Solvency Funding Review

Income Security and Pension Policy Division, Ministry of Finance

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Purpose

- Provide an update on the Solvency Funding Review for defined benefit (DB) pension plans, including an overview of:
  - The current funding rules and the Pension Benefits Guarantee Fund (PBGF);
  - The Solvency Funding Review and stakeholder feedback to-date; and
  - Implications of the Solvency Funding Review on Ontario's pension landscape.

- Outline key objectives and analyze possible reform options relating to:
  - The funding rules for DB pension plans; and
  - The PBGF.

- Set out a recommended approach and discuss next steps.

- Outline implications of the Solvency Funding Review on target benefit multi-employer pension plans (TB MEPPs).

Background: Current DB Funding Rules

- Ontario-registered DB pension plans are generally required to meet **going concern funding** and **solvency funding** requirements.
  - Certain classes of plans are treated differently (e.g., jointly sponsored pension plans (JSPPs) have a permanent solvency funding exemption, and specified Ontario multi-employer pension plans (SOMEPPs) have a temporary exemption) (see Appendices A and B).

Going Concern

- Assumes that the pension plan is in place indefinitely.
- Liabilities are calculated using actuarial assumptions, including an interest rate assumption based on the expected rate of return of the pension fund; currently 5.0% - 6.0% (see Appendix C).
- Any unfunded liability financed through special payments amortized over 15 years.

Solvency

- Calculates the funding required to pay for benefits if the pension plan were to wind up on the valuation date. Some liabilities may be excluded (see Appendix D).
- Liabilities are calculated using an interest rate based on current Government of Canada (GoC) bond yields, which is currently around 2.5%. Any funding deficiencies are eliminated through payments made over five years.

Background: Pension Benefits Guarantee Fund

- Created in 1980 to help offset the effects of pension shortfalls on pension plan members and generally applies to single-employer pension plans. The PBGF pools the risk of wind-up across all plans.

- Guarantees the first $1,000 per month of certain defined benefits if a pension plan winds up with insufficient assets and the employer/sponsor is unable to fund the pension shortfalls (e.g., if the employer is insolvent).
  - Certain benefits are not guaranteed by the PBGF (e.g., future indexation benefits and certain early retirement benefits).
  - PBGF entitlements are related to a plan member's age and years of service. Benefits of individuals who do not meet the minimum requirements are not covered.

- The PBGF is intended to be self-financing through annual assessments paid by sponsors of pension plans with covered benefits; funding is based on a per-member base levy and risk-related fees for underfunded plans.

- The assessment amount equals the lesser of:
  - $5.00 per Ontario beneficiary plus 0.5-1.5% of the unfunded solvency liability related to Ontario members; and
  - $300 per Ontario beneficiary.

Solvency Funding Review Overview

- The 2015 *Ontario Economic Outlook and Fiscal Review* announced a review of the solvency funding rules for DB pension plans; further details were outlined in the 2016 Budget, including the appointment of David Marshall to lead the review.
- Extensive consultation took place through a **Stakeholder Reference Group (SRG)**, **roundtable discussions** with representatives from labour, employers, retirees, broader public sector employers and JSPP administrators, and individual **stakeholder meetings.**
  - See Appendix E for further details on the SRG.
- In July 2016, the government released a consultation paper seeking feedback on possible reform options, categorized under two general approaches:
  - **Approach A:** Solvency funding on a modified basis.
  - **Approach B:** Enhanced going concern requirements, with possible reduced links to solvency.
    - Enhancing the PBGF could offset reductions in benefit security from either approach (see Appendix F).
- Generally, stakeholders provided the following feedback:
  - **Employers (public and private):** Prefer enhanced going concern funding model; generally oppose enhancing the PBGF.
  - **Labour:** Supports a solvency funding model; funding requirements should be reduced only with member consent; supportive of enhancing the PBGF.
  - **Retirees:** Oppose elimination of solvency requirements; any reduction of funding requirements should be accompanied by enhancing PBGF coverage.
  - **Pension professionals:** Many prefer an enhanced going concern funding model.

