Treasury Board Secretariat 7600 Opinion and OTPP Asset Ceiling Document.pdf

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Deloitte LLP ("Deloitte") was engaged to provide an opinion ("Deloitte Opinion") on the application of accounting standards by the Ontario Treasury Board Secretariat. Our opinion, which was issued on October 2, 2016 and is attached hereto, was prepared under professional standards for such reports.

The Deloitte Opinion addressed the question of whether it was possible to record a pension asset related to the plan surplus in the Province's financial statements, given that the plan is jointly sponsored. We concluded that, based on the information provided to us by the Province and our professional judgement, that it was permissible under PSAS to record a pension plan asset, even though the Province's ability to benefit from any plan surplus, through future contribution reductions for example, would need to be negotiated with and agreed between the Province and OTF.

It is to be noted that even if a pension asset is recorded, PSAS would also require that consideration should be given to limiting the recorded amount of this pension asset to an amount that would be less than the calculated amount of the pension surplus. The Deloitte Opinion did not express a view on whether any limit to the recorded amount of the asset is needed in the case of the Province's accounting for the pension asset related to OTPP. Therefore, our Opinion did not express a view on the amount of the pension asset that should be recorded in the Province's financial statements as at March 31, 2016 or at any other date.

Furthermore, the Deloitte Opinion references an earlier engagement report dated August 18, 2016 (the "Report") entitled "Asset Ceiling Calculations for the Ontario Teacher's Pension Plan" which was prepared in conjunction with management. The Report is also attached hereto. The Report was used by management as part of their analysis to determine that no valuation allowance was required against their Pension Asset as at March 31, 2016. The Report was prepared solely to assist management in preparing their own analysis. We were not engaged to and the Report did not express an opinion on the amount of or need for any valuation allowance. Reference to the Report in the Deloitte Opinion should in no way be construed to be an opinion on that earlier report.

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October 2, 2016

Private and confidential

Ms. Karen Hughes
Associate Deputy Minister,
Treasury Board Secretariat,
7 Queen's Park Crescent
Toronto ON M7A 1Y7

Dear Ms. Hughes:

We have been engaged to report on the appropriate application of certain aspects of Canadian public sector accounting standards to the recognition of the accrued benefit asset (also referred to in this report as the Pension Asset or the Asset) related to the Ontario Teachers' Pension Plan (OTPP the Plan) in the Province of Ontario's (also referred to as the Province or the Government of Ontario in this report) accounts as at March 31, 2016. This report is being issued to the Associate Deputy Minister of the Treasury Board Secretariat of the Government of Ontario. Our engagement has been conducted in accordance with Canadian generally accepted standards for such engagements**.**

It should be noted that the responsibility for the proper accounting treatment rests with the preparers of the financial statements, who should consult with their incumbent auditor. Our judgment on the appropriate application of Canadian public sector accounting standards for the specific issue being discussed is based on the facts, circumstances and assumptions provided to us. Should the facts, circumstances or assumptions differ, our conclusion may change.

Statement of facts and assumptions

It should be noted that the following background and facts represent a high level summary of the situation and represent those facts that we considered important in reaching our opinion. They do not purport to be a complete representation of all of the terms of the OTPP or the agreements between the government and the Ontario Teachers' Federation (OTF). Management has acknowledged their agreement with this summary. If these facts are incomplete or incorrect, then our conclusions may change.

"The (Ontario Teachers') pension plan is jointly sponsored by the Ontario government, through the Minister of Education, and the executive of the Ontario Teachers' Federation (OTF). The OTF represents teachers, while the government represents employers.

OTF and the government are equally responsible for ensuring the pension plan has enough money to meet its long-term pension obligations. In addition, they appoint experienced, professional experts to the pension plan's Board.

Statement of facts and assumptions (continued)
Through a six-member Partners' Committee, the sponsors jointly:

- Set benefit levels
- Establish the contribution rate paid by working teachers (which is matched by the Ontario government and other designated employers)
- Decide how to address funding shortfalls or use surplus funds when they arise"

(Source: https://www.otpp.com/corporate/plan-governance)

The governing and other documents that are relevant to the accounting analysis are as follows:

- Teachers' Pension Act (TPA), including Schedule 1
- Partners' Agreement
- Funding Management Policy (FMP)
- Osler's letter dated September 20, 2016; we have not summarized this letter as it should be read in its entirety.

The assets of the pension plan are held by Ontario Teachers' in trust for the beneficiaries of the plan – teachers. The Government does not have unilateral access to the assets of the trust (including changing contribution amounts, taking contribution holidays, or withdrawals). Actions of this nature require negotiation and agreement between the two sponsors.

The following facts and assumptions have been accepted without further analysis or verification:

- As a jointly sponsored plan, the Plan meets the definition of a joint benefit plan under S. 3250 of the Public Sector Handbook.
- The actuarial and other assumptions that factored into the valuation used for accounting purposes, before considering the appropriateness of the recognition of an asset or the need for a valuation allowance related to any asset, are appropriate and meet the requirements of PS 3250.
- The Plan's most recent preliminary funding valuation reported a preliminary funding surplus of $13.2 billion as at January 1, 2016, as reported on the OTPP website. The OTPP's public financial statements showed a deficit for accounting purposes of $1.8 billion in its financial statements as at December 31, 2015. These financial statements are prepared under accounting standards for pension plans in Part IV of the CPA Canada Handbook, which is a different accounting framework than the Province uses for its financial reporting and is also a different framework than is used to calculate the funding surplus or deficit.
- As at March 31, 2016, there were no written agreements in place to access the Plan surplus to reduce future minimum contributions or withdraw any amounts from the Plan.
- The OTPP is regulated by the Financial Services Commission of Ontario. Valuation reports must be filed with this regulator to monitor that assets of the fund are reasonably sufficient to meet the liabilities of the pension plan on a continuing basis. Per 78(1) of the Pension Benefits Act: No money that is surplus may be paid out of a pension fund to the employer without the prior consent of the Superintendent.

Statement of facts and assumptions (continued)

- Management has received legal commentary about the role of the Superintendent. From this advice, management has concluded that despite this regulation the Province could utilize a surplus through contribution reductions as "Neither the PBA nor the regulations to the PBA (the "Regulations") require the Superintendent's consent for surplus to be *utilized* for a contribution holiday or to amend the contribution formula under the OTPP." Further, although changes to the OTPP text would be required to be registered with the Superintendent, "The authority of the Superintendent to refuse to register an amendment under the PBA (in whole or in part) is limited to circumstances where the amendment is void or if the pension plan with the amendment would cease to comply with the PBA and the Regulations." (Source: Osler memo dated September 26, 2016).
- The Auditor General's Office provided a letter dated September 26, 2016 setting out their views. We have read and considered the contents of that letter.

Relevant Extracts from the TPA

Section 5 (1.1) of the TPA states that the total amount of contributions payable by the Minister of Education and the employers who contribute under the pension plan in respect of any year shall not exceed the amount of contributions payable by or on behalf of active plan members in respect of credited service for that year. There can be instances where contributions would not be equal between the sponsors, such as the government's payments in connection with forgone inflation adjustments.

Section 10 of the TPA provides that the Minister of Education and the executive of OTF may enter into an agreement that provides for, among other things, the joint management of the Plan and the sharing of entitlement to gains or surplus under the Plan and of liability for deficiencies in the pension fund.

Pursuant to Section 10 of the TPA, the Minister of Education and the OTF (collectively the Partners) have entered into an agreement for the management of the Plan (Partners' Agreement), to which is appended a Funding Management Policy (FMP) that is deemed to form part of the Partners' Agreement.[1] The FMP provides a framework for the funding of the Plan and how deficits and surpluses will be addressed. The Partners can deviate from the FMP by agreement.

