Scott Clausen
161 Bay Street, PO Box 501
Toronto, Ontario M5J 2S5
+1 416 868 7658
Fax +1 416 868 7555
www.mercer.ca

Department of Finance Canada
Ottawa, Ontario

20 June 2014

Subject: Consultation on Target Benefit Pension Plans

Dear Sir/Madam,

We write in response to the consultation paper "Pension Innovation for Canadians: The Target Benefit Pension Plan" (the Paper). The Paper sets out proposed rules that would apply for pension plans subject to the federal *Pension Benefits Standards Act, 1985* (PBSA). Although the consultation is about making target benefit plan (TBP) design available to private sector and Crown corporation pension plans governed by the PBSA, the consultation provides a timely opportunity to consider the principles that could form the basis for similar policy across the country.

The attached document reflects our professional experience working with a wide variety of pension plans registered under the PBSA as well as pension plans registered in other jurisdictions throughout the country. Target benefit plans provide a promising option to help support sustainable pension coverage in the future. We appreciate the opportunity to provide our input in this process.

We would be pleased to meet with you to discuss our submission.

Sincerely,

(*Original signed by*)
Scott Clausen
Partner

(*Original signed by*)
Leigh Ann Bastien
Partner

Enclosure

c:\users\scott-clausen\documents\target\federal tbp consultation.docx

MERCER

Response to the Department of Finance Canada on the Consultation Paper

Pension Innovation for Canadians: The Target Benefit Pension Plan

June 20, 2014

We write in response to the consultation paper "Pension Innovation for Canadians: The Target Benefit Pension Plan" (the Paper). The Paper sets out proposed rules that would apply for pension plans subject to the federal *Pension Benefits Standards Act, 1985* (PBSA). Although the consultation is about making target benefit plan (TBP) design available to private sector and Crown corporation pension plans governed by the PBSA, the consultation provides a timely opportunity to consider the principles that could form the basis for similar policy across the country.

Overview

There are good reasons why there is growing interest in TBP design. Governments are interested in strengthening retirement income security by providing a viable framework in which more employers will provide pension plans to their employees. The TBP is a promising alternative for supporting pension coverage.

Traditional defined benefit (DB) and traditional defined contribution (DC) plans allocate risk very differently. Employers bear most of the risk in DB plans while employees individually bear the risk in DC plans. Both employers and employees need another option. TBPs can provide greater financial stability than a traditional DB plan for an employer while maintaining some of the economic advantages of a traditional DB plan that benefit employees such as low cost professionally managed investments and, perhaps most importantly, the pooling of longevity risk.

A TBP can be described as a modified DB plan, or as a collective DC plan. Unlike traditional DC plans TBPs provide lifetime retirement benefits to plan members. However, unlike a traditional DB plan that pays a fixed annual pension, the annual pension under a TBP can increase or decrease based on the funded status of the pension plan.

Pension policy makers should take a long-term view and ensure that the legislative framework for TBPs supports and facilitates TBPs that are sustainable, feasible and attractive to employers and employees. In doing so policy makers should examine some of the assumptions about TBPs and test the boundaries.

For example governance is an area that needs fresh thinking “outside the box”. The skills needed to manage risk in a TBP are specialized. The most important principle in governance should be to ensure that those skills are used. The structure within which this is achieved could vary.

In thinking about TBP governance it is useful to delineate two important roles: sponsorship and administration. The TBP design is established at the sponsorship level as the “blueprint” within which the administrator must work. All of the fundamental elements of the design should be in the blueprint, including governance, benefit/contribution levels and the financial triggers that require the administrator to make adjustments. The power to amend the TBP would remain with the sponsor and it is important that the TBP have a stable design with minimal changes over time. The administrator is a fiduciary responsible for investment, benefit administration and member communications – to implement the blueprint. The responsibility for actuarial valuations would rest with the administrator. The Paper proposes that there be these two levels, but suggests that at both levels stakeholder representation would be required.

