Knowledge & Insights

News & Views

Volume 17 | Issue 2
February 2020

In this issue

Canadian Institute of Actuaries finalizes new commuted value standards

In January 2020, the Actuarial Standards Board of the Canadian Institute of Actuaries (CIA) released its updated pension commuted value standards.

The new standards, which are effective as of August 1, 2020, largely reflect the second Exposure Draft of new rules for pension commuted value calculations that was published on November 23, 2018, and discussed in the January 2019 *News & Views*.

Improving lives. Improving business.

Background

The original updated commuted value standard was released in 2017 for consultation. However, its implementation was delayed while the CIA working group prepared a revised draft following the responses that the Actuarial Standards Board received to the initial proposals (as discussed in the July 2017 and September 2018 *News & Views*).

Although the Actuarial Standards Board had originally proposed adopting a new mortality improvement scale in the updated commuted value standards, it announced on June 20, 2019 that it would not be moving forward with the new mortality improvement scale, as discussed in the August 2019 *News & Views*.

Summary of main changes

The new commuted value standards require an assumed retirement age to be based on a 50/50 blend of the most valuable age and the earliest unreduced age, rather than relying on the most valuable retirement age alone.

Under the new standards, interest rates will continue to be based on Government of Canada bond yields, with an adjustment that will vary between 0% and 1.5% depending on the relative yields of provincial and corporate bonds to Government of Canada bonds. The current standard uses a fixed adjustment of 0.90%.

Application to target pension arrangements

Target pension arrangements (TPAs) are plans that can reduce benefits to manage their funded status. In addition to target benefit pension plans, this can include negotiated cost or multi-employer pension plans in some cases. Under the new standards, commuted values for TPAs should be calculated based on the plan's most recent going concern assumptions. However, the plan terms or applicable legislation may require that the funded status of the plan and/or any provision for adverse deviation be included or excluded from the calculation of commuted values.

In the event of any discrepancies between the new commuted value standards and the current rules, TPAs must continue to adhere to the legislation, until such time as the legislation is modified to conform to the new standards.

The new commuted value standards permit early adoption of the TPA standards if all of the sections of the standard applicable to TPAs are adopted at the same time. Early adoption is subject to legislative requirements.

Comment

The new commuted value standards are expected to slightly reduce the commuted values of defined benefit pension entitlements, while increasing the complexity of commuted value calculations. The new standards could also result in significantly reduced commuted values for TPAs, where the plan and applicable legislation permits the new commuted value calculations to be applied.

Ontario increases threshold for audited financial statements, provides for new commuted value standards to be adopted automatically

On December 11, 2019, O. Reg. 420/19 (the Regulation) was filed. The Regulation provides that any update of the commuted value calculations by the Actuarial Standards Board of the Canadian Institute of Actuaries be automatically adopted, as opposed to requiring a specific regulation, as was previously required.

In addition, the asset threshold for requiring pension plans to file audited financial statements was increased from $3 million at the end of a fiscal year to $10 million at the end of a fiscal year. Such pension plans are still required to file unaudited financial statements annually.

Comment

The automatic adoption of the new commuted value standards will make Ontario legislation consistent with other provinces in this respect and remove uncertainty over when Ontario will adopt the new standards.

The increased asset threshold for audited financial statements will provide welcome flexibility and possible cost savings for smaller pension plans registered in Ontario.

Introducing Morneau Shepell's *Pension Risk Bulletin*

Morneau Shepell's Pension Risk Transfer Team has introduced a periodic *Pension Risk Bulletin* to provide pension risk transfer market updates and provide other important information on risk management to defined benefit pension plan ponsors in Canada. The first edition of the *Pension Risk Bulletin* provides a summary of 2019 pension risk transfer activities as well as touching on key trends that Morneau Shepell's Pension Risk Transfer team is expecting for 2020 and beyond.

