I. Governance

Section 19 – Funding Policy

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19.1 Purpose

The purpose of this funding policy is to provide a framework for the sound financial management of the Municipal Employees' Pension Plan (MEPP, or the Plan) by setting out recommended actions to be taken from time to time based on the circumstances of the Plan.

This policy is intended to assist the Municipal Employees' Pension Commission (the Commission) in its decision-making process, its development of recommendations to the Minister of Finance, and its communication with stakeholders by setting out a clear policy framework.

Nothing in this policy should be construed as prohibiting any decision or recommendation that may be made by the Commission in accordance with *The Municipal Employees' Pension Act* (the Act). The Commission will be solely responsible for deciding on the actions to take, if any, upon receiving the results of an annual actuarial valuation.

19.2 Plan Design

MEPP is a defined benefit (DB) pension plan established and governed by the Act, and *The Municipal Employees' Pension Regulations* (the Regulations). The Plan is registered under the *Income Tax Act* (Canada) (the ITA) and is subject to *The Pension Benefits Act, 1992* (the PBA) and *The Pension Benefits Regulations, 1993* (the PBR).

A DB pension plan specifies the amount of benefit that a member will receive at retirement based on a calculation that considers length of service and salary. Benefit levels for MEPP are set in statute. Contribution rates are specified in the Regulations on the recommendation of the Commission based on the advice of an actuary. The Act requires employers to contribute an amount, that in conjunction with employee contributions, would be sufficient to fund the promised benefits. To the extent possible, the employer contribution rate will be set to match the employee contribution rate to meet the shared cost objective articulated in Section 19.4. To date, employer contributions to the Plan have been equal to employee contributions.

19.3 Governance

The Commission administers the Plan and is the trustee of the Municipal Employees' Pension Fund (the Fund). The Commission has in place a Code of Conduct and Conflict of Interest Procedures. The procedures list the fiduciary duties that apply to the members of the Commission in their capacity as trustees of the Plan. A copy of the Code of Conduct and Conflict of Interest Procedures is signed annually by each member of the Commission.

The Commission has a fiduciary responsibility to Plan members to recommend that contribution rates be set at sufficient levels, as calculated by an actuary, to ensure that sufficient assets will be accumulated to deliver the promised benefits on an ongoing basis. The Commission also has a fiduciary duty to manage the investment activities of the Fund in the best interests of all Plan members. To achieve these, the Commission's responsibilities include developing and maintaining a funding policy in conjunction with the investment policy.

19.4 Funding Objectives

The funding policy has been developed based on the following principles:

- Stable funding requirements – Given the Plan's employer and member profile, there is low tolerance for volatility in contribution requirements. Most of the Plan's more than 700 participating employers employ 10 or fewer employees. A majority of the Plan's membership earns less than the Canada Pension Plan's Yearly Maximum Pensionable Earnings (YMPE) and about twenty percent of the membership earns less than half of the YMPE. The YMPE is a widely accepted proxy for the average industrial wage in Canada.

- Benefit security – The Plan should be managed to maintain appropriate margins and contribution levels to prioritize preserving accrued benefits for active and retired members.

- Benefit improvements – The Commission intends to use funding excesses to provide additional allowances to retired members when providing such benefits is appropriate.

- Shared costs – The cost of the Plan, including benefits, administrative and investment expenses will be shared equally by the active members and the participating employers, unless otherwise required by applicable law. The Plan has been funded equally by employees and employers since its inception in 1973.

- Balanced approach - The long-term financial management of the Plan should reflect a balanced approach, and be neither too conservative, thus unduly increasing current contributions or restricting current benefits, nor too optimistic, thus unduly reducing current contributions or increasing current benefits and raising the risk of future plan deficits or contribution increases.

- Contributions must support benefits – Contributions should normally be equal to or greater than the normal cost of benefits as determined by the management valuation report in addition to any deficit funding required.

