

NOVEMBER 10, 2015

SUMMARY OF CIA POSITION

The Canadian retirement system has been the subject of several studies and much public discussion. It is at a crossroads due to the convergence of many forces including increased longevity, prolonged low interest rates, volatile equity markets, emergence of new types of pension plans such as shared risk plans, and a shift by many private plans to a defined contribution model. All of these forces have resulted in a greater public focus on pensions. We have an opportunity to ensure Canada's retirement system meets the needs of current and future retirees.

The CIA wants to participate in the debate on how to improve the retirement income system, as actuaries have valuable contributions to make due to their skills, training, and experience. As well, the profession is guided by a principle of acting with the public interest in mind. The CIA released a broad public position in April 2015 ([A national champion is needed for Canada's pensioners](#)) and wants to expand upon the ideas we presented.

The CIA believes the following:

- **Pillar 1**—Old Age Security (OAS) and Guaranteed Income Supplement (GIS)—requires no significant changes;
- **Pillar 2**—Canada Pension Plan (CPP) and provincial plans—could be expanded modestly,

A CALL TO TIMELY ACTION:

Meeting the Needs of Canada's Future Retirees



subject to conditions outlined in this public position;

- **Pillar 3**—private pension plans and retirement savings—must be changed to be more effective to help plan members generate sufficient retirement income. Specific changes are discussed later in this submission; and
- Canadians are facing uncoordinated vehicles and measures to meet the challenge of retirement planning. Enhancing

the retirement system will be difficult, but is necessary. Change needs political leadership and will take cooperation and a coordinated effort by the federal government and the provinces to ensure that we do not miss this opportunity.

The CIA will be pleased to meet with stakeholders of the Canadian retirement system to explore these ideas further.

PILLAR ONE: SIGNIFICANT CHANGE NOT REQUIRED

The need for change is greatest for Pillars 2 and 3. We observe that the clawback rate for the GIS is 50 percent, which can serve as a deterrent for people who qualify for the GIS to seek additional sources of income.

PILLAR TWO: EXPANSION OF PUBLIC PENSION PLANS

Many government-sponsored proposals, offering additional retirement income to Canadians, have been discussed. They include the following:

- The Québec longevity pension proposed by the expert committee on the future of the Québec retirement system;
- The Ontario Retirement Pension Plan (ORPP) proposed by the government of Ontario;
- A mandatory increase in Québec/Canada Pension Plan (Q/CPP) contributions and benefits; and
- A voluntary supplement to the CPP.

The rationale for these proposed expansions of public pension plans is based on certain assumptions, which must be challenged to ensure public plans are properly designed to address the real problems.

1. Are Canadians saving enough for retirement?

The aforementioned government-sponsored proposals often refer to the number of Canadians who are not saving enough for retirement. This may not be a very meaningful number. There are several reasons why an individual may choose not to contribute to their retirement savings, for example:

- For low-income earners, current government benefits and/or spousal pension benefits may be sufficient; and
- For young homeowners, contributing additional funds to mortgage repayments may be a priority. Deciding to save for retirement at a later date may be appropriate.

Counting those who do not currently save is not necessarily a reliable indicator that savings will not be sufficient later at retirement.

Recent analysis, such as the C.D. Howe commentary 428, “Do Canadians Save Too Little?”, has demonstrated that most current pensioners have saved enough to live comfortably after retirement; some of them may have benefited from high returns and rising housing prices. We recognize that some pensioners are struggling, in particular, singles and immigrants. However, low-income earners do not need to save for retirement and can rely on existing government programs. If these programs are not sufficient for low-income earners above a socially acceptable minimum, then it should be addressed within Pillar 1.

Several studies have attempted to project the number of Canadians in future generations who are at risk of seeing a significant decline in their standard of living. These studies have limitations when formulating public policy, as they rely on assumptions on whether and how future generations will change their behaviors towards retirement planning. Consider the following:

- Will saving increase as one gets closer to retirement?
- Will individuals retire later than the current generation of retirees?
- Will individuals work part-time after retirement?
- Will individuals use some of their

housing capital after retirement?

- Will individuals transfer less to their children upon their death?

Assumptions based on behavioral changes are unreliable. What is likely to occur is that future generations will make changes to prevent an unacceptable decrease in their standard of living at retirement. Whether these changes are sufficient and should be relied on in formulating a public policy is controversial. Some argue that saving more, retiring later, and working part-time will be sufficient for many. Others are concerned that this may not be sufficient for middle-income earners. More analysis should be considered and help in understanding what behavioral changes would be encouraged to prevent an unacceptable decrease in standard of living.

