STAFF REPORT
ACTION REQUIRED
with Confidential Attachment

Toronto Transit Commission (TTC) Pension Fund Society (Society): Preliminary Analysis, OMERS Options

Date:	March 22, 2013
To:	Government Management Committee
From:	Treasurer
Wards:	**All**
Reason for Confidential Information:	This report involves the security of property belonging to the City or one of its agencies, boards, and commissions
Reference Number:	P:\2013\Internal Services\ppeb\gm13001ppeb (AFS16587)

SUMMARY

In response to a request from the Government Management Committee, this report summarizes the outcome of a review undertaken by the Treasurer, in consultation with a third party consultant/actuary, with respect to:

a) a report from OMERS Administration Corporation titled "Second Report on the Preliminary Analysis of OMERS Options — Toronto Transit Commission Pension Fund Society" (OMERS Report);

b) a communication (dated September 26, 2012) from the Toronto Transit Commission Pension Fund Society (PFS) to the Chair of the Toronto Transit Commission (TTC) concerning the OMERS Analysis and advising that for reasons identified in the communication, the PFS Board was not willing to pursue a potential merger of the PFS pension plan (PFS Plan) with the Ontario Municipal Employees Retirement System Plan (OMERS Plan), but that the Board might consider the OMERS Investment Management Inc. fund as a candidate to invest some of the Pension Fund Society's assets as part of a competitive search and due diligence process.

The Treasurer's review has focussed on both the interests of the City of Toronto and the fiduciary responsibilities of the Pension Fund Society (PFS).

RECOMMENDATIONS

The Treasurer recommends that:

1. City Council request the Toronto Transit Commission and the Board of Directors of the Toronto Transit Commission Pension Fund Society, working co-operatively with OMERS, to re-assess the benefits of a possible merger of the Pension Fund Society Plan into the OMERS Plan once the regulations dealing with the mechanics of plan mergers are in place under the *Pension Benefits Act*, and within a year of the regulations being filed.

2. City Council request the Toronto Transit Commission and the Board of Directors of the Toronto Transit Commission Pension Fund Society to apply to the Ontario Ministry of Finance and the Financial Services Commission of Ontario (*i.e.*, the Ontario pension Regulators) again requesting an exemption from the statutory obligation to continue past solvency deficit payments to the Fund of the Pension Fund Society Plan given that effective January 1, 2011 the Plan has been a recognized Jointly Sponsored Pension Plan.

3. City Council request the Toronto Transit Commission and the Board of Directors of the Toronto Transit Commission Pension Fund Society (working with independent external legal advisors), to conduct a formal legal review of the Pension Fund Society's plan documents to ensure transparency in governance and decision making responsibilities, and to ensure consistency between the Society's Bylaws and other policy documents including the Society's Funding Policy.

4. City Council request the Toronto Transit Commission to report back to the Government Management Committee on the outcome of the foregoing recommendations once each is completed.

5. City Council authorize the release of Confidential Attachment 1 if an agreement to merge the Toronto Transit Commission Pension Fund Society Plan with OMERS is approved by the Plan Sponsors (i.e. Toronto Transit Commission and Amalgamated Transit Union Local 113), or the Society authorizes such release and as determined by the City Solicitor.

Financial Impact

There are no financial impacts arising from this report.

As per the most recent actuarial valuation as at January 1, 2012, on a market value basis, the PFS Plan had going-concern assets of $3.825 billion, liabilities of $3.948 billion and a going-concern deficit of $123.0 million. In order to fund current service costs and address the going-concern deficit and past solvency deficits, the sponsors are required to contribute $169 million to the plan in 2013. The total estimated 2013 contribution being made into the Fund of the PFS Plan, in accordance with the contribution formula is $196 million. These contributions are shared equally by the TTC and the active members of the PFS Plan.

Table 1 below summarizes funding requirements and estimated contributions for 2013, outlined in the actuarial valuation report for the PFS Plan as at January 1, 2012.

Table 1: PFS Plan, Estimated Sponsor Contributions for 2013

Funding Component	2013 Estimated Contributions (Million's)
Normal Contributions	$ 139.9
Special Payment for Going Concern Deficit	$ 8.4
Special Payment for pre-January 1, 2011 solvency deficiency	$ 20.7
Total Required Funding/Contribution for 2013	$ 169.0
Additional Contributions based on PFS approved Contribution Formula and Funding Policy	$ 27.0
Total Contributions for 2013	$ 196.0

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 October 18, 2012, the Government Management Committee considered a letter (September 26, 2012) from the Chief Executive Officer of the TTC attaching for submission to City Council, through the Government Management Committee:

a) the OMERS Report setting out the OMERS options with respect to the Society; and,

b) a follow-up letter (September 26, 2012) from the Society to the TTC

[re: GM17.11 Second Report on the Preliminary Analysis of OMERS Options Toronto Transit Commission Pension Fund Society (the "Report")].

