Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

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The Canadian Retirement Income System – a Society Perspective

Building the Foundation for New Retirement Systems Symposium

Washington DC, 28-29 September 2006

OSFI BSIF

Canada

Presentation

- Society’s role in providing retirement income
- What does society want in its retirement system?
- What does society need in its retirement system?
- What type of system achieves these wants/needs?
- How could society benefit from this system?
- Risks faced by retirement systems
- Which risks should be retained / hedged?
- Greatest challenges facing retirement systems

Society’s Role in Providing Retirement Income

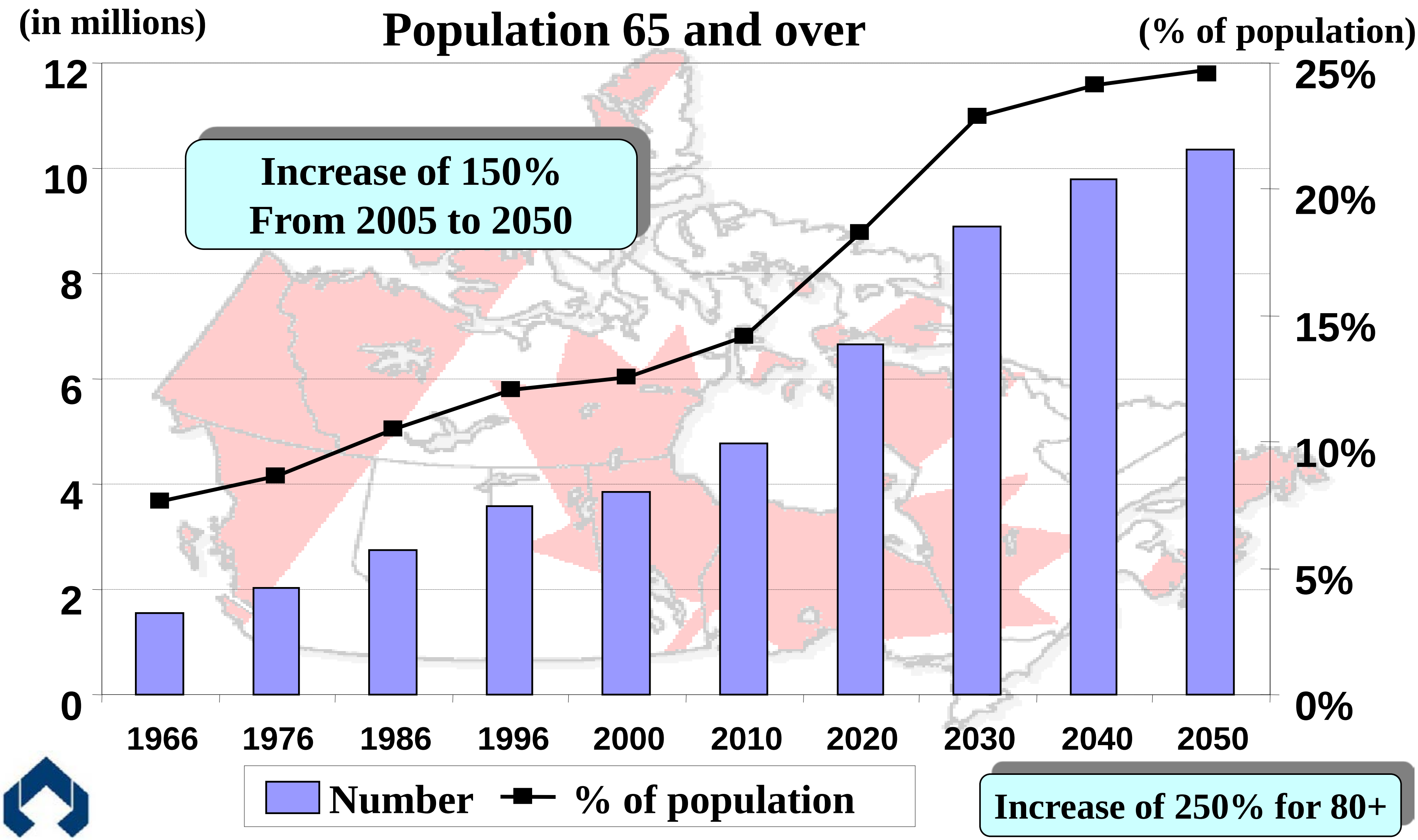
- Reasonable expectations
  - Provide a minimum level of social adequacy for all
  - Redistribution of income through the retirement system
  - Educate on the need to plan and save for retirement