2. What is the appropriate replacement ratio?

Some proposals calling for the expansion of public pension plans often refer to a desirable target replacement ratio of 70 percent. This ratio is too high for many and is not a useful benchmark when debating the role of public plans. Each individual should have a personal target of how much of his standard of living should be maintained after retirement. Such a target will vary:

- Higher for low-income earners (mostly provided through Pillar 1);
- Lower for those who have repaid their mortgage during their working careers;
- Lower for those who have raised children; and
- Higher for those who are single.

This is also a matter of personal preference. Some may prefer to consume more before retirement and others more after retirement. Income needs in retirement is discussed in the paper *Moving Beyond the Limitations of Traditional Replacement Rates*

(MacDonald and Moore, 2011). This paper demonstrates the serious shortcomings of using a universal gross replacement rate to evaluate whether individuals are able to maintain pre-retirement living standards after retirement.

The role of public pension policy should not be to fully maintain a standard of living at retirement; part of this responsibility should be left to individuals. The private sector must also be given a role in helping Canadians plan for retirement. Competition for private savings will incentivize providers to innovate products and services continuously in order to meet the needs of Canadians.

The questions we should be trying to answer on this issue include the following:

- Whether public pension plans should be improved to reduce the risk of a future unfilled gap at retirement; or
- Whether the private sector should be responsible to ensure that this gap be filled.

Relying solely on the private sector to fill future savings gaps is problematic:

- Private sector employers are reluctant to be involved in the retirement of their employees. Many have closed down their defined benefit (DB) plans and replaced them with less-expensive defined contribution (DC) plans.
- There is little evidence that shows Registered Retirement Savings Plan (RRSP) and DC contributions are increasing sufficiently to compensate for the effect of

decreases in interest rates and low expected rates of return on capital, as well as increasing longevity.

- Many are saving through mutual funds with high fees, even though more efficient alternatives are available.

Furthermore, the private sector faces the challenge of how to convert the accumulated capital at retirement into income. It is difficult to know whether Canadians are currently making the right decision on this conversion. But we know that this is a difficult and complex decision to make and that they need assistance.

For these reasons, we believe that, if properly designed, there can be a role for a modest expansion of Pillar 2 to help Canadians prepare for retirement. We lay out the conditions that must be met in an expansion of Pillar 2.

CONDITIONS FOR EXPANSION

The CIA would support an expansion of public plans whether through the C/QPP or a new provincial plan such as the ORPP, if the following conditions are met:

- 1 The expansion is targeted toward those with the greatest need, often identified as the middle-income group.
- 2 Low-income earners should not be required to contribute towards an expansion, as current public plans are generally meeting their needs, and as the current GIS clawback provides disincentives to those who save.
- 3 There is no transfer of cost to future generations. Full benefits are gradually earned over the career period after implementation. There could be transfer of risks to future generations; this may be unavoidable unless the expansion takes the form of a DC supplement.
- 4 There is a reality that the assumptions made on future returns, salary increases, and longevity will not be accurate. Some of the principles underlying shared risk plans should be considered for plans in Pillar 2. The financial effects of this will have to be shared between generations, and this will need a clear policy that states that benefits and contributions will be adjusted according to experience. In particular, future indexation to retirees should be conditional.
- 5 The contributions and the resulting assets are clearly distinguished from the current C/QPP contributions and assets. Otherwise, Canadians will have difficulty understanding the differences in contributions, earnings covered, indexation, etc.
- 6 Eligible Canadians of all provinces should be given access to such an expansion so that the private sector does not have to adjust plans and products according to province of employment.

Our thinking on whether an expansion should be provided through a voluntary expansion of the CPP has been discussed in our separate submission to the federal consultation on CPP expansion that is currently under way.

SHOULD THE EXPANSION BE MANDATORY OR VOLUNTARY?

The answer will depend on the objective of the expansion. If it is to increase coverage or savings, then a mandatory increase would be more appropriate. On the other hand, voluntary contributions by Canadians to a new public plan that would be on a DC basis would meet many of the above conditions. Low-income earners would not be required to contribute; a voluntary Tax Free Savings Account (TFSA) contribution could be offered as an option to low-income earners. The CIA acknowledges that a newly expanded voluntary public plan would compete with the private sector for savings. However, we see some advantages:

- The public plan could address the issue of converting capital into income, in particular through default choice at retirement. The private sector struggles with how to assist Canadians on their choice at retirement, and we are concerned that some Canadians do not have access to objective advice in making this complex decision.
- The public plan could offer the option of an indexed variable annuity at retirement. The private sector does not offer such an option.
- Lower fees could be the result if the cost of the expansion of the public plan is low.

