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June 23, 2014

By e-mail: pensions@fin.gc.ca

Government of Canada
Department of Finance

Subject: Consultation Paper
Pension Innovation for Canadians: The Target Benefit Plan

Dear Sir/Madam:

On behalf of PBI Actuarial Consultants Ltd., we wish to thank you for providing us with the opportunity to make a submission on the approach and elements of a federal Target Benefit Plan ("TBP") framework.

We are in support of any legislative measure aiming at the creation of new pension plans that could offer better retirement security to Canadians or aiming at ensuring the future of defined benefit pension plans in the current environment. As directly stated in the consultation paper "DB pension plans are an important component of Canada's pension framework that provides pension income predictability and security to plan members and an important part of overall employment compensation for many Canadians." Furthermore, target benefit plans are intended to preserve and increase the number of employers that can offer employees an affordable workplace pension plan that has a predictable pension in retirement.

While, we commend the federal government for the initiative to create an additional vehicle to enhance workplace pension plan coverage across Canada, we believe that the main use of this vehicle should be in situations where the only alternative is a defined contribution plan or no plan at all, which would primarily be the case in the private sector and/or non-union environment. For plan members, a target benefit plan is not normally a good alternative to a traditional defined benefit plan and the framework should not have the effect of permitting employers who currently sponsor DB plans to simply abdicate their responsibilities to plan members. We still believe that, in general, DB plans are the best type of plan and are preferable to TBP, in that they generally provide better retirement income protection to workers.

We also believe that the development of these new plans should be done alongside improvements to the public pension plans (CPP/QPP) in order to maintain the promotion of retirement income security in Canada.

The main body of our submission highlights the most important features and responds to the main parts of the drafted framework. The Appendix provides responses to all questions from the consultation paper.

The layout of our submission highlights the following sections:

Understanding Target Benefit Plans

A. Governance

B. Benefit / Funding Policy

C. Disclosure and Communications

D. Conversion of Pension Plans to Target Benefit Plans

E. Termination

Appendix

Finally, we support fully that TBPs can apply in both the multi-employer and single/multiple employer(s) situations, as well as in unionized or non-unionized environments.

Once again, thank you for the opportunity to provide our input on this very important initiative. We would be please to provide any clarification to our submission as required.

Yours truly,

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Understanding Target Benefit Plans

Target benefit pension plans are plans where the employers' financial contributions are limited what has been agreed to as the plan design. If the pension plan becomes underfunded, plan members may have to make additional contributions and/or accept reduced benefits. During times of economic hardship, this type of plan allows for the reduction of retirement benefits, including those already accrued, so that the plan remains sustainable without the employer automatically being required to finance funding shortfalls. Key benefits of this plan are to allow employees to join together in one plan in order to share longevity risk and investment risk, as well as achieve economies of scale. With defined contribution plans, including RRSPs, a member assumes these risks alone.

Various provincial governments have already adopted, or are about to adopt, a specific legislative framework for target benefit pension plans. New Brunswick introduced shared risk plans for employees in their jurisdiction. Alberta and British Columbia have introduced target benefit plan legislation, but have not yet released the regulations. Ontario, while having introduced the conceptual framework, has not yet released target benefit plan rules. In Quebec, the current legislation does not generally allow for the reduction of accrued benefit rights. In the last few years, the Quebec government began allowing the establishment of target pension plans in the pulp and paper industry. However, it remains to be seen whether this framework will be extended. Since 2007, ***member-funded pension plans (MFPP*)** have been allowed. MFPPs allow for the set-up of defined benefit pension plans, with their risk and cost sharing advantages, while protecting the members' accrued benefits. MFPP's key to success is the setting aside of significant reserves for unexpected contingencies.