Relevant extracts from the Partners' Agreement

The Partners' Agreement is between the Province of Ontario and the OTF and sets out the formal relationship between the partners in sponsoring the OTPP. Paragraph 8 of the Partnership Agreement states that the partners will be responsible for designing the Plan structure, setting the benefits of the Plan, developing new policy, deciding what the contribution rate will be, what the funding levels, margins and contingency reserves will be, how to make changes to the Plan and other Plan documents, deciding whether or not to file a valuation more frequently than required by the *Pension Benefits Act,* appointing the OTTP Board, and defining the role of the Board.

Paragraph 74 requires negotiation in good faith regarding changes to the Plan that flow from a valuation that is be filed with the regulators.

Paragraph 75 of the Partners' Agreement requires the Partners to advise the Board of OTPP of what changes affecting benefits and contribution rates they are proposing so that the Board can provide cost estimates and comments on the administrative impact of the changes to both partners as soon as possible.

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[1] Partners' Agreement, section 110.

Relevant extracts from the Partners' Agreement (continued)

If the partners cannot agree on the changes required to the Plan, a mediator is appointed to assist the Partners in coming up with an agreement. The mediator is responsible for submitting a report to the partners on his or her views on the positions of the partners and provide a recommendation to the Partners. If the partners do not accept the mediator's report, the arbitration process will begin and an arbitration board will be appointed. The board will consist of 3 people, with each partner selecting one representative and two appointees will select the final member who is an umpire. Paragraph 94 of the Partners' Agreement indicates that the report created by the arbitration board will be implemented. Paragraph 92 sets some parameters for the arbitration, including part (c), which sets out that the parameters that the award of the arbitration will provide that the contributions from the Minister and employers be equal to those of the members.

In addition to the clauses identified above, the Partners' Agreement has an appendix called the Funding Management Policy which sets out the Partners' responsibilities in making funding decisions and surplus allocation regarding the Plan.

Relevant extracts from the FMP

The FMP is an appendix to the Partners' Agreement that speaks to how the Plan should be funded and how surpluses should be utilized by both parties. The protocol for the use of a surplus under the OTPP is detailed in the FMP adopted by the Ontario Government and OTF as sponsors of the OTPP.

The FMP sets out a complex series of considerations surrounding funding management and the use of any excess of assets over liabilities. The FMP sets out a number of "funding zones", depending on the level of funding in the Plan. The following three are most relevant to addressing surpluses:

i) Restoration zone (Article 3 of the FMP) allows for a surplus to be utilized to "restore" foregone indexation and then to either increase benefits to the "run-rate benefit" level (i.e., the long-term target level) or to lower contributions (or a combination of these two options) (Section 3.06(e)).
ii) Temporary improvement zone (Article 4 of the FMP) is the zone where contributions can be temporarily reduced, a surplus distribution can be made on a temporary basis and/or benefits can be temporarily improved (as long as it does not create a long term cost) (Section 4.05).
iii) Permanent improvement zone is where the Plan is essentially fully funded and has the funding security desired to support permanent changes. Article V (Permanent Improvements) of the FMP provides for permanent actions that can be taken when Plan assets exceed current liabilities by more than 10% of current liabilities. In this regard Section 5.05 provides for actions that can be taken in respect of the amount that assets exceed current liabilities. Such actions can include changes to current benefits, current contributions, or both.

The ability to reduce contributions or increase benefits through the temporary or permanent improvement zone are subject to ensuring that the requirements of 3.06 in the restoration zone are met. Article VIII of the FMP sets out that the parties must agree to any changes arising out of FMP decisions. For filing valuations, if the Partners are unable to agree the mediation process set out in the Partners' Agreement, the arbitration process outlined in the Partners' Agreement will be followed. For valuations that are not filed, either party can decide not to negotiate.

Relevant extracts from the FMP (continued)
It is our understanding that the Plan is currently in the Restoration Zone. We understand that contributions to the OTPP currently include a 1.1% special contribution on all earnings and that the Restoration Contribution Reduction under Section 3.06(e) would if agreed to by both partners, permit this special contribution to be eliminated. This special contribution is scheduled to end in 2026.

If the Plan gets to either the temporary improvement zone or the permanent improvement zone, section 4.06 and subsection 5.05(b) of the FMP provides that a benefit improvement can only occur if the partners (the Ontario government and the OTF) have entered into a written agreement governing the manner in which the contribution by the government and other employers may be adjusted to offset any surplus distribution or benefit improvement (temporary or permanent) to be granted.

Application of accounting principles
Specifically, our report addresses the following questions:

1. Is it necessary for a government to have a legally enforceable right to reduce future contributions in order to recognize a Pension Asset under PS 3250?

2. What is the role of legal uncertainty in assessing the government's expectation of future benefit from a Pension Asset?

Our views in this report are confined to these two questions and do not extend to any earlier reports provided by Deloitte or to any other analysis that may have been presented in draft or in any other manner.

Authoritative literature
In our analysis, we considered the pronouncements and guidance in Section 3250 of the CPA Public Sector Accounting Standards Handbook. What we considered to be the most relevant passages from PS 3250 are reproduced below:

> **The objectives of funding and accounting**
>
> .008 Determining whether a retirement benefit plan should be funded and the amount to be funded each period is a financial management matter. The funding objective is to determine an acceptable policy for financing the estimated ultimate cost of a benefit plan. An actuarial valuation for funding purposes is performed to calculate the contributions required to secure the benefits promised.
>
> .009 The accounting objective is to measure and report the obligation for employee retirement benefits and to attribute the costs of those benefits to the periods in which the related services are rendered. To meet that objective, a method is needed to determine the amount of the obligation for retirement benefits outstanding, which represents the liability at the financial statement date, and the value of the benefits employees earned during the period, which represents the expense of that period. Accordingly, it is necessary to develop accounting estimates of liabilities for retirement benefits and expenses using an actuarial cost method and actuarial assumptions that ensure essential information required for fair presentation of financial condition and results of operations can be reported in government financial statements.

Authoritative literature (continued)

.010 Because the objectives of determining the most appropriate funding policy are not necessarily the same as those of determining the most appropriate accounting method, the liability for accounting purposes may not be the same as the amount due but not yet funded at the financial statement date according to the funding plan. In addition, the retirement benefit expense of the period for accounting purposes may not be the same as the contribution computed in the period for funding purposes.

Actuarial assumptions

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

Joint defined benefit plans

.079 Governments may participate jointly in defined benefit plans where the government shares the risks and rewards jointly with plan participants, represented by a sponsor or sponsors. Joint defined benefit plans are governed by a formal agreement between the sponsors, which establishes that the sponsors have shared control over the plan. A governing board is generally appointed by the joint sponsors with equal representation and a mutually agreed-upon chair.

.080 A government would consider the characteristics of the plan to determine whether it meets the definition of a joint defined benefit plan. In a joint defined benefit plan, funding contributions are shared mutually between the government and the plan members. The sponsors have control over decisions related to the administration of the plan and the level of benefits and contributions on an ongoing basis based on the terms of the contractual agreement. The sponsors share, on an equitable basis, the significant risks associated with the benefit plan. Risk would not be considered to be equitably shared in an arrangement where the government and the joint sponsors fund the plan equally but where the government retains the full risk of the accrued benefit obligation. If the government retains the residual risks it is unlikely that the plan meets the definition of a joint defined benefit plan.

.081 *When a government participates in a joint defined benefit plan, the government's risk is limited to its portion of the plan. The government should account for its portion of the plan in accordance with the standards for defined benefit plans*. [SEPT. 2001]

.082 A government may convert an existing defined benefit plan for which it is the sole sponsor to a joint defined benefit plan where the risks and benefits are shared. When converting to a joint plan, a government would consider whether there are any special accounting issues that arise, including whether the predecessor plan has been settled or partially settled and/or curtailed or partially curtailed. In assessing such issues a government would have regard to its specific circumstances and the terms of the joint defined benefit plan.

Disclosure

.083 The notes and schedules integral to the financial statements would disclose the methods and judgments applied in accounting for accrued benefit obligations and expenses. Full disclosure is particularly important for retirement obligations because the measurements depend heavily upon judgments rather than objective evidence.

