Memorandum

To: All Fellows, Affiliates, Associates, and Correspondents of the Canadian Institute of Actuaries, and other interested parties

From: Josephine Marks, Chair
Actuarial Standards Board

Gavin Benjamin, Chair
Designated Group

Date: January 24, 2020

Subject: **Final Standards – Amendments to Section 3500 of the Practice-Specific Standards for Pension Plans – Pension Commuted Values**

Document 220008

Introduction

These changes to the practice-specific standards for pension commuted values (section 3500) have been approved for distribution by the Actuarial Standards Board (ASB) on January 12, 2020. Due process has been followed in the development of these standards.

The revised standards (and the red-lined version) are attached at the end of this memo.

Background

The ASB is committed to conducting general reviews of all parts of the Standards of Practice on a quinquennial basis. The ASB established a Designated Group (DG) to review the standards of practice for pension commuted values (section 3500), other than those related to the promulgation of mortality assumptions under paragraph 3530.01. This review was to assess the continued appropriateness of the basis for calculating commuted values (CVs), considering the interests of a number of stakeholders including terminating plan members, non-terminating plan members, and plan sponsors. One of the objectives was also to consider whether a different basis should be used to calculate CVs for certain target pension plans and multi-employer pension plans.

The ASB distributed a notice of intent (NOI) on October 15, 2015, to provide the background and general information on these proposed changes, with a deadline for comments of December 19, 2015. An update on the progress of this review was provided at the Canadian Institute of Actuaries' (CIA) Pension Seminar held on November 8, 2016.

The NOI was followed by an exposure draft that summarized the feedback received on the NOI and proposed changes to the practice-specific standards for pension commuted values. The ASB distributed the exposure draft on July 20, 2017, with a deadline for comments of September 18, 2017.

Based on feedback received on the initial exposure draft, the ASB decided to publish a revised exposure draft that summarized the feedback received on the initial exposure draft and proposed changes to the practice-specific standards for pension commuted values which incorporated this feedback. The ASB distributed the revised exposure draft on November 23, 2018, with a deadline for comments of January 31, 2019.

Feedback from Stakeholders

The DG solicited input from various stakeholder groups in the revised exposure draft that was distributed in November 2018. The DG received 28 submissions with comments on the November 2018 exposure draft.

The DG appreciates the feedback received and has taken it into account in the preparation of the final standards of practice. The following sections of this memorandum outline some of the key issues that were raised by stakeholders and considered by the DG.

Summary of Key Issues Raised by Stakeholders and DG Response

The following sections, while not exhaustive, summarize key comments provided by stakeholders, and the DG's response to these comments.

1. **Assumed pension commencement age (paragraphs 3530.06 through 3530.06.3)**

   In the November 2018 exposure draft, the DG indicated that there was likely a bias in favour of the former plan member in assuming that deferred vested members would elect to commence their pension at the age which produces the highest CV. The DG gave consideration to other reasonable approaches and proposed that CVs be calculated assuming there is a 50 per cent probability that a former member will commence their pension at the age which produces the highest CV and a 50 per cent probability that a former member will commence their pension at their earliest unreduced retirement age. The proposal attempted to reduce the bias in the current standards of practice in a practical way that can be applied universally to all pension plans and reflects that not all former members commence their pensions at the age that optimizes the CV. The DG also recommended that the Canadian Institute of Actuaries undertake additional research to further support and refine the assumptions related to the distribution of pension commencement ages of former plan members.

   Many respondents supported a change in the assumption while some did not. Some of these respondents wanted more time to do research to support the assumption that is ultimately adopted. Others view the ability of the former member to elect to commence their pension at the age which produces the highest CV as an entitlement that should be fully reflected in the former member's CV. Some agreed with the proposed assumption, but wanted clarity on the application of the approach in specific circumstances, such as when a pension plan has different early retirement provisions for different periods of service or when a former member's pension is affected by Income Tax Act limits.

Some respondents also requested clarity as to whether retroactive payments can be included in a CV in the case where the former member is past their normal retirement age on the CV valuation date.