We have noted that there also seems to be some confusion in the paper as to the fundamental distinction between target benefit plans ("TBPs") and shared risk plans ("SRPs"), as the two terms are used almost interchangeably. In our view, the distinction is critical and key to the success of TBPs in respect of a number of issues, including the appropriate regulatory environment. In a TBP:

- There is no risk sharing other than between members of the plan; the employer(s) bear no risk, with their liability limited to a fixed agreed-to contribution rate (unless negotiated otherwise), which cannot be "automatically" increased in the case of a deficit, even if only within a range.
- If the employer was on the hook for any type of deficit funding, then a number of the key advantages of TBPs to employers would be effectively negated:
    - Accounting and tax treatment would most likely be defined benefit ("DB") rather than defined contribution ("DC"), thereby meaning that there could potentially be accounting "hits" to the employers' financials (just like the current DB framework).
    - There would also potentially be additional regulatory concerns, and surplus/deficit ownership would be an issue.
- The only true SRPs, in the sense of the sharing of risk between employer(s) and employees, are jointly-sponsored pension plans (JSPPs).

We suspect that the confusion has arisen because of the New Brunswick government's labeling of their TBP as a SRP.

A. Governance

The proposed "joint governance" model is most important, as it reflects both the funder(s) of the cost (the employer(s) and possibly the members) and the bearers of the risk (the members). However, we believe that the bearers of the risks should consist of the majority voting, minimum 50%, in these type of plans.

A TBP is not a (traditional) DB plan, with the associated "guaranteed" benefits, and should not be regulated as such, just as specified multi-employer pension plans ("SMEPPs") (TBPs) are currently not. Many regulators and actuaries would appear to like TBPs to be regulated even more stringently than DB plans, possibly due to a lack of understanding TBPs and/or because of the TBPs' solvency funding exemption ostensibly requiring something else of similar magnitude in increasing the plan's liabilities to replace it (e.g., Alberta's "going-concern cost plus" model). This is not, in our opinion, the *right* solution to the "issue" of TBP funding.

The exceptions the following two areas which have a particular need for appropriate regulatory oversight beyond the typical traditional DB plan:

1) Governance (including Funding Policy); and
2) Communication/Disclosure of the risks involved, who is bearing them, and the implications.

These two items, in our view, should be the focus of the government's regulation of TBPs.

A number of times the paper references/states that "TBPs would provide a high probability of benefit security." The degree of benefit security desired, in our view, is unique to the particular plan and the responsibility of the plan sponsors (PSs) or the Board of Trustees (BOT) if it represents the plan sponsors. In the bigger picture, the relative *balancing* of the competing objectives of adequacy of benefits, affordability of contributions, and security of benefits should be the responsibility of and decided by the PSs/BOT, not the legislator/regulator or the CIA. Once again, this is not a traditional DB plan.

B. Benefit / Funding Policy

We are in support of any legislative measure aiming at the creation of new pension plans that could offer better retirement security to Canadians or aiming at ensuring the future of defined benefit pension plans in the current environment. As directly stated in the consultation paper "DB pension plans are an important component of Canada's pension framework that provides pension income predictability and security to plan members and an important part of overall employment compensation for many Canadians." Furthermore, target benefit plans are intended to preserve and increase the number of employers that can offer employees an affordable workplace pension plan that has a predictable pension in retirement.

While, we commend the federal government for the initiative to create an additional vehicle to enhance workplace pension plan coverage across Canada, we believe that the main use of this vehicle should be in situations where the only alternative is a defined contribution plan or no plan at all, which would primarily be the case in the private sector and/or non-union environment. For plan members, a target benefit plan is not normally a good alternative to a traditional defined benefit plan and the framework should not have the effect of permitting employers who currently sponsor DB plans to simply abdicate their responsibilities to plan members. We still believe that, in general, DB plans are the best type of plan and are preferable to TBP, in that they generally provide better retirement income protection to workers.

We also believe that the development of these new plans should be done alongside improvements to the public pension plans (CPP/QPP) in order to maintain the promotion of retirement income security in Canada.

We totally support no requirement for solvency funding, with benefits on wind-up simply being an asset share. As well, however, we agree with periodic reporting and communication/disclosure of the solvency valuation position and what it means.

