Proposed Criteria for Exempting New Broader Public Sector (BPS) Multi-Employer JSPPs from Solvency Funding Requirements

I. INTRODUCTION

Several employer and employee groups in Ontario's broader public sector (BPS) have expressed interest in converting their single employer pension plans (SEPPs) to become jointly sponsored, merging them with existing jointly sponsored pension plans (JSPPs) or forming new JSPPs. The JSPP model is an alternative approach for providing defined-benefit pensions in the workplace. To facilitate this, the *Building Opportunity and Securing Our Future Act (Budget Measures), 2014* amended the *Pension Benefits Act* (PBA) to provide a legislative framework for the voluntary conversion of BPS SEPPs to JSPPs. Regulations are currently being developed to allow these amendments to be enacted.

Certain parties in Ontario's BPS are considering amalgamating their pension plans to form new multi-employer JSPPs. While the amendments to the PBA will enable these transactions, the parties are understandably interested in knowing whether new multi-employer JSPPs will be exempt from solvency funding requirements.

An exemption from solvency funding requirements would have an impact on the amount and volatility of future required contributions from both members and employers. An exemption would provide both employers and employees with greater certainty about contribution levels and would also minimize potential fluctuations in operating budgets, including salaries. However, it would also mean lower contributions to the plan. Denial or approval of an exemption may determine whether interested plan sponsors and their beneficiaries proceed with conversion and amalgamation.

Solvency funding obligations were introduced to reduce the risk of pension plans being underfunded upon wind-up. The government is interested in ensuring that solvency-exempt plans have characteristics that minimize this risk. To that end, the government is consulting on appropriate criteria to be used in determining whether any new BPS multi-employer JSPPs should be added to the list of solvency-exempt JSPPs. Given the variations in plan design, these criteria would not be set out in regulation, but would be applied and considered on a case-by-case basis.

This paper proposes criteria that the government might use to evaluate whether new multi-employer JSPPs obtain an exemption from solvency funding requirements. While there has been interest from certain BPS employers about whether a solvency exemption would be available should the SEPPs they sponsor simply convert to new single-employer JSPPs, these will not be considered at this time. Feedback is being solicited to determine if the proposed criteria are appropriate and whether additional criteria should be considered.

HOW TO PARTICIPATE

The Ministry of Finance is seeking feedback from interested parties on appropriate criteria for the government to consider in determining whether to exempt from solvency funding requirements a newly-established multi-employer JSPP or a JSPP created as a result of an amalgamation of existing SEPPs.

Comments need not be limited to the proposed criteria set out in this paper. Since certain criteria proposed in this paper set out numerical thresholds, comments are also being sought as to the appropriateness of those thresholds. Suggestions and rationales for alternate thresholds would be appreciated.

Feedback can be submitted to BPS.pensionfeedback@ontario.ca or mailed to:

Solvency Exemption for New BPS Multi-Employer JSPPs
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Submissions must be received by **June 1, 2015**

II. BACKGROUND

The following examines the key differences between JSPPs and SEPPs. It describes solvency funding requirements and the inherent risks for plans exempt from those requirements.

A. Key Differences between JSPPs and SEPPs

There are key differences between SEPPs and JSPPs that can impact both the affordability and benefit security of the retirement income these plans provide, including:

1. **Potential for Reduced Benefits:** *On wind-up, benefits under a JSPP can be reduced if the plan is underfunded; SEPP benefits cannot be reduced unless the sponsor is insolvent and there are insufficient assets to cover pension obligations.*

   Impact: Merger into or conversion to a JSPP increases the risk to members that benefits could be reduced, while reducing the financial obligation of employer sponsors upon wind-up.

2. **Contributions:** *Employer sponsors of SEPPs are solely responsible for funding any deficits (solvency and going-concern) while the plan is ongoing; in a JSPP, responsibility for funding of deficits (and, typically, ongoing normal costs) is shared by the employer and members.*

   Impact: Merger into or conversion to a JSPP spreads risk to members by increasing contributions to fund deficits for which they were previously not responsible. It would also reduce the contributions of employer sponsors as a result of having member-partners that share funding obligations.

