Knowledge & Insights

MORNEAU SHEPELL

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OSFI lifts freeze on commuted value transfers and buy-out annuity purchases

On August 31, 2020, the Office of the Superintendent of Financial Institutions (OSFI) announced it has revised its Directives of the Superintendent pursuant to the *Pension Benefits Standards Act*, 1985 (the Directives) to lift the freeze on commuted value transfers and buy-out annuity purchases effective as of that date.

Reasons for lifting the temporary freeze

In light of the extraordinary circumstances posed by the COVID-19 crisis, OSFI announced a freeze on portability transfers and buy-out annuity purchases relating to defined benefit provisions of federally regulated pension plans effective March 27, 2020. The freeze was meant

to address significant market volatility that resulted from the COVID-19 pandemic, specifically to prevent transfers or annuity purchases from impairing plan solvency. This announcement was discussed in the April 2020 *News & Views*.

OSFI later revised its approach to provide for automatic consent for portability transfers for members who were retirement-eligible, as discussed in the June 2020 *News & Views*.

While markets remain volatile, OSFI says that the economic recovery has been well-sustained and solvency ratios have improved. In addition, OSFI has introduced certain risk-mitigation measures to prevent transfers and annuity purchases from disadvantaging remaining plan members.

Revised restrictions on portability transfers and annuity purchases

The Directives have been revised to reflect conditions on portability transfers and buy-out annuities broadly similar to those that were in place prior to the freeze, but with some adjustments.

In order for a transfer or annuity purchase to be permitted, the amount of the initial transfer cannot exceed the transfer value—namely, the commuted value of the pension benefit multiplied by the plan's "transfer ratio." The "transfer ratio" is a newly introduced term that is defined as the lesser of:

a) the solvency ratio determined in the most recent actuarial report of the plan; and

b) the solvency ratio projected to a date no earlier than March 31, 2020.

Where a plan has a transfer ratio that is less than 1.00, the full value of the pension benefit credit can be transferred only upon meeting certain conditions:

a) A transfer is permitted if the amount by which the commuted value exceeds the transfer value (i.e., the "transfer deficiency") for any individual transfer must be less than 20% of the Year's Maximum Pensionable Earnings (YMPE) and the aggregate value of all pension benefit credits being transferred must not exceed 5% of the plan's assets at the valuation date of the most recent actuarial report. The 5% aggregate limit is determined based on the aggregate value of all pension benefit credits transferred since the later of (i) the effective date of the Directives and (ii) the valuation date of the most recent actuarial report.

b) Alternatively, the employer must remit to the fund the amount of the transfer deficiency.

The conditions for portability transfers are different from those in place prior to the temporary freeze. Prior to the temporary freeze, the exception was granted for transfers that were less than 5% of the YMPE, whereas this individual limit is now 20% of the YMPE. Furthermore, the 5% aggregate limit is now based on the sum of all individual commuted values transferred, whereas before the portability freeze it was based on the sum of all the transfer deficiencies previously transferred out of the plan that were not funded by the employer.

Buy-out annuity purchases are permitted provided that the solvency ratio following the purchase of the annuity" is at least 0.85 or an amount has been paid to the pension fund to maintain the solvency ratio following the purchase of the annuity at the lesser of 0.85 and the transfer ratio. This is the same restriction that applied before the temporary freeze.

Other issues

OSFI has also clarified some additional matters relating to the administration of the temporary freeze and resuming portability transfers.

OSFI indicates that commuted values should be calculated as at the member's termination date. Re-calculation of the commuted value is only permitted if the recalculated amount is greater than the commuted value calculated at the member's termination date plus interest.

A member's entitlement to elect a commuted value transfer at termination is based on the member's entitlement at the time of termination, not at the time the freeze was lifted. Therefore, a member who was eligible at termination to elect a commuted value

transfer remains eligible to elect this option even if the member has reached early retirement age by the time the freeze was lifted and the pension plan does not permit transfers after early retirement age.

