Province of British Columbia
Ministry of Finance

MECHANISMS FOR EXPANDING PENSION COVERAGE AND RETIREMENT INCOME ADEQUACY IN CANADA

This paper seeks your views on how best to address anticipated future shortfalls in Canada's retirement income system (RIS). While Canada is recognized internationally for the long-term financial sustainability of its public pension system and its success in significantly reducing poverty among seniors, a number of suggestions have been made that could improve the effectiveness and adequacy of the RIS for future retirees.

Canada's RIS has been described as being composed of three supporting pillars:

- Pillar One is comprised of publicly funded pension programs that are financed from tax revenues and which focus on the elimination of poverty. These programs are typically available to Canadian citizens and legal residents, based on criteria such as age and years of residence, with or without an income or means test. Pillar One consists of Old Age Security (OAS), the Guaranteed Income Supplement (GIS) and two smaller programs targeted at spouses and surviving spouses (aged 60-64) of OAS/GIS recipients.

- Pillar Two is made up of compulsory programs for the employed and self-employed that focus on providing minimum income protection in retirement by replacing a portion of pre-retirement earnings. These programs are funded by employer and employee contributions, and investment earnings, and are available only to those who contribute. Pillar Two consists of the Canada and Quebec Pension Plans (CPP/QPP).

- Pillar Three consists of voluntary personal savings, including employer-sponsored occupational pension plans and tax-assisted individual retirement savings. Pillar Three includes registered pension plans (RPPs) provided voluntarily by employers and/or unions, group or individual registered retirement savings plans (RRSPs), and the new Tax Free Savings Accounts (TFSAs).

The three pillars combined are intended to provide retirees with adequate income to approximate their pre-retirement living standards.

Many of Canada's current retirees receive a significant proportion of their income from workplace pension plans, one of the key components of Pillar Three. Yet workplace pension coverage has been steadily declining. (Currently, three out of four private sector workers are not covered by a workplace pension plan, and the self-employed are not permitted to be members of these plans.) Further, evidence indicates that the average Canadian is not saving enough through other retirement savings vehicles to fill the gap from declining RPP coverage. RRSPs are tax-effective savings vehicles, but they are not being fully utilized. There is also growing awareness that the capacity of individuals to accumulate personal savings for retirement may be less than expected due to costs associated with retail investment services and the complexities of investing and financial planning.

A number of stakeholders have recommended that the CPP be expanded or supplemented to help fill the gap in retirement savings for Canadians who will retire in the next few decades. Others have called for legislative changes that would strengthen the voluntary savings vehicles in Pillar Three. Many suggest that Canada's RIS can be strengthened through an improved balance amongst the three pillars.

On January 21, 2010, a paper titled "Options for Increasing Pension Coverage among Private Sector Workers in Canada" was publicly released by British Columbia's Finance Minister, Colin Hansen, Chair of the Provincial-Territorial Steering Committee of Ministers on Pension Coverage and Retirement Income Adequacy http://www.fin.gov.bc.ca/pension_plan_options_paper.pdf. The paper provides information on two potential national pension plan solutions to deal with the issue of retirement income adequacy. The proposals and comments of numerous interested groups and stakeholders helped to frame the analysis contained in the paper. These included submissions to the major provincial pension reviews undertaken over the last two years by Alberta, British Columbia, Ontario and Nova Scotia, as well as the recent work commissioned by the federal government.

Federal, provincial and territorial governments have now embarked on a process to analyse a range of possible solutions to deal with the challenges Canadians face over the coming decades as they attempt to save for their retirement years. This will involve further examination of the two national pension options, along with other possible mechanisms that could be of benefit, such as changes to tax and pension standards legislation to improve pension coverage and retirement savings among Canadians. It should be noted that most of the ideas for change presented in this paper would require amendments to federal and/or provincial legislation.

Stakeholders have already made a number of recommendations and suggestions for ways to improve Canada's RIS and these will be considered in the upcoming work of the federal, provincial and territorial governments. However, the British Columbia government believes it is important to provide an opportunity for introducing new ideas to be brought forward for consideration and further evaluating the implications of existing proposals.

Principles and Objectives:

1. Canadians should have effective means to achieve a smooth transition from work to retirement, suffering no significant drop in their standard of living.
2. Individuals should have effective means to save sufficiently over their working lives to achieve income security in retirement.
3. A pan-Canadian approach is preferred to facilitate labour mobility, protect retirement savings, and benefit from economies of scale.
4. Solutions should build on and improve Canada's current RIS, which is based on a strong three-pillar approach (Pillar 1: OAS and GIS, Pillar 2: CPP and QPP, and Pillar 3: RPPs and RRSPs).
5. Pension coverage among private sector workers should increase.