With respect to the mandatory funding policy (FP), the general framework of how benefits and contributions may be increased or decreased is important. The funding policy needs to be a "living, breathing" dynamic document and may be required to be filed with the Regulator and reviewed annually, similar to that required for a SIP&P.

As a general rule-of-thumb, *flexibility* should prevail over *prescriptiveness*. Over-regulation will kill TBPs before they even get "off-the-ground." The reality is that, for most groups of employees, a TBP is a better alternative than a DC plan or (group) RRSP, and certainly better than no plan at all. Finally, over-regulation for the security of a few and to the detriment of most is not the right "balance."

With respect to the paper's outlining of two approaches for funding and to achieving benefit "security" – probabilistic and margin – both, i.e., <u>either</u>, should be allowed and, in fact, not necessarily limited to only those two approaches.

The following points expand on items within the FP framework:

i. Contributions

As mentioned earlier, the employer(s) bear no risk, with their liability limited to a fixed, agreed-to contribution rate (unless negotiated otherwise), which cannot be "automatically" increased in the case of a deficit, even if only within a range.

ii. Benefit Structure

With respect to the paper's discussion of potentially two tiers of benefits – "base" and "ancillary" or otherwise – the legislation/regulations should *allow, but not require,* such differentiation/classification of benefits. Furthermore, there should be **no guaranteed benefits**, "base" or otherwise, in a TBP, otherwise the essential merits of the plan design would be compromised.

Any explicit "*target* reserve margin" or PfAD should be *variable* rather than fixed, i.e., allowed to fluctuate, with it being built-up in good times and drawn down in bad times. Otherwise, it simply becomes a liability with no ability to smooth experience or funding requirements, and only has the impact of providing better security for members on wind-up, which is effectively short-term, at the expense of long-term, thinking.

While we prefer the explicit and flexible reserve funding margin approach to any determination of PfAD, a discount rate margin should also be allowed, or a combination.

iii. Funding: Deficit Recovery Plan/Surplus Utilization Plan

The plan's Funding Policy/Benefits Policy would describe the deficit recovery plan in terms of priorities, e.g., increasing employee contributions, negotiated increase to employer(s) contributions, and/or future service/accrued past service benefit reductions by priority class (actives, deferreds, and retirees).

In a true TBP, just as the members effectively "own" the losses/deficits, the members own 100% of the gains/surpluses. While there would therefore be no concern of how any surplus is allocated between employer(s) and members, the plan's funding policy would presumably outline the priorities for surplus utilization, just as it would outline the priorities for deficit "funding."

C. Disclosure and Communication

Disclosure, communication and education are clearly critical for this type of plan:

a) Only members are at risk;

b) Benefits, even accrued including for retirees, could be reduced;

c) Implications/sensitivity of benefit levels to different investment markets/economic conditions; and

d) Up to the PSs/BOT to determine the optimal balance (appropriate for the particular group of members) of the competing objectives of adequacy, affordability, and security, as well as stability and inter-generational/jurisdictional equity.

D. Conversion of Pension Plans to Target Benefit Plans

As noted earlier, we continue to believe that traditional DB plans provide the best option to plan members in terms of benefit security. TBPs should mainly be used where there is currently a DC plan, no plan at all, or where the only alternative is move away from the traditional DB plan.

Regarding the conversion of DB plans to TBPs, the key concern is accrued DB benefits, in particular those of retirees and of actives within five years of retirement. Obviously, the best solution is the purchasing of annuities, but that is probably unrealistic in most

situations. The next best practical solution is that any possible reduction to retirees (existing as at the conversion date) be the required last option in any benefit reduction plan (after all other priority classes are exhausted), noting that, in the real world of bankruptcies/insolvencies of employers with traditional single-employer DB plans, retirees also do not have 100% protection.

Regarding the conversion of DB plans to TBPs, the process would differ depending on if the benefits are negotiated vs. non-negotiated.

1. Negotiated benefits

   a) At the time of the conversion, any unfunded liability (on a going-concern basis) would be the responsibility of the Employer to fund.

   b) Member consent would be required to convert from a DB plan to a TBP.