However, this new public DC voluntary plan would require new and different administration to maintain accounts for each participant. One would have to assess whether the cost of building this new structure justifies the advantages of this new option, i.e., whether a sufficient number of Canadians would prefer contributing to this new public plan vs. RRSP

contributions vs. Pooled Registered Pension Plan (PRPP) contributions.

OTHER ISSUES

There are three other issues that need to be addressed:

1. Whether the expansion should include survivor and disability benefits. Many Canadians are exposed to a significant reduction in standard of living upon disability and are not covered by private insurance. The need for survivor benefits has been reduced over the years because of the increase in working participation rates of females; however, there are still many one-income families. We believe that post-retirement survivor benefits should be included in the expansion, but that the need for disability benefits should be covered somewhere else.
2. Like the current CPP and OAS, the date at which pension starts to be paid should be flexible, and each Canadian should be free to decide within a range. There will have to be a normal retirement age such as 65, and the pension should be adjusted if one decides to receive it before or after that date. It is not clear whether such normal retirement age will really affect when Canadians elect to stop working. If one believes that it does, and that Canadians should be expected to work after 65, then the normal retirement age should be later than 65, and a mechanism that automatically adjusts the normal retirement age to reflect future changes in longevity could be considered.
3. The benefits should be modest so as to leave sufficient room for the private sector. Defining what is modest is not easy. For example, if an Ontario couple with a house and children would receive an

additional pension of 15 percent of indexed career earnings above 40 percent of the Year's Maximum Pensionable Earnings (i.e., about \$21,000), we estimate they may need to save about 2.5 percent of career earnings to maintain their standard of living, taking into account mortgage payments and child expenses. Other types of families may have to save more.

PILLAR 3: A MORE EFFECTIVE PRIVATE SECTOR

Canadians should expect access to options, services, and products through the private sector to meet their unique needs for retirement savings beyond those covered by public plans. Those needs are different for each Canadian and will vary according to level of earnings, ability to make investment decisions, type of employment, and other factors. Furthermore, the working and saving environment is continuously evolving; as an example, investment products such as exchange-traded funds and the opportunity to work at older ages. Canadians should be given the choices offered by the private sector that can meet those varying needs and that can evolve over time.

DB plans are in decline and the system around them needs to change. The CIA encourages pension regulators to modify the rules to ensure DB plans can once again be an attractive pension option.

1. A new design type, providing pension income, should be made available with appropriate regulations. Stakeholders should be made to understand that DB plans can be transformed into other types of plans:

- ▶ Risk shared plan where the cost is explicitly shared between participants and sponsors;
 - ▶ Target benefit plan (TBP) where accrued benefits can be increased or decreased according to experience. The CIA released a paper on target benefit plans in June 2015 and we encourage a healthy debate on this new form of plan which combines some of the attractive features of defined contribution and defined benefit plans; and
 - ▶ Plans where indexation of pensions is conditional.
2. Current solvency rules have been regularly subject to relief over the past 15 years. DB sponsors need to rely on permanent rules that reflect an appropriate balance between security of benefits on wind-up and affordability. Policymakers need to recognize that stakeholders, including employees, are not willing to recognize the high cost of providing a fully guaranteed DB commitment.
 3. Variation in rules by province is unique in the world. Policymakers need to take a strong position that uniform rules can reduce the cost of offering private plans, thereby enabling more of the contributions to meet the needs of plan beneficiaries.

Canadians need better advice on how to use their capital upon retirement. Several recent studies clearly show there is a lack of financial literacy among Canadians. And Canadians may need assistance in addressing such a complex and difficult decision. Policymakers should be actively promoting a range of solutions, including the availability of independent advisors who would objectively assist Canadians with the full range of options.

Canadians have difficulty choosing a suitable investment product for their savings. Many use mutual funds without a proper understanding of the associated high fees. Policymakers should ensure fees are well disclosed, in particular full disclosure of fees in regulated periodic statements. Policymakers should also ensure through public campaigns that Canadians understand that fees affect retirement income and that there are alternatives with low fees. We are not certain that with these measures the behavior of many Canadians will change and that those who select high fees options will do so with full knowledge. This can be addressed by regulating the maximum fees of a registered savings plan that can be charged through the investment vehicle or mandating even greater disclosure requirements. It is recognized that different investment products have different costs and that the maximum fees will have to reflect the complexity of the product. Providers would be allowed to charge explicitly additional expenses outside the investment vehicle.

FINAL THOUGHTS

Making the Canadian retirement system more effective will need political leadership. The CIA will be pleased to meet with stakeholders in Canada's retirement system to explore the ideas that we have presented further.

For further information, contact Les Dandridge, CIA director, communications and public affairs at 613-236-8196 ext. 114, or by e-mail at les.dandridge@cia-ica.ca.

Public Position Approvals Form

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