Securing Our Retirement Future

Consulting with Ontarians on Canada's Retirement Income System








Ministry of Finance

Ontario

Securing Our Retirement Future:

Consulting with Ontarians on Canada's Retirement Income System

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PREFACE

"How will I pay for my retirement?"

More and more Ontarians are asking this question. Retirement planning has always been a source of stress on the family budget, but the economic downturn of the past two years has cast new light on the issue. It has affected everyone, from my hometown of Windsor to Toronto to Thunder Bay and right across the country. Ontarians have lost thousands of dollars in their registered retirement savings plans (RRSPs) and pension plans have seen double-digit investment losses — even those with a diverse set of investments. Job losses and economic uncertainty also meant families had less money to save in the first place.

Government cannot replace investment losses nor guarantee future returns.
What government can and should do is make saving and planning for retirement easier, more affordable and more secure. Taking steps now will help Ontarians down the road — both as taxpayers and future retirees.

It's often said that Canada's retirement income system has three pillars — of which personal savings is the third. The first pillar is Old Age Security (OAS) which virtually all Canadians get when they reach age 65. The Guaranteed Income Supplement (GIS) is an additional amount available to low-income seniors. Both are administered by the federal government.

The second pillar is the Canada Pension Plan (CPP) and Quebec Pension Plan (QPP), monthly benefits paid to people who have contributed to the plans over the course of their working lives. When combined with OAS and GIS, they help maintain a basic standard of living in retirement.

Canada already has one of the world's best retirement income systems. Our diversified system offers many different vehicles for saving. We can be proud of the fact that the rate of seniors' poverty has seen a significant decline over the past few decades and is now among the lowest in the world.

Yet there is more work to do. Fewer and fewer of us now have a pension through our employer. Our savings rates have dropped. Many of us are paying investment fees that seem high. Mounting evidence shows that many of us are not saving enough to maintain our standard of living in retirement. And beyond the statistics, many Ontarians are feeling insecure and uncertain about their financial future in retirement.

While our system is already strong, we can do a number of things to make it even better. Ontario supports a three-point approach to help create a truly world-leading retirement income system.

First, we need to update our own employment pension laws. These rules have been neglected for over two decades, despite major economic and labour-market changes. Based on the advice of the Ontario Expert Commission on Pensions, our government is moving to modernize and strengthen pension legislation. One major reform bill has been passed and another has recently been introduced.

Second, we must build on the strengths of the CPP through a modest expansion of benefits. The CPP is secure, efficient, portable and fiscally sustainable but there will be increasing pressure on it as the population ages. In Ontario, over the next 20 years, the number of people over age 65 will nearly double. A modest enhancement to the CPP now would provide a significant benefit to these workers when they retire. I believe such an enhancement is affordable if contribution rates are phased in gradually, particularly in light of the over $8 billion in annual tax relief Ontario will be providing to businesses as part of its tax plan.

Third, we need more pension innovation. I believe we can make regulatory changes to harness Canada's world-leading private-sector expertise to provide more efficient, lower-cost retirement options. Current tax and pension rules state that pension plans can only be offered where an employment relationship exists. This limits the retirement savings options available to the self-employed and those who work for small businesses. By changing these laws, we can expand the range of institutions that can set up pension plans, and the range of people who can access them. Large pools of capital could reduce costs and help improve investment returns.

Much remains to be decided about how to pursue each of these steps. What kind of "modest" CPP increase works best? How can we best use pension innovation to provide more efficient, lower-cost savings options? How should we use these tools to make it easier, more affordable, and more secure to prepare for retirement?

The attached consultation paper explains in detail the issues and the options for dealing with these reforms. These important decisions affect us all, so your feedback is especially important. We look forward to hearing from you in advance of the next finance ministers' meeting on December 20, 2010. Adding your voice to an issue that is important to all Canadians will better enable government to make the best decisions.

With an expansion of personal savings, improvements in pension regulation and an agreement to expand the CPP, I am confident we will continue to see a retirement income system that enables people to retire with a sense of financial security. My hope is to bring the issues around retirement income into the forefront for Ontarians so that we think about our future retirement, build our savings and have a comfortable life after work.

