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Finance Canada
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Canada

RE: Pension Innovation for Canadians – The Target Benefit Plan

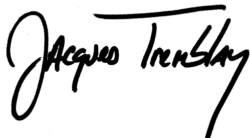
The Canadian Institute of Actuaries (CIA) is the national organization of the actuarial profession. The CIA establishes the Rules of Professional Conduct, guiding principles, and monitoring and discipline processes for qualified actuaries. All members must adhere to the profession's Standards of Practice. The CIA follows its Guiding Principles, including Principle 1, which holds the duty of the profession to the public above the needs of the profession and its members. The CIA also assists the Actuarial Standards Board (ASB) in developing standards of practice applicable to actuaries working in Canada.

We are pleased to provide our comments on the Government of Canada's consultation paper regarding target benefit plans. Our submission consists of both general comments about the proposed framework and objectives, as well as specific comments relating to selected questions from the consultation paper.

Late last year the CIA established a task force whose mandate was to examine and comment on actuarial issues associated with the design, development, and management of target benefit plans. The present submission is based on the work of this task force to date. More information may be found in the task force's final report, to be issued later this year.

Thank you for providing us the opportunity to respond. We continue to be available to discuss any questions you may have, and look forward to providing ongoing feedback if necessary.

Respectfully submitted,



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SUBMISSION BY THE CANADIAN INSTITUTE OF ACTUARIES TO THE DEPARTMENT OF FINANCE

PENSION INNOVATION FOR CANADIANS: THE TARGET BENEFIT PLAN

The CIA agrees with the government's assessment of the challenges facing defined benefit (DB) plans, in particular the magnitude and variability of costs associated with providing guaranteed pensions in a volatile investment environment with low interest rates and increasing longevity. However, we note that many DB plan sponsors and administrators have implemented various initiatives, such as de-risking investment strategies, in order to reduce cost volatility. The CIA also recognizes that Canadian defined contribution (DC) plans have a number of shortcomings, exposing members to longevity and investment risks which they are generally not equipped to manage on an individual basis.

We believe that target benefit plans (TBPs) can provide a valuable alternative to these traditional arrangements, addressing their challenges through a hybrid approach. In particular, TBPs can retain the stability of costs associated with DC plans while allowing members to benefit from improved pension outcomes through the pooling of assets in a common fund and through the pooling of certain risks, similar to DB plans.

The government's consultation paper considers the establishment of TBPs in a variety of settings: crown corporations, multi-employer pension plans (MEPPs), and single private-sector employers falling under federal pension jurisdiction. We support making TBPs available in all of these settings, and specifically both in unionized and non-unionized environments.

The consultation paper also considers the possibility of plans with or without conversion of past service benefits. While we certainly support conversion of accrued benefits under appropriate conditions, we note that the regulations applicable to plans with converted DB service may need to be different from those applicable to those without.

Considering the variety of potential situations in which TBPs might be offered can provide an insight into why an overly prescriptive regulatory approach designed for a specific situation is likely to be inappropriate and ineffective in other situations. For example:

- In plans where highly secure accrued benefits are being converted, the government may be right to focus on significantly limiting the transfer of risk to participants for converted benefits, especially pensioners.
- In plans that are fully funded on a wind-up basis there would not usually be the (actuarial) need to introduce risk upon conversion and a stringent risk threshold could probably be met. However, if pensioners were permitted to opt out of the conversion through an annuity purchase, the plan should be able to introduce more risk to suit the risk appetites of active members on an informed consent basis.
- The typical MEPP has always exposed members to the risk of accrued benefit reductions, so conversions from MEPP status could also be subject to a less stringent risk threshold.
- In plans dealing solely with future accruals, the appropriate benchmark is an individual DC plan (not a DB plan) so the regulations should pose only minimal risk constraints.

Since we are not in a position to address all possible conversion scenarios in our submission, our primary focus here is on TBPs where past service benefits are not being converted. Additional

comments with respect to conversion are provided in a separate section towards the end of this document.

General Comments on the Proposed Regulatory Framework

Given the wide range of potential circumstances—the type of sponsor, the funded status and ongoing viability of the predecessor plan, etc.—and the resulting variety of plan objectives, especially regarding the level of benefit security aimed for, the CIA advocates for TBP regulations that allow for considerable flexibility in plan design and risk management practices.

Specifically, we would like to see regulations focused on the following three areas:

1. Ensuring, through qualitative and quantitative controls, that the various policies of each plan support the specific objectives of the affected parties and the long-term sustainability of the plan as a whole;
2. Placing limits on intergenerational risk transfers that may otherwise endanger sustainability; and
3. Ensuring clear communication with plan members, at inception and at regular intervals, about the potential benefits and risks of the plan.

