

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 (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

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

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 provides that employers contribute an amount equal to required 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 its 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:

- 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. The Plan has been funded equally by employees and employers since its inception in 1973.
- Stable funding requirements – Given the Plan’s employer and member profile, it is evident that there is low tolerance for volatility in funding requirements. Most of the Plan’s more than 700 participating employers employ 10 or fewer employees. Approximately 80 per cent of the membership earns about half of the Canada Pension Plan’s Yearly Maximum Pensionable Earnings (YMPE). The YMPE is a widely accepted proxy for the average industrial wage in Canada.
- 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 in addition to any deficit funding required.
- Inter-member equity – Inequity can arise when the contributions of one group of members in the Plan funds 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 specific margin of assets greater than current liabilities is a normal outcome of funding a pension plan with a bias towards conservatism. This margin should be maintained in the Plan as a cushion against adverse experience that might otherwise require a sudden increase in contribution rates.
- 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

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:

- **Poor investment performance:** If the Plan's investments do not generate investment returns at the expected level, additional contributions will be required to ensure adequate funding.
- **Experience differing from expectations:** Actual experience may differ from the valuation assumptions which can affect the costs for the Plan.
- **Affordability:** If costs rise for the Plan, it may become difficult for members and employers to make the required contributions to the Plan.

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; and
- Actuarial valuation to determine the financial position of the Plan, Plan liabilities and the contribution rates needed to ensure funding stability and adequacy.

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. The Commission uses a liability benchmark composed of investable fixed income assets that have similar characteristics to the liabilities of the Plan. These characteristics include a similar sensitivity to real and overall interest rates (as expressed by duration) and a similar expected growth rate. Through the application and analysis of this benchmark, the Commission has effectively created a link between its funding and investment policies to provide a longer term perspective for the management of the assets in the Plan. As a result of linking the policies together, the asset mix is to be reviewed every three to six years as part of the asset-liability modeling and risk tolerance study.

19.7 Actuarial Methods and Assumptions

The unit credit method is used to determine the Plan's 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. Also under this method, the current service cost is the value of benefits, which will be earned in respect of the year following the valuation date. In addition, a liability due to the "50 per cent rule" is allocated pro-rata on service to the current service cost.

There are three types of actuarial valuations that are prepared for the Plan:

- Management valuation
- Solvency valuation
- Filing valuation

Management Valuation

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

The management valuation 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 means that, in the opinion of the actuary, the assumptions are without bias, neither conservative nor non-conservative.

Over the long term, actual experience should be expected to generate neither excess assets nor a funding deficit. In particular, the best estimate discount rate should reflect the long-term return expectations of the pension fund investments, based on the target asset mix set out in the investment policy. In the short term, deviations of experience versus the best estimate assumptions are expected.

The management valuation shall include reserves for accruals for disabled members; the present value of all future accruals of presently disabled members.

For the management valuation on or after December 31, 2012, the actuarial value of assets will be determined using a smoothing method over not more than five years.

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 management valuation discount rate 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

management valuation discount rate, the following factors will be taken into consideration:

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

The management valuation discount rate 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 management valuation discount rate.

Solvency Valuation

The solvency valuation is a hypothetical wind-up of the Plan. The solvency valuation shall reflect all benefits provided pursuant to *The Pension Benefits Act, 1992* (the PBA) and regulations. 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 Pension Benefits Regulations, 1993 as amended effective June 26, 2013, 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 financial position of a plan and is included as a component of the filing valuation.

Filing Valuation

Generally, the filing valuation will reflect the funding targets established in the management valuation. The filing valuation shall be prepared in accordance with the requirements of the PBA, the *Income Tax Act (Canada)*, and accepted actuarial practice as established by the Canadian Institute of Actuaries.

The filing valuation is prepared and filed with the Superintendent of Pensions and the Canada Revenue Agency with respect to the decisions or recommendations of the Commission with respect to contribution rates and benefits and is used to ensure that the contribution rates are permissible contributions under the *Income Tax Act (Canada)* and satisfy the minimum funding requirements of the PBA.

