leadership beyond finance

Introduction

In 2016, the Ontario government launched a public consultation and review regarding the funding of defined benefit pension plans. The objective of the funding review was to develop a balanced set of reforms that would focus on plan sustainability, affordability and benefit security, and take into account the interests of pension stakeholders – including sponsors, unions, members and retirees. The consultation resulted in new solvency funding legislation, which came into effect May 1, 2018, and many are asking the following questions:

- Do Ontario's new funding rules find a balance between providing companies with funding/cash flow predictability and providing security for workers/pensioners benefits?
- Are these new rules enticing enough to stem the flow of Pension Plan conversions from Defined Benefit Plans to Defined Contribution Plans or the elimination of Pension Plans altogether?

Given that Ontario represents a large proportion of Canadian pension plans and that the majority of large corporate pension plans in Canada are subject to Ontario regulations, this brief paper will attempt to:

- Analyze the main changes,
- Draw some conclusions as to the impacts of these changes on the broader Canadian pension landscape, and
- Raise certain policy issues regulators and plan sponsors may wish to consider.

Here's a brief overview of what's changed and what's new for Ontario's Defined Benefit Pension Plan funding framework.

What's Changed

Solvency Funding

Top-up contributions now only required if pension plan assets represent less than 85% of Solvency liabilities. The top-up funding continues via special payments amortized over 5 years.

Going Concern Funding

The going-concern funding bar is now higher and includes a provision for adverse deviation (PfAD) – see section below for an explanation – meaning the going-concern liabilities under the

new rules are higher than they were under the old rules. In addition, the amortization period for any going concern deficit is now 10 years whereas it was 15 years previously and the special payments schedule is refreshed with each valuation whereas the old rules carried forward the prior valuation's schedule.

Increased Transparency on funded status for Plan members

Plan member statements will be required to explain the difference between the new and old rules. Annual statements will disclose estimates of transfer ratios (solvency funding status) at end of statement period.

Pension Benefits Guarantee Fund (PBGF)

This fund is intended to cover pension benefits (up to a specified amount) when a Pension Plan is wound up and there is a funding shortage. This will result in increases in the annual assessment fee for the plan sponsors and a higher minimum guaranteed pension provided to pensioners.

What's New

Provision for Adverse Deviaions (PfAD)

The new rules introduced a Provision for Adverse Deviations (PfAD) – a reserve within the Plan, which increases the going concern liabilities and current service cost – to be included in determining employer contributions. The PfAD amount will depend on two factors, whether the plan is open or closed to new members and the investment asset mix; with higher fixed income asset ratios resulting in lower PfAD's, and a corresponding lower additional funding requirement.

Benefit Improvements

Plan sponsors will be allowed to improve plan benefits if both the solvency ratio and going concern funding ratio (without PfAD) after the improvement are both 80% or if a top up contribution is made equal to the improvement and both the solvency and going concern ratios after the improvement are at least what they were before.

If new rules result in increased contributions then the additional contributions can be phased-in over 3 years.

Contribution Holidays

Contribution holidays have been restricted to improve benefit security. Contribution holidays are permitted if the plan is fully funded and transfer ratio is at least 105%.

PBGF Fee

The Pension Benefits Guarantee Fund (PBGF) fee can be paid for the pension trust if the plan is in surplus.

Who Benefits from these Changes

What impact will these new rules have on the other Pension Plan jurisdictions in Canada? While Quebec eliminated solvency funding as the primary basis for pension funding in 2016, Ontario chose not to eliminate solvency funding but instead shifted the emphasis to going concern funding. Solvency Funding assumes the Plan is to be wound up and calculates the funding obligation based on Canada bond rates. Going Concern Funding typically eases the burden on companies as it assumes the Company (Pension Plan Sponsor) continues indefinitely and calculates the funding obligation based on expected future stock market and bond returns reflecting how the pension assets are actually invested.

The going concern assumption usually appears to be a reasonable one until such time as financial disaster strikes. Sears Canada is one such example. Sears employees have had their Pension payments reduced by 20% as a result of the Pension Plan being underfunded at the time of the bankruptcy. What must sting for the retirees is the fact that Sears paid hundreds of millions in dividends to its investors over the years leading up to the bankruptcy while the Pension Plan was underfunded by $260M. Although the dividends have been described as excessive, Sears was nevertheless fully complying with the funding requirements under the Pension Benefits Act (PBA). Their retirees have been significantly negatively impacted by this shortfall and at a time in their lives when they have no opportunity to supplement foregone income.

