Analysis

Eckler
CONSULTANTS + ACTUARIES

January 19, 2009

Target benefit plans: the overlooked gem in the OECP Report

Among the 142 recommendations contained in the ***OECP (Ontario Expert Commission on Pensions) Report***, one innovation has been overlooked by many commentators – the recommendation to expand the use of target benefit pension plans for Ontario employees. Specifically, the OECP Report – like similar reports released recently by the ***Alberta/British Columbia Joint Expert Panel on Pension Standards*** and the ***Nova Scotia Pension Review Panel*** – promotes target benefit plans as a practical alternative to traditional defined benefit (DB) and defined contribution (DC) plans.

In fact, the OECP sees target benefit plans as a way to "tempt employers back into offering pensions." This Eckler *Analysis* helps to explain the basis for the Commission's enthusiasm. Specifically, it:

- provides an ***overview*** of target benefit plans (what they are and how they operate);
- outlines some ***pros and cons*** of target benefit plans from the perspective of both members and employers;
- explains the OECP's rationale for recommending that target benefit plans be ***exempted from solvency funding requirements***; and
- outlines some challenges for employers who may consider setting up a target benefit plan, including ***transition issues*** from a DB or DC pension arrangement to a target benefit plan.

We all recognize that there is no silver bullet in the world of pensions – and that target benefit plans won't necessarily work for every group or under every circumstance. That said, this *Analysis* will be of particular interest to:

- single employer sponsors of DB pension plans who are struggling with current funding and/or regulatory issues;
- DC plan sponsors who want to provide their members with greater benefit security and/or amounts, without taking on additional sponsor cost or risk (particularly in an uncertain market); and
- sponsors of single employer pension plans looking to gain economies of scale (and to mitigate related plan risks) by establishing a multi-employer plan.

The OECP has asked for comments on its report by February 27, 2009. If you think a target benefit plan might be a viable option for your organization, foresee transition issues that need to be addressed, or wish to suggest refinements to the proposed model, we strongly encourage you to let the Ontario government know your views – and would be pleased to help you prepare your submission.

Note that the comments provided in this *Analysis* are based on the recommendations contained in the OECP Report as interpreted by Eckler Ltd. These recommendations are not law and many details have not yet been decided (or at least disclosed) by the Ontario government. Our comments are based on our experience with similar types of plans and a reasonable expectation of how the Ontario government might proceed with the recommendations.

A MEMBER OF ABELICA GLOBAL

TARGET BENEFIT PLANS: THE OVERLOOKED GEM IN THE OECP REPORT

Target benefit plans have been around since the 1940s and have provided a very successful alternative to traditional DB and DC plans. The OECP's recommendation is a call to allow for the expanded use of target benefit plans beyond the multi-employer sector where they currently dominate.

Currently, target benefit plans provide pension benefits to almost one million Ontario workers (or 43% of all Ontarians covered by pension plans). Commonly known as multi-employer pension plans (MEPPs), the first target benefit plan in Canada was developed in the 1940s by Sam Eckler. Today, these plans are very popular with unionized workforces in the construction, manufacturing and public sectors, as well as among religious organizations.

The OECP recommends changing legislation to allow the implementation of plans with design, funding and governance characteristics similar to MEPPs, in employment environments where they are not traditionally found or allowed under the current rules. The recommendations would permit sponsors of single employer pension plans (SEPPs) to establish jointly governed target benefit pension plans (JGTBPPs). The OECP envisions that target benefit plans could also serve as a means of facilitating the growth of large-scale plans – through legislation enacted to enable and promote large, commingled target benefit plans – and encourage cooperation among small and medium-sized plans.

The target benefit plan advantage

What makes target benefit plans so appealing is that they move beyond the notion that retirement benefits can only be provided by a "pure" DB or DC approach. This is accomplished by combining a DB approach to providing pension benefits with a DC approach to funding those benefits. In the process, target benefit plans effectively eliminate the plan sponsor risk associated with DB plans and significantly reduce plan member risks associated with DC plans.

Key advantages of target benefit plans	
For members: works much like a DB plan	For employers: works much like a DC plan

• Pension benefits are determined by a set formula
• Assets are invested on an aggregate basis (benefits are not tied to investment performance on an individual's account)
• Mortality risk is pooled (no risk of outliving retirement savings)
• Access to DB-type pension features, such as:
  • subsidized early retirement
  • survivor pensions
  • pre-retirement death, termination and disability benefits
• Surplus is used for the benefit of plan members (e.g., to improve benefits)
• Members have a say in plan governance
	• A fixed schedule of contributions:
	  • no financial liability beyond paying predetermined contributions
	  • pension cost for accounting purposes is equal to employer contributions (i.e., accounting costs are fixed)
	• Contributions are typically expressed as a percentage of pay (or a fixed amount per hour)
	• Easy for members to understand and appreciate the value of the plan
	• The employer is not required to comply with CAP guidelines (which apply when members are offered investment choice under a DC plan)

