

# VISION

JANUARY 2010 VOLUME 13 NUMBER 1

## Retirement Trends in Canada – A Fresh Perspective

**I**n 1999, we published a Vision entitled Retirement Trends in Canada – An Overview. In 2004 we followed up with Retirement Trends in Canada – 5 Years Later, one of our most successful issues ever. (Both are still available in PDF form, at [www.morneausobeco.com](http://www.morneausobeco.com)). Another five years has passed and we are pleased to offer the third installment in this long-term series. In addition to presenting a high-level view of what is currently happening, we will take a look back at past predictions.

---

MORNEAU  
SOBECO

Shepell·fji

Morneau Sobeco has a new website.  
Check it out at [www.morneausobeco.com](http://www.morneausobeco.com)

## THE PENSION DISCONNECT – DOES CANADA REALLY HAVE A PROBLEM?

A curious disconnect is emerging in Canada. A chorus of prominent voices has been lamenting the dismal condition of Canada’s “ailing” pension system and exhorting our politicians to act.

The Canadian Institute of Actuaries (CIA) published a paper in October 2009 that starts out, “For some time, it has been apparent that the Canadian pension system is facing dire circumstances.” It goes on to describe the litany of troubles that readers of this *Vision* will already be familiar with, including funding deficiencies, retirement savings that have “melted away” during the financial crisis, and low pension coverage.

The CIA is not alone. The Canadian Association of Retired Persons (CARP) claims, “Unless workers save more than they currently do through the Canada Pension Plan (including the Quebec Pension Plan), unacceptable levels of poverty among older Canadians will continue.” The 2008 report of the Alberta/B.C. joint expert panel concluded, “The pension system in Alberta and British Columbia is not working well for the majority of Albertans and British Columbians,” and also noted, “The challenges facing the system extend beyond our borders.” The Conference Board of Canada declares, “Many pension leaders acknowledge that radical action is necessary to put things right for the long-term.”

But is our pension situation as dire as it has been painted? The statistical evidence tells a different story.

We will start with news from the Organization for Economic Co-operation and Development (OECD). In its 2009 report, the OECD states that the proportion of retirement income coming from private pensions and other financial assets in Canada is one of the

highest among OECD countries. Income safety nets for seniors are among the highest in the OECD, helping Canada enjoy one of the lowest retiree poverty levels relative to average earnings.

In October 2009, another international body<sup>1</sup> reported that Canada’s retirement system ranks fourth on a global pension index at 73.2, which is just behind the Netherlands (76.1), Australia (74), and Sweden (73.5). Highly developed countries such as Germany and Japan ranked much lower than Canada.

Income safety nets for seniors are among the highest in the OECD, helping Canada enjoy one of the lowest retiree poverty levels relative to average earnings.

This sounds quite positive, but could it be that we’re in the midst of a decline that is not captured by these indexes? Surely Canadians cannot be as well prepared for retirement now as they were 20 years ago, after the last wave of pension reform? This leads us to a second indicator.

A newly released Statistics Canada study shows that at the end of 2008, pension assets in Canada (including social security, occupational plans and RRSPs) totaled \$1.8 trillion. Even though this tally was made near the bottom of the market collapse, it still represents 3.6 times the assets we had in 1990. Even if we adjust for inflation and population change, the 2008 value is still more than double what it was in 1990.

Clearly, we are doing something right in terms of accumulating pension assets. What is better, elderly Canadians are getting their share of the pie. The statistics on this may be surprising but before we get to them, we need to define poverty in a Canadian context.

There is little absolute poverty in Canada if this means living in a state of absolute deprivation. Poverty is usually defined in relative terms: that is, having income

<sup>1</sup> Melbourne Centre for Financial Services in collaboration with Mercer

below a certain level. The most commonly cited measure is Statistics Canada’s Low Income Cut Off (LICO) which is a hybrid of absolute and relative measures of poverty.

The proportion of older Canadians who would be classified as poor under the LICO test turns out to be quite small. Only 4.8% of persons over 65 have income that is below the LICO on an after-tax basis. In a recent study, Michael Veall<sup>2</sup> found that no country has experienced as sharp a decline in elderly poverty since the 1970s as Canada. In fact, only four countries (all European) had poverty rates among the elderly that were lower. If there is a poverty problem, it is younger Canadians who bear the brunt of it. The 2007 figures from Statistics Canada show that 9.9% of persons between ages 18 and 64 are below the LICO – more than twice the percentage of the elderly!

