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The Challenges Facing Target-Benefit Plans: Changes Are Needed to Provincial Pension Standards

Target-benefit pension plans are a welcome addition to the pension landscape, but their success has been hindered by rules unsuited to their design. Fixing that is one of several improvements, from governance to communications, that could help these plans reach their potential.

Barry Gros

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THE STUDY IN BRIEF

Today, the majority of single-employer defined-benefit (DB) pension plans in the private sector have been either closed to future accruals, completely converted to defined-contribution (DC) plans or wound up. This DB exodus, which started slowly in the mid-1980s and picked up speed in the mid-1990s, happened for a variety of reasons. Many years later, as a result, governments reacted by reforming pension legislation to allow more flexible arrangements to replace DB plans, such as target-benefit plans (TBPs)*, shared-risk pension plans (SRPs) and jointly sponsored pension plans (JSPPs). These new more flexible arrangements are crucial to the survival of pension arrangements providing lifetime retirement income security. Yet, TBPs, for one, still face policy hurdles hurting their ability to operate effectively and efficiently.

This *Commentary* traces the origin and evolution of TBPs. It reviews how these plans are managed, how they are regulated and explains how DB-based views within the policymaking community have inappropriately influenced TBP policy. It further explains how the new provision for an adverse deviation (PfAD) regime has been maladapted for TBPs. It recommends helping TBPs thrive by changing the focus from contributions to benefits, by shifting primary responsibility for policy setting to boards overseeing these plans, provided they meet high standards, by improving communication and governance standards, by using best practices to drive new regulations and by helping TBPs reach critical scale.

* The term “target benefit” has a variety of meanings in common usage. It can refer generally to pension plans meeting certain broad criteria. It can also apply specifically to those plans defined by law as having target-benefit provisions. Because the focus of this *Commentary* is on constraints imposed by pension standards, we use the term target benefit in the latter context, where it is defined by law.

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The move to establish regulations for TBPs around eight years ago happened at the same time as the regulations for solvency funding of DB pension plans were being reworked.

Somehow, in this transition not enough time was taken to ask hard questions about how target-benefit plans actually work, about their inherent risk characteristics and how they should be regulated differently from traditional DB plans. Standards for TBPs have generally been set using DB standards as the template. In this *Commentary*, we address how the approach to regulating TBPs went sideways and what needs to change in provincial pension standards¹ for them to operate more effectively and efficiently.

BACKGROUND ON TARGET-BENEFIT PENSION PLANS

The transition in the private sector from traditional single-employer DB pension plans to DC pension plans or other capital accumulation plan arrangements has reached the point where, today, the majority of these plans have either been closed to future accruals, completely converted to DC or wound up. This exodus from DB happened for a variety of reasons, including changes to the Canadian *Income Tax Act* in 1990, the increased

burden of solvency funding resulting from declining interest rates and changes to pension accounting rules. At the same time, we have seen the introduction of other programs to replace the traditional single-employer DB plan, in the form of JSPPs, SRPs and TBPs.

Starting in the mid-2000s, several provinces conducted comprehensive reviews of their pension systems to identify opportunities for fundamental reform of pension legislation (Expert Committee 2008; JEPPS 2008; Expert Commission 2013). One common recommendation was to accommodate a wider range of pension arrangements. Various approaches have resulted that fall under the broad target-benefit category: affordable defined-benefit, limited liability plan, specified contribution target-benefit plan and negotiated contribution plan, but they all tend to have the common characteristics of fixed contributions,² set by either plan terms or negotiations rather than being set directly by actuarial valuations, and a targeted pre-defined formula benefit that is not guaranteed but rather dependent on the plan's financial performance.

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- 1 In Canada, the regulation of pension plans is a provincial responsibility, except for plans covering employees in federally regulated industries, where Ottawa is responsible. The result is that every province and territory, plus the federal government, can have its own set of pension standards.
- 2 Some TBPs have contributions fixed for extended periods of time. Others have contributions fixed for the duration of a collective bargaining agreement. Yet others allow for some movement of contributions within a narrow range. For the purpose of this *Commentary*, we use the term “fixed contributions” to include all of these variations because what we present herein applies to all of them.

Key Concept Explainer

Types of Work Pensions:

Defined-benefit (DB) pension plans: DB plans promise to provide employees upon retirement with a pension calculated according to some specific formula: a percentage of their career average earnings (CAE plans), or of their average earnings during their final years of service (FAE plans); or a fixed sum per month for each month or year worked (flat benefit plans).

