Knowledge & Insights

MORNEAU SHEPELL

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Recent developments in pharmaceutical benefit coverage

Several new developments in 2019 point towards greater government intervention to manage drug prices as well as the cost of public drug plans. These changes may result in better sustainability for private drug plans and point to the need for private plan sponsors to pro-actively manage their drug plans.

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Federal drug pricing regulations

Revised federal drug pricing regulations were published on August 21, 2019, and will become effective on July 1, 2020. These revisions are expected to lower the costs of new patented drugs entering the market by allowing the Patented Medicine Prices Review Board to set prices based on how well the drug works compared to other available therapies and by revising the reference countries used to guide how drugs are priced. The changes are facing a recent constitutional challenge by several pharmaceutical companies.

As the new regulations would only apply to new patented drugs, we do not expect private plans to see a significant reduction in current costs in the foreseeable future. Instead, these changes will contribute to long-term sustainability of private plans as well as government programs by managing new drug costs.

British Columbia biosimilar transition program

British Columbia's provincial PharmaCare program has announced a biosimilar transition program. This program is the first of its kind for a Canadian public drug plan. This program will transition individuals taking certain high-cost biologic medications to lower-cost biosimilar medications. This program is significant in the Canadian marketplace, where most private insurance carriers and public plans do not currently support biosimilar transitions and the utilization of biosimilars is much lower than in other countries. British Columbia expects to save approximately $96.6 million over the first three years of this initiative.

Several insurers have indicated that they will align their coverage with the provincial plan for BC plan members. Since managing the spiraling cost of biologic drugs is one of the highest priority challenges for many private drug plans, increased usage of biosimilars would improve the financial stability of private drug plans.

Pharmacare report released in June 2019

As discussed in the July 2019 *News & Views*, the final report of the Advisory Council on the Implementation of National Pharmacare was released in June 2019, calling for a universal single-payer drug plan for all Canadians phased in between 2022 and 2027. If implemented as proposed, there would be a significant impact to the employer-sponsored drug plan landscape. National pharmacare is anticipated to be a significant issue in the October 2019 federal election.

Insurance companies restrict access to opioids

For reasons unrelated to cost control, many insurance companies have been proactively implementing new controls to manage the supply of opioids to private drug plan members. Many companies have implemented harm-reduction programs that only reimburse short-acting opioids and dispense a reduced supply, minimizing misuse of leftover drugs.

Comment

Drug plans are a key component of employee benefits packages and are typically a highsly valued part of the employee experience. The cost increases associated with private prescription drug plans have been outpacing salary increases for years and some employers are struggling to maintain plans with comprehensive coverage while also investing in employee health and productivity. Plans that have been more proactive in managing costs generally find themselves better able to withstand change and invest in employee health and productivity. However, the 2019 Sanofi Canada health-care survey found that only 26% of plan sponsors regularly receive reports to help understand their drug plan and where dollars are being spent.

Progressive organizations are increasingly focusing on prevention of health problems and overall employee wellbeing to meet the needs of the growing younger and diverse workforce. While some private plans have modernized and leveraged their prescription drug coverage to meet these goals, many other plans still include outdated provisions that represent lost opportunities. A Morneau Shepell consultant can assist organizations in optimizing the value of their drug plan and overall programs for employees.

British Columbia pension funding reform proposals

The British Columbia (BC) Ministry of Finance released a report in August 2019 outlining a proposal for changes to minimum funding requirements for BC-registered defined benefit (DB) pension plans. The report suggests that changes to funding rules could be effective for valuations filed with valuation dates as early as December 31, 2019. The government began its review of the province's solvency funding framework in late 2018 with the issuance of a consultation paper, which was summarized in the November 2018 *News & Views*.

Proposed DB funding framework

Under the proposed funding framework, DB pension plans would be funded on both a going concern and solvency basis.

The solvency funding rules would require DB pension plans to be funded to a reduced level of 85% of the solvency liability. Any solvency deficit would be consolidated at each valuation and amortized over 5 years.

The going concern funding rules would include a provision for adverse deviations (PfAD). The PfAD would generally be equal to the monthly long-term benchmark Government of Canada bond yield as at the valuation date multiplied by 5. The PfAD would be subject to a minimum of 5%, but no maximum. An adjustment to the PfAD would be made for plans that have an exposure of less than 30% to asset classes other than traditional fixed income investments. The PfAD would be calculated and required to be funded on both the going-concern liabilities and the normal cost.

