Presentation at the Pensions, benefits and social security colloquium Pension Reform in Canada (Session E2)
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Good morning. It is a pleasure to be here along with my colleague, Rob Brown, to speak to you about pension reform in Canada.

Presentation Outline *(Slide 1)*
For my presentation, I plan on covering a number of topics relating to the Canadian retirement income system, including the reduction in old-age poverty, incentives in the system that promote longer work periods, the costs of public pension expenditures in Canada and other OECD countries, and the latest pension reforms.

Canadian Retirement Income Security System: Not all eggs in the same basket! *(Slide 2)*
At retirement, most Canadians will receive income from one or more of the following tiers of the system. First, the Old Age Security (OAS) Program is financed on a pay-as-you-go basis, which means that there is no fund. Next, the Canada Pension Plan (CPP), which is similar to the Québec Pension Plan, is financed through contributions paid in equal parts by the employer and employees at a rate of 4.95% each for a total of 9.9%, which is paid by the self-employed. Both plans are partially funded. Finally, the retirement system also allows employers and individuals to participate in occupational private pension plans, Registered Retirement Savings Plans, Tax-Free Savings Accounts, and other savings vehicles, which are all intended to be fully funded.

A diversified funding approach allows Canada's retirement income system to be less vulnerable to changes in economic and demographic conditions than systems in countries that use a single funding approach. In addition, according to international organizations, the Canadian approach based on a mix of public and private pensions is an effective way to provide for retirement income needs.

What is society expecting from its retirement system? *(Slide 3)*
Society needs a strong retirement system that offers a balanced mix of public and private, as well as voluntary and mandatory plans. The system should be both affordable and sustainable for the long term, and built on three key principles: intergenerational equity, solidarity, and responsibility. Intergenerational equity

means fairness between generations such that each generation pays fair contribution rates to sustain the plan over the long term. Intergenerational equity ensures that successive generations do not face significantly higher rates than current generations.

The principle of solidarity refers to society protecting all individuals by collectively ensuring a basic level of assistance or standard of living for low-income retirees. Solidarity should supplement, but not take the place of individual responsibility, for retirement income.

Retirement income security is a shared responsibility between the government, society, employers and individuals. Individuals must save for retirement and employers should help their employees to do so. The role of a government is to implement the required systems to support public and employer-sponsored pension plans and personal savings plans.

Based on these principles, the system should also provide incentives for workers to remain in the labour force longer, especially in the context of an aging population.

Characteristics of an Efficient Retirement System *(Slide 4)*

The Canadian retirement income system, in its present form, is efficient since it provides diversity of income through a mix of private and public pensions. This very important point was recently emphasized in the editorial note of the 2011 edition of the OECD's Pensions at a Glance. The Canadian retirement income system also provides diversification of funding approaches that allows it to adapt to changing economic and demographic conditions. The retirement system has resulted in a reasonable cost of public pensions, a low poverty rate for seniors and a reduction in income inequalities, although income inequalities still do exist. With respect to maintaining a decent standard of living at retirement, several studies subsequent to the last financial crisis have suggested that an increasing number of people will not be able to maintain their standard of living at retirement. Even if the Canadian retirement system compares favourably with those of other countries, it could always be improved.

Canada has one of lowest old-age poverty rates, but much higher population poverty rate *(Slide 5)*

As the population ages and more elderly rely on social security programs, it is interesting to observe the relationship between poverty among seniors and poverty of the overall population. This chart provides a comparison between OECD countries. The combination of Old Age Security, the Guaranteed Income Supplement and the compulsory contributory pension plans (C/QPP) have contributed significantly to reducing poverty among seniors over the past three decades. However, although Canada fares very well with a low incidence of poverty among seniors, its overall population poverty rate is relatively high, and falls about midway when compared to the other OECD countries.

OAS Program Benefits *(Slide 6)*
The Old Age Security Program, which constitutes the first tier of the Canadian retirement income system, was implemented in 1952 and provides a basic pension to all Canadian citizens aged 65 and older, who have lived in Canada for at least ten years after age 18. All the Program's benefits are financed from general tax revenues. The basic OAS pension is subject to income tax, and for those pensioners who have relatively high incomes, their pensions are clawed back at a rate of 15 cents on every dollar above a threshold (over $67,000 in 2011). The program also provides non-taxable benefits for those with little or no other income, namely the Allowance and Guaranteed Income Supplement (GIS). The Allowance is paid between the ages of 60 and 64, whereas the GIS is paid on or after age 65 together with the basic pension. All program benefits are indexed to inflation on a quarterly basis.

