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Pension risk transfer activities are growing in Canada

By Marc Drolet, FCIA, FSA

The stock market crash of 2008 and the declining interest rates that followed have put considerable pressure on sponsors of defined benefit pension plans. Now, a decade later, pension plans are generally in a much healthier position due to good market returns and significantly higher employer contributions. This improvement in funded status explains, at least in part, the growing trend in pension risk transfers, including liability driven investing and group annuity purchases, to reduce volatility of contributions.

In 2017, the Canadian group annuity market established a new record with $3.7 billion in annuity sales, a $1 billion increase over 2016. This trend in pension risk transfer transactions is likely to keep growing in 2018 and beyond. Canadian insurance companies involved in this market are showing increased appetite in terms of capacity, and willingness, to take on larger amount of retiree obligations. Moreover, recent legislative changes across different jurisdictions, namely British Columbia, Quebec and Ontario, have allowed pension plan sponsors to eliminate residual legal risk and having a full discharge of responsibility without having to fully wind up a pension plan. This move towards full discharge will likely spark additional interest from plan sponsors who wish to reduce the size of pension plans on their balance sheet without winding up their pension plans.

Pension risks and growth of group annuity market

Pension plans come with uncertainty, and uncertainty means risks. There are economic risks, such as market risks and interest rate risks (investment risks), and demographic risks, such as increase in life expectancy, to name a few. To reduce investment risks, plan sponsors have changed their asset mix – some have simply reduced their allocation to equities while others have moved to a full liability driven investment (LDI) strategy. However, investment-driven strategies do not deal with longevity risks, namely the risk that the retiree group may outlive actuarial projections. The solution may lie in annuitizing retiree pensions through an annuity purchase.

Historically, the annuitization of retiree pensions was a consequence of a pension plan wind up, but annuity purchases are also a risk-management option for ongoing pension plans. There are buy-in annuities, in which an insurance company and a plan sponsor enter into a contract where the former assumes the longevity and interest rate risk in exchange for an agreed upon premium paid from the latter's pension fund. The payment of pension benefits, member communications and other administrative activities remain the responsibility of the plan sponsor, but the insurer reimburses the sponsor for the benefit cost with a single monthly payment into the pension fund. It is similar to a fixed-income investment, where the monthly insurer payment exactly matches the covered pensioner payments – in other words, an example of a perfect LDI strategy.

One drawback for buy-in annuities is that plan sponsors remain responsible for the administration related to insured pensioners and legally responsible for the payment of benefits in the event of an insurer insolvency (sometimes called the boomerang risk). Consequently, although there is a transfer of the risks to an insurer, the pension benefit obligation for the pensioners covered by a buy-in annuity remain part of the sponsor's financial statements under most accounting rules. It remains a solid risk reduction option, but will not reduce the size of the pension plan on the balance sheet.

The other option is buy-out annuities, where in addition to accepting the longevity and interest rate risks, the insurer assumes administration duties and makes monthly payments to pensioners. In recent years, regulators in the province of British Columbia, Quebec and Ontario have adapted their pension legislation to allow plan sponsors, by meeting certain conditions, to transfer pension risks while eliminating the residual legal risk to the pension plan, making buy-out annuities a significantly more attractive option. A drawback may come in the form of a required special employer contribution to fully fund the buy-out annuity purchase, depending on the solvency ratio and plan jurisdiction, as well as the responsibility to comply with various regulatory requirements.

Who should consider purchasing annuities, and when?

Any plan sponsor who wishes to focus on their core activities and reduce their pension size, risks and administrative burden is a good candidate for

an annuity purchase. Every situation is different, but such transactions appeal to plan sponsors with large, mature pension plans that have already shifted a sizeable amount of plan assets to a fixed-income portfolio and have a large number of retired members. It is not as appealing to newer plans since buy-out annuities are only permitted for retired members in Quebec and for former and retired members in British Columbia and Ontario.

