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HALIFAX REGIONAL MUNICIPALITY

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Halifax Regional Council
November 1, 2005

TO: Mayor Kelly and Members of Halifax Regional Council

SUBMITTED BY:
Gordon Roussel, Co-Chair, HRM Pension Committee

Nigel Field, Co-Chair, HRM Pension Committee

DATE: October 27, 2005

SUBJECT: **Request to Province for Exemption from Solvency Funding Requirements Under the Pension Benefits Act**

ORIGIN

Halifax Regional Municipality Pension Committee.

RECOMMENDATION

It is recommended that :

1. Halifax Regional Council support a proposal from the Halifax Regional Municipality Pension Committee (HRM Pension Committee) to the Province of Nova Scotia, to amend the Regulations under the Pension Benefits Act to exempt the Halifax Regional Municipality Pension Plan ("HRM Plan") from the requirement to fund solvency deficiencies.

2. The Mayor communicate Halifax Regional Council's support in a letter to the Province.

BACKGROUND

Under provincial pension legislation, a registered pension plan is required to file an actuarial valuation every three years. The actuarial valuation is prepared by the actuary for two main purposes; to set the level of contributions required to fund benefits accruing for service under the plan, and to determine the funded status of the plan at the valuation date.

The actuarial valuation must report the plan's funded status on two bases; a going concern basis assuming the pension plan is to continue indefinitely, and a solvency basis, assuming the pension plan is being terminated and the value of all benefits are paid out at the valuation date.

The rationale for plans having to demonstrate their solvency position and fund to eliminate any solvency deficiency is the protection of member benefits in the event that the plan was wound up or that the entity sponsoring the plan ceased to meet contribution obligations, such as in a bankruptcy situation.

Where a plan shows a deficiency in a test of solvency, such deficiency must be funded over a period of not more than five years. Because of the relatively short duration, this requirement can cause extreme variations in plan contributions for both members and employers.

The solvency funding requirement may be reasonable for organizations that could potentially and realistically become insolvent or otherwise terminate their pension plan. The situation for public sector entities such as the Municipality is different due to the unlikely prospect of a plan wind up or employer insolvency.

This distinction has been recognized by both the provincial and federal governments. Both levels of government have exempted a variety of pension plans they sponsor from pension legislation thereby exempting those plans from the solvency test requirements. Plans exempted from these requirements include plans covering provincial civil servants, former Sydney Steel Corporation pension plans, and the teachers' pension plan, as well as federal plans covering federal civil servants, the armed forces, and RCMP personnel.

Last year, with Council's support, the Province responded to lobbying from the HRM Pension Committee and other stakeholder groups to eliminate the requirement to fund the so-called "grow-in" benefit. The grow-in benefit is a required improvement to plan benefits of certain members should a pension plan wind-up. The grow-in benefit put undue pressure on defined benefit plans, and in the Committee's view, unreasonably increased the <u>theoretical</u> liabilities of the HRM Plan, which required the allocation of <u>real</u> assets to fund the deficiency it created. Removing the requirement to fund this benefit resulted in important savings for members and participating employers of the HRM Plan.

DISCUSSION

The financial markets have been difficult for investors generally, and the HRM Plan has not been immune to the negative returns which were experienced in markets throughout the world, especially in 2001 and 2002. During those years, the financial position of the HRM Plan on a going-concern basis deteriorated, but since that time, the going-concern financial position has improved and is now very healthy. However, the financial position on a solvency basis had deteriorated significantly during those two years, and contrary to the financial position on a going-concern basis, the financial position on a solvency basis has continued to deteriorate since 2002, even at a time when investment returns were relatively good. The reason for this seemingly inconsistent result is the impact that falling long term interest rates has had on the valuation of the Plan's liabilities on a solvency basis.

The Pension Benefits Act requires that pension plan liabilities for the required solvency valuation be calculated using discount rates that are based on current (at the valuation date) long term bond yields. Long term bond yields have been reducing constantly for many years, but the reduction has been significant especially since the beginning of 2005. The lower the discount rate the higher the corresponding solvency liability. Therefore, in an environment where investment returns have been at or above 10% per year (before expenses) since 2003, the reduction in interest rates over the same period has produced an unexpected and much more significant increase in solvency liability. This has created an increase in the solvency deficiency for the HRM Plan. This declining effect of interest rates has affected all pension plans in Canada. The HRM Plan is no different from that perspective.

