Knowledge & Insights

MORNEAU SHEPELL

News & Views

Volume 18 | Issue 2
February 2021

In this issue

OSFI releases discussion paper on climate-related risks for federally regulated pension plans

On January 11, 2021, the Office of the Superintendent of Financial Institutions (OSFI) published *Navigating Uncertainty in Climate Change: Promoting Preparedness and Resilience to Climate-Related Risk*. OSFI intends to engage with federally regulated financial institutions (FRFIs), federally regulated pension plans (FRPPs) and other interested stakeholders on the risks resulting from climate change and how they affect the soundness of FRFIs and FRPPs.

Climate-related risks and impact on FRPPs

OSFI discusses the following climate-related risks for FRPPs.

Physical risk (e.g., a severe weather event): physical risk arises from a changing climate, increasing the frequency and severity of wildfires, floods, wind events and rising sea levels, among other things. Such a climate event can affect the value of an FRPPs' holdings in investments, such as commercial real estate.

Transition risk (e.g., increased regulation related to greenhouse gas (GHG) intensive industries): transition risk stems from efforts to reduce GHG emissions as the economy shifts toward a lower GHG footprint and can emerge as a result of current or future government policies to reduce emissions, technological advancements and changes in investor or consumer sentiment. Transition risk can materially change the investment environment over time. As such, FRPPs can be impacted to the extent that their investment is impacted by the transition to a lower GHG economy.

Liability risk (e.g., parties who have suffered loss and damage from climate change seek to recover losses from those whom they believe are responsible): liability risk relates to potential exposure to the risks associated with climate-related litigation. FRPPs may be exposed to various liability risks as a result of climate-related litigation, such as claims by pension plan members or other stakeholders for failing to account for possible risks to GHG-intensive assets.

Promoting FRPP preparedness and resilience against climate-related risks

To achieve preparedness and resilience to climate-related risks, the discussion paper highlights the need to develop a climate-related risk appetite and strategy, as well as, implementation of governance and risk management practices that are commensurate with the FRPP's circumstances. OSFI expects FRPP administrators to consider a wide range of factors affecting their ability to prudently administer their pension plans, including risks that could impact long-term investment performance. OSFI suggests the following ways that FRPP administrators could manage climate-related risks.

Pension plan administrators are advised to assess how the transition to a lower GHG economy may impact the FRPP's investment policy and strategy in the longer term. In addition, prudent management and investment of pension plan assets for an FRPP can also involve evaluating new investment opportunities that may arise from climate change, in the context of the FRPP's Statement of Investment Policies and Procedures (SIP&P).

OSFI indicates that FRPP administrators can systematically manage material climate-related risks within their investment portfolio through effective governance. Implementing controls in investment decision-making processes, for example, can help to assess alignment of the pension plan's climate-related risk management with its risk appetite.

For example, administrators that delegate investment decisions to an investment manager can seek to include climate-related risk considerations in the investment manager's mandate, or choose an investment manager based on its approach to climate-related risks.

OSFI guidance on climate-related risks

Although OSFI recognizes that the current FRPP guidance does not explicitly reference climate-related risks, it notes that the guidance does include principles and expectations that are relevant to FRPPs' management of these risks. However, OSFI confirms that it is reviewing its FRPP guidance, supervisory processes and reporting requirements to determine whether they sufficiently account for climate-related risks.

OSFI hopes to gain an understanding of how FRFIs and FRPPs define, identify, measure and build resilience to climate-related risks. OSFI also seeks feedback on how it can facilitate FRFIs' and FRPPs' preparedness and resilience to such risks.

Stakeholders are invited to submit their submissions and comments to OSFI no later than April 12, 2021.

Comment

OSFI's discussion paper is exploratory and not an official guideline, and furthermore only affects federally regulated pension plans. However, it may signify growing future attention on climate-related risk management by pension regulators in respect of pension investment management.

Federally regulated employers to face new *Pay Equity Act* requirements

The federal government has published proposed Pay Equity Regulations (the Regulations) in the Canada Gazette. The proposed Regulations will support the implementation of the *Pay Equity Act* (the Act), which is designed to help ensure that, on average, women and men in federally regulated public and private sector workplaces receive equal pay for work of equal value (as discussed in the January 2019 *News & Views*). The Act and Regulations will come into force on a date to be proclaimed by the federal government that is expected to be in 2021.

