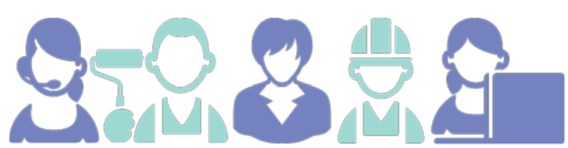
REVIEW OF ONTARIO'S SOLVENCY FUNDING FRAMEWORK FOR DEFINED BENEFIT PENSION PLANS

A Consultation Paper



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Introduction and Mandate

Over the last several years, sponsors of defined benefit single employer pension plans (DB SEPPs) have faced funding pressures associated with persistently low interest rates.

To assist plan sponsors following the 2008 global recession, the Ontario government provided temporary solvency funding relief in 2009 and again in 2012. The intention was to provide sponsors with additional time to fulfil their obligations during unfavorable economic conditions.

However, low interest rates have persisted and many plan sponsors continue to face challenges stemming from their solvency funding obligations under Ontario's *Pension Benefits Act* (PBA). The successive rounds of temporary solvency relief indicate a review of existing pension funding rules would be useful to ensure that they are appropriate for different economic conditions, including those currently affecting the pension system.

While pension funding obligations can be challenging for plan sponsors, they play an important role in providing pension plan beneficiaries with a secure level of benefit.

Recognizing the different interests involved, the 2015 *Ontario Economic Outlook and Fiscal Review* announced the government's plan to:

- Extend the temporary solvency relief, provided in 2009 and 2012, for an additional three years to assist private sector plan sponsors; and
- Review the current solvency funding framework.

The stated purpose of the solvency funding review is to develop "a balanced set of solvency funding reforms that would focus on plan sustainability, affordability and benefit security, and take into account the interests of pension stakeholders – including sponsors, unions, members and retirees." Further temporary solvency relief measures are intended to provide plan sponsors with flexibility as the funding review proceeds.

The 2016 *Ontario Budget* announced further details of the solvency funding review, including the appointment of David Marshall, former president and CEO of the Workplace Safety and Insurance Board to lead the solvency funding review, as well as the government's intention to establish a Stakeholder Reference Group (SRG). These measures are intended to ensure that any reforms to the existing solvency funding framework are balanced and informed by a broad range of stakeholder opinions.

The SRG has now been established. Working with this group and David Marshall, significant consultation with stakeholders, including sponsors, unions, retirees, the broader public sector and experts, has begun to take place.

It should be noted that the focus of this consultation is the reform of funding rules for defined benefit (DB) plans. In 2015, the Ministry of Finance (MOF) released a consultation paper outlining a potential framework for target benefit multi-employer pension plans (TB MEPPs). It is anticipated that most specified Ontario multi-employer pension plans (SOMEPPs) would become TB MEPPs and their current temporary solvency funding exemption would become permanent. Multi-employer pension plans (MEPPs) that do not become TB MEPPs would be required to fund according to the general rules applicable to DB pension plans in Ontario. As a result of these linkages, the DB solvency funding review and the framework for TB MEPPs are being developed in parallel.

How to Participate

The Ministry of Finance is seeking feedback from all interested parties on how best to revise the funding framework for DB pension plans in Ontario.

While some parts of this paper are of a more technical nature, comments at any level of detail are welcome.

Feedback on issues relating to the funding of DB pension plans can be submitted to pension.feedback@ontario.ca or mailed to:

Solvency Funding Review
Pension Initiatives Unit, Pension Policy Branch
Ministry of Finance
7 Queen's Park Crescent
5th Floor, Frost Building South
Toronto, ON M7A 1Y7

Submissions must be received by September 30, 2016.

Context for Solvency Funding Review

Current Pension Landscape

Workplace pension plans, and DB pension plans in particular, are an integral part of Ontario's retirement income system. They provide employers with a tool to attract and retain talent, while giving employees a valuable source of retirement income.

At the end of 2015, there were 1,527 DB pension plans registered in Ontario with 3.5 million members (total of active, former, and retired members). This includes:

- 1.2 million members of 1,440 DB SEPPs (including over 1,000 plans continuing to accrue DB benefits);
- 950,000 members of 77 multi-employer pension plans (MEPPs); and
- 1.3 million members of 10 jointly-sponsored pension plans (JSPPs).

Over the last number of years, both the number of DB plans in Ontario and percentage of Ontario workers with membership in DB plans have been on the decline. In particular, over the last decade, the number[1] of plans included in the Financial Services Commission of Ontario's (FSCO) annual *Report on the Funding of Defined Benefit Pension Plans in Ontario* has decreased by 25 per cent. In addition, over approximately the same period, the percentage of Ontarians covered by a DB plan has decreased from 29 per cent to 23 per cent. Finally, as noted in the 2015 *Ontario Long-Term Report*, some employers are following a global trend of switching from DB pension plans to defined contribution plans.

While there are many factors contributing to these trends, the 2008 global recession, the prolonged period of declining interest rates, and recent volatile asset returns have all highlighted the expense and complexity of sponsoring a DB pension plan. As a result, solvency funding has come under increased scrutiny and many stakeholders have called for reform.

In particular, the following concerns have been raised:

1. **Contribution Volatility:** For plans with significant exposure to equity markets, solvency funding may result in volatile contribution requirements because the liabilities are derived from long term bond yields which can change independently of equity returns. Contribution stability allows plan sponsors to more reliably plan the budgetary allocations required by their pension plans. If required contributions are not stable, plan sponsors may conclude they cannot afford the required contributions.

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[1] This number differs from the total number of Ontario registered pension plans and excludes:

- Designated plans, as defined in the *Income Tax Act.*
- Plans where members are no longer accruing future DB or defined contribution benefits.
- Seven large public sector plans.
- Plans that have been wound up or are in the process of winding up.

2. **Procyclical Contribution Requirements:** An economic climate characterized by depressed asset values and low interest rates will generally result in higher solvency funding requirements, which can often occur at times when plan sponsors are already dealing with the negative effects of the economy.