3. **Pension Benefit Guarantee Fund (PBGF):** *SEPPs are normally covered by the PBGF; JSPPs are not.*

   Impact: Merger into or conversion to a JSPP eliminates PBGF protections in place for plan beneficiaries, while eliminating PBGF premium costs for employer sponsors.

4. **Grow-In Rights:** *Grow-in benefits allow members whose employment has been terminated prior to early-retirement age to have access to early-retirement benefits upon reaching the plan's specified early retirement age. A member of a SEPP is normally eligible for individual grow-in rights if employment is terminated and certain qualifications have been met; JSPPs can, and have opted out of providing grow-in benefits. Without grow-in rights, JSPP members would be required to wait until the normal retirement age to receive an unreduced pension.*

Impact: Merger into or conversion to a JSPP will likely result in the elimination of grow-in rights for members and reduce the employer's contributions required to fund those benefits.

5. **Governance Responsibility**: *SEPPs are normally governed by employer sponsors; JSPPs share responsibility for governance between employers and members.*

   Impact: Merger into or conversion to a JSPP from a SEPP will normally provide members with greater transparency and more accountability for pension plan governance through their representatives. Increased member participation can result in governance being better aligned with member interests. Given the complexities associated with administering a JSPP, it may be difficult to find member representatives with relevant experience and expertise.

B. Solvency Funding and Exemptions for JSPPs

Solvency funding methodology calculates funding requirements to ensure a plan has sufficient assets to fund accrued benefits if the plan was wound-up immediately (i.e., there were no further accruals and contributions). Under the PBA, any identified solvency deficit in a SEPP must be funded through equal monthly payments over five years. The intention is to ensure that, at any given time, accrued benefits are as close to fully funded as possible should the plan be wound-up. This contrasts with going-concern funding, which calculates the level of funding required to ensure benefits can be paid as they come due in an ongoing plan. Any going-concern deficits must be funded over a longer period, by equal monthly payments over 15 years.

Solvency funding requirements were introduced during pension reform in the late 1980's. Initially, solvency requirements did not result in additional funding due to the higher interest rates in place during that time. In today's low-interest rate environment, solvency funding obligations are more onerous than going-concern obligations. Solvency interest rates are generally more conservative than those used in going-concern calculations and actuarial discretion is not available. As a result, plan sponsors subject to solvency funding requirements can face large and volatile solvency payments that may reduce capital available for their operations.

Under the PBA, all SEPPs are required to fund on a solvency basis. Certain multi-employer pension plans are exempt from solvency funding rules in anticipation of their conversion into target benefit plans. These plans will, once new regulations are enacted, be subject to different funding requirements. Most existing JSPPs have also been exempted. (For a comparison of how other jurisdictions approach solvency funding exemptions for public sector pension plans, see Appendix I.)

JSPPs were introduced in Ontario's pension legislation in 2006, primarily to acknowledge their existence. In 2010, the government announced its intention to exempt these plans from solvency funding requirements, citing the recommendation of the 2008 *Report of the Expert Commission on Pensions*. Since a majority of the existing JSPPs were (and are) large public sector plans, the Commission concluded that they would be unlikely to wind-up, making solvency funding unnecessary. In addition, since these plans are able to adjust contributions and prospective benefits (e.g., indexation) outside of the collective bargaining context. They were perceived as better able to adapt to market conditions than many SEPPs. Exemptions for certain JSPPs are provided in Regulation 909 of the PBA, where they are specifically named.

C. Risks Associated with Exemption from Solvency Funding Rules

Defined benefit pension plans face a number of risks that may result in their wind-up. Solvency funding acts as a protection for current and future members in such an event. Removal of solvency funding requirements may increase the following risks:

i. Benefit Security Risk:

SEPPs and JSPPs are not permitted to reduce accrued benefits in an ongoing plan[1]. Employer and employee sponsors facing constraints on their ability to meet funding obligations may only reduce benefits or increase member contributions on a go-forward basis.

