Unpacking the Target Benefit Plan

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

Finding the Right Benefit/Funding Balance

Aon Hewitt's *Guide to Target Benefit Plans*, released in June 2012, provided insights to help all stakeholders better understand how to design, manage, and regulate sustainable TB plans. Now Aon Hewitt is releasing its 2nd Guide, *Unpacking the Target Benefit Plan: Finding the Right Benefit/Funding Balance*. A companion to the first, this new Guide takes a practical look at the issues surrounding pension benefit affordability and sustainability testing.

"Target Benefit Pension Plans are at the forefront of today's discussions of sustainable retirement solutions in Canada," says Karen Hall, Vice President, Retirement, for Aon Hewitt, and one of the guide's primary contributors. "Over half the pension regulatory bodies in the country are wrestling with the concept and are in various stages of drafting legislation and regulations to provide for the Target Benefit (TB) approach."

Finding the Right Benefit/Funding Balance presents a framework for affordability testing and creating a benefit/funding policy, as well as providing examples drawn from actual situations. It also proposes a set of principles with a view to forming a good foundation for Target Benefit sustainability testing, and which might be used by regulators to create a suitable framework for monitoring TB plans. Given a set contribution rate, what level of benefits should be targeted? What would be the trigger points for adjusting the targeted level of benefits? And, given that potential solutions are as numerous as there are actuaries in the country, how might a regulator assess the appropriateness of a particular plan's benefit/funding policy and approach to affordability testing?

The Definition

Let's start by being very clear as to the nature of a TB pension plan, thinks Claude Lockhead, Partner, Canadian Investment Consulting Practice and responsible of the retirement Practice, Eastern Canada for Aon Hewitt. "By definition, the TB plan starts with an agreement concerning the contribution rate. This is identical to a traditional Defined Contribution (DC) plan, where the agreement between sponsor and members concerns the contributions being made to the plan. Further, it is the direct opposite of a traditional Defined Benefit (DB) plan, where the guaranteed element of the plan is the benefits upon retirement and the contribution rate is driven by the plan design selected, the actuarial methods and assumptions adopted, and plan experience. However, unlike a traditional DC plan, TB pools benefit risk to enable a more stable and predictable retirement income stream".

We have two reasons for emphasizing this definition. First, Target Benefit plans are barely out of the gate and the meaning of the term is already evolving. Because of this it is vital that plan sponsors and administrators involved with TB be very clear in describing their plan offering and how it works. Second, the definition highlights the fact that TB requires a fundamental paradigm shift away from traditional DB valuation thinking. What is needed is a risk management approach, where the sustainability analysis evaluates the probability, over an appropriate period of time, that the plan will be able to deliver the targeted benefit with a high degree of certainty.

The Benefit/Funding Policy

Critical in all this is a well thought out benefit/funding policy, which needs to include the following key elements:

Table 1: Key elements of a TB benefit/funding policy

Element	Nature
Testing methodology	A benefit/funding "test" to be used to measure the long-term sustainability of the relationship between "funds available" and "funds required", where: • "funds available" refers to more than the existing assets and includes expectedntributions in the future; and, • "funds required" refers to the value of both past and future benefits.
Actuarial assumptions	A basis for setting actuarial valuation assumptions to value the "funds required".
Reserve levels and trigger points	Consisting of a pre-defined range/zone of acceptable financial measures along with trigger points that would signal benefit adjustments.
Benefit priorities	A pre-determined approach to benefit adjustments at each trigger point.
"Disaster" plan	A clear accountability and responsibility for "disaster" scenarios, where results fall far outside of the range of the pre-defined trigger points.

The Principles

"Based on the examples and discussion presented in the paper," Hall says, "we propose a set of principles for sustainability testing of a TB plan.

"These include:

- The actuarial valuation determines the ability of plan funding to support benefits, with noconcept of "deficit" or "surplus" as at the valuation date. Plan funding is fixed and benefits vary based on the trigger points identified in the benefit/funding policy.
- The actuarial valuation takes a long term view. It includes a benefit/funding test conducted on a regular cycle and incorporating a projection valuation.
- Sensitivity and/or stochastic testing is conducted to estimate the probability that the plan benefits are sustainable.
- The policy applies a moderate approach when setting reserve levels, to minimize the probability of benefit cutbacks. he ideal would be to achieve a wide range where the target benefit level would be maintained.
- Benefit affordability testing must be highly sensitive to member equity. This would include past versus future benefits, application of benefit reductions and improvements, and reserving levels that strike the balance between being conservative without being unduly risk averse.

From a regulatory point of view, there are already guidelines and tools at hand to successfully implement TB. We believe the key to regulating TB pension plans is the benefit/funding policy. The policy needs to be clear, sufficiently detailed, and reasonable in light of the risk sharing deal between plan sponsor and members. It needs to be supported by a sustainability analysis that involves adequate risk testing using projection valuations, and that analysis must be revisited periodically. In addition to a solid benefit/funding policy, the governance structure and member communications must also be aligned to the risk-sharing nature of the pension deal.

"In Canada, we have regulated the DB and DC design to death, but with little positive impact on actually delivering sustainable retirement systems," says Barry Gros, Vice President at Aon Hewitt and one of the guide's primary contributors. "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."

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

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