Public Position

May 19, 2016

Expansion of Public Pension Plans

Canadian Institute of Actuaries | Institut canadien des actuaires

The Canadian Institute of Actuaries

The Canadian Institute of Actuaries (CIA) is the national organization and voice of the actuarial profession. The Institute is dedicated to serving the public through the provision, by the profession's 5,200+ members, of actuarial services and advice of the highest quality. In fact, the Institute holds the duty of the profession to the public above the needs of the profession and its members.

Canadian Institute of Actuaries | Institut canadien des actuaires

Executive Summary

The Expansion of Public Pension Plans: A CIA Public Position

Actuaries have always played a crucial role in the Canadian retirement system. The CIA believes it is timely to share its unique perspective as finance ministers will be meeting in June to discuss possible benefit increases for the Canada Pension Plan and Québec Pension Plan (C/QPP).

This document focuses on the potential expansion of public pension plans and encourages the federal government to take on the leadership role to conclude the debate on this matter.

While it is not the role of the actuarial profession to advocate for any particular position on the merit or lack thereof of any program, the CIA wants to help policymakers consider implications regarding the potential expansion of the C/QPP. For example, the CIA's November 2015 position on the Canadian retirement system (A Call to Timely Action: Meeting the Needs of Canada's Future Retirees) laid out a number of issues that need urgent action by governments to resolve.

As such, if governments agree that the key problem to be addressed is middle income workers without a pension plan and if they agree that the best way to tackle that specific problem is for public pension plans to be expanded, the CIA suggests that the design elements included in this document be considered.

These suggestions are based on the objectives identified in our November 2015 position, which included leaving room for the involvement of the private sector. Keeping in mind the goal of achieving a national consensus, some of these suggestions are also based on the proposed Ontario Retirement Pension Plan (ORPP) features.

Policymakers should seize the opportunity to conclude, in 2016, the debate on the expansion of public plans and implement a national solution in the near future.

The CIA believes that the proposed design features included in this document would appropriately and efficiently address the targeted problem and ensure the long-term sustainability and fairness of an expanded C/QPP.

The key design elements for a possible increase of C/QPP benefits include the following:

Benefit formula and covered earnings: Set a 15 percent pension target after a full career, based on indexed average earnings above a minimum earnings threshold. Set the minimum covered earnings at 50 percent of the year's maximum pensionable earnings (YMPE) and the maximum covered earnings at 150 percent of the YMPE.

Contributions: Set equal employee and employer contributions and consider staggered contribution rates based on age to minimize generational transfers.

Benefit features: Fully fund those new benefits by providing gradual pension accruals, and adjust indexing if necessary so that this new plan remains self-sufficient.

Administration: Use the C/QPP existing structures for collecting contributions, for administering benefits, and for investment functions.

Retirement age: A needed debate on whether the retirement age under public plans should be adjusted, cannot be concluded in 2016. We suggest that the issue of retirement age be addressed before the effective implementation date of any C/QPP expansion.

Context

Actuarial professionals provide advice on all aspects of private and public pensions to governments, plan sponsors, unions, and individuals, including the reserved roles provided for in federal and provincial pension legislation.

One of the profession's main skills is to help assess and analyze complex financial problems involving multiple risks and uncertainties, over time. As a result, actuaries can provide important insights into key public and social challenges.

As the June meeting of Finance Ministers approaches, the CIA believes it is timely to outline some considerations on the expansion of public pension plans that reflect our unique perspective on this important public conversation.

The CIA public position titled A Call to Timely Action: Meeting the Needs of Canada's Future Retirees issued by the CIA in November 2015, proposed items for policymakers to consider when designing an expansion of public pension plans. As well, the CIA also suggested improvements for more effective private sector pension plans and retirement savings.

This position builds on the November document and outlines recent new information and additional thinking on a targeted and modest expansion of the C/QPP.

RECENT DEVELOPMENTS IN THE PUBLIC PENSION ENVIRONMENT

Significant developments on the issue of the expansion of public pension plans have occurred over the past six months. First, the Ontario government released additional details on the ORPP provisions, adjusted the timetable for implementation to begin a year later on January 1, 2018, and released details on its governance structure. Second, federal, provincial, and territorial finance ministers met in December to discuss expansion of C/QPP and some ministers expressed concerns about the impact of a C/QPP expansion on the economy. Following the meeting, the federal Finance Minister confirmed that at their June meeting, the group will consider options for expanding C/QPP. Third, the federal government has proposed changes to Pillar I*, where the gradual increase in the eligibility age for Old Age Security (OAS) will be eliminated, so that the age when benefits can be paid will remain at 65 for OAS and the Guaranteed Income Supplement (GIS). In addition, the GIS will be increased for single low-income seniors.

