

**The Canadian Retirement Income System – a Society Perspective
Building the Foundation for New Retirement Systems Symposium
Washington, DC, September 28-29, 2006**

Presentation outline (Slide 2)

Good morning. It's a pleasure to be here today to talk about the Canadian Retirement Income System from the perspective of society. I'll discuss society's role, its wants and needs for a retirement system, the type of system that would achieve these wants and needs and how society would benefit from such a system, as well as the risks facing such a system in a Canadian context.

Society's role in Providing Retirement Income (Slide 3)

What is society's role in providing retirement income? It is reasonable to expect that a minimum level of social adequacy is available for everyone, that some income is redistributed in the provision of benefits, and that a basic level of financial education on the need to plan and save for retirement is provided. What we cannot expect, however, is that society should be fully responsible for ensuring a sizeable pension for everyone. The individual must have some responsibility for ensuring an adequate retirement income.

What Does Society Want? (Slide 4)

Society's wish list for its retirement system should comprise one that is affordable and sustainable, that includes fairness across generations, and that protects the standard of living post-retirement. To help sustain the system in the face of an aging population, workers should be encouraged to remain on the job longer. Also, to recognize the changing demographics, more options should be available to workers as they approach and enter retirement.

Aging of the Canadian Population (Slide 5)

Why should society encourage workers to remain in the labour force longer? The main reason is the aging of the Canadian population and the expected labour shortage. A significant increase of 150% in the size of the Canadian population over age 65 is expected until 2050. This means that the number of people over age 65 will increase from 4 to 10 million by 2050. During the same period, the population aged 80 and above is expected to increase by 250%.

Future Labour Shortage, likely or not? (Slide 6)

This chart presents a demographic indicator of the expected labour shortage. It shows the ratio between people aged 60 to 64 years to those aged 20-24. That is, a ratio of those who reduce their hours of work or who are leaving the workforce to those who

are entering the workforce. Historically, this ratio was consistently below 50% up until the end of the 80s. It then began to rise and reached 60% by the year 2000. This means that for every 6 people who leave, 10 people enter the workforce. Supply exceeds demand, expressed in economic terms. It is expected that this ratio will equal 1 around 2015. Moreover, as early as 2025, it is projected that for every 13 people who leave, only 10 people will enter the workforce. Note as well the rapid growth in this ratio. This labour shortage could be reduced if aging workers were given incentives to remain in the labour force such as more flexibility in the work-to-retirement transition. The trend is similar for the United States, although less pronounced.

What Does Society Need? (Slide 7)

Society needs a strong public retirement system that is built on three key principles: intergenerational equity, solidarity and responsibility.

Intergenerational equity is 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 also requires that current retirees are not penalized for benefits already earned. 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. It is important for governments to implement the required systems to support public and employer-sponsored pension plans and personal savings plans.

Canadian Income Retirement Security System -- Objectives (Slide 8)

There are three main tiers of the Canadian Income Retirement Security System and each tier has its own objectives. The first tier is Old Age Security (OAS), which is a mandatory program that provides a minimum income at retirement for seniors. This benefit is clawed back through the tax system if the recipient's total income is above a certain level. OAS also provides other benefits including the Guaranteed Income Supplement, which is an income-tested benefit, and the Spousal Allowance.

The second tier is the Canada and Quebec Pension Plans (C/QPP), which are also mandatory plans. The objective of these plans is to replace 25% of the individual's pre-retirement earnings up to the average of the last five years of the Yearly Maximum Pensionable Earnings, which was \$40,540 from years 2002 to 2006. The YMPE is the limit to which employment earnings are subject to CPP contributions.

The third tier is voluntary and consists of employer-sponsored pension plans and private savings, in the form of Registered Pension Plans (RPPs) and Registered Retirement Savings Plans (RRSPs). The objective of the plans in the third tier is to increase retirement savings through tax incentives.

