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2019 Funding Regulations Refine Ontario's Defined Benefit Pension Plan Funding Rules

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On May 1, 2018, a new funding regime came into force for Ontario-registered defined benefit ("DB") pension plans. The new funding regime for DB plans, introduced through Ontario Regulation 250/18 (the "2018 Funding Regulations") and complimentary amendments to the Pension Benefits Act (the "PBA"), replaced the prior long-standing solvency funding regime with enhanced going concern funding requirements. The 2018 Funding Regulations also changed the requirements for taking contribution holidays under an Ontario-registered DB pension plan, using prior year credit balances ("PYCBs") and making certain benefit improvements. Our April 24, 2018 Sidebar includes a summary of the May 1, 2018 changes.

The 2018 Funding Regulations were technical and complex. As a result, a number of interpretative issues arose. On May 21, 2019 Ontario Regulation 105/19 (the "2019 Funding Regulations") was filed. The 2019 Funding Regulations amend various DB plan funding rules set out in Regulation 909 under the PBA (the "General Regulations"). The 2019 Funding Regulations address many of the interpretative issues raised by employers and plan administrators in relation to the 2018 Funding Regulations. Some of the changes apply on a transitional basis while others are permanent.

In this Sidebar we outline key aspects of the 2019 Funding Regulations with a focus on those that apply to single employer pension plans.

Use of Surplus and Prior Year Credit Balances

Effective May 1, 2018, new section 55.1 of the PBA regarding contribution holidays came into effect at the same time as the introduction of the new PBA funding rules. Section 55.1 allows employers to reduce or suspend normal cost contributions, including the provision for adverse deviation ("PfAD") on such contributions, only if a plan has "available actuarial surplus" and provided that other prescribed requirements are met. Generally, available actuarial surplus is the lesser of: (i) the excess of a plan's assets over the sum of its going concern liabilities, PfAD going concern cushion, and any PYCB; and (ii) the amount by which the transfer ratio[1] of the plan is greater than 1.05. The requirement to have available actuarial surplus as a precondition to take a

[1] Or, for a public sector pension plan, the amount by which the **solvency** ratio of the plan is greater than 1.05.

contribution holiday or use a PYCB toward normal cost contributions made the 2018 Funding Regulations more restrictive than the rules in effect prior to May 1, 2018.

Pursuant to Bill 100 (companion legislation to the 2019 Ontario Budget), the PBA has been amended to clarify that section 55.1 does not prevent the reduction or suspension of employer normal cost contributions if the reduction or suspension is otherwise authorized by the PBA or the General Regulations. For plans governed by the 2018 Funding Regulations, this PBA amendment means that a PYCB may be used toward normal cost contributions as well as toward special payment obligations whether or not the pension plan has available actuarial surplus. See our April 15, 2019 Sidebar for further details.

Transitional Changes

The 2019 Funding Regulations amend the 2018 Funding Regulations by providing an exception to section 55.1 of the PBA for employers who continue to fund their plans under the pre-May 1, 2018 funding framework. In these cases, the employer has an opportunity to take contribution holidays and to use PYCBs toward normal cost contributions based on the less restrictive pre-May 1, 2018 regime.

Specifically, the 2019 Funding Regulations exempt plans for which the valuation date for the last-filed report is before December 31, 2017, as well as plans for which the last report was filed before May 1, 2018 (a "Grand-parented Report"), from the PBA section 55.1 restrictions. This change will allow an employer who is funding a plan under a Grand-parented Report to use actuarial gains or a PYCB toward normal cost contributions based on the pre-May 1, 2018 funding regime even if the plan does not have available actuarial surplus, provided that the requirements of the General Regulations are met (including applicable cost certificate filing requirements.) This ability to make use of the pre-May 1, 2018 contribution holiday rules applies until a new valuation report supersedes the Grand-parented Report. The 2019 Funding Regulations also extend the time for filing a cost certificate to allow affected employers to take a contribution holiday for the remainder of 2019. The new deadline is June 30, 2019.

Also, on a transitional basis, the 2019 Funding Regulations revise the definition of PYCB. Where funding is subject to a Grand-parented Report, contributions that were made to a plan by an employer that would not have been required to be made to the plan under the pre-May 1, 2018 contribution holiday regime, may be used to create a PYCB in the next-filed valuation report. This PYCB can then be applied by the employer toward normal cost contributions or any required special payments in the future.

Finally, in respect of a plan which is being funded according to a Grand-parented Report, the 2019 Funding Regulations permit actuarial gains to be applied to pay the Pension Benefit Guarantee Fund assessment that is otherwise payable by the employer.

Other Funding Changes

The 2019 Funding Regulations include further clarification around an employer's ability to use excess contributions to offset contributions otherwise owing to a DB plan. The 2019 Funding Regulations explicitly provide that if contributions are made to a DB plan in accordance with the last-filed valuation and a new DB valuation report is filed in the same year, any excess contribution made to the plan before the date on which the new valuation report is filed may be used to reduce the contributions that would otherwise be required to be made in that plan year. Typically this issue arises when the funding requirements under the last-filed valuation are greater than the funding requirements under a new valuation report. These rules do not apply to jointly sponsored pension plans.

The 2019 Funding Regulations also confirm that the treatment of letters of credit held to secure solvency special payment obligations is the same under the pre-May 1, 2018 funding regime and the post-May 1, 2018 regime.

