

**Submission to Department of Finance**

**Ensuring the Ongoing Strength of  
Canada's Retirement Income System**

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## **Introduction**

This document is in response to the Department of Finance’s request for submissions regarding the discussion around “Ensuring the Ongoing Strength of Canada’s retirement Income System”. There has been an enormous amount of discussion on this issue in recent months, but, in our opinion, none of this really addresses the issues. The actuaries of Westcoast Actuaries have many years of experience in the Canadian and International pension fields and we feel that during this time we have observed developments which have lead to the deterioration in the Canadian System. This is not to say that the situation is bleak – there are many good elements in the system which are working well and don’t need fixing (e.g. OAS and CPP). We present a brief discussion of the reasons why problems have arisen and have suggestions regarding solutions to the problem.

Historically, retirement benefits for Canadians have been provided by a system which has been commonly referred to as the “Three Pillars” – that is that the sources of income post-retirement have come from Government plans (CPP and OAS), employer sponsored pension plans and a person’s own savings (RRSPs etc.). This system has worked well for a considerable period of time.

Our general conclusion is that the weakness in the system currently is with respect to Employer sponsored plans (Pillar II) and the bulk of this document addresses this issue. In our opinion the combined benefits of CPP+OAS+GIS (Pillar I) provide a satisfactory level of basic benefits which is well funded and affordable. It would be an error to expand this basic level of coverage which is bound to introduce deficits into Government programs. Any expansion of the CPP would have to be financed by increased contribution levels which would divert contributions which could be made either to company pension programs or individual’s savings plans. For the same reasons, we are also not in favour of any supplementary pension arrangement which either stacks on to the CPP or otherwise.

With respect to personal savings (Pillar III) there would seem to be adequate incentives for Canadians to save such as RRSPs, TFSAs. The fact that a large proportion of the population either do not make full RRSP contributions up to the permissible limits or don’t make any RRSP contribution at all suggests that expanding the limits for these savings vehicles will not be of great advantage. We feel, however, that there are issues with respect to retirement savings vehicles which we will discuss in this submission.

## **The “Problem” with employer sponsored pension plans**

In our opinion, the current perceived crisis in retirement income for Canadians has come about because of the continuing disincentives which impact on employer sponsored pension plans. In the past employers were prompted to reward long service employees by providing them with financial security in their retirement years with a pension. This was normally provided by a defined benefit pension plan where the member had a pretty good idea what pension they would be receiving to assist in personal retirement planning. As in other countries such as the US and the UK, this “paternalistic” approach has mostly disappeared. It can be argued that changing

attitudes of employers to their employees are to be blamed – benefit programs are expensive and employers are looking for ways to cut costs by cutting back on their benefit programs. If other employers have either terminated their pension plans or converted their defined benefit pension plan into a very much watered down defined contribution plan then it makes the decision so much easier. To the extent that the corporate culture has changed, this will be difficult to fix. However, we believe that there are disincentives which can be eliminated and that if these disincentives are dealt with then some companies will be tempted to consider starting new plans or maintaining their existing programs.

The major sources of disincentive are easy to identify:

**Complexity of legislation which leads to high administration costs.**

**Income Tax legislation**

When the Income Tax Act was rewritten in the late 1980s, there was an opportunity to simplify the system. Instead, the direction taken was to build a complex, detail oriented system which has become worse over time with the multitude of interpretations and policy statements required to maintain such a complex structure. It is reasonable that there should be some overall limit to tax deductibility with respect to pension funds but issues that should concern the Department of Finance and CRA should be limited to establishing rules which have a direct impact on tax deductibility such as maximum benefit levels and excess surplus.

**Provincial legislation**

A major stumbling block to the development of pension plans has been the proliferation of provincial pension legislation. The attitude of provincial governments as a whole has been that an employer doesn't have to provide pension benefits to their employees, but if they do, then they have an mountain of petty regulations to deal with which seem to stem from the assumption that the employer will attempt to cheat the members out of their entitlement unless there is legislation in place to stop this happening.

There is a lack of conformity between provinces – CAPSA seem to have been working on unifying pension legislation between the provinces for a very long time. Surely this is an achievable goal. In the process of reaching uniformity, the opportunity should be taken to eliminate a wealth of unnecessary rules which act as a significant disincentive to employers.