Key Objectives of the Reform

- The Solvency Funding Review was initiated as a result of employers' concerns over high and volatile contribution requirements as well as successive rounds of temporary solvency relief provided by the government.
- Reflecting this, one of the key objectives of the review is to reduce both current contribution amounts and volatility. At the same time, benefit security is one of the main underpinnings of the solvency framework, so maintaining benefit security is another key objective of the review.
- Public statements about the review speak to trying to balance these objectives and interests of stakeholders. As the analysis in the subsequent slides will demonstrate, they are difficult to balance.
- A third objective relates to an emerging government priority related to disclosure and transparency to members, a theme which is echoed in other areas of financial services regulation.
- In summary, the key objectives of the Solvency Funding Review are:
  1. Maintaining **benefit security**;
  2. Reducing both **contribution amounts and volatility**; and
  3. Increasing the **transparency and disclosure** of the funding rules.
- The following slides assess two options against these objectives.

Possible Solvency Funding Reform Options

- The actuarial analysis of the impact of possible reforms led to a focus on the following two options, as being the most feasible and impactful on the objectives:

  1. **Approach A: Modified Solvency Funding, as follows:**
     - Increase the amortization period for funding solvency deficiencies from five years to ten years;
     - Fresh start, i.e., consolidate solvency deficiencies at each valuation date; and
     - Allow employers to withdraw some solvency contributions if a surplus develops by introducing solvency reserve accounts.

  2. **Approach B: Enhanced Going Concern with a "solvency trigger"**
     - Require funding of a cushion, also know as a provision for adverse deviation (PfAD);
     - Shorten amortization period for going concern deficiencies from 15 years to 10 years; and
     - "Solvency Trigger" would require funding if the solvency ratio is below a specified level (e.g., 80% or 85%).

- Under either approach, benefit security could be supported by enhancing PBGF coverage.

Reform Option	Improve Benefit Security	Reduce Employer Contribution amount	Reduce Contribution volatility	Expected Stakeholder Response
Approach A: Modified Solvency Funding	X • Reduced wind up ratio by 5-10 percentage points. • Funding generally approached 100% over 10 or more years.	✓✓ • Decreased contributions on average 5-10 percentage points as a percentage of payroll. • For flat benefit plans (typically in manufacturing sector), decreased 10-15 percentage points over 5 years. • Little change on average over 10 years for all plans.	✓✓✓ • Volatility generally reduced; more significantly over the first 5 years. • Did not require keeping track of different payment schedules, so results in reduced administrative burden for plans and increased transparency for beneficiaries.	• Employers: Not supportive of solvency funding, but some may be moderately supportive that permanent changes being made. • BPS employers: Most believe they should be exempt from solvency entirely. • Labour: Support solvency funding, but would prefer consent for changes. Enhancing PBGF coverage could help. • Retirees: Support solvency funding. May accept changes if PBGF strengthened.
Approach B: Enhanced Going Concern with Solvency "trigger" (80% or 85%)	XX • Reduced wind up ratio by 10-15 percentage points; indexed plans' funding increased 5 -10 percentage points. • Funding did not generally approach 100% over time.	✓✓✓ • For many plans, similar reductions as in Approach A. • Flat benefit plans had decrease of 15-20 percentage points over 5 years. • BPS plan had increase of 0-5 percentage points.	✓✓✓ • Volatility is reduced, particularly for plans funded above solvency trigger.	• Employers: Supportive if PBGF increases are moderate. • BPS employers: Likely would not support a PfAD unless it were small. • Labour: Likely oppose changes. • Retirees: Likely oppose changes, unless solvency trigger is at least 90% and PBGF significantly strengthened.

PBGF Reform Options and Analysis

- Benefit security under any package of funding reform could be increased through enhancements to the PBGF, such as an increase to the current $1,000 maximum monthly guarantee or "cap".

- It is important to note that the average Ontario private sector pension in pay is approximately $1,300 [TBC] per month (excluding MEPPs), and public sector pension in pay (excluding JSPPs) is approximately $2,500 [TBC]. As a result, PBGF changes will vary significantly among plans and among plan members.