Any unfunded going concern liability would be consolidated at each valuation and amortized over 10 years, instead of the current 15 years.

The proposed PfAD formula was developed with the objective of mitigating contribution volatility, reflecting the stakeholder committee's view that interest rate risk is the main risk to which most DB plans are exposed. As at August 31, 2019, the required PfAD for plans with at least 30% of their target asset mix in non-fixed-income asset classes would have been 6.85% of going-concern liabilities.

Comments on the proposals were due by August 30, 2019. Morneau Shepell made a written submission on the proposals.

Comment

The proposed revisions to the funding framework for DB plans are generally welcome for BC pension plan sponsors. Reducing required solvency funding to a threshold of 85% represents an improved balance between benefit security and plan affordability, and is consistent with changes considered or implemented in other Canadian jurisdictions. Reducing the amortization period for going-concern deficits to 10 years is an appropriate measure, considering the reduction in solvency requirements and associated shift in emphasis to going concern funding.

The report states that the objective of the PfAD is to mitigate contribution volatility, not to enhance benefit security. However, we have concerns that the proposed formula to calculate the PfAD will often not accomplish this objective. A PfAD which moves only in line with the level of interest rates and not in response to any other plan experience would unnecessarily restrict plan sponsors' ability to prudently manage contributions. Plan-specific dynamic margins, which are lower when a plan is more poorly funded and higher when the plan is better funded, would be a more effective mechanism in pursuing contribution stability. Our recommended revisions to the government's proposal were set out in our written submission to the BC Ministry of Finance.

FSRA to begin imposing summary administrative penalties for late regulatory filings

On August 13, 2019, the new Ontario pension regulator, the Financial Services Regulatory Authority of Ontario (FSRA), announced that it intends to commence imposing summary administrative monetary penalties (AMPs) effective for filings due on or after September 30, 2019. FSRA will work with plan administrators who have outstanding late filings that were due prior to September 30, 2019, in order to bring plans into compliance. If plans with outstanding late filings are brought into compliance by October 31, 2019, FSRA will not issue summary AMPs.

Background

The Ontario *Pension Benefits Act* was amended effective January 1, 2018, to permit the issuance of administrative penalties for violations of certain legislative requirements. The previous Ontario pension regulator, the Financial Services Commission of Ontario (FSCO), issued an Administrative Monetary Penalties Guideline (the AMP Guideline) in November 2018. The AMP Guideline was discussed in the December 2018 *News & Views.*

There are two types of AMPs: general and summary. A summary AMP relates to a late regulatory filing, in relation to matters such as annual information returns, audited financial statements, actuarial valuation reports, and investment information summaries. Summary AMPs accrue daily with penalties of $100 or $200 for each day of non-compliance. AMPs are capped at $10,000 per contravention or failure to comply for individuals, and $25,000 for corporations or other groups such as boards of trustees.

FSRA's new approach to summary AMPs

Although FSCO had the authority to issue AMPs, it took a relatively flexible approach pending the transition to FSRA. With this announcement, FSRA indicates that it intends to begin applying the AMP provisions in the legislation and following the approach set out in the AMP Guideline beginning for filings due on or after September 30, 2019. Filings with earlier due dates will have until October 31, 2019, to come into compliance without being subject to a summary AMP.

The AMP Guideline states that, upon identifying a late filing, the regulator will send a Letter of Warning giving the plan administrator a set amount of time to correct the issue without a summary AMP being issued.

If the issue is corrected within the specified deadline, a summary AMP will not be issued. If the issue is not corrected, FSRA will send a Letter of Proposed Action proposing to issue a summary AMP but offering an opportunity to present mitigating circumstances. It appears that mitigating circumstances will be primarily external factors such as emergencies, strikes and other business disruptions.

Comment

The FSRA announcement places a greater onus on plan administrators to make regulatory filings on time or to request extensions, if it is not possible to meet the deadlines. If a regulatory deadline is not met, the administrator must be ready to meet the deadline soon thereafter or, absent mitigating circumstances, should expect to be issued a summary AMP.

The FSRA announcement does not affect general AMPs, which can be issued based on non-compliance with substantive legislative provisions of the *Pension Benefits Act*.