3. **High Cost of Benefit Security:** Solvency funding assumes that a DB pension plan will wind up on a specified date; however, plan sponsors often view a pension plan as a long-term investment in their employees. Even for financially sound companies, large solvency deficiencies divert capital that could otherwise be invested in the business and may impede business transactions.

4. **Complexity and Lack of Transparency:** The current funding regime can be difficult to understand; plan beneficiaries are often unclear on the financial state of their pension and may believe, incorrectly, that their benefit is completely guaranteed. While the goal of Ontario's funding regime is to promote benefit security, it does not fully guarantee that there would be no possibility of benefit reductions when pension plans wind up as a result of an insolvent sponsor.

5. **Surplus Issues:** Large solvency contributions may later lead to a significant solvency surplus in the plan when market conditions (e.g., higher interest rates) change. Concerns over large surpluses may discourage sponsors from making more than the minimum required contributions or may even lead them to discontinue their plans.

In the current environment characterized by rapidly maturing DB pension plans, de-risking has become an important consideration for pension plan management. De-risking, and in particular, annuity purchase buyouts, are discussed in more detail later in this paper.

The temporary solvency relief provided by the government for DB pension plans in 2009 and 2012 helped to address some of the challenges associated with the economic conditions at the time. To some degree, the temporary relief has worked. According to FSCO, by the end of 2013, the solvency position of Ontario pension plans had improved significantly. While the solvency position has since deteriorated, it is still higher than the levels immediately after the 2008 global recession.

Ontario’s Pension Funding Requirements

The PBA includes minimum funding requirements for pension plans registered in Ontario. The rules are intended to ensure a pension plan has sufficient assets to deliver the pension benefits on an ongoing basis and to protect pension benefits in situations that involve employer insolvency or bankruptcy.

Minimum funding rules are important because in the event an employer sponsor becomes insolvent with an underfunded DB pension plan, plan beneficiaries may not receive their full pension entitlement. While the likelihood of an employer becoming insolvent and having an underfunded DB pension plan in a given year is low, the impact of such an event, should it occur, on pension plan beneficiaries can be severe.

The PBA minimum funding rules include two types of funding valuations to determine contribution requirements and whether a DB pension plan is sufficiently funded.

- The first, called **going concern funding**, assumes that the pension plan sponsor continues indefinitely. The plan's normal cost, or the cost of the benefits earned under the plan in the year following the valuation date, is calculated on a going concern basis. Any going concern funding deficiencies must be eliminated through payments made over a period of 15 years, starting no more than one year after the valuation date.

  In order to calculate going concern funding requirements, an actuary selects best estimate assumptions. In making these assumptions, it is a common practice to look at a plan’s past experience, and make adjustments to reflect the actuary’s own judgment about the future, with input from the plan sponsor. Actuarial standards provide actuaries with broad discretion; setting assumptions is a subjective process.

  In any actuarial valuation, the most important assumption is the interest rate assumption. For a going concern valuation, the interest rate is generally based on the assumed long-term average return of the pension fund.

- The second funding valuation, called **solvency funding**, is intended to calculate the funding required to pay for benefits if the plan were to wind up on the valuation date. Any funding deficiencies are to be eliminated through payments made over five years, starting no more than one year after the valuation date. To determine solvency funding requirements, an actuary has less discretion in selecting assumptions and must use interest rates based on long-term bond yields. A solvency valuation is an objective assessment of the level of benefit security exhibited by a pension plan at a given point in time and adds a degree of rigour to funding requirements.

Solvency valuations and going concern valuations tend to alternate as the driver of pension costs as conditions in financial markets change. For example, during much of the 1990s, when higher interest rates and stronger investment returns were prevalent, solvency funding requirements were quite low. If going concern valuations had not been in place, plans would have had smaller contribution requirements and therefore lower asset values. This would have left many plans in much worse shape when funding requirements were driven much more by solvency valuations after the year 2000. The requirement for dual valuations may explain why DB pension plans have performed better in Canada than their counterparts in other countries.

Prior to 1988, DB pension plans registered in Ontario were only subject to going concern funding requirements. In 1988, regulations under the PBA were introduced to require pension plans to meet solvency funding requirements in addition to going concern funding requirements – a significant change to Ontario's pension funding rules. Solvency funding was introduced primarily to improve funding standards and to provide an early warning of potential funding deficiencies that could jeopardize the security of members' benefits. At the time, going concern funding requirements permitted future indexation to be excluded from the calculation of liabilities. For consistency, Ontario also made the decision to exempt indexation from its new solvency funding requirements.

In 1992, the government modified solvency funding requirements to strike a better balance between funding requirements and benefit security. The amendments maintained the principle of solvency valuation as an important protection for pension benefits, but allowed additional benefits payable on wind up (e.g., certain early retirement benefits) to be excluded from the solvency funding.

Other steps were taken to ease the impact of solvency funding requirements. Plan administrators were permitted to choose to "smooth" or average interest rates and assets over a period of up to five years when calculating solvency funding requirements. The choice could be used to minimize the plan's solvency funding obligations. In addition, the effective dates of actuarial valuations could be chosen at the discretion of the plan administrator, which could have the effect of reducing contribution requirements.

The importance of solvency funding was recognized in the 2008 Report of the Expert Commission on Pensions, *A Fine Balance*. In particular, the Expert Commission argued that, for Ontario DB SEPPs, there was a strong case for continuing the present funding rules (p. 74, Recommendation 4–13). However, the Report of the Expert Commission was written prior to the 2008 global recession and should be considered in light of the changed economic conditions experienced since its release, including the prolonged period of low long-term interest rates.

Despite the various modifications made to Ontario's solvency funding rules over the years, many plan sponsors have found solvency funding requirements particularly onerous since the 2008 economic downturn, compared to previous periods when equity returns were stronger and long term interest rates were higher.

Broader Public Sector (BPS)[2]

Unlike many other jurisdictions, the pension funding rules under the PBA are of general application to both private and public sector plans.

