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Ontario: Details on new rules for funding and annuity purchase

On December 14, 2017, the Ontario government released further details of its proposed new funding framework. The new details would implement the changes announced previously (see our *News & Views* of December 2017), mostly notably:

- **Reduced solvency funding**, as sponsors will now only be required to fund to 85%;
- **Enhanced going-concern funding**, including details on the Provision for Adverse Deviation (PfAD) added to liabilities and normal cost;
- Requirements to be met before **liabilities can be discharged upon purchase of annuities.**

The proposed rules are expected to lower contributions and reduce volatility for most plan sponsors. Given the significance of the changes, sponsors are encouraged to start planning as soon as possible for a new pension funding paradigm.

Comments on the proposed amendments to the regulations are requested by the Ontario government by January 29, 2018. The new funding framework is expected to be in place for valuations effective beginning December 31, 2017.

Also included are detailed descriptions of modifications to rules for letters of credit; enhanced funding rules for benefit improvements; restrictions on contribution holidays; additional disclosure requirements; transition rules; and certain consequential amendments regarding surplus.

These changes would not apply to jointly sponsored pension plans (JSPPs) or specified Ontario multi-employer pension plans (SOMEPPs), but would apply to multi-employer pension plans (MEPPs) providing defined benefits that are not SOMEPPs.

Many of the existing funding requirements, such as the frequency of valuation reports and solvency smoothing, would not change.

Reduced solvency funding requirements

The rules to determine the solvency special payments would be amended so that special payments would be based on a target solvency ratio of 85% instead of 100%. The reduced solvency deficiency would be funded over five years, starting no later than one year after the valuation date.

The new rules would represent a permanent form of relief, replacing previous temporary forms of relief. New elections to use one or more options under temporary solvency relief measures introduced in 2016 will not be permitted.

An existing letter of credit could be reduced to recognize the new requirements to fund 85% of solvency liabilities, rather than 100% of solvency liabilities.

Enhanced going concern funding requirements

With the exception of special payment schedules established to fund benefit improvements, separate schedules of special payments would no longer be maintained for going concern unfunded liabilities established in different valuation reports. Instead, special payments for unfunded liabilities would be consolidated into one 10-year schedule that begins one year after the plan's valuation date.

Funding of pre- and post-retirement indexation would be required under the new framework, on the same basis as for other benefits. However, contributions in respect of the Provision for Adverse Deviations (PfAD) would not be required for either the going concern liabilities or the normal cost in respect of future indexation.

Provision for Adverse Deviations (PfAD)

A new PfAD would be added to the going concern liabilities and normal cost. The amount of the PfAD would depend on whether the plan is open or closed to new members. The PfAD would be equal to the sum of the following three components:

1. A fixed component of 5% for closed plans and 4% for open plans; plus

2. A component dependent on the plan's asset mix:

Percent of non-fixed income assets	PfAD for closed plans	PfAD for open plans
0%	0%	0%
20%	2%	1%
40%	4%	2%
50%	5%	3%
60%	7%	4%
70%	11%	6%
80%	15%	8%
100%	23%	12%

plus,

3. A component based on the plan's going concern discount rate assumption, added only if the discount rate assumption exceeds a benchmark discount rate (BDR) defined in the Regulation.

Most plans would not be impacted by this third component.

The asset mix component would be determined based on the amount of non-fixed income assets in the plan. Only fixed income investments meeting certain quality requirements, plus 50% of investments in alternative investments such as real estate, infrastructure, mortgages and resource properties, would be considered fixed income assets.

The objective of the PfAD is to reflect the level of risk in the plan's funding and investment policy, but without specific reference to the mismatch of assets and liabilities (as under the Quebec rules). This enhancement to the going concern funding basis can be seen as a compromise to compensate for the permanent relief in the solvency basis.

Benefit improvements

Regulations would allow benefits to be improved in a plan only if after the improvement, the solvency ratio is at least 85% and the going concern funded ratio is at least 90%. A lump sum contribution would be permitted to satisfy these requirements.

The increase in the going concern liabilities and the PfAD arising from a benefit improvement would be funded over five years on a going concern basis, beginning on the effective date of the amendment that improves benefits. Surplus could be used to fully or partially fund benefit improvements.