Key highlights

- Preliminary statistics for 2019 suggest that the total volume transacted has reached the $5 billion mark, another record for Canada.
- Buy-in group annuities represented a large part of the total volume in 2019, reinforcing the fact that they can represent a desirable short- or long-term investment strategy vis-à-vis a low-risk liability driven investment strategy.
- A busy fourth quarter in 2019 that had many insurers reached their annual capacity impaired the market's ability to provide competitive pricing to clients towards the end of the year. Careful planning and an ongoing dialogue with insurers are of paramount importance to obtain a successful result.
- The number of jurisdictions allowing plan administrators to obtain a statutory discharge upon an elective buy-out continues to grow in Canada. As of the end of 2019, statutory discharge following an elective annuity purchase is possible in Québec, Ontario and British Columbia. In 2019, the Nova Scotia and the Federal governments both adopted bills to that effect that have yet to be proclaimed.
- The increasing number of data breaches and heightened scrutiny on cybersecurity risk reinforce the importance of incorporating cybersecurity elements in the due diligence process as part of selecting insurers for pension risk transfer transactions.
- As transaction size keeps increasing for group annuities, reinsurers will have an important role to play to support an insurer's appetite for growth and to provide overall stability in the pension risk transfer market.
- The demand for pension risk transfer activities is still strong even though it is heavily influenced by the financial health of the pension plan. The supply has never been as high. Insurers are often better able to assist plan administrators in addressing interest rate and longevity risks than would otherwise be possible for plan administrators working within the framework of pension legislation.

Court compensates retiree for negligent misrepresentation of benefits

A recent decision of the Alberta Court of Appeal in *Calder v. Alberta* affirmed the decision of the trial judge granting a retired member of a public sector pension plan compensation for the negligent misrepresentation of the member's future benefits. However, the Court declined to award the retired member the full value of the pension benefits that he had been erroneously promised at retirement.

Background

The case stems from a pension plan reorganization for managers working in Alberta's public service. Two new pension plans were created. The Public Service Management Closed Membership Pension Plan (the "Closed Plan") was created for managers who ceased employment prior to August 1, 1992 (the "Inception Date"). The Management Employees Pension Plan ("Management Plan") was created for managers who continued in employment.

This particular case related to managers in the Closed Plan who returned to employment at a later date, and how to calculate their benefit under the Closed Plan. A legislative provision stated that pensionable service after the Inception Date could be considered in calculating benefits under the Closed Plan. A cost of living adjustment was also provided in respect of the past benefits under the Closed Plan.

The Alberta Pensions Services Corporation (APSC), which administers both the Closed Plan and the Management Plan, determined in 2009 that it would take into account salary earned after returning to employment when calculating the benefit under the Closed Plan. However, in 2012, the APSC changed its mind and determined that it should only take into account salary earned between the Inception Date and January 1, 1994, when the previous management pension plan was divided into the two new plans.

Facts of the case

The plaintiff, Dr. Calder, worked for Alberta from 1978 to 1986, and subsequently returned to a management position in 1995, making him a member of both the Closed Plan and the Management Plan. Dr. Calder made several inquiries about his pension entitlements after being skeptical of the pension estimates given to him prior to his retirement, which showed a pension of approximately $8,000 per month. However, after meeting with APSC, he was given assurances that his Closed Plan pension would be determined in accordance with the 2009 interpretation. Relying on these assurances, Dr. Calder retired on September 1, 2011 and commenced receiving $8,000 per month in pension benefits.

Upon the release of the APSC's new interpretation, Dr. Calder's pension was reduced to approximately $2,000 per month. He sued the Province of Alberta and APSC, seeking to restore the 2009 interpretation.

The decision

The trial judge's decision, which was upheld by the Court of Appeal, agreed with the 2012 interpretation and refused to restore the 2009 interpretation. The 2009 interpretation would lead to "double-dipping" by both recognizing the later salary and by providing cost of living adjustments for the change in the cost of living since the previous termination of employment. This would put a returning manager in a much better position than managers who worked continuously for the province. In Dr. Calder's case, his highest average annual salary prior to his departure in 1986 was $40,000, and his highest average annual salary after returning to work for Alberta from 1995 to 2011 was approximately $140,650. The 2009 interpretation resulted in a significant, and erroneous, upward adjustment in pension benefits.