The Government Management Committee requested the Treasurer, working with a third party impartial pension consultant/actuary, OMERS and the Toronto Transit Commission, to review the letter from the Society (including the attachment titled "Second Report on the Preliminary Analysis of OMERS Options, Toronto Transit Commission Pension Fund Society"), and report back to the Government Management Committee in the first quarter of 2013 and that the report focus on both the interest of the City of Toronto and the fiduciary responsibilities of the Society.

Following is the link to the Council decision and staff report:
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2012.GM17.11

ISSUE BACKGROUND

The TTC and the Amalgamated Transit Union Local 113 (Union) jointly sponsor the PFS Plan operated by the Society, which was established as a legal entity separate from the TTC on January 3, 1940. Membership in the Society is a condition of employment with the TTC.

The PFS Plan was originally sponsored by the TTC and certain affiliated employers (such as its subsidiary which operated Gray Coach Lines for some years), but now the TTC and the Union are the remaining employers. The Plan was officially designated a Jointly Sponsored Pension Plan effective January 1, 2011, resulting in shared sponsorship with the Plan members (*i.e.*, joint and equal responsibility for the Plan including funding and plan amendments). The PFS Plan provides defined pension benefits.

As at January 1, 2012, the PFS Plan had 19,200 members: 12,391 active members, 247 deferred vested members, and 6,562 pension recipients (retirees/survivors).

Contractual Pension Benefit Formula

The contractual pension benefits are based on the "best 4-year-average earnings" formula described below.

- Normal Retirement Age (unreduced pension): 60. However, a member may retire on an unreduced pension upon completion of 29 years of credited service or continuous service; and where the member's years of age plus service total at least 80; or credited or continuous service is at least 30 years.

- Early Retirement Age (reduced pension): A member may retire at any time after attaining age 50.

- A member who retires is entitled to the following annual pension (payable monthly):

  - for each year of credited service up to the Base Period date (currently December 31, 2008) 1.6% of the average best four -years earnings before January 1, 2009 up to the average Year's Maximum Pensionable Earnings (YMPE) under the Canada Pension Plan for those four years plus 2.0% of the average earnings above YMPE; plus

  - for each year of credited service after the Base Period – 1.6% of pensionable earnings up to the YMPE plus 2.0% of earnings in the year above the YMPE.

- A member who retires before attaining Normal Retirement Age will receive a reduced annual pension.

The Society's Bylaws allow for benefit improvements, which include updating the Base Period, pensioner increases under an excess interest approach or on an *ad hoc* basis and other benefits as the Board may deem appropriate from time to time. The Board reviews the financial position of the Plan annually in consultation with the Plan's actuary and determines if improvements can be afforded under the Plan's current funding position and contribution rate.

Target Benefit Formula
To guide its decisions with respect to plan benefit levels and contribution rates within the contribution corridor and above-noted contractual benefits, the Board has adopted a Funding Policy. In addition to the contractual benefits, the Funding Policy provides for a target benefit threshold for improvements to Members' benefits through specified funding mechanisms, including margins built into the actuarial valuation assumptions and an explicit provision for future pensioner increases. The primary objective of the target benefits is to update Members' benefits to current levels (e.g. update Base Period from current December 31, 2008 to current years and provide regular pensioner increases) based on affordability given the existing funding position and the contribution rates of the Plan.

It is important to note that the 4-year Base Period is not automatically updated. Instead, it is up to the Board to update the Base Period, dependent on the financial position of the plan. This is also the case with cost-of-living indexing, which is not guaranteed. It is reviewed annually by the Board and decisions are made based on the financial position of the Plan and available funding. As a result, improvements to the plan are not guaranteed, and instead, provided only when the plan can afford them. In cases where benefit improvements are recommended, they require Board approval, TTC sanction and Member ratification.

Jointly Sponsored Pension Plan (JSPP) Status
For a period of over seven (7) years prior to 2011, the Board has sought relief from solvency funding from the Provincial government. As at January 1, 2011, when the Society would have been required to file an actuarial valuation with Ontario's Pension Regulators, the solvency liability was estimated to be in the order of $426 million which would have required annual contributions upwards of $80 million (50% TTC, 50% employees) to meet the solvency funding requirements. Not only would this have had a significant impact on plan members (increased contributions, lower benefits), but the TTC may have required a 20-cent fare increase to support the solvency payments. At the same time, it was clear that solvency funding would never be required for the TTC PFS, as a broader public sector pension plan. Consequently the Board, Members, Union and the TTC all endorsed movement to JSPP status in order to receive exemption from the solvency requirements.