Restrictions on contribution holidays

Contribution holidays, in which surplus is used to lower contributions requirements for the normal cost of a plan and the PfAD in respect of the normal cost, would be permitted if:

1. The PfAD is fully funded on a going concern basis;
2. The plan's transfer ratio is at least 1.05;
3. A cost certificate is filed within the first 90 days of a plan's fiscal year, each year a contribution holiday is taken; and
4. Notice is provided to plan participants, any unions representing members, and a pension advisory committee, if one exists.

In addition, the value of assets that could be used to take a contribution holiday for a year would be limited to 20% of the plan's available actuarial surplus, as identified in the plan's last filed valuation report.

Surplus plan assets would no longer be available to pay Pension Benefits Guarantee Fund assessments.

Transitional rules

If the total funding requirements under the new funding framework are greater than the total funding requirements under the current rules, the increase would be phased in over three years. The plan would be exempt from increases in the first year, pay ⅓ of the increase in the second year, and ⅔ of the increase in the third year.

Purchase of annuities discharging liabilities

An additional release provided details on "buy-out" annuity purchases that would permit defined benefit liabilities to be extinguished. "Buy-in" annuities will still be considered an investment of the plan (without liabilities being discharged).

- The buy-out annuity would need to provide the same benefit to the former or retired member or spouse of a retired member as they would have received from the pension plan if the annuity had not been purchased.
- The former member or retired member would retain their entitlement to surplus, in the event there is surplus when the plan is wound up in the future, if they were entitled to surplus under the plan documents at the time of the purchase of the annuity (whether or not there was surplus in the plan at the date of the annuity purchase).

- The insurance company, the annuity contract and the purchase would need to meet prescribed requirements.
- The administrator would need to provide notice of the purchase to the former member or retired member, in accordance with prescribed requirements. The administrator would also need to file with the regulator a certificate prepared and signed by an actuary certifying that the administrator has complied with the requirements set out in legislation in respect of the purchase.
- After a buy-out annuity purchase, the solvency funding ratio of the plan would need to be at least the higher of:

  1. The plan's solvency funding ratio immediately before the annuity purchase; and
  2. A solvency funding ratio of 100% (or 85% after the new framework is established).

  If the solvency funding ratio of the pension plan is less after the buy-out annuity purchase, within 30 days of the date of the purchase of the annuity, contributions would be required to bring the solvency ratio to the higher of the plan's solvency funding ratio immediately before the annuity purchase and 100% (or 85% after the new framework is established).

Past annuity purchases could be discharged if an actuarial certificate is provided certifying that the original purchase or subsequent adjustments made to the original purchase result in prescribed requirements being satisfied. Notice to members would also need to be provided.

Remaining details to be released

Other matters that are part of the new framework, including funding and governance policies as well as changes related to the Pension Benefits Guarantee Fund, will appear in subsequent government releases, possibly by this spring.

Conclusions and next steps

The proposed shift away from volatile solvency funding and towards more stable, long term going-concern funding will result in lower and more predictable contributions for most but not all plans. Many will benefit from filing a new valuation to implement the rules as soon as possible; others will wait and take advantage of transition measures. The changes will also encourage sponsors to review funding, investment and de-risking policies,in order to re-optimize their strategies.

The proposed rules are subject to consultation until **January 29, 2018** and we expect regulations will be released shortly thereafter. Sponsors are encouraged to start planning as soon as possible for the new pension funding paradigm.

Québec: Regulation on funding policies and annuity purchases

The final version of the *Regulation to amend the Regulation respecting supplemental pension plans* (the "regulation") was published on December 20, 2017 in the *Gazette officielle du Québec*. The regulation came into force on January 4, 2018.

This regulation, which addresses funding policies and annuity purchasing policies, makes only a few changes to the draft regulation published on July 12, 2017. For details about the draft regulation, see our *News & Views* of August 2017.

The following summarizes the main changes to the initial draft regulation:

1. Funding policy

Each plan must adopt a funding policy by **January 4, 2019**. Note that the *Supplemental Pension Plans Act* provides that the funding policy must be adopted by the person or body who may amend the plan.

With respect to the subjects that must be addressed in the funding policy, it is no longer necessary to mention the market trends observed in the employer's sector. The policy must outline the principles related to plan funding, the main characteristics of the employer and the employer's sector, the type of pension plan, its main provisions and demographic characteristics, the funding objectives of the plan with regards to variations in and the level of contributions, the main funding risks and the employer's and active members' level of risk tolerance. The regulation also provides for optional content.

