



EXCLUSIVE INTERVIEW:

Today I'm pleased to be talking to Barry Gros, a senior actuary and VP at Aon Hewitt. He is going to answer some questions about the inclusion of "target benefits" in Phase 2 of Ontario Pension Reform.

Thanks for joining me today Barry.

Q. Barry, can you explain to me what target benefits are, and how a target benefit plan (TBP) differs from a typical defined benefit (DB) pension plan?

A: While there seems to be some confusion in the industry as to what exactly a target benefit plan is, I think the definition in the Ontario Expert Commission report works very well. It states that TBP is a DB plan that is funded through fixed contributions, and your typical multi-employer pension plan is a great example of a TBP.

When we drill down, a TBP differs from a typical DB pension plan in at least four ways:

- In a TBP the contributions going in typically are fixed, set by a pre-determined formula. In a typical DB plan, contributions are set by an actuarial valuation and consist of two components: a service cost component for benefits being earned in the future and a special payment component to make up for any current asset shortfalls for benefits earned in the past.
- A key principle under a typical DB plan is that benefits earned to date cannot be reduced. This is codified in all the pension and benefits acts. This would not necessarily be the case under a TBP.
- In a TBP there are no surplus ownership issues, which is a huge advantage. Plan members would have clear title to any surplus should the plan be wound up.
- Under pension accounting, your typical DB plan has to go through a horrendous accrual accounting and reporting process, while so far, a TBP would be accounted for as a DC plan. However, there is a push at the international accounting level to change this.

Q. What are some of the key elements of the in Ontario Bill 120 relating to TBPs?

A: The Bill is pretty light on detail, but it does indicate that for a plan to be a TBP:

- The pension benefits cannot be defined contribution (DC).
- The employer contribution obligation is limited to a fixed amount set out in one or more collective agreements.
- The administrator has unrestricted power to reduce benefits, both earned to date and earned in the future.
- Ancillary benefits are considered part of the target benefit.

Another key element is that TBP can only exist in a collectively bargained environment, which I think is unfortunate.

Q. Why might a TBP be attractive to some employers that currently sponsor a traditional DB plan?

A. Two of the biggest issue for many DB plans today are that:

- There's no "flex" in the plan to allow it to endure hard times.
- Contribution rates for many plans — especially those in the public sector — are not sustainable.

To be able to manage a plan properly, the benefit policy, the funding policy and the investment policy all have to be coordinated and all three have to have some level of "flex" in order to help the plan survive in hard times.

The TBP does two key things:

- It fixes the employer's cost, both from a cash funding perspective and a financial reporting perspective, providing much desired certainty; and
- It gives plans the "flex" required by allowing benefits to be one of the release values available if the investment performance doesn't come through.

Q. In September 2008, Aon Consulting released a white paper on a plan design you called the “affordable defined benefit plan” or ADB. How did the ADB plan differ from the model established in Bill 120?

Actually Sheryl, there really are not many differences. They are very similar from a design perspective. We won't be able to tell until the regulations are out how the two might vary operationally.

The primary difference based on what we see in Bill120 is the requirement for the TBP to exist within a collectively bargained environment. It was never envisaged that the ADB would have this restriction.

Q. I understand you have some concerns about the TBP provisions in Bill 120. Could you share them with us?

A. It's hard to comment too much without seeing the detail in the regulations. My main concern at this point is that while the province acknowledges the need for greater design flexibility, it seems to only be willing to give it where there's a collective bargaining agent.

I would suggest that there have been enough poorly run multi-employer plans (MEPPs) to illustrate that having a collective bargaining agreement in place is not a prerequisite for good governance. What is important is not that there is a collective bargaining agreement, but that the plan be jointly-trusted with appropriate representation from the retiree population. Also, the plan sponsor should not have unilateral control of any part of the running of the plan once it is established.

Q. Why do you think the legislation limits operation of these plans to cases where employer contributions are collectively bargained and do you think that will hold up right to final passage of the bill?

A. From reading the Arthur's report on the Expert Commission on Pensions, it's clear that Professor Arthurs is ideologically predisposed in this direction so this recommendation is not surprising and the government seems to have accepted it.

I believe the gist of what is really being recommended is to wrest control of the plan from the sponsor and have the plan managed jointly with the members so members (including retired members) have a role to play. There's a lot of merit to that general concept but it just doesn't have to be restricted to the collectively bargained arena.

Q. Aon is the actuary for the University of British Columbia Staff Pension Plan which operates a target benefit plan. If funding is inadequate benefits have to be reduced, but this has never happened. What practices and plan design features contribute to the plan's success and how can other employers emulate them?

A. First of all, the UBC Staff Plan has never been stressed to the point where it actually had to reduce benefits. To my knowledge, the success of the UBC Plan to date has largely been around retaining a sufficient reserve to be able to weather the storm, including the two perfect storms we have had in the last decade. That said, I know they have been reviewing the benefits as a possible prelude to benefit changes that will reduce exposure to future shocks.

If we leave the UBC Staff plan for the moment, I think the key design elements for a successful TBP plan are actually the same ones that we used 30 years ago, before the equity markets took off and lulled us into believing that annual 10%+ returns were easily achievable. For example:

- Rather than promise a benefit based on final average earnings, offer one based on average earnings over a career, possibly with upgrades to the benefit.
- Minimize early retirement subsidies and bridge benefits. With life expectancy well into the 80's now, we need plans focussed on providing benefits at normal retirement age, not windfall gains a plan member can take out of the plan when going to another job.
- Eliminate automatic indexing of pensions in payment. Improvements in pensions in pay would be based on a combination of the need, based on changes in the cost of living and the ability of the plan to provide those increases.
- Minimize subsidies based on marital/spousal status. We seem to have accepted that the value of pensions should be independent of gender, yet still support the idea that a member with a spouse should take more out of the plan than one without.

Q. What kinds of organizations will be a good fit for TBPs? What kinds of transition issues do you envisage if an organization wants to move from a traditional DB plan to a TBP?

A. I believe the general traits of an organization where a TBP would be a good fit are critical mass or size (at least a few thousand members) and some sense of permanence to the organization.

Many MEPPs already operate this way, which shows that TBP is a good candidate for an industry-based employee population — say plumbers, pipefitters, or other trades. Many public sector plans have moved partially in this direction whether it's a Teachers or a HOOPP, by changing from automatic CPI indexing to conditional indexing.

So, one of the primary growth areas for the TBP would be private or public sector collectively bargained DB plans where is a push from employers to convert from DB to DC, and pushback from unions with a DB bias. The TBP would be a good compromise in situations like this.

As far as being able to transition from a traditional DB plan to a TBP, I could see the following being a plausible scenario:

- Could only be contemplated while the plan is fully funded.
- Retirees would be carved off along with an appropriate share of assets, so that their pension is not subject to reduction
- Necessary buy-in/approval of active members at the transition time in order for them to move from a so-called "fully secured" position to one where their earned pension was more at risk.

So it will be interesting to see what comes out in the Regulations to Bill 120 in the way of flexibility, because based on what we've seen so far, Ontario has shown no great desire or interest to expand or promote the expansion of pension coverage.

Q. Now we are seeing this Ontario initiative. Have any of the other jurisdictions jumped on the band wagon?

A. I know that Alberta and B.C. were quite interested in it but as you are well aware, we haven't really seen anything from them. The feds have shown some interest in this area but they also have very strongly come out in favour of only having TDB plans, where plans are collectively bargained.

It was a pleasure to chat with you today Barry. It will be interesting to see what if any changes are made to Bill 120 before it is passed and proclaimed into law. Thanks again.

You are very welcome.

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