



STAFF REPORT ACTION REQUIRED

City-Sponsored Pre-OMERS Pension Plans – Analysis of Alternative Investment and Pension Administration through OMERS

Date:	August 31, 2011
To:	Government Management Committee
From:	Treasurer
Wards:	All
Reference Number:	P:\2011\Internal Services\ppeb\gm11009ppeb (AFS14005)

SUMMARY

This report summarizes the outcome of a preliminary analysis of options with respect to the Ontario Municipal Employees Retirement System (OMERS) providing alternative management and/or pension administration services for the City's five Pre-OMERS Pension Plans. Based on the analysis of the options, the report recommends that staff be authorized to enter into discussions with OMERS and other appropriate parties regarding the terms of a potential merger of the City's five (5) Pre-OMERS pension plans into OMERS; to evaluate the option of winding-up the five (5) Pre-OMERS pension plans; and to report back to Government Management Committee once all the necessary provincial regulations are in place and proposed terms and conditions of a potential merger have been negotiated.

RECOMMENDATIONS

The Treasurer recommends that:

1. Staff be authorized to pursue an investigation into a possible merger of the City's five Pre-OMERS pension plans with the OMERS plan, including entering into necessary discussions with the Ministry of Finance, the Financial Services Commission of Ontario (FSCO), the respective administrators of the City's five Pre-OMERS Pension Plans and the OMERS Administration Corporation;
2. Staff investigate and evaluate the possibility of winding up the City's five (5) Pre-OMERS Pension Plans, including the distribution of surplus assets;

3. Staff be authorized to retain such experts, including external legal counsel and actuaries, as may be necessary to assist in the assessment, evaluation and potential implementation of: i) a merger of the City's five (5) Pre-OMERS Pension Plans into OMERS plan; and, ii) winding up of the City's five (5) Pre-OMERS Pension Plans; subject to an upset cost limit of \$0.850 million, to be funded through the Employee/Retiree Benefits Reserve Fund;
4. This report be forwarded to the Budget Committee to approve the increase in the 2011 Non-Program Operating Budget for pension consulting by \$0.850 million gross and \$0 net, funded by the Employee/Retiree Benefits Reserve Fund;
5. The Treasurer be requested to report back on recommended next steps once the investigation of the options is completed, and the regulations dealing with the mechanics of plan mergers are in place under the *Pension Benefits Act*.

Financial Impact

In order to ensure full assessment of key issues with respect to a potential merger and to avoid litigation initiated by plan members and/or challenges from FSCO, it is necessary to retain external experts, including legal counsel and actuaries, subject to an upset cost limit of \$0.850 million.

Funding for the external experts will come from the Employee/Retiree Benefits Reserve Fund. For 2011, \$0.100 million has been budgeted within the Non-Program funded by this Reserve Fund for regular pension consulting. An additional \$0.850 million will be required for this review. Through this report, staff is asking the Budget Committee for authorization to adjust the 2011 Non-Program Operating Budget accordingly.

The City's five (5) Pre-OMERS Pension Plans have total assets of approximately \$1.8 billion. The City is scheduled to make \$14.6 million in special payments in 2011 and \$14.5 million in 2012 on account of "solvency" deficiencies with respect to two of those Plans (Police and York). The City spends approximately \$1 million per year administering the five plans.

A potential merger with OMERS and/or a wind-up of the five Pre-OMERS Pension Plans is anticipated to minimize or eliminate the requirements for special payments and provide cost savings with respect to the administration of the Plans, while continuing to protect the rights of those entitled to benefits under the Plans.

The Deputy City Manager and Chief Financial Officer has reviewed this report and agrees with the financial impact information.

