# Pension Reform in Canada In Canada —
# An Actuarial Perspective

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## Introduction

This paper is written in two parts. In the first section, we give background material on the existing Canadian Income Security system, including both government-sponsored systems and private sector supplements. This is to give the rest of the paper its proper context.

Part two of the paper is the report from the Canadian Institute of Actuaries' Task Force on Government-Facilitated Retirement Income Plans, published in March 2010 to provide a response from the Canadian actuarial profession on the continuing pension reform debate in Canada. I was the chair of this task force.

## The Canadian Context

We will describe the Canadian Retirement Income Security system as being composed of three Pillars (as defined by the World Bank).

We will refer to the Guaranteed Income Supplement and Old Age Security as Pillar 0. Pillar 1 will refer to the government-sponsored contributory and earnings based Canada-Quebec Pension Plans. Pillar 2 will refer to employer-sponsored registered pension plans. Finally, Pillar 3 will refer to voluntary savings (some of which are tax incented) such as registered retirement savings plans (RRSPs) and tax-free savings accounts (TFSAs).

Readers should consider $1 CAD to be equal to $1 USD.

### a. The Guaranteed Income Supplement (GIS)

The government-sponsored portion of the Canadian Retirement Income Security system is highly targeted with the clear purpose of alleviating poverty in retirement.

The first tier of these benefits is welfare benefits called the Guaranteed Income Supplement (GIS). The maximum GIS benefit as of July 2010 was $658.40 (single) or $7,901 per annum.

GIS benefits are clawed back at a 50 percent rate for every dollar the individual has of their own source, except for the Old Age Security benefit. This means that it is often not wise to expect or to force low-income workers to save for retirement since they will lose 50 percent of every retirement income dollar they produce. In many provinces, there are additional provincial programs (e.g., the Guaranteed Annual Income System, or GAINS program, in Ontario) that effectively create a 100 percent clawback rate. This clawback becomes extremely important in designing any alternative program.

GIS benefits are not taxable (not a big deal given the very low income of the recipients) and the system is funded from general tax revenues. It is thus a pay-as-you-go plan. One-third of Canadian retirees today receive at least a partial GIS.

### b. Old Age Security (OAS)

Old Age Security (OAS) benefits are paid to all Canadians 65 and older who have lived for 40 years in Canada (pro-rata payments are made to those with less residency). The OAS benefit as of July 2010 was $521.62 a month or $6,259 per annum. Thus, a recipient of a full GIS plus OAS benefit would receive $14,160 per annum (or about 30 percent of average yearly earnings).

OAS is funded by general tax revenues. OAS benefits are taxable income. Both OAS and GIS benefits increase quarterly based on the consumer price index (not a wage index).

OAS also has a clawback but not as severe as for the GIS. OAS benefits are clawed back at a marginal rate of 15 percent once your own personal income exceeds $62,000. Thus, recipients with their own source retirement income of $104,000 receive no OAS at all.

### c. The Canada/Quebec Pension Plans (C/QPP)

The Canada Pension Plan and the Quebec Pension Plan are virtually identical and workers have full portability between plans.

C/QPP are earnings related contributory pension plans. Participation for those earning more than $3,500 per annum is mandatory. The contribution rate is 9.9 percent split equally between the worker and the employer (the self-employed pay the full 9.9 percent). There is a tax credit for these contributions (i.e., a tax deduction but at the tax rate of an average Canadian). Benefits are taxable income.

Actuarial reports of the CPP show that it is sustainable over 75 years at the contribution rate of 9.9 percent. The QPP requires a rate of contribution slightly in excess of 9.9 percent to achieve long-term sustainability.

Contributions and benefit accruals stop at the year's maximum pensionable earnings (YMPE). In 2010, the YMPE was $47,200. This is approximately the average yearly earnings in Canada.

The benefit accrual rate is 25 percent of wages up to the YMPE. The maximum CPP benefit in 2010 was $934.17 monthly or $11,210 per annum. Thus, a person with a maximum OAS plus a maximum CPP would receive $25,370 or about 37 percent of average earnings. Thus, we can see there is still a lot of room for Canadians to save for retirement in other vehicles.

### d. **Private Sector Employer Registered Pension Plans (RPPs)**

Similar to the U.S., Canada has seen a measurable shift in employer-sponsored registered pension plans (RPPs) from defined benefits (D.B.) to defined contribution (D.C.) plans. Most of the D.B. RPPs cover public employees. In total, D.B. RPP plans cover 35 percent of the work force but only 22 percent of the private sector work force. And, both of these numbers are in decline.

Thus, there is a growing concern that the next generation of workers may not retire with adequate income. Research has shown this is especially true for those now earning between $40,000 and $80,000.

Within defined limits, contributions to both D.B. and D.C. plans are tax-deductible for both the employer and employees. Plans with employee contributions are the norm.

This, then, is the context upon which the CIA produced its task force report on government-facilitated retirement income plans.

# CIA Task Force on Government-Facilitated Retirement Income Plans

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# Executive Summary

## 1. Terms of Reference

At its November 2009 meeting, the Canadian Institute of Actuaries (CIA) appointed a task force with the mandate to develop the CIA's public position on expanded/modified government programs in relation to retirement income.

## 2. Target Population

The paper first posits that the target population for these proposals is not all Canadians. Government-sponsored systems of Old Age Security (OAS), Guaranteed Income Supplement (GIS) and Canada/Quebec Pension Plan (C/QPP) provide a significant floor of protection for low-income Canadians and it would be unwise to force lower-income Canadians to save further for retirement, especially given the implications of the GIS clawback.

At the other end of the spectrum, a significant proportion of Canadians are saving adequately for retirement through a combination of registered pension plans (RPPs), registered retirement savings plans (RRSPs) and homeownership, and have the opportunity to achieve adequate retirement income security.

Thus, those to whom this document is addressed (at most, one-third of the Canadian population) are workers who are not using or are unable to use the systems available to them today.

## 3. New Savings Models

Is there a way to create a new savings model that would result in a higher level of participation by these Canadians? The document will review three proposed pension systems and in that review outline the advantages and disadvantages of each. These will include:

- **Smart D.C. Plans:** We believe two specific proposals fall under this heading, a. The Canadian Supplementary Pension Plan (CSPP) as proposed by Keith Ambachtsheer; and b. The Alberta/British Columbia (ABC) provincially facilitated plan.
- **Plans to expand the C/QPP:** With specific examples proposed by the Canadian Labour Congress (CLC), the National Association of Federal Retirees (FSNA) and the Canadian Association of Retired Persons (CARP). These will be reviewed as one proposal.
- **Target Benefit Plans:** We believe both the Ontario Expert Commission on Pensions (OECP) and the Nova Scotia Pension Review Panel proposed systems that fall under this title. It is also true that the Quebec member-funded pension plan and simplified pension plans meet many of the criteria for this type of system.

## 4. Principles for a Good Pension System

In recent years, several papers have been published, and the Whitehorse meeting in December 2009 led to the publication of the Baldwin and Mintz reports, which were reviewed by the task force.

From these numerous papers, the task force identified several important variables in any potential pension model. For each variable, the task force has outlined advantages and disadvantages of each option (normally there are two) and has also opined on what it sees as the optimal outcome.

The variables under consideration were:

- Mandatory/voluntary;D.B. or D.C.;
- Public/private;
- Pay-as-you-go/fully funded;
- One size fits all or choice;
- Pay-out options; and
- Portability.

## 5. Pension Proposal Review

The task force described and reviewed the three proposed pension systems mentioned previously and commented on them with regards to the variables and criteria mentioned above. This section presents the commentaries on each of these proposals.

### Smart D.C. Plans: The Canadian Supplementary Pension Plan as Proposed by Keith Ambachtsheer

In reviewing several proposals for pension reform, we found this to be one of the most attractive. We are not surprised other proposals (e.g., the Alberta/British Columbia proposal) mimic the Canadian Supplementary Pension Plan arrangements very closely.

For example, we find it logical to have an earnings floor below which no contributions are made so low-income Canadians are not forced to contribute to this plan only to find their extra benefits are swept away in the GIS clawback.

However, we do have concerns.

This plan, in fact, all of the plans reviewed, create the possibility that many existing and superior private plans may be closed and replaced with less advantageous schemes.

We see a serious challenge here as to how to get this system up and running given it is a scheme where enrollment is the default but with an opt-out provision. (This may be less of a problem in Quebec, which already has its own infrastructure to collect QPP contributions.)

While we agree with the $30,000 earnings level before any contributions, some workers may view this as being unfair.

There may be issues in forcing this scheme onto employers and workers, and to effectively deal with the appropriate communication leading up to a stay-in-or-opt-out decision will be a challenge.

