national union

pensions backgrounder #9

Key Elements of a Pension Plan: A Checklist

Part 9 in a Series

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BACKGROUNDER #9

Key Elements of a Pension Plan: A Checklist

There is a lot more to learn about a pension plan than simply how much it will pay an individual upon retirement. There are many different types of pension plans and many variations in the benefits to which a member might be entitled. It is not an easy task to analyze the positive and negative aspects of a particular pension plan and any analysis will vary based on differing individual circumstances.

Information in this section is of a general nature – it's a checklist to help an individual to begin to understand his or her pension plan. Remember, pension plans vary greatly and minimum standards that apply to registered pension plans are based on provincial pension legislation (see section entitled *Legislative Framework Governing Pensions*). It is also important to note that many of the pension concepts noted below only relate to defined benefit (DB) pension plans (see section entitled *Workplace Pension Plans*).

In preparing a checklist of this sort, it is also difficult to avoid technical terms entirely. To assist in understanding the information below, the reader might want to refer to the glossary of terms at the end of the manual (see *Appendix I – The Language of Pensions: A Glossary*).

For details about a specific plan, individual members should contact the plan administrator.

••• Membership and Eligibility

A workplace pension plan may be established for all employees or just for certain groups or classes of employees. A class of employees is normally defined by the nature and terms of employment, for example, salaried or hourly employees, unionized or non-unionized employees, supervisors, managers, executives, corporate officers or employees who work at a specific location or division. Once a pension plan is established for a group of employees, every employee in that class is eligible to join that plan.

Separate plans can also be established for full-time and part-time employees.

Membership in a pension plan can be either mandatory or voluntary.

Eligibility to join a pension plan is based on employment and length of service. Part-time employees, casual, temporary workers or new hires might not be entitled to join the pension plan until they have reached a minimal length of service (i.e. – work 700 hours) or earned a certain level of income (i.e. – earned at least 35% of the Year's Maximum Pensionable Earnings, a term used in the CPP).

Our objective is that all past service, beginning from the time employment first commences, be recognized and that employees become eligible to purchase credits for past service at a specified date – for example, when the employee becomes vested. We should also seek 100% plan participation, for full-time, part-time and temporary workers.

••• Definition of Credited Service

Most pension benefits are based on years of pensionable service. If service under the pension plan is not the same as service with the employer, the pension will be smaller than it should be. This situation can arise under a number of circumstances, for example, when service under a newly established pension plan is credited on day one of the new plan, even if employees have spent many years with an employer. The definition of credited service can make a huge difference in the size and adequacy of the pension a member will receive at retirement.

A second issue in the definition of credited service is how absences from work will be treated. Service may be interrupted for sick leave, disability, maternity or parental leave, lay-off, absence on union business, educational leave and so on. A related issue is what happens when members are terminated and are then re-hired. Pension plans routinely include provisions stating that members who are terminated and then re-hired must start from scratch.

A third issue, which has become quite pronounced in the public sector in recent years, relates to what happens when organizations are privatized, devolved to other levels of government or combined with organizations operating under different collective agreements or pension practices.

Our negotiating objectives should be to obtain as broad a definition of credited service as possible, to ensure that seniority is maintained and to preserve (or upgrade) existing benefits when organizations or jurisdictions change.

••• Contributions

Pension plans are either contributory or non-contributory. In a contributory plan, both the employees and the employer must make contributions to the plan. Member contributions are usually a percentage of earnings, as described in the plan terms, and are normally made by payroll deduction. In a non-contributory plan, only the employer is required to make contributions. In some pension plans, you can also make additional voluntary contributions, which allow you to purchase additional pension benefits.

The employer and member contributions to a registered pension plan, and the investment earnings on those contributions, must be held separate and apart from the assets of the employer. This is in order to protect the assets of the pension fund in the event the employer becomes insolvent or goes bankrupt.

Ultimately, the important thing to remember about contributions to a pension plan is that they are the deferred wages of employees. Employee's contributions are obvious in a contributory pension plan. In a non-contributory plan, however, employees contribute, although less obviously, to the cost of benefits by way of foregone wage increases.

