SIDEBAR
News, Announcements & Insight

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Pension, Benefits & Executive Compensation Law

April 24, 2018

Reduced Solvency Funding and PfADs Change the Ontario DB Funding Landscape

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Ontario Regulation 250/18 (the "Funding Regulation") was issued on April 18, 2018 and introduces a new funding regime for Ontario-registered defined benefit ("DB") pension plans. The new DB funding regime essentially replaces the existing solvency funding regime with enhanced going concern funding. These are significant changes.

With few exceptions, the terms of the Funding Regulation will be in force as of May 1, 2018. Certain complimentary amendments to the *Pension Benefits Act* (the "PBA") will also come into effect as of May 1, 2018. Taken together, these amendments generally complete the funding overhaul announced by the Ministry of Finance in 2017 and in the province's previous Fall Economic Update, which we outlined in a previous Sidebar, *Welcome Amendments to the Ontario Pension Benefits Act Contained in Stronger, Fairer Ontario Act (Budget Measures), 2017*.

Other regulations were also issued on April 18, 2018 to ensure the new regime aligns with existing special regulations and asset transfer requirements under the PBA. These are listed at the end of this Sidebar.[1]

Introduction

The current solvency funding rules have been the main driver of the special payments required to be made to DB pension plans across Canada for the last 30 years. For at least the past decade, solvency special payments have been very high, volatile, unpredictable and the source of multiple rounds of temporary funding relief in both the private and broader public sector. The implementation of the Funding Regulation will drastically shift this paradigm to a regime that is anticipated to result in more stable funding requirements, as going concern funding will take centre stage for all single employer DB plans registered in Ontario except those that are less than 85% funded on a solvency basis.

[1] In addition, the regulations that will, upon meeting certain conditions, provide pension plan administrators with a discharge upon the purchase of buy out annuities to transfer pension payment obligations to insurance companies were made on March 27, 2018 and will be effective as of July 1, 2018. This regulation will be the subject of a separate Sidebar.

Application of New Funding Regulation

The Funding Regulation provides that the new rules will generally apply to valuation reports for single employer DB pension plans if the valuation report has a valuation date on or after December 31, 2017 and is filed after the Funding Regulation comes into force on May 1, 2018. As of the time of this Sidebar's publication, there is only a short window available for plan administrators to file valuation reports that are not subject to the new Funding Regulation.

DB plan funding rules as set out in Regulation 909/90 under the PBA (the "General Regulations") will continue to apply except where amended by the Funding Regulation, or by one of the consequential regulations listed at the end of this Sidebar. For example, the rules around the frequency of valuations will not change. Valuations will continue to be required triennially unless there are solvency concerns (e.g., the funded status determined on a solvency basis is less than 85%), in which case annual valuations will be required.

The Funding Regulation is intended to avoid the need for *ad hoc* solvency relief measures in the future. The general solvency relief measures introduced in 2016 (for example, the option to amortize a solvency deficiency over ten years) will not be available going forward. The Funding Regulation will apply to both private and public sector pension plans, although existing funding relief in place for public sector plans will continue on a transitional basis (see *Special Transition for Public Sector (including Broader Public Sector) Plans*, later in this Sidebar).

Notably, the Funding Regulation does not apply to those jointly sponsored pension plans ("JSPPs") that are listed at subsection 1.3.1(3) of the General Regulation.

Reduced Solvency Funding

Currently, if an Ontario-registered DB pension plan has a solvency deficiency on a valuation date, i.e., the plan is less than 100% funded on a solvency basis, the deficiency must be amortized over five years, starting not later than one year after the valuation date.

Consistent with past announcements, the Funding Regulation establishes a ***reduced solvency deficiency*** as the basis for future solvency special payments. No solvency special payments will be required if a plan's solvency funded status is 85% or greater. The amortization period is generally unchanged - any reduced solvency deficiency must be funded over five years starting not later than one year after the valuation date.

