K. Paul Duxbury, F.S.A., F.C.I.A.

Actuarial Consulting Services

1164 Hunt Club Road
Cambridge, ON N3E 1A1

Phone: (519) 249-0083
1-888-791-9290
Fax: (519) 249-0084
1-888-791-9307
Cell: (905) 691-7126
Email: pduxbury@rogers.com

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Mr. Stuart Laidlaw
Unit Chair
CEP Local 87M
Toronto, Ontario

Dear Mr. Laidlaw:

Re: Target Benefit Plan vs. Defined Contribution Plan

As requested, I am writing to you to give a brief outline of the differences between a defined contribution plan (such the plan in which your members already participate) and a target benefit plan such as the Multi-Sector Pension Plan ("MSPP") offered by CUPE and SEIU. I have reviewed the MSPP website.

First of all, in any comparison of pension plans, it is important to remember that for any pension or retirement savings arrangement the following is true:

Contributions + Investment Income = Benefits + Expenses

In other words, at the end of the day, a better plan costs more, and a cheaper plan delivers lower benefits, whether it's defined benefit, defined contribution or target benefit.

Under defined benefit plans, the formula for determining the amount of pension is spelled out in the plan text. The employer cost varies according to actual experience under the plan. Under a defined contribution arrangement, the plan spells out the formula for determining the amount of the contribution. The amount of pension available will vary according to actual experience.

Target benefit plans have been around for a very long time but they weren't often called target benefit plans. If they were referred to in a manner to reflect their nature, they were referred to as negotiated cost or defined benefit/defined contribution.

The typical multi-employer plan is a target benefit plan. The MSPP is a multi-employer plan and has been in existence since 2001. The SEIU has sponsored at least two multi-employer plans of which I am aware. One is the Nursing Homes and Related Industries Pension Plan to which the MSPP is uncannily similar and for which I was the actuary for the first several years of its existence (until I changed employers).

In practice, a multi-employer plan functions like a traditional defined benefit plan with the difference being that, if the contributions are insufficient, the benefits would be cut as opposed to the employer making up the shortfall as is the case in a true defined benefit plan. (Note that, in practice, additional contributions could be negotiated into the multi-employer plan or the target benefit plan. Similarly the employees often end up bearing some of the risk under defined benefit plans through higher contributions, or benefit reductions, even on accrued benefits in the case of employer insolvency.)

The Ontario Expert Commission on Pension Reform popularized the term “target benefit” and recommended that they be encouraged.

The name “Target Benefit” underscores the fact that benefits may not be as promised. Under the current nomenclature, the members (almost everyone, actually) think of them as defined benefit plans. Thus, members are stunned if the benefits are cut. The trustees do everything they can to avoid reducing benefits, sometimes delaying the decision unduly and making the situation worse as a result.

Under a target benefit plan, like a defined benefit plan, the formula for determining the amount of pension is spelled out in the plan text. However, unlike a defined benefit plan, the employer is not required to make up the shortfall, the benefits must be reduced.

From the employer’s perspective, the target benefit plan is the same as a defined contribution plan. Their contribution is fixed so there is no risk to the employer. The accounting treatment is the same as for defined contribution. From a tax perspective, target benefit plans are treated as defined contribution for both the employer and the employees (at least if the Plan is a specified multi-employer plan, which the MSPP is).

Under a target benefit plan, the risk to the individual member is closer to that of a defined benefit plan. The risks are spread among the members so that bad years near or after retirement don’t affect a particular individual. However, there is more risk in that benefits may be reduced. Typically, a target benefit plan will set the benefit level such that there is a safety margin; that is, the contributions are 10%-20% higher than the actual cost of the benefits. This allows the benefit level to be maintained in spite of experience fluctuations. If experience goes well, the unneeded safety margin can be used to make benefit improvements to members (active, retired or terminated).

While an in-depth discussion of the actuarial valuation process is beyond the scope of this letter, I have included an appendix that summarizes the key items in the process.

That being said, the letter from Ian Thompson, co-chair of the MSPP board of trustees indicates that the plan was 43% funded on a wind-up basis at 1/1/2009 but contributions were sufficient to fund the plan on the going concern basis. No more recent actuarial information appears to be available. 1/1/2009 was a very bad point in time for the funded status of pension plans in general but there hasn't been a lot of improvement since then. However, 43% is well below the average funded ratio in Canada, which I understand o be in the 70%-75% range.