Background: the *Pay Equity Act*

The Act requires federally regulated employers of ten or more employees to establish a pay equity plan to identify and compare the compensation associated with predominantly female and predominantly male job classes of similar value.

If a pay equity plan discloses differences in compensation between predominantly female and predominantly male job classes, the employer must increase compensation to employees in the underpaid predominantly female job classes as required by the pay equity plan. These pay increases must begin within three years of the Act being proclaimed into force, although phased-in increases are permitted in some circumstances.

In addition, employers of 100 or more employees, as well as unionized employers, are required to establish a pay equity committee to develop and update the pay equity plan.

Finally, a Pay Equity Commissioner appointed within the Canadian Human Rights Commission will administer and enforce the Act.

The Pay Equity Commissioner will facilitate dispute resolution and issue binding orders where necessary, promote compliance through a system of administrative monetary penalties, and conduct compliance audits and investigations.

Proposals for the Pay Equity Regulations

The proposed Regulations would support the implementation of the Act by providing details on specific aspects of the process. In order to give effect to the Act, the Regulations propose to provide the following:

1. **Requirements for posting of documents in the workplace:** The proposed Regulations would require employers to make posting available in either electronic or printed forms, leaving it to the employer or committee to choose the appropriate format, provided the posting is easily accessible.

2. **Time limits for applications and notices with the Pay Equity Commissioner:** The proposed Regulations set time limits for the submission of the applications and notices that are required under the Act to be submitted to the Pay Equity Commissioner throughout the pay equity process.

3. **Mathematical factors for comparing compensation:** Under the Act, two possible methods are available for comparing the average compensations between predominantly male and predominantly female job classes, the "equal average" method and the "equal line" method. The proposed Regulations set the formulae for the two methods.

4. **Steps to follow when regression lines cross under the equal line method:** Under the equal line method two regression lines are created, one for males and one for females, each one representing the relationship between job values and hourly rates of compensation. Instructions are provided for what to do when female and male regression lines cross, resulting in part of the female line resting higher than part of the male line.

5. **A method for developing a pay equity plan when there are no predominantly male job classes:** Two options are provided for situations in which there is no male comparator available, the "proxy" method and the "typical job classes" method. The proxy method would require an employer or pay equity committee without a male comparator to select three or more predominantly male job classes from another organization or business covered by the Act and to develop proxy male job classes in their plan. The proposed Regulations would set out requirements to be met by both the employer of the proxy workplace and by the employer or committee in need of a male comparator. The typical job classes method would require an employer or pay equity committee without a male comparator to use three fictional predominantly male job classes (maintenance worker, technician, and manager) set out in the proposed Regulations to complete their pay equity plans. A similar method is used in Quebec's pay equity regime using two fictional job classes.

6. **A process for updating pay equity plans:** The proposed Regulations include a list of the types of changes that could have an impact on pay equity and therefore warrant re-examination.

Comment

Once they come into force, the Act and Regulations will impose considerable obligations on mid-sized and large federally regulated employers, requiring them to take proactive steps aimed evaluating their own approaches to compensation and taking remedial steps where necessary. Federally regulated employers of ten or more employees should begin to take steps to create a pay equity plan and, in the case of employers of 100 or more employees, to establish a pay equity committee. Employers that anticipate having to report significant discrepancies between male- and female-predominant job classes should begin considering the costs involved with remedying those imbalances within the specified timelines.

Update: Quebec permits target benefit pension plans

On December 11, 2020, Quebec passed Bill 68, *An Act mainly to allow the establishment of target benefit pension plans*, which amends the *Supplemental Pension Plans Act* to allow for the establishment of target benefit pension plans registered in the province of Quebec. Bill 68 became immediately effective.

The bill—which was discussed in the November 2020 *News & Views* and summarized in detail in a Special Communiqué—also allows pension plans with defined contribution provisions and voluntary retirement savings plans (VRSPs) to establish variable payment life annuity (VPLA) funds.

Changes from the original version of Bill 68

The final version contains a number of changes from the original version of Bill 68.

