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PENSIONS IN CANADA

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Discussion of the future of private pension plans in Canada including the following problems:

1. Indexing for inflation

2. Employee mobility

3. Human rights legislation

MR. GEOFFREY HORROCKS: The development of the private pensions industry in Canada since 1945 was conditioned on the influence of several social and economic factors, namely:

1. A modest level of social security. Until 1966 the only government sponsored program was federal old age security which provided a flat benefit to all Canadians at age 70.

2. Tolerable levels of inflation by current standards.

3. Favourable tax treatment of employee pension contributions.

4. A high rate of personal savings.

Plans developed in this environment naturally followed a pattern of high employee contribution providing a benefit as high as 70% of career earnings for long service members. Criticism of the private pension industry is largely focussed on this type of plan which has failed to react to changes in the external factors that have already occurred.

In the short term, therefore, changes in private plans will reflect the catch-up necessary to recognize the existing situation.

Specifically, I see the following trends already in progress and likely to continue and expand:

A. Benefit Level

With the expansion of social security to now include a mature Canada/Quebec earnings related programme which provides a benefit of 25% of final average earnings ceiling (YMPE for 1979 - $11,700), over-pensioning at the low to middle income salary range is a possibility.

A married couple age 65 will receive a total of $4,090 per annum from Old Age Security plus a further $2,617 Canada/Quebec Pension assuming only the husband has worked. Given these numbers, it seems unnecessary for the private plan to provide a benefit in excess of 30% of pre-retirement earnings at the YMPE salary level.

Direct offset of Old Age Security benefits is unacceptable to plan members. Direct offset of Canada Pension has not experienced the same negative reaction - but this may be on the horizon.

I am suggesting a benefit level either split at the YMPE ceiling, say 3/4% / 1-1/4% or 1% / 1-1/2%, or a single benefit level at the lower figure to provide adequacy up to the YMPE. Benefits related to higher salaries would be provided through a supplementary plan.

B. Earnings Base

Inflation at 8% to 10% per annum quickly clouds the attraction of pension benefits based on career earnings. Much of the inadequacy of benefits being paid to recent retirees is a result of the imbalance between career and final earnings.

A practice often used in Canada over the past 10 - 15 years has been to periodically update accrued career benefits to a recent base year salary thereby avoiding the open-ended commitment to a final pay formula while effectively providing final pay related benefits.

Notwithstanding the logic of this approach, it seems to me that, given the background of final pay plans for government employees and the almost universal pattern of union negotiated plans improving their benefits for all service, the trend towards final pay formulae in the private sector will continue. The trend towards a lower unit benefit discussed above will assist in the move towards final earnings in that a 1% final formula may philosophically be more acceptable than a 2% final formula.

C. Employee Contributions

Canadian taxpayers may deduct from gross income the lesser of 20% of income or $3,500 contributions to a registered pension plan. Historically, this attractive tax incentive has justified the general pattern of contributory pension plans in Canada.

Factors which have disturbed this pattern in recent years are:

a) Increased visibility of registered retirement savings plans (RRSP) and new programs such as registered home ownership savings plans (RHOSP): RRSP's have been available for over 20 years and provide for tax deferrment of up to $3,500 per annum reduced by any employee pension plan contributions. Promotional activity by the institutions which offer RRSP's and the introduction of optional investment vehicles - fixed income, equity, mortgage - has made Canadians aware that tax deferrment is not restricted to pension plan contributions.

b) Growth of union negotiated plans on a non-contributory basis with ever increasing benefits: It is possible to compare a unionized tradesman working side by side with a salaried foreman where the union man receives an annual pension credit, non-contributory, of $10 per month or say 3/4 of 1% of his salary of $16,000 compared with the foreman who may be asked to contribute 4% or 5% of salary for a benefit which to him may seem little better than the 3/4 of 1% earned by the tradesman.

c) Reduced level of personal savings confirms a growing reluctance on the part of Canadians to save for their own retirement.

d) Unattractive interest return offered by most plans on death or termination compared to going RRSP rates.

e) Influence of benefit structure of plans of Canadian companies that are subsidiaries of U.S. parents.