Multi-employer plans tend, on average, to be less well funded than single employer plans because multi-employer plans are flat benefit plans whereas many single employer plans are final or best average earnings plans for which the going concern funding includes projections for salary increases, which results in higher funding requirements relative to flat benefit plans.

You may want to contact the fund to get more recent actuarial information. There is also the CEP Multi-Employer Plan that was originally established by the CWC. I understand that it is not 100% funded but I don't know the funded status or the exact benefit formula (but it is the same basic concept). You may want to contact the CEP National for more information.

Some pros and cons of target benefit versus defined contributions are as follows:

1. A large, professionally managed pension fund would be expected to earn more from investments than individually managed individual accounts, especially after fees.
2. Target benefit is more difficult and expensive to administer because of more stringent regulatory supervision.
3. Relative to target benefit, defined contribution allocates a larger portion of the funds to younger employees and less to older employees (see examples below).
4. A relatively larger amount of money is given to members who terminate under a defined contribution plan than under a target benefit plan.
5. Surpluses under the target benefit plan belong to the members and will be used for benefit improvements (e.g., benefit levels, indexation). Conversely, benefits may have to be reduced if funds are insufficient to support the promised level of benefits. (There are no surpluses or deficiencies under a defined contribution plan.)
6. It is more difficult to plan for retirement under a defined contribution plan (need to estimate how long you will live and what rate of return you'll earn on your investments for your lifetime). There is the possibility of having to reduce the standard of living or possibly run out of funds completely. Conversely, the retiree may live more frugally than necessary early in retirement and end up with more than enough later on.
7. While market fluctuations may work themselves out in the long run for a pension fund or a young member of a defined contribution plan, a big market drop near or after retirement can have a major impact on the retirement plans of a defined contribution plan member. A member close to retirement may have to delay retiring and a retired member may have to return to work.

I don't have specific contribution information for your current defined contribution plan. Many defined contribution plans offer various optional levels of member contributions and the company match percentage may vary according to the member's contribution rate. Under the MSPP, I don't believe optional contribution levels would be permitted and the employer must pay at least as much as the employees. I have prepared some simplified examples based on assumed annual contributions of $5,000 per year, increasing at 2% per year. Benefits for both plans (except the past service benefit would be proportional; that is, if contributions start at

$6,000 per year, the benefits would be 20% higher ($6,000÷$5,000). I have used retirement at age 65 in 5, 10, 15, …, 40 years and an annuity for life but no less than 5 years. I have assumed interest rates of 4%, 5% and 6% for the defined contribution pension plan. I have shown the benefit that would be earned from the future service contributions ($1.55 per month per $100 of contribution) under the MSPP and the full past service benefit ($26.20 per eligible year of past service to a maximum of $186.20) and the total. As can be seen, the MSPP provides better benefits in most cases. The defined contribution plan gets better with higher interest rates and longer service (which is to be expected).

Years to	MSPP			DCPP		
Ret	**Past Svc**	**Fut Svc**	**Total**	**4%**	**5%**	**6%**
5	**$133**	**$403**	**$536**	**$182**	**$203**	**$226**
10	**$186**	**$849**	**$1,035**	**$422**	**$484**	**$552**
15	**$186**	**$1,340**	**$1,526**	**$735**	**$865**	**$1,015**
20	**$186**	**$1,883**	**$2,069**	**$1,139**	**$1,378**	**$1,662**
25	**$186**	**$2,482**	**$2,669**	**$1,656**	**$2,061**	**$2,560**
30	**$186**	**$3,144**	**$3,330**	**$2,313**	**$2,964**	**$3,797**
35	**$186**	**$3,875**	**$4,061**	**$3,143**	**$4,151**	**$5,491**
40	**$186**	**$4,681**	**$4,867**	**$4,188**	**$5,704**	**$7,800**

In summary, the MSPP has many advantages relative to the defined contribution plan. However, it depends on the rates of return that will be earned on the funds and younger members may fare better in the long run under the defined contribution plan. Moreover, the current funded status is a concern.

