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E-BRIEF

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RETIREMENT SAVING AND INCOME

DC Plans and the ORPP: Why Fees Matter

by
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- As the Ontario government prepares to implement its Ontario Retirement Pension Plan (ORPP), it needs to consider an anomaly that could unfairly penalize many employers as well as the people the plan intends to help.
- Not all Ontario employers and workers will have to make ORPP contributions. Where an employer sponsors a pension plan deemed ORPP-comparable, ORPP participation will be optional.
- Unless the ORPP-comparability test for defined-contribution (DC) plans recognizes employer-paid pension plan expenses as contributions, employers who do pay these expenses may be treated unfairly, while other employers would be discouraged from paying DC expenses at all.

The public pension plan now being established by the Ontario government, the ORPP, is designed to deliver a lifetime retirement income that replaces 15 percent of earnings after 40 years of participation. The first contributions are scheduled to begin in January 2018. Following a phase-in period that ends in 2021, Ontario employers and employees covered by the ORPP will annually each contribute from 1.9 percent to 2.1 percent of cash and non-cash earnings between $3,500 and a maximum of $90,000 in 2017, indexed to wage inflation (Ontario 2015a; Ontario 2015a; Ontario 2016a; Ontario 2016b).

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Not all Ontario employers and workers will have to make ORPP contributions. Where an employer sponsors a pension plan deemed ORPP-comparable, ORPP participation will be optional.

One would think that it would be easy to compare defined-contribution (DC) pension plans by simply looking at what is being contributed by plan members and their employers, respectively. But getting to the heart of the matter requires a bit more digging. Regardless of how much each party puts in, DC pension plans can have very different outcomes depending on plan expenses and who pays them. Consequently, comparisons made solely based on inputs without regard to outcomes can be quite misleading.

How DC input costs are paid has a material and substantial impact on members' outcomes. For DC plans generally, this E-Brief illustrates how inputs can be structured most cost-effectively for employers with the best outcomes for members. As private-sector workers become increasingly dependent on DC plans for retirement income, this has important policy implications in terms of how DC plans are designed and governed.

For Ontario employers, in particular, we show that recognition of some DC-plan inputs (i.e., direct contributions) and not others (i.e., employer-paid expenses) for purposes of determining "comparability" with the looming ORPP may result in some DC plan sponsors being required to make ORPP contributions, even though their plans deliver member outcomes that are equal to or better than DC plans sponsored by employers who will be permitted to opt out of the ORPP.

On August 7, 2015, the Ontario Ministry of Finance issued a Technical Bulletin outlining the criteria a pension plan will need to meet to be considered ORPP-comparable. (Ontario 2015b). For defined-benefit (DB) plans, the minimum comparability threshold is an annual accrual rate of 0.5 percent, or its value-equivalent in a flat-benefit DB plan.[1] Meanwhile, to be considered ORPP-comparable, a DC plan must have total contributions of 8 percent of base-salary earnings, with the employer making at least 50 percent of that total minimum contribution (i.e., 4 percent).

What does "Contribution" Mean?

The contribution-based comparability threshold for DC plans raises an important question: what counts as an employer "contribution" to a DC plan? More specifically, will employer-paid expenses be regarded as contributions?[2]

As Table 1 shows, a 30-year decline in DB pension coverage for Canada's private sector has been partially offset by an increase in DC pension coverage over the same period. Serendipitously, the treatment of plan expenses under the ORPP-comparability test points to a broader issue that has received little attention from policymakers to date: how should DC plan expenses be paid? This is an important question, for the following reasons:

- Employer-paid expenses effectively deliver the same value to DC plan members as employer-paid contributions;
- For a given employer cost, DC plan members' overall outcomes are better when employers pay expenses; and

1 The so-called 'Flat Benefit Formula' is a standard method of calculating an employer's contribution to an employee's defined-benefit plan whereby the employer multiplies an employee's months of service by a predetermined flat monthly rate.

2 With employer-funded DB plans, this issue does not arise because employers effectively pay plan expenses, either directly outside the plan or indirectly as increased plan contributions.

- Better DC plan governance can be expected with the employer-pay expense model.

Given the demonstrable advantages of the employer-pay expense model, we recommend that expenses paid directly by employers sponsoring DC plans should count as contributions for purposes of determining whether a particular DC plan is ORPP-comparable. To the extent that employer-paid DC expenses are not recognized as contributions for purposes of ORPP-comparability, employers will be discouraged from establishing and maintaining the DC pension-delivery models that operate most efficiently and deliver the best outcomes for members.

More broadly – and given the increasing importance of DC plans as a source of retirement income for Canada's private-sector workers – we hope this E-Brief will enhance understanding of DC plan expenses and stimulate a constructive dialogue about those expenses among policymakers, regulators, plan sponsors, plan members and service providers.

