Knowledge & Insights

MORNEAU SHEPELL

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BC issues consultation paper on solvency funding reform

On October 22, 2018, the B.C. Ministry of Finance issued a consultation paper providing options for reforming the funding framework for defined benefit (DB) pension plans registered in British Columbia. Broadly speaking, the consultation paper proposes either modifications to the current solvency funding regime, or the abolition of solvency funding and its replacement with enhanced going concern funding. These options are similar to proposals recently seen in other provinces such as Ontario, Nova Scotia and Manitoba.

Background

The objectives of the review are to protect benefit security, provide contribution predictability to employers, support pension plan sustainability, and to maintain DB pension coverage.

The consultation paper identifies the following issues that have created financial difficulties for DB pension plans:

- Contribution volatility for both employers and employees that makes planning difficult;
- Procyclical contribution requirements that increase during periods of economic distress;
- Solvency rules are considered short-term funding rules in the case that the plan was immediately wound up, while many pension plans are long-term commitments. The costs of these funding rules make it harder for employers to invest in their businesses and can result in reduced wages and other benefits for employees; and
- Employer concerns over excess funding and surplus being difficult to withdraw.

Options for Reform

The proposals are similar to proposals that were made in the Ontario solvency funding review in 2016, which led to 2018 funding reforms, and the ongoing Nova Scotia and Manitoba solvency funding reviews. There are also similarities to the funding reforms adopted in Quebec in 2016.

Approach A: Modified solvency funding

Approach A would modify the current solvency funding requirements to attempt to achieve the objectives of the review. Approach A could involve one or more of the following options:

1. Lengthen the five year amortization period (e.g. to ten years) for a solvency deficit which would reduce volatility and the size of payments.
2. Consolidate solvency deficiencies to reduce volatility and the size of payments (i.e. have a fresh start and begin a new five year amortization after every valuation instead of continuing with existing payment streams);
3. Use smoothed asset values to reduce volatility;
4. Use an interest rate average over a specified period to reduce volatility;
5. Fund less than 100% of the solvency liability to reduce the size of payments while still providing some level of benefit security.

Approach B: Replace solvency funding with enhanced going-concern funding

Approach B would eliminate solvency funding altogether and replace it with enhanced going concern funding requirements. The two options for enhancing going-concern funding would be as follows:

1. Shorten the fifteen year amortization period for a going-concern deficit;
2. Require a provision for adverse deviation (PfAD) which would provide added benefit security. The PfAD could be determined based on the investment policy, plan maturity, benefit provisions and/or the financial strength of the employer.

Commuted value transfer rule modification

An additional reform measure was proposed that could be used with either approach above. This involves modifying the commuted value transfer rules to provide a benefit that balances the interests of the remaining members with the ability to transfer benefits out of the plan. This could be accomplished by adjusting the interest rate used in the calculation higher in order to produce a lower transfer value.

Comment

Employers with DB pension plans registered in British Columbia will welcome the solvency funding review and hope that it leads to concrete reform measures in the near future. The release of the consultation paper confirms the trend towards solvency funding reform across Canada.

In conjunction with the review, British Columbia is also forming a Stakeholder Advisory Committee to provide input as well as focused consultations with specific stakeholder groups such as employers, unions, plan members and pension industry advisors.

Comments can be submitted until **December 14, 2018.** Morneau Shepell will be one of the stakeholders making submissions.

Ontario funding reform update: Ontario requires amendments to Statements of Investment Policies and Procedures and plan texts

As part of Ontario's funding reform which became effective May 1, 2018, most Ontario-registered defined benefit (DB) pension plans will have to make amendments to their Statements of Investment Policies and Procedures (SIPPs) and pension plan texts. For most plans, these amendments will be required to be made over the next year.

Required Amendments to Ontario SIPPs

Effective May 1, 2018, each SIPP must include a target asset allocation that reflects the categories of investments that are already reflected on financial statements and defined in subsection 76(12) of the regulations under the *Pension Benefits Act* (the Regulations). Given that the list of investment categories is not broken down by the traditional groupings such as equities, bonds and cash equivalents, this means that nearly every SIPP for an Ontario-registered DB pension plan will require amendment to add target asset allocations that are compliant with the amended Regulations.