Employer-sponsored DB SEPPs are common in the BPS. As such, the same funding challenges faced by private sector pensions are also placing significant pressure on most BPS plan sponsors. For this reason, BPS plans were not precluded from the temporary solvency relief measures introduced in 2009. In addition, in 2011, the government provided further temporary solvency funding relief to Ontario's BPS in exchange for employers and employees exploring changes that would improve the long-term sustainability of their pension plans.

In 2011, the government permanently exempted six JSPPs in the BPS from solvency funding requirements, as recommended in the Report of the Expert Commission. While there are no stated criteria for exempting these JSPPs from solvency funding requirements, most of these plans are large MEPPs.

In 2012, the government indicated its support for the joint sponsorship model for Ontario's BPS pension plans. To that end, Bill 14, the *Building Opportunity and Securing Our Future Act (Budget Measures), 2014,* made amendments to the PBA to facilitate the transfer of assets from employer-sponsored DB SEPPs to JSPPs and allow employer-sponsored DB SEPPs to be merged with or converted to JSPPs. These legislative amendments, along with the final regulations, were proclaimed on November 1, 2015.

In a JSPP, plan members share responsibility for funding benefits, which could include the requirement to fund a going concern liability or solvency deficiency. Fundamental to the conversion of DB SEPPs to JSPPs has been the question of the solvency status of plans and funding requirements, since plan members must understand the funding responsibilities they are agreeing to assume.

While the focus of this solvency funding review is on funding rules for DB SEPPs, the implications of any changes in this area may extend more broadly to other types of plans. In light of this, the government is seeking feedback from all plans on potential changes in DB pension plan funding requirements.

[2] This term is intended to apply to "Public sector pension plans" as defined under subsection 1(5) of the PBA. Note that this would include plans sponsored directly by the government.

Pension Benefits Guarantee Fund (PBGF)

In 1980, the Ontario government established the Pension Benefits Guarantee Fund (PBGF), which is intended to ensure that a minimum pension benefit level will be paid to members in the event of employer insolvency. With a few exceptions, members of DB SEPPs are covered by the PBGF, which protects the first $1,000 of a plan beneficiary's monthly pension.

The PBGF is administered by FSCO and is funded by assessments paid by employer sponsors of eligible DB pension plans. While the PBGF generally has had sufficient assets to fulfill its obligation to protect the first $1,000 of a retiree's monthly pension, there have been some instances where the government has provided financial assistance to the PBGF in the form of a loan or a grant to ensure the PBGF was able to satisfy claims.

The PBGF is unique to Ontario; no other jurisdiction in Canada has an equivalent program. However, it is important to note that the PBGF's parameters, including the $1,000 guarantee were established in 1980 and based on a system of funding rules which were developed over 25 years ago.

Given the importance of the PBGF to benefit security, any reforms to Ontario's funding rules should consider the future role of the PBGF, the level of benefit guarantee and how the assessments supporting the operation of the fund would be determined.

Solvency Funding Review Objectives

As noted in the 2016 Budget, the government recognizes that this review should lead to the development of a balanced set of solvency funding reforms and take into account the interests of pension stakeholders. The following discussion is intended to articulate the various objectives that the solvency funding review is attempting to balance.

Benefit Security

Pension benefits are a form of deferred compensation. For those with the opportunity to participate, a DB plan is an integral part of their retirement savings plan. A pension benefit is considered fully secure if the pension plan has sufficient assets to ensure its payment. Funding requirements should play an important role in providing individuals who have accrued benefits while working with a level of benefit security. Solvency funding is generally considered the most effective way to protect accrued pension benefits. As indicated above, a limited level of protection of pension benefits for some plan beneficiaries has been provided by the PBGF.

Affordability & Sustainability

To the extent possible, a funding framework should be designed to make contributions to pension plans affordable and to ensure contributions made to the plan will be sufficient to pay out accrued benefits over the long-term.

From the sponsor's perspective, the pension plan can be considered unaffordable if the required contributions place significant pressure on the business. Such pressure can weaken the plan sponsor's commitment to the pension plan. A pension plan is sustainable if, over the long term, it has sufficient assets to meet its obligations. This requires sufficient funding, but if a sponsor considers contribution requirements to be unaffordable, the plan may not be sustainable.

The actual cost of a pension plan depends on the level of benefits the plan pays, the amount of investment and administrative expenses paid by the plan, and the investment income earned on the plan's assets. The cost of a pension plan can be reduced only by lowering benefit levels and expenses or increasing investment income. In DB plans, future accruals may be reduced, but the sponsor has an obligation to provide accrued benefits.

Pension Coverage

The government's goal is to strengthen retirement security for Ontarians. On June 20, 2016, the federal government and provinces, with Ontario playing a leadership role, reached a historic agreement-in-principle to enhance the Canada Pension Plan (CPP). Consistent with the current CPP, the enhanced CPP will, once fully implemented, be a mandatory public pension plan that will provide secure benefits that will be predictable, portable, indexed to inflation and paid for life.

In addition to mandatory savings programs, voluntary savings vehicles such as workplace pension plans are an important source of retirement income for Ontarians. Pension plans also contribute to the economic and social well-being of the province by investing their funds, increasing the purchasing power of pension beneficiaries, and reducing the reliance of older Ontarians on tax-supported income supplements and needs-related, in-kind benefits.

Consideration should be given to how to encourage current DB plan sponsors to maintain existing workplace pension plans as well as whether it is possible to encourage employers to establish new workplace pension plans. However, increasing or maintaining pension coverage by impairing benefit security may not be desirable. Weaker legislated funding requirements also translate to increased risk for the PBGF, an area of interest to the government.

The reform proposals contained in this paper recognize that maintaining the voluntary employment pension system will depend on the ability of such a system to respond to the changing needs of employers and employees. This involves the competing objectives of providing adequate benefits for plan beneficiaries and appropriate funding rules for plan sponsors.

Transparency

Transparent funding rules are important for all stakeholders for different reasons. Clear funding obligations allow plan sponsors to understand their obligations and may reduce regulatory burden. Reduced complexity also better positions plan beneficiaries to understand the state of their pension plan, to assess the risk that may exist, and to make informed decisions.