- Unreasonable expectations
  - ***Fully*** responsible for providing a sizeable retirement income to all individuals

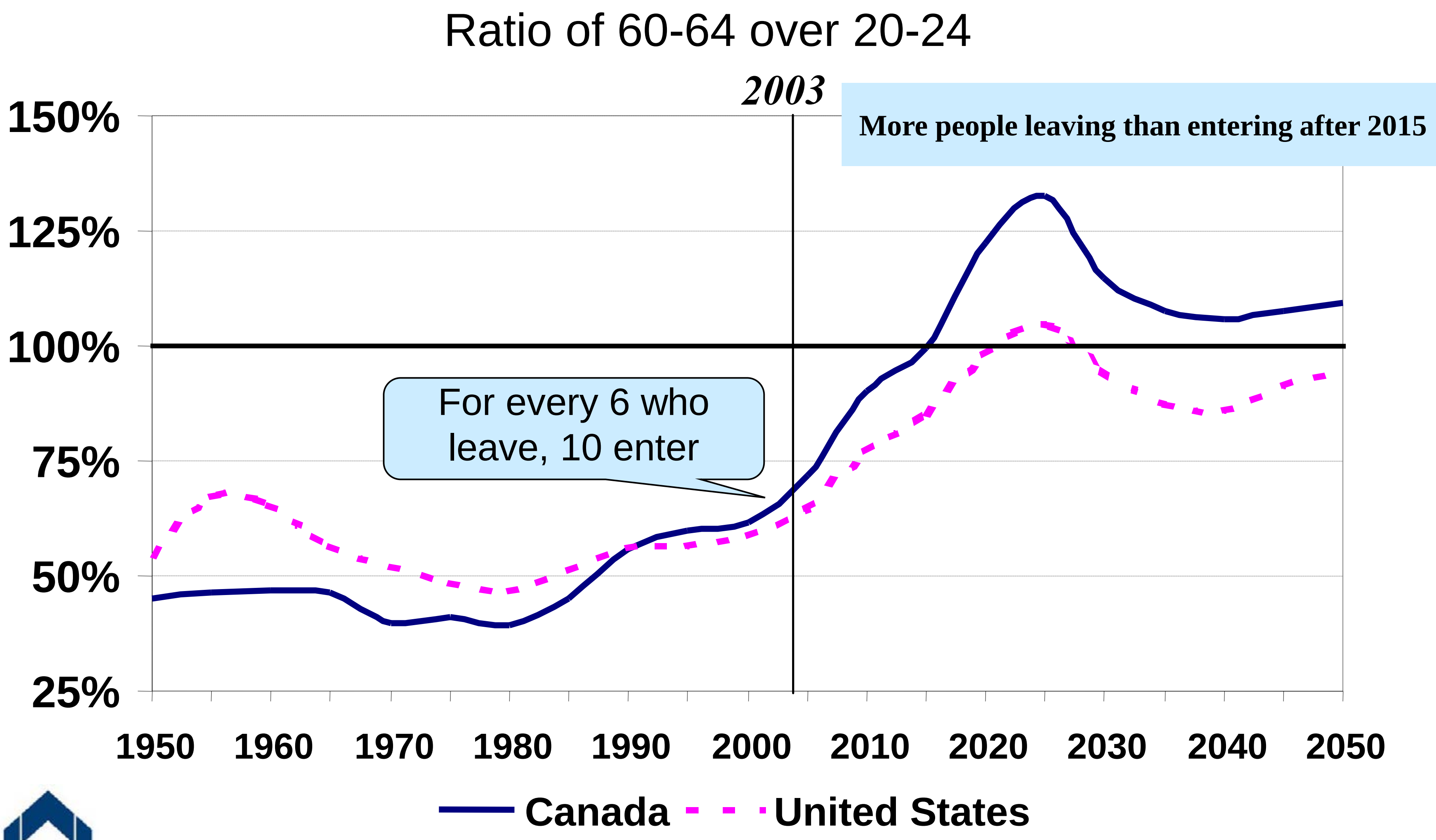
What Does Society Want?

- Affordable and sustainable system
- Intergenerational equity
- Maintain standard of living after retirement
- Workers to remain in the labour force longer
- Flexibility in work-to-retirement transition

Aging of the Canadian Population



Future Labour Shortage, likely or not?



