PENSION REFORM CURRENT ISSUES – APRIL 2011[1]
by
MURRAY GOLD

I. EXECUTIVE SUMMARY

As Canada heads to the polls on May 2, 2011, pension reform has emerged as one of the key issues in the campaign. This isn't surprising – private pension plan coverage has been in steady decline for decades, and Canadians are increasingly concerned about their retirements. The level of retirement savings in Canada is not adequate and the financial mechanisms for individuals to save for retirement (i.e. RRSPs) are too expensive, and take too large a bite out of Canadian's future retirement incomes.

Canadians who will retire over the next decades cannot expect the same retirements as their parents. This is primarily because employment based pension plans are declining, and providing lesser retirement benefits. This decline will affect Canada's middle-class especially hard – it is Canada's middle-class that is dependent on traditional employment based pension plans, and middle-income earners will feel this loss most severely.

This paper reviews Canada's retirement income system, and explains how it works. It looks at the Old Age Security ("OAS"), the Guaranteed Income Supplement ("GIS"), the Canada Pension Plan ("CPP") and employment based pensions, and explains how they function and work together. Finally, the paper reviews the political parties' pension platforms in the 2011 election, and compares and evaluates them.

[1] **This paper is regularly updated. This is the April 25, 2010 version.**

Murray Gold is a Partner in the Pension and Benefits Group at Koskie Minsky LLP. He served as an Expert Advisor to the Ontario Expert Commission on Pensions.

II. INTRODUCTION

Reform of Canada's pension system is on the table for the first time since the 1960s. In recent years, we have seen expert commission reports in Quebec, Ontario, Nova Scotia and Alberta/British Columbia, and Ministerial meetings to consider a range of proposals for fundamental reform. Academics and professionals, employer and labour organizations, and the financial industry have all weighed into the debate. Pension reform is prominent on the federal parties' election platforms

This paper reviews Canada's current retirement arrangements. It concludes that an important component of Canada's pension system is deteriorating, jeopardizing the quality of retirement for middle class Canadians. The paper examines reform proposals, and proposes a way forward.

III. CANADA'S PENSION SYSTEM TODAY

Canada's pension system consists of three 'Pillars':

- Pillar 1: the public basic income programs OAS, GIS and related spousal programs, and provincial income support and subsidy programs;
- Pillar 2: the public pension program (CPP); and
- Pillar 3: employer, union or jointly sponsored retirement plans (called 'registered pension plans' or 'RPPs'), as well as individual or group RRSPs, and the recently introduced tax free savings accounts ('TSFA').

What are these programs? What are they intended to accomplish? Are they working?

Pillar 1

Pillar 1 programs – old age security, guaranteed income supplement and a variety of provincial programs – exist to provide all Canadians age 65 and over with a basic income. They are available to all seniors, whether or not they were in the paid workforce and regardless of unemployment, sickness or disability. They are intended to keep the elderly out of poverty. Their income targets are not high, and they are to be evaluated based on whether or not they meet a standard of adequacy and decency in retirement.

The only significant requirement for the main Pillar 1 programs (OAS and GIS) is Canadian residency. A minimum of 10 years residency in Canada is required for any entitlement to OAS and GIS, and maximum benefits are paid only to those with 40 years or more of Canadian residency. Those with between 10 and 40 years of residency in Canada get some but not the maximum OAS and GIS benefits.

Pillar 1 programs are paid for from current tax revenues. Accordingly, Pillar one programs redistribute current income from employers and active employees to seniors. This is quite fair, as Canadians generally expect to live beyond age 65, and working Canadians have been quite prepared to redistribute income to seniors on the understanding that, when they reach age 65, they too will be eligible for these same programs.

Here are a few important facts about the OAS:

- OAS pays a maximum of $524.23.00 per month (or $6290.76 per year) per person;[2]
- OAS is 'clawed-back' from elderly Canadians with annual incomes between $67,888 and $109,607; at $109,607 OAS is completely clawed back;
- OAS is indexed to prices (i.e. to the cost of living) and not to wages; if wages climb faster than prices, the income of OAS recipients falls behind in comparison with the incomes of active wage-earners.

And here are some key facts about the GIS:

- GIS is based on the same eligibility criteria as the OAS, so it is paid to those age 65 and older who have been resident in Canada for at least 10 years with maximum benefits paid after 40 years of residency;
- Maximum GIS is $661.69 per month, or $7940.28 per year for an individual[3] and $873.90 per month, or $10,486.80 per year for a couple where both partners are eligible for OAS and GIS[4];
- Unlike OAS, GIS is income-tested, meaning that the amount of GIS paid by the government declines if the recipient has any other non-OAS income; the GIS declines by 50 cents for every dollar of non-OAS income received by the GIS recipient:
- GIS declines to zero for individuals with non-OAS income of $15,888, and for couples with non-OAS incomes of $20,976.[5]

At maximum benefit levels, here is what Pillar 1 programs pay to Canadians in 2011[6]:

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[2] see: http://www.servicecanada.gc.ca/eng/isp/oas/oasrates.shtml
[3] see: http://www.servicecanada.gc.ca/eng/isp/oas/tabrates/tab1-1.shtml
[4] see: http://www.servicecanada.gc.ca/eng/isp/oas/tabrates/tab2-1.shtml
[5] see: http://www.servicecanada.gc.ca/eng/isp/oas/tabrates/tab2-25.shtml
[6] These figures are for those who receive no income other than OAS, GIS and the Ontario GAINS supplement and do not consider other subsidies that may be available for housing or medical care. For information concerning the Guaranteed Annual Income System, see: http://www.rev.gov.on.ca/en/credit/gains/

Single	Single	Qualified Couple, Both Receive Maximum OAS	Qualified Couple, Both Receive Maximum OAS
Single	**Single**	**Per Person**	**Couple**
OAS/GIS Maximum	$1,185.92	$961.18 per month	$1,922.36 per month
Gains	$83.00 per month	$83.00 per month	$166.00 per month
Total Per Month	$1,268.92 per month	$1,044.18 per month	$2,088.36 per month
Total Per Year	$15,227.04 per year	$12,530.16 per year	$25,060.32 per year.

