Special Notice

February 12, 2020

Actuarial Standards Board publishes revised final standards for the determination of pension plan commuted values

On January 24, 2020, the Actuarial Standards Board (ASB) *released* final amendments to section 3500 of the practice-specific standards for pension plans – pension commuted values (revised standards).

For traditional single-employer pension plans, the revised commuted value (CV) standards change the interest rate spread approach and no longer assumes a member will elect a pension commencement age that would fully maximize the value of the pension. Changes to the interest rate spread approach in the current environment will likely have the impact of reducing CVs, while the effect of the new retirement age assumption could also reduce CVs (depending on plan provisions).

The revised standards also contemplate a separate category of plans, called target pension arrangements (TPAs), and prescribe an alternative approach to calculating a CV for these plans. The definition of a TPA is outlined in the revised standards. Where permitted by legislation, CVs payable from TPAs under the revised standards will be based on going concern assumptions and, if permitted by the terms of the plan and applicable legislation, can also be adjusted to reflect the plan's funded status. The revised standards allow plan administrators of TPAs to make certain decisions with respect to some of the assumptions, including whether or not margins are to be included.

The revised standards become effective August 1, 2020, although early adoption is permitted for TPAs. This *Special Notice* highlights some of the changes and their potential implications for plan sponsors, administrators and members.

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Background

The revised standards are the culmination of a multi-year process begun by the ASB with the publication of a *Notice of Intent* to review the standards of practice (SOP) for CVs under section 3500 in October 2015. Based on input from many interested stakeholders, the ASB issued two exposure drafts (*July 2017* and *November 2018*) and solicited further input from stakeholders to determine final steps.

The review considered the continued appropriateness of the basis for calculating CVs, considering the interests of a wide variety of stakeholders including terminating plan members, non-terminating plan members, and plan sponsors. Of special consideration was whether a different basis should be used to calculate CVs for certain target pension plans and multi-employer pension plans.

Changes affecting traditional single-employer pension plans

The revised standards change the interest rate spread approach. The new approach is based on a blend of provincial bond yield spreads and corporate bond yield spreads relative to Government of Canada bond yields, with an upper limit of 1.5% and lower limit of 0%. The current standards used a constant spread of 0.9%.

Additionally, CVs will no longer assume that plan members will always choose to commence their pension at an age that maximizes the value of the pension benefit. The revised standards apply an assumption that there is a 50% chance a plan member will commence their pension at the date that produces the highest potential value, and a 50% chance the plan member will commence their pension at the earliest eligibility date for a full, unreduced pension.

Implications

The effect of the change in the interest rate spread approach will depend on the bond indices used to calculate the spread and economic conditions at the time of calculation.

The table below shows a sample of the CV rates over the past two years under the current standards and what they would have been under the revised standards. The comparison shows that select interest rates (for the first 10 years) would have been similar, but ultimate interest rates (after 10 years) would have increased slightly under the revised standards. All else being equal, an increase in interest rates will decrease CV payouts made to terminating members.

Calculation month	CV rates under old standards		Estimated CV rates under revised standards		Estimated % change in CV
	Select	*Ultimate*	*Select*	*Ultimate*	
June 2018	3.10%	3.20%	3.00%	3.40%	-3%
December 2018	3.20%	3.40%	3.20%	3.70%	-6%
June 2019	2.40%	2.90%	2.40%	3.20%	-6%
December 2019	2.40%	2.50%	2.30%	2.70%	-3%

Changes in interest rates will affect individuals differently depending on the terminating member's age and the plan provisions. For illustration purposes, we have included an estimate of the effect this may have on a 45-year-old member terminating from a plan with a normal retirement age of 65, no early retirement subsidies, and no post-retirement indexation.

