Reform of Ontario's Funding Rules for Defined Benefit Pension Plans: Description of Proposed Funding Rules

On May 19, 2017, the government announced that it would be implementing a new framework for defined benefit (DB) pension plans. The new funding framework for DB pension plans includes:

1. Shortening the amortization period from 15 years to 10 years for funding a going concern shortfall in the plan.

2. Consolidating going concern special payment requirements into a single schedule when a new report is filed.

3. Requiring the funding of a reserve within the plan, called a Provision for Adverse Deviations (PfAD).

4. Requiring funding on a solvency basis if needed to improve the plan's funded status to 85 per cent on a solvency basis.

5. Increasing the guarantee provided by the Pension Benefits Guarantee Fund from $1,000 per month to $1,500 per month.

6. Providing funding rules for benefit improvements and restricting contribution holidays to improve benefit security.

These changes would not apply to jointly sponsored pension plans (JSPPs) that are listed in s. 1.3.1(3) of Regulation 909 (the Regulation) under the *Pension Benefits Act.* The changes would also not apply to specified Ontario multi-employer pension plans (SOMEPPs), but would apply to MEPPs providing defined benefits that are not SOMEPPs. In June 2017, the government announced that it would be implementing a new framework for target benefit multi-employer pension plans. Consultations on the rules applicable to these plans will be held separately.

This posting provides details of the proposed amendments to the Regulation to implement many of the May 2017 proposals. The intention is for these changes to apply to valuation reports dated on or after December 31, 2017, that are filed after the new framework comes in force, except if otherwise noted. The Ministry encourages interested stakeholders to provide feedback on all aspects of these proposed changes to ensure the changes best achieve the government's objectives of protecting benefits for workers and retirees while helping keep workplace pension plans affordable, enabling Ontario businesses to grow and compete. Comments on these proposals should be received by the Ministry of Finance by **January 29, 2018**.

Proposals regarding certain aspects of the new framework for DB pension plans, including providing a discharge of liabilities when annuities are purchased for retirees or deferred plan members, requirements for funding policies and governance policies and changes to the PBGF under the new $1,500 per month guarantee, will be posted for consultation in the near future.

Please note that, except for the modifications detailed in this posting, the current requirements of the Regulation will continue to apply. For example, rules regarding frequency of filing valuation reports will not change.

Solvency Funding Rules

Determination of Solvency Special Payments

Currently, a pension plan has a solvency deficiency on a valuation date if the sum of the solvency liabilities, the solvency liability adjustment and the prior year credit balance exceeds the sum of the solvency assets and the solvency asset adjustment. Also, excluding certain options for funding that have been temporarily available, a solvency deficiency must be amortized over five years, starting not later than one year after the valuation date.

These rules would be amended so that special payments would be based not on a solvency deficiency but on a reduced solvency deficiency, equal to the positive difference, if any, between the sum of 85% of the solvency liabilities, 85% of the solvency liability adjustment and the prior year credit balance, and the sum of the solvency assets and the solvency asset adjustment. The reduced solvency deficiency would be funded over five years starting not later than one year after the valuation date.

Solvency Excess and Transition

Currently, a pension plan has a solvency excess on a valuation date if the sum of the solvency assets and the solvency asset adjustment exceeds the sum of the solvency liabilities, the prior year credit balance, and the solvency liability adjustment. If a plan has a solvency excess, it means that its scheduled special payments are more than sufficient to meet solvency funding requirements. Note that a plan need not be fully funded on a solvency basis to have a solvency excess.

If a pension plan has a solvency excess, the permanent rules in the Regulation allow for a reduction in the length of the amortization period in respect of any existing solvency special payment schedule but prohibit a reduction in the monthly payment amounts.

Under the proposed new funding framework, a pension plan would have a solvency excess on a valuation date if the sum of the solvency assets and the solvency asset adjustment, exceeds the sum of the prior year credit balance, 85% of the solvency liabilities, and 85% of the solvency liability adjustment. As is currently the case, if a pension plan has a solvency excess, the Regulation would allow for a reduction in the length of the amortization period in respect of any existing solvency special payment schedule but would prohibit a reduction in the monthly payment amounts.