- Actuarial modeling was performed to assess the impact of increasing the cap from $1,000/month to $1,500, $2,000 and $2,500:
  - Increasing the cap by any amount would increase the average benefit paid by each of the plans, but in most cases not significantly.
    - For example, for the career average plan modelled, increasing the PBGF cap from $1,000 to $2,500 resulted in the average benefit increasing from 94% to 96%.
  - In general, increasing the cap to $1,500, $2,000 or $2,500 had a larger impact for plans with higher benefits.
    - For example, the career average earnings plan modelled has an average monthly pension less than $500. The impact of increasing the cap is minimal for this plan.
  - In contrast, the broader public sector final average earnings plan that was modelled has an average monthly pension greater than $1,800. As a result, the impact of increasing the monthly guarantee for this plan is more significant.
    - For example, $1,000 guarantee gives 16% their full benefit; $2,500 guarantee gives 37% their full benefit.

Recommendation and Considerations

- Overall, modified solvency funding **best balances the key objectives** of the solvency funding review:
  - This approach would better maintain benefit security;
    - Since modified solvency funding better maintains benefit security, future claims against the PBGF would be smaller than if enhanced going concern funding were introduced, reducing pressure on the sustainability of the PBGF.
  - Both contribution amounts and volatility would be reduced from the status quo; and
  - Provides increased transparency and is easier to communicate to plan beneficiaries than an enhanced going concern funding model.

- This approach would be accompanied by strengthened disclosure requirements (e.g., annual filing on a plan's funding position which would be communicated to beneficiaries).

Recommendation and Considerations (cont'd)

- Modified solvency funding also **best balances stakeholder interests**:
  - Labour would prefer modified solvency funding over enhanced going concern funding, but would be opposed to the reduction in funding requirements particularly without consent. An enhancement to the PBGF would help mitigate this. Labour would not support solvency reserve accounts.
  - Retirees may support modified solvency funding, including a modest reduction in contributions, if it was accompanied by a significant enhancement of the PBGF.
  - Private sector employers will be supportive that permanent changes have been made to modify the existing regime and will appreciate the introduction of solvency reserve accounts. They will likely believe the changes do not go far enough.
  - BPS employers are generally opposed to maintaining solvency funding. However, actuarial modelling illustrates that an enhanced going concern funding regime would generally be more expensive for BPS employers.
  - Many pension professionals will likely agree with private sector employers and generally believe that an enhanced going concern funding regime is desirable as it allows employers to fund their plans over a longer period of time.

Implications for TB MEPPs

- Target benefit pension plans have fixed contributions and are able to address funding deficits by reducing accrued benefits, including pension benefits being paid to retirees.

- TB MEPPs are currently considered DB pension plans under the *Pension Benefits Act* (PBA) and are subject to DB rules, including solvency funding requirements.
  - The PBA currently permits MEPPs established by a collective agreement or trust agreement to offer target benefits; however, no distinct TB framework exists.

- In 2007, the government enacted a temporary solvency funding exemption for Specified Ontario MEPPs (SOMEPPs). This temporary exemption will expire on August 31, 2017.

- In July 2015, the government released a consultation paper that proposed a permanent exemption from solvency funding requirements for TB MEPPs and proposed that they fund on going concern basis with a PfAD, partly funded by contributions.

- A Minister's briefing on a new framework for TB MEPPs is expected to be held later this month.
  - If DB SEPPs continue to fund on a modified solvency basis, it is likely that a TB MEPP framework would be similar to that outlined in the 2015 consultation paper i.e. going concern funding with a PfAD.

Next Steps

	Solvency Funding Review (DB plans, private sector and BPS)	TB MEPP Framework
January 2017	Developed proposed reforms.	Actuarial analysis performed. Developed proposed reforms.
Winter 2017	Seek Minister's direction on TB MEPP framework. Attend JEP/Cabinet on outcome of solvency funding review and direction on TB MEPPs.	
Budget 2017	Outline vision for private sector and BPS DB plans and TB MEPPs, including reference to transition measures for DB plans and TB MEPPs (e.g., extension of the Regulations which expire August 2017).	
Spring-Summer 2017	Attend LRC/Cabinet for approval of transition measures. Draft reform packages.	
Fall 2017	Introduce necessary amendments to PBA, e.g., in fall bill; post regulatory amendments on Regulatory Registry.	
Late 2017/Early 2018	Regulations sent to Cabinet for approval.	

