Knowledge & Insights

MORNEAU SHEPELL

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In this issue

Ontario: Proposed changes to Pension Benefits Guarantee Fund assessments

On January 19, 2018, the Ontario Ministry of Finance (the "MOF") released a description of proposed changes to the assessment formula for the Pension Benefits Guarantee Fund (PBGF). The PBGF is a fund established under the Ontario *Pension Benefits Act* to ensure that a minimum pension benefit is paid to Ontario plan members of certain types of defined benefit pension plans, if these plans are wound up with insufficient funds.

The proposed changes to the PBGF assessments are related to the 50% increase in the PBGF coverage limit (see our *News & Views* of December 2017).

If the proposed changes are adopted, they would result in the elimination of some components of the current PBGF assessment structure, the addition of a new component based on a pension plan's PBGF liabilities, and an increase in some components of the current PBGF assessment structure.

Elimination of current components

If adopted, the proposed changes would result in the elimination of some components of the current PBGF assessment structure by:

- Eliminating the basic assessment of $5 per pension plan member; and
- Eliminating the current minimum pension plan assessment of $250.

New component

The proposed changes would add a new component based on a pension plan's PBGF liabilities with the introduction of an assessment component equal to 0.015% of a plan's PBGF liabilities. For example, if the PGBF liabilities are $100 million, then this component would be equal to $15,000; it would not vary regardless of how well those liabilities are funded.

Increase of current components

The proposed changes would also affect the PBGF assessment by:

- Revising the existing risk-based assessment formula to increase existing rates for each tier of the laddered three-tier, risk-based assessment formula by 50%;
- Increasing the plant closure permanent benefit assessment such that the rate applied would increase from 2% to 3% times the liability for plant closure and permanent lay off benefits that the employer elected to exclude from solvency liabilities; and
- Increasing the maximum assessment per plan member from $300 to $600.

The proposed changes would take effect for plan assessments on or after January 1, 2019. The MOF has stated that the proposed changes to the PBGF assessment formula fit within the broader framework of proposed reforms to the funding rules for pension plans registered in Ontario. However, to the extent their plan membership includes Ontario members, defined benefit pension plans that are registered in jurisdictions outside Ontario will also be impacted by these proposed changes to the PBFG assessments, even though they will not be impacted by Ontario's funding reform.

The Ontario Ministry of Finance is accepting comments on the proposed changes until **February 20, 2018**.

Manitoba: Proposed changes to the *Pension Benefits Act*

On January 10, 2018, Manitoba's Minister of Finance launched a public consultation to strengthen the existing provincial pension system. The Department of Finance published a consultation paper as part of the public review of the *Pension Benefits Act* (PBA).

This announcement follows the recent review by the Pension Commission of Manitoba of the province's PBA, which is required by statute every 5 years.

The Commission's review focused on:

- New plan designs;
- Funding rules;
- Locking-in provisions;
- Compulsory pension plan membership;
- Division of pensions on relationship breakdown; and
- Clarification of legislative gaps.

The Commission's recommendations propose changes to defined benefits (DB) plans to create flexible requirements for plan funding, as funding issues have placed a significant burden on plan sponsors. One key objective for DB plans is to develop solvency-funding reforms that consider plan sustainability, affordability and benefit security of the plan sponsor, unions, members and retirees. The Commission's proposed changes, similar to those adopted in other jurisdictions, include eliminating solvency funding, enhancing going-concern requirements and introducing a solvency reserve account.

The Commission's Recommendations:

New Plan Designs

The Commission recommends that a new and more flexible target benefit/shared risk plan design be permitted, which would be flexible enough to apply to a broad range of pension plans (i.e. for single employers, multi-employers, private sector and public sector). The plan would be jointly trusteed, exempt from solvency funding and would apply only to future benefit accruals (although the consultation document asks whether conversion should be permitted for future service only or not). Going-concern commuted values would be paid based on the funded status of the plan.

Funding rules

The Commission recommends that solvency funding be required only if the plan's solvency ratio is below a threshold level of 85%. The solvency funding would only be required until the solvency ratio has increased to at least the threshold level.

The current solvency rules would be replaced with a regime that requires enhanced going-concern funding, which could include funding of an excess amount (provision for adverse deviation), shortening the current period for funding unfunded liabilities, restricting investment return assumptions to a maximum level set by the Superintendent, and basing benefit improvements on the solvency position of the plan.

Solvency Reserve Accounts (SRAs) would be permitted as a separate account within a plan fund, to hold solvency deficiency payments that can be used to fund shortfalls or be withdrawn by the employer if the surplus exceeds a prescribed amount.