In general, the essential questions about Pillar 1 programs concern whether they provide an adequate level of benefits. Can people live a basic life with OAS and GIS? Do they fall into poverty? How do the residency requirements affect Canada's immigrant population? Are the amounts paid to individuals and couples fair to each type of household?

The OAS and GIS are very much the foundation of Canada's retirement income security programs. Here are the statistics, from Statistics Canada's January 2010 OAS and CPP Statistical Bulletin about how many Canadians rely on the means-tested retirement income programs:

- 4,781,975 Canadians are receiving full or partial OAS benefits[7]; about 94% of them receive a full OAS benefit, while about 6% receive a partial benefit;

- 1,622,832 Canadians are receiving full or partial GIS benefits;

- 34% of OAS recipients are also receiving full or partial GIS benefits;

This means that 34% of the Canadian elderly have incomes (other than from OAS) below $15,888 (for individuals), or $20,976 (for couples) (provincial supplements are generally in addition to these amounts). Adding full OAS benefits to these figures (about 94% of OAS recipients receive a full OAS benefit), this means that about 1/3[8] of Canadian seniors receive no more than $22,178 as individuals, or, if they are part of an elderly couple both of whom receive OAS, live together on a family income of under $33,557.

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[7] See: http://www.servicecanada.gc.ca/eng/isp/statistics/pdf/statbulletin1110.pdf

[8] Also of interest is that many people, who are eligible for the GIS, are not receiving it. Statistics Canada reports[8] that about 10% of those eligible to receive the GIS did not apply for it. This suggests that the percentage of elderly Canadians in domestic units with non-OAS incomes below $15,888 (for individuals) and $20,976 (for couples) is higher than 34 % - perhaps closer to 38%. See Statistics Canada, the Daily, July 22, 2009 "Study: The Guaranteed Income Supplement Update".

These figures – the percentage of seniors who currently receive the GIS, and the maximum benefits available from the OAS and GIS – are significant because they tell us two things. First, they tell us where Canadians find themselves as seniors if their combined annual CPP and Pillar three incomes are under $20,976 for a couple or $15,888 for an individual. This includes all senior couples with each spouse receiving maximum CPP earnings but no other pension income. These couples receive less than $33,557. Individuals with CPP and Pillar 3 incomes of $15,888 or less receive less than $22,178 when the OAS and GIS are added. And these numbers tell us one more thing – that some 37% of Canadian seniors are earning at or under this level of retirement income.

Pillar 2

Pillar 2 consists of the CPP. It covers the employed and the self-employed. Unlike OAS and GIS, CPP participation depends on working in the paid workforce or being self-employed. The amount of a CPP pension depends on how many years a person has contributed to the CPP, and how much they earned in each of those years.

At its maximum benefit level, the CPP is designed to replace 25% of a person's earnings (up to the average industrial wage) over their working life. The average industrial wage is currently about $48,300, and is described in the CPP as the 'Year's Maximum Pensionable Earnings' or 'YMPE'. The "YMPE" is an important part of the CPP formula – it sets the upper limit on the amount of wages on which CPP contributions must be paid, and therefore limits the benefits provided under the CPP. The YMPE is adjusted each year to reflect increases to the average industrial wage.

The CPP benefit formula is, however, complex. Here is a sense of how it works.

In principle, Canadians are expected to participate in the CPP from age 18 to age 65. The CPP permits all participants to drop their seven lowest earning years from the averaging formula (this will rise to 8 years in 2014), so that a person's CPP is generally based on the best 38 years of earnings. The ability to drop the seven lowest years of earnings provides some benefit to those who are out of the workforce on account of post-secondary studies or unemployment. Additional years of non-participation are permitted on account of child-rearing and disability. Beyond these permitted 'drop out' years, however, periods outside the paid workforce between the ages of 18 and 65 reduce the value of the participant's ultimate CPP benefit.

Monthly CPP are adjusted lower if a participant begins to receive the CPP before age 65, and higher if they begin the CPP after age 65.

Contributions to CPP are currently 9.9% of pay, for earnings between $3500 and the YMPE. The $3500 amount is referred to as the "year's basic earnings" or 'YBE'. The YBE is now frozen at $3500, but it used to be indexed. The purpose of the YBE is to exempt low incomes from CPP contributions. This is fair, because, at low income levels, the effect of the CPP is largely to reduce the GIS.

For the employed, both the employer and the employee pay CPP contributions of 4.95% of pay between the YBE and the YMPE. The self-employed pay both the employee and employer contributions – they pay 9.9% of pay from $3500 to the $48,300 YMPE limit.

In 2011, maximum CPP benefits were $960 per month ($11,520 per year), but average CPP benefits are only $504.88 per month ($6054 per year)[9]. This fact – that the average CPP benefit is well below the maximum possible benefit, is very important when considering the impact of the CPP.

Why is the current average CPP benefit so much lower than the maximum benefit? Each of the following factors reduces CPP benefits below the maximum:

- first, Canadians whose average income was below the CPP maximum earnings level during much of their working lives are will not receive the CPP maximum pension;

- second, many Canadians have not worked the maximum number of years required to qualify for a maximum benefit, because of years of post-secondary education, years of unemployment or early retirement;

- third, many Canadians commence receipt of their CPP benefits before age 65, but, when they do, the amount of their pension is reduced by .5% for every month of early retirement (the reduction will increase to .6% for every month of retirement before age 65, effective 2012) – so, a person retiring at age 60 (50 months before age 65) currently receives 25% less than the benefit they would receive at age 65.

Seniors who receive a CPP benefit but have no other non-OAS income, lose 50 cents of GIS for every dollar of CPP benefit they receive.[10] In this sense, the CPP, as a contributory Pillar two plan, is designed to replace the GIS (a redistributive Pillar one program) for working Canadians. For a Canadian couple in 2011, both of whom receive the maximum CPP pension, the GIS benefit is completely eliminated[11].