2011 Federal Budget: Guaranteed Income Supplement (GIS) Top-Up *(Slide 7)*
As announced recently in the Canadian federal budget, the GIS has been topped up by up to $50 per month for single seniors and up to $70 per month for couples effective July 1st, 2011 to recognize the financial hardship of those especially in need. With the top-up, the maximum GIS monthly benefits payable for the third quarter in 2011 are $724 for singles and $960 for couples. The federal government has estimated that the top-up will improve the financial security of more than 680,000 seniors, which is about 14% of the senior population aged 65 and older.

Pension Reform in Canada – much research done *(Slide 8)*
To date, there has been much discussion, research, and analysis conducted regarding the Canadian retirement income system and ways to improve it. This research includes reports prepared by various working groups and experts, and in particular, by groups commissioned by or departments of the federal, provincial and territorial governments. The list of such reports shown here is by no means exhaustive. Moreover, the debate continues on as to the best ways to protect the retirement income security of Canadians. The findings of various studies have indicated that middle- to higher-income Canadians are not saving enough and thus are at risk of experiencing a substantial drop in their standard of living in retirement.

Pension Reform in Canada: Tax-Free Savings Accounts *(Slide 9)*
Recently, a new type of savings vehicle was introduced by the federal government to promote saving by Canadians. Tax-Free Savings Accounts, or TFSAs, provide tax-sheltered savings vehicles for the purpose of general saving as for retirement. The maximum after-tax contribution allowed per year is $5,000. Both investment

income earned in the accounts and account withdrawals are tax-free. Furthermore, such TFSA-related income does not affect income-tested benefits, such as the GIS. These characteristics of TFSAs provide incentives to save.

Tax-Free Savings Accounts *(cont'd) (Slide 10)*
The impact of TFSAs was included for the first time in the most recent 9th Actuarial Report on the OAS Program. In particular, exclusion of TFSA-related income from the determination of the OAS Recovery Tax and eligibility for and amounts of the GIS and Allowance benefits were taken into account in the projections. However, given the recent introduction of TFSAs, no data were available as to the impact on OAS Program benefits. What is expected, though, is that the impact will grow over time as the accounts are utilized. Assumptions of future valuation reports will be updated accordingly as experience develops.

Incentives to Save *(Slide 11)*
As mentioned earlier, TFSAs provide an incentive to save. This is in addition to an income tax provision known as pension income splitting, whereby a couple may split their combined pension incomes so as to reduce their taxes. The degree to which these two means are used to shield income depends on the level of income. Those with lower income will rely more heavily on using TFSAs to protect their income-tested benefits from being clawed back. Middle-income individuals will likely use both means, but rely more on pension income splitting to reduce taxes. Those with higher income will make use of both means to reduce both the OAS Recovery Tax and taxable income.

CPP Recent Amendments 2011-2016: Bill C-51 – Economic Recovery Act (stimulus) *(Slide 12)*
Amendments to the Canada Pension Plan, as given in Bill C-51, were agreed to by the federal, provincial, and territorial finance ministers at their May 2009 triennial review meeting. As stated in their Information Paper released at the time, the proposed changes are intended to "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." The amendments provide incentives to work longer by changing various provisions of the Plan.

First, to provide greater flexibility, the work cessation test will be removed as of 2012. Removal of the test allows for a continuation of work with earnings supplemented by the CPP pension, which could assist with phasing into retirement.

Flexibility is also improved by increasing the general drop-out provision from 15% to 17% by 2014. This will provide for up to an additional year of low earnings to be dropped from the earnings average used in determining the retirement pension, thereby increasing it. As CPP disability and survivor benefits depend on the retirement pension, they will increase as well. Those individuals who experience more years of low earnings over their careers will in particular benefit from this change.

CPP Recent Amendments 2011-2016: Bill C-51 – Economic Recovery Act (stimulus) ***(cont'd) (Slide 13)***
The Plan as it is today does not allow beneficiaries to contribute and accrue an additional benefit. Starting in 2012, CPP pensioners younger than 65 who choose to continue working will be required to contribute, while contributions will be optional for pensioners 65 or older. In either case, employers of working beneficiaries who contribute will also be required to contribute. The additional contributions will provide for post-retirement benefits (PRBs), and these benefits will be in addition to the basic pension received.

Next, as a means to improve fairness, the pension adjustment factors will be restored to their actuarially fair values by 2016. In 1987, flexible retirement provisions were introduced: early and late retirement pension take-up was allowed with corresponding adjustment factors of 0.5% per month for each month before or after age 65 applied.

The late retirement factor has already started to change this year. Its change will be phased in over a three-year period ending in 2013, leading to an ultimate value of 0.7% per month, for a maximum increase of 42% at age 70. The early retirement factor will change over a five-year period commencing 2012, and will reach an ultimate value of 0.6% per month, for a maximum reduction of 36% at age 60.