Any reform measures undertaken should strive to increase the transparency of the funding rules to all interested parties.

Balancing Stakeholder Interests

A robust regulatory regime should balance the often competing interests of DB pension plan stakeholders. For example:

- **Active employees** are concerned with their plans' providing sufficient retirement income, the ease with which their benefits can be transferred from one employer plan to another and their continued employment and corresponding wage levels.
- **Retirees** are concerned with the financial strength of their plan and its ability to continue to provide pensions that maintain their purchasing power.
- **Former members** are concerned with their plan's ability to provide sufficient retirement income as well as purchasing power when they start receiving a pension at a future date.
- **Employer sponsors** are concerned with the cost of providing pension benefits and the rules governing how that cost must be met.

Various professionals, including actuaries, accountants, administration professionals, and pension lawyers have an interest in the regulatory regime within which they practice. Input from these groups is important to ensure that the new funding regime does not cause concerns from an actuarial, legal, or accounting perspective.

The objectives outlined above should be balanced against each other in developing any package of funding reforms. For example, relaxing solvency funding requirements may reduce benefit security for members, but concerns of sponsors about the current requirements may reduce DB plan coverage, which is also undesirable. This consultation is intended to encourage stakeholders to comment on ways to balance these varied interests.

Approaches and Options for Solvency Funding Reform

There are numerous options to reforming Ontario's funding framework for DB plans. This section consolidates the possible options into two general approaches:

A. Maintaining the requirement to fund on both going concern and solvency bases, while modifying solvency funding requirements.

B. Enhancing going concern funding requirements while eliminating current solvency funding requirements.

Each approach is described in detail below. Under each approach, there are a number of options; these are not intended to be mutually exclusive. The paper attempts to outline some of the potential benefits of each option without indicating a preferred approach or option(s).

At the end of this section, additional reform measures to enhance benefit security are considered. These measures could be put in place in conjunction with any of the funding reforms outlined in the paper.

Approach A – Modified Solvency Funding Rules

The underlying objective of solvency funding – to ensure a pension plan has sufficient assets to pay the benefits accrued in the event an employer sponsor becomes insolvent – is sound. However, as discussed earlier, the current economic conditions have highlighted the practical challenges to solvency funding.

Approach A maintains the principle of solvency funding for DB plans and considers possible modifications to existing requirements to address issues identified by stakeholders, including the current economic reality of prolonged low long-term interest rates. This approach generally assumes that existing exclusions from solvency funding (e.g., indexation) would remain in place.

Options for Modifying Solvency Funding Rules

It may be desirable to implement one or a combination of the following options in order to balance their impacts and the varied interests of stakeholders.

Option 1: Average Solvency Ratios

Description

In 2010, the federal government modified its solvency funding regime, requiring pension plans to fund a deficiency derived from an average solvency ratio as opposed to a solvency deficiency identified in any one year. In addition, valuation reports for federally registered pension plans are required to be filed on an annual basis unless the plan is very well funded (i.e. the solvency ratio is 120 per cent or greater). The average solvency ratio is not to be used for other purposes (e.g., disclosure in the annual member statements).

Under this option, a pension plan would calculate the average solvency ratio over three years. The average solvency ratio and the solvency liabilities on the valuation date would then be used to calculate the deficiency to be funded. One fifth of this deficiency would be required to be funded each year. A variation on this method would be to permit plan sponsors to fund according to the lower of the average solvency ratio and the actual solvency ratio on the valuation date.

Rationale

Using average solvency ratios or the lower of the average solvency ratio and the actual solvency ratio on a valuation date would result in less volatile contribution requirements, a significant concern for plan sponsors. To the extent that contribution volatility causes sponsors to close their plans, this option may encourage plan sponsors to continue their DB plans. The use of average solvency ratios would serve to moderate the impact of fluctuations in asset values and interest rates on solvency payments.

This option also enhances transparency by ensuring that all pension plans are funded using the same methodology and plan administrators are not able to employ different methodologies, depending on which results would produce lower solvency funding contributions.

Option 2: Lengthened Amortization Period

Description

The PBA currently requires solvency deficiencies to be amortized over five years. The period of time over which solvency deficiencies must be amortized could be lengthened (e.g., to 10 years).

Rationale

Increasing the amortization period would both reduce the size of solvency payments for underfunded pension plans and moderate volatility.

Option 3: Consolidation of Solvency Deficiencies

Description

Under the current rules, if a plan has a solvency deficiency at a valuation date, a schedule is established and the deficiency must be amortized over five years, beginning within one year from the valuation date. At the next valuation date, assuming a solvency deficiency is identified, another five year schedule is established. Instead of requiring plan sponsors to have different schedules of solvency payments, solvency deficiencies could be consolidated (i.e. "fresh start") and re-amortized at each valuation.

Rationale

Allowing for a "fresh start" at each valuation date would increase transparency by simplifying Ontario's funding rules, making it easier to understand how pension plans are funded. Similar to Option 2, it would also reduce the size of solvency payments for underfunded pension plans and moderate volatility, addressing concerns of plan sponsors.

Option 4: Funding a Percentage of the Solvency Liability

Description

Rather than targeting full funding on a solvency basis, the target could be reduced from 100 per cent to a certain percentage of the solvency liability, reducing solvency payments.

To mitigate the effects of decreased benefit security associated with this option, the $1,000 guarantee provided through the PBGF could be increased. Adjustments would have to be made to the PBGF assessment formula to reflect the larger role the PBGF would be expected to play. However, because the PBGF pools risk, the higher PBGF assessment would likely result in a reduction to the total pension expenditure for the sponsor.

Rationale

This option would address the sponsors' concerns regarding large solvency payments while continuing to provide a degree of benefit security with a link to solvency funding, in a transparent manner.

Increasing PBGF coverage would allow employer sponsors to pool the risk of insolvency among many employers, instead of each having to bear the risk separately. Given that few employers are at risk of insolvency at a particular time, this may provide benefit security while moderating employer contributions.