It is more important to focus on those who receive the average CPP benefit than those who may receive the maximum possible CPP benefit, since relatively few people do receive a maximum CPP.

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[9] See: http://www.servicecanada.gc.ca/eng/isp/pub/factsheets/rates.shtml

[10] Note that the first $3500 of employment income is not counted, so GIS recipients can earn up to $3500 in employment income without reducing their GIS payments. CPP payments, however, are not employment income, so every $1 of CPP reduces GIS by 50 cents. See: http://www.cdhowe.org/pdf/backgrounder_65.pdf.

[11] Individuals age 65 and over who receive a full CPP will, however, continue to receive a partial GIS if their only source of non-OAS income is the CPP, even if their CPP benefit is at the maximum level. That individuals will continue to receive the GIS, even with maximum CPP benefits, while couples with two maximum CPP benefits will not, reflects the difference in the permitted amounts of non-OAS incomes to individual and couples, which in turn reflects the fact that two people can live together, sharing a residence, appliances and other necessities of life for less than it costs two single individuals to live separately.

A couple (both age 65 or over), in which both members received the OAS and the 2011 average $504.88 per month in CPP benefits, would still receive a partial GIS. This couple, with each person receiving the 2011 average CPP, would, together receive about $2441.72 per month, or $29,300 per year, from the combined OAS/GIS and CPP programs[12].

The main question about the CPP is the adequacy of its benefits. Bear in mind that, at best, the CPP is intended to replace only 25% of a person's average lifetime income, up to the average industrial wage. The actual amount of CPP benefit is affected by the time a person spends in the paid workforce, their average earnings during their period of employment and their date of retirement. When all of these factors are considered, it is not surprising that the CPP offers a relatively modest benefit to Canadian seniors.

The issue of CPP adequacy affects men and women differently - the average CPP benefit for women in 2006 was only $352 per month, while the average monthly benefit paid to men was $592[13]. This question of adequacy has become especially serious given the deterioration in 'Pillar 3' of Canada's retirement income system, discussed below.

Pillar 3

Pillar 3 retirement income programs are quite different from Pillars 1 and 2. Pillar 3 programs, which include pension plans and RRSPs, are not social programs sponsored by governments for the entire population (OAS/GIS), or mandatory, universal pension plans for the entire paid workforce (CPP). Rather, Pillar 3 pension plans and group RRSPs are based in the workplace, and generally cover only those employees who work for the employer that participates in them. Pillar 3 also has an individual savings component (RRSPs and TFSAs) that are not tied to the employer at all.

There are a number of other differences that distinguish Pillar 3 retirement arrangements from Pillar 1 and 2 programs.

Pillar 3 Programs are Voluntary

Pillar 3 programs – which include employer sponsored pension plans, group and individual RRSPs and tax free savings accounts – are, first and foremost, voluntary programs. No law obliges an employer to establish a pension plan, or a group RRSP, and many do not. Similarly, no law requires an individual to contribute to an RRSP, or to keep money in an RRSP or TSFA until retirement (money can be withdrawn from at any time). All Pillar 3 programs are voluntary, unlike the OAS and the GIS, which are statutory programs to which all Canadians contribute through their taxes, and the CPP, which is mandatory for all employed and self-employed persons.

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[12] See: www.servicecanada.gc.ca/eng/isp/oas/tabrates/tab2-2.shtml). An individual senior who receives the average $504.50 monthly CPP benefit, would have a combined OAS/GIS/CPP annual income of $17,261.04 (http://www.servicecanada.gc.ca/eng/isp/oas/tabrates/tab1-2.shtml).

[13] See 23rd Actuarial Valuation of the Canada Pension plan, table 64.

Within Pillar 3, there are degrees of voluntariness. An employer may sponsor a pension plan because of a collectively bargained obligation to do so, or because they want to do so, quite apart from any collective bargaining obligation, for human resources reasons. Employees may be compelled by their employer or their collective agreement to participate, or employee participation may be voluntary. The one area where personal participation is almost always purely voluntary to the employee is the area of personal retirement savings through RRSPs or TFSAs.

Participation in the RRSP sector is very low, and highly stratified by income. According to RBC Economics, "RRSP Contributions 1968-2008…And beyond to 2020", Canadians' contributions to RRSPs peaked in 1998 at 5% of personal disposable income, and then commenced a steady descent to 3.5% of personal disposable income in 2008. In 1997, 41% of Canadian taxpayers contributed to an RRSP; participation had declined to 34% in 2008[14]. In the same vein, Statistics Canada reports that Canadians are using only between 5 and 6% of the RRSP room available to them. This means that RRSP participation levels are in decline and that RRSP contributions aren't very high, and, more seriously, have been falling for a decade. These figures highlight the key weakness of a voluntary retirement savings program – people don't use them, notwithstanding substantial financial and tax incentives to do so.

Pillar 3 Pension Arrangements Vary Considerably – Some are better than others

There are many variations between pension plans, but perhaps the most basic distinction is between defined benefit and defined contribution pension plans:

- **Defined Benefit (DB) Plan** - When a person retires from a defined benefit plan, they receive a pension for life calculated using a formula that typically depends on the person's years of service, their average salary in the 3-5 years prior to retirement and an 'accrual rate'. So for example, a 35 year employee with final average earnings of $50,000 and an accrual rate of 2%, would receive a pension equal to 2% (accrual rate) multiplied by 35 (years of service) multiplied by $50,000 (final average earnings), or $35,000 per year. The pension may, or may not, be indexed, depending on its terms. The employee receives this amount for life, and, after death, his or her spouse continues to receive 60% of the pension for the spouse's life[15].

