



STAFF REPORT ACTION REQUIRED

Metropolitan Toronto Police Benefit Plan – 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\gm14005ppeb (AFS18682)

SUMMARY

This report submits the Actuarial Valuation as at December 31, 2013 (Attachment 2), for the Metropolitan Toronto Police Benefit Fund (MTPBF). 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 continue 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 MTPBF's Board of Trustees, a letter of credit from the City's banker instead of making the remainder of those contributions.

The 2013 Valuation sets forth the financial position of the Fund for the year ended December 31, 2013, and shows a funding excess of \$17.7 million on a going-concern basis, a shortfall of \$2.548 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 \$37.250 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 Mercer Human Resource Consulting with respect to the Metropolitan Toronto Police Benefit Fund (MTPBF).
2. City Council approve the special contributions already made to the Fund in 2014 in the amount of \$2.548 million, being equal to the 2013 wind-up shortfall, as the only statutorily required special contribution to the Fund in 2014, 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 part of the \$37.250 million solvency deficiency shown in the 2013 Actuarial Valuation which is in excess of the 2013 wind-up shortfall.
3. In the event that FSCO directs that the City must take steps under the PBA to eliminate all of the \$37.250 million smoothed solvency deficiency shown in the 2013 Actuarial Valuation, City Council:
 - a) authorize the Treasurer to make a catch-up payment to the MTPBF, 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, after allowing for the \$2.548 million special contribution already made in 2014, to a maximum of \$11.5 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 Board of Trustees 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 \$36.233 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 MTPBF filed with FSCO;
 - d) approve a Non-Program Operating Budget increase of \$10,300 gross and \$0 net funded from the Employee/Retiree Benefits Reserve Fund for \$10,300 to cover the cost of the Letter of Credit in 2014.

Financial Impact

The 2013 Actuarial Valuation shows a solvency (wind-up) deficiency of \$2.548 million and a smoothed solvency deficit of \$37.250 million.

Under CRA's interpretation, the City is "required" to make special payments for 2014 of only \$2.548 million, which it has already made on the basis of the 2010 valuation. No further payments are required from 2014 to 2018.

However, under the *Pension Benefits Act*, the City is required to make special payments commencing in 2014 to eliminate the \$37.250 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 Board of Trustees 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 \$36.233 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 \$10,300 and a maximum cost of approximately \$0.470 million over the 5 year period (average of \$0.095 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 \$0.370 million to \$0.555 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 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: \$14,069,223 (inclusive of interest of \$71,223) for

the solvency deficiency in 2014, \$9,014,400 in 2015, and \$5,664,000 in each of the years of 2016 to 2018.

Funding of \$12,987,600 to cover these special annual payments have been included in the 2014 Non-Program Operating Budget in the Employee/Retiree Benefits Reserve Fund. Should City Council not approve the Letter of Credit, staff will require City Council to authorize an increase to the 2014 Non-Program Operating Budget of \$1,071,604 gross, \$0 net funded from the Employee / Retiree Benefits Reserve Fund, as a result of the new annual special payment requirements resulting from the 2013 Actuarial Valuation.

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 Metropolitan Toronto Police Benefit Plan is submitted annually to Council. The last such report was considered by Government Management Committee meeting held on May 13, 2013, when it received GM22.5 "Metropolitan Toronto Police Benefit Fund – Actuarial Report as at December 31, 2012". Following is the link to the report and decision document:

<http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2013.GM22.5>

The last Actuarial Valuation Report of the Metropolitan Toronto Police Benefit Plan which was filed with FSCO and formed the basis on which Council approved special payments into the Plan as required by provincial legislation (i.e. the *Pension Benefits Act*) was adopted by City Council at its meeting held on June 14 and 15, 2011 [re: EX6.12 "Metropolitan Toronto Police Benefit Plan – Actuarial Report as at December 31, 2010 – (Item GM3.5)"]. Following is the link to the report and decision document:

<http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2011.EX6.12>

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 (5) 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 Board of Trustees.

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 Police Plan has adopted a smoothed approach for its solvency valuation since December 2002 to minimize major swings in the valuation of Plan assets and liabilities.

Asset Mix and Investment Returns of the Fund

Given the demographics of the plan members, the Board of Trustees invests the Fund’s assets conservatively in a well-diversified portfolio of equity and fixed-income securities. The Board 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	5%
Bonds	45%
Canadian Equity	30%
U.S. and Other Foreign Equity	20%
TOTAL	100%

The 2013 market rate of return net of expense was 11.13%.