Pursuant to a Memorandum of Agreement (Sponsorship Agreement) dated May 14, 2011 between the TTC and the Amalgamated Transit Union, Local 113 (Union), the Society registered the TTS PFS Plan as a Jointly Sponsored Pension Plan (JSPP) with the Superintendent of Financial Services for Ontario and the Canada Revenue Agency effective as of January 1, 2011, and amended its Bylaws accordingly. The joint Sponsors of the Plan (or Plan Sponsors) are the Union (on behalf of its members) and the TTC. The Plan Sponsors are jointly responsible for the administration of the Society (through equal representation on the Board) and the funding of the Plan, including any deficits. As a result of the Plan's JSPP status, effective January 1, 2011 the sponsors are exempt from the obligation to fund any future solvency deficits; however, both sponsors are still responsible for making special payments on account of past solvency deficiencies.

The Agreement requires that after each actuarial valuation report is prepared, the Board must decide whether to change contribution rates or benefit levels or keep the status quo within the parameters outlined in the Bylaws and the Funding Policy. We have been advised by TTC staff that in all cases any contribution or benefit changes would require an amendment to the Bylaws, which would require approval / sanction from the TTC.

Decisions Regarding Merger:
Any decision of the PFS Plan to merge with OMERS must be made and approved by the TTC and the Union jointly as Sponsors of the pension plan, and ratified by its Members.

Role and Fiduciary Responsibility of the Board
The Society is administered by the Board, which consists of ten (10) directors, five (5) of whom are appointed by the TTC and five (5) of whom are appointed by the Union. The Board, serving as the administrator of the PFS Plan, has a fiduciary responsibility to hold, invest and administer the Fund and pay benefits from it in accordance with the Bylaws of the Society, applicable legislation and in the best interests of the Plan members and beneficiaries.

The Board may appoint service providers (*e.g.*, investment managers, actuaries) to assist with meeting its obligations; however, as administrator it is ultimately responsible and accountable for the administration and management of the Plan, and the investment of assets. Responsibilities of the administrator include:

a) pension administration (including payment of pensions);
b) investment of plan assets (including establishing investment policies and objectives, determining an investment approach, and selecting investment managers);
c) financial reporting (including monitoring of financial statements and actuarial valuations) and compliance with all reporting and notification requirements under the *Pension Benefits Act* and the *Income Tax Act.*

The Board has full power to decide all matters arising under the Bylaws of the Society pertaining to plan administration.

Changes to the Bylaws of the Society:
Any changes to the Bylaws of the Society require Bylaw amendments which must be approved by the Board and sanctioned by the TTC, and ratified by the members. As outlined in section 3.09 of the Bylaw, although either the Board or the Society members in a general meeting can approve changes to the Bylaws, such changes are enforceable only if sanctioned by the TTC. This would apply to all changes in benefits, including pensioner indexation, updates to the Base Period and any changes in contribution rates.

Establishing Contribution Rates:
In accordance with the Sponsorship Agreement, the Board can approve setting the contribution rates within the specified contribution corridor of:

- The upper contribution limit of 11.25% and 12.85% of earnings up to the Yearly Maximum Pension Earnings (YMPE) as defined by the Canada Revenue Agency; and,
- The lower limit of 9.25% and 10.85% of earnings above the YMPE.

Given that the contribution rates are stipulated in the Bylaws, any changes approved by the Board within this corridor would require TTC sanction and Membership ratification of the Bylaw amendment. The Board must receive advanced Sponsor approval for changes outside of these limits, which would require changes to the Bylaws, TTC sanction and Membership ratification.

COMMENTS

As requested by the Government Management Committee, City staff have been working with a pension consultant/actuary, Buck Consultants, to conduct an independent review of the information and opinions provided by both the TTC, the Society and OMERS with regard to the various options put forward by OMERS. As a point of disclosure, Buck is currently the actuary for the OMERS Sponsors Corporation (SC). Buck has confirmed that they do not have a conflict in this situation and have taken measures to ensure that the consultants working on this project are different than those working with OMERS and that information provided as part of this analysis will not be shared or used for any other purpose.

The OMERS Pension Plan is a jointly-sponsored multi-employer pension plan whose members consist primarily of employees of Ontario municipalities, local boards, public utilities and non teaching workers at the school boards. The Plan has approximately 419,007 members and 947 participating employers. As at December 31, 2011, the Plan had going-concern assets of $54.921 billion, liabilities of $64.548 billion and a going-concern funding deficit of $7.290 billion. In the OMERS Report, OMERS identified three options for the Society's consideration:

1) investment management services through OMERS Investment Management Inc.;
2) provision by OMERS of Member/Employer Services and Pension Payroll (*i.e.*, Administrative Services);
3) full merger with OMERS.

