Knowledge & Insights

MORNEAU SHEPELL

# News & Views

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## Nova Scotia: Details on new rules for DB funding

Building on the initial changes that were introduced as a part of Bill 109, the Nova Scotia government recently released further details on its proposed funding framework for defined benefit DB pension plans and amendments that will be made to the regulations. The proposed DB funding framework will permit plans to fund on a reduced solvency basis of 85%, but require funding on an enhanced going concern basis by specifying a 10-year going concern amortization period and requiring funding of a Provision for Adverse Deviation (PfAD). The proposed framework also includes other changes.

## Enhanced going concern funding requirements

The enhanced going concern funding rules would apply to all DB plans, including solvency exempt plans that would nevertheless maintain their current solvency exemption. The funding of the PfAD would have to be established and applied to the pension plan's liabilities, but not to the normal cost. The PfAD would have to be funded in the same manner as the plan's going concern liabilities.

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 after the pension plan's valuation date.

## PfAD calculation options

Two options are being considered as the required methodology for calculating a PfAD. Comments are being sought on the appropriate PfAD methodology, as well as on whether a different PfAD should apply for solvency exempt plans and public sector plans.

Under the first option, the PfAD would be determined based on the below two-dimensional grid, which considers the duration of assets relative to the duration of liabilities, thereby incorporating both a measure of interest rate risk and a measure of market risk.

### Option 1: PfAD Determined Based on Asset/Liability Duration Ratio

| % Assets in Variable Securities | Asset/Liability Duration Ratio | | | | |
|---|---|---|---|---|---|
| | 0% | 25% | 50% | 75% | 100% |
| 0% | 7% | 5% | 3% | 1% | 0% |
| 20% | 9% | 7% | 5% | 3% | 1% |
| 40% | 11% | 9% | 7% | 5% | 3% |
| 50% | 12% | 10% | 8% | 6% | 4% |
| 60% | 14% | 12% | 10% | 8% | 6% |
| 70% | 17% | 15% | 13% | 11% | 9% |
| 80% | 19% | 17% | 15% | 13% | 11% |
| 100% | 22% | 20% | 18% | 16% | 15% |

Under the second option, the PfAD would be determined based on the percentage of the plan's assets invested in variable income securities (i.e., non-fixed income) plus a fixed component applicable to all plans. Comments are being sought as to what would constitute "variable income securities".

### Option 2: PfAD based on variable income securities

| % Assets in Variable Securities | Variable PfAD Component | Fixed PfAD Component | PfAD |
|---|---|---|---|
| 0% | 0% | 5% | 5% |
| 20% | 1% | 5% | 6% |
| 40% | 3% | 5% | 8% |
| 50% | 4% | 5% | 9% |
| 60% | 5% | 5% | 10% |
| 70% | 8% | 5% | 13% |
| 80% | 11% | 5% | 16% |
| 100% | 17% | 5% | 22% |

Further, if a pension plan valuation report uses a discount rate that exceeds a certain level (the current level under consideration is Ontario's Benchmark Discount Rate[1]), the PfAD would have to be supplemented by an additional amount.

The recent legislative amendments introduced reserve accounts for special payments made in respect of solvency deficiencies. The proposal requests comments on whether PfAD funding should be eligible for reserve accounts, as well as what other employer contributions should be permitted to be put in reserve accounts.

1 Ontario's Benchmark Discount Rate is the sum of:
- The rate given by CANSIM V39056 (Government of Canada long-term bond yield) for the valuation date;
- The proportion of the plan's target asset mix allocated to non-fixed income investments times 5% (i.e., a risk premium of 5% on non-fixed income assets);
- The proportion of the plan's target asset mix allocated to fixed income investments times 1.5% (i.e., a risk premium of 1.5% on fixed income assets); and
- 0.5% for diversification;

where "non-fixed income investments" has a similar definition as "variable-yield investments" under Quebec rules.

## Reduced solvency funding requirements

Plan sponsors would be permitted to elect, on a go-forward basis, to permanently fund their solvency liabilities to 85% instead of 100%. The reduced solvency deficiencies would have to be funded over five years and no consolidation of prior years' deficiencies would be permitted.

Similar to past rules for electing temporary solvency funding relief, the election to fund on a reduced solvency basis could only move forward if fewer than one third of plan participants object to the proposal.

## Restrictions on contribution holidays

Contribution holidays would only be permitted if the pension plan remains at least 110% funded on a going concern basis and 110% funded on a solvency basis after the holiday is taken. Comments on the appropriateness of the 110% standard are being sought.

