Target Benefit Plans

First in a series of Guides on Target Benefit Pension Plans published by Aon Hewitt

The Future of Sustainable Retirement

The economic turmoil of the last decade has called into question the ability of traditional pension plans, whether defined benefit or defined contribution, to adequately deliver sustainable retirement benefits. Knowing the importance of meeting the need for more sustainable retirement solutions, Aon Hewitt is releasing its guide, Target Benefit Plans: The Future of Sustainable Retirement Programs, which outlines the need for more sustainable approaches to retirement programs and highlights its expertise in working with target benefit plans. A sustainable pension plan is one that can consistently deliver, through favorable and adverse circumstances, an appropriate range of benefits within an acceptable range of costs over the long-term. It is based on a solid understanding by all stakeholders of the risk factors involved and the understanding of the critical need to have a pension plan that can adjust both costs and benefits in response to actual experience. The whole point of sustainability is to avoid severe corrections to both contributions and benefits.

Where traditional defined benefit (DB) and defined contribution (DC) plans have fundamentally failed is the one-sided nature of their risk allocation and their inability to adapt to changing times. With weak equity markets in recent years and continually declining interest rates, DB plan sponsors, who tend to shoulder the funding risk inherent in these plans, have been unable to invest their way out of their DB pension deficits. Meanwhile, DC plan members, who shoulder the risks to benefits inherent in these plans, have seen the value of their retirement nest eggs struggle to grow and eroded by increasing longevity.

The target benefit approach leverages the best aspects of DB and DC while minimizing the main disadvantages of each. A target benefit (TB) pension plan has fixed contributions, a targeted defined benefit level, and a benefits/funding policy that prescribes the methods for varying benefits based on affordability, with pre-set reserve levels and a pre-determined order of benefit adjustments.

The key difference between TB and other sustainable approaches is that TB pension plan contributions are set first—at a fixed level or within a fixed range—and benefits are derived based on affordability, with the ability to adjust benefits as experience develops.

TB can be seen to operate more as a "pooled DC" approach rather than a DB approach trying to fix its costs. Other elements key to the success of target benefit plans are the margins built into the costing of the targeted benefit promise and the ongoing testing of the sustainability of contribution/benefit combination.

TB is far from a new concept in Canada. Many of the principles on which TB plans are based have existed for years in the traditional multi-employer pension plan (MEPP). Furthermore, the UBC Staff Pension Plan is a perfect example of an existing situation where the target benefit approach has succeeded for decades. The plan administrators embraced the concept of sustainability testing almost 20 years ago, ensuring the plan maintained sufficient reserves in good times to deal with turbulent times and most recently introducing cost neutral changes to increase lifetime benefits while enhancing overall equity amongst members.

Another perfect example of where the target benefit approach works is Resolute Forest Products. The Resolute interest in TB arose out of a company restructuring. The new company needed a more stable pension cost than that provided by its existing DB pension plans and, given the significant union presence, traditional DC wasn't a viable option. The DB benefits in effect prior to the adoption of a TB approach were kept in place and not converted to TB. Aspects of the TB design that were important to ongoing success included: a fixed contribution going into the plan, maintenance of an adequate benefit level for current and new members, joint governance with half of the Board of Trustees comprised of plan member representatives, and a complete review of the investment policy to take into account the change in the nature of plan risks in moving from traditional DB to TB.

Some situations seem particularly ripe for TB. The ideal private sector situation might be one where the employer is suffering with poorly funded plan(s); hasn't been able to invest its way out of its pension deficit; is contemplating getting out of DB; and has strong unions and/or a culture that limits the viability of a move to DC. TB also has great potential for public sector situations where:

- the cost of the existing plan is becoming unsustainable for members and/or employers and intolerable for taxpayers;
- existing benefits have no levers for adjustment in adverse times;
- the scale permits effective risk pooling and cost efficiency;
- and human resources requirements, and the nature of the career path, mean there is a need for a compromise solution that involves something other than traditional DC.

In Canada, we have taken two relatively simple tools, DB and DC design, and regulated them to death but with little positive impact on actually delivering sustainable retirement systems. Sustainable pensions are essential for the prosperity of our country – especially in light of the general aging of the population. While it is time for change, we don't necessarily need radical change. We actually have the tools in place – we just need to use them more effectively and permit more flexibility in their application. TB has great potential to achieve what we are all looking for: sustainable retirement income.

To request a full copy of the guide, and for more information email info@aonhewitt.com.

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