To summarize, we find that (a) Canada has nearly eradicated poverty amongst its seniors, (b) we have made more progress in this regard in recent years than any other developed country, and (c) our seniors are appreciably better off than our younger citizens.

With this backdrop, how do we reconcile the impression that Canada is facing a pension crisis?

## WHY WE THINK WE HAVE A PENSION PROBLEM

It seems we have the income in retirement to meet our basic needs but not necessarily to meet all of our wants. For illustration purposes, consider the following table which defines five levels of pre-retirement earnings for a single-income couple:

Income Level	Pre-Retirement Earnings	Target Retirement Income (% of Pre-Retirement Earnings)
Low I	\$ 15,000	100%
Low II	\$ 30,000	80%
Middle I	\$ 50,000	70%
Middle II	\$ 80,000	60%
High	\$150,000	50%

The target retirement income for each income bracket is a somewhat arbitrary percentage. It is more than enough to satisfy the basic necessities but perhaps a little less (at least at the higher income levels) than is needed to maintain the pre-retirement standard of living.

Based on these target percentages, the chart below shows the gap that has to be filled at age 65 with retirement income from personal savings, occupational pensions, and other sources.

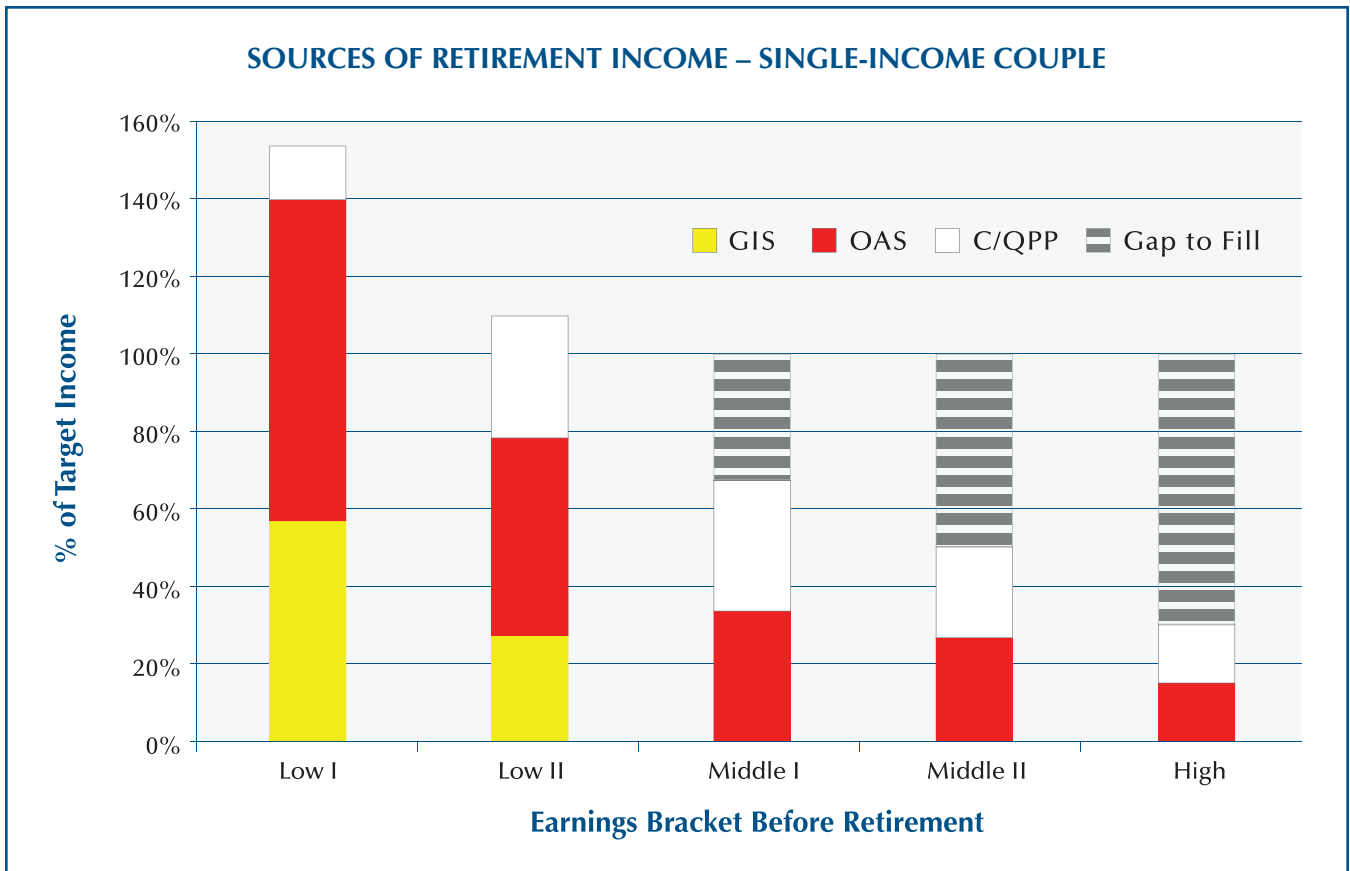
### GLOSSARY OF ACRONYMS

“CAP” means capital accumulation plan, including DC pension plans, RRSPs, TFSA, and Deferred Profit Sharing Plans.

“DB” means defined benefit.

“DC” means defined contribution and may mean only defined contribution pension plans or all capital accumulation plans, depending on the context.

<sup>2</sup> Canadian Pension Policy, November 2008



This chart indicates there is no retirement income gap to be filled for low-earners but there is a gap for middle and high earners – one that gets larger as earnings rise. From this, pension observers have somehow come to the conclusion that the gap is, in fact, too large and hence we must be facing a pension crisis.

The conclusion that better fits the facts is we have underestimated the resourcefulness of Canadians. We have found ways to fill a good portion of the gap through a variety of means, including RRSPs, occupational pensions, inheritances, small business ownership, and downsized homes. Very seldom do Canada’s seniors ask for a handout to make ends meet. *The irony is that those seeking government bailouts tend to be the stakeholders of multi-billion dollar pension funds that already provide pensions in excess of what the average Canadian enjoys.*