Putting these trends together, we can compare the typical Canadian plan of recent years being a 2% integrated career earnings benefit, possibly with periodic updates and requiring a 5% integrated employee contribution, with the plan of not too many years hence which will be non-contributory and provide a final pay benefit formula of 1% of earnings with possibly a greater unit benefit over the YMPE ceiling.

Turning now to other factors which will influence the development of pension plans both private and government.

<u>Human Rights Legislation</u>

1. The Canadian Human Rights Commission, established in 1977, has recently issued draft regulations which do not exempt money purchase pension plans from the provisions of the Act. The regulations purport to require equal benefits rather than equal values. These regulations are in conflict with Ontario Human Rights Legislation which allows equal contributions for males and females, and with the Canadian Human Rights Legislation itself. Equal contributions are permitted to Profit Sharing Plans, Severance Award Plans, and Registered Retirement Savings Plans.

   A strong lobby has been raised to point out the logic of equal value rather than equal benefits, but the emotional counter arguments based on equal need and the specific life expectancy of one particular female should not be discounted.

   If by chance the draft regulations were approved, there would likely be a substantial shift of the nation's 7,000 money purchase plans into other forms of retirement savings.

2. In Alberta, a female filed a complaint concerning the purchase of a life annuity in which she received 11% less than the annuity available to a male of the same age. The Board of Inquiry in Alberta ruled the practice to be a violation of its Individual Rights Protection Act and recommended appropriate clarification of the intent of the Insurance Act.

While a decision in favour of unisex pricing may not directly impact on pension plan design and costing, it may well represent the thin edge of the wedge away from the concept of fairness and equity towards an extreme interpretation of non-discrimination.

The same inquiry ruled that the practice of charging single male drivers under 30 higher auto insurance rates violated the legislation, a view supported by the Ontario Consumer and Commercial Relations Minister who said recently that "unisex automobile insurance is inevitable".

These activities in Canada, coupled with the U.S.Supreme Court decision in the Manhart case, can only lead to the conclusion that alleged sex and age discrimination will be an important consideration in the development of pension plans over the next few years.

3. "The last great human rights issue to be tackled" according to Senator David Croll, the 79-year old chairman of the Special Senate Committee on Retirement Age policies is the question of a Mandatory Retirement Age. All major political parties in Canada opposed mandatory retirement as part of their platform in the recent election campaign. Notwithstanding the opposition of the Canadian Labour Congress which is "emphatically opposed" to abolishing mandatory retirement and by contrast proposes earlier retirement with greater pension benefits both from the government and the private sector, it seems at this point in time that legislation similar to that in force in the United States will be in place in Canada in the near term.

Social Security

Another common proposal of the major political parties in Canada is the extension of the Canada Pension Plan to spouses employed in the home. Having tremendous political appeal, those who point out the practical difficulties of permitting voluntary contributions risk being regarded as lacking vision and being intent on preserving the status quo.

Spouses' allowances paid to those between ages 60 and 64 whose partners are over age 65 and in receipt of the Guaranteed Income Supplement are presently cut off on the death of the older spouse. Who would question the elimination of this provision regardless of the government returned to power?

More fundamentally, there is no doubt that the government through its social security program is willing and able to step in to fill any gaps that are left or appear to be left open by the private sector. Basic questions of portability and indexation are of particular concern and are covered as part of this panel discussion. If the private sector does not react positively to the concerns of plan members, major improvements in the statutory benefits will be legislated, not perhaps to the 75% level at age 60 requested by the Canadian Labour Congress, but through a more modest increment in the basic benefit level of 25%.

Summary

One of the major difficulties faced by the pension consultant is his appearance as a member of "the establishment", out of touch with the realities of change and intent on preserving the private system intact. He is vehemently opposed to governmental incursions even when the need is an obvious result of a weakness in the private system. He recommends investigative studies and is seldom innovative to the needs of the consumer.

