Intelligence MEMOS

From: Barry Gros

To: Canada's Pension Regulators

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Re: **Standards Hinder the Proper Management of Target Benefit Pension Plans**

The majority of single-employer defined-benefit (DB) pension plans in the private sector have been either closed to future accruals, completely converted to defined-contribution plans or wound up. Their influence lingers, however, in pension regulation.

It took government years to reform pension legislation to allow more flexible arrangements, including target-benefit plans (TBPs), which don't guarantee pensions but allow them to be adjusted up or down contingent upon meeting specific financial metrics.

Yet, their use continues to be hindered by regulations that neither reflect how these plans work nor how they are managed because they use DB-based models inappropriate for TBPs.

While it's not surprising that benefit adjustments in TBPs are driven by actuarial valuation results, what is surprising is there's no discussion of valuation methods in consultation papers released by the provinces. The financial position of a TBP will guide decisions whether to proceed with benefit improvements, benefit cuts, or stay with the status quo. The choice of actuarial methods has a direct impact on this process.

Administrators of TBPs typically assess the sustainability of their benefit policy objectives by comparing the sum of assets accumulated to date and the current value of projected contributions with the current value of projected targeted benefits for both past and future participation. This is generally known as the aggregate actuarial method. A primary benefit of this method is that it uses all of the best information available, both past experience and future expectations, to develop a fuller picture than a method that simple relies on what's happened to date. This method also allows the incorporation of changes in future demographics of the plan, which can be critical depending on the nature of the plan and the industry in which members work. It also provides significant flexibility in setting appropriate margins to assist the plan in meeting its benefit policy objectives.

Pension regulations, on the other hand, look solely at what's happened to date and focus on assessing whether participants and employers are contributing enough, essentially treating the targeted benefit as fixed. TBP legislation pretty much dictates the use of the unit credit actuarial method – where the actuarial liability is determined using a service-based pro-rated allocation of projected benefits at retirement and benefit cost is determined on an allocation of projected benefits expected to be earned in the next year – in its TBP standards along with the requirement to have a provision for adverse deviation (PfAD) tacked onto the annual benefit cost.

The focus of this actuarial method is to provide a cost of benefits to be funded, which is basically what a traditional DB plan requires. This method is not well suited to assessing long term sustainability and has limited utility for TBPs. It wouldn't be so bad if the provincially set PfADs were low, say under 10 percent, which fits with the minimum compliance purpose of pension legislation. But PfADs at higher levels can easily result in asset cushions that analysis using aggregate methods does not support, with the end result being the unnecessary suppression of member benefits. This is exactly what has been happening in BC since the current TBP legislation was promulgated in 2015, with PfADs often in excess of 30 percent.

While we are expecting to see revised PfAD regulations in BC by the end of the year, unfortunately, that legislation will unlikely address the actuarial methods issue because that would require an amendment to the Pension Benefits Standards Act, which we understand is not practical at this time.

Then there's the issue of actuarial standards of practice that require, when providing advice on a plan with fixed contributions, the actuary indicate whether the contributions are adequate to fund the pension plan in accordance with the law (emphasis added.) I see a few problems with this. Firstly, the issue isn't adequacy of contributions, which assumes that benefits are guaranteed (not the case for TBPs.) Secondly, the real issue is the sustainability of a non-guaranteed benefit in accordance with the plan's benefit policy. The law does not set this policy. Thirdly, if the law is flawed, this puts the actuary in an awkward balancing act between what the law requires and what the actuary's judgment indicates is more appropriate.

There is no reason why TBPs cannot be governed by reasonable legislation and standards that reflect the actual nature of these plans. The change we need in provincial legislation is to move away from mimicking DB legislation and reflect that individual TBPs have the right to set their own benefit policy objectives.

Furthermore, the laws and regulations should focus on monitoring plans' sustainability and action plans to deliver on those plan-specific objectives. From an actuarial standards perspective, perhaps it is time for the Canadian Institute of Actuaries to develop a position on appropriate ways to establish, monitor and maintain sustainable TBPs.

Barry Gros is a retired actuary and Chair, Pension Board, University of British Columbia Staff Pension Plan, a target benefit pension plan since 1972.