New JSPPs, created from the merger of existing SEPPs, are likely to have a pool of existing retirees and accrued benefits which must be funded. Since active members are jointly responsible for funding in a JSPP, they will effectively be subsidizing fluctuations resulting from changes in the liabilities for retired and deferred members. If the pool of active members becomes too small relative to other plan participants, contribution increases may not be sufficient to address funding shortfalls. The only alternative may be to wind-up the plan, creating the risk of benefit reduction for all plan beneficiaries without the availability of grow-in rights (should the JSPP opt-out) and PBGF benefits.

ii. Employer and Sector Risks

The security of a pension plan depends on the employer's ability to pay its ongoing costs. If a private-sector employer is not profitable, it will have difficulty meeting its pension obligations. Similarly, in the BPS, if public funding is reduced or the employer's operations are privatized, the BPS sponsor may have difficulty meeting its pension obligations, thereby increasing the risk of a plan being underfunded upon wind-up.

[1] As noted, JSPPs can reduce accrued benefits if winding-up.

Business risk may extend beyond any individual employer to an entire sector. For instance, many private-sector employers face restructuring or business closures as a result of innovation and technological advancement. While some stakeholders take the position that solvency funding is not necessary for BPS plans as they are unlikely to be wound-up, the public-sector continues to evolve and is not immune to restructuring, privatization or technological advancement. For example, Canada Post has recently announced its intention to stop door-to-door mail delivery as other methods of communication have replaced mail and impacted its business model.

Simply put, any negative impacts on the operations of an employer or sector could increase the likelihood that an employer will be unable to meet its funding obligations. This, in turn, increases the probability that a JSPP will wind-up in an underfunded position, necessitating benefit reductions.

iii. Demographic and Investment Risk

The Canadian Institute of Actuaries (CIA) recently revised the mortality tables plan actuaries must use for calculating pension liabilities. These revisions reflect the fact that individuals are living longer than was previously the case. As a result of using these new tables, plans are facing increases in contributions to fund benefits for members who are living longer and receiving pension payments longer than previously expected. For example, Morneau Shepell estimates that pension plan liabilities will increase by 3-10% as a result of the CIA-mandated use of newly revised tables.

These additional costs have the potential to increase funding requirements beyond what is affordable for employer sponsors, increasing the risk of wind-up. The trend towards longer lifespans is expected to continue, and plans may be addressing unanticipated cost increases in the future.

More mature plans could also face increased funding challenges due to a growing proportion of deferred members and retirees in relation to active members. These challenges may also increase the likelihood of an underfunded wind-up, as a result of the:

- contribution increases available from a small group of active members to offset cost increases related to a large group no longer contributing to the plan; and

- greater reliance on riskier investments with higher returns to fulfill funding obligations, during a time when a more conservative investment strategy may be prudent. A conservative investment strategy typically reduces the amount of investment income available to fund benefits. Mature plans may be vulnerable to negative market impacts resulting in a reduced ability to meet ongoing benefit obligations.

III. PROPOSED CRITERIA FOR EXEMPTION FROM SOLVENCY FUNDING

With these risks in mind, the government is seeking comment on the following proposed criteria and any additional characteristics which may assist in determining whether an exemption from solvency funding requirements is appropriate for a new BPS multi-employer JSPP.

While certain criteria lend themselves to quantitative thresholds, others do not. In assessing the appropriateness of a solvency exemption for a specific BPS multi-employer JSPP, a careful analysis and weighing of all factors, both quantitative and qualitative, would be required. The government would examine plan characteristics to determine whether its features, taken as a whole, serve to reduce the additional risk created by a solvency exemption.

A. Number of Participating Employers

A larger number of participating employers contributing to a pension plan can reduce the risk of the plan being wound-up. This is because the risk of insolvency is diversified over a larger employer base; in the event that one employer becomes insolvent, there remain multiple employers available to sustain the plan.

The number of participating employers is one of the criteria for granting a temporary solvency exemption for certain MEPPs. MEPPs typically have a large number of employers contributing to a single plan. In 2007, a new class of MEPP was created, known as specified Ontario multi-employer pension plans (SOMEPPs); one of the criteria for the SOMEPP solvency exemption is that at least 15 non-affiliated employers participate in the plan. The rationale for this requirement is that it lowers the risk of plan wind-up by spreading risk among many employers.