DECISION HISTORY

At its meeting of May 17 - 19, 2011, City Council adopted the following Government Management Committee recommendations with respect to report GM3.9 titled “City Sponsored Pre-OMERS Pension Plans and the Toronto Transit Commission (TTC) Pension Fund Society”:

1. City Council request OMERS to work with the Treasurer to commence a gap analysis on regulatory, policy and actuarial aspects of information provided by City staff on the five City-Sponsored Pre-OMERS Pension Plans.
2. The Treasurer, working co-operatively with OMERS staff, report back to the September 15, 2011, meeting of the Government Management Committee with detailed options with respect to alternative investment management and pension administration of the five (5) City-Sponsored pre-OMERS Pension Plans.
3. The Chief General Manager of the Toronto Transit Commission (TTC), working co-operatively with OMERS staff, and under the direction of the TTC, develop a detailed work plan outlining an evaluation of options available to the TTC Pension Fund Society and report back to the September 15, 2011 meeting of the Government Management Committee.
4. In order to save time and external fees, both the Treasurer and the TTC Pension Fund Society staff meet with OMERS staff concerning their respective reports to City Council on what aspects of the current evaluation process outlined in the report (April 13, 2011) from the Treasurer require further review by external advisors and what can be formulated as joint/mutual positions to be addressed with the Province of Ontario or its agencies in advance of pending regulations.
5. City Council further direct that all relevant information identified by OMERS staff be provided in order to assist all the parties in completing a Work Plan of said analysis to the June 28, 2011 meeting of the Government Management Committee in order to evaluate the progress of this important initiative.

Following is the link to the Council decision and staff report:

<http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2011.GM3.9>

At its meeting of June 28, 2011, the Government Management Committee received a staff report outlining a work plan with respect to the evaluation of three (3) options related to OMERS providing alternative pension investment, administration and /or management services for the City's Pre-OMERS pension plans (re: GM5.2 titled “City Sponsored Pre-OMERS Pension Plans and the Toronto Transit Commission (TTC) Pension Fund Society – Work Plans”).

Following is the link to the staff report and Committee Decision:

<http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2011.GM5.2>

ISSUE BACKGROUND

The City of Toronto is the sponsor of five (5) Pre-OMERS Pension Plans (the City Plans), which were in existence prior to July 1, 1968 as of which date Ontario municipalities were permitted to make contributions to a non-OMERS plan only for existing employees who were already members of the other plan . The City Plans are registered under the *Pension Benefits Act* (PBA) and consist of the:

- Metropolitan Toronto Pension Plan (Metro);
- Metropolitan Toronto Police Benefit Plan (Police);
- Corporation of the City of York Employee Pension Plan (York);
- Toronto Civic Employees' Pension & Benefit Plan (Civic); and,
- Toronto Fire Department Superannuation and Benefit Plan (Fire).

Each is a single-employer plan and have total estimated assets of approximately \$1.8 Billion, which may not be intermingled.

The City Plans have only 13 active members remaining and provide defined benefits calculated on the basis of a member's best consecutive five years of earnings to approximately 7,367 retirees and surviving spouses. The Plans are closed and no new members may be enrolled. All employees/retirees covered by the plans were hired prior to July 1, 1968. There are no regular contributions being made into the funds of the Plans by employees or the City since all remaining employees in the Plans have attained 35 years of credited service. Special payments are being made by the City into the funds of two of the Plans in accordance with the PBA to eliminate actuarially-determined inadequacies.

Additional background information on the structure and mandate of the City's five Pre-OMERS Pension Plans and the City's responsibility for the plans, is available in an April 2010 report to Committee, GM31.1 "Pre-OMERS City-Sponsored Pension Plans, TTC-Sponsored Pension Plan and the OMERS Pension Plan", at the following link: <http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2010.GM31.1>

COMMENTS

As identified in the June 2011 report to Government Management Committee, staff have worked co-operatively with OMERS on a preliminary assessment of the following three (3) options with respect to OMERS providing alternative pension investment, administration and /or management services for the City's Pre-OMERS pension plans:

- (1) Investment Management by OMERS;
- (2) Pension Payroll and Member Services through OMERS; and,
- (3) Full Merger with the OMERS Plan.