The SIPP can retain its pre-existing asset table, if a compliant table of target asset allocations is also added. If there are two asset allocation tables, the plan administrator must comply with both tables.

Who is affected?

All Ontario-registered DB pension plans are affected. FSCO has also confirmed that defined contribution pension plans where administrators (rather than plan members) direct investments are also subject to this requirement. Defined contribution pension plans where members make investment choices are not affected.

When is the change required?

The Regulations did not specify a deadline for submission of amendments to a SIPP; however, given that the change is required in order for the SIPP to be compliant, it would be prudent to make the amendment soon. It has been suggested by FSCO that SIPP amendments should be made by the end of 2019 at the latest.

Any amendment to a SIPP must be filed with FSCO via the Pension Services Portal within 60 days of the amendment being made.

Required Amendments to Ontario DB Plan Texts

Also effective May 1, 2018, the Regulations have been amended to state that an Ontario-registered defined benefit pension plan must include specific plan wording regarding employer's duty to fund the following items:

a) the provision for adverse deviations in respect of the normal cost;

b) any plan amendment that increases going concern liabilities; and

c) any reduced solvency deficiency under the plan.

Prior to this amendment to the Regulations, an Ontario-registered DB pension was required to set

out the employer's duty to fund the normal cost and any going concern unfunded liability and solvency deficiency under the plan.

Although many pension plan texts set out the general requirement to fund the pension plan in accordance with legislative requirement, it appears that the legislative intent is that the plan text must specifically set out the items to be funded, as per the Regulations. Therefore, all Ontario-registered DB pension plans will have to be amended to set out specific funding requirements under the amended regulations in order to comply with the legislative change.

When is the Change Required?

The regulations provide that any amendment needed to bring the plan document into compliance must be made within 12 months after the date the first valuation report with an effective date on or after December 31, 2017 is filed. Any pension plan amendment must be filed with FSCO in hard copy or through the Pension Services Portal within 60 days of being made.

Comment

The new requirements will effectively require most or all Ontario DB pension plans to amend their SIPPs and pension plan texts over the next year. A DB SIPP must already be reviewed at least once annually, as per the regulations. The annual review may be a good time to make any required amendment. If a DB plan text is being amended for other purposes, it may be a good opportunity to include the newly required wording regarding plan funding. If not, Ontario DB plan sponsors should determine their deadline for making the required amendments and ensure that the amendment can be made by the legislative deadline.

Morneau Shepell consultants, including our investment and governance, legal and compliance consultants, are available to assist with reviewing existing documents, drafting and filing the required amendments.

New EI parental sharing benefit introduced and employment leaves expanded in Nova Scotia and New Brunswick

The federal government recently set a start date for a new Employment Insurance (EI) parental sharing benefit that was announced in the 2018 Federal Budget. In addition, Nova Scotia has expanded parental leave periods, as well as leaves for the care of a critically ill child and adult. Finally, New Brunswick ahs introduced domestic violence leave.

New EI parental sharing benefit

On September 26, 2018, the Government of Canada announced that it intends to launch a new Employment Insurance Parental Sharing Benefit on March 17, 2019. The new benefit was previously announced in the 2018 Federal Budget. This measure was originally anticipated to come into effect in June 2019; however, the it will now be implemented three months earlier.

Under the current rules, either parent may receive up to 35 weeks of EI standard parental leave benefits, and the other parent can receive the remainder of the 35 weeks. (The 35 weeks may be extended to 61 weeks at a lower rate.) As such, if a couple decided that one parent would take the 35 weeks of EI parental leave benefits, there are no EI parental leave benefits available to the other parent.

Under the new EI parental sharing benefit, a second parent may receive up to an additional five weeks of benefits for a total of 40 weeks of EI standard parental leave benefits between two parents. The additional five weeks can only be taken by a second parent. Eight additional weeks are available for those who choose the extended parental leave option.

Parents with children born or placed for adoption on or after March 17, 2019, will be eligible for the new benefit.