COMMENTS

The Metropolitan Toronto Police Benefit Plan is one of five (5) pre-OMERS pension plans sponsored by the City of Toronto. It covers two (2) active officer members, 1,215 retired officers and 721 survivor pensioners. The Plan's Administrator is the Metropolitan Toronto Police Benefit Fund Board of Trustees ("the Board of Trustees").

The Benefit Plan's Actuary, Mercer Human Resources Consulting, conducts an annual actuarial valuation of the assets and liabilities of the Plan's Fund and recently submitted to the Board of Trustees, its actuarial valuation report for 2013. The purpose of the valuation is to determine:

- a) the financial position of the Fund 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.

Going-Concern Valuation

The Valuation shows that at December 31, 2013, the Plan had actuarial assets of \$522.9 million, liabilities of \$505.2 million and a going-concern excess of \$17.7 million, down from a going-concern excess of \$26.9 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 \$1.5 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 improved by \$16.2 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 \$542.5 million was less than the actuarial liabilities of \$545.0 million, producing a solvency (wind-up) deficit of \$2.548 million, which is an improvement as compared to December 31, 2012 (when the Plan had a solvency (wind-up) deficit of \$87.7 million) and as compared to December 31, 2010 (when the Plan had a solvency (wind-up) deficit of \$33.1 million). The improvement is largely related to improved investment returns.

Solvency Smoothed Valuation

Since December 2002, the Police Plan has utilized a smoothed method for its solvency valuations, as permitted under PBA regulation. The 2013 Valuation shows that on a smoothed basis, the value of the assets of \$512.1 million was less than the actuarial liabilities of \$549.4 million, producing a total solvency deficiency of \$37.250 million as at December 31, 2013. The previous valuation as at December 31, 2012 had indicated a smoothed solvency deficiency of \$50.6 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 also improved when compared to the December 31, 2010 solvency deficit of \$46.3 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 \$37.250 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*	\$14,069,223
2015	\$9,014,400
2016	\$5,664,000
2017	\$5,664,000
2018	\$5,664,000
TOTAL	\$40,075,623

*The 2014 special payment includes \$13,998,000 to fund the solvency deficiency and \$71,223 in interest.

However, in the case of the 2013 actuarial valuation, there is a significant difference between the Solvency (Wind-up) deficiency of \$2.548 million and the "Smoothed" Solvency Valuation deficiency of \$37.250 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 \$2.548 million)

Table 3

Year	Special Payment
2014*	\$2,548,000
2015	0
2016	0
2017	0
2018	0
TOTAL	\$2,548,000

Given that this is the first time 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 fund the Plan according to the CRA's interpretation of the *Income Tax Act* which would require special payments of \$2.548 million in 2014. Through implementation of the special payment schedule approved by Council in 2011 with respect to the Actual Valuation as at December 31, 2010, the City has already made the required special payments of \$2.548 million in 2014 (and suspended any further payment); and,
- b) should FSCO demand elimination of the full \$37.250 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 it 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

Plan members have not received a cost-of-living increase since 2003, since the Plan had a solvency deficiency at the end of that year and has had a solvency deficiency at the end of every year since. From 2004 onward, the City of Toronto, as the Plan Sponsor, has had to make special payments to the Plan to eliminate those deficiencies. The chart below outlines the total special payments made by the City since:

Table 4

Year	Special Payment made by City
2004	\$704,000
2005	\$12,467,000
2006	\$12,306,000
2007	\$4,907,000
2008	\$2,417,000
2009	\$5,880,000
2010	\$9,637,200
2011	\$12,987,600
2012	\$12,987,600
2013	\$12,987,600
2014	2,548,000
Total	\$89,829,000

As reflected in this report, by 2014, the City of Toronto has made a total of \$89,829 million in special payments to the Fund of the Plan in order to deal with solvency deficiencies since 2004.

Plan members have expressed concern over the lack of cost-of-living increases for the past number of years. However, given the current financial position of the Fund, the 2013 Actuarial Valuation does not support a cost-of-living increase for 2014. In addition, as outlined above, given the significant amount of special payments that have been made by the City since 2004, it is not feasible for the City to incur any additional cost with respect to granting cost-of-living increases until such time as the Fund is fully solvent and the City of Toronto no longer makes special payments.

The Board, at its meeting on April 30, 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

Giuliana Carbone
 Treasurer

ATTACHMENTS

- Attachment 1: Police Pension Plan 5-Year Amortized Special Payment/Line of Credit Schedule
- Attachment 2: Metropolitan Toronto Police Benefit Fund, Report on the Actuarial Valuation for Funding Purposes as at December 31, 2013, March 2014