Option 5: Solvency Funding for Certain Benefits Only

Description

Under this option, normal retirement benefits would be funded on a going concern basis only.

As in Option 4, in order to maintain benefit security in the absence of solvency funding, the guarantee provided by the PBGF could be increased to cover a larger proportion of a pension benefit (i.e., increase the $1,000 PBGF guarantee). Plans offering certain additional benefits, such as subsidized early retirement benefits, could be required to fund such benefits on both going concern and solvency bases. Expanding the PBGF guarantee for only normal retirement benefits would prevent plans with less generous benefits from subsidizing those with richer benefits.

An alternative to this option would be to require the normal retirement benefits to be funded on both going concern and solvency bases. The additional benefits would be funded on a going concern basis only, with additional benefit security provided by the PBGF.

Rationale

This option provides an opportunity to lower contribution volatility and costs for sponsors while pooling risks that DB sponsors face. These impacts would increase the affordability and sustainability of their plans while maintaining a high degree of benefit security for plan beneficiaries.

Option 6: Solvency Reserve Accounts (SRAs)

Description

The intent of solvency funding is to protect against the short-term risk of an underfunded plan winding up with an insolvent employer. If the solvency contributions that were made to reduce this risk are no longer needed because of favourable experience, it may be possible to allow the sponsor to withdraw some surplus through the use of SRAs.

An SRA is a separate account within a pension plan fund established to hold payments made in respect of a solvency deficiency.

Before such withdrawals would be permitted, a sufficient level of surplus would be needed so that future experience losses would be less likely to put benefits at risk.

With the consent of the Superintendent of Financial Services, employer withdrawals up to a prescribed maximum could be made from the SRA when the solvency position exceeded a certain threshold in excess of 100%. These employer withdrawals could be made irrespective of a plan’s provisions.

Rationale

Plan sponsors have expressed concern over large surpluses that could result from high solvency contribution requirements. SRAs address this concern by permitting surplus amounts, subject to certain restrictions, to be withdrawn. This option also balances stakeholder interests by addressing plan sponsors' concerns while maintaining the benefit security provided by solvency funding.

Option 7: Letters of Credit (LOCs)

Description

Currently in Ontario, LOCs obtained from a financial institution can be used to cover solvency special payments for up to 15% of solvency liabilities. A higher limit on the use of LOCs could be considered.

Rationale

In effect, a LOC is a promise to pay the fund an agreed sum in certain circumstances, such as if the plan sponsor fails to renew the LOC prior to its expiration date or fund a deficit on plan wind up. LOCs, while expensive to obtain, are similar to SRAs in that they balance stakeholder interests by addressing sponsor concerns regarding large contribution requirements while maintaining the benefit security provided by solvency funding. In addition, for sponsors who prepare financial statements in accordance with international accounting standards, LOCs could reduce the impact of minimum funding requirements on accounting disclosures.

Questions for Consideration

1. What are the advantages and disadvantages of maintaining but modifying solvency funding requirements?

2. Which option or combination of options would be most effective in balancing the different interests of plan sponsors, unions, members and retirees?

3. Is there an appropriate solvency funding level below 100% which could be required? For example, should pension plans only be required to fund on a solvency basis to 80%?

4. If solvency funding requirements are modified, what changes to the PBGF would help maintain benefit security without placing onerous requirements on plan sponsors?

5. If solvency funding requirements are maintained in a modified way, what would be an appropriate limit on the use of LOCs?

Approach B – Eliminate Current Solvency Funding Rules and Strengthen Going Concern Funding

Some stakeholders have expressed concerns with the premise of solvency funding; that is, to fund a pension plan assuming the pension plan will wind up on the valuation date.

Going concern funding assumes a pension plan will continue indefinitely. Sponsors of DB pension plans often view a pension plan as a long-term investment in their employees and see going concern funding as a more appropriate funding methodology. In addition, stakeholders have expressed particular concern with the volatile and procyclical nature of solvency funding.

It should be noted that while going concern funding is based on accepted actuarial principles, it can be a confusing concept and frequently misunderstood. Statements such as “a plan is fully funded on a going concern basis” may create a misconception among plan beneficiaries that the accrued benefits are secure even if the plan sponsor were to become insolvent. The going concern liability, even if strengthened, does not represent the real cost of paying out the promised benefits for plan beneficiaries at a given time. For these reasons, eliminating solvency funding requirements should be accompanied by strengthened going concern funding requirements.

Approach B considers relying on strengthened going concern funding requirements for DB pension plans as the basis for establishing contributions requirements. An enhanced going concern approach to funding would reduce the financial burden on many plan sponsors as well as result in less volatility. To the extent that plan sponsors are closing DB plans due to cost and volatility, an enhanced going concern approach would encourage current plan sponsors to maintain their existing workplace pension plans.

Solvency valuations could continue to play a role with respect to transparency and disclosure, given such valuations provide valuable information to the regulator and plan beneficiaries; plans could continue to be required to provide solvency valuations and disclose transfer ratios in all filed valuation reports and perhaps more.

Options for Enhanced Going Concern Funding

The following measures could be considered to enhance going concern funding requirements. Similar to Approach A, it may be desirable to implement one or a combination of the following options in order to balance the varied interests of stakeholders.

Option 1: Require a Funding Cushion (Provision for Adverse Deviation)

Description

In the absence of solvency funding, one way to strengthen going concern funding is to require the funding of a cushion, also referred to as a reserve or Provision for Adverse Deviation (PfAD). A PfAD is a required asset amount in excess of a plan's liabilities that must be funded before the plan may take action (e.g., benefit improvements) that could weaken the plan's funded position. A PfAD is typically expressed as a percentage of a plan's liabilities.

While a PfAD would reduce the risk of a plan being underfunded in a wind-up, a PfAD is not a replacement for or equivalent to solvency funding.

The PfAD could be calculated based on the extent to which a plan’s investment strategy is inconsistent with its demographic profile. This would link a plan’s funding requirements to the investment risk to which it is exposed. For example, a mature plan with a large proportion of retirees and greater equity exposure would exhibit a high degree of asset/liability mismatch and therefore require a greater PfAD.

