The Actuarial Profession
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Pensions, benefits and social security colloquium 2011

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Pension Reform in Canada

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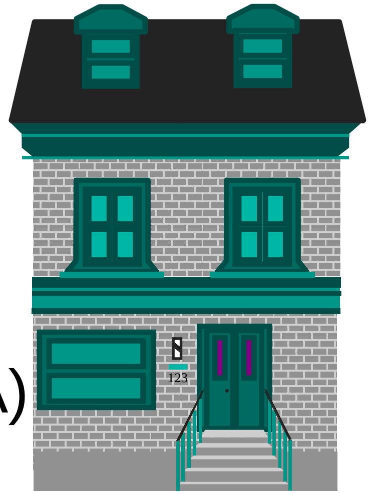
Presentation

- Canadian Retirement Income System
- Principles and Objectives of a Retirement System
- Reducing Poverty Among Seniors
- Incentives to Save and Work Longer
- Reasonable Economic Cost of Public Pensions
- Pension Reform for Retirement Income Adequacy
- Conclusion

Canadian Retirement Income System: Not all eggs in the same basket!

Canadian retirement system with mixed funding approaches is well recognized in the world for its capacity to adapt rapidly to changing conditions.

- Pay-as-you-go funding (OAS/GIS: universal basic pension/supplement)
- Partial funding (CPP/QPP: DB Earnings-Related)
- Full funding (Occupational Pension Plans/RRSP/TFSA)



What is society expecting from its retirement system?

A mixture of public / private and voluntary / mandatory pensions that results in:

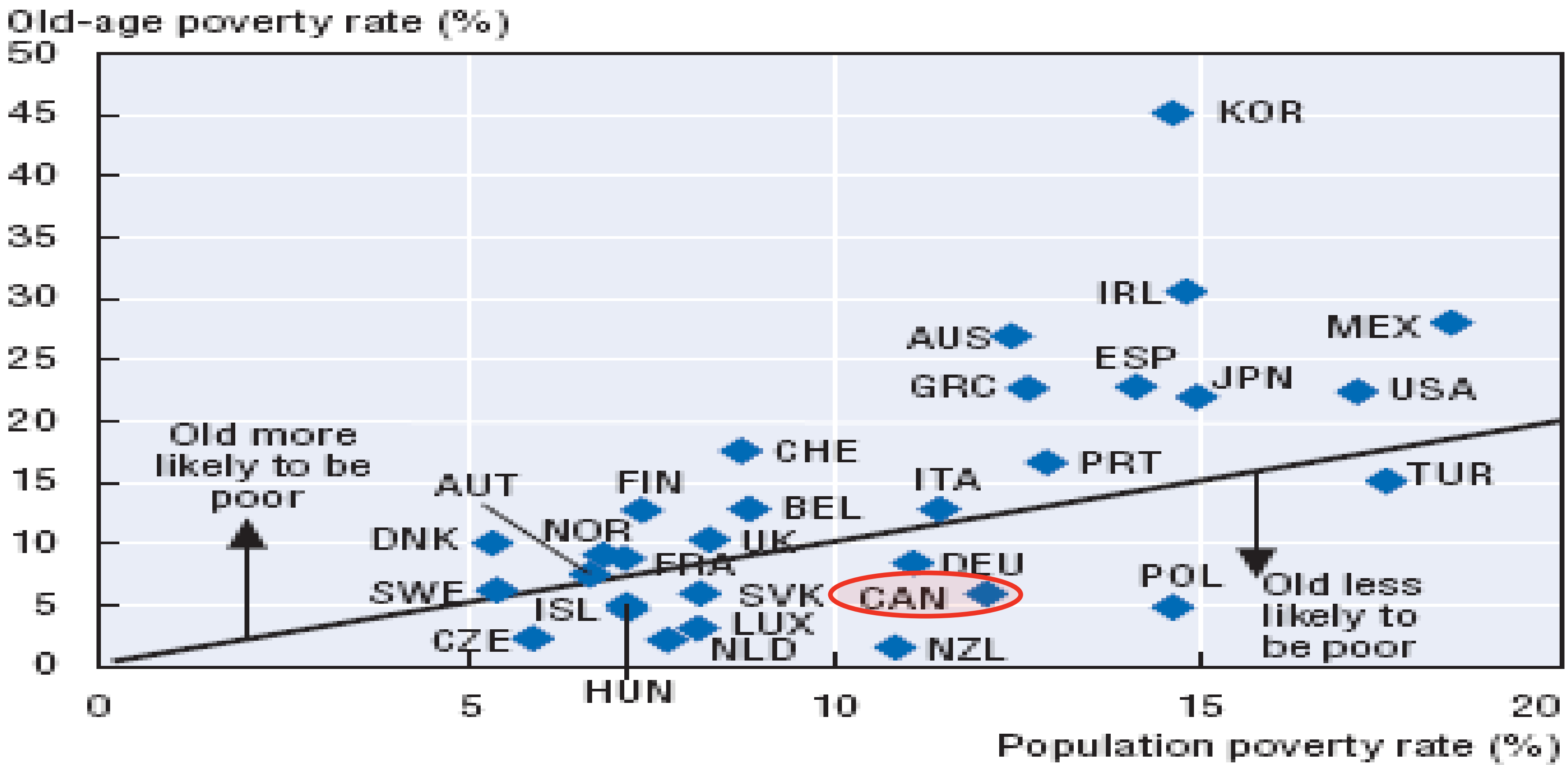
- **Affordable and sustainable** system
- Intergenerational **equity**
- **Solidarity:** society protects all individuals and collectively ensures a basic level of assistance/standard of living for low-income retirees
- **Responsibility:** retirement income security is a shared responsibility between the government, society, employers and individuals
  - Maintain standard of living after retirement
- **Proper interaction with labour market:** incentives to remain in the labour force and flexibility in work-to-retirement transition

