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Changes coming for pension plan commuted-value standards

Yaelle Gang, the Canadian Investment Review | February 3, 2020

After **years of consultation**, the Canadian Institute of Actuaries' Actuarial Standards Board has finalized changes to key components of how commuted values payable from pension plans are calculated.

Among other applications, 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.

For traditional defined benefit plans, the big changes to the commuted-value standard rules include changes to the assumed age of retirement and the interest rates used in the calculation.

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Under the current rules, the commuted value is calculated by assuming 100 per cent of members will take their pension at the optimal age. Under the incoming rules, the actuaries will assume a 50 per cent probability a plan member would start the pension at the optimal date and a 50 per cent probability the member would start at the earliest date they're entitled to an unreduced lifetime pension.

"When you look to the pension commencement age of deferred vested members, the anecdotal experience of many actuaries is that deferred vested members don't necessarily, or definitely don't in all situations, start their pension at the optimal age," says Gavin Benjamin, senior director of retirement at Willis Tower Watson, who led the designated group responsible for revising the standards. "So the rationale for making the change is to try and attempt to come up with an assumption, which is more in line with what a deferred vested member might do in terms of when they'd start their pension."

Dean Newell, vice-president at Actuarial Solutions Inc., says for plans with generous early retirement provisions, the changes could be material and would reduce commuted values for impacted members. "However, for plans that generally don't have generous early retirement subsidies, that 50-50 weighting would have no impact."

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As well, since commuted values are reflected in a solvency valuation, lower commuted values would lead to lower solvency liabilities and therefore higher solvency ratios, he adds.

Another change for traditional DB plans is around interest rate assumptions. Under current standards, the interest rates are based on Government of Canada bond yields with a fixed spread adjustment of 90 basis points. However, under the new standards, the spread will vary monthly based on corporate and provincial bond yields.

"So overall, the interest rate assumption will be more market-based under the revised standards," says Benjamin.

The intent of this change is because the current 90 basis points is meant to be an adjustment for illiquidity, he adds. "The fact that, if the person who is receiving the commuted value had in fact instead elected to receive the monthly pension from the pension plan, that's a promise which is usually very secure but not very liquid."

In reality, the adjustment for things like illiquidity changes over time as markets change, he says, noting the effect on commuted value payments will depend on the market. "When you look back at recent years, the change would have resulted in higher interest rates, which means lower commuted values. But that's not necessarily the case going forward."

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In addition to the changes to traditional DB plans, the new commuted-value standards now distinguish between DB plans and target pension arrangements, which are defined as any ongoing plan that allows a reduction to accrued benefits.

"The big change for target [pension] arrangements is that they're going to have a lot more flexibility in how they're going to come up with their commuted value," says Newell. "The standards now say that target [pension] arrangements will be able to determine their commuted-value calculation as, effectively, the actuarial present value using their going-concern assumptions. And they could also adjust their commuted value to reflect the funded status of the plan if they wish to do so."

Under target pension arrangements, the accrued benefits can be reduced to manage the finances of the plan, says Benjamin. "The thinking is that, for these types of plans, the pension promise is fundamentally different where it does anticipate a potential reduction in accrued pensions in order to balance the finances of the plan and therefore the approach for calculating commuted values should be different."

The new rules for target pension arrangements also provide the administrator with increased flexibility around which interest rate is used, whether to consider the funding cushion for going concern in the calculation, whether to adjust the retirement age assumption and whether to reflect the funded status of the plan or the member's share of plan assets.

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Since some provinces have their own rules for target pension arrangements, the changes won't apply in all jurisdictions. However, where applicable, these changes will result in reduced commuted-value amounts — in some cases significantly, says Benjamin.

"Generally speaking, in today's low interest rate environment, commuted values using the going-concern assumptions would likely be lower than the commuted values using the prescribed assumptions under the previous standards," notes Newell.

Benjamin advises plan sponsors to think about the various areas these changes could affect. For example, they may need to update administrative systems to reflect the change in the pension commencement age assumption, as well as communications to member.

The changes could also affect supplemental plans and solvency valuations. "I think sponsors should be thinking about the various things that the commuted-value standards touch in their oversight of their pension plans," says Benjamin.

The new changes take effect for valuations as of Aug. 1, 2020, with early adoption permitted for target pension arrangements.

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