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International Brotherhood of Electrical Workers
Fraternité internationale des ouvriers en électricité

DEFINED BENEFIT PENSION PLAN

KNOW THE FACTS

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DEFINED BENEFIT PENSION PLAN

A Defined Benefit Pension Plan is insurance against senior poverty.

But some special interest groups are lobbying for these plans to be replaced by Defined Contribution plans.

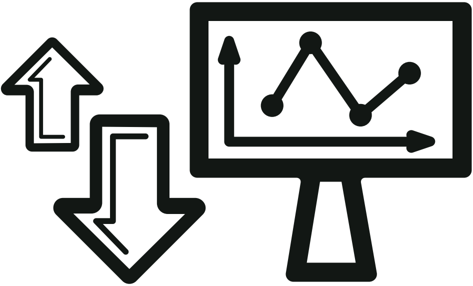
But Defined Contribution plans leave many seniors unable to retire in dignity.

This booklet examines both retirement funding alternatives. It shows the facts, exposes the myths, looks at relevant history, considers what the experts are saying, and suggests how Defined Benefit plans could be adjusted to ensure they are affordable.

THE DIFFERENCE

Defined Benefit pensions guarantee retirees a fixed amount of pension payments for life. They will not outlive their pensions.

Defined Contribution pensions are really just RRSPs, and as such, their value goes up and down with the markets. There is no guarantee they will provide enough to retire on, and in a great many cases, they don't.



THE FACTS

There is a considerable body of research comparing Defined Benefit and Defined Contribution pension plans, and the overwhelming conclusion is that Defined Benefit plans are best for employees, employers, and taxpayers in general.

Part of the reason is because they are cheaper. The research, including extensive financial modeling by the National Institute on Retirement Security, shows that a Defined Benefit plan can provide the same level of retirement benefits as a Defined Contribution plan at about half the cost. (46% lower)

THE MYTH THAT DEFINED CONTRIBUTION PLANS ARE CHEAPER

Often when a switch from Defined Benefit to Defined Contribution is made, employers will use the change as an opportunity to reduce the amount they contribute. Of course this saves the employer money, but it isn't because DC plans are cheaper, it's because the employer is reducing the employee's benefits.

WHY DB PLANS ARE BETTER THAN DC PLANS

There are many reasons. Here is one:

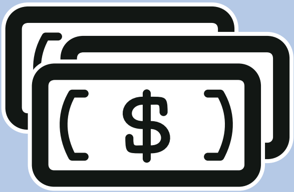
1. DB plans manage longevity risk better because they pool a large number of individuals, so they only have to manage for "average life expectancy". If you have a DC plan, you have 2 options.

   - You ration your pension to last you through your maximum life expectancy. If you die before you reach it, this means you probably didn't enjoy the lifestyle you could have. But we're sure the company that provides your plan will thank you.

   - You enjoy your retirement but run out of money before you die. This means you are forced on government assistance. (see Australian experience elsewhere in this booklet)

And here's another one:

2. DB plans achieve greater investment returns. There are 2 main reasons:
    - Unlike the members in them, DB plans don't age because younger members join to replace those on the other end. This means DB plans can take advantage of investment opportunities that come from a balanced portfolio.
    - DB plans have lower administrative costs. DC plans are usually based on retail mutual funds, with fees that are typically 1.5 to 2.5 percent annually. These fees erode the value of the savings, leaving the member with up to 40% less retirement income.



Defined Benefit plans are fairly common in the public sector, but in the private sector, in many cases, Canada is following the lead of the U.S., where Defined Benefit plans have been replaced by Defined Contribution, or RRSP type savings plans. (As you will see elsewhere in this booklet this trend is starting to reverse itself as it is discovered how inadequate they are) but for now, many private sector employees are given no choice but Defined Contribution plans.

This is creating division, with one sector of the workforce with adequate DB pensions, while others have iffy DC plans or no pensions at all.

Some vested interest groups argue that the solution to this is to reduce or eliminate DB pensions – in other words, give everybody an inadequate pension.

The better solution is to provide all workers with a pension that allows them to retire in dignity. Despite the rhetoric to the contrary, there are ways to do this in an affordable, sustainable way.