6. Solutions should target those at risk of not having sufficient retirement savings to maintain the pre-retirement standard of living.

Proposed solutions will be evaluated on the basis of their potential to align with the principles and to achieve the stated objectives. Evaluation criteria will include the likelihood of each proposal to achieve long-term savings accumulations (retirement income adequacy), low cost, administrative efficiency, transparency and investor protection.

Approaches

The range of possible approaches to pension reform falls into in four broad categories:

- Expansion of the existing CPP;
- Creation of a voluntary defined contribution supplement to the CPP;
- Modernization of pension standards to improve flexibility in pension plan design; and
- Tax reform – changes to *Income Tax Act* (Canada).

1. Expansion of the existing CPP

Under this approach, variations on the existing CPP will be examined. Some variations on this approach have been proposed by the Federal Superannuates National Association, the Canadian Labour Congress, the Canadian Association of Retired Persons and other organizations. (Possible changes to the QPP would need to be addressed and assessed separately by the Government of Quebec.)

The CPP is a national, mandatory defined benefit (DB) pension plan. (A DB pension plan is a plan that promises to deliver a specified monthly retirement benefit that is predetermined by formulas based on earnings history, years of service and age rather than being determined based on contributions and related investment returns.)

All employers, employees and the self-employed are required to pay combined contributions (currently 9.9 per cent) on employment and self-employment income up to the Year's Maximum Pensionable Earnings (YMPE), a limit set annually by the CPP based on that year's average wage in Canada ($47,200 in 2010). Funds are invested by an independent, expert board of trustees. Canada's federal, provincial, and territorial Finance Ministers are the stewards of the plan. Like all DB plans, longevity risk (the risk that an individual will outlive the value of his or her assets) is pooled among members. A maximum pension is payable if an individual earns the maximum pensionable earnings under the CPP over a 40 year period. The maximum pension payable in 2010 is $934.17 per month, which, together with OAS, would provide about 40 per cent of the average monthly wage in Canada in 2010.

According to the 2007 World Bank study "Pensions Panorama", Canada's public pensions (Pillars One and Two), although financially strong, provide considerably less income for individuals in middle to higher income classes than public pensions in most other comparable (OECD) countries. The degree to which coverage and retirement income adequacy would be improved under an expanded CPP would depend on the details of the model adopted, i.e. the targeted earnings replacement rate on career pensionable earnings (currently 25 per cent) and/or the maximum level of income that would be subject to contributions, the YMPE.

The targeted replacement rate is the percentage of pre-retirement earnings sought to be provided by the pension plan – e.g., if an individual earned $50,000 before retirement, and the targeted replacement rate was 60 per cent, one would expect that earnings in retirement would equal approximately $30,000 (60 per cent of $50,000). The target replacement rate needed to maintain an individual's pre-retirement standard of living varies depending on the level of pre-retirement income and other factors, such as whether there will continue to be mortgage payments required or if there will be significant costs in retirement. It is generally agreed that higher replacement rates are required for individuals earning very low incomes before retirement.

The CPP could be expanded by increasing the targeted replacement rate or by increasing the YMPE. An increase in the replacement rate on career pensionable earnings would increase retirement benefits and contributions for *all* participants in the plan. An increase in the YMPE would improve retirement benefits for only those individuals who earn more than the average wage during their careers. Employers and individuals would pay contributions on earnings that had not previously been covered under the CPP.

2. Creation of a voluntary defined contribution supplement to the CPP

Under this approach, a new, voluntary defined contribution (DC) plan would be designed and established for all Canadian workers who currently do not have a registered pension plan, including the self-employed. (A DC plan is a plan under which each member's contributions, set in advance, are used to provide that person's retirement benefits. The amount of the benefits depends on the level of contributions and amount of investment income earned in the fund, rather than being predetermined by formula.) The new plan could be developed as a 'top-up' to the CPP. This design could significantly reduce start-up costs and make it possible for ongoing administration and investment costs to be very low, which would maximize the rate of return for plan members.

The plan would be established in legislation by a new statute, but would be regulated under the existing regulatory framework for pensions and income tax (as is the case with all multi-employer pension plans). The new legislation would clarify who assumes the role of fiduciary (the entity charged with acting in the best interests of plan members), governance requirements, administration, investment management, and investment performance expectations. The proposal is based on proposals by Keith Ambachtsheer, Director, Rotman International Centre for Pension Management, and the November 2008 report of the Alberta – British Columbia Joint Expert Panel on Pension Standards.

