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Pensions Division
Financial and Consumer Affairs Authority
Suite 601, 1919 Saskatchewan Drive
Regina, Saskatchewan
S4P 4H2

29 July 2016

Subject: **Consultation Paper - Proposed Regime for Negotiated Cost Pension Plans**

Dear Madam/Sir,

We are pleased to provide our response to the above-noted consultation paper (Paper). While the Paper is about negotiated cost pension plans (NCPPs) the Paper asks for comment on the appropriateness of the funding framework for other categories of plans. In our view, the funding framework should be applicable to all target benefit plans (TBPs), not just NCPPs, and to other types of shared risk plans[1]. There is little reason to distinguish between union and non-union, public and private, and between multi-employer and single employer, TBPs. We urge the government to form its policies to encourage this plan type in many forms.

The appendix to this letter summarizes ten principles for TBPs that we believe should be realized in any new legislation.

In 2014, we responded to the federal Department of Finance consultation on TBPs. The overview comments that we made in that 2014 submission are also relevant for Saskatchewan's developing policy on TBPs. They are reproduced below.

> "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

[1] See Principle # 3 in the appendix to this letter.

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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(s) 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 [federal] 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 [federal] 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."

We strongly agree with the principle stated in the Paper that the regime for NCPPs (and TBPs) should be flexible, allowing decisions to be made that are appropriate for the individual characteristics and needs of the plan. The contribution level, scope of contribution variability (if any) and order of priorities for changes in benefit levels should all be for the sponsor(s) to decide in establishing the plan design. These features should be part of the broader plan terms[2]. Except where the sponsor(s) choose to delegate design decisions to the administrator, the administrator's only duty would be to ascertain, via actuarial analysis, whether the triggers for action exist. Legislation should not dictate the steps to be taken in response to a funding shortfall, but the broader plan terms should be required to be complete and clear on measures and their triggers for shortfall and for surplus.

Our comments in response to the specific questions in the Paper are set out below. As requested in question 1, we are discussing additional concerns or considerations within our responses.

Part 1. Introduction & Background

2. *Do you agree with the principles?*

   We generally agree with the four principles that are put forward in the Paper but believe that "benefit security" principle would be better replaced with "benefit/contribution stability" principle. Given the very nature of a NCPP, a "reasonable level" of benefit security cannot really be guaranteed. A better objective would be the stability of benefits / contributions. We would suggest a fifth principle: "strong governance and risk management". A robust and fiduciary oriented governance and risk management structure which clearly articulates the roles and responsibilities of the various stakeholders has the highest likelihood of generating positive results for the plan and its members.

[2] Broader plan terms include the plan text & amendments, trust agreements and policies (investment, funding & benefit, risk management, communication, etc.)

Part 2. Funding

3. Do you agree with the proposed funding requirements, including the method of calculating the PfAD?

Funding Requirements

We generally agree with the minimum funding requirements set out in the Paper. Contributions should cover the current service cost (CSC), including a PfAD, and the unfunded liability special payments, if any.

The PfAD calculated on the going-concern liabilities should not be required to be funded but should rather be used to restrict the ability for the benefit improvements when plan assets are less than the liabilities plus the PfAD.

Not requiring that the PfAD on the CSC to be funded in the first actuarial valuation report following the adoption of the proposed Funding Regime is a reasonable compromise to give time to existing plans to adjust benefit levels.

In the event an actuarial valuation shows that contributions are greater than the CSC but do not fully cover the PfAD on the CSC, we would suggest that it should not trigger an immediate reduction in future service benefits or increase in contributions. Often, such a situation may be due to a short-term event, like the Brexit, which may depress future investment return expectations for a short period. Instead, we would recommend that action be required only if the contributions in two successive valuations do not cover the PfAD. If a valuation shows that contributions are less than the CSC, then immediate action should be taken by the plan sponsor/ administrator.

It should be made clear that the CSC and the going concern liabilities are to be valued based on best estimate actuarial assumptions.

We also support an amortization period of 15 years for unfunded liabilities as proposed. The plan administrator should always have the ability to amortize the deficit over a shorter period based on the plan’s documented funding & benefit policy.