### WHAT NEXT?

Let’s pause to give ourselves, Canadians, a collective pat on the back for doing a better job preparing for retirement than we thought. Of course, there is still work to be done. If we downgrade the rhetoric from “crisis” to “problem” there are still issues that need to be addressed. Two issues in particular stand out.

## LOW PENSION COVERAGE

In a Canadian context, talk of low pension coverage refers to the participation rate within occupational registered pension plans. The percentage of paid workers who are covered by an occupational plan fell from 46.1% in 1977 to 38.3% in 2007. If we focus only on workers in the private sector, the percentage is much lower again. There are many reasons for this decline, including:

- Growth of group RRSPs as the primary retirement vehicle (RRSPs are not included in the coverage figures),
- Decline in the unionized workforce (where pension plans prevailed), and
- Increase in workforce mobility and the resulting de-emphasis on pensions within the compensation package.

It is important to realize that while better coverage within occupational plans is desirable, our goal is for something less than 100% coverage. Here are some reasons:

- As we have seen, low income employees can already expect retirement income from government sources alone to replace 100% of pre-retirement earnings,
- The coverage rates do not include participation in group RRSPs, which are essentially equivalent to DC pension plans,
- Young employees may be wiser to pay down debt first, and
- The self-employed will tend to rely on personal savings plus their businesses.

Even with these caveats, it is desirable to make it easier for Canadians to close the pension gap. Other than encouraging personal savings, there are basically three ways to improve the situation:

1. Expand the Canada/Quebec Pension Plan (C/QPP).
2. Make it easier for employers to set up and maintain occupational pension plans.
3. Introduce a government-sponsored CAP to supplement social security.

Expanding the C/QPP is an idea that has the backing of CARP, the Canadian Labour Congress, and the NDP, among others. It would, however, appear to be a non-starter. The OECD reported, in June 2009, that OECD countries face budget deficits of 9% of GDP, which leaves little room for generous public pensions. Some countries have already cut back future spending on public pensions and others are considering it. To expand our own social security at a time when others are doing the opposite appears questionable at best and highly irresponsible at worst. We could well be creating a significant financial burden for our children and grandchildren.