ONTARIO RETIREMENT PENSION PLAN (ORPP)

The ORPP design, as currently proposed, is meeting some of the desirable attributes proposed in the CIA's November position paper, including the following:

- Full funding of the expansion of public pension plans, with benefits gradually earned over the working career period, after implementation;
- Adjustments to benefits and contributions according to experience, including future indexation; and
- A governance structure that is sufficiently independent to ensure the sustainability of the plan.

However, the ORPP design does not meet several of our desirable attributes, including:

- The design is not targeted towards the middle-income group and requires contributions from low-income earners; and
- The resulting benefits would not leave sufficient room for savings through the private sector by middle-income earners.

A NATIONAL EXPANDED C/QPP

That said, the CIA maintains that a national consensus on the expansion of public pension plans is necessary, so that all Canadians would be entitled to similar benefits from those plans. It is difficult to justify variations by province or territory on the basis of needs. Such variations result in a less-efficient system, including potential complications for national employers. Furthermore, introducing a separate provincial plan such as the ORPP will add to an already too-complicated retirement system.

Policymakers should first confirm whether an expansion of public pension plans is in the best interest of most Canadians. This is not an easy decision as the confirmation depends on the following:

- **Whether the behaviour of Canadians will change sufficiently** in the future so that the next generation would retire with a comparable standard of living. For example, the next generation of Canadians may choose to increase its savings rate, retire later, spend less after retirement, use its housing capital, and leave less inheritance to others upon death. These behavioural changes may ensure the future adequacy and sustainability of the current system.
- **Whether the private sector will be able to adjust to the new environment** and to better meet the needs of Canadians. In particular, in response to consumer demand, the private sector could continue to innovate by developing new products and services to better assist Canadians in planning for retirement, in converting capital into income and in choosing how private

** Pillar I refers to Old Age Security, Pillar II to the C/QPP, and Pillar III to private pension plans.*

savings are to be efficiently managed. We recognize that the private sector is facing challenges in meeting those needs, and that many smaller employers are not interested in sponsoring pension plans. And, some regulatory changes may assist the private sector in meeting those challenges, in particular for work-related pension plans.

- **How much flexibility and responsibility should be left to Canadians** and their employers, recognizing that needs vary.

If policymakers a) resolve that they cannot rely on change in behaviour of Canadians and their employers or change in private sector developments and b) decide that public pension plans should be expanded, the CIA offers the following considerations on an expansion of public pension plans, including examples of possible solutions, which would require further analysis.

1. The level of additional pension benefits to be provided by the expanded plan should be modest, which we view as a compromise between the following:

a. Being generous enough to substantially achieve the objective of fulfilling the perceived need (i.e., that the next generation will not face a significant reduction in its standard of living at retirement); and

b. Leaving room for Canadians and their employers to remain responsible for a portion of the savings required to achieve their desired standard of living at retirement, allowing for individual needs and private sector innovation. Many are arguing that one of the strengths of the Canadian system compared to other countries is that we can rely on retirement income coming from different sources.

The CIA believes that the 15 percent target proposed under the ORPP could be such a compromise, provided that the minimum earnings threshold is increased. As one example, a 15 percent target benefit on earnings above 50 percent of the YMPE as defined under the C/QPP would significantly address the perceived need and still leave sufficient room for the private sector to continue to play its role in developing new products and for Canadians to keep sufficient personal responsibility to reflect the variations in needs.

A typical middle-income family with mortgage and children would still need to save in order to maintain the same standard of living at retirement as the average over their working years. For example, it can be estimated that if a new public pension plan covers earnings above 50 percent of the YMPE, with a benefit formula of 15 percent, then each spouse would still need to save, in private sector vehicles (work-related pension plans or individual savings), approximately 7.5 percent of earnings between 50 percent and 100 percent of the YMPE, and approximately 10.3 percent of earnings above the YMPE, if any. (The assumptions used in estimating those contributions are described in the appendix.)

Others, i.e., high-income earners, singles, and those wanting to retire early, would need to save more. However, we note that if the earning threshold is significantly lower than 50 percent of the YMPE, with a 15 percent target, there would be no need to save for most low- to middle-income earners.

2. Should low-income earners be exempted?

On the one hand, low-income earners a) are adequately covered by current public pension plans (i.e., Pillars I and II), b) are facing high clawback rates from GIS if they save or contribute more to a public pension plan or other registered plans, and c) may be better off contributing to a non-registered plan such as a Tax-Free Savings Account (TFSA). A recent publication by Doug Chandler and co-sponsored by the CIA illustrates that point (Tax-Deferred Retirement Saving in Canada, dated March 2016).

