STAFF REPORT
ACTION REQUIRED

Toronto Fire Department Superannuation and Benefit Fund – Actuarial Report as at December 31, 2013

Date:	May 30, 2014
To:	Government Management Committee
From:	Treasurer
Wards:	All
Reference Number:	P:\2014\Internal Services\ppeb\gm14007ppeb (AFS18684)

SUMMARY

This report submits the Actuarial Valuation as at December 31, 2013 (Attachment 2), for the Toronto Fire Department Superannuation and Benefit Fund (the "Fire Fund"). The report requests funding from the Employee/Retiree Benefits Reserve Fund so that if the City receives a direction from the provincial pension regulator to commence making monthly contributions for the elimination of the smoothed solvency deficiency shown in the Valuation in accordance with Ontario pension legislation, the City will be able to:

a) pay as of the date of the direction, a catch-up amount, including interest; and,
b) provide to the Fund`s Benefit Fund Committee, a letter of credit from the City's banker instead of making any further contributions.

The 2013 Valuation sets forth the financial position of the Plan for the year ended December 31, 2013, and shows a funding excess of $9.452 million on a going-concern basis, a surplus of $11.0 million on an unsmoothed solvency (wind-up) basis, and a deficiency on a smoothed solvency basis (*i.e.*, rolling 4-year averaging of net asset losses/ gains) of $4.978 million. The Valuation also provides an amortization schedule of special contributions for eliminating the solvency deficiency within the mandatory five (5) years.

The Valuation explains that the Province's requirements for special contributions under the *Pension Benefits Act* (PBA) in the case of a solvency deficiency conflict with the Canada Revenue Agency's (CRA) interpretation of the regulations under the *Income Tax Act* (ITA), which stipulate generally that special contributions cannot be made for shortfalls in excess of the wind-up deficiency, if any.

Given that the CRA and the Financial Services Commission of Ontario (FSCO) which is responsible for compliance with the PBA, are apparently working on, but have not yet resolved the conflict, staff are seeking Council authority to deal with the Fund's shortfall

on the basis of the contribution limitation under the ITA, but in the event that FSCO requires that the entire smoothed solvency deficiency under the PBA must form the basis of action by the City, a letter of credit be issued accordingly.

RECOMMENDATIONS

The Treasurer recommends that:

1. City Council receive the "Report on the Actuarial Valuation for Funding Purposes as at December 31, 2013" (Attachment 2) prepared by Buck Consultants with respect to the Toronto Fire Department Superannuation and Benefit Fund.

2. City Council approve the deferral of any special payments to the Fire Fund given the windup surplus of the Plan, until such time as the Financial Services Commission of Ontario (FSCO) requires, if it ever does, the City to take steps under the *Pension Benefits Act* (PBA) to eliminate the $4.978 million solvency deficiency shown in the 2013 Actuarial Valuation.

3. In the event that FSCO directs that the City must take steps under the PBA to eliminate the $4.978 million smoothed solvency deficiency shown in the 2013 Actuarial Valuation, City Council:
   (a) authorize the Treasurer to make a catch-up payment to the Plan, including interest, to cover the originally scheduled special contributions shown in Attachment 1 from January 1, 2014 up to such date in 2014 on which the City may be so directed by FSCO, to a maximum of $1.1 million, as long as the CRA has confirmed that such contributions will not constitute a breach of the ITA regulations;
   (b) authorize the Treasurer to arrange for the issuance to the Fund`s Benefit Fund Committee of an automatically renewing 1-year letter of credit in accordance with the Regulations under the PBA to cover the remainder of the special contributions as they would have come due to a maximum of $5.294 million, as per Attachment 1;
   (c) authorize the Treasurer to arrange for reduction in the face value of any such Letter of Credit to match any reduction in the smoothed solvency deficiency shown in any subsequent Actuarial Valuation of the Plan filed with FSCO;
   (d) approve a Non-Program Operating Budget increase of $795 gross and $0 net funded from the Employee/Retiree Benefits Reserve Fund for $795 to cover the annual cost of the Letter of Credit.

Financial Impact

The 2013 Actuarial Valuation shows a solvency (wind-up) surplus of $11.0 but a smoothed solvency deficit of $4.978 million.

