MERCER

25 April 2014

COMMUNIQUÉ

FEDERAL CONSULTATION ON TARGET BENEFIT PENSION PLANS

On April 24, 2014, the Department of Finance Canada released a consultation paper, "Pension Innovation for Canadians: The Target Benefit Plan" (the Paper). This is a welcome development at this time when there is a surge of interest in this pension plan design. A consensus is building that target benefit pension plans (TBPs) provide a viable way to create sustainable pension plans that can adapt to different economic cycles. If governments create an environment in which the TBP is attractive to employers and employees, retirement income security will be enhanced. See our Communiqué of September 9, 2013 for a discussion of the merits of this design.

This Communiqué provides highlights from the Paper, which proposes a TBP model to be implemented under the *Pension Benefits Standards Act, 1985*. It would be available to all private sector and Crown corporation pension plans governed by that Act. The proposal does not apply to federal public sector pension plans, which are governed by different legislation.

Governance

A TBP would have a two-tier governance structure. A board of trustees would be the administrator and fiduciary responsible for administering the plan, member communications, and making decisions in accordance with the plan documents (including the plan text and the governance, funding, investment and other policies that must be created). The board, however, would not have the power to amend these documents. The documents would be established, and any future amendments would be made, by the employer, employees and retirees. Unilateral amendments by the employer would not be permitted.

The board of trustees must have representation by members, retirees and other beneficiaries. Employer representation would be optional. Independent expert members could be appointed.

A comprehensive governance policy would be required.

Funding Standards

Solvency funding would not be required, but solvency valuations would be done for disclosure purposes. The funding requirement would be based on an enhanced going concern valuation, and the Paper asks for comments about which of two approaches is preferable. In one approach a funding ratio would be calculated using an explicit provision for adverse deviation that is based on the plan's asset allocation and degree of maturity. The other approach resembles the New Brunswick shared risk pension plan model. Probability tests would be applied, such as a 90% probability that base benefits would not be reduced over a specified time frame.

A funding policy would be required. Input is sought on the frequency of valuations.

Contributions

The proposed contribution model requires contributions in excess of the cost of benefits being accrued in order to establish a buffer to withstand shocks. Variable or fixed employer contributions, and variable employee contributions, would be allowed as required by the terms of the plan. In all cases variable contributions must have a cap. Employer and employee contributions would not have to be equal. Triggers for contribution increases and decreases must be pre-determined. Decreases could not occur unless the plan is fully funded.

Temporary solvency contributions by the employer would be required for a certain (unspecified) number of years following conversion of a defined benefit plan to a TBP.

Benefits

A TBP could classify benefits as base or ancillary. When funding is insufficient, ancillary benefits would be reduced first. Base benefits would be the last to be reduced. Reduction of accrued benefits would be permitted. A TBP's benefit structure and the order of priority for reduction, restoration and enhancements would be determined at the outset in the plan documents.

Terminating plan members would have portability rights following the existing rules that require a transfer option to be provided if the member is more than 10 years from pensionable age. The transfer value ("termination value") would reflect the conditional nature of the benefit. It would equal the value of the member's target base benefit calculated on a going concern basis, adjusted by the funded ratio of the plan shown in the most recent valuation. This could be further adjusted if the funded ratio has changed by more than 10%. Under this approach, surplus or deficit would be reflected in the termination value.

Benefits on plan termination would be determined in accordance with the plan's funded status, with no requirement for further funding (except as noted below for recently converted plans).

Deficit Recovery and Surplus Utilization

A deficit recovery plan and a surplus utilization plan must be established. These set the trigger and timeline for implementing adjustments, describe all response measures and order of priority, set the minimum funding or surplus margin to be maintained, and provide for the approval process. The board of trustees would have the authority and obligation to implement the measures without having to seek the consent of the parties.

Disclosure and Communications

In addition to the disclosure and communications required by existing rules, TBPs would be required to provide information relevant to the TBP design. This would include a comprehensive explanation of the plan's funding policy and benefits rules, notification of changes driven by the deficit recovery and surplus utilization plans, and details in annual statements about expected base and ancillary benefits if the plan continues to perform under existing conditions.

Required filings would include details of the plan's funding, governance, investment and risk management policies, and details of member communications.

Converting Existing Plans

Existing defined benefit and defined contribution plans could convert to a TBP design if all parties consent. On conversion, accrued defined benefits could be reduced, and be made subject to future reduction as base benefits. Future indexation for retirees would be considered an ancillary benefit. Any going concern deficit (taking into account changes to benefits) would have to be fully funded. Solvency funding would be required temporarily after conversion and if the plan were to be terminated within five years after conversion.

The Paper does not specify the level of consent that would be acceptable, nor how various affected parties (such as non-union members and retirees) are to be represented in the process.

Consultation

The government seeks input from pension plan sponsors, unions, actuaries, lawyers and retirees. The Paper also asks federal pension plan sponsors, and employers who do not provide pension plans, to indicate whether they would consider offering a TBP with reasons why or why not. The consultation period ends on June 23. Submissions should be sent by email to pensions@fin.gc.ca.

Comment

The Paper provides an informative discussion of the rationale behind the proposals. The proposals emphasize flexibility and negotiated self-determination in the initial design of a TBP, and they appropriately create stability of plan design after inception by requiring future amendments to be agreed upon by the employer, employees and retirees.

The requirement for the consent of all parties to a conversion of existing plans makes sense, and it is essential for this possibility to exist.

It would be desirable for TBPs to be available in a multi-employer framework with an administrative body that is independent of the parties, such as a trust company or other professional trustee. However, the proposals in the paper would prevent the creation of such a TBP. This approach would be particularly useful for small to mid-sized employers that could not otherwise achieve the scale needed for a TBP to operate effectively.

This consultation can contribute to the formation of policy in the provinces as well as at the federal level, and it would be ideal if jurisdictional differences are minimized. We expect the consultation to produce a focussed and much needed debate on how the legislative framework for TBP design can be used to support and encourage sustainable defined benefit pension plans.

For more information, contact your Mercer consultant or the following Mercer consultants:

Scott Clausen
416 868 7658
scott.clausen@mercer.com

Cory Skinner
613 760 2979
cory.skinner@mercer.com

Leigh Ann Bastien
416 868 2568
leighann.bastien@mercer.com

Mercer Offices:

Calgary
403 269 4945

Edmonton
780 483 5288

Halifax
902 429 7050

London
519 672 9310

Montréal
514 285 1802

Ottawa
613 230 9348

Québec City
418 658 3435

Regina
306 791 4558

Saskatoon
306 683 6950

Toronto
416 868 2000

Vancouver
604 683 6761

Winnipeg
204 947 0055

Mercer Website: **www.mercer.ca**