Option 1 – OMERS Investment Management:
OMERS established the OMERS Investment Management Inc. (OIM) to provide investment management services to other Canadian pension plans. The OIM is a legal entity which is separate from the OMERS Administration Corporation, and provides clients with two options to utilize its investment management services:

1) the “T Contract” which provides the total fund return earned by the OMERS Plan; and,

2) the “S Contract” which provides the return earned by the OAC on one of its private-market asset-class portfolios.

After reviewing the information provided by both OMERS and the Society, City staff believe, on the basis of a review of performance over the past five (5) years and a future outlook provided by the actuary, that there may be a potential benefit to be gained if the Society utilizes OMERS Investment Management through an “S Contract”. In its report, OMERS outlined that on a cumulative basis, it has outperformed the PFS Plan by 0.53% per annum, net of investment related expenses, from 2007-2011. Taking 2012 returns into consideration, OMERS outperformed the PFS Plan by 0.15%, net of investment related expenses, from 2007-2012. This is reflected in Table 2 – Comparison of Net Investment Earnings 2007-2012. Additionally, the expected future long-term real rate of return for the PFS Plan is 3.25% compared to an expected long-term real rate of return of 4.25% for OMERS, based on the asset mixes as at January 1, 2011. However, the TTC Pension Fund Society Board is in the process of revising the Plan's asset mix which is expected to generate an additional 0.9% return and thereby narrow the gap between the current expected returns of the two plans.

Table 2 – Comparison of Net Investment Earnings - 2007-2012

Years	Gross Returns		Investment Management Fees		PFS Net Excess Return
	OMERS(1)	PFS(2)	OMERS(3)	PFS(4)	(2)-(1)+(3)-(4)
2012	10.03%	11.7%	0.53%	0.31%	1.89%
2011	3.2%	3.3%	0.58%	0.26%	0.42%
2010	12.0%	10.8%	0.64%	0.23%	-0.79%
2009	10.6%	13.6%	0.55%	0.22%	3.33%
2008	-15.3%	-15.5%	0.45%	0.27%	-0.02%
2007	8.7%	2.8%	0.40%	0.25%	-5.75%
2007 -2011 Average	3.3%	2.5%	0.52%	0.25%	-0.53%
2007-2012 Average	4.87%	4.45%	0.53%	0.26%	-0.15%

Although City staff believe that utilization of OMERS Investment Management Services may result in a potential benefit to the PFS Plan through greater investment performance, any decision regarding investment management must be made by the Society's Board, and not the TTC or City Council, given that the Board has full fiduciary duties to allocate the Plan assets and to select, monitor and terminate the appointment of investment managers.

In its letter of September 26, 2012, the Board acknowledged that it may consider OMERS Investment Management as a candidate to invest some of the Plan's assets as part of a competitive search and due diligence process.

Morneau Report

On May 30, 2012, the Deputy Premier of Ontario and Minister of Finance, Dwight Duncan appointed William Morneau as a Pension Investment Advisor to help the government determine the advantages of pooled asset management for Ontario's Public Sector Pension Plans. The *Morneau Report: Facilitating Pooled Asset Management for Ontario's Public Sector Institutions* has recommended the creation of a new pooled-asset managing corporation to oversee investments on behalf of Ontario's Public Sector Pension Plans. In his Report, the Advisor recommended that pension plans and investment funds with less than $40 billion in assets should be compelled to participate in any pooling framework. The Advisor also contemplated that the government may wish to consider exemptions for plans featuring jointly-sponsored governance structures. The PFS has received an explicit exemption from the mandatory pooling framework.

Option 2 – Member/Employer Services and Pension Payroll (i.e. Administrative Services) via OMERS:

OMERS has indicated that this option is not currently feasible so staff have not analyzed it.

Option 3 – Full Merger with OMERS:

A full merger of the PFS Plan with OMERS would involve a transfer of all the assets, liabilities and membership of the PFS Plan into the OMERS Pension Plan. Under this option, the TTC and the Union would be removed as the joint plan sponsors and the Society and the Board would be dissolved. All governance, administration and investment of the PFS Plan would be transferred to OMERS.

The funding requirements of the PFS Plan for benefits which have accrued before the merger would be determined at the time of the merger, and would need to be agreed upon by the both the Board and OMERS. In addition a merger would require changes to the OMERS Plan text and the PFS Bylaws which would require approval from the Sponsors and the PFS membership.

The merger decision is not one which could be made by City Council or the TTC alone. Any decision of the PFS Plan to merge with OMERS must be made and approved by the TTC and the Union jointly as Sponsors of the pension plan, and ratified by its Members.