Under the CRA's interpretation, the City is not "required" to make special payments from 2014 to 2018.

However, under the *Pension Benefits Act*, the City is required to make special payments commencing in 2014 to eliminate the $11.0 million "smoothed" solvency deficiency over a period not exceeding five (5) years. FSCO and the CRA are aware of the conflict between the two Acts but have not yet adopted a formal position, and are dealing with the matter on a case-by-case basis.

In the event that the FSCO, with CRA concurrence, directs the City to make special payment contributions based on the full smoothed solvency deficiency, it is recommended that this solvency deficiency be eliminated by paying first all arrears in the amortization schedule and then by providing a Letter of Credit to the Fund`s Benefit Fund Committee in the amount of the remaining scheduled special contributions as they accrue from time to time. This means that the initial face value of the Letter would be equal to the amount of the first special contribution amount covered by it, and the Letter would provide for automatic increases in the face value in step with the subsequent scheduled amounts. The maximum total value of the letter of credit will be $5.294 million reflected on the last line of the amortization schedule prepared by the Fund's actuary and attached as Attachment 1, less any special payments made in the period between January 1, 2014 and the date the City receives the direction from FSCO.

The issuance of a Letter of Credit will cost the City a fee of approximately 0.50% *per annum* of the Letter's face value, which is the lowest rate that is charged by chartered banks to their customers who have the best credit ratings. Assuming that the first payment covered by the Letter is payment number 7 as shown in Attachment 1, the cost for providing the Letter of Credit in its first year will therefore be approximately $795.00 and a maximum cost of approximately $0.059 million over the five (5) year period (average of $0.012 million per year) if the face value of the Letter ever reaches the scheduled maximum. Funding for the cost of the Letter of Credit would be from the Employee / Retiree Benefits Reserve Fund. However, the letter of credit will allow the City to earn approximately 1.5% to 2 % per annum on the funds that it can continue to retain and invest as a result of no longer being required to make special payments. The net financial benefit to the City would be approximately 1% to 1.5% (or approximately $0.005 million to $0.008 million, at the maximum face value) per year based on current interest-earning levels.

If the CRA's current objections can be overcome, and City Council's preference is to issue cash payments over five (5) years to satisfy its requirement under the Ontario legislation to eliminate the smoothed solvency deficit, the City would be required to make the following special payments: $1,096,946 (inclusive of interest of $9,646) for the solvency deficiency in 2014 and $1,087,300 in each of the years 2015 to 2018.

Should Council prefer to make the special payments, Council would need to authorize an increase to the 2014 Non Program Operating Budget of $1.097 million gross and $0 net, funded from the Employee / Retiree Benefits Reserve Fund.

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

DECISION HISTORY

The Actuarial Valuation Report of the Toronto Fire Department Superannuation and Benefit Fund is submitted annually to Council. The last such report was considered by Government Management Committee meeting held on May 24, 2012, when it received GM14.7 "Actuarial Valuation Reports of the Toronto Fire Department Superannuation and Benefit Fund (Fire), Corporation of the City of York Employee Pension Plan (York) and the Metropolitan Toronto Police Benefit Plan". Following is the link to the report and decision document:
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2012.GM14.7

The last Actuarial Valuation Report of the Toronto Fire Department Superannuation and Benefit Fund that was filed with CRA and FSCO was adopted by City Council at its meeting held on May17, 2011 "Toronto Fire Department Superannuation and Benefit Fund – Actuarial Report as at December 31, 2010 – (Item GM3.3)". Following is the link to the report and decision document:
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2011.GM3.3

At its meeting held on February 19 and 20, 2014, City Council ratified an application to the Ontario Ministry of Finance requesting that the City of Toronto be provided the option to arrange for letters of credit to replace any solvency payments required for 2014 and future years with respect to the City's five pre-OMERS pension plans (re: EX38.6 – "Pre-OMERS Pension Plans – Application for Letter of Credit Provision"). Following is the link to the report and decision document:
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2014.EX38.6