Also, as a one-time transition measure, in the first valuation report filed under the proposed new funding framework, a solvency excess could be used to reduce either the monthly payment amount or amortization period in respect of a previously established solvency special payment schedule, provided that the schedule has less than six years remaining. This recognizes that existing solvency special payments have been determined based on a 100% solvency funding goal and allows them to be adjusted to reflect an 85% goal.

Previous Solvency Funding Relief

Under the proposed new funding framework, new elections to use one or more options under solvency relief measures introduced in 2016 would not be permitted. For example, a plan administrator would not be able to elect to amortize a reduced solvency deficiency over 10 years.

Also, special rules would no longer apply for determining the solvency asset adjustment (e.g., s. 5.6 (6) 8 iii and 8.1 iii ;s. 5.6.1 (6) 6 iv and 7 iv; and s. 5.6.2(6) 6 v and 7 v) and governing the rules for solvency excess (e.g., s. 5.6 (6) 1; s. 5.6.1 (6) 1; and s. 5.6.2 (6) 1) for plans for which certain relief measures were elected. Instead, the Regulation would be amended to ensure that all previously scheduled solvency special payments, including those established under temporary solvency relief, are taken into account when determining the solvency asset adjustment. Solvency excess would be governed under the general provisions, amended as described above.

Temporary Solvency Funding Relief for Public Sector Plans (Regulation. 178/11)

There are 25 public sector plans that have received temporary solvency funding relief provided through Reg. 178/11 (the BPS Regulation). These plans are listed in Schedules 1 and 2 of the BPS Regulation. Since the permanent solvency funding target would be reduced to 85% in the proposed framework, the government is proposing the following rules to assist the transition of these plans to the new funding framework.

- Any valuation filed before the effective date of the proposed regulation would be filed using the funding rules under the BPS Regulation.

- Also, any valuation with a valuation date before December 31, 2017 would be filed using the funding rules under the BPS Regulation.

- Any valuation with a valuation date on or after December 31, 2017 that is filed on or after the effective date of the proposed new funding framework would be filed using the funding rules under the new regulation.

- Conditions and restrictions on contribution holidays and benefit improvements as described in subsection 4(4) of the BPS Regulation continue to apply until stipulations described in subsection 12(7) or subsection 16(3) of the BPS Regulation, as applicable, are satisfied.

Letters of Credit

Under the proposed new funding framework, a letter of credit would be able to be reduced if 85% of the sum of the solvency liabilities and the solvency liability adjustment is less than or equal to the sum of:

- The solvency assets;
- An amount, which may be positive or negative, by which the value of the solvency assets are adjusted as a result of applying an averaging method that stabilizes short-term fluctuations in the market value of the plan assets; and
- The present value of the total amount of all letters of credit held in trust for the pension fund, after the reduction in the amount of the letter of credit.

This would recognize the new requirements to fund 85% of solvency liabilities, rather than 100% of solvency liabilities. For example, it would mean that if a plan is 70% funded on a solvency basis, letters of credit could be used to fund solvency special payments for 15% of solvency liabilities, and no other payments determined on a solvency basis would be required.

Going Concern Funding Rules

Going Concern Funding Deficiencies

Under the proposed new funding framework, separate schedules of special payments would not be maintained for going concern unfunded liabilities established in different valuation reports. Instead, special payments for unfunded liabilities would be consolidated into one 10-year schedule that begins one year after the plan's valuation date. Going concern special payments set out in a report would apply to the period commencing one year after the effective date of the report until one year after the effective date of the subsequent report.

However, separate schedules would be maintained when needed to fund benefit improvements. A separate schedule would also be maintained when a plan is established for a past service unfunded actuarial liability, which provides for benefits in respect of the period prior to its effective date.

Funding for Indexation

Funding pre- and post-retirement indexation (escalated adjustments) would be required under the new framework on the same basis as for other benefits. However, contributions in respect of the PfAD would not be required for either the going concern liabilities or the normal cost in respect of future indexation.