••• Vesting

When pension benefits are vested, this means that the employee is unconditionally entitled to receive the pension benefits that have accrued under the plan as a result of satisfying age or service requirements. In the case of a DC plan, being vested means an employee is entitled to receive a pension benefit equal to the value of the contributions the employer made on his / her behalf as well as the employee's own contributions, if any, plus investment earnings. In the case of a DB plan, being vested means an employee is entitled to receive the pension benefits accrued according to the benefit formula. Being vested does not mean an employee is entitled to the employer's contributions; it means the employee is entitled to the promised pension benefit (that is, the benefit that she / he has accrued), consistent with the type of the employee's plan.

In other words, vesting enables a plan member to qualify for pension credits without remaining a plan member until retirement. Without vesting, plan members would only receive their own contributions plus interest when they change jobs.

Required conditions for vesting are outlined in the plan document and must, at a minimum, meet the requirements of the applicable pension benefits legislation (either federal or provincial) which determines vesting by attainment of a certain age and / or completion of a specified period of service or plan membership.

••• Locking-In

Locking-in is a legislated provision that means the plan member cannot withdraw their own or their employer's contributions in cash and can only use them to provide a pension at retirement. The date at which contributions are locked in varies by jurisdiction and is determined by attainment of a certain age and / or completion of a specified period of service or plan membership.

Locking-in protects the pension funds from being used for anything but retirement purposes. Creditors can not seize locked-in pension benefits.

As a result of pension legislation, locking-in provisions may allow for the value of a worker's pension to be transferred to another locked-in retirement arrangement (i.e. the funds do not necessarily have to stay in the original pension account).

••• Deferred Vesting

When an employee terminates employment before eligibility for retirement and is vested, he or she may be entitled to a deferred pension. The problem is that the benefit may be frozen, thereby losing its real value over time. It is therefore important to ensure that there is indexing or another mechanism in place, to preserve the pension benefit.

••• Portability

Portability means that employees have the ability to 'take' their pension credits with them when they change jobs. Although pension legislation requires some form of portability, true portability has not yet been achieved.

Generally, pension legislation requires plan sponsors to provide employees who terminate employment with a number of options for the vested portion of their pension:

• the employee can leave his or her pension in the pension fund and receive a pension in the future (a 'deferred vested benefit');

• the employee can take the value of his or her pension and purchase an annuity from an insurance company;

• the employee can take the value of his or her pension and transfer it to a locked-in RRSP (or in Quebec, to a Locked-in Retirement Account – LIRA); and

• the employee can transfer the value of his or her pension into the new employer's registered pension plan, if the new employer agrees to accept the transfer.

Where this option exists, it is often because 'reciprocal transfer arrangements' have been made between employers.

••• Normal Retirement Age (or Date)

In a pension plan, the normal retirement age or date is the time at which the employee becomes eligible to receive an unreduced pension. This age or date must be set out in the pension plan and can be no later than one year after an employee turns 65.

This does not necessarily mean that the employee must retire at that time. The age at which an employee is eligible to retire under a plan will depend upon the terms of his / her employment and upon any applicable legislation.

••• Retirement Benefits

The benefits provision of a DB pension plan sets out the formula that will determine the actual amount of a member's pension benefits. Some factors to consider:

• Are the benefits integrated or stacked with CPP / QPP? Stacked results in higher benefits, but also higher contributions.

• Are the benefits integrated with OAS? Most provinces no longer allow this.

• What percentage of salary will the member's pension benefits offer upon retirement?

• Is a member forced to contribute beyond 35 years and yet land up with a maximum benefit capped at 35 years?

• Is there provision for ad hoc or (preferably) automatic indexing? Is the indexing fixed to the CPI or to the CPI minus some amount?

• Is there an early retirement bridge benefit?

• Are past service credits and military service credits accepted?

••• Early Retirement Age

Many jurisdictions allow pension plan members to retire early if they are within 10 years of the normal retirement age. The pension plan should specify the age at which a member may apply for early retirement with a reduced benefit.

••• Reduced Benefits for Early Retirement

When members retire early, there is less time for contributions made on their behalf to earn interest and build up enough money to pay the promised benefit. As well, the pension will have to be paid for a longer period of time than if the member retired at the normal retirement age. For these reasons, members who retire early are given a reduced benefit.

