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To: Gil McGowan, President, Alberta Federation of Labour

From: Susan Chortyk and Tony Williams
PBI Actuarial Consultants Ltd.

Subject: **Expansion of Pension Coverage – Review of ABC Plan**

Introduction

The issue of adequate income in retirement for workers has long been a concern of labour organizations across Canada and PBI Actuarial Consultants Ltd. (PBI) shares this concern. The exceedingly more complex accounting, funding and solvency rules for defined benefit pension plans, coupled with the lack of coordination across provincial and federal jurisdictions for all registered pension plans, has discouraged companies from establishing new pension plans. There has also been a trend to wind up existing defined benefit pension plans and replace them with defined contribution (DC) arrangements, which limit company costs but shift investment risk entirely to the employees. We share the Alberta Federation of Labour's (AFL) belief that it is vital to increase the coverage of workers under pension plans, but equally importantly, to ensure that the income these workers receive in retirement will be adequate to meet their needs. We believe that there are major drawbacks to defined contribution (DC) arrangements. DC plans may be appropriate for some situations such as for smaller employers or where there is a transient workforce. However, we believe DC plans are inappropriate as the main source of retirement income for most Canadians.

In its report entitled "Getting our Acts Together – Pension Reform in Alberta and British Columbia", the Joint Expert Panel on Pension Standards also expressed its concern over the lack of pension coverage in occupational pension plans for workers and proposed that a plan, which it called the "ABC Plan" be established to address this concern. We agree with the principle of broader coverage of pension plans in Canada to allow more Canadians to provide for themselves in retirement. However, we believe that Defined Benefit (DB) plans offer a more efficient model and provide better risk sharing between the employer and employee.

The AFL has requested that PBI review the proposed ABC Plan and provide our comments. Accordingly, we have done some projections of the retirement income that could expect to be paid from the plan under various scenarios.

The ABC Plan

The ABC Plan proposed by the Joint Panel would be a DC registered pension plan to which employees and, ideally, employers would contribute. The plan as proposed would automatically enroll all employers and employees in both provinces.

In order to make the plan design as flexible as possible, it is proposed that there would be a provision that would allow employers to opt out of the arrangement. If this occurred, employees could elect to either participate by making employee contributions only or the employees could also opt out.

Under the proposed plan, if an employer did elect to participate in the plan, there could also be an arrangement by which employees did not have to participate.

The panel proposed that the plan be set up on a not-for-profit basis, structured perhaps as a pension society with a board of governors operating at arm's length from government. Administrative services would also be performed by an organization operating at arm's length from the government. Employees and employers would not have any investment choice, but rather the board of governors would direct the investment of the assets. There would be no guarantees on benefits to be provided from the plan. Contributions levels would be flexible with employee contribution levels of 3%, 6% and 9% of pay proposed, with matching employer contributions if the employer does not opt out. Under the suggested plan design, the employer could elect the level of contribution it wished to make (i.e., 3%, 6% or 9%) and employees would make a matching contribution.

ABC Plan Design Issues

While we applaud the goal of trying to create a way to expand pension coverage to more workers, we believe the proposed ABC Plan has serious design issues. We disagree with the concept of a DC platform which shifts all the investment risk to employees. While the ABC Plan addresses the issue of higher investment expenses that DC plans may have, the drawbacks to DC plans in general have been well documented:

- unpredictability of income at retirement,
- variability of benefits depending on economic conditions at retirement date, and
- generally inadequate contribution levels to provide meaningful benefits.

We do not think it is realistic to believe that an employer who currently does not have a pension plan will now contribute 6% or 9% of pay to this proposed plan simply because of its administrative simplicity and lack of risk to the employer. An example of this is the Saskatchewan Pension Plan which was established in 1986 and allows anyone between the ages of 18 to 71 to join by simply filling out an application form. Rules for participation by employers are equally simple, yet there are currently only 30,000 members enrolled in the plan. And as we have illustrated on the attached charts, lower contribution levels do not provide adequate income in retirement.

Analysis of Projected Benefits Payable from the ABC Plan

The most common way to assess adequacy of post-retirement income is to measure it in terms of "replacement ratios" – the ratio of income in retirement to employment income immediately prior to retirement. The rule of thumb most often quoted is that a person needs about 70% of the income they were earning immediately prior to retirement to live comfortably in retirement. Of course, while this number varies by individual, and may be lower for higher-income Canadians, it is likely a good measure for most people.