Enrolment in the plan would be automatic, with the opportunity for workers to opt out – for example, if they have alternative retirement savings vehicles that they prefer. Economies of scale and portability could be achieved by creating one large plan that would bring together unrelated employees, self-employed individuals and employers.

The proposal envisions an annual contribution rate of 10 per cent of earnings: five per cent each from the employer and employee (in addition to current CPP contributions), although employers may also have the opportunity to opt out of contributions. A tiered approach could also be considered, offering an option of three per cent, six per cent or nine per cent each. Contribution levels could change over time to accommodate changes in priorities and financial resources of the member or the employer.

The plan would not be sponsored by government, nor would government be responsible for pension obligations to members. The plan itself would be governed by an independent board of trustees with related expertise. The funds could be invested either through the existing CPP Investment Board, or some other entity. The board of trustees of the new plan could hire agents, through an open tender process, to invest the funds and to provide other relevant services as required. Board appointments could be made by a nominating committee, similar to the current arrangement for the CPP Investment Board (CPPIB). However, the difference would be that the board in this case would be the fiduciary of the plan rather than the investment manager, as is the case with the CPPIB (the "fiduciary" role for the CPP is assumed by the Ministers of Finance as stewards of the plan).

3. Modernization of pension standards to improve flexibility in pension plan design

All Canadian provinces (except Prince Edward Island) and the federal government have pension benefits standards laws that set minimum standards for RPP investments, eligibility for benefits, funding requirements and disclosure to members. These standards are comprised of rules that are detailed and prescriptive for the traditional DB plan and are less well developed for other types of plans, such as DC plans.

Pension plans have two fundamental characteristics that distinguish them from other retirement savings vehicles:

- The plan sponsor has a fiduciary duty to plan members to act only in the best interests of the plan members in all actions undertaken in relation to the plan and its fund; and
- Pension plan funds are 'locked-in' – i.e. subject to restrictions that ensure the money is used for a retirement pension.

Both characteristics preserve the intended purpose of pension plans, which is to provide income security for individuals when they are no longer expected to work.

Several Canadian jurisdictions have recently reviewed their pension standards and identified possible changes to promote new pension plan designs. A number of private sector organizations – including insurance companies who operate plans and plan sponsors – have proposed that such changes are a good way to increase pension coverage and retirement savings for individual Canadians. These proposals include:

- Under a principles-based approach:
    - Create principles in the statute that would apply to all plan types and create different detailed rules for different types of plans in regulation or administrative policy (DB, DC, target benefit, etc.);
    - Permit the regulator to approve, and issue guidelines for, new plan designs;
    - Broaden the definition of plan administrator to permit an entity that is not an employer or a board of trustees to sponsor a plan (e.g., multi-employer groups, professional

  associations, not-for-profit corporations) subject to the requirement that the administrator, as the fiduciary for the plan members, must be in a position to make decisions in the best interests of members; and
  - Broaden the definition of member to permit a worker who is not an employee to become a member (e.g., self-employed).
- For voluntary plans, enable the plan sponsor to:
  - Enrol members through automatic enrolment and assign a default investment portfolio, subject to the right to opt out; and
  - Annually increase a member's contribution rate to the maximum permitted under the plan, subject to the right to opt out.

4. Tax reform – changes to *Income Tax Act* (Canada)

This category of proposals involves possible amendments to the *Income Tax Act* (Canada) that have been suggested by stakeholders to promote greater retirement savings in registered retirement savings vehicles (RPPs, RRSPs, and TFSAs). The *Income Tax Act* (Canada) comes within federal jurisdiction and any changes to it would have to be agreed to and implemented at the federal level. The *Income Tax Act* (Canada) and regulations set out the tax rules that must be followed to maintain registered status. The purpose of the tax rules is to create a level playing field among different types of tax-preferred retirement savings and to set a ceiling on the preferential tax treatment of retirement savings.