As an increasing number of analysts expect an increase in interest rates, should plan sponsors wait to consider annuitization of their pensioners? The premium required by insurance companies is inversely correlated with interest rates; in other words, as interest rates rise, the required premiums decrease (and vice versa). Instinctively, plan sponsors may be tempted to wait for interest rates to rise before transacting. However, the reality is that no one has a crystal ball. In addition, an annuity purchase can be seen as an attractive alternative to an investment in a bond portfolio aiming at tracking the solvency liabilities because with a bond portfolio, when interest rates rise, liabilities will fall with falls in investment value.

Steps and timeline

The annuity purchase process involves many steps and many stakeholders. As such, it is essential for plan sponsors to work with experts to ensure that all necessary steps are taken and to ensure the transaction achieves the plan sponsor's objectives. The process usually starts with a feasibility study to evaluate whether an annuity purchase makes sense, an analysis of the purchase's potential financial impacts on contributions and pension expense, and finalize the project plan. Having a structured plan and careful preparation is essential for a successful and efficient transaction.

The preparation phase often includes a pensioner audit to improve the accuracy of data, and the gathering of additional information such as pensioners' job title and pay prior to retirement. It should also include a review of the current asset allocation and the optimal asset allocation for the remaining plan assets after a potential transaction to determine the scope and size of the annuity purchase.

Once the analysis is complete and a tentative decision to purchase has been made, quotations are requested from insurers. The delay between the request is made and the quotations are received varies depending on size and plan complexity. It usually ranges from 4 to 6 weeks depending on the size of the transaction. The quotes are requested on a coordinated bid date to allow all of the quotes to be analyzed on a comparable basis. This part of the process is very time sensitive, as insurers often guarantee their quotes for only a few hours. If a transaction occurs, a series of events will unfold including contract signing, premium payment, transfer of data, implementation by the insurer, communication with affected members, and regulatory filings.

Communicating with former and retired members affected by the purchase

Some paternalistic employers may be reluctant to consider annuity purchases as it can be interpreted as a corporation cutting off ties with retirees that have spent their entire career working for them. However, the reality is most retirees would be better off having their monthly pension guaranteed by an insurance company rather than being paid by a pension plan that is subject to the risk of employer bankruptcy or insolvency. Insurers are subject to strict capital adequacy tests and solvency requirements that make insurance company failure unlikely, though certainly possible. In addition, a not-for-profit organization called Assuris protects every Canadian annuity holder up to $2,000 per month or 85% of the promised benefit, whichever is higher, should their life insurance company fail. This level of protection is not available for most employer sponsored pension plans.

Conclusion

As plan sponsors search for risk-management solutions, some regulators have adapted and changed their pension legislation to allow buy-

out annuities. As pension plans move closer to full funding, this is a good time for plan sponsors to revisit their pension risk tolerance and assess whether an annuity purchase can assist with their de-risking goals. A close monitoring of the plan's solvency position combined with a tracking of the insurers' appetite and willingness to transact can be a great start.

Organizations that are interested to know more about annuity purchases, LDI investing or other risk transfer strategies, should contact Morneau Shepell. Our asset and risk management and annuity purchase teams can work closely with your Morneau Shepell actuary and plan an optimal de-risking strategy or a pension risk transfer transaction that is in line with your organization's objectives.

Update: Employment leave provisions amended in British Columbia, New Brunswick and Newfoundland and Labrador

Recent amendments to employment standards legislation in British Columbia, New Brunswick and Newfoundland and Labrador have received royal assent, and bring certain types of leave in line with the federal government's recent changes to employment insurance (EI) rules effective December 3, 2017. Changes to provincial leave provisions in these provinces provide employees with new and extended periods of job protection for various types of leaves.

British Columbia

Bill 6 received royal assent and came into force on May 17, 2018. The maximum lengths of parental and compassionate care leave periods are extended in accordance with the recent EI changes. Furthermore, Bill 6 introduces leaves of absence for the death or crime-related disappearance of a child.

New Brunswick

Bill 44 received royal assent and came into force, with one exception, on March 16, 2018. Bill 44 amends the New Brunswick *Employment Standards Act* to create a new leave for care of a critically ill adult leave and expand maternity and parental leave provisions. Bill 44 also allows a family member who is not a parent to take a leave for care of a critically ill child.

