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The Association of Canadian Pension Management
L'Association canadienne des administrateurs de régimes de retraite

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ACPM Target Benefit Plan Supplemental Paper

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FOREWORD

THE ASSOCIATION OF CANADIAN PENSION MANAGEMENT (ACPM)

ACPM is a national non-profit volunteer-based organization acting as the informed voice of plan sponsors, administrators and their service providers, advocating for improvement to the Canadian retirement income system. Our membership represents over 400 retirement income plans consisting of more than 3 million plan members, with assets under management in excess of $330 billion.

ACPM believes in the following principles as the basis for its policy development in support of an effective and sustainable Canadian retirement income system:

Diversification through Voluntary / Mandatory and Public / Private Options

Canada's retirement income system should be comprised of an appropriate mix of voluntary Third Pillar and mandatory First and Second Pillar components.

Third Pillar Coverage

Third Pillar retirement income plan coverage should be encouraged and play a meaningful ongoing role in Canada's retirement income system.

Adequacy and Security

The components of Canada's retirement income system should collectively enable Canadians to receive adequate and secure retirement incomes.

Affordability

The components of Canada's retirement income system should be affordable for both employers and employees.

Innovation in Plan Design

Canada's retirement income system should encourage and permit innovation in Third Pillar plan design.

Adaptability

Canada's retirement income system should be able to adapt to changing circumstances without the need for comprehensive legislative change.

Harmonization

Canada's pension legislation should be harmonized.

I. INTRODUCTION

In March 2012, the ACPM released a policy paper on target benefit plans ("**TBPs**").[1] In that paper, the ACPM recommended TBPs as a viable alternative to traditional defined benefit ("**DB**") and defined contribution ("**DC**") pension plans. The ACPM urged the provincial and federal governments to take the necessary steps to amend pension and tax legislation to make TBPs widely available.

The purpose of this supplemental TBP policy paper (the "**Supplemental TBP Paper**") is to provide the ACPM's recommendations for a framework to facilitate the conversion from traditional private sector[2] DB and DC plans to TBPs, as we view balanced and manageable conversion rules to be a key facet underlying the successful growth of TBPs in Canada. In the interest of greater flexibility, the options set out here present a broader range of possible conversion models than did the original ACPM TBP Paper.

In addition, this Supplemental TBP Paper reviews several welcome developments in relation to TBPs that have occurred since the initial TBP paper was released, such as the adoption of legislation governing TBPs in several provinces and the shared risk model, a type of TBP, implemented in New Brunswick.[3]

II. EXECUTIVE SUMMARY

For governments and policymakers considering the implementation of rules to facilitate conversions from traditional DB pension plans to TBPs, the ACPM has the following recommendations:

- Conversion rules must be balanced, manageable and flexible;
- Plans must be permitted to convert accrued past service benefits;
- Rules should permit conversions with the consent of affected plan beneficiaries;
- Conversions <u>without</u> affected beneficiary consent should only be permitted[4] provided strict requirements on risk management are imposed, such as the stochastic method of valuation being utilized in respect of New Brunswick shared risk plans with a very high (97.5%) full funding probability threshold;
- Legislators and policymakers should consult with the Canadian Institute of Actuaries ("**CIA**") in order to develop strong standards of practice for stochastic modeling in actuarial valuations for TBPs and to ensure consistency and harmonization of such standards across all jurisdictions introducing TBPs;

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[1] ACPM, *ACPM Target Benefit Plan Paper* ("**ACPM TBP Paper**") available online at www.acpm-acarr.com

[2] We note that TBPs, wholly or in part, have either been implemented or are being considered in respect of public sector pension plans in the provinces of New Brunswick, Alberta, Nova Scotia, Prince Edward Island and Newfoundland.

[3] On April 24, 2014, the federal government released a consultation paper on a potential target benefit plan framework titled *Pension Innovation for Canadians – The Target Benefit Plan* (available online at http://www.fin.gc.ca/activty/consult/pic-impicc-eng.asp). The content of the consultation paper has been addressed in detail in a separate submission to the federal government by the ACPM on June 27, 2014 and is not dealt with in this Supplemental TBP Paper.

[4] Subject to any applicable labour law restrictions.

- Rules permitting conversions with affected beneficiary consent should be based on the one-third of affected member objection standard. There is precedent for this approach in the rules applicable to surplus sharing and solvency relief. Requiring 100% or other level of positive affected beneficiary consent to a conversion would be completely impractical, rendering most if not all conversions impossible to implement;

- Partial conversions should also be permitted where only certain benefits provided under the DB plan are converted to target benefits. While base DB benefits would be protected, maintained and funded under this model, some portion of the optional, non-core DB benefits could be converted to target benefits. A variant on this partial conversion option is to permit conversion for some groups of plan beneficiaries only, but not others (e.g. permit for active members but not retirees); and finally

- Full funding of DB plan deficits should be required in cases where a converted TBP winds up within 5 years after converting from DB to TBP. The objective of such a rule would be to dissuade parties from converting a DB plan mainly (or partly) to avoid funding an existing solvency deficit. Such full funding should be based on the solvency deficit that existed at the conversion date, calculated as if the DB plan had been wound up at the conversion date[5].

