Pension Innovation

New Brunswick's Shared Risk Model

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New Brunswick has enacted legislation to permit shared risk pension plans (SRPs), a type of target benefit plan (TBP), while other Canadian provinces have passed amendments to enable TBPs. This article discusses considerations for employers and employees contemplating an SRP.

The shared risk plan (SRP) is an innovative plan design option that was recently introduced in the province of New Brunswick. In 2012, the provincial government enacted legislation to permit SRPs, a type of target benefit plan (TBP), in the public and private sector, for single employer and multi-employer arrangements and for unionized and nonunionized workplaces.[1] Several plans in the province, including the Certain Bargaining Employees of New Brunswick Hospitals Plan, City of Saint John Pension Plan and the Pension Plan for CUPE Employees of New Brunswick Hospitals, have converted to shared risk.

Other Canadian jurisdictions including Ontario, Nova Scotia, Alberta and British Columbia have passed amendments to their pension legislation to enable TBPs; however, these amendments have not yet been proclaimed in force and there are no regulations. Quebec has implemented legislation to permit TBPs in the pulp and paper sector. Saskatchewan takes the position that its current pension legislative framework permits TBPs.

As a type of TBP, the shared risk design combines some of the best features from traditional defined benefit (DB) and defined contribution (DC) models. Similar to DC plans, the employer and employee contributions are fixed and predictable—subject to slight variations. SRPs deliver a DB-type targeted pension benefit to employees upon retirement. However, unlike DB plans, the retirement benefit is a "target" and can be reduced if economic circumstances warrant.

In a nutshell, the SRP model has three key components:

1. Plan design distinguishes between highly secure "base" benefits and moderately secure "ancillary" benefits.
2. Protocols that require or permit actions to change benefits and/or contributions in response to the plan's overall financial condition
3. A prescribed risk management regulatory framework to help keep the plans on track.

The SRP model is designed such that base benefits are highly secure but may be reduced in dire economic circumstances, and ancillary benefits are allowed only if the plan's financial condition permits them. The model is designed to self-correct and adjust to fluctuating economic conditions. Where there are excess funds, more money can be spent on benefits. Where the funding of the plan is less robust, less money will be spent.

This paper will discuss the SRP design as compared to traditional DB and DC models from the point of view of both employers and employees.

Considerations for Employers

Cost Certainty

From the employer's cost perspective, SRPs work like DC plans in most respects. The employer's contributions are predetermined—within a narrow range of contribution levels. Employers prefer the predictable pension costs provided by the SRP model to the cost uncertainty associated with DB plans.

No Solvency Funding Required

SRPs are not required to fund on a solvency basis, which means employers aren't required to make additional special contributions based on plan solvency levels. It is, however, possible that employer and employee contributions may be increased within a certain predetermined range in accordance with the plan's funding policy if the plan fails certain funding tests in a given year. SRPs are required to file annual funding policy valuations. The funded level is measured on a 15-year open group basis, which means that the present value of the next 15 years of excess contributions is factored into the calculation when determining the plan's "assets."

Employee Retention

In a marketplace competing for talent, the employer can provide competitive benefits to encourage employee recruitment and retention. The SRP design includes a targeted DB-type pension benefit for members and risk pooling, which may be more attractive to many employees than a DC plan or group registered retirement savings plan.

Risk Pooling

Financial risks, including longevity and investment risk, are pooled under an SRP, similar to a DB plan. This is discussed more below.

Ability to Convert Accrued Benefits

While controversial, this is an attractive aspect of the SRP model for plan sponsors. Where a plan is converted, all the accrued defined benefit or defined contribution benefits become part of the SRP and subject to SRP rules, including future conditional cost of living adjustments (COLAs) and the possible reduction of benefits. As pension standards legislation generally protects accrued benefits, conversion of past benefits to a targeted benefit regime requires legislation to permit such a conversion. In 2012, New Brunswick passed legislation to allow conversion of existing plans to shared risk and to provide immunity to plan sponsors and other stakeholders that do so.

No Right to Surplus

As the money in the plan belongs to the members, the plan sponsor does not have the right to surplus. Contribution holidays are not permitted under the SRP model unless required by the Income Tax Act.

Different Governance Model

The employer also is the administrator for many employer-sponsored pension plans. The appointment of a board of trustees to manage an SRP means that the employer gives up control over plan administration. This loss of control, however, has the positive effect of encouraging more employee/union involvement in plan governance.

Potentially Increased Administrative Costs

SRPs have more annual compliance requirements. For example, plans must annually file a funding policy valuation, and the administrator is required to review and file confirmation of review of certain key documents. Such enhanced regulatory requirements and oversight will likely increase the plan's administrative costs. Depending on the plan's terms, such costs may be borne by the plan in accordance with the applicable laws or by the employer.

Considerations for Employees

DB-Type Benefit

SRPs provide a predictable pension with DB attributes. Employees can understand the targeted pension they can expect to receive on retirement, similar to a DB plan. This is in contrast to a DC plan where employees may know their account balance but not understand what retirement income they can anticipate based on such account balance.