The preliminary analysis has been conducted in an effort to narrow the options with the intent of undertaking further analysis on options that are most likely to improve the City's financial position by minimizing or eliminating special payment requirements, while continuing to protect the interest of the Pension Plans and its members.

OMERS is in a unique position to discuss the three options with the City as one of only two public-sector pension administrators with the legislative authority to provide other pension plans with investment-management and/or administrative services. The other administrator with similar authority is the Ontario Teachers' Pension Plan Board. In addition, the OMERS Plan is the only pension plan with which the City Plans may be allowed to merge, in accordance with the *City of Toronto Act, 2006*, the *Municipal Act, 2001* and the *Ontario Municipal Employees Retirement System Act, 2006*.

Attachment 1 is a report prepared by OMERS summarizing the preliminary analysis of each of the three options identified above. City staff worked closely with OMERS on the evaluation of the options and conducted its own analysis to verify the information provided by OMERS.

The preliminary assessment of the three options noted above indicates that the only option which warrants further investigation is the full merger option. This option may result in a significant financial benefit to the City by reducing and/or eliminating future special payment requirements and administrative costs, while continuing to protect pension plan members' pensions.

The other two options (investment management or pension payroll; and, member services through OMERS) are not being recommended for further analysis or implementation. The investment management option would require significant changes to the existing investment policies and strategies of the City Plans which may expose the Plans to additional risk and would need to be further investigated by each of their Boards. The member services through OMERS option would be more costly than the status quo. Attachment 1, page 7, provides a comparison of OMERS' estimated costs for providing member services (\$1.124 million per year excluding one-time start up costs) with the City's current costs (\$1.035 million per year).

In addition to moving forward with an in-depth review of a full merger with the OMERS Plan, staff are recommending a full analysis of a potential wind-up of each of the City Plans. A wind-up of the Plans could result in a significant financial benefit to the City by eliminating the need for special payments and annual administration costs. In addition, this option may provide the City with the ability to receive some or whatever surplus remains in each Plan following wind-up through a surplus distribution. In order to ensure that the City proceeds with the most viable and financially sustainable option, an evaluation of the wind-up option is critical.

The remainder of this report focuses on the following two options recommended for further investigation and a report back to Government Management Committee:

- (1) Full Merger of the City Plans with the OMERS Plan; and
- (2) Wind-Up of the City Plans.

Full Merger with OMERS

A full merger of the City's five Pre-OMERS Pension Plans with OMERS would involve a transfer of the assets and liabilities of each of the City's Plans to the OMERS Plan. Such a transfer, if viable and financially prudent/cost-effective, would result in termination of the City's status as sponsor of the Plans. Consequently, depending on the regulatory requirements, the City's obligations for special payments and pension benefits under the Plans would be settled at the time of merger. Some of the Plans may turn out to have surpluses (more than what OMERS would require from an actuarial point of view to ensure adequate funding for all future benefits), but whether or not the City would have any ownership rights in such surplus assets will depend on the Plan's governing by-law, the PBA and its regulations.

This is the most complex of the options being evaluated. The potential asset transfer and merger of the City Plans with the OMERS Plan would be subject to the new asset transfer section of the PBA, the relevant part of which says:

"No person shall transfer assets between pension plans if the transferred assets relate to the provision of defined benefits unless,

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(b) the transfer satisfies the prescribed requirements and the Superintendent has consented in advance to the transfer."

However, as of the date of this report, the corresponding regulations ("prescribed requirements") have not yet been released.

In addition to complying with the forthcoming regulations and being approved by the Superintendent of Financial Services under FSCO, there are several potential legal hurdles which must be addressed prior to moving forward with a potential merger in order to protect the City's interests and minimize the potential for legal action against the City by Plan members. However, this option, if successful, would eliminate the City's role in the City Plans and would eliminate the requirement for Plan administrators (*i.e.*, Board of Trustees or Pension Committees) given that plan governance, administration and the investment management would in each case be transferred to OMERS.