The General Regulation will continue to generally allow an employer to reduce the period over which solvency special payments are made if the scheduled payments are more than sufficient to meet solvency funding requirements.

The Funding Regulation confirms that benefits that were not previously required to be included in solvency liabilities continue to be excluded (notably, indexation/cost of living adjustments).

Letters of Credit

Currently, letters of credit can be used in lieu of employer solvency special payments to a maximum of 15% of a plan's solvency liabilities. Letters of credit to a maximum of 15% of a plan's solvency liabilities will continue to be available in lieu of employer contributions to fund the reduced solvency deficiency. The Funding Regulation will enable an employer to reduce an existing letter of credit to the extent that it was securing a solvency deficiency over the 85% reduced solvency deficiency threshold.

Enhanced Going Concern Funding

The Funding Regulation contains extensive changes to the going concern funding regime. The changes include consolidation of most going concern special payments into a single schedule of payments (known as a "fresh start" approach); shortening of the amortization period from 15 years to 10 years (8 years for certain benefit improvements, as discussed below); and the introduction of a funding cushion, known as a PfAD (defined below), that will apply to both the normal cost for current service accruals and past service liabilities.

The Funding Regulation also clarifies that indexation or cost of living adjustments are required to be accounted for when calculating the normal cost and going concern liabilities.

Amortization Periods

The Funding Regulation reduces the amortization period for unfunded going concern liabilities from 15 years to 10 years, and combines special payments required to eliminate past service unfunded actuarial liabilities that arise in reports filed after May 1, 2018, into a separate 10-year schedule commencing on the effective date of the plan. Past service unfunded actuarial liabilities arising in reports filed before May 1, 2018, will be amortized on a 15-year schedule from the date the liability arose.

Separate amortization schedules will be maintained for benefit improvements (discussed further below), depending on whether they are required by law, filed before May 1, 2018 or made to implement a benefit agreed to in a collective agreement before

May 1, 2018 provided the agreement is in place immediately before that date. Benefit improvements that meet any of those conditions will qualify for a 10-year amortization schedule, while benefit improvements that do not will be amortized over 8 years. A separate amortization schedule will also be maintained when a new plan is established with past service benefits.

Provision for Adverse Deviation ("PfAD")

A PfAD is a new concept for Ontario-registered DB pension plans. While the requirement to fund a PfAD was introduced for Quebec-registered DB plans in 2017, the Ontario PfAD rules are different and are expected to have a less significant impact on DB funding.

The PfAD will apply to both normal cost contributions and going concern liabilities. In other words, it will apply to create a funding cushion for both past service and future service liabilities.

PfAD contributions in respect of normal costs will be determined by multiplying the PfAD percentage, which itself will be determined based on the characteristics of the particular plan, by the normal cost.

PfAD contributions in respect of going concern liabilities will be determined by multiplying the PfAD percentage by the going concern liabilities, and amortized over 10 years in the same manner as the plan's going concern unfunded liability.

Notably, liabilities associated with both pre-retirement indexing and post-retirement indexing may be excluded for the purposes of determining the PfAD in respect of both the normal cost and going concern liabilities.

The Funding Regulation also outlines how the PfAD percentage will be calculated. It will be a formula with three components, "A", "B", and "C", explained in further detail below:

1. **Component "A":** A fixed component in an amount equal to 5% for "closed plans" and 4% for all others.

   A "closed plan" is defined as "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."

   It will be important to consider this definition carefully in order to determine whether the closed plan percentage applies to any DB pension plans in respect of which future service is earned on a DC basis, and whether it applies to an entire pension plan even where a very small group no longer participates in a DB component of the plan on a future service basis (or participates in a different plan on a future service basis).