Defined-contribution (DC) pension plans: DC plans promise to provide employees upon retirement with a sum representing fixed monthly contributions by their employer (and sometimes by the employees as well), plus any return on the investment of these contributions achieved prior to retirement. In many DC plans, employees either select from a limited range of investment options or manage the investment of the fund themselves.

Multi-employer Pension Plan (MEPP): MEPPs are pension plans covering workers employed by a number of employers, usually in the same economic sector. They are customarily funded by fixed contributions; in the event these contributions are insufficient to pay for the benefits provided, the benefits may have to be reduced. MEPPs are administered by boards of trustees at least 50 percent of whom must represent the active members of the plan. [Note: Ontario definition, may differ in other pension jurisdictions.]

Jointly Sponsored Pension Plan (JSPP): JSPPs are DB plans in which the employer or employer representatives and the members share responsibility for its funding and governance.

Target-Benefit Pension Plans: Target-benefit pension plans aim to provide a defined benefit but are funded through fixed contributions. If the fixed contributions are insufficient to provide the target benefits, the benefits may be reduced. MEPPs are typically target-benefit plans.

Shared-Risk Plans (SRPs): SRPs have components of target-benefit plans as generally the base benefits under a shared risk plan are based on a targeted pension formula (usually a career average formula). Ancillary benefits (benefits such as COLA, bridge benefits and early retirement subsidies) will only be provided where there are sufficient funds in the plan. However, all benefits (base benefits and ancillary benefits, both past and future) under a shared risk plan may be reduced if there are insufficient funds. [Note: These plans are found primarily in New Brunswick.]

Sources: Definitions are taken from Expert Commission (2008), except for Shared Risk Plans, which is taken from Osler (2013).

It is worth noting that our review of Canadian pension systems reflects a global trend. In many countries where DB-like promises once dominated the pension landscape, similar pressures have led to the emergence of a variety of new designs that reflect some common themes:

- Need for flexibility in the benefit being delivered;
- Need for rethinking how costs and risks are shared among stakeholders; and
- Need for even-handed treatment of different generations.

The original intent of TBPs, at the most basic level, was to provide greater flexibility when it came to available retirement vehicles. The aim was to find a middle ground with a better balancing of the risks of DB and DC plans – a middle ground where sponsors wanting to get out of DB burdens, whether perceived or real, could provide their employees with a viable alternative to a DC plan, especially one that would provide a lifetime pension.

In Canada, we are fortunate to have a rich history of negotiated-cost multi-employer pension plans (MEPPs), many of which have always had the flexibility to reduce accrued benefits, if needed. The vast majority of these plans have been well run, but they kept running into issues with solvency funding requirements³ over many years, resulting in benefits having to be valued at very low interest rates and, with contributions being fixed, benefits often having to be significantly reduced and even in some cases, suspended for a period of time. Over the same period of time, there was a substantial

lobbying effort to replace solvency funding rules for MEPPs and to come up with a more appropriate regulatory regime. And in several provinces this effort tied in with the emergence of the regulatory regime for TBPs. So, the emergence of TBPs can be seen as the next-generation of MEPPs: they kept many of the existing design features and, at the same time, upgraded how these plans are managed by formalizing some of the most robust practices of well-run MEPPs.

In addition to MEPPs, there existed also a small number of guerrilla TBPs, like the University of British Columbia Staff Pension Plan, that were operating within the DB regulatory system but for all intents and purposes were run as TBPs. Indeed, even 10 years ago, Canada had plenty of robust experience to draw from in considering new approaches to pension plan viability, and there was a lot of enthusiasm and anticipation for TBPs. However, so far there has been limited take up across Canada, with the exception of in BC. But even there, with nearly 40 TBPs, many of which resulted from conversions from MEPPs, not all MEPPs converted for the simple reason that the TBP funding rules are more punitive than the existing DB funding rules that apply to MEPPs.

THE DISCONNECT BETWEEN MANAGING AND REGULATING TBPS

My view, supported by research,⁴ is that the primary problem with current TBP regulation and the source of most existing friction with existing

3 Under solvency funding, the pension valuation assumes the plan is about to be wound up with its assets having to be used immediately to settle existing liabilities.