Members and participating employers have faced two contribution increases since April 1, 1998 and another has been announced to take effect as of April 2006. The current contribution rate for the majority of members and employers is 8.56% of earnings each. The rate will increase to 10.36% each (a total of over 20%) in April 2006.

The last actuarial valuation of the HRM Plan was filed as at December 31, 2003. Therefore, the next mandatory filing will be as at December 31, 2006 and will be filed during 2007. Any increased contribution required to adequately fund the Plan would be incurred in 2007 and subsequent years.

Current projections of the 2007 contribution rate by the HRM Plan's actuary suggest that further contribution increases will be required if solvency test requirements are maintained. The most recent projection prepared as at August 2005 indicates that the combined (employer and employee) contribution rate is heading towards a level of about 30% of payroll for 2007 (combination of solvency deficiency and cost of benefits accruing during the year). Out of the above 2007 projected cost of 30% of payroll, about 15% of payroll goes towards funding the solvency deficiency and the other 15% of payroll towards the cost of benefits accruing during the year.

This contingent funding might be justifiable if there was any prospect of the HRM Plan being wound up or the Municipality becoming insolvent. Since such an eventuality is likely never to materialize, the solvency requirements impose a very significant financial burden where there is little practical risk to member benefits.

It is the opinion of the HRM Pension Committee that the contribution rate has reached a level at which further increases could not be tolerated by some employees without severe financial hardship. As well, the increased cost to the Municipality would no doubt put pressure on its ability to maintain current services without increasing taxes.

Given the very significant magnitude of the numbers and understanding that such a high contribution rate is unacceptable from both the participating employers and the members, the HRM Pension Committee is of the opinion that the Municipality should be proactive.

If the HRM Plan was exempted from funding such solvency deficiencies, the expected contribution rate for 2007 would drop from the expected 30% of payroll to about 15% of payroll (to be split equally between participating employers and members).

Further, exempting the HRM Plan from the solvency funding requirements of the Pension Benefits Act would not compromise member benefits and would allow the Municipality greater flexibility to allocate funds where the need is greater.

It is possible that the Province may decide not to grant the exemption being requested by the Committee. An alternative position that may be taken would be to allow an extension of the amortization period for funding of solvency deficiencies from the current five year maximum to a longer period (Nova Scotia universities were granted fifteen year amortizations in May 2005). While this alternative would provide some relief, it does not avoid the solvency funding requirement altogether. The Committee believes, for the reasons stated in this report, that solvency funding is unnecessary in terms of protecting member benefits.

BUDGET IMPLICATIONS

As of April 2006, the Municipality will face an increase in its contributions to the pension plan equal to 1.8% of its payroll, which equates to approximately $2.8 million per year. Notification of the April 2006 increase has been sent to all Plan members and participating employers. If the exemption from solvency is not granted by the Province, a further increase in Municipality contributions is expected in January 2007. The January 2007 increase is predicted to be about 5% of payroll, which represents about $7.8 million per year, and assumes current benefit levels are maintained.

FINANCIAL MANAGEMENT POLICIES / BUSINESS PLAN

This report complies with the Municipality's Multi-Year Financial Strategy, the approved Operating, Capital and Reserve budgets, policies and procedures regarding withdrawals from the utilization of Capital and Operating reserves, as well as any relevant legislation.

ALTERNATIVES

In seeking the support of Regional Council in this important and financially consequential effort, the Committee wants to confirm that it clearly prefers that full exemption be the initiative that is given Council's full support. However, it is acknowledged that the Province may choose to extend more limited relief in the form of a longer amortization period for solvency deficiencies such as was granted to universities. We respectfully request that if the Province takes this approach and the Committee feels that full exemption is not going to be granted, that Council support the extended amortization approach as an alternative.

ATTACHMENTS

None

A copy of this report can be obtained online at http://www.halifax.ca/council/agendasc/cagenda.html then choose the appropriate meeting date, or by contacting the Office of the Municipal Clerk at 490-4210, or Fax 490-4208.