Pension Asset Ceiling

As a follow up to yesterday's meeting regarding the comments provided on your view on the pension asset ceiling test, we have assembled some additional information that we believe should be considered in reaching a conclusion on this issue.

To recap, we understood your view initially expressed to us yesterday to be as follows:

- The pension asset for TPP of $10.1 billion should be written off. The pension asset was created based on the difference in the discount rates used in TPP's standalone financial statements and the discount rate used by the Province, which you described as fictitious.
- You have requested that additional disclosure being included in the financial statements of the Province regarding the Province's ability to realize the benefit of the asset, should the final view conclude the writing off the asset is not required.
- While our discussed focused exclusively on TPP, we have assumed the same view holds for OPSEU. Should that not be the case, please advise.

Province's view

The Province continues to believe that the assets are appropriately stated for the following reasons:

- The assets result from the excess of the contributions and asset returns over the projected benefit obligations. Given there have been no issues raised with respect to either the contributions or the asset returns, we will only focus on the impact of the projected benefit obligation
- The project benefit obligation has been estimated using a discount rate based on the expected return on assets as permitted by PSAB (see paragraph .44 below). That method has been consistently applied by the Province since at least 2000.
- OTPP also used a discount rate based on the expected return on assets until 1999, at which point it changed its policy to use a rate based on high yield corporate bonds. We have attached the 2000 financial statements.

Financial Statements 2000.pdf

<u>PS3250</u>

.042 *Actuarial assumptions should be based on the government's best estimates of expected long-term experience and short-term forecasts.* [SEPT. 2001]

.043 One commonly used approach that meets this standard is the use of streamed rate assumptions. Under the streamed rate approach, the short-term forecast of fund asset earnings, for example, would reflect the rates of return that assets currently held in the fund will earn until their maturity. As those assets mature, assumptions about their expected earnings on reinvestment would move to the expected long-term rate. Similarly, there would be streamed rate assumptions for salary increases.

.020 The retirement benefits interest expense is the net of:

(a) the interest cost on the accrued benefit obligation determined by applying the discount rate determined at the beginning of the period in accordance with paragraph PS 3250.044 to the average value of the accrued benefit obligation for the period; and

(b) the expected return on plan assets for a defined benefit plan, determined by applying the assumed rate of return on plan assets to the average market-related value of assets for the period.

.044 The actuarial assumptions underlying the valuation of the retirement benefit liability and expense would be internally consistent. For example, **when a government determines its discount rates by reference to its plan asset earnings, the assumptions used to determine the short-term forecast incorporated in the discount rates would be consistent with the short-term forecast of rates of return on assets currently held in the fund**. When a government determines its discount rates by reference to its cost of borrowing, the assumptions used to determine the short-term forecast incorporated in the discount rates would be consistent with the specific rates of interest and the periods committed to by the government on the amounts borrowed.

- Though 3250.044 indicates one option is to use discount rates by reference to the cost of borrowing, based on our jurisdictional scan of the other provinces' financial statements, we have not found any jurisdictions that uses the government borrowing rate to value their pension obligations for plans that are funded by plan assets.
- We have included our analysis Pension Discount Rate Analysis for AG.

OTTP

OTTP prepares its financial statements in accordance with Part IV of the CPA Handbook. Section 4600 in part IV provides guidance on accounting for investments and pension obligations. For all other items, a pension plan chooses to follow IFRS or ASPE. OTTP has chosen to follow IFRS.

For the recording of the pension obligation, the guidance in Section 4600 is as follows:

22 *A pension plan shall measure the pension obligation required by paragraph 4600.12(g) in accordance with paragraph 4600.05(v). For this purpose,* ***a pension plan may measure the pension obligation at the defined benefit obligation amount determined by the plan's sponsor.***

.23 Guidance on determining the defined benefit obligation can be found in EMPLOYEE FUTURE BENEFITS, Section 3462, in Part II of the Handbook, and in IAS 19 *Employee Benefits* in Part I of the Handbook.

4600.12(g) is the requirement to distinguish the pension obligation in the statement of financial position and 4600.05(v) is the definition of a pension obligation of a defined benefit pension plan, which states the following, "A pension obligation of a defined benefit pension plan is the actuarial present value of accrued pension benefits determined by applying best estimate assumptions and the projected benefit method prorated on services."

As noted, pension plans have a considerable amount of choice in determining how to account for their pension obligations – the amount as determined by the plan sponsor, using the guidance in ASPE, or using the guidance in IFRS.

OTTP has chosen to use the guidance in IFRS – notably IAS 19 and states in its financial statements (December 2015 year end):

"The discount rate is based on market rates, as at the valuation date, of bonds issued by the Province of Ontario, which have characteristics similar to the Plan's liabilities. The discount rate was determined by applying a weighted average discount rate that reflects the estimated timing and amount of benefit payments. The inflation rate is the geometric difference between the yield on Government of Canada long-term nominal bonds and Government of Canada real-return bonds. The salary escalation rate incorporates the inflation rate assumption and long-term expectation of growth in real wages".

We have included the guidance in from IAS 19 below for comparison:

IAS 19

83 The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. For currencies for which there is no deep market in such high quality corporate bonds, the market yields (at the end of the reporting period) on government bonds denominated in that currency shall be used. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.

86 In some cases, there may be no deep market in bonds with a sufficiently long maturity to match the estimated maturity of all the benefit payments. In such cases, an entity uses current market rates of the appropriate term to discount shorter-term payments, and estimates the discount rate for longer maturities by extrapolating current market rates along the yield curve. The total present value of a defined benefit obligation is unlikely to be particularly sensitive to the discount rate applied to the portion of benefits that is payable beyond the final maturity of the available corporate or government bonds.

- OTTP is an outlier in using a discount rate based on the guidance in IAS 19 based on our review of the stand-alone financial statements of the provincially sponsored plans. We have attached our preliminary analysis.
- We also considered your comment that this asset is a "fictitious asset". The funding valuations completed by OTTP and submitted to FSCO, demonstrate the that plan is overfunded. Based on the guidance provided to the members of the plan on the OTTP's website, the surplus in the plan at March 31, 2016 (at 100%) is $13.1 billion. The difference between the $10 billion asset and the 50% of the $13.1 billion, or $6.5 billion is primarily based on the discount rate used. The preparation of the funding valuation is based on prescribed requirement and is not an accounting valuation. Nonetheless, it speaks to the fact that the plan, on a funding basis, has a surplus.

To summarize:

- The discount rates used to value the projected benefit obligation are consistent with the requirements of PSAB.
- The AG has reviewed the discount rate each year and based on the understanding of those involved in the current year and historically, has never raised a concern with the rates used.
- The asset recorded on the pension's books is not fictitious.