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Revisiting the commuted-value standards

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The Actuarial Standards Board is consulting on changes to key components of how the commuted value for a pension plan is calculated.

The commuted-value standard is used to determine how much to pay a terminating plan member who chooses to take their pension payment as a lump sum. It's also a key part of calculating solvency ratios.

The most significant proposals are for certain types of target-benefit and multi-employer plans, says Gavin Benjamin, senior director of retirement at Willis Tower Watson, who led the designated group to re-evaluate these standards.

While the proposals, if adopted, wouldn't change the fundamental approach for calculating the commuted value in traditional benefits plans, there are three key changes the consultation is putting forward.

The first is changing the way the discount rate is used to calculate commuted values for DB plans to more closely reflect financial markets at the time of the calculation. "In the past, the discount rates have been based on Government of Canada bond yields," says Benjamin. "The proposed approach is to — as well as reflecting Government of Canada bond yields — also look at provincial bond yields and corporate bond yields and incorporate all that information into determining the discount rate to calculate commuted values."

Another proposed change is updating the mortality assumptions to reflect a new mortality improvement scale published in 2017, he says. And the final proposal is changing the assumed pension commencement date.

"The way the current standard works is the actuary selects the assumed pension commencement age, which maximizes the commuted value, and that's not always the age that the former member would have received an unreduced pension," says Benjamin.

The consultation proposes a new assumption that there's a 50 per cent probability a plan member would start the pension at an optimal date and a 50 per cent probability the member would start at the earliest date that they're entitled to an unreduced lifetime pension.

"You'll calculate the value of the pension twice," says Jason Vary, president at Actuarial Solutions Inc. "You'll calculate the value of the pension assuming that the member retires at, let's say, 55, if that's the optimal age, and then you'll value the pension assuming that the member retires at 62, if that's the unreduced age, and then you'll just take 50 per cent of the first number and 50 per cent of the second number."

Actuaries could still use the calculation assuming an optimal age if they wanted to because the standard is a minimum, says Benjamin.

"Really, the rationale for making the change is that, although there haven't been in-depth studies of when former members start their pensions, just generally the observation of people like myself who have been working in the industry for a while and other members of the group is that if you look at the behaviour of former plan members, when they start their pensions it's by no means always at the optimal age."

Vary says the most controversial of the proposed changes relates to the optimal age. "The actuarial profession is certainly discussing this commuted-value standard a lot, especially around the optimal age thing. There's lots of opinions around optimal age, so I'm sure they will get lots of comments back."

Yet he notes the impact will depend on the plan.

"For some plans, it will make no difference because the optimal age might have been 65, the unreduced age might be 65 and mathematically it will be no different," says Vary. "But for some plans with very generous early retirement provisions, the commuted value could be lower by 20 per cent or more based on the new proposed standard. So 20 per cent or more is significant in my mind."

Using a 50-50 assumption is too arbitrary and too simple, he says, because each plan is going to be different. "I don't like the solution because you're applying this very broad solution across all plans in Canada, and it's not going to work for many of those plans. It's too simple. In my view, the optimal age for everybody was better, is more elegant and sure maybe it was biased in favour of the plan member as they exited, but I would solve that problem a different way . . . by applying a plan's transfer ratio to people's commuted values as they leave the plan."

This would mean keeping the requirement of assuming a member retires at the optimal age, yet reflecting the current solvency funded status of the plan when transferring the commuted value out of the plan. "Let's say a plan is 85 per cent funded, then the person who's electing to take a lump-sum commuted value out of the plan would get 85 cents on the dollar on the way out."

This recommendation should only apply to people who have a choice, not those who must take the commuted-value lump sum like in a death benefit scenario, he adds.

The proposed changes can be positive for solvency ratios, notes Vary.

This is because solvency valuations are premised on assuming a plan winds up on the valuation date and all benefits are settled. In the event of a windup, plan members who haven't started their pensions are offered a commuted value. And so, in a solvency valuation, the actuary assumes that a certain portion of the obligations would be settled through commuted-value payments. "The level of impact will vary, very much plan by plan, in terms of the plan demographics and the plan provisions and so on, but changes to the commuted value standards do have an impact on solvency valuations," says Benjamin.

The proposed changes to the commuted-value standard could also potentially translate into changes to going-concern valuations — although not as much as for solvency and this may not be material, says Benjamin, explaining going-concern tests assume the plan continues indefinitely. "But in making that assumption, the actuary does assume that plan members terminate in the future and potentially some of those terminating members might elect a commuted-value payment."

The changes won't come into effect until the second half of 2019 at the earliest, says Benjamin, noting the final decision will be based on the comments received through the consultation and whether the proposals require further exploration.

If the changes are accepted and put forth as final, this could have a different effective date in different jurisdictions as well, he says, noting some pension legislation refers to actuarial standards of practice, while some provinces refer to a particular version of the commuted-value standards. "And so, for those provinces, they'll actually have to update their regulations to refer to the most recent version when a new version of the standards comes out."

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