Changes to the PfAD Calculation

As explained in further detail on our April 24, 2018 Sidebar, the 2018 Funding Regulations introduced the concept of a PfAD to create an explicit going concern funding cushion in conjunction with de-emphasis of solvency funding requirements.

Closed Plan Definition

The PfAD calculation is, in part, determined based on whether a plan is "closed". The General Regulations require a larger PfAD be used to determine funding obligations when a pension plan is a "closed plan" compared to when it is not. The 2019 Funding Regulations revise the definition of "closed plan".

The 2018 Funding Regulations read as follows:

> "closed plan" means a pension plan at least one portion of which, according to the terms of the plan, does not permit new members to join and accrue defined benefits.

The "closed plan" definition is a factor to consider in a number of circumstances, including, for example, successor plan situations following a purchase and sale transaction, defined contribution conversions, and the many circumstances where the DB provisions of a plan become closed to a specified group of newly hired (or existing) employees within a member "class" previously covered by the plan.

The 2018 Funding Regulations' closed plan definition was problematic because it captured plans that were closed to even a very small sub-set of members. In such situations, the closed nature of the plan would typically have no effect on the plan's risk profile, and as a result, did not justify a higher PfAD.

The 2019 Funding Regulations revise the definition in a number of respects. Most importantly, a materiality threshold is adopted. A "closed plan" is now defined as a pension plan,

> (a) that has no members who are entitled to defined benefits, or
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> (b) in which at least 25 per cent of the members of the plan who are entitled to defined benefits are in a class or classes of employees from which new members are not permitted, according to the terms of the plan, to join the plan and accrue defined benefits.

In summary, the 2019 Funding Regulations provide that, if DB accruals cease for a group of members that represents 25% or less of the overall DB plan membership, measured as at a particular valuation date, the plan will <u>not</u> be considered closed for purposes of the PfAD calculation. The creation of a threshold percentage of plan membership to whom the plan is closed is a welcome change for plan sponsors that have ceased DB accruals to a small sub-set of a plan's overall membership.

As well, the new definition specifically provides that members who participate in a pension plan on a defined contribution basis are not to be counted as part of the total plan membership for purposes of assessing whether the plan is a closed plan.

Finally, the new definition also clarifies that a plan with no active members is a "closed plan" for PfAD calculation purposes.

It will be important to work through the new "closed plan" definition in all "two-tier" pension plans, purchase and sale situations, and any other situation where (even historically) a plan was closed to certain groups of members to assess how the new "closed plan" definition applies to any particular plan.

Fixed Income Asset Allocations

The PfAD calculation is, in part, determined based on a plan's target fixed income and non-fixed income asset allocations, as set out in the plan's Statement of Investment

Policies and Procedures ("SIP&P") effective as at a particular valuation date. The PfAD increases as the plan's target allocation to non-fixed income assets increases.

Fixed income investments (held directly or indirectly through pooling arrangements) must meet prescribed credit rating criteria in order to be considered fixed income assets for purposes of the PfAD calculation. Under the 2018 Funding Regulations, if any portion of the target allocation to fixed income assets (within the short term note/T-Bill, Canadian debt or non-Canadian debt categories) does not meet the credit rating threshold, the entire target allocation would be "tainted" and none of the target allocation was considered a fixed income investment for purposes of the PfAD calculation.

The 2019 Funding Regulations provide that the portion of the target allocation to a fixed income category that meets the minimum credit rating threshold will be treated as fixed income, and the portion of the target allocation that does not meet the prescribed credit rating requirements will be considered 50% non-fixed income for purposes of the PfAD calculation.

Under transitional rules that apply for valuation dates up to December 31, 2019, actual assets held by the pension fund on the valuation date (as contrasted with the target asset allocation in the plan's SIP&P) are used to calculate the PfAD and assess whether assets meet credit rating requirements. The 2019 Funding Regulations amend the transitional rules to ensure that half of the value of the fixed income assets that do not meet the prescribed credit rating requirements can be treated as fixed income assets for PfAD calculation purposes.

Pension plan administrators will need to consider how the changes to the "closed plan" definition and the treatment of non-investment grade fixed income assets impact PfAD calculations both in the context of amending SIP&Ps to reflect PfAD requirements and, where applicable, allowing the employer to take immediate advantage of lower PfAD funding requirements resulting from these changes.

Benefit Improvements

The PBA was previously amended to allow the government to prescribe funding levels below which benefit improvements made after May 1, 2018 could not be made without requiring the benefit improvement to be immediately funded on a going concern and solvency basis through a lump sum contribution.[2] The 2018 Funding Regulations set that prescribed funding level at 80% for both the plan's solvency ratio and the plan's going concern funded ratio.

[2] Certain benefit improvements are exempt from the prescribed funding test, including amendments required by law and benefit improvements agreed to in collective agreements before May 1, 2018.

The 2019 Funding Regulations clarify the rules regarding such lump sum contributions and add additional flexibility for employers wishing to implement benefit improvements without fully funding the entire cost upfront. For example, the 2019 Funding Regulations contemplate a lump sum contribution being made to satisfy a portion of the cost of the benefit improvement and ensure the plan is 80% funded on a going concern and solvency basis. The balance of the cost of the benefit improvement could then be amortized over 8 years on a going concern basis.

The 2019 Funding Regulations confirm that the new benefit improvement funding requirements do not apply to certain jointly sponsored pension plans or specified Ontario multi-employer pension plans.

If you have any questions regarding this update please do not hesitate to call a sidebar with any of us – we're here to help.

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