Canadian Retirement Income Security System – Funding (Slide 9)

At retirement, most Canadians will receive an income from one or both of the following pension schemes. The Old Age Security (OAS) Program is financed on a pay-as-you-go basis, which means that there is no fund. The Canada Pension Plan, which is similar to the Québec Pension Plan, is financed through contributions paid in equal parts by the employer and employees. The contribution rate of 9.9% in 2005 and thereafter will provide Plan's assets equal to approximately 25% of the Plan's liability within about 15 years. Lastly, private pension plans and RRSPs are fully funded, which means that each generation pays for its own benefits. Given these three main sources of income for citizens over age 65, it is reasonable to say that the Canadian system is funded at 40% to 45% of future liabilities. 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, the Canadian approach based on a mix of public and private pensions is an effective way to provide for retirement income needs, according to international organizations.

An Efficient Retirement System Achieves These Wants and Needs by... (Slide 10)

An efficient retirement system is one that is able to achieve the wants and needs discussed earlier by focusing on the following principles:

- the diversification of sources of retirement income. Canada's mix of public and private pensions represents an effective way to provide retirement income;
- the diversification of funding approaches. This allows Canada's retirement income system to adapt rapidly to changing demographic and economic conditions;
- the reasonableness of the cost of public pensions. The cost of public pensions is expected to increase from 5% of the GDP in 2005 to 7% in 2030, much below Germany, Italy and France but higher than for the U.S. and the U.K.;

- the reduction of poverty among seniors. The combination of Old Age Security, the Guaranteed Income Supplement and the compulsory contributory pension plans (C/QPP) has contributed significantly to reducing poverty among seniors over the past three decades. The percentage of low-income seniors decreased from about 21% in 1980 to 7% in 2003. The OECD considers Canada to be the country which has the least difficulty ensuring the economic well-being of retirees and protecting vulnerable groups in society;
- the reduction of income inequalities. The Canadian system is oriented toward a reduction in poverty, although more in the form of increasing the income of poorer people, rather than reducing income inequalities;
- and, the maintenance of the standard of living at retirement.

Although a national pension system could always be improved, the Canadian retirement income system meets these conditions for efficiency.

How Can Society Benefit from this System? (Slide 11)

The benefits of a good retirement system include a reduction in poverty and the preservation of intergenerational equity. Through its public programs, Canada has been successful in substantially lowering poverty amongst the elderly and sustaining intergenerational equity. Increased savings through registered plans helps to ease pressure on social security. However, this is a difficult task to accomplish. In Canada, about 60% of workers in 2003 were not covered by a registered pension plan and available RRSP contribution room remains high and is growing from year to year. As one possible solution, the mandatory social insurance programs could be expanded to provide a portion of the voluntary RPP coverage. Overall, a good retirement system reduces the financial burden on society.

Risks Affecting Retirement Income Security (Slide 12)

There are many risks facing retirement income security, including those listed here. These risks are handled to varying degrees by the different components of a retirement system. Some risks indeed present more of a challenge than others. However, a robust and diverse retirement system is able to mitigate these risks through various forms of hedging and other proactive measures. The risks that society should be most concerned about are low participation in the third tier, a lack of knowledge regarding retirement planning and funding risk of employer-sponsored pension plans. In fact, low coverage in the third tier indicates that individuals are not proactive enough in their retirement planning.

Risk Retention and Hedging – First Tier (Slide 13)

Starting with the first tier of the Canadian system, that is, the Old Age Security Program and the Guaranteed Income Supplement, we see the main risks facing these

plans. As a reminder, these plans are financed from general revenues. The benefits are indexed only to inflation. Inflation as opposed to wage indexation does provide a degree of hedging against rising costs. The program may be subject to further pressure from inadequate retirement savings by the public through poor planning and low participation in private plans. In the event the economy performs poorly, costs would rise in terms of the GDP. All these risks are, for the most part, retained.

Canadian Aging - OAS Expenditures as % of GDP (Slide 14)

How do we position ourselves for the future aging of the Canadian population knowing that the cost of the Public Pension Plans (OAS/ CPP/ QPP) is expected to increase from the current 5% of the GDP in 2003 to 7% in 2030? On one hand, the ratio of OAS expenditures to GDP increases from 2.4% to 3.2% between 2010 and 2030, driven largely by the retirement of the baby boomers. On the other hand, Canada has shown the largest budgetary improvements of any of the other G-7 countries over the past decade. Balancing the budget and taking steps to put the debt as a proportion of gross domestic product on a downward track are effective ways to ensure sustainable financing of Old Age Security funded from the government's Consolidated Revenue Fund.