Bill 44 will also permit regulations to be established concerning domestic violence, intimate partner violence or sexual violence leave. Those provisions come into force upon proclamation.

Newfoundland and Labrador

Bill 29 received royal assent and came into force on March 12, 2018. Bill 29 amends the *Labour Standards Act* to increase the amount of parental leave available from 35 weeks to 61 weeks and introduces a new critically ill adult care leave of up to 17 weeks. Bill 29 also allows a family member who is not a parent to take a leave for care of a critically ill child.

Comment

British Columbia requires pension and benefit accrual to continue during a leave period, subject to the employee making the required contributions under the plan, while New Brunswick and Newfoundland and Labrador do not. The changes to leave periods in British Columbia will require an extension to the potential length of benefit coverage under pension and benefit plans in those jurisdictions. Employers with plan members in New Brunswick and Newfoundland and Labrador will need to consider whether to extend pension and benefit accrual during extended leave periods to members, even though not legally required. Morneau Shepell will continue to monitor and keep you updated on the expansion of employment leave periods.

Summary of changes to the British Columbia *Employment Standards Act*

Leave type	Effective date	Previous maximum period of leave	New maximum period of leave
Pregnancy	May 17, 2018	May begin 11 weeks before due date and last up to 17 weeks	May begin 13 weeks before due date and last up to 17 weeks
Parental	May 17, 2018	If pregnancy leave taken: 35 weeks	If pregnancy leave taken: 61 weeks
		If pregnancy leave not taken: 37 weeks	If pregnancy leave not taken: 62 weeks
		Combined pregnancy and parental leave: 52 weeks	Combined pregnancy and parental leave: 78 weeks
Compassionate care	May 17, 2018	8 weeks	27 weeks
Disappearance of child (new)	May 17, 2018	0 weeks	52 weeks
Death of Child (new)	May 17, 2018	0 weeks	104 weeks

Summary of changes to the New Brunswick *Employment Standards Act*

Leave type	Effective date	Previous maximum period of leave	New maximum period of leave
Maternity	March 16, 2018	May begin 11 weeks before due date and last up to 17 weeks	May begin 13 weeks before due date and last up to 17 weeks
Child care (i.e., parental)	March 16, 2018	37 weeks for two employees	62 weeks for two employees
		Combined child care and maternity leave: 52 weeks for two employees	Combined child care and maternity leave: 78 weeks for two employees
Critically ill adult (new)	March 16, 2018	0 weeks	16 weeks for all employees in respect of one critically ill adult
Domestic violence, intimate partner violence or sexual violence (new)	On a date to be proclaimed	0 weeks	To be prescribed by regulation

Summary of changes to the Newfoundland and Labrador *Labour Standards Act*

Leave type	Effective date	Previous maximum period of leave	New maximum period of leave
Parental	March 12, 2018	35 weeks	61 weeks
Critically ill adult (new)	March 12, 2018	0 weeks	17 weeks

Injured former employee successful in long term disability claim two years after termination

Employers should be aware that termination of employment does not necessarily mean an employee will be barred in all cases from making a long-term disability (LTD) claim for injuries that occurred while they were employed, even if the policy is designed to foreclose the possibility. The recent Ontario Court of Appeal decision in *MacIvor v Pitney Bowes* provides an interesting insight into this possibility. In MacIvor, the employee was successful in an LTD claim submitted two years after resigning, and five years after the injury itself.

Background

Mr. MacIvor was severely injured in 2005 while attending an event sponsored by his employer in Costa Rica. He was off work for 4 months due to a significant back injury and a traumatic brain injury. In hindsight, while the focus during his recovery was on his back issues, it was the extent of his brain injury that would have greater bearing on his life. Upon his return to work, he struggled to perform at the same level as he had prior to his injury. His employer modified his work duties but he continued to struggle and, three years after incurring his injuries, he resigned. He quickly found similar employment with another company but performance issues related to his brain injury continued and he was terminated by his new employer within a year. He was refused LTD

coverage under his new employer's policy, as the injury occurred prior to his employment.