Limit on the carrying amount of an accrued benefit asset

.050 *An accrued benefit asset should be presented on a government's statement of financial position net of any valuation allowance. When a defined benefit plan gives rise to an accrued benefit asset, a government should recognize a valuation allowance for any excess of the adjusted benefit asset over the expected future benefit. A change in valuation allowance should be recognized in the statement of operations for the period in which the change occurs.* [SEPT. 2001]

.051 A government with a defined benefit plan may have an accrued benefit asset for accounting purposes. An accrued benefit asset arises when the government's total contributions to the plan, including interest earned thereon, are greater than the retirement benefit expense recognized since the start of the plan. Contributions reflect the funding objectives of the plan. The benefit expense reflects the accounting objectives and may differ for a number of reasons, including the fact that actuarial gains and losses are deferred and amortized in future periods.

.052 A government may benefit from an accrued benefit asset either by withdrawing surplus assets or by taking a contribution holiday or receiving a refund of contributions. The accrued benefit asset may become impaired when there is a plan surplus for accounting purposes that the government is not entitled to benefit from fully. For example, there may be a regulatory moratorium on pension surplus withdrawals or uncertainties as to a government's legal right to use a plan's accounting surplus.

.053 To determine the extent to which an accrued benefit asset may be impaired, the government first determines the adjusted benefit asset . The adjusted benefit asset is the accrued benefit asset less net unamortized actuarial losses (determined on a basis using market value of assets).

.054 The adjusted benefit asset is then compared to the expected future benefit . When the expected future benefit exceeds the adjusted benefit asset, the accrued benefit asset is not impaired and, accordingly, no valuation allowance is required. The chart included as Appendix A to this Section is intended to set out the relationship between the various defined terms.

.055 The objective of the standard in paragraph PS 3250.050 is to limit a government's accrued benefit asset to the amount it can realize in the future. The expected future benefit is a calculated amount representing the benefit a government expects to realize from a plan surplus. An expected future benefit includes any withdrawable surplus or reduction in future contributions.

.056 A government determines its expected future benefit as the sum of:

a) the present value of its expected future accruals for service for the current number of active employees, less the present value of required employee contributions and minimum contributions the government is required to make regardless of any surplus; and

b) the amount of the plan surplus that can be withdrawn in accordance with the existing plan and any applicable laws and regulations.

Limit on the carrying amount of an accrued benefit asset (continued)

.057 A government's expected future accruals for service for the current number of active employees are determined on a basis consistent with that used to determine its accrued benefit obligation. These expected future accruals for service, less required employee contributions and minimum contributions the government is required to make regardless of any surplus, are then discounted back to the current period to determine the present value. The interest rate used to calculate this present value is the expected rate of return on plan assets used to determine the benefit expense in the period.

.058 When administration expenses are paid by the plan and included in the normal cost calculation, a best estimate of the future administration expense is included in the expected future accruals for service. When administration expenses are paid by the plan and not included in the normal cost calculation, the rate of return on plan assets is adjusted to reflect the deduction of the administrative expenses.

.059 A key factor in determining a government's expected future benefit from a defined benefit plan with a plan surplus for accounting purposes is the ability of the government to withdraw assets from the plan. The expected future benefit includes amounts to which a government has a legally enforceable right of withdrawal. It excludes any withdrawable plan surplus a government is currently required, or intends, to allocate to employees. A government may not anticipate obtaining a legally enforceable right to withdraw a portion of a plan surplus to which it is not currently entitled, whether on the basis of precedent or otherwise. Accordingly, when withdrawal of plan surplus requires the approval of employees or an appropriate regulatory authority or a court of law, a government excludes any amount subject to this restriction from its expected future benefit until such approval has been obtained. A change in the allocation of surplus between a government and its employees is incorporated into the calculation of the expected future benefit only when it has been agreed to and, when required, approved by the appropriate regulatory authorities.

We also considered the following definitions as set out in the glossary of PS 3250:

- An **accrued benefit asset** is the amount of any asset recognized on a government's statement of financial position in respect of employee retirement benefits before deducting any valuation allowance that may be required. It is the sum of the government's accumulated cash contributions less the sum of the current and prior years' benefit expenses (before any change in the valuation allowance).
- The **expected future benefit** is a calculated amount representing the benefit a government expects to realize from a plan surplus. An expected future benefit includes any withdrawable surplus or reduction in future contributions. A government determines its expected future benefit as the sum of:
  (a) the present value of its expected future accruals for service for the current number of active employees, less the present value of required employee contributions and minimum contributions the government is required to make regardless of any surplus; and
  (b) the amount of the plan surplus that can be withdrawn in accordance with the existing plan and any applicable laws and regulations.

Limit on the carrying amount of an accrued benefit asset (continued)

- A **joint defined benefit plan** is a contractual arrangement between the government and another sponsor or sponsors representing plan participants that has all of the following characteristics:
  (a) the sponsors co-operate toward achieving the significant clearly defined common goal of providing retirement benefits in exchange for services rendered by the employees;
  (b) funding contributions are shared mutually between the government and the plan members, represented by the non-government sponsor;
  (c) the sponsors share control of decisions related to the administration of the retirement benefit plan and to the level of benefits and contributions on an ongoing basis; and
  (d) the significant risks associated with the retirement benefit plan are shared on an equitable basis between the government and the plan members, represented by the non-government sponsor.

The contractual arrangement establishes that the sponsors have shared control over the retirement benefit plan, and ensures that neither party is in a position to control the plan unilaterally. Nevertheless, overall, there must be an equitable relationship between the funding by the government of the retirement benefit plan, the extent of control it is able to exercise over the plan and the risks and benefits that accrue to the government from the plan.

CONSIDERATION OF QUESTION 1

Application of PS 3250 to Joint Defined Benefit Plans
A joint defined benefit plan is a unique sort of retirement benefit plan where the sponsors have shared control over the plan. As a result, no one party can, by itself, control decisions around funding, benefits and other matters; funding contributions, risks and benefits are to be shared mutually between the sponsors. We would note that paragraph .081 of PS 3250 clearly states that a government should account for its portion of the plan in accordance with the standards for defined benefit plans. As a result, the Province of Ontario accounts for its proportionate share of OTPP and has historically recorded its share as 50% of the plan.

The Province of Ontario's Public Accounts have included a Pension Asset related to OTPP since fiscal 2001/2002. We have been informed that this situation has arisen because, to this point in time, the government's share of the total contributions to the Plan plus the actual investment returns on the Plan's assets have exceeded the government's share of the accumulated retirement benefit expense. The accounting for the accrued benefit obligation results from a complex process involving significant assumptions and actuarial calculations covering a very long time frame as is required by S 3250. S 3250.51 includes an explicit acknowledgement that the accounting position and funding position can be quite different, as follows: "Contributions reflect the funding objectives of the Plan. The benefit expense reflects the accounting objectives and may differ for a number of reasons."

The assumptions used in the calculation of the accrued benefit obligation are required to be the "government's best estimate of expected long-term experience and short-term forecasts" (3250.42) and each key assumption must be based on the government's best estimate of those future events that have an effect on the accrued benefit obligation (3250.41). This approach is designed to recognize the long-term nature of the retirement promises with appropriate consideration of, but not undue influence of, experience expected in the short-term. 3250.57 requires that the future service cost calculation included in the calculation of the valuation allowance be determined on a consistent basis with that used to determine the accrued benefit obligation itself. The Province of Ontario has determined the discount rate to be used in valuing the pension obligation related to OTPP by referencing the expected rate of return on Plan Assets, which is one of the acceptable references suggested on PS 3250.44. We express no view on the actual rates that were chosen.

Application of the limit on the carrying amount of an accrued benefit asset
PS 3250.50 requires that an accrued benefit asset should be presented on a government's statement of financial position net of any valuation allowance. When a defined benefit plan gives rise to an accrued benefit asset, a government should recognize a valuation allowance for any excess of the adjusted benefit asset over the expected future benefit. This comparison between the adjusted benefit asset and the expected future benefit informs whether a valuation allowance is required and if so, how much of a valuation allowance should be recorded. (It should be noted that "accrued benefit asset" and "adjusted benefit asset" are defined terms used in S. 3250. As at March 31, 2016, in this particular case, management has represented to us that these two amounts are the same.)