2. **Component "B":** A variable component dependent on the plan's combined target asset allocation for non-fixed income assets, as set out in the plan's Statement of Investment Policies and Procedures ("SIP&P") effective on the valuation date, as follows:

Column 1 Item	**Column 2** Combined target asset allocation for non-fixed income assets	**Column 3** Value of "B" for closed plan	**Column 4** Value of "B" for plan other than closed plan
1.	0%	0	0
2.	20%	0.02	0.01
3.	40%	0.04	0.02
4.	50%	0.05	0.03
5.	60%	0.07	0.04
6.	70%	0.11	0.06
7.	80%	0.15	0.08
8.	100%	0.23	0.12

For valuation reports dated prior to December 31, 2019, a plan's actual asset allocation, as reported on the plan's financial statements, may be used provided that the assets meet certain minimum credit rating requirements.

A broad array of assets are considered to be "fixed income" for the purpose of determining the PfAD. Bonds, cash, term deposits, short-term notes, treasury bills, GICs and insured contracts all qualify as fixed income securities. Buy-in annuities held as plan assets favourably impact the calculation. Short-term notes, as well as bonds and debentures that are not otherwise recognized as fixed income assets, may be considered "fixed income" assets for PfAD purposes provided they meet minimum credit rating requirements. Non-fixed income assets include employer-issued securities and domestic and international stocks other than those that qualify as fixed-income securities.

50% of specified investments that are alternative investments (e.g., real estate, resource properties, income producing properties, infrastructure, mortgage loans, venture capital) will be considered non-fixed income assets for the purposes of the calculation. Pension plan assets invested through a pooled fund will be allocated as fixed income or non-fixed income depending on the securities in which the pooled fund invests.

3. **Component "C":** A variable component, based on the plan's going concern discount rate, which applies only if the discount rate exceeds a benchmark discount rate (BDR), determined in part based on Government of Canada long-term bond yields and factors applied to the plan's targeted fixed income and non-fixed income asset allocations. This component is designed to impose some discipline on the selection of appropriate discount rate assumptions.

Benefit Improvements

The PBA was previously amended to allow the government to prescribe funding levels below which benefit improvements could not be made without immediate funding. The Funding Regulation sets that prescribed funding level at 80% for both the plan's solvency ratio and the plan's going concern funded ratio. A lump sum contribution can be made to facilitate a benefit improvement by ensuring that a plan satisfies these requirements.

These requirements will not apply to an amendment if the amendment is filed before May 1, 2018 or if it is made to implement a benefit agreed upon in a collective agreement before May 1, 2018 provided the agreement is in place immediately before that date.

As indicated above, depending on the circumstances of the amendment, the increase in the going concern liabilities that arises after a benefit improvement is made will need to be funded over either 8 years or 10 years beginning on the effective date of the amendment. Actuarial surplus may continue to be used to fully or partially fund benefit improvements, subject to certain restrictions.

Contribution Holidays

The PBA was also previously amended to explicitly allow contribution holidays from payments of the normal cost and PfAD in respect of the normal cost provided actuarial surplus is available. The Funding Regulation establishes the framework applicable to those new legislative provisions.

Under the current regime, actuarial gains can be applied to reduce contributions in respect of going concern unfunded liabilities and normal cost contributions, provided the plan is fully funded on both a going concern and solvency basis. The new rules place tighter restrictions on contribution holidays, which will be available only to lower the contribution requirements of an employer or members for the normal cost and the PfAD in respect of the normal cost, again provided that no special payments are required or have been deferred.

The amount of the available surplus will be the lesser of:

- the excess of the plan's assets over the sum of its going concern liabilities, PfAD, and the prior year credit balance; and
- in the case of a public sector pension plan, the amount that, if deducted from the solvency assets of the pension plan, would reduce its solvency ratio to 1.05; or
- in the case of any other plan, the amount that, if it were deducted from the solvency assets of the pension plan, would reduce the transfer ratio to 1.05.

Other than for designated plans or individual pension plans, a cost certificate must be filed within 90 days of the beginning of each plan year in which a contribution holiday is taken.

The value of assets that could be used to take a contribution holiday for a year is limited to the lesser of the available actuarial surplus for the fiscal year reported in the plan's last valuation report, and the amount (if any) of estimated available actuarial surplus for the fiscal year as reported in the actuarial cost certificate filed for that year.