The second option – promoting the occupational pension system – is something that we strongly endorse. It is also where the pension industry has been focusing most of its energies of late, as was highlighted by the recommendations of the expert review panels across Canada (see our March 2009 *Vision, Pension Reform Across Canada*). While this is a laudable initiative, we realize that progress will be difficult. Coverage has been declining not expanding, and the new reform initiatives would be doing well if they merely stabilize the situation.

Employers want less regulation, but this is not what governments tend to deliver. Given the calls for funding relief within DB pension plans in the past 12 months, governments will be even less inclined to propose employer-friendly regulations; such measures might be perceived as putting members' pensions further at risk (and might even do so in some cases).

In the short term, the most likely outcome for the occupational pension system is that it will become even more closely regulated in reaction to the financial crisis – a good thing for the individuals who are lucky enough to enjoy coverage. The downside is that the majority of the private sector workforce will not have access to occupational pensions. Nothing on the horizon, including recent changes to federally regulated plans or the Ontario announcement that pension reforms are on the way, seems likely to change that. Our prediction is that the occupational pension system will carry on, and it may even thrive again if new plan designs such as hybrid plans and target benefit plans ever become popular.

We now come to the third option: introducing a government-sponsored plan to supplement C/QPP. A number of approaches have been proposed, such as Keith Ambachtsheer's Canada Supplementary Pension Plan<sup>3</sup> and the Joint Expert Panel on Pension Standards' (JEPPS) ABC plan. The various proposals share some basic characteristics. They are:

- Run by the government or some other entity that is overseen by the government (a private-public partnership is also possible),
- Available to any employee in the province (or the country, if it becomes national) on an optional basis, possibly with auto-enrollment,

- Defined contribution, not defined benefit, and
- Low administration and low investment fees (likely below 50 basis points).

As this *Vision* goes to press, it is highly likely that B.C. and Alberta will decide to implement a plan with these characteristics – at least for employees in their respective provinces. The question is, where it will go from there. Three possibilities are:

Given the calls for funding relief within DB pension plans in the past 12 months, governments will be even less inclined to propose employer-friendly regulations.

1. It might remain a solution solely for Western Canada.
2. Other provinces might jump on the bandwagon.
3. It might morph into a national initiative.

In our opinion, a government-sponsored supplementary DC plan *might* be a good thing if it is done right. First, we need assurance that the governance issues that plagued

the Caisse de Dépôt recently cannot recur. Second, investment management fees would need to be low. Third, under no circumstances should participation in such a plan be mandatory. If the issue is meeting wants rather than needs, contribution levels should be left to the discretion of individuals and their employers rather than being mandated by government.

As we have seen, Canada's pension problems are minor relative to almost any other developed country. Any substantial increase in forced savings could result in many Canadians over-saving for retirement and doing so at the expense of their pre-retirement lifestyle. The right contribution rate for a single-income family in a rental unit, where the earner works until 60, will be excessive for a dual-income family that own their own home and work until 70.

<sup>3</sup> C.D. Howe Institute Commentary, May 2008.

## LONGEVITY RISK

We can expect to live about five years longer now than we were back in the 1960s. While it means that defined benefit pensions have become more expensive, the cost has been manageable for the sponsors of DB pension plans. Each cost increase has been fairly modest and has been preceded by sufficient notice.

Longevity risk is a bigger problem, though, for society as a whole and for individuals who rely on personal savings or CAPs for much of their retirement income.

From a society perspective, people living longer means that fewer workers will support more retirees. This effect can be mitigated if the starting age for full government pensions (now 65) increases in lockstep. To some industry observers, it seems natural and even inevitable that increases in life expectancy should result in an increase to the retirement age for full government pension. This has indeed happened in some developed countries, including the US (where the age is now 67), but it is unlikely to happen here for some time, if only because the issue has not received much national exposure thus far.

For individuals, longevity risk is the risk of outliving one's retirement savings. Someone retiring at age 60 may live one year longer or 40 years longer. Longevity is an issue mainly for middle-income Canadians who rely on personal savings and CAPs for a good part of their retirement income. Unless one buys an annuity, the retiree is almost certain to face one of three outcomes:

1. Spending too much and actually outliving his/her savings.
2. Spending too cautiously and thus living unnecessarily below one's means in retirement.
3. Spending the right amount but worrying the entire time about outliving one's savings.