We also recommend that the conversion of DC plans to TBPs be permitted and supported.

The ACPM reiterates that:

1) The TBP is an innovative and viable pension model which has a high likelihood of providing an adequate pension income to members;

2) TBPs promote the objectives of sustainability, coverage and adequacy; and

3) Federal and provincial governments should act quickly to:

    - enact regulations for the operation of current TBP legislation where already introduced,

    - introduce TBP legislation where it does not yet exist, and

    - implement rules enabling the conversion of traditional DB and DC plans to TBP designs for past and future service.

III. DEVELOPMENTS SINCE THE ORIGINAL ACPM TBP PAPER

We have attached, as Appendix A to this paper, a summary of the legislative and policy developments relating to TBPs since the ACPM released its first policy paper on TBPs in March 2012. The most

[5] Some variations on such a requirement could include:
a) increasing that deficit amount with interest between the conversion date and the wind-up date;
b) reducing that deficit with the portion of employer contributions that served to build a margin for adverse deviations between the conversion date and the wind-up date;
c) reducing that deficit gradually over the 5-year transition period; and/or
d) imposing temporary security measures such as a deemed trust or letters of credit during that 5-year period to cover the amortization payments that would have been required otherwise.

significant development has been the adoption of legislation implementing a shared risk plan framework in New Brunswick. While the ACPM does not endorse the New Brunswick model as the only possible model, we focus on it in detail for purposes of this paper because it is currently the only model for fully retroactive DB to TBP conversion that has been enacted by legislation in Canada to date.

IV. RECOMMENDATIONS OF THE ACPM FOR CONVERTING DB PLANS TO TBPS

The Case for Enabling Conversions

In 1976, 37% of the Canadian workforce was covered by a DB plan, but challenges to the sustainability of DB plans have reduced DB coverage to 25% in 2012.[6] In addition, the percentage of Canadian employees in DC plans has increased over the same period from 2% to 6%.[7] Only about a third of the workforce is therefore covered by a private pension plan. The decline in pension coverage and specifically in DB plan coverage is a worrisome trend.

As the ACPM submitted in its initial plan paper, TBPs are a viable solution for the funding challenges faced by sponsors of DB plans, and may help stem the tide away from traditional DB plans, which provide the greatest retirement security to employees. If so, TBPs have the potential to improve pension coverage and adequacy.

Allowing a plan to convert accrued benefits is important to plan sponsors in some circumstances, particularly where plans face funding challenges due to changing economic and other circumstances. For example, conversion of accrued benefits may be a fairer alternative than having future generations pay more and/or receive less than earlier generations. These funding challenges have arisen in many plans as the size of the contributing active workforce is shrinking relative to a larger retiree population. In addition, people are living longer than anticipated when many DB plans were first established. Succinctly put, this means that pensions are being paid for a longer period of time even as fewer active members are contributing. If design changes such as conversion of accrued benefits are not permitted, the younger plan participants may well have to bear a disproportionate level of financial responsibility and risk in relation to their plan benefits and, unless the plan sponsor is willing to assume the funding risk, could well receive lesser pensions in the future.

Policymakers will need to determine whether TBPs should be permissible only on a go-forward basis or whether changes to accrued benefits should be permitted, as is the case in New Brunswick. Given the many advantages that TBPs may have for the Canadian retirement income system, the ACPM recommends that governments act promptly to not only introduce rules permitting TBPs, but also balanced and practical rules which would permit the conversion of accrued DB and/or DC benefits into a TBP model.

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[6] Statistics Canada, http://www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/famil120a-eng.htm; *Plan Sustainability: Alternatives Across Canada*, presentation by Randy Bauslaugh, Ian Edelist and Jana Steele to the Ontario Bar Association's Institute on February 7, 2014.
[7] *Ibid.*

Options for Conversion

1. TBPs Permissible on a Go-Forward Basis Only – No Conversion of Accrued Benefits

In the absence of legislation permitting the conversion of accrued benefits, the approach of DB sponsors converting to TBPs can only be to start fresh with the TBP plan going forward, while accepting the ongoing responsibility for the funding of the DB plan. Sponsors seeking to limit their exposure to DB risks going forward have the following options available to them (in addition to the status quo):

- Allow the existing DB members to continue earning DB pension benefits, but close the plan to new hires;

- Freeze benefits under the DB plan, with no further service accruals and perhaps no recognition of future earnings and/or removal of early retirement subsidies (where permitted by legislation); or

- Wind up the DB plan (this option is not likely to be as attractive as it would mean the TBP is starting from scratch with zero assets and an insufficient base for plan expenses).[8]

Where one of these options has been implemented, experience to date has shown that the replacement plan for the DB plan, going forward, is either (i) a DC type of plan (usually a CAP), or (ii) no pension plan at all. If steps are not taken to facilitate conversion of the past service/accrued benefits, this will lead to far fewer TBPs than would otherwise be the case, and less pension plan coverage/adequacy. For these reasons, the ACPM does not recommend this approach.