The impact of the new pension commencement assumption will vary depending on plan provisions. For plans without early retirement subsidies, the change could have no impact on CVs. However, CVs will generally be lower under the new standards for plans with early retirement subsidies; the more generous the early retirement subsidies provided by a plan, the greater the decrease this change in assumption will have on CVs. For example, if the same 45-year-old we considered above belongs to a plan with a 3% reduction to the pension for each year their retirement age precedes age 65, the revised standards could lower their CV by a further 4% to 7%.

Individuals responsible for the administration of pension plans should review their systems in anticipation of implementing the new retirement age assumption and for determining the appropriate interest rates for CV calculations starting August 1, 2020. It is expected that interest rates, or underlying yields, will ultimately be made available through the Canadian Institute of Actuaries; however, at this time they are only available via subscription with certain data providers.

Depending on the legislative environment, economic experience, and a plan's provisions, the solvency or wind-up liabilities associated with the portion of members assumed to elect lump-sum CVs may decrease due to the revised standards. Plan sponsors may wish to consider the effect these changes may have on their plan.

Changes affecting target pension arrangements

The revised standards have added a new definition of target pension arrangements (TPA), which includes plans that are permitted by applicable legislation to reduce the accrued pensions of plan members and beneficiaries while the plan is ongoing and where the reduction in accrued pensions is not necessarily caused by the financial distress of the plan sponsor or sponsors. Some plans, such as certain target benefit plans and multi-employer pension plans, are intended to fit in this category, while for other plans, such as some jointly sponsored pension plans, the definition may apply on a case-by-case basis. Some jurisdictions' legislation may also determine whether a plan can be considered a TPA for the purpose of determining CVs. To the extent permitted by applicable legislation, CVs for TPAs will now be based on going concern valuation assumptions, with the potential for adjustments to the CV based on the funded ratio of the plan, calculated on the same basis as used in the CV calculation. Going concern assumptions for CV calculations, as well as for the TPA's funded ratio if applied to adjust the CV, will generally not include implicit or explicit margins for adverse deviations for this purpose. TPAs may elect to adopt the revised CV standards prior to the August 1, 2020 effective date, provided all the revisions are adopted at the same time for the plan.

Implications for TPAs

Depending on the approach chosen by the plan, in the current interest-rate environment, the CVs under the revised standards should result in lower amounts being paid to terminating plan members of TPAs than under the current standards. If adjustments to the CVs based on the funded status of the plan are applied, the revised standards will better reflect the terminating member's asset share. Plan administrators may wish to consider the option to adjust for the funded ratio of the plan and whether it is the right choice for their plan. If a plan intends to adjust CVs based on its funded ratio, it must be permitted by provincial legislation and reflected in the plan's documentation.

In addition, plan administrators will likely want to consider whether to elect early adoption of the revised standards, including consideration of how that decision will affect members terminating around the effective date chosen, as well as the need for administrative implementation of the new approach.

Those responsible for the administration of affected plans should begin reviewing their systems and communications in anticipation of the effective date of the revised standards.

Certain decisions regarding CV calculation methodology will need to be supported by plan documents, governance policies, and applicable legislation. It is not yet clear whether provincial legislation will allow the new CV standards for TPAs to be used when determining solvency or wind-up liabilities associated with the portion of members assumed to elect lump-sum CVs when preparing regular actuarial valuations. Plan sponsors may wish to review plan texts, governance policies, and benefit management strategies in light of the change in the CV basis.

Other items of interest

Other items of interest to plan sponsors, administrators and members include:

- Anyone who produces CVs (including non-actuaries) are subject to the requirements of the SOP;
- If the period for which the CV applies – before recomputation is required – is not otherwise established by the terms of the plan, administrative practice, or legislation, the default period will now be nine months;
- If required by legislation, retroactive payments should be included in CVs if members are beyond their earliest unreduced retirement age;
- Unless otherwise required by legislation, interest rates used to adjust the CV between the valuation date and the payment date should be those used in the CV calculation;
- For plans with indexation, rounding options are more flexible;
- New detail is provided regarding pension escalation for plans with conditional indexation; and
- New disclosure requirements will need to be reflected in communications with members, including a statement that 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 plan.

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