2. Annuity purchasing policy

The regulation contains information regarding the annuity purchase policy and its content. Since it is not required that an annuity purchase policy be established, the regulation does not set a deadline for adopting such a policy. However, the policy must be adopted before an annuity may be purchased.

The regulation now indicates that it is possible to not proceed with an annuity purchase (if, for example, the premium required by the insurer is not considered very attractive) in circumstances when the pension to which the member or beneficiary is entitled is unavailable on the market due to its nature and it is proposed to be replaced by an annuity with similar characteristics. In such a case, the member or beneficiary must consent in writing to the replacement of the characteristics of his or her pension. The notice provided to the member or beneficiary for the purposes of consent must indicate that the purchase of annuities is contingent on the premium required by the insurer and that a notice will be provided to each member or beneficiary who has consented to the replacement once his or her annuity has been purchased, or once it is decided to not proceed with the payment of benefits by means of an annuity purchase.

3. Subjects on the agenda of the annual meeting

Information about annuity purchases must only be provided if annuity purchases were actually made in accordance with the annuity purchase policy since the previous annual meeting. The required information includes the number of annuities purchased and the premium required by the insurer for each annuity purchased and, if applicable, the amount of the employer's special annuity purchasing payment.

4. Partition of benefits after divorce and seizure

Details were provided in this regard and will apply to partitions and seizures with a date of execution subsequent to March 31, 2018.

Comments

The regulation provides a number of details that were expected. However, further details will be required for pension plans in the municipal and university sectors. For example, the regulation no longer contains provisions regarding the provision for adverse deviation (PfAD) as of January 4, 2018. However, the PfAD is still required to determine the surplus assets available for municipal and university sector pension plans.

Although a reasonable time period has been set for adoption of a funding policy, careful consideration of policy content and plan risk management should begin without delay. Existing documents, such as the investment policy and internal by-laws, should be reviewed to ensure consistency. Note that it is the responsibility of the pension committee to adopt the investment policy and internal by-laws. Furthermore, the pension committee must receive a copy of the funding policy.

Nova Scotia: Regulations on asset transfers

On November 28, 2017, the Nova Scotia government amended its *Pension Benefits Regulations* to establish clear criteria for asset transfers. There are two types of transfers: 1) transfers between pension plans where there is a sale or disposition of the employer's business or the assets of the business (successor employer situations); 2) where an employer ceases to make contributions to an original pension plan and a successor pension plan is established (successor plan situations).

The Nova Scotia regulations are similar to Ontario regulations with respect to asset transfers and provide for the following:

- Information requirements for applications to obtain the Superintendent's consent to a transfer of assets;
- Prescribed notices to eligible and ineligible members, former members, retired members and other persons entitled to benefits under the original pension plan, as well as bargaining agents and advisory committees;
- Prescribed notices, information and election forms to be provided when transfer consent is required under the transfer agreement;
- Transfers of assets performed on a solvency basis, where the solvency ratio of the successor pension plan after the transfer is either (i) at least 100% for successor plan transfers (85% for successor employer transfers); or (ii) no more than 5% below the solvency ratio of the transferring and receiving pension plans before the transfer;
- Continuation of the employer's obligation to make special payments under the original pension plan until the transfer of assets is completed;
- Transfers of assets are not permitted if the receiving pension plan provides for any reduction in accrued pension benefits or ancillary benefits where the transferring pension plan did not provide for such reduction.

The new regulations will provide a clear and relatively straightforward method of transferring assets between pension plans. However, as in Ontario, the requirements with respect to contents and deadlines for notices and applications are strict.

Alberta: Updated dental fee guide

Alberta released in late November 2017 a new dental fee guide effective January 1, 2018, that was developed in collaboration with the Alberta Dental Association and College (ADAC) and that recommends lower dental fees than the fee guide released in August 2017. The edition released earlier in 2017 was criticized for only including a two to three percent decrease in fees that Alberta dentists typically charged. Following the August 2017 release, the Alberta Minister of Health committed to working closely with ADAC to revise the fee guide.

The Alberta Dental Association discontinued publishing a provincial dental fee guide in 1997. 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. Every other Canadian provincial dental association publishes a fee guide which is updated annually.