If an administrator was granted consent by OSFI to make a transfer or annuity purchase subject to certain conditions, those conditions no longer apply as of August 31, 2020. Rather, the new conditions on portability transfers included in the revised Directives will apply.

Comment

The end of the temporary freeze indicates a renewed confidence in the economic recovery and the prospects for defined benefit pension plans from OSFI. Plan administrators will be required to implement the updated Directives and to process any commuted value transfers that have been delayed as a result of the freeze.

OSFI has indicated that it may decide to reintroduce a temporary freeze or change the conditions for such transfers and annuity purchases as a result of future events, such as a further deterioration in the financial and economic environment.

Ontario court decision extends principle of resulting trust to beneficiary designations

The Ontario Superior Court recently decided in *Calmusky v. Calmusky* that the beneficiary of a Registered Retirement Income Fund (RRIF) was holding the benefits in trust for the estate of the deceased RRIF owner.[1] In doing so, the court applied a legal principle known as the presumption of resulting trust, which requires that the beneficiary, in order to retain the funds, demonstrate that the RRIF owner intended that the beneficiary have true ownership of the funds upon the RRIF owner's death.

The case was a dispute over the estate of a father who had two adult sons, one of whom he lived with and the other who lived in Alberta. The father named his son Gary, who he lived with, as the joint holder of his bank accounts, as well as designating him as the beneficiary under his RRIF. Following the father's passing, his other son Randy argued that Gary held the bank accounts and RRIF on a resulting trust in favour of their father's estate. Gary argued that he was entitled to the proceeds of the joint bank accounts by right of survivorship and to the RRIF as the designated beneficiary of the plan.

The presumption of resulting trust applies when a person gratuitously transfers property to another, including an adult child. In such a case, the property is presumed to be held in trust for the transferor, unless the recipient can demonstrate that the transferor intended the recipient to have beneficial title to the funds.

Ultimately, the court applied the presumption of resulting trust to both the joint bank accounts and the RRIF. It found that Gary was not able to demonstrate that the father intended that he should keep either the bank account or the RRIF proceeds. As a result, Gary was required to return the funds to his father's estate.

Comment

Calmusky is the first Ontario case in which the presumption of resulting trust has been applied to a beneficiary designation. The case highlights the potential challenges that can be made to beneficiary designations by other heirs and the potential delays in distributing death benefits that may result. It also creates additional onus on the individuals making beneficiary designations to make their intentions clear and to provide evidence of their intentions that can be produced at a later time by their intended beneficiaries.

1 *Calmusky v. Calmusky*, 2020 ONSC 1506.

Update: CRA newsletter on annuity purchases from pension plans

On July 24, 2020, the Registered Plans Directorate of the Canada Revenue Agency (CRA) released Newsletter 20-1 on the topic of buy-out annuity contracts and, in particular, the question of what constitutes a "material difference" between an annuity purchased in satisfaction of a pension obligation and the original pension benefit.

The release follows the publication of a draft version of the newsletter, which was discussed in the February 2019 *News & Views*.

Under section 147.4 of the *Income Tax Act*, a beneficiary will not be taxed on the acquisition of an annuity that was purchased in satisfaction of a pension obligation, provided the annuity's terms are "not materially different" from those of the pension plan. The newsletter considers what constitutes a material difference in certain contexts.

The CRA newsletter remains largely unchanged from the initial draft. The major development in both the draft and final versions of the newsletter is that the CRA has indicated it will generally accept fixed-rate indexation in lieu of a full indexed adjustment based on the Consumer Price Index. The CRA had indicated that the fixed rate could be based upon either the mid-range of the Bank of Canada's inflation-control range at the date of purchase or the spread between Canada long-term bond yields and real return bonds in the month of purchase or the month preceding. A fixed rate between these two options would also be acceptable.

If an annuity contract uses a different substitution method, the CRA will consider the alternative upon written request.