4 Barbara Sanders, an actuary and professor at Simon Fraser University, and I conducted research in 2018/2019 covering plans where at least part of the benefit is dependent on the plan's financial position. We called these "contingent pension plans" and they included: TBPs, SRPs, MEPPs and JSPPs with conditional inflation protection (Gros 2020; Gros and Sanders 2019, 2020). The focus of the research, which consisted of 30 confidential interviews with key individuals across Canada involved in the management of contingent pension plans, including actuaries, lawyers and plan administrators, was on how plans define, operationalize and communicate sustainability. All references to "research" in this *Commentary* refer to this body of work.

regulations is the significant disconnect between how TBPs are managed and how they are regulated. This conclusion has two parts. First, I will look at how TBP management has evolved through the incorporation of risk-management practices, the use of funding methods that focus on the long term (e.g., the aggregate method⁵) and the reliance on actionable metrics for decision-making. I will then contrast this with how the regulations have evolved into a focus on funded position and benefit security.

When it comes to assessing the state of TBP management today we have quite a few data points, including experience with the UBC Staff Pension Plan and our research on plan sustainability, which uncovered many best practices. The most important observation is that many TBPs have embraced a risk-management paradigm. Actuaries and other service providers have expended a lot of effort in educating TBP administrators (who are often boards of trustees) to help them understand and embrace their strategic role in running their plan, rather than being focused on operational or administrative matters. The upshot is that the plans that invest in these resources now approach risk proactively, instead of being reactive. This means identifying potential pain points, using these to establish risk tolerances, and then creating appropriate investment and benefit policies.

The key decisions for boards managing TBPs and what they care about most are:

- What level of benefits can our contributions support?
- When can benefits be increased? and
- When must benefits be decreased?

In looking at the level of benefits that the contributions can be expected to support, the expected cost of providing such benefits has to

be lower than the contributions. Without such a gap, the benefit cannot be supported. There is no theoretically correct answer as to how big this gap should be. This is a policy choice. If we were to use best-estimate assumptions to calculate the cost of benefits and leave no gap between this cost and the contributions, then over the long run there would be only a 50 percent chance that the contributions would support the targeted benefits. Leaving a bigger gap improves the likelihood of the contributions being adequate and reduces the likelihood of benefit reductions in the future.

There is another practical reason to include a gap. The cost of benefits is actuarially determined using a valuation model that contains various assumptions and is highly dependent upon the demographics of plan members. The valuation assumptions include: investment return, longevity, the incidence of members terminating and retiring, and the election by plan members of benefits that contain subsidies (e.g., early retirement provisions and spousal death benefits). The assumptions are educated guesses about the future and can change over time. For example, longevity assumptions are regularly recalibrated and investment return expectations evolve. Similarly, a plan's demographic profile may drift.

All of these factors affect the cost of the targeted benefits. In fact, this is the primary risk associated with the cost of benefits. When reviewing whether contributions can support the targeted benefits after the benefits have been set, the subsequent review of short-term variations between actual vs. expected experience can be tricky. Are variations simply a transitory or natural phenomenon, or do they reflect a permanent deviation? The fact that the risk related to the cost of benefits exists through future exposure to valuation assumption changes,

5 Rather than just looking at what has occurred to date, the aggregate method takes into account current assets and expected future contributions along with benefits earned to date and expected in the future. The method can also incorporate assumptions about future changes in plan membership.

which happens when there are shifts in long-term expectations, is a critical conclusion that I could not find in any literature.

Finally, a large gap between benefit costs and contributions provides more protection from over-estimating the benefit levels that the contributions can support – it improves benefit security in the sense of being able to deliver the targeted benefits with higher likelihood.⁶ At the same time, the bigger the gap, the lower the benefit level, resulting in lower benefit adequacy for plan members. Conversely, the smaller the gap, the greater the benefit.

Clearly, this balancing act is not a trivial matter. As our research confirmed, contingent pension plans (including TBPs) make a great effort to develop policies that attempt to balance benefit adequacy and security according to their members' needs and expectations. When and how to adjust benefits, higher or lower, usually comes down to choosing actionable metrics. This means deciding what will be measured and when corrective action will be taken.

Actionable metrics are not unique to TBPs; they also exist for traditional DB plans. In a typical single-employer DB plan, the focus is deciding how much to contribute (since the benefit formula is fixed). The key metric is usually the plan's funded position, which determines whether amortization payments should be made to supplement the plan's service cost.⁷ Traditional actuarial practice has assessed a plan's funded status based on a closed-group valuation, typically using a unit credit (UC)

cost method.⁸ This approach has been reinforced by provincial regulations. Therefore, when considering the viability of a DB plan, the funded status is a key actionable metric and any required corrective action is taken by adjusting the contributions.

