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The Association of Canadian Pension Management
L'Association canadienne des administrateurs de régimes de retraite

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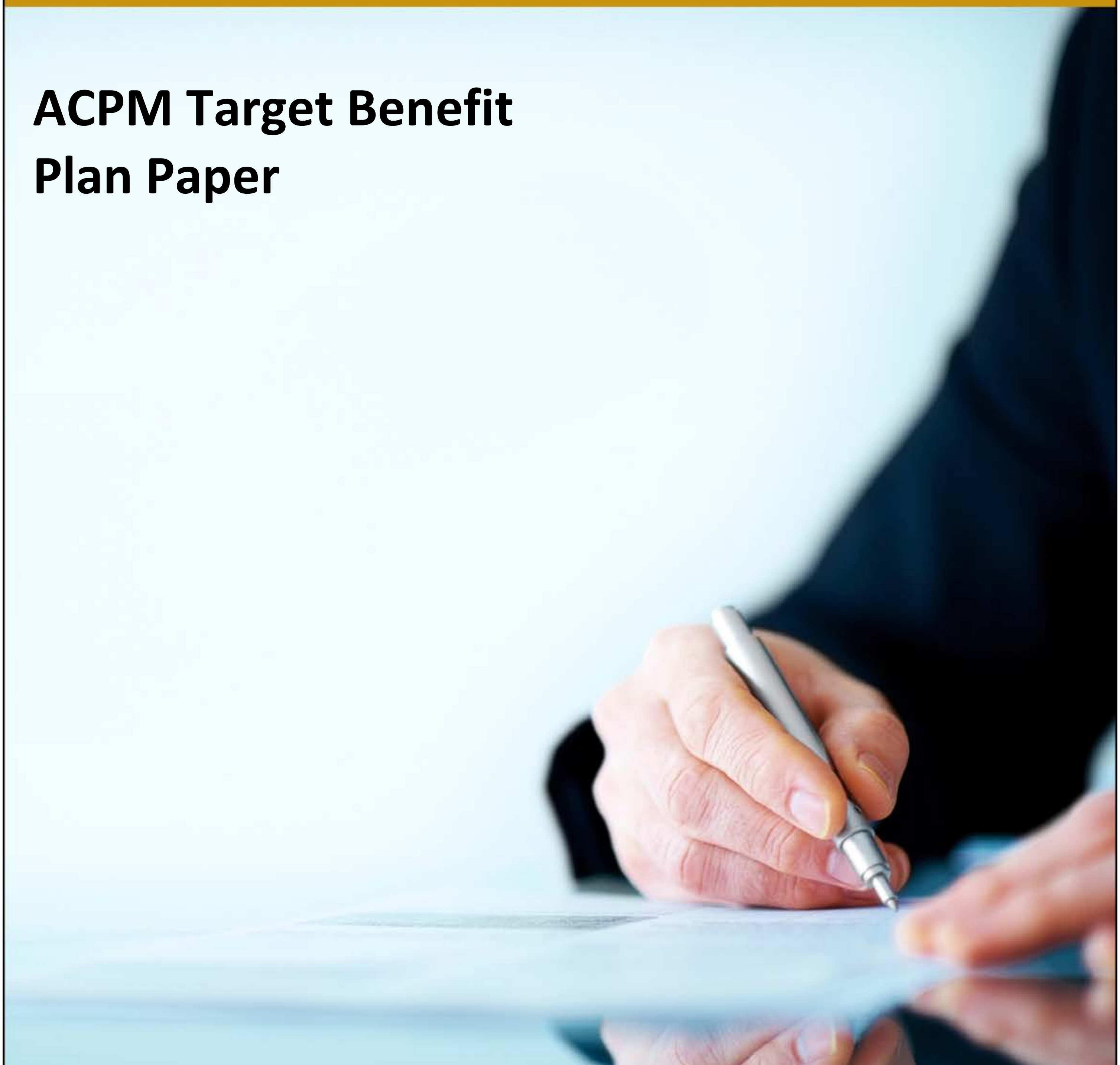
ACPM Target Benefit Plan Paper



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FOREWORD

The Association of Canadian Pension Management (ACPM)

The Association of Canadian Pension Management (ACPM) is the informed voice of Canadian pension plan sponsors, administrators and their allied service providers. Established in 1976, the ACPM advocates for an effective and sustainable Canadian retirement income system through a non-profit organization supported by a growing membership and a team of volunteer experts. Our members are drawn from all aspects of the industry from one side of this country to the other. We represent over 400 pension plans consisting of more than 3 million plan members, with total assets under management in excess of $330 billion.

The ACPM promotes its vision for the development of a world leading retirement income system in Canada by championing the following Guiding Principles:

- Clarity in legislation, regulations and retirement income arrangements;
- Balanced consideration of other stakeholders' interests; and
- Excellence in governance and administration

The ACPM regularly advocates and participates in public dialogue on pension issues.

I. INTRODUCTION

The Issues: Coverage and Adequacy

Considered on a global basis, Canada's retirement income system (a mix of public and private retirement plans) rates very highly.[1] Yet over the past few years, we have seen increasing evidence of "cracks" appearing in the system. For example, there is recent statistical evidence showing a decline in the number of Canadians with coverage under registered pension plans, particularly in the private sector.[2]

While there has been an increase in the number of Canadian workers covered under defined contribution (DC) pension plans, it has not been sufficient to offset the decline in coverage under defined benefit (DB) pension plans in the private sector.[3] The result: we have fewer Canadians in DB plans and more in DC, but overall less with any kind of retirement plan. There is also recent evidence suggesting that workers covered under DC plans may have to delay their retirement due to lack of sufficient retirement savings.[4]

We also refer readers to the "Summary Report for the Finance Ministers Working Group on Retirement Income Adequacy in Canada" (2009) (the "**Mintz Report**"),[5] which concluded that some Canadians may not be saving enough for retirement, in particular modest and middle income households. The Mintz Report identified declining participation in employer sponsored pension plans and low participation rates in RRSPs as contributing factors to this problem.

