Knowledge & Insights

MORNEAU SHEPELL

News & Views

Volume 17 | Issue 12
December 2020

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Federal government consulting on solvency funding relief and other measures

On November 6, 2020, the federal Department of Finance released a consultation paper on solvency funding relief options for 2021 and a number of other proposed measures that would affect federally regulated pension plans.

The consultation paper proposes a number of changes, including solvency funding relief, new governance requirements, and the introduction of solvency reserve accounts and variable payment life annuities.

Temporary solvency funding relief

The federal government introduced a moratorium on solvency special payments from April 1, 2020, to December 30, 2020. It is now considering the following relief measures for 2021 and beyond to mitigate the impacts of the pandemic on defined benefit (DB) plan sponsors:

1. **Extending the solvency amortization period to ten years:** Under this approach, federally regulated DB plans would be allowed to extend the amortization period for solvency special payments from five to ten years, provided they obtain either buy-in from plan beneficiaries or a letter of credit covering the difference in payments resulting from the extended amortization. Given the extended duration of this relief option, the government would require informed consent from plan beneficiaries.

2. **One-time extension of solvency amortization period to ten years:** This approach would allow plans to extend their amortization schedules to ten years for the 2021 plan year only, such that solvency funding requirements for 2021 would be one-tenth the plan's solvency deficiency, instead of one-fifth (as currently required).

3. **Extension of the letter of credit limit:** Currently, federal pension legislation permits plan providers to use letters of credit from financial institutions to cover up to 15% of solvency liabilities, in place of solvency special payments. This approach would temporarily extend the limit on the use of the letter of credit from the current 15 per cent of solvency liabilities, to a new limit to be determined at the discretion of the issuer.

4. **Alternative valuation methodologies:** This approach would allow plan sponsors to employ an alternative methodology for solvency valuations, in order to shield plans from volatility in funding contribution levels resulting from extreme market changes. For example, plan sponsors could be permitted to use a discount rate averaged over three years rather than the market discount rate, or calculate the average solvency ratio over five years instead of three. Alternatively, the requirement to file a valuation report at the end of 2020 may be deferred or made optional.

Governance proposals

The government is considering a number of permanent measures to enhance plan governance and administration.

Currently, if a multi-employer pension plan is administered by a pension committee (such as in the case of non-unionized environments), the committee must include plan member and retiree representatives. The consultation paper proposes to apply the requirement for member and retiree representation to single-employer plans and multi-employer plans that are governed by Boards of Trustees.

The consultation paper also proposes to amend the *Pension Benefits Standards Act* (PBSA) to require all federally regulated pension plans to establish governance policies, which would have to be provided to the Superintendent of Financial Institutions upon request.

Additionally, all multi-employer negotiated contribution plans would be required to establish and maintain funding policies as well. Since negotiated contribution plans generally have fixed contribution rates and allow benefits to be reduced to address funding deficits, the government says funding policies would assist them in managing risk and benefit security. Funding policies would be encouraged but not required for single-employer and other multi-employer DB plans.

The federal government is also considering measures to encourage federally regulated pension plans to consider environmental, social and governance (ESG) factors in their investment and risk management strategies, including the risks and opportunities presented by climate change.

One possible approach would be to mandate that pension plans disclose in their statements of investment policies and procedures (SIPPs) whether and how they consider ESG factors. This would mirror the requirement currently in place in Ontario.

Pension plan administrators could also be required to file their SIPPs with the Office of the Superintendent of Financial Institutions (OSFI) or provide them to OSFI upon request.

Deemed consent to electronic communications

The consultation paper proposes that electronic communications rules be revised so as to permit plan administrators to rely on deemed consent to receive pension communications electronically. Such an approach would apply to plan members and their spouses and common-law partners. This proposal follows the release of the revised Guideline No. 2 – Electronic Communications in the Pension Industry (which was discussed in the December 2018 *News & Views*), in which the Canadian Association of Pension Supervisory Authorities (CAPSA) encouraged jurisdictions to recognize deemed consent by members to receive communications electronically.