- **Defined Contribution (DC) Plan** – In a defined contribution plan, both the employer and the employee contribute regular amounts to an account for the employee. The account is invested in financial instruments (typically stocks and bonds) until retirement. When the employee retires, the amount in the account is used to provide retirement income. The amount of retirement income, however, is unpredictable – it depends on whether and to what extent the employee's

[14] Statistics Canada, Participation in Private Retirement Savings Plans, 1997 – 2008, p.1, Highlights. www.statcan.gc.ca/pub/13f0026m/13f0026m2010001-eng.htm

[15] Pension legislation in fact would allow the $50,000 to be reduced to the member to take account of the survivor benefit provided to the spouse.

account has grown with investment earnings, and also depends on what the employee does with the account at retirement, the level of interest rates at the time of retirement and how long the employee lives.

In general, there has been a clear trend, internationally and in Canada, away from DB and towards DC arrangements, although the rate of change has been difficult to measure in Canada because the data on pension plan participants doesn't always distinguish between DB and DC plan members. Baldwin, supra (p.55) has estimated that some 50% of private sector employees are in DC arrangements. Public sector employees remain overwhelmingly in DB Plans. Overall, about 20% of Pillar 3 pension plan members are in DC plans.[16]

The erosion of Pillar 3 DB pensions is a problem, because it reduces the predictability and reliability of a person's retirement income. DB plan members are entitled to a fixed (and perhaps indexed) pension for their lives, and then their spouses are also entitled to a 60% benefit for their lives. DB members can plan the timing and nature of their retirements with the knowledge of what their retirement incomes will be. Those incomes are only in jeopardy if their pension plans and their employers both become insolvent at the same time.

DC members do not enjoy the same predictability. Because of volatile investment returns, changing interest rates and personal choices by DC plan members, DC retirement incomes can vary quite considerably, even between persons with DC retirement accounts of the same size who happen to retire at different times, or experience different luck in their investments.

Pillar 3 Programs Vary in Cost

Finally, Pillar 3 programs are provided through the financial services industry. Investment managers invest monies for pension plans, while the mutual fund and insurance industries service individual RRSP holders. In general, big pension plans can deal relatively well with the financial services sector, because they can use their large size to bargain favourable fee arrangements. But small plans in Canada, and especially individual RRSP investors, pay fees that are among the highest in the world.

Every dollar paid in fees reduces the amount of retirement savings available to invest and grow, and ultimately to pay retirement incomes.

Important studies by Keith Ambachtsheer and Rob Bauer in 2007 compared pension fund costs with mutual fund costs[17] and found mutual fund costs to be very significantly higher than pension fund costs, resulting in large differences between retirement income expectations of pension plan members as opposed to individual RRSP holders. In regard to Canadian equities, for example, Ambachtsheer and Bauer found that

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[16]See: Report of the Ontario Expert Commission on Pensions, "A Fine Balance, Safe Pensions, Affordable Plans, Fair Rules" at s.3.2.1; http://www.fin.gov.on.ca/en/consultations/pension/report/chpt3.html#section_3_2

[17]See, for example, "Losing Ground", Benefits Canada March 2007 (http://www.benefitscanada.com/investments/asset-classes/losing-ground-9477)

Canadian pension funds outperformed their benchmarks over the period 1996-2004 by 1.2%, while, during the same period, Canadian mutual funds underperformed their benchmarks significantly – mutual fund performance was -2.6% relative to their benchmarks over the same period[18]. In other words, after accounting for expenses in both measures, mutual funds underperformed their pension plan counterparts by an astounding 3.8%[19].

What is the implication for mutual fund holders' retirement incomes of such high fees? Ambachtsheer and Bauer compared the retirement income that a $50,000 earner saving $10,000 every year could expect to receive from a pension plan versus an RRSP invested in mutual funds. They found a range of pension plan expenses, and a range of mutual fund expenses (the range of mutual fund expenses was much higher than the range of pension fund expenses). Assuming a pension expense at the high end of the pension range, and a mutual fund expense at the low end of the mutual fund range, Ambachtsheer and Bauer found a 22% difference in expected retirement incomes – the pension plan member could expect a pension of $41,000 per year while the mutual fund holder making the same contributions over the same period of time could expect a retirement income of only $32,000.

The point is this: one of the keys to producing decent retirement incomes for Canadians is keeping investment expenses low. The financial services industry has failed to deliver on this key objective for individual RRSP investors, most particularly the 60% or so of them who rely on mutual funds.

Pillar 3 is Declining

Here are some important measurements of the health of Pillar 3:

- The percentage of the Canadian workforce covered by a Pillar 3 pension plan has declined from a high of 46.1% in the late 1970s to about 32% in 2008[20]. This means that over 2/3 of Canadian employees do not participate in a registered Pillar 3 pension plan.

- While only a third of Canadian employees participate in a Pillar 3 pension plan, there are considerable differences in participation by income level. For example, 86% of employees in the top 20% of income earners participate in a Pillar 3 pension plan, while only 9% of the bottom 20% of income earners do so.

- At the same time, as set out above, participation in RRSPs is also declining.

[18] Ambachtsheer and Bauer found that this underperformance "was entirely due to the average 2.75% per annum in incurred investment expenses" and that "any incurred sales charges would make the value-loss even more severe."
[19] As noted in ftn 17, mutual fund underperformance would have been even worse if sales charges had been taken into account.
[20]see Baldwin, Research Study on the Canadian Retirement Income System: Final Report, p.8, and Statistics Canada, Participation in Private Retirement Savings Plans, 1997 – 2008, www.statcan.gc.ca/pub/13f0026m/13f0026m2010001-eng.htm

These numbers demonstrate that a growing percentage of Canadian employees are excluded from the Pillar 3 pension system. This, of course, reflects the voluntary nature of the private pension and RRSP systems. By contrast, participation rates in the CPP have not declined, because the CPP is a mandatory system and employers and employees cannot opt out of it.