Other factors that could be used to calculate the PfAD could include:

- The benefit provisions (e.g., a final average plan or one with generous early retirement benefits may require a larger PfAD than a flat benefit plan or one with modest early retirement benefits);
- Plan maturity and demographics;
- The plan's interest rate assumptions (e.g., the PfAD could be increased if an aggressive rate of return relative to some benchmark is assumed); and
- The financial strength of the sponsoring entity.

A PfAD could be used to determine:

- When plans might make changes, by requiring a plan to be more than fully funded before allowing any action that could weaken its funded position (e.g. reduce contributions, increase benefits, or withdraw surplus).
- The filing frequency of actuarial reports. For example, a plan could be required to file annual valuations if its assets were less than its liabilities plus its PfAD; otherwise the plan could file valuation reports once every three years.

Rationale
A PfAD can increase benefit security by increasing the assets accumulated in a pension plan, mitigating risks associated with benefit reductions on wind up due to sponsor insolvency. Currently such risks are managed through solvency funding requirements.

A PfAD can also protect plan beneficiaries against the risks associated with actuarial assumptions, benefit improvements, and investment strategies.

Option 2: Shortened Amortization Period

Description
Special payments to fund any going concern unfunded liability could be amortized over a period shorter than the current 15 years.

Rationale
A shortened amortization period would increase contribution requirements and thereby help to improve benefit security.

Option 3: Restrictions on Return on Investment Assumptions

Description

As discussed earlier, actuaries have considerable discretion when selecting assumptions and methods for a going concern valuation of a DB pension plan. The interest rate is typically the most significant assumption in determining the liabilities and current service cost in a going concern valuation.

Regulations could require the Superintendent to periodically set a maximum best estimate interest rate. The best estimate rate chosen by the actuary would not be permitted to exceed this maximum rate.

The approach used by the Superintendent to set the maximum interest rate should not be unduly influenced by short-term financial market volatility and interest rate fluctuations underlying the pricing of fixed income securities. Also, the maximum interest rate could apply to a plan with investments that include no more than a certain percentage of fixed income securities. For plans with a greater exposure to fixed income securities, the maximum interest rate may have to be decreased accordingly.

Another option for determining funding requirements would be to use an interest rate employed in calculating pension obligations on an accounting basis. Under international accounting standards, pension obligations must be valued with an interest rate based on high-quality long-term corporate bonds. This rate could be used to help determine the interest rate for valuing going concern liabilities on a funding basis.

Rationale

Restrictions on the interest rate assumption would be a transparent way to prevent overly aggressive assumptions relating to the rate of return on investments that can be expected by a plan. Requiring more conservative assumptions also enhances benefit security by preventing plan sponsors from relying too heavily on investment returns in order to fund the accrued benefits.

Option 4: Solvency Trigger for Enhanced Funding

Description

Under this approach, solvency could continue to play a role in funding by using a plan's solvency position to determine whether additional funding is needed or if the plan would be allowed to take an action that would weaken its funded position. For example, if a plan fell below a certain threshold of solvency (e.g., 80%), additional funding requirements such as a lump sum contribution could be triggered.

Rationale

Requiring certain actions to be taken if a plan's solvency position falls below a prescribed threshold is an acknowledgement that, irrespective of the funding method, ensuring a specified level of benefit security is paramount. Requiring measures to be taken if a plan were to fall below the threshold would also improve transparency for pension stakeholders.

Option 5: Enhance the PBGF

Description

In the absence of solvency funding, it is likely that plans would have lower asset values on wind up. In the event of a wind-up involving an insolvent employer, the PBGF could be required to fund larger claims. As a consequence, PBGF assessments would likely need to be increased in order to reduce the risk to the PBGF.

The PBGF assessment calculation could also be more sophisticated. For example, consideration could be given to not only the funded status of the plan, but also to other factors such as the extent to which a plan's investment strategy is consistent with its demographic profile. For example, a mature plan with a large proportion of retirees and greater equity exposure would exhibit a high degree of asset/liability mismatch and therefore require a larger assessment to be paid to the PBGF.

The current level of protection provided by PBGF could also be increased. However, coverage could not be increased without appropriately increasing PBGF assessments.

Rationale

Increased assessments to fund the PBGF as well as increased coverage by the PBGF would increase benefit security, which would be particularly beneficial in the absence of solvency funding. In addition, this option allows plan sponsors to pool the risk of employer insolvency among many employers.

An enhanced going concern funding regime complemented by increased PBGF coverage balances stakeholders' interests and could reduce overall costs for plan sponsors, potentially encouraging current plan sponsors to maintain their existing workplace pension plans.

Questions for Consideration

1. What are the advantages and disadvantages of eliminating solvency funding requirements and introducing enhanced going concern funding requirements?
2. Which combination of the options described above would best moderate contribution levels and volatility while providing some degree of benefit security?
3. Are there any other restrictions that could be placed on actuarial assumptions (e.g., salary projection rate for final average plans or mortality assumptions)?
4. Are there other measures to enhance going concern requirements that should be considered?
5. Should a plan's funding requirements be linked through a PfAD to their investment strategies to prevent excessive risk taking?

Additional Complementary Reform Measures

As noted earlier, in a balanced package of reforms, there may be several additional changes that could be introduced along with either Approach A or B described above. A number of these measures would help to balance reforms that could reduce the security of plan beneficiaries' benefits.

1. Annual Valuation Reports

Description

Currently, subject to certain limitations, plan administrators have discretion to choose the effective dates of actuarial valuations which can affect contribution requirements. In addition, pension plans with a solvency funding ratio of greater than 85% are only required to file valuations every three years.

It may be desirable to require pension plans to file actuarial valuation reports annually on consistent dates, irrespective of the funded position of the plan disclosed in the last filed report. Actuarial reports could be required to disclose both going concern and solvency financial positions regardless of any reforms made to the existing funding rules.

