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Department of Finance Canada
pensions@fin.gc.ca

Dear Sir/Madam,

We are writing in response to the Department of Finance (Finance) Consultation Paper, *Pension Innovation for Canadians: The Target Benefit Plan*. The comments below provide our views on key elements of the Consultation Paper in relation to form and content of a framework for federally regulated target benefit plans (TBPs).

Eckler actuaries have been consulting to a type of target benefit pension plan, namely multi-employer pension plans (MEPPs), since the first such plans were established in the 1940s. As a result, we have decades of experience with the design, governance and financial management of these plans. Although the federal TBP model will naturally have some different characteristics than the typical MEPP framework, the experience gained from such plans should provide valuable insights. Our extensive MEPP experience informs many of our comments on the issues raised by Finance in the Consultation Paper.

Our comments address the issues that we believe are of greatest importance raised in, or as a result of, the Consultation Paper. On some issues, our comments are framed as responses to the questions posed by the Consultation Paper; on others, we have provided general comments on matters to consider.

Governance: Section 4.1

One of the defining characteristics of a TBP compared to a conventional defined benefit (DB) plan is that all of the risk associated with the pension promise is shifted from the plan sponsor to the plan members. As a result, in our view a joint governance structure with plan member representation as described below is a must in any TBP framework.

Q: Is this governance framework appropriate for federally-regulated private sector and Crown corporation pension plans wishing to convert to a target benefit plan?

Q: 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)?

A: The governance framework proposed in the Consultation Paper requires that plan members, retirees and other beneficiaries be represented and have voting rights on the TBP's board of trustees. All trustees, regardless of their affiliation to a group of members or to the employer, have the fiduciary duty to act in the best interest of the plan members and in accordance with the plan documents. In contrast, if trustees are appointed to represent a specific group of members, there may be a tendency to only represent those members rather than all plan members. Therefore, we do not believe that it is appropriate for the proposed TBP legislation to require board representation specifically by class of members (e.g., retirees and other beneficiaries).

While we agree that the parties may want to appoint external representatives to the board, we do not believe that this should be a legislated requirement. Members (and the employer as appropriate) should be able to appoint whomever they choose to govern the plan. Employees in a non-unionized environment will need to develop a democratic structure to determine governance. The structure should not be legislated other than it should allow all beneficiaries the ability to participate in the process. We note that jointly governed non-unionized MEPPs already exist.

The proposed framework also notes that the plan sponsor can be represented on the board, but that this representation is not a requirement. A lack of plan sponsor representation on the board may be plausible as in most cases the fixed contribution requirement by the plan sponsor limits their risk and is, in fact, the sponsor's only requirement or obligation to the plan. With that being said, plan sponsor representation on the board has advantages, which include:

- The plan sponsor will bring a different perspective and views to the decision making.
- The pension plan is a benefit provided to their employees, so the plan sponsor has an interest in the plan providing a valuable benefit and being healthy.

The process for appointing members to the board should be clearly defined in the governance policy. If this process requires that each of the groups represented chooses their board members, then their voice and opinions will be represented. The different groups of members will also be able to appoint the appropriate representatives who are qualified to make such decisions on their behalf. The governance policy should also clearly specify the terms of participating on the board, such as conflict of interest rules, code of conduct, term of appointment, etc. If the board members are bound by these rules, in addition to their fiduciary obligations at law, then they must act in the best interest of the plan and all of its members.

Q: Should the Board of Trustees have powers to amend plan documents?

Q: What should be the plan member support level requirement for making substantial amendments to the plan text?

A: The Consultation Paper notes that the board would not have the power to amend the relevant plan documents and that the amending power would remain with the employer, members and retirees. We believe that this requirement would produce significant inefficiencies in the administration and governance of the plan. More importantly, as the employer's interests in and obligations to the plan will, in most cases, be limited to the requirement to make the specified contributions, it is inappropriate for the employer to have amending power over all aspects of the plan. As a result, we recommend that the board of trustees be responsible for all operations of the plan, including the power to amend plan documents. The amending power should be determined by the settlors of the trust (employer(s), union(s) etc.) and set out in the trust agreement – the settlors or the board, assuming such authority is provided in the trust agreement, may choose to establish an amending process that may or may not include member and/or employer ratification of some or all plan amendments. While we do not believe that this structure should be legislated, the legislation should clearly indicate that the board of trustees has full authority over all aspects of plan governance.