Further, we believe the following features present issues that need to be addressed:

- Leaving all administration and investments to a public body such as CPP Investment Board versus delegating major portions to private institutions;
- Opting-out rules should be well-defined and simple to administer;
- Full transparency and clear communication would be important;
- The possibility that participants might be allowed to transfer accumulated amounts from other plans could be administratively problematic;
- The annuitization mechanism should be self-sufficient and should minimize anti-selection possibilities;
- The plan will not deliver full benefits for 30 to 35 years; and
- As the plan matures, one should expect plan values to fluctuate with the vagaries of the investment rates of return since the plan's benefits will be more dependent on investment income.

Finally, we would submit that there be a small number of investment options and that an employer should be allowed to make this coverage mandatory for his/her employees.

**Smart D.C. Plans: The Alberta/British Columbia Provincially Facilitated Plan**

While we understand the government will have to take action to facilitate the creation of such a plan, we see no reason for it to be the plan sponsor. Thus, we support the option that the administration be tendered out. Evidence indicates the private sector could administer such a plan effectively and efficiently.

However, advice given to participants must be completely unbiased. Thus, the advisory infrastructure should have no financial interest in the plan.

We support the concept of auto-enrollment for reasons outlined in our "Principles" section.

We agree expenses should be low and would expect expenses less than 0.5 percent of assets.

We appreciate the fact that the plan may require a minimum earnings threshold for eligibility. As pointed out previously, lower-income workers are ill advised to create small private savings funds. This will only result in the loss of the GIS benefits (along with similar provincial top-ups and other subsidies).

We do not agree the majority of the pension board needs to be pension experts. While the board would benefit from having such experts, it is much more critical to have people with developed corporate governance skills and experience who have an independent point of view, credibility, conviction of views and the courage to make key board corporate governance decisions.

We agree with the other major attributes of the proposed plan known as of today.

In a later report (*Options for Increasing Pension Coverage Among Private Sector Workers in Canada*), British Columbia's finance minister puts more meat on the Alberta/British Columbia plan's bones. However, we do have concerns about statements in this paper.

It estimates that the CSPP will produce replacement ratios between 70 and 75 percent once government benefits are taken into account. However, Ambachtsheer said his target was 60 percent. We are wary of presuming contributions of 10 percent of earnings in excess of $30,000 can produce even a 60 percent replacement ratio in today's market.

We also suspect none of the CPP extensions identified in this latter report can produce the 60 to 85 percent replacement ratios advocated in the report without additional voluntary savings. We provide funding numbers for expansion of the C/QPP in the next section of the report.

We would note further that, as with any new fully funded scheme, the plan will not deliver full benefits for 30 to 35 years. Finally, as the plan matures, one should expect plan values to fluctuate with the vagaries of the investment rates of return since the plan's benefits will be more dependent on investment income.

Finally, the proposal to date has not made it clear how contributions would be collected and remitted.

**Plans to Expand the C/QPP**

Expanding the C/QPP has some definite advantages. Much of the required infrastructure already exists. Contributions can be made by macro payroll deduction and required annual individual adjustments can be made through one's tax return. The investment capabilities of the CPPIB (and the Caisse de dépôt et placement du Québec) also already exist.

Clearly, the plan will benefit from economies that accrue with size.

We, do, however, see problems and issues.

First as outlined above, we are opposed to any new benefits financed by pay-as-you-go financing. New benefits should be fully funded to avoid intergenerational inequities.

However, if the new benefits are to be fully funded, then it will take 40 years before new full benefits can be achieved. That means such a proposal has practically no impact in the near term, and it is important that proponents make this fact clear in explaining their proposals to the public.

Clearly, full disclosure of the impact on C/QPP contribution rates is also a must and these estimates must be backed by acceptable actuarial analyses and projections.

We worry this new "minimum" benefit could soon become the "maximum" total benefit. That is, by expanding the C/QPP to provide "average" Canadians with retirement income security, we would expect many good employer-sponsored pension plans to be terminated. This is not advantageous.

Further, if we use the earnings base of the current C/QPP where contributions start once earnings exceed $3,500 (not indexed), then many low-income workers will be forced to save further for retirement only to lose their GIC benefits later. Again, we see this as a disadvantage.

We also see serious political problems in proposals to extend the C/QPP. At the moment, the contribution rate for the C/QPP is 9.9 percent. If extended benefits were added on a fully funded basis, these extended benefits would only require a contribution rate of about 6 percent. This is because today, out of the 9.9 percent contribution, about 4 percent goes to pay for the legacy liabilities, that is, those benefits accrued in the period when funding was closer to a pay-as-you-go rate. Will we have a system where contributions up to the year's maximum pensionable earnings remain at 9.9 percent but extended benefits above the YMPE will cost only 6 percent? We doubt this plan could be defended politically.

In reviewing proposals to expand the C/QPP, this task force prefers an upward expansion of the plan by raising the YMPE rather than the benefit rate. The benefit rate is currently 25 percent on earnings up to the YMPE. The National Association of Federal Retirees (FSNA) proposal shows that if the benefit rate were increased from 25 percent to 70 percent, contributions up to the YMPE would have to be 19.8 percent versus 9.9 percent today (shared equally between workers and employers). This would be a huge burden for low-income workers and could also have a significant impact on labor market economic parameters. Further, as with many of the proposals, the expanded C/QPP would do little or nothing for those who qualify for GIS benefits.

We would also note that since the new benefits are to be fully funded, as the plan matures, the required contribution rate will be much more sensitive to the rate of return on the invested plan assets and will inevitably rise and fall with investment returns.

Such an expansion would also have a highly disturbing effect on existing employer plans (e.g., renegotiation of existing benefits/contributions).

Finally, we see no reason to put "all of our eggs into one basket." Certainly there are examples of extremely large funds that have not made wise investment decisions. Why not have a diversified system with some public administration (OAS/C/QPP) and some private; some partially funded benefits (C/QPP) and some fully funded? Should we be placing all of our retirement income security needs into one plan and one agency? No.

**Target Benefit Plans**

We believe it is time to adopt a system that shares the pension risks more evenly between plan sponsors and workers. Classical D.B. plans generally leave all of the risks with the plan sponsor while classical D.C. plans leave all of the risks with the worker.

For example, we are comfortable with not promising full indexation for all benefits. We note that the Ontario Teachers' Plan has been recently modified so future retirement benefits will only have 50 percent indexation guaranteed. The rest will depend on the capability to pay such benefits (i.e., the plan's funding health).

We would note that in the target benefit plan outlined above, accrued benefits could decrease in value. This would require amendments to the Pension Benefits Acts (PBAs). We would further recommend that Revenue Canada determine the pension adjustments for this plan as it would be for a D.C. plan.

On the negative, we do not see how this plan could work if participants could opt in and out at will. We just perceive there to be too much risk of anti-selection in this environment. So, while we prefer a voluntary system, we believe this proposal would either have to have mandatory participation or extremely limited rights to opt in and out.

These proposed plans do not exist today (although some Ontario multi-employer pension plans are quite similar). This presents a great opportunity to learn from best practices, and reflect on suitable features at the detailed level.

MEPPs is multi-employer pension plans (as you have it).

While commingling of plan assets is possible today, it happens rarely as unconnected entities have no easy way to get together to provide for retirement income solutions. This is one example of where one would need government facilitation to make the new scheme operable.

We would also expect that the plan trustees would control the investment of the pooled funds, not the individual participant. This, again, increases the mandatory nature of this model versus a more flexible voluntary approach.

Finally, we believe there will need to be allowance for contributions that vary by age. This may require amendments to various legislations and regulations.

## 6. Conclusion

This paper has laid out a series of principles against which the CIA suggests we could evaluate any proposal for a new pension system. At each decision point in the logic tree, we evaluate advantages and disadvantages of the system options. We have noted the CIA preference for each criterion.

It is our position that amending several rules that now exist in the Income Tax Act (ITA) and in the various Pension Benefit Acts (PBAs) would greatly assist the existing pension system to operate more efficiently and effectively. Certainly amendments to the ITA and PBAs (as outlined above) would be necessary to allow for the new pension systems that we have reviewed in this document. We contend that the ITA and PBAs should assist and guide plan innovation (e.g., large commingled asset pools with no common employment relationship involved; target benefit plans) rather than stifling it, as is the case today. Even if new plan models are accepted, amendments to the PBA and ITA should be encouraged to expand the pension coverage in the existing system.

Further, it is our position that the more restrictions we put on any new system, the lower will be the level of participation. If the goal is to achieve improved pension coverage, then we would hope to have a minimal number of mandated rules and restrictions.