Table 1: Private Sector Pension Coverage 1984 – 2014

Year	1984	2014
Employed Workforce	7,257,900	11,561,000
DB Plan Members	2,251,590	1,399,902
DB Coverage Rate	31%	12.1%
DC Plan Members	233,341	893,713
DC Coverage Rate	3.2%	7.7%

Source: Statistics Canada Tables 282-0089 and 280-0016.

Who Pays the Fees: Why it Matters

Operating a DC pension plan requires a number of services, including the following:

- Maintaining records for contributions and member accounts;
- Managing investments;
- Educating, informing and communicating with members;
- Selecting and monitoring service providers (e.g., record keepers and investment managers); and
- Complying with regulatory requirements.

These services cost money, often paid by fees charged to members' accounts. Much has been written about fees' impact on the accumulation of retirement savings in DC plans and RRSPs. Much less attention has been paid to the merits of who should pay operating expenses – DC plan members or their employers.

There are generally three payment models for DC operating expenses:[3]

3 We were unable to uncover any meaningful study or commentary on either the merits of each of these payment models or their prevalence in Canada. In the US, about 35 percent of employers reportedly pay some plan expenses from unvested forfeitures (ICI 2014). However, US DC plan members typically pay the majority of the expenses. For plans with assets between $1 million and $10 million, for example, employers cover only 17 percent of the cost and participants the remainder (Deloitte 2013). In Canada, our understanding is that the member-pay-all model is most prevalent; the shared-payment model is somewhat typical of larger DC plans while the employer-pay-all model is rare. We believe improvements in the design, cost-effectiveness, governance and member outcomes in DC plans would be facilitated by better information about DC plans, perhaps though broad-based surveys of DC plan members and sponsors, expansion of existing industry surveys and enhanced disclosure requirements.

1. All expenses are paid by members, often through a combination of direct and indirect charges;
2. Responsibility for payment of expenses is shared, with some paid by the employer (e.g., record-keeping fees) and some paid by members (e.g., investment management fees); and
3. All expenses are paid by the employer outside of the plan.

Where an employer contributes 4 percent of pay to a DC pension plan in which operating expenses are paid from member accounts, the value members realize from that contribution is reduced. This fact is not fully understood by DC plan members: evidence suggests that more than 70 percent believe they do not pay any fees at all (AARP 2011). While this could change if pension standards were to require full disclosure of all plan expenses, current guidelines for DC expense disclosure are only voluntary and also permit disclosure on an "aggregate" basis (CAPSA 2004).

It matters very much who pays plan expenses. Table 2 shows two DC plans with an equivalent employer cost. In the first (Plan A), expenses are paid from members' accounts. In the second (Plan B), expenses are paid by the employer. With an employer contribution of only 1.71 percent of payroll – less than half the 4-percent-employer contribution made to Plan A – members of Plan B have substantially the same accumulation outcomes. They also get more tax-deferred retirement-saving room – 20 percent more after 10 years.[4] Even though it has the same employer cost as the ORPP-comparable Plan A and delivers a better overall outcome for members, Plan B would not be regarded as ORPP-comparable if the comparability test recognizes only direct employer contributions.

How can it be the case that the Plan B employer can reduce direct DC contributions by more than half, even as the plan delivers the same accumulation outcomes? The reason is simple: because the employer picks up the fees, members get 2 percent more annually-compounded net investment earnings since their account values are no longer reduced each year to pay expenses. Over time, the positive effect on member account balances is significant.

Why the Employer–Pay Model is Better

Earlier, we listed three expense-payment models for DC pension plans. While the first two are the most prevalent, the third (employer-paid expenses) offers a number of advantages for both plan members and employers.

For plan members, the pluses include the following:

- ***Better transparency*** – With service costs often bundled into a single fee expressed as a percentage of assets, DC plan expense disclosures can be very difficult to understand. Removing fees from the picture makes it much easier for plan members to follow and understand the development of their account balances.

4 Assumptions used for this analysis are: 160 DC plan members (approximately the average membership of Ontario-registered DC pension plans) earning an average of $50,000 annually (approximately the average wage in Ontario) participate for a 10-year period (to reflect that workers change jobs). Wage inflation is 2 percent. Investment return and fees are 5 percent and 2 percent, respectively. Each member has a starting balance of $35,000 (approximately the average DC account balance in Ontario) at the beginning of the projection period along with one-year's unused RRSP contribution room. Investment returns are time-weighted and fees are applied monthly. See online Appendix A for 10-year projections using higher and lower investment-return and fee assumptions.