Source for US : United Nations Projections, 2003

What Does Society Need?

- A retirement system built on the principles of:
  - 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
- Incentives to remain in the labour force

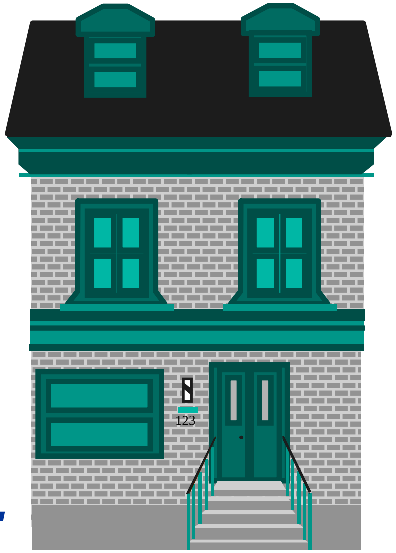
Canadian Retirement Income Security

	Programs	Objective
VOLUNTARY	3. Employer pension plans and private savings (RPP / RRSP)	Increase retirement savings through tax incentive
MANDATORY	2. CPP / QPP	Replace 25% of pre-retirement earnings up to avg. of last 5 yrs of YMPE (avg 2002-2006: $40,540)
MANDATORY	1. Old Age Security/ Guaranteed Income Supplement	Provide minimum income at retirement for seniors

Canadian Retirement Income Security

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

- Full funding (RPP/RRSP)
- Partial funding (CPP/QPP)
- Pay-as-you-go funding (OAS/GIS)



The Canadian retirement system could be viewed as about 40% to 45% funded.

An Efficient Retirement System Achieves These Wants and Needs by…

- 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 ✓

How Can Society Benefit From This System?

- Decreased poverty
- Intergenerational equity
- Increased use of the third tier leading to lower costs in the lower tiers
  - However, approximately 60% of Canadian workers are not covered by a RPP and contributions to RRSPs are far below the maximum allowed
  - The mandatory portion of the retirement system could possibly replace some of the employer component. For instance, the Canada Pension Plan could be expanded.
- Minimize economic cost to society (tax burden)