DG comments – After carefully considering the various submissions, the DG is still of the view that the revised assumption proposed in the November 2018 exposure draft is less biased than assuming that deferred vested members would elect to commence their pension at the age which produces the highest CV. The DG also concluded that since the current assumption is also not based on specific research, there is no need to delay the implementation of a revised assumption until the conclusion of research conducted by the Canadian Institute of Actuaries. If subsequent research supports a change in the approach, then the approach can be modified in the future.

The final standards include additional paragraphs to provide clarity for special situations, such as when a plan has different early retirement provisions for different periods of service or when a former member's pension is affected by Income Tax Act limits.

Also, wording changes have been made to the standards to clarify that retroactive payments can be included in a CV where inclusion of the payments are required by applicable legislation.

2. Interest rate spreads approach (paragraphs 3540.06.1 and 3540.06.2)

The changes to the approach for calculating the spreads above Government of Canada bond yields used to determine the commuted value interest rates are described in the initial and revised exposure drafts. Only a few respondents did not agree with the proposed approach. Some respondents to the November 2018 exposure draft requested more information on the rationale for the minimum and maximum spreads introduced in the November 2018 exposure draft.

DG comments –The DG maintains its recommendation and provides more information below on the rationale for the minimum and maximum spreads.

<u>Minimum and maximum spreads</u>

- As communicated when the November 2018 exposure draft was released, the DG recognizes that there may be unusual financial market conditions, such as the 2008–2009 financial crisis, during which time corporate bond spreads widened significantly. This could result in a situation in which a CV is calculated using a valuation date on which bond spreads are unusually high (and, as a result, the CV is unusually low), while the CV is paid a few weeks later at which time bond spreads have reverted back to more normal levels. For this reason, the DG proposed an adjustment in the November 2018 exposure draft whereby the interest rate spread adjustments would be capped at 150 bps. Based on a review of monthly spreads over a historical period of close to 40 years, it was observed that the 150 bps cap was attained on only a small number of occasions. The DG therefore expects that the 150 bps cap on the spread adjustments to apply only in unusual market conditions and that it represents a reasonable measure in the event of such market conditions.

- The minimum of 0 per cent, when determining the bond yield spreads, that was introduced in the November 2018 exposure draft ensures that the calculated provincial and corporate spreads can never be negative. When performing the 40-year review of historical spreads mentioned above, it was observed in a few occasions that some provincial and/or corporate bond yields were slightly lower than the Government of Canada bond yields for a temporary period, which generated negative provincial/corporate spreads. The minimum of 0 per cent is intended to mitigate the effects of these types of unusual market conditions that are expected to be short-lived.
- The DG also proposes regular monitoring of the monthly rates and approach used to calculate the interest rate spread adjustments in the event that the financial market environment changes and the methodology for calculating the spread adjustments requires modification. The monitoring and governance of future changes will be addressed in the first half of 2020.

3. Rounding of rates of interest and rates of pension escalation (paragraph 3540.13)

In the November 2018 exposure draft, the DG proposed three methods of rounding the rates of interest and rates of pension escalation, to provide more flexibility to pension plan administrators. Only a small number of submissions commented on the proposed rounding changes and the submissions were equally split between those who agree and disagree with providing such additional flexibility.

DG comments – The DG continues to believe that some flexibility should be provided for practical considerations and to accommodate the approaches already programmed in pension administration systems. The final standards maintain two of the three rounding approaches proposed in the November 2018 exposure draft. The approach in which the rates of interest would be rounded to the nearest multiple of 0.10 per cent combined with unrounded rates of pension escalation has been removed, since the DG concluded that there is not a strong rationale for permitting this rounding approach. The final standards have also been amended to clarify the methodology underlying the second of the two remaining rounding approaches.

4. **Characteristics of pension plans that will be considered target pension arrangements (TPA) for the purpose of calculating CVs (paragraph 3570.01)**

   Once again, most submissions on the November 2018 exposure draft did not address this question. There was one submission that supported the exposure draft as drafted. The DG did receive five submissions suggesting that jointly sponsored pension plans (JSPPs) and two submissions suggesting that Québec member funded plans (MFPs) be permitted to use subsection 3570 when calculating CVs. The submissions assert that the methodology under subsection 3570 is more aligned with the shared risk approach, funding and governance structure of JSPPs and MFPs. In some of these submissions, concern was expressed that by not enabling JSPPs and MFPs to use subsection 3570, members who do not take lump sums from the plan were subsidizing members who do.

