TARGET BENEFIT PLANS

The Facts

What are target benefit plans?

Target benefit plans (TBPs) are a unique type of pension plan that blend elements of defined-benefit and defined-contribution plans to provide a base monthly pension at retirement (which may be allowed to change, depending on the pension plan's performance) with limited or conditional indexation. The benefits paid in retirement are linked with how well the pension plan performs. Target benefit plans are similar to jointly-sponsored or multi-employer pension plans, where a number of employers (usually within the same industry) share a pension plan.

Target benefit plans shift the concept of risk. With defined-benefit pensions, the employer or plan sponsor is usually wholly responsible to ensure the pension promise is fulfilled. The employer and to some extent active employees are responsible for making up pension funding shortfalls, through their contributions and the plan's investments. With defined-contribution plans, employees bear all of the risk – their contributions are known, but the benefit they will receive in retirement is not. By linking the pension benefit and indexing with plan performance, and allowing benefit reductions, retirees become partially responsible for making-up plan funding shortfalls.

Target benefit plans offer pooling of assets between employees and economies of scale, and funds are managed in much the same way as in a defined-benefit plan – although target benefit plans may be invested more conservatively to protect against the chances of a funding deficit.

Usually, target benefit plan provisions in pension legislation allow new target benefit plans to be set up, or for employers or plan sponsors to convert from a defined-benefit or defined-contribution plan to a target benefit plan.

How do target benefit plans differ from defined-benefit pension plans?

Defined-benefit pensions are plans where an employer or plan sponsor promises a specified pension amount upon an employee's retirement. The pension is determined by a formula that is defined and known in advance, and usually based on the employee's earning history, years of service and a multiplier. The formula typically does not change. Target benefit plans are exactly that – a target -- they provide a general sense of what the final pension amount will be. But that target can move if the pension plan does not perform well.

Most defined-benefit plans have indexation, to ensure retirees' incomes keep up with inflation. Some plans provide full indexation based on, for example, the Consumer Price Index; other plans may provide a portion of indexing based on the Consumer Price Indexing. Some pension plans have an indexing formula based on average inflation over a set period of time. Target benefit plan indexing is typically conditional on positive plan performance. Further, some plans may have rules or limits on how much of the plan's money can be used on indexing.

Defined-benefit plans have are currently facing a new element of risk – rising costs due to difficult markets and shifting demographics. Target benefit plans may eliminate some of this risk by providing flexibility in the benefits that are paid, and in thereby shifting the risk of making up for shortfalls from the employer to the employees and retirees.

In recent years, it has been difficult to accurately account for defined-benefit plans' performance and make projections on their sustainability. As a result, we've seen many companies and governments, particularly in the United States and Europe, run into serious difficulties. Ideally, accounting in target benefit plans is based on contributions made, which is similar in practice to defined-contribution plans – in effect, a "real time" projection of the health of the fund and the benefits that can be paid from it.

How do target benefit plans differ from defined-contribution plans?

The approximate amount of pension benefit paid under target benefit plans is usually known. While it is less certain than the pension paid under a defined-benefit plan, there is far more certainty of an approximate amount to be paid than the outcome with a defined-contribution plan. The benefit that will be available in a defined-contribution plan is not known until very near retirement.

Individuals who have defined contribution plans make investment decisions largely on their own. All too often, however, the majority of people are not well-enough informed or qualified to make their own investment decisions. Studies have shown that plan administrators and investment professionals make better investment decisions than individual employees. With target benefit plans, assets are pooled and invested in a similar manner as for defined-benefit plans. This is likely to result in better economies of scale and better investment performance than defined-contributions can provide.

Target benefit plans also pay a pension over retirees' lifetimes. Retirees may have to be concerned with some benefit reductions if their plan's performance is poor over a period of time, but they will usually not have to be concerned with whether or not they will outlive their retirement savings.

What are the risks?

Accrued benefits are subject to reduction if the plan's funding level falls below a given threshold. This may sound like a theory, but over the past decade, approxmiately 25 percent of multi-employer pension plans have had to reduce benefits. That risk can never be entirely eliminated.

The overall plan risk is shifted heavily towards retirees. According to PBI Actuarial consultants: "there is no risk sharing other than between members of the plan; the employer(s) bear no risk, with their liability limited to a fixed agreed-to contribution rate (unless negotiated otherwise), which cannot be "automatically" increased in the case of a deficit..."[1].

In some jurisdictions, people who recently retired with a defined-benefit pension have had their pension shifted to a new target benefit regime. This means that the pension they thought they would have at retirement, as well as the indexing they expected, may be reduced after they worked for it.

In April 2014, the federal government released a consultation paper that proposed a federal framework that would allow federally-regulated employers and Crown corporations to implement target benefit plans for their employees and retirees. The federal framework, as it had been presented, also allowed for a conversion that could reduce accrued defined-benefits and the elimination of defined-benefit liabilities – simply put, employers with defined-benefit plans would be permitted to convert those plans to target benefit plans, and that could impact the retirement income security of people who have already retired.

Some provinces have already implemented target benefit plans. New Brunswick recently implemented them for their public sector; Quebec has made them available to some industries, such as the pulp and paper sector; and other provinces, have studied the possibility of implementation (ex: Alberta, before the last election).

During the 2015 Election, Justin Trudeau said TBPs made sense in "certain circumstances" but that "any changes to existing Defined Benefit Pensions (DBP) should be made on a going-forward basis." However, after the election, Bill Morneau was named Finance Minister. Mr. Morneau has been fond of TBPs saying in 2013 : "we need legislation enabling Target Benefit Plans and Shared Risk Plans in all Canadian jurisdictions." It remains to be seen what this government's position on TBPs will be.

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1 PBI Actuarial Consultants Ltd., "Consultation Paper Pension Innovation for Canadians: The Target Benefit Plan". June 23, 2014

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