2. Conversion of Accrued Benefits Permissible

Presently, New Brunswick is the only jurisdiction that has enacted legislation to expressly permit the conversion of accrued benefits on a broad basis. Some DB plans have tried to deal with their deficits by increasing contribution rates and reducing benefits going forward, primarily by reducing ancillary benefits such as indexing on future benefits earned, and in other cases by removing early retirement subsidies. However, this approach means that current plan members will likely not be able to achieve the same benefits that current retirees are enjoying, at least not at the same cost. While this may make the DB plan sustainable, it can result in current plan members paying significantly higher contribution rates than those paid by retirees during their working lives.[9]

When a DB plan is not fully funded, a potential solution to promote sustainability is enabling legislation to permit the reduction of accrued benefits accumulated by current and former plan members. Since accrued benefits are protected, their conversion to the TBP model is possible only through legislative action expressly permitting conversion (with or without member consent to the conversion). The conversion options available through legislative action are discussed further below.

a. Conversion by Plan Sponsor <u>without</u> Beneficiary Consent

As discussed above, accrued benefits are protected at law. For this reason, specific legislation must be passed to permit conversion of accrued benefits without any input from plan beneficiaries, subject to

[8] Aon Hewitt, *Target Benefit Plan – The Future of Sustainable Retirement Programs* (June 2012), pp. 17-18.
[9] Canadian Institutional Investment Network, *2012 Canada's Pension Landscape Report: The Evolution of Risk*.

any applicable labour law restrictions. This is the approach adopted in New Brunswick. Relying on specific legislation, permitting conversion also immunizes plan sponsors from litigation exposure. However, this approach requires government action.

If specific legislation is passed, it will have to address the issue of the plan sponsor's obligation to fund accrued benefits under the original DB plan. Specifically, employer sponsors of DB plans are legally obligated to fund the deficiencies in the plan on both an ongoing and termination basis. In a TBP (as is the case currently under MEPPs/JSPPs), the obligation to fund deficiencies on an ongoing basis is shared between the employer and the employees. The questions for legislators are: How will the legislation address deficiencies in regard to past service that was earned under an employer-sponsored DB plan if the past service is transferred to TBP? And what about the deficiencies that may arise with respect to future service? Legislators will also have to consider how this type of conversion would take place in workplaces in which plans are collectively bargained. In such cases, union agreement will likely be necessary as a matter of labour/contract law.

If legislation allows a conversion from DB to TBP for accrued benefits, it should specify certain rules on how to manage the new risk of benefit reduction created for benefits that were previously guaranteed by the employer. In cases where such a conversion is possible without obtaining consent from plan beneficiaries (or their union representatives, as applicable), rules on risk management should be very strict.

The NB Shared Risk Plan is an example of such a model that has proved to be workable. In New Brunswick, where conversion to a TBP is possible without consent from members or their union, the rules that are imposed for risk management can be considered relatively strict, requiring a 97.5% probability that defined base benefits will not be reduced over the next 20 years. While we support the viability of this stochastic method of actuarial valuation and risk management, we are of the view that it should not be the only option offered by legislation. Rather, we support greater flexibility in respect of legislative options for conversion, including those outlined below.

In addition, we strongly recommend that legislators and policymakers consult with the CIA in order to develop strong standards of practice for stochastic modeling in actuarial valuations for TBPs and to ensure consistency and harmonization of such standards across all jurisdictions introducing TBPs.

b. Conversion <u>with</u> Beneficiary Consent

Another option would be for pension legislation to be amended to allow conversions where a certain specified number (or percentage) of affected plan beneficiaries consent (or do not object) to a conversion proposal. We refer to plan beneficiaries here rather than members because the rights and interests of several groups of plan beneficiaries are affected. These beneficiaries include active members, retirees and other beneficiaries (e.g., spouses or dependent children in receipt of a survivor pension and deferred vested members). In a unionized workplace, the union can consent on behalf of active unionized members, but not other beneficiary groups. Broadly speaking, we note that there is precedent for the consent approach in the rules applicable to surplus sharing and solvency relief under current pension legislation.

Given the fundamental character of the change from DB plan to TBP (loss of solvency funding, loss of the employer covenant, loss of PBGF protection for Ontario members, etc.), the policy question for legislators is whether TBP legislation should require affected beneficiary consent for conversion of accrued benefits to TBP. On one hand, it seems equitable that beneficiaries should have a say over a change that impacts the level and security of their benefits. On the other hand, securing beneficiary consent would likely entail an administrative process that can cause significant delays and may not succeed in many cases, to the detriment of some groups of plan beneficiaries and ultimately to plan sustainability in the long run.

A related issue is the level of consent required. For example, if opting for a consensual approach, should it be necessary that all beneficiaries consent to the conversion or should a consent super-majority (e.g. 67%) suffice? For practical reasons, requiring 100% beneficiary consent would be setting the bar too high because obtaining such consent could prove impossible. In addition, requiring 100% consent could also result in unfairness because it could allow a few beneficiaries to impose their will at the expense of the majority. A consent "super-majority" threshold (for each of active members and retirees voting separately) seems to be the more practical approach because this option offers the advantages of substantial beneficiary support for the conversion without effectively allowing individual vetoes.