Funding rules which require “wind-up” funding when there is no great likelihood of plan wind-up seem to conflict with the long-term time span of the typical pension plan. To ask a plan sponsor to fund in the unlikely possibility of a plan wind up seems unreasonable when there is little likelihood that the plan will actually windup.

### **Asymmetric surplus rules**

When there is a deficit in a plan, the employer has to make this good. Provincial regulators, however, have made it very difficult for the employer to take advantage of surpluses by limiting surplus reversion to the employer and putting limits on contribution holidays.

### **Accounting rules**

A negative factor for employers in implementing and maintaining pension plans is having to account for their pension liabilities under various accounting standards (CICA 3461, IFRS, FAS etc.). The accounting profession as a whole has drawn up these rules with apparently little concern for the impact they might have on the development of pension plans.

### **Solutions to the Problem**

There has been a vast amount of discussion recently regarding solutions to the problem from Expert commissions, governments, industry experts, CIA etc. Quite frankly, we find these discussions disappointing as they seem to recommend minor changes to the existing system. It is hard to see how these recommendations will serve to do anything more than build another level of complexity on the already too complex infrastructure. Examples of this “Band-aid” approach are minor adjustments to the Ontario PBA which will clearly not encourage an employer to keep their DB plan or set up a new one. Or, extensions to the CPP or standalone DC arrangements sponsored by the provinces. The major issue which should be addressed is the demise of the RPP and how these plans might be resurrected.

In order to rectify the system to persuade employers to opt back into the pension system, there have to be radical changes to cause this to happen.

Our suggestions to remove the disincentives listed above are as follows:

#### **Income Tax Act**

Redesign the tax system to allow additional deductions for employers making contributions to pension plans. For example, give an additional 25% tax credit for employer contributions to an RPP.

Totally rewrite the relevant sections of the Income Tax Act and regulations dealing with pension plans to eliminate all the detailed rules. This would also eliminate all the rulings that CRA has had to develop to support its position on issues where the ITA and Regulations are ambiguous or silent.

A simple set of rules are all that are required. As an example of the simplification process you need to look no further than the pension system in the UK. Inland Revenue (who never really had a considerable impact or involvement in pension plans) were given the task of simplifying the UK income tax act as it pertained to pension plans. Somewhat surprisingly

they did this by eliminating most of the rules that they had in place and simplified their regime totally by establishing a lifetime maximum benefit from all pension plans as a lump sum value equal to 20 times the accrued pension applied at retirement. Implementing this type of arrangement would be quite radical but we feel is achievable and this the simplified approach would be welcomed.

[A Canadian example for applying this approach would be to take the current limit of \$2,500, multiply it by an average working life of 40 years then apply a factor of 15 to convert to a lump sum of 1.5 million. This amount should be indexed by AIW. All grandfathering would be eliminated as this introduces complications.]

### **Provincial Legislation**

Eliminate all provincial pension standards legislation and replace with one set of rules and one regulator (OSFI?). Establish a Pan-Canadian plan with minimum standards which are greatly simplified. [The UK and the US, for example, only have one set of rules.] This could be based on the work CAPSA has done in this area.

Minimum standards that might be retained:

- Immediate vesting for all benefits.
- Cost sharing would be by double refund rather than the current cumbersome “50%” rule system.
- Make rules uniform for all periods - eliminate “before” and “after” legislation changes.
- Either eliminate unisex rules or make them mandatory for all benefits.
- Post-retirement spousal benefits at 60% unless spouse waives the benefit

Solvency valuations should be eliminated. Actuarial valuations which are required for defined benefit pension plan should be basically the going concern valuation - unfunded liabilities which occur should be funded over the remaining working lifetime of the plan pension plan members. It will be the duty of the regulators purely to assess whether this is a reasonable assumption or whether because of the health or otherwise of the plan sponsor a shorter period might be more appropriate. As you may be aware the Pensions Act 2004 in the United Kingdom works in exactly this way.

Legislation should encourage the development of hybrid and flexible benefit plans. The cash balance plan is a popular vehicle in the US and should be accommodated in Canadian legislation.