   DG comments – The DG continues to maintain the view that the definition of TPAs as proposed in the July 2017 and November 2018 exposure drafts remains appropriate, as the definition focuses on the nature of the benefit that the former member is foregoing by receiving a CV. The DG considered the concern over cross-subsidization between groups of members for JSPPs and MFPs, but ultimately concluded that it was not a sufficient reason to include these plans in the definition of plans that should fall under subsection 3570. Other than in the case of defined contribution plans, pension plans often provide cross-subsidization between members for a variety of reasons. All members of a plan at some point are exposed to the risk of termination from the plan, and a portion of a plan's contributions is allocated to fund a former member's option to elect a lump sum of equivalent value to the benefit foregone in the event the former member elects a CV.

   The DG continues to acknowledge that the rationale for permitting JSPPs, MFPs, and other plans with similar characteristics to use subsection 3570 when calculating CVs has merit and encourages policy-makers to consider whether pension legislation in their jurisdiction should permit the use of subsection 3570 for these types of plans.

5. **Approach for calculating CVs payable from target pension arrangements (paragraphs 3570.03 through 3570.08)**

   In the November 2018 exposure draft, the DG concluded that an appropriate approach for determining the economic value of a pension payable from a TPA is to calculate the actuarial present value of the former member's pension using the plan's going concern funding assumptions, without any adjustment based on the pension plan's funded ratio. The justification for this approach is that it reflects the former member's target pension at the time of termination of plan membership and is consistent with the valuation basis used in determining the ongoing funding and affordability of the target pensions of plan members. The November 2018 exposure draft also concluded that, in order to be consistent with the basis used to fund the pension plan, the assumptions used to calculate a former member's CV would include any margins for adverse deviations that are reflected in the going concern funding assumptions.

The DG acknowledged that, depending on the governing documents of the pension plan, and related communications to members, for a particular TPA or the public policy considerations of a particular jurisdiction, it may be appropriate to adjust the actuarial present value of the former member's pension up or down based on the pension plan's funded status. Therefore, the DG proposed that the standards of practice allow for the possibility that adjusting the CV based on the funded status of the pension plan may be appropriate in circumstances where they are required by applicable legislation or by the terms of the pension plan, as described in a plan text, benefits policy, and/or collective agreement.

A few submissions provided feedback that the going concern funding assumptions should not include margins for adverse deviations, with the predominant reason being that the additional funding resulting from the inclusion of any margins could be considered a form of surplus. A few submissions also requested clarification as to whether explicit provisions for adverse deviations that are included in the valuation basis and any adjustments to the going concern valuation interest rate to reflect expenses expected to be paid from plan assets should be reflected in the CV calculation.

DG comments – The DG discussed the above submissions and continues to support the going concern approach for TPAs outlined in the November 2018 exposure draft. The DG agreed that most of the feedback regarding margins had merit. The DG concluded that margins for adverse deviations and any explicit provisions for adverse deviations should not be included in the going concern assumptions used to calculate the CVs for TPAs, unless their use in the calculation of CVs is required by applicable legislation or by the terms of the pension plan, as described in a plan text, benefits policy, and/or collective agreement.

The DG also concluded that adjustments to the interest rate for investment expenses expected to be paid from plan assets in the funding basis should be included in the going concern assumptions used to calculate the CVs for TPAs, whereas adjustments for non-investment (e.g., administrative) expenses would be reflected in the discount rate if such adjustment is required by applicable legislation or by the terms of the pension plan, as described in a plan text, benefits policy, and/or collective agreement.

The standards also provide that, where the CV is adjusted to reflect the funded status of the plan, there should be consistency between the going concern assumptions used to calculate the present value of the member's benefit entitlement and the assumptions used to calculate the funded ratio of the pension plan.

6. **Reasonable modification of assumptions (paragraphs 3570.09 and 3570.10)**

   A few submissions discussed modifications that should be made to the assumptions for fairness amongst the different groups of plan members, and modifications that should be allowed for purposes of simplifying calculations. One submission specifically commented on the need to use a universal longevity assumption across all member groups; one that does not differentiate by an individual's characteristics outside of age and/or gender.

