24 FEBRUARY 2010

TWO PERSPECTIVES ON PENSION REFORM

Crisis? What Crisis?

BY PAUL FORESTELL

D uring 2009, retirement savings frequently made headline news. The news stories all focused on the same question, regardless of whether it was asked in the context of employer-sponsored defined benefit (DB) plans or defined contribution (DC) plans or of individual Canadians’ RRSPs: Do Canadians have enough retirement savings?

When all equity markets simultaneously went into free fall in the second half of 2008, retirement assets in Canada and the rest of the world went down with them. Pension coverage levels—particularly in the private sector—were scrutinized, and many raised concerns about inadequate pension coverage in Canada.

Leading the way on this issue were the governments of Alberta and British Columbia, with their proposal for a broad-based DC plan for all Canadians. Based on this discussion, pensions became a key agenda item at the much-anticipated meeting of provincial and federal finance ministers in Whitehorse on Dec. 8, 2009.

Moving Toward Reform
What happened in Whitehorse? Jack Mintz, research director for the Working Group on Retirement Income Adequacy of Federal-Provincial-Territorial Ministers of Finance, presented his report, which found that the Canadian retirement system is working well and, in fact, is one of the best systems in the world. His conclusion is consistent with the Melbourne Mercer Global Pension Index, which ranked Canada fourth out of 11 countries.

So do we have a pension problem? If so, what is it, and what should we do about it?

The Options
The problem is likely not as dire as it has been portrayed in the headlines, but it still exists. We should be concerned about a decline in pension coverage, as this could set us up for issues down the road.

Give Choice a Chance

BY RANDY COLWELL

M any countries are dealing with the issue of a significant savings shortfall for certain groups of individuals at or near retirement. Canada is one of them, and we may be drifting further in that direction—with a very real risk of falling behind the savings pack.

The Canadian savings rate is currently below that of the U.S., France, Germany and Italy. In fact, Canada now has one of the lowest savings rates among the 20 member countries of the Organisation for Economic Co-operation and Development. With an estimated 3.5 million private sector workers without an occupational retirement income and savings plan, action is necessary to ensure that future Canadian retirees have an adequate level of income in retirement.

But what type of action is best? Expand the benefits and contributions for the Canada/Quebec Pension Plan (C/QPP)? Create a national government-run defined contribution (DC) plan?

Both approaches have their supporters, but an examination of the reforms in other countries suggests there may be more effective methods of encouraging Canadians to save more for retirement—methods that preserve choice at both the employer and individual saver levels but also contain strong incentives to increase saving.

The Post-Whitehorse Consensus
The December 2009 meeting of government finance ministers in Whitehorse revealed a consensus among many participants: the system in which we are operating isn’t broken, and most Canadians will likely have enough retirement income to sustain an adequate standard of living in retirement. However, pockets of under-savers do exist. Estimates suggest that one-fifth of Canadians may not have sufficient savings to replace at least 90% of their pre-retirement consumption, with higher degrees of inadequacy especially for middle-income Canadians.

How can we turn our collective energy to improving the system and ensure that more Canadians are better financially prepared for retirement? Any plan to improve the retirement income and savings system should close the pension coverage gap and provide retirement income adequacy for life in an affordable way. The system needs to be sustainable during tough economic times and accessible to all Canadians. These adjustments must be doable on a timely basis, and what better way to make improvements than by sharing the responsibility between individuals and government?

Here’s a closer look at a proposed solution that meets those objectives and includes some of the features that are currently at work in varying forms outside of Canada.

A Nudge in the Right Direction
This solution involves making legislative changes to enable retirement and savings providers to create national multi-employer DC pension plans, which also include provisions for self-employed people to contribute. Under such a national multi-employer arrangement, employers without a suitable retirement savings plan would offer occupational savings options to their employees and still retain control over three key aspects: choosing their own qualified providers, determining their own employer contribution rate and, if desired, opting out of the plan completely.

