Knowledge & Insights

MORNEAU SHEPELL

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In this issue

Updates on timing and contents of revised pension commuted value standards

The Actuarial Standards Board (ASB) of the Canadian Institute of Actuaries recently announced that it would not move forward with an updated mortality improvement scale in its upcoming revised pension Commuted Value Standards (the Revised Standards). The ASB also provided an update on the timing of the release of the Revised Standards. These changes will be of interested to defined benefit pension plan sponsors and participating employers.

Mortality improvement scale changes cancelled

A mortality improvement scale sets out assumptions on how quickly future life expectancies are expected to improve, which is an important factor in calculating liabilities for defined benefit pension plans.

In January 2019, the ASB released an initial communication which proposed to adopt the MI-2017 mortality improvement scale (the MI-2017 scale) for pension commuted value calculations under the upcoming Revised Standards. The MI-2017 scale would have been combined with the base mortality table, the 2014 Canadian Pensioner Mortality table (the CPM 2014), instead of the current CPM-B mortality improvement scale, which was released in 2007. The key features of the MI-2017 scale were discussed in the May 2017 *News & Views*.

On June 20, 2019, the ASB announced that it will no longer be moving forward with its promulgation of the MI-2017 scale along with the forthcoming Revised Standards.

The ASB's decision is the result of comments it has received since its January 2019 announcement. In general, the submitted comments did not support the promulgation. A common question raised by commenters was how to appropriately implement the MI-2017 scale in conjunction with CPM 2014, given that CPM 2014 already incorporates several years of mortality projections. In addition, the ASB also considered that the differences between the MI-2017 scale and the current CPM-B scale are insufficient to justify a change.

Timing for release of the Revised Standards

On July 3, 2019, the ASB provided an update on the expected timing of the Revised Standards. The ASB anticipates that the Revised Standards will be released in the early fall of 2019, and that they will not be required to come into effect before the end of 2019. However, it is possible that early adoption of the Revised Standards will be allowed at the discretion of pension plan sponsors, as long as early adoption is permitted under pension regulations.

Comment

The MI-2017 scale was expected to increase commuted values by approximately 0.5% on average and, with this decision, commuted values will no longer be subject to the increase.

The timing of the Revised Standards has been delayed a number of times, which has been viewed as a disappointment for some defined benefit plan sponsors. The delays are likely the result of the substantive changes involved, as well as the number of comments that the ASB received regarding the changes.

2019 Survey – Economic assumptions for accounting

Recently, Morneau Shepell issued its 19th annual survey on the economic assumptions used by Canadian public companies to account for the costs of their defined benefit plans. The data was gathered from audited financial statements as at December 31, 2018.

Here are a few highlights of the survey:

- Discount rates at December 31, 2018 have increased when compared to the prior year. The median discount rate was 3.80% as at December 31, 2018 compared to 3.50% a year earlier. The discount rates used for non-pension benefits are similar to those used for pension benefits.
- More than three quarters of the companies surveyed used a compensation increase assumption between 2.50% and 3.50% (median of 3.00%, which is identical to last year's median).
- Companies surveyed showed a 95% overall ratio of pension assets to defined benefit obligation for accounting purposes.

- The median assumption for the short-term medical cost trend rate was 5.70% (a 0.20% decrease over the previous year's median), while the median ultimate trend rate was 4.50% (identical to last year).

For complete details of the survey, please refer to the document available on the Morneau Shepell website.

Ontario releases proposed framework on pension plan electronic communications

On August 6, 2019, the Ontario Ministry of Finance released proposed legislative amendments that would permit pension plans to use electronic communications as a default communication method, with appropriate safeguards, to provide pension plan information to their members. This follows on the announcement in 2019 Ontario Budget that the government was considering such measures.

Deemed consent to receive electronic communications

The draft amendments to the *Pension Benefits Act* (the Act) will permit pension plan administrators to provide notices, statements and other records to members and former members in electronic form based on deemed consent.

In order to provide for deemed consent, the administrator will be required to first provide a written notice to members, setting out the date on which documents will begin to be sent electronically, the recipient's last known email address, a statement explaining that the recipient may, at any time, instruct the administrator to send documents in a written form other than an electronic form, and any other prescribed information.