Increases in special payments should be deferred for one year with the option to phase in contributions over a period of up to three years, with special payments still required to be made over 15 years. This deferral and phase-in recognizes administrative practicalities where employee and employer contributions can vary based on the results of a new funding valuation.

The solvency position of a plan should be measured but the solvency deficiency, if any, not funded. Hypothetical solvency special payments should not have to be calculated and disclosed in the actuarial valuation report.

There should be no regulatory limits placed on member or employer contributions, including rules for proportionality, other than limits that exist under the Income Tax Act. The split of employee and employer contributions should be left up to design of the plan in the same way that the split of employee and employer contributions under DC plans do not include regulatory limits.

Given the nature of NCPPs, we agree with the proposed prohibition on the withdrawal of the Accessible Going Concern Excess (AGCE) and the use of the AGCE for CSC contribution holidays. However, legislation should allow broader plan terms to permit contribution levels to vary within a certain range, depending on the financial health of the plans, as long as that provision is known to and accepted by participating employers and members.

Calculation of PfAD

The proposed Funding Regime mirrors Alberta's approach for Collectively Bargained Multi-Employer Plans for the calculation of the PfAD. It is based on the level of equity allocation[3] in the plan's asset mix, with an increase if the going concern discount rate assumed by the actuary exceeds a benchmark. While this approach has the merit of being simple, it does not reflect another significant risk to which a plan is subject, the duration mismatch between the fixed-income portion of the assets and the plan liabilities (also known as the "interest risk"). The interest risk can exist even for a fully funded plan with 100% assets invested in fixed income when the duration of the fixed-income portfolio differs from the duration of the liabilities. The interest risk is amplified when a portion of the assets are allocated to equities or when the plan is not fully funded. In those circumstances, the interest risk can be fully hedged by using overlay (derivatives) strategies.

The Quebec government recently adopted new funding rules for single employer DB plans under which solvency funding was replaced by an enhanced going concern funding approach with a required PfAD. The calculation of the PfAD under the Quebec rules is based on both the target allocation in "variable yield" investments (i.e. not fixed-income investments) and the extent of asset/liability duration matching.[4] We believe this more sophisticated approach in the calculation of the PfAD should be used for NCPPs in Saskatchewan as it would encourage

[3] Under the Alberta approach, alternatives are not considered to be part of the equity allocation

[4] Under the Quebec approach, up to 50% of real-estate and infrastructure investments can be considered as "fixed-income

plan administrators to manage both the return risk from variable yield investments and the interest risk in their plans. In our opinion, that approach would make the calculation of the benchmark discount rate unnecessary.

Of course, an individual plan's funding & benefit policy could establish a higher PfAD level to reflect the plan's objectives related to balancing intergenerational equity and benefit/contribution stability, in light of the plan's benefit structure and projected growth. With the exception of a minimum PfAD, minimum funding requirements should recognize that different plans may be designed to meet different levels of benefit risk. Some plans may adopt minimal margins focusing on intergenerational equity with more frequent increases and decreases to benefit levels while other plans may adopt larger PfAD provisions focusing on contribution/benefit stability.

While we favour the PfAD approach for determining a funding margin, we also believe that large plans should have the ability to use probability measures supported by stochastic testing in place of the PfAD approach.

Annual funding valuations would be appropriate for disclosure purposes. However for plans that are in a healthy surplus position, 3-year valuation cycles should be allowed for regulatory filing purposes.

4. *Should the rules be more prescriptive regarding the funding policy for an NCPP (e.g. require that such plans have a funding policy; set-out the minimum contents of a funding policy?)*

NCPPs and other TBPs should be required to have a funding & benefit policy. The funding & benefit policy should be set out in the broader plan terms. The funding & benefit policy design should remain relatively stable. However, it should be reviewed at regular intervals to determine if fine tuning is required.

We do not think that there should be minimum content rules for the funding & benefit policy. The funding & benefit policy should not have to be filed with the regulators.

5. *Is stress testing an appropriate way to understand the risks of an NCPP?*

Stress testing can be a useful risk management tool. Stress testing should focus on factors that can materially impact the funded status/benefit levels of the plan. These factors may vary by plan, as recognized in the Paper.

As proposed, stress testing should be performed in conjunction with each filed valuation. We agree that the stress testing should not impact the minimum funding requirements.

