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Information Bulletin

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Ontario's New Funding Framework (PfAD Details and More)

As announced in its 2017 Budget, the Ontario government is in the process of developing a new defined benefit pension plan funding framework.

Some amendments to the *Pension Benefits Act* (PBA) related to the new funding framework were included in Bill 177.[1]

The two key changes to the funding framework are:

- Softening of solvency funding requirements from 100% of solvency liabilities to 85% of solvency liabilities
- Balanced by the requirement to add a Provision for Adverse Deviations (PfAD) in the going concern valuation, and a shortening of the amortization period for going concern deficits from 15 to 10 years

On December 14th, the Ontario government released a description of proposed regulations relating to the new funding framework[2] (Proposal). The Proposal provides the long-awaited details of the PfAD for going concern valuations, information on transition to the new funding framework, and more details on requirements for benefit improvements and contribution holidays.

The intention is for these changes to apply to valuation reports dated on or after December 31, 2017, that are filed after the new framework comes into force, except if otherwise noted.

Comments on the Proposal can to be submitted until January 29, 2018.

Provision for Adverse Deviations (PfAD)

The going concern valuation will require that a PfAD be added to both normal cost and the going concern liabilities. The PfAD will be higher for plans that are closed to new members (Closed Plans) than for plans that still accept new entrants (Open Plans).

The PfAD will be the sum of three components:

1. **Fixed Component:** A basic fixed component of 5% for Closed Plans and 4% for Open Plans
2. **Asset Mix Component:** A component that increases with the percentage of plan target assets invested in non-fixed income assets. This component is shown in the following table.

Asset Mix Component[3]

Percent of non-fixed income assets[4]	PfAD for Closed plans	PfAD for Open plans
0%	0%	0%
20%	2%	1%
40%	4%	2%
50%	5%	3%
60%	7%	4%
70%	11%	6%
80%	15%	8%
100%	23%	12%

3. **Discount Rate Component:** An additional reserve if the plan's best estimate discount rate is above a benchmark discount rate (BDR). This component is equal to Plan Duration times (Discount Rate minus BDR).

   The BDR is based on long-term government bond yields, risk premiums on assets, and an allowance for diversification. To be more specific the BDR is equal to the sum of:

   – The Government of Canada long bond yield[5]

   – The proportion of the plan's target asset mix allocated to non-fixed income investments times 5%

   – The proportion of the plan's target asset mix allocated to fixed income investments times 1.5%

   – 0.5% for diversification

   This component is expected to be zero for most plans at this time. For a typical plan with 60% non-fixed income assets, the BDR is estimated to be 6.44% for a December 2017 valuation date. Based on the *2016 Report on the Funding of Defined Benefit Pension Plans in Ontario*,[6] 94% of the plans were using a going concern discount rate at or below 6%.

For purposes of determining the PfAD and the BDR, allocations to specified alternative investments (e.g., real estate, infrastructure) would be deemed to be 50% fixed income and 50% non-fixed income as these types of investments have both fixed income and non-fixed income characteristics.

The PfAD is added to both the normal cost and the going concern liabilities. Thus the going concern contribution requirement will be:

- Normal cost plus PfAD on the normal cost
- Amortization over 10 years of going concern unfunded liability, where the going concern unfunded liability reflects the deficiency of assets relative to the going concern liability plus the PfAD on the going concern liability

In light of the new PfAD, plan sponsors might expect changes to the going-concern discount rate assumptions, such as eliminating the implicit margin for adverse deviation in conjunction with having an explicit PfAD, as well as benchmarking with the BDR.

Restart 10-Year Amortization

Under the proposed funding framework, a going concern unfunded liability will be amortized over 10 years. Special payments would be consolidated into a single amortization schedule that begins one year after the valuation, and the amortization schedule would restart with each new valuation with no need to maintain prior layers of amortization payments. However, separate amortization schedules for unfunded liabilities would still be required for benefit improvements.