The final version provides that an employer may only establish a target benefit plan if the eligible employees consent to the obligations they will face under the plan. While member consent is generally not required to increase member contributions, it may be required in some instances outside of prescribed circumstances. If so, an application for registration would need to be accompanied by attestations for any required consents.

The final version also states that benefits that have been reduced may be restored if the plan's assets (as at the actuarial valuation date) are both greater than 105% of its liabilities and greater than its liabilities increased by 50% of the value of the stabilization provision target level, on a funding basis.

In addition, the final version allows for pension indexation after retirement. The indexation rate will need to be a fixed rate and cannot be tied to any indices or vary in time. A provision was also added permitting members whose benefits are underfunded upon employer withdrawal or plan termination to transfer their benefits to another pension plan, subject to certain requirements.

Additional regulations that will provide additional guidance on the various new measures are expected.

Financial Services Regulatory Authority of Ontario changes address

On February 1, 2021 the Financial Services Regulatory Authority of Ontario (FSRA) moved to a new address.

Financial Services Regulatory
Authority of Ontario (FSRA)
25 Sheppard Avenue West, Suite 100
Toronto, Ontario M2N 6S6

FSRA's other contact details remain unchanged.

Effective immediately, all mail directed to FSRA should be directed to the new address.

Newfoundland introduces financial hardship and non-residency unlocking

The government of Newfoundland and Labrador has filed Regulation 4/21 and passed Bill 54, which together provide for the unlocking of benefits held in locked-in retirement savings arrangements for reasons of financial hardship or non-residency in Canada. These changes take effect on March 1, 2021, and only affect locked-in retirement savings arrangements such as Locked-in Retirement Accounts (LIRAs), Life Income Funds (LIFs) and Locked-in Retirement Income Funds (LRIFs).

These changes follow a consultation period in which the province of Newfoundland and Labrador accepted feedback on its unlocking proposals, as discussed in the September 2020 *News & Views*.

Financial hardship unlocking requirements

Effective March 1, 2021, a person can qualify for financial hardship unlocking if the person's expected total income for the year is not more than 66.66% of the year's maximum pensionable earnings (YMPE) for the year ($41,063 for 2021). For unlocking benefits on this basis, the amount that may be unlocked is determined by subtracting 75% of the person's expected income from 50% of the YMPE for the year of the withdrawal.

A person can also access financial hardship if any one of the following circumstances exists:

1. Inability to pay for medical expenses incurred or to be incurred by the account owner, a spouse or dependent;
2. Inability to pay for disability-related expenses incurred or to be incurred by the account owner, a spouse or dependent;
3. Default on a mortgage that is secured against the account owner's or spouse's principal residence;
4. Arrears in the payment of rent for the account owner's or spouse's principal residence;
5. The first month's rent and a security deposit for the account owner or spouse.

The regulation specifies the type of documentation that must be provided to the financial institution holding the locked-in funds. The account owner's spouse (including a co-habiting partner) must consent to the withdrawal in the prescribed form.

Financial institutions offering locked-in funds must submit a semi-annual report to the Newfoundland and Labrador Superintendent of Pensions setting out the number and total amount of financial hardship unlocking withdrawals.

Non-residency unlocking requirements

Effective March 1, 2021, the owner of a locked-in retirement savings arrangement may withdraw the full amount if the person has resided outside Canada for at least two consecutive calendar years and provides the prescribed documentation, including a spousal waiver if applicable.

Comment

The introduction of these two new forms of unlocking will be useful to owners of locked-in retirement savings accounts subject to Newfoundland legislation who face financial hardship or have become non-residents of Canada.

Morneau Shepell accounting assumptions survey for Ontario hospital post-retirement benefits

Morneau Shepell recently conducted a survey of accounting assumptions for over sixty Ontario hospitals with respect to their post-retirement medical and dental benefit provisions. Assumptions in the survey include retirement age, benefit take-up rates, and percentage retiring with a covered spouse or dependent. These assumptions are set by hospital management based on a combination of recent experience and forward-looking expectations. Medical and dental coverage for retirees generally expire at age 65 for most hospital workers.