Investment Pooling

Most individuals do not have the investment experience or expertise necessary to effectively manage their investments, and pooling investments effectively transfers those responsibilities to the plan. Plus, pooling of assets allows for lower investment management fees and administration costs and access to alternative investment classes. As in a DB plan, SRPs pool investment risk.

Longevity Pooling

Similar to DB plans, longevity risk pooling is an important component of TBPs. Unlike a DC plan where members have to save for their own lifetimes and risk outliving their savings, an SRP allows for pooling of this longevity risk.

Excess Funds Spent on Benefits

In the event an SRP has excess funds, the employer cannot decide unilaterally to take a contribution holiday. Once the employer and employee contributions are made to an SRP, the plan money belongs to the members and must be used to benefit plan members. Hence, any excess funding (minus any administrative expenses borne by the plan) will be spent on member benefits in accordance with the funding policy. These may include COLAs, bridge benefits, enhanced early retirement subsidies or other permissible member benefits.

Intergenerational Equity

While controversial, the ability to convert accrued benefits where a plan is converted from DB to an SRP can promote intergenerational equity. Where a DB plan has funding issues, including issues that have arisen primarily due to demographic shifts or increased longevity, these are generally borne by increased active employee and/or employer contributions and/or reductions to future benefits for active members. SRPs aim to share some of the burden across all membership classes.

Robust Risk Management

SRPs are subject to prescribed risk management goals and procedures. For example, SRPs are required to undergo annual stress testing. At the inception of the plan, there must be at least a 97.5% probability that base benefits will not be reduced over a 20-year period. Also, there must be at least a 75% certainty that certain ancillary benefits will be paid over the same period. The required stress testing helps to ensure that the contributions are set at the appropriate level for the benefits when the plan is established and that corrective actions, if necessary, will be taken in a timely manner over the plan's lifetime.

Arm's Length Administration

SRPs remove the administration function from the plan sponsor. SRPs must be administered by a trustee, board of trustees or not-for-profit corporation. SRP trustees are required to act independently of the party who appointed them and have fiduciary obligations to act in the best interests of the plan's beneficiaries. While New Brunswick's regulations do not mandate a specific constitution of the board of trustees, most of the plans that have converted to the SRP model have an equal distribution of trustees appointed by the employee groups and the employer.

Benefits May Be Reduced

The benefits (both base and ancillary) under an SRP may

Takeaways

- SRPs are a type of TBP that combine features from traditional defined benefit and defined contribution models.
- Employer and employee contributions are fixed and predictable, subject to slight variations. The DB-like retirement benefit is a target that can be reduced if economic circumstances warrant.
- Cost certainty is one of the key employer considerations for SRPs. Employer contributions are predetermined within a narrow range of contribution levels.
- Another consideration for employers is that all money in the plan belongs to members, and the plan sponsor does not have the right to surplus.
- Employees can understand the targeted pension they can expect to receive at retirement, unlike a DC plan that provides information about their account balances but not how much retirement income to expect based on the account balance.
- Employee contributions to SRPs have been set at higher levels in many plans that converted from a contributory DB model to an SRP.

be reduced in accordance with the law and the plan's funding policy if the plan fails the prescribed funding test in two consecutive years. However, if there is such a reduction to benefits, once the plan has sufficient funds the reduction must be reversed for future payments.

Employee Contributions May Be Higher

The contribution levels are set when the plan is established. In many plans that converted from a contributory DB model to an SRP, the employee contributions were set at a higher level than preconversion.

Different Portability Calculation

SRPs are designed to encourage members to leave their money in the plan. A deferred vested member who leaves his or her money in the plan is entitled to future benefit improvements in accordance with the plan's funding policy. For those employees who want to exit the plan and exercise their portability options, the termination value is calculated under the shared risk regulations based on the termination value funded status of the plan at the time of transfer, so it will be different than the commuted value in a DB plan.[2]

Conclusion

SRPs represent a new way of thinking outside the DB/DC universe. They are a type of TBP but have additional requirements. These plans are designed to help ensure that the target benefits are secured through sophisticated risk management requirements. As set out above, there are different considerations for SRPs as compared to DB and DC plans from the perspective of employers and employees.

The pension plan universe should not be viewed as a one-size-fits-all model. For some organizations and workforces, either a DB or a DC design may be the best option. However, for other organizations and workforces, a target benefit design, such as an SRP or other innovative plan designs, may be desirable. Accordingly, policy makers in other jurisdictions should be encouraged to consider and allow alternative plan designs outside the traditional DB and DC models, such as single employer TBPs or SRPs.

BIOS

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Endnotes

1. An Act to Amend the Pension Benefits Act, S.N.B. 2012, C. 38; New Brunswick Regulation 2012-75 ["shared risk regulations"].
2. Termination value is calculated as the greater of a) the employee contributions plus interest; and b) an amount calculated by multiplying the actuarial value of the member's accrued benefits at the termination date by the termination value funded ratio under the most recent actuarial valuation (unless the administrator has reason to believe that such termination value funded ratio has been reduced by more than 10% in which case payment is suspended until a new ratio can be calculated).