I have tried to briefly cover a lot of information in this letter. I would be pleased to discuss any of the above with you.

Yours truly,

K. Paul Duxbury

Appendix

Actuarial Valuations – General

In this appendix, I will give a very brief description of the actuarial process.

An actuarial valuation of a pension plan is the process of determining the current financial value of the benefits promised by the pension plan, most of which will not be paid out for many years into the future. In other words, the actuarial valuation estimates how much money must be set aside now and in the future in order to ensure that there are sufficient funds to pay the benefits when they come due.

In order to determine the actuarial value of the benefits, the actuary obtains the data from the employer on all the members of the plan; active members, pensioners and beneficiaries and inactive vested members (that is, members who are no longer active members of the plan because they have terminated employment or perhaps changed employment to a category not covered by the plan but who have retained a right to a benefit from the plan).

The data includes information on everything that may have an impact on the amount or timing of the payments from the plan such as age, sex, years of employment, years of participation in the plan, salary, accrued benefit, accumulated employee contributions and, for pensioners, age, sex, the amount of benefit, the form of pension, date of retirement, age and sex of the spouse, etc.

In order to estimate the value of the benefits, the actuary must make assumptions about all the factors that could come into play in the future that may have an impact on the amount and timing of the benefit payments.

The actuarial method must also be chosen. The actuarial method is the method of allocating the cost of the pension benefits over various time periods. There are several possible methods but the Unit Credit method (also sometimes called the accrued benefit method) is by far the most common in Canada since that is the method contemplated in the legislation. This is the method that the actuary for the plan has used.

Under the Unit Credit method, the actuarial liability is the actuarial value of the benefits in respect of service prior to the valuation date. This is compared to the assets. If the assets exceed the liabilities, there is a surplus. If the assets are less than the liabilities, there is an unfunded liability. The Ontario Pension Benefits Act requires the unfunded liability to be paid off over periods of five to fifteen years from the date the particular portion of the unfunded liability arose. The current service cost (sometimes referred to as the normal cost) is the actuarial value of the benefits accruing in the year following the date of the valuation. The employer current service cost is the excess of the total current service cost over the amount of the employee contributions required in accordance with the terms of the plan.

The Ontario Pension Benefits Act requires that the actuarial valuation be performed in two ways. The first is known as the going concern valuation (sometimes referred to as the ongoing basis).

In this valuation, the plan is assumed to continue indefinitely into the future. Assumptions are made regarding retirement age, termination of employment, disability, future salary increases and the rate of interest, which is based on what the actuary perceives to be a reasonable expectation of the rate of return on the fund's investments (usually a mixture of stocks and bonds) over the indefinite future. Also, on the going concern basis, rather than using the market value of assets, which can fluctuate dramatically from valuation to valuation, the asset values may be "smoothed", producing a less volatile actuarial value of assets.

An actuarial gain and loss analysis is usually included in the valuation report. This shows how experience evolved during the period between valuations; that is, it compares actual experience to what was expected based upon the actuarial assumptions and reconciles the change in unfunded liability or surplus from one valuation to the next.

The second valuation is called the solvency valuation. It is, with some permitted modifications to minimize contribution requirement fluctuations, a wind-up valuation. That is, the plan is assumed to be terminated on the valuation date. There is no need for assumptions regarding termination of employment or disability. Members are assumed to commence their pensions at the date that produces the most valuable pension and the interest assumption is not at the actuary's discretion, but is based on the rate of return currently available on Government of Canada long-term bonds. Currently, these rates are around 2.5% to 4%.

Unfunded liabilities may be paid off over a period of 15 years on the going concern basis and over 5 years on the solvency basis.

Separate and apart from the legislative funding requirements, most companies also have to produce separate figures for accounting purposes; commonly referred to as "pension expense". The logic is that the pension benefits earned under a pension plan have a value which should be allocated to the period the benefits were earned, irrespective of when the company actually contributes to the pension plan. Thus, the pension expense may be more or less than the actual contributions made by the company. A common occurrence is where the plan is in a surplus position and the Company takes a contribution holiday but the Company still shows a pension expense. In many instances, this is the number the Company focuses on in negotiations, since this is the number that shows up in the company's financial statements (and affects the executives' bonuses).