Q&A Prepared by the Canadian Institute of Actuaries for CAPSA regarding Commuted Values of Pensions

March 2005

Document 205014

Ce document est disponible en français

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This document provides general questions and answers to administrators and members of pension plans as a result of the new *Standard of Practice for Determining Pension Commuted Values*, effective February 1, 2005. Unless required by a pension jurisdiction, this new standard is not applicable for marriage breakdown or other actuarial evidence calculations.

1. What do we mean by the "commuted value" of a pension?

A commuted value is the lump-sum value of benefits payable from a pension plan sometime in the future. The pension must come from a pension plan registered under either a pension benefits standards act of a province or the federal government of Canada.

2. When can a plan member decide to receive a commuted value?

Specific rules apply in each jurisdiction, but normally a commuted value is payable to a member upon termination of pension plan membership or to his/her spouse or beneficiary upon death.

3. Why is the commuted value calculated with rules set by actuaries?

Because of their training, actuaries are uniquely qualified to convert a stream of future pension payments to a lump-sum amount. Pension regulators rely on this expertise and therefore the various pension benefits standards acts require that commuted values payable upon termination of membership be calculated according to the Canadian Institute of Actuaries' (CIA) standard of practice.

The laws in most jurisdictions provide for commuted values to be determined in the manner currently specified by the CIA from time to time. However, three jurisdictions have referred to the old CIA standard by name in their regulations (Ontario, Québec and New Brunswick). These jurisdictions have either amended their regulations already, or are expected to do so shortly following February 1, 2005.

4. Can someone estimate a commuted value in a simple manner?

There is no simple "rule of thumb" for determining a commuted value since the value is dependent on various demographic and financial factors. However, as a general rule, commuted values increase with age. Also, commuted values increase as interest rates decrease.

5. Why does the CIA need to change the standard now?

The previous CIA standard was developed in 1993. That standard used the most current, widely accepted, mortality table then available – the 1983 Group Annuity Mortality Table. Also, for purposes of estimating future interest rates, the standard struck a balance between the need for simplicity (largely imposed by available software) and the need for accuracy. More than 10 years after the standard's enactment, many actuaries felt that there was room for improvement.

Mortality is continually improving and people are living longer. The new standard for determining commuted values reflects this by using an updated mortality table – the Uninsured Pensioners 1994 Table – with projections for further improvements in mortality since 1994 and into the future.

The new standard's interest rate basis reflects current financial market information to a greater degree than the old standard and advances in software allow the use of a more complex interest rate basis.

6. When will the new standard come into effect?

The new standard is effective on February 1, 2005[1]. The valuation date will determine if the previous or new standard is applicable.

The valuation date means the date at which a commuted value is being calculated. Generally, this will be the date on which a plan member becomes entitled to a pension resulting from termination of plan membership. However, if there is a delay in paying a commuted value, it may be recomputed using a later valuation date.

7. How did the CIA establish the new standard?

A committee of the CIA, known as the Committee on Pension Plan Financial Reporting (PPFRC), was charged with developing the new standard. Over a period of several years, the PPFRC sought input from actuaries across the country and developed an initial draft standard. This draft was put through a formal adoption process during which input from actuaries was solicited, received and analysed. The PPFRC also sought, received and analyzed the input of other interested parties, including pension regulators, plan administrators, plan sponsors and labour organizations. All this input resulted in some changes to the original draft and ultimately to the final standard.

8. How does the new standard differ from the previous standard?

The new standard reflects the longer life expectancy of individuals as mortality continues to improve, and is more closely linked to market interest rates at the time of calculation.

9. How and when does the CIA expect to revise the standard in the future?

The new standard has been adopted for an interim period of three years. During that time, discussions will occur to confirm whether future changes should be made. Following these discussions, if it is determined that modifications are required, they will occur prior to the expiration of the three-year period.

10. What interest rates are used in the calculation?

The method uses two variable interest rates. The first rate applies for 10 years and is based on yields of medium-term Government of Canada bonds. The second rate applies after 10 years and is based on yields of long-term Government of Canada bonds. The rates are adjusted to the extent, if any, that the pension is indexed.

11. Where can I find information on the related bond yields?

The Bank of Canada provides information on Government of Canada bond yields. You can access this information via their website at <www.bankofcanada.ca/en/index.html>.

12. What inflation rates are used in the calculation?

The new standard defines how to determine commuted values for both non-indexed pensions and indexed pensions. The commuted values of non-indexed pensions are based on the yields of non-indexed bonds, and the commuted values of indexed pensions are based on the yields of indexed bonds. The difference between these two yield rates is the assumed underlying inflation rate. As these two bond yields change, the assumed underlying inflation rate will also change.

13. What mortality rates are used in the calculation and why?

In order to better reflect current life expectancy and future mortality improvement, the calculations use an updated mortality table, the Uninsured Pensioners 1994 Table projected for anticipated mortality improvements to 2015. This table represents the observed mortality for members of pension plans. The table generally reflects longer life spans than the population at large since it represents the subset of the population that is or was employed.

14. Is the calculation different for a man versus a woman?

Most jurisdictions require the use of unisex mortality tables when calculating commuted values from a pension plan. Consequently, a commuted value will usually vary according to the male/female distribution of the plan instead of the specific gender of the member.

However, the use of unisex mortality is not permitted in Québec. As females are expected to live longer than males, commuted values for females will be greater than commuted values for males. In Alberta, individual plans may elect to use either unisex mortality or sex-differentiated mortality.

15. How does the calculation change compared to the previous standard and why?

The changes to the method of determining interest rates may result in an increase or decrease in the commuted value of pensions from the amount calculated under the previous standard. The impact of the new standard will also depend on whether pension benefits are automatically indexed, the level of interest rates, the age of the member and, where unisex tables are used, the distribution of the members by gender.

16. Will the new rules have an impact on the solvency of the pension plan?

The new standard will affect pension plan solvency or wind-up valuations, since the liability for plan members who are entitled to commuted values must be calculated according to the CIA standard of practice.

Depending on the current yields in the bond market at the date of the valuation, the new standard may result in either higher or lower liabilities relative to the previous standard. Of course, the use of the updated mortality table will result in higher liabilities than the previous standard, other things being equal.

(Footnotes)

1 As of the date of this publication, Québec has not adopted the revised standard, although the proposed regulatory changes are in process. Administrators should follow the requirements under the Québec law.