2. Non-Negotiated benefits

   a) At the time of the conversion, any unfunded liability (on a going-concern basis) would be the responsibility of the Employer to fund.

   b) Member consent would be required in order for the BOT to reduce accrued benefits and/or accrued benefits that are going to be part of the TBP.

Additional protection for retirees and other classes of members would be the requirement that if a TBP terminates within five to ten years of conversion from DB, the current five-year wind-up funding by the employer(s) would be required; in any event, conversion of DB past service benefits would not be mandatory, particularly as negotiated by a union.

E. Termination

i. Individual Termination and Portability

We support the fact that commuted values (CVs) be reduced to the funding ratio, as it is the only equitable approach. The key here is that the basis for the CV and funding ratio be consistent, which is what is proposed in the paper, i.e., the CV is determined on the basis of the going-concern (GC) funding basis, then it is reduced to the GC funded ratio. In no case should the ratio applied be allowed to exceed 100%. We would not include any funding margins, explicit or implicit, in the determination of the CVs – the plan member always has the option of leaving their funds in the plan, thereby avoiding any perceived "penalty," and taking the future risk along with the rest of the membership; as an alternative, a termination value equal to the product of the solvency CV and transfer/solvency ratio (again consistent) would be appropriate.

ii. Plan Termination and Wind-up

As indicated earlier, benefits on wind-up would simply be an asset share.

APPENDIX

Questions from the consultation paper are *italicized* with our response below each question.

4.1 Administration and Governance

- *Is this governance framework appropriate for federally-regulated private sector and Crown corporation pension plans wishing to convert to a target benefit plan?*
    - We believe it is critical that members be represented in the governance of these plans to the extent of at least 50% control.
- *Should the federal legislation or regulations be prescriptive regarding the composition of the governance body (e.g., proportion of plan members and retirees, presence of independent trustees)?*
    - Not other than as stated above.
- *Should the Board of Trustees have powers to amend plan documents?*
    - We believe that the BOT, if it represents the interests of the plan sponsors (the funders of the cost and the bearers of the risk), should be the one responsible for amending the plan.
- *What should be the plan member support level requirement for making substantial amendments to the plan text?*
    - See above
- *Should there be different governance framework provisions applicable to federally-regulated pension plans in unionized and non-unionized environments?*
    - Only to the extent that, in a non-union environment, there is a process for election or appointment of member representatives (similar to a union environment).
- *What type of process could be used for negotiating provisions of the plan with employees in federally-regulated non-unionized environments?*
    - That is why there is a board to represent the best interest of the member.

4.2 Funding Policy

- *Is the going concern valuation sufficient to measure and fund target benefits?*
    - Yes
    - Solvency should be reported for information purposes only, not for funding purposes.
- *Which approach should be adopted under the federal legislative and regulatory framework: the margin or the probability test?*
    - Neither should be prescribed, i.e. both should be allowed, plus any other appropriate and reasonable method.
- *Is the PfAD approach appropriate as a funding margin or should a different margin calculation be provided for or allowed (e.g., through a discount rate margin)?*
    - Both should be allowed but neither should be required.
- *What is the appropriate time horizon for the purposes of calculating the PfAD?*
    - There is no one answer – this depends on the circumstances of the plan.
- *Should going concern valuations be required on a closed group or open group basis?*
    - Neither should be required, but both should be allowed.
- *How frequently should valuations be required?*
    - Every 2 years, unless the funded ratio is less than 85% then annually.

- *Should some of the specifics on the funding policy (e.g., PfAD rates) rely on guidance from sources such as the Canadian Institute of Actuaries (CIA) or should they be more fully prescribed in legislation or regulations?*

    - They should not be prescribed in the legislation.

4.3 Contributions

- *Is this approach to contributions for federally-regulated plans appropriate?*

Contributions, like benefits, can also be a lever for these plans. The difference as compared to a traditional DB plan, is that employer contribution increases are not automatic or required, but have to be restated or agreed to.