The publication of the final version of the newsletter will give comfort to administrators of plans with indexation provisions that wishing to satisfy pension obligations though the purchase of buy-out annuities, as well as former members of defined benefit pension plans who wish to purchase annuities in lieu of receiving a pension directly from the plan.

Newfoundland consultation on unlocking of pension benefits for financial hardship

On July 29, 2020, the Newfoundland and Labrador (NL) government announced that it was considering amendments to the *Pension Benefits Act* regarding the unlocking of pension benefits for situations of financial hardship.

Options being considered would provide unlocking access to individuals who have transferred their pension benefits from a pension plan to a locked-in retirement vehicle. The NL government is seeking comments on some key issues like financial hardship criteria and eligibility, dollar amounts that could be accessed, frequency of unlocking and type of locked-in accounts from which funds could be accessed. The NL government also indicated that, like all of the other jurisdictions who provide unlocking for situations of financial hardship, the option of unlocking pension benefits under a pension plan would not be considered.

Public comments are requested by September 30, 2020.

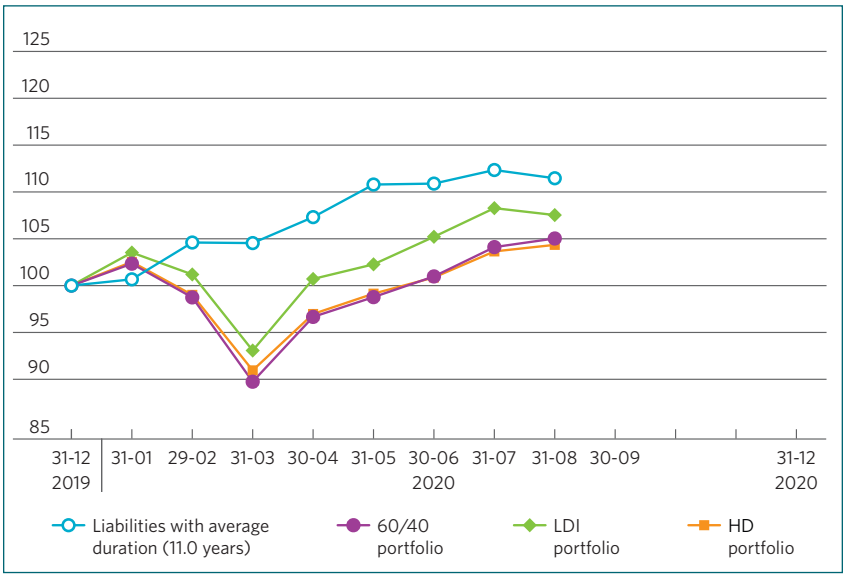
Comment

The COVID-19 pandemic has created financial pressures for many individuals and the NL government has indicated that it has received many inquiries and requests to access retirement income. The consultation process will thereby be of interest for many pension plan stakeholders, including former members.

Tracking the funded status of pension plans as at August 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 CIA guidance for valuations effective June 30, 2020 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



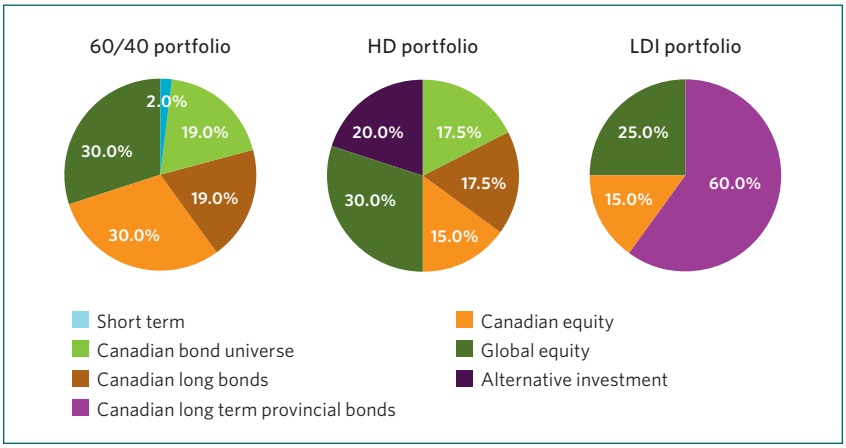
During the month of August, Canadian equity markets, global equity markets (CAD) as well as alternative investments showed positive returns. However, Canadian universe bonds, Canadian long-term bonds and Canadian long-term provincial bonds showed negative returns. With a return of 0.9%, the 60/40 portfolio outperformed the highly diversified portfolio (HD) (0.7%) and the low volatility portfolio (LDI[1]) (-0.7%).