Introduction of solvency reserve accounts

The paper also proposes a legislative framework for solvency reserve accounts (SRAs). An SRA would operate as a separate or notional account within a DB pension fund into which an employer could remit solvency special payments. The funds remitted in respect of special payments could be withdrawn by the employer if the plan later develops a surplus on a solvency basis and is fully funded on a going concern basis, subject to certain conditions. Employers would not be required to seek the approval of OSFI to withdraw funds from an SRA.

Introduction of variable payment life annuities

It is proposed that federally regulated Pooled Retirement Pension Plans (PRPPs) and defined contribution (DC) pension plans would be able to offer variable payment life annuities (VPLAs). VPLAs will provide plan members with lifetime retirement income payments that vary based on investment returns and the mortality experience of the fund. The proposed framework builds on proposed tax legislation set out in the 2019 federal budget, as discussed in the March 2019 *News & Views*.

In order to ensure that VPLA payments are consistent with the fund's ability to provide a lifetime retirement income, VPLAs would be required to implement any required benefit changes at least once every three years, based on an actuarial valuation of the fund's sustainability. In order to operate, the plan must reasonably expect the VPLA fund to maintain a minimum of 10 members on an ongoing basis.

Plan members who elect a VPLA would be permitted to receive a VPLA based on just a portion of their account balance, while transferring the remaining funds to a locked-in retirement income vehicle, leaving them in the plan to be withdrawn as variable benefits (if the plan so permits), or using them to purchase a fixed life annuity from a regulated insurance provider.

Any retiree with a spouse or common law partner would have to obtain spousal consent to participate in a VPLA.

If the VPLA option is terminated, the administrator would need to submit a termination report to OSFI. Members would be entitled to receive the commuted value of their VPLA benefits and would be provided the same portability options currently available to members of PRPP and DC plans.

Guidelines for obtaining special solvency funding relief

The consultation paper includes proposed ministerial guidelines on the process for obtaining special solvency funding relief. When the relief options available under the PBSA such as letters of credit or the distressed pension plan workout scheme are insufficient, the employer may seek special funding regulations that would provide temporary pension funding relief to the employer in order to relieve employer's short-term financial constraints and improve the plan's long-term sustainability.

The guidelines would include information on the process for seeking special funding relief under the PBSA, details on what is to be included in relief applications, factors to be considered in considering special funding regulations, and restrictions that may be imposed on corporations while the special relief is in place.

Consultation period

The Department of Finance has invited interested parties to comment on the proposals, either with general comments or responses to specific questions posed throughout the consultation paper. Submissions will be accepted until January 14, 2021.

Court clarifies valuation of federal pensions for marital breakdowns in Ontario

In a recent case, the Ontario Court of Appeal provided guidance on how federally regulated pensions are to be valued in marital breakdown settlements in Ontario. *Van Delst v. Hronowsky*[1] (*Hronowsky*) discusses the interpretation of the term "normal retirement date", as well as the valuation of survivor benefits.

After 20 years of marriage, Ms. Van Delst and Mr. Hronowsky separated in September 2016. Both parties were members of the federal *Public Service Superannuation Act* (PSSA). Mr. Hronowsky had retired in December 2016, while Ms. Van Delst was still an active member. The appeal concerned a number of decisions made by the trial judge with respect to the valuation of their respective pensions. The Court of Appeal was required to interpret subsection 10.1(2) of the *Family Law Act* (FLA), which requires that the Ontario method of valuation should be applied where reasonably possible for valuing pensions that are not provincially regulated, with "necessary modifications".[2]

Survivor and contingent survivor benefits

The Court of Appeal found that the value of Ms. Van Delst's survivor benefits from Mr. Hronowsky's pension should be excluded. This is because she would lose the right to such benefits under the PSSA upon completion of the divorce. The Court of Appeal also found that the value of contingent survivor benefits should be included in the calculation of the commuted value of the pension, as per actuarial practice and regulatory guidance in Ontario. A contingent survivor benefit is the potential future survivor benefit payable to a pension member's future spouse (if any). This is because the pension values should be calculated the same way they would be treated if they were Ontario pensions, unless there are compelling reasons not to.

With respect to the contingent survivor benefits, the Court of Appeal noted that the ability to confer a survivor benefit on a future partner is of value to a pension member even if the member does not receive these funds personally, and that the usual provincial approach could be applied to federal pensions.