Our objective is to ensure that the reduction in our members' benefits for early retirement is as low as possible.

This issue is complicated by the fact that the *Income Tax Act* says that benefits must be reduced by at least 3% per year prior to age 60 unless the maximum pensionable service is achieved or the job is designated as a 'public safety' occupation. The occupations specified in law are firefighter, police officer, corrections officer, air traffic controller and commercial airline pilot.

Actuarial estimates put the costs in the 5% to 7% per year range and at some point it is important to know how much the other members should 'subsidize' the early-retired group.

••• Unreduced Pensions

Pension plans often include provisions for members to retire early with an unreduced pension once they have reached a certain age and / or completed a certain number of years' service. For example, early retirement with an unreduced benefit may be permitted once the worker has completed 30 years' service; or when age plus years of service equals 80.

A related issue is the provision, by some employers, of special arrangements for early retirement that allows for unreduced pensions, even though normal plan criteria may not have been met.

Another issue concerns designated 'public safety' occupations. In these occupations, if their plan so provides, a plan member may retire early with an unreduced benefit if the member has reached age 50, if age plus service equals 75, or if he or she has 25 years' service.

Our concern is that these occupations are currently largely male-dominated. At the same time, there are other, female-dominated occupations, such as nursing, which are not specified in law although they have equal or even greater 'public safety' considerations.

Early retirement is an important part of our overall retirement objective. Allowing employees to retire early with the dignity that adequate income permits, not only improves the quality of life, it can also help create jobs for younger Canadians and / or reduce layoffs. In order to encourage early retirement, we need to negotiate unreduced early retirement provisions, to the extent they are permitted by tax laws and regulations.

••• Bridge Benefits

Bridge or supplementary benefits are paid to workers who retire early to make their retirement income equal to the amount of income they will be eligible to receive from OAS and CPP / QPP at the age of 65. The benefit is then reduced at age 65 equal to the amount an individual is now eligible to receive under OAS and CPP (see also section entitled *Workplace Pensions*).

••• Disability Pensions

Many pension plans pay some form of disability benefit, but in many cases, the benefit is inadequate. In many cases, it may be more appropriate to provide benefits through a long-term disability plan (LTD) until the worker reaches age 65, than through the pension plan.

If disabled members are provided for through LTD, it is important to make sure the member continues to accrue pension credits while he or she is disabled. That way, when the member reaches retirement age, she or he will still be able to get a decent pension.

It is also desirable to have a minimum disability pension. But where there is a minimum benefit, care must be taken that any offsets for Workers' Compensation benefits and / or CPP / QPP disability benefits do not nullify the minimum benefit.

••• Pre-retirement Death Benefits

Some plans provide a pre-retirement death benefit. Death benefits are paid to a pension plan member's beneficiary when the member dies before retiring, and the member still has contributions on deposit with the plan. The member's spouse is usually the beneficiary unless the spouse consents in writing to the nomination of another beneficiary. If there is no spouse and no named beneficiary on file prior to the date of the plan member's death, death benefits are paid to the plan member's estate. The amount of the death benefit usually will depend on the member's age at date of death and years of contributory service.

••• Survivor Benefits

Legislation in all jurisdictions now requires that a spousal benefit be available as part of the normal form of pension for those with spouses. If an employee has a spouse when he / she retires, the employee's pension must be paid as a joint and survivor pension unless the employee and her / his spouse waive this right. This allows the surviving spouse to receive a lifetime pension after the employee's death that will be at least 60% ($66^{2/3}$% in Manitoba) of the monthly pension that was paid to the employee. The surviving spouse would also continue to receive these payments if he or she later became the spouse of another person.

In a joint and survivor pension arrangement, the dollar amount of the monthly pension a member would have received if he / she did not have a spouse may be reduced to fund the payments that will continue throughout the member's lifetime and that of his or her spouse. If the spouse dies before the member, the pension continues to be paid at the reduced amount.

••• Disability Benefits

A good pension plan should provide for continued plan membership while a member is disabled and receiving long-term disability benefits. Ideally, the accrual of pensionable service should continue. Employee contributions should be waived or paid by the employer. Disability retirement without reduction should be available for the worker who is disabled and cannot return to work.