Further, notice of the contribution holiday must be provided to plan beneficiaries, any unions representing members, and the plan's pension advisory committee, if any, within the first 6 months of the fiscal year in which the contribution holiday is to occur. This notice can be combined with annual and biennial benefit statements, if applicable.

Transitional Provisions

General Transition for All Plans

The Funding Regulation contains transition rules applicable to the first valuation report filed under the new funding framework. The following phase-in schedule will be available to most pension plans where the total contribution requirements (i.e., the total of normal cost requirements, all required special payments, and any required payments due to the PfAD) under the new framework are greater than they would have been under the old rules:

- for the first year following the valuation date, contribution requirements are exempt from increases due to the new rules.

- in the second year following the valuation date, one-third of the increase in contributions is required.

- in the third year following the valuation date, two-thirds of the increase in contributions is required.

For the first valuation report of a plan governed by the Funding Regulation, a reduction to the amount of the monthly solvency special payments for any amortization period for which special payments end within six years of the valuation date is now permitted.

Special Transition for Public Sector (including Broader Public Sector) Plans

A number of public sector plans have received temporary solvency funding relief provided through O. Reg. 178/11 (the "BPS Regulation"). Regulations released contemporaneously with the Funding Regulation make the new funding rules applicable to such public sector plans, subject to the BPS Regulation.

The new funding requirements under the Funding Regulation will apply to all plans upon the filing of the first valuation report with a valuation date on or after December 31, 2017. However, the more stringent restrictions on benefit improvements and contribution holidays under the BPS Regulations will continue to apply to public sector plans that received temporary solvency funding relief. These restrictions will govern until the earlier of 19 years after the plan's stage one valuation date and the filing date of the second of two consecutive valuation reports indicating the plan has a minimum transfer value of 1.0.

Other Amendments

The Funding Regulation contains other amendments to several provisions of the General Regulation. These include changes to:

- the content of valuation reports;

- the content of actuarial cost certificates;

- the content of the SIP&P, which must include the plan's target asset allocation for each asset class;

- active plan surplus withdrawal rules;

- the disclosure of funding information to plan beneficiaries in annual statements and biennial statements, effective January 1, 2019; and

- Pension Benefits Guarantee Fund assessment calculations, effective January 1, 2019.

Pension Plan Amendments Required

The Funding Regulation prescribes a deadline within which plan sponsors must amend their pension plans to recognize the new and modified funding obligations. In particular, all pension plans must set out the obligation of the employer and members, as applicable, to fund:

(a) the provision for adverse deviations in respect of the normal cost;

(b) any plan amendment that increases going concern liabilities; and

(c) except for jointly sponsored pension plans, any reduced solvency deficiency under the plan.

The Funding Regulation requires these amendments to be made within 12 months after the first valuation report with a valuation date on or after December 31, 2017 is filed.

Consequential Regulations

Several other context-, plan- and sector-specific regulations were released along with the Funding Regulation to facilitate the transition to the new funding regime. Asset transfers and pension plans that were previously subject to a special Ontario regulation will need to be assessed with regard to the plan's particular circumstances to determine the full impact of the new funding regime.

These consequential regulations are as follows:

- Certain Public Sector Plans: Regulation 257/18

- Asset Transfers & Conversions: Regulation 253/18 and Regulation 255/18

- General Motors (GM) Pension Plans: Regulation 252/18

- Resolute FP Canada Inc. Pension Plans: Regulation 251/18

- Essar Steel Algoma Inc. Pension Plans: Regulation 254/18

- U.S. Steel Canada Inc. Pension Plans: Regulation 256/18
- General Synod Pension Plan of the Anglican Church of Canada: Regulation 258/18 and Regulation 258/19

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The Funding Regulation will have a significant impact on Ontario-registered DB pension plans, which impact will vary depending on the individual characteristics of the plan including its current going concern and solvency funded status, investment mix, use of letters of credit and use of de-risking strategies.

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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