In contrast, TBPs have a different focus and different actionable metrics. Contributions are generally predetermined. The key decisions for their management boards are for future and past service benefits. Each decision requires its own actionable metric. The best practice identified through our research and the way the majority of TBPs address these questions is through the use of aggregate funding methods that include all contributions, past and future, and all benefits, past and future. Furthermore, policy changes impacting future benefits can be reflected in these aggregate valuations in ways that a UC valuation cannot.

The actionable metrics for all three of these critical decisions – benefit levels, when to increase benefits and when they should be decreased – typically use stochastic tools and the plan's stated position on benefit stability and rate/size of acceptable benefit changes. For example, in the UBC Staff Pension Plan, its benefit policy supports 50 percent (of inflation) post-retirement indexing as long as the aggregate funded ratio, known as its Benefit/Funding test, is greater than 110 percent. It is worth noting that our research revealed that many plans use multiple metrics in making benefit-related decisions.

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- 6 I believe this is the most appropriate way to look at “benefit security” in a TBP, where there are no legislated guarantees; i.e., having a higher likelihood of the targeted benefit being delivered.
 - 7 Under actuarial funding methods, the service cost is the actuarially determined value of benefits accruing in the year following the measurement date.
 - 8 Unit credit funding is based on the principle that the pension to be provided at retirement age will be divided into as many “units” as there are active membership years, with one unit assigned to each year (Trowbridge 1999). As a result, the cost of plan benefits under this method is an amalgam of the costs for each individual for the coming year. And these individual annual benefit costs will increase as a member ages, reflecting the time value of money (i.e., the increasingly shortened period of time over which to discount the benefit from the assumed retirement age to the current age).

There is no universally right answer as to what metrics are best suited for a particular plan. Actionable metrics can be expected to vary by plan. This much is obvious if we consider that TBPs can exist along a wide spectrum from DB-like plans at one end to DC-like plans on the other. The collective defined-contribution (CDC) scheme in the UK is a perfect example of a TBP on the DC end. The CDC design places a high priority on intergenerational equity, and the accrued benefit is adjusted (up or down) annually based on fund performance, with some restrictions on downward adjustments. By contrast, so far, most TBPs in Canada exist at the DB end of the spectrum with infrequent reductions and considerably more intergenerational risk-sharing. But there's no reason why new TBPs, especially single employer TBPs recently allowed by pension legislation in British Columbia, should not be allowed to exist at the DC end of the TBP spectrum. Ideally, each plan would decide on the relative importance of benefit security, benefit stability and intergenerational equity and set actionable metrics based on that.

That said, we must stress that these actionable metrics aren't perfect: they are usually just a convenient, deterministic shorthand for some desired outcome in a more complex, stochastic context. They are easier to work with than the full stochastic tests, but their shelf life is also shorter – they need to be revisited as the plan and its environment evolves. For example, for the UBC Staff Pension Plan, the 110 percent aggregate funded ratio may be an appropriate actionable metric today for granting 50 percent post-retirement indexing. But if, in five or 10 years, the plan finds itself in a significantly different market environment with different inflation expectations or with a radically different demographic profile, then

110 percent might not be the right goal post for achieving the original objective. In other words, the actionable metric is not only plan specific but may also need to be revised from time to time, even if the underlying goal or objective does not change.

To recap, TBPs are managed using a variety of actionable metrics, some of which are based on some sort of aggregate or open-group valuation that takes into account the future evolution of the benefits and contributions. The metrics are developed using stochastic tools applied over a long horizon and reflect plan-specific priorities and trade-offs among benefit security, stability and adequacy. The metrics are then adjusted when the current or future expected environment changes. This is in sharp contrast with provincial pension regulations that prescribe their own actionable metrics, typically based on UC valuations and developed using a much shorter horizon, such as a three-year valuation cycle.

We next would like to demonstrate how considerable problems result from TBPs making key benefit decisions using aggregate funding tools and then having to overlay the UC minimum funding requirements in the pension standards.

Boards managing TBPs typically want benefit rates to be level for a period of time, often for the duration of a collective agreement, and even longer in many cases. Table 1 presents a situation where the board wants the benefit to accrue over the next five years at a constant rate of \$91 per year.⁹ This benefit rate is developed using an aggregate method that includes the expected contributions over the five-year period (not just the upcoming year). The right-most column shows the maximum amount of annual pension that pension standards typically would allow the plan to provide, assuming the test is applied each year. In this example, the

9 This simplified illustration consists of a pension plan with one member age 60 with an annual contribution negotiated for the next five years of \$1,100/yr. The other main assumptions are: an immediate annuity factor of 14.0 at age 65, a discount rate of 5%/yr and no PfAD.