Some key findings of the survey are as follows:

- Despite trends of Canadian workers retiring at later ages, the most common retirement age assumption for hospital workers is age 60. This is likely heavily influenced by the employees' pension plan early retirement incentives.
- Cost sharing arrangements of retiree medical plans have a high degree of influence on the voluntary take-up rates of coverage. Interestingly, when benefits are fully paid for by the retiree, it is expected that half of them will participate in the plan. This relatively high rate demonstrates the need for cost certainty amongst pre-age 65 retirees with respect to their medical and dental retiree coverage.
- Most retirees are expected to elect a covered spouse or dependent at retirement, with an average assumption of 65%. However, there is a wide range from hospital to hospital with this assumption, as it varies from 45% to 100% electing family coverage at retirement. This shows us that not every hospital has the same demographic profile and highlights the importance of our work in helping our hospital clients select customized best-estimate accounting assumptions.

This survey will allow hospitals in Ontario to benchmark their post-retirement benefit accounting assumptions in comparison to their industry. Morneau Shepell will be performing this survey annually and over time we expect that the results will reveal more demographic trends.

Morneau Shepell's January 2021 *Pension Risk Bulletin*: Readiness paid off in a turbulent year

Morneau Shepell publishes a periodic *Pension Risk Bulletin* to provide updates and views on pension risk transfer and risk management to defined benefit (DB) pension plan sponsors in Canada. In the first 2021 issue of the *Pension Risk Bulletin*, we review the turbulent year that was 2020 for pension risk transfer activities and address trends that Morneau Shepell's Pension Risk Transfer team is expecting for 2021 and beyond.

Key Highlights

- In the face of the public health crisis caused by the COVID-19 pandemic, the Canadian group annuity market has proven to be strong and resilient in 2020 with an estimated volume of $4.5 billion, a figure not too far from 2019's record-breaking year for Canada.
- The third quarter saw a record-breaking transaction of $1.8 billion completed in a single day, of which approximately $1.1 billion was with

a single insurer. 2020 has been a testament to how a single transaction can significantly affect the total volume in a given year.

- March and April of 2020 displayed significant financial market volatility as well as a liquidity crunch affecting the bond market, particularly for corporate bonds. Market volatility was such that the Canadian Institute of Actuaries published an off-cycle solvency proxy on April 30, 2020.
- Stakeholders were reminded of how volatile the funded status of a pension plan can be. At the end of the first quarter, equity valuations had tanked and risk-free interest rates were at record low levels, leading to a deterioration of pension plan's solvency ratio. As the year progressed, the interventions of central banks and governments to boost local economies took effect, which led to an incredible turnaround for the equity markets and pension plan funded positions increasing back to levels that were close to what they were at the beginning of the year.
- The widening of credit spreads during the peak of the crisis allowed insurers to find higher yielding fixed-income assets, which improved group annuity pricing for the transactions that went to market at that time or shortly thereafter.
- Canada saw its third longevity insurance agreement completed at the beginning of 2020 for the Co-operative Superannuation Society (CSS) pension plan. The agreement allowed the CSS plan, a defined contribution type arrangement that provides optional guaranteed lifetime retirement income, to transfer longevity risk for $660 million of liabilities to Cooperators Life Insurance Company.
- The appetite from insurers and the industry as a whole continues to grow for group annuities. A growing number of insurers are allocating an increasing amount of financial and human resources to pension risk transfers.
- Data-driven longevity insurance products will eventually become more prevalent, particularly for plan sponsors or administrators seeking plan sustainability over the long term.

New monthly publication: Pension Indices

Readers of *News & Views* have come to expect two sections in each issue relating to pension statistics titled "Tracking the funded status of pension plans" and "Impact on pension expense under international accounting."

We are now introducing a new, separate Morneau Shepell monthly publication called *Pension Indices*, to be published a few days after each month end. *Pension Indices* will include details on how the following pension solvency and accounting metrics move from month to month for a typical pension plan:

- Solvency ratio
- Commuted value
- Annuity purchase cost
- Accounting balance sheet
- Accounting pension expense
- Asset Value.

The January 2021 *Pension Indices* is now available on Morneau Shepell's website.

MORNEAU SHEPELL

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