Knowledge & Insights

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In this issue

British Columbia adopts DB funding reform and introduces single employer target benefit plans

On December 12, 2019, British Columbia amended its *Pension Benefits Standards Regulation* to increase going concern funding requirements and reduce solvency funding requirements for provincially-regulated defined benefit (DB) pension plans.

The amendments also permit single employers to offer target benefit plans on a go-forward basis. The amendments are summarized in the BC Financial Services Authority (FSA) Information Bulletin PENS 19-004 and are generally in line with the proposals that were summarized in the September 2019 *News & Views*.

Solvency funding

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

A DB plan must maintain a solvency ratio of at least 85% after a plan amendment providing for benefit improvements.

Going concern funding

The going concern funding rules include a provision for adverse deviation (PfAD). The PfAD is generally equal to the monthly long-term benchmark Government of Canada bond yield as at the valuation date, multiplied by five.

The PfAD is subject to a minimum of 5%, but no maximum. A downward adjustment to the PfAD is made for plans with an exposure of at least 70% to traditional fixed income investments. The PfAD is calculated and funded on both going-concern liabilities and the normal cost.

Any unfunded going concern liability is consolidated at each valuation and amortized over 10 years, instead of the current 15 years. The unfunded going concern liability to be amortized must include an allowance for the PfAD.

For actuarial valuations as at December 31, 2019, the required PfAD for plans with at least 30% of their target asset mix in non-fixed-income asset classes is equal to 8.35% of going-concern liabilities and of the normal cost.

Application of the new funding framework

The new regulations apply to actuarial valuations with effective dates on or after December 31, 2019.

The solvency relief options that had previously been offered to pension plans will no longer be available as of December 31, 2019. Any previously elected solvency relief options will cease to apply as of the first review date on or after December 31, 2019. Furthermore, the FSA has advised that it will cease to approve applications for extensions of the solvency funding period under its general authority to extend regulatory deadlines.

Target benefit plans

Single employer target benefit plans are now possible in British Columbia. The target benefit provisions of the legislation were previously limited to multi-employer pension plans. Since the right to convert past benefits to target benefits is restricted to multi-employer negotiated cost pension plans, single employer target benefit provisions would only be possible in respect of future benefits.

Comment

Although we would have preferred not to see the PfAD solely based on interest rate risk, the changes are broadly positive for DB plan sponsors in British Columbia and should improve the sustainability of DB plans in the province. British Columbia employers who sponsor DB pension plans may wish to file early actuarial valuations as of December 31, 2019, in order to take advantage of the new provisions.

The reduced amortization period for going-concern deficits and introduction of the PfAD is reflective of the shift in emphasis away from solvency funding and towards enhanced funding on a going concern basis across Canada, as enacted in Ontario and Quebec, and as proposed in Manitoba and Nova Scotia.

The introduction of single employer target benefit plans gives employers greater flexibility to offer retirement programs that best meet their needs, but it remains to be seen how many employers choose to take advantage of these provisions.

Ontario permits variable benefits in DC pension plans

Following the publication of Regulations 368/19 and 369/19 under the Ontario *Pension Benefits Act* (PBA), Ontario's rules permitting defined contribution (DC) pension plans to offer variable benefits to their former members came into force on January 1, 2020. The variable benefit rules permit former members to receive a retirement income directly from a DC pension plan, rather than transferring a member's pension benefit to a prescribed savings arrangement or using it to fund the purchase of an annuity.

The province of Ontario first published a description of the variable benefits regulation on March 20, 2018 and a draft regulation on April 11, 2019 (as described in the April 2018 and May 2019 *News & Views*, respectively).

Rules for administering variable benefit accounts

DC pension plans offering variable benefits are required to give prescribed information about variable benefits as part of the former member's retirement option statement. The statement must include a statement that the retired member will have the option of transferring up to 50% of the amount transferred to the variable benefit account at the time it was established to an unlocked registered retirement savings arrangement within 60 days of establishing the variable benefit account.