Table 2: DC Plan Comparison – Member-Paid vs. Employer-Paid Expenses

		DC Plan A Member-Paid Expenses	DC Plan B Employer-Paid Expenses	Difference
1	Starting Plan Balance	$5,600,000	$5,600,000	
2	Starting Member Account Balance	$35,000	$35,000	
3	Ten-Year Payroll	$87,598,000	$87,598,000	
4	Employer Contribution Rate	4%	1.71%	
5	Member Contribution Rate	4%	4%	
6	Employer Contributions	$3,504,000	$1,498,000	($2,006,000)
7	Member Contributions	$3,504,000	$3,504,000	
8	Fees Paid from Plan Accounts	$2,040,000	$0	($2,040,000)
9	Employer-Paid Fees	$0	$2,006,000	$2,006,000
10	Net Investment Earnings	$2,972,000	$4,929,000	$1,957,000
11	Effective Rate of Investment Return	2.94%	5%	2.06%
12	Ending Plan Balance	$15,580,000	$15,531,000	($49,000)
13	Ending Member Account Balance	$97,400	$97,100	($300)
14	Employer Total Cost	$3,504,000	$3,504,000	
15	Employer Cost as % of Payroll	4%	4%	
16	Starting RRSP Room per Member	$8,820	$8,820	
17	Ending RRSP Room per Member	$63,570	$76,110	$12,540

Source: Authors' calculations.

- ***Better plan governance*** – While plan sponsors do have a fiduciary duty to review expenses periodically, this does not entail an obligation to get the "best deal" – only a requirement to ensure that expenses are reasonably within market terms and conditions. Employers pay close attention to what they pay for directly, with the result that plan expenses are likely to be monitored more closely and negotiated more aggressively by an employer who pays them. This additional monitoring would likely expand to other aspects of the plan, improving plan governance generally.
- ***More RRSP room*** – With equivalent outcomes being possible from lower employer direct contributions, members' Pension Adjustments[5] will be lower, resulting in more RRSP room for members for a given level of employer cost.
- ***Potentially more direct contributions*** – Employers committed to a fixed DC plan cost as a percentage of payroll would be expected to increase direct plan contributions if or when expenses decline – as they likely will when there is a strong economic incentive to negotiate fees.

5 Pension Adjustments reported to the Canada Revenue Agency reduce pension plan members' RRSP contribution room.

- ***More potential for better outcomes*** – While the riskiness of a given investment portfolio doesn't vary based on who pays plan expenses, members will have better investment outcomes if their accounts earn the gross investment rate of return rather than an investment return reduced by fees.

The employer-paid-expense model also offers benefits for employers:

- ***Less fiduciary risk*** – An employer who pays DC plan expenses is no longer accountable to plan members for the amount of fees that would otherwise be charged to their accounts – a popular subject matter for litigation in other jurisdictions (Randazzo 2015).
- ***Greater employee goodwill*** – Employers who pay plan expenses can so inform members – and do, in our experience. This creates opportunities to demonstrate that a DC plan with employer-paid fees delivers better member outcomes as compared to plans with member-paid fees.
- ***System optimization*** – Employers paying expenses directly will have a strong economic incentive to negotiate fees and service levels that is lacking in the member-paid expense model, where many members are even unaware they pay fees. By eliminating an agent-principal conflict that characterizes many DC plans, the employer-paid expense model can be expected to result in better fee disclosure, better monitoring of costs and services, lower overall operating costs for DC plans – and a better bottom line for employers and members.

ORPP-Comparability – Evaluation and Compliance

To determine whether a particular pension plan is and remains ORPP-comparable, the Ontario government will need access to up-to-date information regarding contributions, benefits and membership for existing plans. Currently, all pension plan sponsors are required to file an annual information return (AIR). These AIRs will likely be the best way to capture information needed to determine ORPP-comparability – including information about how DC plan expenses are paid and the quantum of those expenses.

Conclusion

Determining ORPP-comparability of DC pension plans based solely on one type of nominal input (i.e., direct contributions) without regard to other inputs that contribute value (i.e., employer-paid expenses) would be inequitable for DC sponsors who pay expenses directly. It would also lead to the unintended and undesirable consequence of discouraging employers from establishing, operating and maintaining the kind of DC pension plan that operates optimally for both DC plan members and their employers. To ensure that this model is adopted more broadly and – at a minimum – not discouraged, we urge the Ontario finance minister to develop a policy that includes employer-paid expenses as contributions for purposes of establishing which DC pension plans will be regarded as ORPP-comparable.

While the issue of ORPP-comparability affects only Ontario employees and their employers, the steadily increasing membership in DC plans nationally suggests that a dialogue about DC expenses and how they are paid is of significant and increasing importance to all Canadian DC plan sponsors and their members. Available evidence suggests that the employer-pay model for DC plan expenses is all too rare despite its demonstrable superiority. As implementation rules for the ORPP are developed, this points to an opportunity for the Ontario government to lead the way in improving pension outcomes and governance more broadly – for both DC plan members and ORPP contributors – by ensuring the ORPP-comparability test recognizes employer-paid DC plan expenses as contributions.

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