In our opinion, it is preferable to have a defined benefit program as such programs make retirement planning significantly more certain. It is also our opinion that a plan which pays 90%

of the promised benefit is better than no plan at all.

### **Surplus asymmetry**

Employers should have access to surplus funds either to take contribution holidays or refunds. These can be based on the funded level of the plan. An alternative would be to allow creation of a separate “side fund” which can be used to top-up the funding when required. This type of arrangement would eliminate surplus ownership issues which appear to be more of a legal than pension standards issue.

### **Accounting rules**

The accounting standards for pension are becoming international in nature with the adoption of IFRS. As such this may be the most difficult issue to deal with. Dialogue should at least be established with the CICA to get them to accept that for Canadian accounting purposes for pension plans, a much less draconian set of rules than IAS or FAS can be used.

### **General Retirement Savings – Problems and Possible Solutions**

With respect to general retirement and pension savings vehicle such as Registered Retirement Savings Plan (RRSP), Individual Pension Plan (IPP), Tax-Free Savings Account (TFSA), we have the following general views regarding some common problems and possible solutions from a retirement savings perspective:

1. **Excessively High Management Expense Ratio (MER)** – Various survey results have indicated that Canada has one of the highest MER’s for its investment funds among all the OECD countries. The defined contribution programs rely heavily on achieving reasonable net rates of return to accumulate sufficient capital at retirement to provide pension adequacy. High MER products extract so much from the accumulation of wealth that people generally do not have sufficient funds to retire on. The whole investment industry is so much driven by fund companies promoting their high MER funds through the sales channels and investment advisors promising high returns to justify their fees that there is not much left for the average investors – the people who wish to save more for retirement. It would be a better pension world if policies could be introduced to direct the market more towards investments in institutionally managed low MER funds or ETFs. People should pay for their investment advisory and retirement or financial planning separately on a fee-for-service basis. Otherwise we will always be dealing with the problem of having investment advisors pushing high MER (and usually higher commission) products to their clients’ detriment. Clients do not get good value-added investment advisory and financial/retirement planning services relative to the compensation they pay their advisors that is embedded in the MER. It would also be helpful if fees for retirement planning and financial planning are deductible for income tax purposes.
2. **Competency of Investment Advisors / Financial Planners** – We quite often come across investment advisors and financial planners who do not even understand what the term “change in unrealized gains and losses” means. Can we trust some of these people

with our hard earned savings dollars? The Canadian system does not provide very solid support for investment advisors to educate themselves for the benefit of their clients. At the entry level the competition is so fierce that most institutions offer only commission and revenue sharing positions, not salaried positions. If one does not make the cut, there are hundred others going after the position. This is not a healthy system as it is driven by “relationship building” and not “knowledge or expertise acquisition”. We all have a fairly good idea about the quality of service we are getting in engaging physicians, plumbers or carpenters but the same can not be said for investment advisors and financial planners. Does that have something to do with their education and training process?

3. **Complexity of Investment and Insurance Products** – Institutions often bundle their investment and insurance products beyond even the comprehension of even a finance Ph.D. Some examples are Universal Life Policies, Segregated Funds, Guaranteed Minimum Withdrawal Benefits. How do you expect the average citizen to understand exactly how these products work? Most of these products have very high MER, very high commission, and are sales oriented. There is a big mismatch when you have commerce transacted on highly sophisticated products between highly unsophisticated parties. Institutions seems to package these products in such a fashion that the consumers do not mind paying these high MERs because they have very high perceived value for the embedded guarantees which are very complex.
4. **Advisor’s Interest not Aligned With the Client’s** – We have encountered many situations where in our opinion the advisor’s recommendation or action may not be in the best interest of the client. A good example would be a recommendation that a pension plan member terminate employment from a public sector pension plan prior to reaching retirement age so as to access a lump sum commuted value. Quite often the lump sum may involve a large taxable lump sum for the member for the amount in excess of the Income Tax Regulation 8517 maximum transfer limit. By taking a lump sum commuted value, the member lose not only some tax efficiency by having a significant amount subject to immediate taxation, they may also forfeit certain post-retirement non-pension benefits that are provided only to members on pension. The advisors who are so hungry for the investment dollars to earn a living that they may be recommending an option that will permit them access to these pension dollars, not necessarily the option that is most beneficial to the client.