Rationale

Establishing set annual valuation dates would increase transparency as well as benefit security. While pension plans that are more than 85% funded on a solvency basis are permitted to file valuations every three years, they may also choose to file a valuation report earlier in order to coincide with favourable economic conditions so as to reduce contribution requirements.

Annual valuations would also provide plan beneficiaries with more regular and accurate information regarding the funded status of their plan.

2. Written Policies

Description

Currently, all pension plans are required to establish and file with FSCO a Statement of Investment Policies and Procedures (SIP&P). Pension plans could also be required to establish and file with FSCO policies related to governance and funding.

Rationale

In addition to promoting benefit security by requiring a disciplined approach to funding, these policies would also provide transparency to plan beneficiaries regarding the governance and operation of their plan.

3. Commuted Values

Description

Commuted value (CV) refers to the lump sum value today of an individual's future pension payments. Standards established by the Canadian Institute of Actuaries prescribe the actuarial methods and assumptions for calculating the CV. In particular, they set out the interest rate and mortality assumptions necessary to do these calculations.

Under the PBA, when an individual terminates employment, there is a requirement to pay 100% of plan member's CV. In order to protect the benefits of the remaining members, the CV could be modified to provide an appropriate termination benefit that balances the best interests of the plan beneficiaries with individuals' portability rights.

For example, the CV could be modified to pay individuals electing to leave the plan an amount that is more reflective of the underlying risk associated with the pension benefit. This could be accomplished by appropriately increasing the interest rate used to calculate the CV.

Rationale

Modifying the CV payout rules would have a direct impact on costs and could directly impact the affordability of plans for sponsors. This option could also help balance the interests of retirees and non-retirees.

4. Restrictions on Contribution Holidays and Benefit Improvements:

Description

The Expert Commission on Pensions proposed that restrictions on contribution holidays and funding benefit improvements be introduced to help strengthen pension plan funding. The government consulted on specific proposals regarding contribution holidays and funding benefit improvements in 2015, but has not adopted any new regulations pending the outcome of the solvency funding review.

Currently, contribution holidays are only permitted if a plan has sufficient surplus on a going concern basis and if there is no solvency deficiency. Contribution holidays could be permitted only if a PfAD (on a going-concern or solvency basis) is fully funded. Furthermore, plan administrators could be required to file annual statements confirming eligibility to continue a contribution holiday.

Restrictions could also be put in place regarding plans' ability to improve benefits. At present, there are no restrictions on benefit improvements beyond the regular funding requirements. In situations where a plan's going concern funded ratio is less than a given percentage, there could be a requirement to immediately fund the portion of a benefit improvement below the threshold and the balance over a period shorter than the amortization period for other funding deficiencies.

Rationale

Restrictions on contribution holidays would prevent plan sponsors from continuing contribution holidays when funded positions have deteriorated since the last filed actuarial valuation report. Enhanced funding requirements for benefit improvements would promote benefit security by making sure that such improvements would not erode a plan's funded position. It would also increase transparency in the collective bargaining process by requiring the more immediate recognition of the cost of a negotiated benefit increase.

5. Administrator Discharge for Annuity Buyouts

Description

Annuity buyouts refer to situations where a plan administrator makes a one-time payment to an insurance company in respect of one or more plan beneficiaries in return for an annuity. By purchasing annuities, plan administrators are able to transfer certain responsibilities of the plan, including the payment of pension benefits, to the insurance company.

Currently, plan administrators retain the pension obligations of the beneficiaries for whom they purchase buyout annuities, unless members elect to transfer their CV out of the plan or annuities are purchased during a plan wind up. These obligations include continued payments to the PBGF, disclosure requirements, and responsibility to make pension payments in the event the insurer becomes insolvent. As such, these continuing obligations make buy-out annuities less attractive to plan administrators.

In order to allow for wider use of buyout annuities, the government could amend the PBA to discharge plan administrators from their obligations if the administrator purchases annuities from insurance companies and certain conditions are met.

Rationale

Annuities provided by insurance companies could provide greater benefit security for the plan beneficiaries. This is because insurance companies have more stringent capital requirements than pension plans. By the nature of their business, they are better focused on managing risk, and in the event of an insurer's insolvency, annuity insurance, through Assuris (an organization that provides specified levels of protection against loss of benefits due to the financial failure of a member Canadian insurance company), provides greater coverage than the PBGF.

Providing a discharge for plan administrators from their obligations if the administrator purchases annuities from insurance companies and certain conditions are met would allow plan administrators to pursue de-risking strategies by transferring certain funding risks associated with interest rates and investment returns to insurance companies. This could mitigate contribution volatility.

6. The PBGF

Description

As described under Approaches A and B above, changes to PBGF coverage could be pursued regardless the Approach selected. The modification to solvency funding rules under both Approach A and B could result in plans having fewer assets to pay benefits. To maintain benefit security, level of benefit guaranteed by PBGF could be increased from the current $1,000. A corresponding adjustment to the PBGF assessment formula would be required to protect the PBGF.

Rationale

Simultaneously reducing funding requirements and increasing the level of benefit guaranteed by the PBGF (in conjunction with adjustments to the PBGF assessment formula) would allow employers to maintain benefit security and reduce overall costs by pooling the risk of employer insolvency among many employers. This may promote, or at least help maintain, the number of individuals covered by a DB pension plans.

Questions for Consideration

1. Which of these measures would be appropriate to help provide balance to a package including one of the two approaches described above? What other measures, if any, could be considered in a balanced reform package?

2. To what extent would annual valuations, and funding and governance policies help to protect benefits if solvency funding requirements are modified or removed?

3. Should restrictions be placed on annuity buyouts that result in a discharge to the administrator? For example, before a discharge is given should a certain funded level be attained? Should buyouts be for retirees and/or former members only?

4. Should recipients of buyout annuities retain their membership status for the purpose of sharing a surplus from a future wind-up?