Because of the negligible decrease in fees included in the August 2017 fee guide and the reaction of the Alberta Minister of Health, a number of insurers chose not to use it immediately. Based on responses to Morneau Shepell from a number of insurers, the new fee guide is to be adopted by the industry effective January 1, 2018.

ADAC has suggested that the new fee guide represents an 8.5% reduction in average prices for 60 common dental procedures. However, one insurer's analysis found that applying the new fee guide resulted in cost savings of only 3.5% compared to their current reasonable and customary fees.

While the establishment of a dental fee guide in Alberta is generally favourable for plan sponsors, it is safe to say that dental costs in the province will remain above average for some time. There has not been any indication on what adjustments to the fee guide can be expected in future years.

Most group benefit contracts stipulate that reimbursements are made according to the current year's dental fee guide, though some plan sponsors may have other contractual arrangements which will affect their costs. Some plan sponsors may need to amend their contractual wording as a result of the new dental fee guide. It is important to note that fee guides are recommendations and dental offices are not obligated to follow the suggested fees. Plan members visiting dentists who charge fees above those in the fee guide can expect to incur out of pocket expenses.

Leaves of absence: Updated rules affecting pension and benefit plans

Effective December 3, 2017, the federal Employment Insurance (EI) rules were updated to permit maternity benefits to be paid for up to 15 weeks, and parental leave benefits to be paid for up to 61 weeks. At the same time, a new adult caregiver benefit is payable for up to 15 weeks, and a child caregiver benefit is payable for up to 35 weeks. The changes to maternity and parental benefits under EI affect all provinces except Quebec, which has its own parental leave insurance program. Quebec employees will be eligible for expanded EI caregiver benefits.

All jurisdictions in Canada recognize the right of an employee to take an unpaid leave from work for a specified period of time without losing his or her job. Some of these jurisdictions have already increased the leave periods in their employment standards legislation in order to correspond with the federal EI changes. In those jurisdictions that have not increased the leave periods in their employment standards legislation, it is optional for the employer to provide an unpaid leave that corresponds to the federal EI changes.

Furthermore, a number of jurisdictions, namely British Columbia, Nova Scotia, Ontario, PEI, Quebec, Saskatchewan and the federal government (in respect of federally regulated employees) have provisions requiring pension and benefit accrual to continue during a leave period, subject to the employee making the required contributions under the plan. Once the applicable leave period is extended in those jurisdictions, this will require an extension to the potential length of benefit coverage under pension and benefit plans in those jurisdictions.

Employers with plan members in other provinces will need to consider whether to extend pension and benefit accrual during extended leave periods to members, even though not legally required.

This means that employers need to review their policies and procedures, including their pension plan texts, to ensure that they comply with the extended leave periods, understand the consequences for their pension plans, and make any required changes.

As of January 1, 2018, Ontario and the federal jurisdiction have made amendments to their leave periods to correspond to the federal EI changes. These changes are summarized below, along with certain other changes that were made in Alberta. We will monitor developments in other provinces.

Ontario

An Ontario employee continues to participate in pension and benefit plans during a statutory leave period unless the employee elects in writing not to do so. The employee must make his or her required contributions under the plan.

An exception to this provision exists when the employee takes a reservist leave to serve with the Canadian Forces.

A number of statutory leaves have been extended or created pursuant to Ontario Bill 148. Employees will be entitled to a continuation of pension and benefit coverage during such leaves. A summary of the changes can be found in the following table.

Ontario: Leave Type	Effective Date	Previous Leave Granted	New Leave granted
Personal Emergency Leave	January 1, 2018	None	10 days *(2 of the days paid)*
Family Medical Leave	January 1, 2018	8 weeks	28 weeks
Pregnancy Leave	January 1, 2018	6 weeks	12 weeks
Parental Leave • Employees who have taken pregnancy leaves • Employees who have not taken pregnancy leave	December 3, 2017	 35 weeks 37 weeks	 61 weeks 63 weeks
Child Death Leave (regardless if crime-related)	January 1, 2018	None	104 weeks
Crime-Related Child Disappearance Leave	January 1, 2018	52 weeks	104 weeks
Critical Illness Leave • Critically ill child • Critically ill adult	December 3, 2017	 37 weeks 0 weeks	 37 weeks in a 52-week period 17 weeks in a 52-week period
Domestic or Sexual Violence Leave	January 1, 2018	0 weeks	10 days of leave and up to 15 weeks of leave *(first 5 days of the leave will be paid)*

Federal

Federally regulated workers now have the right to take up to 63 weeks of parental leave. This is an increase from the previous maximum period of 37 weeks.