PS 3250.52 contemplates that there are two ways in which a government can benefit from an accrued benefit asset. A government may benefit from an accrued benefit asset either by withdrawing surplus assets or by taking a contribution holiday or receiving a refund of contributions. As such, an expected future benefit would include the ability to either withdraw plan assets from the plan or reduce future contributions.

PS3250.52 also goes on to consider that an accrued benefit asset may become impaired when there is a plan surplus that the government is not entitled to benefit from fully. The paragraphs in the standard that follow determine how a government would go about considering the extent of any impairment, which would give rise to a valuation allowance. In order to make this determination, the government is required to consider the "expected future benefit", which would effectively create a ceiling for the asset. Here the guidance diverges between benefit expected to be realized through future reductions in contributions and those to be realized through withdrawal of surplus.

Specifically with respect to withdrawal of surplus, PS 3250.59 is very clear that expected future benefit can only be asserted where the government has a current legally enforceable right to withdraw assets from the Plan. We considered whether this guidance should be applied to cases where the expected future benefit related to the Pension Asset is expected to be realized through reduced contributions and concluded that the guidance does not apply in this situation; while PS 3250.59 does introduce the concept of a legally enforceable right, it does so solely in the context of a government's future withdrawal of a Plan surplus, and not in the context of a government's reduction of future contributions. We believe it reasonable to conclude that if the standard setters had intended legal enforceability to be the test, they would have included that notion throughout the guidance, instead of only raising it in the context of a withdrawal of surplus. In the situation at hand, the Province is not asserting an expected future benefit based on surplus withdrawal. Instead the Province's position is that the future benefit is expected to be realized through future contribution reductions. Therefore, we do not believe that 3250.59 applies in this case.

Additionally, in forming our view on the application of PS 3250 to Joint Defined Benefit Plans, we noted that there is specific guidance (PS 3250.81) that requires the Government to account for a portion of the Plan in accordance with the standards for defined benefit plans.

For the reasons stated above, we are of the view for Question 1, that legal enforceability of a government's right to access a pension plan surplus through future contribution reductions is not necessary to justify recognition of a Pension Asset. We believe that the guidance in PS 3250 is the primary source of GAAP on this topic and, since it is clear, there is no need to look at any other potential sources of GAAP.

CONSIDERATION OF QUESTION 2

Since we have concluded that legal enforceability is not a necessary requirement to support a government's right to access a pension plan surplus through future contribution reductions, we further considered what role legal considerations should play in the measurement of the Pension Asset. We note that PS 3250.52 requires one to consider "uncertainties as to a government's legal right to use a plan's accounting surplus." Our interpretation of this guidance is that it presents a lower threshold than legal enforceability. Specifically, the amount of Pension Asset that gets recorded needs to be subject to considerations around any legal uncertainties. This consideration will involve significant professional judgment. However, it is our view that uncertainty does not need to be reduced to zero in order to recognize a Pension Asset.

PS 3250.53 to .58 lay out a mathematical calculation that determines the adjusted benefit asset and the expected future benefit, and tests whether a government can expect to recover its accrued benefit asset through a withdrawal of surplus or through the reduction of future contributions. The stated objective of this exercise, as set out in PS3250.055, is to limit the amount of the government's accrued benefit asset to the amount "it can realize in the future." The expected future benefit is further described as "a calculated amount representing the benefit a government expects to realize from a plan surplus", where realization includes a reduction in future contributions. A valuation allowance is recorded against the Pension Asset to limit the asset value, if necessary, based on this analysis.

PS 3250.55 indicates that the expected future benefit is a calculation that represents the benefit a government expects to realize from a plan surplus. This calculation is further described in PS 3250.56(a), which sets out that the government's calculation of expected future benefit would be the present value of its expected future accruals for service for the current number of active employees, less the present value of required employee contributions and minimum contributions the government is required to make regardless of any surplus. Note that in the case at hand, the calculations are done on a 50% basis since the starting point, per PS 3250.81 and as set out in the fact summary above, is that the government accounts for its portion of the Plan. For this same reason, employee contributions are also excluded in this case since they would represent the teachers' portion of the Plan.

PS 3250.55 indicates that the expected future benefit is a calculation that represents the benefit a government expects to realize from a plan surplus. The expected future benefit would operate as a ceiling on the Pension Asset value to be recorded in the accounts. For example, if the Pension Asset were $150, but the expected future benefit calculated as described above were $100, a valuation allowance of $50 would be recorded against the Pension Asset and the asset recorded in the government's financial statements would be reduced to $100.

There are two parts to the calculation of expected future benefit. The first part of the calculation is the sum of the present value of the expected future accruals for service for the current number of active employees. This amount is required to be calculated using consistent assumptions as those used for the calculation of the accrued benefit obligation itself. The second part of the calculation is the present value of required employee contributions and minimum required contributions by the government itself, regardless of any surplus. The main area for judgment in the above calculation is in the determination of future minimum contributions required to be made by the government regardless of any surplus. There is no further guidance in S 3250 as to how this calculation should be performed and what restrictions or parameters should be factored into this calculation.

Determining the number of years of contributions to include should involve consideration of legal uncertainty as set out in PS 3250.52. With respect to this uncertainty, we would observe that there are a number of considerations that may be relevant. As part of this analysis, we reviewed Osler's legal letter of September 20, 2016. That letter makes a number of observations about the Plan agreements and governing documents that we will not reiterate here. Osler's do note that legal enforceability does not exist. However, as noted above we do not believe that legal enforceability is required in this case.

Future reductions in contributions will need to be negotiated and agreed between both sponsors, who are required under the Plan governing documents to bargain in good faith. There are a number of factors to consider and it is possible for reasonable professionals to arrive at different conclusions, even when confronted with the same set of facts and circumstances. These considerations will be highly judgmental.

With respect to these judgments, we offer the following observations. We express no opinion on the completeness of this list of observations or the relative importance of each of these points.

- Plan documents and design contemplates the shared nature of the Plan.
- Section 10 of the Partners agreement require that the partners meet every 3 years to discuss changes to the Plan.
- As described to us by management, there was a long history of sharing surpluses through various mechanisms during the 1990's when funding surpluses were more common. The FMP also contemplates a sharing of surpluses.
- As described to us by management, in addition to the history of surplus utilization noted in the facts and assumptions, it is worth noting that the actions taken around inflation indexation and subsequent restoration of those benefits are a recent example of the sharing philosophy governing operation of the OTPP. Starting in 2011 in response to a deficit situation, it was determined that indexation would be reduced for teachers retiring after 2009. Consistent with the 50/50 approach inherent in the Plan operation, the government agreed to make payments (often referred to as "share the pain" payments) into the Plan that would effectively match the value of benefits foregone by teachers. In 2014, 2015 and 2016, surpluses were used to restore some of the lost indexation. This decision results in a decrease in the Province's "share the pain" payments.
- The FMP explicitly considers the possibility of contribution reductions at different funding levels, although both sponsors need to agree. The OTPP's investment performance has consistently outperformed expectations. If this situation continues the funding surplus can be expected to continue to grow. Modelling could be performed to help estimate when the different funding zones will be reached and probability of contribution reductions may be increased.
- We also note that Canada Revenue Agency establishes limits for pension surpluses. When these limits are breached, steps need to be taken to reduce the surplus. In such a situation, contribution reductions would be one way to reduce the surplus that would need to be negotiated by the parties within their overall framework for negotiation. Again, modelling could be done to develop expectations as to when these CRA limits could be expected to be reached.
- Contributions are generally borne equally by the Province and the teachers. It may be reasonable to presume that teachers will also want to see contribution reductions at some point. Admittedly, increases in benefits could also use any surplus; however, it may be reasonable to expect that the interests of taxpayers and teachers will need to be weighed in the "good faith" bargaining process such that unequal weighting towards increases in benefits may be unlikely.