In short, there is an emerging coverage/adequacy problem affecting the Canadian retirement income system. The ACPM is of the view that this problem needs to be addressed by prompt and significant government action.

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[1] For example, see: Whitehouse, E., "Canada's Retirement-Income Provision: An International Perspective" (OECD Social Policy Division, 2009).

[2] Based on the latest available data (Statistics Canada. 2011, "*Pension Plans in Canada*") (the "**StatsCan Survey**"): Private sector membership in DB plans declined 3.6% in 2009. It also shows that about 80% of public sector employees have a workplace pension plan, while just 25% of private sector workers do. And to further supplement that, Towers Watson conducted a survey in 2011 (Towers Watson, "*De-Risking: Are You Prepared When Opportunities Arise? – Findings From the 2011 Survey on Pension Risk*" (March, 2011) online: http://www.towerswatson.com/assets/pdf/4669/Towers-Watson-Canadian-Pension-Risk-Survey.pdf.), which found that only 49% of private sector DB plans are open to all employees, 37% are closed to new hires, and 13% are closed to all future accruals.

[3] The StatsCan Survey shows that the number of workers in the private sector with pension coverage (both DB and DC plans) declined by 2.1 % (which is very large in relation to prior years).

[4] Towers Watson, "*Pension Freedom Further Away – New Towers Watson "Pension Freedom Index" Shows Canadians Working Longer*" (October 26, 2011) online: http://www.towerswatson.com/canada-english/press/5735 - Expected retirement age of Canadian workers has increased from age 60 (in 2007) to age 67 (in 2011). See also, Sun Life Financial, "*Canadian Unretirement Index Report*" (March, 2011), which shows the average Canadian intends to retire at age 68 (over 3 years higher than the average in 2010).

[5] J. Mintz, "*Summary Report on Retirement Income Adequacy Research*" (Research Working Group on Retirement Income Adequacy of Federal-Provincial-Territorial Ministers of Finance, December 18, 2009).

Solutions: Public versus Private Pensions

There have been a number of different ideas put forward as potential solutions to the emerging problems of coverage and adequacy in the Canadian retirement income system. One such idea is to improve public pensions (*e.g.,* improve benefits and/or expand coverage under the Canada Pension Plan (**CPP**) / Quebec Pension Plan (**QPP**).

Another potential solution is the new type of retirement plan recently introduced by the federal government. In December 2010, the Ministry of Finance released a *Draft Framework for Pooled Registered Pension Plans* (**PRPPs**). From the December 2010 Framework document (a concept paper), the federal government has taken the lead in bringing the PRPP into actual existence. On November 17, 2011, the Government released Bill C-25, the *Pooled Registered Pension Plans Act* for first reading. And in December, 2011, the Federal government issued draft legislative proposals under the *Income Tax Act* (Canada) (**ITA**) to provide for the establishment of PRPPs. It is proposed that these changes will come into force at the same time as Bill C-25.

The stated goal of the PRPP--to increase pension savings/coverage for certain groups of Canadians--is based on the research/conclusions in the Mintz Report and is intended to be responsive to the perceived problem that fewer and fewer Canadians have access to a workplace pension plan.

As governments continue to develop new solutions to address the issues of retirement income coverage and adequacy for Canadians (such as the PRPP), there is **an increasing urgency to more quickly identify and develop additional new and innovative retirement plan designs that are able to meet these challenges.**

The ACPM, as the informed voice of the retirement industry in Canada, fully supports the concept of pension innovation, and the need to continuously improve retirement plan designs and products to meet the needs of Canadians and to provide solutions to the challenges currently facing the Canadian retirement system and its participants. In this context, we believe that "innovation" includes identifying new plan types, features or designs that might encourage more participation by Canadian workers in pension plans and which we believe might serve to help address the issues of coverage and adequacy.

To that end, we have identified some of the features of the current pension system that we think are contributing factors to declining coverage under employer sponsored pension plans, and have considered plan design features that might address these factors preparing this Report.

II. TARGET BENEFIT PLANS – A VIABLE SOLUTION?

Sponsors of DB pension plans are continuing to struggle with the significant funding challenges posed by continuing low interest and annuity rates, complex and increasingly volatile investment markets, chronic solvency funding issues and mark to market accounting. And members of DC retirement plans are becoming increasingly aware of the significant effect that market volatility can have on their retirement savings, and the challenges they face to attain a predictable retirement date and income. For both DB and DC plans, there is a need to find viable solutions to the design, funding and financial issues affecting traditional registered pension plans.

More flexible funding rules for DB plans are considered by many (including the ACPM) as an important part of the solution, but there is also considerable dialogue about alternative plan designs that would allow a different balance of financial risks between employers and participants.

One such alternative plan design that could achieve perhaps a better balance of risks than traditional DB and DC plans, and that is gaining more and more traction, is the concept of the "target benefit plan" sponsored by a single employer, several employers or a union (referred to in this report as the "**TBP**"). Anecdotally, we understand that a number of organizations would be very interested in implementing a TBP if pension legislation were to permit such a concept.

The TBP is not a type of plan, per se, it is more properly thought of as a concept which can be implemented through a number of different plan designs.

The *Report of the Alberta/British Columbia Joint Expert Panel on Pension Standards ("**JEPPS Report**")*[6] endorsed enabling a new type of pension plan, called the "specified contribution target benefit plan", which we also consider to be similar in concept to the TBP.

The *Report of the Ontario Expert Commission on Pensions* ("**OECP Report**")[7], also included a proposal that we again consider to be similar in concept to the TBP: a sponsor of a single-employer pension plan could enter into an agreement with a union, or comparable organization representing plan members, to establish a jointly governed target benefit pension plan ("**JGTBPP**"). The OECP Report stressed that JGTBPPs should:

- have an appropriate governance structure in which member and retiree representatives make up at least half of the governing body;
- be funded on a similar basis as many multi-employer and jointly-sponsored plans; and
- be required to provide disclosure materials to plan members and retirees that clearly explain the nature of target benefits and the risks related to potential benefit reductions.