INTRODUCTION

Several recent studies have identified trends that could result in many of tomorrow's seniors experiencing a decline in their standard of living in retirement. The Ontario government has launched a comprehensive plan to strengthen the retirement income system (RIS) for Ontarians. The plan consists of three key elements:

- modernizing Ontario's *Pension Benefits Act* (PBA) to enhance the reliability, security and affordability of employment-based defined benefit plans in Ontario;
- supporting a modest increase to the Canada Pension Plan (CPP) to ensure that Canadians have an improved pension in retirement; and
- working with other governments and pension stakeholders to develop new and innovative ways for Canadians to save for retirement.

Ontario's plan to strengthen the retirement income system is an essential element in the government's Open Ontario plan to create jobs and enhance the quality of life for all Ontarians.

Many details regarding these three elements are still under discussion. The objective of this paper is to seek the views of Ontarians and other Canadians on the proposals for a modest CPP expansion and for pension innovation in advance of the next round of discussions with the federal government, other provinces and territories.

STRENGTHENING THE RETIREMENT INCOME SYSTEM

After extensive consultations, the government recently introduced a second set of reforms to modernize and strengthen pensions in Ontario. The Securing Pension Benefits Now and for the Future Act, 2010 proposes changes to the PBA that would strengthen pension funding rules, clarify pension surplus rules and ensure a more sustainable Ontario Pension Benefits Guarantee Fund.

This bill builds on the first phase of reforms passed by the legislature on May 5, 2010 (the *Pension Benefits Amendment Act, 2010).*

In June 2010, Ontario proposed a two-pronged approach to RIS reform:

- a modest expansion of the CPP, fully funded and phased in; and
- pension innovation to expand the types of institutions that can offer pension plans and the range of working individuals who can participate, as well as to reduce the costs of the plans.

The CPP is secure, efficient and covers over 90 per cent of working Canadians, but it delivers a relatively modest pension. Tax-assisted retirement savings, such as pensions and RRSPs, are an integral part of Canada's retirement income system and are especially important to middle- and upper-middle income earners. However, recent evidence indicates that there are gaps in voluntary savings. Ontario's view is that progress can be made in closing these gaps through pension innovation.

Pension innovation, through regulatory and tax changes, together with a modest CPP expansion, would help Canadians achieve an affordable and secure retirement. A challenge will be to design and implement these two elements so as to minimize the potential burden on Ontario families and businesses. Ontario is seeking the perspectives of Ontarians and other Canadians on these important issues.

Guiding Principles for Reform

Ontario's approach to RIS reform will be guided by the following principles:

- *balanced* — seek compromise across competing views;
- *affordable* — costs are reasonable for individuals and businesses;
- *effective* — increase pension coverage and opportunities for retirement savings;
- *transparent* — provide opportunity for public input on clear and distinct options;
- *pan-Canadian* — national in scope while still permitting regional distinctions; and
- *evidence-based* — reforms should be based on sound evidence.

Financial Literacy

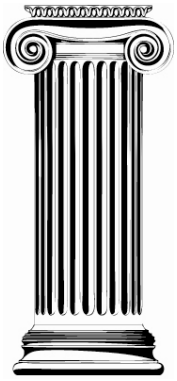
Basic financial literacy can play an important part in making individuals more comfortable with the many steps and decisions involved in planning and investing for retirement.

Ontario is implementing various provincial financial literacy initiatives to help Ontarians acquire this important life skill. The Ontario Securities Commission provides funding for the Investor Education Fund, which supports investor education and financial literacy initiatives in Ontario. The Ministry of Education is working on plans to integrate financial literacy into the Ontario school curriculum. Ontario is also awaiting the upcoming report of the federal Task Force on Financial Literacy, with the expectation that its findings and recommendations will help inform the development of any additional literacy initiatives.

AN OVERVIEW OF CANADA'S RETIREMENT INCOME SYSTEM

THE THREE PILLARS

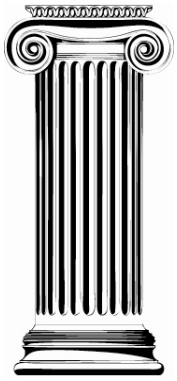
OAS/GIS



Pillar 1: Publicly Funded Income Security Programs for Seniors

Includes Old Age Security (OAS) and the Guaranteed Income Supplement (GIS). These are intended to provide an income floor for seniors. Currently, OAS and GIS provide a minimum income floor of about $14,160 to a single senior. Ontario's Guaranteed Annual Income System (GAINS) can provide low-income seniors with nearly $1,000 per year in addition to federal benefits.