We believe that TBP design options that do not have joint governance should be considered. For example single employer or multi-employer TBPs with an independent professional administrator should be possible. If the TBP design mandates paired measures to respond to surpluses or deficits that apply to both active and inactive members, this also achieves the balance and fairness that joint governance is meant to provide.

The other key area for open thinking is the TBP design itself, including the extent to which elements of the design should be prescribed. The Paper does an excellent job of setting up this debate. Plans in which active members and pensioners share the risk and reward of plan experience have two primary and competing objectives: intergenerational equity and benefit/contribution stability. A high level of intergenerational equity can be achieved by constantly adjusting benefits and contributions. Stable benefits and contributions can be achieved by setting contribution levels far in excess of expected cost, but the current generation subsidizes the next generation, or vice versa. Each TBP needs to have the appropriate balance between these competing objectives but there is no single right answer for all plans.

There is a lot of discussion about converting past service DB entitlements to TBP design, and this option should be available. However, we think the more prevalent outcome, for DB plans that change, is that existing DB would not be converted.

Finally, an examination of the tax treatment of TBPs is needed. The current pension adjustment (PA) rules for DB plans are designed to deal with final average earnings benefits with full ancillaries in plans where all benefits are guaranteed. TBPs are very different from this profile. TBPs are also different from DC plans, and the current DC PA rules may not be well suited to plans that are actuarially funded.

Below we summarize our understanding of the proposals in the Paper and provide our comments.

Administration and Governance

The Proposal

The Paper proposes a joint governance structure with participation by the employer/sponsor, employees, pensioners and other beneficiaries. The administrator would be a Board of Trustees or similar body made up of representatives from, or selected by, each constituency, with level of representation and voting rights negotiated at the outset. Decision-making rules would need to ensure that no party has disproportionate power. Independent representatives could also be selected.

The role of the administrator would be to administer the plan and make decisions in accordance with the plan documents. It would not have the power to amend the plan. The power to amend would remain with the employer, employees and pensioners. Employers would not be allowed to unilaterally amend the plan provisions. Delegation by the administrator, including delegation to the employer, would be permitted.

A governance policy would be required which would be part of the plan documents. It would set out all of the above as well as matters such as the appointment process, the voting process, conflict of interest rules, skill sets required from a certain number of appointees and remuneration and expense policy.

The regulator would have the power to remove an unfit administrator. Current PBSA provisions would protect the administrator from liability when relying on specific types of documents prepared by certain professionals.

Comment

Representation on the administrative body should mean that each constituent group may appoint the person(s) of their choice, without requiring that they choose from among themselves. A union could appoint employees or independent persons on behalf of its members. The number and proportion of representation should not be regulated. This would be determined at the sponsor level as a feature of the plan design. As fiduciaries the selected individuals owe loyalty to all current and future plan members, not only to the group who appointed them. As suggested in the Paper, the administrative fiduciary role should be clearly separated from the sponsorship role.

Governance models that do not have joint governance at the administrator level should be explored. A fundamental principle in governance is that the interests of the party or parties at risk must be protected. Where there are conflicting interests, one way to achieve balance is to have representation in decision-making. Another way is to have a completely independent fiduciary charged with a duty of care for all. In both approaches, it is important to ensure that appropriate knowledge and expertise is used. In a representative structure, this can be achieved through appointment of experts and delegation. In the independent administrator model, a form of licencing and regulatory supervision could be used to hold the administrator to enforceable standards.

Plan member interest in joint governance might be very low. If we view TBP as a collective DC plan, we can observe that individual plan members might prefer the collective investment and pooled mortality risk over traditional DC, and to rely on a fiduciary standard of care for those responsible for managing these risks. The retiring plan member might prefer to have a lifetime pension subject to some fluctuation, and continued professional management of the investments, over managing capital, income and longevity risk on their own. Where plan members do not have a role in governance it might be appropriate to balance this by providing the option at retirement for them to transfer their investment to another vehicle.