- Inter-member equity – Inequity can arise when the contributions of one group of members in the Plan fund benefits for other groups. This can occur as an intergenerational inequity, between different classes of members such as general and designated members, or by provisions that unfairly enrich one member at the expense of the Plan and ultimately, other members. The funding requirements of a group or class of members should bear a consistent and proportional relationship to the benefits being provided to that group or class of members.

- Asset reserves – Holding a margin of assets greater than current liabilities is a standard approach to funding a pension plan and is required by the provincial pension regulator, the Financial and Consumer Affairs Authority (FCAA). This margin provides a cushion against adverse experience that might otherwise require a sudden increase in contribution rates, e.g.

- Integration of funding and investment policies – The funding and investment policies are the key tools available to the Commission for the management of risk and the achievement of the Plan's objectives. The two policies should be managed together through an integrated process to ensure that, in combination, they increase the likelihood that the Plan's objectives will be achieved and that risk is appropriately managed. The funding policy is the primary policy. The investment policy should support the objectives and principles underlying the funding policy, within the Commission's risk tolerances.

19.5 Key Risks and Implications

The Plan faces a number of risks to meeting the purpose and objectives of the funding policy. The following are the most significant of these risks:

- Investment risk – The cost of the Plan (benefits and expenses) are funded by contributions and investment returns from the Fund. In order to earn a reasonable return in the long run and to keep Plan contributions at a reasonable level, the Plan invests in certain asset classes that have uncertain and sometimes volatile returns. Investment risk is the risk that the Plan Fund does not consistently generate investment returns at the expected levels, as reflected in the discount rate used in the actuarial valuation.
- Assumption risk – To determine the contribution requirements under the Plan, the actuary uses long term assumptions in the actuarial valuation. Assumption risk is the risk that actual experience turns out to be worse than assumed, resulting in a shortfall in the funding of the Plan.
- Demographic risk – Demographic risk covers the risk that active and/or inactive membership characteristics (such as average age) change over time, or that there is an unexpected large shift in the demographic characteristics of the Plan as a whole (e.g., high ratio of retired to active member liabilities), affecting the funding requirements of the Plan.

The primary implications of these risks are summarized below:

- Contribution rate volatility: Fluctuating Plan experience, such as poor investment returns, may translate to volatile contribution requirements, resulting in unstable contribution rates for both employers and members.

- Contribution rate increases: Contribution rate increases may be necessary to fund higher normal actuarial cost due to changes in economic conditions or in the active membership profile, or to fund Plan deficits due to poor Plan experience. This may result in increases to contribution rates for the current generation of active members in order to fund deficits generated from liabilities of a previous generation of members.
- Contribution rates becoming unaffordable: If the contribution rates increase due to negative Plan experience, it may become difficult for members and employers to make the required contributions to the Plan.
- Benefit security: To the extent that negative Plan experience cannot be addressed by increased contribution rates, benefits for members may need to be reduced.

These risks are monitored and addressed by the Commission through various activities and tools.

- Annual review of the Statement of Investment Policies and Procedures (SIP&P);
- Periodic assessment of plan design;
- Periodic asset-liability studies;
- Actuarial valuations, using asset smoothing, to determine the financial position of the Plan, plan liabilities and the contribution rates needed to ensure funding stability and adequacy; and
- Annual review of a risk monitoring dashboard that looks at the level and trend of the risks.

19.6 Investment Policy linked to Funding Policy

Investment policy, directed by the SIP&P, is a separate policy addressing the appropriate investment of the Fund.

There is significant linkage between the Plan's funding policy and the investment policy. In particular:

- The going-concern discount rate used in the management valuation report is based on the expected long-term return of the asset mix outlined in the investment policy;
- The expected asset returns in the investment policy should be consistent with the going-concern discount rate used in the management valuation report;
- The investment policy should support the objectives and principles underlying the funding policy, including the funding target and thresholds outlined in Sections 19.8 and 19.9, within the Commission's risk tolerances;
- Asset-liability studies take into account the funding policy when the asset mix is reviewed; and

- The Commission uses a liability benchmark based on the current actuarial discount rate of the Plan as a proxy for the movement of the Plan's liabilities. This should see the liability benchmark grow in similar fashion to the actual liabilities of the Plan.