Plans with Indexing

If a plan provides indexation, a PfAD will not be required on the portion of the normal cost and the going concern liabilities that reflect the value of future indexing.

Example of Application of Provision for Adverse Deviations

The description of the proposed rules included the following example to illustrate how the PfAD requirements would be applied.[7]

> **Example of Application of the Provision for Adverse Deviations**
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> An open plan's assets are 40% fixed income and 60% non-fixed income. The actuary's best estimate discount rate is 6.5%, gross of all expenses, and the duration of the plan's liabilities is 15. If the yield on Government of Canada long bonds is 2.27%:
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> - The plan's BDR is 2.27% + (0.6 x 5%) + (0.4 x 1.5%) + 0.5% = 6.37%
> - The plan's PfAD would be 4% + 4% + 15 x (6.5% – 6.37%) = 9.95%
>
> If a plan with no indexing has going concern liabilities of $100,000, assets of $90,000, and a normal cost of $12,000, the PfAD on the normal cost would be 9.95% of $12,000, or $1,194. The plan's going concern unfunded liability would be
>
> Liabilities + PfAD on liabilities – assets
>
> $100,000 + (9.95% x $100,000) – $90,000 = $19,950
>
> Going concern special payments required until the next valuation report is filed would be the amount determined by amortizing $19,950 over 10 years. However, required contributions based on this schedule of special payments would be made only for the period commencing one year after the effective date of the report until one year after the effective date of the subsequent report, when a new schedule of special payments would be established based on the updated going concern funded position of the plan.
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Benefit Improvements

The new funding framework will put restrictions on when a plan can provide benefit improvements, and benefit improvements must be funded more quickly. The liability associated with a benefit improvement, plus the PfAD on that liability, must be funded over five years starting on the effective date of the improvement (no one-year deferral) and the amortization schedule must be maintained separately.

Benefit improvements can only be provided if the plan's solvency ratio is at least 85%, and the going concern funding ratio (without any PfAD) is at least 90%. If a plan falls short of these thresholds, then a lump sum contribution could be made to satisfy these requirements.

Contribution Holidays

The proposed funding framework would permit contributions holidays for the normal cost and the PfAD on the normal cost only if all of the following conditions are met:

- The plan must be fully funded on a going concern basis, including the PfAD on going concern liabilities
- On a wind-up basis, the transfer ratio must be above 1.05 even after reducing solvency assets by the amount of surplus needed for the contribution holiday
- A cost certificate must be filed in each year a contribution holiday is taken
- Notice is provided to plan members, and any unions and pension advisory committee (if there is one)

In addition, the amount of surplus used for a contribution holiday in the year is limited to 20% of the plan's available surplus (taking into account the requirement to fully fund the PfAD and maintain a transfer ratio of at least at 1.05).

Previous Solvency Funding Relief

The relief measures introduced in 2016 (option to consolidate existing solvency payment schedules, and the option to elect to amortize solvency deficiencies over 10 years) will no longer be permitted. The solvency funding requirement is reduced to 85% of the solvency liability, but any new deficiency based on this reduced target must be funded over five years.

For plans for which certain relief measures were elected previously, special rules for determining the solvency asset adjustment and the special payments when there is a solvency excess would no longer be permitted under the new framework.

Broader Public Sector Plans will have separate rules for temporary solvency funding relief to allow for the transition to the new framework.

Letters of Credit

Letters of Credit can still be used to meet solvency funding contribution requirements. However in recognition of the fact that the proposed new rules will only require funding of 85% of solvency liabilities. For example, the letter of credit could be used to bring a plan's funding from 70% on a solvency basis to 85%. The regulations will be amended to make it clear that a letter of credit can be reduced if the 85% target is met.

Transitional Funding Rules

While the proposed funding regime is expected to reduce contribution requirements for many plan sponsors (particularly those that are not well funded on a solvency basis), some plans could see an increase in contribution requirements under the proposed rules.