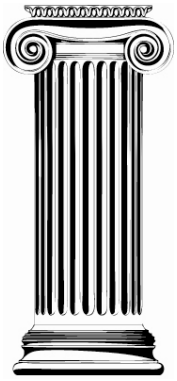
CPP/QPP



Pillar 2: Canada/Quebec Pension Plan

CPP or QPP (in Quebec). The CPP and QPP are mandatory pension programs for the employed and self-employed, and are intended to replace 25 per cent of career average pensionable earnings. The programs are funded by employer and employee contributions and investment earnings. The CPP is administered by the federal government.

REGISTERED PENSIONS & ACCOUNTS



Pillar 3: Tax-Assisted Voluntary Private Savings

Private sources of tax-assisted retirement savings, including employment pension plans and RRSPs.

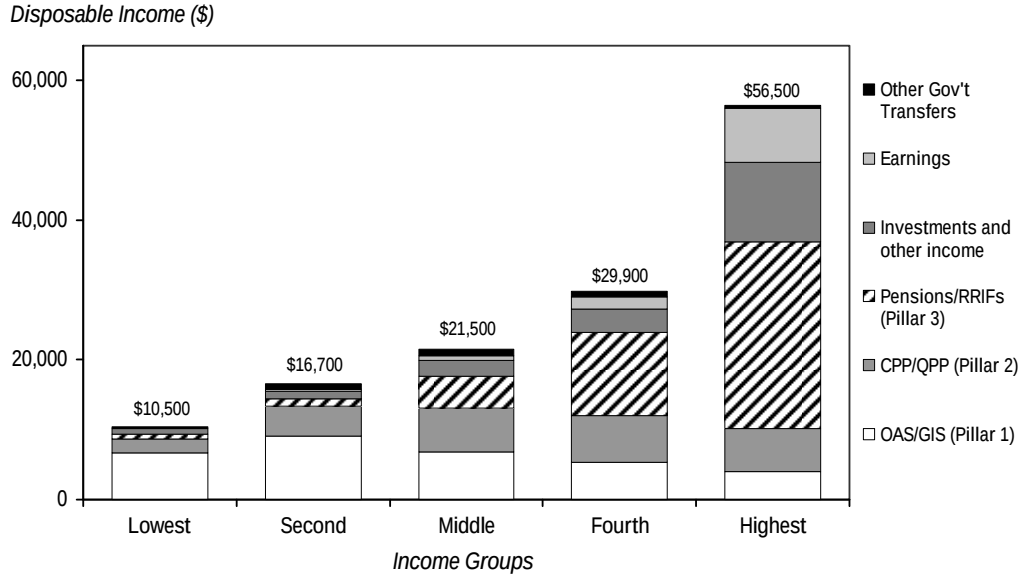
In addition to the three pillars of retirement-specific income, Canadians may rely on other assets, both financial and non-financial (such as a business or home), to help finance their retirement.

SOURCES OF INCOME IN RETIREMENT

Chart 1 illustrates the diverse sources of income for Canadians aged 65 and over. Those with lower incomes derive most of their income from OAS/GIS. For those with middle incomes, OAS and CPP together make up about 60 per cent of total retirement income. Those with higher incomes rely more on income from employment pensions, registered retirement income funds (RRIFs), and investments and other income in retirement. Earnings are also a significant source of income for those in the highest income ranges.

Income of Individuals Age 65 and Over, Canada, 2007

Chart 1



Notes: Other government transfers include Employment Insurance benefits, child tax benefits, provincial tax credits, social assistance, etc. Income taxes and other deductions were deducted proportionately from each income source. "Income Groups" refers to quintiles.
Sources: Statistics Canada's Survey of Labour and Income Dynamics and Ontario Ministry of Finance.

KEY CHALLENGES FACING CANADA'S RETIREMENT INCOME SYSTEM

While the current retirement income system works well for most of today's seniors, research has shown that some middle- and high-income earners have gaps in their retirement savings. In a 2009 study, pension expert Bob Baldwin concluded that:

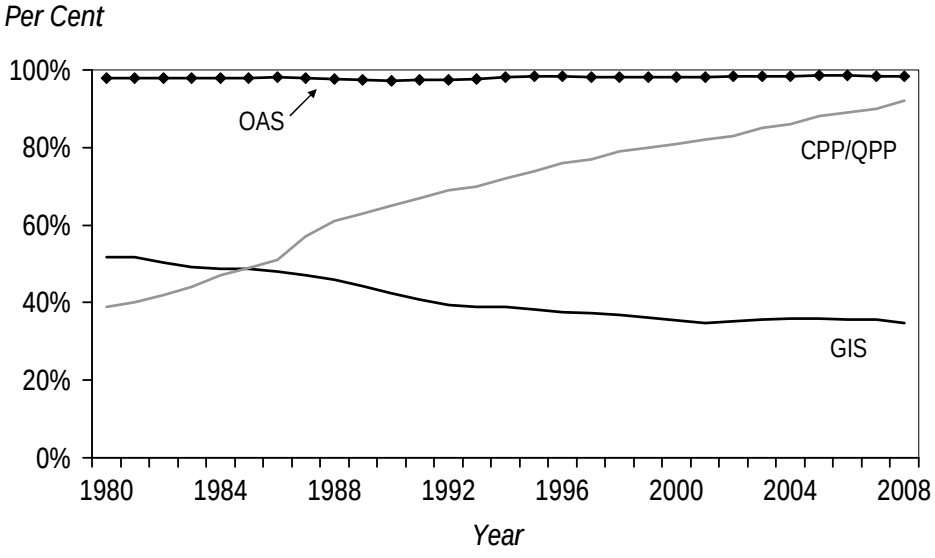
> The status quo is an option. However, it is an option that may leave a significant minority of people with moderate to high earnings facing a decline in their standard of living in retirement, and force many people to rely on sub-optimal pension and retirement savings institutions.

Two issues identified are the relatively small percentage of people with employment pension plans and low earnings replacement in retirement.

RETIREMENT COVERAGE COULD BE IMPROVED

Canada has one of the lowest rates of senior poverty among countries in the Organisation for Economic Co-operation and Development (OECD). This is largely due to the fact that OAS and GIS, or Pillar 1, reach the vast majority of Canadian seniors and Pillar 2 (CPP and QPP) also has broad coverage, with more than 90 per cent of seniors receiving benefits.

Seniors Receiving CPP/QPP, OAS and GIS, 1980 to 2008 — Chart 2



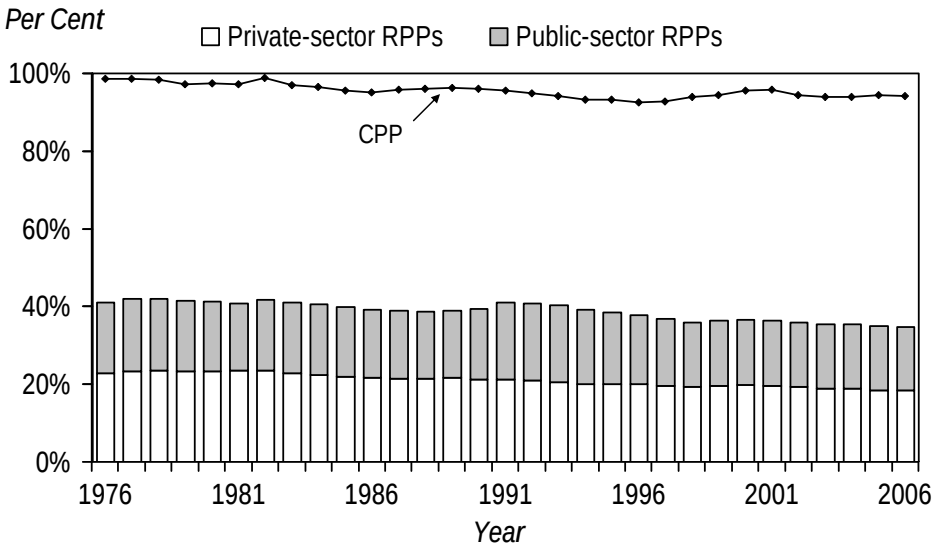
Note: Per cent of population age 65 and over.
Source: Human Resources and Skills Development Canada.

Coverage from Pillar 3 savings (employment pensions, RRSPs) is less extensive and can vary over an individual's working lifetime as a result of changing jobs or moving between employment and self-employment.

Employment pension plan coverage has gradually declined over the past 20 years. Currently, about 35 per cent of Canadian workers have employment pension plans. Private-sector workers represent about four-fifths of total Canadian employment. Less than one-quarter of private-sector workers have a pension plan, representing about 18 per cent of total Canadian employment. Public-sector workers represent about one-fifth of total Canadian employment. More than four-fifths of public-sector workers have a pension plan, representing about 17 per cent of Canadian employment.