If the recipient does not instruct the administrator to send the documents in a written form, he or she will be deemed to have consented to accept documents sent in an electronic form. The recipient may request written documents at any time and the administrator is required to comply with such instructions.

The information must be sent by way of a secure information system that ensures the intended recipient identify themselves before accessing the document and that complies with any other prescribed rules.

The Financial Services Regulatory Authority of Ontario (FSRA) will have authority to prescribe additional rules in respect of electronic communications.

Application

The deemed consent provisions apply only to members and former members (i.e., deferred members) of a plan. Retired members in receipt of a pension, surviving spouses and others entitled to pension plan benefits are not covered by the proposals. A pension plan may obtain actual consent for electronic communications in respect of such individuals.

The deemed consent provisions apply to documents sent under the Act, such as notices, statements and other records. In most cases, they will only apply to Ontario members and former members, but may also apply to some notices and statements sent to non-Ontario members and former members of Ontario-registered pension plans.

Comment

The proposed deemed consent rules have the potential to significantly expand the scope of electronic communications for Ontario pension plan administrators. Although it is unlikely that all communications will ever be sent electronically, the proposals will make it possible to send a much higher proportion of communications electronically.

The government release does not set out the effective date for the proposed changes.

Public comments were permitted until August 27, 2019.

Ontario updates fee assessments for pension plans while BC proposes fee increase

The new Ontario pension regulator, the Financial Services Regulatory Authority of Ontario (FSRA), has released a new rule updating fees and assessments payable by the pension sector. At the same time, the British Columbia pension regulator, the Financial Institutions Commission of British Columbia (FICOM), has issued a consultation paper on proposed increases to pension assessments in British Columbia.

FSRA releases new rule on assessments and fees

The Financial Services Regulatory Authority of Ontario (FSRA) released its new rule governing fees and assessments, Rule 2019-001, Assessment and Fees (the Fee Rule) on June 8, 2019. As FSRA is intended to be a self-funded regulator that will operate on a cost recovery basis, the Fee Rule is designed to promote a simple, consistent and fair funding model. These fee assessments apply to all pension plans registered in Ontario, including both defined benefit and defined contribution pension plans, and replace the previous fee assessments that were charged by the Financial Services Commission of Ontario.

The minimum assessment for a pension plan has increased from $250 to $750 to take account of the estimated cost to regulate small pension plans. This will apply to all pension plans with 78 or fewer beneficiaries. The term "beneficiaries" includes active, former and retired members, as well as other beneficiaries in receipt of or with a right to a death benefit.

For plans with 79 or more beneficiaries, a tiered approach will be taken based on the amount of FSRA's budget for the pension sector remaining after the minimum assessment is charged to small pension plans. This share will be calculated based on a formula that includes up to six tiers depending on the number of beneficiaries. The tiered approach is intended to better reflect that, at a certain level, as the number of beneficiaries increases, the regulatory cost per additional beneficiary declines.

The $75,000 maximum charge for a pension plan has been eliminated.

Proposed fee increases in BC

FICOM is also meant to be self-funded by fees from the financial services entities it regulates. FICOM released a Pension Fees Consultation Paper on June 10, 2019, seeking input on its proposed regulatory fee structure for the pension industry in British Columbia.

The proposed changes would see fees increase from $6.15 to $8.35 per active member, and from $4.50 to $7.30 per non-active member. The minimum fee would grow from $200 to $250, while the maximum fee would be raised to $85,000 from $75,000. The new fees would take effect for plan years ending January 1, 2020 or later, and would apply to all pension plans registered in British Columbia, including both defined benefit and defined contribution pension plans.

According to the consultation paper, the current fee structure for pension filings is insufficient to cover operations. The fee structure was last amended July 1, 2008. According to FICOM, due to changing economic conditions, larger asset sizes and increased plan risk, it is necessary to revise the fee structure once again. FICOM plans to revisit its fee structure more regularly in the future.

According to FICOM, its proposed fee structure is competitive with other pension regulators in Canada.