Locking-in provisions

The Commission recommends the introduction of unlocking due to financial hardship for Locked-In Retirement Accounts (LIRAs) and Life Income Funds (LIFs). The following financial hardship qualification criteria are proposed:

- Eviction for rental arrears;
- Foreclosure;
- Medical/dental expenses not covered by other insurance/government programs; and
- If an individual's income is less than ⅔ of the yearly maximum pensionable earnings (YMPE) under the Canada Pension Plan (i.e. less than $37,267 for 2018), that individual may unlock up to ½ of the YMPE (i.e. up to $27,950 in 2018).

Also proposed is the expansion of the current provisions allowing LIF owners to make a one-time transfer of 50% of their LIF to an unlocked prescribed RRIF. The expanded provision would permit funds from a LIRA to be unlocked under the same conditions. The Commission further recommends that at the age of 65, 100% unlocking of LIRAs and LIFs be permitted.

Compulsory pension plan membership

Continuing compulsory pension plan membership as a condition of employment has been recommended (where there is a pension plan in effect).

Division of pensions on relationship breakdown

The Commission recommends that the portion of the pension that is to be divided upon a relationship breakdown, be determined under *The Family Property Act* rather than the PBA. This is subject to the spouse or common-law partner not receiving more than 50% of the pension earned during the period of the relationship.

Clarification of legislative gaps

The Commission proposes reform to the following provisions in the PBA:

- Amend the provision setting out entitlement to ancillary benefits to clarify when the benefit is vested and that it must be included in the calculation of commuted values;
- Amend the pension committee requirements to permit a vacant position where there is no inactive member in the plan or no inactive member willing to be on a pension committee;
- Amend the Multi-unit pension plan (MUPP) provisions to be consistent with the multi-employer and specified multi-employer provisions in other jurisdictions and the *Income Tax Act*; and
- Amend the provision setting out when an individual ceases to be an active member of a DB plan, to provide that a member may choose to suspend membership and contributions at the normal retirement age (normally age 65), while remaining employed. Upon subsequent commencement of a pension, the pension accrued to the age of 65 would be actuarially increased from age 65 to the member's actual retirement date.

For those who would like to provide submissions on the discussion questions in the consultation paper and recommendations in the Commission's report, the closing date for submissions is **February 21, 2018**.

Review of Public Sector Accounting of retirement benefits

In 2014, the Public Sector Accounting Board (PSAB) identified, as part of a survey, the review of Section 3250 (*Retirement Benefits*) and Section 3255 (*Post-employment Benefits, Compensated Absences and Termination Benefits*) as one of its top priorities. With other accounting standards subject to major revisions in recent years, as well as the introduction of new types of pension plans in Canada, it is a good opportunity to review the provisions of PS 3250 and PS 3255 and determine if changes are required. Thus, PSAB established the *Employee Benefits Task Force* (Task Force) in 2015 to undertake the project. The Task Force decided to split the review process into two phases:

1. Phase One addresses the deferral of experience gains and losses and discount rates, which could lead to amendments to the current standards.
2. Phase Two focuses on how to account for the new types of defined benefit pension plans in Canada (shared risk plans, target benefit plans), multi-employer defined benefit pension plans and vested sick leave benefits. This phase will ultimately lead to the replacement of the existing PS 3250 and PS 3255 sections with a completely new comprehensive section.

The Task Force published the first Invitation to comment (ITC) in November 2016, which was focused on the deferral provisions of the standards. The February 2017 issue of *News & Views* outlined the main features of that ITC.

The Task Force has now published the second *Invitation to comment* (ITC) in November 2017, which is focused on the discount rate guidance in Section PS 3250.

Section PS 3250 does not provide specific guidance on which discount rate should be used to estimate the accrued benefit obligation. It refers to two discount rate bases in the examples used to illustrate the principle that actuarial assumptions underlying the valuation of retirement benefit liability and expense should be internally consistent. In practice, the expected return on plan assets is usually used to determine the present value of the accrued benefit obligation of benefit plans that are fully or partially funded. The entity's cost of borrowing is usually used to determine the present value of the accrued benefit obligation of benefit plans that are unfunded.

PSAB needs to consider if the discount rate guidance in Section PS 3250 is sufficient and whether the two discount rates commonly used in the public sector are appropriate and provide useful information for accounting purposes because some concerns have been raised about the current practice. There are also concerns about using one discount rate basis to determine the accrued benefit obligation of plans that are fully funded and partially funded, and another discount rate basis to determine the accrued benefit obligation of plans that are unfunded.

This ITC suggests alternative bases to determine the discount rate assumption:

- Expected return on plan assets;
- Expected return of an effective hedge portfolio;
- Market yields of high-quality debt instruments;
- Market yields of risk-free debt instruments;
- The entity's cost of borrowing; or
- The effective settlement rate.

An alternative discount rate approach could be any of the six discount rate bases identified above, reflecting one of three possible views: a current, average, or a projected view.