Canada CPP, RPP Coverage
Proportion of All Paid Workers, 1976 to 2006

Chart 3



Note: Per cent of paid employees contributing to the CPP and employment pension plans (RPPs).
Sources: Statistics Canada, Human Resources and Skills Development Canada and Régie des rentes du Québec.

AN ADEQUATE AND SECURE RETIREMENT INCOME

The long-term decline in employment pension plan coverage combined with the change in types of plan coverage, low levels of household savings, as well as increasing lifespans[1] are the main reasons for concern about income adequacy in retirement.

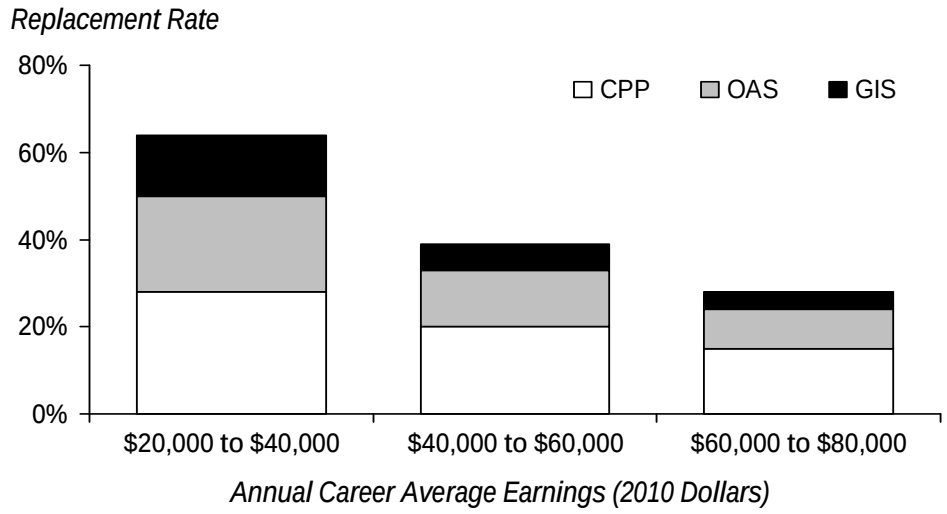
Income adequacy is the ability to maintain a comparable standard of living before and after retirement. This can be measured by means of a replacement rate, which refers to retirement income as a percentage of pre-retirement earnings.

> ***Discussion Question**: How much income do you think you will need in retirement to maintain your standard of living? What portion is this of your current income?*
>
> *Do you belong to an employment pension plan? If so, is it a defined benefit or defined contribution plan?*
>
> *Do you expect your future OAS and CPP benefits, together with your employment pension plan and/or private savings, will provide you with sufficient income in retirement?*

[1] Statistics Canada, various publications.

Chart 4 shows the career average earnings replacement rate for selected income ranges resulting from public pension sources only, in the absence of private savings. Due to OAS, GIS and CPP benefits, individuals with low career earnings generally have a relatively high income replacement rate in retirement. Higher-income earners have much lower replacement rates. Therefore, they require Pillar 3 (i.e., private) savings to achieve an adequate level of income replacement in retirement.

CPP, OAS and GIS Replacement Rates by Annual Career Average Earnings in the Absence of Private Savings — Chart 4



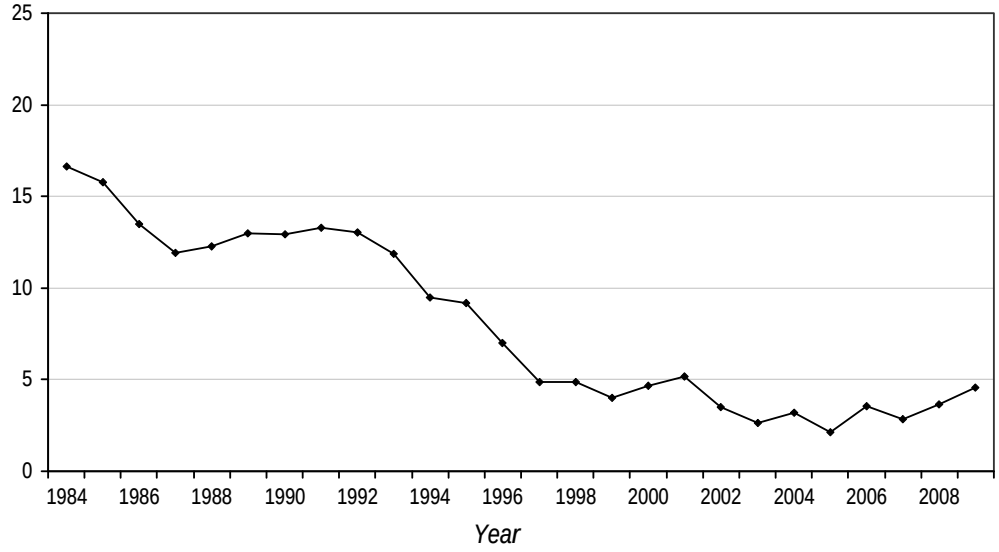
Notes: Replacement rate calculations exclude employment pensions or private savings. Income from these sources, such as pension income, RRSP or RRIF income, would reduce GIS benefits. CPP benefit calculations do not include the CPP child rearing or disability dropout provisions.
Sources: Statistics Canada's LifePaths Model and Ontario Ministry of Finance's lifetime earnings calculation.