Eventually, two years after terminating his employment with his first employer, Mr. MacIvor filed a claim under his former employer's LTD policy (the "LTD Policy"). The insurer denied the claim and Mr. MacIvor commenced an action against them and his former employer.

At trial, the parties submitted an agreed statement of facts, concurring that Mr. MacIvor was totally disabled from the time of the initial injury. The medical evidence would demonstrate that the severity and the permanent nature of Mr. MacIvor's brain injury was not originally apparent.

Trial Decision

The trial judge dismissed Mr. MacIvor's claim for coverage, finding that that he did not qualify for benefits due to the "Termination of Coverage" language in the LTD Policy. The trial judge held this language provided that there was no coverage for persons who were not employed by the employer. Consequently, Mr. MacIvor could not make a successful claim because he had quit his job and was no longer an employee, and so he was no longer covered by the LTD Policy.

Appeal Decision

Mr. MacIvor appealed to the Ontario Court of Appeal, with the main issue being whether Mr. MacIvor, as a former employee, was entitled to coverage under the LTD Policy?

The Appeal Court reversed the trial decision, finding that the LTD Policy, when considered in totality, covered claims that arise during the course of an employee's employment. This included, as in this case, when an employee does not discover the claim, or the severity of their injury, for some time afterwards.

The "Termination of Coverage" language in the LTD Policy is intended to bar future claims arising subsequent to terminating employment, not claims that may have arisen during the course of the employee's employment. Consequently, as in this case, where an employee's claim arises as the result of an injury or medical condition that occurred during the employee's employment, the LTD Policy provides coverage.

In rejecting the lower court's decision that coverage ended when Mr. MacIvor resigned, the Appeal Court held that the termination provisions did not exclude coverage for undiscovered disability claims that originated during the employee's employment stating:

> *To so conclude would leave former employees in an untenable position of having no disability coverage from either their former or new employer. Such a result would be contrary to the very purpose of the disability insurance and the plain meaning of the coverage provision.*

The Appeal Court also considered claims that Mr. MacIvor did not meet the deadlines for submitting a claim and proof of claim under the LTD Policy. The Appeal Court did not apply these deadlines, given that he did not appreciate the extent of his brain injuries for a significant amount of time.

Comment

While the fact scenario at issue in *MacIvor* is not a common one, employers and insurers should take note that terminating the employment relationship does not necessarily bar future LTD claims. A terminated employee could be successful in a claim for LTD coverage as a result of injuries that occurred while they were employed. Furthermore, a court may tend to interpret limitation periods and contractual deadlines generously towards an employee who is genuinely injured and is seen to be acting in good faith. LTD insurers and employers should ensure that all aspects of an employee's injuries are considered, including potential future claims.

Alberta court ruling permits division of pension benefits by former common-law spouses

A recent Alberta court decision effectively provides that pension benefits of former common-law spouses may be divided in Alberta. Until now, the Alberta *Employment Pension Plans Act* (EPPA) has only allowed the division of pensions of former married couples.

Background

Ms. Lubianesky and her common-law spouse, Mr. Gazdag, cohabitated for approximately 15 years and had two children. In 2015, the couple entered into a Parenting, Support and Property Agreement (the Agreement), whereby the parties agreed to transfer funds from Mr. Gazdag's pension plan and registered retirement savings plan (RRSP) to Ms. Lubianesky. However, the EPPA only permits division of pension funds in the case of formerly married couples. As such, the pension plan administrator did not transfer the pension funds to Ms. Lubianesky pursuant to the Agreement.

Court ruling

Ms. Lubianesky made an application under the *Canadian Charter of Rights and Freedoms* (the Charter) to challenge the provisions of the EPPA limiting pension division to formerly married couples. Ms. Lubianesky argued that the EPPA denied a benefit to unmarried spouses that is afforded to married spouses, namely that the EPPA prevented unmarried spouses from structuring their financial and legal affairs as they see fit.