In order to analyze the income that would be payable to an individual who was covered by the ABC plan, we looked at current income levels of $30,000 to $100,000 and assumed that these salaries would increase at 4% a year, and we looked at contribution rates that varied between 3% and 18% of pay. We assumed the contributions to the plan would earn on average 4%, 5% or 6% per annum to retirement. We believe that these rate-of-return assumptions are appropriate long-term assumptions.

We also assumed various ages at entry for members joining the ABC plan, but for purposes of the attached charts we have used an individual (male) who enters the plan at age 35. We assumed that the benefit payable from the ABC Plan would be paid as a joint and 60% survivor annuity, with post-retirement indexing equal to two-thirds of the CPI.

The other assumptions used in our projection are summarized on the attached charts. For purposes of simplifying our calculations we have ignored the effect of the OAS clawback and we have assumed that members would be entitled to maximum CPP benefits on retirement.

Chart 1:

This chart assumes a total contribution rate of 6% (3% employer, 3% employee) of pay and assumes the member retires at age 60. When combining the benefits payable from CPP, OAS (which is payable from age 65) and the ABC Plan, the replacement ratio ranges from a low of 18% (for a high income individual) to a high of 43% for an individual who is at the lower end of the pay scale.

Chart 2:

This chart is the same as Chart 1 but assumes the member retires at age 65. When combining the benefits payable from CPP, OAS and the ABC Plan, the replacement ratio ranges from a low of 23% (for a high income individual) to a high of 55% for an individual who is at the lower end of the pay scale.

Chart 3:

This chart looks at an individual earning $50,000 today who retires at age 60 and compares the replacement ratios under various contribution scenarios (6%, 12% and 18% of pay in total). Even with an 18% contribution rate, this individual can only expect a replacement ratio of 60% of income in retirement.

Chart 4:

This chart is the same as Chart 3, but assumes the member retires at age 65. It is only at the 18% (9% employer, 9% employee) contribution level, using the assumption that the rate of return on the contributions averages 6% a year over 30 years that the replacement ratio exceeds 70% (it is 80% under these assumptions). As stated earlier, we believe it is highly unlikely an employer will agree to contribute 9% of pay to this plan.

Charts 5 – 8

Charts 5 through 8 repeat the projections done in Charts 1 through 4 but assume no matching employer contributions. As expected, the replacement ratios are significantly lower and under all scenarios provide replacement ratios that fall well short of the recommended 70%.

Alternatives for Providing Adequate Income

Our projections illustrate that, unless you use exceedingly optimistic (and, in our view, unrealistic) assumptions, the benefits payable from the proposed ABC plan will be unlikely to provide the income individuals need in retirement. When coupled with the uncertainty that surrounds the income that will ultimately be paid from a defined contribution arrangement and the infrastructure that would need to be created to set up and administer the plan, we believe that other options should be explored.

The problems with the current pension system that put DB plans at a disadvantage, such as complex accounting, funding and solvency rules and the lack of coordination of pension legislation across jurisdictions should be addressed. These are all topics of current discussion by industry professionals.

In addition to addressing the problems that are creating barriers to the creation of new DB plans, there are inherent advantages to the idea of also expanding coverage under CPP. The almost universal coverage of workers under CPP is already in place, as are the systems for collection of contributions, the governance, and the administrative and investment structures. The benefits payable from CPP are defined benefits, enabling individuals to be able to estimate fairly accurately what income they can expect to receive when they retire. Even the Joint Panel in its report acknowledged that for any mandatory plan to be successful, it would have to be a national plan to avoid placing employers in BC and Alberta at a competitive disadvantage. Increasing the level of compensation covered for purposes of determining CPP benefits and increasing the level of benefit could accomplish the goal of providing adequate retirement income for a majority of Canadians in the workforce. As this was not part of our original mandate, we have not analyzed the cost of expanding CPP coverage, or looked at comparable replacement ratios under an expanded CPP.

Conclusion

The analysis shows that the level of retirement income expected to be produced under the DC-based ABC Plan is not alone adequate as a supplement to CPP/OAS unless very high contributions are made by the employee and employer, investment returns are high and contributions begin at an early age. The use of a non-mandatory defined contribution arrangement to increase worker coverage by occupational pension plans will result in some expanded coverage of workers but it is not likely to provide income that is meaningful or adequate for workers in the their post-retirement years.

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Enclosures: (8)

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