Financial Impacts Resulting from a Merger

A merger of the City Plans with OMERS could result in a significant financial benefit to the City by reducing and/or eliminating future special payment requirements and administrative costs, possibly with a return of some of the surplus assets, if there are any.

Attachment 1 provides high-level estimated potential savings/financial impacts resulting from a possible merger (estimated by OMERS at roughly "an additional \$80 million being available for benefit improvements or other disposition" based on a number of high level assumptions). These estimates by OMERS are very preliminary and cannot be validated by City staff at this time, given the following:

- a) until the new PBA regulations are filed and discussions are held with the Ministry of Finance, there is a lack of clarity regarding:

- the appropriate actuarial assumptions to be used to determine asset transfer amounts at the time of merger;
 - how solvency plan deficits will be dealt with at the time of a merger;
 - how much of plan surplus (if there is any) will need to be transferred to OMERS, the ownership of any remaining surplus, and how or whether surplus requirements would jeopardize the City's interests;
- b) the actual asset transfer amounts will need to be negotiated with OMERS and the differences in plan designs (*e.g.*, COLA, outlined below) must be taken into consideration; until such time as these negotiations take place, the cost/benefit to the City is unknown;
- c) there will likely be one-time costs involved in a merger which will need to be negotiated and factored into the merger agreement and would depend on the nature of the agreement and the PBA regulations.

The requirements of the forthcoming regulations and the outcome of discussions with FSCO and OMERS will be critical in determining whether it is in the City's interests to proceed with such a merger.

Given that three (3) of the City Plans currently have surplus assets, it is imperative that the City retain independent legal and actuarial experts to provide advice throughout this process in order to protect its interests. The forthcoming regulations will likely require that some portion of the surplus be transferred to OMERS if a merger takes place. However, the extent of that portion is currently unknown and the ownership of any untransferred surplus will have to be determined.

The actual asset amounts transferred from the City Plans to the OMERS Plan would be:

- a) subject to negotiations between the City and OMERS; and,
- b) dependent on the assumptions being used to determine the funded status of the City Plans at the time of the merger. As outlined in the section below titled "b) Closed, Single Employee Plan vs. Open Jointly-Sponsored Plan", OMERS assumptions are far less conservative than the assumptions which have been historically used for the City Plans.

Assuming the ability to utilize OMERS's less conservative assumptions for the purpose of a merger, and their suitability, it may be possible to provide the same benefit provisions to pensioners with a reduction in Plan funding liabilities. Any agreement reached with OMERS would be subject to compliance with the forthcoming regulations and approval and consent of the FSCO Superintendent.

In addition, assuming approval/consent by the Superintendent, it may be possible to eliminate the need to meet the "solvency"-funding test at the time of a merger. This would mean that the asset and liability transfer amounts would be determined only on the basis of going-concern financial criterion. Consequently, surplus (or a greater surplus) could exist, part of which would probably have to be transferred to OMERS in accordance with the new regulations.

These matters must be addressed with the Ministry of Finance and/or FSCO before any assessment can be made of the benefits of a merger. The PBA currently requires that where Plans have a deficiency, a transfer will not be approved until certain conditions are satisfied. Given that the new regulations have not been released, it is not known exactly what future conditions will be. However, it is possible that some sort of top-up payment may be required and if so, the City could be required to make a substantial contribution to those Plans which are underfunded before a merger is approved.

Comparison of Benefit Provisions and Funding Status

The pension benefits under the City Plans are similar to those under the OMERS Plan in that the basic pension benefits are calculated on the basis of on an employee's best consecutive five (5) years of earnings. This is helpful given that Plan merger principles and related legislation requires that any pensioner benefits must be protected and maintained or improved through a merger.