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No retirement system is perfect, nor is any about to become perfect. Bad things can—and do—happen to good retirement systems. However, there are steps that we should take to make the Canadian system more robust and flexible to handle the economic changes that will inevitably occur. The Whitehorse meeting focused on three possibilities:

1. An expanded Canada/Quebec Pension Plan (C/QPP);
2. A voluntary broad-based DC plan sponsored by the government; and
3. A voluntary broad-based DC plan sponsored by the private sector.

While an expanded C/QPP may seem appealing, the financials will likely make it ineffective. Contributions would need to increase dramatically over a short period of time, while pension increases would need to be phased in over 30 to 40 years. Unless this happens, the cost of the expanded C/QPP will lead to intergenerational transfers. In other words, a smaller working population would be paying more than just the cost of its benefits in order to pay for a large number of baby boomers who retired with increased pensions.

Broad-based DC plans have more merit as a potential tool to address pension coverage. Canada already has a DC approach with its RRSPs and tax-free savings accounts (TFSA). However, many studies have indicated that RRSPs are underutilized. Any proposals to implement a voluntary DC plan must address the key barriers to saving under the current RRSP and TFSA structures, such as cost and flexibility.

Cost Concerns

The issue of cost relates to the fees paid by individual savers to their advisors and investment managers. While low-cost investment vehicles such as index funds, exchange-traded funds and online brokerages are available in Canada, a high proportion of retirement savings still finds its way into higher-cost funds where the difference in fees eats away at the return over time. Even in employer-sponsored DC plans, where fees are typically lower during the employee’s working life, employees are often forced to move their retirement funds into higher-cost vehicles at retirement.

The issue of fees should be addressed through a combination of investor education and low-cost, unbiased advice. Investors need to understand the impact of high fees on their retirement savings and how to manage this cost better. An advisor’s compensation is higher when individuals choose higher-cost funds. It’s crucial that unbiased, non-conflicted advice is available to the individual investor.

A broad-based DC plan that spans a province or the country has the potential to lower costs through economies of scale that could result from larger pension arrangements. If this is combined with an investment structure that directs savings to lower-cost options, it will go a long way toward increasing the retirement savings of people who join the plan voluntarily.

The other issue that will need to be addressed is getting individuals and/or companies to join the arrangement voluntarily. Flexibility in the system will help encourage people to join. An individual’s ability to save for retirement varies greatly over his or her lifetime. In their ’20s, individuals are more likely to be at a lower pay level and have less money to set aside for retirement. Expenses tend to peak in their ’30s and ’40s, with mortgage payments and childcare costs eating up much of their income. Reducing their debt levels is—and should be—their first concern. As they enter their ’50s, disposable cash is available and individuals typically begin to seriously set aside money for retirement.

A Matter of Incentive

In order to create greater incentives to save, thought should be given to creating options for contributing and withdrawing money from the arrangement.

For example, given the typical pattern of savings by individuals, would it be possible to allow individuals to carry forward unused DC contribution room from their ’30s and ’40s to their ’50s? This option is already available for RRSPs, so it will not result in a tax cost and would make the broad-based DC plan more attractive to employees. Similarly attractive would be more flexible options to draw benefits upon retirement, allowing retirees to manage investment risk and longevity risk more cost-effectively.

For pension reform to be effective in increasing retirement savings for all Canadians, it must address the issues and barriers that are preventing Canadians from using all of the retirement savings tools currently available. In Canada, we have a very good retirement system—any reforms must ensure that we make it better. Reducing cost and increasing flexibility will be important elements of meeting this goal. BC

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But why choose to opt out when under a multi-employer arrangement:

• it is the provider that assumes the time-consuming duties of the administrator and carries out all regulatory and legislative requirements;
• the pooling of many employers and employees creates scale and offers a standardized plan design that allows for affordable plan prices and access to pooling of mortality risks; and
• employees can tap into a sophisticated customer service system that already exists, including telephone customer care centres, online financial planning tools and education materials to foster enhanced financial literacy.