The Crisis Today in Pillar 3 Pensions

Canadian pension laws generally require that a pension plan should always have enough money to pay the pensions it has promised. If the pension plan doesn't have enough money, it is 'underfunded'. Additional monies must be contributed to the pension plan, generally by the employer, over a period of time to make up the underfunding. Most pension plans today are somewhat underfunded – a legacy of the 2008 financial crisis. We have seen some terrible consequences of pension plan underfunding where the employer becomes bankrupt before it can fully fund its pension commitments.

While we know that 'underfunding' may have tragic consequences – witness the substantial reductions in pension benefits at Nortel – we don't have a single universally accepted sense for 'how much funding is enough'. This is because we need different amounts of money to pay the same pensions under different future circumstances. If a dollar contributed to a pension fund today grows 20 fold by the time of retirement, then the contributions required today to pay for a future pension are much less than if the same dollar only grows 10 fold. If a pension plan is 'wound-up' following the insolvency of the employer sponsor, and the pensions must be provided by purchasing annuities from insurance companies, then the cost of the pension is going to be much higher than if the pension plan continues as a going concern over a lengthy period of time[21].

Two principal techniques have been used to deal with the funding risk (i.e. the risk that the pension plan does not have enough money to pay the pensions as promised): (a) pension insurance arrangements, such as Ontario's Pension Benefits Guarantee Fund[22], which insure some part of the pension if the employer becomes insolvent, or (b) pension funding rules that obligate employers to make contributions at a high level so that the chance of an underfunding is minimized[23]. We have relied heavily on (b) –

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[21] Where a company has an underfunded pension plan, and then becomes bankrupt, the pension plan's underfunding 'crystallizes'. Without any further possibility of additional contributions from the now-bankrupt employer, the pension plan must be wound up and the promised pensions must be reduced. This is what is happening now at Nortel; it has also happened to a number of steel, pulp and paper, auto parts and manufacturing companies and their employees and pensioners over the past decade.

[22] Ontario has a unique (in Canada) system of pension insurance that is supposed to top up an underfunded pension plan, at least in part, when an employer becomes bankrupt. The United States and Great Britain have similar pension insurance arrangements, but neither the federal government nor any other Canadian province sponsors any pension insurance plan. Recently, Ontario has capped its financial commitment to pension insurance, and this leaves Pillar 3 DB pension plans more vulnerable than they have been to the twin risks of underfunding and employer bankruptcy.

[23] When a company has an underfunded pension plan, pension funding regulations require the company to put money into the pension plan to eliminate its underfunding. This has occurred during and following the financial crisis, at the worst possible time for many companies. The financial strain created by having to make large pension payments during a severe recession, when the company's business is at its weakest, has caused many companies to look for ways to close their DB plans.

expensive pension funding rules - but employers have become increasingly resistant to paying these costs, and have turned against DB plans because of them.

If the decline in Pillar 3 is to be arrested, we need to solve the pension funding problem. Too expensive funding rules don't work – stringent funding rules that seek to protect against all contingencies (especially employer insolvency) are too expensive and simply deter the provision of pensions. Yet, if we move away from strict funding requirements, there is an increased risk that pension plans won't have the money they need to pay promised benefits, and so we need to address that risk.

Recent expert reports suggest two other systemic[24] ways to address the funding risk in defined benefit plans:

a. **Pension Insurance Arrangements –** The risk of employer insolvency can be addressed either on a plan by plan basis, or on a system wide basis through a system wide pension insurance plan. We know that not all pension sponsors will become insolvent, much less will they become insolvent at the same time. This means that, on a system wide basis, we don't need all the pension funding that every plan is supposed to accumulate at the plan level to address the possibility of insolvency at each plan. We should be able to replace expensive pension funding requirements with less expensive pension insurance premiums. On a system wide basis, this should make pensions less expensive to provide. But pension insurance arrangements are tough to design and administer properly, because premiums must be set properly and yet are frequently determined politically. They must also be established on a sufficiently wide scale to truly benefit from diversification and risk pooling – in Canada, this likely means that pension insurance needs to be established at the federal level. One of the advantages of pension insurance is that it would permit less stringent funding rules[25]. Seen as federal support for an essential social objective – adequate retirement incomes for Canadians – it would be a very worthwhile arrangement. However, governments in Canada, most particularly at the federal level, have shown no interest in using pension guarantees to support the voluntary pension sector.

b. **Joint Sponsorship –** Ontario has pioneered the development of jointly sponsored pension plans, primarily in the public sector. These are plans in which the funding obligations and funding risks are shared between employees and employers. Shortfalls in funding are generally shared between employees and

[24] In addition to changing the way we approach the funding risks, most jurisdictions are also developing rules for pension arrangements that are some way in between classic DB and DC plans. These are so-called target benefit plans, which 'target' but do not guarantee a specific level of retirement income. Unlike in a DC plan, all assets in the target benefit plan are pooled and invested together, rather than maintained in individual accounts and invested individually. Unlike in a DB plan, however, benefits under a target plan may be reduced if investment returns are not sufficient to pay for promised benefits.

[25] Not all employer sponsors of pension plans will become insolvent. Yet, current rules require that each plan be funded as though the employer will become insolvent – a very expensive proposition. If the risk of insolvency is shifted, in whole or in part, to a pension insurance arrangement, then premiums can be set to cover actual anticipated insolvencies, and employers may be relieved of some or all of their solvency funding obligations.

employers, reducing the burden on the employer side but increasing the burden for employees. These plans require that employees have a trade union in order to function effectively. They are among the most successful plans in Canada, offering a secure defined benefit pension, albeit at a substantial price (member and employer contributions can exceed 12% for each side under current conditions). An important advantage of this model is that the plan's funding risks are assumed by the employer and the employees (through their trade union) and decisions about those risks are taken by representatives of both sides. In genuine jointly sponsored arrangements, where both sides accept the funding risk, a higher risk tolerance is warranted.