Appendix A: Funding Rules for Different Classes of Plans

- When first implemented 30 years ago, solvency funding rules applied to all DB plans.
- Recent reforms in funding rules and temporary funding relief programs have been enacted so that different classes of pension plans are funded differently.
- In 2007, Ontario provided a temporary solvency funding exemption for specified Ontario multi-employer pension plans (SOMEPPs), a class of multi-employer pension plans (MEPPs).
  - Following a consultation in summer 2015, Ontario is developing a new regulatory framework for target benefit MEPPs, which will include SOMEPPs.
- In 2009, 2012, and 2016, temporary solvency funding relief was provided to DB plans to respond to the funding pressures faced by pension plans resulting from investment losses (in 2009) and low long-term interest rates (all three years).
- In 2011, the government permanently exempted certain JSPPs from the requirement to fund on a solvency basis.
- In 2011, the government also introduced temporary solvency funding relief for public sector single-employer pension plans.
  - The public-sector temporary solvency funding relief measures have reduced the solvency funding requirements for qualifying SEPPs. As a result, plan sponsors were not put in a position where they had to reduce staff or programs and services.

Appendix B: Specified Ontario Multi-Employer Pension Plans (SOMEPPs)

- In 2007, MEPPs meeting certain criteria were temporarily exempted from solvency funding and called SOMEPPs. The eligibility criteria are:
  - At the end of the previous year, no more than 95 per cent of the members of the plan were employed by one employer.
  - During the previous year, at least 15 employers made contributions to the plan or at least 10 per cent of the members of the plan were employed by two or more employers.
  - All or substantially all of the employers who contribute to the plan are not exempt from tax under Part I of the federal *Income Tax Act* .
  - All employers contribute to the plan pursuant to one or more collective agreements.
  - The employers' contributions to the plan are limited to a fixed amount set out in one or more collective agreements.
  - The administrator is authorized to determine the benefits to be provided under the plan, whether or not a collective agreement imposes restrictions on the exercise of that authority.
  - Nothing in the documents that create and support the plan prevents the administrator from reducing the amount of or the commuted value of a pension benefit, a pension, a deferred pension or an ancillary benefit.
- SOMEPPs are be able to maintain that status under current rules until September 1, 2017.

Appendix C: Impact of Interest Rate Assumptions

- The key assumption in determining both the going concern and solvency liabilities is the interest rate.
  - According to recent data released by the Financial Services Commission of Ontario (FSCO), most plans use a going concern interest rate between 5.0% and 6.0%, reflecting the expected rate of return of the fund, whereas solvency interest rates are currently around 2.5%.

- In recent years, GoC bond yields have been much lower than long term average returns on pension funds.
  - As a result, solvency liabilities have exceeded going concern liabilities, and pension plan contributions have been largely determined by solvency funding.
  - In contrast, there have been periods, such as the 1990s, when GoC bond yields were higher than long term average returns of pension funds, and, as a result, plan contributions were largely determined by going concern funding.

- Many sponsors of DB plans have indicated that the resulting large and volatile solvency contributions have posed financial challenges.
  - FSCO reported that the estimated median solvency ratio of Ontario DB plans was 79% as of September 30, 2016. However, as of December 31, 2016, that had improved to 91%, largely because of interest rate increases.
  - As these changes show, basing the solvency interest rate on GoC bond yields contributes significantly to the volatility of solvency contributions.

Appendix C: Impact of Interest Rate Assumptions (cont'd)

- Solvency valuations for DB pension plans in Canada generally use two solvency interest rates, based on the expected form of settlement of the pension benefit on plan wind up.

- One interest rate is for members who may transfer a lump sum out of the plan (e.g. active members). The basis for the solvency rate for transfers is dictated by standards produced by the Actuarial Standards Board and is based on Government of Canada (GoC) bond yields.