To encourage working Canadians to save more, a multi-employer plan would also provide three “automatic solutions” for employees.

Automatic enrollment – Employees would be automatically enrolled into the plan at a pre-set contribution rate and invested in a default investment option. (Employees could opt out but would have to actively choose to do so.)

Automatic re-enrollment for those who opt out – Employees who choose to opt out would be automatically re-enrolled at the end of a three-year period. (Again, employees could opt out but would have to actively choose to do so.)

Automatic contribution increases – Employee contribution levels would be periodically (or at defined events, such as a pay raise) increased by a specified amount up to the plan’s maximum contribution amount.

While each of these solutions would be challenging to implement under our current employment and tax legislation, they are worth pursuing, as they’ve proven to be highly successful strategies for increasing savings in other jurisdictions.

Lessons From Abroad

People are often surprised to learn how widespread the use of automatic solutions is in many parts of the world and how successful they have been in getting more people to save more money for their retirement.

The concepts of auto-enrollment and automatic contribution increases have been enthusiastically embraced in the U.S., as evidenced by recent research on the issue from several U.S. industry leaders. For example, in a 2009 Watson Wyatt survey of 149 companies, 47% said they were auto-enrolling employees into DC plans. Of those that did not offer auto-enrollment, one-third were considering it.

Not only is auto-enrollment proving to be popular, but it’s also been highly effective. In a recently released study, Vanguard reported that plans with auto-enrollment features had an average participation rate of 84% versus only 60% in plans without auto-enrollment. Similar findings have been reported in other U.S. studies, and this trend is expected to continue. A Spectrem Group survey suggests that within two years, auto-enrollment will be in place in more than 80% of U.S. group retirement savings plans with $10 million or more in assets.

The use of automatic contribution increases has also been effective in increasing the savings rate. A study by Richard H. Thaler of The University of Chicago and Shlomo Benartzi of the University of California, Los Angeles found that a high proportion (78%) of those offered an automatic contribution increase arrangement agreed to join the plan. Of those who did, the vast majority (80%) remained in it through four pay raises, with the average savings rate increasing from 3.5% to 13.6% over the course of 40 months.

The use of auto solutions is also growing in the U.K. Hewitt’s annual U.K. DC survey indicates that the percentage of U.K. plans with auto-enrollment increased from 17% to 24% between 2007 and 2008. And, as with the U.S. experience, participation rates were significantly higher for plans with auto-enrollment than for plans without the feature (88% versus 50%).

The Value of Choice

Some have argued that a new agency should deliver a national DC pension plan, either by expanding an existing program such as the CPP or by creating a new government agency to deliver a new supplementary savings plan. However, there are risks to this approach. If the CPP is changed to play a significantly larger role, diversification would decline and risk would increase, as Canadians would be drawing a far greater portion of their retirement income from a single source.

There would also be inefficiencies through duplication. Canada’s financial services sector has already made significant investments in technology, established key investment management relationships to manage funds and built customer care centres and websites to handle millions of requests from retirement savings plan participants each year. Duplicating this effort within a new national agency would be both inefficient and time-consuming.

Finally, we live in a society that values choice. Competition is what drives product and service innovation, as well as continuous improvement among providers. For this reason, the best solution is not a system of mandatory worker contributions, even if the motive is to ensure high participation rates. Auto-enrollment and auto-increase of contributions with an opt-out is the right kind of choice: it is working well in other countries and can be successful in Canada, too.

To create a retirement income environment that permits and encourages all Canadians to save more for retirement through the workplace will take a joint effort by industry, government and individuals. Canada has a long and proud history of building public policies that serve one of the most diverse populations anywhere—while our system isn’t perfect, there’s no denying that it is admired worldwide. By working collaboratively, we can make the necessary adjustments to the retirement income and savings system that will allow and encourage workplace saving for all Canadians.

We’re fortunate to be able to choose from so many options, but we need to get it right. The financial future of generations of Canadian retirees depends on it.

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