The proposal to increase the CPP would have helped considerably, for one thing it would have reduced pressure on other pension plans, and on the federal treasury with fewer seniors requiring safety net incomes like the Guaranteed Income Supplement. The modest increases that were suggested for the CPP, phased in over several years, would have been painless and affordable, but unfortunately the federal government chose a different plan that most experts agree will not help much at all.

WHAT EXPERTS SAY

The Canadian Institute of Actuaries says:

"Defined Benefit pensions are particularly effective. Their demise is not in the best interest of Canadians – both employees and employers."

The Pension Research Council of the Wharton School of the University of Pennsylvania is among the many experts who say DB pensions are better for all concerned. They include this reason:

> “DB plans also encourage orderly turnover of personnel by allowing employees to depart from the workforce with a clear knowledge of their pension benefits and with the assurance that the benefit payment will continue for life. By contrast, the DC plan provides no assurance that an employee will be financially prepared for retirement at any specific age or level of experience. Unfortunately this uncertainty (or, in some cases, certainty of the inadequacy of one's benefits) causes employees to remain on the job even when their ability to perform job duties is in decline. Clearly this may also complicate the employer's role, forcing decisions with unpleasant consequences for everyone.”

David Dodge, former Governor of the Bank of Canada sums up as well as anyone, the comparison of Defined Benefit vs Defined Contribution pension plans. Here's what he says:

- Defined Contribution plans do not eliminate risks for employers
- Because of market risk, DC plans can fall short of ensuring adequate retirement income for employees
- For society as a whole, Defined Benefit plans can mitigate risks more effectively than DC plans can
- Defined Benefit plans are a powerful tool for attracting and retaining employees
- DB plans eliminate the risk of retiring with very low incomes

Here's some of what John Crooker, recently retired CEO of the Healthcare of Ontario Pension Plan says about Defined Benefit plans:

“The beauty of DB plans is you know in advance what you'll get out of them. Not many people in other types of plans realize that you need to save $500,000 to provide yourself with an annual pension of $25,000, but that's the reality. We owe it to people to help them get there – we need to make workplace pensions better, not worse.”

“The average Canadian has saved just $60,000 in his or her RRSP by retirement age. It's just not enough – you can't live on that for 20, 30 years.”

> “There is no more efficient, more effective way to deliver pensions to people than the DB model. With good governance, professional investors, a sound investment strategy, and mandatory contributions by members and employers, you can get there.”

Crooker knows whereof he speaks. HOOPP is committed to Defined Benefit pensions and stands as one of the best examples of a financially secure pension fund. The average HOOPP pension starting in 2010 was $18,400 – meaning that after 25 years, a retiree will have received $460,000 in pension payments.

As Crooker points out – there is no reason other DB plans can't duplicate this kind of success and stability.

WE SHOULD LEARN FROM HISTORY

Winston Churchill said "*Those that fail to learn from history, are doomed to repeat it*."

Let's not go down a road that others have regretted travelling.

If we abandon Defined Benefit pensions in favour of a Defined Contribution scheme, we will be doing just that and may be doomed indeed. It is the history on this that suggests so.

WEST VIRGINIA TEACHERS

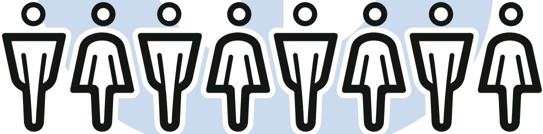
In 1991, the State of West Virginia ended its Defined Benefit plan for teachers, opting for a Defined Contribution plan instead. Here's what the DC plan did for the teachers of West Virginia.

In 2006, 15 years into the plan their average pension account balance was less than $34,000, not nearly enough savings for retirement. This resulted in legal challenges that ended in 2008 with legislation that amounted to allowing the teachers a do-over, essentially erasing the 17 years of DC pensions, and replacing it with what they would have been entitled to under a DB plan, had the change not been made.

Many would say the West Virginia teachers dodged a bullet. If they hadn't been permitted to revert to a Defined Benefit plan, many wouldn't have been able to afford to retire. Their options would have been to continue working long past their prime, or have taxpayers subsidize their retirement years.

Somewhat ironic, given that it was to relieve stress on taxpayers that their pensions were switched in the first place.

Of course they are the exception. Most others don't have the option of a do-over.