## Other proposed changes

Proposed changes include solvency funding exemptions for individual pension plans sponsored by business owners and significant shareholders, and incorporation by reference of the federal *Pension Benefits Standards Act* investment rules.

Also included are amendments that would improve the ability of solvency exempt plans to improve benefits. These plans would be able to make benefit improvements funded over five years if, at the time of benefit improvement, the plan is fully funded on going concern basis and 85% funded on a solvency basis. Further, with respect to solvency exempt plans who exhibit solvency concerns (i.e., solvency funded status below 0.85), they would no longer be required to file annual valuation reports but would instead be required to file annual cost certificates.

## Transitional rules

For pension plans whose contribution requirements would increase as a result of the new funding framework, it is proposed that a three-year transitional period be put in place. Comments on the need and the length of a transition period are being sought.

## Conclusions and next steps

The proposed rules are expected to reduce funding costs for some plans and increase funding costs for other plans in the short term. Over the longer term, however, funding requirements should be less volatile for most plan sponsors and the new funding regime would maintain a high degree of benefit security for members. The proposed changes will encourage plan sponsors to review funding and investment policies in order to optimize their strategies.

The proposed rules are subject to consultation until June 21, 2019 and regulations are expected for fall 2019. Sponsors are encouraged to start planning as soon as possible for the new pension funding regime.

# Ontario releases new funding regulation

On May 21, 2019, the government of Ontario filed O. Reg. 105/19, which makes some clarifications, technical corrections and adjustments in the new funding framework for defined benefit (DB) pension plans that took effect on May 1, 2018 and was discussed in the May 2018 *News & Views*. Some of the key changes are summarized below.

## Excess contributions

The regulation clarifies how excess contributions made in the period between a valuation date and when the associated actuarial report is filed may be used. These excess contributions can be applied to reduce any payment required to be made after the report is filed provided they are applied before the earlier of: (i) the last day of the fiscal year in which the report is filed and (ii) the filing date of a subsequent report. However, this option is not available if the most recent report is filed more than 12 months after the valuation date of the report, even if a filing extension was granted.

Contributions in excess of the funding requirements for a plan with a valuation date for the last-filed report before December 31, 2017 or the last report filed before May 1, 2018, may be used to create a prior year credit balance in the next valuation report and applied to reduce normal cost contributions or special payments under the new report.

## Specified Ontario Multi-Employer Pension Plans (SOMEPPs)

The regulations are amended to clarify that restrictions on benefit improvements and the requirement for a target asset allocation in the SIPP do not apply to SOMEPPs.

## Contribution holidays

The rules for contribution holidays are amended to provide that an actuarial cost certificate does not need to be filed in order to take a contribution holiday, if a valuation report or cost certificate with a valuation date that is not earlier than the day immediately before the beginning of the report's fiscal year is prepared and filed. The report or cost certificate must show that there is still sufficient available actuarial surplus.

Although a cost certificate must be filed within 90 days of the start of the fiscal year in order to take a contribution holiday, a transitional extension is granted with the deadline extended to June 30, 2019 for fiscal years beginning on or after July 1, 2018. Furthermore, a plan with a valuation date for the last-filed report before December 31, 2017 or the last report filed before May 1, 2018, is exempt from the contribution holiday restrictions under the new funding rules.

Also, where a planned contribution reduction is to occur more than six months after the start of a fiscal year, the notice must be given within six months following the end of the fiscal year of the reduction. This permits the notice to be combined with the next annual statement.

## Definition of "closed plan"

The definition of "closed plan" for PfAD calculations is amended. With the passage of the new regulation, a closed plan is defined as a DB plan in which at least 25% of the members of the plan who are entitled to defined benefits are in classes of employees from which new members are not permitted to join the plan and accrue DB benefits.

## Target asset allocations for PfAD calculations

The regulation makes a number of changes to the PfAD calculation formula. The formula was reworded to clarify that the figure for "closed plans" pertains to plans that are closed on the valuation date.

The regulation clarifies that the minimum credit rating set out in the plan's statement of investment policies and procedures (SIPP) may refer to a portion of—not necessarily all—fixed income assets in the investment category. This effectively allows investment grade fixed income to be recognized as fixed income in the PfAD calculation, while fixed income investments that do not meet minimum credit ratings are effectively treated as equity-like investments.

The rules are also amended to clarify that the requirement for a SIPP to specify target asset allocations does not apply to defined contribution pension plans, including those in which the administrator directs the investments.

## Technical amendments and transition rules

A number of technical amendments are made in respect of the implementation of the new funding rules, disclosures to members, letters of credit and jointly sponsored pension plans.