The sponsor(s) of the TBP would appoint the administrator, and there should be regulatory supervision, as proposed in the Paper, where the regulator has the same powers over an administrator that it has for other pension plans. It is important to note for purposes of the governance discussion that the TBP design itself should mandate paired measures that apply to both active and inactive members to respond to surpluses and deficits - establishing a balanced allocation of risk, and preventing this decision from being made by the fiduciary administrator.

The traditional standard of care for a pension plan fiduciary is to act in the best interests of members. For a TBP, it would be better to state the obligation of the TBP fiduciary in terms of the purposes of the plan, or in terms of the best interests of current and future members.

At the sponsor level it should not be necessary for the pension standards legislation to regulate whether employers and employees negotiate a newly established TBP or a TBP for future service. This has never been necessary for establishing a DB plan or a DC plan and should not be a requirement for establishing a TBP. Some TBPs could be jointly sponsored, and this would be a common approach where a union represents plan members. Others could be sponsored by the employer. The TBP blueprint should clearly say who the sponsor is, and what powers it has. We agree that the sponsor, whether a joint sponsor or the employer, should have the amending power. Where there is a union, the union would act on behalf of its members for purposes of plan amendments. The issue is different if existing DB benefits are to be converted and on this, please see our comments below on conversion.

We agree that the sponsor(s) should create the governance structure and policy. Among the items on the list of governance policy contents in the Paper, the administrator's voting rules and conflict of interest process could instead be allocated to the administrator.

Protection from liability is important, and we agree that TBP administrators should have the benefit of the existing PBSA protection when relying in good faith on certain professionally prepared documents. There remains an issue for TBPs and other plans whose fiduciary body is made up of individuals who are not indemnified by their employer. Liability insurance is needed but is very difficult to obtain.

Funding Policy

The Proposal

A TBP would not be subject to solvency funding requirements. The funding test would be based on a going concern valuation enhanced either by a provision for adverse deviation (PfAD) or a probability measure. The level of a PfAD would be based on plan-specific metrics such as the asset allocation and degree of plan maturity. The probability measure would set a percentage probability threshold, such as 90% for base benefits and 75% for ancillary benefits, that the benefit would not be reduced.

Periodic valuations would include the results of stress testing. Solvency valuations would be performed for disclosure purposes.

A funding policy must be established and filed with the regulator.

The Paper seeks input on valuation frequency and the appropriate time horizon for the funding test.

Comment

We agree that a going concern valuation should be used to measure and fund target benefits.

We favour the PfAD approach for determining a funding margin. We believe that stochastic testing and probability measures would be a best practice for risk management and would be done routinely in the larger plans. While a probability measure could be used as a minimum standard, it would take greater regulatory resources to monitor it. However, consideration should be given to allowing very large TBPs to use probability measures supported by stochastic testing in place of the PfAD measure.

As proposed in the Paper, the level of PfAD should be determined for each plan based on asset mix and maturity. The regulations should set an objective for the proper level of security, for example having a percentage probability of maintaining full funding for base and ancillary benefits over a given period of time, and then prescribe a formula that determines the level of PfAD that satisfies this objective. Development of the formula that will determine a plan's PfAD should be done with CIA input but the regulation should not incorporate CIA documents or positions by reference. Any link between asset mix and PfAD should consider whether a plan has adopted an investment strategy that uses alternative investments, such as interest rate overlays to reduce interest rate risk while maintaining exposure to equity markets.

For purposes of the going concern valuation, we support a 15 year open group projection that assumes a stable population unless it is known that it will not be stable. The projection from the valuation date should determine whether contributions would be sufficient so that in 15 years the plan is expected to be fully funded including the PfAD.

Annual funding valuations for TBPs would be appropriate.