As a result of linking the policies together, the asset mix in the investment policy is to be reviewed every four to six years as part of the asset-liability modeling and risk tolerance study.

19.7 Actuarial Methods and Assumptions

The projected unit credit method is used to determine the Plan's going-concern financial position. Under this method, the actuarial value of the Plan assets is compared with the actuarial present value of pensions accrued in respect of service at the valuation date. Under this method, the normal actuarial cost is the value of benefits which will be earned in respect of the year following the valuation date. Further, additional amounts due to the "50 per cent cost sharing rule" are included in the actuarial liabilities and the normal actuarial cost.

There are two actuarial valuation reports prepared for the Plan:

- Management valuation report: A management valuation report includes a best-estimate going-concern valuation of the Plan which is used by the Commission for decision-making purposes. The management valuation report may also include a solvency valuation when requested by the Commission.
- Filing valuation report: A filing valuation report is prepared for filing with FCAA and the CRA. It includes a going-concern valuation which includes a margin for adverse deviations at a level agreed upon by the Commission. A solvency valuation of the Plan is also included per regulatory requirements.

<u>Management Valuation Report</u>

The management valuation report will be the primary source of information upon which the Commission will base its decisions or recommendations regarding contribution rates and additional benefits.

The going-concern valuation in the management valuation report shall be prepared using best estimate economic and demographic assumptions and in accordance with accepted actuarial practice, as established by the Canadian Institute of Actuaries. "Best estimate assumptions" are assumptions that, in the opinion of the actuary, are without bias, neither conservative nor non-conservative. Using best estimate assumptions, actual experience should be expected to generate neither positive nor negative impact to the Plan's financial position over the long run. In the short term, deviations of experience versus the best estimate assumptions are expected.

The going-concern valuation in the management valuation report shall include reserves for accruals for disabled members in the liabilities equal to the present value of all future accruals of presently disabled members.

For the going-concern valuation in management valuation reports on or after December 31, 2012, the actuarial value of assets will be determined using a smoothing method over not more than five years. For decision making and risk monitoring purposes, the funding position using the market value of assets will also be considered. The resulting actuarial value of assets will be limited to not more than 110 per cent, nor less than 90 per cent, of the corresponding market value of assets.

The going-concern discount rate in the management valuation report should be set at a level that reflects the expected long-term return of the total asset portfolio on a market basis. In selecting the discount rate, the following factors will be taken into consideration:

- The Plan's Funding Policy;
- The Plan's SIP&P including:
    - Any hedging or overlay strategies that the Plan may employ, and
    - Any planned changes in the SIP&P;
- Long-term expectations on asset returns of various asset classes and investment strategies included in the Plan's SIP&P; and
- The investment horizon.

The going-concern discount rate in the management valuation report will also include a provision for future investment management expenses and administration expenses of the Plan.

It is recognized that a change to the investment policy may require a change to the going-concern discount rate in the management valuation report.

Filing Valuation Report

The filing valuation report shall be prepared in accordance with the requirements of the PBA, the ITA, and accepted actuarial practice as established by the Canadian Institute of Actuaries. It is filed with FCAA and the CRA to ensure that the calculated contribution rates are permissible under the ITA and satisfy the minimum funding requirements of the PBA.

The filing valuation report includes a going-concern valuation that is based on the going-concern valuation in the management valuation report and incorporates a margin for adverse deviations at a level agreed upon by the Commission.

For the going-concern valuation in filing valuation reports on or after December 31, 2021, the following explicit margins should be included:

- An explicit margin reserve in the going-concern liabilities equal to the minimum of 20% of the best estimate going-concern liabilities and the going-concern surplus; and
- An explicit margin in the going-concern normal cost equal to the minimum of 20% of the best estimate going-concern normal cost and the contribution excess.