Should the Sponsors determine to go ahead with a merger, their decision would be binding, subject to fulfilling their respective obligations under the Agreement, the Bylaws, the *Pension Benefits Act* (PBA) and subject to approval by the regulator (*i.e.*, the Financial Services Commission of Ontario (FSCO)).

In its letter dated September 26, 2012, the PFS Board indicated that it was not willing to pursue a merger with OMERS, and its reasons summarized below:

- There are significant differences between the benefit structures of the OMERS Plan and the PFS Plan (summarized in Table 3 below). Adoption of potentially costly guarantees for benefits based on OMERS' final average earnings provisions and contractual indexing is not the direction that the Board believes it should be going at this time.

- The contribution increases for the PFS Plan are capped by way of a contribution corridor.

- The provisions of the PFS Plan are conservative and provide the Board and the Sponsors with an invaluable tool to contain costs in a proven, fiscally responsible, way.

- The Board is confident that the members of the PFS Plan are satisfied with the Plan's current benefit structure and would not easily entertain / ratify a merger with OMERS.

Table 3: Comparison of Contractual Pension Benefit Provisions (TTC PFS vs. OMERS)

Plan Provision	TTC PFS	OMERS	
		NRA 60	NRA 65
Normal Retirement Date	Age 60	Age 60	Age 65
Earliest Retirement Date	Age 50	Age 50	Age 55
Average Earnings Definition	Average of highest **4** years earnings up to Base Period (currently Dec 31, 2008)	Highest Average Earnings over **5** consecutive years	
Pension Benefits are based on a member's	**Best 4-year Career Average Earnings up to a "Base Year"** (Current Base year is Dec 31 2008)	**Best 5-year Final Average Earning** (Current)	
Pension Increases	Indexing based on the excess of the rate of interest earned by the Fixed Income portion of the Fund over the valuation rate of interest, or on an *ad hoc* basis.	Contractually Indexed to CPI (maximum 6% per annum)	
Contribution Increases	Capped by way of a contribution corridor. Contribution rate changes beyond the corridor must be negotiated by Plan Sponsors.	Set by the Sponsors Corporation (SC) based on the funding valuation results	
2013 Contribution Rates	9.25% to YMPE/10.85% above YMPE YMPE: Yearly Maximum Pension Earnings	9.3% to YMPE/15.9% aboveYMPE	9.0% to YMPE/14.6% above YMPE

It is important to recognize that any potential merger of the TTC PFS with OMERS would be effective under the new sections of the *Pension Benefit Act* and new asset transfer regulations which have not yet been released by the Province. The new sections of the *Pension Benefit Act* will, once in force, require that post-merger pension benefits for:

- inactive members (i.e. pension recipients) must be maintained or improved;

- active members must be protected, but not necessarily replicated as long as the "prescribed value" of benefits for each individual member is preserved.

The pending asset transfer regulations are expected to prescribe the requirements for funding and related rules for mergers, including clarification regarding the appropriate actuarial assumptions to be used to determine asset transfer amounts at the time of merger; and, guidance on how to determine the prescribed value of contractual pension benefits which have accrued for members and must be protected.

For a plan merger to occur:

- the administrators for both plans (*i.e.*, the PFS Board and the OMERS Sponsorship Corporation and the OMERS Administration Corporation) would need to negotiate and agree on the level of assets to be transferred, and the level and types of benefits to be provided.

- the consent of the pension regulator (*i.e.*, FSCO) would be required to ensure the protection of member benefits.

A potential pension plan merger of this magnitude would require significant due diligence and a thorough assessment of financial impacts, which cannot be accurately undertaken until the required pension regulations are filed, and both parties (TTC PFS and OMERS) agree on the terms and conditions of the merger, including the appropriate level and type of benefits to be provided. Accordingly, it is premature to determine if a merger would benefit the TTC and/or the PFS Members.

The OMERS Report was intended to provide a high-level analysis of potential scenarios in order to assist in determining whether a merger of the PFS Plan with the OMERS Plan would be worth considering in more detail once the required pension regulations are filed by the Province. The Treasurer and her staff, working with an external consultant / actuary, reviewed the OMERS estimates and the PFS Board's response to the OMERS Report and have determined that while it is premature to make a final decision at this point, this should be reviewed once the pension regulations are filed and a review of the PFS's plan documents is conducted to ensure consistency with the Society's Bylaws and other policy documents.

For a merger of the PFS Plan with the OMERS Plan to be of value to the TTC and/or the PFS Plan members, there needs to be a material benefit or value gained in one or more of the following three areas:

a) surplus availability;

b) reduction in plan costs;

c) improved risk management/governance.

The balance of this report summarizes the Treasurer's review of these three areas.