Funding Policy: Section 4.2

We believe the establishment of a robust funding policy is key to the success of any TBP framework. Our answers to the specific questions asked about this topic in Section 4.2 of the Consultation Paper are provided below. Please note that these comments apply only to future service benefits in a TBP – we address the subject of past service (i.e. pre-conversion) benefits in our comments on Section 4.8 below.

Q: Is the going concern valuation sufficient to measure and fund target benefits?

A: Yes, a going concern valuation is an appropriate method to measure and fund target benefits. A key objective in funding a TBP is funding sustainability and management of funding volatility. Solvency funding is inherently volatile. The result of a solvency-based funding regime is benefit volatility, which undermines the credibility and security of the pension system.

Q: Which approach should be adopted under the federal legislative and regulatory framework: the margin or the probability test?

A: In our opinion, while both approaches could result in the same outcome for plan members, the margin approach would be the preferred approach. While the probability approach is more sophisticated, it is also more difficult to administer and communicate effectively and may give members a sense of benefit security that is greater than what is actually provided by the target benefit approach (i.e., a 97.5% probability of no benefit reductions seems very close to a guarantee). Moreover, depending on the actuarial model used, results could vary materially from one actuary to another as there is currently no professional standard for the use of the probability approach outlined in the Consultation Paper. The margin could be determined using a probability-type test, but it would be simpler to describe the margin rather than the probability test directly. As noted in our discussion of other considerations later in our submission, there may still be a role for probability testing in relation to stress-testing.

Q: ***Is the provision for adverse deviation (PfAD) approach appropriate as a funding margin or should different margin calculation be provided for or allowed?***

A: We believe that the PfAD approach is appropriate.

Q: ***What is the appropriate time horizon for the purposes of calculating the PfAD?***

A: While we believe that a 15-20 year horizon would be appropriate, and reflective of the going concern funding priority, some plans may wish to tie the time horizon to their plans' demographic profiles. For example, the PfAD calculated could be referenced over the expected average remaining service life (EARSL) of the active membership group.

Q: ***Should going concern valuations be required on a closed group or open group basis?***

A: Going concern valuations should be prepared on a closed group basis. The open group basis could be used for other purposes, such as education, stress testing (as discussed below), etc.

Q: ***How frequently should valuations be required?***

A: While we believe that triennial valuations are sufficient, we note that valuations should also be required to confirm a mandatory benefit reduction or the use of surplus. However, this requirement should not be legislated.

Q: ***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?***

A: We do not believe that the specifics of the funding policy should be fully prescribed in legislation or regulations, and believe that it appropriate to rely on professional guidance from the CIA and other sources.

Disclosure and Communications: Section 4.7

Given the ability of TBPs to adjust benefits up or down in specific circumstances, we believe that detailed and ongoing communication is required for members and other beneficiaries. We therefore support the enhanced disclosure requirements outlined in the Consultation Paper. Members should be entitled to receive information about the factors that can influence whether their target benefits are increased or decreased. However, enhanced disclosure and communication are two different things. TBP administrators should ensure that the information required to be disclosed in the Consultation Paper is provided to members in a meaningful way – the facts and their implications must be explained in a comprehensible, easy to understand, manner.

Conversion of Pension Plans to TBPs: Section 4.8

The conversion of existing pension plans – and in particular the rules around the conversion of past service benefits (or benefits accrued at the time of conversion) – is likely to be among the most difficult and contentious aspects of implementing a TBP. The Consultation Paper acknowledges this by recognizing the need for transitional rules around the conversion process, and by recognizing the need to distinguish "converted benefits" – i.e., benefits originally accrued under a traditional DB plan but which now find themselves under a TBP structure – from future benefits accrued following the conversion. We support the Consultation Paper's proposals for:

- Treating converted benefits as base benefits, which are then subject to the overall operational structure of the TBP;
- Full funding on a going concern basis at the time of conversion;
- Measures that restrict the ability of those seeking to avoid the current wind-up funding rules by simply converting to a TBP (with an exception for the conversion of MEPPs to TBPs-see our comments below); and
- Allowing, as part of the TBP framework, conversion of defined contribution (DC) plans to a TBP structure.

