Bringing Union Values to Pension Investing

"Pension Talk"

April 2006

8 – A Secure Financial Retirement – The Defined Benefit Pension Plan

Introduction

The trade union movement has long advocated for defined benefit (DB) pension plans as the very best model for securing members' retirement income. This has not changed – even in the face of the current financing difficulties which have led some to declare that the DB plans are dead. In both the U.K. and the U.S. a movement has been unfolding in recent years calling for defined contribution (DC) plans to replace DB plans.

Newspaper headlines make regular reference to any or all of: pension plans that have swung dramatically from a surplus to a deficit position; employers bemoaning the big increase they face in required contributions; and the prospect of pension plans being wound up with assets that are insufficient to pay all of the promised benefits.

This issue of Pension Talk will review the key reasons why CUPE and the trade union movement remain committed to the DB pension plan. Moving to a DC or registered savings plan type of retirement scheme represents a weakening of the Canadian pension system. This would be a major concession and harm member's retirement wages.

Why we advocate for DB pension plans or what members lose by converting to a DC plan?

There are three key reasons why CUPE advocates for DB pension plans. These include:

1. Adequate, secure, and predictable pension income;
2. Equality issues can be addressed;
3. Defined benefit plans are a collective approach.

1. <u>Adequate, secure, and predictable pension income</u>

The defining feature of a DB plan is that the wage collected at the end of the day is defined. There is a formula found in the plan text that describes how the pension wage will be calculated. That is, every plan member gets the same deal. Most public sector worker pension plans have what is called a final average earnings type formula that pays on the member's highest earnings (usually average 5 years) multiplied by the number of years contributing to the pension plan. Many also provide an inflation protected wage. This means that CUPE members will have a retirement income reflective of current wages, one that is predictable.

Defined contribution plans, sometimes called money purchase plans, are different. The wage collected at the end of the day is not predictable. It depends entirely on the size of the pot of money the individual has, the prevailing interest rates of the day, how long you live and fees charged by the financial institution. This is not predictable and almost never adequate. Only those lucky enough to have made correct investment decisions, retire on the correct date, and don't outlive their fund, win. Most will lose. The following demonstrates the risks and inequalities associated with a DC plan:

a)

Investment Risk

In DC plans, it is the individual member that bears the risk. The factors that determine the size of the pension wage cannot be controlled by individuals.

Two plan members with the same average investment over time (8%):

John and Bev each join the plan earning $20,000/year. Over 30 years, each get 3% yearly raise. Each contributes 4%.

SUCCESSIVE 10 YEAR INVESTMENT EARNINGS	JOHN	BEV
Years 1 – 10	6%	10%
Years 11 – 20	8%	8%
Years 21 – 30	10%	6%
Account balance after 30 years	$148,212	$117,460
Monthly income at 65	$1,431.35	$843.71

Because Bev's actual versus "average" rate of return was higher when her pot of money was smaller her account balance is significantly lower than John's. This translates into a much smaller pension wage.

Further, the return to the plan member is better under a DB plan. This is because DB plans are managed over the long term with a better risk/return profile. Defined contribution plans, especially if the member directs her/his investment, mean management over a short term and asset mix policy decisions without adequate tools along with excessive fees.

b) Longevity risk

On retirement the DB fund keeps going with decision-making based on the entire membership in the plan. In a DC plan, the retiree has only her/his "pot of money" which attracts huge fees.

There are two options for converting a DC "fund" to a retirement wage. One is an annuity, the other an income fund. Financial institutions charge for annuities based on conservative assumptions and given substantial administrative fees, and the result is smaller monthly paycheques. The expected returns from a life income fund are markedly lower given the short term assumptions used. This, along with the much higher management fees, mean smaller retirement wages.

"An employer-sponsored pension plan invested in a diversified portfolio earning 8% over the long run can provide an annual benefit using about one-half the principal it would take the individual to fund the same benefits." – Mercer 2004.

