INSIGHTS

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Reforms May Be the Death Knell for Target Benefit Plans

By D. Cameron Hunter

Recent and proposed pension reforms for **target benefit plans (TBPs)** – removing solvency funding requirements in favour of more stringent going-concern standards – are a move in the right direction. However, in the process, governments appear to have lost sight of the ultimate purpose of pension plans: **providing members with reasonable pensions based on fixed contributions made by members and employers.** This singular focus on protecting benefits at the expense of providing adequate pension levels will have unexpected consequences and could threaten the growth, or even the survival, of TBPs.

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Emergence of TBPs in Canada

Aside from the mega public-sector pension plans, TBPs are Canada's unsung pension heroes. Originally developed as multi-employer pension plans (MEPPs) created by unions, these plans have provided meaningful financial security to millions of Canadians since the 1940s.

In the past decade, the success of MEPPs, coupled with the demise of traditional single-employer defined benefit pension plans, has led Canadian legislators to attempt to expand TBPs beyond the historic MEPP universe. In truly Canadian fashion, many provinces across Canada have conducted detailed expert studies on these plans (e.g., negotiated cost pension plans, shared risk plans, collectively bargained multi-employer pension plans, etc.).

Regardless of jurisdiction, the three key characteristics of a TBP are:

1. a fixed level of funding not related to the financial position of the TBP;
2. the legal ability to reduce accrued benefits; and
3. majority control by plan members over governance of the TBP.[1]

The third characteristic has led some outsiders to conclude that TBPs are providing overly generous benefits at the expense of the TBP's long-term sustainability. Yet this simply hasn't been the case. There are always a few outliers, but the clear majority of TBPs regularly assess the long-term sustainability of their benefit structure and make adjustments as required, as one would expect from a pension plan with a "target benefit."

As the TBP structure has evolved, legislators have been developing new funding requirements. Ideally, TBPs should be subject only to going-concern funding requirements, with no additional provisions. Trustees owe a fiduciary duty to all plan members, which is a strong control mechanism to ensure the plan remains sustainable. Additional funding requirements generally inhibit trustees' flexibility to address plan-specific sustainability issues and also layer on potentially unnecessary restrictions.

Minimum versus prudent funding

Unfortunately, there are concerns about "rogue" actuaries who use aggressive assumptions, producing larger benefits and therefore jeopardizing the TBP's long-term sustainability – a perspective that comes from conflating *minimum* funding requirements with *prudent* funding requirements. The fundamental difference is the action required if the funding test or requirement is not met.

If *minimum* funding requirements are not met, then benefits must be reduced. If the plan's *prudent* funding requirements are not met, then the trustees must consider appropriate actions, which could include changing the investment strategy to increase expected investment returns, introducing contributions specifically to improve funding, or reducing or restructuring benefits.

It makes no sense for minimum funding requirements to be the same as prudent funding requirements. However, this is the approach legislators seem to be taking with rules such as:

- forcing plans to maintain massive contingency reserves, known as Provisions for Adverse Deviation (PfADs);
- limiting benefit improvements until the PfAD is fully funded; and
- doubling up the PfAD provision when the TBP has a shortfall (since PfAD funding isn't suspended when a plan is eliminating a shortfall).

*[1] This is not true under the proposed **Bill C-27, An Act to Amend the Pension Benefits Standards Act, 1985**, the federal government's attempt at adding TBPs to the federal pension framework. This is one of a number of fundamental flaws of Bill C-27.*

Although the TBP funding regimes have merits, these prescriptive requirements have the potential to bring an end to TBPs. Why? TBPs, like all pension plans, need new, younger members to offset the aging and retiring members. Younger members are far less likely to continue to support the TBP if it provides a small pension and their pensions are infrequently improved. In the extreme, they may call for the end of the TBP so they can redirect contributions to a registered retirement savings plan or another savings plan.

This fear isn't far-fetched. Under Alberta's pension rules, a PfAD could easily be 25% or more. Requiring plan members to allocate a quarter of their contributions to a reserve that won't provide any benefits to the current generation could cause widespread revolt against the TBP. Legislators don't seem to have considered such risks, or if they have, those concerns have been dismissed.

Solutions to foster TBP growth

Making some simple changes to the current or proposed frameworks would protect existing TBPs and help these plans grow in the future.

- **Lower the PfAD requirement.** It should be much lower than what has been proposed to date and not more than 5%. Trustees will usually have incorporated other margins through their prudent funding approach in excess of any minimum required by law.
- **Allow benefit improvements** if there are enough contributions to cover the cost over a reasonable period, such as 10 or 15 years.
- **Use the PfAD wisely.** If there is a shortfall, reduce the PfAD funding requirement to the greater of the existing PfAD and the required amortization amount.
- **Allow trustees to reflect the PfAD in the actuarial assumptions,** whether explicitly or implicitly.

With their reforms, legislators appear to be looking only at benefit security – and the likely casualties will be benefit adequacy and generational equity. This myopic approach may backfire and lead to fewer, not more, TBPs. In addition, existing TBPs may come under pressure from younger members to reduce or redirect contributions elsewhere, given the potentially modest benefits they will provide.

We need to find a better balance between maintaining greater target benefit security and providing a reasonable pension for a fixed contribution – the reason these plans were created in the first place.

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