We believe that any conversion should require the consent of affected plan members and retirees. However, we are aware that there are a wide variety of consent mechanisms, and believe that employer and member groups should be able to determine which mechanism works best in their particular case - subject to the approval of the Superintendent of Financial Institutions.

Individual Termination Considerations: Section 4.10

We support the Consultation Paper's proposal that the termination value determined for a member who terminates from a TBP should be calculated based on the funded ratio of the plan at the time of termination. We also note that members will always retain the option to elect a deferred pension in the event of termination.

Application to MEPPs: Section 4.12

We believe that federally-regulated negotiated cost MEPPs should be able to convert to a TBP. To a great extent, such plans would incorporate many of the proposed elements of the federal TBP framework. However, a number of elements of the Consultation Paper should be considered differently for MEPPs, as discussed below.

- *Governance Structure (Section 4.1):* The Consultation Paper suggests that a TBP may have a joint governance structure, which may involve the participation of employer(s)/sponsor(s), active members, retired members other plan beneficiaries and independent participants. We believe that the framework should not prescribe the governance structure, other than requiring that at least half of the members of the board of trustees be beneficiaries of the plan. A MEPP would be established through

a trust agreement between a union(s) and a number of unrelated employers. The plan's contributions are specified in the collective agreement(s) between the parties or in the plan document itself. Since, in the case of such a plan, there is a structure in place for negotiations between the parties, there is a process by which the parties can make an informed agreement on the appropriate structure of the board. This could include employer trustees, but should not be a requirement. We note that there are a number of successful MEPPs that have no employer representation on the board of trustees.
The Consultation Paper includes the suggestion that the board would not have the power to amend documents such as the plan text, benefits policy, funding policy, etc. The TBP would be a legally separate entity. The board of trustees acts as plan administrator and as such has full authority to manage all aspects of the plan, with the exception to setting employer and employee contribution rates. Since plan members bear the risks of the plan, some plans require plan member consent of certain benefits, but this structure should be determined through the trust agreement and should not be legislated. It should be recognized that a requirement for all required amendments of the specified documents to be ratified by the membership, with the related communications and logistics, could be impractical and costly for a plan, especially if the amendment was administrative or "housekeeping" in nature. The proposal seems to be based on there being a board of trustees which is separate from a "plan sponsor". In the case of a MEPP, there is typically no plan sponsor as distinct from the board – so the requirement that the board refer any changes in documents to a plan sponsor is not appropriate or possible.

- *Funding Policy (Section 4.2) and Benefit Structure (section 4.4):* The application of TBP regulations to MEPPs should recognize that many such plans do not necessarily have significant "ancillary benefits" – they typically have no indexation provisions or bridging benefits. Subsidized early retirement may exist, but it is doubtful that plan members would consider them "ancillary" to any "base" benefits. Therefore, the categorization of benefits into "base benefits" and "ancillary benefits", and the application of distinct funding policy to each class, may not be obvious or appropriate for these plans. We suggest that, if the final TBP framework requires a categorization of benefits into "base benefits" and "ancillary benefits", with the application of distinct funding policy to each class, the regulations would need to permit some way of allocating monthly accrued benefits into "base" and "ancillary" amounts, in situations where the MEPP provides minimal ancillary benefits. However, we believe it is preferable for such plans not be required to categorize benefits into "base benefits" and "ancillary benefits". In a related matter, and further to our general comments on funding policy above, we believe it is preferable for such plans to be subject to a funding requirement under the TBP framework that applies a PfAD to the going concern funding of the entire benefit, as this is more practical and more transparent to the plans' members.

- *Conversion of Pension Plans to TBPs (Section 4.8):* The Consultation Paper includes the requirement that plans to be converted must be fully funded on a going concern basis upon conversion and that any going concern deficit would be required to be made up by the employer at the time of conversion. Negotiated cost MEPPs would not have the ability to unilaterally require the employers to make additional contributions to make up for any going concern deficit at conversion. Should this be a requirement, the effect on MEPPs could be a reduction in benefits – possibly followed in the shortterm by a reinstatement of benefits. We do not believe that a change in registration status should trigger benefit reductions.

We suggest that such plans be permitted to convert if they can demonstrate that there is a sufficient contribution margin (excess of expected contributions over cost of benefits being earned plus any provision for ongoing expenses) to make up the going concern deficit over a prescribed period.