It is important to note that PSAB has not yet established a preliminary view on this issue, which is one of the main reasons why the ITC is seeking stakeholder input.

Stakeholders may send their comments until **March 9, 2018**.

The Task Force is planning to work in 2018 on the third *Invitation to Comment*, which will relate to Phase Two of the project. The effective date of any potential amendment to the standards will likely be a few years away as a result of PSAB's due process.

Prescription drugs: Price reductions announced

Effective April 1, 2018, the prices of nearly 70 of the top prescribed generic drugs in Canada will be reduced by 25 to 40% as a result of an agreement announced jointly by the pan-Canadian Pharmaceutical Alliance (pCPA) and the Canadian Generic Pharmaceutical Association. The two organizations have reached a five-year agreement to facilitate the price reductions. The agreement also stipulates that the participating public drug plans will not pursue tendering for generic drugs over the life of the deal. There was a similar agreement reached in Quebec in 2017.

It is estimated that this initiative will save participating drug plans up to $ 3 billion over five years.

The pCPA has negotiated a series of price decreases for selected generic drugs over the years, leveraging economies of scale. The intent of the organization has been to reduce prescription drug costs for provincial and federal drug programs. The pCPA was established in 2010 and now includes all provincial, territorial, and federal prescription drug plans. Though private plan sponsors are not represented by the pCPA, these plans still benefit from reduced generic drug prices, as well as other measures such as reduced prices for high cost hepatitis C drugs (see details in our *News & Views* of April 2017).

The Canadian Life and Health Insurance Association (CLHIA) issued a news release that was supportive of this announcement. CLHIA is still advocating for insurers to be represented in the pCPA as they feel a single buying group for prescription drugs would be a more equitable approach for all Canadians. While pCPA's negotiations for generic drugs provide transparency on pricing, brand name drug price negotiations remain confidential and only benefit the represented provincial and federal drugs plans.

The prices of affected generics already include substantial discounts to the brand name prices due to a series of past price reductions. In fact, the list of

drugs outlined in this latest announcement includes the six drugs included in the initial cPCA generic drug agreement in 2013: generic versions of *Lipitor*® and *Altace*® (cardiovascular), *Losec*® and *Pariet*® (gastrointestinal), *Effexor*® (depression) and *Norvasc*® (high blood pressure). Costs will reduce to as low as 10% of the brand name equivalent for certain therapies included in this latest announcement, but plan sponsors' savings will depend on plan member usage, generic drug utilization rates, and the prescription drug plan design in place. In addition, pharmacies may take steps to raise dispensing fees or drug mark up to recover lost revenue, which would lead to other increases borne by plan sponsors. While these latest reductions are not game changers, the aggregate reduction in generic drug prices over the last 5 to 10 years has been significant.

If we apply the announced price reductions to a sample plan, we can estimate that this could result in a reduction in prescription drug costs of approximately 1% to 3%, although this could vary significantly depending on the group's profile and the characteristics of the plan.

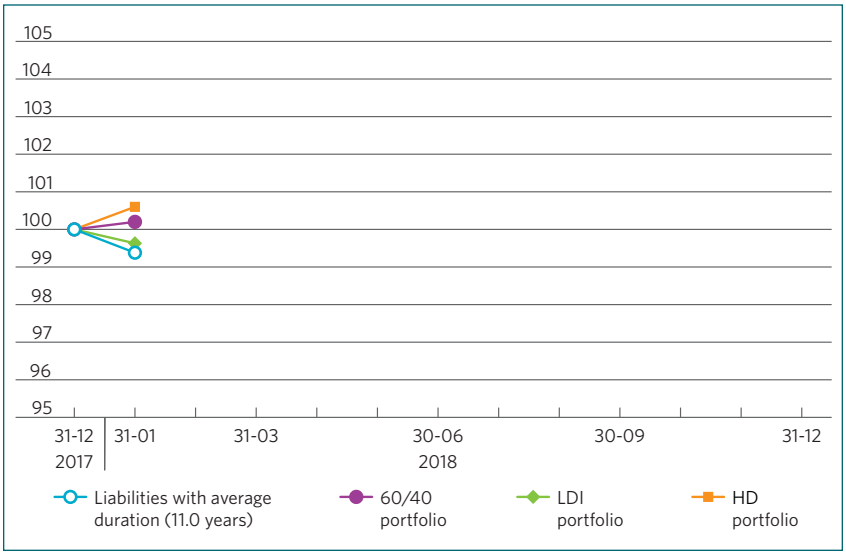
The impact of the five-year moratorium on tendering is unclear. Advocates suggest that the agreement provides generic manufacturers stability and is less likely to result in drug supply problems. Critics believe that lower prices could be achieved through maintaining a competitive process.