FSRA permits delegated administrators to make and revoke delegations on Pension Services Portal

The Financial Services Regulatory Authority of Ontario (FSRA) has created a new role of "Delegated Administrator" under the Pension Services Portal (PSP). This will allow Delegated Administrators who work for service providers such as Morneau Shepell to make and revoke delegations for the employees within their organizations. It also permits more than one employee of the pension plan administrator (usually the employer) to manage delegations both within and outside of the organizations.

Under the previous system, the "Primary Administrator" (usually an individual who works for the employer) would be required to provide or revoke access to all agents. No other individual inside or outside of the organization would be permitted to manage delegation rights.

FSRA says the change is intended to reduce the burden on Primary Administrators that outsource the administration and investment functions of their pension plans to third parties.

There are now four categories of delegates to whom a Primary Administrator may delegate PSP access: Delegated Administrator, Secondary Administrator, Agent and Actuary.

The announcement was accompanied by instructions on the new PSP delegation/revocation process.

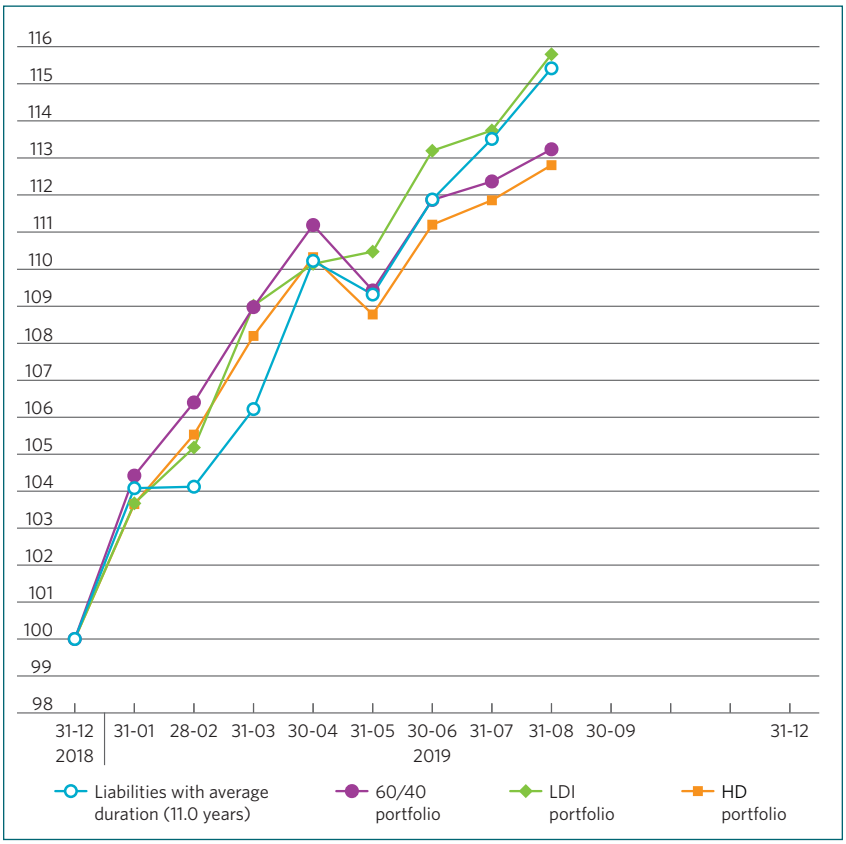
Comment

The new delegation process will relieve Primary Administrators of some of the obligations associated with managing PSP access. A third party Delegated Administrator will be able to manage its own team's access to the PSP without needing to ask the Primary Administrator to make changes every time an agent needs to be added or revoked. Furthermore, an internal Delegated Administrator of a pension plan administrator will be able to share most of the responsibilities of the Primary Administrator.

