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Information Bulletin

In this issue

Proposed Changes to Determination of Pension Commuted Values

The Actuarial Standards Board in Canada (ASB) has issued a publication which proposes changes to the standards governing how pension commuted values (Commuted Values) are calculated.

These proposed standards impact the level of lump sums paid out of many pension plans on termination, pre-retirement death and, when available, on retirement. The proposed standards are intended to more closely reflect market conditions.

Based on recent market conditions, for most defined benefit plans, Commuted Values under the proposed standards are expected to be slightly lower than under the current standards. For some target benefit and multi-employer pension plans, the Commuted Values could be substantially less, particularly if the plan is underfunded.

The proposed standards are not expected to come into force earlier than the second quarter of 2018; well after the completion of a consultation period ending on September 18, 2017. In some jurisdictions, even after the standards are adopted, enabling regulations must be passed before calculations are performed in accordance with such new standards.

In the remainder of this Information Bulletin, we provide more details on the proposed changes, their potential impact, as well as the expected timing.

Most Significant Changes

There are two principal changes proposed:

- Commuted Values are determined using discount rates derived using risk-free rates of Government of Canada bonds plus a spread, to adjust for the fact that pensions are less liquid. The proposals recommend a change to the method used to determine the spread.
- A new method is proposed to determine Commuted Values for Target Pension Arrangements (these are plans where accrued pension benefits may be reduced to protect the ongoing financial position of the plan – many multi-employer pension plans would meet this criteria).

Change in Spreads

The current method for determining discount rates for the calculation of Commuted Values includes a fixed spread above the risk free rates on mid and long term Government of Canada bonds. This spread is intended to adjust for the fact that pensions are much less liquid than Government of Canada bonds. The fixed spread was set at 90 basis points when standards were reviewed in the past, based on a survey of historical data at that time. However, there is evidence that the spread is not static and changes with market conditions.

The proposed standards are migrating away from this 'fixed' spread to a model where the spreads will be variable on a monthly basis going forward. They will instead be dependent upon the spreads between Government of Canada bond yields and their provincial and corporate counterparts, with a two-thirds weighting given to that of provincial and a one-third weighting to corporate.

Financial Impact

The impact on Commuted Values of this fundamental change to how the spreads in the underlying discount rates are determined is variable. Historically speaking:

- For the period leading up to the 2008 financial crisis, the proposed method would have produced higher commuted values than the current method.
- Since then, however, the proposed method would have produced lower commuted values than the current method (especially for the first two years following the financial crisis) and this continues to be the case currently.

Two discount rates are used to determine commuted values: a rate for the first 10 years and a rate for the years thereafter. Higher discount rates result in lower commuted values. A comparison of the historical impact on the discount rates is illustrated in the following table:

Average Increase (Decrease) in Discount Rates from Current to Proposed Standards

Period	Difference in Rate for First 10 Years	Difference in Rate for Later Years
2004-2007	(0.50)	(0.23)
2008-2009	0.52	0.59
2010-2017	0.12	0.41
Total Period	(0.01)	0.25

Source: Fiera Capital and FTSE/TMX Canada

As at January 1, 2017, for example, for a non-indexed pension, the underlying discount rates would be 10 basis points higher for the first 10 years and 35 basis points higher for the period beyond 10 years. This would result in commuted values that were about 5% lower at older ages and up to 15% lower at younger ages.

If the post 2008 financial crisis experience continues, this is expected to result in slightly lower lump sum benefits which will lead to lower solvency liabilities and overall plan costs.

Although the proposed spread is now variable, based on past data, this would not increase the overall variability of the Commuted Value discount rates. In fact, this new spread method may enable plan sponsors to more readily immunize their plan liabilities using provincial and corporate bonds.

Plan Administration Impact

We do not expect that this change will have a material impact on plan administration and its supporting systems. In particular, discount rates each month will be based upon published bond yield indices (i.e., series) for any required elements (e.g., Government of Canada bond yields, provincial bond yields, and corporate bond yields). It is anticipated that the Canadian Institute of Actuaries (CIA) will publish the rates on a monthly basis so plan administrators will not have to gather these rates every month.