Normal retirement date

The PSSA does not specify a normal retirement date for members. The trial judge had made her own estimates of the date that the parties were expected to retire. However, the Court of Appeal found that the functional equivalent of the normal retirement date is the date that any member of the plan can retire with an unreduced pension. For both the husband and the wife, the PSSA provided for an unreduced pension at age 60 for any contributor with two years of pensionable service. As such, the Ontario valuation methodology should have been modified to use age 60 as the normal retirement date.

The Court of Appeal offered some general principles to be followed in the valuation of non-Ontario pensions under the Ontario family law regime. It noted that the legislature had intended to create certainty and avoid costly litigation when it adopted the new family law regime. In reaching its findings, the Court of Appeal shed light on the correct approach to pension valuation issues for non-Ontario regulated pensions:

1. The parties should request that the pension administrator generate a value based on Ontario law. In doing so, the scheme of the Ontario *Pension Benefits Act* (PBA) should be followed as closely as possible. The Court of Appeal noted that the

1 *Van Delst v. Hronowsky*, 2020 ONCA 329.

2 The parties chose not to proceed under the federal *Pension Benefits Division Act*, which otherwise would have applied to a pension under the PSSA.

legislative intent under s. 10.1(2) of the FLA is clear that a non-Ontario pension be valued, where reasonably possible, in the same manner as an Ontario regulated pension unless there are compelling reasons not to. This means that the valuation formula in the PBA regulation should be applied to a non-Ontario pension, with modifications only where necessary.

2. Where the parties to family law litigation do not find it possible to settle on a method, for example if the plan administrator refuses to calculate the value or the parties cannot agree to the proper modifications to be made, the parties may refer such issues to the court for direction. If court direction is sought, a jointly appointed expert on valuation is encouraged, rather than using competing pension experts.

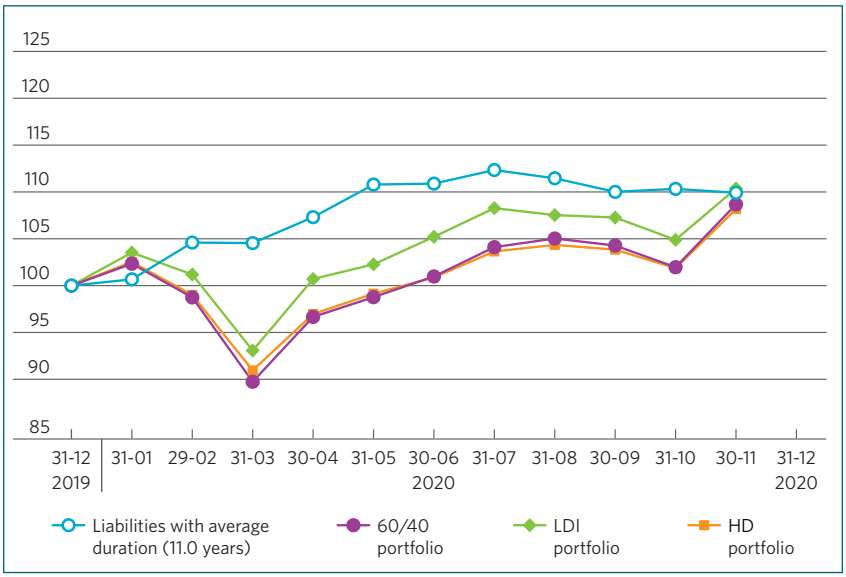
Comments

By explaining the application of the FLA in the context of Ontario pension division, *Hronowsky* provides valuable guidance to both pension plan administrators and family law litigants in the valuation and division of pensions that are not regulated by Ontario pension legislation. These types of pension plans can include federally regulated pension plans, public service pension plans, and supplemental pension plans.