Comment

The recent changes in British Columbia and Ontario, as well as the recent proposed increases in Quebec that was discussed in the July 2019 *News & Views* , may indicate a growing focus on cost recovery for pension regulators.

The Ontario changes are somewhat complex, being dependent on FSRA's annual budget and the distribution of plans it oversees. It can be expected that they will result in higher fees for many plans. While the impact is most obvious for small pension plans whose minimum assessment will increase from $250 to $750, the removal of the fee cap for very large pension plans, most of which are in the public sector, will also result in significant fee increases.

The British Columbia fee increase will clearly result in slightly higher operating costs for British Columbia pension plans, with plans having proportionately larger inactive populations seeing the largest increases and the largest plans facing the lowest increase in percentage terms. Comments on the new proposed fee schedule were permitted until July 24, 2019.

Quebec's annuity purchasing policy

In July 2019, Retraite Québec added a new web page summarizing the Annuity Purchasing Policy. Establishing such a policy allows plan administrators to discharge their obligation to pay pension benefits by purchasing annuities from an insurer. Retraite Québec's web page addresses various aspects of this process, as summarized below.

Introducing an annuity purchasing policy

When an annuity purchasing policy is adopted, it does not have to be submitted to Retraite Québec. However, the plan text must be amended to indicate that the plan administrator is authorized to settle or discharge the benefits in accordance with the annuity purchasing policy. The plan text should also outline the preconditions that will permit the plan administrator to purchase annuities to settle the rights of members and beneficiaries, as well as the rules which may apply.

If there is no annuity purchasing policy, one may still purchase annuities from an insurer. However, it would not be considered a discharge of their rights and the members concerned would remain members of the plan. If an annuity purchasing policy were subsequently adopted, it would be possible, through subrogation, to proceed with a discharge.

Plans concerned

The payment of benefits under an annuity purchasing policy applies to pension plans registered in Quebec, except for the following types of plans:

- Target-benefit pension plans
- Member-funded pension plans (MFPP)
- University and municipal sector pension plans

Pensions concerned

Only pensions already in payment and pensions for which an application for payment has been filed may be discharged under an annuity purchasing policy.

Annuity purchasing process and annuity characteristics

There are two categories of annuity purchases: purchases without modifications and purchases with modifications.

Annuity purchase without modifications

The purchase of annuities without modifications means that the annuity paid by an insurance company must have the same characteristics as the pension payable under the plan. The annuity amount, joint and survivor conditions, and guaranteed period must all remain the same.

The plan administrator does not have to obtain plan member's consent to purchase an annuity without modifications. However, the members and

beneficiaries concerned must be notified and informed of the amount and characteristics of the purchased annuity, the name and contact information of the insurance company, as well as the rules regarding the termination of a plan that has an asset surplus or a deficit arising from employer insolvency.

Annuity purchase with modifications

The purchase of an annuity with modifications applies when the pension characteristics are not available on the market. In such circumstances, an annuity with similar characteristics may be purchased from an insurer only if the replacement annuity's value is equal to the value of the pension payable from the plan, on a solvency basis, as of the date of the agreement with the insurance company.

To purchase an annuity with modifications, the prior consent of the members and beneficiaries concerned must be obtained in writing within 30 days. Only annuities for which written consent has been received may be purchased. However, the plan administrator is under no obligation to proceed if, for example, the number of consents received are insufficient to obtain a reasonable price. Once the purchase has been made, members and beneficiaries must be notified in the same manner as for a purchase of the pension without modifications.

Fees

Since the establishment and updating of an annuity purchasing policy is considered a plan administrative expenses, such fees are assumed by the pension fund, unless the plan text states otherwise.

Content of the annuity purchasing policy

The Regulations under the *Supplemental Pension Plans Act* identify the main subjects that must be addressed in an annuity purchasing policy. Some of these subjects are addressed in more detail on Retraite Québec's website:

- Elements that trigger the purchase of annuities
- Conditions for paying a portion of the member's benefits
- Criteria for selecting annuities to guarantee
- Process and criteria for selecting the insurance company

Funding criteria and special monitoring

For the annuity purchase to constitute a discharge under the annuity purchasing policy, a special annuity purchasing payment may be required in order to maintain the plan's degree of solvency or restore it to 100%. If such a payment is required, the employer must consent in writing.

