Target Benefit Pension Plans: The Canadian Experience

National Coordinating Committee for Multiemployer Plans (NCCMP)

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Target Benefit Plans in Canada

- More than 50 years' experience in Canada
- Many different names:
  1. Multi-employer DB Pension Plan
     - Established pursuant to a trust, or
     - Established pursuant to a collective agreement
  2. Negotiated Cost Plan
  3. Shared Risk Plan
  4. Target Benefit Plan

- Other names include:
  1. Defined Ambition (UK)
  2. Collective Defined Contribution (UK, Netherlands)

Target Benefit Pension Plans In Canada -- Main Features

- **Fixed Contributions**
  - Defined amount, or
  - An amount within a defined corridor that can be adjusted by plan fiduciaries, but only within the corridor.

- **Joint governance**
  - At least ½ of trustees must "represent" plan members.

- **Reduction of accrued defined (target) benefits**
  - Plan fiduciaries (trustees) <u>must</u> reduce accrued benefits, including pensions in pay, if assets and the fixed rate of contributions do not support the target DBs (as determined by actuarial valuation) <u>and</u> participating employers and plan members are unwilling or unable to agree to increase contributions.

Target Benefit Plans in Canada

Advantages:

- Combines the best attributes of DB and DC:
  - Cost and financial reporting certainty of DC
    - Employers generally obtain DC accounting treatment, unless history of contribution increases rather than benefit adjustments
  - Cost efficiency of DB
  - Lifetime pensions as in DB
  - Consolidated expert investment management as in DB
  - Lower legal risk as in DB
  - Exempt from PBGF
  - No "last man standing" employer withdrawal liability
- Employers and beneficiaries obtain economies of scale that reduce overall cost
- Independent fiduciary administration with equal Employer and Participant representation
- Mirrors design of Canada's most successful plans – OMERS, OTTPP, HOOPP, CAAT …

Disadvantages:

- Retirement benefit is aspirational, not guaranteed
  - Is it really an issue? (CSI example)
- Not currently available in all Canadian jurisdictions
  - Lack of consistent rules where they are permitted

Target Benefit Plans
The Best of DC and DB

	Target Benefit	Defined Benefit	Defined Contribution
Retirement income	Predictable	Predictable	Uncertain
Employer financial risk	Low	High (uncertain)	Low (certain)
Employer fiduciary risk	Low	Low	High
Investments	Professionally managed	Professionally managed	Do-it-yourself
Cost of benefits	Low	Low	High
PBGF	Exempt	Covered	Exempt

Target Benefit & DB Plans Deliver More Bang for the Buck

Target Benefit & DB plans deliver the same $1 of pension income at about ½ the cost of DC plans.

- **Scale, no member investment choice and pooling of investment risk**
  - **saves 25% - 30%**
- **Balanced portfolio throughout retirement**
  - **saves 10%-12%**
- **Pooling of longevity risk**
  - **saves 10%-12%**

Put another way, contributions must be twice as high in a typical DC plan to produce the same $1 of retirement income under a DB or Target Benefit plan.

History and Experience With Target Benefit Plans In Canada

- Not available in all provinces, and in some provinces, only available in unionized workplaces
- More than 35% of active participants in DB Plans in the Province of Ontario are in target benefit plans
  - Plus another 35% in what are now public sector JSPPs
    - i.e., composite plans are arguably the most prevalent type of plan by numbers of persons covered
- Many of Canada's celebrated "Maple Leaf Plans" are, or started as target benefit plans:
  - Ontario Teachers, OMERS, HOOPP …
- Almost all target benefit plans are in unionized workplaces
  - 66 of 70 plans in Ontario
  - **BUT** this may change (lawyers, architects, pharmacists, accountants, doctors, massage therapists and other SMEs)

History and Experience With Target Benefit Plans In Canada

Failures ?

- No outright failures because these plans can bend, rather than break
- There are occasional governance issues:
  - Union plan (no management trustees) -- Illegal investment in Caribbean project that created union jobs, perks for trustees and resulted in loss of fund value
  - Union policy to "never reduce benefits" impaired functioning of board of trustees, exacerbated funding problems, and resulted in unsustainable levels of contribution (in excess of 24% of earnings)
  - Internal union conflict -- Ontario union local separated from US-based international union for nationalist reasons – required court proceedings to remove "rebel" trustees and divide the plan
  - Management trustees "force" investment in participating employers
  - Investment decision deadlock because of union trustees' desire to invest to preserve or create union jobs, rather than financial risk/reward
  - Plan administration held hostage to external union/management conflict – they couldn't agree to meet, or to pay service–providers
  - Petulance: Lack of pensions expertise, leadership and personal effectiveness skills among trustees caused inertia resulting in court appointed lawyer to advise them

History and Experience With Target Benefit Plans

Notable Successes

- ***Christian Schools International MEPP***
  - Canadian “DB plan” survived consequences of 2008-13 recession by reducing accrued rights to early retirement in 2015 and partially restoring rights in 2016.
  - U.S. plan on which Canadian plan modelled was forced to convert to DC in 2019.
  - Participant surveys show greater appreciation for Canadian plan after reduction made !