While stochastic testing and probability measures would be a best practice for risk management and would be done routinely in the larger plans, deterministic stress tests should be the norm if the regulations require stress testing.

Regulatory actions should be limited to ensuring that stress testing is done and integrated in the plan administrator decision processes. It is unclear to us how the regulator will challenge the appropriateness of the actuarial assumptions based on the stress testing results. Actuarial assumptions used to calculate the going concern liability and CSC must reflect the actuary's best estimate. Stress testing results will inform the actuary and plan administrator on the implications of experience diverging from best estimate. A more likely action resulting from stress testing results will be to increase the PfAD beyond the minimum regulatory level.

Part 3. Benefit Improvements & Benefit Reductions

6. *Do you agree that an NCPP should have AGCE in order to improve benefits?*

   We agree that an NCPP or other TBP should have a defined threshold at which benefit improvements become possible. The AGCE is a reasonable threshold as a regulatory minimum, unless the plan actuary can certify that future contributions will cover the cost of the improvements.

7. *Do you feel that there should be rules in the Regulations regarding the order of benefits to be reduced to meet the solvency tests?*

   The regulations should not set out a priority sequence. Regulation should focus on requiring the funding & benefit policy to describe how the plan administrator will address the process of benefit reductions and/or contribution increases. As proposed, valuation reports filed with the regulator will need to describe the actions being taken (contribution increases or reductions of accrued or future benefits) to deal with funding shortfalls that may arise.

   Similarly, for restoration of benefits, while it may make general sense to restore 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, we believe that plans should be able to establish their own set of measures and priorities. As hard coded rules can lead to unintended inequities, it would be preferable for legislation to be principle based acknowledging the importance of equity among plan members.

   We do think that it should be mandatory for an NCPP or other TBP to have a funding & benefit policy so that there is completeness and clarity for each plan, in the absence of hard coded regulations. The funding & benefit policy should be in the broader plan terms.

With respect to plan termination, the proposal is to continue to use the methodology for benefit reduction (if necessary) that is already in place. On plan termination benefit entitlements should be determined as lump sum values calculated using going concern assumptions and then adjusted to the plan's funded ratio. Pensioners should have an option to purchase an annuity with the amount of their lump sum 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.

Legislation could state that any benefit improvement in the 3 years prior to a plan termination, which resulted in a deficit at the wind-up date, shall be rescinded.

Part 4. Benefit Types

8. *Would the NCPPs that you are involved with be interested in GC CVs?*

   Yes, GC CVs would be of interest as a design option as proposed, but not as a requirement. This option should be made available to NCPP Public Plans as well.

9. *Are there any significant issues respecting preparation of an AVR, member communications, or inequity where an NCPP provides for both methodologies of calculation commuted values (i.e. CIA CV and GC CV)?*

   We believe that significant inequities could occur where an NCPP provides for CIA CVs on past service and GC CV on future service. After the payout of a CIA CV, the remaining members of the NCPP could be disadvantaged when the full CIA CV benefit is paid out (after the transfer deficiency holdback) without any deficiencies being funded. In addition, a member receiving a CIA CV would be advantaged as they would be receiving a level of guarantee that is not offered in the plan.

   Communication issues can also arise as plans will have to communicate the difference between the CIA CV and GC CV methodologies to members as well as the risks associated with each under method.

10. *What are your views on the proposed methodology used to calculate the GC CV?*

    We agree in principle that the GC CV should reflect the conditional nature of the benefit, determined on a going concern basis consistent with the plan's funding valuation. Where the funded ratio[5] is below one, the lump sum values should be reduced in line with the plan's

[5] Calculated without the PfAD

funded ratio. Where the funded ratio is above one it should be a matter of plan design whether the surplus is included.

We note that communication to plan members will be critical so that members fully understand the amount they crystallize by taking out their value when the plan is less than fully funded versus the risks they have retaining their pension in the plan.

11. *Given that members could be entitled to a GC CV (a CV that reflects the funded status), should plans that use the GC CV methodology be required to file periodic updates on their funded position to ensure that commuted value more accurately reflects the funded position of the plan at the time of transfer?*

Regulations should require an annual update of the funded status for use in lump sum benefit calculations. Plans should have the ability, but not the requirement, to update this funded status on a more frequent basis.