If the annuity purchasing policy so provides, the special payment may be subject to special monitoring so that the employer may recover it in the event of an appropriation of surplus assets.

Annual meeting

If there have been discharges of benefits under the annuity purchasing policy during the year, the following subjects must be on the agenda of the annual meeting:

- Number of annuity purchase transactions and premium required by the insurance company for each transaction
- Selection criteria for the annuities and the insurance company
- Plan solvency ratio before and after each annuity purchase and the amount of any special annuity purchasing payments
- The main changes made to the annuity purchasing policy since the last annual meeting

Plan termination and employer withdrawal

Although a person whose pension was purchased in accordance with the annuity purchasing policy is, as of the date of such purchase, no longer a member or beneficiary of the plan, that person retains his or her status as a plan member or beneficiary for three years. If the plan is terminated during that period and has surplus assets, that person will be considered a member or beneficiary with respect to allocation of

the surplus. On the other hand, if the plan terminates in a deficit position due to the insolvency of the plan sponsor, the guaranteed annuity will also be reduced, in the same manner as that of the other members and beneficiaries.

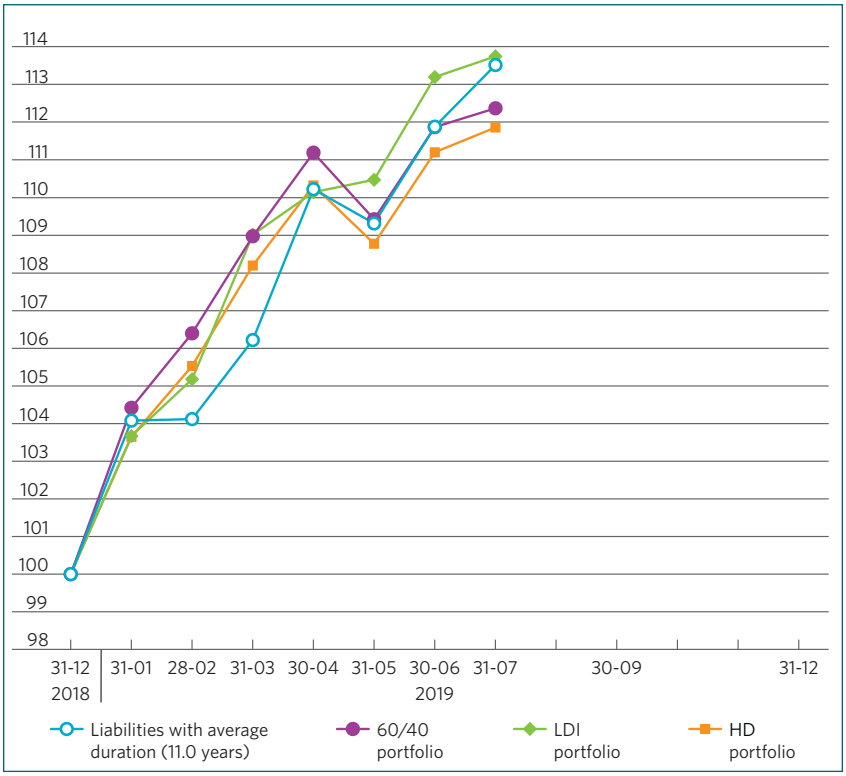
Comment

Retraite Québec provides additional information on its website to facilitate the implementation of annuity purchasing policies by sponsors who wish to mitigate their risks. However, sponsors in the municipal and university sectors will be disappointed to learn that the rules governing such purchases still do not apply to their plans. Furthermore, the information provided does not address the challenges faced by plans with members in several jurisdictions.