Table 1: Comparison of Pension Funding Models

Age	Annual Pension for the Year (Aggregate Funding Method)	Maximum Annual Pension for the Year (UC Funding Method)
	\$	
60	91	100
61	91	96
62	91	91
63	91	87
64	91	83

Source: Author's calculations.

plan complies with the pension standards for the first three years but is offside for the remaining two years, where the \$91 target benefit exceeds the maximum allowed and the plan benefit would have to be reduced.

I could find no awareness or acknowledgement of this disconnect in funding methods in any TBP literature or studies. I believe that maintaining a UC focus in the regulation of TBPs has the potential for the standards to get in the way of boards prudently managing their plans and members receiving the benefits they deserve.

It is worth noting that aggregate funding methods are common among JSPPs in Ontario and fully accepted under that province's pension standards.¹⁰ This is relevant as there is a lot more affinity between TBPs and JSPPs than between TBPs and single-employer DB plans because of the similarities in governance structures and their common focus on benefits' long-term sustainability.

JEPPS (2008) was one of the first reports to review the TBP concept in depth, where the concept was referred to as a "specified contribution target-benefit plan." It was in this report where the concept of the going-concern-plus¹¹ funding approach arose as an alternative to solvency funding. And the "plus" part consisted of a provision for adverse deviation (i.e., PfAD) that would be determined through a robust assessment of the risks inherent to each plan. However, it seems clear from reading the report that a primary purpose of the PfAD was benefit security.

Another interesting observation from JEPPS (2008) is that the report actually recommended congruency between the valuation of TBPs and their regulation (i.e., "The legislation should also require that a reasonable method be used for costing benefit improvements: benefit improvements should be valued on the same going-concern-plus basis as required for the minimum

10 Section 47.7.1 of *Ontario Pension Benefits Act* R.R.O. 1990, Regulation 909.

11 The going-concern-plus approach takes a long-term approach to funding (i.e., going-concern) rather than a short-term (i.e., solvency) view and incorporates an explicit provision for adverse deviation.

funding standards”). However, my position is that JEPPS got it backwards. Legislation should not drive how TBPs are valued. It cannot keep up with advances in actuarial best practices because pension standards are seldom a high priority for legislators, and it can take years for needed changes to pension standards to get on the legislative agenda. It would be much more useful for the management of TBPs if legislation would be grounded in industry best practices and written with enough flexibility to adapt as best practices evolve.

IMPACT OF A PREVAILING DB BIAS IN TBP POLICY

With a DB plan, the primary focus is on whether the assets can deliver the guaranteed benefits. This means that pension standards focus primarily on the plan’s funded position, whether on a going-concern basis or on a solvency basis, or both. The biggest risk to members in traditional single-employer DB plans is the failure of the sponsor resulting in the plan being wound up with insufficient assets to provide all of the benefits earned (e.g., Sears Canada and Nortel). Contributions to these plans are not set in advance and are the result of a regular actuarial valuation process that must conform to pension standards regarding amortizing deficits, resulting in a combination of service costs and amortization payments, as appropriate. This means that contributions can be expected to change with every valuation cycle, although plan sponsors often strive to minimize the volatility of their contributions.

Many jurisdictions now require an explicit funding policy for DB plans yet, in practice, most single-employer DB plans simply contribute the minimum required by the statutory valuation. So the pension standards become the de facto funding policy. However, the bottom line is that funded status is what matters – i.e., what position would the plan be in if it should wind up. And a full plan windup has a much higher likelihood of happening

in a plan with only one employer than in a plan with many.

Moving now to TBPs, this focus on funded status, with financial management generally only looking to the next actuarial valuation, and wanting to protect members in the event of plan windup, is not consistent with the plan’s inherent nature. Not only can this focus be detrimental to its ongoing management, it can also affect benefit adequacy.

As mentioned earlier for TBPs, while a benefit service cost can be actuarially determined, actual contribution commitments are often set independently of any actuarial valuation process. This is an important point. Therefore, the concept of funding policy can be seen as a bit absurd in the context of a TBP. What really matters is the relationship between benefits and contributions. The question to be asked should be: have the benefits been over-promised or under-promised? This requires a shift from a DB-based view focused on required contributions to a TBP-based view focused on the benefit levels that can be supported.