The *Report of the Nova Scotia Pension Review Panel* included recommendations on jointly sponsored pension plans that could apply to single employers, as well as the target benefit plan concept that would closely resemble specified multi-employer pension plans, but that could be utilized more broadly.

We further note that Ontario's Bill 120, *Securing Pension Benefits Now and for the Future Act, 2010*, which received royal assent on December 8, 2010, makes changes to the *Pension Benefits Act* (Ontario) (the "**PBA**") to introduce TBPs. Specifically, the provisions of Bill 120, which are not yet in force, permit the establishment of TBPs in the unionized context only and exempt TBPs from the general prohibition on the reduction of accrued benefits and the transfer rules under the PBA. Schedule "A" attached hereto summarizes the provisions of the PBA relating to TBPs (for ease of reference).

In short, TBPs are plans that aim to provide a "defined benefit" but are funded through fixed employer contributions. If the fixed contributions are not sufficient to provide the target benefits, accrued benefits can be reduced.

More precisely, we define a TBP as a type of pension plan whereby contributions are fixed according to a pre-determined rate (or formula) which is expected to be sufficient to fund benefits determined with a DB-like formula (*i.e.,* target benefits). A key feature of the TBP is that accrued benefits can be increased or reduced from time to time if the funded status of the plan turns out to be excessive or insufficient to provide the target benefits. We believe that TBPs will be attractive to both members and employers. TBP members would receive many of the same benefits as if they had participated in a traditional DB

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[6] Report of the Alberta / British Columbia Joint Expert Panel on Pension Standards, *"Getting Our Acts Together"*, November 2008.

[7] Report of the Ontario Expert Commission on Pensions, *"A Fine Balance- Safe Pensions, Affordable Plans and Fair Rules"*, November 2008.

plan, including pooling of investment and longevity risk, but the employer is no longer bearing all of the funding risks associated with DB benefits (this funding risk is seen as a key motivating force behind the decline in DB plans in the private sector).

We also believe that there is widespread support for the TBP concept. All stakeholders seem to agree that it is an innovative plan design that could, at a minimum, help to manage market and interest rate volatility and increase or protect pension coverage in Canada. It can also be seen as a helpful “middle ground” between the traditional DB plan and the DC plan design features.

We recognize, however, that while there is likely to be considerable support for the TBP concept, there are some contrasting views on how TBPs should be designed, governed and regulated. We have attempted to address a number of these issues in this report.

TBPs: The Value Proposition

With appropriate plan design, governance and legislation, TBPs could be a very cost-effective method of delivering adequate retirement benefits through a risk shared arrangement. Each stakeholder group should see benefits over more traditional DB and DC programs allowing for the potential of expanding overall coverage. Some of the benefits which TBPs may provide to various stakeholders are summarized below.

Members – Improvements over Capital Accumulation Plans (CAPs)

- Significantly higher expected (target) benefit at the same CAP cost, via risk sharing:
    - Pooling of longevity risk - members do not have to over save for the possibility of living beyond the average plan member OR face the risk of outliving their CAP account balance
    - Pooling of investment risk – the studies show that the average plan member investing on his own significantly underperforms professional investment programs
- Easier to plan for retirement
    - Target benefit is formula based
    - Retirement date sensitivity risk is low – retirement benefits are not based on individual account balance at a date when markets could be very volatile. Members get the DB style benefits of asset pooling and a target benefit formula which should be predictable (or less volatile).
    - No conversion risk – No need to convert to an insured annuity at prevailing market rates at retirement. (Market annuities have margins for profit, anti-selection, and other risks which can be avoided with pension payments being made out of the fund.) In addition, ancillary benefits (*e.g.,* inflation protection) may not be available in the annuity market at a competitive cost.
    - TBP should provide a more predictable stream of benefit payments (compared to LIF or similar CAP conversion vehicles)

Employers

- HR – improvements over CAP plans
    - Retirement patterns would be less tied to investment market performance
    - Defined or target retirement benefits are favoured by "pension or retirement savvy" employees for retention purposes
    - Provide more flexibility for workforce management strategies[8]
- Finance – improvements over DB plans
    - No surprises - fixed contribution rate
    - No volatility in pension expense and balance sheet impacts (a significant reason for getting rid of DB) – simply expense contributions like DC plans
    - No solvency or wind-up cost and variability (or higher absolute costs)
    - No PBGF premiums (in Ontario)
    - Plan causes fewer issues and is more portable under employer M&A activity

Governments

- Finance
    - More efficient use of capital than under a CAP – delivers benefits at a cost-effective rate (reduces tax deductions when compared to alternatives – assuming benefit adequacy target is the same)
    - When compared to DC plans, more investment of retirement funds in venture capital, which is beneficial for our economy
    - Reduce public v. private sector concerns surrounding application of solvency funding rules, assuming that TBPs would be exempted from these rules.
- Taxpayers
    - No PBGF risk (in Ontario) and pension bailouts
    - Provide more options to employers to expand coverage – thereby reducing dependency on public programs and certain individual voluntary retirement savings

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[8] For example, we could envision that an employer would accept paying an additional amount for a limited period to a TBP, provided that this extra money is fully used to provide early retirement incentive to a specified group of plan members.

III. THE TARGET BENEFITS SUBCOMMITTEE

One part of the ACPM's Five Point Plan to improve retirement income coverage in Canada is to enable more innovation in plan design such as target benefit plans. The ACPM's National Policy Committee determined that it would be useful for the ACPM to join the dialogue on TBPs and to articulate a comprehensive position on the subject. In order to develop its position, the National Policy Committee established a subcommittee, the Target Benefits Subcommittee, to prepare a report on TBPs.

The Subcommittee members were: Paul Litner (Chair), Peter Shena, Andrew G. Harrison, Serge Charbonneau, Derek Dobson, Chris Brown, Graham Hills, Susan L. Nickerson, Emilian Groch, Étienne Brodeur, Jacques Lafrance and Scott Perkin, supported by the ACPM staff. Subcommittee members were drawn from the legal and actuarial professions, as well as from both public and private sector pension plans.