In Canada, the study period is over. The major report of the Ontario Royal Commission is expected this summer and the Lazar report has been presented to the federal government and will likely be published in the fall. Recommendations from these reports will be a challenge to the private pension industry which it cannot afford to pass by. The purpose of these comments is to highlight some major areas where change can be anticipated, namely:

1. Trend towards non-contributory plans.
2. Benefits related to final average earnings.
3. Formula integration rather than direct offset.
4. Lower private plan replacement ratios.
5. Protection of benefits against inflation.
6. Protection of spouses against cessation of benefits on death.
7. A rational approach to portability.
8. Extension of Canada Pension Plan coverage to females employed in home.
9. Disclosure of nature of benefits and costs.
10. Extension of human rights philosophy to benefits.

MR. THOMAS H. DANCY: The topic suggests that there will be changes in the pension scene in Canada.

Will there be changes?

My answer is an emphatic YES based on the vocal protests of pensioners and the extent of various government reviews:

1. The Quebec Confirentes Group has already presented a report calling for radical changes in the pension system.
2. The Ontario Royal Commission on Pensions Report is now slightly overdue.

3. The Federal Interdepartmental Review has been completed with an anticipated release to the public in the fall.

4. The Senate's Committee on Retirement Age.

Is Change Necessary?

Our present pension system has evolved in the private sector from the original paternalistic approach to pensions as a reward for long service with the goevernment pensions alleviating the gaps created by this approach. The result:

1. Only 12% of the income of those over age 65 comes from private pension plans - less than the pensioners earn in interest on their bank accounts.

2. Some 54 percent receive the income tested guaranteed income supplement which is set at a level to bring those without other income up to the poverty level. This proportion is lower than in the early 1970's when about two-thirds were receiving the guaranteed income supplement. Nevertheless, we can expect at least partial reliance on the supplement for some time to come as a married couple with income of $9,000 would still receive some supplement. Its mere existence is a disincentive to the lower paid worker to save for retirement through a private pension or a registered savings programme.

If change is inevitable, our purpose is to identify those changes which should be implemented within the constraints of sound financing and productive use of capital. I add these criteria as we obviously must avoid the kind of proposal which emanated from the Canadian Labour Congress a few years ago to expand the Canada Pension Plan to provide 75% of income at age 60. Since this would cost over 30% of payroll and would largely dry up private pensions as a source of investment capital, it must be summarily rejected.

What then can a Private Pension System do?

Coverage

The first problem contributing to the 12% of income is the non-member of a private pension plan or the surviving spouse of the member who rejected a joint and last survivor annuity. The popularly quoted figure is that only 40% of working Canadians belong to private pension plans. The pension industry consoles itself by manipulating Statistics Canada figures to demonstrate that over 60% of the full-time employed Canadians between 25 and 65 are covered. This, of course, includes government employees who are members of private plans on a compulsory basis. If these are removed, the coverage of private sector employees reduces back to approximately 53%. Part of the problem is employees who have an opportunity to join a pension plan and turn it down. This may not be such a bad idea on their part if the pension plan provides them with a 4% interest credit on their contributions and they know that there will not be any employer contribution in respect of them until they are much older. If pension plans are going to remain contributory, we must make the rate of return to the employee attractive. Even if this costs the plan something, it is pretty cheap vesting.

So much for the employer who has a plan, but a greater problem is the employer without a plan. Frankly, I am skeptical of resolving this problem without mandating minimum benefits.

Portability of Benefits

If pensions become considered as deferred wages, then the forfeitures arising from failure to fulfill vesting requirements will no longer be tolerated. Likely costs will increase but benefits for long service employees may well decrease in the interests of a more equitable arrangement.

