Municipal Employers Pension Centre of Ontario

June 30, 2010

The Honourable Dwight Duncan

Minister of Finance

7th Floor, Frost Building South

7 Queen's Park Crescent

Toronto, ON M7A 1Y7

Dear Minister:

Re: Commentary on Phase II of Ontario Pension Reform

Recently, Municipal Employer Pension Centre of Ontario (MEPCO) staff have met with senior Ministry of Finance officials to discuss the next phase of pension reform in Ontario, preliminary to our own assessment of the fundamental issues that still need to be addressed. The attached submission captures our response to the pension commentary in the 2010 Provincial Budget and two specific issues – funding and indexation- which have a very high potential to significantly impact both OMERS Plan members and employers.

In pursuing and legislating pension reform, it is critical that the Government understand that the Pension Benefits Act provisions and regulations recognize the essential differences between single employer pension plans (SEPPS) and multi-employer pension plans (MEPPS)/jointly sponsored pension plans (JSPPs), which to operate effectively and efficiently, require a different regulatory regime. This continues to be our clear message to Government in its pension reform initiatives as they relate to OMERS, a public sector, multi-employer, jointly sponsored plan. The OMERS Plan is not subject to the same risks, e.g. insolvency, as other pension plans and a reform approach that "levels the playing field" or pursues a uniform, "one size fits all' treatment of pension plans is badly flawed public policy. Legislation resulting from this kind of approach is wasteful of constrained resources, puts increased and unnecessary funding pressures on members and employers. In the case of the OMERS Plan, the Ontario Government as an employer, will also face increased costs through its transfers to school boards, children's' aid societies and other sectors, such as local electricity distribution corporations or conversely, these entities will have less money available for front line services in their funding envelopes.

Ontario municipalities have great difficulty in passing along increased pension funding costs to their taxpayers. Tax increases to pay for increased pension funding, where there are no corresponding increases in the services delivered, will garner little or no public support.

We appreciate this opportunity to provide further input on what Ontario municipalities see as key pension reform issues and we look forward to working cooperatively as two orders of government to resolve our concerns in a way that is responsible in managing pension sustainability pressures and that minimizes risks to the taxpayers that we both serve.

Yours truly,

Doug Reycraft

Chair

Cc The Honourable Dalton McGuinty, Premier of Ontario

The Honourable Jim Bradley, Minister of Municipal Affairs and Housing

Deputy Minister Peter Wallace, Ministry of Finance

Deputy Minister Bill Forward, Ministry of Municipal Affairs and Housing

Steve Orsini, Associate Deputy Minister, Office of the Budget, Taxation and Pensions

Sriram Subrahmanyan, Assistant Deputy Minister, Taxation Policy Division in the Office of the Budget, Taxation and Pensions

The Honourable Laurel Broten, Minister of Children and Youth Services

The Honourable Leona Dombrowsky, Minister of Education

The Honourable Brad Duguid, Minister of Energy and Infrastructure

John Crocker, President & Chief Executive Officer, Hospitals of Ontario Pension Plan

Jim Leech, President and Chief Executive Officer, Ontario Teachers' Pension Plan

Derek Dobson, President and Plan Manager, Colleges of Applied Arts and Technology Pension Plan

OMERS SC/AC Employer representatives

MEPCO
Commentary on Phase II of Pension Reform.

1.0 INTRODUCTION

The Municipal Employers Pension Centre of Ontario (MEPCO) is a wholly owned subsidiary of the Association of Municipalities of Ontario (AMO), which has the responsibility for research, advice and liaison on matters relating to the Ontario Municipal Employers Retirement System (OMERS). AMO is the named sponsor representing 385 municipal employers that are part of OMERS. Municipal employers represent about 49% of all of the employers enrolled in OMERS. OMERS is one of the largest jointly sponsored pension plans (JSPPs) in Ontario. Jointly sponsored plans are different from other plans in that parties jointly sponsor and govern the plan, share risks and bargain collectively on benefits. This means that there are reduced operating risks, e.g. extremely low risk of insolvency, for jointly sponsored plans, which justifies a different legislative regime in order for such plans to operate effectively and efficiently. It is critical that the Government recognizes the fundamental differences between single employer pension plans (SEPPs) and JSPPs, as an important principle in pension reform legislation. The recommendations that MEPCO is making for the next phase of reform are based on this important premise. We welcome the opportunity to comment again on the progress towards pension standards reform as it pertains to the OMERS plan.

It is reassuring to see this government's commitment to pension standards reform, as evidenced by the number of issues tackled in Bill 236, the first round of pension reform. We were also pleased to see that one of our key areas of interest, asset transfers between pension plans, was included in Bill 236. On the other hand, we were somewhat disappointed with the negative option approach taken to dealing with grow-in for JSPPs.

With the next round of pension reform imminent, we believe it necessary to comment on fundamental issues still to be addressed. In Section 3, you will find our response to the pension commentary in the 2010 Ontario Budget. Further commentary follows on some specific issues - funding and indexation - both of which have the potential to significantly affect both plan members and their employers under OMERS.