These explicit margins are consistent with the funding situation threshold levels as outlined in sub-section 19.9 before benefit improvements or contribution reductions may be considered.

The filing valuation report may also, when necessary, include an additional going concern valuation to support the eligibility of contributions under the ITA. Such valuation may include adjustments for anticipated future cost of living increases and/or additional margins and will be used to determine the maximum eligible contributions under the ITA.

A solvency valuation represents a hypothetical wind-up of the Plan and is also included in the filing valuation report as required by the PBA. The solvency value of assets shall be the market value of assets, including accrued income and contributions and net of accrued payments and expenses.

The PBR no longer requires most public sector pension plans to fund a solvency deficiency as these plans are not likely to experience a material risk of under-funded plan wind-up. However, a solvency valuation is still completed as a measure of the financial position of a plan and is included as a component of the filing valuation report.

Timing of Valuations

The Commission will ask the actuary to prepare a management valuation report each year to be presented as soon as practicable after the end of the year. While it is not mandatory, the Commission may also request a solvency valuation to be incorporated into the management valuation report.

The filing valuation report shall be prepared by the actuary at least triennially, as required by the PBA

The Commission may strategically request the preparation and filing of a valuation to manage volatility in funding requirements or if filing the valuation is otherwise beneficial in the judgement of the Commission.

Experience Studies

The Plan's actuarial model relies on best estimates of long-term future experience (assumptions) to inform the Plan's financial measurements and required contributions. Monitoring changes in demographic trends is important to ensure the Plan's demographic assumptions are consistent with the trends.

While year-to-year experience gains and losses are an indication of real-time or short-term trends, an experience study analyzes ongoing experience shifts, longer-term demographic trends, and can highlight how significant plan or economic events affect the Plan within the longer trends and can provide a data driven basis for adjusting best estimate assumptions.

The Commission will budget for and consider the possibility of experience studies every four to five years to ensure systematic, periodic review of trends affecting the Plan. The Commission may consider experience studies sooner if gain-loss analysis reveals significant or persistent variance between the Plan's experience and the best estimate that may indicate a shift in trends.

19.8 Funding Target

The management (best-estimate, going-concern) funded ratio is defined as:

a) The actuarial value of assets, divided by
b) The going-concern liabilities in the management valuation report.

To provide a margin for adverse deviations, the funding target for the Plan shall be a management funded ratio equal to 110 per cent.

When the management funded ratio exceeds the funding target, benefit improvements and/or contribution reductions may be considered, depending on the funding situation of the Plan, as described below. When the management funded ratio is less than the funding target, contribution increases and/or benefit reductions may be considered, depending on the funding situation of the Plan, as described below.

As per the PBA, benefit improvements can only be contemplated if the solvency ratio would exceed 90 per cent after implementation of the improvement.

The target funding contributions to the Plan are equal to the sum of:

a) 100 per cent to 115 per cent of the normal actuarial cost as determined by the management valuation report; plus
b) Special payments sufficient to amortize any shortfall of the actuarial value of assets relative to the funding target over an appropriate period.

Generally, any shortfall of the actuarial value of assets relative to the funding target should be amortized over a period not exceeding 10 years. However, the Commission will determine the appropriate amortization period for each deficit revealed, with each period not exceeding 10 years.

19.9 Funding Situations: Assessment and Considerations

Summary of Funding Situation Threshold Levels

Management Funded Ratio	Actions to Consider
< 110%	Increasing contributions or reducing benefits
110% - 120%	No changes to contributions or benefits
120% - 140%	Increasing benefits or reducing contributions (lower priority)
> 140%	Larger increases to benefits or reducing contributions

Additional details of the assessment of the funding situation and considerations within each threshold level are outlined below.