It should be noted that the new actuarially fair values were determined using a steady-state rate contribution method. By this method, the steady-state rate remains the same whether all individuals take their benefit at age 65, 60, or any other age up to 70. The steady-state rate method is an aggregate method that recognizes all the benefit provisions of the Plan and its financing elements, and thereby ensures cost neutrality to the Plan and to all contributors and beneficiaries collectively. The factors are not meant to be necessarily actuarially fair on an individual basis.

Going forward, the adjustment factors will be reassessed and reported on a regular basis of at least every nine years. The finance ministers will review these reassessments and recommend changes as deemed necessary.

Pension Reform: Increase in pensionable age ***(Slide 14)***
As population aging has affected many countries, social program costs have been or are anticipated to rise. Public pensions constitute a major government expenditure. OECD countries have taken measures to counter the strain from their public pension expenditures by implementing an increase in the pensionable age, defined "as the

age at which an individual with a full career can first receive full pension benefits in the main pension scheme" of a country, where a full pension means that no actuarial reduction has been applied. Here and in the next slide we see a summary of revisions taken by a number of countries, emphasized in green. There is a clear trend to move to higher pensionable ages at or above age 65 by the year 2050. Overall, the pensionable age for men is set to increase in eleven countries.

Increase in pensionable age for women is more pronounced *(Slide 15)*

Compared to the last slide, it's seen that more (thirteen) countries will raise the pensionable age for women. In the future, the majority of these countries will have pensionable ages that are the same for men and women. An age difference will remain in Switzerland, Turkey, and Poland.

Reasonable Economic Cost of Public Pensions – Federal Old Age Security (OAS) Program *(Slide 16)*

To what extent is the aging of the Canadian population driving the expected increase in public pension plan costs? The ratio of OAS expenditures to GDP is expected to increase from 2.3% to 3.1% between 2010 and 2030, driven largely by the retirement of the baby boomers. The number of OAS beneficiaries is expected to almost double by 2030. Over the long term, the inflation-indexed benefits will grow at a slower pace compared to wages, which will in turn lead to increased sustainability of the Program.

Reasonable Economic Cost of Public Pensions – Canada Pension Plan (CPP) *(Slide 17)*

In 1998, amendments to the CPP were implemented to restore the financial sustainability of the Plan. These amendments were based on several principles, including increasing the level of funding to stabilize the contribution rate, improving intergenerational equity, and securing the financial status of the Plan over the long term.

A major change was modifying the financing approach from a pay-as-you-go basis to a hybrid of pay-as-you-go financing and full funding, called "steady-state funding". Steady-state funding is thus a partial funding approach. Other key changes of the reform were steep increases in the contribution rate combined with a freeze of the Year's Basic Exemption (YBE), a slowing of the future growth of benefits, the creation of the CPPIB to invest the Plan's assets "with a view to achieving a maximum rate of return, without undue risk of loss", the introduction of incremental full funding for new or improved benefits, the introduction of self-sustaining provisions, and an increase in the frequency of periodic reviews of the Plan.

Reasonable Economic Cost of Public Pensions – CPP *(cont'd) (Slide 18)*
Steady-state funding of the CPP was introduced in order to build a reserve of assets and to stabilize the ratio of assets to expenditures (or A/E ratio) over time. The steady-state rate is the lowest constant contribution rate that stabilizes the A/E ratio over the long term, before the consideration of any full funding of increased or new benefits. Although the financing methodology could always be changed or reworked altogether, the objective of prefunding the Plan should remain paramount. By stabilizing the asset/expenditure over time, the steady-state methodology helps to ensure that the CPP is affordable and sustainable for current and future generations of Canadians. Moreover, steady-state funding of the CPP, as a form of partial funding, complements the funding approaches of the other components of the Canadian retirement income system.

Reasonable Economic Cost of Public Pensions – CPP *(cont'd) (Slide 19)*
Incremental full funding requires that changes to the CPP that increase or add new benefits be fully funded. As for steady-state funding, incremental full funding was introduced to improve fairness across generations. While steady-state funding eases some of the contribution burden on future generations, full funding ensures that each generation that receives benefit enrichments is more likely to pay for such enrichments in full, so that the associated costs are not passed on to future generations.

Together, the Plan thus has two financing objectives and an overall minimum contribution rate equal to the sum of the two respective funding rates.

Reasonable Economic Cost of Public Pensions – CPP *(cont'd) (Slide 20)*
The insufficient rates provisions of the Canada Pension Plan are self-sustaining provisions meant to safeguard the Plan in the case where the Chief Actuary calculates a steady-state contribution rate that is above the legislated rate of 9.9% and the finance ministers cannot reach an agreement on the solution to restore the long-term sustainability of the Plan. This design provides the Plan with a safety net without diminishing politicians' responsibility for the Plan's future.