Is it the government's responsibility to have stricter funding guidelines or do Boards of Directors have to do a better job of balancing their responsibility to shareholders with their fiduciary responsibility to retirees? Will the decisions made by the Sears Board of Directors influence fiduciary responsibilities?

The reduction in the amortization period from 15 years to 10 years for Going Concern funding will, all other factors being equal, increase the funding of Pension Plans. The shorter the amortization period, the higher the contributions. The introduction of the PfAD also increases the going-concern funding requirement.

The Pension benefit provided by the PBFG in the event a Pension Plan is wound up and at the time of the wind up has insufficient funds to pay its pensioners, increases under the new rules from $1,000/month to $1,500 month. This represents a 50% increase and is a significant improvement in the protection of pensioners. The increase in this benefit is supported by increases to the PBFG fees assessed to plan sponsors. The increase in benefits funded by the increase in the PBGF assessments demonstrates the balancing act Ontario is trying achieve. Ontario is the only jurisdiction in Canada to have a program such as this. Is it sustainable and

would it be necessary if Pension Plans were required to be fully funded? Why should companies with Defined Benefit Pension Plans be required to pay insurance premiums in the event of another company's bankruptcy?

The increase in transparency on members statements is an effort by the Ontario government to ensure Plan members have the most current information available to them. However, Pension Plan member apathy is a real challenge for employers. Will the increase in information included in statements awaken the Plan members and/or cause unnecessary concern?

The new rules linking benefit improvements to minimum funding requirements is prudent and ensures alignment of increased benefits with funding and affordability. It prevents providing enhanced benefits today by eroding the funding status to the potential detriment of future pension benefits.

The ability of plan sponsors to use pension surpluses and contribution holidays has always been controversial and the tightening of the rules as well as the increased transparency to Plan members should be seen as a reasonable compromise.

Summary of Changes by Primary Beneficiary

The table below provides a high level summary of the major changes and who the primary beneficiary will be. It illustrates the net result of the government's attempt to find an appropriate balance between the interests of plan sponsors (employers) and plan members (employees and pensioners).

Changes/New Items	**Company**	**Plan/Members**
Top-up Solvency Funding Only Required below 85%	✓	
Emphasis on Going Concern Funding	✓	
Shortened Going Concern Amortization Period		✓
Increased Transparency on Members Statements		✓
Increased PBGF Assessment & Guarantee		✓
Provisions for Adverse Deviations		✓
Funding Rules for Benefit Improvements	✓	✓
Restrictions on Contribution Holidays		✓
Actuarial Surplus used to pay PBGF	✓	

Ontario's new funding framework for Defined Benefit Pension Plans clearly tries to find an appropriate balance between protecting and maintaining retirement benefits while enabling companies to have more funding flexibility to grow and be more competitive. The new rules

increase the complexity of Pension Plan funding requirements and we recommend plan sponsors work closely with its Pension consultants and/or Actuaries in developing appropriate pension management and governance strategies.

Conclusion

The above analysis demonstrates that the new Ontario pension funding legislation does indeed attempt to achieve a balance between the interests of employers and plan members. Although it is difficult to determine who benefits the most, it does appear that the gains made by plan sponsors are relatively more meaningful than those made by plan members. Since the changes provide plan sponsors with some additional funding flexibility, the new rules may result in a slower rate of conversion of defined benefit to defined contribution pension plans. However, the fact remains that defined benefit pension plans create complex financial risks for plan sponsors and that compliance with government regulations will continue to be administratively burdensome. Consequently, the new Ontario rules combined with the expansion of the Canada Pension Plan are unlikely to persuade employers contemplating the creation of a new pension plan to opt for the defined benefit variety over the less risky (from a plan sponsor perspective) and easier-to-administer defined contribution variety.

Definitions

Solvency Funding – Calculates the funding required to pay all of the benefits owed to its members assuming the Pension Plan is wound up today. A deficit exists if the Plan assets are insufficient to pay all of the benefits.

Going Concern Funding – Assumes the Pension Plan sponsor continues indefinitely. Actuarial calculations are based on numerous assumptions, the most important of which is the interest rate assumption, expected returns of different asset classes and longevity..

Transfer ratio – solvency assets divided by solvency liabilities

Closed Pension Plan – A DB Pension Plan that does not allow new members to join and accrue benefits

FEI Canada Pension Committee

Kevin Sorhaitz
James (Tony) Hooper
Jayne Connolly
Don Wishart
Gerry Wahl
Rolland Morier
May Han