Finally, we submit that this document can be used by public policy analysts in evaluating any new pension plan models proposed for Canada.

The actuarial profession, through the CIA, sincerely looks forward to being active participants in this process. In that regard, we commend readers to review the 2009 CIA discussion paper *Retooling Canada's Ailing Pension System Now, For the Future*.

## Preamble

The Canadian Institute of Actuaries submits that actuaries have a key role to play in any significant reform of Canadian pension plans. As a result, the CIA formed a task force to look at certain characteristics of government-facilitated plans that may be proposed in the pension reform debate.

*The mandate of this task force was to develop the CIA's public position on expanded/modified government programs in relation to retirement income. This position should include:*

- *A description of the issues (including pros and cons);*
- *An inventory of the positions presented and comments on their pros and cons;*
- *A high-level review of international issues and solutions identified in comparable situations (the task force found an excellent paper researched by Edward Whitehouse of the Organisation for Economic Co-operation and Development as commissioned by the Federal Ministry of Finance. A short summary of that report is provided in Appendix A.);*
- *Data and facts to support the position, or identification of data required to support it;*
- *A list of criteria/pertinent factors that will help the CIA comment/react to moves made by the politicians in the area of government-facilitated plans; and*
- *If possible, the outline of a scenario the CIA could propose to the politicians to resolve, in whole or in part, the issues presented in the various proposals.*

The members of the task force were Rob Brown (chair), Serge Charbonneau, Derek Gerard, Emilian Groch, Malcolm Hamilton, Danielle G. Morin and Richard Neault.

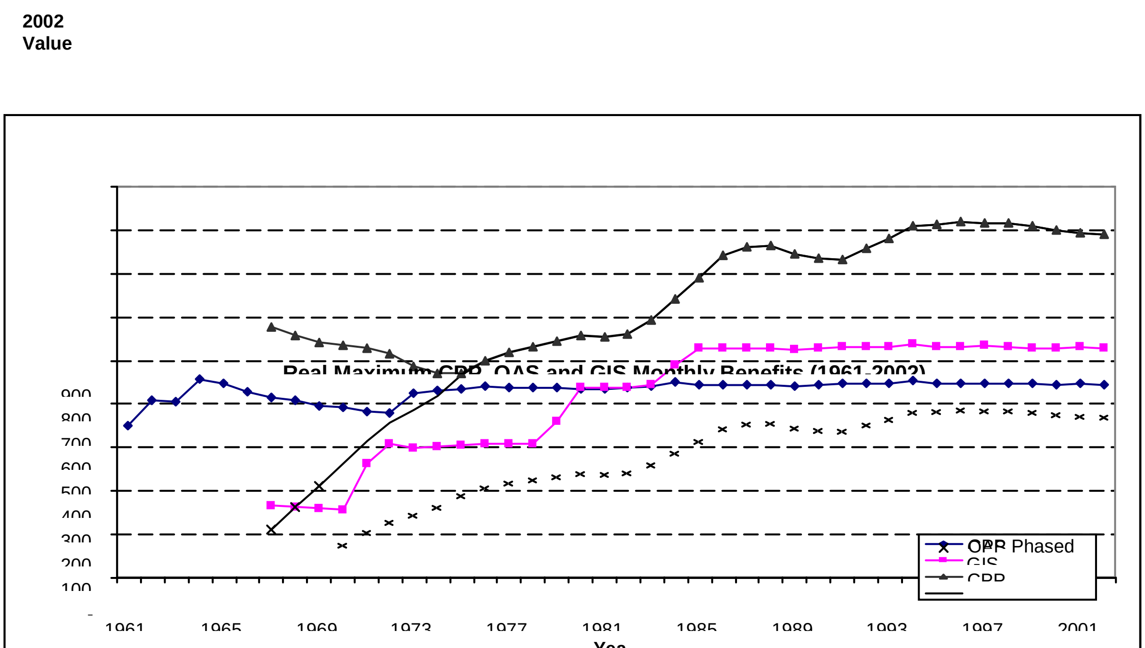
## Section I: Introduction

There is a level of concern among Canadians, and our politicians, that not all of the population is preparing fully for their retirement income security. In particular, it is believed we could be doing a better job in providing paths to retirement income security. We should also be attempting to find and promote methods to create a more effective and efficient system. If such a system existed, we believe coverage rates would rise.

It is the position of this CIA task force that the government-sponsored systems of Old Age Security (OAS), Guaranteed Income Supplement (GIS) and Canada/Quebec Pension Plan (C/QPP) provide a significant floor of protection for low-income Canadians and that these benefits have increased since their inception (as seen in Figure 1).

In our opinion, it would be unwise to force lower-income Canadians to save further for retirement, especially given the implications of the GIS clawback.

**Figure 1**
**Real Maximum CPP, OAS and GIS Monthly Benefits 1961-2002 (Single)**




**Notes: GIS benefits are for single individual. The CPP phase-in calculation is for December of the indicated year.**

*Source: CPP Office of the Chief Actuary.*

At the other end of the spectrum, as documented by Baldwin and Mintz in the next section, a significant proportion of Canadians are saving adequately for retirement through a combination of registered pension plans (RPPs), registered retirement savings plans (RRSPs) and homeownership (which can be shown to be very important for a secure retirement), and have the opportunity to achieve adequate retirement income security.

Thus, those to whom this document is addressed (at most, one-third of the Canadian population) are workers not using or unable to use the systems available to them today including RPPs, RRSPs and tax-free savings accounts (TFSAs). This may be because their employer has not established a savings vehicle for them (e.g., RPP or group RRSP). For example, only 22 percent of private sector workers have a workplace pension.

When it comes to RRSPs, low coverage rates may be because workers find investment alternatives for their individual savings to be overly expensive in terms of sales fees and management expense fees. It may be they feel blocked by the bureaucracy these plans create and the number of decisions that must be made. Not acting to save for retirement is a perfectly normal human trait. It is always easier to do nothing. In turn, some may decide not to save since any path they commit to may turn out to be wrong in the long run. Others may not save because, after paying for the necessities of life, there is simply no money left.

Is there a way to create a new savings model that would result in a higher level of participation by these Canadians? In the document that follows, we will review three proposed pension systems and in that review outline the advantages and disadvantages of each. These will include:

1. **Smart D.C. Plans:** We believe that two specific proposals fall under this heading.

    a. The Canadian Supplementary Pension Plan (CSPP) as proposed by Keith Ambachtsheer; and
    b. The Alberta/British Columbia (ABC) provincially facilitated plan.

2. **Plans to expand the C/QPP:** With specific examples proposed by the Canadian Labour Congress (CLC), the National Association of Federal Retirees (FSNA) and the Canadian Association of Retired Persons (CARP). These will be reviewed as one proposal.

3. **Target Benefit Plans.** We believe both the Ontario Expert Commission on Pensions (OECP) and the Nova Scotia Pension Review Panel proposed systems that fall under this title. It is also true that the Quebec member-funded pension plan and simplified pension plans meet many of the criteria for this type of system.

There are two important components within this model. First, the defined benefit is a target and is not guaranteed. Second, the assets backing such plans are commingled into very large assets pools. We will see the impact of these two components later in the paper (see Section IV-3).

In addition, the CIA feels strongly that improvements to the systems that now exist can and should be made so they could operate more effectively and efficiently. The CIA has published many documents with that in mind, including *Retooling Canada's Ailing Pension System Now, for the Future* which can be found at: (http://www.actuaries.ca/members/publications/2009/209097e.pdf)

In the discussion that follows, the document considers several important variables in any potential pension model. For each variable, the task force has outlined advantages and disadvantages of each option (normally there are two) and has also opined on what it sees as the optimal outcome.

## Section II: Recent Canadian Research

Because of the Whitehorse meetings in mid-December, we now have two further research documents to consider.

**a. Baldwin Report**

In recent Canadian research done for the Ministry of Finance, Government of Ontario, Bob Baldwin points out that while pension coverage rates are trending downward, more Canadian workers than ever have pension coverage. This anomaly is explained by the rapid growth of the Canadian labor force. The latter is explained largely by the continued rise in female labor force participation rates (in the period from the mid-1990s to 2007, the percentage of women receiving C/QPP benefits has increased from 70 to 84 percent while the percentage with third pillar [RPPs and RRSPs] income has increased from 34 to 55 percent). So more Canadians than ever have pensions (in fact, 5.9 million), but because the labor force is growing faster than the number of workers with pensions, the pension coverage rate is down. It is also true that the private sector D.B. coverage is down. These data do not include group RRSPs, a growing vehicle for employers to provide employees with pension benefits.