Nova Scotia expands parental leave period and leaves for the care of a critically ill child and adult

On October 11, 2018, Nova Scotia amended its labour standards legislation to provide for increased pregnancy and parental leave periods, as well as introducing a new form of leave for the care of critically ill adults and expanding leave for the care of a critically ill child. These amendments are in line with recent amendments to the EI rules, as discussed in our January 2018 *News & Views*.

Specifically, Nova Scotia has:

- Decreased the maximum period of pregnancy leave from 17 weeks to 16 weeks, to accommodate the decrease in waiting period for EI benefits to one week;
- Increased the maximum period of parental leave from 52 weeks to 77 weeks;
- Increased the maximum period of combined pregnancy/parental leave from 52 weeks to 77 weeks;
- Created a new 16 week critically ill adult care leave; and
- Expanded the number of family members who can take a critically ill child care leave.

These changes came into effect immediately on October 11, 2018.

New Brunswick creates domestic violence leave

Effective September 1, 2018, New Brunswick has introduced leave for employees who experience domestic, intimate partner or sexual violence (Domestic Violence Leave). This new form of leave is also available for employees with a child that experiences domestic violence.

The new Regulations provide the following two separate types of Domestic Violence Leave, both of which may be taken by an eligible employee in any year:

- up to 10 days to be used intermittently or continuously; and/or
- up to 16 weeks to be used in one continuous period, of which the first 5 days would be paid.

An employee must be employed for more than 90 days to be eligible for a Domestic Violence Leave. An employee may be granted a Domestic Violence Leave only for certain specified purposes.

Comment

The new EI Parental Sharing benefit will provide for an additional five weeks of leave to be taken by a second parent, typically the father, and may result in more parents taking parental leave after the birth of a child. Employers with employees located in Nova Scotia will have to maintain pension and benefit plan coverage during the new extended periods of leave that have been adopted, provided that employees make any required contributions. With the introduction of Domestic Violence Leave, New Brunswick joins a growing number of provinces that require domestic violence leave to be granted. Some of these provinces require a certain number of such days to be paid by the employer.

Morneau Shepell will continue to monitor and keep you updated on the expansion of employment leave periods.

Ontario draft policy: surplus withdrawal upon wind-up

On October 15, 2018, the Financial Services Commission of Ontario (FSCO) announced that it was in the process of updating FSCO's surplus policies based on changes to the *Pension Benefits Act* that became effective on July 1, 2012. The surplus policies set out FSCO's expectations respecting applicatons for the payment of surplus to employers.

To date, two draft surplus policies were posted by FSCO for consultation, namely, *Policy S900-512: Application by Employer for Payment of Surplus on Wind Up of a Pension Plan* and *Policy S900-514: Surplus Distribution by Written Agreement – The Role of Legal Counsel*. This summary discusses draft Policy 900-512 (the Draft Policy), as Policy S900-514 is less noteworthy.

Employer application for surplus withdrawal upon pension plan wind-up

The Draft Policy outlines the process for applying to the Superintendent of Financial Services (the Superintendent) for consent for the payment of surplus to an employer on a pension plan wind up. Employer withdrawals from an ongoing pension plan will be the subject of a future FSCO policy.

The Draft Policy will replace two pre-existing policies that set out rules for surplus withdrawal on full and partial wind-ups. The Draft Policy will apply to surplus withdrawal on both full and partial wind-ups. Note that the *Pension Benefits Act* permits partial wind-ups only with an effective date that is prior to July 1, 2012.

As the Draft Policy states, there are three possible bases for the payment of surplus to an employer on a plan wind-up: a) the pension plan terms authorize payment to the employer, b) written agreement between the employer, members and others entitled to payments from the pension plan; and c) court order.