However, there are two key differences between the City Plans and the OMERS Plan that may have a material impact on the asset-transfer calculations for a merger:

a) Cost-of-living adjustment (COLA)

Under the OMERS Plan, an automatic or guaranteed increase is provided each year (matching the Consumer Price Index up to a maximum of 6 % per annum); whereas Cost-of-Living Adjustments for pensioners under the City Plans are not guaranteed:

- the Civic, Fire and York Plans provide increases, contingent on conditions specified in each of the By-Laws, including sufficient investment return.
- the Metro and Police Plans have no provisions for annual pensioner increases, although Council has traditionally given consideration to the administrators' recommendations for *ad hoc* increases, and authorized same if the financial status of the Plan so warranted.

OMERS and the City will need to negotiate terms with respect to COLA adjustments, and City staff will need to assess the financial impact on the City and/or Plan members.

b) Closed, Single Employee Plan vs. Open Jointly-Sponsored Plan

The City Plans are closed single-employer plans sponsored and guaranteed by the City of the Toronto (*i.e.*, the City must fund any solvency and going-concern funding deficiencies). Funding on a solvency basis assumes that the plan was wound up at the end of the last calendar year (*i.e.*, as if its assets had been used to meet its liabilities at that time, including the purchase of annuities for its pensioners, unretired members and expected qualified survivors) and requires that any deficiency revealed in an actuarial valuation report filed with FSCO be eliminated by the employer over a period of no longer than five (5) years. Funding on a going-concern basis assumes that the plan will continue to operate indefinitely, and any deficiency shown in a filed report must be eliminated by the employer over a period of no longer than fifteen (15) years. Filing is generally required every three (3) years, but if a deficiency is shown in any filed report, a report must be filed following the end of the next year.

OMERS, on the other hand, is an open Plan that is jointly funded by members and employers (*i.e.*, the risk of dealing with funding deficiencies is shared by both the members and the employers equally). Therefore, the OMERS Plan is exempt from the "solvency" funding requirement, although it must still meet the "going-concern" funding requirement. As a result, OMERS does not have the same challenging financial requirement to fund solvency deficiencies.

As a result of this difference, actuarial assumptions used for funding purposes are significantly different, with the City Plans using much more conservative assumptions, in accordance with actuarial standards of practice, than the assumptions used by OMERS. These more conservative assumptions have a direct impact on the funding status of the Plans.

Authority/Legal Issues

It is within City Council's power to authorize a merger of the City Plans with OMERS. This would require amendment of the Plans' governing By-laws. The *City of Toronto Act, 2006* (the "COTA"), which provides generally for the continuation of pre-OMERS plans for certain employees, clearly authorizes Council to amend the existing pension by-laws for the Metro and Police Plans. Other By-Laws contain an explicit amendment power, with the exception of the Civic Plan which is silent. Nevertheless, the Ontario Court of Appeal has recently affirmed that the PBA "presupposes" that an employer has power to amend a plan. However, in the Fire Plan, that power is subject to the Board's approval.

There are a number of legal issues associated with a merger including possible statutory restrictions, trust issues, treatment of surplus, resolution of solvency deficiencies and differences in plan benefits, which could present obstacles to a merger. Staff are working with the City's legal advisors and OMERS to assess these issues fully. The forthcoming Regulations should help address some of the legal issues identified and are expected to:

- prescribe the requirements for funding and related rules for mergers (including rules to address transfers from single employer plans, like the City Plans, to jointly sponsored pension plans, like OMERS);
- require that some part of whatever surplus exists be included in the transfer (other new sections of the Act, though not yet proclaimed in force, specifically call for part of any surplus to be transferred, as prescribed by Regulation, in the case of transfers in connection with take-over of a business by a new employer, or adoption of a new plan by the same employer);
- specify the standards for the Superintendent to apply in providing consent to a transfer of assets — it is expected that the Superintendent will have less discretion than under current practice.

OMERS and the City have an opportunity to provide important input through discussion with the Ministry of Finance, on the contents of the new asset-transfer regulations. Key issues include the handling a plan's funding inadequacies, significant differences in size between the two merging plans, and actuarial assumptions used to determine asset transfer amounts.