2. Equality issues

Defined benefit plans can deal with equality issues. For example, they can provide deemed service for a leave of absence for child rearing; inflation protection without reduction in the basic pension wage; pay disability pensions based on deemed go forward service; pay early retirement without penalty using criteria that work for short service workers like immigrants and women; and pay spousal benefits without reduction to the basic pension wage.

The aim of the pension wage, like our current wage, must be to pay the best income possible. In a DC plan the individual must buy (take a lower basic wage) all of the non-basic wage provisions. There will be some members that can afford more than others because of good luck with investment timing and day of retirement. Disability pensions cannot be upgraded, leaves of absence cannot be overlooked, inflation protection (for the vast majority of CUPE members) will be unaffordable and early retirement pay cheques and spousal benefits cannot be enhanced without cost to the lifetime pension wage.

Because we can negotiate the terms of the DB plans, CUPE locals have the ability to ensure that pension equality is a priority at the bargaining table.

3. <u>Collective approach to wages</u>

   A DB pension plan is a collective approach to setting wages. Employers share in the risk in DB plans. The employer's financial commitment varies depending on the terms of the plan and economic situation of the day. In these economic times employers (and sometimes members) are required to pay more to keep the DB pension plans fully funded.

   In a DC plan the employer has absolutely no liability/risk. Plan members and retirees carry all of the risk. In a DB plan everyone has the same terms apply to them. If we achieve inflation protection every pension plan member gets it not just those who can afford to buy it. If we negotiate a higher percentage replacement rate in the basic pension wage formula everyone will get it.

   A DC plan is like playing the lottery, a few will win but the vast majority will not. The collective approach means that the majority of members are better off, just like setting the current wage in the collective agreement. We can't imagine individual workers negotiating their current wage, why would we want this for our retirement wages?

What is the Threat to our DB Plans?

The main reason DB plans are coming under attack is the need for contributions, (often in increased amounts) by employers. Some plans are also requiring increasing contributions from plan members.

Funding for DB plans is based on an actuarial report (valuation). Defined benefit plans are pre-funded. That is, contributions are made throughout one's career, generally by both the worker and the employer to fully pay for the promised retirement wages.

In the late 1980's and the mid to late 1990's surplus was common mainly due to high rates of return on financial assets. Typically this translated into contribution holidays for our employers (and sometimes for plan members). The sharp decline in stock prices over the period from mid 2000 through March 2003, past contribution holidays and assumption changes by actuaries combined with low interest rates have caused increasing liabilities. This means increased funding for workplace plans.

Do we really have a funding crisis?

There is much law/regulation surrounding pension plan funding. Experience has taught us that we need the law in order to secure retirement income. It is regulation that requires the need for increased funding to our DB pension plans. Otherwise, there just wouldn't be enough money in the fund and plan members would be the ones to pay the price through smaller than promised retirement incomes.

By law, unfunded liabilities must be paid, over time (generally 15 years for going concern deficiencies and 5 years for solvency deficiencies).

It is worth noting that this is not the first time that we have been in this circumstance, nor will it be the last. But the need for real funding, sometimes increased funding, to DB plans does not mean we should get rid of them.

Conclusion

CUPE has strong policy in place supporting defined benefit plans, along with a position of "no concessions". Along with the vast majority of Canadian unions, we have always been advocates for DB because it is the model that delivers both security and fairness to all members.

While it is certainly true that investment markets have been volatile in recent years, and that this has meant increases in pension contributions for many of us, this is not evidence of a need to move away from DB plans. To the contrary, these increases are needed to protect the promised benefit that is being paid by the plan. Clearly, a plan whose contribution levels are permanently frozen – like most DC plans – will inevitably pay out substantially different entitlements to plan members. They produce some winners, and more losers. These difficult periods of turmoil in financial markets need to be understood as opportunities to underline the importance of our pensions in general – and the security that only defined benefit plans can offer.

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