Employers, in adopting final salary plans, have relied on employee turnover to keep their costs down. The cost reduction comes from employees leaving before vesting, the freezing of vested benefits and the excluding of service with a prior employer in the calculation of a benefit. Employees are becoming increasingly concerned about these forfeitures and are looking for earlier vesting as well as portability. In this context I am using the term "vesting" to refer to preserving accrued benefits on termination of employment as opposed to "portability" which is the facility to transfer funds from one plan to another with corresponding credits for service. If the portability mechanism worked perfectly, the employee who works for several employers, each of whom has a final pay pension plan, would end up with a final pay pension based on total service with the various employers and each employer would have contributed his fair share.

Portability has existed for some time in Canada by means of reciprocal agreements generally between employers in the public sector. These have tended to be complicated and costly and require specific adoption by each employer. To be effective, a more generalized approach is required and, if properly drawn should prevent the kinds of abuse which has led the Department of National Revenue to restrict portability to specific reciprocal agreements.

Criteria for Evaluating a Portability Proposal

To be effective, the following features should be included:

1. The same conditions for eligibility for portable benefits must apply to employees both entering and leaving the plan.

2. The additional credited service of a new entrant to the plan who has met the conditions for eligibility for portable benefits must be calculated on exactly the same basis as the transfer value would have been calculated if the employee were leaving the plan.

3. The full amount determined by the portable benefit calculation must be available for transfer to another plan.

4. The plan must be prepared to accept a transfer of funds from a new employee whether or not the employee is immediately eligible under the new plan.

5. The minimum transfer value would include an employer contribution such as an amount equal to an employee's contributions or an equivalent value for non-contributory plans.

6. Any plan which has a minimum service requirement for membership in the plan should waive that requirement for employees who bring in a transfer value with them when hired.

7. When an employee is hired with a credit for prior service, the prior service would be applied to reduce any period of service required for vesting under the plan.

These proposals do not achieve the objective of 100% portability of service to a benefit with the final employer of total service. Nevertheless, they represent a significant starting point while leaving considerable flexibility open to employers but nevertheless significantly improving portability in the eyes of mobile employees.

Comments

1 & 2. Rather than trying to determine equivalent values for eligibility and service with the very real complication of reciprocal agreements, the proposals simply say that the calculations be done the same way for employees coming in with portable benefits as for those leaving.

3 & 4. If portability is to be achieved, the funds must move from one employer to the other.

5. The proposal to have a minimum employer contribution strikes at the root of one of the problems of merely vesting; namely, that a benefit is frozen at the time of termination of employment even though the employer may have been contributing and funding towards a much higher projected benefit at retirement.

6 & 7. These proposals take a significant step toward credit for full service without imposing a variety of waiting periods and toward eliminating forfeitures under the vesting formula.

Obstacles to Portability

The main obstacle is inertia and indifference. Employers are reluctant to increase costs, and, in general, exhibit little concern for terminated employees. Employees, on the other hand, are not generally sufficiently pension conscious during the ages of greatest mobility to be concerned about preserving pension rights and, in fact, tend to take their own contributions out of a plan whenever possible upon termination of employment.

The alternative, of course, is compulsion under private plans or expansion of government programmes to make up for these gaps.

There are also technical impediments relative to the benefits which have not been funded and, of course, current Department of National Revenue Regulations would not permit a blanket type of portability arrangement. I am satisfied that, if a portability scheme were to be developed, both provincial and federal regulatory officials would find ways to support such a programme without undermining the purpose of their present regulations.

Indexing of Benefits

It is difficult to talk on this subject in relation to the Canadian scene because of the acrimony which has arisen over the indexing of civil service pensions. A significant part of the private sector also recognizes its obligation to retirees to ameliorate the worst effects of inflation. In fact, in a survey a couple of years ago, it was established that 80% of the larger employers had increased pensions in the course of payment on some basis.

These increases have been referred to as "ad hoc" because, although they may occur fairly regularly on a consistent pattern, there is no advance commitment. They are subject to the employer being able to afford them in addition to the compensation package for active workers or they may be part of a bargaining agreement.