Each of these objectives is elaborated below.

1. Ensuring Plan Policies Support Objectives of Parties and Long-Term Sustainability

We support the approach taken in the consultation paper regarding additional filing requirements with the supervisor, including details of the benefits/funding policy of the plan, its governance policy, its investment policy, and its risk management goals and procedures. These policies would be based on the specific benefit preferences and risk tolerances of the affected parties and, as such, may differ significantly from plan to plan.

We note that the consultation paper considers the "funding policy", the "funding deficit recovery plan", and the "funding surplus utilization plan" separately in order to separate the issues and questions applicable to each area. In practice these elements could be combined in a benefit/funding policy, including:

- An affordability testing methodology, which is the test(s) that would be used to measure the long-term affordability and sustainability of the plan;
- The actuarial assumptions to be used to value liabilities for purposes of the affordability test(s);
- A pre-defined set of trigger points for action, based on the affordability test(s); and
- A pre-defined priority list of actions to be taken in terms of contribution and benefit adjustments, in response to the trigger points being reached.

The affordability tests could be stochastic or deterministic. If deterministic, they could be based on a variety of actuarial valuation methods, e.g., unit credit, entry age normal, and aggregate. Our preference would be not to constrain practice in this regard through regulation. Instead, we believe there should be guidance on the different approaches—e.g., projected unit credit versus aggregate method, and open group versus closed group valuations—and their suitability towards the objective of plan sustainability. The CIA would be pleased to offer assistance in this regard.

We advocate for the same flexibility in determining appropriate trigger points for action: these should be tailored to the specific circumstances of the plan, reflecting the priorities as well as the contribution and benefit risk tolerances of the affected parties and the availability of various benefit levers, e.g., conditional indexation, other ancillary benefits subject to affordability, and changes to service accruals. From a technical standpoint the trigger could be a single point, above and below which adjustments need to be made. However, from a practical standpoint (especially if the plan's objectives include year-to-year benefit stability) we expect the trigger points to define a "range of affordability" within which no action would need to be taken and contributions/benefits could remain at their current levels, and outside of which the priority list of actions would be invoked. In the context of Alberta's going-concern-plus funding model this would correspond to minimum and maximum PfAD (provision for adverse deviations) levels. In the context of New Brunswick's shared risk model this would be the equivalent of the no-action-range based on the open group funded ratio (100 percent on the lower end, 140 percent on the higher end).

Again, our preference would be for the trigger points not being specifically regulated, especially not in the form of minimum/maximum PfADs, since these could vary significantly based on the asset mix, demographic profile, and benefit structure of the plan, and on the risk tolerances of the parties.

We appreciate that such a flexible approach may leave the government uneasy about the level of benefit security[1] provided by the plan, which is a major focus of the consultation paper. If appropriately communicated, the risk of benefit reduction—and benefit improvement—is not bad by itself; the risk of creating unwarranted expectations is what needs to be avoided. The CIA will provide guidance where appropriate.

If, nevertheless, the government feels that the regulations must specify some minimum probability threshold for benefit security, it would need to be set at a reasonable level that can accommodate a variety of risk tolerances and objectives; for example, a 75 percent likelihood that the benefit delivered will be equal to or greater than the target. If the benefit/funding policy is well-defined (i.e., it has clearly defined testing methodology, assumptions, trigger points, and actions) then the projected likelihood of meeting or not meeting the target benefit level over a certain horizon can be estimated using stochastic methods.

If a minimum threshold is established in the regulations, the requirement should be that this minimum be met at the inception of the plan. For many plans, it would be impractical to re-evaluate this probability at frequent intervals. Instead, as noted above, plans should be allowed to develop a simpler, deterministic affordability test—e.g., a set of minimum/maximum PfADs—specific to their own circumstances and apply that test going forward, as long as it is shown at inception that the test, combined with all other aspects of the benefit/funding policy, leads to the minimum benefit security threshold being met. Such a flexible approach would not preclude plans from using stochastic projections as their primary risk management tool but would not make it a requirement for all plans.

We believe this approach would be a reasonable compromise between the more onerous requirements of the New Brunswick regulations, which prescribe a very high benefit security threshold that may not be appropriate for all plans, especially those converting from DC, and

[1] Although the term "benefit security" is not explicitly defined in the consultation paper, we understand it to mean the ability to deliver at least the target benefit in an ongoing plan.

