FTR Now

Review of Ontario’s Solvency Funding Framework for Defined Benefit Pension Plans Sets Out Potential Options For Change

Date: August 22, 2016

As described in our *FTR Now* of July 26, 2016, *Marshall Consultation Paper on Ontario Pension Solvency Funding Framework Released*, the Ontario government is undertaking a review of the current solvency funding framework (the Marshall Review) under the Ontario *Pension Benefits Act* (PBA). Following significant consultations with stakeholder groups, the Ontario government released a consultation paper on July 26, 2016 seeking feedback on a number of possible changes to the current solvency funding framework applicable to defined benefit (DB) pension plans.

In this *FTR Now*, we briefly summarize the options identified in the *Review of Ontario’s Solvency Funding Framework for Defined Benefit Pension Plans* (the Consultation Paper). The Marshall Review is a key opportunity for employers to inform the government’s policy on DB pension plan funding. As unions, retirees, and representatives of members will likely be making submissions in response to the Consultation Paper, we encourage employers to provide feedback as well.

Background

Under the current funding Ontario PBA framework, most DB plans are subject to rules that apply equally to both private and broader public sector (BPS) pension plans. In general, the assets and liabilities of DB pension plans are required to be valued and funded on both a going concern and a solvency basis. For over a decade, many DB plans have been significantly underfunded on a solvency basis, primarily due to low long-term interest rates. Due to the cost and unpredictability that solvency deficiencies and the current solvency funding requirements place on employers, in 2009, 2012 and 2016, three separate rounds of temporary solvency funding relief have been provided under the Ontario PBA. Other Canadian jurisdictions have responded to the DB funding concerns by making permanent changes to the funding rules applicable to DB pension plans. For example, in 2016, Quebec eliminated solvency funding, but enhanced the going concern funding requirement and in 2014 and 2015, Alberta and British Columbia introduced solvency reserve account provisions.

The Marshall Review was commenced to respond to these longstanding systemic funding problems. The Marshall Review is guided by the following stated objectives: benefit security, affordability and sustainability, pension coverage, transparency and balancing stakeholder interests. These objectives inform the options set out in the Consultation Paper.

As background to the Marshall Review, it is important to note that Ontario maintains the Pension Benefits Guarantee Fund (PBGF), which effectively provides insurance coverage for up to the first $1,000 per month of a member’s DB pension in the event that a DB pension plan is wound up with insufficient assets and the employer is insolvent. Employers who provide DB plans pay assessments to fund the PBGF. The PBGF is the only pension insurance scheme of its kind in Canada. As noted in the Consultation Paper, the existence of the PBGF will invariably be taken into account by the Ontario government in future changes to the funding regime.

The Consultation Paper also specifically addresses funding issues in the BPS, which has received sector specific temporary funding relief in recent years. The Consultation Paper suggests that changes to the general PBA funding rules may extend more broadly to all forms of BPS plans, including jointly sponsored pension plans.

The Consultation Paper sets out two broad approaches to changing the current funding framework, with a number of options under each approach. These two approaches and the options identified in the Consultation Paper for each is summarized below. One or more of the options could be implemented under the approach that is ultimately adopted.

Approach A – Modifying Solvency Funding

Approach A maintains the principle of solvency funding for DB plans and considers possible modifications to existing funding requirements to address issues identified by stakeholders. Under Approach A, the Consultation Paper identifies seven possible options for reform.

Option 1- Average Solvency Ratios. A pension plan would calculate the average solvency ratio over three years and the plan would be funded on the basis of the average solvency ratio. This approach was adopted for federally regulated plans in 2010. A variation could be to fund according to the lower of the average solvency ratio and the actual solvency ratio on the valuation date.

Option 2 – Permanently Lengthened Amortization Period. The amortization period for solvency funding could be extended from five years to a longer period, such as 10 years.

Option 3 – Consolidation of Solvency Deficiencies. When each actuarial valuation of a DB plan is performed and filed, all solvency deficiencies could be consolidated and re-amortized. This option was made available in the prior Ontario temporary measures and provides a “fresh start” for funding of the consolidated deficit at each valuation.

Option 4 – Funding Only a Percentage of the Solvency Liability. Under this option, DB plans would not be required to fund to 100% but would be required to fund to a lower threshold (e.g., 80%). It is possible that the PBGF assessment formula could be increased if this option is adopted.

Option 5 – Solvency Funding for Certain Benefits Only. Under this option, normal retirement benefits would be funded on a going concern basis only and only specific benefits (such as subsidized early retirement benefits) would be funded on both a going concern and a solvency basis. Alternatively, normal retirement benefits could be funded on both a going concern and a solvency basis, while enhanced benefits would be funded on only a going concern basis. This option could include changes to the PBGF to enhance coverage for normal retirement benefits.