- *Should some of the specifics concerning contributions be determined by plan members or more fully prescribed in legislation or regulations?*

    - Determined by the plan.

4.4 Benefit Structure

- *Is the approach of categorizing benefits in two classes appropriate?*

    - This approach should be allowed but not required.

- *Should base and ancillary benefits be determined by pension plans or more fully prescribed in federal legislation or regulations?*

    - By the particular plan (if this approach of two-tiered benefits is used).

4.5 Funding Deficit Recovery Plan

- *Should the deficit recovery measures and their prioritization be determined by plan members or more fully prescribed in federal legislation or regulations? If the latter, what measures should be prescribed and what should be their order of priority?*

    - This should not be prescribed but rather be part of the plans benefit/funding policy.

- *Should deficit recovery measures be triggered as soon as the PfAD starts to be depleted or the probability test is not met?*

    - This is part of the benefit/funding policy.

4.6 Funding Surplus Utilization Plan

- *Should the surplus utilization measures and their prioritization be determined by plan members or more fully prescribed in legislation or regulations? If the latter, what measures should be prescribed and what should their order of priority be?*

    - This should not be prescribed but rather be part of the plans benefit/funding policy.

- *What would be an appropriate margin (over the fully-funded level) to allow surplus utilization? What would be an appropriate cap on the utilization of surplus?*

    - This is part of the plan's benefit/funding policy.

4.7 Disclosure and Communications

- *What are your views on the proposed additional disclosure requirements listed above?*

    - We agree with additional disclosure and communication, for these type of plans, that are clear and understandable.

- *What are your views on the timing, frequency, and sequence for communicating these additional disclosure items?*

    - Annually based on the most recently filed valuation.

- *What are your views on requiring the plan administrator to report the solvency funding ratio of the plan in its annual reports for informational purposes only?*

    - Agree.

4.8 Conversion of Pension Plans to Target Benefit Plans

- *What are your views on how benefits are treated upon conversion?*
    - We are in favor of conversion being available in situations where the only alternatives are DC/RRSP or no plan at all.
    - Reduction to retirees (at the conversion date) benefits should be the last option
    - Termination of a plan within 5 to 10 years of the conversion date should be required to solvency fund.
- *Do you have any other views on how accrued benefits should be calculated at the time of conversion?*
    - Unless the benefit formula is being significantly altered (e.g. final average earnings plan changed to a career average earnings plan) then the benefit should be based on the projected benefit at retirement.
- *What views, if any, do you have on converting federally-regulated DC plans to TBPs?*
    - We believe moving from a DC framework to the TBP framework is very positive for plan members;
    - We believe the least complicated approach to conversion is to freeze the DC plan with respect to new contributions and not convert.

4.9 Portability and Locking-in Rules

- *Are there any TBP-specific issues in relation to locking-in and portability that should be addressed in the federal legislative and regulatory framework?*
    - Locking-in and portability should be similar to that of current DB legislation.

4.10 Individual Termination

- *What are your views on the methodology used to calculate the individual termination value?*

    - The termination value should be based on the commuted value determined on the going-concern basis and apply the going-concern funded ratio (up to a maximum of 100%). If the individual chooses to leave the money in the plan as a deferred pension there will be no reduction applied.

4.11 Plan Termination and Wind-up

- *What are your views on the formula used for calculating termination value? Would it be more appropriate to use the solvency funding ratio?*

    - Termination value is the amount of assets at time of termination. Each member's share of their assets would be based on the going-concern liability.

- *What are your views on applying solvency requirements in the case of plan termination within 5 years of conversion from a federally-regulated DB plan?*

    - In should be a minimum of 5 years, and possibly 10 years.

4.12 Application to Multi-Employer Plans

- *To what extent could the proposed elements of the federal TBP framework apply in a multi-employer context?*

    - Legislation should clearly allow TBPs, regardless of the type – multi-employer, single/multiple-employer(s), unionized and non-unionized.

- *What elements of the plan design would need to be different from the single employer environment?*

    - We see no difference (i.e. dependent on the particular plan and its governance structure).