- Another interest rate is used for members where an annuity purchase is expected (e.g., retired members). The rates are based on current GoC bond yields, which are a good proxy for annuity rates because insurance companies tend to match liabilities in respect of annuities with bonds.

- Ontario permits plans to use solvency interest rates smoothed (e.g. averaged) over five years.

Appendix D: Benefits not Funded under Solvency Rules

- Ontario funding rules allow plans to exclude from funding liabilities due to the following benefits:
  - Indexation (also called escalated adjustments or cost of living increases);
  - Plant closure benefits (if a previous election was made; no new elections);
  - Permanent layoff benefits (if a previous election was made; no new elections);
  - Special allowances for which a member has not met all age and service eligibility requirements;
  - Consent benefits for which a member has not met all eligibility requirements;
  - Prospective benefit increases not yet in effect;
  - Early retirement window benefits;
  - Pension benefits and ancillary benefits payable under a qualifying annuity contract purchased before Jan. 1, 1993.

Appendix E: Stakeholder Reference Group

- The Stakeholder Reference Group is an eight person reference group with representation from affected stakeholder groups.
  - Intended to ensure reforms are informed by a broad range of stakeholder opinions.

Pension Experts – Employer – Side

- Winston Woo (CME, Director, Taxation, Pensions & Government Programs)
- Caroline Hughes (CME, VP Government Relations, Ford Canada)

Pension Experts – Labour

- Corey Vermey (Unifor, Director, Pensions & Benefits Department)
- Louis Ehrlichman (formerly IAMAW; also served on Financial Services Tribunal)

Retirees

- Robert Farmer (President, Canadian Federation of Pensioners)

Lawyers – Employer-Side

- Elizabeth Brown (Hicks Morley)

Lawyers – Labour

- Simon Archer (Koskie Minsky)

Actuarial Expert

- Allan Shapira (Aon Hewitt)

Appendix F: Overview of Consultation Paper

- The consultation paper released on July 26, 2016 was intended to solicit feedback from affected stakeholders; it did not indicate a preferred approach.
  - To date, over 90 submissions have been received.
- Stated objectives include:
  - Ensuring that **benefit security** is maintained by requiring adequate and appropriate funding of pension plans.
  - Creating a funding framework for pension plans that will **reduce both contribution amounts and volatility**.
  - Encouraging current plan sponsors to **maintain existing workplace pension plans and incent the growth** of the voluntary employment pension system.
  - Increasing the **transparency** of the funding rules.
  - **Balancing stakeholder interests**.
- Reform options were categorized under two approaches.
  - **Approach A** continues to require solvency funding on a modified basis.
  - **Approach B** is based on enhanced going concern requirements, with possible reduced links to solvency.
- Both approaches included the possibility of offsetting any reduction in benefit security by expanding the role of the PBGF.

Appendix F: Overview of Consultation Paper (cont'd)

Approach A – Modified Solvency Funding	Approach B – Enhanced Going Concern	Additional Reform Measures
1. Use three-year average of the solvency ratio. 2. Fund solvency deficiencies over a longer period. 3. Allow solvency deficiencies to be consolidated and re-amortized. 4. Funding a percentage lower than 100% of the solvency liabilities (e.g., 80%). 5. Normal retirement benefits funded on a going concern basis only 6. Solvency reserve accounts 7. A higher limit on the use of letters of credit.	1. Require funding for a provision for adverse deviation (PfAD). 2. Fund going concern deficiencies over a shorter period. 3. Restrict Return on Investment assumptions (e.g., ceiling on interest rate). 4. Additional funding requirements if plan solvency position falls below a threshold (e.g., 80%). 5. Enhance PBGF by adjusting both coverage and assessments.	1. Annual filing of actuarial valuation reports on consistent dates. 2. Filing of governance and funding policies. 3. Modified commuted value payout rules on member termination. 4. Restrict contribution holidays and strengthen funding requirements for benefit improvements. 5. Administrator discharge for annuity buyouts after certain conditions are met. 6. Increase PBGF assessments and increase the $1,000 PBGF cap.