September 2016 Newsletter

Pension Plan Design for Smaller Employers

Smaller employers have the same need to include a pension plan in the total compensation package of their employees as larger employers – attraction, retention, engagement, obligations to long service employees, etc. However, many smaller employers must also be focused on cost stability, risk management and administrative simplicity.

As a result, a capital accumulation plan ("CAP") has been the vehicle of choice for smaller employers. CAP plans can come in two variants - a defined contribution ("DC") pension plan or a group registered retirement savings plan. However, a CAP plan is not an effective way to provide retirement benefits. This newsletter discusses how a much more effective solution, a defined benefit ("DB") pension plan, could work for a smaller employer.

In our experience, there has been a growing interest of employees in DB plans. This has been validated in more formal surveys. Willis Towers Watson report in their October 4, 2016 press release that: *"More than half of Canadian millennials would sacrifice pay for guaranteed retirement benefits"*.

A CAP plan is not a pension plan, but rather, is a tax-effective means of accumulating assets that can be withdrawn in retirement. At retirement, a CAP member must assume the investment risk and longevity risk or purchase a life annuity from a life insurer. In the current economic environment, life annuities appear very expensive and are seldom purchased. Essentially, there is no practical way for CAP members, or their employer, to protect against investment and longevity risk after retirement. This reality is further complicated by a general lack of investment acumen among CAP plan members and ineffective investor education efforts.

However, other than encouraging the purchase of annuities at retirement, there is little that the employer who sponsors a CAP plan can do to protect the employee, and the employer, from the compounding risks in retirement – longevity risk[1] and investment risk. Life expectancy for an employee age 65 is close to age 90, but this means that there is a 50% chance of dying before age 90 and a 50% chance of dying after age 90. It is impossible to establish an effective investment policy to provide retirement income with an uncertain end date – even if the retired employee had the requisite investment acumen.

A DB pension plan sponsor assumes the risk of providing a lifetime pension for life. Essentially the investment and longevity risks are assumed by the employer. Therefore, a DB pension plan for a smaller employer must be affordable and be designed to eliminate as much financial risk as possible from the employer and to simplify the administration.

First, to maintain employer costs at an affordable level for smaller employers, both employees and the employer should contribute to a DB pension plan.

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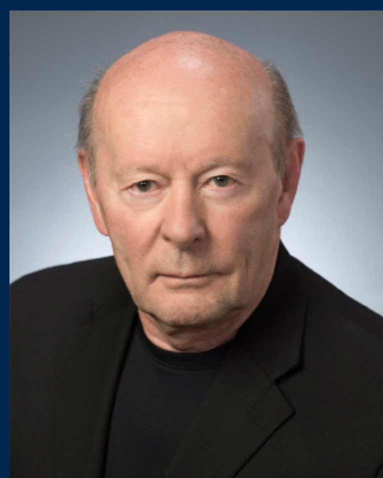

"We offer practical and intelligent consulting solutions."

1 The risk that the CAP member will exhaust the assets before death (and live in poverty thereafter) or that the CAP member will die before the assets are exhausted (and leave an unintended estate).

DB pension plans are typically integrated[2] with the Canada Pension Plan ("CPP") to equalize the total of public and private pension provided above and below the maximum pensionable earnings level (the "YMPE") of the CPP. The new enhancement to the CPP agreed this year should also be recognized in any new DB plan design.

For illustration, a DB pension plan that has a pension unit of 0.5% on salary up to the YMPE and 1.33% of salary above the YMPE would be consistent with the enhanced CPP. This plan would provide a pension for life of about 27% of salary in the year before retirement. The enhanced CPP plus OAS would add a further 22% of salary for a total of close to 50% of salary[3]. Since work related expenses and payroll deductions disappear at retirement and income taxes will be lower in retirement, a pension of 50% of salary in the year before retirement is adequate to replace a large portion of pre-retirement consumption. This plan could be funded with a contribution of less than 10% of salary[4], shared equally by the employer and employees.

