Canada’s retirement income system

• Public pensions unrelated to employment
  – Old Age Security
  – Guaranteed Income Supplement
  – Various provincial add-ons
• Public pensions related to employment
  – Canada/Quebec Pension Plan
• Private retirement income arrangements
  – Registered pension plans
    • Defined Contribution / Defined Benefit
  – Registered Retirement Savings Plans
    • Supported by tax deferral
  – Other savings
    • Not supported by tax deferral

How are we doing?
Universal non-employment related

• By any measure, a substantial success

• Poverty in over-65 population has been reduced dramatically – both incidence of poverty and depth of poverty.

• Sharp contrast to experience with poverty in under-65 population.

• Details differ from province-to-province; Alberta has the lowest poverty rates, and the lowest incidence of near-poverty.
Incidence and Depth of Low Income
Seniors and non-seniors -- 1976 to 2011

Source: Statistics Canada CANSIM 202-0804

65 + % poor

65+median % gap

Incidence and Depth of Low Income 
Seniors and non-seniors -- 1976 to 2011 
Source: Statistics Canada CANSIM 202-0804 

- 65 + % poor 
- 65+median % gap 
- Under 65 % poor 
- Under 65 median % gap 


Ranges: 0% to 70%
Universal employment related

• Initial funding model and assumptions challenged in the late 1980s by shifting demographics and investment economics
• The process of review and renewal that began in the early 1990s and culminated in:
  – modest benefit changes;
  – substantial contribution increases; and
  – a change in the funding model to a stability funding model
has been largely successful
• According to Canada’s Chief Actuary, the CPP now has sufficient assets to absorb the full impact of the passage of the baby boom generation through the system.
Private retirement income arrangements

• A conspicuous failure
  – Pensions
    • Low and declining coverage rate in the private sector
    • Especially on a risk-adjusted basis – DB coverage is lower and rate of decline in coverage faster
  – RSPs
    • Participation rate low and positively related to income
    • Contribution rate low and positively related to income
    • Early withdrawal rate negatively related to income
Pension Coverage, Percent of the Paid Labour Force, 1977-2010, Canada
Private Sector Pension Coverage
Percent of the Paid Labour Force
1977 to 2010
Average Unused RRSP Room
Canada
2000 to 2010
The roots of the problem:
Pensions as an employment benefit

- Employer-based plans do not deal well with employee or employer turnover
  - Termination benefits generally do not support employees’ retirement income planning objectives and generally change the form of the benefit

- Because DB plans are associated with union representation
  - The decline in DB coverage is linked to the decline in union density in Canada
The roots of the problem: The changing risk / return environment

• Old assumptions about employers’ ability or willingness to bear risk no longer hold
  » Employers have different expectations over their business longevity
  » Global competition affects the individual employers’ ability to bear risk is reduced
  » Long-term risks aren’t an attractive proposition in a quarter-to-quarter world

• In investment returns, size matters; and size matters now more than ever
  » Significantly different opportunity sets
  » Higher fees and lower net returns for smaller investors
The roots of the problem:
A system that is stacked against the individual retirement saver

• Canadian mutual fund fees are among the highest in the world;
  – The issue is not financial literacy; the issue is an imbalance of market power

• There is no cost-effective mechanism for converting a pool of savings at retirement into a lifetime income
  – Canada’s annuity market is thin and expensive
  – Canada’s market for indexed annuities is non-existent

• Is low participation in RSPs evidence of inadequate savings or a rational response to a system that is stacked in favour of financial institutions?
In other words --

• The labour market, demographic, economic and risk sharing assumptions on which our retirement income system’s design were based are no longer valid
Life Expectancy at Age 65
Canada 1900 to 2005

Female
Male
Long-Term RRB Yield
November 1991 to October 2012
Example -- impact of fees on retirement savings

Assumptions: $40,000 initial salary; 3% annual increase; 10% of income saved; 3.5% fixed income return; 6.5% equity return; average Canadian mutual fund fees
The roots of the problem: Quality and regulation in a voluntary system

• The retirement income system depends on employers’ willingness to create and maintain pension plans
  » Canadian employers are voting with their feet

• Regulatory changes may ease the pressure from employers to exit the pension field
  » But at what price in light of our retirement income security objectives
  » Regulatory changes will not alter the economic environment

• Regulatory changes will not lead employers to create new pension plans
  » Regulatory changes do not alter an economic environment that is hostile to single-employer plans
Three critical issues

- Investment risk – the risk that your retirement savings will miss your retirement savings target
- Longevity risk – the risk that you will outlive your retirement savings
- Generational risk – the risk that the impact of adjustments in response to demographic and economic change is unfairly distributed between generations
Probability of outliving retirement savings by target retirement savings age

Ontario individuals alive at age 65
Source: Statistics Canada Life Tables 2007 to 2009
Investment Returns Compared
Defined Benefit vs. IRA; Defined Benefit vs. 401(k)
United States
1998 to 2003

% differential DB vs alternatives

1998  1999  2000  2001  2002  2003

DB - IRA

DB - 401(k)
Some sobering facts

- Large DB plans in North America have earned 7.15% after costs in the past 20 years; large DC plans have earned 5.7% -- to offset the difference with higher savings, you would have to save 40% more; the results for individually based investments are even worse.

- Reducing the probability that you will outlive your retirement savings from 50% to 25% increases your target savings by 23%; reducing it to 10% increases target savings by 37%.

- To achieve a 25% probability of outliving your pension, you would have to have 64% more at retirement than a DB plan would have to have to provide a 0% probability of running out.
Net replacement rate at 1 times average earnings
Net replacement rate at 2 times average earnings

Pensions / Savings

OAS/GIS

C/QPP