Memorandum

DECEMBER 22, 2017

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Emerging Details of New Funding Framework for Defined Benefit Pension Plans in Ontario

Introduction

On December 14, 2017, the Ontario Government kicked off a consultation period on the description of the proposed regulations relating to the new funding framework for DB pension plans. This was the long awaited next step following their original announcement in May 2017. Many of the changes will be welcome news for plan sponsors in that contribution requirements will be less volatile going forward; although, there are several challenges with the new rules, which we will discuss in this memo.

Nearly simultaneously, the Ontario Government also released a description of proposed regulations relating to a discharge of liabilities for annuities purchased by ongoing DB pension plans. While not the focus of this memo, we have already started compiling our list of issues and challenges with their proposed rules; stay tuned for a future blog on this topic.

Note that the Ontario Government has only released a *description* of the proposed regulations, which could change based on comments they receive during the consultation period ending on January 29, 2018. After that date, they will likely release draft regulations for comments, so it may be a while before all the final details are known.

Changes to the Funding Rules

Solvency Funding

Under the proposed rules, solvency special payments would only be required to fund the pension plan up to 85% of the solvency liabilities rather than the current requirement to fund to 100% of the solvency liabilities.

Unchanged from the current rules, any solvency deficit would need to be funded over five years, starting one year after the valuation date. Also, it will remain possible to exclude certain benefits, such as indexing, from the solvency liabilities and to continue to "smooth" the solvency results over a period of up to five years.

Letters of credit will continue to be permitted to fund solvency special payments of up to 15% of the solvency liabilities. This means that with the new 85% target, if the plan was only 70% funded on a solvency basis, a letter of credit could be used to fund the remaining 15% and no solvency special payments would be required. The new rules will also permit the reduction of an existing letter of credit to reflect the reduced 85% target.

Going Concern Funding

Under the proposed rules, the going concern liabilities and current service costs will be "grossed up" to include a mandated Provision for Adverse Deviations (PfAD). The PfAD will increase the funding target to something above 100% of going concern liabilities. The going concern liabilities must now include the cost of any contractual indexing of benefits (if they weren't already), although no PfAD will be required for those liabilities *(continued on next page).*

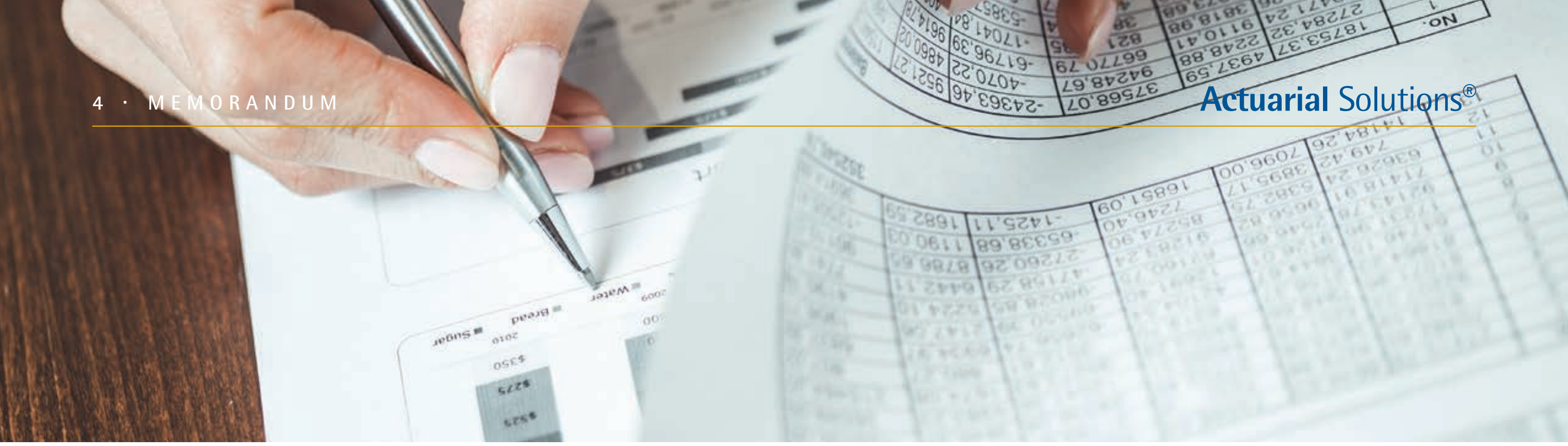
The level of the PfAD will be determined based on the asset mix of the plan, whether the plan is open or closed to new members, and how the discount rate compares to the "Benchmark Discount Rate" which is a rate that will be prescribed in the regulations. The PfAD could be as low as 4% and as high as 30% or more, but we expect most PfADs to be in the range of 8% to 15%.