Key disadvantages of target benefit plans	
For members	For employers
• Target benefit plan benefits may be reduced • Plan membership may result in a greater reduction in RRSP contribution room (than membership in a DC plan)	• Employer must be willing to share plan governance with plan members through an employee association or similar body • Transition of an existing DB SEPP may be challenging • Employer does not have unilateral control over plan design: • Less ability to use plan as an employment management tool • Employer has no claim to any plan surplus

Here's how target benefit plans work:[1]

- The *level of contributions* to the plan is fixed. Contributions are determined based on a formula (normally related to compensation or hours worked) and do not vary based on the financial position of the pension plan.
- The plan uses a predetermined *pension formula*. The formula can be based on average earnings or a fixed amount per year of service – or related to contributions on hours worked. The formula is based on the expected contributions flowing into the plan, plan member demographics (e.g., service and salary), ancillary benefit costs, assumptions for future investment return, and expected incidence of member retirements, terminations, etc.
- If the pension formula turns out to be too low given actual plan experience, benefits can be increased. If the formula turns out to be too generous, benefits can be reduced. The goal, of course, is to maintain a stable formula that provides predictable benefits for members.
- It is proposed that the target benefit plans be *governed by a board of trustees*. Given that the board has the power to increase or decrease benefits, and that plan members are directly affected by these decisions, member involvement in governance is an essential element of target benefit plans. For this reason, the OECP Report recommends that the target benefit plan governing board include at least 50% representation from the plan member group, including retirees.
- The board has no responsibility for establishing the level of contributions or other employment terms between an employer and employee. Its fundamental mission is to work with the established contribution level (whatever it might be) to design the plan and oversee its ongoing operations. This includes investing the plan assets, managing the plan's funding based on prudent long-term assumptions and making sure the plan is administered in compliance with the plan terms and applicable legislation.
- Because employer-related concerns are not the only factors driving plan design, the resulting plan terms are also likely to be influenced by:
  - member priorities (benefit accrual rates versus ancillary benefits, such as survivor benefits or early retirement); and
  - equity issues between members (equity between different generations of members and different types of members).
- In accordance with current governance best practices, the board has an overriding responsibility to promote full transparency around the operation of the plan and to communicate with members on an ongoing basis to ensure that they fully comprehend the risks and rewards of plan membership.

Employer perspective – some pros and cons

- The employer's only obligations under a target benefit plan are to remit contributions on time and in the right amount, to provide data for plan administration and, perhaps, to facilitate required member communications. The employer may have representatives on the board, but is not required to (the only requirement is that the governing board include at least 50% representation from the plan member group).
- There is no requirement for the employer to participate in the administration of the plan, as administration is the responsibility of the board and its agents.
- The pension cost for financial statement purposes is simply the employer contributions remitted in the year (employer accounting costs are fixed). No liability or asset is recorded on the employer's balance sheet (assuming that target benefit plans are treated in a similar way to MEPPs under current accounting standards).
- There is no employer obligation to increase contributions to fund any shortfall in the plan or any benefit improvement that the board of trustees may wish to make. The employer is only obligated to remit the required contributions required under the plan. Any additional funding levels would need to be approved by the employer.
- The employer has no claim to any "surplus" in the plan. Plan surplus is used for benefit improvements, as decided by the board.
- The employer has less ability to use the pension plan as an employment management tool because it does not have unilateral control over plan design. The employer cannot, for instance, unilaterally decide to provide early retirement incentives in order to reduce its workforce.

---

1 This commentary assumes that the Ontario government enacts legislation for JGTBPPs similar to current legislation governing MEPPs.

- In a unionized environment, the employer must be willing to share plan governance with the union.
- In a non-unionized environment, the employer must be willing to facilitate the creation of some kind of democratic employee association to help govern the plan.
- The sponsors of an existing SEPP must be willing and able to manage transition challenges (see *Transition to a target benefit plan* on the next page).

Employee perspective – some pros and cons

- From an employee perspective, a target benefit plan would be similar to a traditional DB plan – it pays a lifetime benefit based on a formula, includes a 60% survivor benefit (with a range of optional survivor benefits) and perhaps other ancillary benefits (such as early retirement). The key difference is that the benefit formula may be adjusted up or down during the course of the employee's membership in the plan.
- A pension adjustment (PA) would be reported annually for each plan member using a method that is standard for members of DB plans. This method tends to produce a PA that is higher than the actual contribution and, therefore, tends to reduce a member's RRSP contribution room more than a DC plan.
- The possibility that the benefit may be reduced may make the target benefit plan less attractive than a traditional DB plan. However, in cases where an employer can no longer afford a traditional DB arrangement (or is no longer willing or able to bear the potential cost fluctuations), a target benefit plan would likely have significant appeal over a DC plan (or a "no plan" alternative). This is because a target benefit plan maintains the following DB plan advantages for its members:
  - The assets of the plan are invested for the plan as a whole, and not on an individual basis. This typically translates into lower investment management fees and higher long-term investment returns. Not only can a pension plan invest in larger, professionally managed asset pools, it also has a much longer investment horizon than a given individual member, has greater access to professional advisers and can, therefore, execute a much more efficient investment strategy. The benefits of large asset pools are even greater in the case of large, commingled target benefit plans.
  - The longevity risk is spread across all plan members so members can't outlive benefits. Spreading the longevity risk over all plan members allows for the average level of retirement benefit to be higher for a given contribution than it would generally be under a Group RRSP or DC pension plan.
  - Most DB plans do not allow for formal member participation in the plan's governance. Many plan members will appreciate the opportunity to participate in the management of the target benefit plan.

