FTR Now

Ringing in the New Year with New Pension Plan Funding Rules

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As previously discussed, the Ontario government has been developing new pension funding rules for Ontario defined benefit (DB) pension plans. On December 14, 2017, the government released the highly anticipated details of the new pension funding rules for single employer DB plans (Funding Framework). The Funding Framework provides the basis for amendments to the funding-related provisions of the *Pension Benefits Act* (PBA) regulations and supports related amendments to the PBA found in Bill 177, the *Stronger, Fairer Ontario Act (Budget Measures), 2017* (Bill 177) that were recently passed but are not yet in force. The government is seeking comments on the Funding Framework until January 29, 2018, after which the necessary regulatory amendments will be finalized. The government intends for the new funding rules to be applicable to DB plan actuarial valuations dated on or after December 31, 2017 that are filed after the Funding Framework becomes effective.

This *FTR Now* describes the Funding Framework and the likely transitional rules that will be of considerable interest for employers when planning for 2018 and beyond, as well as related complementary measures.

Reduced Solvency Deficiencies

At the centre of the Funding Framework are the changes to the solvency funding rules applicable to DB plans. Solvency funding values a DB plan on the basis that the pension plan has wound up on the date of the valuation and all liabilities have come due, which results in significant and volatile funding obligations. While the Ontario government has not proposed the complete elimination of solvency funding (which was the approach taken by the Quebec government in 2015), the solvency funding requirements will be significantly reduced.

As expected, the Funding Framework confirms that employers will no longer be required to fund to 100% on a solvency basis. Instead, solvency funding special payments will be required only where a pension plan is less than 85% funded. The employer will be required to make special payments to fund the pension plan back up to 85% over five years, with special payments starting no later than 12 months after the date of the last filed valuation.

Letters of credit will continue to be permitted to cover an amount of solvency special payments owing to a DB plan, up to 15% of the pension plan’s liabilities. Where letters of credit are currently in place, the employer may be permitted to reduce or eliminate the letter of credit based on the requirement to only fund on a solvency basis if the pension plan is less than 85% funded.

Enhanced Going Concern Funding

The *quid pro quo* for reduced solvency funding obligations will be enhanced going concern funding. This will be achieved through accelerated going concern funding and the implementation of a Provision for Adverse Deviation (PfAD), which is a funding cushion. Going concern funding values a DB plan on the basis that the pension plan is ongoing and is more consistent with the long-term objectives of a pension plan.

Under the Funding Framework, going concern unfunded liabilities will be amortized over 10 years instead of the current 15 years. This will increase the required special payments in each year of a funding schedule if there is an unfunded liability identified in a valuation report.

The Funding Framework will also provide a “fresh start” on going concern amortization schedules every valuation, such that going concern unfunded liabilities are consolidated and re-amortized each valuation. However, special payments to fund benefit improvements (discussed below) and for past service unfunded liabilities for new pension plans will have separate, fixed schedules.

PfAD Formula Revealed

While most of the details regarding the reduction of solvency funding requirements and the enhancement of the going concern funding rules are consistent with the government’s prior announcements, the Funding Framework contains important new details regarding the manner in which the PfAD will be calculated. The PfAD must be funded by the employer (except in jointly sponsored pension plans that are not exempt from solvency funding, in which case, the members may also contribute to the PfAD). Employers who have not been able to estimate their funding costs under the new rules without the PfAD formula can now begin to calculate the potential impact of the Funding Framework for their pension plan(s).

The PfAD shall be determined as a percentage of a DB plan’s going concern liabilities and normal cost (but will not apply to future indexation going concern liabilities or normal cost). The PfAD in respect of going concern liabilities will be included in the plan’s going concern unfunded liabilities and amortized over 10 years as discussed above. The PfAD in respect of the normal costs will be paid along side the annual normal costs of the plan. Under the Funding Framework, the PfAD will be determined as the sum of the following three components:

Open v. Closed Plans: The first component of the PfAD is a base funding requirement depending on whether the DB plan or component is “open” to new members or “closed” to new members. An open DB plan will have a fixed PfAD component of 4%. If a DB plan or component is closed to new members, the plan will have a fixed PfAD component of 5%.

Plan Asset Mix: The next component of the PfAD is determined based on the target asset mix of the pension plan (as specified in the pension plan’s Statement of Investment Principles and Procedures) and is designed to encourage plans to select investments that are “appropriate for funding long-term pension obligations.” As a result, the more heavily weighted a DB plan is towards investments in non-fixed income assets, the higher the PfAD will be.

Non-fixed income assets will include all equities and employer issued securities. However, the regulations may specify characteristics of investments that do not qualify as fixed income assets for purposes of the PfAD calculation. In addition, 50% of alternative investments will be considered non-fixed income assets for purposes of the PfAD calculation.