The proposals suggested by stakeholders include:

- Introduce lifetime retirement savings limits as well as or instead of annual limits;
- Allow individuals to repay RRSP withdrawals used in times of financial hardship;
- Increase the age limit on RRSPs (currently contributions must cease and RRSPs must be converted to cash or annuity at age 71);
- Permit the creation of pension security funds by employers to meet their solvency obligations without creating surplus ownership issues;
- Provide a better balance of tax compliance rules between the retirement savings possible under various registered retirement savings vehicles;
- Update rules on the maximum transfer values from DB to DC plans to allow the tax-free transfer of the value of DB benefits;
- Allow tax-deductible employee contributions to broad-based plans where the employer opts not to participate; and
- Allow self-employed individuals to make deductible contributions to a registered pension plan.

5. A blend of options

While the various proposals for pension reform have been presented separately for the purpose of this consultation paper, many could be combined to improve the overall effectiveness of Canada's RIS. Further, a blended approach would have the advantage of strengthening both the second and third pillars of Canada's RIS, thus improving the balance of Canada's three pillars to the benefit of all Canadians.

One example of a blended approach is:

- Expand the CPP by increasing the YMPE;
- Create a new, voluntary national supplemental plan for those who currently do not have an RPP; and
- Modernize pension standards and related tax rules so that new types of pension plans that meet the needs of today's workers and employers can be created.

QUESTIONS:

Below are some questions relating to the proposals presented in this paper, which may help to focus your submission on these topics. Please provide responses to as many questions as possible. At the same time, if you have other comments not addressed by these questions, please include them. Your responses will help us better identify and understand the implications of the ideas proposed.

1. Is there merit in pursuing options to expand the existing CPP as a way to improve retirement income adequacy for future Canadian retirees?

2. If yes, which alternative, increasing the YMPE under the CPP or increasing the targeted earnings replacement rate, or a combination of the two, would best meet the needs of future Canadian retirees?

3. When considering increasing contributions in order to increase retirement benefits, should individuals with very low incomes be expected to put aside more for retirement when they may already be having trouble getting by? If not, what range of earnings do you think should be subject to increased contributions to the CPP?

4. If you think that the existing CPP should be expanded, how much of an increase in CPP retirement pensions, compared with current levels, would be advisable?

5. Do you think that participation in a supplementary plan should be completely voluntary, voluntary but only through being permitted to opt out after being auto-enrolled, or fully mandatory? Is mandatory enrolment necessary to ensure pension coverage is substantially increased?

6. Under a new supplementary voluntary plan, it is envisioned that investment choice would be limited, to keep costs down and utilize expert investment management. How much investment choice do you think is necessary to provide sufficient flexibility for individuals? Is there such thing as too much choice?

7. Should the supplementary plan have features that lessen risk to the individual, such as shifting the individual's investments gradually to less-risky investments over time, and/or purchasing annuities gradually as the individual nears retirement age? Should these features be automatic or should they also be a choice offered to individuals?

8. Will modernizing pension standards legislation to encourage pension innovation result in increased pension coverage? If yes, why? If no, why not?

9. How can the interests of members in a pension plan be protected in instances where a board of trustees or employer is not the Administrator (i.e., the fiduciary) for the plan?

10. A number of stakeholders have suggested that very large pension funds are required in order to minimize costs through economies of scale and maximize investment returns. Do you agree? Are there risks associated with pension funds that become very large?

11. Numerous stakeholders have suggested that the *Income Tax Act* (Canada) should be changed to remove obstacles to expanding pension coverage. The *Income Tax Act* (Canada) comes within federal jurisdiction and any changes to it would have to be agreed to and implemented at the federal level. At the same time, we are interested in what, if any, changes you may think would be effective on their own or in combination with other measures in increasing pension coverage and retirement savings. Do you have any comments on the types of tax reforms outlined in this paper, or other suggestions for federal income tax changes that could help increase pension coverage?

12. Currently, Pillars One and Two (OAS, GIS and CPP) are designed to provide 40 per cent of career average wages at the normal retirement age of 65. Individuals with lower incomes will receive more than 40 per cent of career average earnings from Pillars One and Two, and individuals earning incomes greater than the average wage over their working lives will receive less than 40 per cent. Pillar Three (voluntary savings through RPPs, RRSPs and TFSAs) is expected to provide the remaining income to meet Canadians' retirement income goals. Is this the appropriate balance between the three pillars of Canada's retirement income system, or should some other apportionment be pursued?

13. Do you have any comments about the potential impacts on your business regarding any of the proposals described in this paper?

14. Can you think of other examples of blended approaches that would achieve increased pension coverage for future retirees?

15. What measures show the greatest promise in increasing pension plan coverage and retirement income adequacy for Canadians?

DEADLINE FOR COMMENTS: April 1, 2010

Please submit comments to:

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