Management Funded Ratio Below 110 Per Cent

If the management funded ratio of the Plan is below 110 per cent, the Commission should not recommend a reduction in contribution rates from previously established levels and should consider whether an increase in contribution rates is required to reduce the risk of the Plan's management funded ratio falling further and/or the risk of even larger contributions being required in subsequent years. Alternatively, or in combination with increasing contributions to the fund, the Commission may make recommendations regarding benefit reductions appropriate to the financial circumstances of the Plan, as outlined in sub-section 19.11.

Contributions in this funding situation should normally be in the range of 100 per cent to 115 per cent of the management valuation report normal actuarial cost, and may be higher than 115 per cent if deemed appropriate by the Commission, but should at least equal the sum of:

a) 100 per cent of the normal actuarial cost as determined by the management valuation report; plus
b) Special payments sufficient to amortize any shortfall of the actuarial value of assets relative to the funding target over an appropriate period.

Notwithstanding the above, the total contribution rates shall not exceed the maximums specified in sub-section 19.10.

Management Funded Ratio Equal to or Above 110 Per Cent and Below 120 Per Cent

If the management funded ratio of the Plan is equal to or above 110 per cent and below 120 per cent, the Commission should not consider granting any benefit improvements. The Commission should not recommend a reduction in contribution rates from previously established levels. Contributions in this funding situation should normally be in the range of 100 per cent to 115 per cent of the management valuation report normal actuarial cost, and may be higher than 115 per cent if deemed appropriate by the Commission.

Management Funded Ratio Equal to or Above 120 Per Cent and Below 140 Per Cent

If the management funded ratio of the Plan is equal to or above 120 per cent and below 140 per cent, the Commission may consider the restoration of previous benefit reductions or granting an additional allowance to retired members based on increases in the Consumer Price Index in respect of the current year and in respect of past years for which no additional allowance was granted. Depending on the situation, the Commission may also consider recommending a reduction in contribution rates for active members and employers, however, priority would normally be given to restoring previous benefit reductions or granting additional allowances to retired members before reducing contribution rates. Contributions in this funding situation should normally be in the range of 100 per cent to 115 per cent of the management valuation report normal actuarial cost, and may be higher than 115 per cent if deemed appropriate by the Commission.

Management Funded Ratio 140 Per Cent and Above

If the management funded ratio of the Plan is equal to or above 140 per cent, the Commission may consider recommending the restoration of previous benefit reductions, temporary benefit improvements to any class of members, and granting additional allowances for retired members. In addition, the Commission may consider recommending a reduction in contribution rates for active members and employers, including consideration of a full contribution holiday until the next annual review. Contributions in this funding situation should normally be in the range of 90 per cent to 110 per cent of the management valuation report normal actuarial cost, and may be higher than 110 per cent if deemed appropriate by the Commission.

Other Factors

When considering actions as described above, the Commission should take into account factors other than the management and solvency funded ratios, including the ratio of the actuarial value of assets to the market value of assets and changes in economic conditions since the valuation date.

If the management funded ratio is at the lower end of a range of the ratios described above, the Commission may choose to be more conservative in its actions that are normally permitted within the range. Similarly, if economic conditions have deteriorated since the valuation date, the Commission should consider the likely impact of such events on the management and solvency funded ratios which may lead to more conservative decisions than might otherwise occur.

19.10 Maximum Contributions

The respective employee and employer contributions will fund both normal actuarial cost and, where applicable, special payments sufficient to amortize any shortfall of the actuarial value of assets relative to the funding target over an appropriate period.

The Commission has established that employee and matching employer contributions may not exceed 18 per cent of covered payroll for general members and 25 per cent of covered payroll for designated members. Factors in specifying maximum contribution levels include:

- The average salary for plan members is significantly less than the YMPE. Contribution levels above nine per cent could unduly burden lower wage earners.
- Contribution rates above nine per cent require approval from the Canada Revenue Agency. These are only approved for a specified time frame in relation to a particular actuarial valuation.
- Contributions above the identified maximums could unduly burden employers.