Characteristics of an Efficient Retirement System

- Diversification of sources of retirement income
- Diversification of funding approaches
- Reasonable economic cost of public pensions (% of GDP)
- Reduction of poverty among seniors
- Reduction of income inequalities
- Maintenance of standard of living at retirement

Canada has one of lowest old-age poverty rates, but much higher population poverty rate

Income Poverty Rates of Older People (65+) and Whole Population, Percentage with incomes less than 50% of median household disposable income*



*OECD Pensions at a Glance 2011: Retirement-Income Systems in OECD and G20 Countries

OAS Program Benefits

- All OAS Program Benefits paid from general tax revenues.
- Basic OAS pension payable at age 65 based on years of residency.
  - subject to income tax, and a recovery tax for amounts exceeding $67,668.
  - indexed to inflation.
- Allowance is a monthly benefit paid to seniors with low income whose spouses/common-law partners receive the GIS and OAS, or to survivors, aged 60-64.
  - income-tested, not subject to income tax, indexed to inflation.

2011 Federal Budget:
Guaranteed Income Supplement (GIS) Top-Up

- GIS is a non-taxable monthly benefit paid to seniors who receive a basic OAS pension and who have little or no other income.
  - income-tested and indexed to inflation.
  - employment income deduction of $3,500 allowed.
- Canadian Federal Budget of 6 June 2011:
  - **Top-up of GIS effective 1 July 2011:**
    - annual top-up benefit of up to $600 for single seniors and up to $840 for couples.
    - estimated by Federal Government to improve financial security of more than 680,000 seniors.

Pension Reform in Canada – much research done

Much research and analysis conducted to date:

- “Research Study on the Canadian Retirement Income System” (Bob Baldwin, November 2009)
- “Summary Report on Retirement Income Adequacy Research” (Jack Mintz – Research Working Group on Retirement Income Adequacy, December 2009)
- “Options for Increasing Pension Coverage Among Private Sector Workers in Canada” (Colin Hansen – Steering Committee of Ministers on Pension Coverage and Retirement Income Adequacy, January 2010)
- “Securing Our Retirement Future: Consulting with Ontarians on Canada’s Retirement Income System” (Ontario Ministry of Finance, October 2010)
- *Etc.!: many more research papers…*

Pension Reform in Canada: Tax-Free Savings Accounts

- Tax-Free Savings Accounts (TFSAs) were introduced in Part 1 of Bill C-50 in 2008.
- Since 2009, Canadian residents aged 18 or older can contribute $5,000 annually to TFSAs.
- TFSA withdrawals as well as investment income earned in TFSAs (TFSA-related income) are tax-free.
- TFSA-related income does not affect eligibility for federal income-tested benefits, such as GIS benefits.

