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09 September 2013

COMMUNIQUÉ

FINDING A BETTER PENSION PLAN DESIGN

Target benefit pension plans. They're a hot topic, and they're included in the newest pension legislation reforms in Canada. But: is this a good pension plan design? There are many reasons why the answer is yes.

Basic goals

The goal of retirement savings is simple – set assets aside, earn investment income on those assets and use the accumulated assets to provide adequate lifetime retirement income. This goal is true regardless of whether the assets are being accumulated in a defined benefit (DB) pension plan, a defined contribution (DC) pension plan or an RRSP.

The achievement of that goal is far from simple as it depends on many unknown factors. How much should be set aside each year? How should the assets be invested? How much retirement income will the contributions and investment income provide? How much retirement income is needed?

The roads well travelled

Historically, many employers established DB plans to provide retirement income for their employees. The employers assumed the risk of guaranteeing safe, adequate pensions for their employees. When plans were newly established, liabilities were small and this guarantee had little financial risk.

Today, interest rates remain low and mortality continues to improve faster than expected, increasing the cost of providing pensions. DB plans established long ago have grown in size and become mature. This evolution has increased the financial risk of guaranteeing pension benefits under a DB plan, as both good and bad experience can result in large changes in contribution requirements and in the employer's financial statements. Eventually, with accrued benefits protected from reduction, traditional DB plans can become unsustainable as the number of retirees grows.

As a consequence, over time most employers in the private sector have replaced their traditional DB plans with DC plans. DC plans fall at the opposite end of the risk spectrum. However, financial risk does not disappear in a DC plan – it is merely transferred from the employer to the employee. Employees are responsible for investing their retirement savings and ensuring that they save enough to provide an adequate retirement income. They assume the risk of outliving their retirement savings.

For many reasons, this transfer of risk results in a less efficient pension system:

- Lack of financial literacy and lack of attention to the investment task is a big problem in DC plans. Some DC plan investors choose last year's best performing investments or invest in "safe" investments that provide little return.
- While investment fees charged to DC plan members are lower than fees charged by retail mutual funds, the fees are typically higher than the institutional investment fees paid by DB plans.
- Individuals are not likely to purchase annuities at the time of retirement. High annuity prices (caused by low interest rates and insurer loads for fees and profit) and lack of flexibility are often cited as reasons not to purchase annuities. However, individuals who do not purchase annuities should save more to cover the possibility that they will be one of the few individuals who live well into their 90s. Otherwise they might deplete their retirement savings while still living.

Retirement planning can also be more challenging under a DC plan. Few plan members are able to predict the amount of retirement income that will be provided by their DC account balance until they are close to retirement. At that time, increased contributions will have little time to accumulate and working longer may be the only option, if their retirement savings are insufficient.

New direction

Employers want more cost certainty, but many human resources departments like the value that DB plans have provided in the past to help attract and retain employees. Most individual employees are not well suited to manage investment risks on their own and longevity risk is very hard to manage on an individual basis. There is no single retirement plan design that fits every employer and employee situation. Some employers may choose to balance these needs by providing various forms of hybrid pension designs. For example, a DB plan of 1% of final average earnings for each year of service plus a DC plan to supplement the pension.

A target benefit plan lands between a traditional DB plan and a traditional DC plan. Target benefit plans can define fixed contribution requirements or contribution requirements that vary within a reasonable range. These contributions can be entirely funded by the employer or can be shared by the employer and employees. This contribution structure provides cost certainty.

Target benefit plans also achieve important economic efficiencies:

- Retirement savings are invested on a pooled basis by professional money managers rather than by individual plan members. This pooling should result in better investment performance and lower investment management fees. It should also allow institutional money managers to use alternative investments that are not normally available to smaller investors.

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- Longevity risk is pooled among all plan members removing the pressure on individuals to manage their own longevity risk. Target benefit plans can, in some ways, be thought of as a not-for-profit variable annuity product.

Single-employer target benefit plans appear to hold a lot of promise – they almost sound too good to be true: a lifetime pension funded with fixed contributions. However, target benefit plans do not eliminate risk. The same risks, and potential rewards, exist in a target benefit plan that exist in DB and DC plans. In all plan designs, contributions and investment income will ultimately provide pension benefits – there is no magic new money created in a target benefit pension plan. The difference is that a target benefit plan can provide an economically efficient way to distribute the risk.

The key to a target benefit plan is that, while the plan intends to provide a target retirement income, the amount of pension provided is not guaranteed. Conditional benefits, such as future indexing, can be eliminated on a temporary basis if the plan experiences losses and does not have sufficient assets to provide these benefits. Target benefit plans can also reduce accrued benefits for both active and retired members. In good times benefits are restored or improved.

These variable benefits are meant to be managed so that all plan members are treated as equitably as possible. Without variable accrued benefits, contribution increases and downward benefit adjustments can only take place for future service, so that active plan members bear the burden for a past generation's benefits.

If target benefit plans are to provide reasonable, sustainable benefits over the long term, neither contribution rates nor benefit levels can remain unchanged forever. Therefore, a key objective for a target benefit plan is to have a stable relationship between contribution and benefit levels, and on-going risk modelling is an important aspect of managing a target benefit pension plan.

Most employees may prefer the lifetime guaranteed benefit provided by a traditional DB plan but this is no longer a realistic offering for most employers. In the alternative, employees might value a pension plan that provides a target benefit most, but not all, of the time, over a DC plan where the employees each bear their own individual investment and longevity risk.

Lessons learned

As pension plan designs continue to evolve, it is becoming clearer that sustainable pension plans that balance the needs of all parties over the long term must have both contribution and benefit flexibility to adapt to different economic cycles.

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