We agree that solvency funding requirements should not apply to a TBP. It is important to disclose what would happen if a TBP were terminated at a given point in time. However, a solvency valuation is probably not the most suitable approach for that disclosure. The disclosure of a funded status using traditional solvency valuation assumptions would provide information that does not reflect how benefits would be settled if the TBP were terminated. If a TBP were terminated it would not settle benefits in the same manner as a traditional DB plan as the benefits are not guaranteed. Lump sum payments would not be calculated using the CIA transfer value basis and annuities would not be purchased from an insurance company with a pre-defined amount. We believe that it is important for a TBP to disclose information to plan members about what would happen if the TBP were to wind up and regulations should require this disclosure but we suggest that individual plans should be responsible for determining the best way to disclose this information based on how benefits would be settled in the particular TBP.

Contributions

The Proposal

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, and if the plan has fixed employer contributions and variable member contributions, a member contribution increase must be the first step in response to a funding shortfall.

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.

Comment

We agree that there should be a high degree of design flexibility as suggested by the Paper, and with the principle that in a TBP employer and member contributions must have a cap. It also makes sense to prevent contribution decreases when the plan is not fully funded. The contribution level, scope of variability (if any) and order of priorities should all be for the sponsor(s) to decide in establishing the plan design. We agree that these features must be part of the plan terms. The administrator's duty would be to ascertain, via actuarial valuation, whether the triggers for action exist. Legislation should not require member contribution increases as the first step in response to a funding shortfall unless the range for member contributions is narrow, otherwise this action could result in inequities between active and inactive members.

A TBP should be exempt from the 50% cost sharing rule, as the ratio of member and employer contributions is determined by the plan design. Any proportion of employee to employer contributions should be permitted, with employee contributions being lower than, equal to or higher than employer contributions. The Income Tax Act rule that restricts employee contributions to a 50-50 share should not apply.

We note that the 9% limit on member contributions imposed by the Income Tax Act is too low for TBPs and other cost-shared plans in which members may be required to contribute according to actuarial results.

With respect to solvency funding on conversion of past service DB to TBP, we disagree that solvency special payments by the employer should be required for a period of time following conversion. The right thing for all DB plans is to move away from solvency to an enhanced going concern funding requirement. The legacy DB should be funded on this basis.

Benefit Structure

The Proposal

A TBP would 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.

Comment

We agree that a base and ancillary benefit structure is needed. It is important for plan members to have a base benefit that has a significant degree of reliability, while ancillary benefits are adjusted first to respond to the plan's funded status. We support allowing plans to establish their own set of measures and priorities, but we believe that it would be appropriate to require a plan to provide for restoration of benefits in reverse order following the sequence in which they were reduced, and to pull back on enhancements in reverse order following the sequence in which they were granted.

Deficit Recovery

The Proposal

A deficit recovery plan must be established. This sets the trigger and timeline for implementing adjustments, describes all response measures and order of priority, sets the minimum funding or margin to be maintained, and provides 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.

Under a PfAD approach, recovery measures would be required as soon as the PfAD is completely depleted, but plans should set a higher standard to maintain the PfAD.

A one-year maximum time period for response is suggested.

Comment

It should be clear that the deficit recovery plan is part of the plan terms and cannot be changed by the plan administrator.

The minimum level of funding that requires action, and the maximum time frame for action, should be prescribed. Corrective measures should be required if the projected contributions over the next 15 years are insufficient to reach full funding including the PfAD. The prescribed maximum time period for initiating recovery measures should be one year from the valuation date as it is not practical to initiate recovery measures retroactively to the valuation date. If contribution increases are required, it should be possible for the increase to be phased-in by allowing the rate of contributions to increase in steps over a period of up to three years.

We agree that the measures would be implemented by the administrator without any sponsor involvement, and that plans could be designed with a more rigorous approach. However the administrator should not be able to deviate from the approach stated in the plan terms.

Surplus Utilization

The Proposal

A surplus utilization plan must be established. This sets the trigger and timeline for implementing adjustments, describes all response measures and order of priority, sets the minimum funding or margin to be maintained, and provides 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.