Incentives to save!

Tax-Free Savings Accounts *(cont'd)*

- TFSA-related income affects Old Age Security (OAS) Program benefits as follows:
  - The basic pension: TFSA-related income is not considered to be income for the purpose of the OAS Recovery Tax.
  - GIS and Allowance: TFSA-related income is not considered for determining eligibility for and amount of benefits.
- No data on TFSAs impact on OAS benefits were available for the 9th OAS Program Actuarial Report.
- The projected impact of TFSAs will grow over time as people gradually adjust their saving behavior.

TFSAs assumptions will be carefully monitored and adjusted in future, if needed

Incentives to Save

TFSAs and pension income splitting

- Low-income:
  - use of TFSAs to shield income from income-tested benefits.
- Middle-income:
  - use of TFSAs, but more reliance on pension income splitting for couples to reduce taxable income.
- High-income:
  - use of both TFSAs and pension income splitting to reduce OAS Recovery Tax and taxable income.

CPP Recent Amendments 2011-2016: Bill C-51 – Economic Recovery Act (stimulus)

Incentives to work longer:

- "The proposed changes will provide greater flexibility for older workers to combine pension and work income if they so wish; modestly expand pension coverage, and improve fairness in the Plan's flexible retirement provisions."
    - Information Paper on Proposed Changes to the CPP, Dept. of Finance, May 2009.
- Improved flexibility:
    - removal of Work Cessation Test starting 2012.
    - increase in General Drop-Out Provision from 15% (7 years) to 17% by 2014 (8 years).

CPP Recent Amendments 2011-2016: Bill C-51 – Economic Recovery Act (stimulus) *(cont'd)*

Incentives to work longer:

- Improved pension coverage:
  - effective 2012, require working beneficiaries under 65 to contribute and allow (optional) for those 65+ (up to 70), with employers required to contribute. Additional contributions provide additional post-retirement benefits.
- Improved fairness in flexible retirement provisions:
  - restore pension adjustment factors to actuarially fair values:
    - early pension take-up (60 up to 65): downward adjustment of 0.5% per month → 0.6% per month 2012-2016.
    - late pension take-up (after 65 to 70): upward adjustment of 0.5% per month → 0.7% per month 2011-2013.

Pension Reform: Increase in pensionable age

OECD: Men's Pensionable Age in 2010 and 2050*

2010 (average age: 63.0)		
< 65	**65**	**> 65**
Belgium (60), Czech Republic (61), France (60.5), Greece (57), Hungary (60), Italy (59), Korea (60), Luxembourg (60), Slovak Republic (62), Turkey (44.9)	Australia, Austria, **Canada**, Denmark, Finland, Germany, Ireland, Japan, Mexico, Netherlands, New Zealand, Poland, Portugal, Spain, Sweden, Switzerland, UK	Iceland (67), Norway (67), U.S. (66)
10 countries	**17 countries**	**3 countries**
2050 (average age: 64.6)		
< 65	**65**	**> 65**
Belgium (60), **France (62)**, **Greece (60)**, Luxembourg (60), Slovak Republic (62), **Turkey (62.3)**	Austria, **Canada**, **Czech Republic**, Finland, Germany, **Hungary**, Ireland, **Italy**, Japan, **Korea**, Mexico, Netherlands, New Zealand, Poland, Portugal, Spain, Sweden, Switzerland	**Australia (67)**, **Denmark (67)**, Iceland (67), Norway (67), **UK (68)**, **U.S. (67)**
6 countries	**18 countries**	**6 countries**

*Source: Chomik, R. and E. R. Whitehouse (2010), "Trends in Pension Eligibility Ages and Life Expectancy, 1950-2050", *OECD Social, Employment and Migration Working Papers*, No. 105, OECD Publishing. http://dx.doi.org/10.1787/5km68fzhs2q4-en