Overall, declines in the percentage of the Canadian workforce covered by Pillar 3 pensions, the shift away from DB to DC plans, the increased underfunding of DB plans and the erosion of pension insurance, mean that Pillar 3 coverage is declining both quantitatively (coverage is down by about 14% of the workforce since the late 1970s) and qualitatively (DC plans do not provide the same predictable quality of retirement income as DB plans). While measures can be taken to alleviate the stress on DB arrangements (through revised funding standards, coupled with some pension insurance or joint employee-employer sponsorship), such measures are not likely to be widely implemented as governments withdraw from rather than reinvigorate the voluntary Pillar three pension system.

IV. THE PENSION CHALLENGE – RETIREMENT INCOMES IN THE YEARS TO COME

The challenge today is to provide future retirees with a standard of living that is equal to or better than the standard enjoyed by today's retirees. We have an impending retirement income crisis because we are not likely to achieve that objective on our current path.

In order to appreciate what is happening with retirement incomes, we need to consider four separate groups of retirees:

- those who rely only on the OAS and GIS (i.e. those with no participation in the CPP);
- those who may expect to receive OAS and CPP, and perhaps some GIS;
- those who may expect to receive OAS, CPP and a pension income through a Pillar 3 arrangement;
- those who may expect to receive OAS, CPP, a pension income through a Pillar 3 arrangement and additional retirement income through private savings outside of Pillar 3 arrangements (i.e private savings and investments).

There are no current changes that will cause those seniors who will rely only on OAS and GIS in the future to be worse off in absolute terms than their counterparts today. Because OAS and GIS benefits are formally indexed to the increase in prices, rather

than the increase in wages, however, there is a slow erosion in the relative standard of living of these retirees vis-à-vis active workers. Some important questions for these recipients are:

- whether the current OAS/GIS minimum income combination is adequate; and
- will future OAS and GIS payments be indexed to the average wage (in which case their incomes will grow at the same pace as actively employed people) or to the average level of price increase (in which case their purchasing power won't change, but they may become less well off in comparison to their working children).

Similarly, for those who will also receive the CPP, but will not have any non-OAS income other than the CPP, tomorrow also looks comparable to today. Again, for these Canadians, there are important questions about adequacy and future indexation.

The challenge today concerns those Canadians who also rely on Pillar 3 for their retirement incomes. In principle, our objective should be to at least maintain, if not increase, the proportion of the Canadian workforce with Pillar 3 benefits, and to maintain or increase the amount and the security of those Pillar 3 benefits.

We have a problem today with this group, because Pillar 3 cannot be expected to produce the same retirement incomes in the future as it does today. This reflects:

- declining Pillar 3 pension plan coverage as a percentage of the workforce;
- declining quality of Pillar 3 pension plans (from DB towards DC);
- erosion of benefits from Pillar 3 pension plans, especially in regard to inflation protection;
- underfunding of Pillar 3 pension plans;
- inadequate pension insurance protections for Pillar 3 DB plans.

The insufficiency of private, voluntary savings – even where they benefit from substantial tax incentives – to fill the retirement savings gap, is clear from several perspectives. In his study, titled "Retirement Savings by Canadian Households" published by the federal Department of Finance in December 2009, Keith Horner concluded that those "saving for retirement through RRSPs alone were much more likely to fall short of the savings rate benchmarks than those belonging to RPPs" (registered pension plans) (see p. 2). This reflects the factors reviewed above in relation to voluntary plans – fewer Canadians are contributing to voluntary arrangements, and the amounts they are contributing, as a percentage of their disposable income, has been on a steady decline. There is no reason to believe that voluntary retirement savings programs, even with financial and tax incentives, will suddenly reverse course and put Canadians on a path to decent retirement incomes.

And of course, we know that private RRSP savings are a highly inefficient way of accumulating retirement savings, because of the high fees charged by the financial services industry.

This issue must also be addressed in the near term, because it takes a long time to save for retirement. We cannot wait until today's 30 year olds are 64 years old to begin addressing their retirement needs – there won't be enough time to save the necessary amounts. If we do nothing now, today's 30 year olds will be relying on their children for retirement support.

So, with the pension component of Pillar 3 deteriorating, and the private RRSP component failing to fill the gap and costing far too much, how do we address the needs of Canada's current and future retirees?

OAS/GIS Seniors

1. The OAS/GIS programs are low-income programs funded from general tax revenues. As such, they are not retirement 'savings' plans. Instead of being funded through savings, they are paid for out of current tax revenues. As such, they do not raise the question 'how much should current workers save for their retirements.' Rather, they raise questions about the level of income that is appropriate for all elderly, regardless of personal saving, to be financed from current tax revenues.

2. The standard of adequacy against which these programs is measured is rather vague. OAS and GIS (and provincial supplements) are designed to provide a 'basic income' to the elderly. This is generally considered to be something in excess of a poverty level, though OAS/GIS do not always meet even this anti-poverty objective.

4. Canada has not really engaged in a debate about what level of income is appropriate for elderly Canadians. We lack a clear standard against which to measure basic income adequacy for seniors. Canada has not one but several competing measures of low income used to measure poverty levels, but these measures considerably and there is no consensus as to which one is most appropriate.[26]

5. The next step in the OAS/GIS discussion is to have a debate about the level of basic income adequacy for seniors. What is a decent basic income for the elderly in Canada? What does an elderly person's budget look like? What levels and

[26] There are several measures of poverty in Canada, the so-called 'low income measure' (LIM), 'low income cut-off' (LICO) and 'market basket measure'. Each measure is controversial, because people mean different things when they refer to 'poverty'. The LIM in 2007 was $15,400 for an individual and $23,100 for a couple. LICOs vary depending on several factors, including location (rural is different from urban); LICOs in 2007 were between $14,914 and $21,666 for an individual, and between $18,567 and $26,972 for a couple. The Market Basket Measure was similarly between $12,142 and $15,884 for an individual $16,998 and $22,238 for a couple.

forms of income transfer from the working to the retired populations make sense for today and tomorrow?