••• Inflation Protection

This takes two forms: protection before and after retirement. The best way to ensure inflation protection before retirement is to have a best or final average earnings benefit formula. This ensures that a member's pension benefit is calculated using her / his highest wage level that reflects the wage raises received over those years. After retirement, further inflation adjustments are required to prevent a member's pension being outstripped by rising prices.

It is important to note that while inflation may not seem as relevant in today's environment as it once was, it could very well return at some future date. Even with a minimal inflation rate, an employee who draws on his or her pension for 30 or more years could find themselves with significantly lower incomes over time, if their pensions are not inflation protected.

••• Wind-up (or Partial Wind-up) of a Pension Plan

A wind-up occurs when a pension plan is terminated or discontinued, in whole or in part, usually at the decision of the employer. This most often occurs as a result of a downsizing or restructuring where the employment of a significant number of active plan members is terminated, when a business or part of a business is shut down or when an employer becomes insolvent or bankrupt. However, depending on the circumstances, an employer can simply decide to discontinue a pension plan.

Generally wind-ups rarely occur in the public sector as governments and other public service employers do not shut down, become insolvent or bankrupt. In fact the only substantive example of a wind-up of a public sector defined benefit pension plan is in Saskatchewan when in the late 1970s the Saskatchewan government wound up its defined benefit plan and legislated a new defined contribution pension plan based on matching employer and employee contributions and individual investment accounts. The plan covers all new employees hired after 1977 and any existing employees who chose to transfer their accrued pensions from the old defined benefit scheme to the new plan. There is no other case in the Canadian public sector of an established defined benefit scheme being replaced with a defined contribution scheme.

In July 2004, the Supreme Court of Canada handed down an important decision dealing with the treatment of surpluses on the partial wind-up of a defined benefit (DB) pension plan. In its decision on the '*Monsanto*' case, the Supreme Court concluded that, on the effective date of a partial wind-up, employers will be required to distribute, either to the affected plan members or to the employer, a pro-rata share of the actuarial surplus relating to the part of any pension plan being wound up. This distribution of actuarial surplus would occur regardless of whether plan members were required to contribute to the pension plan.

The Supreme Court did not indicate, however, how the distribution should be split between the members affected and the employer. In outlining the policy and practical reasons supporting this interpretation, the Supreme Court noted that "requiring that the pro-rata share of the actuarial surplus be distributed at the time of partial wind-up is unlikely to compromise the continuing integrity of the pension fund".

Although the '*Monsanto*' decision dealt with Ontario law, similar wording appears in pension legislation across Canada and this decision impacted on pension legislation in all jurisdictions of Canada.

••• Employee Information

In every jurisdiction there are legislative standards in place to ensure members are informed about their plan. These minimum standards include:

- explanation / summary of plan with description of members' entitlements and obligations;
- explanation / summary of notification of registration of any plan amendments, especially those affecting the members' benefits;
- annual benefit statement; and
- statement of benefits due on members' retirement, termination or death.

Ideally, at a minimum, the plan sponsor should provide members with access to actuarial valuations; annual information returns that may be required under provincial or federal legislation; the pension document, as amended; the trust agreement(s); the insurance contract(s); the pension fund reports; and the detailed financial statements setting out the specific holdings in the pension fund.

••• Surplus Assets

In employer sponsored plans, the payment of surplus funds to the employer is usually technically possible; however, there are invariably a number of stringent conditions that must be met. The most important is that the plan should specifically allow for employer withdrawal of surplus.

Workers should never accept the premise that employer-sponsors 'own' their pension plans and that the fund's assets or surpluses can be used at the employer's total discretion. Surpluses, no matter how they arise, are part of a worker's total compensation package. Despite this, there may be specified conditions where workers might gain – through achieving other benefits – from sharing these pension surpluses with their employers.

In a jointly trusteed plan, both the liabilities and the rewards are shared equally. If there is a surplus, there is a requirement for the parties to agree on the use of the surplus. Uses could include pension plan improvements or reduction in contributions by both the employer and the members.