The insufficient rates provisions provide the way to automatically increase the contribution rate and to freeze the benefits. The combination of these two measures allows for cost sharing between contributors and beneficiaries.

Reasonable Economic Cost of Public Pensions – Québec Pension Plan (QPP) *(Slide 21)*
Measures have also been announced recently in the province of Québec Budget to amend the Québec Pension Plan in light of the findings of the latest triennial actuarial report on the QPP as at the end of 2009. Specifically, the steady-state rate for the Plan was determined to be higher than the legislated rate. In response, the

legislated rate is set to increase to 10.8% over the next few years. On an ongoing basis, the steady-state rate will be redetermined, and further action will be taken if necessary.

Reasonable Economic Cost of Public Pensions – QPP *(cont'd) (Slide 22)*
Moreover, after the rate increase transition period is over, an automatic rate adjustment mechanism will take effect. If the steady-state rate is determined to exceed the legislated rate by more than 0.1 percentage point, the legislated rate will increase automatically by 0.1 percentage point each year until the excess difference is eliminated. However, the Québec government may still choose to suspend the mechanism in order to implement alternative measures.

Lastly, as a further means of restoring financial sustainability, the early and late pension adjustment factors for the QPP are set to change to the same new ultimate factors for the CPP of 0.6% per month for early take-up (before age 65) and 0.7% per month for late take-up (after 65) by the same time (in 2016 and 2013, respectively).

Projected Public Expenditure on Pensions as % of GDP: OECD Comparison 2010-2050 *(Slide 23)*
As the population ages and more elderly rely on social security programs, it is interesting to observe the projected increases in public pension expenditures relative to the GDP for different OECD countries. Canada fares quite well with a projected ratio of 6.6 in 2030, declining after to 6.3 by 2050. Most other countries shown have projected ratios that continue to increase and in some cases, substantially. Only Sweden is observed to have a projected ratio in 2050 lower than its ratio in 2010. Nevertheless, in all countries, public pensions represent a significant expenditure.

Pension Reform on Retirement Income Adequacy – Maintaining Standard of Living in Retirement *(Slide 24)*
This chart shows that net pension replacement rates are higher for Canadians at lower earnings levels. Compared to the OECD average, Canada fares better at the lower earnings. This is illustrative of the strength of Canada's retirement income security for low-income individuals. The Netherlands stands out as providing generous replacement rates at all income levels.

Pension Reform on Retirement Income Adequacy *(Slide 25)*
In addition to the measures already mentioned, the federal, provincial, and territorial finance ministers agreed in June 2010 to further promote retirement income adequacy in several ways, specifically by the creation of "Pooled Registered Pension Plans" or PRPPs, by improving the financial literacy level of the Canadian public, and by considering options for a modest, phased-in, and fully funded expansion of the CPP.

Pension Reform on Retirement Income Adequacy *(cont'd) (Slide 26)*
With respect to improving financial literacy, a task force was created to examine the issue and subsequently issued a report with recommendations. Regarding PRPPs, the Minister of State for Finance met this past summer with provincial and territorial finance ministers as well as the public in cross-country consultations. And regarding a CPP expansion, work on different options is ongoing.

Pension Reform on Retirement Income Adequacy *(cont'd) (Slide 27)*
The general characteristics of PRPPs have been laid out by the federal government. Shown here are key items. PRPPs are meant to provide accessible, portable, and low-cost defined contribution plans to those individuals, both employees and the self-employed, who don't currently belong to an employer-sponsored pension plan. Cost will be lowered by having the funds pooled, and the funds will be managed by regulated financial institutions that will have fiduciary obligations. Depending on the jurisdiction, employers may or may not be obligated to offer a PRPP to their employees. Enrolment could be automatic with employees allowed to opt out. The contribution rate would be set by employers, with employees required to contribute and employers also contributing if they choose. Only a relatively small number of investment options would be given, including a default option, and full disclosure would be provided of all account activity. Lastly, but importantly, the tax code will need to be amended and regulatory harmonization enabled.

Conclusion *(Slide 28)*
What is generally agreed upon when it comes to pension reform is that retirement income security is a shared responsibility between the government, society, employers and individuals. What is difficult, though, to determine is what the different levels of responsibility are or should be, how they interact or should interact with each other, and based on that, the optimal means of improving retirement income adequacy, <u>all</u> while simultaneously trying to meet two overall objectives: 1) to provide at least an adequate standard of living in retirement, and 2) to ensure that the system is and remains financially sustainable to taxpayers and contributors.

Thank you. I would be very pleased to answer any questions.