Logistically, the legislation could adopt either an opting in or opting out policy to measure affected beneficiary support for the conversion. In the opting in scenario, beneficiaries would be asked to indicate specifically whether they consent to the conversion to a TBP. If the number of beneficiaries who opt to support conversion is sufficient to fulfill the pre-determined consent threshold requirements, all the plan beneficiaries would be converted to the TBP. In the opting out scenario, beneficiaries are deemed to consent to conversion unless they expressly opt out. If the number of beneficiaries who do not opt out is sufficient to fulfill the consent requirements, all the plan beneficiaries (including those who opted out) would be converted to the TBP.

The ACPM supports and recommends that the "opting out" approach be adopted based on a one-third of affected beneficiary objection standard. That is, to block a conversion, one-third of affected beneficiaries would have to confirm their objection to the proposed change. In order to ensure that the conversion is not rejected by more than one-third of a particular beneficiary group, especially retirees, the employer would likely be required to enter into negotiations with each group similar to negotiations typically undertaken in the past to achieve appropriate consent levels required to withdraw surplus. In the case of retirees, who would likely have the least to gain from a plan conversion to a TBP, employers could offer them higher priority in the benefit reduction formula under the plan or indexing of benefits. Alternatively, the employer could offer to buy out their benefits through an annuity purchase or potentially permit portability of their benefits from the plan, which would require a change to pension legislation to allow retirees to transfer their benefits out of the plan prior to conversion.

The consent model is, in our view, a viable and preferred alternative to a model which would require full funding of past service liabilities in that it permits the relevant parties to come to their own agreement regarding funding requirements. Absent such agreement, employers are unlikely to achieve the levels of consent required to convert to a TBP.

In cases where a conversion occurs with beneficiary consent, the rules to impose risk management measures may not be as strict as those applicable where a conversion occurs without beneficiary consent (as discussed in (a) above).

c. *Conversion Based on Financial Needs*

An alternative option for conversion is to allow the DB plan sponsor to restructure the plan with the regulator's approval and without affected beneficiary consent, but only if it can demonstrate that the current plan is unsustainable. This approach is akin to the option under the *Companies' Creditors*

Arrangement Act[10] to allow an insolvent company to restructure its operations in certain severe financial circumstances without the consent of the affected creditors.

The ACPM does not recommend this option because: (i) it is not good pension policy to wait until plan funding and/or sponsor financial circumstances are dire before allowing conversion to a TBP; and (ii) this process would be too cumbersome and uncertain to be widely utilized by plan sponsors, and therefore it would not meaningfully promote pension coverage and adequacy.

d. Partial Conversion

Another alternative is to convert only certain benefits provided under the DB plan. While base DB benefits would be protected, maintained and funded under this model, some portion of the optional, non-core DB benefits (e.g., ancillary benefits, including early retirement subsidies, indexing, or future earnings component of benefit formula) could be converted to target benefits.

This approach continues the traditional approach of securing base benefits under DB provisions and allows sponsors to institute target benefits that would allow them to deal with funding fluctuations and protect plan sustainability. To the extent a fully retroactive conversion of existing DB ancillary benefit provisions is desired by a plan sponsor, the same requirements regarding funding or consent should be applied to a partial conversion as to the conversion of the plan as a whole. Alternatively, the provision could be enacted on a going forward basis, subject to any constraints on amendment in the plan terms.

We note that there are existing examples of pension plans having a traditional DB pension promise coupled with conditional “target” ancillary benefits (e.g., jointly sponsored pension plans in Ontario), and this appears to assist these plans in terms of ongoing funding/sustainability issues.

A variant on the partial conversion option is to permit conversion for some groups of plan beneficiaries only, but not others (e.g. permit for active members but not retirees).

Either way, we think that partial conversion rules would improve the flexibility of the TBP model and the ACPM supports the adoption of partial conversion rules to maximize possible take up on TBPs.

e. Full Funding and Conversion

One final conversion option would be for pension legislation to specifically allow an employer to convert the accrued benefits to TBP, but only after: (i) fully funding the accrued DB benefit on a solvency basis, and (ii) giving plan beneficiaries (actives, retirees and other beneficiaries) the option to transfer the commuted value of their accrued benefits out of the plan in lieu of participating in the conversion.

A similar conversion option was previously outlined in the ACPM TBP Paper as follows:

> For simplicity, in order to transition past service traditional DB benefits to a target benefit design, a TBP should be a stand-alone pension plan. New hires who enter the TBP would accrue all benefits on a target basis. Those employees who would “convert” or “transition” from the employer’s traditional DB plan to the TBP should accrue future benefits (from the effective date of transfer) on a target basis. The employer

[10] R.S.C., 1985, c. C-36.

> should be permitted to offer these employees and inactive DB plan members the option of transferring past service benefit liabilities (and a proportionate amount of the DB plan assets) to the TBP.
>
> Where there is a funding deficit in respect of transferred DB liabilities, the employer should continue to fully fund these liabilities by way of special payments for the remainder of the going concern or solvency amortization period in accordance with the schedule of payments as of the date of conversion. The key concept regarding the 100% past service benefit funding is that a former DB member should commence participation in the TBP with a clean slate and assume the risk the TBP represents after this date. The funding payment schedule in respect of past service benefits should not vary from what is in place prior to conversion. Any experience gains or losses in respect of these benefits that occur after the date of entry should fall under the TBP design and as such, these past service benefits could be increased or reduced. Should the TBP be terminated prior to the end of the past service funding payment schedule, the employer would still be required to pay the remaining balance of its schedule of payments as at the date of conversion.[11]

Again, this approach is a distinct alternative to the consent approach as it effectively permits beneficiaries to elect to opt in or out of the conversion on an individual basis.