2.0 SPECIFIC PENSION ISSUES

2.1 *Funding*

The cash contributions required to go into a pension plan, commonly referred to as funding, are inexorably linked to benefit policy and investment policy. It is critical in JSPPs like OMERS that mechanisms be in place to smooth out funding over time as large changes in funding requirements cause a number of issues, including budgeting problems for municipal and other employers and inter-generational inequity.

The Alberta/BC Joint Expert Panel on Pensions made a particularly enlightened statement with respect to correcting deficiencies: "The test and the remedy are two separate issues". The Federal Government seems to have taken this to heart in its recently proposed minimum solvency funding standards by introducing an average solvency ratio concept. We have not noticed any similar commentary coming from Ontario.

The funding of the OMERS plan is truly a joint responsibility of the member and employer representatives on the OMERS Sponsors Corporation. It was reassuring that the report of the Ontario Expert Commission on Pensions (the Report) concluded, and we strongly agree, that JSPPs should be required to fund only on the basis of going concern valuations, for several reasons:

- We believe funding standards should be allowed to vary based on the risk inherent in the nature of the plan. The rationale for solvency funding when it was first introduced 30 years ago was to ensure sufficient funds had been set aside to fully provide for benefits promised in the event that the plan was terminated due to the **plan sponsor's insolvency** (emphasis added). Clearly, this risk should not be a primary concern for the OMERS plan given the nature of its almost 1,000 participating employers. Otherwise, it sends a negative signal about how the province considers the financial well-being of public sector entities enrolled in OMERS.

- The nature of the governance of the OMERS plan is such that all aspects of the plan benefits and the funding thereof are subject to negotiation between plan members and their employers, in an environment where each side has equal representation and significant professional support both through OMERS staff and external advisors. Therefore, additional legislatively imposed safeguards are not needed to the same degree as they might with a single employer pension plan, especially where plan members have no role in the governance of the plan.

- Plan sponsors involved with OMERS have the taxpayer as their primary source of funds, which becomes problematic in dealing with the highly volatile funding requirements that result from the shortened amortization period associated with solvency funding.

The one recommendation from the Report that we take exception to is the recommendation for shortened amortization periods for JSPPs similar to what has been required for Specified Ontario Multi-employer Pension Plans (SOMEPPs). We understand the need for balance in making legislative changes, but, as indicated above, we believe that funding standards should vary based on the nature of the risk inherent in the plan and this should include risks related to the nature of a plan's governance structure. SOMEPPs typically have very different risk characteristics than OMERS. This is especially so when factoring in the difference in the nature of the industries and business that typically participate in SOMEPPs versus those that participate in OMERS.

As a final comment, the primary purpose of funding, in combination with investment returns, is to secure the benefits promised. In the attempt to maximize investment returns, Defined Benefit pension plans can follow investment strategies that result in a mismatch between the plan's assets and liabilities. Given the high degree of volatility in funded ratios that can result, a comprehensive risk mitigation strategy for dealing with the benefit security issue in these situations would include:

- A clear long term funding strategy that can sustain the benefits promised.
- Investment strategies that help mitigate against infrequent but highly negative investment returns in the short term.
- A practice of annual valuations to be able to stay current with the plan financial position and to adjust long term funding needs accordingly.
- A sufficient reserve built up to withstand significant chaotic market events that could have catastrophic consequences for the plan. Given that we are just recovering from such an event in 2008, it is not reasonable to expect a plan to build up a significant reserve overnight.

2.2 *Indexing*

Recommendation 4-21 of the Report states:

> The government should proclaim in force the provisions of the Pension Benefits Act that allow it to require pensions to be inflation-adjusted in accordance with a formula to be prescribed. That formula should be restricted to "inflation emergencies".

It is worthwhile noting that no definition of "inflation emergencies" has been provided and the Report is also silent on what might be appropriate in terms of prescribed indexation benefits.

The issue of inflation eroding the real value of pensions is a broad social issue. We are puzzled by this recommendation and strongly recommend that it not be incorporated in the next round of reform proposals, for several reasons:

- Inflation is highly unpredictable. Consequently, funding for inflation protection in advance generally comes at a very high cost. It is for this very reason that several large pension plans in Ontario have moved from a guarantee of 100% inflation protection to a more flexible approach involving a combination of a lower guarantee and ad hoc indexing based on the financial condition of the plan.
- The imposition of inflation protection onto existing voluntary retirement programs will be a fundamental change in the deal provided. Given the cost implications of such intervention, it is not acceptable to implement it as an add-on cost. Action has been taken in the past with respect to pension standards to deal with broader social issues, the primary example being to ensure that spouses would be protected by requiring a spousal form of payment, unless otherwise declined. However, the cost of providing a spousal form of payment was not forced on plan sponsors and plans could adjust the pension benefit to take into account the longer expected payout period. A similar approach could be taken with inflation protection, by offering it as an optional form of payment, for which the member would pay the price not the plan.
- Vague legislation is always a problem. We cannot have legislation dealing with subjective conditions such as "inflation emergencies".
- As we've already indicated, the OMERS benefits are actively managed by the OMERS Sponsors Corporation. It is critical to the ongoing management of the plan and to ensure the sustainability of the benefits that the Sponsors Corporation be able to manage the benefits of the plan and the cost thereof without undue and unnecessary regulatory intervention.