On the other hand, there would be added complications, though possibly small, in administering a minimum earning threshold that excludes many, in particular for those who change employment during the year. Furthermore, it is not possible to know whether current low-income earners in a given year will be entitled to GIS in the future, as they could earn more later in their working lifetime. There are advantages in having a simple universal plan where all Canadians are participating.

A minimum earnings threshold of around 50 percent of the YMPE would be a reasonable compromise.

3. Should earnings above the YMPE be covered by the expanded plan?

Although many of those earners have access to private or collective savings arrangements, the CIA recognizes the concerns about whether there will be a savings gap for many of those earners and whether the efficiency of the overall retirement system can be improved. For example, decisions related to the selection of investments, options on converting capital into income at retirement, and understanding fees for individual savings are complicated. The CIA maintains that expanding the C/QPP coverage above YMPE, for example, to a level similar to ORPP (e.g., $90,000), or simply 150 percent or 200 percent of the YMPE, could prove to be appropriate in order to target specifically those who earn slightly more than the YMPE, although this could also add certain complexities, including its impact on existing workplace pension plans.

A maximum earnings threshold of around 150% of YMPE would be appropriate.

4. Should the clawback under GIS be reviewed?

Low-income earners are currently penalized if they save for retirement, including their participation in the C/QPP. Although some of them do not need to save, because the combination of C/QPP, OAS, and GIS is sufficient to replace almost all of their pre-retirement income, in general, Canadians should not be discouraged from saving. It is noted that the relatively new TFSAs can be useful for this purpose. The CIA suggests that the GIS clawback be reviewed; for example, income from public (and possibly private) pension plans could be subject to a lower clawback rate (e.g., 25 percent instead of 50 percent). A decision about this would need to be based on an impact analysis to be prepared by the Office of the Chief Actuary.

5. Should employers and members of registered pension plans providing comparable benefits have the option of not contributing to an expanded public pension plan?

Many pension plans are well-governed and provide good pensions to Canadians, so there would be no need to change the mix of the amount of pension being provided from these comparable plans compared to public plans. Furthermore, allowing some large plans to opt out of a new public pension plan will ensure some diversification in the management of retirement savings assets.

On the other hand, the management of such an opt-out option will introduce administrative complexities; simplicity in a public plan is an advantage. Furthermore, it is unknown how many of these plans will exercise the opt-out option and decide that employee and employer retirement savings contributions would produce better benefits in their employer-sponsored plans rather than in a public pension plan. We note that if the option is not available, many existing employer-sponsored plans will need to be amended and renegotiated in order to reflect the expansion of the public plan.

Policymakers will need to balance these and other considerations when deciding whether or not to exclude employees covered in a comparable private pension plan from participating in an expanded public pension plan.

6. Should the normal retirement age remain at 65 or be increased to reflect the longer period of retirement?

The current OAS and C/QPP rules, with an adjustment depending on the age at which pension payments begin between ages 60 and 70 (or 65 and 70 for OAS), help to disconnect the decision to stop working from the decision to begin receiving a pension, so the normal retirement age under C/QPP may not be a significant factor that Canadians consider in deciding when to stop working.

We have noted that the ORPP design is based on a normal retirement age of 65 (i.e., the age at which an unreduced pension is payable) and that the federal government has reinstated the normal retirement age of age 65 for OAS. The CIA suggests allowing the postponement of pension payments to a later age such as 75 with an equivalent adjustment. The adjustment makes it cost neutral to the plan, while helping individuals to plan withdrawals from other sources. A similar extension could be considered also for OAS, registered pension plans, and registered retirement income funds.

The CIA published a report in 2013 on the issue of retirement age titled, Issues Related to Increasing the "Retirement Age". We encourage policymakers, after conclusion of the current debate on C/QPP expansion, to consider these issues about the role of public policy on whether Canadians should work longer.

We accept that an expanded public pension plan could have the same normal retirement age of 65 as C/QPP. However, there are arguments in favor of increasing the age at which a pension under the expanded plan would be payable without reduction as follows:

- The expanded C/QPP will mature in about 40 years. Canadians will understand that the next generation might be expected to work past age 65 as longevity improvements will continue and that there is a global trend where such age is increased in many countries; and
- The cost and the benefits of the expanded C/QPP would be reduced leaving more pension responsibility to the private sector and resulting in a more affordable expansion.