Going concern special payments will be required to fund any deficits over a 10-year period (not the 15-year period permitted in the current rules). The going concern special payments will now start one year after the valuation date and will apply until one year after the next valuation date. The going concern special payments will be consolidated and amortized over a new 10-year period at each valuation, except for special payments related to benefit improvements *(see below)*.

Benefit Improvements

Under the proposed rules, benefit improvements will only be permitted if after the improvement the solvency ratio remains above 85% and the going concern funded ratio remains above 90%. If a benefit improvement is provided in a pension plan that does not meet these thresholds, then a lump sum contribution would be required to meet the requirements.

The increase in the going concern liabilities, including the PfAD, due to the benefit improvement would need to be funded over five years beginning on the effective date of the plan amendment. While surplus can be used to fully or partially funded the benefit improvement, any special payment schedules related to benefit improvements may not be consolidated and re-amortized with other going concern special payments.



Surplus and Contribution Holidays

Under the proposed rules, there will be very strict rules regarding contributions holidays.
A contribution holiday may only be taken if:

- The actual assets in the plan (excluding the value of any letter of credit) must be at least equal to the going concern liabilities plus the PfAD;
- The plan's transfer ratio (which is based on the plan's wind-up liabilities, and may include benefits that are excluded from the solvency liabilities) must remain above 105%, after excluding the assets for the contribution holiday;
- The maximum contribution holiday in each year is limited to 20% of the 'available actuarial surplus', which is the lesser of (i) the amount of assets above the going concern liabilities plus PfAD, or (ii) the assets above 105% of the wind-up liabilities;
- An actuarial cost certificate is filed within the first 90 days of the plan's fiscal; and
- Notice is provided to plan participants and any unions regarding the contribution holiday

On a related note, premiums to the Pension Benefits Guarantee Fund will no longer be permitted to be paid from surplus.

Transitional Rules

Given the significant changes under the proposed rules, various transitional measures will be available to plan sponsors. These include one-time adjustments to solvency special payment schedules to reflect the lower funding target in the first actuarial valuation under the new rules.

In addition, if the first actuarial valuation requires higher contribution requirements under the proposed rules than under the current rules, the increased contributions will be phased in over three years starting on the valuation date.

Given that the new rules will only apply to valuations on or after December 31, 2017 that are filed after the new rules are enacted, some plan sponsors may even choose to do a valuation early in order to lock in the old rules for as long as possible if the additional PfAD requirements will result in higher contributions overall. Conversely, plans that are currently on schedule to make solvency special payments for the next three years may choose to do an early valuation as at December 31, 2017 once the new rules are enacted in order to reduce their contribution requirements starting in 2018.

With respect to plan participants, after the first valuation is filed under the new rules, an explanation of the changes to going concern and solvency funding must be included the plan participants' next annual or biennial statement.

What's Next

The Ontario Government has stated that there will be further consultations related to the proposed regulations in respect of other aspects of the new funding regime, such as the new requirements for governance and funding policies, changes to the benefits and premiums under the Pension Benefits Guarantee Fund, and details on the registry for unclaimed pension benefits.

Notably absent from the proposed rules are related changes that we have seen in other provinces, such as:

- Adjustments to the lump sum commuted values offered to terminating plan members to reflect the funded status of the plan;
- Adjustments to the surplus rules to allow that additional contributions made by plan sponsors to fund PfADs and certain deficits may be used in the future to take contribution holiday or revert to the plan sponsor upon wind-up.

We expect that the Ontario Government will receive submissions pointing out these items, but we're unsure if they will make any adjustments to the rules finally chosen.

Next Steps

Please be assured that we will keep you informed as future developments unfold on this topic.

Please feel free to contact your consultant (Jason, Dean, Carly or Joe) if you would like to discuss any of the above.

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