- In determining the range of possible outcomes, it is noted that measurement uncertainty may exist (PS 2130.03). This paragraph also notes that many items are measured using management's best estimates based on assumptions that reflect the most probable set of economic conditions and planned courses of action. As noted in PS 2130.13, "As a result of the estimation process, a government would be able to determine a range of reasonably possible amounts in accordance with assumptions that are realistic, supportable, internally consistent, and consistent with planned courses of action. The range of reasonably possible amounts would exclude amounts at the outer edges of possibility since such amounts, while possible, are considered to be outside the best estimate range. Relevant information available to the government to develop a reasonable range includes past experience, precedents, and opportunities to reach alternative arrangements."

However, application and weighting of these and other considerations is a highly judgmental exercise and it is possible that there is a range of reasonable conclusions that may result in a range of reasonable estimates for the valuation allowance to be taken against the Pension Asset. We are unable to opine on whether a valuation allowance is needed, and if so, what a reasonable range of estimates would be.

Given the complexities and degree of judgment involved in these matters, appropriate disclosure is a matter of significance as is recognized in 3250.83 which states, in part, *"Full disclosure is particularly important for retirement obligations because the measurements depend heavily upon judgments rather than objective evidence"*. This importance is also highlighted in the context of joint benefit plans in 3250.93 which requires that the unique nature and terms of any joint plans be disclosed.

We would also note that Deloitte prepared a report dated August 18, 2016 entitled "Asset Ceiling Calculations for the Ontario Teacher's Pension Plan" in conjunction with management that was used by management as part of their analysis to determine that no valuation allowance was required against their Pension Asset as at March 31, 2016. That report was prepared solely to assist management in preparing their own analysis. We were not engaged to and did not express an opinion on the amount of or need for any valuation allowance, nor do we express an opinion on this analysis at this point. Reference to the August 18, 2016 report in this report should in no way be construed to be an opinion on that earlier report.

The ultimate responsibility for the decision on the appropriate application of Canadian Public Sector Accounting Standards for the specific transaction described above rests with management as preparers of the financial statements, who should consult with the Auditor General of Ontario. Our judgment on the appropriate application of Canadian Public Sector Accounting Standards for the specific situation described above is based on the facts, circumstances and assumptions provided to us. Should the facts, circumstances or assumptions differ, our conclusion may change.

This report is intended solely for the information and use of Ms. Karen Hughes and management of the Government of Ontario and is not intended to be and should not be used by anyone other than the above party and the Auditor General of Ontario or for any other purpose. For further clarity, this report should not be distributed to anyone outside those named in the previous sentence, nor should it be quoted from outside this group for any purpose. Please contact Kerry Danyluk, National Director of Accounting Services, regarding any questions about the content of this report (416 775-7183 or kdanyluk@deloitte.ca).

Yours truly,

Deloitte LLP.

Chartered Professional Accountants
Licensed Public Accountants

Deloitte.

Analysis of Pension Asset Ceiling Accounting Considerations for the Office of the Provincial Controller Division re: Ontario Teachers’ Pension Plan (OTPP)

August 19, 2016

Table of contents

Introduction

In preparation of the Province of Ontario Financial statements, the Office of the Provincial Controller Division (OPCD) has retained Deloitte to provide support in analyzing issues around pension accounting. The present document is prepared in relation to the assessment of the application of public sector accounting standards as related to asset ceiling and valuation allowance to the Ontario Teachers' Pension Plan (OTPP).

The relevant accounting standard referenced in our analysis is public sector accounting standard PS3250 on retirement benefits.

The document will cover the following elements:

- Summary of the situation;
- Overview of the accounting paragraphs that apply to this and the explanation;
- Review of the considerations that go into the asset ceiling test and the Expected Future Benefit (EFB) calculation;
- Review of the employer access to future contribution reduction or surplus withdrawal;
- Summary of findings relating to observations made in discussing the applicability of the asset ceiling test for Ontario's 2015-16 Financial statements.

We are available to discuss the content of this document.

Martin Raymond
Partner, FSA, FCIA

Trevor Gary
Senior Consultant

Section 1 – Summary of the situation

The OPCD in preparation of the Ontario Financial statements for 2015-16 has requested support to assess potential asset ceiling risks in relation to the calculation for the OTPP reported on the Province's consolidated financial statements.

Here are a few facts obtained from discussion / documentation around the OTPP and its accounting:

- The plan is covered by its own legislation, the Teachers' Pension Act
- Most recent funding report was prepared at January 1, 2015 with contributions set for 2015, 2016 and 2017
- The OTPP is a Joint Sponsored Pension Plan (JSPP) as per the Ontario Pension Benefit Act (PBA)
- The plan is accounted for using Joint defined accounting provisions of the standards and the government portion of the plan is determined at 50% of the overall plan, this reflects the 50/50 sharing principle underlying the OTPP (per Teachers' Pension Act par. 5 (1.1) and 10 (1) and page 16 of the funding valuation report – extracts provided in Section 4)
- The total accounting service accrual (service cost) is about $2.9B per year calculated in accordance with PSAB (per the Jan. 26, 2016 Mercer letter to OTPP)
- The recent accounting surplus measure (Dec 31, 2015) for the portion of the government (50% of the total plan) is around $20B, using a market-related value of assets (smoothed assets). The surplus using fair value measure of assets is about $28B (per the excel supporting file for accounting calculations received).

We note that the accounting actuarial values are prepared at Dec 31, 2015 and that an adjustment for March 31, 2016 is performed to obtain the year-end values. The balance sheet asset position for the OTPP can be illustrated as follows: (per the excel supporting file for accounting calculations received)

(all figures in $B)	Total plan	50% Share of the plan
Market related value of assets	157.0	78.5
Value of obligation	116.4	58.2
Surplus (deficit)	40.6	20.3
Unamortized (gains) losses	(18.0)	(9.0)
Adjustment for March 31, 2016	(1.8)	(0.9)
Asset (liability) position	20.8	10.4
Specific Government adjustment		(0.3)
Final asset (liability) position on balance sheet		10.1

This document will cover the following key questions:

- What are the key considerations that go into the asset ceiling determination?
- What is the impact of an asset ceiling for 2015-16, if applicable?
- Is there an asset ceiling impact for OTPP as at March 31, 2016 (that would apply to the $10.1B shown above) and if so how is it calculated?

Below is a list of documents and references used in our analysis.

List of documents
Funding management policy (FMP) of OTPP – agreement between the parties to the plan (provided by OPCD)
Asset ceiling documentation prepared by Allan Shapira (Aon) dated August 2, 2016 (provided by OPCD)
Actuarial valuation report of OTPP as at January 1, 2015 – funding purposes – prepared by Mercer (provided by OPCD)
Accounting standards PS3250 on post-employment benefits
Teachers' Pension Act (found on the internet)
Discussions with OPCD and Allan Shapira (incl. overview of some results used in this document) including a summary note prepared by Nadine Petsche, Director of Accounting Policy and Financial Reporting at OPCD (August 4, 2016)
Excel supporting file for accounting calculations (provided by OPCD)
Supporting document from OTPP to OPCD on accounting results, including the communication from Mercer on valuation results for different assumption basis – both documents dated Jan. 26, 2016 (provided by OPCD)

Section 2 – Relevant PS3250 paragraphs

Below are some extracts from the PS3250 which are relevant for calculating the limit on carrying amount of accrued benefit asset (the asset ceiling test) and the joint defined benefit which are relevant to the analysis and position taken for financial statement preparation. Note that the underlined are from us.