Option 6 – Solvency Reserve Accounts (SRAs). SRAs “ring-fence” solvency payments made by employers and allow employers to withdraw assets if and when surpluses arise. SRAs were introduced as an option for employers funding pension plans that are subject to Alberta and British Columbia pension legislation.

Option 7 – Letters of Credit. Currently letters of credit can be used to cover special payments up to 15% of a pension plan’s solvency liabilities. A higher limit could be implemented to allow increased use of letters of credit.

Approach B – Eliminating Current Solvency Funding Requirements

Approach B eliminates solvency funding requirements and strengthens the going concern funding requirements for DB plans. Although solvency funding is not required under Approach B, plan administrators would continue to be required to prepare and file solvency valuations. Under Approach B, five options are discussed in the Consultation Paper.

Option 1 – Provision for Adverse Deviation (PfAD). DB plans could be required to maintain a funding cushion, referred to as a PfAD, which is typically expressed as a percentage of a plan’s liabilities. This is the model adopted in Quebec, which eliminated solvency funding earlier this year and now requires enhanced going concern funding. A PfAD could be calculated based on a variety of factors including: the plan’s investment strategy; the plan’s benefit provisions; the plan’s interest rate assumptions; and/or the financial strength of the sponsoring entity.

Option 2 – Shorten the Amortization Period. Currently, the amortization period for funding going concern unfunded liabilities is 15 years. This period could be shortened (e.g., five or eight years).

Option 3 – Restrictions on Return on Investment Assumptions. Under this option, the discount rate, which is the key assumption used in preparing the going concern valuation of a DB plan, would be regulated. A maximum best estimate interest rate would be set by the regulator, which could depend on the percentage of fixed income securities held by a plan. An alternative would be to use an interest rate employed in calculating pension obligations on an accounting basis (in the private sector, this is typically based on high-quality long-term corporate bonds but this would be different in the BPS).

Option 4 – Solvency Trigger for Enhanced Funding. Although solvency funding would not be required, additional funding (e.g., lump sum contributions) would be triggered if the solvency position of a DB plan falls below a specified level (e.g., 80%).

Option 5 – Enhance the PBGF. If solvency funding is removed, the Consultation Paper states that, due to increased risk on the PBGF, the PBGF assessments employers pay could be increased.

Additional Complementary Reform Measures Noted in the Consultation Paper

In addition to the options under both Approaches, the Consultation Paper sets out the following “complementary reform” options on which it seeks stakeholder feedback:

1. DB plans could be required to file annual valuation reports.
2. In addition to Statements of Investment Policies and Procedures, DB plans could be required to maintain and file written governance and funding policies. This requirement was implemented recently in Alberta and British Columbia.
3. The rules regarding commuted value (CV) calculations could be modified to reflect a “more appropriate” termination benefit. For example, the interest rate used to calculate CV payments could be increased.
4. Restrictions on contribution holidays and benefit improvements could be imposed. Restrictions on benefit improvements could require accelerated funding of an improvement if made while the plan is funded below a specified level (e.g., 85%). Proposed restrictions on contribution holidays could limit contribution holidays unless the plan is funded to at least 105% on a wind up basis. Restrictions on contribution holidays and benefit improvements have been the subject of prior consultation. It is likely that prior proposals would be reissued and perhaps revised depending on changes made to the PBA regulations.
5. To support more de-risking of DB plans, the Consultation Paper indicates that a statutory discharge could be implemented to relieve administrators of liabilities after a buyout annuity has been purchased.
6. The Consultation Paper reiterates that possible changes to the PBGF could be pursued regardless of the Approach that is selected, such as increasing the level of benefits covered by the PBGF along with a corresponding adjustment to the PBGF assessment formula.

Employers Encouraged to Make Submissions

The Consultation Paper invites submissions from interested stakeholders before September 30, 2016. The feedback will be considered in the process of developing the proposed funding reforms, which are expected to be published for additional public consultation before they are finalized.

The current PBA funding rules have been in place for almost 30 years – the framework was implemented in 1988. Through the Marshall Review, the Ontario government has committed significant effort and resources to review alternate models that will achieve the stated objectives. The Marshall Review is an important opportunity for employers to inform the government’s proposed changes to the funding framework and, as such, we encourage employers to make submissions. The desirability of the various options set out in the Consultation Paper will vary amongst employers. Employers will need to consider all of the various options carefully and how they would impact the DB plans they sponsor as a precursor to making any submissions.

If you have questions about the solvency review, or would like assistance to make a submission, please contact Natasha D. Monkman at 416.864.7302, or any member of the Hicks Morley Pension, Benefits & Executive Compensation Group.

The articles in this client update provide general information and should not be relied on as legal advice or opinion. This publication is copyrighted by Hicks Morley Hamilton Stewart Storie LLP and may not be photocopied or reproduced in any form, in whole or in part, without the express permission of Hicks Morley Hamilton Stewart Storie LLP. ©