If policymakers decide that Canadians should be incented to work past age 65 because of longevity improvements that are expected to continue or if policymakers decide that the cost of the expansion should be reduced, then an expanded C/QPP could have a normal retirement age later than 65, or the adjustments for those who elect to receive the pension at ages other than 65 could be adjusted to provide incentives to work longer.

CIA's Suggestions

The CIA suggests that if policymakers want to expand public pension plans, the following design be considered. Many of these suggestions are based on the ORPP in order to help arrive at a national consensus.

BENEFIT FORMULA, BENEFIT PROVISIONS, AND COVERED EARNINGS

- Set a 15 percent pension target after a full career, based on indexed average earnings, above some minimum threshold earnings.
- Fully fund benefits and start pension accrual with a single implementation date of, say, January 1, 2020 to allow time for plan sponsors and the economy to adjust, and for authorities to prepare for the administration of the new public pension plan.
  - It should be understood that the objective of full funding without generational transfer most likely entails that current workers will accumulate a partial benefit based only on their years of participation from 2020.
- Increase the minimum threshold earnings from $3,500 to 50 percent of the YMPE, so that there would be no contributions or benefits for earnings below 50 percent of the YMPE, subject to an analysis of the number of low-income earners expected to receive the GIS, and to an analysis of administrative complexities that could emerge (e.g., integration with private pension plans).
- Increase maximum earnings to 150 percent of the YMPE to address the potential gap in savings for middle-income Canadians, subject to an analysis of administrative complexities.
- Therefore, for someone at the YMPE, the pension target would be 7.5 percent of earnings and for someone at 150 percent of the YMPE the pension target becomes 10 percent.
- Benefits and contributions should not be recognized in the calculation of a Canadian's pension adjustment (therefore no impact on Registered Retirement Savings Plan (RRSP) savings thresholds) as improvements are modest and universal.
- Ancillary benefits should be limited to a minimum; but could include survivor benefits after retirement and accrual of benefits while on disability.

CONTRIBUTIONS

- Share contributions 50/50 between employees and employers.
- Establish contributions according to an actuarial basis that includes some margins so that there is an appropriate compromise between stability of contributions and risk transfer between generations (it is anticipated that this contribution rate will not be too dissimilar to the ORPP's 3.8 percent, but applicable on earnings above 50 percent of the YMPE).
- Since current older workers could obtain a significant subsidy from younger workers if their contribution rate is the same, consider a fairer approach where the contribution rate varies by age, such as 0.9 percent below age 40, 1.9 percent from 40 to 50, and 2.9 percent from age 50, although the rate could be fixed at 1.9 percent at all ages for the employer portion.

FLEXIBILITY

- In order to ensure long-term sustainability and affordability, benefits should be set based on targets, allowing for adjustments in contributions and benefit levels.
- Establish clear rules on how contributions and benefits will be adjusted according to experience. In particular, we would anticipate that indexing should not be guaranteed. Transfer of risk between generations should be managed with triggers leading to automatic changes in benefits and contributions.
- Accept that:

  a) Contributions may be volatile in order to avoid risk transfer to the next generation;

  b) Benefits might need to be adjusted, including the normal retirement age; and/or

  c) Benefits may not be fully indexed to inflation. This is unavoidable so that the plan be fully funded, that a transfer of increased costs to the next generation is minimized, and that assets are invested in a diversified portfolio with uncertain and volatile returns.
- Communicate clearly that benefits (including indexation) and contributions will be adjusted according to plan experience.

RETIREMENT AGE

- Continue to use age 65 as the normal retirement age, but allow Canadians to retire between ages 60 and 75, with adjustments calculated on an actuarial equivalent basis.

IMPLEMENTATION

- Use the C/QPP existing structures for investments, as the current Canada Pension Plan Investment Board (or Caisse de dépôt in Québec) is independent with a strong governance structure, but analyze the advantages of a second separate investment structure, when the size of the assets to be accumulated with the expansion of C/QPP will be very large and given the difference in the funding target of the expanded C/QPP.
- Use the C/QPP existing structures for collection of contributions and for calculation and determination of benefits.
- Establish a separate investment policy for the second-tier C/QPP that will represent a trade off between stability and affordability of contributions.
- Maintain a clear and separate governance structure and accounting between the current basic C/QPP and the new second-tier C/QPP; this is required if contribution rules and benefit levels are different. It is important that Canadians understand that the expanded C/QPP is separate from the current C/QPP, which will be a challenge.
- Confirm rules to allow sponsors with private pension plans to reduce future accruals, even in plans subject to collective bargaining.