### Comment

The corrections and clarifications were required in order to help the new Ontario DB funding rules to function effectively. However, the amendments to permit the use of excess contributions to reduce any future pension contribution until the end of the fiscal year and in respect of the definition of "closed plans" are substantive amendments that will have a positive impact on some Ontario DB pension plan sponsors.

# CAPSA releases revised electronic communications guideline

On May 8, 2019, the Canadian Association of Pension Supervisory Authorities (CAPSA) released the revised Guideline No. 2 – Electronic Communications in the Pension Industry (the Guideline). The first draft of the revised Guideline was released in November 2018 and discussed in the December 2018 *News & Views* (the Draft Guideline). The purpose of the Guideline is to provide a set of principle-based industry standards and best practices for pension plan administrators to adopt, in conjunction with legislative requirements, as part of their electronic communications (i.e., e-communications) framework. The revised Guideline will replace the 2002 version of the Guideline.

## Changes from the Draft Guideline

The Guideline includes the following revisions and clarifications from the Draft Guideline:

- The Guideline now clarifies that it is not intended to apply to e-communication that pension plan administrators and/or plan sponsors receive from individuals. CAPSA recommends that individuals communicate with pension plans through secure information systems, but this is not the responsibility of the pension plan.
- The Guideline notes the responsibility of the recipient to ensure that their contact information on file with the plan administrator is up to date, to facilitate ongoing e-communications.
- The Draft Guideline only provided that, where legislation requires information to be provided in a specific form, the e-communication must mirror the content of the paper copy. The Guideline now also provides that, where the legislation requires a specific method of providing information, that requirement must be met. For example, where legislation requires a notice to be placed in a newspaper, sending an e-mail would not be sufficient.
- Both the Draft Guideline and the Guideline require that plan administrators must implement a protocol to protect the security of information that is sent and retained, as well as to retrieve lost or corrupted data. The Guideline now states that the protocol should be reviewed as often as is reasonable, as well as when new methods of transmitting e-communication are developed or new security threats are discovered.
- The Guideline states that e-communication that contains confidential information should be delivered to or made accessible to the intended recipient through secure information systems, without specifying how that is to be done. It explicitly states that the plan administrator is responsible for ensuring that the communications channel protects confidential information and accurately delivers information to intended recipients only.

### Comment

The final version of the Guideline includes helpful clarifications on roles and responsibilities of both pension plan administrators and recipients of information from pension plans. In general, the Guideline takes a principles-based approach to ensuring that the information is delivered and that confidential information is delivered securely. It also requires information delivery protocols to be periodically reviewed and updated, and that they be updated in response to technological changes or new security threats. At the same time, the Guideline continues to recognize the necessity of complying with any specific legislative requirements.

# Quebec adopts amendments to its *Pay Equity Act*

On April 10, 2019, the Quebec National Assembly assented to Bill 10, *An Act to amend the Pay Equity Act* mainly to improve the pay equity audit process. The purpose of the *Pay Equity Act* is to redress differences in compensation due to the systematic gender discrimination suffered by persons who occupy positions in predominantly female job classes. The main changes introduced by Bill 10 are to give employees the opportunity to participate in the periodic pay equity audit process, and to ensure that pay equity adjustments become payable on the date of the organizational change or event leading to such adjustments, even if retroactively. The introduction of Bill 10 was discussed in the March 2019 *News & Views*.

## Employee participation in the pay equity audit process

Until April 10, 2019, an employer could conduct a pay equity audit without employee participation, even when the initial pay equity plan was adopted by the pay equity committee. Employee participation in the pay equity audit consisted solely of receiving employer postings and having the right to provide comments or request additional information not later than 60 days after the posting.

As of April 10, 2019, if the pay equity plan was developed by a pay equity committee or if the employees are members of a certified association or union, the employer must send information about the pay equity audit to employee representatives not later than 60 days before the first posting. Representatives of employees who are not members of an association or union in the organization must be sent comparable information within the same time period.

The employer must also put measures in place to allow for employee representatives to provide comments or ask questions, not later than 60 days before the first internal posting of audit results, except when the first posting occurs within the period from April 10 to July 9, 2019.

## Effective date of pay adjustments arising from the pay equity audit

Bill 10 will now require retroactive pay adjustments based on the date of the events leading to the pay disparity, rather than the date of the audit. This legislative change is the result of a Supreme Court of Canada decision handed down on May 10, 2018, which concluded that certain provisions of the *Pay Equity Act* contravened the Canadian *Charter of Rights and Freedoms*[1].