12. *Should the ability to convert past benefits to benefits calculated using the GC CV methodologies be provided at this time to NCPPs?*

Yes. As described in the Paper, the member's basic benefit is not reduced on an individual basis when a GC CV is offered (and is kept whole if left in the plan), but could be reduced in the future to meet funding requirements. The GC CV is more consistent with the conditional nature of the benefit than the CIA CV, and it can be said that paying out the CIA CV is inequitable.

Part 5. Communications

13. *Is the communications framework appropriate for NCPPs?*

As stated in our response to question 9, communication issues may arise if plans will have to communicate the difference between the CIA CV and GC CV methodologies as well as the risks associated with each under method. We recommend more simplified disclosure requirements; you may wish to refer to the Alberta *Employment Pension Plans Regulations* in this regard.

Part 6. Administration & Governance

14. Should there be more or less rules regarding NCPP governing bodies (Administrator and/or sponsor)? For example, should the regulations prescribe the proportion of plan members and retirees, presence of independent trustees, required knowledge and skills, etc.?

We think that there could be fewer rules regarding governing bodies for NCPPs and other TBPs. Governance structure should form part of the broader plan terms. Any review and change of governance structure should be the responsibility of the plan sponsor(s) and change should be infrequent.

The number and proportion of representation and independent trustees should not be regulated. This would be determined at the sponsor level as a feature of the plan design.

Finally it should be possible for the sponsors of NCPPs and TBPs to hire an independent professional administrator, assuming the broader plan terms are clear on how funding shortfalls are to be addressed.

15. Should the legislation or regulations be more prescriptive regarding the governance policy for NCPPs (e.g. require that such plans have a governance policy; set-out the minimum contents of a governance policy?

We think that a governance policy should be required, but that the content requirements should be principle based and not prescriptive. The policy should be comprehensive and encompasses the entire governance structure at both the sponsor and administrator levels.

Part 7. Transition Rules

16. Is the transition framework appropriate? Have all issues been addressed?

We expect that many NCPPs will need more time to consider plan design and governance adjustments that are warranted under the new rules, including time for negotiation with the relevant unions if necessary. A grandfathering period of three or more years should be in place to allow renegotiation followed by a period of preparation.

As well, having the Transition Report being that of the first actuarial valuation with a date of December 31, 2016 (or later) does not leave enough time for the government to adopt new legislation and for plan administrators to adapt. We would suggest that December 31, 2017 be the date of the first actuarial valuation to be considered for a Transition Report.

17. Do you agree with transitioning the PfAD on the CSC over a 3 year period?

We agree that a delay of the PfAD contribution on the CSC is appropriate. The proposal states that this funding would be required for the next-filed valuation. It would be preferable for the new CSC funding to apply after 3 years even if valuations are filed voluntarily before then.

Part 8. Additional Considerations – Section 8.1 –Alternative Enhanced Going Concern

18. Do you feel the "Enhanced Going Concern" option would be an acceptable regime as opposed to the Proposed Regime?

Our comments on the key differences between the Alternative Regime and the Proposed Regime are as follows:

- The only advantage that we see for providing the regulator's expectations for PfAD via bulletins would be that the effectiveness of the PfAD table proposed[6] under the Funding Regime has yet to be tested on "real cases". Consequently, if an update to the PfAD table were required, it would be easier and faster to communicate. That said, we would not expect the PfAD table to change often and, if it is contained in the regulation rather than legislation, the amendment process should be relatively straight forward.

- It is unclear to us why the unfunded liability amortization period would be reduced to 10 years. In our experience, it is critical for NCPPs and TBPs to have flexibility on addressing a funding shortfall.

- We do not agree on benefit improvements being restricted based on the solvency position of the plan. NCPPs and TBPs should be managed strictly based on a going concern approach. We therefore much prefer the approach proposed under the Funding Regime where benefit improvements can be granted only if there is AGCE[7]. In our opinion, this reflects best practice for the administration of NCPPs and TBPs. That said, the solvency position should be calculated at each valuation to inform all stakeholders of the plan's funded level if it were terminated.