The trial judge and Court of Appeal refused to restore the 2009 interpretation of the APSC. They held that a pension plan must always be administered correctly in accordance with the legislation, even if the mistake was longstanding. Therefore, the APSC was correct to adjust the pension downwards, despite what was promised to Dr. Calder prior to his retirement. His pension was not restored to $8,000 per month and he was not compensated for the loss of $6,000 per month of pension, which would have been worth approximately $1.5 million.

The trial judge held that if Dr. Calder had been properly advised in 2011, he would have deferred retirement for three additional years. The trial judge ruled that Dr. Calder should be placed in the same position with respect to his retirement that he would have been in had he worked for those additional three years. This amounted to a lump sum of $265,017, including a gross-up for taxes.

The decision was based on the tort of negligent misrepresentation, which requires the following elements:

1. A duty of care existed based on a special relationship between the representor and the representee.
2. A representation was made that was untrue, inaccurate or misleading.
3. The representor acted negligently in making the representation.
4. The representee relied, in a reasonable manner, on the representation.
5. The reliance was detrimental to the representee in the sense that damages resulted.

The compensation was due for the damage done by the mistaken representation, rather than providing Dr. Calder with what he was promised prior to retiring.

Comment

The Court of Appeal and trial judge decisions demonstrate the importance of careful plan interpretation, particularly when members are relying on such interpretations in making financial planning and retirement decisions. Incorrect interpretations can result in liability for negligent misrepresentation, which can result in the requirement to put the recipient of such negligent misrepresentation in the same position they would have been had the representation not been made. However, this case demonstrates that a pension plan and administrator may not be liable for the full amount that the individual was promised, even if the individual has already started to receive a pension based on an incorrect interpretation.

Proposed exemption of certain individual pension plans and designated plans from Ontario pension legislation

On December 20, 2019, the Ontario Ministry of Finance released its consultation with stakeholders on proposed changes to the *Pension Benefits Act* (PBA), which would exempt certain individual pension plans (IPPs) and designated plans (DPs) from the application of the PBA.

The consultation also invites stakeholders to provide feedback on which areas, if any, the Financial Services Regulatory Authority (FSRA) should have rule-making authority on for the IPPs and DPs that remain subject to the PBA.

Allowing certain IPPs and DPs to elect to be exempt from the PBA

It is proposed that employers of IPPs and DPs registered under the PBA be allowed to elect whether to be exempt from the PBA, provided that all of the following criteria are met:

- Every member is connected with the employer;
- Every former member and retired member was connected with the employer immediately before leaving the company or retiring; and
- Every member, former member, retired member and other person entitled to benefits under the plan has consented in writing to the exemption.

The term "connected" comes from the income tax regulations and would typically include significant shareholders and their family members.

The member consent would include an acknowledgement that, as a result of the exemption, the PBA, the regulations and FSRA rules would not apply to any benefits or entitlements accrued by the member under the plan, whether the benefits or entitlements accrued before or after the effective date of the exemption.

The effective date of such an election would need to be set out in the election itself, and such election would have to be filed with FSRA.

Once exempt from the application of the PBA, the IPP or DP would be closed to individuals who are not connected with the employer. The PBA, the regulations, and FSRA rules would no longer apply to an exempt IPP or DP, including any past benefits or entitlements accrued under the plan. An exemption would continue to apply with respect to an IPP or DP, even if a member, former member or retired member was connected with the employer, then ceases to be connected.

Automatically exempting certain IPPs and DPs that are established after the date when the proposed amendments would come into force

Where an IPP or DP is established *after* the date the proposed amendments are to come into force and contains only members who are connected with the employer, it is proposed that the IPP or DP be automatically exempt from the application of the PBA. Therefore, the IPP or DP would require no election or registration under the PBA.

Exempting IPPs and DPs that have had their ITA registration revoked

Lastly, where the IPP or DP has had its *Income Tax Act* (ITA) registration revoked, while still being registered under the PBA, the IPP or DP would be automatically exempt from the application of the PBA, as of a date set out in the proposed amendments. Therefore, the revoked IPP or DP would require no election to become exempt from PBA regulation.