Further, Baldwin points out that with the increased female labor force participation rates, "no coverage" families are not increasing in numbers. One should also take into consideration pension splitting on divorce and survivor benefits in retirement in determining pension coverage rates.

Finally, Baldwin states that just because a worker does not have third pillar coverage at a particular point in time does not mean they will acquire no pension benefits over the working lifetime. Workers move from job to job. Some jobs have pensions and some do not. So, it is quite likely that the coverage rate at a given moment provides an imperfect indication of how many Canadians retire with some pension benefits.

The report indicates that the retirement income that Canadians receive today (including OAS and C/QPP) is up significantly from previous years. This is partially because of the maturation of the C/QPP and improvement in OAS/GIS benefits (see, for example, Figure 1) but employer-sponsored pension benefits are also a part of this improvement. From 1976 to 2007, for couples, real incomes increased by 55 percent. For singles, the real increase was 79 percent. For couples at the fifth percentile, their income was up 99 percent. For those at the 95$^{th}$ percentile, it was up 28 percent. For singles, the comparable numbers were 140 percent and 79 percent. The increase in income due to the maturation of the C/QPP was almost fully realized by the mid-1990s, whereas the increase in pension income continued through to 2007.

Baldwin's report refers to a paper by Veall that provides an international comparative perspective on poverty among the elderly in the 24 countries that participate in the Luxembourg Income Study (LIS). Veall finds that from 1970 to 2000, no country experienced as sharp a decline in elderly poverty as did Canada, and, in 2000, only four had poverty rates lower than Canada's 6 percent among the elderly (a lower rate than child poverty and poverty among the general population).

As to replacement rates, Baldwin quotes a longitudinal study by LaRochelle-Cote, Myles and Picot indicating a median replacement rate that holds level by age at about 80 percent. This study does note that within different income quintiles there are significant differences in replacement rates, however.

## b. Mintz Report

The Mintz paper is actually a summary of research reports from six sources including one from Malcolm Hamilton, an actuary. These papers were solicited by the federal Ministry of Finance.

Highlights of the summary include:

> "Canadians are, by and large, doing relatively well in ensuring that they have adequate savings for their retirement. The OECD suggests the Canadian retirement income system performs exceedingly well by international standards, with the three pillars enabling Canadians to provide enough retirement income to sustain an adequate standard of living in retirement. Canada has one of the lower poverty rates among elders among OECD countries."
> "These estimates suggest that one-fifth of Canadians may not have sufficient RPPs and RRSP assets to replace at least 90 percent of their pre-retirement consumption."
>
> "Some very recent evidence has shown that Canadians with RPPs have somewhat less retirement income than those without RPPs because non-RPP holders tend to have other assets to support their retirement as well as more likely work after the age of 65."
>
> "The research suggests that active management does not provide returns on a persistent basis any better than passive management for both pension plans and mutual funds. Once taking into account active management costs, passive managed assets would provide superior returns. Individual investors do not seem to be advised sufficiently to invest in indexed and exchange-traded funds to improve fund performance."

The tone of the Whitehorse summit was one of "the sky is not falling." Ministers agreed to meet again to discuss pensions in May 2010.

We agree we need not overly worry about many segments of Canadian workers. The current population of retirees has, in the main, done a good job in providing for their retirement (see Appendix A). However, it is not clear if this is true for today's workers — tomorrow's retirees.

We are also aware there are few solutions to many of the problems faced today. For example, for those already retired, where the sponsoring company is entering bankruptcy, no pension legislative amendments nor any new pension model can avoid some significant pain for them at this stage.

Canadians now have a myriad of possible pension system models to review and debate. These include the ideas contained in three provincial reviews; Alberta/British Columbia, Nova Scotia and Ontario. We can also study the record to date of the member-funded pension plans in Quebec as to their successes and failures.

Individuals and lobby groups have also entered the fray. Some encourage an expansion of the existing C/QPP. These include the CLC, the FSNA (through the voice of Bernard Dussault, former CPP actuary) and the CARP. Others envision a voluntary supplement to the C/QPP such as the Canadian Supplementary Pension Plan outlined by Keith Ambachtsheer.

This CIA task force took it upon itself to review these model systems and to provide commentary as to their advantages and disadvantages. As we proceeded through the exercise, we found our analysis always followed a highly similar "tree" of decision points and that we needed to start by creating some guiding principles as to what constitutes a "good" pension system.

Historically, the CIA position has been that employer-sponsored D.B. plans are a good retirement income security tool and they need to be supported. More specifically, a small number of well-defined amendments to our current Pension Benefits Act and the Income Tax Act could make the environment for employer-sponsored pension plans much healthier, thus lessening the probability of even more D.B. plans exiting the marketplace. To be more specific, if the PBA allowed accrued benefits to decrease, and if the ITA used a pension adjustment equal to the defined contribution for a target benefit plan, this would encourage target benefit plans (discussed in more detail later) and other innovative models. In fact, if the environment were made healthy enough, one could imagine new D.B. plans being formed (not something that many expect with today's rules and regulations). At the very least, the PBAs and the ITA should not inhibit pension plan innovation as they do today.

Finally, we commend readers to review the 2009 CIA discussion paper *Retooling Canada's Ailing Pension System Now, for the Future.* This was meant to provide suggestions to improve the environment for employer-sponsored plans and also to improve the security of the benefit promises therein to worker/participants.

## Section III: Principles for a "Good" Pension System

As we created this discussion paper, we found our decisions had a level of priority. That is, decisions on early criteria (e.g., mandatory or voluntary) had a direct impact on later decisions as will be seen.

For all of the system proposals listed above, we found we were going through a very similar decision tree in analyzing their advantages and disadvantages. We thus decided to lay down these decision points and our preference for each option.

**Mandatory/Voluntary**

Should this "new" plan have mandatory or voluntary participation?

There are advantages and disadvantages to both approaches.

If the plan is mandatory, it makes record keeping easier and general administration somewhat less costly. We could, for example, have payroll deductions that go into a mandatory scheme. It is more difficult to have macro-level payroll deductions if each worker has the choice to join or not. Is this a cost we expect the employer to bear or will individuals submit their contributions directly to the new pension institution or determine their contribution once a year in their tax return?

It is our position, however, that there are a number of reasons the scheme should not be mandatory. Many lower-income Canadians would be ill advised to join a pension system where they have to make contributions today out of very small paychecks that only result in illusory benefits later because of our current system of GIS clawbacks (i.e., they would pay now for no net gain later).

As previously documented, the current income security safety net Canada has designed, i.e., OAS, GIS and C/QPP, is doing an acceptable job providing an effective income base to protect elderly Canadians from poverty. This is our guaranteed floor of protection. Thus, it is not necessary for every Canadian to save beyond these mandatory schemes.

There are other reasons to make the system voluntary. For example, many young Canadians would be well advised to pay down their debt prior to saving for retirement. That would not be the result if the "new" pension system were mandatory. Some Canadians own their own business and believe investing in that business will produce a higher return (and more economic security later on) than contributing to a pension plan. Many workers will be happy with their existing employer-sponsored pension and will not want to participate in yet another layer of savings. Thus, the decision to join or not would be available to each employer and each employee. We realize that this may add to the administrative costs and may create the possibility of anti-selection.

In speculating on the final model, we anticipate and support the concept that the ability to save for retirement in total will have limits similar to those that exist today (e.g., $22,000 and 18 percent of earnings). So, if a worker has RRSP contribution room left (after considering their employer-sponsored plan) then they could voluntarily contribute that remaining amount into this new plan.

Some of the proposals would work more effectively if we had mixed mandatory/voluntary attributes. For example, we could support proposals where the employer's involvement was mandatory at least to the extent of collecting and remitting employee contributions. Beyond that, we could see a scheme where the employer contributions were zero. We recognize this extra paperwork will still be an issue for small employers.

One feature that would assist in avoiding anti-selection and keeping costs to a minimum would be to have "auto enrollment." That is, the default option is "participation." Workers would have to take action to opt out. Data from the U.S. show that "auto enrollment" increases the plan participation rates remarkably. Having a simple and flexible plan definitely helps here. We do understand this still adds to the system's complexity but not beyond what already exists in many situations.

We envision a plan/institution commingling contributions from a wide variety of participants. In particular, participants would not have to have a common employment relationship. Even the self-employed could join. We believe this would significantly raise the participation rates for those who are not participants today.

**D.B. or D.C.**

If the proposed plan is a D.B. plan, then it is necessary that the proposal define clearly how the plan will be administered. This is particularly true if the plan is voluntary. It is difficult to see how a truly voluntary D.B. plan, where participants could opt in and out at will, would operate. However, if the decision goes in favor of a D.B. model, then we would strongly urge that the plan be fully funded (more on this later) as is the case now for any new benefits within the CPP. This will impact the illustrated cost factors. If not fully funded, this creates potential inter-generational wealth transfer issues, as will be discussed later.