Fixed income assets will include bonds, cash, term deposits, short-term notes and treasury bills, GICs and insured contracts, such as annuities held as plan assets. Investments that have both fixed and non-fixed income, such as mutual funds or balanced funds, will be allocated depending on the securities held by the specific fund.

This component of the PfAD calculation is determined based on the following table:

% 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%

Discount Rate: The final component of the PfAD calculation will be determined based on the DB plan's going concern discount rate. The discount rate is an actuarial assumption relating to the assumed rate of return on the plan's assets. An additional amount will be added to the PfAD if a DB plan's discount rate exceeds a benchmark discount rate (BDR). The BDR will be the sum of (i) the Government of Canada long bond yield in the month of the valuation, (ii) the proportion of the plan's asset mix allocated to non-fixed income multiplied by 5%, (iii) the proportion of the plan's asset mix allocated to fixed income multiplied by 1.5% and (iv) 0.5% for diversification.

This component is intended to reduce the likelihood of plans selecting inappropriately high discount rates to reduce contribution requirements. The additional PfAD amount will be determined by multiplying the duration of the plan's going concern liabilities (e.g. 15 years) by the difference between the plan's best estimate discount rate and the BDR.

For most DB plans, which are commonly invested in 50-70% non-fixed income assets, it is anticipated that the PfAD will likely range between 7% to 16%.

Restrictions on Benefit Improvements

The Funding Framework also prescribes long anticipated limits for benefit improvements based on a plan's funding level. Benefits may only be improved if the solvency ratio of the plan would be at least 85% and the going concern funded ratio would be at least 90% after the improvement is made. An additional lump sum contribution to the plan could also be made to the plan to satisfy these requirements in order to permit the benefit improvement. Benefit improvements could also be fully or partially funded by available surplus.

Accelerated funding will also apply to benefit improvements. An increase in going concern liabilities and the PfAD related to a benefit improvement will need to be funded on a going concern basis over five years and the additional payments must be funded on separate schedules from other going concern special payments. The enhanced funding requirements will begin on the effective the date of the amendment providing for the benefit improvements.

Limits Applicable to Contribution Holidays

The Funding Framework will also establish long awaited thresholds that will govern when a contribution holiday is permissible for normal cost and PfAD contributions. In order for a contribution holiday to be permissible, the plan's PfAD must be fully funded on a going concern basis. In addition, the contribution holiday must not reduce the solvency assets such that the transfer ratio (the ratio of the plan's assets to liabilities) will be below 1.05. The Funding Framework also indicates that new notice and filing requirements will apply to contribution holidays. With the exception of designated plans or individual pension plans, a contribution holiday may be taken only if an actuarial cost certificate is filed with the Superintendent of Financial Services (Superintendent) within the first 90 days of the plan's fiscal year.

The value of assets that may be used to take a contribution holiday for a year will be limited to 20% of the plan's available actuarial surplus for the fiscal year, as identified in the plan's last filed valuation report. The available actuarial surplus will be the 20% of the lesser of the excess of going concern assets over all going concern liabilities (including the PfAD in respect of going concern liabilities) or the amount by which the solvency assets could be reduced such that the transfer ratio would equal 1.05. The amount of the actuarial surplus that will be permitted to be used for the contribution holiday for normal costs and for the PfAD on normal costs will be the lesser of the amount of available actuarial surplus in the last filed report or the amount of estimated available actuarial surplus in the actuarial cost certificate for the specific year.

The new requirements for contribution holidays will be applicable on the valuation date of the first report filed under the

Funding Framework.

Surplus Use and Withdrawals Restricted

Under the Funding Framework, new rules will apply for determining surplus and withdrawing surplus from a continuing plan. Corresponding amendments to the PBA made by Bill 177 require an additional amount of surplus to remain in a continuing pension plan after a surplus withdrawal in respect of the PfAD.

The Funding Framework will also amend the PBA regulation to provide that the liabilities used to determine whether a plan has surplus, including for purposes of withdrawal from an ongoing plan, would be the greater of:

- the solvency liabilities plus the liabilities for any benefits excluded from the solvency liabilities, such as indexation, but not including liabilities payable under qualifying annuity contracts; and
- the going concern liabilities plus the PfAD in respect of the going concern liabilities.

In addition, the PBA will be amended to no longer permit surplus assets to be used for purposes of the employer's payments to the Pension Benefits Guarantee Fund (PBGF).

Transitioning to the New Funding Framework

The Funding Framework contains several provisions relating to the transition from the current funding rules to the Funding Framework. A three-year transition period would be provided to plans if the total contribution requirements under the Funding Framework are greater than the total contribution requirements under the current rules. The increased payments may be phased-in as follows:

- In the first year following the date of the initial valuation report, no increase will be applicable.
- One-third of the increase in contributions will be required to be recognized in the second year after the initial valuation date under the Funding Framework.
- Two-thirds of the increase in contributions will be required to be recognized in the third year after the initial valuation under the Funding Framework.
- The full increase to contributions will be required to be recognized after the three-year transition period.