PERSONAL SAVINGS RATES HAVE FALLEN

As can be seen in Chart 5, the proportion of personal disposable income flowing into savings[2] has generally been declining in Canada since the early 1980s. Despite trending slightly upward since 2007, it remains at historically low levels. While household net worth has been rising, this is largely due to the rising value of real estate.

Personal Savings Flows in Canada, 1984 to 2009 — Chart 5

Per Cent of Disposable Income (%)



Note: Disposable income is personal income less personal direct taxes and other current transfers from persons to government.
Source: Statistics Canada.

Canadians are not taking full advantage of tax-assisted savings. In 2008, there was $540 billion in unused RRSP "contribution" room, which represented 87 per cent of the total RRSP room available. Recent analysis suggests that today's households are saving less than previous generations.[3]

[2] Personal savings are calculated in the System of National Accounts as the difference between the amount households receive as income and their expenditures on taxes and personal consumption. The savings data do not take into account changes in household wealth, such as financial assets, home equity and retirement savings.

[3] TD Bank Financial Group–Special Report, "Retirement Income Security Reform," June 10, 2010.

***Discussion Question**: Are you concerned about your ability to save?*

Do you make RRSP contributions? Do you utilize the RRSP room available to you?

What factors may prevent you from taking full advantage of your RRSP room?

GETTING A BETTER RETURN

Individuals may not be getting the best returns on their savings if they are facing higher fees or lower investment returns.

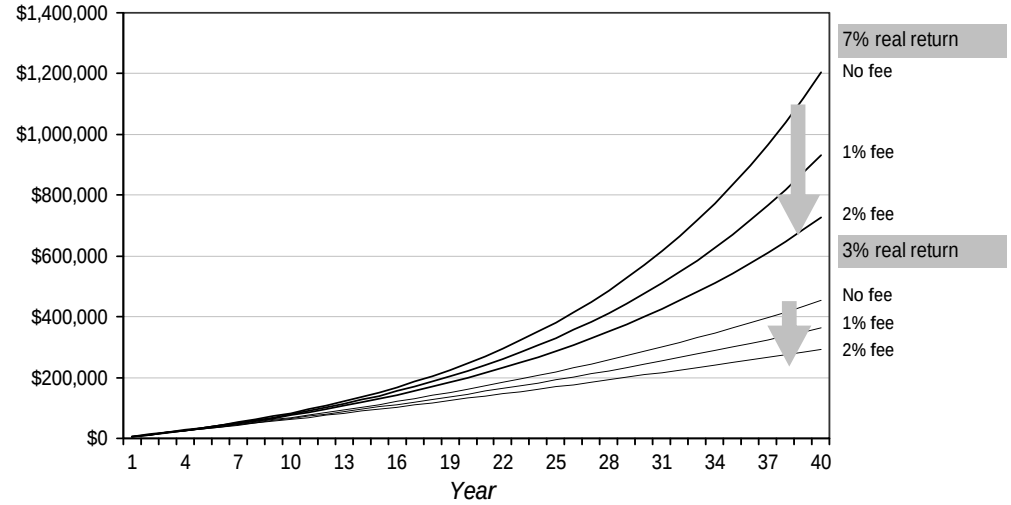
While a range of investment fees are offered in the retail market, usually based on the type of investment product purchased, individual investors may have a hard time navigating through the choices.