If the proposed plan is D.C., then participants need to understand the potential outcome of the total contributions made to the plan. Full disclosure of key elements is essential. It is recommended that the proponents provide detailed projections on the size of benefit the defined contribution is expected to buy (consistent with the current CAP guidelines). If the level of contribution is a choice made by the participant/employer, then a table to illustrate the expected benefits from a variety of contribution options should be part of the proposal. The benefit level should either be in constant dollars or illustrated as a replacement ratio. Knowing the assumptions upon which such projections are made is also vital. Full transparency is required. We anticipate the authors of such projections will also include in their reports many caveats about the projections being only estimates. Certainly, they are not guarantees.

Various types of risk are present in D.B. and D.C. plans. D.B. risks can be borne by the employer and/or the plan participants, directly or indirectly. Classical D.C. plans backed by individual accounts create many risks to the plan participant. These include:

- Investment risk;
- Expense risk;
- Inflation risk (both in the accumulation and payout periods);
- Interest rate risk (if the payout is annuitized); and
- Longevity risk (if the payout is not annuitized).

However, all of the plans reviewed in this document are not individual account D.C. plans. Instead, most propose to commingle the plan assets in large (e.g., greater than $20 billion) asset pools. This greatly decreases the investment and expense risks. Further, for plans this large, one could foresee them managing the payout of benefits, thus minimizing the last three risks listed above.

**Public/Private**

Many of the proposals in front of Canadians today (e.g., several variations of expansion of the C/QPP) call for a new pension model that is publicly administered. Again, some suggest that to achieve the economies we all hope for, public administration is necessary.

We are not convinced that is necessarily true. There is evidence to show it is possible to have a new pension system with both private administration and low expense ratios (e.g., below 50 basis points in total) if the plan is relatively simple in design. In fact, examples of similar inexpensive systems exist today in the private sector (e.g., some large multi-employer pension plans [MEPP] and some large single-employer D.B. plans). We also believe we can learn from both the successes and disappointments of the recent Quebec MFPP model.

While government initiation/facilitation of a new pension system may be necessary, that does not mean government administration. Certainly the government would wish to make it abundantly clear that taxpayers are not back-stopping any minimum values for these plans.

A much easier route would be to have government change a small number of existing rules and regulations (previously outlined). In this way, a more efficient system could easily exist with private administration. For example, it is our position that allowing unrelated workers, including the self-employed, to participate in one pension plan would be advantageous (this would be similar to a very large MEPP). While this is not impossible today, it is very difficult and, as a result, is really not done. This does not require public administration.

We also see private sector investment management as advantageous. As will be seen in a moment, we think participants should have choice in their investment portfolio that might not be the case if the investment management, for example, strictly followed the current model of the Canadian Pension Plan Investment Board (CPPIB) or the Caisse (the Caisse does allow customized investment options at the plan level for different public plans).

If public administration is the chosen path, we would, as an absolute minimum, recommend that the administration of the system and the investment of its assets be housed in an institution at complete arm's length from the government with an independent board, for which successors are selected by the current board.

Evidence indicates a large pension scheme (e.g., greater $20 billion), administered by the private sector, once mature, should be able to run at a very low total cost (e.g., less than 50 basis points for administration, investment and advice).

We would also want to minimize any potential "agency" impacts. That is, advisors to plan participants should not be incented toward any one option by varying rewards (e.g., sales commissions). Advisors should be totally unbiased and have an alignment of their best interests and the client's best interests. Further, investment management should be independent of the advisors and their advice. These last two points cannot be over-emphasized.

When it comes to the factor of administrative/operational expenses, we are sensitive to the fact that the more choice and flexibility a system offers, the higher one should expect the cost to be.

**Pay-as-you-go/Fully Funded**

If you wish Canadians to have instant increased benefits, then the new plan would have to be financed on a pay-as-you-go (PAYGO) basis. In PAYGO financing, each individual cohort does not pay the full cost of its benefits. Rather, a portion of the liability is paid for by the next generation. This would mean a very real liability is passed on to the next generation of participants. We do not propose this for any new system and cannot see how this could work in a voluntary system.

For each cohort to pay for its own benefits, a fully funded system is the appropriate model (which is now required for any new CPP benefits). However, that means that full benefits will not be available for at least one generation (e.g., not for 30 to 35 years). We do not believe a system that purports to create instant benefits can also purport to be fully funded by current contributions (i.e., has no dependence on future contributions). Such a combination is not possible.

Regardless of the means of financing, any plan proposal requires complete illustrations as to its costs and benefits. For example, a D.C. plan with 5 percent annual contributions will not provide a 70 percent replacement ratio upon retirement. There must be absolute transparency in this regard, consistent with the Capital Accumulation Provision (CAP) guidelines.

The task force was in agreement that any new pension tier should be fully funded. This means that "instant new benefits" are not possible.

## One Size Fits All or Choice

If the plan is to be mandatory, then the benefit/contribution structure could be extremely simple and basic. For example, there might not be any choice as to the benefit/contribution structure on the part of the individual plan participant.

If the plan is to be voluntary for workers, then it seems to follow logically that participants should have some choice in the benefit/contribution structure. We are also in favor of choice for the plan participants in their ability to opt in or opt out and to have a choice of their investment portfolio (but a limited number of options, e.g., five or six). In both instances, we prefer a strong default option. For enrollment, the default would be "opt in." Participants would have to take action to opt out. There should also be a strong investment default option (similar to that required in the CAP guidelines) since we would anticipate the majority of participants to fall into the default option.

We are cognizant that, by adding more choice, the cost of the system would be expected to rise. For administrative efficiency, for an employer with no existing plan, we would suggest they must opt in to the extent of withholding and remitting contributions on behalf of participating employees. We understand this may be opposed by some employers because of the inherent expenses. There still remains the outstanding issue of how the collection/remittance would actually occur. It would be possible for employers to make zero contributions. The self-employed would be allowed to join.

We envision the creation of this new plan/institution mainly to help those workers who have limited capabilities in helping themselves. Unless the GIS clawback rules are amended, we would not expect lower-income workers to participate nor would we counsel them to do so. While it might be possible to create new retirement savings systems that are not subject to the GIS clawback (such as TFSAs), this would create two types of retirement savings vehicles under two types of rules, which we would not support. The solution lies in amending the GIS clawback rules, a separate topic of discussion.

We would not recommend as many choices as are now available for those saving for retirement through a RRSP, however. For example, we would not have a "self-mortgage" choice for new homebuyers, nor a registered education savings plan choice for young parents, nor a spousal RRSP option. Again, one desirable feature is low cost and some simplification is required for the system to run at a very low cost ratio.

## Pay-Out Options

What options should participants have when they move to the pay-out phase? Should they be allowed to cash out? Should they be allowed a Life Income Fund (LIF)/Retirement Income Fund (RIF) option? Should they be forced to annuitize? If the choice is mandated annuitization, will there be a defined age at which such annuitization should begin (i.e., deferred annuities)? Should the plan self-annuitize?

One problem is that a voluntary system should anticipate some level of anti-selection in who annuitizes. Those who sense a high value will definitely participate. Those who do not see the annuity option as being as valuable (e.g., those in poor health) will either not participate or will only participate at the minimum level imposed.

If we view this new plan as being similar to group RRSPs, then it is our position that the choices now available to those with RRSPs (with the exception of self-mortgaging, education withdrawals, spousal plans and other special interest options) should also be available to these plan participants. That is, they should be able to choose to annuitize or move funds into a LIF or RIF or even cash out (and pay the commensurate taxes). While this does introduce a level of anti-selection and, therefore, higher costs, we do not see these costs as overwhelming the system. This is especially true if the "normal" payout model has some minimum guarantee periods or is a joint and last survivor annuity.

While we understand there are measurable advantages to having participant's funds locked in, we do not see this as a politically viable position given recent public pressure to reduce restrictions applicable to locked-in retirement accounts (LIRAs).

One would expect that if the asset pools achieve the size that we anticipate (e.g., greater than $20 billion), the plan, even if it is a D.C. plan, could take on the aggregate longevity risk and pay out benefits based on actuarial expected values. We contend the resulting risk would be manageable.

Further, we could adopt some of the attributes of target benefit plans (details to follow) in this new tier. For example, we could cost a plan that anticipates full CPI indexation of benefits (hard to get today in the private sector). However, if some assumptions are not realized (e.g., mortality improves faster than assumed or investment returns are lower than assumed) then the CPI indexation could be made contingent on the health of the plan funding. Obviously, this requires a plan of a certain minimum size for credibility, unless the government decides to provide basic guarantees.