While the total amount of maternity leave will remain at 17 weeks, women will be able to commence their unpaid leave of absence up to 13 weeks prior to the child's due date. The cap on the cumulative amount of maternity and parental leave that two employees may take with respect to the same birth or adoption cannot exceed 78 weeks, which is an increase from 52 weeks.

Federally regulated employees with adult family members who are critically ill will now be eligible to take unpaid leaves of up to 17 weeks. Family members of a critically ill child will be eligible to take unpaid leaves of up to 37 weeks. This period is unchanged, but is now available to family members in addition to adults.

Employers will be required to continue to pay contributions to pension, health and disability benefits during the employee's leave of absence for the full duration of the leave of absence, as newly legislated. However, employers will not have to contribute if the employee does not pay their contributions within a reasonable time.

The following chart lists the legislative changes to the relevant leave periods and identifies the additional number of weeks that employers will need to contribute to pension, health and disability benefits.

Federal: Leave Type	Effective Date	Previous Leave Granted	New Leave granted
Parental Leave	December 3, 2017	37 weeks	63 weeks
Aggregate Leave • *Maternity and Parental*	December 3, 2017	52 weeks	78 weeks
Caregiver - Critically Ill • Child – *Family Member*	December 3, 2017	37 weeks, but only applicable to parents	37 weeks
Caregiver - Critically Ill • Adult – *Family Member*	December 3, 2017	None	17 weeks

Alberta

Alberta has increased its compassionate care leave provisions from 8 weeks to 27 weeks. Maternity leave is extended from 15 weeks to 16 weeks. Parental leave provisions have not yet been amended to correspond with EI changes. A number of other forms of leave have also been created.

Alberta does not require pension and benefit coverage to continue during leave periods. Therefore, pension and benefit coverage during such leave periods depends on the employer's policies and documentation.

Income Tax Act limitations on pension accrual during leave periods

The *Income Tax Act* and corresponding regulations (the "ITA") permit a pension plan to provide coverage during an employee's unpaid leave period. The amount of deemed compensation during such leave periods must be reasonable and is termed "prescribed compensation". The maximum period of prescribed compensation for an employee with a single employer is five years, plus an additional three years in respect of periods of maternity and parental leave.

With the extended leave periods, employers will need to ensure that these cumulative leave periods are monitored and that the maximum amounts of prescribed compensation are not exceeded.

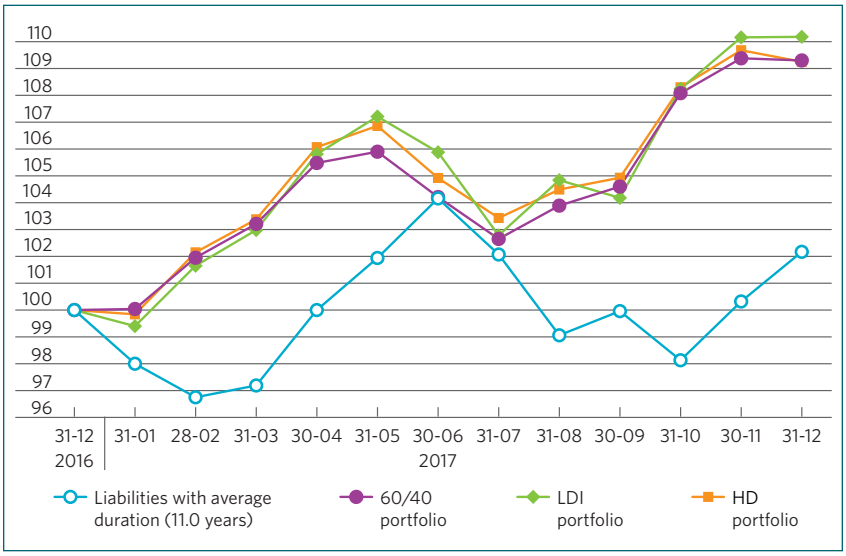
Conclusion

The creation and extension of statutory leave periods will have a significant impact on Canadian workplaces. As employees take advantage of extended maternity and parental leaves, as well as other forms of leaves, employers will have to ensure that their pension and benefit plan coverage complies with their statutory obligations. In addition, they should ensure that workplace policies and documentation accurately reflects the employer's intentions and the benefits provided to employees.