Alberta's going-concern-plus framework, where a much simpler test is applied but the resulting probability of being able to deliver the target is not plan-specific.

2. Placing Limits on Intergenerational Risk Transfers

To address sustainability, the government may consider monitoring intergenerational risk transfers. For example, the regulations may require some sort of demonstration, at inception, that the risk profile of the plan is not expected to change drastically over time. The CIA would be pleased to provide more detail about the types of demonstrations that may be effective in this regard. The objective of requiring such a demonstration would not be for the supervisor to explicitly "approve" the policies based on some quantitative measure, but rather to ensure that this information was made available to the parties at the outset and that risks and rewards were knowingly structured in a particular way.

In addition, we support the government in placing explicit limits on intergenerational risk transfers. Specifically, we support prescriptive regulations regarding the types of actions that can be taken when the trigger points are reached, with different plans having the choice to use/not to use certain actions. We also support placing explicit limits on the actions that affect only current and future members while providing a limited additional protection to retired members, similar to what was included in the New Brunswick regulations.

3. Ensuring Clear Communication with Plan Members

We support detailed and prescriptive regulations regarding communication and disclosure to members. The CIA strongly believes that disclosure to members about the nature of the plan, particularly the fact that benefits are not guaranteed, is crucial to managing member expectations.

Other comments

We would also like to offer some comments regarding specific questions asked in the consultation paper.

Contributions

The consultation paper considers allowing variable employer contributions with a cap. We support this as an option available to employers, but not as a requirement. We note that the accounting treatment of this type of contribution commitment is not clear at this time.

Benefit Structure

The consultation paper makes reference to plan administrators being "provided with the flexibility to identify if any benefits are fully guaranteed, such as accrued benefits". We strongly oppose this notion. While a TBP may wish to offer a *higher* level of benefit security with respect to accrued benefits than other benefits, trying to offer *full* benefit guarantees results in essentially unlimited risk. With fixed (or capped) contributions and fixed benefits, a very large proportion of the risk would be transferred to future generations, which is neither sustainable nor equitable.

Regarding the two-tier structure suggested for benefits, the CIA believes it could be an option but should not be mandated. We recognize that such a division can be helpful in the situation where accrued benefits are being converted and the original plan has an indexing provision (before or after retirement) which can be used as an additional lever in the TBP. In other

situations, this level of complexity may not be needed. Also, some parties may not wish to have ancillaries as the first lever in their plan design.

We would also like to request that the regulations specifically exempt TBPs from the excess contribution rule under the Pension Benefits Standards Act as application of this rule can impair the ability of the benefit adjustment mechanisms to achieve their purpose.

Individual Termination

We support the notion that the benefits payable on individual termination be a share of the plan assets determined in proportion to the liabilities of the plan measured using the methods and assumptions used in the affordability test (the "going concern basis"). We appreciate the flexibility given to plans in choosing whether to include a proportion of the buffers in this termination value or limiting the proportionate share associated with any "excess assets".

Plan Termination

We agree that, given the nature of the plan, the amount payable to each member on plan termination should be the share of the plan assets determined in proportion to the individual's liabilities in the plan, including the member's share of residual buffers, if any. There should be no obligation for any party to "top up" the plan assets on plan termination in the event that plan assets are not sufficient to provide the target benefit.

Plan Size

Small plans have limited capacity for risk sharing and might not have the resources required to properly implement and manage a TBP. The government may wish to consider giving incentives to small plans considering the TBP model to merge in order to achieve critical size and to be able to benefit from economies of scale. Alternatively, the government could consider licensing TBP providers who could offer a low-cost solution, along the same lines as a pooled registered pension plan. We note that consolidation of pension plans with conditional benefits has occurred in the Netherlands over the last decade, with the number of plans decreasing from about 3,000 to less than 500.

Conversion to TBP

We believe the government's proposed approach to conversion is reasonable. In particular, we agree with the proposal to apply DB termination rules to plans that terminate within five years of conversion.

We also appreciate the government's desire to avoid significant risks being transferred to members already in receipt of pensions under a DB plan at the time of conversion. We note that the appropriate minimum level of benefit security attached to converted accrued benefits depends, in part, on what level of consent, if any, is required or attained. If a reasonable level of consent is required from retired members at the time of conversion, the regulations can be less prescriptive about benefit security because any "deal" that does not provide an attractive risk/reward proposition to retired members will likely be rejected by them. On the other hand, if consent of the retiree group is not required, the regulations should be more specific in establishing an appropriate benefit security threshold for conversion of accrued benefits, which may be different from the benefit security threshold applied to future service.