

A road map to clarity on the multi-employer pension plan promise



By *Joe Nunes*



I've been in the defined benefit pension business for more than 30 years. I've spent most of my career with single-employer plans, although a few of my clients have sponsored target-benefit arrangements.

While there are nuances, I consider a target-benefit plan to be one that determines benefits to members on a defined benefit basis while setting out employer contributions on a defined contribution basis. To allow for that mix, target-benefit plans permit benefit reductions when contributions fall short.

My goal is to share what I consider an outsider's view of the challenge of funding traditional jointly trustee plans and hopefully offer some perspective on the considerations for trustees as they take on that task. For convenience, I refer to these arrangements as multi-employer plans.

Actuarial rules of the road

For defined benefit plans in general, actuarial standards have tried to balance two efforts: to systematically set aside

money to pay retirement benefits and to protect earned benefits in the event the employer can no longer contribute.

That balancing worked perfectly fine in the past when windup liabilities were much smaller than going-concern obligations. Unfortunately, it has become increasingly difficult amid declining interest rates and pension reforms that added improved termination benefits. To properly fund a plan today, trustees must focus on which of those two efforts is the priority.

Today's actuarial standards don't prioritize those efforts; instead, they focus on clear disclosure of a plan's progress on both going-concern and solvency funding. The balancing falls to the regulatory authorities and, ultimately, the legislative bodies.

Promises, promises

For trustees of multi-employer plans to decide whether to focus on setting aside contributions systematically or prioritize benefit security, they must first determine what they've promised to do.

Difficulties have arisen when union trustees have seen the pension promise as a defined benefit commitment where employers should pay whatever it takes to fund the obligation, while management trustees have viewed it as a defined contribution arrangement that assumes no new contributions unless the parties move to negotiate them separately at the bargaining table.

In an ideal world, the settlors of the trust would have made the promise clear for the trustees. Unfortunately, in my experience, that hasn't always been the case. Until trustees get on the same page, it's difficult for actuaries to give good advice on how to balance contribution rates with benefit increases and reductions.

The DB view

Although multi-employer arrangements will come with a requirement that trustees have permission to reduce benefits to balance the plan's funding, few boards want to take that step until it's clear that it's absolutely necessary. Trustees are also aware that plan members are just a few steps away from a capable lawyer looking to help them blame someone for pension cuts.

To avoid benefit cuts, trustees must do one or a combination of the following:

- Build margins in the plan;
- Tell employers they must stand ready to contribute more when called upon by the actuary; or
- Let plan members know they'll need to make up additional contribution requirements from their own paycheques.

MULTI-EMPLOYER PENSION PLANS IN CANADA

	2013	2014	2015	2016	2017
Number of plans	399	400	417	428	451
Active members	1,002,849	1,006,872	1,061,787	1,063,860	1,024,967

Source: Statistics Canada

The problem with margins in a multi-employer plan is they're inherently an intergenerational transfer from the members who help build them to those who ultimately benefit. Relying on member contributions creates similar issues of intergenerational equity.

The DC view

While postponing pension cuts until absolutely necessary protects retirees in the moment, it also increases the size of the inevitable reductions if positive plan experience doesn't materialize in time.

I've seen trustees agonize over benefit cuts as the plan's funded status continually eroded. After reaching the point where contributions needed to increase by 30 per cent or more, one board couldn't get enough employers onside and the plan went into windup. Lawsuits ensued.

If the trustees take a defined contribution view, they must be ready to cut benefits quickly when funding levels fall. Likewise, the board would have the ability to give frequent small increases in benefits when funding levels rise. Contingent indexing is the perfect tool to deliver such frequent small increases, and it should be no surprise that many jointly sponsored plans have moved to that approach as a way to dole out investment gains.

Within the defined contribution view, there's still room to smooth contribution and benefit levels through margins or reserves, but the smoothing should be small and over short periods. Large smoothing efforts over long periods return you to the defined benefit view.

Funding policy

Historically, plan sponsors have enjoyed great freedom to set benefit levels and investment policies. Sponsors of single-employer plans raised and lowered

contributions and improved benefits as they pleased. The only thing that was off the table for the sponsor of a single-employer plan was cutting benefits.

Trustees of multi-employer plans have the same luxuries of reducing contributions and increasing benefits. Multi-employer plans trade the plan sponsor's duty to pay higher contributions when needed with the trustees' obligation to cut benefits when necessary. None of that was important before 2000, because continuous investment gains allowed trustees to ignore what they would do when the tide turned.

The tide eventually turned, and for some it was a tsunami. Interest rates that had been declining for my entire career finally fell below actuaries' best estimates for long-term investment return assumptions in the late 1990s, and the dot-com bubble burst in the early 2000s. Suddenly, plan sponsors and boards had hard choices to make.

The situation exposed the critical need for a funding policy. Investment policies almost always focused on how much risk the plan would take in pursuit of managing pension costs. They rarely addressed what would happen when returns were insufficient. The absence of a funding policy embedded in the investment policy reflected the fact that legislation didn't require it and the notion that very few people want to plan their own funeral.

In the absence of a funding policy, sponsors of single-employer plans found themselves scrambling for contributions that wrecked budgets and lamenting that if they had understood how much risk they were taking, they wouldn't have done so. For multi-employer plans, discussion and disagreement often ensued on whether it was the defined benefit or defined contribution view that

should drive decision-making in a crisis. The resulting delays often compounded the problem. Lawsuits ensued.

Over time, more and more boards saw the importance of a clear funding policy. Funding policies have been on the uptick in the target-benefit arena, and Ontario's new proposed legislation will make them mandatory for all plans.

Clear communication

If you've read this far into the article, you're probably ready for me to tell you what trustees should do to solve this complex problem elegantly.

Unfortunately, there is no answer. It's unfortunate if actuaries have left plan sponsors with the impression that we can make it all better with a nudge of the discount rate. Actuaries don't control the investment markets, plan members' lifespans or employment levels. Actuaries help the stewards of pension promises to predict their costs and make appropriate adjustments as time marches on.

The answer, then, is communication. Actuaries and investment professionals need to ensure plan sponsors and trustees understand risk, reward and volatility. Those sponsors and trustees need to make sure plan members know who's backing the pension promise and how secure it is.

Postscript

At this point, if you are a trustee, you should be asking yourself if converting to a pure defined contribution plan is the best thing you can do to be confident that plan members will never see benefit reductions.

The answer may be yes, and the fact that most sponsors of single-employer plans have chosen that option should give you a clue on the easy choice at this fork in the road. But before you decide, let me remind you that the target-benefit plan has merit. Multi-employer pension plans benefit from industry-leading governance models and offer access to professional advisors who become more affordable as they spread their costs over a large bucket of assets. So for those who are up for the defined benefit challenge, they may find themselves happier with the results they can deliver to plan members. 

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