  We note that Appendix A to the Paper does not completely align with guidance provided by the Pensions Division as it relates to the restriction on benefit improvements. In situations

[6] We have suggested to use the 2-dimensional table contained in the new Quebec funding rules
[7] Or in situations where the plan actuary can certify that future contributions will cover the cost of the improvements, as discussed in our response to question 6

where the solvency ratio was below 90%, Mercer was advised that the benefit improvement would be admissible provided the aggregate contribution requirements do not increase following the benefit improvement. Furthermore, for purposes of this test, we were also advised that the aggregate contribution requirements include current service cost, going-concern special payments and notional solvency special payments.

We therefore believe that the Proposed Regime is a better approach than the Enhanced Going Concern option.

Part 8. Additional Considerations – Section 8.2 – Expand the Proposed Regime to Other Pension Plans

19. Should a framework similar to the Proposed Regime be an option available to other types of pension plans registered under the Act?

The review of pension funding rules in Saskatchewan is part of a worldwide trend to reflect on, adapt and reposition the public and private pension systems, whether in terms of design or funding. The current funding requirements for defined benefit plans[8], combined with the changing economic and demographic context, have served to generate required contributions at a level and volatility that have become difficult to sustain over the long term for the sponsors of these types of pension plans.

The increasing number of temporary funding relief measures proposed by the regulators over recent years was meant to attenuate the irritants resulting from the permanent funding requirements, and thereby curb the waning interest of private sector companies in defined benefit pension plans, primarily those put in place for non-unionized employees, where the pension plan is not part of a collective agreement. However, it is becoming clear that a more fundamental reform is needed, and we are pleased to see that the Saskatchewan government is addressing the matter.

It is our opinion that the legislative and regulatory framework that defines the funding requirements for defined benefit pension plans should be based on the following principles so that organizations that offer this type of pension plan can benefit from a supportive environment:

- Saskatchewan employers that sponsor defined benefit pension plans must remain competitive with peer companies in the other Canadian provinces and the United States.

[8] We label "defined benefit plans" plans for which accrued benefits cannot be reduced and funding shortfalls are addressed by increases in (employer) contributions.

- Pension plan sponsors and members are not prepared to fund benefits that are fully guaranteed regardless of the economic and demographic context, due to the high cost of such guarantees. A compromise needs to be found between benefit security and the related cost.

- Funding rules must be permanent and predictable, and designed in a manner that avoids the need for them to be subject to frequent systemic amendments based on the prevailing economic conditions. However, they should make allowance for the fact that special arrangements could be needed for sponsors experiencing difficulty, and grant stakeholders a certain degree of flexibility to adapt their funding to their particular situation in a context of negotiations.

- The legislative and regulatory framework should encourage pension plan sponsors to manage risks effectively and appropriately communicate those risks to members.

The elimination of the requirement to fund defined benefit plans on a solvency basis, combined with the use of a going-concern funding target with a required PfAD that reflects the risk profile of the plan, would be significant changes that correspond to the principles mentioned previously.

The Quebec government has adopted in 2016 a new funding approach for single employer defined benefit plans that is in line with the above principles. While, under the Quebec approach benefits, the funding target is not aiming at keeping the plan fully funded on a solvency basis, the plan sponsor is still responsible to fully fund any solvency deficiency upon a plan wind-up. While it follows the same principles as the proposed Funding Regime for TBPs described in this Paper, the Quebec approach is more stringent in the way the PfAD (called “stabilization provision”) must be managed for single employer defined benefit plans. We encourage you to consider adopting the new Quebec funding rules for single employer defined benefit plans in Saskatchewan, as long as legislation is also amended to require that the employer is responsible to fund any funding shortfall on plan wind-up.

As we mentioned in the introduction, the proposed Funding Regime for TBPs should apply to all TBPs, whether multi-employer, single employer, unionized or non-unionized, private or public.

Part 8. Additional Considerations – Section 8.3 –Multi-Jurisdictional Pension Plans

20. What issues to you foresee will need to be addressed with respect to GC CVs and multi-jurisdictional plans?

The funding & benefit policies of NCPPs and other TBPs are directly linked. In order for these plans to work as intended, the funding and benefit rules must be aligned with the province of registration regardless of the province that individual plan members are employed. An agreement between the provinces and the federal government similar to the CAPSA multi-jurisdictional agreement would be needed to support that approach. The current development of TBP regulations across Canada would be an opportune time to harmonized regulation across Canada for these plans.