Timing of Valuations

The Commission will request the actuary to conduct a management valuation 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 be prepared in conjunction with any management valuation. If the Commission requests a solvency valuation be prepared in conjunction with a management valuation, the solvency results will be incorporated into the management valuation report.

The filing valuation shall be prepared by the actuary at least triennially, as required by the PBA, or earlier. The solvency valuation shall be prepared in conjunction with the preparation of the filing valuation in accordance with the requirements of the PBA and in accordance with accepted actuarial practice, as established by the Canadian Institute of Actuaries.

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.

19.8 Funding Target

The management funded ratio is defined as:

- a) The actuarial value of assets, divided by
- b) The sum of management valuation liabilities plus reserves.

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.

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; 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

Management Funded Ratio Below 100 Per Cent

If the management funded ratio of the Plan is below 100 per cent, the Commission should consider contribution rates at least equal the sum of:

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

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.

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 100 Per Cent and 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 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; 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 115 Per Cent

If the management funded ratio of the Plan is equal to or above 110 per cent and below 115 per cent, the Commission should not consider granting any temporary 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 normal actuarial cost, and may be higher than 115 per cent if deemed appropriate by the Commission.

Management Funded Ratio Equal to or Above 115 Per Cent and Below 125 Per Cent

If the management funded ratio of the Plan is equal to or above 115 per cent and below 125 per cent, the Commission may consider the restoration of previous benefit reductions or granting an additional allowance to retired members based on one year's increase in the Consumer Price Index, but not exceeding two per cent. 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 normal actuarial cost, and may be higher than 115 per cent if deemed appropriate by the Commission.

Management Funded Ratio Equal to or Above 125 Per Cent and Below 140 Per Cent

If the management funded ratio of the Plan is equal to or above 125 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. In addition, the Commission may consider recommending a reduction in contribution rates for active members and employers, but should ensure that contributions are no less than 100 per cent of the management valuation normal actuarial cost. Contributions in this funding situation should normally be in the range of 100 per cent to 110 per cent of the management valuation normal actuarial cost, and may be higher than 110 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 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 just above one of the thresholds described above, the Commission may choose to be more conservative in its actions. Similarly, if the fund has sustained investment losses since the valuation date, or if interest rates used to determine solvency discount rates have fallen 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

If the management funded ratio of the Plan is below the funding target, 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.

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

In keeping with the shared cost nature of MEPP, the employee and employer contributions will be equal.

Factors in specifying maximum contribution levels:

- 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.

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 may request the preparation of a Sustainability Study by the Plan's actuary. The Sustainability Study should outline the anticipated number of years in which the Plan will remain sustainable without the implementation of benefit reductions. Based on the results of the Sustainability Study, the Commission's actions are to be guided by the following:

Expected to remain sustainable for 10 or more years

The Commission should continue to monitor the Plan, with no immediate benefit reduction recommendations.

Expected to become unsustainable in six to 10 years

The Commission should review and/or amend the Plan's guiding principles, targets and policy boundaries prior to recommending benefit reductions.

Expected to become unsustainable in three to six years

The Commission should conduct further actuarial analysis, costing and consultations prior to recommending benefit reductions.

Expected to become unsustainable in less than three years

The Commission is to 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

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;
- Managing investment risk;
- Providing a competitive level of benefits;

- Maintaining an affordable level of funding;
- Avoiding abrupt changes in funding requirements;
- 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:

- a) Change to five-year final average salary in benefit calculation; and/or
- b) Delay in early retirement provision by up to 2.5 years; and/or
- c) Removal of bridge benefit; and/or
- d) 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.

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. 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, along with the management (including the solvency) valuations, is made available on the Plan website and is accessible by the general public. Any specific inquiries concerning this policy should be directed to the Director, Policy and Executive Secretary of the Municipal Employees' Pension Commission.

19.15 History

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