Proposed Criterion:

In order to obtain an exemption from solvency funding requirements, a newly-established multi-employer JSPP in the BPS would consist of at least five participating employers. A minimum of five participating employers could adequately share the risk of a participating employer becoming insolvent. Having fewer than five would increase the risk that financial difficulties encountered by one employer could put a pension plan at risk of winding-up.

B. Membership Composition by Participating Employer

As noted above, possessing a large number of participating employers can mitigate risk by sharing it between plans; however, risk sharing will only be effective if it is appropriately spread across similarly sized employers. One large employer, whose membership dwarfs the membership of the others, would still be able to substantially influence the health of the pension plan. As such, another possible criterion for consideration might be a diverse membership that can reduce the impact on plan sustainability if an adverse event is experienced by one of the participating employers.

With respect to SOMEPPs, in order to qualify for solvency exemption, no more than 95% of the combined membership may be employed by a single employer. However, given that it is expected that the number of participating employers in a new BPS multi-employer JSPP will be significantly lower than the dozens that are often found in a MEPP, a 95% limit may not be appropriate in these circumstances.

Proposed Criterion:

In order to obtain an exemption from solvency funding requirements, a newly-established multi-employer JSPP in the BPS should not have any participating employer with over 50% of the plan beneficiaries.

In addition, it is proposed that consideration be given to the current and projected mix of active members and retirees in the new JSPP to increase the likelihood that the plan is more sustainable in the long term by having more contributing members to address funding shortfalls.

C. Amount of Assets under Management

In general, those pension plans able to earn consistent, risk-adjusted returns on investments while keeping administrative costs low are more likely to be sustainable over the long term. Typically, these plans possess the asset magnitude required to access alternative investment opportunities. In addition, they have the resources necessary to use sophisticated risk management systems aimed at maximizing returns while minimizing investment risk.

The Financial Services Commission of Ontario (FSCO) noted in its *2013 Report on the Finding of Defined Benefit Plans in Ontario* that large plans have higher average returns and lower investment fees than small plans. With respect to administrative and investment fees, larger pension plans find economies of scale not usually available to smaller plans. Bill Morneau, in his capacity as Pension Investment Advisor to the Ontario government, concluded in his 2012 report, *Facilitating Pooled Asset Management for Ontario's Public-Sector Institutions,* that pension plans begin to experience many of these economies of scale when they surpass $5 billion in assets.

Proposed Criterion:

In order to obtain an exemption from solvency funding requirements, a newly-established multi-employer JSPP in the BPS should have a baseline asset level of $5 billion.

D. Governance Practices

Pension plans that better manage risk tend, over the long-term, to outperform those that do not. By managing risk, it is expected that plans will face fewer negative consequences that could affect the plan's long-term sustainability and affordability.

Risk management is the primary focus of plan governance. Plans that are well-governed create systems and accountabilities that serve to reduce risk to member benefits and also contribute to the sustainability of the plan itself. Effective risk management tools help to mitigate pension risk by providing early indicators that funding may be insufficient to cover long-term obligations.

While governance effectiveness may be difficult to measure quantitatively, careful assessment of the qualitative features of a plan's governance would help determine whether it adheres to good governance practices. The Canadian Association of Pension Supervisory Authorities (CAPSA), an inter-jurisdictional association of pension regulators, prepares voluntary guidelines in a number of areas of pension management. These guidelines are frequently referenced by pension industry experts. CAPSA's *Pension Plan Governance Guidelines* recommend that plan administrators establish a policy detailing the roles and responsibilities of those involved in plan governance. The document also sets out general principles for effective governance that plans can adapt to their particular circumstances.

Using the CAPSA principles identified as best practices, a governance policy adopted by new JSPPs could be expected to address the following:

- the roles, responsibilities, and accountability of all participants in the plan governance process, including the process by which members of the board of trustees are selected;

- governance objectives for the administration of the plan, particularly as they relate to how the plan ensures that it complies with all regulatory requirements, such as filings;

- performance measures and procedures for monitoring the performance of those who have decision-making authority and those to whom responsibilities have been delegated;

- an internal control framework that addresses plan risks; and
- a code of conduct for members of the board of trustees to guide them in carrying out their fiduciary obligations.