Risk Retention and Hedging – Second Tier (Slide 15)

The Canada and Québec Pension Plans are mandatory plans for all Canadian workers. Employees and employers each contribute an equal share of the 9.9% contribution rate, up to the yearly maximum.

The CPP is a partially funded plan that employs steady-state funding. The goal of steady-state funding is to stabilize and minimize the contribution rate. Steady state funding requires that the contribution rate be set no lower than the lowest rate expected to ensure the long-term financial stability of the Plan without recourse to further rate increases. A funding level of 20-25% is sufficient to meet this condition for the CPP. The current steady-state funding is expected to generate contributions that exceed the benefits paid out every year up until 2021. Over time, this will create a large enough reserve to help pay the growing costs that are expected as more and more baby boomers begin to collect a retirement pension.

All risks faced by the CPP are hedged through this steady-state funding and I will explain how in a moment. As well, the Canada Pension Plan Investment Board, which invests the excess of contributions over benefits paid in the markets, attempts to hedge any investment risk that the CPP Fund might be exposed to through diversification.

CPP Steady-State Funding (Slide 16)

At the time of the amendments and according to the actuarial report produced in September 1997, the steady-state contribution rate was deemed to be 9.9% in 2003 and to remain at that level for the years thereafter. As a result, the legislated contribution rate is 9.9%. Under the last actuarial report, the steady-state rate now stands at 9.8%. As the legislated rate is higher than the steady-state rate, the funding status of the Plan will improve over time, and the greater this difference, the greater the improvement.

CPP Steady-State Funding (Slide 17)

Steady-state funding has a built-in hedge that is used when the calculated steady-state contribution rate is higher than the current 9.9%. The default provisions in the *Canada Pension Plan Act* may result in adjustments being made to the contribution rate and benefits in payment if the federal and provincial governments reach no agreement in response to the actuarial determination of the steady-state contribution rate. If the new steady-state rate is 10.1%, one half of the excess of the new steady-state rate over the 9.9%, that is 0.1%, will be applied to an increase in the contribution rate and the other half will be applied to non-indexation of benefits in pay in order to keep the steady-state rate at 10.0%. In other words, the contributors and the beneficiaries would equally support the additional cost shown in the actuarial report.

Risk Retention and Hedging – Third Tier (Slide 18)

The third tier of the Canadian retirement system consists of employer-sponsored registered pension plans, as well as personal savings through vehicles such as Registered Retirement Savings Plans. These plans are voluntary and fully funded. These types of plans face many risks and although there are hedges available for most of these risks, they are not necessarily employed in all situations. This third tier is very important because it bridges the gap between the income provided by the public plans and the income required to maintain one's standard of living after retirement. A great concern is that coverage in this tier is very low, even though tax incentives exist to encourage individuals and employers to make contributions to these plans. As discussed earlier, a possible expansion to the mandatory retirement plans, such as the CPP, would decrease this risk.

Greatest Challenges Facing Retirement Systems (Slide 19)

The Canadian retirement income system is in very good shape compared to other countries when we consider that future liabilities for the system as a whole are funded at about 40% to 45%. However, there are some areas that are posing challenges. Low coverage in the third tier is a concern because it indicates that individuals are not

proactive enough when planning for their retirement. Another obvious concern is the funding level and funding risk faced by employer-sponsored defined benefit plans.

There has been a trend of risk responsibility being shifted from the employer to the employee as the number of DB plans has decreased while the number of DC plans has increased. This transfer of risk to the employee could further decrease retirement income as individuals with little or no investment knowledge must make decisions about how to invest their pensions.

Finally, the anticipated aging of the population will be pronounced in Canada. Contrary to the other industrialized countries, Canada should not undergo a decline in its working population due to expected future immigration. However, the anticipated aging of the Canadian labour force and the labour shortage that may result will be one of the biggest challenges in the years ahead.

Thank you for the opportunity to speak to you today about our Canadian Retirement Income System from society's perspective.