Very rarely are they as much as the full cost of living increase with the usual amount covering some 60% of the cost of living increase. The increase may apply only up to a certain level of income and it may be adjusted depending on the age of the pensioner.

In some instances, the amount of the increase may be based on the investment performance of the fund.

Considerations on the Index to be Used.

Indexing is usually associated with the cost of living or consumer price index. It has never been demonstrated that this is an appropriate index for pensioners and, in fact, in the U.K. a separate index for pensioners has been developed. Geoffrey Calvert's studies in Canada indicated that the cost of living for pensioners did not increase as fast as the general consumer price index. This phenomenon could, of course, be interpreted differently. Pensioners may cut their spending because of fear of the effects of inflation in the future.

There is a further defect in the consumer price index in that it includes both imported inflation as well as domestically-engendered inflation. The distinction I am trying to draw on these two types of inflation is that the only remedy to imported inflation is some belt tightening or to make up for it in exports. A much stronger argument can be made for trying to protect pensioners from domestically-produced inflation. The main difficulty is persuading current workers to forego wage increases in favour of improving benefits to pensioners. They all agree that the increases should be made but do not expect a personal cost to be involved.

Some time ago, variable annuities with investments partly in fixed income and partly in common stocks were proposed as the financial mechanism to guard against inflation. Over long periods of time, this relationship does tend to prevail, but, in the short run, as we have seen all too often in the last decade, inflation can be accelerating and both stock and bond prices declining.

More recently, attention has focussed on the rate of interest in relation to the rate of inflation. This is a different measurement than including the capital value of the investments in the calculation. It is true that inflation

tends to drive interest rates higher but in our experience over the last quarter century as inflation ratcheted upwards the expectations of inflation have been less than the realization and consequently, long-term bond interest rates have not kept pace with actual inflation. Short-term interest rates have tended to be more realistic in this regard.

There is an interesting new development in U.S. securities referred to as variable rate notes in which the rate of return varies every six months according to the rate of return on short-term treasury bills plus a premium but with the principal repayable in twelve or fifteen years. This type of security tends to provide the sensitivity to short-term inflation expectations while at the same time allowing for a longer term of investment as is generally deemed more appropriate for pension funds. There is usually a floor rate of interest. Currently, these securities are returning 11% or 12% for a six-month period. I suggest that they are an attractive form of investment for a pension plan to consider for at least part of the pensioner liability. This type of security is also available in the United Kingdom with a shorter maturity but as yet, to my knowledge, has not emerged in Canada.

There have been two other suggestions relating to investment return and the indexing of pension funds.

1. James E. Pesando of the University of Toronto has suggested that the government provide inflation insurance against the cost of living deviating from the expected rate of inflation in the interest rate. As an illustration, if inflation was expected to average 7% over a reasonably long period of time and the real rate of return on a safe fixed income investment is 3%, then a long-term bond should yield 10%. The calculation of the cost of an annuity, either to be purchased from an insurance company or paid out of a fund, would be based on the 3% real rate of return. Deviations from the 7% expected average inflation rate would result in payments to or from the government. This method involves an annual accounting which could be avoided by charging the cost of the actual cost-of-living annuity calculated at 3% interest against the remaining balance in the reserve. In this way, the government would only come into the process when all of the inflation premiums had been used up. Or, vice versa, if they were not used up, there would be a credit back to the government at the death of an annuitant or at the expiry of the maturity of the bond.

2. Another proposal to facilitate indexed pensions is to offer indexed bonds. It is likely, however, that corporate treasurers would be as concerned about the potential drain on their firm from indexed bonds as they are now about indexed pensions. Consequently, it is likely that the government would be the primary issuer of such securities and this would result in further pressures on the private sector capital market.

All of these devices relative to indexing merely serve to perpetuate an inflationary psychology on the premise that everyone can be protected one way or another. The logical result of such an argument is to ask "Who needs inflation anyway?".