3.0 MEPCO RESPONSE TO PENSION COMMENTARY IN THE 2010 ONTARIO BUDGET

This Section responds to principles and reforms the Province put forward in the 2010 Provincial Budget Papers.

3.1. Extracted from Chapter III, of the Budget Paper: *Supporting Sustainable Public-Sector Pension Plans*

The government will consider additional temporary funding relief measures for public-sector and broader public sector (BPS) pension plans if certain conditions related to greater sharing of risk and governance are met, such as:

- *Converting to joint sponsorship for future service;*
- *More equitable sharing of the normal cost of providing benefits between plan sponsors and members;*
- *Linking some future benefits, such as inflation protection, to plan performance; and*
- *Enhancing cost certainty and affordability through benefit adjustments that make the plans more sustainable.*

MEPCO supports this suggestion and notes that the OMERS plan already meets these conditions in several ways:

- OMERs already has a joint governance structure, shared equally between employers and unions representing their collectively bargained employees;
- OMERS is funded 50/50 by participating employees and their employees;
- With respect to the last two points, the OMERS Specified Plan Change process (a by-law of the Sponsor's Corporation) provides the mechanism to implement them.

3.2. The following table consists of principles listed in Chapter III, section headed: *A Vision for Further Reform*, together with MEPCO's response:

Principle	MEPCO Response
1. Funding should be required for all benefits that a pension plan provides	OMERS currently does this through its going concern valuation, which, it is our understanding, is the sole intended basis for determining the funding of JSPPs.
2. Risk and responsibility should be shared among stakeholders	This is already the case with OMERS due to the nature of its joint governance structure and equal cost sharing.
3. Funding rules should match benefit and governance structures	We agree and would go one step further, suggesting that the net risk in a plan (of benefits not being delivered) should be factored into determining the appropriate funding rules for different types of plans in different circumstances. We suggest that OMERS, from a governance perspective alone, would fit into the lowest of risk categories.

3. 3 The following table consists of reforms to be explored, listed in Chapter III, section headed: *A Vision for Further Reform*, together with MEPCO's response:

For further exploration	MEPCO Response
1.Strengthen the requirements for taking contribution holidays and require disclosure of contribution holidays to plan members and retirees	We support this direction. From MEPCO's perspective, while contributions holidays can provide much wanted flexibility, they have the potential to create inter-generational inequities if taken for an extended period of time.

For further exploration	MEPCO Response
2. Enhance the requirements for funding benefit improvements when existing benefits are not fully funded and require that all benefit improvements be funded more quickly	We support this direction.
3. Limit the extent to which funding can be based on valuations that exclude the value of certain benefits, employ asset values that significantly depart from market values, or smooth assets	OMERS currently includes all plan benefits with respect to its going concern valuation, which, it is our understanding, is the sole intended basis for determining the funding of JSPPs. We agree that market values must be used to determine the "true" funded position. However, experience has proven that pension plan financials can be very volatile and assets smoothing is one of the few tools available to achieve reasonably level contribution rates, which are critical to the sustainability of JSPPs.
4. Further encourage innovative plan design for "flexible pension plan", as permitted under the federal Income Tax Act	We support this direction. However, OMERS has significantly subsidized ancillary benefits and the flexible pension plan approach currently has limited application to the OMERS plan.
5. Permit letters of credit to be used to partially satisfy solvency funding requirements	Assuming JSPPs will be exempt from solvency funding, this will have no impact for municipalities participating in OMERS. Furthermore, it is worth pointing out that letters of credit are unlikely to be of much use to most employers in the public sector and broad public sector.
6. Clarify procedures for determining surplus entitlement when a pension plan winds up	We support this direction.
7. Set a uniform funding threshold at which annual valuations would be required	Many large pension plans prepare valuations annually but file them less frequently. The current triennial valuation requirement is valued by many plan sponsors because it is a tool to assist in achieving more level funding. If the general funding rules were such that more level funding was a natural outcome, then sponsors would not need the triennial valuation filing in their funding tool kit. However, fees related to actuarial valuations do affect the cost of running a pension plan and there needs to be a reasonable balance between plans costs and ensuring adequate funding, especially for smaller pension plans.

CONCLUSION:

MEPCO wants to emphasize again, that as the province moves into the next phase of pension reform, it must consider the varying levels of risk inherent in the range of pension plans, arising from the types and numbers of sponsors and plan governance mechanisms. The “one size fits all” approach, while simple, may attract unintentional but severe consequences.