Province of Manitoba
Department of Finance

MECHANISMS FOR EXPANDING PENSION COVERAGE AND RETIREMENT INCOME ADEQUACY IN CANADA

The Government of Manitoba is working with other provinces and territories, and the federal government, to consider opportunities for enhancing Canada's retirement income system. The overall goal of this exercise is to increase savings of individuals (i.e. future retirees) who are not currently saving enough to obtain sufficient levels of replacement income to maintain their standard of living in retirement.

The analysis is being informed by a comprehensive research program, as well as proposals and comments submitted by numerous interested groups and individuals. Finance Ministers will consider this information at their May meeting and present recommendations to Canada's premiers at the August 2010 Council of the Federation meeting.

This paper seeks your views on this important issue. The government of Manitoba wants to ensure that the perspectives of Manitobans are reflected in recommendations as they are developed. The Manitoba government also believes this process provides an opportunity for introducing new ideas and further evaluating the implications of existing proposals.

BACKGROUND:

Canada's retirement income system 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. These programs are typically available to Canadian citizens and legal residents, based on criteria such as age, years of residence, and income level. 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. 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 retirement savings plans and individual retirement savings. Pillar Three includes workplace registered pension plans (RPPs), group or individual registered retirement savings plans (RRSPs), and the new Tax Free Savings Accounts (TFSAs).

Pillars One and Two together provide minimum income protection in retirement by replacing up to approximately 40% of average career earnings. The three pillars combined are intended to provide retirees with adequate income to approximate their pre-retirement living standards.

Generally, current retirees are receiving adequate income replacement levels from Canada's retirement income system. However, the situation for future retirees is less certain. Registered pension plan (RPP) coverage is declining and evidence indicates that the average Canadian is not saving enough through RRSPs and other retirement savings vehicles to fill the gap.

APPROACHES:

A range of possible approaches to enhancing Canada's retirement income system have been proposed by various stakeholders. These ideas have been organized into four broad categories and are summarized below:

- Expansion of the existing Canada Pension Plan;
- 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).

Additional details on options are provided in the paper titled "Options for Increasing Pension Coverage among Private Sector Workers in Canada", developed through 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 research commissioned by the federal government, to improve understanding of the Canadian retirement income system, is available on the Finance Canada website.

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 retirement income system. Further, a blended approach would have the advantage of strengthening both the second and third pillars of Canada's retirement income system, thus improving the balance of Canada's three pillars to the benefit of all Canadians.

One example of a blended approach is:

- Expand the Canada Pension Plan by increasing the Year's Maximum Pensionable Earnings;
- 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.

<u>QUESTIONS</u>:

Below are some questions that will help to focus your submission. 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.

1. *"Improvements should be made to Canada's retirement income system to ensure that individuals have effective means to save sufficiently over their working lives to achieve adequate incomes in retirement."* <u>Do you agree with this statement? If so, please identify the specific areas that you feel require improvement</u>?

2. The nature and scope of changes required to the retirement income system are still being debated. Some stakeholders feel that fundamental changes are required; others believe that Canada's system is working relatively well and that incremental changes within the current framework would be sufficient at this point in time. <u>Which overall approach do you think would be most beneficial?</u>

3. Currently, Pillars One and Two (OAS, GIS and CPP) are designed to provide up to 40 per cent of career average wages (lower income earners generally receive more than 40%, higher income earners less than 40%). Pillar Three (voluntary savings through RPPs, RRSPs and TFSAs) is expected to provide the remaining income to meet Canadians' retirement income goals. <u>Is this the appropriate balance between the three pillars of Canada's retirement income system?</u>

4. This paper describes a number of possible mechanisms for increasing retirement savings in Canada. Please provide your views on these options, including comments on the more technical aspects of the proposals. <u>What do you feel are the merits of the various options? Do you have particular concerns with any these options?</u>

5. <u>Do you think that additional *mandatory* measures are required to ensure adequate retirement savings in Canada? Do you think this would be better accomplished through expanded CPP coverage, through mandatory enrolment in a new supplementary plan, or a combination?</u>

6. <u>If a *voluntary* supplementary plan were to be introduced, do you think that participation in the plan should be completely voluntary (i.e. individuals would have to sign up for the plan) or voluntary but only through being permitted to opt out after being enrolled automatically?</u>

7. Research commissioned for this review shows that Canada's retirement income system generally does a good job of providing minimum income protection to seniors. Canada has one of the lowest senior poverty rates among developed countries. <u>How might the options presented in this paper positively or negatively affect lower income workers? Please consider short and long term impacts.</u>

8. The research also states that, although the general picture is positive, there may be subsets of the elderly population who experience higher rates of poverty, including single women

and immigrants. What improvements to Canada's retirement income system might help to address this issue?

9. Employers play a critical role in Canada's retirement income system. However, the proportion of Canadian workers with employer-sponsored registered pension plans has been steadily declining for many years. How do you think these options would affect employers' participation in, and support for, the retirement income system?

10. Do you have any other ideas for measures that would help to improve Canada's retirement income system?

DEADLINE FOR COMMENTS: April 30, 2010

Please submit comments to:

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Please note that Manitoba will be using the results of the consultation and comments received to help inform the ongoing discussions among federal, provincial and territorial Finance Ministers. Please be advised that given the nature of this process comments may be attributed to their source.