**Portability**

One issue, especially for D.B. plans, is the portability of plan benefits. Any new system should explain how it would handle pension assets of employees who change employers. This could mean moving to a new employer or into self-employment. Does the proposed plan have portability features superior to those that exist today?

Expansion of the C/QPP clearly maximizes portability. The other systems being reviewed have strong D.C. attributes, and we would see them having the portability attributes of D.C. plans.

In this regard, the CIA sees advantages if the new system allows workers to move their plan assets to a different, but qualified, asset pool. In this regard, we would anticipate a very limited number of "qualified" asset pools and we would anticipate that any one worker would normally be expected to belong to only one asset pool. We want to achieve the advantages of size. While we do not wish to create a new individual accounts D.C. system, we think it only fair that workers also be allowed to move their assets into a personal RRSP account.

Under these new systems, there should be no need to track employment relationships or terminations as is the case for the C/QPP now. This feature needs to be confirmed proposal by proposal.

# Section IV: Pension Proposal Review

## 1. The Smart D.C. Option

### a. The Canada Supplementary Pension Plan (Keith Ambachtsheer)

This is a very specific proposal that has been carefully thought through.

However, it is still incomplete. For example, how would the proposed plan fit into the existing tax regime? Can you be in an employer-sponsored pension plan and the CSPP at the same time? What would the pension adjustment be? In the commentary below, we assume the CSPP will be taxed like group RRSPs.

The main arguments put forward by Ambachtsheer for the plan design are:

- A need to pool resources, and mitigate not only financial risk and longevity risk, but agency risk as well;
- 3.5 million Canadian workers are not in workplace pensions and not accumulating sufficient savings to maintain a decent post-work standard of living;
- 5.5 million Canadian workers are paying too much for asset management, which results in low rates of return (agency costs can run to 2 percent to 4 percent of assets);
- The need for a predictable, adequate standard of living over a complete post-work life cycle;
- A hope for full participation by all workers;
- The need for cost-effective delivery prioritizing the interest of the worker being served (poor governance can cost 1 percent to 2 percent of assets);
- OAS/GIS/C/QPP replace 40 percent of the median wage or about $16,000 per annum (single) and $27,500 per annum for a couple, which is a good floor;
- The desire for a consistent life-time standard of living pre- and post-retirement; and
- Size matters; large funds (greater than $50 billion) exceed returns in small funds (less than $100 million) by 1 percent per annum.

Key features of the plan are:

- Auto enrollment of all non-covered (RPP) workers into the CSPP (but you can opt out);
- Use of the C/QPP payroll deduction mechanism and with funds directed into personal accounts;
- The same tax support limits as today (i.e., 18 percent/$22,000);
- A target benefit that would provide a 60 percent replacement ratio (integrated with OAS/C/QPP);

- An earnings floor (≅ \$30,000) below which no contributions are made (note there is automatically an upper bound for tax incented contributions of \$22,000, which implies an earnings limit as high as \$250,000 at an assumed contribution rate of 10 percent);
- An automatic default contribution rate;
- A provision for an opt-out option for both employers and employees;
- Allowance for transfer of existing RRSP assets to the CSPP;
- Administration at arm's length from the government similar to the CPPIB (total costs should be at or below 0.3 percent of assets per annum);
- Investment principles similar to the CPPIB (i.e., a risk optimizing portfolio plus a hedging portfolio for those with low risk tolerance);
- Strong communication of results and the expectation of realizing the target benefit; and
- A system of buying deferred annuities at age 45 with a target of 50 percent annuitization at age 65 (can opt out and take RRIF benefits).

Ambachtsheer notes this will require federal and provincial government facilitation (though that does not imply government administration). He notes his plan is similar to the existing Teachers Insurance and Annuity Association — College Retirement Equities Fund (TIAA-CREF) system in the U.S. that manages pension arrangements for 3.5 million teachers/professors working for 15,000 employers. Assets are \$450 billion.

**Commentary**

In reviewing several proposals for pension reform, we found this to be one of the most attractive. We are not surprised other proposals (e.g., the Alberta/British Columbia proposal) mimic the CSPP arrangements very closely.

For example, we find it logical to have an earnings floor below which no contributions are made so that low-income Canadians are not forced to contribute to this plan only to find their extra benefits are swept away in the GIS clawback.

However, we do have some concerns.

This plan, in fact all of the plans reviewed, create the possibility that many existing and superior private plans may be closed and replaced with less advantageous schemes.

We see a serious challenge here as to how to get this system up and running given it is a scheme where enrollment is the default but with an opt-out provision. (This may be less of a problem in Quebec, where Quebec already has its own infrastructure to collect QPP contributions.)

While we agree with the \$30,000 earnings level before any contributions, some workers may view this as being unfair.

There may be issues in forcing this scheme onto employers and workers and to effectively deal with all the appropriate communication leading up to a stay-in-or-opt-out decision will be a challenge.

Further, we believe the following features present issues that need to be addressed:

- Leaving all administration and investments to a public body such as CPPIB versus delegating major portions to private institutions;
- Opting-out rules should be well-defined and simple to administer;
- Full transparency and clear communication would be important;
- The possibility that participants might be allowed to transfer accumulated amounts from other plans could be administratively problematic;
- The annuitization mechanism should be self-sufficient and should minimize anti-selection possibilities;
- The plan will not deliver full benefits for 30 to 35 years; and
- As the plan matures, one should expect plan values to fluctuate with the vagaries of the investment rates of return since the plan’s benefits will be more dependent on investment income.

Finally, we would submit that there be a small number of investment options and that an employer should be allowed to make this coverage mandatory for his/her employees.

### b. The Alberta/British Columbia (ABC) Pension Plan

We find this plan (to the extent that details are known at this time) to be very similar in nature to Ambachtsheer’s CSPP (but without an explicit annuitization component) and can be reviewed as a subset of the CSPP system. We are also informed other provinces are considering a similar plan option.

The ABC Plan:

- Is meant to create coverage for employers and employees who have no plan today;
- Is a government-run supplemental pension;
- Is a D.C. Plan, and anticipates both employee and employer contributions;
- Enrollment is not mandatory but the plan does use auto-enrollment. That is, both employers and employees must take action to opt out;
- Administration of the plan could be tendered out to the private sector;
- Total administrative and investment management expenses should be less than 0.5 percent of assets;
- Eligibility might require a minimum earnings threshold;
- There will be immediate vesting;
- Locking-in rules will be the same as for Single Employer Pension Plans (SEPPs);
- Administration will lie with an arm’s length agency; and
- The majority of the board will be pension experts.

**Commentary**

While we understand the government will have to take action to facilitate the creation of such a plan, we see no reason for the government to be the plan sponsor. Thus, we support the option that the administration be tendered out. Evidence indicates the private sector could administer such a plan effectively and efficiently.

However, advice given to participants must be completely unbiased. Thus, the advisory infrastructure should have no financial interest in the plan.

We support the concept of auto-enrollment for reasons outlined in our “Principles” section.

We agree that expenses should be low and would expect expenses less than 0.5 percent of assets.

We appreciate the fact that the plan may require a minimum earnings threshold for eligibility. As pointed out previously, lower-income workers are ill advised to create small private savings funds. This will only result in the loss of the GIS benefits (along with similar provincial top-ups and other subsidies).

We do not agree the majority of the pension board needs to be pension experts. While the board would benefit from having such experts, it is much more critical to have people with developed corporate governance skills and experience who have an independent point of view, credibility, conviction of views and the courage to make key board corporate governance decisions.

We agree with the other major attributes of the proposed plan known as of today.

In a later report (*Options for Increasing Pension Coverage Among Private Sector Workers in Canada*) British Columbia’s finance minister puts more meat on the ABC bones. However, we do have concerns about statements in this paper.

It estimates that the CSPP will produce replacement ratios between 70 and 75 percent once government benefits are taken into account. However, Ambachtsheer said his target was 60 percent. We are wary of presuming contributions of 10 percent of earnings in excess of $30,000 can produce even a 60 percent replacement ratio in today’s market.

We also suspect none of the CPP extensions identified in this latter report can produce the 60 to 85 percent replacement ratios advocated in the report without additional voluntary savings. We provide funding numbers for expansion of the C/QPP in the next section of the report.

We would note further that, as with any new fully funded scheme, the plan will not deliver full benefits for 30 to 35 years. Finally, as the plan matures, one should expect plan values to fluctuate with the vagaries of the investment rates of return since the plan's benefits will be more dependent on investment income.

Finally, the proposal to date has not made it clear how contributions would be collected and remitted.