Tracking the funded status of pension plans as at November 30, 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 September 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



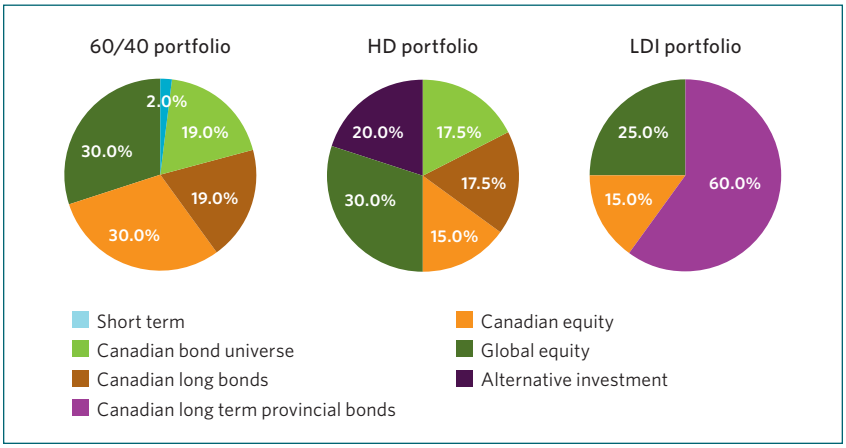
During the month of November, Canadian universe bonds, Canadian long-term bonds, Canadian long-term provincial bonds, Canadian equity markets, global equity markets (CAD) as well as alternative investments showed positive returns. With a return of 6.6%, the 60/40 outperformed the highly diversified portfolio (HD) (6.2%) and the low volatility portfolio (LDI[1]) (5.2%).

The prescribed CIA annuity purchase rates decreased while the commuted value rates used in the calculation of solvency liabilities increased 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 November 30, 2020 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	98.9%	100.4%	98.4%
90%	89.0%	90.4%	88.6%
80%	79.1%	80.3%	78.7%
70%	69.2%	70.3%	68.9%
60%	59.3%	60.3%	59.1%



Since the beginning of the year, driven by positive returns in the Canadian universe bonds, Canadian long-term bonds, Canadian long-term provincial bonds, Canadian equities and global equities, the LDI portfolio, the 60/40 portfolio and the HD portfolio returned 10.4%, 8.7% and 8.2% respectively. The solvency liabilities fluctuated over that same period from 9.8% to 9.9% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at November 30, 2020 stands between -1.6% and 0.4%.

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

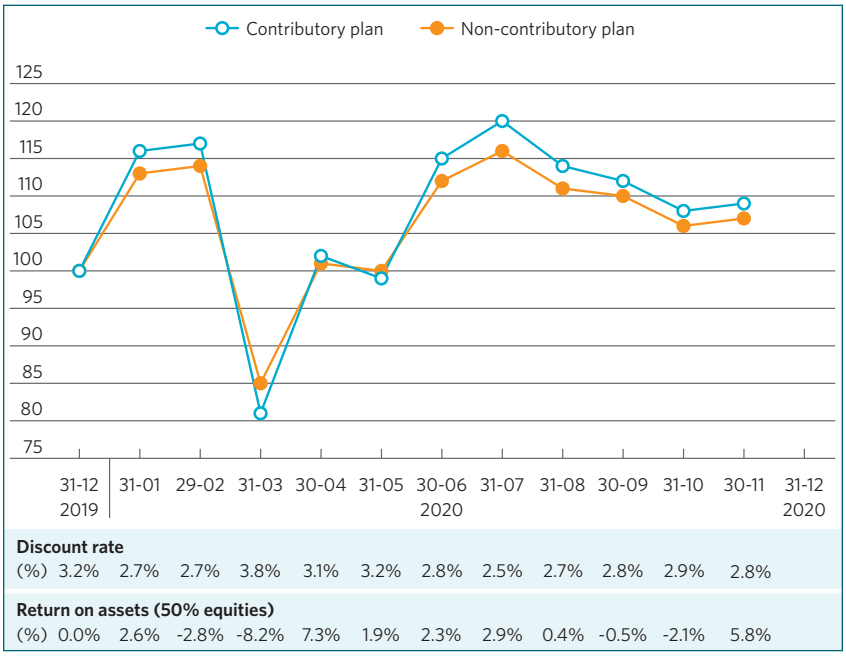
Comments

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 November 30, 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



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	November 2020	Change in 2020
11	3.06%	2.55%	-51 bps
14	3.13%	2.73%	-40 bps
17	3.17%	2.83%	-34 bps
20	3.20%	2.90%	-30 bps

Since the beginning of the year, the pension expense has increased by 9% (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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