Some key points of the Draft Policy and the new surplus withdrawal rules are as follows:

- There is now a statement that an employer will not generally file a surplus application until payment of the basic benefits has been approved by the Superintendent. Under the current surplus policies, it is stated that the Superintendent will not complete his consideration of the surplus application until he has approved payment of the basic benefits.
- The administrator of the plan must disclose if buy-out annuities were previously purchased, as members who were subject to buy-out annuities retain their rights to surplus pursuant to the new buy-out annuity rules under the *Pension Benefits Act*.
- If the application is made on the basis of the pension plan terms authorizing payment to the employer, a historical analysis of the plan documentation is required. The terms of any predecessor plan must also be analyzed if the pension plan is a successor pension plan (i.e., it received assets under past asset transfers).
- A historical analysis is not required if the withdrawal is authorized under court order or written agreement.
- A written agreement requires the consent of two-thirds of the active members. It also requires the consent of he number which is considered appropriate in the circumstances by the Superintendent of former members, retired members and other persons entitled to payments under the pension plan on the date of the wind up. In most cases, the Superintendent has determined the appropriate number is two-thirds of this group; however, the number is ultimately at the discretion of the Superintendent.
- Detailed requirements are provided for the surplus application notice to members and written agreement with members and other persons with an entitlement in the pension plan.
- A detailed surplus application outline is provided.
- A certificate of compliance with respect to surplus withdrawal requirements in respect of members located outside of Ontario is required.

Comment

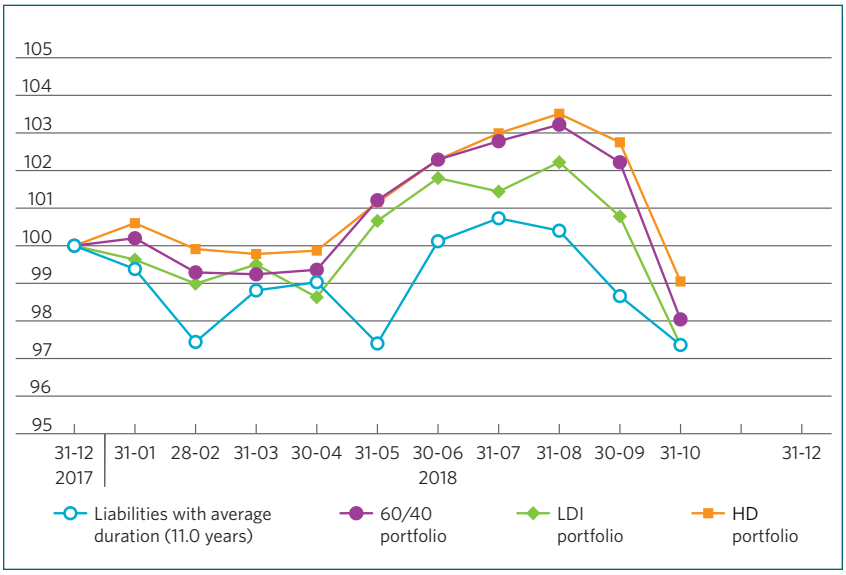
The release of the Draft Policy and the promise of a draft policy on surplus withdrawal from an ongoing pension plan will be welcome to employers of Ontario-registered defined benefit pension plans who are contemplating access to surplus funds in their pension plans. The current surplus withdrawal policies are outdated, raising a source of uncertainty for employers and members in this situation.

The deadline for submitting comments to FSCO was **November 12, 2018**.

Tracking the funded status of pension plans as at October 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 September 30, 2018 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



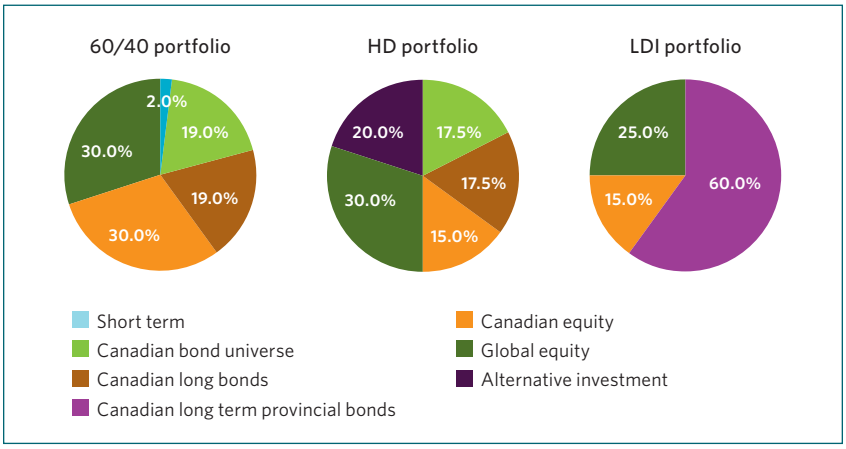
During the month of October, Canadian universe bonds, Canadian long-term bonds, Canadian long-term provincial bonds, Canadian equity markets, global equity markets (CAD) as well as alternative investments showed negative returns. With a return of -3.4%, the low volatility portfolio (LDI[1]) did slightly better than the highly diversified portfolio (HD) (-3.6%) and the 60/40 portfolio (-4.1%).