The proposed framework provides transitional relief, by allowing plans to phase into a higher contribution requirement. In particular, if the new framework produces higher contributions than the current rules, plans will have three years to phase into the higher contribution requirements after filing the first report under the new framework. For example, if the first valuation report under the new framework is dated January 1, 2020, then:

- In the first year (2020), contribution requirements would be exempt from the increases due to the new rules
- In the second year (2021), one third of the increase in contributions would be required
- In the third year (2022), two thirds of the increase would be required

In addition, as a one-time transition measure, if there is a solvency excess in the first valuation filed under the new framework, such excess can be used to reduce either the payment amount or the amortization period in respect of those previously established solvency special payment schedules that have less than 6 years remaining. This measure will adjust the special payments to reflect the new 85% funding goal.

New Disclosures Required

Ontario will require that the first annual pension statement for active members and biennial statement for inactive plan members after the new rules come into effect must include wording that describes the changes in funding requirements.

Statutory Discharge on Annuity Purchase

In addition to the new funding framework, a new PBA section[8] will provide a statutory discharge when an administrator of a single employer pension plan purchases an annuity, provided that the purchase of an annuity does not change the nature of the benefits or payments, and certain prescribed conditions are met. Additional contributions would be required if the solvency funding ratio falls below the required levels.

On December 14th, the Ontario government also released a description of proposed regulations relating to the discharge for the purchase of annuities[9]. The proposed regulations will require:

- member notice to be provided
- a compliance certificate from the actuary to be filed with the regulator along with a copy of the annuity contract
- plan solvency funding levels to be maintained so that remaining plan beneficiaries are not negatively affected [specifically, the plan’s solvency funding ratio should be the higher of the solvency funding ratio before the annuity purchase or 100% (to be reduced to 85% once the new solvency funding framework comes into force)], and
- the annuity contract itself must also contain particular provisions that will be set out in the new Regulations (e.g., annuity is exempt from seizure, and joint and survivor annuity is required where there is a spouse)

The discharge can apply to pre-existing annuity contracts but they will have to meet these conditions or be adjusted first.

What’s Next?

While the Proposal is open for comment for 45 days, we expect the draft regulation will be released shortly after. Sponsors of plans that are currently in the process of preparing an actuarial valuation should consider the implications of the new funding framework, their contribution strategy as well as the filing timing of such valuations. Over the longer term, plan sponsors should reassess the long term funding, investment policy and, where relevant, determine whether or not to formulate annuity purchase policies for their plans.

Your Aon Hewitt consultant will be reaching out to you to discuss these changes in more detail, and in particular, to review how these changes will impact your plans and funding requirements.

Footnotes

1. Ontario Bill 177, *Stronger, Fairer Ontario Act (Budget Measures), 2017* (which received royal assent on December 14, 2017).
2. Ontario Ministry of Finance, *Reform of Ontario's Funding Rules for Defined Benefit Pension Plans: Description of New Funding Rules*, Queen's Printer for Ontario, 2017, p.6.
3. Ontario Ministry of Finance, 2017, p. 6.
4. If the percent of non-fixed income assets is between the values shown, interpolate to determine the exact PfAD.
5. From Bank of Canada CANSIM series V122544.
6. Financial Services Commission of Ontario, *2016 Report on the Funding of Defined Benefit Pension Plans in Ontario*, Queen's Printer for Ontario, 2017, p. 17.
7. Ontario Ministry of Finance, 2017, p. 7.
8. Ontario Bill 177, 2017, para. 20.
9. Ontario Ministry of Finance, *Description of Proposed Regulations to Provide Pension Plan Administrators with a Discharge of Liabilities in Respect of the Purchase of Annuities for Former and Retired Members of a SEPP*, Queen's Printer for Ontario, 2017.

Contact Information

Should you wish additional information on this topic, please contact your local Aon Hewitt Consultant, or send an email to info@aonhewitt.com.

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