   DG comments – The DG agreed with the comments. Adjustments were made to paragraph 3570.09, and paragraph 3570.10 was added to clarify that an actuary should use judgment to modify assumptions if needed so that they are appropriate for the deferred member group as a whole and so that the mortality assumption does not disadvantage specific deferred vested members versus the plan membership as a whole. The intent is that the modified going concern assumptions applied in determining the CV of an individual former member would be as consistent as possible with the going concern funding assumptions, while still resulting in a fair and reasonable value attributable to the individual's target benefit accrued in the plan.

7. **Alternative methods and assumptions when calculating CVs for TPAs (paragraph 3520.12)**

   Paragraph 3520.12 of the current standards permits, under certain circumstances, alternative methods and assumptions that produce higher values than the methodology prescribed in the standards. Under the share of assets approach proposed for TPAs in the July 2017 exposure draft, the DG concluded that alternative methods and assumptions should not be permitted under the standards for TPAs. These plans were therefore explicitly excluded from paragraph 3520.12 in the version of the standards proposed in the July 2017 exposure draft.

   DG comments – With the change in approach for TPAs in the final revisions to the standards from the share of assets approach to the actuarial present value of the former member's pension using the plan's going concern funding assumptions, the DG concluded that the exclusion in paragraph 3520.12 for TPAs is no longer needed, and that it is acceptable to calculate a higher CV if the conditions described in paragraph 3520.12 are met. This change also allows for a simplification of the additional disclosure requirements for TPAs contained at the end of subsection 3570 compared to the proposals in the exposure drafts.

8. **Wind-ups out of scope of the CV standards for TPAs (paragraph 3510.03)**

   A few submissions requested that the CV standards address the calculation of CVs for TPAs in the case of full or partial plan wind-up. Paragraph 3510.03 proposed in the November 2018 exposure draft explicitly provides that section 3500 of the standards does not apply in the case of the full or partial wind-up of a TPA.

   DG comments – Since the approach for calculating CVs for a TPA is premised on the pension plan being a going concern, the DG concluded that section 3500 of the standards should not apply in the case of a full or partial wind-up of a TPA and that this issue is not within the mandate of the DG. The DG has notified the ASB of this issue and has suggested to the ASB that it be addressed as part of the ASB's quinquennial review of the entire pension-specific standards of practice.

Other modifications to the Standards of Practice

The following additional changes have been made to the final standards compared to the proposed changes included in the November 2018 exposure draft:

- The standards now clarify that the provincial and corporate bond yield spreads used to determine the CV interest rates will be based on indices published by FTSE Canada Debt Capital Markets, or other indices or calculation bases that may be promulgated from time to time by the ASB.
- Since the non-indexed interest rates and escalation adjustments are each determined explicitly under the revised standards, the calculation of increases in the Consumer Price Index described in paragraph 3540.09 has been changed to be based on the geometric differences between non-indexed and real-return Government of Canada bond yields, with the Government of Canada yields used to calculate increases in the Consumer Price Index beyond 10 years adjusted to approximate the shape of the yield curve beyond 10 years. Previously, the calculation of increases in the Consumer Price Index were based on the geometric differences between non-indexed and real CV interest rates.
- The disclosure requirements in subsection 3550 have been changed to require a statement that because a CV is based on a number of assumptions, the retirement income provided by the CV may be either greater or less than the pension payments that the member would have received from the pension plan. Subsection 3550 has also been modified to simplify the disclosure requirements when a CV does not comply with the standards as a result of the requirements of applicable legislation.

Effective Date

The ASB is aware that some of the modifications to the methodology for calculating CVs contained in these revised standards may take some time for pension plan administrators to implement in their administration systems. There are also some jurisdictions for which pension regulations will need to be changed in order to permit the use of the revised standards. However, there are also some administrators of TPAs who would like to reflect the methodology changes contained in the revised standards as soon as possible.

Therefore, to provide time for plan administrators to modify their administration systems, these revisions to the standards of practice become effective on August 1, 2020. However, early adoption of these revisions is permitted for TPAs that fall under new subsection 3570, as long as all the revisions are adopted at the same time for a particular pension plan.

Members of the DG

The members of the DG are Gavin Benjamin (Chair), Ty Faulds, Conrad Ferguson, Dani Goraichy, Jamie Jocsak, José Legault, Tim McGorman, Mark Mervyn, and Catherine Robertson.

JM, GB