The mandate of the Target Benefits Subcommittee was to review various papers, reports and legislative proposals that discuss the concept of the TBP, and to develop the ACPM's policy position on how TBPs should be designed, governed and regulated to be effective in Canada, for presentation to the National Policy Committee.

The Subcommittee has also considered which features should not be included as part of the TBP design, and has cited its reasons for such. The purpose of the Report is to allow the ACPM to develop and put forward an informed view on TBPs to governments contemplating the concept and, if appropriate, to actively promote the development of TBPs as a new type of retirement plan available to single employers (as the TBP concept has been successfully utilized in the multi-employer plan context for decades).

As part of its mandate, the Target Benefits Subcommittee examined the papers, reports, legislative proposals and reference materials set out in Schedule "B" hereto.

IV. FINDINGS AND RECOMMENDATIONS OF THE SUBCOMMITTEE

The members of the Subcommittee identified eight key plan design features of TBPs that will be essential in order for TBPs to be effective in Canada. We also identified a number of issues in relation to each of the eight design features that will have to be resolved in drafting legislation to enable TBPs. These are discussed in further detail below.

A. <u>Employer Contributions</u>

Fixed Level of Employer Contributions

One of the fundamental design features of a TBP is that employer contributions must be fixed at a pre-determined level or amount to which the employer is willing to commit. In the event that a TBP is underfunded and the funded status must be addressed, increasing employer contributions must not be legislatively required. While employers (or employees) should be permitted to increase contributions as part of their human resources strategy (or personal retirement planning), either voluntarily or as a result of collective bargaining, there should be no legal obligation to do so.

The level of employer (and employee) contributions should be clearly set out in the plan text. Such provisions could only changed by way of a plan amendment (and thus would be subject to the amending provisions of the plan as well as any advance notification requirements in pension standards legislation). Any changes in the employer contribution rate should only be made with the consent of the employer and, in the unionized environment, any changes to the contribution rates could also be subject to the terms of a collective agreement.

The legislation should allow for some flexibility in determining the rate of (or formula for) contributions, so long as the rate/formula is clearly set out in the plan documents. For example, we would not preclude the possibility of a TBP providing for fixed contributions (whether fixed dollar amounts or as a percentage of salary) or for a "contribution corridor" providing for higher or lower contributions in any given year, subject to minimum and maximum contribution amounts.

The key to success of a TBP is that the employer's contributions must be a fixed cost, and this must be made clear in the governing legislation.

Need to Set Out Clear Rules

Just as with certain multi-employer pension plans ("**MEPPs**") and jointly sponsored pension plans ("**JSPPs**") in Ontario, the pension standards legislation should clearly define TBPs (as a separate category of pension plan) and set out rules that are specific to this type of plan. As noted above, it is essential that the rules regarding employer contributions be clearly set out in the legislation.

Many of the current legislative provisions applicable to MEPPs and JSPPs would be similarly applicable to TBPs (*e.g.,* exemptions from solvency funding), and could be used as a foundation for developing funding rules for TBPs. However, we believe that the principle of fixed employer contributions to TBPs should be even more detailed and clear than the current funding rules applicable to MEPPs and JSPPs. For instance, it must be clear that any rules in Canada prohibiting the reduction of accrued pensions and making the employer responsible for funding deficits do not apply to TBPs.

Application Outside the Unionized Environment

We note that currently the MEPP rules, in most jurisdictions, can only apply in a unionized environment. There should be a clear recognition in the pension standards legislation that the TBP framework can be applied in both single-employer and multi-employer contexts, and in both unionized and non-unionized environments.

We strongly believe that the TBP concept can work in a non-unionized single-employer context. Moreover, there is an urgent need to make it available in the non-unionized context as employers and their employees are expected, in many cases, to find this concept more attractive and balanced from a risk-sharing standpoint than the traditional DB or DC alternatives.

For example, the PBA currently recognizes that "the obligation of the employer to contribute [under a MEPP] is limited to a fixed amount set out in a collective agreement".[9] More comprehensive wording would be required in order to make TBPs available to non-unionized employees. Contributions could not be tied exclusively to collective agreements since there will not necessarily be a collective agreement. The reference to "fixed employer contributions" would have to be tied to the official plan text. The official TBP text would also have to specify who has the power to amend the TBP provisions.

Governments might be concerned about expanding TBPs to the non-unionized sector due to the fact that non-unionized employees do not have the benefit of the protections that unionized employees enjoy by virtue of being represented by a union. We think that this concern can be addressed in a

[9] Pension Benefits Act, R.S.O. 1990, Chpt. P.8 at ss. 14(3).

number of ways, including: plan governance requirements, enhanced disclosure requirements and representation by other (non-labour) organizations.

We also believe that TBP member protections could be more clearly established in the pension standards legislation. For instance, pension legislation could more clearly spell out the contents of the plan document as to how contributions would be determined (or benefits reduced) for a TBP in a non-unionized environment.

Enforcement mechanisms

There will also have to be mechanisms in place to ensure that a TBP administrator can easily enforce the employer's obligation to contribute. The existing regime may be sufficient (*i.e.*, deemed trust, fines), but more reflection may be needed to confirm whether any additional rules may be appropriate for TBPs in the non-unionized environment (*e.g.*, where there is no union/collective agreement mechanism for enforcing employer contribution requirements or where the employer is also the plan administrator).

Reduction of Contributions

Given the nature of a TBP, careful consideration should be given to the circumstances in which changes in contributions can be made, and whether any amendments to pension legislation are necessary to ensure that these principles are clear. For instance, we think that pension legislation should provide clear answers to the following questions:

- If the employer contributions are fixed at a set amount, should the employer be able to reduce its contributions at some point in time?
    - We would answer "yes", as TPBs are a voluntary pension arrangement, but this should be subject to any limits in the plan text and/or applicable collective agreement and any prior notification requirements.
    - Also, no retroactive reductions of contributions should be permitted.
- Should an employer be allowed to reduce its contributions when the plan is in a surplus position?
    - Only if expressly permitted under the plan terms and subject to any limits in applicable collective agreements.
    - The use of excess assets should be clearly addressed in the plan document.