Part 9. Closing Comments & Contact Information

21. Please provide any additional comments or information related to this paper.

50% cost sharing rule

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, subject to applicable requirements under the Income Tax Act.

Governance

Most legislation in Canada concerning NCPPs and other TBPs requires joint governance in some form, with employer and member representation at the plan administrator level (the fiduciary level). However, we think that the governance structure does not need to be based on this representational model.

The concept of representation suggests that loyalties of a given trustee would lie with the constituency that appointed them. However, representation on the administrative body should mean that each constituent group may appoint the person(s) of their choice, including independent persons, on behalf of the group. As fiduciaries, the selected individuals owe loyalty to all current and future plan members, not only to the group who appointed them.

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.

The imposition of a fiduciary duty on the board is the most effective way to ensure that the relevant interests of all plan members are adequately considered. The fiduciary duty should be expressed as a requirement to consider the best interests of current and future plan members (or alternatively to take into account the purpose of the plan).

The administrative fiduciary role should be clearly separated from the sponsorship role.

Protection from liability is important. NCPP and TBP administrators should have the benefit of legislated protection when relying in good faith on certain professionally prepared documents. There is an obligation of process but not of results and the regulation could help reaffirm this.

Closure

We welcome you to contact the undersigned for discussion about any of the issues raised in the Paper and in our responses above.

Sincerely,

Deanna (Dea) Napen, FSC, FCIA
Partner

Luc Girard, FSA, FCIA
Partner

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Appendix
Ten Principles For Target Benefit Pension Plans

1. **Target benefit plans should not be restricted to unionized groups.**

   Often it is assumed that target benefit plans should only be available to unionized employee groups. The rationale for focusing on unionized groups is likely a concern that the interests of plan members and retirees might not be adequately protected without the representative structure that is provided in a unionized setting.

   In our view, the legislation could establish rules regarding the governance structure of target benefit plans (including minimum levels of employee and retiree representation, where applicable) that would adequately address this concern. Furthermore, regulators can and should have the authority to ensure that the interests of all plan members are protected in the plan's governance structure.

   Restricting access to unionized groups would be of limited effectiveness in improving retirement coverage, given the declining rates of unionization and the fact that pension arrangements are already far more prevalent in unionized workplaces than in non-unionized workplaces.

2. **Target benefit plans should be available to single employers and also be available in a multi-employer framework (with an administrative body that can either be independent of plan members or include member representatives).**

   In order to work effectively, target benefit plans will require a level of governance, communication and administration effort that is comparable to or greater than the effort required to run a regular defined benefit plan. One of the primary reasons why pension plan coverage is low is that many small and medium size businesses are unable or unwilling to bear the cost and effort of establishing and monitoring their own pension arrangements.

   Current legislation permits multi-employer plans where the administrator is the union representing plan members. In our view, the administrator of the multi-employer target benefit plan could be an independent organization such as a bank, insurance company or other expert body, with no linkages to either the participating employers or their employees. Permitting a multi-employer framework in which an independent third party provider would run the pension plan would allow smaller employers (particularly with non-unionized employees) to make these plans available to their employees at a lower cost and with minimal administrative effort. It would also allow for economies of scale because the costs of running the plans could be spread over a larger asset base and many employers.

In many respects, this pooled approach is similar to the approach used for Pooled Registered Pension Plans (PRPPs). There is one fundamental difference between the PRPP and a pooled target benefit plan. The PRPP model is intended to be a defined contribution framework with each individual member bearing their own risks. In contrast, under multi-employer target benefit plan, the investment and longevity risks of all members would be pooled together providing economic efficiencies, with the assets invested by a professional investment manager.

3. **Regulations should permit flexibility in establishing plan designs that meet different risk allocation objectives.**

So-called “shared risk” plans are very similar in many respects to target benefit plans in that the costs and risks of the plan are shared between the employers and employees in a defined fashion. However, there is typically one fundamental difference – accrued benefits cannot be reduced under a shared risk plan, whereas one of the fundamental features of a target benefit plan is the ability to reduce accrued benefits. Under a shared risk plan, contributions and a conditional benefit provision such indexing are typically allowed to very within an certain range to deal with a funding shortfall.