A DB pension plan for smaller employers should include robust risk management features. This is best accomplished by crediting pensions each year as a function of current salaries with no exposure to future salary increases or inflation. The total contributions are set on a conservative basis and emerging surplus would be used, in part, to increase the accrued pensions. Significant surplus reserves would be held to minimize the chance that contributions would ever have to be increased. This career-average update approach also simplifies the record keeping and administration functions.

When the income tax rules are updated to accommodate target benefit pension plans, a career-average update plan implemented with a target benefit provision would be even more attractive. A target benefit pension plan would include the best features of both a DB pension plan and a DC pension plan. Employer contributions would be fixed, accrued benefits could be reduced to offset adverse plan experience and, after retirement, the individual longevity and investment risks would be shared among all plan members.

DB pension plans for smaller employers are typically administered by the actuarial firm selected to perform actuarial valuations. The Lesniewski Moore Consulting Group offers a full service administration package for DB pension plans (implementation, regulatory compliance, actuarial valuations, benefit calculations, communication, investment monitoring). The costs of administration can be paid from the plan assets.

A properly designed DB pension plan with robust risk management features is a viable and effective alternative to a CAP plan for smaller employers. In conjunction with the new and enhanced CPP and OAS, it can provide adequate pensions at modest cost and with limited risk to the employer. A DB pension plan or a target benefit plan eliminates the individual investment and longevity risk embedded in a CAP plan. Litigation from employees in a CAP plan is forestalled by participation in a DB pension plan. More importantly, the DB pension plan responds to the growing employee desire for more secure pensions in retirement.

The business rationale for an employer-sponsorred pension plan is to reinforce human resource management initiatives to attract, retain and engage the workforce necessary to the success of the business. A DB pension plan may once again be an important tool in the human resource management toolkit.

Please feel free to contact me for more details or a discussion of how a properly designed and implemented DB plan could help you achieve your human resource management goals.

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2 A lower pension unit is credited on salary up to the YMPE
3 Assuming a new employee age 30 with a salary of $100,000 in 2016 and future salary increases of 3% per annum.
4 Assuming a discount rate of 5% per annum and the Canadian Pensioners Mortality Table (Private sector) at 2016 and projected with Scale B on a two-dimensional generational basis for an employee group with an average salary of about $100,000.

	DB Pension Plan	DC Pension Plan	Group RRSP
Pension promise	Pension payable for life	No lifetime pension unless life annuity purchased at retirement	No lifetime pension unless life annuity purchased at retirement
Form of Benefit	Pension payable for life or, if plan permits, transfer commuted value to RRIF	Transfer account value to locked-in RRIF or purchase life annuity	Transfer account value to non-locked-in RRIF or purchase life annuity
Employee contributions permitted	Yes	Yes	Yes
Employer contributions	Contribution subject to increase if DB plan becomes underfunded	Contributions are fixed	Employer contribution is added to salary and subject to payroll taxes (CPP, EI, medical)
Assets can only be used to provide benefits to plan members	Yes	Yes	Employee can withdraw after retirement for any purpose
Benefits or withdrawals are taxable income to employee	Yes	Yes	Yes
Risk to employer	Higher contributions	Litigation from retired employees if pension expectations not met, with attendant reputational risk	Litigation from retired employees if pension expectations not met, with attendant reputational risk
Risk mitigation (employer)	Conservative funding and benefit policies, Career-average update approach, Target benefit approach when legislation permits	Effective communication, selection of investment policies, default option, investor education	Effective communication, selection of investment policies, default option, investor education
Risk to employee	Employer becomes bankrupt when the plan is in deficit	Poor investment choices before retirement, Poor investment choices after retirement, Outliving assets, Premature death	Poor investment choices before retirement, Poor investment choices after retirement, Outliving assets, Premature death, Withdrawals not used for retirement
Risk mitigation (employee)	No practical means to mitigate risk	Purchase annuity at retirement	Purchase annuity at retirement

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