B. <u>Ability to Reduce Benefits</u>

Benefit Reduction and Risk Sharing

In order for TBPs to be effective, pension standards legislation must permit benefit reductions for active, deferred and retired members of a TBP. However, the legislation should permit a TBP sponsor to provide for different risk sharing/benefit reduction profiles in the plan text (*i.e.*, some plan sponsors may want to provide more protection to older or lower income pensioners).

The TBP text should clearly specify what benefit reductions will be possible and how they would be applied. The basic reduction rules should be determined in advance so that all stakeholders have a good understanding of the applicable rules. Pension regulators may wish to develop flexible but clear guidelines on which types of benefit reduction principles or provisions would be acceptable for the registration of a TBP. A reduction in benefits should not be permissible if the most recent actuarial valuation shows that the current benefit target is sustainable until the date of the next scheduled valuation.

Benefit reductions may affect active and retired plan participants in different ways. For example, pensioners are typically less able to mitigate the impact of a benefit reduction than active members. As such, pensioners may need time to make necessary adjustment to their expenses and maybe even to their lifestyle expectations. To ensure that such plan participants are not caught off-guard we believe that the legislation should require that the TBP administrator provide members with advance notice of planned benefit reductions and/or contribution rate increases – we propose 4 to 6 months (in the case of benefit reductions) – unless immediate action is sanctioned by the regulator.

Any situations involving benefit reductions that are not contemplated by, or clearly addressed in, the TBP text should be decided by the administrator of the TBP, acting in a fiduciary capacity.

The TBP text should also deal with surplus/excess assets issues. For instance, it should specify which portion of the TBP's surplus can be used and for which purposes it could be used. It could include, as a default position, provisions specifying the use of any surplus to raise benefits back up to pre-reduction levels (if prior reductions had occurred) or provide for contribution rate reductions. Moreover, the plan text should define priorities when distributing surplus funds and such priorities must be consistent with the stated risk sharing profile.

Commuted Value upon Termination of Active Membership

Where a terminated member is entitled to the commuted value of his/her benefits, the amount payable should be the commuted value of the benefits, adjusted by the TBP's funded ratio. Such value and funded ratio should be determined using a basis (going-concern or wind-up) that is consistent with the basis used to determine the target benefits as specified in the plan text.

The TBP text should also set out other rules pertaining to the payment of commuted values, including:

- The timing of commuted value payments (*e.g.,* payable only at year end, or twice per year).
- The funded ratio to be used for determining the commuted value payment (as determined in last filed valuation, or wait for next filed valuation to determine amount).
- Whether commuted values are credited with interest, and at what rate, between the date of termination of membership and payment of the commuted value.

We also considered whether there should be a guarantee that terminating members will get at least their own contributions back on termination of membership in the plan. While seen as a potentially worthwhile (and low cost) feature, we ultimately rejected this approach as it could cause serious employer concerns from an accounting perspective (see Section F below) and equitable issues (*e.g.,* should the guarantee only be provided to the extent that it does not result in benefit reductions for retirees?)

C. <u>Governance</u>

Joint Governance

As mentioned in other sections of this Report, we recommend that the funding deal, and the appropriate issues and responses thereto, as well as the benefit determination and adjustment rules, be clearly spelled out in the plan document and clearly communicated to TBP members. Under these circumstances, regulations should allow flexibility to select the governance model that is most appropriate for the particular TBP situation.

In a unionized setting, the parties would likely negotiate the TBP governance structure. In this regard, we note that the OECP Report considered the concept of jointly governed unionized TBPs. This Report, however, didn't seem to recognize the possibility that single employers in non-unionized settings might also want to offer TBPs to their workforce.

On the other hand the JEPPS Report did recognize that TBPs might exist within the non-unionized space. The JEPPS Report specifically recommended that:

> *A new category should be created in the pension legislation for funding and disclosure for single and multi-employer plans with similar characteristics, called specified contribution target benefit plans. The essential characteristics of such a plan are:*
>
> - *Contributions are limited to specified employer and employee contributions ("specified" by the parties to the deal, whether through a collective bargaining agreement or another method).*
> - *Employer(s) are limited in their liability to providing the specified contributions.*
> - *There is a formula benefit set out in the plan document but it is subject to reduction if funding is not sufficient and can therefore be considered a target benefit.*[10]

Clearly absent from this new category of specified contribution target benefit (SCTB) plans is any requirement that they be jointly governed. In fact, the JEPPS Report went on to further state, under one of its recommendations regarding SCTB governance: *"We do not endorse any single governance structure as the most suitable."* (Recommendation 8.2.6-A).

In order to increase the chance that TBPs will improve pension plan coverage, regulations should not mandate a specific governance model, but should provide sufficient flexibility to accommodate different circumstances. For example, while joint governance might be appropriate in the multi-employer or unionized context, such a model (if mandated) may deter many single employers in the non-unionized space from offering TBPs. The objective of increased pension coverage through TBPs would obviously suffer as a result.

Regardless of the governance structure that may be adopted in each case, however, the rules currently applicable to the legal duties of pension plan administrators should also apply to those administering TBPs. For example, TBP administrators (and their agents) will be subject to fiduciary duties and legal standards *vis-à-vis* investment decisions and member communications, among other things.

D. <u>Communication of Risk to Members</u>

It is a defining feature of a TBP that benefits can be reduced if the assets in the pension fund are insufficient to cover the target pension benefits. Accordingly, it is crucial that this possibility be adequately communicated to the members of the plan.

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10 *Supra* Note 6 at Recommendation 8.2.1-A.