- ***Iceland***:
  - 25 industry-wide MEPPs covering 95% of workers
  - All plans are target benefit plans
  - All were able to bend, not break
    - Economic meltdown in 2008-2011
    - All plans cut accrued benefits by about 50% – including pensions in pay
    - Almost 100% restoration by 2018

Recent Trends In Target Plans in Canada

- 2013 New Brunswick "invents" what it calls the "shared risk plan"
  - Great marketing label !!!
  - Shared risks and rewards
  - Introduces probabilistic funding rules
  - Prescribes ordering of benefit reductions and restorations
- Elimination of discrimination between union and non-union workplaces
  - Conventional wisdom that only a union can provide effective oversight mechanism for target benefit plans is giving way to broader governance considerations, including representation by inactive participants (retirees or deferred vested), independent expert trustees, and plans for industry associations that are not unions.
- View of target benefit plans as a way to expand pension coverage among SMEs that are members of industry-wide associations
  - as opposed to a halfway house to prevent DB plans from capitulating or converting to DC
- Public Sector JSPPs with composite structure opening up to private sector employers
  - OP Trust
  - CAAT
- Single employer target benefit plans
  - ???

Recent Trends In Target Benefit Plans in Canada

Introduction of statutory funding thresholds that require benefit reductions or permit benefit increases:

- Historically a fiduciary decision based on going concern valuation with solvency/wind-up testing and actuarial recommendations

- Now splintered, but 2 main approaches evolving
  1. Going concern valuation with cushion
     - Stipulated amount +
  2. Probabilistic (95% core and 75% ancillary)
     - Based on stochastic and deterministic modelling

- Prescriptive regulations for benefit adjustments (up and down)
  - Must reduce if going concern valuation shows funded ratio less than “x“ (e.g., 85%)
  - May not increase until:
    - going concern with cushion achieved, or
    - probabilistic thresholds achieved, or
    - contributions increased to maintain current funded ratio (e.g., if above 85%)
  - New Brunswick prescribes ordering of reductions and restorations

Target Benefit Plans: Keys to Successful Plans

Plan design

- ❑ Build in levers (ancillary benefits) that can be adjusted without touching the core benefit
  - Indexing
    - Pre-retirement
    - Post-retirement
  - Bridging benefits
  - Unreduced or partially reduced early retirement benefits
  - Normal form of benefit
  - Use career average with periodic upgrades, rather than final average formula
- ❑ Make use of *ad hoc* benefit improvements

Target Benefit Plans: <u>The</u> Key to a Successful Plan

GOVERNANCE

Governance

- ***Reduce politics and management/labor dynamics and import financial institution governance principles***
  - Bi-cameral sponsor – trustee structure: use it
  - Trustee selection
    - Guided by skills matrix
    - Retention of labour management representation, but broaden representation to include
      - Inactive participants (retirees and deferreds)
      - Independent and expert trustees
  - Trustee term limits
  - Trustee compensation
    - Pay for expert and independent trustees
  - Promote and insist on continuing trustee education and development
  - More frequent meetings (at least quarterly)
  - Socialize
- ***Use <u>expert</u> advisors (lawyer, actuary, investment, communications)***
  - Review at least every 5 years
  - Consider an expert pool of approved counsel

Common Benefit Formulae In Target Benefit Plans in Canada

- Generally the same as DB:
  - Career average or final average earnings
    - E.g., 2% of career average earnings x years of service = annual pension
  - Unit or flat rate benefit formula
    - E.g., $500 x years of service = annual pension
- Career average and unit benefit likely the most common
- Many plans allow employers to sign on for different levels of contributions and benefits
- Consider a contribution based formula

Contribution Benefit Formula

Provision	Description
Pension Formula	8.5% of total contributions with pre- and post-retirement indexing (CPI up to 2% annually).
Pensionable Earnings	Earnings up to tax deductible limits.
Contributions: • Minimum Employer contribution of 1% Pensionable Earnings • Employee required contributions cannot be more than employer contributions • Employer may permit additional voluntary contributions by employee participants • Plan may permit individuals to "convert" DC balances by purchasing past service benefits	1%-18% of Pensionable Earnings.
Normal Form of Pension	Lifetime monthly pension, guaranteed 5 years.
Other Forms of Pension • Actuarial equivalent of Normal Form	• Mandatory joint & last survivor spouse pension, unless spouse waives. • Other forms of lifetime pensions available.
Normal Retirement	Age 65.
Early Retirement Pension	Actuarial equivalent as early as age 55.
Postponed Retirement	Benefit accruals continue through age 71.