The obvious solution – buying an annuity – is something that few Canadians are willing to consider when given the choice. There are many reasons for their reluctance such as wanting to maintain control of their capital. Some of these reasons are quite defensible and no amount of “education” will change the minds of most pending retirees. As more CAP participants reach retirement age, insurance companies would be well-advised to create new annuity products that overcome the perceived shortcomings – though this is more easily said than done.

A less obvious, but more promising, solution might be to allow the pension start date for C/QPP and OAS to be deferred as late as age 75 (retirees could receive about double the annual pension as a result). The individual who chose this option would then use accumulations from personal

savings and CAPs to provide income between retirement age and age 75. If one could postpone receiving government pensions, the problem of spending the right amount of personal savings is concentrated within a shorter period, thereby eliminating much of the longevity risk.

A less obvious, but more promising, solution might be to allow the pension start date for C/QPP and OAS to be deferred as late as age 75.

LOOKING BACK – WHAT WE SAID IN 2004

We will close with a summary of the trends that we identified five years ago along with a description of what has actually happened.

What We Said in 2004	What Has Happened
<p>In 2004, <b>low pension coverage</b> in occupational plans was the biggest issue.</p>	<p>Low coverage is still the biggest issue. Besides improving the occupational pension system, a government-run supplementary CAP may become reality in the near future.</p>
<p><b>Accounting was moving to mark-to-market (M2M)</b> meaning immediate recognition of gains and losses. We said this would drive employers from DB to DC.</p>	<p>The move to M2M has not occurred yet, but part of it is expected in 2011 when IFRS accounting takes effect in Canada. Some migration to DC since 2004 has occurred nonetheless.</p>
<p>We thought <b>plan design</b> would become <b>more flexible</b> in terms of organizations having both DB and DC pension plans.</p>	<p>Any apparent flexibility is actually due to closed or grandfathered DB pension plans coexisting alongside newer DC pension plans in the same organization. Unless something dramatic occurs (see “innovation” below) those closed DB pension plans will eventually vanish, leaving only the DC arrangements.</p>
<p>We noted that pension legislation discouraged <b>innovation in plan design</b>, i.e., hybrids with DB and DC elements.</p>	<p>The Expert Panels on Pension Reform in Nova Scotia, Ontario, Alberta, and B.C. all acknowledged that innovation is needed if the occupational system is to thrive. The challenge will be to encourage DC pension plan sponsors to adopt hybrid plans.</p>
<p>We said that <b>public sector DB pension plans</b> would <b>convert to DC</b> only if public pressure for change became too intense.</p>	<p>Our two-tiered pension system in Canada (with the private sector being the “have-nots”) is a growing issue but we do not expect public sector DB pensions to convert to DC any time soon.</p>
<p><b>Age 65 will lose its magic.</b> Mandatory retirement will be abolished and the pension commencement age for full social security pensions would eventually rise.</p>	<p>Mandatory retirement has indeed been abolished and with increasing life spans, there is more discussion of increasing the age for full pension entitlement. Nothing is expected to happen for years to come, though.</p>
<p><b>Financial economics</b> was gaining currency. This basically means securing pensions with bonds rather than stocks.</p>	<p>The application of financial economics to pensions never became a trend, partly because interest rates went too low and the apparent cost impact was too great. We are, however, seeing more pension funds reducing their equity weighting.</p>
<p>We noted the <b>leading edge of baby boomers</b> was 58 and that employers would want to eliminate early retirement subsidies to discourage their employees from retiring in droves.</p>	<p>It proved to be mainly public sector employers who sought to keep older workers around and they did this by adding phased retirement, not by taking away entitlements. In the private sector, economics has trumped demographics. Few companies are trying to discourage older employees from retiring, even though the leading edge of boomers is now 63.</p>
<p>The <b>DC time bomb</b>: when DC participants start to retire in large numbers, it will cause potential fallout.</p>	<p>That bomb may never go off but simply seep gas from time to time. The 2008-09 market meltdown has indeed caused some employees in CAPs to defer retirement but few see this as a crisis.</p>

### CONCLUSIONS

Canada's pension system is a lot stronger than we think. We can still fine-tune it by promoting occupational pensions, but this will require pension legislation that is more employer-friendly than we expect to see any time soon. Hybrid plans, however, may still become the answer.

We can also strengthen the system by bringing in provincial or national supplementary savings plans but these should be voluntary in nature, low in cost, and accompanied by strong governance.