Communication Upon Enrolment, Termination and Retirement

Communication of the target nature of the benefit should be made to a person at the time the person joins the plan, upon termination of employment, upon retirement, and to the member's spouse or beneficiary upon death. Required elements of the communication may be prescribed, and should include:

- a clear, plain language statement that employer contributions are fixed, that benefits may be reduced if the assets of the pension fund are insufficient to pay the pension benefits, and that the reduction may apply to both accrued benefits and the future accrual of benefits;
- the current funded ratio, on both a going concern and wind-up basis;
- the benefit policy (see discussion in Section B – Ability to Reduce Benefits), including the process by which benefits would be increased or reduced;
- factors, if determined, which would be used by the administrator in reducing or increasing benefits (*e.g.,* differentiating between active and retired members, reduction of accrued benefits versus future accrual of benefits, and any protection of pre-conversion DB benefits in a converted plan);
- if assets are transferred out of the plan pursuant to a portability option, the rules governing the computation of the transfer amount.

Communication Upon Conversion

Upon conversion of an existing DB plan to a TBP, enhanced disclosure should be provided, particularly if the accrued defined benefit is converted into a target benefit going forward**. (See discussion in Section H – Transitional Rules).**

Communication During Membership

Communication of the target nature of the benefit should also be made to the member at regular intervals (at least annually) during the person's membership in the plan (as an active member, deferred vested member and retired member). Required elements of the communication may be prescribed, and should include:

- the funded status of the plan, on both a going concern and wind-up basis;
- the investment performance of the pension fund;
- sources of significant changes in plan liabilities;
- the results of any required stress testing of the plan;
- the administrator's assessment of the need to reduce benefits, or the opportunity to increase benefits, including a discussion of the risk factors affecting the plan (*e.g.,* investment performance, changes in interest rates, and changes in mortality rates);
- the benefit policy, including the process by which benefits would be increased or reduced;
- what would happen if the plan were terminated immediately.

If the administrator of the TBP is not also the employer, the administrator should also be required to communicate the information described above to the employer.

Forms of Communication

Disclosure should be in writing, and electronic disclosure should be permitted, subject to the same safeguards as apply to electronic communication generally. Additional disclosure in person (individually or in groups) might be encouraged but should not be required. We suggest that the form of disclosure mirror the existing requirements for DB plans, as some employers will have both.

If the administrator of the TBP is not also the employer, the rules will need to ensure that communications effectively reach the members, as the communication obligation will be on the administrator, whereas the employer will have more direct contact with the plan members.

E. Funding Requirements

Need for Flexibility

Rigid funding rules would be an important deterrent for employers who would consider establishing TBPs (as was the case for member-funded pension plans in Quebec). In order for TBPs to become a successful pension arrangement, an important degree of flexibility must be allowed under the funding regulations that will be adopted in respect of TBPs.

Actuarial Assumptions

The Canadian Institute of Actuaries (CIA) and the Actuarial Standards Board (ASB) have already set out numerous standards and guidance that should be followed for the valuation of pension plans, based on the structure of the pension plan and the risks and obligations that it entails. Target benefit pension plans have existed for decades in several jurisdictions (*e.g.,* MEPPs) and valuation assumptions are monitored in the current framework.

Given the delicate balance of delivering the promised benefits versus providing adequate benefits and intergenerational equity, the policy objectives of any constraints that might be imposed by regulators on the actuarial assumptions that may be used for valuation purposes should be clearly articulated. However, it should be clearly understood by all stakeholders that any mandated margins will reduce the benefits of the plan on a per dollar contribution basis, thereby reducing the effectiveness of the plan in delivering adequate retirement benefits.

With any margin, there will be a shift in intergenerational equity. It may be difficult to justify why a desired margin should be established if the funding target is 100% over time (recognizing that any margin creates a lower benefit target). At the time when sponsors are determining the TBP provisions, any desired funding margins should be documented in a funding policy to be adopted for the plan.

The TBP text or its funding policy (or administrator to the extent allowed by the TBP text or funding policy) should be allowed to determine when specific margins for adverse deviation are required and their magnitude In other *words*, no minimum margin should be required by the legislation. However, margins can be developed and communicated in a funding policy to reflect the economic realities, desired risk tolerance and the importance of intergenerational equity.

In addition, it is important for TBP members and sponsors to be informed that there is no participation in the Ontario PBGF and that deficits on wind up are not required to be funded.

Valuation Methods and Rules

The target benefits should be measured and funded on a going concern basis. A valuation on a wind up basis should only be required for disclosure purposes.

The actuarial method used (*e.g.,* projected unit credit, modified aggregate, etc.) should not be defined in the legislation but should be determined by the TBP sponsor (in consultation with actuarial advisors) and articulated in the plan text or funding policy (or assigned to the administrator by the TBP text or its funding policy), including a clear definition of what happens to benefits if funding deficits or surpluses emerge. Again, we believe that CIA professional standards and guidance will suffice to produce the proper valuation of the liabilities. If regulations were to prescribe the valuation standards and methods they must clearly address the variety of inherently different risks by type of plan, which we believe would be too constraining or cumbersome.

An amortization period should be determined by the TBP text, funding policy or administrator based on the objectives of the plan. If the pension regulators should deem it necessary to impose a maximum permitted amortization period, the current period applicable to going concern deficits DB plans (*i.e.,* 15 years) should be preferred.

Disclosure

A TBP sponsor, or else the administrator in some cases, should be required to adopt both a funding and a benefit policy reflecting the terms of the TBP text, and such policies should have to be communicated to all plan members and the participating employer(s).

Plan Termination

Rules as to treatment of benefits/funding on plan termination must be clearly set out in the TBP text, and be subject to (i) prescribed minimum standards, and (ii) regulatory approval. Minimum standards must set out those items to be included in the plan text, but should include some flexibility. Once established in the plan text, there should be little or no discretion left to the administrator, except where interpretation may be required. In other words the plan text should, to the extent possible, address how deficits and surplus gets allocated on wind up. For example, if there is a deficit, the plan text may require that benefit improvements within the 5 years preceding wind up get reduced first or may establish other types of priorities.

F. <u>Treatment of TBPs for Accounting Purposes</u>

One of the reasons why some employers do not wish to continue sponsoring a DB pension plan is the way that accounting rules impose recognition of financial risks on their financial statements. If we would like employers to embrace TBPs, it is considered crucial for employers (especially in the private sector) to be able to account for their participation in the TBP using the accounting rules applicable to DC plans, as is the case for most MEPPs.