Comment

The proposal would potentially be of benefit to employers who provide IPPs or DPs to employees with significant shareholdings and their family members, as it would reduce many compliance costs. However, actuarial valuations would still be required at least every four years if contributions are to be made to the IPP or DP. Annual information returns would also have to be filed with the Canada Revenue Agency.

In some cases, a careful analysis will be required to determine if the IPP or DP members qualify or qualified as "connected" under the ITA. In particular, many DP members may not be considered connected.

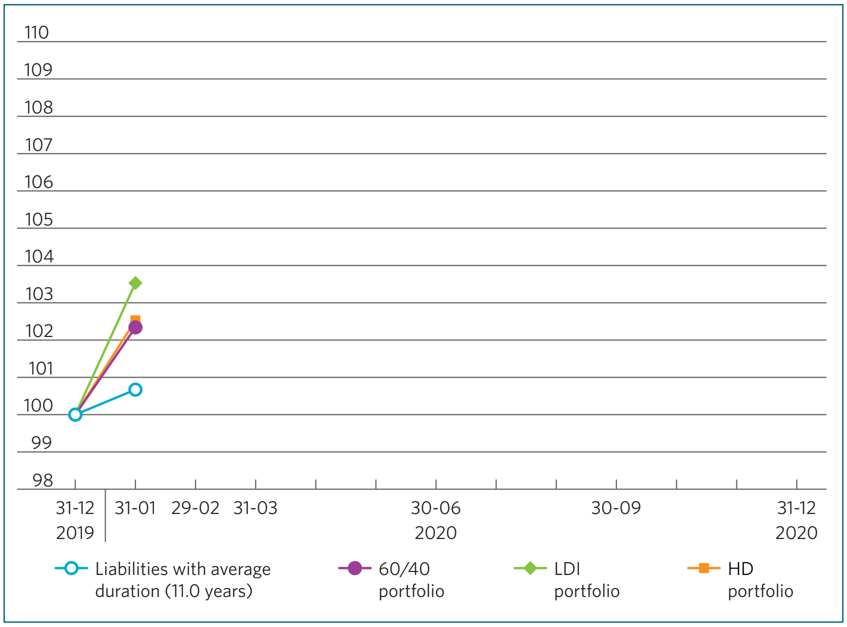
Once exempted from the PBA, the IPP or DP members would lose the protections of the PBA and would lose recourse to FSRA, even if they lose connected status in the future. This may be a concern to members in some cases, for example if a family business that sponsors an IPP or DP is sold to a third party.

Public comments were requested by January 23, 2020. Morneau Shepell made a submission to the Ministry of Finance.

Tracking the funded status of pension plans as at January 31, 2020

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



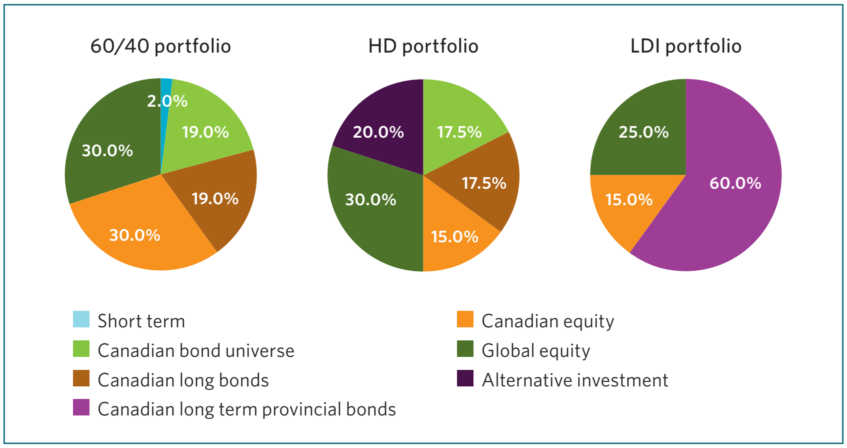
During the month of January, Canadian universe bonds, Canadian long-term bonds, Canadian long-term provincial bonds, Canadian equity markets, global equity markets (CAD) as well as alternative investments showed positive returns. With a return of 3.5%, the low volatility portfolio (LDI[1]) outperformed the highly diversified portfolio (HD) (2.5%) and the 60/40 portfolio (2.3%).