TBPs will typically want to provide the best benefit adequacy possible by aiming for the highest payout level appropriate for the contributions they receive. Plans expect these benefits to be in place over a period of time well beyond the typical three-year valuation cycle. As was showed earlier, the usual UC valuation that is central to the regulation and operation of DB plans is not the best tool for managing this relationship, but this is the basis on which pension standards are written and on which TBPs are monitored by regulators. Therefore, there is a significant disconnect. Our research shows that many respondents did not see the statutory actuarial valuation as being their primary plan management tool, often not even useful in that regard. Many plans used other valuation methods, not limited to the aggregate method, and many plans used multiple metrics in assessing the financial wellness of their plan and the sustainability of the current benefit/contribution balance.

THE PFAD

And then there's the PfAD. DB plans need provisions for adverse deviation. TBPs need actionable metrics. Different plans. Different risk characteristics. Different needs. How did we get so far off track?

Going-concern-plus funding, with a PfAD on the service cost, has been adopted in several Canadian jurisdictions as part of the solution to move away from 100 percent solvency funding for DB pension plans. In that context, the PfAD makes sense as a way to compensate somewhat for the lower benefit security resulting from reducing the solvency-funding target, generally from 100 percent to 85 percent. In other words, in the DB space, the PfAD is a complete add-on to the funding that otherwise would have been made. Furthermore, the PfAD has no role in defining or limiting the DB benefit promise. Think about that – no direct impact on the level of benefits.

So, why even have a PfAD on the service cost of TBPs? Well, let's first be very clear that with TBPs, unlike with DB plans, the PfAD generally does not result in additional contributions going into the plan. It mostly works to reduce the level of benefits that will be paid from the plan. That is a very big difference from DB plans that requires a different approach to regulation.

Some suggest that the PfAD on the service cost will fund the PfAD on the liability as service costs convert to liability over time. This may make some sense for start-up plans where there is no past service. Otherwise, it could take a long time to build up a buffer on the liability simply from plan experience. Such an approach makes less sense, perhaps no sense, in a very mature TBP where the service cost can be less than 5 percent of the liabilities. In that situation, there's no reasonable PfAD that can materially affect the plan's financial position.

Back to what is the PfAD on the service cost supposed to do? When looking at the risks inherent in the service cost, they are not, contrary

to popular belief, in any way directly related to the plan's statement of policies and procedures or current asset mix. For some reason, this seems to be a very prevalent way of thinking; i.e., that PfADs for TBPs need to be driven by a plan's target asset mix. There is no question this makes sense for DB plans. The argument is less strong, possibly not even applicable, when looking at TB plans.

As highlighted earlier, any PfAD on the service cost should simply recognize that the assumptions used in the valuation model to determine the service cost might have to change over time. It is this change in the underlying assumptions driving the service cost that will directly affect the adequacy of contributions to deliver targeted future benefits. Fluctuations in plan experience over the short term do not necessarily indicate any inadequacy in the valuation assumptions. Indeed, such short-term fluctuations are expected, and it is only over time that one can truly determine if the benefits were over- or under-promised.

Furthermore, it is not possible for the PfAD on the service cost to assist with managing short-term volatility. To expect it to do so, the PfAD would have to be so high as to significantly reduce member future benefit accruals. The volatility issue is a factor with respect to accrued benefits, not the service cost.

Moving on to the PfAD on the liability, it typically exists in pension standards as a threshold to determine whether benefit improvements can be made, or what was earlier called an actionable metric. It has also been represented as a means by which to provide some level of benefit security by restricting benefit increases. It is worth noting that there typically is no legal requirement to explicitly fund the PfAD on the liability. For example, where a TBP is 105 percent funded and there is a requirement for a 15 percent PfAD, there are no statutory requirements to fund that 10-percentage-point difference (i.e., 15 percent minus the 5 percent that the plan is already over funded). Presumably, this PfAD is expected to

evolve organically. Such an approach seems less like a provision for adverse deviation and more like an actionable metric.

There is another fundamental question: whose role is it to determine the acceptable level of benefit variability – government or the plan itself? And, furthermore, should the same standards be imposed on all plans? These are important policy issues. Even if we say that it is good and fair for government to be setting actionable metrics, we believe that the actual metric chosen (UC funded status) and its levels (developed based on short-term, closed-group valuations) are totally mismatched to how many TBPs actually make benefit decisions.

One might argue that the point of minimum standards is to catch the bad apples and that the PfAD on the liability exists to force a certain actionable metric onto plans that would otherwise not choose reasonable measurements. This is not the right approach. Problems tend to happen when the plan has poor governance, and this is what we will address next.