A DC plan may permit the transfer of only a portion of a former member's DC account to a variable account, in which case a former member may elect to transfer part of the account to a variable benefit account. Otherwise, the entire amount credited to the former member will be transferred to the former member's variable benefit account.

A spouse's consent is required to establish a variable benefit account, unless the spouse is living separate and apart from the former member.

After the establishment of a variable benefit account, the retired member will receive a statement requiring the retired member to elect the amount to be paid during the calendar year, the method of payment and the frequency of payments, if the plan permits more than one payment per year. If the retired member does not make an initial election, the minimum amount will be paid. The retired member may be restricted to changing the election only once annually, but a pension plan may also permit a retired member to make more than one change annually.

The amount paid from a variable benefit account in a given year must be at least equal to the annual minimum amount set under the *Income Tax Act*, while the maximum amount that can be paid out in a calendar year mirrors the limits applicable to life income funds in Ontario.

For retired members with variable benefit accounts, the administrator must provide annual statements, including the amount and nature of the fees and expenses charged to the variable benefit account, if any.

Death benefits

A retired member's spouse who is not living separate and apart is entitled to the variable benefit account upon the retired member's death, unless the spouse waives the right to the death benefit. A spouse who was designated a specified beneficiary by the member has the right to continue to receive an income from the pension plan. A retired member and a specified beneficiary also have the right to designate a beneficiary who is not a spouse.

Upon the death of a retired member who was receiving variable benefits, a surviving spouse whom the member had designated as a specified beneficiary may elect to continue receiving variable benefits rather than a lump sum benefit.

Commentary

The introduction of variable benefit accounts allows DC pension plans to offer Ontario members the option of receiving variable benefits in retirement directly from the pension plan. By providing this option, a DC pension plan can make the pension plan more attractive to members, offer lower investment management fees throughout retirement, and retain assets in the pension plan, potentially providing greater negotiating power with service providers. Pension plans are not required to offer variable benefit accounts to their members.

With the introduction of variable benefit accounts in Ontario, such accounts are now permitted everywhere in Canada except in New Brunswick and Newfoundland and Labrador.

Developments affecting federally regulated pension plans

The Office of the Superintendent of Financial Institutions (OSFI) has released issue 22 of its *InfoPensions* newsletter, which includes a number of announcements that affect federally-registered pension plans.

Electronic amendment filing

As of April 1, 2020, plan administrators filing plan amendments will be required to upload the applicable plan amendment filing form, along will all other relevant documents, to the Regulatory Reporting System (RRS), which is currently used to make filings such as the Annual Information Return (AIR). The new RSS system will not apply to applications that require the Superintendent's authorization, such as defined benefit transfers of assets between pension plans.

Updated returns for regular annual filings

OSFI announced changes to some of the annual regulatory returns that federally-registered pension plans must file.

The Actuarial Information Summary and the Solvency Information Return have been amended for plan years ending October 31, 2019 or later. For plan years ending December 31, 2019, a revised AIR, Certified Financial Statement, Pension Plan Annual Corporate Certification and Replicating Portfolio Information Summary are to be used.

OSFI has also developed a new Auditor's Report Filing Confirmation that all plans must complete in order to determine whether the plan will be required to submit an auditor's report.

Revised instruction guides are expected to be posted in the spring of 2020.

Contributions schedule

In an effort to address issues arising from late contributions, OSFI has posted a Schedule of Expected Contributions Form that may be used to inform trustees or custodians of amounts to be remitted to the pension fund, as pension plan administrators are required to do under section 9.1 of the *Pension Benefits Standards Act, 1985*. Use of the form is optional.

Requirements for an annuity purchase discharge

OSFI summarizes some of the conditions that an administrator will have to satisfy in order to take advantage of the provisions of Bill C-97 that amend the federal *Pension Benefits Standards Act, 1985* to permit a plan administrator to satisfy an obligation under the plan to provide a pension benefit to a former member or survivor through the purchase of an immediate or deferred life annuity. While Bill C-97 was passed on June 21, 2019, these provisions are not yet in force as of the end of 2019.