A variation on this question of full funding was suggested in the Federal consultation paper published in April 2014 whereby full funding would be required only in cases where a plan winds up within 5 years after converting from DB to TBP. The objective of such a rule would be to dissuade parties to convert a DB plan mainly (or partly) to avoid funding an existing solvency deficit. In its submission to the Federal Department of Finance, the ACPM suggested that such full funding should be based on the solvency deficit that existed at the conversion date, calculated as if the DB plan had been wound up at the conversion date (i.e. for a plan subject to Federal legislation, this would be calculated without applying the three-year averaging method).

Some variations on such a requirement could include:

a) Increasing that deficit amount with interest between the conversion date and the wind-up date;

b) Reducing that deficit with the portion of employer contributions that served to build a margin for adverse deviations between the conversion date and the wind-up date;

c) Reducing that deficit gradually over the 5-year transition period; and/or

d) Imposing temporary security measures such as a deemed trust or letters of credit during that 5-year period to cover the amortization payments that would have been required otherwise.

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[11] At page 19.

3. DC Plan Conversions

We recommend that the conversion of defined contribution (DC) plans to TBPs be permitted and supported. For DC pension plan administrators concerned about their responsibility to educate their DC plan members to make informed decisions (e.g., on contribution levels and investment options), a TBP may have some appeal. Likewise, the pooling of risk in a TBP could be attractive to DC plan sponsors and members should be encouraged.

V. CONCLUSIONS AND RECOMMENDATIONS

While DB plans provide members with a reliable pension at retirement and allow for pooling of the longevity and investment risks, plan sponsors assume a significant cost uncertainty, a burden which many of them are not willing to shoulder any longer. In DC plans there is cost certainty for the plan sponsors, but there are no benefits of risk pooling, and members are often asked to make complicated investment decisions for which they may not be properly equipped. While traditional DB and DC plans have their challenges, TBPs combine the most favourable elements of the two traditional models and more equitably balance the risks and costs between the plan sponsor and members in order to increase the plan's sustainability. The TBP is a viable alternative to the DB/DC dichotomy and represents the best chance to provide an adequate pension income to members in the long run.

In summary, for governments and policymakers considering the implementation of rules to facilitate conversions from traditional DB pension plans to TBPs, the ACPM has the following recommendations:

- Conversion rules must be balanced, manageable and flexible;
- Plans must be permitted to convert accrued past service benefits;
- Rules should permit conversions with the consent of affected plan beneficiaries;
- Conversions <u>without</u> affected beneficiary consent should only be permitted provided strict requirements on risk management are imposed, such as the stochastic method of valuation being utilized in respect of New Brunswick Shared Risk Plans with a very high (97.5%) full funding probability threshold;
- Legislators and policymakers should consult with the CIA in order to develop strong standards of practice for stochastic modeling in actuarial valuations for TBPs and to ensure consistency and harmonization of such standards across all jurisdictions introducing TBPs;
- Rules permitting conversions <u>with</u> affected beneficiary consent should be based on the one-third of affected member objection standard. There is precedent for this approach in the rules applicable to surplus sharing and solvency relief. Requiring 100% or other level of positive affected beneficiary consent to a conversion would be completely impractical, rendering most if not all conversions impossible to implement;
- Partial conversions should also be permitted where only certain benefits provided under the DB plan are converted to target benefits. While base DB benefits would be protected, maintained and funded under this model, some portion of the optional, non-core DB benefits could be converted to target benefits. A variant on this partial conversion option is to permit conversion

for some groups of plan beneficiaries only, but not others (e.g. permit for active members but not retirees); and finally;

- Full funding of DB plan deficits should be required in cases where a converted TBP winds up within 5 years after converting from DB to TBP. The objective of such a rule would be to dissuade parties to convert a DB plan mainly (or partly) to avoid funding an existing solvency deficit. Such full funding should be based on the solvency deficit that existed at the conversion date, calculated as if the DB plan had been wound up at the conversion date. This rule could be supplemented by certain additional conditions, as suggested in subsection IV(2)(e) above.

We also recommend that the conversion of DC plans to TBPs be permitted and supported.

TBPs have great potential and promote the objectives of plan sustainability, benefit coverage and pension adequacy. Governments and policymakers should act expeditiously to permit TBPs and specifically to enable conversions from traditional DB and DC plans to TBPs so that more Canadians can achieve a sustainable retirement income.