The reality is that an increasing number of Canadians are going to receive retirement income from CAPs rather than from DB pension plans. This means that longevity risk (at the individual level) will become a bigger problem. Government can alleviate that risk by allowing deferral of OAS and C/QPP pensions beyond 65.

## OTHER PUBLICATIONS BY MORNEAU SOBECO



PUBLICATION	WHAT IT IS	FREQUENCY
<i>60 Second Survey</i> *	A quick (4-question) survey on a pension or benefits topic of current interest; results are sent a week later	Monthly
<i>News &amp; Views</i> *	Description of recent pension & benefits developments	Monthly
<i>30,000 Feet</i> *	A companion to News & Views, briefly summarizing developments most likely to have lasting implications	Quarterly
<i>Vision</i>	In-depth analysis of a major pension or benefits issue of long-term significance	2-4 times a year
<i>Universe</i> *	Survey of pooled fund investment returns	Quarterly
CICA Accounting Survey	Survey of economic assumptions used for accounting purposes by 100 Canadian public companies	Annual
Statistics*	Compendium of pension and benefits statistics	Annual
Morneau Sobeco Handbook	Reference manual on pensions and benefits, published by CCH	
Summary of Pension Legislation	On-line detailed summary of differences in pension legislation by jurisdiction (published by CCH)	

\* A link to the Morneau Sobeco web-site is sent to subscribers by e-mail; other publications are paper-based.

## VISION

---

### ABOUT MORNEAU SOBECO

Morneau Sobeco Income Fund is the largest Canadian-owned firm providing human resource consulting and outsourcing services. Through Morneau Sobeco and Shepell-fgi, its two operating entities, the firm delivers solutions to assist employers in managing the financial security, health and productivity of their employees. With over 2,300 employees in offices across North America, Morneau Sobeco Income Fund offers its services to organizations that are situated in Canada, in the United States and around the globe.

#### CALGARY

---

940 6<sup>th</sup> Avenue SW  
Suite 1121  
Calgary AB T2P 3T1

**T** 403.246.5228  
**F** 403.246.5257

#### FREDERICTON

---

77 Westmorland Street  
Suite 300, Frederick Square  
Fredericton NB E3B 6Z3

**T** 506.458.9081  
**F** 506.458.9548

#### HALIFAX

---

5151 George Street  
Suite 1700  
Halifax NS B3J 1M5

**T** 902.429.8013  
**F** 902.420.1932

#### KITCHENER

---

Duke Tower, Suite 301  
30 Duke Street West  
Kitchener ON N2H 3W5

**T** 519.568.6935  
**F** 519.568.7002

#### LONDON

---

255 Queens Avenue  
Suite 700  
London ON N6A 5R8

**T** 519.438.0193  
**F** 519.438.0196

#### MONTRÉAL

---

Tour de la Bourse – Place Victoria  
800, rue du Square-Victoria  
Bureau 4 000, C.P. 211  
Montréal QC H4Z 0A4

**T** 514.878.9090  
**F** 514.875.2673

#### OTTAWA

---

99 Metcalfe Street  
Suite 1203  
Ottawa ON K1P 6L7

**T** 613.238.4272  
**F** 613.238.3714

#### PITTSBURGH

---

Seven Parkway Center  
875 Greentree Road, Suite 500  
Pittsburgh PA 15220

**T** 412.919.4800  
**F** 412.922.6619

#### QUÉBEC

---

79, boul. René-Lévesque Est  
Bureau 100  
Québec QC G1R 5N5

**T** 418.529.4536  
**F** 418.529.6447

#### ST. JOHN'S

---

16 Forest Road  
Suite 303  
St. John's NL A1C 2B9

**T** 709.753.4500  
**F** 709.753.3207

#### TORONTO

---

895 Don Mills Road, Suite 700  
One Morneau Sobeco Centre  
Toronto ON M3C 1W3

**T** 416.445.2700  
**F** 416.445.7989

#### VANCOUVER

---

2925 Virtual Way  
Suite 310  
Vancouver BC V5M 4X5

**T** 604.642.5200  
**F** 604.632.9930

WEB SITE: [www.morneausobeco.com](http://www.morneausobeco.com)  
E-MAIL: [info@morneausobeco.com](mailto:info@morneausobeco.com)