AUSTRALIA

One jurisdiction that has possibly the longest history with Defined Contribution pension plans is Australia. So it is worth looking at how it's going there, decades after that country abandoned Defined Benefit pensions. Here's the snapshot:

- 50% of Australian seniors are living below the poverty line
- 70% of Australian seniors claim some form of government assistance
- 65% of Australian seniors have no money left in their DC plans by the time they reach 75
- the average Australian male has only $130,000 in his DC plan at retirement
- the average Australian female has just $45,000

The Australian government's costs of providing social programs have gone up dramatically because of the switch to DC plans.

UNITED STATES

The first generation of Americans in which a high percentage have Defined Contribution plans (or 401k's as they are identified in the U.S.) is beginning to retire. It's not pretty.

According to data compiled by the Federal Reserve and analyzed by the Centre for Retirement Research at Boston College, the median household headed by someone aged 60 to 62 with a DC account has less than 25% of what they would need to maintain their standard of living in retirement.

As a result many are postponing retirement, moving to cheaper housing, buying less expensive food, cutting back on travel, taking bigger risks with investments and making other sacrifices, with many looking at working well into their 70s.

While this is all very depressing, a growing number of jurisdictions are doing something about it. While states like West Virginia have reversed its move away from Defined Benefit pensions, others have learned from its example and aren't switching in the first place.

One of the latest is New York City, where the city comptroller launched a major study which convinced him the city will be better off to stick with its Defined Benefit plan for city employees.

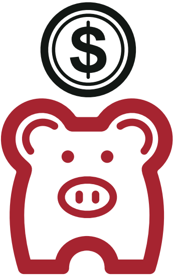
CANADA

That's the Australian and American experience, but there is nothing to suggest the experience in Canada would be any different, it is just that in those countries there is more history to learn from because DC plans have been around longer.

Here's what we do know. Stats Can confirms that most Canadians are not saving enough for retirement, with the average Canadian accumulating only about $60,000 in his or her RRSP before retirement. That equates to only $3,000 a year. This is why many believe the new pension option the federal government has opted for instead of beefing up the CPP won't work – because it is just another savings plan based on voluntary contributions.

Which brings us to a major flaw with the logic that changing to DC plans will save taxpayers money. If these plans fall flat in ensuring an adequate retirement (as has, and is, happening elsewhere), the pressure on taxpayer dollars will actually be more, when these retirees will need to have basic costs like medical and housing supplemented by government social services – not to mention they aren't spending much money and they are paying little, if any, taxes.

If you think DC plans save taxpayers money, you should think again.



DO DEFINED BENEFIT PLANS NEED TO BE CHANGED?

Yes they do, but let's not throw the baby out with the bath water. A Defined Benefit plan is far superior to a Defined Contribution plan for all concerned – the focus then, should be on fixing it, not replacing it. Replacing it with a Defined Contribution scheme would amount to a race to the bottom. History shows that where this has occurred it has been a mistake (see *We should Learn from History* earlier in this booklet.)

The best case scenario is a Defined Benefit plan for everybody.

And it can be affordable.

All it would take are a few adjustments.

WHAT SHOULD BE DONE?

Former Bank of Canada Governor David Dodge says two specific adjustments should be made to Defined Benefit plans:

- Remove the tax regulations that don't allow overfunding beyond 10%. This means reserves can be built up in good times to see the fund through lean times.

- Improve the incentives for sponsors. Sponsors tend not to make special contributions to cover deficits because of uncertainty about the legal status of any surplus. Legal decisions have tended to give employees the right to pensions surpluses, even though they typically bear none of the responsibility for any deficit.

Because of these two factors, sponsors have incentives to keep plans only minimally funded and to avoid surpluses.

Fix these two things, and the concerns about these plans costing taxpayers too much should be satisfied.

For more information on this issue, a website set up by the Association for Retirement Income Adequacy does a good job of keeping up-to-date with the most recent developments.

www.ariapensions.ca

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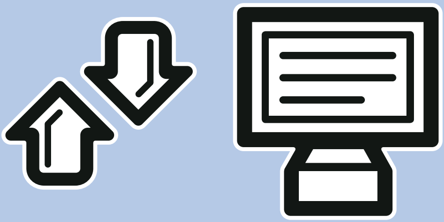

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