Intelligence MEMOS

From: Barry Gros

To: Canada's Pension Regulators

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Re: **We Need to Align Regulation and Management of Target-Benefit Pension Plans**

How should Canada regulate a target payment that is not guaranteed?

This question is seldom asked, let alone answered, when it comes to setting standards for regulating target-benefit pension plans (TBPs.)

Managing risk under target-benefit plans is best realized through management practices that fully integrate funding and benefit policies and outline the material risks facing the plan and how to respond to these risks, according to research published by both the C.D. Howe Institute and the Financial Services Regulatory Authority of Ontario. Well-managed TBPs do exactly this, and they do it using a long-term planning horizon.

In practice, however, the regulatory approach for TBPs takes a totally opposite approach, treating these plans like guaranteed, defined-benefit plans but with a different contribution sufficiency test. The focus tends to be on protecting accrued benefits, with the key measurement metric being the funded position rather than the long term sustainability of the benefits, and using actuarial funding methods that do not – and cannot – take into account future plan developments.

It is regulation by rear view mirror.

This disconnect between management and regulation creates information asymmetry between what the plans are working with and what the regulators receive. Unfortunately, this asymmetry puts regulators at a disadvantage, often creating friction between plans and the regulators, and it benefits no one, certainly not plan members.

The solution is straightforward, but will require a paradigm shift. First, while they might look alike in some ways, we have to recognize that target-benefit plans operate very differently than defined-benefit plans. With defined-benefit plans, once the benefit formula is fixed, the focus is on a periodic truing up of the contributions needed to support that guaranteed benefit. So having a funding policy that takes into account the risks the plan will encounter and how the plan will deal with them by altering the contributions required, makes a lot of sense. And much of defined-benefit plan regulation pertains to putting constraints on an employer's unilateral decisions regarding funding and utilization of surpluses.

With target-benefit plans, the employer's role is very different. It generally ends once the contribution rates have been set or negotiated, typically independently of the benefit level. After that, it's up to the plan's board of trustees to set the benefit levels and adjust them as appropriate.

Employers have no ability to under-contribute or strip out a surplus. So the focus of the boards becomes one of determining optimal benefit levels, walking a fine line between either over-benefiting or under-benefiting. If financial problems emerge, experience has shown that the source can generally be traced back to the boards, either through their actions or inaction.

Secondly, the nature of the risks is different. While the actuarial valuation of DB and TBP plans use the same assumption sets, they need to be looked at from a different angle. In DB, with contributions being reset every three years, the dominant risk factor is investment return given its volatility over such short periods of time. The other valuation assumptions, like mortality and retirement rates, while important, rarely experience similar volatility over 36 months.

TBPs typically want to be able to set benefits for an extended period of time. What affects the sustainability of benefits under a TBP (i.e., what challenges the appropriateness of the benefits that were set in the past) are the long-term trends of the valuation assumptions used to set those benefit levels, not short-term volatility in any of the assumptions used. In other words, changes to expectations for future long-term investment returns, from whenever benefit rates were initially set, are a key consideration. Short-term volatility isn't always a good predictor of longer term trends.

Best practices evolve constantly and, unfortunately, pension regulation is rarely top of mind with politicians. Change in pension standards can take years, sometimes decades. If we want to make real progress in regulating TBPs, they need to better align with industry's best practices, with enough flexibility that they do not stagnate or become redundant.

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