Since the analysis of the workforce data for each pay equity audit may be separated by a period of up to five years, this change implies that a lump sum payment bearing interest at the legal rate may be calculated from a date up to five years before the effective date of the workforce data analysis for the pay equity audit. Under certain conditions, payment of the retroactive adjustments may be spread over a period of four years.

## Other changes

Other changes in the application of the *Pay Equity Act* have been in effect since April 10, 2019. The Commission des normes, de l'équité, de la santé et sécurité du travail (CNESST), the regulator responsible for the application of the *Pay Equity Act*, may now group similar complaints, and the form for filing a complaint is now prescribed by law.

The employer's obligation to issue advance notice that the pay equity results will be posted has been eliminated.

Some additional information must now be posted internally. Going forward, if no questions or observations are received by the employer or the employer's representative after a posting, the subsequent posting must state this, noting that any complaint must be submitted to the CNESST on the prescribed form and providing information about the remedies and deadlines with respect to the complaint.

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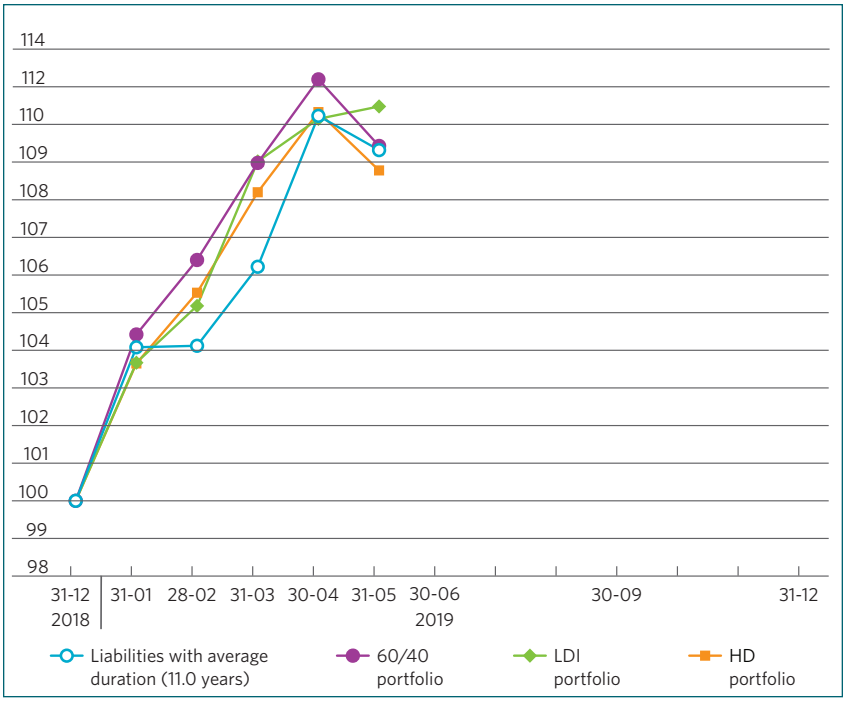
1 *Quebec (Attorney General) v. Alliance du personnel professionnel et technique de la santé et des services sociaux*, 2018 SCC 17.

# Tracking the funded status of pension plans as at May 31, 2019

This graph shows the changes in the financial position of a typical defined benefit plan with an average duration since December 31, 2018. For this illustration, assets and liabilities of the plan were each arbitrarily set at $100 million as at December 31, 2018. The estimate of the solvency liabilities reflects the new CIA guidance for valuations effective March 31, 2019 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, 2018



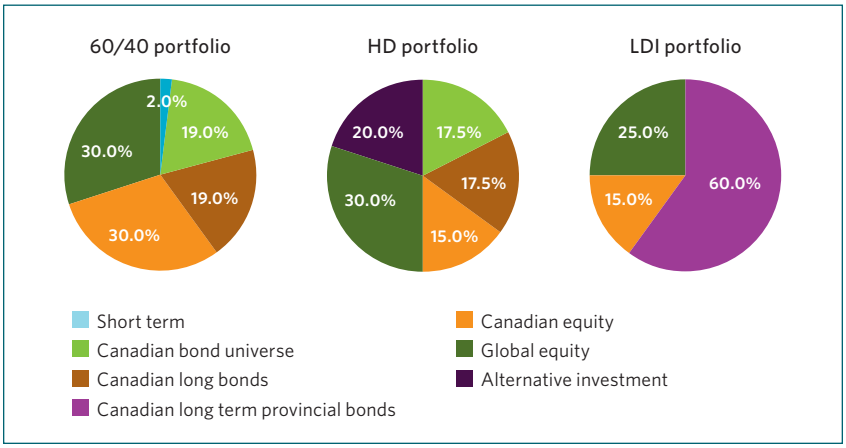

During the month of May, Canadian universe bonds, Canadian long-term bonds as well as Canadian long-term provincial bonds showed positive returns while Canadian equity markets, global equity markets (CAD) and alternative investments showed negative returns. With a return of 0.3%, the low volatility portfolio (LDI[1]) outperformed both the highly diversified portfolio (HD) (-1.4%) and the 60/40 portfolio (-1.6%).