5. What changes to the PBGF would be needed if solvency funding is replaced by enhanced going concern requirements?

6. Would employers be willing to pay higher PBGF assessments for lower funding requirements?

Next Steps

The consultation paper solicits written feedback from stakeholders, but is not intended to be the only mechanism of consultation. Consultations with the SRG, other stakeholders and subject matter experts will continue throughout the summer and fall.

It is anticipated that any proposed funding reforms will be made available for public feedback in fall 2016. Following stakeholder feedback, necessary legislative or regulatory amendments would be drafted.

Appendix – Solvency Funding Review – Principles and Options

Guiding Principles

1. Benefit Security
2. Affordability and Sustainability
3. Pension Coverage
4. Transparency
5. Balancing Stakeholder Interests

Index of Options

Adjustments to Actuarial Methods, Assumptions and Definitions

1. Provision for Adverse Deviations (see Approach B, Option 1)
2. Prescribe interest rate assumption and possibly other assumptions & methods (see Approach B, Option 3)
3. Average solvency ratio (see Approach A, Option 1)
4. Basis used to calculate commuted values (see Additional Measures, Option 3)

Funding Options

1. Modified amortization period for solvency deficiencies including “fresh start” (see Approach A, Option 2 and Approach A, Option 3)
2. Modified amortization period for going concern unfunded liabilities (see Approach B, Option 2)
3. Conditions for contribution holidays (see Additional Measures, Option 4)
4. Exemption from funding on a solvency basis for certain benefits (see Approach A, Option 5)
5. Funding a percentage of the solvency liabilities (see Approach A, Option 4)
6. Solvency trigger for enhanced funding (see Approach B, Option 4)

Additional funding required for benefit improvements (see Additional Measures, Option 4)

1. Increase limit for Letters of Credit (see Approach A, Option 7)
2. Solvency Reserve Account (see Approach A, Option 6)
3. Administrator discharge for annuity buyouts (see Additional Measures, Option 5)

Modification to the Pension Benefits Guarantee Fund (PBGF)

1. Increase PBGF premium (see Approach B, Option 5 and Additional Measures, Option 6)
2. Increase $1,000 PBGF cap (see Approach B, Option 5 and Additional Measures, Option 6)

Enhanced Disclosure Requirements

1. Annual valuation reports (see Additional Measures, Option 1)
2. Written policies (see Additional Measures, Option 2)

Glossary

Accrued pension benefit

Amount of pension in a defined benefit pension plan that a member or retired member is entitled to receive. The pension being paid to a retired member is the retired member's accrued pension. A member's accrued benefit is the amount of pension the member would receive based on the years of plan membership at a given date.

Actuarial valuation report

A report prepared by an actuary that determines the financial status of a pension plan at a certain date of calculation and the required contributions for a period of time after the date of calculation. Defined benefit pension plans are required to file a valuation report at least once every three years with the regulator. For most defined benefit pension plans, annual valuation reports are required if the solvency funding level falls below a certain threshold.

Commuted value

The lump sum value of a member's accrued benefits as specified by regulation. In a defined benefit plan, the commuted value of a member's benefits is calculated according to standards set by the Canadian Institute of Actuaries.

Contribution Holiday

The use of surplus to reduce required contributions for normal costs by employers and/or members.

Defined benefit pension plan

A pension plan that provides its members with a pension on retirement given by formula, usually based on a flat dollar benefit per year of service or a percentage of salary and length of service.

Defined contribution pension plan

A pension plan in which members accumulate savings in investment accounts that are later used to provide income in the member's retirement. The monthly pension is unspecified.

Going concern funding

This method of pension valuation for a defined benefit plan assumes the plan will continue indefinitely and its assets must be sufficient to meet its liabilities (i.e., the pension benefits) as they come due in the future.

Indexation

In relation to pensions, this is the amount that the monthly pension payment may be increased from one year to the next to provide inflation protection. If indexation is provided, it is often based on the increase in the cost of living as calculated by Statistics Canada.

Jointly Sponsored Pension Plan (JSPP)

A pension plan in which the employer(s) and the members must share responsibility for the funding – including funding for any shortfalls – and governance. JSPPs may be either a MEPP or a SEPP. A JSPP must provide defined benefits to plan members. Benefit reductions, except in wind-up situations, are prohibited. The regulations to the PBA list certain JSPPs that are exempt from solvency funding requirements.

Multi-employer pension plan (MEPP)

A pension plan to which two or more non-affiliated employers make contributions. Members are employed by one of the participating employers, which are usually in the same economic sector.

Normal cost

The ongoing cost to fund the benefits that members are accruing in a pension plan, calculated by an actuary.

Pension Benefits Act (PBA)

The Ontario legislation that establishes minimum standards for registered pension plans.

Pension Benefits Guarantee Fund (PBGF)

A special fund that was established by the Ontario government in 1980 to "top up" the first $1,000 per month of certain defined benefits for members in Ontario if the plan is wound up and funding requirements cannot be met (e.g., the employer sponsor is bankrupt).

Single-employer pension plan (SEPP)

A pension plan covering workers employed by a single employer or by employers that are affiliated.

Specified Ontario Multi-Employer Pension Plan (SOMEPP)

Until August 31, 2017, a MEPP can be a SOMEPP and, as a consequence, have a solvency funding exemption, if the administrator files an election and the MEPP satisfies criteria in s. 6.0.2 of Regulation 909 under the PBA.

Solvency funding

This method of valuation for a defined benefit plan assumes the plan is being wound up as of the valuation date so that its assets will have to be used immediately to meet its existing liabilities. Solvency funding requirements are meant to help ensure that the plan assets could fund all liabilities if the plan were to wind up.

Surplus

Plans are considered to be in “surplus” if they have more assets than required to meet their anticipated obligations on both a going concern and a solvency basis, based on actuarial valuation reports. It should be noted that the amount of surplus remains “notional” (determined by actuarial assumptions) until a plan is actually wound up, at which time, the surplus, if any, is crystallized.

Target benefit pension plan

A pension plan whose goal is to provide its members with a specified monthly pension on retirement, but is funded with fixed contributions and can address funding shortfalls by reducing accrued benefits.