The prescribed CIA Annuity purchase rates increased as well as the commuted value rates used in the calculation of solvency liabilities. As a result, the solvency liabilities decreased by 1.3% for a medium duration plan. For this type of plan, an investment in the 60/40, the LDI or the HD portfolio resulted in a decrease of the solvency ratio.

[1] Liability driven investment

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. The graph shows the asset allocation of the three typical portfolios.

Initial solvency ratio as at December 31, 2017	Evolution of the solvency ratio as at October 31, 2018 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	100.7%	100.0%	101.7%
90%	90.6%	90.0%	91.6%
80%	80.6%	80.0%	81.4%
70%	70.5%	70.0%	71.2%
60%	60.4%	60.0%	61.0%



Since the beginning of the year, driven by negative returns in Canadian universe bonds, Canadian long-term bonds, Canadian long-term provincial bonds as well as Canadian equity markets, the 60/40 portfolio, the LDI portfolio and the HD portfolio returned -2.0%, -2.6% and -1.0 % respectively. The solvency liabilities fluctuated over that same period from -2.4% to -2.6% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at October 31, 2018 stands between 0.0% and 1.7%.

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

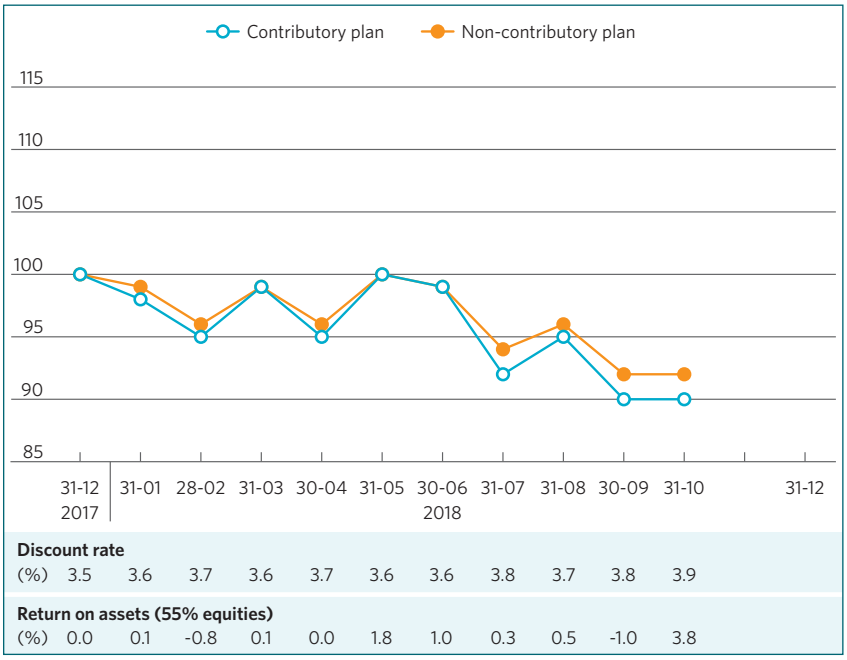
Comments

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.

Impact on pension expense under international accounting as at October 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	October 2018	Change in 2018
11	3.39%	3.82%	+43 bps
14	3.48%	3.89%	+41 bps
17	3.53%	3.94%	+41 bps
20	3.57%	3.97%	+40 bps

Since the beginning of the year, the pension expense has decreased by 10% (for a contributory plan) due to an increase in discount rates despite negative returns on assets.

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

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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