**4. Plans to expand the C/QPP:**

There are many variations on this theme. In this section, we will comment on similar proposals made by the Canadian Labour Congress, Canadian Association of Retired Persons and National Association of Federal Retirees.

**Commentary**

Expanding the C/QPP has some definite advantages. Much of the required infrastructure already exists. Contributions can be made by macro payroll deduction and required annual individual adjustments can be made through one's tax return. The investment capabilities of the CPPIB (and the Caisse) also already exist.

Clearly, the plan will benefit from economies that accrue with size.

We, do, however, see problems and issues.

First as outlined above, we are opposed to any new benefits financed by PAYGO financing. New benefits should be fully funded to avoid intergenerational inequities.

However, if the new benefits are to be fully funded, then it will take 40 years before new full benefits can be achieved. That means such a proposal has practically no impact in the near term, and it is important that proponents make this fact clear in explaining their proposals to the public.

Clearly, full disclosure of the impact on C/QPP contribution rates is also a must and these estimates must be backed by acceptable actuarial analyses and projections.

We worry this new "minimum" benefit could soon become the "maximum" total benefit. That is, by expanding the C/QPP to provide "average" Canadians with retirement income security, we would expect many good employer-sponsored pension plans to be terminated. This is not advantageous.

Further, if we use the earnings base of the current C/QPP where contributions start once earnings exceed $3,500 (not indexed), then many low-income workers will be forced to save further for retirement only to lose their GIC benefits later. Again, we see this as a disadvantage.

We also see serious political problems in proposals to extend the C/QPP. At the moment, the contribution rate for the C/QPP is 9.9 percent. If extended benefits were added on a fully funded basis, these extended benefits would only require a contribution rate of about 6 percent. This is because today, out of the 9.9 percent contribution, about 4 percent goes to pay for the legacy liabilities, that is, those benefits accrued in the period when funding was closer to a pay-as-you-go rate. Will we have a system where contributions up to the year's maximum pensionable earnings (YMPE) remain at 9.9 percent but extended benefits above the YMPE will cost only 6 percent? We doubt that this plan could be defended politically.

In reviewing proposals to expand the C/QPP, this task force prefers an upward expansion of the plan by raising the YMPE rather than the benefit rate. The benefit rate is currently 25 percent on earnings up to the YMPE. The National Association of Federal Retirees proposal shows that if the benefit rate were increased from 25 to 70 percent, contributions up to the YMPE would have to be 19.8 percent versus 9.9 percent today (shared equally between workers and employers). This would be a huge burden for low-income workers and could also have a significant impact on labor market economic parameters. Further, as with many of the proposals, the expanded C/QPP would do little or nothing for those who qualify for GIS benefits.

We would also note that since the new benefits are to be fully funded, as the plan matures, the required contribution rate will be much more sensitive to the rate of return on the invested plan assets and will inevitably rise and fall with investment returns.

Such an expansion would also have a highly disturbing effect on existing employer plans (e.g., renegotiation of existing benefits/contributions).

Finally, we see no reason to put "all of our eggs into one basket." Certainly there are examples of extremely large funds that have not made wise investment decisions. Why not have a diversified system with some public administration (OAS/C/QPP) and some private; some partially funded benefits (C/QPP) and some fully funded? Should we be placing all of our retirement income security needs into one plan and one agency? No.

## 5. A Target Benefit Plan

While there is no explicit proposal before the politicians today that exactly fits the model, as stated, we believe this meets the tone of the recommendations made by the Ontario Expert Commission on Pensions and the Nova Scotia Pension Review Panel.

There are two parts to these proposals. The first is to create target benefit plans (as explained in a moment) and the second is to create large commingled asset pools for the participants in these plans.

Each worker/participant has a target benefit that the plan is meant to achieve. The required contributions to the plan are determined by starting with the target benefit and working backward (given a number of actuarial assumptions) to the contribution that is needed to achieve the target benefit. If things go better than assumed in this calculation, benefits can be increased. If the results are worse than assumed, then benefits can be decreased. These plans require only defined contributions from the plan sponsor.

As stated, the required contribution would be calculated as the rate necessary to achieve the target benefit. This occurs in many multi-employer pension plans today (however, this plan is not restricted to being a MEPP). In times of poor investment returns, accrued pension benefits would have to decrease in value. In good times, excess benefits could accrue.

One benefit variable within the "target" could be the indexation of benefits both before and after retirement. For the accruals phase, this would impact the extent to which benefits are a function of final average salaries versus career average; after retirement, indexation of benefits (full versus partial) would be a function of the funding health of the plan.

Benefit security could be enhanced (although not guaranteed) by using slightly conservative assumptions in the actuarial projections (e.g., a rate of return that would be earned by a risk-free asset portfolio).

Assets backing these plans would be allowed and encouraged to be commingled. Many small plans and even individual workers (e.g., the self-employed) could join such a commingled asset pool. This would provide the system with the efficiencies of size both as to administration and as to investment expenses. Further, the large fund could invest beyond what mutual funds for individual accounts are capable of today. Size matters. In this regard, there would not have to be a workplace relationship between the worker/participant and the "sponsor." In fact, new participants should be able to transfer existing third pillar assets into this pool.

Such a plan would clearly benefit from collective risk management. Target benefits could be viewed as an expectation rather than a "hope" (the latter might describe many individual account prospects).

In the case of fund wind-up, each participant would get a proportion of the assets to transfer to a new "qualified" mechanism.

The plan is meant to be fully funded at any moment.

The Quebec member-funded pension plan might be considered an example of such a target benefit plan. However, it has some features that restrict its adoption (and it has not been adopted widely to date). For example, the plan is intended only for companies that have a collective bargaining agreement unless waived by the Minister of National Revenue.

The target benefit plan described above need not have this extra restriction.

## Commentary

We believe it is time to adopt a system that shares the pension risks more evenly between plan sponsors and workers. Classical D.B. plans generally leave all of the risks with the plan sponsor while classical D.C. plans leave all of the risks with the worker.

For example, we are comfortable with not promising full indexation for all benefits. We note that the Ontario Teachers' Plan has been recently modified so future retirement benefits will only have 50 percent indexation guaranteed. The rest will depend on the capability to pay such benefits (i.e., the plan's funding health).

We would note that in the target benefit plan outlined above, accrued benefits could decrease in value. This would require amendments to the PBAs. We would further recommend that Revenue Canada determine the pension adjustments for this plan as it would be for a D.C. plan.

On the negative, we do not see how this plan could work if participants could opt in and out at will. We just perceive there to be too much risk of anti-selection in this environment. So, while we prefer a voluntary system, we believe that this proposal would either have to have mandatory participation or have extremely limited rights to opt in and out.

These proposed plans do not exist today (although some Ontario MEPPs are quite similar). This presents a great opportunity to learn from best practices, and to reflect on suitable features at the detailed level.

While commingling of plan assets is possible today, it happens rarely as unconnected entities have no easy way to get together to provide for retirement income solutions.. This is one example of where one would need government facilitation to make the new scheme operable.

We would also expect that the plan trustees would control the investment of the pooled funds, not the individual participant. This, again, increases the mandatory nature of this model versus a more flexible voluntary approach.

Finally, we believe that there will need to be allowance for contributions that vary by age. This may require amendments to various legislations and regulations.

## Section V: Conclusion

This paper has laid out a series of principles against which the CIA suggests we could evaluate any proposal for a new pension system. At each decision point in the logic tree, we evaluate advantages and disadvantages of the system options. We have noted the CIA preference for each criterion.

It is our position that amending several rules that now exist in the ITA and in the various PBAs would greatly assist the existing pension system to operate more efficiently and effectively. Certainly amendments to the ITA and PBAs (as outlined above) would be necessary to allow for the new pension systems that we have reviewed in this document. We contend that the ITA and PBAs should assist and guide plan innovation (e.g., large commingled asset pools with no common employment relationship involved; target benefit plans) rather than stifling it, as is the case today. Even if new plan models are accepted, amendments to the PBA and ITA should be encouraged to expand the pension coverage in the existing system.

Further, it is our position that the more restrictions we put on any new system, the lower will be the level of participation. If the goal is to achieve improved pension coverage, then we would hope to have a minimal number of mandated rules and restrictions.

Finally, we submit that this document can be used by public policy analysts in evaluating any new pension plan models proposed for Canada.

The actuarial profession, through the CIA, sincerely looks forward to being active participants in this process. In that regard, we commend readers to review the 2009 CIA discussion paper *Retooling Canada's Ailing Pension System Now, for the Future*.