In contrast, large group plans typically have lower service fees and their size better positions them to diversify investment risk, which improves their long-term investment returns.

Chart 6 illustrates the effect that management fees can have on retirement savings over time. Note that regardless of the real rate of return, investment fees of one or two per cent annually result in significantly reduced savings at retirement.

Hypothetical Impact of Fund Fees on Retirement Savings

Chart 6



Note: Based on $6,000 annual contributions, 3% and 7% annual real return reinvested, over 40 years.
Source: Ontario Ministry of Finance.

***Discussion Question**: What can be done to help reduce fees charged on investment funds?*

PRIVATE SAVINGS' RISKS

Individual savings may not provide a predictable or adequate income in retirement. Risks to savings include longevity risk (i.e., having adequate savings to last through a retirement of both uncertain length and well-being), and inflation risk if income streams are not indexed. Also, the cost of annuities that provide a secure and constant source of income in retirement can fluctuate in unpredictable ways.

SECURING OUR FUTURE: AREAS FOR REFORM

PART I: EXPAND THE CANADA PENSION PLAN

When the CPP was first put in place, benefits were considered sufficient when taken in conjunction with OAS, GIS and personal tax-assisted savings.

The CPP may no longer meet the earnings replacement needs of working individuals. CPP benefits are intended to replace 25 per cent of a contributor's career average annual pensionable earnings. The maximum CPP retirement benefit for new retirees in 2010 is $934.17 per month, or $11,210 per year.

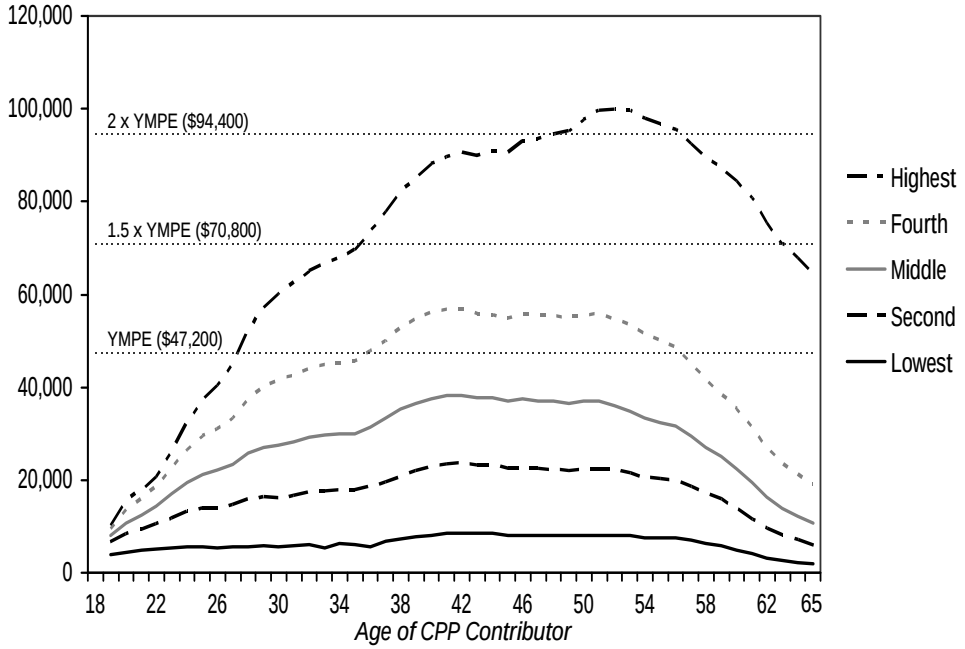
However, most beneficiaries do not receive the maximum benefit. In 2008, only 12 per cent of newly retired male beneficiaries and only two per cent of newly retired females received the maximum pension. The average new CPP pension paid in January 2010 was $6,283 per year, or just 56 per cent of the maximum benefit.

The difference between the maximum benefit and what people actually receive is due in part to the fact that CPP benefits are based on career average pensionable earnings. Annual earnings can vary widely over a person's working life, particularly at the beginning and end of a career. Also, pensionable earnings are limited by the CPP earnings ceiling, meaning that workers are limited in their ability to increase CPP benefits in years of higher earnings.

Chart 7 shows that average earnings increase substantially with age. Many workers with earnings significantly above the average wage for most of their careers have a number of years with lower earnings. Since CPP benefits are based on average pensionable earnings over an entire career, and contributions are limited by the earnings ceiling, many contributors do not receive the maximum CPP benefit.