Surplus would be defined as assets in excess of 100% of the going concern ratio including the PfAD, plus a supplemental margin, such as 5%. Plans could set a higher threshold. Surplus must be used when the threshold is reached.

A cap on surplus utilization would have to be set by the plan terms, such as a percentage of the surplus amount. Plan terms would also set a time frame for implementation.

Entitlement to use surplus while the plan is ongoing would not be prescribed and would be determined by the plan terms.

Comment

We agree with these proposals. It is important, for stability, to have a range within which the funded status is good and where the plan administrator does not have to implement any measures.

We note that the current Income Tax Act rule requires a contribution holiday when a surplus is 25% of liabilities. AllowingTBPs to accumulate greater surpluses than this without reducing contributions should be considered.

Investments

The Paper does not address investments expressly except to mention the role of asset allocation in the determination of the PfAD and to say that an investment policy would be among the required filings for a TBP. The plan administrator should be responsible for investments in a TBP and not the sponsor(s). Our view is that the current rules requiring the administrator to invest according to fiduciary standards should continue to apply. The regulator would have oversight to watch for excessive investment risk.

Disclosure and Communications

The Proposal

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.

Comment

We agree with these proposals.

Converting Existing Plans

The Proposal

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 current 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) would be represented in the process.

Comment

The first and foremost concern about conversion of existing DB plans to TBP is that reducing benefits that are already accrued and guaranteed by the employer and by legislation, or placing them at risk of reduction, is certainly not a good thing. Our current laws on employer insolvency and bankruptcy, including the deemed trust rules of the PBSA, address the scope and process for benefit reduction as a last resort. We have great concern about legislative proposals that would take away existing rights. Having said that; within the context of a distressed pension plan workout scheme or insolvency proceedings and with appropriate process and legal representation for members, conversion to TBP from DB for all liabilities could be the right solution in some cases.

Outside of that context, we agree that conversion of legacy DB should be subject to employee and retiree consent.

For active employees there might be some scope for revising the pension deal within the employment contract or collective agreement, depending on the degree of proposed change. A consent mechanism such as obtaining a large majority of positive consent (majority consent), receiving less than 30% (or lesser percentage) objection (negative consent), or having the union consent if the union wishes to take this responsibility, could be considered. If a departure from individual consent is considered, there should at a minimum be very clear rules and legal representation for the employees (through the union if applicable).

For inactive plan members, who have no employment bargaining power and whose reliance on the guaranteed income is more immediate, mechanisms such as negative consent and majority consent used in lieu of individual consent need to be considered even more carefully. The process should be clear and open, with legal representation for the inactive plan members.

If thresholds for inactive member majority consent or negative consent are set at a high enough level then it would be feasible for objectors to stop a conversion that is a "bad deal". Therefore there would be an incentive for an employer/sponsor who wants to convert to offer a "good deal" that is likely to be accepted. On the other hand, if the thresholds are met, a conversion could proceed despite express objection from some individuals. It would be difficult to convince those individuals that the process was fair.

If individual consent were required for conversion of inactive members' benefits to TBP there would also be a strong incentive for the employer/sponsor to offer a good deal. However, the possibility of obtaining 100% consent is low to non-existent, no matter how attractive the offer might be.

In both approaches a mechanism for excluding those who do not consent or who object, as applicable, should be available. This could include the ability to purchase annuities for those members, with a full discharge for the plan. Consideration should be given to allowing the conversion of inflation based indexation to fixed rate indexation to facilitate the purchase of annuities for indexed plans.

For plans that convert from DB to future service TBP, it would be very complicated for the plan and for the regulator to manage them together. It would be more straightforward if the TBP is established in a separate vehicle, while the employer continues to sponsor the legacy DB plan.

The regulator should not require the legacy DB plan to be wound up only because it has no active members.

We agree that conversion of DC to TBP should also be available, subject to individual member consent.