CPP Seniors

1. For those who rely on the OAS, the CPP and the GIS, the key question, again, is whether they are likely to receive an adequate income in retirement. But, unlike for those who rely exclusively on OAS and GIS, the question of retirement income adequacy for CPP recipients is also a question of retirement savings. It is the element of retirement savings, and, in particular, retirement saving through the CPP, that increases the post-retirement income of this group above the OAS/GIS level.

2. The CPP is currently designed to replace only 25% of a person's average annual earnings (up to each year's average industrial wage). This isn't much by any adequacy standard. In Canada, we have generally assumed that, in order to sustain a person's standard of living after retirement, their post-retirement income must be at least 70% of their pre-retirement income. The CPP alone doesn't get an average wage-earner to a 70% replacement rate, even with the OAS and a partial GIS.

3. With a maximum CPP benefit, a couple each of whom was in the paid workforce for their entire working lives earning an average wage ($48,300 each) will receive a maximum of $11,520 each from the CPP, and an additional $6290.76 each from the OAS (their GIS is clawed back). So, from a pre-retirement income of $96,600, this couple, with nothing but the maximum CPP, is left with a retirement income of $35,621, or only about 37% of their pre-retirement household income. And this assumes that our average earning couple receives the maximum CPP, whereas we know that most Canadians receive only about 60% of the maximum CPP benefit.

4. For those who will depend only on the OAS, GIS and CPP, the future looks much as it does today – no changes are currently under public consideration by government for these programs. But there is, for this group, an important caveat. Measured by income replacement, this group is not coming close to the 70% replacement ratio that is generally considered to be desirable.

Pillar Three Seniors

1. The most significant changes underway today affect Pillar 3 pensions. As we have seen, Pillar 3 coverage is in steady decline. Within Pillar 3, DB pensions are in decline, especially in the private sector. And Pillar 3's purely voluntary RRSP savings are a small fraction of what they need to be in order to deliver decent retirement incomes. This means that, in the future, Pillar 3 seniors are not likely to enjoy the standard of living in retirement as today's Pillar 3 retirees.

2. Pillar 3 isn't easy to fix. DB pensions are unattractive to employers because they must be funded to protect against the employer's insolvency. Funding rules have been changed, in part, and continue to be adjusted, but deeper changes would weaken the reliability of the pension system, and erodes peoples' confidence in it. The alternative to funding is pension insurance, but this requires that premiums be set at proper levels, and most governments in Canada (most notably the federal government) have not been prepared to support the DB pension system in this way.

V. THE PARTIES' 2011 ELECTION PROPOSALS

Given the severity of Canada's pension crisis, it is not surprising that all federal parties have significant pension planks in their platforms. The main proposals are as follows:

1. **Financial Sector Sponsored Voluntary 'Pooled Registered Pension Plans' ("PRPPs") –** This proposal would allow insurance companies, banks and other financial institutions to offer DC retirement savings plans. On the one hand, this advances the cause of pension coverage by allowing for the creation of large plans that can aggregate the savings of many Canadians, and by allowing institutions other than employers to sponsor pension plans. This combination of advantages may be particularly useful for the self-employed. On the other hand, this proposal has three significant limitations:

    a. The only allowable benefit is a DC savings account. As discussed, this form of retirement savings does not offer the type of predictable retirement income that a DB plan offers, or that Canadians expect from the CPP.

    b. It is to be offered only by financial institutions - the same institutions that now offer Canadians mutual funds that are far too expensive in relation to readily available alternatives. Unfortunately, there is no reason to think that financial institutions would be any lower-cost in the proposed 'pooled retirement savings plan' than they are currently in their mutual fund offerings. Higher financial institution fees mean less money available for retirement and lower retirement incomes. It is not surprising that this proposal is strongly supported by the financial services industry.

    c. 'Pooled registered retirement plans' are intended to be entirely voluntary. However, the history of voluntary plans (RRSPs, for instance) is that they are terribly under-utilized and do not fill the retirement savings gap, even with significant financial and tax incentives. There is little reason to think that another voluntary plan will materially change the retirement income picture.

2. **'Secure Retirement Option' to be administered by the Canada Pension Plan Investment Board –** This is also a proposal to create a new, defined contribution plan that is not sponsored by an employer. In this case, the Secure Retirement

Option would be sponsored by the Canada Pension Plan Investment Board. This proposal is therefore similar to the PRPP, but, rather than being provided through the financial services sector, it would be provided through the Canada Pension Plan Investment Board, on a not for profit basis. Because it eliminates the complexities and fees of the financial services sector, this option is preferable to the PRPP. However, the 'Secure Pension Option' is still a voluntary plan, and so unlikely to have a significant impact on pension coverage or the level of retirement savings[27].

3. **CPP Enhancements –** These are proposals to gradually increase the CPP so that it replaces more than the 25% of average lifetime income for those who have earned up to the average industrial wage. The NDP proposes to double the CPP over a period of time and to permit Canadians to make additional voluntary contributions to the CPP; the Liberals propose an increase but haven't set out the amount or nature of their proposed changes to the CPP. The Canadian Labour Congress has estimated that doubling the CPP benefit would require an employee contribution increase of .43% of pensionable earnings (earnings up to the YMPE) each year for 7 years, and matching employer contribution increases. The CPP is a defined benefit plan, that provides predictable and secure retirement benefits. The CPP is available to all employed and self-employed Canadians, and its benefit is full portable so that people can build a CPP pension regardless of where they work. This option is most likely to provide the pension coverage Canadians require, at a reasonable expense.

4. **OAS and GIS Improvements –** The Liberals, NDP, Conservatives and Bloc Quebecois have proposed steps to enhance and improve the OAS and GIS. These include increases in annual GIS expenditures (by $700 million per year, under NDP and Liberal proposals and $300 million per year under the Conservatives' proposal, and in the monthly payments to eligible recipients by $110 under a proposal by the Bloc Quebecois) and to automatically enroll eligible seniors for the OAS and GIS and provide extended back payments to late enrolled eligible seniors. Automatic enrolment would address the significant number of seniors who are eligible for the GIS but do not apply for it.