Limit on the carrying amount of an accrued benefit asset

.050 *An accrued benefit asset should be presented on a government's statement of financial position net of any valuation allowance. When a defined benefit plan gives rise to an accrued benefit asset, a government should recognize a valuation allowance for any excess of the adjusted benefit asset over the expected future benefit. A change in valuation allowance should be recognized in the statement of operations for the period in which the change occurs.* [SEPT. 2001]

.051 A government with a defined benefit plan may have an accrued benefit asset for accounting purposes. An accrued benefit asset arises when the government's total contributions to the plan, including interest earned thereon, are greater than the retirement benefit expense recognized since the start of the plan. Contributions reflect the funding objectives of the plan. The benefit expense reflects the accounting objectives and may differ for a number of reasons, including the fact that actuarial gains and losses are deferred and amortized in future periods.

.052 A government may benefit from an accrued benefit asset either by withdrawing surplus assets or by taking a contribution holiday or receiving a refund of contributions. The accrued benefit asset may become impaired when there is a plan surplus for accounting purposes that the government is not entitled to benefit from fully. For example, there may be a regulatory moratorium on pension surplus withdrawals or uncertainties as to a government's legal right to use a plan's accounting surplus.

.053 To determine the extent to which an accrued benefit asset may be impaired, the government first determines the adjusted benefit asset. The adjusted benefit asset is the accrued benefit asset less net unamortized actuarial losses (determined on a basis using market value of assets).

.054 The adjusted benefit asset is then compared to the expected future benefit. When the expected future benefit exceeds the adjusted benefit asset, the accrued benefit asset is not impaired and, accordingly, no valuation allowance is required. The chart included as Appendix A to this Section is intended to set out the relationship between the various defined terms.

.055 The objective of the standard in paragraph PS 3250.050 is to limit a government's accrued benefit asset to the amount it can realize in the future. The expected future benefit is a calculated amount representing the benefit a government expects to realize from a plan surplus. An expected future benefit includes any withdrawable surplus or reduction in future contributions.

.056 A government determines its expected future benefit as the sum of:

a. the present value of its expected future accruals for service for the current number of active employees, less the present value of required employee contributions and minimum contributions the government is required to make regardless of any surplus; and
b. the amount of the plan surplus that can be withdrawn in accordance with the existing plan and any applicable laws and regulations.

.057 A government's expected future accruals for service for the current number of active employees are determined on a basis consistent with that used to determine its accrued benefit obligation. These expected future accruals for service, less required employee contributions and minimum contributions the government is required to make regardless of any surplus, are then discounted back to the current period to determine the present value. The interest rate used to calculate this present value is the expected rate of return on plan assets used to determine the benefit expense in the period.

.058 When administration expenses are paid by the plan and included in the normal cost calculation, a best estimate of the future administration expense is included in the expected future accruals for service. When administration expenses are paid by the plan and not included in the normal cost calculation, the rate of return on plan assets is adjusted to reflect the deduction of the administrative expenses.

.059 A key factor in determining a government's expected future benefit from a defined benefit plan with a plan surplus for accounting purposes is the ability of the government to withdraw assets from the plan. The expected future benefit includes amounts to which a government has a legally enforceable right of withdrawal. It excludes any withdrawable plan surplus a government is currently required, or intends, to allocate to employees. A government may not anticipate obtaining a legally enforceable right to withdraw a portion of a plan surplus to which it is not currently entitled, whether on the basis of precedent or otherwise. Accordingly, when withdrawal of plan surplus requires the approval of employees or an appropriate regulatory authority or a court of law, a government excludes any amount subject to this restriction from its expected future benefit until such approval has been obtained. A change in the allocation of surplus between a government and its employees is incorporated into the calculation of the expected future benefit only when it has been agreed to and, when required, approved by the appropriate regulatory authorities.

Joint defined benefit plans

.079 Governments may participate jointly in defined benefit plans where the government shares the risks and rewards jointly with plan participants, represented by a sponsor or sponsors. Joint defined benefit plans are governed by a formal agreement between the sponsors, which establishes that the sponsors have shared control over the plan. A governing board is generally appointed by the joint sponsors with equal representation and a mutually agreed-upon chair.

.080 A government would consider the characteristics of the plan to determine whether it meets the definition of a joint defined benefit plan. In a joint defined benefit plan, funding contributions are shared mutually between the government and the plan members. The sponsors have control over decisions related to the administration of the plan and the level of benefits and contributions on an ongoing basis based on the terms of the contractual agreement. The sponsors share, on an equitable basis, the significant risks associated with the benefit plan. Risk would not be considered to be equitably shared in an arrangement where the government and the joint sponsors fund the plan equally but where the government retains the full risk of the accrued benefit obligation. If the government retains the residual risks it is unlikely that the plan meets the definition of a joint defined benefit plan.

.081 *When a government participates in a joint defined benefit plan, the government's risk is limited to its portion of the plan. The government should account for its portion of the plan in accordance with the standards for defined benefit plans.* [SEPT. 2001]

.082 A government may convert an existing defined benefit plan for which it is the sole sponsor to a joint defined benefit plan where the risks and benefits are shared. When converting to a joint plan, a government would consider whether there are any special accounting issues that arise, including whether the predecessor plan has been settled or partially settled and/or curtailed or partially curtailed. In assessing such issues a government would have regard to its specific circumstances and the terms of the joint defined benefit plan.

Section 3 – Asset ceiling test and EFB calculation basis

PS3250.053 refers to the adjusted benefit asset. This is the amount on which the asset ceiling test applies (PS3250.054) by comparing it to the Expected future benefit (EFB). In many cases, we are seeing unamortized losses, and the adjusted benefit asset effectively equals the accounting surplus. However, for the OTPP, as shown in the Section 1, it is unamortized gains which exist rather than losses.

In this situation, if we take the OTPP case, we would have:

- Adjusted benefit asset = accrued benefit asset less unamort. losses = $10.1B - $0.0B = $10.1B
- So the amount to test against EFB would be $10.1B

Further, PS3250.053 refers to market value of assets rather than market-related value of assets that allows for some smoothing of assets gains and losses (which is used under OTPP). Considering that the market value of assets (total plan) is $171.4B at Dec 31, 2015 as per the excel file for accounting calculation and applying the 50% share, we do get $85.7B for the Government share. The difference represents gains on assets not yet reflected in the market-related value of assets and therefore, the unamortized (gains) losses are adjusted accordingly for the test. Making the adjustment for market value measures, we would therefore obtain the following:

(all figures in $B)	50% Share of the plan-market related value	50% Share of the plan market value
Value of assets	78.5	85.7
Value of obligation	58.2	58.2
Surplus (deficit)	20.3	27.5
Unamortized (gains) losses	(9.0)	(16.2)
Adjustment for March 31, 2016	(0.9)	(0.9)
Asset (liability) position	10.4	10.4
Specific Government adjustment	(0.3)	(0.3)
Final Asset (liability) position on balance sheet	10.1	10.1

We note that the end result for the test is still $10.1B adjusted benefit asset on either market-related value or market value. This occurs because the test is showing unamortized gains in both basis. If unamortized losses were present instead, the results of the test would differ.

The above are basic considerations of the asset ceiling test and mostly straight-forward in application. The most challenging part of the asset ceiling test is identifying the basis to value the EFB under PS3250.056. There are various elements to be considered in this calculation that will determine the amount to use. The definition of EFB incorporates key components that need some analysis. The present section deals with these components.

Definition of EFB

.056 A government determines its expected future benefit as the sum of:

a. the present value of its expected future accruals for service for the current number of active employees, less the present value of required employee contributions and minimum contributions the government is required to make regardless of any surplus; and
b. the amount of the plan surplus that can be withdrawn in accordance with the existing plan and any applicable laws and regulations.

Key components of the definition are:

- present value calculation
- future service accruals
- current number of active employees
- required employee contributions
- minimum contributions the government is required to make regardless of any surplus
- amount of surplus that can be withdrawn

Current number of employees – Open group notion

Under the definition of the EFB, it is indicated that the present value of future accruals for service is to be based on the current number of active employees. The application of this particular element of the calculation has generally been seen in practice as assuming that the plan would have a perpetuity of future accruals since active employees terminating or retiring would be replaced by new active employees, keeping the number equal to the current population. Unless there is signal or expectation of reduction in population (e.g. if the plan was closed to new entrants or if the employer is going through downsizing), this open group notion has been observed in practice.