Tracking the funded status of pension plans as at August 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



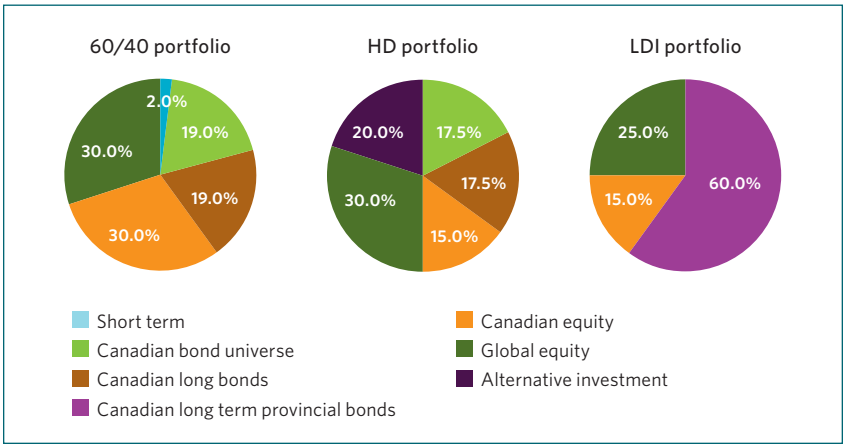
During the month of August, Canadian universe bonds, Canadian long-term bonds, Canadian long-term provincial bonds, Canadian equity markets as well as alternative investments showed positive returns. However, global equity markets (CAD) showed negative returns. With a return of 1.8%, the low volatility portfolio (LDI[1]) outperformed the highly diversified portfolio (HD) (0.9%) and the 60/40 portfolio (0.8%).

The prescribed CIA annuity purchase rates decreased while the commuted value rates used in the calculation of solvency liabilities increased for the first 10 years and decreased after 10 years during the month. As a result, the solvency liabilities increased by 1.7% 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, while an investment in the LDI portfolio resulted in an increase 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 August 31, 2019 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	98.1%	100.3%	97.7%
90%	88.3%	90.3%	88.0%
80%	78.5%	80.3%	78.2%
70%	68.7%	70.2%	68.4%
60%	58.9%	60.2%	58.6%



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 13.3%, 15.8% and 12.8% respectively. The solvency liabilities fluctuated over that same period from 14.5% to 16.3% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at August 31, 2019 stands between -2.3% and 0.3%.

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

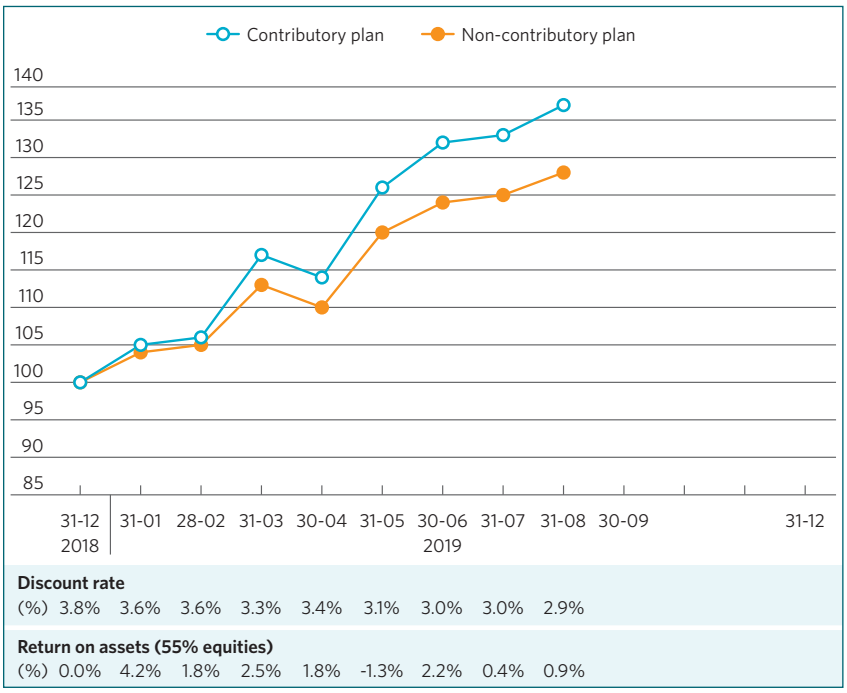
Comments

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 August 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	August 2019	Change in 2019
11	3.72%	2.75%	-97 bps
14	3.81%	2.85%	-96 bps
17	3.87%	2.91%	-96 bps
20	3.90%	2.95%	-95 bps

Since the beginning of the year, the pension expense has increased by 37% (for a contributory plan) due to the decrease in the discount rates, despite the good returns on assets (relative to the discount rate).

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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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