How the contribution formula works

- **Year 1**

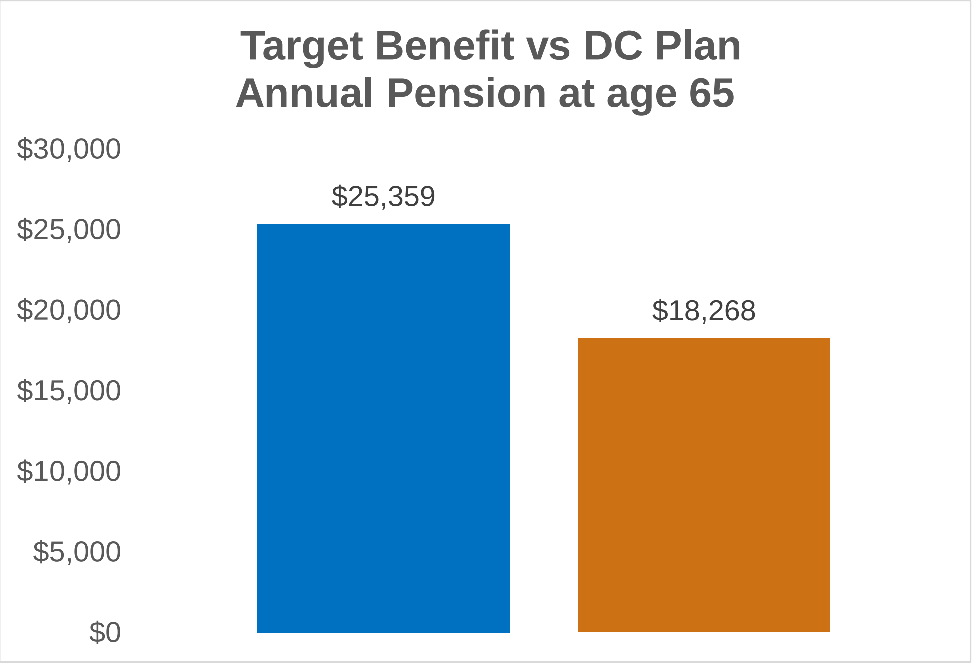
Contribution:	**$10,000**	
	x 8.5%	
Accrued:	**$850**	(payable at age 65)

- **Year 2**

Contribution:	**$10,000**	
	x 8.5%	
	$850	
	+ $850	(Year 1 accrual)
	+ $17	(CPI @ 2% on year 1 accrual)
Accrued:	**$1717**	(payable at age 65)

Amanda is 35 & saves 8% per year

Contributions			
	Rate	**Year 1**	**Year 30**
Employee	4%	$2,800	$4,972
Employer	4%	$2,800	$4,972



Amanda
Age: 35
Projected service: 30 years
Earnings at age 35: $70,000

Key Assumptions:
- Investment 4.0% (DC), 4.5% (DB) return (net of all fees).
- 2% indexing of salary and pre-retirement pension.
- Annual pension in today's dollars at age 65

Summary of Funding and Benefit Adjustment Approaches in Canada

Funding Rules

- Fixed contributions – in all jurisdictions.
- Minimum 3-year actuarial valuations to ensure fixed contributions and assets will support target benefit levels – in all jurisdictions.
- Annual valuations, if funding below legislatively prescribed funded ratio, e.g., 85% assets to liabilities.
- 3 valuation approaches in Canada to ensure target benefits are supported:
  1. Going concern with provision for adverse deviation -PfAD (funding cushion) **OR**
  2. Probabilistic (95% core benefit and 75% ancillaries) **OR**
  3. Going concern with solvency testing