While the focus of many plan sponsors in recent years has been on high cost specialty drugs, cost saving opportunities for generic drugs should not be ignored. The therapies included in this agreement are claimed under a majority of drug plans in Canada. This recent announcement underscores the importance for plan sponsors to implement cost containment measures, such as prescription drug cards, lowest cost alternative, formularies, and specialty drug management.

Tracking the funded status of pension plans as at January 31, 2018

This graph shows the changes in the financial position of a typical defined benefit plan with an average duration since December 31, 2017. For this illustration, assets and liabilities of the plan were each arbitrarily set at $100 million as at December 31, 2017. The estimate of the solvency liabilities reflects the new CIA guidance for valuations effective December 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, 2017



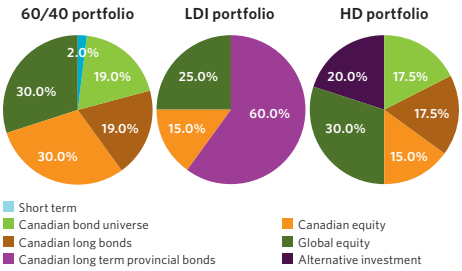
During the month of January, Canadian universe bonds, Canadian long-term bonds, Canadian long-term provincial bonds and Canadian equity markets showed negative returns, while alternative investments and global equity markets (CAD) showed positive returns. With a return of 0.6%, the highly diversified portfolio (HD) outperformed the 60/40 portfolio (0.2%) and the low volatility portfolio (LDI[1]) (-0.4%). The relative outperformance of the HD portfolio is mainly due to its larger allocation to alternative investments. The prescribed CIA annuity purchase rates and the commuted value rates used in the calculation of solvency liabilities increased during the month. As a result, the solvency liabilities decreased by 0.6% 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 slight increase of the solvency ratio.

Initial solvency ratio as at December 31, 2017	Evolution of the solvency ratio as at January 31, 2018 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	100.8%	100.3%	101.2%
90%	90.7%	90.2%	91.1%
80%	80.7%	80.2%	81.0%
70%	70.6%	70.2%	70.9%
60%	60.5%	60.2%	60.7%

[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, 2017 as well as the asset allocation of the three typical portfolios.

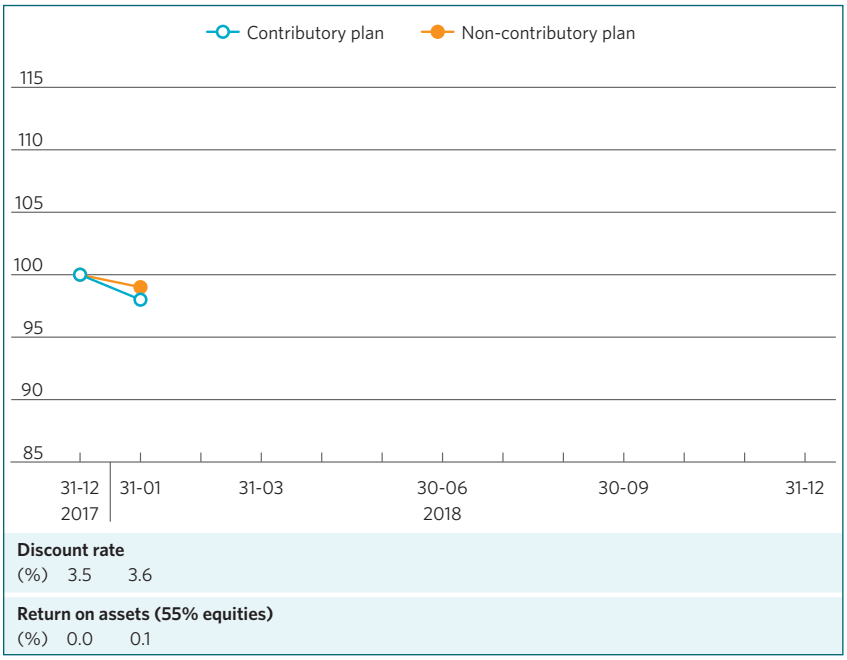
Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.

Impact on pension expense under international accounting as at January 31, 2018

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, 2017



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 2017	January 2018	Change in 2018
11	3.39%	3.49%	+10 bps
14	3.48%	3.56%	+8 bps
17	3.53%	3.60%	+7 bps
20	3.57%	3.63%	+6 bps

Since the beginning of the year, the pension expense has decreased by 2% (for a contributory plan) due to the increase in the discount rates.

Comments

1. The expense is established as at December 31, 2017, based on the average financial position of the pension plans used in our *2017 Survey of Economic Assumptions in Accounting for Pensions and Other Post-Retirement Benefits report* (i.e. a ratio of assets to obligation value of 93% as at December 31, 2016).
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 2017 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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