Target Pension Arrangements

The proposed changes affecting Target Pension Arrangements (TPAs) are significant and represent a fundamental change for these types of pension plans.

The ASB subscribes to the general belief that a commuted value represents the economic value (however defined) of a pension benefit that the former plan member forgoes by receiving such a commuted value. However, the proposed changes redefine the application of this philosophy for TPAs. It recognizes that TPA benefits are not 100% guaranteed and may be reduced in the future based on the ongoing financial condition of the plan.

The proposed changes assert that, for a TPA, the economic value of a plan member's benefits is represented by the share of the pension plan assets reasonably attributable to the plan member.

For a TPA, the commuted value will be calculated as follows:

Going Concern funded ratio of the pension plan
multiplied by
Going Concern liability of the former member

These calculations will be prepared using the assumptions from the most recently filed funding valuation, but with the removal of any margins (i.e., best estimate). Market value must be used for the determination of assets in this going concern funded ratio.

The calculation date for the funded ratio of the pension plan must be within three months of, but no later than, the commuted value determination date. The funded ratio can be derived from an extrapolation of the pension plan liabilities since the valuation date of the most recently filed actuarial valuation.

Financial Impact

Clearly, the impact of this change varies depending upon the going concern funded ratio of each affected TPA. As well, the specific going concern actuarial assumptions in place represent a key determinant in the amount that any particular withdrawing plan member would receive. However, in most cases this proposed method would be expected to significantly reduce Commuted Values paid from TPAs.

Plan Administration Impact

We expect this will significantly impact plan administration for many target benefit and multi-employer pension plans. Administration systems and member statements will need to be updated. Actuarial calculations will be required on at least a quarterly basis to update the funded ratio.

Other Noteworthy Changes

Re-computation Period

As market conditions change, the value of a pension changes. Therefore, after a period of time has elapsed from the initial calculation date, a commuted value should be re-computed based on updated market conditions. The length of the re-computation period has historically been left to the plan administrator, presumably in consultation with the plan actuary. There is no specific guidance in current standards. The new proposal still expresses the view that this re-computation period should be set by the plan terms, applicable legislation or by the plan administrator. But, failing having this set by any of the above, the re-computation period would be nine months.

Disclosures

Most notably, for indexed plans, it was previously sufficient to disclose the net discount rates (i.e., nominal rates net of underlying inflation) used to determine commuted values. The proposed standards require that the nominal interest rates and the pension escalation (i.e., inflation) assumptions be disclosed separately.

Timeline

The ASB has released these changes in draft form with a comment period for stakeholders to express their view on the proposed changes. The timeline to adoption of the proposed changes, including any necessary tweaks emanating from feedback provided, is dependent upon the volume and content of commentary received. Assuming events proceed without severe disruption, it is anticipated that these new standards would be published with an effective date during the second or third quarter of 2018.

As mentioned, in certain jurisdictions (such as Ontario), changes to regulations must be enacted in order to specifically reference these new standards. Normally, consultation between the ASB, the CIA and the respective governments, where this is necessary, is launched in advance so that the required regulations are enacted in a timely manner, but we will have to wait to see how that process evolves once the ASB changes are nearer to adoption.

Commentary

The ASB has been studying many aspects of the standards governing the determination of Commuted Values. The proposed changes could have been more far-reaching, but the group within the ASB responsible for examining these standards concluded that only these two, admittedly significant, changes warranted updating.

The change for TPAs is important and fundamental. It undoubtedly emanates from a concern that terminating members be treated no more or no less favourably than continuing plan participants. Updates to plan administration will be required.

For other pension plans, the change in methodology for spreads on Government of Canada bond yields arises from thorough analysis of the behaviour of interest rates over extended economic cycles. Evidently, a fixed spread has been deemed non-representative of how the inherent illiquidity premium prevalent in the marketplace works. This change to a model where spreads are derived from provincial and corporate bond yields better mirrors economic conditions. It is expected to have minimal impact on plan administration.

Contact Information

Should you wish additional information on this topic, please contact your local Aon Hewitt Consultant, or send an email to info@aonhewitt.com.

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