It is our understanding that in some other countries (*e.g.,* Switzerland), a similar type of plan to a TBP is available and is reported in accordance with the DC accounting rules since, in the event that the plan's current assets and expected contributions are not sufficient to fund expected benefits, an agreement has to be reached to adjust the benefits, unless the parties agree to increase the contributions.

Overview of the Current Accounting Rules

Most employers are now switching to international accounting standards, prescribed by IFRS. In particular, under those standards, a new draft IAS-19 was released in June 2011 and is currently expected to become effective around 2013.

These new accounting standards include a definition of what can be considered a DC plan and some explanations as to how to differentiate it from a DB plan. If there is any possibility that the employer contribution obligation might vary, the plan generally cannot be considered as a DC plan.

Examples of plans that might not be considered as a DC plan include:

- a plan guaranteeing that employees will receive at least a refund of their own contributions (therefore, this should not be a required feature of a TBP, and it should be clear that any reduction of benefits does not guarantee a refund of contributions over and above the plan funding level on termination);

- a plan in respect of which there is an established past practice of increasing employer contributions when funding is insufficient; and

- a plan in respect of which there is an agreement to increase employer contributions in future years in a way that covers losses for past service.

The rules under CICA and FASB may be relevant for certain employers who will not be subject to IFRS. Therefore for those employers who are not subject to IFRS (*e.g.,* public sector, not for profit), to the extent that rules similar to those in effect under IFRS would cause the TBP to be viewed as something other than a DC plan for accounting purposes, they would have similar concerns. As a result, the TBP rules should also be structured to avoid DB accounting treatment under CICA and FASB for such employers.

It may be possible that different auditors have different interpretations of the same rules, so we should try to arrive at rules that leave as little variation as possible in the interpretation of accounting standards.

Need to Draft the TBP Rules Carefully

It will be important to ensure that no rules relating to TBPs that are incorporated into the pension standards legislation could compromise the classification of TBPs as DC plans for accounting purposes. For example, there should be no rule requiring a minimum benefit equal to the member's accumulated contributions. However, it would still be possible for some plans to provide such a minimum guarantee if desired, although some employers may be reluctant to participate in such plans if they are concerned about the accounting treatment.

Communication

It is expected that auditors will review communication materials provided to members in reaching their decision as to whether the DC accounting rules should apply or not. It will thus be important to clearly specify in pension standards legislation that the employer contributions are limited and that, if the funding level of the plan becomes insufficient, the benefits may be reduced accordingly.

Transitional Rules

It will also be important to verify whether certain transitional rules might have an impact on whether a TBP retains certain DB features that make it impossible to apply the DC accounting rules. For example, depending on enabling legislation, if an employer wishes to transition from an existing DB plan to a TBP in respect of future service, but the transitional rules impose the continuation of certain DB features (such as a minimum pension for past service or for existing retirees), it is not obvious at this point that an employer could simply maintain two components within a single plan or whether it would be necessary to completely segregate the two groups in separate plans. Such potential uncertainty would need to be clarified when rules are drafted.

G. <u>Treatment of TBPs for Tax Purposes</u>

General Considerations

TBPs are intended to be tax-assisted retirement savings plans and as such amendments to the ITA will likely be necessary to recognize the TBP as a new type of retirement savings plan, similar to the ITA amendments recently proposed for PRPPs. The ITA treatment of TBPs should ensure that:

- employer and employee contributions to the TBP are deductible;
- investment income and gains on assets held by the TBP are non-taxable;
- benefits are taxed in the hands of the individual member upon retirement; and
- benefits payable from the TBP are eligible for pension income credits and pension income splitting, as with other types of pension payments.

ITA Limits

There are two possible approaches under the ITA to apply tax limits on TBPs: (i) DB tax limits (which are benefits focused), or (ii) DC tax limits (which are contributions focused).

On the one hand, we note that DC tax limits would provide an element of simplicity to plan administration, as PAs would be simpler to calculate and there would be no need to administer PARs, PSPAs, the DB tax limit, etc. We think that many employers/administrators might see this as an attractive feature of a TBP.

On the other hand, with DB tax limits an employer could periodically elect to contribute additional funds to make up a deficit or to reduce contributions using a going-concern surplus, which would also be attractive features of a TBP.

We see some benefits (and drawbacks) to both approaches. We would submit that either approach would be acceptable, so long as the rules are consistently and fairly applied when compared to the tax treatment of comparable plans.

H. Transitional Rules

In order for TBPs to be a viable alternative for plan sponsors, we would consider it essential to permit the transition or conversion of benefits from a sponsor's current DB plan to a TBP. We suggest the following rules be adopted for transitioning past service traditional DB benefits to a TBP.

Structure and Funding of Past Service Benefits

For simplicity, in order to transition past service traditional DB benefits to a target benefit design, a TBP should be a stand-alone pension plan. New hires who enter the TBP would accrue all benefits on a target basis. Those employees who would "convert" or "transition" from the employer's traditional DB plan to the TBP should accrue future benefits (from the effective date of transfer) on a target basis. The employer should be permitted to offer these employees and inactive DB plan members the option of transferring past service benefit liabilities (and a proportionate amount of the DB plan assets) to the TBP.

Where there is a funding deficit in respect of transferred DB liabilities, the employer should continue to fully fund these liabilities by way of special payments for the remainder of the going concern or solvency amortization period in accordance with the schedule of payments as of the date of conversion. The key concept regarding the 100% past service benefit funding is that a former DB member should commence participation in the TBP with a clean slate and assume the risk the TBP represents after this date. The funding payment schedule in respect of past service benefits should not vary from what is in place prior to conversion. Any experience gains or losses in respect of these benefits that occur after the date of entry should fall under the TBP design and as such these past service benefits could be increased or reduced. Should the TBP be terminated prior to the end of the past service funding payment schedule, the employer would still be required to pay the remaining balance of its schedule of payments as at the date of conversion.