Risks Affecting Retirement Income Security

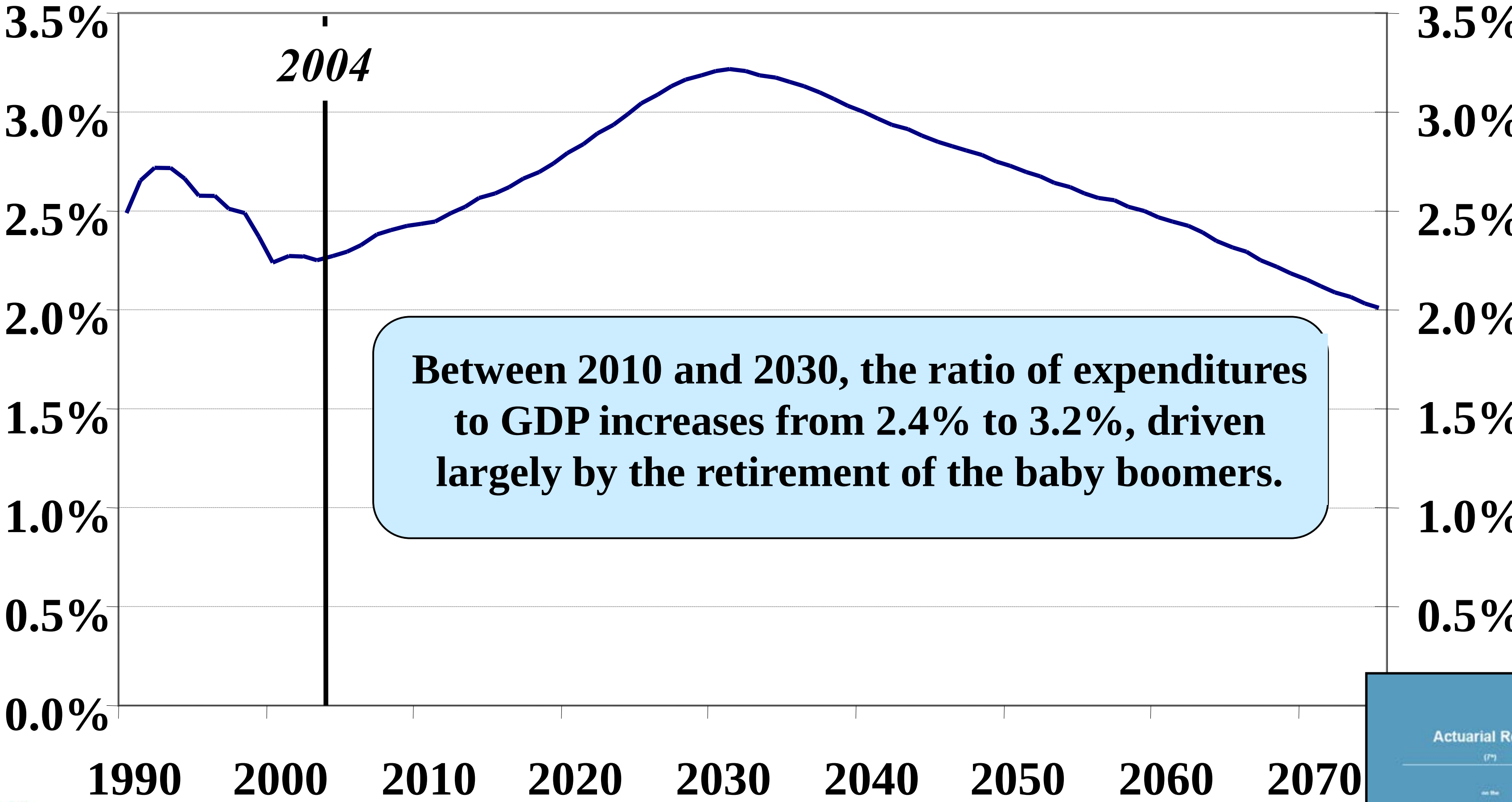
- Low participation in third tier
- Financial Illiteracy
- Funding Risk: *Accumulated assets are insufficient to meet pension obligations*
- Investment risk: *Investment returns less than expected*
- Market risk: *Market failure*
- Inflation risk: *Savings not adequately protected from inflation*
- Retirement risk: *Earlier than expected retirement from employer failure/restructuring/downsizing, health issues, etc.*
- Longevity risk: *Outliving one's retirement assets*
- Operational / System risk: *Inadequate / failed internal processes, people*

Risk Retention and Hedging

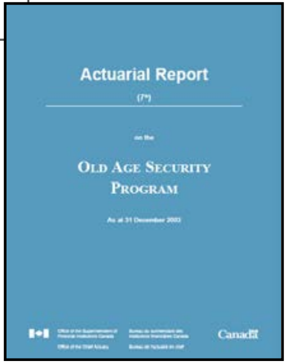
- First Tier: OAS/GIS
  - Paid out of general revenues of Government of Canada
  - Main risks:
    - Insufficient cost of living adjustments
    - Longevity risk
    - Low participation in the higher tiers
    - Low economic growth → significant increase in cost as % of GDP
  - Most of the risk is retained; partial hedging of costs through inflation indexation instead of full GDP indexation

How do we position for the aging of the Canadian population?