Joint Workplan with OMERS

Attachment 2 to this report is a joint workplan with OMERS outlining key tasks that will need to be completed over the next few months to finalize the analysis and implementation of a potential merger agreement. Given the complexity of the issues that need to be investigated and resolved, and the uncertainty regarding the filing of the required regulations by the Province and the approval of the merger by FSCO, a minimum of 12 to 24 months will be needed to complete the work. The timelines provided in the workplan are based on the best case scenario, and preliminary assumptions regarding the timing of regulations, FSCO approval and so on.

Wind-Up of the 5 Pre-OMERS Pension Plans

An additional option which warrants investigation is the wind-up of the City Plans. The PBA requires that a pension fund be administered by one (or a combination) of the following entities: (a) a government, (b) a qualified insurance company, (c) a trust corporation, individual trustees or a corporate pension society, (d) the federal government annuities branch, or (e) a statutorily authorized board, agency, commission or corporation.

A wind-up of the Plans would entail the purchase of annuities from an insurance company authorized to undertake life insurance in Canada, for each plan member, pensioner and/or potential qualifying survivor (usually the spouse). The pension benefits would be equal to or greater than those provided to plan members today.

A wind-up of the City Plans through the purchase of annuities from an insurance company would result in the elimination of the administration and funding costs associated with the City Plans and termination of the City's status as sponsor of the Plans.

However, the City would need to eliminate any funding short-falls of the Plans in full at the time of the wind-up.

In addition, a wind-up may provide the City with ownership of some or all of the surplus assets, without requiring the application of the forthcoming “merger” regulations. Ownership of surplus assets will be dependent on the wording of the governing by-law of the Plans in that respect and its legal validity.

The PBA sets out the circumstances under which the Superintendent is empowered to consent to a refund of surplus assets to an employer on wind-up of a pension plan. Subsection 79(3) of the PBA states:

- (3) Subject to section 89 (hearing and appeal), the Superintendent shall not consent to an application by an employer in respect of surplus in a pension plan that is being wound up in whole or in part unless,
 - (a) the Superintendent is satisfied, based on reports provided with the application for payment of the surplus, that the pension plan has a surplus;
 - (b) the payment of surplus to the employer on the wind up of the pension plan is authorized either as provided in section 77.11 or by a court order declaring that the employer is entitled to the surplus when the plan is being wound up;
 - (c) provision has been made for the payment of all liabilities of the pension plan as calculated for purposes of termination of the pension plan; and
 - (d) the applicant and the pension plan comply with all other requirements prescribed under other sections of this Act in respect of the payment of surplus money out of a pension fund.

Section 77.11 of the PBA permits agreements between plan members/beneficiaries and plan sponsors for the distribution of surplus assets remaining after plan wind-up notwithstanding the requirements of any trust.

As a result, a detailed analysis of all relevant documentation and City by-laws must be conducted to establish surplus entitlement. In addition, there may be additional legal issues associated with trust issues and surplus distribution which could present obstacles to this option.

Given the potential significant financial benefit that may be achievable through a wind-up of the City Plans, it is critical that this option be fully evaluated in order to ensure that the City proceeds with the most viable and financially sustainable option with respect to the Pre-OMERS Pension Plans.

Next Steps

In order to perform a full assessment of the key issues with respect to a potential merger and/or wind-up of the five Pre-OMERS Pension Plans, and avoid potential litigation, it is necessary to retain independent legal and actuarial advisors to provide advice and guidance throughout and to support City staff in any necessary negotiations. It is also critical that OMERS jointly with City staff begin discussions with the Ministry of Finance and FSCO on the principles of a potential merger.

Following these discussions and completion of a full investigation and evaluation of both the merger and wind-up options, staff will report back to Committee with its findings and recommended next steps.

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SIGNATURE

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ATTACHMENTS

Attachment 1 – Preliminary Analysis of OMERS Options - City of Toronto Pre-OMERS Pension Plans

Attachment 2 – Merger Work Plan – City of Toronto and OMERS