Given the structural similarities between shared risk plans and target benefit plans, we would expect that the governance objectives of well-run target benefit plans would be very similar to those of shared risk plans.

Almost universally, shared risk plans have two primary and competing objectives:

A. Inter-generational equity (i.e. attempting to charge each generation of employees and employers their fair share of the cost); and

B. Benefit/contribution stability (i.e. minimizing changes to the benefit and contribution levels, since these are disruptive to employees and employers).

On the one hand, a plan can ensure a high level of inter-generational equity by constantly adjusting contribution levels and/or benefit levels based on actual past experience, and evolving economic forecasts. However, this approach would obviously do a poor job of managing benefit and contribution stability.

On the other hand, a plan can enjoy a very stable level of benefits and contributions by ensuring that the contribution levels are far in excess of the expected cost of the benefits being promised and by employing various smoothing techniques. However, this necessarily results in the current generation subsidizing the next generation. This could also work in the opposite direction, where contribution rates are too low relative to the promised benefits due to optimistic assumptions about future experience, resulting in the next generation subsidizing the current generation.

The challenge for each plan is to find an appropriate balance between the two objectives. We do not believe that there is a single right answer to this question, and that it is best left to the individual plans to find that balance.

Under the New Brunswick legislation a plan cannot qualify as a Shared Risk Pension Plan unless certain metrics regarding the likelihood of benefit reductions and level of indexation are met. Based on our analysis, meeting these objectives may result in a fairly high level of contributions compared to the promised level of benefits (i.e. it would be closer to the benefit/contribution stability objective than the inter-generational equity objective). While this balance may be right for some groups, it will not be right for all groups – and the legislation should leave it to the individual plans to find the right balance.

Once a target benefit plan is established and its parameters defined, the plan's risk and reward allocation should be required to remain stable.

4. **Administrators of target benefit plans should be required to establish a robust governance framework, including well-thought out investment, funding & benefit policies.**

   There are some important issues that need to be addressed in terms of the governance structure of single employer target benefit plans – do they have to be jointly-governed by the employer and members, or could they be governed by only the employer, or only the union (or other representative member group in non-unionized situations)? There is no "one-size-fits-all" answer to this question. As noted previously, we think it will be important to allow for the possibility that an independent body could administer a target benefit plan under a multi-employer framework.

   Regardless, it will be important for the governing entity to establish a robust governance structure which clearly articulates the roles and responsibilities of the various stakeholders. The governing entity should be required to establish a detailed plan-specific funding & benefit policy that discusses how:

- Underfunded plans will be brought back to a fully funded status through benefit adjustments, contribution adjustments (if any) or reduction in margins for adverse deviations;

- Surpluses in overfunded plans will be dealt with through benefit improvements, contribution reductions (if any) or increasing margins for adverse deviations.

The New Brunswick shared risk legislation places certain direct restrictions on the treatment of surpluses and deficits, and indirect restrictions through the imposition of their primary and secondary tests. We believe it is preferable for the details of the funding policy to be left to the individual plans based on their particular objectives and risk tolerances, with the pension regulator having the power to examine whether a funding policy is in fact appropriate given the circumstances of a specific plan.

5. **Target benefit plans should be exempt from solvency funding but should be subject to rigorous going-concern funding standards.**

Given the nature of target benefit plans, we do not believe that it is appropriate to fund these plans on a solvency basis. Target benefit plans are similar in many respects to jointly-sponsored pension plans and multi-employer pension plans. Many governments have already come to the conclusion that shared risk plans and MEPPs should be exempt from solvency funding – and we believe it would only be natural to extend this to target benefit plans.

While solvency funding is not appropriate for target benefit plans, we do think that regular financial analysis is critical to ensure that target benefit plans function effectively. It would be reasonable for the legislation to require that annual valuations be filed, and for plans to perform some form of stress testing or stochastic testing.

As many plans are currently utilizing temporary funding relief, where applicable, the transition to more rigorous going-concern funding standards should include a transition period.