As part of ensuring good governance practices, a growing number of sophisticated pension plans also use tools that provide sponsors with quantitative information that can be used to guide plan governance by limiting and/or managing liabilities. For example, tools that are often used by pension plans include:

Asset-Liability Management Studies (ALM)

The objective of an ALM study is to provide plan sponsors with an optimal asset allocation that closely matches the liability cash flows of a pension plan. Matching assets to liabilities reduces the risk that a plan finds itself with insufficient assets to pay promised benefits, necessitating increased contributions or an underfunded wind-up. ALM studies provide insight into how the characteristics of a plan, such as contribution rates, benefit accrual rates and indexation will impact funding for the plan. This information allows plan sponsors to set informed policies for funding, plan design, and investment strategies.

Many existing public-sector JSPPs regularly conduct asset-liability management studies. For example, the Ontario Teachers' Pension Plan's "Statement of Policies and Procedures" requires that "the Board shall conduct asset/liability studies. These studies lead to the recommendation and adoption of a long-term asset mix policy that aims to fund the liabilities and reduce the risk of adverse consequences to the Plan from increases in liabilities."

Funding Policy

A funding policy identifies a pre-determined course of action in the event that a plan is in surplus or deficit. The policy provides procedures to adjust contribution and/or benefit levels depending on the funded status of the plan. Plans are more sustainable because action is taken before any significant underfunding occurs. Although benefits can be altered prospectively in a JSPP, accrued benefits remain fixed. A formal funding policy is a good means of ensuring action is taken to address funding shortfalls.

The existence of a funding policy provides evidence that the parties have turned their attention to a variety of issues that have the potential to impact plan funding and security. The policy also provides transparency to members by clearly identifying how such issues would be addressed.

Provisions for Adverse Deviations (PfAD)

As noted, in the absence of solvency funding, there is a greater risk of benefit reductions upon wind-up if a plan is funded solely on a going-concern basis. Plans may wish to put in place a funding cushion against the possibility of adverse events. Such a cushion is frequently referred to as a "Provision for Adverse Deviations".

> ***Proposed Criterion:***
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> In order to obtain a solvency exemption, an examination of overall governance practices, beginning with the CAPSA guidelines, should be included in the assessment of any newly created multi-employer JSPPs in the BPS.
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> As part of this review, particular attention could be paid to the risk management tools that are put in place as an objective measure of one or more components of plan governance. (The adoption of any specific risk management tool is not being recommended; the appropriateness of a given tool will vary based on the needs of the individual plans.)
>
> An examination of board composition and capability could also be conducted as part of the assessment of governance capability. For example, plans with expert pension boards may be advantageous given the complexities associated with administering a JSPP. In addition, boards that provide for retiree input, in addition to current member input, may be viewed as better protecting the interests of all beneficiaries.

IV. SUMMARY

Solvency funding is intended to address the risk that there is inadequate funding in the event of a wind-up of a pension plan. BPS employers contemplating amalgamating their SEPPs to establish new multi-employer JSPPs are seeking to be exempted from solvency funding. Such an exemption may increase risk; in order to justify an exemption from solvency funding requirements, plan sponsors must be able to demonstrate that they have otherwise addressed this risk through the design or operation of their pension plan. The proposed criteria are intended to capture certain plan characteristics that would help mitigate risk.

Appendix I:

APPROACH OF OTHER JURISDICTIONS

Other jurisdictions address funding requirements for public sector pension plans in a variety of ways. It is important to note that a direct comparison is difficult because plan-types (e.g., JSPPs, SEPPs) and their structural and legal implications are not identical from jurisdiction to jurisdiction.

Other Canadian Jurisdictions

Canadian jurisdictions have embraced solvency funding rules for pension plans. Traditional DB private sector pension plans must be solvency funded in all jurisdictions that regulate pensions. However, a majority of Canadian jurisdictions have provided exemptions from solvency funding requirements to certain public sector pension plans, as follows:

- British Columbia: Since 2009, B.C.'s public sector pension plans, such as the Municipal Pension Plan, have been exempt from solvency funding requirements. However, many broader public sector plans or Crown corporation pension plans are not exempt (e.g., B.C. Hydro, ICBC, university pension plans and Worksafe B.C.).