Defined contribution pension plan study

OSFI includes some preliminary observations following its survey on defined contribution (DC)

pension plans in which members are permitted to make investment choices ("member choice account plans"), which was initially circulated in December of 2018. According to the survey, the most popular default investment option was a target-date fund, which 55% of member choice account plans use as their default option, followed by a balanced fund, which 25% of plans used as their default investment choice. OSFI notes that money market funds are not generally considered to be a suitable default option, despite being used as such by some pension plan administrators.

The survey found that the median number of investment options offered to members in member choice account plans is 22. While the average number of options offered is 34, OSFI suggests this number skews high due to a small number of plans that offer a number of options that is well-above the average. OSFI suggests that a large number of investment options to be overwhelming to most plan members, and could be difficult for an administrator to review.

The survey revealed that, while administrators are generally aware of investment management fees, the amount of administrative fees paid by the plan members and/or by the employer is not well known. OSFI encourages administrators to become aware of all fees relating to their plan and inquire about fees with their service providers.

Annual assessments of pension plans

OSFI has set a basic rate of $10 for plan years ending between October 1, 2019 and September 30, 2020. This represents an increase of $1 from the basic rate that is currently in effect. The basic rate is used to calculate the annual assessments that are invoiced to pension plans by OSFI. The minimum assessment amount will increase from $450 to $500 and the maximum assessment amount will increase from $180,000 to $200,000. OSFI will determine a plan's assessment after the plan has filed its Application for Registration or its AIR, and will send invoices approximately 45 days after determining the assessment, regardless of the AIR's due date.

Update: Proposed changes to employee stock option tax rules delayed

On December 19, 2019, the federal government announced that the proposed changes to the tax treatment of employee stock options would not come into force on the previously proposed date of January 1, 2020. The proposed changes to the tax treatment of employee stock options were summarized in the July 2019 edition of *News & Views* and would limit the use of the current employee stock option tax regime for employees of large, established companies.

On June 17, 2019, the federal Minister of Finance tabled a Notice of Ways and Means Motion to implement the new limitations. Stakeholders were consulted for input on the characterization of companies that should be considered "start-up, emerging, and scale-up companies", as these corporations would not be subject to the new employee stock option tax rules.

Although the consultations closed on September 16, 2019, the government continues to review stakeholder input against the proposed new regime, and as a result, the proposed changes to the tax treatment of employee stock options did not come into force on the previously proposed date of January 1, 2020. The government has confirmed that it will announce further details of this measure, including the new coming-into-force date, in the 2020 federal budget.

Comment

The delay in the coming-into-force date will provide organizations with greater time to review and plan for the new employee stock option tax rules. As part of its review and planning, some organizations may wish to consider alternative forms of incentive-based compensation. Morneau Shepell's compensation consulting practice, with its extensive experience in incentive program design and stock option administration, can assist clients in updating incentive programs to achieve their goals.

New and extended employment leave provisions in Saskatchewan

Saskatchewan has adopted a number of new and extended employment leave provisions that will affect pension and benefit plan sponsors.

Pursuant to Bill 153, maternity and adoption leave periods were increased from 18 weeks to 19 weeks. Parental leave was also extended from 34 weeks to 59 weeks for a parent who takes maternity or adoption leave, and extended from 37 weeks to 63 weeks for a parent who does not take maternity or adoption leave.

Interpersonal violence leave was expanded to include leave for victims of sexual violence. Furthermore, employees are now permitted to take up to 17 weeks of leave to care for a critically ill adult family member.

Bill 172 amended *The Saskatchewan Employment Act* to allow employees to take five paid days and five unpaid days of leave, compared to the previous 10 days of unpaid leave. To be eligible for such leave, the employee, employee's child or a person for whom an employee is a caregiver for, must be a victim of interpersonal or sexual violence.

The changes in Bills 153 and 172 came into effect on May 15, 2019.

On November 27, 2019, Saskatchewan introduced Bill 200, which would extend the period of parental leave by a further eight weeks to account for the new shared parental Employment Insurance benefit. Bill 200 will come into force upon proclamation.