The Consultation Paper also states that temporary solvency contributions by the employer would be required to facilitate the conversion requirements, which ensures solvency funding is maintained for a certain number of years following conversion. Since negotiated cost MEPPs would not have the ability to unilaterally require the employers to make temporarily increased contributions in this manner, they would not be able to comply with this requirement. Since the current legislation permits benefit reductions for MEPPs and that the effect of imposing solvency funding is typically a reduction in benefits when a shortfall exists, we suggest that plan members consent be required to convert their plan to a TBP.

Other Considerations

In addition to the issues discussed in our preceding comments, we believe there are two issues that, while not specifically addressed in the Consultation Paper that should be examined when discussing the content and adoption of a federal TBP framework.

1. Size Matters

The question of whether a pension plan should have a minimum number of active members and/or a minimum ratio of active members to retired members in order to qualify to adopt the TBP structure is one that should be – but is generally not – examined when discussing a move to TBPs.

A key reason for a plan sponsor to move to a TBP (from a traditional DB plan) is to shift all pension risks, including investment and demographic risks, to plan members. A key reason that plan members may accept such a move, where the alternative is to move to a DC arrangement, is that such risks can be “pooled” rather than being borne individually. In order to assume these risks, a TBP must have a minimum number of plan participants over which to spread these significant risks. There has been much discussion on the merits of large asset pools being more efficient than smaller pools in relation to registered pension plans (RPPs) generally – these concepts apply equally to a TBP.

Despite this fact, there is little discussion of the impact of demographic risks on pension plans. Currently, only mortality risk is being discussed in light of recent reports on increasing life expectancy. While more important, the risk that plan demographics may change and the cost implications of these changes on RPPs is not discussed at all. Consider a situation where a workplace with a small membership (however small is defined) suffers a significant downsizing. As downsizings typically affect younger workers, the remaining workforce will likely contain a large percentage of older workers. In this situation, as a result of the demographic composition of the reduced workforce, pension costs will increase as contributions will be invested for a shorter period of time, generating less investment income.

Similarly, it is more difficult for a pension plan that has a relatively large proportion of liabilities in respect of retired members to absorb experience losses. This is due to the fact that generally the only corrective action available is some combination of reduced future accruals (borne only by active members and not retirees), an increase in contributions (again borne only by active members and not retirees) and/or a reduction in accrued benefits (which may be borne by all members, but is exceptionally difficult on members, especially retired members). Where the proportion of inactive members' liabilities is relatively small (e.g., less than one-third of total plan liabilities), imposing corrective action solely on active members is not nearly as onerous.

We suggest that the government establish guidelines regarding the recommended minimum size component before a pension plan can adopt a TBP structure. Plans that fall outside these guidelines could still adopt a target benefit structure by combining with other small plans or joining an existing group.

2. STRESS TESTING

As discussed in our comments on Section 4.2 of the Consultation Paper below, we believe that the use of a margin funding approach is preferable to the use of a probability test. However, we note that probability testing could still have application to the proposed TBP framework.

As was suggested by Alberta Treasury Board and Finance in its 2013 Position Paper on *Target Benefit Funding Rules* (Position Paper), we believe that federal TBPs should perform deterministic stress testing. This testing would require the plan's actuary to identify the risk characteristics that are most applicable to the pension plan. The Position Paper recommended that regulations be established giving the actuaries leeway to identify any relevant stresses, and to determine the magnitude of the stress testing, subject to any conditions that may be imposed by the regulator. Some examples of stress testing include:

- Variances in employment levels/contributions;
- Cash flow analysis from (a) new contributions and (b) internally generated from invested assets; and
- Decline in the value of the equity component of plan assets.

If stress testing is included in the federal TBP framework, we believe the results should not impact the funding requirements of the plan. Instead, as outlined in the Position Paper, the results of the stress testing should be used to educate the plan's trustees on the key risks facing the plan. Stress testing provides another means by which the board can understand the nature and magnitude of the risk factors in their plans and can provide relevant input to the review of any action required by a plan's funding policy.

We thank you again for the opportunity to provide our comments on the Consultation Paper. Should you have any questions on the topics discussed above, or wish to discuss any other aspect of the Consultation Paper, please feel free to contact Cameron Hunter (416-696-3020; chunter@eckler.ca).

Sincerely,

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