[1] Liability driven investment

The prescribed CIA Annuity purchase rates decreased while the commuted value rates used in the calculation of solvency liabilities slightly increased during the month. As a result, the solvency liabilities increased slightly for a medium duration plan. For this type of plan, an investment in the LDI, in the HD and in the 60/40 portfolio resulted in an increase 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, 2019.
The graph shows the asset allocation of the three typical portfolios.

Initial solvency ratio as at December 31, 2019	Evolution of the solvency ratio as at January 31, 2020 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	101.7%	102.8%	101.9%
90%	91.5%	92.6%	91.7%
80%	81.3%	82.3%	81.5%
70%	71.2%	72.0%	71.3%
60%	61.0%	61.7%	61.1%



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

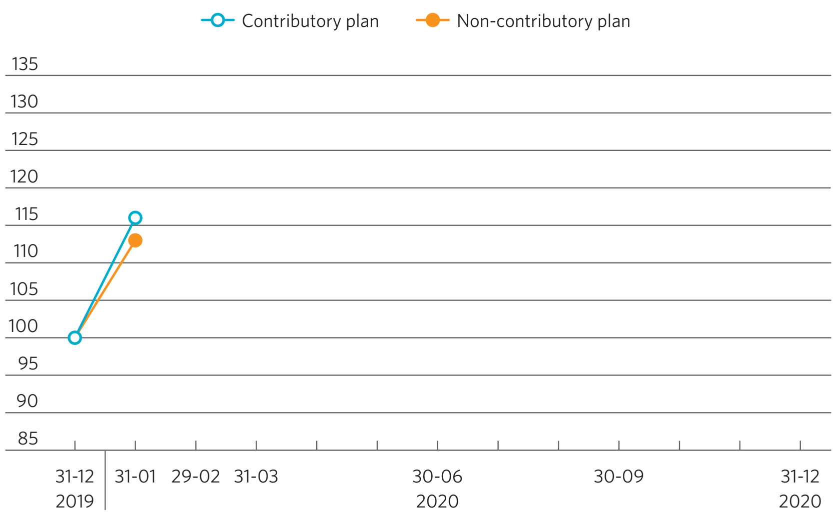
Comments

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 January 31, 2020

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, 2019



Discount rate
(%) 3.2% 2.7%

Return on assets (50% equities)
(%) 0.0% 2.6%

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 2019	January 2020	Change in 2020
11	3.06%	2.61%	-45 bps
14	3.13%	2.69%	-44 bps
17	3.17%	2.73%	-44 bps
20	3.20%	2.77%	-43 bps

Since the beginning of the year, the pension expense has increased by 16% (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, 2019, based on the average financial position of the pension plans used in our 2019 *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, 2018).

2. The return on assets corresponds to the return on the Morneau Shepell benchmark portfolio (50% equities and 50% fixed income), which reflects the average asset mix in our 2019 Survey.

3. The actuarial obligation is that of a final average earnings plan, without indexing (two scenarios: with and without employee contributions).

Editorial Team

LEAD EDITOR:
Andrew Zur, LL.B.
Pension Consulting

ACTUARIAL EDITOR:
Sonia Trudeau, FCIA, FSA
Pension Consulting

BENEFITS EDITOR:
David White, CEBS
Benefits Consulting

LIFEWORKS EDITOR:
Kathryn Goodwin, MA, RCC
LifeWorks by Morneau Shepell

TRANSLATION:
Paule Mercier, C. Tr.
Senior Manager, Translation Department

Authors

Omid Afshari Niko, CFA, ASA
Asset and Risk Management

Delphine Collard, AICA
Pension Consulting

Marc Drolet, FCIA, FSA, CFA
Asset & Risk Management

William Gallant
Asset & Risk Management

Christian Laurin, FCIA, FSA
Pension Consulting

Véronique Lauzière, FCIA, FSA
Asset & Risk Management

Tracy Solhi, J.D.
Pension Consulting

Paul Winnett, FSA, FCIA, CFA
Pension Consulting

Andrew Zur, LL.B.
Pension Consulting