Increase in pensionable age for women is more pronounced

OECD: Women's Pensionable Age in 2010 and 2050*

2010 (average age: 61.9)		
< 65	**65**	**> 65**
Australia (62), Austria (60), Belgium (60), Czech Republic (58.7), France (60.5), Greece (57), Hungary (59), Italy (59), Korea (60), Luxembourg (60), Poland (60), Slovak Republic (57), Switzerland (63), Turkey (41), UK (60)	**Canada**, Denmark, Finland, Germany, Ireland, Japan, Mexico, Netherlands, New Zealand, Portugal, Spain, Sweden	Iceland (67), Norway (67), U.S. (66)
15 countries	**12 countries**	**3 countries**
2050 (average age: 64.4)		
< 65	**65**	**> 65**
Belgium (60), **France (62)**, **Greece (60)**, Luxembourg (60), Poland (60), **Slovak Republic (62)**, **Turkey (60.8)**	**Austria**, **Canada**, **Czech Republic**, Finland, Germany, **Hungary**, Ireland, **Italy**, Japan, **Korea**, Mexico, Netherlands, New Zealand, Portugal, Spain, Sweden	**Australia (67)**, **Denmark (67)**, Iceland (67), Norway (67), **UK (68)**, **U.S. (67)**
8 countries	**16 countries**	**6 countries**

*Source: Chomik, R. and E. R. Whitehouse (2010), "Trends in Pension Eligibility Ages and Life Expectancy, 1950-2050", *OECD Social, Employment and Migration Working Papers*, No. 105, OECD Publishing. http://dx.doi.org/10.1787/5km68fzhs2q4-en

Reasonable Economic Cost of Public Pensions – Federal Old Age Security (OAS) Program

OAS Program

- Ratio of OAS expenditures to GDP projected to increase from 2.3% in 2010 to 3.1% by 2030, driven mainly by retirement of baby boomers.
- After peak in 2030, ratio projected to decrease to 2.6% by 2050, due to expected slower growth in inflation compared to growth in GDP and projected higher incomes of new retirees.
  - Long-term implications:
    - benefits inflation-indexed, not wage-indexed
    - increased sustainability of Program.

Reasonable Economic Cost of Public Pensions – Canada Pension Plan (CPP)

Canada Pension Plan is jointly managed by federal, provincial and territorial Ministers of Finance.

- 1998 amendments:
  - PayGo to partial (“steady-state”) funding,
  - increase in contribution rate,
  - freeze of Year’s Basic Exemption,
  - slowdown in growth of benefits,
  - new investment policy - creation of CPP Investment Board,
  - incremental full funding for new/improved benefits,
  - self-sustaining provisions,
  - more frequent periodic reviews.

Reasonable Economic Cost of Public Pensions – CPP *(cont'd)*

Canada Pension Plan

- Steady-State Funding:
  - partial funding approach (hybrid of PayGo and full funding);
  - introduced to build a reserve of assets and stabilize the ratio of assets to expenditures (A/E) over time.
  - steady-state rate = lowest constant contribution rate that stabilizes the A/E ratio over the long term, before consideration of any full funding of new or improved benefits.

***Demographic and economic (including investment) risks faced by the CPP are partially hedged through steady-state funding*.**

Reasonable Economic Cost of Public Pensions – CPP *(cont'd)*

Canada Pension Plan

- Incremental Full Funding:
  - Incremental rate applied for new or improved benefits.

→ ***CPP has two financing objectives (steady-state <u>and</u> incremental full funding).***

- **Minimum Contribution Rate = Steady-State + Incremental Full Funding Rates.**

Reasonable Economic Cost of Public Pensions – CPP *(cont'd)*

The CPP self-adjustment mechanism

Insufficient Rates Provisions

If the legislated contribution rate is less than the steady-state contribution rate
AND
if the federal, provincial and territorial Finance Ministers cannot reach an agreement to increase or maintain the legislated rate,
THEN
insufficient rates provisions apply.

- **Legislated contribution rate increased by ½ of excess over three years**
- **Benefits frozen until next review (three years)**
- **At end of three years, next review performed to determine financial status of Plan.**

Reasonable Economic Cost of Public Pensions – Québec Pension Plan (QPP)

Québec government announced changes to the QPP in 2011-2012 Budget

- **Increase in QPP contribution rate:**
  - steady-state rate of most recent triennial actuarial report is 11.02% versus 9.9% legislated rate.
  - →legislated rate to increase by 0.15 percentage point (ppt) per year starting 2012 until reaches 10.8% in 2017.
  - →steady-state rate to be reassessed every three years to determine whether planned increase in legislated rate is sufficient or further action required.