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 0.8% for a medium duration plan. For this type of plan, an investment in the 60/40 or in the HD portfolio resulted in a decrease of the solvency ratio and an investment in the LDI portfolio resulted in an increase of the 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, 2018.
The graph shows the asset allocation of the three typical portfolios.

| Initial solvency ratio as at December 31, 2018 | Evolution of the solvency ratio as at May 31, 2019 for three different portfolios | | |
|---|---|---|---|
| | 60/40 portfolio | Low volatility portfolio (LDI) | Highly diversified portfolio |
| 100% | 100.1% | 101.1% | 99.5% |
| 90% | 90.1% | 91.0% | 89.6% |
| 80% | 80.1% | 80.9% | 79.6% |
| 70% | 70.1% | 70.7% | 69.7% |
| 60% | 60.1% | 60.6% | 59.7% |




Since the beginning of the year, driven by strong positive returns in the Canadian equity markets, global equity markets as well as the alternative investments, the 60/40 portfolio, the LDI portfolio and the HD portfolio returned 9.4%, 10.5% and 8.8% respectively. The solvency liabilities fluctuated over that same period from 8.8% to 9.8% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at May 31, 2019 stands between -0.5% and 1.1%.

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

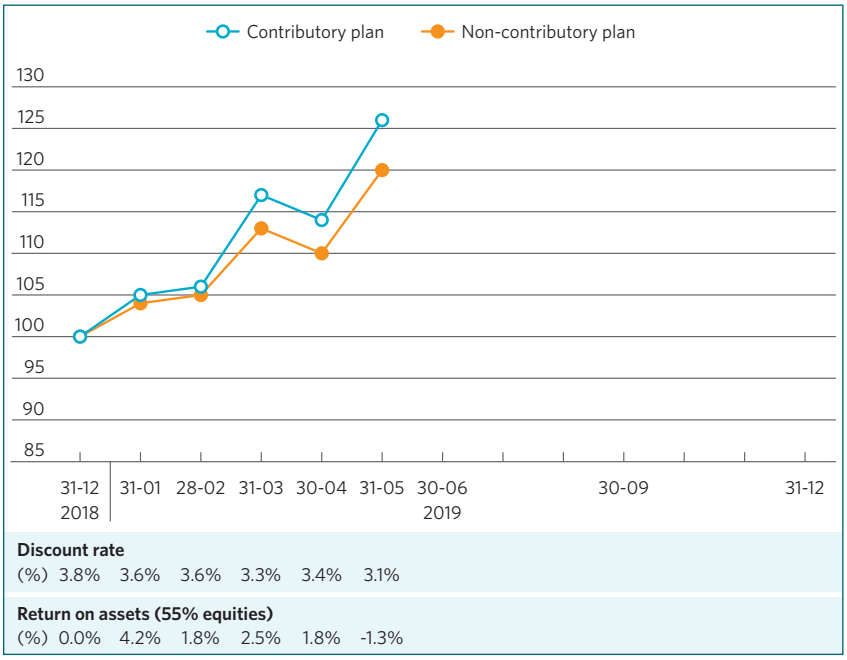
## Comments

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 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 May 31, 2019

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, 2018




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 2018 | May 2019 | Change in 2019 |
|---|---|---|---|
| 11 | 3.72% | 3.00% | -72 bps |
| 14 | 3.81% | 3.10% | -71 bps |
| 17 | 3.87% | 3.16% | -71 bps |
| 20 | 3.90% | 3.20% | -70 bps |

Since the beginning of the year, the pension expense has increased by 26 % (for a contributory plan) due to the decrease in the discount rates, despite the good returns on assets (relative to the discount rate).

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

## Comments

1. The expense is established as at December 31, 2018, based on the average financial position of the pension plans used in our 2018 *Survey of Economic Assumptions in Accounting for Pensions and Other Post-Retirement Benefits report* (i.e. a ratio of assets to obligation value of 95% as at December 31, 2017).
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 2018 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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