Tracking the funded status of pension plans as at July 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 June 30, 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



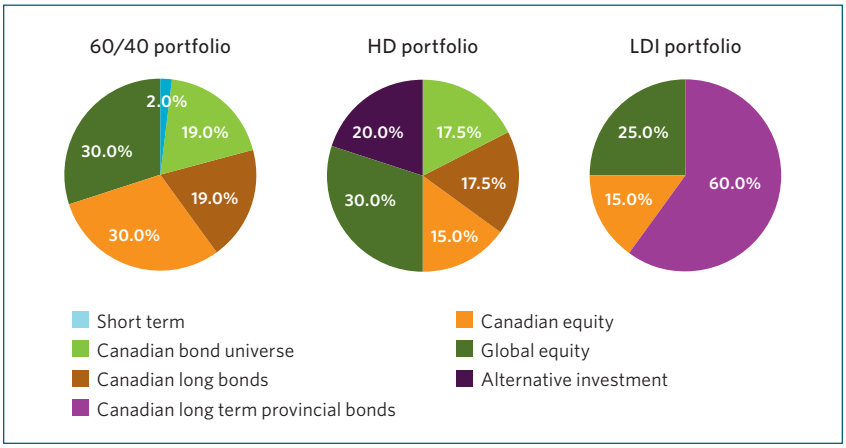
During the month of July, Canadian long-term bonds, Canadian long-term provincial bonds, Canadian equity markets as well as global equity markets (CAD) showed positive returns. Similarly, the alternative investments showed positive returns as well. With a return of 0.6%, the highly diversified portfolio (HD) outperformed the low volatility portfolio (LDI[1]) (0.5%) and the 60/40 portfolio (0.5%).

The prescribed CIA annuity purchase rates increased slightly while the commuted value rates used in the calculation of solvency liabilities decreased during the month. As a result, the solvency liabilities increased by 1.5% for a medium duration plan. For this type of plan, an investment in the 60/40, in the HD or in the LDI 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, 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 July 31, 2019 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	99.0%	100.2%	98.5%
90%	89.1%	90.2%	88.7%
80%	79.2%	80.2%	78.8%
70%	69.3%	70.1%	69.0%
60%	59.4%	60.1%	59.1%



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 12.4%, 13.8% and 11.9% respectively. The solvency liabilities fluctuated over that same period from 13.0% to 14.1% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at July 31, 2019 stands between -1.5% and 0.2%.

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

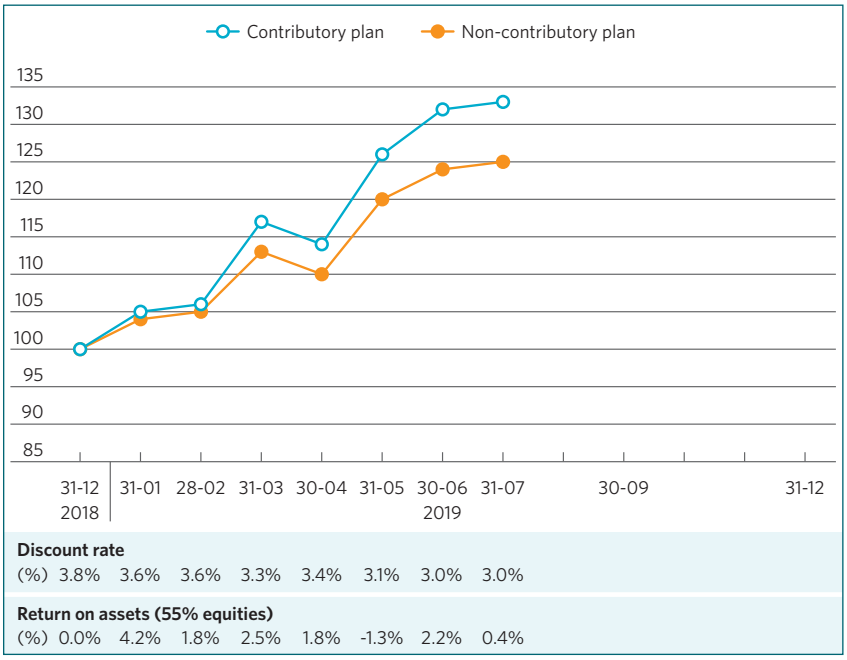
Comments

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 July 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	July 2019	Change in 2019
11	3.72%	2.89%	-83 bps
14	3.81%	2.97%	-84 bps
17	3.87%	3.02%	-85 bps
20	3.90%	3.05%	-85 bps

Since the beginning of the year, the pension expense has increased by 33% (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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