Future service accruals - Projection of salary

Under the definition of the EFB, we are performing a present value calculation and therefore this assumes that the underlying components of the calculation are projected into the future (future accruals and contributions). In performing such projection, an increase in salary based on the accounting assumption for salary increase would be applicable.

Present value – discounting effect

Calculation of a present value requires the determination of an interest rate to use. Under PS3250.057, the interest rate used is determined in reference to the expected rate of return on plan assets used to determine the benefit expense.

Future service accruals and required employee contributions - Joint Defined Benefit accounting

Since the OTPP is accounted for based on joint defined benefit provisions of the accounting standards, the asset ceiling test needs to be performed based on the government's portion of the plan (par. PS3250.081). Looking at the EFB definition, it means that the calculation of PS3250.056 a) needs to be adjusted to only reflect the employer share (50% of the total accruals) and to remove any employee contributions that were considered in the calculation (since this relates to the employee portion of the plan).

<u>Observations on PS3250 EFB calculation (in practice)</u>

Deloitte has shared with management that historically there has been in practice a very liberal application of the PS3250 asset ceiling calculation. The EFB has generally been determined as the present value of all future employer service accruals (perpetuity) considering the increase of salary factored into the calculation. This approach is based on View 1 described in the minimum employer contribution required discussion below. One simple way of obtaining that value is based on the following calculation:

- Determine the total accrual for service for one year
- Determine the accrual for service for the employer for one year (i.e. total accrual net of the employee portion)
- Calculate the perpetuity of increasing service cost as follows : accrual of service for employer / (expected return on plan assets – salary increase)
- To illustrate this for OTPP, we did get the following information
  - Total service accrual = $2.9B
  - Employer service accrual (assuming 50% share) = $2.9B / 2 = $1.45B
  - Expected return on plan assets = 6.25% (per the Jan 26, 2016 document and the observed values used in the excel file for accounting calculation)
  - Salary increase = 3% (excluding merit/promotional scale for simplicity - per the Jan 26, 2016 document and the observed values used in the excel file for accounting calculation)
  - Perpetuity = $1.45B / (6.25% - 3%) = $44.6B

<u>Minimum employer contributions required regardless of any surplus – Views for determination in EFB calculation</u>

There has been in recent years more questions around the meaning of the EFB definition and mostly around what the last part of PS3250.056 a) means. The terminology used of "minimum employer contribution required regardless of any surplus" has been discussed and there have been different views on what this represents.

One view (View 1) focus on whether there is a minimum employer contribution under the plan / legislation that is required even if a surplus would be present. For instance, a plan contribution could be defined as always being at least of 5% of salaries. In such circumstances, there would be a contribution requirement to a minimum level for every year even when surplus is present. If no such minimum exists and there is a possibility to get to 0% contribution, for instance in surplus position, then there would be no minimum contribution required "regardless of any surplus". This view leads to no reduction in the EFB calculation in cases where no minimum % contribution exists in the plan provisions. In the example above, the perpetuity of $44.6B is not reduced and therefore EFB remains at $44.6B.

Another view (View 2) is that minimum required contribution must at least consider the effect of the most recent funding valuation report. This report determines what contribution requirement applies to the current period of the valuation report and until a new report is completed. For instance, if the employer needs to contribute for the next 3 years a certain amount of contribution (service cost and special contribution for deficit), then this represents the minimum required employer contribution regardless of any surplus. As an example, under the most recent funding report of the OTPP (Jan 1, 2015) this amount is about $1.7B per year for 2015, 2016 and 2017 which includes service cost and also special contributions. Contributions from 2018 will be determined based on a new valuation report and therefore are unknown as of now (no minimum required contribution on the valuation date for years beyond 2017). In the example above, the perpetuity of $44.6B is reduced by 2 years of $1.7B (excluding interest for simplicity) for an EFB of $41.2B.

Finally, a more extreme view (View 3) could be to actually prepare detailed future projections of funding valuation results on either a deterministic calculation with identification of the actual year(s) when funding surplus would be present or a stochastic calculation to identify what is the probability of occurrence of funding surplus in future years and the outcome in those cases for contribution reduction/surplus withdrawal. Such an approach would need the inclusion of some many complex assumptions and the preparation of a high volume of calculations. In the example above, the perpetuity of $44.6B would be reduced more than View 1 or View 2 because of possible future years in the projection that lead to required contribution payments.

We have never seen in practice the use of View 3 under PS3250, while View 1 has been largely used historically. On the other hand, we note that View 2 has been recently observed as a possible emerging interpretation of the paragraph 3250.056.

Amount of surplus that can be withdrawn and contribution reduction availability – OTPP plan characteristics

One element of importance (PS3250.052 and PS3250.059) is to identify whether the employer does have access to the surplus based on legislation and plan characteristics. Is there really some way the government can either withdraw surplus from the plan or reduce future contributions through contribution holiday. The OTPP does have its own Legislation (Teachers' Pension Act) and a Funding policy (Funding Management Policy – FMP) agreed between employer / employees to determine whether and how surplus can be used under the plan. The FMP provides insight on this significant element and is dealt with in the next section.

Section 4 – Sharing principle, contribution reduction and surplus withdrawal

Extracts from the Teachers' Pension Act

The following paragraphs of the Teachers' Pension Act are supporting elements for the use of the 50 / 50 sharing of contributions - paragraph 5. (1.1) - and also support the use of the Funding Management Policy agreed between the parties for treatment of the surpluses and deficits – paragraph 10. (1) 3.

Contributions by the Crown

5. (1) The Minister of Finance shall pay from the Consolidated Revenue Fund an amount equal to contributions under the pension plan payable by the Minister of Education. R.S.O. 1990, c. T.1, s. 5 (1); 1993, c. 39, s. 3 (1); 2005, c. 31, Sched. 21, s. 2 (1).

Matching contributions

(1.1) The total amount of the contributions payable by the Minister of Education and the employers who contribute under the pension plan in respect of any year shall not exceed the amount of contributions payable by or on behalf of active plan members in respect of credited service for that year. 1991, c. 52, s. 3; 1993, c. 39, s. 3 (1); 2005, c. 31, Sched. 21, s. 2 (2).

Joint management

10. (1) The Minister of Education and the executive of The Ontario Teachers' Federation may enter into an agreement that provides for the following matters:

1. The joint management of the pension plan by the Minister and the executive of the Federation.
2. The composition of the Board, the appointment of the members of the Board and the delineation of the powers and duties of the Board.
3. The sharing of entitlement to gains or surplus under the plan and of liability for deficiencies in the pension fund by the Minister, the employers who contribute under the plan and the active plan members.
4. The amendment of the plan, including the amendment of Schedule 1, by agreement between the Minister and the executive of the Federation.
5. The resolution of disputes between the Minister and the executive of the Federation with respect to amendments to the plan.
6. Any other matter to which the Minister and the executive of the Federation agree. 1991, c. 52, s. 6; 1993, c. 39, s. 5; 2005, c. 31, Sched. 21, s. 4 (1).

Extracts from the most recent funding valuation report (Jan. 1, 2015 – page 16)

The extracts show that Government contributions are matching employees, besides a small portion for LT disability cases and also that there might be an additional contribution for what is referred as foregone inflation. These are supporting the assessment of the 50 / 50 sharing nature of the plan.

- The Province or Designated Employers, as the case may be, should generally match active teacher contributions. However, in the case of teachers on LTIP, they should pay 12.0% (6.9% for Designated Employers if disability occurred before January 1, 1991) of the member's pensionable earnings, indexed to inflation in accordance with the Teachers' Pension Act.

- In addition to the above matching contributions, the Province and Designated Employers are also required to make special contributions for any year in which the cumulative cost-of-living adjustment to pensions in respect of service after 2009 is less than 100% of CPI increases (but only to the first 50% of any inflation foregone) since the members' retirement. The amount of such special contributions is equal to the amount by which the pensions or other entitlements received by members for the year are less than the pension amounts they would have received for that year if 100% CPI indexing had been provided for post-2009 service.