Concluding Remarks

If policymakers decide that an expansion of public pension plans is necessary, the above design:

- Can be implemented nationally and could be proposed to all provinces and territories.
- May not result in a too substantial increase in administrative cost if the current C/QPP structure is used, especially if there is no opting-out for comparable plans. There would be some additional administrative cost implications by using thresholds of 50 percent and 150 percent of the YMPE.
- Will leave sufficient responsibility to Canadians for savings through individual or collective plans, with consumer demand encouraging the private sector to continue developing new products and services.
- Is fair to low-income earners and would avoid a punitive GIS clawback for many, as they are excluded.
- Targets middle-income workers without a private pension plan.
- Is not too disruptive for private pension plans, as they may reduce their benefits and contributions with the expanded C/QPP as they have done with the basic C/QPP, although this could be a bit more complex if covered earnings exceed the YMPE.
- Will not penalize future generations as the plan would be fully funded, although there could be subsidies within the current generation of workers if contribution rates are uniform. Such a subsidy could flow to older from younger members contributing at the same rate, but this could be addressed by varying somewhat the employee contribution rate by age (and not only for the current generation).

Obviously, other designs exist that may substantially meet the desired characteristics of a public plan expansion set out by the CIA.

Policymakers have a unique opportunity to conclude the debate on the expansion of public pension plans, and to begin addressing other issues that Canadians are facing in planning for retirement, such as the suggestions noted in our November 2015 public position to improve private pension plan rules.

For further information, contact Pascale Belleau, CIA associate director, public affairs, at 613-236-8196 ext. 148, or by e-mail at pascale.belleau@cia-ica.ca.

Disclaimer: This public position does not necessarily represent the views of all members of the CIA.

Appendix

To estimate the amount that a typical Canadian couple needs to save to maintain its standard of living upon retirement we adopted the following methodology and assumptions.

METHODOLOGY

First, we estimated the level of income at which government programs would fully maintain the couple's standard of living without any supplementary savings from the couple or their employers. This establishes the earnings threshold above which personal savings are required.

We then estimated the amount that each spouse would need to save on earnings between the threshold and the YMPE to achieve an adequate level of post-retirement income.

Finally, we estimated the additional amount that the couple would need to save on earnings between one and two times the YMPE to achieve an adequate level of post-retirement income.

For this purpose, the couple's post-retirement income was said to be adequate if the couple's post retirement income, after tax, adjusted for inflation, equals or exceeds the couple's pre-retirement income, after tax, averaged over their working career, adjusted for inflation, reduced by:

- Any amounts saved for retirement;
- The cost of acquiring a house and other non-financial assets prior to retirement; and
- The cost of raising and supporting children.

ASSUMPTIONS

To perform the calculation we must make many assumptions and the results are unavoidably sensitive to these assumptions. The most impactful assumptions are the following:

- The couple resides in Ontario. They have two children. They buy a home that costs four times their gross annual income and accumulate other non-financial assets worth one times their gross annual income.
- Prices increase by 2 percent per annum. Wages increase by 3 percent per annum.
- The couple's income increases with wages and is evenly divided between the spouses.
- The couple saves for retirement through RRSPs and earns a 5 percent annual rate of return after investment expenses. The mortgage rate is also 5 percent.
- The couple marries at 25, starts working at 25, retires at 65 and dies at 90.
- The couple raises two children, incurring expenses of 15 percent of their net income over their whole career.
- Upon retirement, depending on their RRSP income, the couple qualifies for income from OAS, GIS, the C/QPP, refundable tax credits and, in addition, an expanded C/QPP. The expanded C/QPP replaces 15 percent of covered earnings from a lower threshold (assumed to be 0 or 0.5 times the YMPE).

RESULTS

If the expanded C/QPP replaces 15 percent of covered earnings above 0.5 times the YMPE:

- There is no need for retirement savings if the couple collectively earns less than the YMPE (i.e., each spouse earns less than 0.5 times the YMPE).
- Couples earning more than the YMPE should each contribute, over their whole working career:
    - 7.5 percent on earnings between 0.5 times the YMPE and 1.0 times the YMPE; and
    - 10.3 percent on earnings above the YMPE.

If the expanded C/QPP replaces 15 percent of all covered earnings:

- There is no need for retirement savings if the couple collectively earns less than 1.25 times the YMPE (i.e., each spouse earns less than 0.625 times the YMPE).
- Couples earning more than 1.25 times the YMPE should each contribute, over their whole working career:
    - 5 percent on earnings between 0.625 times the YMPE and 1.0 times the YMPE; and
    - 10.3 percent on earnings above the YMPE.