Tracking the funded status of pension plans as at December 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 September 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



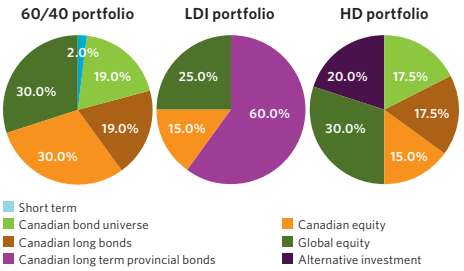
During the month of December, Canadian universe bonds, Canadian long-term bonds, alternative investments and global equity markets (CAD) showed negative returns while Canadian long-term provincial bonds and Canadian equity markets (CAD) showed positive returns. With a return of 0.0%, the low volatility portfolio (LDI[1]) outperformed the 60/40 portfolio (-0.1%) and the highly diversified portfolio (HD) (-0.4%). The relative outperformance of the LDI portfolio is mainly due to its larger allocation to Canadian long-term provincial bonds. The prescribed CIA annuity purchase rates **increased** during the month, however, the commuted value rates used in the calculation of solvency liabilities **decreased**. As a result, the solvency liabilities increased by 1.8% 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 decrease of the solvency ratio.

Initial solvency ratio as at December 31, 2016	Evolution of the solvency ratio as at December 31, 2017 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	107.0%	107.8%	106.9%
90%	96.3%	97.1%	96.2%
80%	85.6%	86.3%	85.5%
70%	74.9%	75.5%	74.9%
60%	64.2%	64.7%	64.2%

[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 and global equity markets, Canadian long-term bonds, Canadian long-term provincial bonds as well as the alternative investments, the 60/40 portfolio, the LDI portfolio and the HD portfolio returned 9.3%, 10.2% and 9.3% respectively. The solvency liabilities fluctuated over that same period from 1.6% to 2.4% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at December 31, 2017 stands between 4.2% and 7.8%.

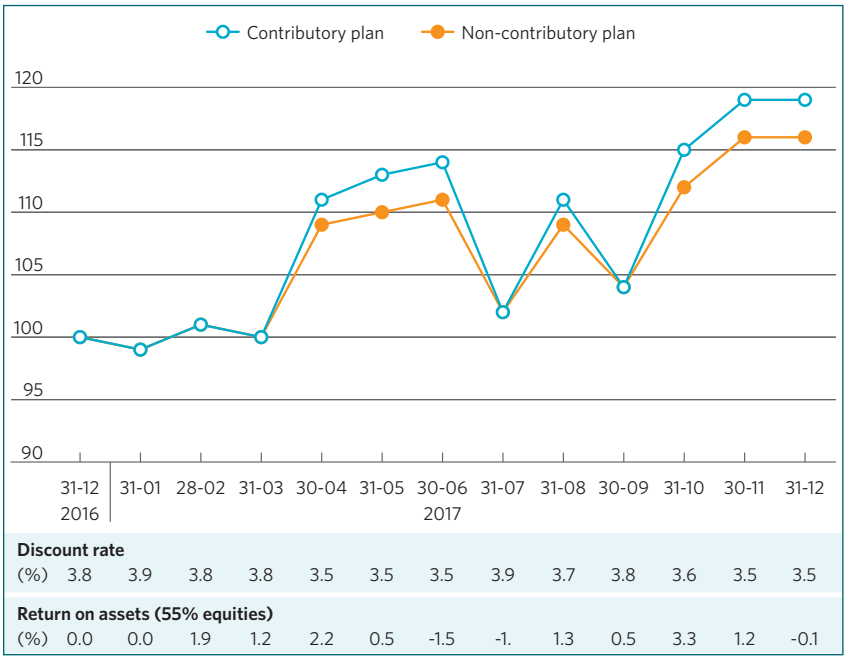
Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.

Impact on pension expense under international accounting as at December 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



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	December 2017	Change in 2017
11	3.66%	3.39%	-27 bps
14	3.81%	3.48%	-33 bps
17	3.90%	3.53%	-37 bps
20	3.96%	3.57%	-39 bps

Since the beginning of the year, the pension expense has increased by 19% (for a contributory plan) due to the decrease in the discount rates, despite 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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