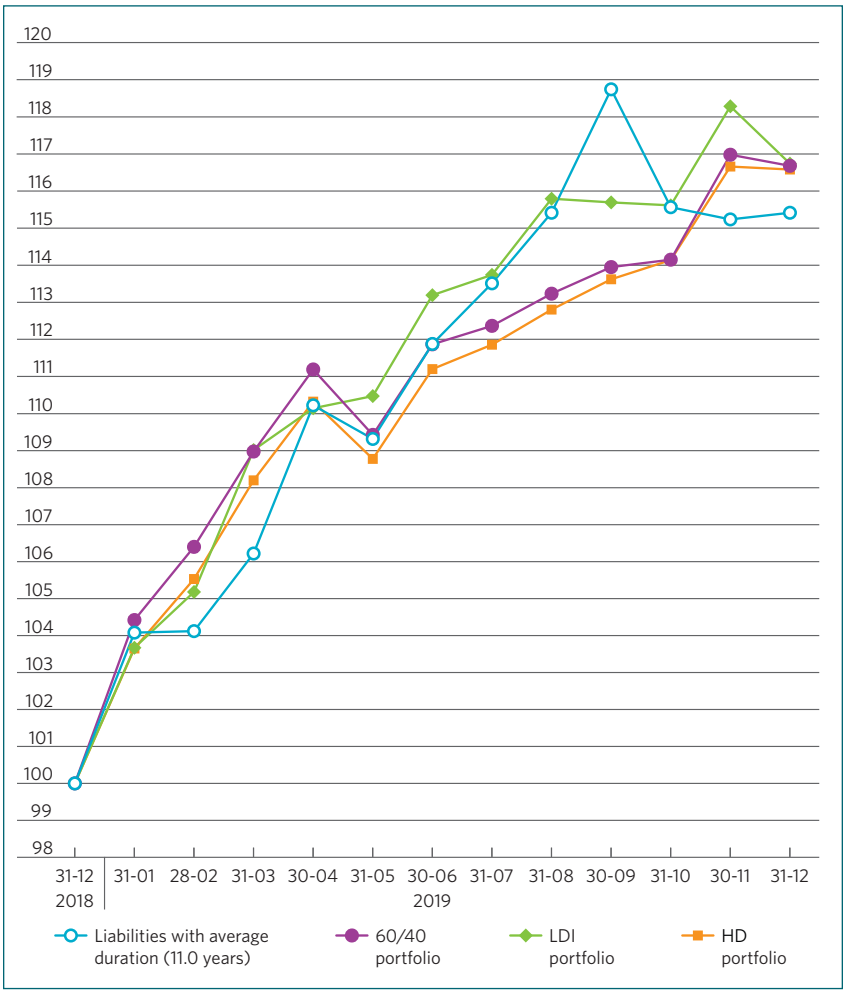
Comment

Saskatchewan requires pension and benefit accrual to continue during a leave period, subject to the employee making the required contributions under the plan. This means that Saskatchewan employers must ensure that their pension and benefit plan coverage complies with their statutory obligations. In addition, Saskatchewan employers should review workplace policies and documentation to ensure that the leaves available to employees are accurately reflected.

Tracking the funded status of pension plans as at December 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 September 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