INSUFFICIENT FOCUS ON GOVERNANCE OR COMMUNICATION

Our research indicated that governance is an important contributor to sustainability. It is where the “rubber hits the road,” as one of our interviewees said (Gros and Sander 2019). JEPPS 2008 indicated that poor governance is often the root cause when pension plans fail to deliver on their promises. Expert Commission (2008) also emphasized this point. As part of our research, we were even able to show a direct link between governance and plan sustainability (Gros and Sander 2020).

It is important to remember that governing boards cannot actually control a plan’s funded position. They can only identify and manage the risks their plan is exposed to. It is their decisions to mitigate these risks that make the difference. Ensuring that a plan has a coherent mission and

beliefs, selecting the right people for key leadership roles and putting in place the right decision-making processes can help guide current and future boards in their task of delivering the benefits their plan members deserve.

From our research, we learned that another significant non-financial contributor to sustainability is member communication (Gros and Sander 2019). Our interviewees had a lot to say about communication, especially how generally bad it is. They say that what is missing when it comes to communication is that many people, including policymakers, confuse disclosure with communication. The two are not the same. Disclosure pushes information out to members without the sender having any idea whether it was received or whether the intended messages were understood. True communication includes a feedback loop so you can assess whether the intended messages were received and whether members interpreted your communications in ways you hadn’t anticipated.

WHAT CAN WE DO TO HELP TBPS THRIVE?

Five recommendations on what needs to be done for TBPs to continue to be a viable alternative for providing lifetime retirement income follow.

Change the Conversation

First and foremost, we need to change the conversation. Too often the discussion of TBPs is around contribution adequacy or contribution sufficiency when we really should be talking about what benefits the contributions can support. It may seem like semantics to some, but words are important. They set expectations of how people look at things. They are often accompanied by connotations and preconceived notions as to what they mean, not necessarily what was intended. Specifically, an emphasis shift is required because:

- It could spur positive legislative changes. If TBP legislation restricts TBP design to the DB end of the TBP spectrum, then there will be less innovation. As a result, the desire of pension reform reviews from almost 15 years ago to have a broader range of alternative designs will not be realized.
- Secondly, forcing TBPs to the DB end of the spectrum and adding restrictions on TBP funding that make no sense will make it more difficult to treat current and future plan members on an even-handed basis.

How do we put the focus on where it should be – benefits? After all, that’s what the plan is all about, determining appropriate levels of benefits for the contributions being received. This conversation starts at the board level, covering important questions such as:

- What level of benefit adequacy would we like to attain?
- How do we want to incorporate/treat intergenerational equity?
- How much benefit variability are we willing to tolerate?
- What levers and/or margins do we want to incorporate to protect certain aspects of the plan, like base benefits, over others, such as indexing?
- How will we extend the conversation to plan members so that they will have an appreciation of the deal?

This is exactly what well-managed plans do: they focus on the benefits. Without a change in the conversation, it will be difficult if not impossible to make headway where needed to have TBPs thrive.

Shift the Major Responsibility for Policy Setting from Regulations to the Boards Overseeing these Plans, while at the same time Setting Higher Standards for Board Performance

Secondly, it is worth asking the question: what is pension legislation meant to protect and from whom or what? In the DB world, where benefits are supposed to be guaranteed, we have seen that

promise broken numerous times when businesses have failed and plans were wound up with inadequate assets and members having limited recourse. Therefore, it is easy to understand the drive for strong pension standards around funding and surplus usage – too often, members’ best interests have not been properly taken into account.

In the case of TBPs, there are no funding issues because the funding is generally fixed. There are no surplus issues because any surplus belongs to the plan’s members. Lastly, the fundamental and legal benefit promise is different: benefits are not guaranteed. As such, the risk to members in TBPs experiencing a reduction in their benefits results not from employers adhering to minimum funding standards or inappropriate surplus utilization by employers, but due to other factors, such as:

- “over-benefiting” decisions by pension committees/boards;
- poor investment performance;
- poor assumption setting; or
- pension committees/boards adopting a high-risk investment policy with insufficient mechanisms to manage investment volatility.

In all of these cases, the source of the problem is primarily poor plan management and/or poor governance, not inadequate funding standards. For TBPs, legislated standards ought to focus more on governance and communication. Focusing primarily on financial measures will provide limited progress. It won’t prevent boards from making bad or inappropriate decisions.