Consent to Transition/Convert

Similar to the current rules for conversions from DB to DC benefits, if the DB plan sponsor wishes to offer a DB to TBP conversion each active or inactive member eligible for the conversion option should be given the right to elect whether or not to convert their past service benefits to the TBP (regardless of whether or not he or she is represented by a union). Each eligible member should receive a statement setting out the information needed in order for the member to make an informed decision. The information to be contained in the statement should be prescribed.

Termination/Death of Converted DB Member

Should a converted DB member terminate employment with a portability option or die, the member or the member's beneficiary should have the option of either transferring the funded lump sum value of his or her benefits out of the plan (*i.e.*, the lump sum value of their benefit x funded ratio) or leaving the benefit in the TBP until the past service funding schedule has expired.

Spousal Consent

In some cases, retirees may wish to convert their current DB pension to a pension in the TBP in order to access increased benefits provided under the TBP such as indexing. Retirees who wish to convert to the TBP and whose pension has a spousal continuance component (survivor benefit) would require spousal consent (in prescribed form) before the conversion can be implemented in respect of that retiree.

V. IMPLEMENTATION ISSUES

As with any other type of pension plan, it will be important for governments to consider the following issues in implementing TBPs to ensure that they are successful:

- Harmonization – to the extent possible, legislation applicable to TBPs should be harmonized among the various federal and provincial jurisdictions.

- Simplicity of Administration – If TBPs become subject to overly complex legislation and/or regulation, they will lose much of their appeal (complexity of administration has been identified as a contributing factor to employers not wanting to maintain traditional pension plans).

- Flexibility – As will be evident from the discussion of TBP issues above, we see flexibility (in plan design, funding etc.) as a beneficial part of the TBP. To the extent possible, rules regulating TBPs should permit some flexibility to ensure that the TBP appeals to a broad spectrum of employers and employees.

VI. CONCLUSIONS

We have concluded that the TBP is a viable concept and that the time has come for governments to take the necessary steps to amend pension and tax legislation to make TBPs broadly available.

While there are many issues that will need to be addressed in implementing TBPs, these issues are not insurmountable. Indeed, in this Report we have suggested ways in which governments might address these issues in taking action to enable TBPs.

It is important to note that we see TBPs as another option in the range of retirement plans available to Canadians—the TBP is not intended to replace existing single employer DB plans, traditional DC plans or even new plan types like the PRPP. Having said that, we also think that TBPs, if properly designed and implemented, will have features that make them more appealing to employers and employees than some other retirement income arrangements.

As such, we conclude that TBPs have the potential to be an important part of the solution to the emerging issues of coverage and adequacy that we see in the Canadian retirement income system. We strongly urge governments to promptly take the necessary action to enable single employer TBPs to be offered up to Canadian workers, in an effort to further enhance the Canadian retirement income system.

Schedule "A"

Excerpts from the *Pension Benefits Act* (Ontario)

1. New Definition

"target benefit" means a pension benefit that is a target benefit as determined under section 39.2;

2. Exemptions To The Void Amendment Rule

Reduction of benefits
14. (1) An amendment to a pension plan is void if the amendment purports to reduce,

(a) the amount or the commuted value of a pension benefit accrued under the pension plan with respect to employment before the effective date of the amendment;

(b) the amount or the commuted value of a pension or a deferred pension accrued under the pension plan; or

(c) the amount or the commuted value of an ancillary benefit for which a member or former member has met all eligibility requirements under the pension plan necessary to exercise the right to receive payment of the benefit.

...

Same, target benefits

(3.1) Subsection (1) does not apply in respect of a pension plan that provides only target benefits or in respect of that part of a pension plan that provides target benefits.

...

Target benefits

39.2 (1) The pension benefits provided by a pension plan are target benefits if all of the following criteria are satisfied:

1. The pension benefits are not defined contribution benefits.

2. The obligation of the employer to contribute to the pension fund is limited to a fixed amount set out in one or more collective agreements.

3. The administrator is authorized, by the documents that create and support the pension plan and pension fund, to reduce benefits, deferred pensions or pensions accrued under the plan, both while the plan is ongoing and upon wind up.

4. The reduction referred to in paragraph 3 is not prohibited by the terms of any applicable collective agreement or by the pension legislation of a designated jurisdiction.

5. The pension benefits satisfy such other criteria as may be prescribed.

6. The pension plan satisfies such other criteria as may be prescribed.

Same

(2) Despite subsection (1), the pension benefits provided by a pension plan are not target benefits if the administrator's authority to reduce benefits, deferred pensions or pensions accrued under the plan is restricted in a manner or to an extent that is prohibited by regulation for target benefits.

Same

(3) Ancillary benefits provided by a pension plan that provides target benefits are also target benefits.

Certain multi-jurisdictional pension plans

(4) For a designated multi-jurisdictional pension plan, the pension benefits are target benefits in such circumstances as may be prescribed even though, in a designated jurisdiction, the administrator's authority to reduce benefits, deferred pensions or pensions for members and former members in that jurisdiction is prohibited or restricted under the pension legislation of that jurisdiction.

...

Ancillary Benefits

Use in calculating pension benefit

40 (2) An ancillary benefit for which a member has met all eligibility requirements under the pension plan necessary to exercise the right to receive payment of the benefit shall be included in calculating the member's pension benefit or the commuted value of the pension benefit.

...

Treatment re target benefits

40 (5) Subsection (2) applies with respect to ancillary benefits under a pension plan that provides target benefits, except in such circumstances as may be prescribed.

3. Exemption to the Transfer Rules

Reduction re target benefits

39 (4.3) If a former member transfers an amount under subsection 42 (1) in connection with his or her deferred pension under a pension plan that provides target benefits, and if the transferred amount was reduced under subsection 42 (2.1),

(a) the lump sum payment to which the former member is entitled under subsection (4) must be reduced in the prescribed manner; and

(b) subsection (3) does not apply with respect to the reduced lump sum payment.

...

42 (2.1) If a pension plan that provides target benefits does not require contributions to be made in respect of any solvency deficiency that relates to the target benefits, the amount that a former member is entitled to require the administrator to pay under subsection (1) that relates to target benefits may be reduced in the prescribed manner and in the prescribed circumstances.

Schedule "B "

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