- Alberta: Since 2003, certain publicly funded pension plans may apply for an exemption from making solvency special payments.

- Saskatchewan: Effective June 26, 2013, most public sector defined benefit pension plans are exempt from solvency funding rules. Instead, they are required to fund going-concern deficits over 10-years rather than the standard 15-years.

- Manitoba: Since 2010, certain public sector pension plans have been able to elect to receive a solvency exemption if no more than 1/3 of members and 1/3 of other beneficiaries object.

- New Brunswick: University and municipal defined benefit pension plans may be exempt from solvency funding rules if a majority of plan members consent by vote.

- Nova Scotia: As of December 2012, municipal and university pension plans are exempted from solvency funding requirements for an unidentified period of time. Plans with solvency ratios less than 85% must file valuations annually.

- Newfoundland/Labrador: Certain university and municipal plans have been exempted from solvency funding requirements.

In addition, Quebec has provided a time-limited reduction in solvency special payments for municipal and university pension plans, among others.

The federal government has not provided exemptions for public service pension plans. A number of jurisdictions, including the federal government and Ontario, have provided solvency funding relief programs for both public and private sector plans as means of cushioning the impact of market conditions.

The United States:

Pension plan regulation is a federal responsibility in the United States. Passed in 1974, *the Employee Retirement Income Security Act* (ERISA), requires all private sector pension plans to be funded using a calculation method similar to solvency funding. Public sector plans are exempted from this legislation. Aside from certain tax rules, public sector plans are only subject to legislation put in place by their own sponsors (i.e., state or federal governments).[2]

Federal employees hired after 1983 are enrolled in an unfunded DB plan and a funded DC plan.[3] State and local governments offer mainly DB plans. These plans are not required to be funded, but states have often created their own legislation outlining funding requirements. However, there is no single compulsory standard for calculating and enforcing contributions to these plans. Many use a method of calculating sufficiency of funding using expected investment returns as the discount rate[4]. This is a similar approach to going-concern funding.

Without specific funding requirements, political sponsors have demonstrated a preference to use their resources to finance current program spending at the expense of pension plan contributions. The result is that many American public sector pension plans are significantly underfunded. It has been estimated that state and local pension plans were underfunded by USD$4.7 trillion at the end of 2014.[5] From 2007 to 2011, governments underpaid contributions to major plans by USD$62 billion[6]. Absent significant tax increases, these governments will be forced to make difficult choices between maintaining current program spending and financing pension contributions.

Outside North America:

The issue of granting solvency exemptions for public sector plans is not an issue in most countries because few, if any, require funding on a solvency basis. In fact, a large majority of

[2] "*Retirement Benefits in the Public and Private Sectors—A Comparison of Trends, Regulatory Environments, and Related Issues*", Research Paper 13-002, Texas Pension Review Board, August 2013.
[3] *Supra*, Note 1.
[4] Boyd, D.B., Kiernan, P.J., "*Strengthening the Security of Public Sector Defined Benefit Pension Plans*", The Blinken Report, Nelson A. Rockefeller Institute of Government, State University of New York, January 2014.
[5] *State Budget Solution*, November 12, 2014.
[6] *Ibid*, p.x.

countries that provide defined benefit pension plans specifically for their public sector employees do not require those plans to be funded in legally-separate pension funds. Instead, these plans are "pay-as-you-go", meaning they are financed directly out of the government's revenue. Reserves may be created, however they remain the legal property of the government. Pay-as-you-go schemes exist in countries such as Austria, Belgium, Finland, Japan, Mexico, France, Greece and Korea.[7]

Some pay-as-you-go schemes may acknowledge associated liabilities in the government's fiscal accounts. This was the approach used until 2000 by the federal government in Canada for funding the federal Public Sector Pension Plan.

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[7] Ponds, E., Severinson, C., Yermo, J., "*Funding in Public Sector Pension Plans—International Evidence*", OECD Working Paper on Finance, Insurance and Private Pensions #8, May 2011.