APPENDIX A

SUMMARY OF LEGISLATIVE DEVELOPMENTS

1. Shared Risk Plan Design Implemented in New Brunswick

a. Overview of the Shared Risk Model

Faced with crippling DB plan deficits, diminishing investment returns and workforce trends that saw workers retire earlier but live longer, the Province of New Brunswick appointed an independent Task Force to examine the long-term stability and security of pensions in the province. The mandate of the Task Force was to make recommendations that fulfill the objectives of benefit security, plan sustainability and pension affordability. As guiding principles, the Task Force was committed to transparency (all stakeholders understand the pension deal) and equity (no party can game the system at the expense of another).[12]

At the recommendation of the Task Force, New Brunswick introduced legislation to permit shared risk plans ("**SRPs**") and to immunize plan sponsors who implement the new plan model from liability. New Brunswick's *Pension Benefits Act*[13] was amended to include a new Part II for SRPs and accompanying regulations followed shortly afterward.[14]

SRPs are a type of TBP that offer two levels of benefits. First, the base benefits are provided on a base benefit formula (typically, a career average formula) Second, the ancillary benefits under an SRP (such as indexation to insulate the benefit from inflation, bridge benefits and early retirement subsidies) are provided only if there are sufficient funds in the plan as measured against the guidelines in the plan's funding policy. Importantly, all benefits (including pensions in pay) – base and ancillary, past and future – under an SRP may be reduced if there are insufficient funds in the plan, although base benefits are less likely to be reduced and have priority to be reinstated.

As a TBP, SRPs are designed to be flexible so that they can function well and deliver a predictable level of benefits in a wide spectrum of economic scenarios. To help mitigate the risk of possible future benefit reductions, New Brunswick has taken steps to prescribe certain risk management requirements in the *Shared Risk Regulations*. Also, the requirement that adverse economic and demographic conditions be addressed on a timely basis further demonstrates the legislative intent that targeted benefits should be paid with a high degree of certainty.

The legislation in New Brunswick contemplates that SRPs would be a viable plan design option in a broad range of circumstances. Unlike the TBP model that has been proposed in certain other jurisdictions, New Brunswick does not restrict SRPs to the collective bargaining arena. The SRP design can be applied to public or private sector pension plans, unionized or non-unionized environments, and in a single or multi-employer context. Furthermore, one of the bolder aspects of SRPs is that the model is not limited to future service, but rather allows the conversion of accrued benefits (including pensions

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[12] Task Force on Protecting Pensions, *Shared Risk Pensions – A New Model for New Brunswick*, available online at http://www2.gnb.ca/content/dam/gnb/Corporate/pdf/Pension/Protecting_Pensions.pdf.
[13] SNB 1987, c P-5.1 (the "***NB PBA***").
[14] *New Brunswick Regulation 2012-75* under the *NB PBA* (the "***Shared Risk Regulations***").

in pay). The design allows plan sponsors considering pension alternatives to select the SRP model irrespective of the nature of the employer and the workforce.

b. Unique Aspects of the SRP Design

The SRP plan design has certain features that make it unique, as follows:

i. Ability to Convert Accrued Benefits

Canadian pension standards legislation protects accrued benefits.[15] As well, it is a general principle of common law that, once a pension right is vested, it cannot be divested or changed unilaterally by the employer.[16] The legislation in New Brunswick dealt with these general legal principles, which could be an impediment to converting from traditional DB plans, by specifically allowing the conversion of accrued defined benefit or defined contribution pension benefits to a "shared risk" model. Consequently, upon conversion to the SRP model, all the accrued benefits become part of the SRP and therefore subject to the shared risk plan rules, including future conditional cost of living adjustments ("**COLA**") and, possibly, benefit reductions. The legislation in New Brunswick also provides immunity to plan sponsors who convert a pension plan to a SRP.[17]

ii. All Contributions to the Plan Become Member Money

In a typical SRP, both the employer and the employee contribute to the plan. Once contributions are made, they can be used in accordance with the plan text and the funding policy only for the benefit of the members (subject to any administrative expenses payable from the plan).[18] Consequently, unlike in a DB plan where surplus entitlement disputes can arise, the SRP sponsor has no right to surplus. Contribution holidays can generally only be taken where required under the *Income Tax Act*. While not the only viable model regarding treatment of surplus, the clear demarcation of pension funds as money belonging to the members on wind up prevents the protracted litigation over who is entitled to funding surpluses that plagued many DB plans in the 1980s and 1990s.

iii. Prescribed Risk Management and Funding Requirements

When an SRP is established, the *NB PBA* requires certain stress testing at the outset.[19] The contributions are set such that the projected benefits can be paid in the vast majority of economic scenarios and the plan can satisfy the risk management requirements under the legislation.[20] The primary risk management goal of a SRP is that there be a minimum 97.5% probability that base benefits will not be reduced over a 20-year period.[21] The secondary risk management goal is that, on average, at least 75% of the value of certain ancillary benefits will

[15] *For example, see Pension Benefits Act*, RSO 1990, c P.8 [*ON PBA*], s. 14(1); see also, *NB PBA, supra* note 2, s. 12(1).
[16] *Quinn v. New Brunswick (Minister of Finance),* 2011 NBQB 182, ¶ 90.
[17] *NB PBA*, s. 100.81(2).
[18] *Shared Risk Regulations*, ss. 10 and 6(2).
[19] S. 100.6(2)(c).
[20] *NB PBA*, ss. 100.6(2)(a)(i)(D) and 100.6(2)(b)(iii).
[21] *NB PBA*, s. 7(1).

be paid over a 20-year period.[22] These risk management requirements have to be satisfied when the plan is established and periodically afterward. Moreover, the Superintendent can require additional tests at any time.