As a remedy, Ms. Lubianesky asked that the court "read in" or in other words, effectively amend the EPPA, to extend the application of s. 78(a) of the EPPA to unmarried spouses. The court agreed, and declared that s. 78(a) of the EPPA be read as follows:

> "agreement" means a written agreement between pension partners that provides for the division and distribution of a benefit and that meets the requirements of sections 37 and 38 of the *Matrimonial Property Act, mutatis mutandis*, whether or not that Act is applicable as between the pension partners.

It should be noted that a common-law partner is considered a "pension partner", or spouse, under the EPPA after three years of cohabitation or after living in a marriage-like relationship "of some permanence" if there is a child of the relationship. Other jurisdictions have different definitions of common-law partners.

Alberta regulatory response

On May 23, 2018, the Alberta Superintendent of Pensions issued EPPA Update 18-03, Eligibility for Pension Credit Splitting on Relationship Breakdown Extended to Common-Law Spouses (EPPA Update 18-03), which notifies plan administrators of this decision and provides additional guidance. In particular, EPPA Update 18-03 points out that up to 50% of the benefits earned during a relationship, which now includes a period of common-law cohabitation as well as the period of marriage, may now transferred to a former spouse.

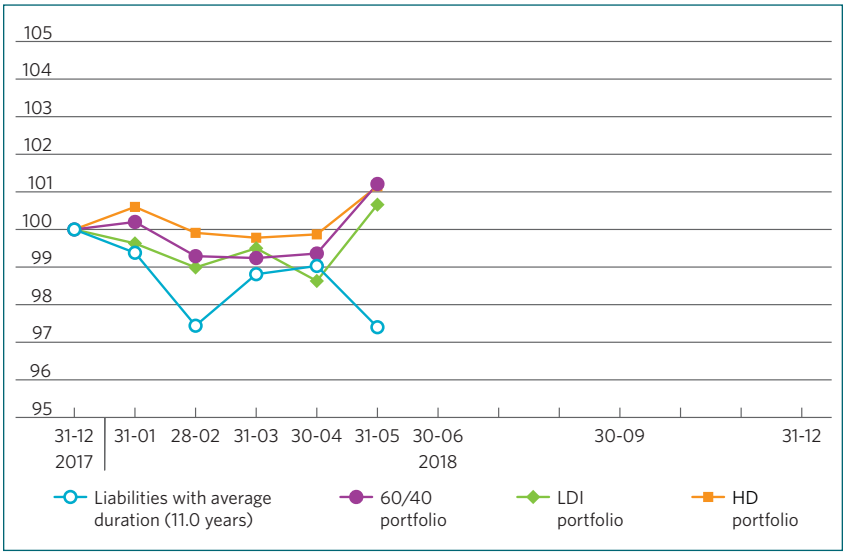
Comment

Currently, this decision only applies to members subject to Alberta pension legislation, regardless of the plan's province of registration. Pension plan administrators with Alberta members are required to apply this change for common-law relationship breakdowns in respect of Alberta members, former members and retired members.

Tracking the funded status of pension plans as at May 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



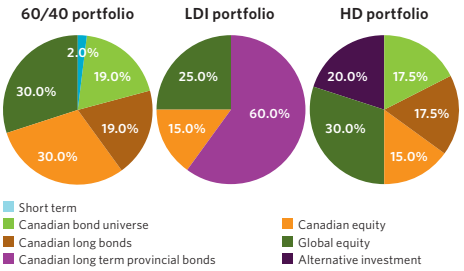
During the month of May, Canadian equity markets, Canadian universe and long-term bonds, Canadian long-term provincial bonds as well as global equity markets (CAD) showed positive returns while alternative investments showed negative returns. With a return of 2.1%, the low volatility portfolio (LDI[1]) outperformed the 60/40 portfolio (1.9%) and the highly diversified portfolio (HD) (1.3%). The relative outperformance of the LDI portfolio is mainly due to a larger allocation in the Canadian long-term provincial bonds. The prescribed CIA Annuity purchase rates decreased while the commuted value rates used in the calculation of solvency liabilities increased during the month. As a result, the solvency liabilities decreased by 1.7% for a medium duration plan. For this type of plan, an investment in the 60/40, LDI portfolio or the HD portfolio resulted in an increase of the solvency ratio.