In keeping with the shared cost nature of MEPP, the employee and employer contributions will be managed to be equal, unless otherwise required by applicable law.

19.11 Benefit Reductions

Should contribution increases not be sufficient to restore the Plan to the target funded ratio and prior to the consideration of benefit reductions; the Commission will review a framework with the Plan's actuary to assess the short and long term financial and contribution outlook of the Plan with and without implementation of benefit reductions. Based on this review, the Commission may consider the following actions:

- Continue to monitor the Plan, with no immediate benefit reduction recommendations.
- Review and/or amend the Plan's guiding principles, targets and policy boundaries prior to recommending benefit reductions.
- Conduct further actuarial analysis, costing and consultations prior to recommending benefit reductions.
- Determine a course of action to restore the sustainability of the Plan. The Commission is committed that any actions taken with respect to benefit reductions shall be enacted with consultation and communication with the Plan's stakeholders.

Benefit Reduction Guiding Principles

If benefit reductions are contemplated, the Commission's decisions may be guided by the following principles (in order of importance):

- Preserving accrued benefits for active and retired members;
- Ensuring the Plan design is sustainable within a probability acceptable to the Commission;
- Maintaining equity between categories of plan members;
- Avoiding abrupt changes in benefit levels;
- Maintaining investment risk at reasonable level;
- Providing a competitive level of benefits;
- Maintaining an affordable level of contributions;
- Avoiding abrupt changes in the contribution rates;
- Managing intergenerational equity;
- Providing minimum target benefits of the Plan; and
- Ensuring actual funding contributions are within acceptable ranges above the minimum funding requirements.

If it is determined that benefit reductions are required in order to restore the sustainability of the Plan, these reductions, as permitted by law, may include any or all of the following, in no specific order:

- Change to five-year final average salary in benefit calculation; and/or
- Change to the early retirement reduction, or delaying unreduced pension commencement age; and/or
- Removal or reduction of bridge benefit; and/or
- Any additional benefit reduction deemed necessary by the Commission.

This does not limit the Commission from considering other changes to the Plan as may be necessary.

19.12 Utilization of Assets Exceeding Liabilities

Reserve assets that exceed a reasonable margin should be shared among different classes of members and employers; recognizing past contributions towards the development of this margin, the sharing of future financial risks of the Plan, and as permitted by law. Assessing the level of a reasonable margin requires consideration of several factors including, projections of the funded status of the plan and contribution levels, economic trends, and demographic trends. The funding situation threshold levels outlined in sub-section 19.9 have taken these into consideration, however, these factors need to be regularly re-assessed to determine appropriate margin levels and appropriate actions for the Commission.

When the Plan is at or above the funding situation thresholds outlined in sub-section 19.9 that allow the Commission to consider providing increases to benefits or reductions to contribution rates, the Commission will review a framework with the Plan's actuary to assist with determining appropriate utilization of assets exceeding liabilities. This framework should include a review of the following:

- Qualitative considerations;
- Funding policy considerations and thresholds;
- Assessment of the current financial position of the Plan and the estimated impact of providing an increase;
- Assessment of the estimated impact on the long-term projected financial position of the Plan; and
- Implementation considerations.

19.13 Monitoring

The environment within which the Plan operates is not static. The legal, regulatory, and economic environments that affect the management of the Plan are all subject to change. In addition, the Plan is continuing to mature and active members are expected to comprise a declining proportion of the liabilities in the future.

Periodic reviews of the funding policy are essential to ensure that the policy remains relevant and appropriate. At a minimum, this funding policy should be formally reviewed every three years. An asset/liability study may also be conducted in conjunction with the formal funding policy review. An earlier review may be required if, in the opinion of the Commission, significant changes to the environment or the Act have occurred since the most recent review.

19.14 Communication Policy

This funding policy and the filing valuation reports are made available on the Plan website and therefore accessible by the general public. Any specific inquiries concerning this policy should be directed to the Director, Policy and Governance, Plannera Pensions & Benefits .

19.15 History

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