 stands between 2.9% and 5.8%.

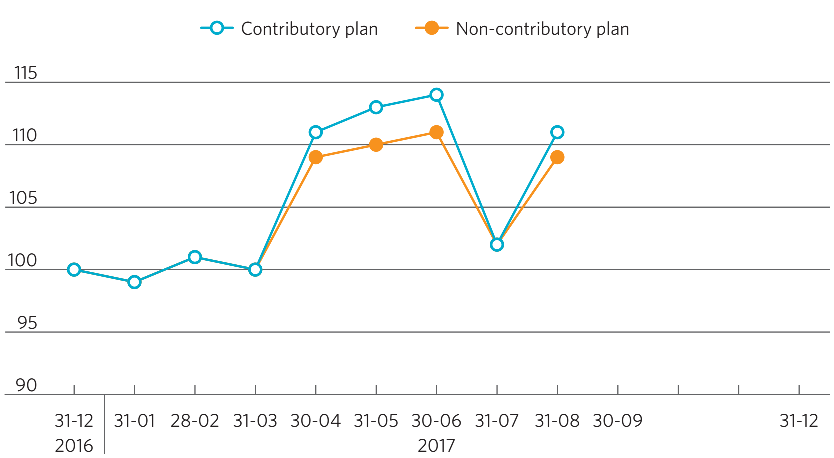
Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.

Impact on pension expense under international accounting as at August 31, 2017

Every year, companies must establish an expense for their defined benefit pension plans.

The graph shows the expense impact for a typical pension plan that starts the year at an arbitrary value of 100 (expense index). The expense is influenced by changes in the discount rate based on high-quality corporate and provincial (adjusted) bonds and the median return of pension fund assets.

Expense Index from December 31, 2016



Discount rate (%)	3.8	3.9	3.8	3.8	3.5	3.5	3.5	3.9	3.7
Return on assets (55% equities) (%)	0.0	0.0	1.9	1.2	2.2	0.5	-1.5	-1.	1.3

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	August 2017	Change in 2017
11	3.66%	3.49%	-17 pdb
14	3.81%	3.62%	-19 pdb
17	3.90%	3.71%	-19 pdb
20	3.96%	3.76%	-20 pdb

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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