In addition to the stress testing required at the outset of the plan, SRPs must pass annual stress tests in conjunction with an annual actuarial valuation to determine whether any actions must or may be taken in a given year. The annual stress modelling involves at least 1,000 series of simulations of economic parameters for at least 20 years based on actuarial assumptions that satisfy certain requirements.[23] The annual testing ensures that the plan functions well on an ongoing basis.

The *Shared Risk Regulations* require each SRP to have a funding policy.[24] The funding policy acts as a roadmap for the management of the plan. It stipulates how funding deficits or excesses must be addressed by the trustees. A funding policy must contain a funding deficit recovery plan that outlines what actions must be taken if there are any funding concerns.[25] The funding policy must also incorporate an excess utilization plan that sets out the actions the administrator may or must take when the plan has excess funds.[26]

iv. No Requirement to Fund on a Solvency Basis

SRPs are not required to be funded on a solvency basis. Instead, SRPs must file annual funding policy valuations.[27] The funded level is measured on a 15-year open group basis, which means that the present value of the next 15 years of excess contributions is factored into the calculation when determining the plan's "assets". The *Shared Risk Regulations* also contain requirements regarding the actuarial assumptions to be used in such funding policy valuations.[28]

v. Independent Administrator

The SRP can be administered by a trustee, board of trustees or non-profit corporation. If the trustee is a non-profit corporation, each director on the board is a trustee of the SRP. The only obligation and fiduciary duty of each trustee is to carry out the purposes of the plan. The funding policy acts as a normative roadmap for the governance of the plan and removes some of the discretion that the trustees could otherwise exercise in their governance of the plan.

c. Commentary

As noted above, the most significant and welcome aspect of the SRP model in New Brunswick is that it provides a framework for the conversion of DB and DC plans to SRPs on a fully retroactive basis. That is, it overrides normal statutory restrictions on making changes to accrued benefits in order to enable conversions to TBPs, as has previously been endorsed by the ACPM. This is a "sea change" in Canadian pension regulation, as all other Canadian jurisdictions continue to prohibit plan amendments that would

[22] *NB PBA*, s. 7(3).
[23] *NB PBA,* s. 7(5); *Shared Risk Regulations*, s. 15(4), s. 14(7).
[24] *Ibid*.
[25] *Shared Risk Regulations*, s. 11(1).
[26] *Ibid*, s. 12.
[27] *NB PBA*, s. 100.61(1) and *Shared Risk Regulations*, s. 14(5).
[28] *Shared Risk Regulations*, s. 14(7).

reduce accrued benefits except in the very limited circumstances. It is, in our view, a necessary aspect of a successful TBP framework-- if TBPs are to become a viable and widely adopted model. The ability to make changes to both accrued benefits and future benefits from time to time, where necessary, allows plan sponsors to have greater certainty regarding contribution levels and, as such, promotes plan sustainability. On the beneficiary side, the ability to make changes to both accrued and future benefits (rather than being restricted to increasing contributions or reducing future benefits in order to ensure a plan is sustainable) supports intergenerational equity, and ensures that all plan beneficiaries bear the downside risks of the plan, and also benefit from the upside.[29]

As currently drafted, the NB PBA contemplates the conversion of DB and DC plans in their entirety to the SRP model. In this regard, the legislation lacks provisions that would allow plan sponsors to establish target benefit provisions in plans that are otherwise not TBPs, as was our previous recommendation in the ACPM TBP Paper. For example, it may be desirable for an existing DB plan to make certain ancillary benefits such as cost of living adjustments contingent on funding to make a plan more sustainable while at the same time providing certainty with respect to other benefits. This type of model has recently been embraced by certain Ontario jointly sponsored pension plans ("**JSPPs**").

2. Target Benefit Legislative Developments in Canada

TBPs have existed for some time in the multi-employer arena in most Canadian jurisdictions, but have not been permitted for single employer plans. In its initial TBP paper, the ACPM urged provincial governments to take the necessary steps to amend pension and tax legislation to make TBPs broadly available. Several provinces across the country have made changes in their pension legislation to expand the scope of TBPs. We will review the current status of TBP legislation in each Canadian jurisdiction below.

a. Ontario

In Ontario the *Securing Pension Benefits Now and for the Future Act*[30] (formerly Bill 120) amended the *Pension Benefits Act*[31] to introduce provisions governing TBPs. These provisions will come into force on proclamation. The operational framework for the legislation remains unknown until accompanying regulations are released. The 2013 Ontario Budget mentioned that the government intends to implement regulations with respect to eligible multi-employer TBPs, but did not indicate whether TBPs would be made available outside of the collective bargaining arena.[32] Based on the current legislation, it appears that TBPs will likely only be permitted in Ontario for the unionized workforce.

b. Nova Scotia

Similarly, in Nova Scotia, the new *Pension Benefits Act*[33] (formerly Bill 96) includes provisions governing TBPs and has received Royal Assent on December 15, 2011. The Act has not yet been proclaimed in force and until accompanying regulations are released it remains unknown how the legislation will

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[29] For a full discussion of benefits for sponsors, beneficiaries and governments/tax payers, see ACPM TBP Paper, note 1.
[30] 2010, S.O. 2010 c. 24.
[31] R.S.O. 1990, c. P.8.
[32] Ontario Budget, *A Prosperous and Fair Ontario*, pp. 275-278.
[33] S.N.S. 2011, c. 41.

operate. Similar to Ontario, TBPs are possible in Nova Scotia only pursuant to collective agreements for the unionized workforce.

c. Québec

In Québec the current legislative framework governing TBPs includes the *Act to provide for the establishment of target-benefit pension plans in certain pulp and paper sector enterprises*[34] (formerly Bill 15) which came into force on December 7, 2012 and the *Regulation respecting target-benefit pension plans in certain pulp and paper sector* enterprises which was published in the Gazette officielle du Québec on November 6, 2013. These provisions are retroactive to December 31, 2010 to accommodate certain TBPs which were established effective January 1st, 2011. While promising, the Québec legislative developments currently have a very limited scope because they apply exclusively to certain companies in the pulp and paper sector.