Reasonable Economic Cost of Public Pensions – Québec Pension Plan (QPP) *(cont'd)*

Québec government announced changes to the QPP in 2011-2012 Budget

- **Automatic QPP contribution rate adjustment mechanism:**
  - → mechanism to take effect in 2018, following legislated rate increases.
  - → if assessed steady-state rate exceeds legislated contribution rate by more than 0.1 ppt, the legislated rate will be increased automatically by 0.1 ppt per year until excess difference is eliminated.
  - → automatic increases subject to suspension by government in order to implement alternative measures.

Projected Public Expenditure on Pensions as % of GDP: OECD Comparison 2010-2050*

	2010	2030	2050
Australia	3.6	4.3	4.9
Canada	5.0	6.6	6.3
Finland	10.7	13.9	13.3
France	13.5	14.2	14.2
Germany	10.2	11.5	12.3
Greece	11.6	17.1	24.0
Ireland	4.1	5.4	8.0
Italy	14.0	14.8	14.7
Netherlands	6.5	9.3	10.3
Spain	8.9	13.3	18.2
Sweden	9.6	9.5	9.0
United Kingdom	6.7	7.6	8.1
United States	4.6	4.9	4.8

***Source: Pensions at a Glance 2011 - Retirement-Income Systems in OECD and G20 Countries**

Pension Reform on Retirement Income Adequacy – Maintaining Standard of Living in Retirement

Net Pension Replacement Rates by Earnings – Men in OECD Countries*

Individual Earnings, multiple of mean			
Country	0.5 (%)	1 (%)	1.5 (%)
Canada	**88.7**	**57.3**	**39.7**
UK	67.5	41.5	30.5
U.S.	63.8	50.0	46.6
OECD34	**82.8**	**68.8**	**63.4**
Netherlands	104.5	99.8	96.4

***Source: Pensions at a Glance 2011 - Retirement-Income Systems in OECD and G20 Countries**

Pension Reform on Retirement Income Adequacy

- Introduction of TFSAs, GIS top-up (federal jurisdiction);
- In June 2010, federal, provincial and territorial Ministers of Finance agreed to work on three areas to increase retirement income adequacy:
  - the creation of broad-based DC pension plans (Pooled Registered Pension Plans (PRPPs)) aimed at those not covered by a workplace registered pension plan;
  - to improve financial literacy; and
  - to develop options for a modest, phased-in and fully funded CPP Expansion

Pension Reform on Retirement Income Adequacy *(cont'd)*

Finance Ministers have agreed to go forward with:

- improving financial literacy and PRPPs.
  - Report of Recommendations on Financial Literacy published by task force in February 2011.
  - Minister of State (Finance) to consult with provincial and territorial Finance Ministers and general public over summer 2011 on how to implement PRPPs.
- asking officials to continue their work on options for the CPP.

Pension Reform on Retirement Income Adequacy *(cont'd)*

PRPP Characteristics and Requirements:

- accessible, straightforward, low cost (large pools of capital), portable;
- depending on jurisdiction, employers may offer or be obligated to offer a PRPP to employees, with automatic enrolment and opt-out allowed;
- contributions paid by employees and possibly also employer with rate set by employer; contributions locked-in with exceptions.
- fiduciary duty and responsibilities of administrators (regulated financial institutions);
- default investment option and manageable number of alternative options; education resources provided;
- full disclosure: plan provisions, account activity, performance, fees, illustrations of retirement income;
- modifications to tax rules and high level regulatory harmonization required.

Conclusion

Retirement income adequacy is a shared responsibility between the government, society, employers and individuals.

What is difficult to determine for a system is:

- what the different levels of responsibility are or should be;
- how a system's tiers interact or should interact; and
- considering all aspects together, the optimal means of improving retirement income adequacy.

…while at the same time trying to meet its two overarching goals:

1. Provide, at a minimum, an adequate standard of living in retirement.
2. Ensure the financial sustainability of a system to taxpayers and contributors.