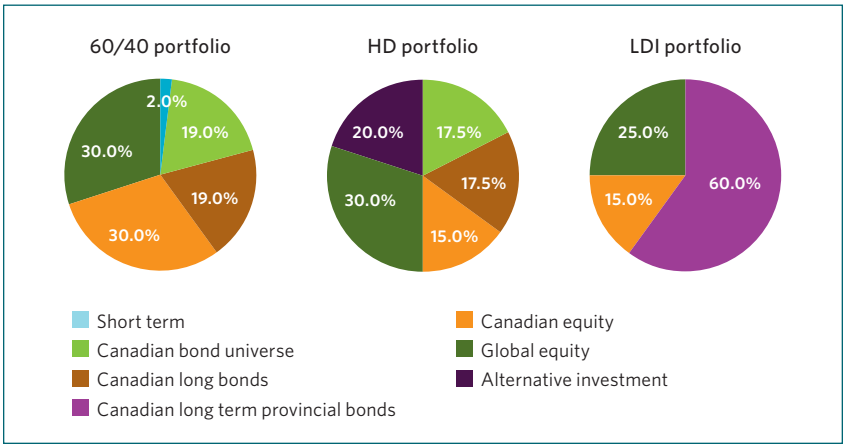
During the month of December, Canadian equity markets, global equity markets (CAD) as well as alternative investments showed positive returns. However, Canadian universe bonds, Canadian long-term bonds and Canadian long-term provincial bonds showed negative returns. With a return of -0.1%, the highly diversified portfolio (HD) outperformed the 60/40 portfolio (-0.3%) and the low volatility portfolio (LDI[1]) (-1.3%).

[1] Liability driven investment

The prescribed CIA Annuity purchase rates increased while the commuted value rates used in the calculation of solvency liabilities slightly decreased during the month. As a result, the solvency liabilities slightly increased for a medium duration plan. For this type of plan, an investment in the 60/40, in the HD and the LDI portfolio resulted in a decrease of the solvency ratio.

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 December 31, 2019 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	101.1%	101.2%	101.0%
90%	91.0%	91.0%	90.9%
80%	80.9%	80.9%	80.8%
70%	70.8%	70.8%	70.7%
60%	60.7%	60.7%	60.6%



Since the beginning of the year, driven by strong positive returns in the Canadian fixed income and equity markets, global equity markets as well as the alternative investments, the 60/40 portfolio, the LDI portfolio and the HD portfolio returned 16.7%, 16.8% and 16.6% respectively. The solvency liabilities fluctuated over that same period from 15.2% to 15.6% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at December 31, 2019 stands between 0.6% and 1.2%.

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

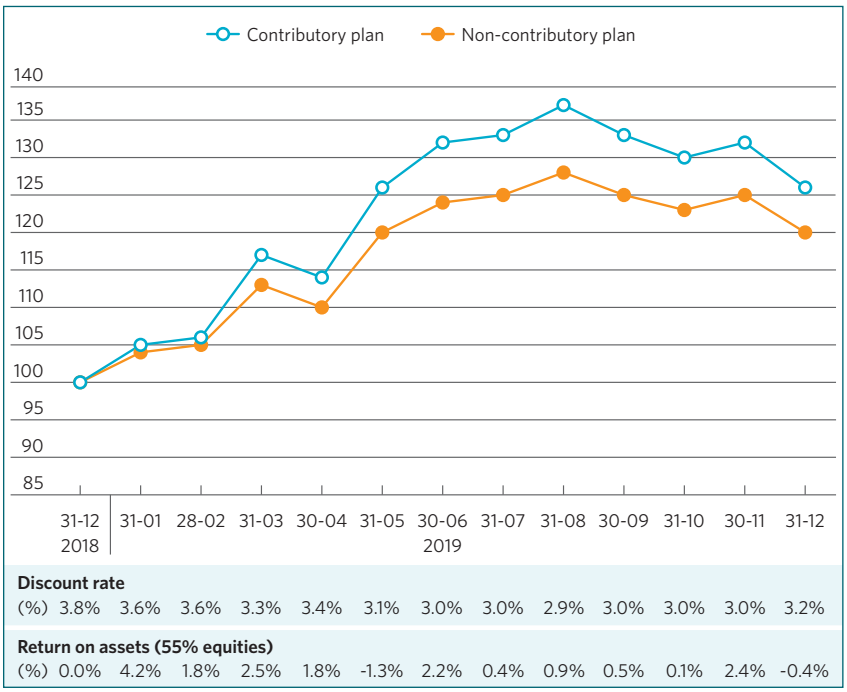
Comments

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 December 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	December 2019	Change in 2019
11	3.72%	3.06%	-66 bps
14	3.81%	3.13%	-68 bps
17	3.87%	3.17%	-70 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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