Initial solvency ratio as at December 31, 2017	Evolution of the solvency ratio as at May 31, 2018 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	103.9%	103.3%	103.9%
90%	93.5%	93.0%	93.5%
80%	83.1%	82.7%	83.1%
70%	72.7%	72.3%	72.7%
60%	62.3%	62.0%	62.3%

[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.



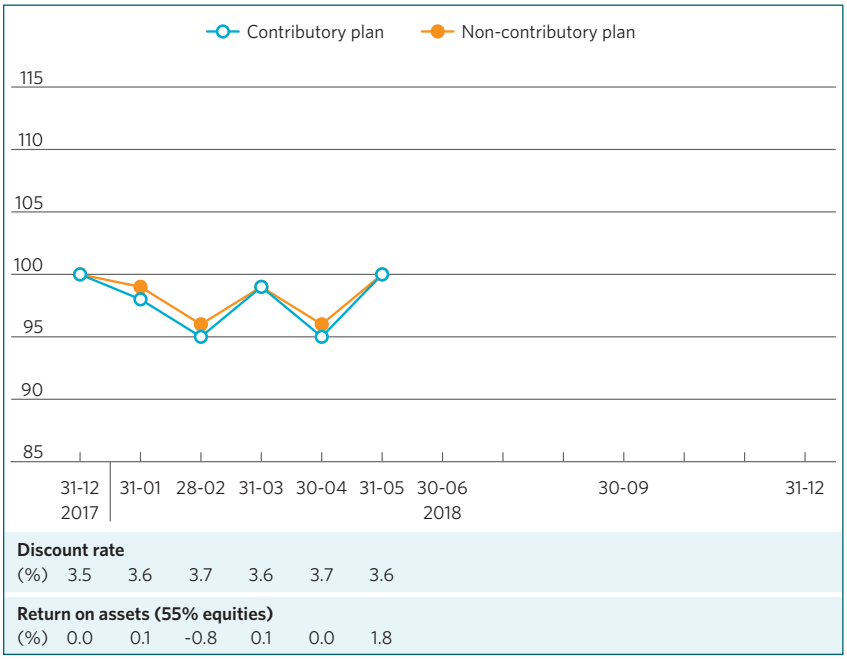
The table shows the impact of past returns on plan assets and the effect of interest rate changes on solvency liabilities of a medium duration plan, based on the plan's initial solvency ratio as at December 31, 2017 as well as the asset allocation of the three typical portfolios. Since the beginning of the year, driven by positives returns in Canadian equity markets and global equity markets (CAD), the 60/40 portfolio, the LDI portfolio and the HD portfolio returned 1.2%, 0.7% and 1.1% respectively. The solvency liabilities fluctuated over that same period by -2.6% for all type of duration of the group of retirees. The variation in the plan's solvency ratio as at May 31, 2018 stands between 2.0% and 3.9%.

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

Impact on pension expense under international accounting as at May 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	May 2018	Change in 2018
11	3.39%	3.48%	+9 bps
14	3.48%	3.55%	+7 bps
17	3.53%	3.59%	+6 bps
20	3.57%	3.61%	+4 bps

The discount rate has decreased in the last month, resulting in an increased expense, despite good returns (relative to the discount rate). Since the beginning of the year, the slight increase in the discount rate combined with returns slightly below expectations (relative to the discount rate) has resulted in the pension expense returning almost to its level to the beginning of the year.

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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Authors

Luca Centomo
Asset and Risk Management

J. Gregory Clooney, LL.B.
Pension Legislation

Marc Drolet, FCIA, FSA
Pension Consulting

Sébastien Éthier, FCIA, FSA
Pension Consulting

Omid Afshari Niko, CFA, ASA
Asset and Risk Management

Tracy Solhi, J.D.
Pension Legislation

Alexandra Sonnenwirth
Pension Consulting

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