Evolution of Old Age Security Expenditures in % of GDP



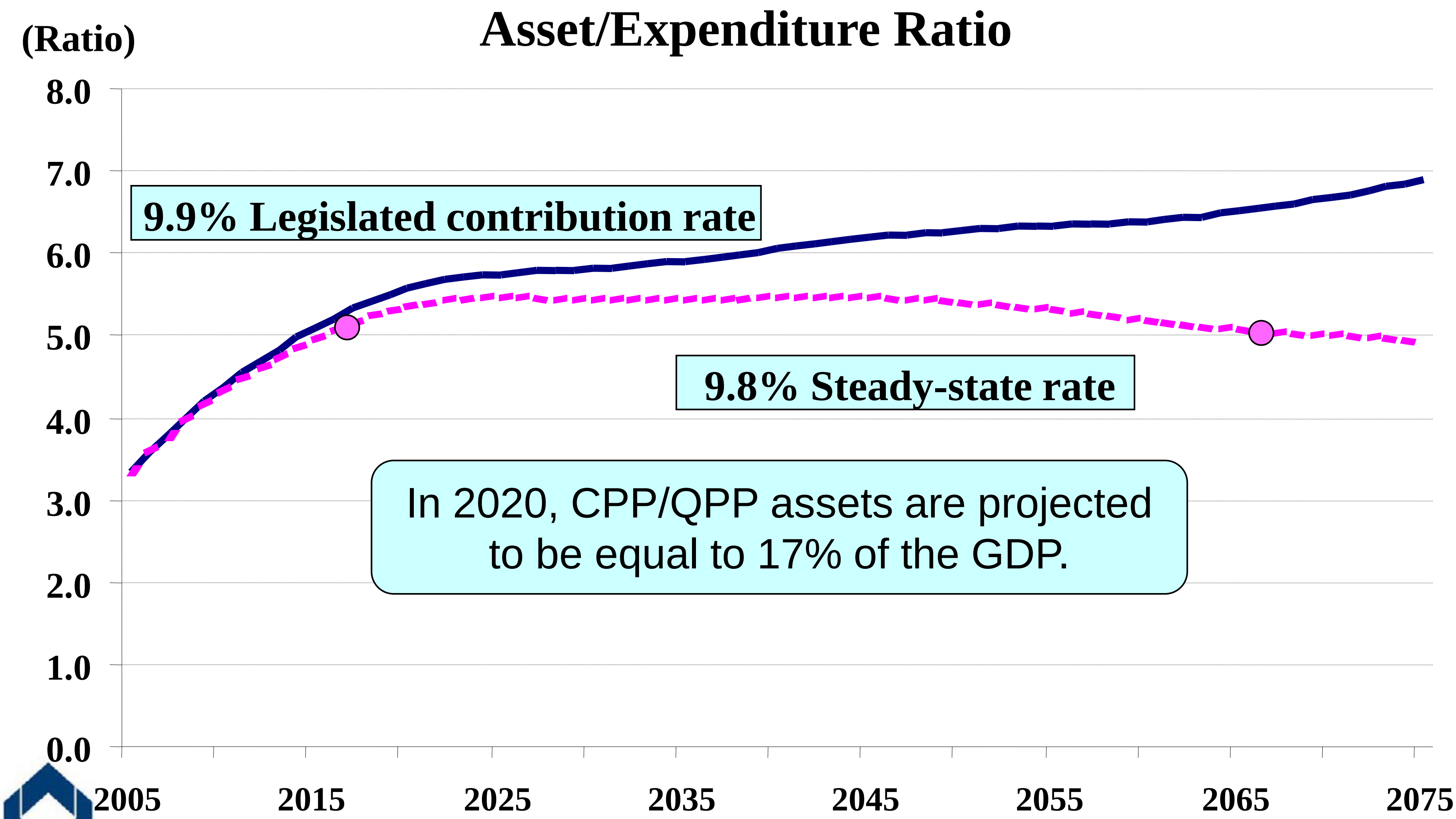
$28 billion in 2004; $37 billion in 2010; $110 billion in 2030



Risk Retention and Hedging

- Second Tier: CPP/QPP
  - Partial funding through employee/employer contributions
  - Steady-state financing goal: stabilize and minimize the contribution rate
  - Steady-state contribution rate: lowest rate that can be charged that is sufficient to sustain the Plan without further increase
    - A funding level of 20-25% is sufficient to meet that condition for the CPP
  - All risks faced by the CPP are partially hedged through steady-state financing
  - Investment and market risks are also hedged through investment diversification

CPP Steady-State Funding



CPP Steady-State Funding

- If the legislated contribution rate is lower than the steady-state rate AND if finance ministers cannot reach agreement on a solution, then default provisions apply:
  - Contribution rate increased by ½ of excess over three years, subject to maximum increase of 0.2% per year
  - Benefits frozen until next review (3 years)
  - At end of three years, next review performed to determine financial status of Plan.

Risk Retention and Hedging

- Third Tier: RPP / RRSP
  - Funded by employee/employer contributions and personal savings

Risk	Hedges Available
Low coverage	Possible expansion of lower tiers
Funding	Investment diversification; professional fund management
Investment / Market	Investment diversification
Inflation	Inflation-sensitive investments; indexed annuities
Longevity	Annuities
Financial Illiteracy	Education; improved communication from financial sector

Greatest Challenges Facing Retirement Systems

- Low coverage, especially in the third tier
- Individuals' lack of knowledge and involvement in retirement planning
- Employer-sponsored plan funding risk
  - Trend of risk responsibility being shifted from the employer to the employee (decrease in DB plans, increase in DC plans)
- Aging of the population

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Retirement 20/20

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Thank you

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