Surplus Availability

As mentioned above, it is premature to determine the exact amount of surplus that may be available to the TTC, if any, should a merger occur, as there are too many unknown variables at this point in time. However, to help gauge whether a possible merger is worth considering once the pension regulations are filed, OMERS staff have identified two high-level benefit scenarios for a potential merger of the PFS Plan with the OMERS Plan which they feel on a preliminary basis would preserve the value of accrued member benefits that would need to be protected. It is important to keep in mind that these are hypothetical scenarios and cannot be relied upon to make a final decision. The scenarios presented by OMERS for estimation purposes only are:

- a modified normal retirement date age (NRA) 60 plan, with automatic indexation of 0.5% per annum; and,
- a modified normal retirement date age (NRA) 65 plan, with automatic indexation of 0.5% per annum.

The independent actuary retained by the City has reviewed the OMERS estimates, summarized in Table 4 below, and has noted that in presenting its scenarios, OMERS relied on the going-concern market financial position of the PFS Plan as at January 1, 2011. At the time, the PFS Plan reflected a **market value surplus of $100 million**. It is important to note that as outlined in the financial implications section of this report, the financial position of the PFS Plan has changed since that time and results as at January 1, 2012 reflect a market value deficit of $123.0 million.

Table 4: Financial Position & Surplus Consideration of OMERS Options as at January 1, 2011

Based on Jan 1, 2011 Valuation	PFS Plan Status (Pre-Merger)	OMERS Scenario 1: NRA 60		OMERS Scenario 2: NRA 65	
		Estimated Position	Compared to PFS Current Status	Estimated Position	Compared to PFS Current Status
Assets available for Transfer (i.e. market value)	$3.7 B	$3.7 B	0	$3.7 B	0
Going Concern Liabilities (Active, Retired & Deferred members)	$3.6 B	$3.6 B	0	$3.5 B	$0.1 B
Surplus (are estimates based on the actuarial valuation as of Jan 2011)	**$0.1 B**	$0.1 B	0	**$0.2 B**	**$0.1 B**
Discount Rate	5.75%	6.5%		6.5%	
Potential Surplus: 50% PFS Members 50% TTC/Sponsors					**$50 M** **$50 M**
Note: Distribution and/or use of surplus will be subject to pending pension regulations. The regulations will prescribe the portion (or possibly all) of the surplus to be transferred upon a potential merger					

As reflected in Table 4, above, it is estimated that there would be no additional surplus available under the first OMERS scenario (NRS 60 plan). However, under the second OMERS scenario (NRA 65), it is estimated that there is a potential for $100 million in additional surplus should the TTC PFS Board, Plan Sponsors and its members agree to the level of benefits provided under the NRA 65 scenario. The TTC PFS membership would be required to agree to increase Normal Retirement Age by five years.

The main reason for the additional estimated surplus under the NRA 65 scenario is the difference in discount rate between the OMERS Plan (6.5%) and the PFS Plan (5.75%). The difference in the discount rates results from the following:

- the OMERS Plan has a higher expected long-term rate of fund return (primarily as a result of differing underlying asset mixes); and,

- the PFS Plan's valuation principles have more conservative margins built into the discount rate as a result of different risk tolerances, and some conservatism built into the Society's Funding Policy, including meeting the objective of providing target benefits.

Recognizing that it is a long, expensive process to negotiate and establish a final surplus sharing agreement with PFS Plan members, the amount of surplus generated from a potential merger needs to be significant to make it worthwhile. While the $100 million in additional potential surplus estimated under OMERS' NRA 65 scenario appears significant, it is important to consider the following:

a) 50% of that estimated surplus (i.e. $50 million) would belong to the PFS Plan members;

b) of the remaining 50% or $50 million:

- the regulations will prescribe a portion (or possibly all) of the surplus to be transferred to OMERS;

- a portion will be needed to offset significant start-up / transition costs.

  Plan termination expenses (*e.g.*, legal and actuarial costs, termination of existing arrangements, communications *etc.*) are significant and are estimated by the Society's actuary to be $8.5 million. A merger of this significance will have even greater costs. OMERS has not quantified, and thus taken into account, the impact of transition costs in its analysis and estimates.

As mentioned previously, without the required regulations in place, it is premature to estimate the level of surplus, if any, that may be available at the time of a possible merger. However, based on OMERS high-level, preliminary scenarios, there may be merit in requesting the TTC and the PFS Board to re-assess the benefits of a possible merger of the PFS Plan into the OMERS Plan, once the regulations dealing with the mechanics of plan mergers are in place under the *Pension Benefits Act*.