Provision for Adverse Deviations and Related Contribution Requirements

A PfAD would be a percentage used to determined additional contributions in respect of the normal cost and in respect of the going concern liabilities of a plan. Under the proposed new funding framework:

- Contributions for the PfAD in respect of the normal cost would be paid by the employer along with the employer's normal cost contributions; however, members of JSPPs (not listed in s. 1.3.1 of the Regulation) may share in making these contributions, as with any other required contributions. These contributions would be determined by multiplying the PfAD by the normal cost; however, as noted previously, costs for future indexation would be excluded from the normal cost to determine PfAD contribution requirements.

- The PfAD in respect of accrued liabilities would be determined by multiplying the PfAD by the going concern liabilities, excluding liabilities for future indexation. Any unfunded portion would be included in a plan's going concern unfunded liability and amortized over 10 years. For example, if a plan's PfAD is 10% and its going concern assets are 95% of going concern liabilities, then going concern special payments would be created that are intended to increase assets by 15% of liabilities.

The PfAD would depend on whether the plan is open or closed to new members. If a pension plan has a DB provision that is closed to new members, its PfAD would be determined using the requirements for closed plans.

A plan's PfAD would also depend on the proportion of assets that are not considered fixed income in the target asset mix that will be required to be set out in its Statement of Investment Policies and Procedures (SIP&P) effective on the valuation date. However, if the administrator knows or ought to know that the target asset mix is expected to change, the PfAD must reflect the anticipated target asset mix.

For purposes of the PfAD, non-fixed income assets would include all equities and employer issued securities. Fixed income assets would generally include bonds, cash, term deposits, short-term notes and treasury bills, GICs, and insured contracts, including annuities held as plan assets. Fixed income assets could include a variety of securities that have different features; however, they would be of a certain quality that can be used to support pension liabilities. For example, the Regulation would provide details on characteristics of bonds that would not constitute fixed income assets for purposes of the PfAD.

Also, 50% of specified investments that are alternative investments (e.g., real estate, resource properties, income producing properties, infrastructure, mortgage loans) would be considered non-fixed income assets. This acknowledges that these investments have both fixed income and non-fixed income characteristics. Mutual fund assets would be allocated as fixed income or non-fixed income depending on the securities in which the fund invests. For example, the portion of a plan's investment in a balanced fund considered fixed income would depend on how much of the balanced fund is allocated to assets that would be classified as fixed income for purposes of the PfAD.

The PfAD would be the sum of three components:

- A fixed component of 5% for closed plans and 4% for open plans. This would strengthen the funding of going concern unfunded liabilities under rules that include a "fresh start" for going concern special payments.

- A component dependent on the plan's asset mix, to encourage investments appropriate for funding long-term pension obligations. This component would be determined by the table below. If the percent of non-fixed income assets is between two values in the first column, then the PfAD component is obtained by linearly interpolating between the PfAD values; for example, if a closed plan's investments are 55% non-fixed income (midway between 50% and 60%), then the PfAD component for the asset mix would be 6% (midway between 5% and 7%).

Percent of non-fixed income assets	PfAD for Closed plans	PfAD for Open plans
0%	0%	0%
20%	2%	1%
40%	4%	2%
50%	5%	3%
60%	7%	4%
70%	11%	6%
80%	15%	8%
100%	23%	12%

- A component based on the plan's going concern discount rate, added only if the discount rate exceeds a benchmark discount rate (BDR) defined in the Regulation. This component would reduce the likelihood of inadequate contribution requirements that could result from inappropriate assumptions. Specifically, the PfAD would be increased by the duration of the plan's going concern liabilities multiplied by the difference between the plan's best estimate discount rate, gross of all expenses, and the BDR. In this context, the duration would be the percent increase in liabilities due to a one percent decrease in the discount rate. The BDR would be the sum of:

    - The rate given by CANSIM V122544 (Government of Canada long bond yield - see Bank of Canada website) in the month of the valuation date;

- The proportion of plan's target asset mix allocated to non-fixed income investments times 5% (i.e., a risk premium of 5% on non-fixed income assets);

- The proportion of plan's target asset mix allocated to fixed income investments times 1.5% (i.e., a risk premium of 1.5% on fixed income assets); and

- 0.5% for diversification.