ISSUE BACKGROUND

Pension plans are governed by the *Pension Benefits Act* (PBA) and regulated through the Financial Services Commission of Ontario (FSCO). The FSCO is an arm's-length agency of the Ontario Ministry of Finance, which is responsible for the administration and enforcement of the PBA and regulations under the Act. The PBA establishes the minimum standards for registered pension plans, and the regulations under it require the annual preparation of an Actuarial Valuation of a pension plan's assets and liabilities in order to determine the funded status of the plan on both a going-concern basis and a solvency basis. An actuarial valuation report must be filed with FSCO and the Canada Revenue Agency (CRA) at least every three (3) years, unless at the end of any year the plan has a solvency deficiency in excess of 15% (i.e., the plan is less than 85% funded) in which case it must be filed each year until the deficiency is eliminated. The approval of the actuarial valuation report and the decision as to whether to file the report with FSCO and the CRA is the responsibility of the Pension Fund`s Benefit Fund Committee.

The last valuation report filed with FSCO and the CRA was the Actuarial Valuation as at December 31, 2010. Therefore, the December 2013 Actuarial Valuation Report must be filed this year.

Going-concern valuation: assumes that the plan will be ongoing for an indefinite period of time. The valuation predicts how liabilities and assets are likely to accumulate in the future. A going-concern comparison of the plan's projected performance with its actual performance over the past three (3) year period can generate either a going-concern surplus (if the valuation shows the plan to be over-funded) or an "unfunded liability" (if the valuation shows the plan to be under-funded). An unfunded liability on a going-concern basis must be eliminated by the employer by one or more special payments, which may be amortized over a period not exceeding fifteen (15) years.

Solvency (or Wind-up) valuation: assumes that the plan was wound up on the Valuation date with all amounts coming due (*i.e.*, as if its assets had been used to meet its existing liabilities, including the purchase of annuities for its pensioners and unretired members).

Smoothed solvency valuation: To minimize short-term fluctuations in the market value of plan assets and estimated liabilities, the *Pension Benefits Act* and its regulations permit the "smoothing" of assets and liabilities over a period of up to five (5) years (referred to as a Solvency Smoothed Valuation). The Fire Plan has adopted a smoothed approach for its solvency valuation since December 2008 to minimize major swings in the valuation of Plan assets and liabilities.

Asset Mix and Investment Returns of the Plan

Given the demographics of the plan members, the Committee invests the Plan's assets conservatively in a well-diversified portfolio of equity and fixed-income securities. The Committee monitors the investments prudently, with advice from the investment advisors retained by it in accordance with a Statement of Investment Policies and Procedures, which it reviews annually.

The target asset mix of the Fund as set out in the Statement of Investment Policies and Procedures is as follows:

Table 1

Asset Mix	
Cash & Equivalents	2%
Fixed Income	48%
Canadian Equity	20%
U.S. and Other Foreign Equity	30%
TOTAL	**100%**

The 2013 market rate of return net of expense was 15.1%.

COMMENTS

The Toronto Fire Department Superannuation and Benefit Fund is one of five (5) pre-OMERS pension plans sponsored by the City of Toronto. It covers 477 pensioners and 335 survivor pensioners. The Plan's Administrator is the Committee of the Toronto Fire Department Superannuation and Benefit Fund ("the Committee").

The Plan's Actuary, Buck Consultants, conducts an annual actuarial valuation of the assets and liabilities of the Plan and recently submitted to the Committee, its actuarial valuation report for 2013. The purpose of the valuation is to determine:

a) the financial position of the Plan as at December 31, 2013 on a going-concern, solvency (wind-up), and solvency smoothed basis; and

b) the minimum funding requirements by the City during the 2014 calendar year, if applicable.

Going-Concern Valuation

The Valuation shows that at December 31, 2013, the Plan had actuarial assets of $230.257 million, liabilities of $220.805 million and a going-concern excess of $9.452 million, down from a going-concern excess of $26.6 million as at December 31, 2012. The decrease from 2012 is primarily the result of a provincially-mandated change to the mortality assumptions of Plan Members used to calculate actuarial liabilities. Compared to the going-concern excess of $31.9 million shown in the actuarial valuation as at December 31, 2010 (which was the last valuation filed with FSCO), the funded status of the Plan has deteriorated by $22.4 million.