5. **Private Pension System Supports –** The NDP and the Liberals both propose supports for the private Pillar three pension system. The NDP supports a national pension insurance arrangement, protecting up to $2500 in monthly pension benefits. The NDP also proposes to establish a national agency to assist private pension plans where their employer sponsors are insolvent. The Liberals also propose a stranded pension agency, which will allow private pension plan members to transfer their pensions to the CPP when their employers become insolvent. Pension insurance arrangements will support existing defined benefit plans and encourage new ones; stranded agency proposals will alleviate the worst consequences for members and pensioners when the employer sponsors of their pension plans become insolvent.

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[27] The 'Secure Pension Option' is promoted by the Liberal Party of Canada.

6. **Disability Benefits –** Although not part of the pension system perse, disability benefits are much like pension benefits. Like pensions, disability benefits are income support programs that pay a benefit over a lengthy period, often for the remainder of a recipient's life. However, unlike pensions, no law requires that disability benefits be funded at all – they may simply be paid from an employer's operating revenue. So, when an employer becomes insolvent, disability benefits are in serious jeopardy, and may terminate altogether. The Conservative Party has proposed preferential tax treatment for amounts received as lump sums on account of the termination of disability benefits, where the receipt arises before 2012. The Liberals and the NDP propose better protection for disability benefits in the bankruptcy process. The Conservative proposal will assist disability recipients who receive lump sum payments, but only if their entitlements arise before 2012. The NDP and Liberal proposals to reform the Bankruptcy and Insolvency Act could assist disability claimants in the future as well.

7. **TFSA Enhancement –** The Conservatives propose doubling the tax free savings account (TFSA) limit from $5,000 to $10,000 annually, once the federal budget is balanced[28]. The TFSA is a savings account in which investment income and capital gains are not taxed, and withdrawals from a TSFA do not affect a senior's entitlement to the GIS or certain other income supports. However, amounts in a TFSA may be withdrawn at any time and for any reason, and are not targeted specifically to retirement savings. They are provided by the financial services sector and attract financial service sector fees.

In summary, the pension proposals break down into four categories: (i) OAS/GIS enhancements; (ii) CPP enhancements; (iii) financial sector product enhancements; and (iv) support for the private pension sector. In addition, there are important proposals regarding disability benefits from the NDP and the Liberals.

The main differences between the parties are that the Conservative proposals focus on enhanced financial sector offerings (TFSAs and PRPPs), while the other parties emphasize the universal OAS/GIS and CPP. The Conservative platform does not create any supports for the private pension system, while the NDP proposes a supportive pension insurance plan and the Liberals propose a 'stranded pension agency' to help pension plan members affected by a bankruptcy to move their pensions to the CPP.

Australia has in place a mandatory defined contribution pension system, under which a large number of for-profit and not for profit companies provide retirement savings plan options. The theory was that competition between the providers would lower costs, but this hasn't really happened. A recently published report on Australia's mandatory DC financial sector funds, the "Super System Review Final Report" concluded that competition had failed to deliver low fees for the following reasons:

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[28] The Conservatives argue that they would balance the federal budget within the next mandate.

"3.3 Why hasn't competition delivered optimal outcomes already?

In classical economic theory, markets efficiently allocate resources, shape products and determine prices. In superannuation, competition in the market for super at the consumer level (i.e. between funds competing for the business of a new member) has so far been relatively weak. This is because superannuation is different. In addition to the fact that super is compulsory, normal consumer demand-led competition is made more difficult because:

Failure to exercise choice: Often a member doesn't choose the fund to which they belong. New employees typically simply become a member of their employer's default fund;

Lack of price awareness: Compulsory contributions don't come directly out of members' pockets, nor do the fees and other costs charged by the fund (at least not until they retire). This makes people much less price aware and much less likely to make a decision based on price or cost;

Lack of interest: Members are often not engaged with their super until closer to retirement and so will not be sufficiently interested to respond to competitive behaviour on the part of funds until that time (if at all);

Agency and structural issues: There are limited opportunities for member vigilance, on the one hand, or incentives for agency vigilance, on the other, to reduce prices;

Complexity: Super is inherently complex and many consumers do not feel confident making decisions about it;

Lack of comparability: Even if members are engaged up to a point, there is a lack of contestability at consumer level because of product complexity and lack of information and transparency about fees and performance; and

Frictions: Lastly, even if someone is interested in switching funds, often the paperwork and other frictions' in changing funds become too big a disincentive and they give up."

We should expect the same problems with a financial service sector model in Canada. Fees and expenses would likely remain high because the competitive offerings are complex, differ considerably the one from the next, and are therefore difficult to

understand and compare, all of which make it very difficult if not impossible for 'consumers' to use the power of the marketplace to insist on lower prices and better products. We are likely to have a high expense result with the proposed financial sector products, much as we have had with RRSPs. This analysis suggests that the Conservative PRPP and TFSA proposals will not be as effective for Canadians as the Liberal 'Secure Retirement Option' or the voluntary additional CPP contribution option promoted by the NDP.

A second difference between the parties in this area concerns mandatory versus voluntary pension programs. Ultimately, most peoples' retirements depend on some combination of both mandatory and voluntary elements. In Canada, mandatory elements focus on two things - universal benefits to combat poverty among seniors (OAS and GIS), and a modest universal benefit above the GIS low income threshold to preserve the basics of a middle class retirement (the CPP). We have relied on the voluntary elements – Pillar 3 – to secure retirements above these levels. The crisis today is very much a Pillar 3 crisis, caused by declining participation rates, declining contributions, declining quality of coverage and relatively high fees. The voluntary alternatives aren't likely to fix these problems. This means that, if middle class retirements are to be protected, the mandatory CPP must be improved to fill at least part of the gap created by the decline of Pillar 3 retirement arrangements.