Example of Application of the Provision for Adverse Deviations

An open plan's assets are 40% fixed income and 60% non-fixed income. The actuary's best estimate discount rate is 6.5%, gross of all expenses, and the duration of the plan's liabilities is 15. If the yield on Government of Canada long bonds is 2.27%:

- The plan's BDR is 2.27% + (0.6 x 5%) + (0.4 x 1.5%) + 0.5% = 6.37%.

- The plan's PfAD would be 4% + 4% + 15 x (6.5% – 6.37%) = 9.95%.

If a plan with no indexing has going concern liabilities of $100,000, assets of $90,000, and a normal cost of $12,000, the PfAD on the normal cost would be 9.95% of $12,000, or $1,194. The plan's going concern unfunded liability would be

Liabilities + PfAD on liabilities – assets
$100,000 + (9.95% x $100,000) – $90,000 = $19,950.

Going concern special payments required until the next valuation report is filed would be the amount determined by amortizing $19,950 over 10 years. However, required contributions based on this schedule of special payments would be made only for the period commencing one year after the effective date of the report until one year after the effective date of the subsequent report, when a new schedule of special payments would be established based on the updated going concern funded position of the plan.

Adjusting Going Concern Special Payment Schedules

Under the proposed new funding framework, most going concern special payment schedules would be consolidated at each valuation. However, consistent with the goal of strengthening funding for benefit improvements, special payments to fund benefit improvements and for past service unfunded actuarial liabilities that are established for a new plan would be maintained and have fixed schedules.

- The present value of going concern special payments in respect of any benefit improvement (including one with an effective date on the valuation date) or a past service unfunded actuarial liability would be included in the plan's going concern assets.

- If on a valuation date the sum of a plan's going concern assets exceeds the sum of the going concern liabilities, the provision for adverse deviations in respect of the going concern liabilities, and the prior year credit balance, then the excess could be used to reduce the length of the amortization period of any of the fixed schedules but cannot be used to reduce the monthly payment amounts of those fixed schedules.

Benefit Improvements

Bill 177, the *Stronger, Fairer Ontario Act (Budget Measures), 2017,* amends unproclaimed section s. 14.0.1 of the *Pension Benefits* Act to allow the government to prescribe a funding level below which benefit improvements could not be made.

Under the proposed new funding framework, regulations would allow benefits to be improved in a plan only if after the improvement the solvency ratio is at least 85% and the going concern funded ratio is at least 90%. A lump sum contribution would be permitted to satisfy these requirements. In this context, the going concern funded ratio would be the ratio of the value of the going concern assets (excluding the value of any going concern special payments) to the going concern liabilities (which would not include the PfAD in respect of the liabilities).

The increase in the going concern liabilities and the PfAD in respect of those liabilities that arises after a benefit improvement is made would be funded over five years on a going concern basis, beginning on the effective date of the amendment that improves benefits. Surplus could be used to fully or partially fund the benefit improvement. Special payment schedules to fund benefit improvements would not be consolidated with other going concern special payment schedules.

Contribution Holidays

Under the proposed new funding framework, surplus would be available for a "contribution holiday", in which surplus is used to lower the contribution requirements of an employer or members for the normal cost and the PfAD in respect of the normal cost, if:

- The plan's PfAD is fully funded on a going concern basis (e.g., if the plan's PfAD is 15%, then the value of the plan's assets determined on the basis of a going concern valuation, including accrued and receivable income but excluding the amount of any letter of credit held in trust for the pension plan, must be at least 115% of the plan's going concern liabilities);

- After reducing the solvency assets by the amount of surplus used to lower contribution requirements, the plan's transfer ratio is at least 1.05;

- A cost certificate is filed each year a contribution holiday is taken; and

- Notice is provided to plan participants, any unions representing members, and the plan's advisory committee (if there is one).