We do not agree that if DB legacy liabilities are converted, solvency special payments should be required after conversion. The proposal to require additional funding from the employer if the TBP is terminated with a deficit within five years is appropriate. We have some concern that if the deficit is measured at the date of plan termination, the employer is being asked to back stop the investment risk that it might no longer control after the conversion date. The alternative is to require the employer to fund the lesser of the deficit that existed at the conversion date and the deficit at the plan termination date.

Portability

The Proposal

Plan members who terminate employment 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. Plans could offer portability for members who are within 10 years from pensionable age.

Comment

We agree that providing portability options should be mandatory for members more than 10 years from pensionable age. Whether to offer portability (including an option to purchase an annuity) to members at retirement age is a very important issue for TBPs. Arguments for requiring the option to be offered suggest that the individual should have the option to convert the entitlement into guaranteed income, to avoid the benefit risk of the TBP. This might be especially important if the retiree is dissatisfied with plan governance or does not have the opportunity to participate in joint governance. Arguments for not requiring the option suggest that the TBP needs to retain its retirees for stability and consistency over time. In our view the right approach would be plan specific.

Individual Termination Value

The Proposal

The transfer value ("termination value") offered for portability 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%. A decision to include buffer margins in the termination value would be determined by the plan text.

Comment

We agree with the principle that the termination value should reflect the conditional nature of the benefit. It should be determined on a going concern basis consistent with the plan's funding valuation, recognizing the funded ratio of the plan. We agree that including buffer margins in the termination value should be a matter of plan design for sharing rewards and not a prescribed requirement. A plan should also be able to determine whether plan surplus is included in the termination value. For example, where surplus is not included the termination value could be capped at 100% of the target benefit including base and ancillary benefits.

Plan Termination and Wind up

The Proposal

Benefits on plan termination would be determined in accordance with the plan's funded status, with no requirement for further funding (except as proposed above for recently converted plans). All plan members, including retirees, would be entitled to the commuted value of their benefits as they exist at the time of wind up. The actual benefit available would be adjusted by the plan's funded ratio. Accordingly the commuted value could be reduced, or if there is surplus, the surplus would be distributed to the members and retirees.

OSFI would have the power to terminate a TBP if employer contributions stop, if the employer discontinues business affecting all or a substantial portion of employed plan members, if benefit credits cease or if OSFI believes the plan no longer meets going concern funding standards. The plan administrator or the employer could terminate the plan.

A plan termination within five years following conversion from DB would be subject to the funding rules for DB plan terminations, to address the risk that employers will seek conversion so as to terminate the plan without funding them. The conversion would be considered void if the sponsor terminates the plan, and could be voided by OSFI if OSFI terminates the plan.

Comment

We agree that benefit entitlements should be determined as lump sum values that reflect available assets, with no further funding required. It is important to ensure that pensioners have an option to purchase an annuity with the amount of their entitlement (subject to tax rules that would exclude use of surplus for this purpose). It might also be useful for the rules to permit a group annuity purchase.

It makes sense for OSFI to have power to terminate the plan on the basis proposed, similar to the power to terminate other types of pension plan. It should be necessary for the plan terms, as determined by the sponsor(s) to specify whether the sponsor(s), employer or administrator has the power to terminate the plan.

We agree with the proposal to require additional employer funding if a TBP is terminated with a deficit within five years after conversion from DB.

Multi-employer Pension Plans

The Proposal

Input is sought about the extent to which the TBP proposals could apply to multi-employer pension plans (MEPPs).

Comment

In theory all of the proposals could apply to MEPPs that can reduce benefits based on the funded status of the plan. However, some established MEPPs might not be able to renegotiate or amend the plan terms, so grandfathering might be necessary on some matters. The proposals for reporting and disclosure should apply to MEPPs.

Small to mid-sized employers might be attracted to TBP design if it is available in a multi-employer format. TBPs need large scale in order to work as intended.