Intelligence MEMOS

From: Bob Baldwin

To: Legislators and public at large

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Re: **In the "DB" pension plans versus "DC" debate, TB plans have plenty of appeal**

Advocates for pure defined benefit (DB) pension plans have criticized Bill C-27 which would allow federally regulated employers to replace their defined benefit plans with target benefit plans. I too share a preference for DB, but I also recognize that it is possible to prefer DB pensions while acknowledging their weaknesses. This, in many ways, helps to envision a future for pension plans that doesn't necessarily mean being on either one end of the DB to defined contribution (DC) spectrum.

Outcomes in all types of workplace pension plans depend on key factors such as contributions, salary trajectories, returns on investment, and mortality. So what is it that would allow a DB plan to provide a more predictable outcome? The answer is twofold: 1) Varying the contribution (saving) rate through time to meet a predetermined benefit target; and/or 2) cross-subsidies within and between different cohorts of participants.

In pure DB plans, all of the future uncertainty will show up in variable contribution rates and none in variable benefits. The plan sponsor(s) must have an unlimited willingness and ability to contribute more to the plan if need be – a largely implausible feature.

In practice, when contributions reach the 15 to 20 percent level, even pure DB plans began allocating some financial risk to benefits (usually by making cost-of-living indexation contingent on the funded status of the plan). Moreover above some level, escalating pension contributions begin to depress preretirement living standards below post retirement levels. In other words, you can have too much pension!

On the other hand, DC plans – especially those that are mostly self-directed – impose uncertainty on plan members with respect to the retirement incomes they will provide and demand knowledge, skills and experience of plan members – not to mention time.

The actual world of pension design is a spectrum, not a binary choice between DB and DC. Some plans are mainly DB but allocate some financial risk to the indexation of benefits. A few grandfathered Canadian DC plans include minimum benefit guarantees. Policymakers, therefore, should not get stuck on the DB and DC labels but understand how financial risks are being allocated.

The desirability of DB plans in providing a relatively predictable retirement income is not diminished by the challenges these plans face. But clearly, the DB proposition is strengthened when reconciled with acceptable levels and degrees of contribution volatility. It also has to be reconciled with reasonable degrees of cross-subsidization within and between cohorts of plan members. With regard to cross-subsidies, a regime in which accrued benefits cannot be reduced places all financial risk on young and future plan members.

Target benefit plans, such as multi-employer plans, avoid these problems by moving to the middle of the spectrum and spreading the risk sharing across all cohorts. It is reasonable to assume these plans will have plenty of appeal going forward.

Bob Baldwin is a Proprietor at Baldwin Consulting and a member of the C.D. Howe Institute's Pension Policy Council.