Solvency (Wind-up) Valuation

As part of the 2013 Actuarial Valuation, the actuary completed a solvency valuation comparing the Plan's assets at market value with the cost of purchasing annuities at wind-up to satisfy the Plan's benefit obligations. The Valuation shows that on a solvency (wind-up) basis, the value of the assets of $245.984 million was greater than the actuarial liabilities of $234.985 million, producing a solvency (wind-up) surplus of $10.999 million, which is an improvement as compared to December 31, 2012 (when the Plan had a solvency (wind-up) deficit of $24.2 million) and as compared to December 31, 2010 (when the Plan had a solvency (wind-up) surplus of $1.8 million). The improvement is largely related to improved investment returns.

Solvency Smoothed Valuation

Since December 2008, the Fire Plan has utilized a smoothed method for it's solvency valuations, as permitted under PBA regulations. The 2013 Valuation shows that on a smoothed basis, the value of the assets of $230.007 million was less than the actuarial liabilities of $234.985 million, producing a total solvency deficiency of $4.978 million as at December 31, 2013. The previous valuation as at December 31, 2012 had indicated a smoothed solvency deficiency of $7.9 million. The improvement in the smoothed solvency position is due to better-than-expected asset returns in 2013. The funded status of the Plan has diminished when compared to the December 31, 2010 solvency surplus, which was $4.5 million.

The smoothed solvency deficiency is higher than the solvency wind-up deficiency because under a smoothed valuation the increase in assets resulting from strong investment returns in 2013 is not all recognized in 2013 – the gain is "smoothed" over four years. Under the wind-up valuation, the total gain is recognized in 2013.

Normally and in accordance with FSCO's guidelines under the *Pensions Benefits Act*, the smoothed solvency deficiency of $5.0 million would need to be eliminated within the five (5) years following 2013. For a full five-year amortization, the City of Toronto would normally be required to make the following special payments:

Table 2

Year	Special Payment
2014*	$1,096,946
2015	$1,087,300
2016	$1,087,300
2017	$1,087,300
2018	$1,087,300
TOTAL	**$5,446,146**

*The 2014 special payment includes $1,087,300 to fund the solvency deficiency and $9,646 in interest.

However, in the case of the 2013 actuarial valuation, there is a significant difference between the Solvency (Wind-up) surplus of $11.0 and the "Smoothed" Solvency Valuation deficiency of $5.0 million. Based on the CRA's interpretation of the Regulations under the *Income Tax Act*, if a smoothed solvency valuation results in a solvency deficiency which is greater than that which would be determined under a solvency wind-up valuation, an employer may make special contributions only to eliminate the value of the wind-up deficiency (which in this case is $0).

Given that this is the first year we have encountered a situation where FSCO's contribution guidelines conflict with the CRA's interpretive rules, we sought advice from the City Solicitor's office and external legal counsel.

Legal Advice

Staff have been advised that both the CRA and FSCO are aware of the conflict, and that there is a material risk that smoothed solvency contributions would not be viewed by the CRA as eligible contributions under the Income *Tax Act*. FSCO has not yet adopted a formal position, and are dealing with the matter on a case-by-case basis.

On the basis of the review and advice of the external legal counsel, it was determined that a reasonable approach would be to obtain City Council approval to:

a) initially accept the CRA's interpretation of the *Income Tax Act* which would require no special payments in 2014; and,

b) should FSCO demand that the City commence immediate elimination of the full $4.978 million solvency deficiency, authorize staff to issue catch up payments to

the date of the direction received from FSCO (including interest) to cover the portions of the originally scheduled monthly special contributions outlined in Attachment 1; and, to arrange for a letter of credit for the balance of the special contributions required.

Given the shortened Committee and Council schedule in 2014, and the fact that Actuarial Valuation must be filed by September with appropriate contributions being made from the date the City hears from FSCO, if applicable, approval is required for both scenarios.

Letter of Credit

On October 29, 2013, the provincial government announced its intention to amend Regulation 909 under the *Pension Benefits Act* (PBA) of Ontario to permit any public-sector employers which sponsors a single-employer pension plan (SEPP) and meets certain stated qualifications, to have the option of eliminating a solvency deficiency in a pension plan by providing an acceptable letter of credit to the plan trustee rather than by making special payments to the plan. Any such employer interested in taking advantage of that option was required to submit an application to the Ministry of Finance by December 31, 2013.