In addition, as a one-time transition measure, plans will be permitted to apply solvency excess (which will now be determined on the basis of 85% of the solvency liabilities) identified in the initial valuation report to reduce either (i) the amortization period of previously established solvency special payment schedules with six or fewer years remaining or (ii) the monthly payment amount of solvency special payments (as opposed to only shortening existing schedules).

Under the Funding Framework, plans will not be permitted to elect one or more of the temporary solvency relief measures that were introduced in 2016 (for non-public sector plans) and will not be permitted to use the modified solvency asset adjustment available under such relief. Instead, all previously scheduled solvency special payments, including those established under temporary relief measures, will be taken into account when determining a plan's solvency asset adjustment under the Funding Framework.

The Funding Framework also contains specific transition provisions for pension plans in the broader public sector (BPS) that are subject to O. Reg. 178/11, which provides temporary solvency relief for BPS pension plans. For these plans, any valuation report filed before the effective date of the Funding Framework (including those filed before December 31, 2017) may continue to use the BPS funding relief rules. Any valuation report dated on or after December 31, 2017 that is filed on or after the Funding Framework is in effect must use the new rules under the Funding Framework. The restrictions on benefit improvements and contribution holidays set out under the Funding Framework will not apply to BPS plans until the restrictions set out in the BPS funding relief rules expire (which depends on when the plan entered the BPS funding relief regime).

Once the Funding Framework is in effect, plan administrators will be required to include an explanation regarding how funding rules have changed in the prescribed annual statements provided to active members and biennial statements provided to retired members and former members. The explanation will include a description of the reduced solvency funding requirements and the requirement to fund the PfAD.

Discharge for Annuity Purchases

On December 14, 2017, the government also released the description of the proposed rules that, when in effect, will support a discharge of liabilities for pension plan administrators who purchase annuities for former or retired plan members. The annuity discharge is one of the complementary reforms that the government indicated that it would introduce along with the Funding Framework. As previously discussed, the discharge will be available to administrators of single employer DB plans.

In addition to requirements set out in new section 43.1 of the PBA, the PBA regulations will be amended to specify the funding requirements for an annuity purchase. The discharge for annuity purchases will be granted if the solvency ratio of the plan remains the higher of (i) the plan's solvency ratio immediately before the annuity purchase; and (ii) 85% (assuming the Funding Framework is implemented – otherwise, this will be 100%). If the solvency ratio of the plan will be lower after the annuity purchase, the employer must make a lump sum contribution to the plan within 30 days of the annuity purchase in an amount that is sufficient to bring the solvency ratio back up to the higher of the thresholds specified above.

If a plan administrator has already purchased annuities for former members or retired members, section 43.1 of the PBA will permit the plan administrator to take steps to receive the new discharge of liabilities. Similar funding requirements will apply if a plan administrator adjusts the annuity to satisfy the new requirements of section 43.1.

The PBA regulations will also be amended to specify the required content of the annuity contract, which includes:

- a clear description of the benefits purchased;
- statements that money payable under the annuity is exempt from execution, seizure and attachments and that no money may be assigned, charged or transferred except as permitted in the context of a marriage breakdown;
- benefits in the form of a joint and survivor annuity if the annuitant had a spouse at the time that payments commence, unless the spouse has provided a waiver in accordance with the PBA;
- the amount of the life annuity will be determined on a basis that does not take into account the sex of the annuitant;
- on the death of the annuitant before the payments commence, the annuity shall be administered in accordance with the pre-retirement provisions of the PBA; and
- the annuity contract must permit variation in the event of the shortened life expectancy of the annuitant (provided that the related conditions of the PBA are satisfied).

The annuity contract must be filed with the Superintendent.

The PBA regulations will also be amended to specify the content of notices required to be provided to former members and retired members for whom an annuity is purchased before the plan administrator is discharged of liability. The notices will indicate that the annuity has been purchased and that the benefit is the same as provided under the pension plan. The notices must also provide a summary of the insurance contract and the name and contact information of the insurance company. The members must also be advised that the plan administrator intends to seek the discharge of liability and if the plan administrator is discharged, the member will no longer be a member of the pension plan (except for purposes of potential surplus sharing if the pension plan is wound up in the future).

More Details Still to Come

The Funding Framework provides significant details that allow employers to better estimate the impact of the new funding rules on their pension funding costs. However, the Funding Framework does not yet provide details regarding the potential

increased costs associated with expanded coverage of the PBGF (up to the first $1,500 of monthly benefits). In addition, the government has not yet released the details of the new requirements for plans to establish and file funding and governance policies. Once those details are released, employers and plan administrators will need to review any existing policies to determine what, if anything, must be created or amended and filed with the Superintendent.

Please contact any member of our Pension, Benefits and Executive Compensation group with any questions that you may have relating to the Funding Framework or if you would like assistance with a submission to the government regarding the Funding Framework.

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