Reduction in Plan Cost

Given that the prescribed value of the benefits must, at a minimum, remain the same pre- and post-merger, the overall plan costs could only be reduced if:

a) contributions/funding levels are minimized while adequate funding of the plan in accordance with provincial legislative requirements and PFS Bylaw requirements continues to be ensured;

b) investment earnings are improved; and/or

c) expenses are reduced.

These conditions can be expressed mathematically by the following equation:

Benefits = Contributions + Investment Earnings – Expenses.

<u>Contributions</u>

Contribution levels for the PFS Plan are set based on required levels as set out in the most recent actuarial valuation report for the PFS Plan, the Sponsorship Agreement, the Plan’s Bylaws and Funding Policy. Given the jointly sponsored status of the PFS Plan, the plan is exempted from solvency funding on any deficits that may arise effective January 1, 2011 and onwards. However, special payments that were in place as a result of past solvency deficits are still required to be made.

At the time of filing its first actuarial valuation as a JSPP, as at January 1, 2011, the PFS Board and its legal and actuarial advisors had extensive negotiations with the Ministry of Finance and the Financial Services Commission of Ontario (i.e. the Ontario pension Regulators) arguing that prior solvency deficits no longer serve a purpose now that the Plan is a recognized JSPP and will fund only on a going concern basis. These special payments which total over $110 million, and are payable until 2018 (approximately $20 million in each of years 2013 to 2017, and $10 million in 2018) were not forgiven by the Regulators at that time. Only a prospective solvency funding exemption was provided to the Society. Given that these special payments for prior solvency deficits no longer serve a purpose now that the Plan is a recognized JSPP, it is recommended that the PFS Board, with support from external legal advisors specializing in pension requirements, apply to the Ontario Regulators again, requesting an exemption from the obligation to fund past solvency deficits. This proposal can be made to the Regulators without a merger. Should the Regulators grant the requested exemption, contribution levels may be reduced by approximately $20 million in each of years 2013 to 2017 and $10 million in 2018.

Additionally, as is reflected in Table 1 under the Financial Impact section of this report, the PFS Plan's January 1, 2012 actuarial valuation report shows that estimated contributions that will be remitted to the fund in 2013 will be in excess of the minimum required (including solvency and going-concern special payments) by approximately $27 million and that such excess is expected to continue, or increase, on the basis of the established funding schedule.

Investment Earnings
As discussed above under the section of the report titled "Option 1 – OMERS Investment Management", on a cumulative net return basis, the OMERS Plan outperformed the PFS Plan by 0.53% per annum over the 5 years 2007 to 2011. The PFS outperformed OMERS by 1.7% in 2012. There may be a potential benefit to be gained if the PFS Plan taps into OMERS private markets investments through an "S Contract". A merger is not required for this option, and the PFS Board has acknowledged that it may consider this option as part of a competitive search and due diligence process.

Expenses
With respect to expenses, a review of administrative expenses paid for through the OMERS Plan and the PFS Plan indicates that on a per capita basis, administrative expenses are very comparable ignoring the higher-than-usual expenses that occurred in 2011 as a result of the additional services related to moving the PFS Plan to JSPP status. However, the administration expenses are not shared equally between the sponsors.

The TTC currently pays close to $2 million to cover the PFS Plan administration and office expenses, as required by the Society's By-laws. If the full joint-sharing model of OMERS applied upon merger, then the TTC's administrative expenses could be reduced by close to $1 million annually, which does not represent administrative savings, but instead a shift to joint responsibility of these costs.

The PFS administration costs are not significant given the size of the PFS plan and taking into consideration the costs associated with implementing a merger, which the actuary advises will be significant ($8.5 million or greater) and must be factored into any evaluation. Realization of any true administrative savings will be delayed many years after completion of an actual merger.

Improved Risk Management/Governance

The independent actuary retained by the City advises, and the Treasurer concurs, that the PFS Plan appears to be a well-managed plan from an active member fiduciary perspective. The Society's risk-management model is strong as Base Period updates and pensioner increases are provided only if affordable by the Plan (compared to OMERS' requirements for pre-funding for final average benefits and contractual indexing). This approach ensures that the Plan remains in a strong financial position during times of investment market turmoil, which provides security of members' accrued benefits. Additionally, it is a jointly-sponsored pension plan with the risk split equally between the TTC and Plan Members; and, the process for implementing any benefit improvements is such that the PFS Board approves, TTC sanctions and then Plan Members ratify the changes.

From an overall governance perspective, the PFS Board of Directors consists of ten (10) active members of the PFS – five (5) appointed by the TTC and five (5) appointed by the Union. As well, the Board is also in the process of developing a procedure to identify an independent Chief Executive Officer of the Society who shall have overall responsibility for the day-to-day management of the PFS Plan in accordance with the Sponsorship Agreement. No retired member representation and no external parties (i.e. non-members) are authorized to be on the Board under the Bylaw. The TTC has the ability to raise issues of concern or interest as a Plan Sponsor. The TTC, through the sanctioning of the PFS Bylaw changes has significant influence over the Plan's benefit structure and setting of contribution rates. The interests/concerns of the City (who funds the TTC agency) are heard through the TTC sanctioning process.