Funding Management Policy (FMP)

The FMP is a document agreed between employer / employees that identifies how the plan is to be funded and specifically how it will deal with deficit and surplus situations. We are particularly interested to identify whether in surplus position the government has access to surplus withdrawal or contribution reduction.

The idea of the plan is that the employer contribution will match the employees' contribution. The use of Joint Defined benefit accounting under PS3250 reflects that general principle underlying the nature of the plan by applying a 50/50 share.

The plan also has provisions that make post-retirement indexing for some service period (post-2009) conditional on the plan financial situation. Should the indexing not be provided fully (100% CPI), some portion (or all) of the indexing amount not provided to the retirees (called foregone inflation) will lead to additional employer contribution in that year. This also reflects the 50 / 50 principle of the plan in that on the employee side, a benefit is not fully provided (less than 100% indexing for retirees) and on the employer side an additional contribution is paid. In similar way, if and when benefits would be increased to the employees, the employer would also get a similar benefit in value (contribution reduction and/or surplus withdrawal).

The FMP will have first use of surplus to reduce contributions to the "basic contribution level" which is the 2012 value (10.4% of salary below YMPE and 12.0% above YMPE) and / or increase benefit to restore any foregone inflation. The Partners need to agree on the actions that will be taken. We also note that for the employer, should the contribution rate already be at the basic rate and a surplus is present, surplus withdrawal and / or further contribution reduction is also possible action to be taken.

In discussing with Allan Shapira (Aon), we understand that the FMP has five funding zones:

- The middle zone is the Fully Funded zone under which base benefits and contributions are maintained. In this zone, the plan is adequately funded to provide base benefits (including indexation at 100% of CPI) supported by the base contributions. Given the volatility of market factors and the numerous assumptions in the funding valuation, "fully funded" is considered a range.
- There are two zones below the Fully Funded zone that address the treatment of deficits (through additional contributions and / or reduction of benefits).
- There are two zones above the Fully Funded zone that address the treatment of surpluses. The first zone is the Temporary Plan Improvement zone where contributions can be temporarily reduced, a surplus distribution can be made on a temporary basis and/or benefits can be temporarily improved (as long as it does not create a long term cost). If the surplus reaches a

specified level, the next zone, the Permanent Plan Improvement zone, provides for permanent changes to contribution rates and/or benefits.

We also note that surplus distribution is a possible approach to deal with surplus in the FMP as per paragraphs 1.06 and 4.04.

Under the FMP, a surplus distribution or a benefit improvement can only be made if the Partners have entered into a written agreement governing the manner in which employer contributions will be adjusted to offset any surplus distribution or changes in benefits that are reflected in the obligation value through benefit changes.

As illustrated in the latter zones above, the FMP considers that surplus situations and actions taken can be of permanent nature but also temporary nature. We understand that the inclusion of temporary use of the surplus has the effect of having more likelihood of years of surplus usage than if only permanent approach was possible.

Based on the information received, we note that the accounting obligation calculated for the financial statements, and the accounting surplus resulting from that obligation value, is already including an assumption that 100% CPI is provided. Therefore, the accounting surplus is already based on fully restored benefits and full indexing. Any remaining surplus would therefore be available from the employer side to reduce the contribution level or withdraw surplus.

We also note that the accounting valuation is based on best estimate assumptions and that the surplus amount determined by that calculation represents what is the most likely outcome, considering that assumptions are realized in the future. As such, the amount for the employer portion does represent a realistic potential value to the government in contribution reduction and / or surplus withdrawal. We do not know when the actual event would take place and whether it would be through contribution reduction or surplus withdrawal, but we know that this represents a realistic economic benefit.

Section 3.06 of the FMP does identify the steps of restoration of indexing and also identifies under 3.06 e) the contribution reduction action that can apply. We note again that the accounting obligation measure already includes the 100% CPI indexing and therefore covers the escalated adjustements defined in 3.06.

Section 3.06 *Application of Restoration Basis Excess*: For purposes of clarity, excesses identified pursuant to Section 3.05 shall be applied in the following order, provided that the partners reserve the right to reconsider such application having regard to the contribution rate and benefits then in effect, prevailing economic circumstances and other relevant factors:

(a) *Bring Escalated Adjustments to 50% for Post-2013 Service*: to provide escalated adjustments up to 50% of the CPI adjustment in respect of service accrued after 2013 for the period covered by the valuation, and assumed thereafter at the same rate;

(b) *Bring Escalated Adjustments to 100%*: to provide escalated adjustments up to 100% of the CPI adjustment for the period covered by the valuation, and assumed thereafter at the same rate;

(c) *Restore Escalated Adjustments for Post-2013 Years*: to provide escalated adjustments to increase, to the extent possible, the current accumulated adjustment ratio for each year after 2013, to the current accumulated adjustment ratio for the period from 2010 to 2013, beginning with the first year in which current escalated adjustments were less than 50% of the run-rate escalated adjustments;

(d) *Restore Escalated Adjustments for Post-2009 Years*: to provide escalated adjustments to increase, to the extent possible, the current accumulated adjustment ratio for each year after 2009 to the run-rate accumulated adjustment ratio, beginning with the first year in which current escalated adjustments were less than run-rate escalated adjustments;

(e) *Provide Benefit Increases or Contribution Rate Reductions*: to provide the following:

(i) an increase in benefits, where the present value of current benefits is less than the present value of run-rate benefits,

(ii) a reduction in contribution rates, where the present value of current contributions exceeds the present value of basic contributions, or

(iii) a combination of (i) and (ii).

(Last amended May 27, 2015 – Effective March 6, 2015)

Section 5 – Asset ceiling for OTPP

The factors illustrated in the Section 4 coming from the analysis of the FMP and surplus application are considerations to determine the Government access to the surplus. We have discussed the plan mechanics with OPCD and here are the key factors of the FMP and OTPP plan characteristics that would be considered in support of the Government Expected future benefit coming from surplus withdrawal and contribution reduction:

- The plan nature is defined to be a 50 / 50 share between employees and employer
- Looking at the FMP, this principle applies to bad news and good news, hence for deficit and surplus situations
- The employer can benefit from surplus withdrawal and contribution reduction
- The surplus situations could be dealt with permanent and temporary changes, increasing the likelihood of surplus application
- The accounting valuation currently includes a 100% CPI indexing, hence the resulting accounting surplus to the employer portion has already fully restored benefits considered
- Accounting valuation uses best estimate assumptions and therefore the resulting surplus is considered a realistic value

Based on the Government view on the OTPP and our discussions with OPCD, we understand that the position is that the asset position should not be reduced by any valuation allowance. This position is based on the nature of the sharing principle of the OTPP which allows for the Government to have access to the surplus and hence the Economic benefit. It is unknown when the benefit will materialize and what form it will take but it is of realistic economic value.

That being said, a very important consideration is that the amount determined represents what the accounting defines as the best estimate. The selection of assumptions to prepare the accounting valuation is therefore significant to ensure that the surplus calculated is realistic. Considering the accounting standards requirement to use best estimate assumptions, it is reasonable to consider that those assumptions are selected by the Government as best estimates and therefore the surplus determined is a realistic value of what benefit the Government may realize in the future through surplus withdrawal/contribution reduction.

Should the characteristics of the plan or the FMP parameters change in the future, or if the Government has a different view on the application of the OTPP provisions and the FMP for surpluses, this may affect the Government access to surplus and hence the Government view on asset ceiling test.

Based on the facts coming from the FMP, the plan nature and based on discussions with OPCD, it has been determined that the current view is that any surplus identified to the Government portion would be used to its own benefit and that the Government is not obligated to using any surplus towards increasing benefits to the members (either through historic practice or internal policy). The above analysis provides evidence to support OPCD's position that no valuation allowance is required to the OTPP asset amount reported under PSAB.