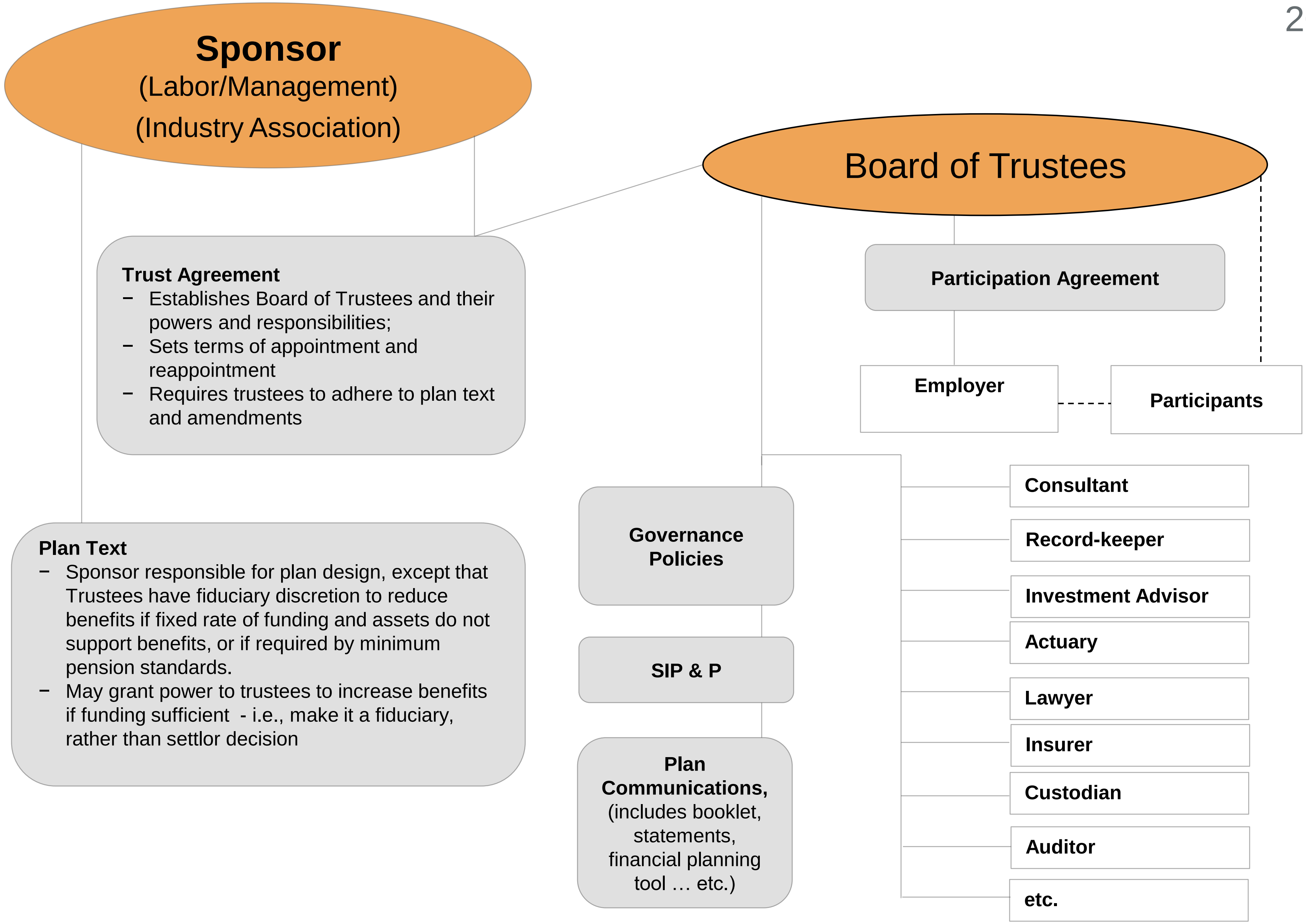
Benefit Change Rules

Generally left to Trustee (fiduciary) discretion

- Plans may require "sponsor" consultation or approval (e.g., labor/management or association agreement).

Increasingly, legislation is introducing non-discretionary triggers or restrictions, for example:

- No improvements unless
  - Plan funded ratio exceeds 100% + PfAD, **or**
  - Contributions increased to maintain current funded ratio
- Benefit reductions must occur if going concern funding less than legislatively prescribed funded ratio e.g., 85% assets to liabilities.


Sponsor
(Labor/Management)
(Industry Association)
Board of Trustees
Trust Agreement
− Establishes Board of Trustees and their powers and responsibilities;
− Sets terms of appointment and reappointment
− Requires trustees to adhere to plan text and amendments
Participation Agreement
Employer
Participants
Plan Text
− Sponsor responsible for plan design, except that Trustees have fiduciary discretion to reduce benefits if fixed rate of funding and assets do not support benefits, or if required by minimum pension standards.
− May grant power to trustees to increase benefits if funding sufficient - i.e., make it a fiduciary, rather than settlor decision
Governance Policies
SIP & P
Plan Communications, (includes booklet, statements, financial planning tool … etc.)
Consultant
Record-keeper
Investment Advisor
Actuary
Lawyer
Insurer
Custodian
Auditor
etc.

Questions and Comments

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