At its meeting held on February 19 and 20, 2014, City Council ratified an application (submitted by staff on December 18, 2013 in compliance with the legislated deadline) to the Ontario Ministry of Finance requesting that the City of Toronto be provided the option to arrange for letters of credit to replace any solvency payments required for 2014 and future years with respect to the City's five (5) pre-OMERS pension plans (re: EX38.6 – "Pre-OMERS Pension Plans – Application for Letter of Credit Provision").

On May 1, 2014, the Province amended Ontario Regulation 909 under the PBA to add a new subsection 5.2.1(1.1), effective July 1, 2014, making section 55.2 of the PBA permitting use of letters of credit applicable to each of the five (5) City-sponsored pension plans. They had previously been available only to employers sponsoring private-sector plans.

Under the Regulation, an employer providing a letter of credit is required to make interest payments with respect to the solvency deficiency, calculated at the rate of interest applicable to an amortization, unless the interest payments are included in the amount of the letter of credit. Since the schedule of payments was prepared by the actuary on an amortized basis, and staff's recommendation for a letter of credit covering the payments outstanding from time to time, the result will be that the interest payments will be so included and will not need to be satisfied by additional cash payments.

The Regulation also requires there to be an agreement among the letter issuer, the plan trustee and the plan administrator under which the trustee is required to demand payment if the plan is about to be terminated, or the letter is about to expire without being replaced, and there is a deficiency still outstanding. The amount of the letter may be reduced in step with reductions in the solvency deficiency.

The use of a letter of credit would provide the City, as the sponsor of the Plan, more flexibility in managing its cash flow and investment decisions without compromising security for pensioners (whose benefits would continue to be fully protected) or the City's legislative obligation to ensure that the Plan is fully funded. The City will continue to be responsible for funding the Plan to 100% on a solvency basis either by making cash contributions to cover any funding deficiency or by providing a letter of credit for the amount of the funding requirement.

In the event that the City receives additional information from FSCO and/or the CRA with regard to the application of the PBA and ITA, affirming that the special payment contributions for the solvency deficiency must be determined in accordance with the smoothed valuation, staff is recommending that Council authorize the use of a Letter of Credit to guarantee payment of the deficiency should the law require such payment.

The Regulations under the *Pension Benefits Act* permit the face value of a Letter to be reduced to match any decrease in the solvency deficiency as shown in any subsequent Actuarial Valuation filed with FSCO, and it is recommended that the Treasurer be authorized to do so.

Under the Regulation, the employer is not permitted to use a letter of credit to fund any special payment requirements that are in arrears. As a result, should the City be directed by FSCO that is must eliminate the whole smoothed solvency deficiency, there will be a requirement for the City to pay the difference, with interest, between the special payments which it made to the Fund up to the amount of the unsmoothed wind-up shortfall, and the special payments it ought to have made from January 1, 2014, up to the date the City is notified by FSCO. A Letter of Credit will then be obtained for the remaining amortized special payments required to eliminate the solvency deficiency.

Cost-of-Living Increases

While the Fund's governing by-law contains a formula providing for an annual increase in benefits after any year in which the actuary has calculated that there has been an excess investment rate of return and that there are sufficient surpluses, Plan members have not received such an annual increase since 2010. The Fund had a solvency surplus of $4.5 million at the end of that year, but did not have an excess investment rate of return and so there was no increase under the by-law formula in 2011.

In view of the Fund`s financial condition, no *ad hoc* increase was granted for 2011 either. For the three (3) years since then, the Fund has had a solvency deficiency and therefore has not met the 'sufficient surpluses' requirement."

Plan members have expressed concern over the lack of increases for the past number of years. However, given the current financial position of the Plan, the 2013 Actuarial Valuation does not support an *ad hoc* cost-of-living increase outside the by-law formula for 2014.

The Committee, at its meeting on April 4, 2014, approved the recommendation of the actuary that no cost-of-living increase be provided to pensioners in 2014 and approved the smoothed solvency valuation report.

CONTACT

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SIGNATURE

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Giuliana Carbone
Treasurer

ATTACHMENTS

Attachment 1 Toronto Fire Department Superannuation and Benefit Fund 5-Year Amortized Special Payment/Line of Credit (LOC) Schedule

Attachment 2 Toronto Fire Department Superannuation and Benefit Fund, Actuarial Valuation Report as of December 31, 2013, April 2014