In addition, the value of assets that could be used to take a contribution holiday for a year would be limited to 20% of the plan's available actuarial surplus, as identified in the plan's last filed valuation report. The available actuarial surplus in a particular fiscal year covered by the report would be 20% of the lesser of:

- the amount by which the value of the plan's assets determined on the basis of a going concern valuation, including accrued and receivable income but excluding the amount of any letter of credit held in trust for the pension plan, exceeds the sum of going concern liabilities, the provision for adverse deviations in respect of going concern liabilities, and the prior year credit balance, and

- the amount, if any, by which the solvency assets could be reduced such that the transfer ratio would equal 1.05.

With the exception of designated plans or individual pension plans, a contribution holiday could be taken only if an actuarial cost certificate is filed with the Superintendent within the first 90 days of the plan's fiscal year. The actuarial cost certificate would set out the estimated available actuarial surplus based on estimated going concern liabilities, estimated solvency liabilities, and estimated liabilities for excluded benefits (other than those payable under qualifying annuity contracts). The amount of available actuarial surplus that can be used to reduce contributions for normal cost and PfAD on the normal cost for a particular fiscal year would be the lesser of:

- the amount of available actuarial surplus for the particular fiscal year, as set out in the last filed report; and
- the amount of estimated available actuarial surplus as set in the actuarial cost certificate for the particular fiscal year.

However, the rules regarding the cost certificate would be slightly modified in the fiscal year a valuation report is filed. An actuarial cost certificate would still be filed with the Superintendent. However, once the new report has been filed, the amount of available actuarial surplus to reduce contributions for normal costs in the fiscal year could be based on the new report and any restriction imposed by the actuarial cost certificate would be lifted. A catch-up contribution, calculated using existing rules (see s. 12 of the

Regulation), may be required if the contributions based on the cost certificate are less than what the filed report indicated.

The proposed new requirements for contribution holidays would commence on the valuation date of the first report filed under the new framework.

Transitional Funding Rules

If the total contribution requirements (i.e., the total of normal cost requirements, all required special payments, and any required payments due to the PfAD) for a plan under the proposed new funding framework are greater than the total contribution requirements under the current rules, transitional rules under the proposed new framework would allow the increase to be phased in. For the three years following the valuation date of the first report filed under the proposed new funding framework, plans would not have to pay the full amount of the increase, if any, in contributions due to the new rules. For example, suppose the first report prepared under the new framework has a valuation date of January 1, 2020, then:

- In 2020, contribution requirements would be exempt from increases due to the new rules.
- In 2021, one third of the increase in contributions would be required.
- In 2022, two thirds of the increase in contributions would be required.

This means sponsors would have at least three years to adjust to new funding requirements due to the PfAD, the shorter amortization period, and new funding rules for indexation (if applicable).

Disclosure Requirements

The Regulation requires plan administrators to send annual statements to active members and biennial statements to retired members and former members. For the first statement sent to active members, former members or retired members once the proposed new funding framework is in effect, the administrator would be required to include an explanation that funding rules have changed, including a description of the reduction in solvency funding requirements from 100% to 85% and a description of the requirement to fund a PfAD on a going concern basis.

Consequential Amendments regarding Surplus

Certain regulatory adjustments to the rules for surplus withdrawal from a continuing plan would be made to maintain consistency with the funding rules. Note that Bill 177 requires an additional amount to remain in a continuing pension plan after a surplus withdrawal in respect of the PfAD (see Schedule 33, s. 30 of Bill 177).

When assessing if a plan has a surplus, the Regulation currently requires that the greater of the going concern liabilities and the solvency liabilities be used.

The Regulation would be amended to require that, when determining whether a plan has a surplus, the liabilities used would be the greater of:

- the solvency liabilities plus the liabilities for any benefits excluded from the solvency liabilities (other than those payable under qualifying annuity contracts); and
- the going concern liabilities plus the PfAD in respect of the going concern liabilities.

The same liabilities would be used to determine the requirements for the amount of remaining surplus after a withdrawal is made from a continuing plan under subclause 79(1)(d)(ii) of the *Pension Benefits Act*.

Furthermore, surplus plan assets would not be available for assessments that employers are required to pay to the Pension Benefits Guarantee Fund, meaning s. 7(4) of the Regulation would be repealed.