In addition, several years ago Québec adopted special rules on a variation of TBPs called Member-Funded Pension Plans ("**MFPPs**"). Those plans have fixed employer contributions, variable employee contributions and provide defined benefits that are assumed in the actuarial valuation to include conditional indexing of pensions with full CPI before and after retirement. However, this indexing is granted only if the plan's financial situation allows it. If the financial situation of the plan can no longer support such indexing granted to date, then it must be financed by an increase in future employee contributions. Only a few MFPPs have been set up so far, but some include numerous small employers.

d. Alberta

In Alberta the new *Employment Pension Plan Act*[35](formerly Bill 10) (the "**New EPPA**") includes provisions governing TBPs and received Royal Assent on December 10, 2012. The Act has been proclaimed in force effective September 1, 2014.

On April 16, 2014, Alberta introduced a new Bill 10, titled *Employment Pension (Private Sector) Plans Amendment Act, 2014*.[36] If passed, the Bill will amend the New EPPA.

Bill 10 proposes to provide for conversions of DB plans to TBPs outside of the multi-employer regime currently contemplated by the New EPPA. Like the NB PBA, the proposed Alberta legislation would permit the conversion of accrued benefits. The detailed rules for such conversions are to be prescribed and are not yet available. Further Government consultations on Bill 10 are currently underway.

e. British Columbia

British Columbia's *Pension Benefits Standards Act*[37] (formerly Bill 38) includes provisions governing TBPs and received Royal Assent on May 31, 2012. The Act has not yet been proclaimed in force and we won't know how the legislation operates in practice until regulations are also released. As in other provinces, TBPs are currently possible in British Columbia only in the multi-employer context for the unionized workforce.

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[34] 2012, ch. 32.
[35] S.A. 2012, c. E-8.1.
[36] As of the date of this paper, the bill has passed second reading and has been referred to Standing Committee.
[37] S.B.C. 2012 c. 30.

f. New Brunswick

New Brunswick's *An Act to Amend the Pension Benefits Act*[38] (formerly Bill 63), introduced the new SRP pension plan design. Bill 63 came into effect on July 1, 2012. The *Shared Risk Plans Regulations* were filed on August 14, 2012 and provide operational details about the administration of SRPs. New Brunswick's Bill 20, *An Act to Amend the Pension Benefits Act*, received Royal Assent in December 2012 and has retroactive effect to July 1, 2012. In addition, *An Act Respecting Pensions under the Public Service Superannuation Act* (formerly Bill 11) repealed the *Public Service Superannuation Act* ("**PSSA**") and converted the pension plan under the PSSA to a shared risk plan that provides for a protected benefit floor under which benefits of public sector employees cannot be reduced. Bill 11 received Royal Assent on December 13, 2013 and came into effect on January 1, 2014. Another recent legislative development in the province is the introduction for first reading on March 26, 2014 of Bill 51, *An Act Respecting Members' Pensions*, which proposes to move Members of the Legislative Assembly ("**MLAs**") to the shared risk pension plan currently available for other public sector employees in New Brunswick. Bill 51 does not provide for a protected benefit floor as is available for other public sector employees. The amendments to the *NB PBA* in Bill 51 came into force on July 1, 2014.

g. Saskatchewan

Saskatchewan takes the position that its current pension legislative framework permits TBPs. The Saskatchewan Pension Division of the Financial and Consumer Affairs Authority confirmed that the *Pension Benefits Act*[39] already allows TBPs, so no legislative amendments are required. Section 40 of the *Pension Benefits Act* allows a plan sponsor to limit the contribution levels to the amount negotiated under a collective bargaining agreement. If funds are insufficient to enable the current level of benefits, benefits can be reduced.

h. Other Provinces

In Manitoba and Newfoundland and Labrador there is no legislative framework for TBPs outside the multi-employer context. Prince Edward Island does not have any pension legislation in force.

i. Federal

At the federal level (which includes the Canadian territories), negotiated contribution pension plans have existed for some time in the multi-employer environment. TBPs can work within the existing rules for negotiated contribution plans which means that, at least presently, target benefits are possible only for multi-employer plans.

The federal government has also released a consultation paper on TBPs titled *Pension Innovation for Canadians – The Target Benefit Plan*.[40] The content of this paper has been addressed in detail in a separate submission (click here for the submission) and is not repeated in this Supplemental TBP Paper.

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[38] S.N.B. 2012 c. 38.
[39] SS 1992, c P-6.001.
[40] See note 2 above.

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