Additionally, the actuary retained by the City, identified some possible inconsistencies between the approved Bylaws and certain Society documents/policies, particularly with respect to funding of target versus contractual benefits. In response to this concern, TTC staff have advised that in 2011 (when the TTC PFS converted to a JSPP), the Plan Bylaws were updated and approved by the Board and the TTC. Additionally, a Funding Policy was developed by the Board through extensive consultation with its legal and actuarial advisors. The Funding Policy was developed to provide guidance to the Board in setting benefit and contribution levels given the Plan's unique benefit structure and within the boundaries of the contractual benefits as defined in the Bylaws.

To enhance consistency and transparency between its Bylaws and other policy documents including the Funding Policy, it is recommended that the TTC and the PFS Board (working with independent external legal advisors), conduct a formal legal review of the Society's plan documents, ensuring that governance and decision making responsibilities are clearly defined.

CONCLUSION

The Treasurer, in consultation with Buck Consultants, has reviewed the communications and reports provided by both the Society and OMERS, and advises that until the:

- required regulations governing pension mergers are filed by the Province; and,

- plan documents of the PFS Plan undergo an independent formal legal review to ensure consistency between the Society's Bylaws and other policy documents including its Funding Policy,

it is not reasonably possible to determine whether a merger of the PFS Plan with the OMERS Plan will be financially beneficial to the TTC and the PFS Members. However, given the high-level potential scenario estimates provided by OMERS, it is recommended that the TTC and the Society re-assess the benefits of a potential merger with OMERS once the pension regulations are filed and a review of the plan documents of the PFS Plan is conducted to ensure consistency between the Society's Bylaws and its other policy documents.

Given that the process to merge the plans will be long (requiring PFS Members to approve a potential merger and a final surplus sharing agreement), and start-up / transition costs will be significant, the potential surplus resulting from a merger would have to be significant in order to make it worthwhile.

Any decision to merge the PFS Plan with the OMERS Plan can be made only by the Sponsors and the TTC PFS Board focussing on what is in the plan Members' best interests. A merger would require a change to the TTC PFS Bylaws, which would have to be ratified by the PFS Members.

Even without a merger, there are opportunities to possibly reduce contribution funding levels by requesting the Ontario pension Regulators for an exemption from the obligation to continue making payments into the PFS Plan on account of past solvency deficits. Given that effective January 1, 2011, the PFS Plan became recognized as jointly sponsored, the special payments for prior solvency deficits no longer serve a purpose and will only contribute to surplus levels on a going-concern basis.

While it is acknowledged that the PFS Plan is a well-managed JSPP with a strong risk-management model to ensure continued affordability, a formal legal review of the TTC of the Society's plan documents is recommended to ensure transparency in governance and decision making responsibilities, and to ensure consistency between the Society's Bylaws and other policy documents including its Funding Policy.

As noted by OMERS in its report, any plan merger would take at least 12 to 24 months to complete, but realistically such an undertaking of this magnitude will likely take many years, especially when surplus is involved. A sample of some of the many areas for consideration include:

- a thorough review and understanding of the pension regulations, which it is hoped be filed this year;
- a thorough review of the proposed benefit levels by individual member;
- legal review of Society Bylaws that preclude certain changes in benefit levels;
- a negotiated agreement between OMERS and the PFS Plan sponsors or the PFS Board on their behalf on level of assets to be transferred, level and types of pension benefits to be provided, level of transition support provided by each organization, *etc.*;
- a review of equity considerations of various current and future groups within OMERS as it relates to PFS Plan members;
- establishment of a surplus sharing arrangement with members of the PFS Plan;
- administration of member pension and surplus benefits;
- ratification of the merger by Members of the PFS Plan;
- obtaining the consent of Ontario's pension Regulators;
- communication with, and education of, Plan members.

CONTACT

Celine Chiovitti, Director, Pension, Payroll & Employee Benefits
Tel: (416) 397-4143, Fax: (416) 397-0835, E-mail: cchiovit@toronto.ca

SIGNATURE

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Giuliana Carbone
Treasurer

ATTACHMENTS

Confidential Attachment 1: Report from Buck Consultants (March 8, 2013), "Review of the Second Report on the Preliminary Analysis of OMERS Options Toronto Transit Commission Pension Fund Society (PFS) and the Toronto Transit Commission (TTC) Report dated September 26, 2012"