Exempted from solvency funding

The OECP recommends that target benefit plans be subject to going concern funding only and that solvency funding should not apply. This recommendation is based on the premise that target benefit plans are similar in nature to MEPPs – for which the OECP has also recommended an exemption from solvency funding.

The OECP's rationale for this recommendation is that:

- the plan has the ability to adjust benefits to accommodate changing economic environments and cope with a shortfall, and
- target benefit plan members have significant control over the board's decisions and are fully informed as to the plan's risks.

We agree with this rationale. Another argument against solvency funding for target benefit plans is that the solvency funded position is very volatile. Since contribution rates are typically difficult to change, the application of solvency funding can lead to large swings in benefits.

Funding the plan on a going concern basis clearly puts a greater onus on the board to ensure that the plan's funding and investment policy is sufficiently conservative. Under normal circumstances, this would be achieved by using a relatively low discount rate assumption, conservative assumptions for future mortality and/or additional contingency reserves. On this point, we note that it is unlikely that even an extremely conservative actuarial basis would have fully insulated a plan – in the short term – from the severe market downturns recently experienced. No board can be held to a standard of being "100% right" in the short term or completely shielding their members' from risk; but a board should be expected to manage the plan's funding basis so that, over the long term, members benefits are reasonably stable, especially when compared against benefits provided from an individual account in a Group RRSP or DC plan.

Transition to a target benefit plan

The OECP does not address how a transition to a target benefit plan from an existing DB or DC plan should be carried out, except to say that it favours "a simplified conversion process...driven largely by a concern for transparency and democratic decision-making."

In most cases, however, the two key transition issues would be:

1. establishing a joint governance structure, and
2. deciding on the treatment of benefits accrued under the existing plan.

Documentation would need to be drawn up to set out the details of the composition and operation of the governing board. And, in the absence of a union, the employer would need to facilitate the establishment of a democratic association or similar body to help govern the plan.

The OECP Report talks only about applying target benefits on a going-forward basis and does not deal with the issue of accrued benefits. Current legislation does not allow accrued benefits under an existing DB plan to be reduced, so accrued DB plan benefits could not be assumed by a new target benefit plan under the current rules. A DB plan sponsor could simply "freeze" the existing plan and implement a target benefit plan going forward. However, it is hoped that any new legislation would recognize the merits of creating target benefit plans and would allow sponsors of existing DB or DC plans to negotiate the terms of any transition with their members – including a possibility of reduction in benefits accrued under the existing plan – with appropriate requirements for member disclosure and agreement.

Transition from a DC plan should be fairly straightforward. The key consideration in terms of accrued DC benefits would be whether account balances should be transferred into the new target benefit plan. If so, a formula would have to be established for converting these balances into target benefit plan amounts for past service.

Of course, in addition to dealing with the issues of joint governance and accrued benefits, any transition to a target benefit plan would involve creating or amending the trust and working out all of the plan terms, including contribution levels.

Next steps

We are encouraged by the OECP's strong call for innovation in Ontario's pension system. Clearly, if there was ever a time for all stakeholders to embrace and get on with such innovation, this is it.

Target benefit plans have provided a very successful retirement income plan structure for many workers in Ontario and across Canada for decades. In addition to the OECP promoting the expansion of target benefit plans to more workplace environments, this type of plan design has also received broad-based support in the reports recently released by the Alberta/British Columbia Joint Expert Panel on Pension Standards and the Nova Scotia Pension Review Panel.

The OECP has asked for comments on its report by February 27, 2009. If you think a target benefit plan might be a viable option for your organization, foresee transition issues that need to be addressed, or wish to suggest refinements to the proposed model, we strongly encourage you to let the Ontario government know your views – and would be pleased to help you prepare your submission.

Note that the comments provided in this Analysis *are based on the recommendations contained in the OECP Report as interpreted by Eckler Ltd. These recommendations are not law and many details have not yet been decided (or at least disclosed) by the Ontario government. Our comments are based on our experience with these types of plans and a reasonable expectation of how the Ontario government might proceed with the recommendations.*

Halifax 902 492 2822

Montreal 514 395 1188

Quebec City 418 780 1366

Toronto 416 429 3330

Winnipeg 204 988 1586

Vancouver 604 682 1381

Barbados 246 228 0865

Jamaica 876 908 1203

Eckler
CONSULTANTS + ACTUARIES

www.eckler.ca