Elevate the Importance of Governance and Communication

Thirdly, going forward, we need to recognize the importance of governance and communication to the sustainability of TBPs. These are areas where all parties involved with managing TBPs need to increase their knowledge of what constitutes good governance and, in particular, what constitutes good communication rather than just disclosure.

Expert Commission (2008) suggested a number of improvements to the governance of MEPPs such as:

- Appoint members with differing interests as trustees (e.g., by ensuring retirees are represented);
- Appoint third-party non-beneficiaries as trustees; and
- Lessen conflicts when benefit adjustments are needed by adopting formulaic rules, where possible, for benefit adjustments.

JEPPS (2008) contained similar recommendations. As well, the Canadian Association of Pension Supervisory Authorities Guideline No. 4 and its associated self-assessment questionnaire for board members are excellent tools that set the baseline for governance best practices. Furthermore, we have seen the growth of education around governance, granted targeted towards members of boards of trustees, by organizations such as the International Foundation of Employee Benefits (IFEB). It is important to see governance as a constantly evolving process, not a destination, as governance needs and practices can be expected to evolve as a plan's needs and industry best practices evolve.

Regarding communication, we suggest that TBPs adopt a communication policy similar to an investment, funding or governance policy. Such a policy would not be hard to implement and, at a minimum, would include:

- Identification of all key audiences;
- A statement of goals and objectives for the communication plan; and
- Identification of all communication activities, by audience, indicating their purpose, expected outcomes and measurement metrics, so that each activity can be effectively managed.

Develop Policy in Conjunction with Industry Best Practice

Fourthly, policy needs to be developed in conjunction with an understanding of industry best practices, not in isolation from the real world. So much can be learned from plans that are already doing a stellar job and are not in need of further legislation (Gros and Sander 2019). What we found from our research is that there are a lot of devoted and competent advisers working with these plans, with years of experience through differing economic cycles and various attempts by legislators to solve the so-called “pension problem.” We need to find ways to better tap into this expertise.

I am encouraged by initiatives, as in BC,¹² that involve joint working groups with representatives from the pension actuarial community, regulators and policymakers, where participants are willing to have open and frank conversations about how these plans operate and where regulations should focus to best protect member rights. These initiatives engage in constructive joint problem solving in a way that goes beyond typical consultation processes, so that government policymakers can truly make informed decisions.

But as we learned from our research, there are still plans that want only to do the minimum required by law. So, rather than develop completely new rules that might disadvantage plans that are already setting best practices, would it not be better to extend these proven best practices to other plans?

TBPs Need Scale

Lastly, TBPs need scale. They need to be able to attain size quickly. TBPs are sophisticated financial instruments. Sophisticated instruments need sophisticated tools to be managed properly. Scale

12 Full disclosure: I am part of the joint British Columbia-Alberta working group currently reviewing changes to the PfAD legislation for TBPs.

means plans can afford the tools needed to assess risks properly and make appropriate decisions. It also means a productive communication plan on a cost-effective basis.

Two ways to achieve scale in TBPs are: through the creation of new collective TBPs to replace single standalone plans, especially smaller ones, and by allowing plans that convert to target benefit for future service to include converting past service benefits. The tendency in Canada so far has been to restrict TBPs to future service accruals only. Clearly, this means that in many cases scale will not be achieved for several decades. One of the primary benefits of scale is that it can materially reduce the cost of running a plan as a percentage of assets. And that is certainly a worthy goal. By not allowing conversion of past service benefits into TBPs, especially from MEPPs, the result is higher plan costs and lower member benefits until that scale can be achieved.

CONCLUSION

Having started out with great promise, TBPs are not reaching their full potential. The reasons for this include:

- The complete disconnect between how they are managed and how they are regulated;

- The prevailing DB bias that haunts TBP regulation;
- A misunderstanding of the difference between PfADs and actionable metrics; and
- A focus on financial issues at the expense of governance and communication.

Can we fix this? Of course we can. But to do so:

- We need to change how we talk about TBPs. We need to change the conversation.
- We need regulations that set minimum standards and do not become the de facto benefit policy.
- We need regulations that are grounded in industry best practices.
- We need to shift the real responsibility for policy setting to the managing boards but at the same time raise the standard of expected board performance.
- And, lastly, we need scale for these plans to thrive and operate efficiently and effectively.

We have learned a lot about TBPs in the past decade, and that learning needs to continue. It took more than 40 years to really understand DB plans. We can never assume we know everything there is to know about something as complex as managing a TBP.

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