The prescribed CIA annuity purchase rates increased while the commuted value rates used in the calculation of solvency liabilities remained stable during the month. As a result, the solvency liabilities decreased for a medium duration plan. For this type of plan, an investment in the 60/40, in the HD and 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, 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 August 31, 2020 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	94.2%	96.5%	93.6%
90%	84.8%	86.8%	84.3%
80%	75.4%	77.2%	74.9%
70%	66.0%	67.5%	65.5%
60%	56.5%	57.9%	56.2%



Since the beginning of the year, driven by positive returns in the Canadian universe bonds, Canadian long-term bonds, Canadian long-term provincial bonds and global equities, the LDI portfolio, the 60/40 portfolio and the HD portfolio returned 7.5%, 5.0% and 4.4% respectively. The solvency liabilities fluctuated over that same period from 11.3% to 11.5% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at August 31, 2020 stands between -6.4% and -2.1%.

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

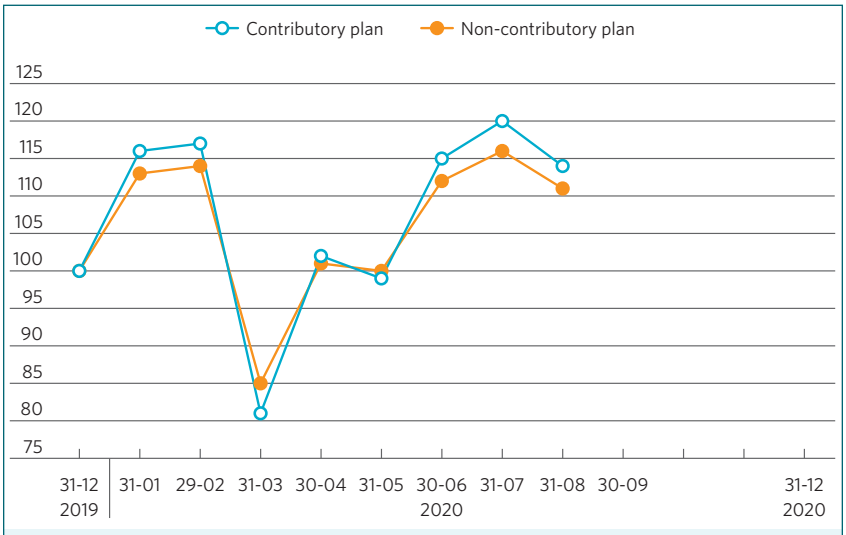
Comments

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 August 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



	31-12 2019	31-01	29-02	31-03	30-04	31-05	30-06 2020	31-07	31-08	30-09	31-12 2020
Discount rate (%)	3.2%	2.7%	2.7%	3.8%	3.1%	3.2%	2.8%	2.5%	2.7%		
Return on assets (50% equities) (%)	0.0%	2.6%	-2.8%	-8.2%	7.3%	1.9%	2.3%	2.9%	0.4%		

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	August 2020	Change in 2020
11	3.06%	2.52%	-54 bps
14	3.13%	2.67%	-46 bps
17	3.17%	2.75%	-42 bps
20	3.20%	2.81%	-39 bps

Since the beginning of the year, the pension expense has increased by 14% (for a contributory plan) mainly due to the decrease in the discount rates.

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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).

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