# Appendix A
# Canada's Retirement-Income Provision: An International Perspective

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This report was produced at the request of the Department of Finance, Canada, as an input to the analysis of the Research Working Group on Retirement-Income Adequacy. This analysis covers 12 countries that are members of the OECD. What is presented here is a short summary of this report's highlights.

Resource-tested schemes, such as the guaranteed income supplement (GIS) in Canada, pay a higher benefit to poorer pensioners and lower or zero benefits to richer retirees. Means-tested benefits — GIS — are received by about a third of older Canadians.

Ongoing OECD work suggests the different parts of Canada's public retirement-income system, working together, provide strong protection for interrupted work histories without unduly affecting incentives for people to work and save.

In addition to the mandatory parts of the pension system (OAS, C/QPP), voluntary retirement provision is most significant in Canada, Ireland, the United Kingdom and the United States. Private pensions provide a substantial part of the retirement-income package in these countries.

In Canada, sponsoring a private pension is voluntary. Coverage of private pensions increases strongly with earnings. In Canada, just 10 percent of people in the lowest two deciles of the earnings distribution have private pensions, compared with over 85 percent of people in the highest two deciles.

The analysis of pension systems in this report is built around a framework of six objectives:

- Coverage of the pension system, by both mandatory and voluntary schemes;
- Adequacy of retirement benefits;
- Financial sustainability and affordability of pensions to taxpayers and contributors;
- Economic efficiency: minimizing the distortions of the retirement-income system on individuals' economic behavior, such as labor supply and savings outside of pension plans;
- Administrative efficiency: keeping the cost of collecting contributions, paying benefits and, where necessary, managing investments as low as possible; and
- Security of benefits in the face of different risk and uncertainties.

The analysis begins with a broad definition of adequacy: comparing average incomes of older people (over 65) with average incomes of the population as a whole. The measure used is “disposable” income, i.e., net of personal income taxes and social security contributions. Total household income, divided among household member(s), is “equivalized” to adjust for differences in household size.

Those older than 65 had, on average over all OECD countries, 82.4 percent of population incomes in the mid-2000s. Canada’s figure of 90.8 percent is well above the OECD average, with only France and Germany of the 12 countries analyzed here having higher relative incomes for older people.

The second empirical results focus on older people with low incomes, presenting data on old-age poverty in OECD countries. It compares older people’s incomes with a poverty line. Poverty is measured against a yardstick dependent on median household incomes. Secondly, the poverty thresholds are country-specific. This analysis sets the threshold for poverty at 50 percent of median, equivalized household disposable income.

In the mid-2000s, 13.3 percent of older people (over 65) were income poor on average in OECD countries. The old-age poverty rate was just 4.4 percent in Canada, the fifth lowest among the 30 OECD countries. In Canada, the Netherlands and New Zealand, old-age poverty rates are significantly below those for the population as a whole.

The replacement rate from the mandatory schemes in Canada (GIS, OAS and CPP/QPP, all of which are publicly provided) is 45 percent. This is rather less than the OECD average of 59 percent, but higher than seven of the 12 countries studied here.

Canada has strongly progressive mandatory retirement-income systems. For low earners, the replacement rate exceeds the OECD average, but then the gap between Canada and the OECD average grows larger as earnings increase.

Focusing on the replacement rate from mandatory parts of the retirement-income system and comparing national calculations with the OECD average (59 percent), in Canada there is a “pension gap,” a measure of the voluntary pension savings needed to finance retirement.

With a full contribution history, the proportion of earnings that would need to be paid into retirement savings plans to fill the pension gap is not generally large. In Australia, Canada, Germany and the United States. the required contribution rate is 3.5 to 4.5 percent.

If we do not assume a lifetime of contributions, for the countries shown, the average of the required contribution rate increases from 4.7 to 6.5 percent with 10 missing years, and to 9.8 percent with 20 years missing.

A full career of contributions at the assumed contribution rates would deliver a total replacement rate — including public and voluntary private pensions — of about 75 percent in Canada, Ireland, the United Kingdom and the United States. This is significantly higher than the OECD average replacement rate from mandatory schemes of just under 60 percent.

Canada currently spends about 4.5 percent of national income on pensioners. This is significantly below the average for the 30 OECD countries of 7.4 percent. Of the 12 countries under study here, only Australia and Ireland have lower public pension expenditures as a percentage of gross domestic product. The 27 EU member states currently spend nearly 9 percent of GDP on pensions on average. The forecasts suggest that, holding everything else constant, demographic change would approximately double public pension spending to an average of 18 percent. National financial projections for Canada show an increase in pensions spending from about 4.5 percent of GDP now to 6.2 percent by 2060.

One of the main drivers for this lower expenditure in the future in Canada is the expectation of continued inward migration of about 0.5 percent of population per year, which gives Canada a more favorable demographic outlook than many European countries. The analysis suggests that Canada does not face major challenges of financial sustainability with its public pension schemes.

Canada's public pension system appears to be administered at low cost. The World Bank has collected information on administrative expenses; the database includes 11 OECD countries. Relative to national income, Canada spends just one quarter of the average for these countries. Only New Zealand's public pension system is cheaper to run than Canada's.

The main issue in Canada is the scale of administrative charges for personal pensions (RRSPs). Information provided suggests that many RRSPs have charges of 2 percent of assets per year, or even more. These higher-cost options tend to be actively managed, individual RRSPs. Nevertheless, there are lower cost options. For example, investing through indexed rather than actively managed funds involves typically only about half the costs and exchange-traded funds are cheaper still. Also, many people have group RRSPs where, due to economies of scale, costs also tend to be lower.

A levy of 1 percent of assets implies that 21.5 percent of the total retirement accumulation (or, equivalently, 21.5 percent of contributions) is paid in fees. With a levy of 2 percent of assets, the charge ratio is 37.3 percent. These calculations are made at the OECD's baseline assumption of 3.5 percent investment return. The impact of charges on retirement incomes cannot be stressed enough: Moving from a levy of 2 percent of assets per year to 0.5 percent would increase net benefits by more than 40 percent.

The best approach for an individual faced with uncertainty — and, by extension, for a government seeking to do the best thing for its citizens — is to use a mixture of ways of providing retirement incomes. Each of the elements of the system has its own strengths and weaknesses, and a flexible balance among them not only diversifies risk but also offers a better balance of burden-sharing between generations.

Canada already has well diversified retirement-income provision.

## Conclusions

Viewed from an international perspective, Canada has a high-performing pension system.

- Old-age poverty is comparatively rare and retirees' incomes compare favorably with those of the population as a whole;
- The basic pension — Old Age Security (OAS) — and the means-tested scheme — Guaranteed-Income Supplement (GIS) — ensure universal coverage and form a very effective safety net for the old-age incomes of people who spend periods out of the labor market (caring for children, for example) or have low earnings. The provision for "drop-out" years in calculating C/QPP benefits is also effective and appropriate;
- Long-term projections show that public retirement-income provision is financially sustainable. Population aging will naturally increase public pension spending, but the rate of growth is lower and the starting point better than many OECD countries. Moreover, the earnings-related schemes (C/QPP) have built up substantial reserves to meet these future liabilities; and
- Retirement-income provision in Canada is well diversified: between public and private provision and pay-as-you-go and pre-funding as financing mechanisms. Diversification offers security against the range of many different risks and uncertainties affecting pension systems and individuals' retirement incomes.

Nevertheless, this report has also set out concerns about retirement-income provision for people of working age today:

- Coverage of private pensions, particularly among low-to-middle earners and, to a lesser extent, younger workers, is less than complete. While the lowest earners will be able to get by on public pensions, projected replacement rates for middle earners from public benefits are below the OECD average. The analysis here suggests that most workers with a full contribution history will fill this pension gap through voluntary retirement savings. Nevertheless, there are concerns that interrupted contribution histories will leave a retirement-savings gap, and
- Administrative charges for personal pensions (RRSPs) are high for people with individual plans, especially those invested through actively managed funds. Such charges can take a substantial proportion of people's retirement savings.

Avenues of research and consideration:

- Encouraging coverage of and contributions to private pensions, e.g., "automatic-enrollment" into private pensions;
- Consider indexing the target minimum retirement income provided by the basic and means-tested schemes (OAS and GIS) to growth in earnings to ensure that future generations of retirees' living standards do not fall behind those of the population as a whole;
- Increasing pension age. There is no pressing financial or fiscal need to increase pension ages in the foreseeable future. However, the reduced benefit expenditures

from a higher pension age could be used to augment the value of benefits, for example;

- Bearing down on administrative charges for personal pensions (RRSPs); and
- Improving the investment of people's defined-contribution pension savings, by moving automatically toward less risky assets as people near retirement.

To summarize, Canada's retirement-income system scores very well on measures of income adequacy for today's retirees.