6. **On conversion to a target benefit design, existing defined benefit plans should not be allowed to unilaterally convert guaranteed past service benefits into target benefits without the consent of plan members, or, where applicable the unions that represent them. However, legislation should allow sponsors to gradually transition away from solvency funding of past service benefits (even in circumstances where only future service benefits are converted to a target benefit design).**

Over the last 10 to 15 years, many sponsors of defined benefit (DB) plans have begun a transition toward defined contribution (DC) plans. In most cases, the primary reason for the move has been to reduce the level and volatility of pension costs. In some cases, the

employers would acknowledge that a DC plan is not a perfect model for their employees, but that they were faced with little choice given the cost volatility pressures. It would be good public policy to encourage (or at least not discourage) DB plan sponsors to move to target benefit plans as an alternative to a DC model. We note that studies have shown that a target benefit approach is a more efficient model for delivery of retirement benefits than a DC approach because it deals with investment and longevity risk in a more effective manner[9].

If a target benefit model provides cost certainty similar to a DC plan but is expected to provide additional retirement benefits to plan members, some sponsors of DB plans may decide to convert to a target benefit model rather than a DC approach.

We believe that it would not be appropriate to allow employers to unilaterally change past service benefit promises under an ongoing plan without the consent of plan members (or the union that legally represents the plan members). In any event, some plans may leave past service unchanged. One way in which the government could create an incentive to adopt target benefit plans is with respect to the funding of past service benefits that are not being converted. Solvency funding requirements related to past service benefits should be phased out over a 3 year period for sponsors who move to a target benefit model for future service as an incentive for DB plan sponsors to move towards a target benefit model rather than a DC model.

7. **DC plans should be allowed to transition to a target benefit design for past service, with members permitted (but not required) to convert their account balances into target benefit pensions on a going-concern basis.**

   If a target benefit model provides similar cost certainty as a DC plan but provides additional retirement security (and arguably higher benefits), employers may want to convert their DC plans to a target benefit model.

   We believe that legislation should permit such a conversion to be done easily. In particular, we think it would be reasonable to permit (but not require) active members to convert their DC account balances to a past service target pension (based on the going-concern funding assumptions).

[9] Several studies have shown that the DB model is more efficient in delivering benefits than a DC model (i.e. more benefit dollars for a given level of cost) due primarily to expert investment management, pooling of longevity risk, an indefinite investment horizon, the elimination of behavioural biases by employees in selecting investments, and the avoidance of the need to annuitize at market interest rates.

8. **Target benefit plans should allow employee and employer contributions to be either fixed or variable within a fixed range (as established by plan documentation).**

   In the narrowest context, a target benefit plan has a fixed level of contributions. While many plan sponsors may decide to have a fixed contribution level, we believe that the legislation should not require that target benefit plans maintain a fixed level of contributions. Allowing contributions to vary within a defined band may be desirable feature for some sponsors since it could provide cost protection and mitigate the frequency and size of benefit reductions

9. **Target benefit plans should allow terminating members to elect a transfer value determined on a going-concern basis that reflects the plan's funded status and the risk and reward sharing of the benefit design.**

   The right to commute benefits is an important feature of current pension legislation in Canada. It allows individuals to manage their own pension benefits once they leave an employer if they wish to do so and/or to consolidate their retirement savings.

   Given the nature of target benefit plans, the current CIA commuted value basis is not an appropriate method for determining commuted values. We believe that the use of the going-concern basis, adjusted to reflect the plan's funded status, is the more appropriate approach for a target benefit plan. Members who choose to commute would receive a proportionate share of the fund, whether in deficit or in surplus. This is effectively the approach being employed under the New Brunswick legislation.

10. **Legislation should require that comprehensive and transparent communications be provided to members and beneficiaries on the nature of the pension arrangement, including regular updates on the funded status of the plan and the resulting implications for members and beneficiaries.**

    We believe that it is absolutely critical that plan members understand their pension deal – that the benefit is a target but not a promise. Legislation should require initial and annual communication to all members about the nature of the plan. The communication should include information on plan performance, funded status, planned adjustments to benefits or contributions due to past year performance, and projections of benefit levels (including some indication of the potential variability of benefit levels).