Average Earnings by Earnings Group, Canada, Ages 18 to 65 Chart 7

Earnings (2010 dollars)



Notes: The YMPE refers to the earnings ceiling in the CPP. Contributors cannot earn CPP entitlements on earnings above the YMPE. The YMPE in 2010 is $47,200, and increases each year with the average wage. Earnings groups are based on career average and reflect quintiles.
Sources: Statistics Canada's LifePaths Model and Ontario Ministry of Finance's lifetime earnings calculation.

In June 2010, federal, provincial and territorial ministers of finance agreed to explore a "modest" expansion of the CPP. The CPP already provides relatively modest benefits, especially when compared with similar plans in other jurisdictions and employment pension plans.

Although differences exist between the programs,[4] the Social Security program in the United States has an earnings ceiling of $106,800 (about $109,000 Cdn), compared to the CPP's $47,200, and an average replacement rate of about 40 per cent. Likewise, under the Canadian federal *Income Tax Act*, defined benefit pension plans have an implicit earnings ceiling of $124,700.[5]

[4] The U.S. Social Security program is a pay-as-you-go plan, compared with the CPP's steady-state funding arrangement. Also, the United States has no program similar to Canada's OAS, or "Pillar 1" income.

[5] The federal *Income Tax Act* limits the maximum benefit in a defined benefit plan to two per cent of final average earnings to $2,494 per year of service (2010). Therefore, the maximum pension for someone with 35 years of service is $87,290, or 70 per cent of $124,700.

On June 10, 2010, Ontario Finance Minister Dwight Duncan wrote to his federal and provincial counterparts indicating his support for an enhanced CPP to strengthen retirement savings. On the same day, federal Finance Minister Flaherty also wrote, "In my consultations, I heard strong support for the CPP and the central role that it plays in our government supported retirement income system." Minister Flaherty continued, "I believe that we should consider a modest, phased-in and fully funded enhancement to defined benefits under the CPP in order to increase savings adequacy in the future."

The CPP is an Attractive Vehicle for Change

Canadians are saving less than they once did and many do not take full advantage of voluntary tax-assisted savings opportunities. A declining portion of the working population has access to employment pension plans. This means that many Canadians could experience a material decrease in their standard of living upon retirement unless changes are made.

The CPP provides a secure, fully indexed, defined benefit pension to virtually all working Canadians and is fully portable across Canada. The CPP does not carry the risk of default that is inherent in private plans due to bankruptcy or insolvency of the employer. CPP administrative costs, at 2.3 per cent of plan expenditures, are less than half those of most employment pension plans.[6]

Costs associated with RRSPs are also high compared to the CPP. Many RRSPs have fees of two per cent or more of assets per year, which can erode investment gains over time. This compares with the CPP's 0.6 per cent of assets per year. CPP costs include the cost of administering pensions, while RRSP costs do not.

The unique attributes of the CPP make its expansion an attractive option for bolstering retirement incomes. The Government of Ontario, along with the federal government and the other provinces and territories, have been exploring options for expanding the CPP.

Approaches to a CPP Enhancement

CPP retirement benefits are based on two main components: the replacement rate and the earnings ceiling. The CPP replacement rate is 25 per cent, meaning that CPP benefits replace 25 per cent of an individual's career average earnings, up to a limit. The limit, or annual earnings ceiling, is currently $47,200. Contributors cannot earn CPP entitlements on earnings above this ceiling. The earnings ceiling is called the Year's Maximum Pensionable Earnings (YMPE) and it increases each year with the average wage.

[6] Statistics Canada and the Office of the CPP Chief Actuary.

There are three main approaches to expanding the CPP.

1. **Increase the replacement rate:** Increasing the maximum replacement rate from the current 25 per cent to a higher rate, such as 35 per cent, would benefit all CPP contributors.

2. **Increase the earnings ceiling:** Currently, workers cannot earn CPP entitlements on earnings above $47,200. The earnings ceiling could be raised by, for example, 1.5 times to $70,800, or be doubled to $94,400.

   This approach would benefit contributors whose annual earnings are higher than the YMPE at least some of the time, including those who had relatively low earnings early in their careers but whose wages rose later in life.

   In 2007, 5.2 million workers, or 37 per cent of all workers, had earnings above the YMPE.[7] Of full-time workers aged 45 and over, the portion with earnings over the YMPE is nearly half.[8]

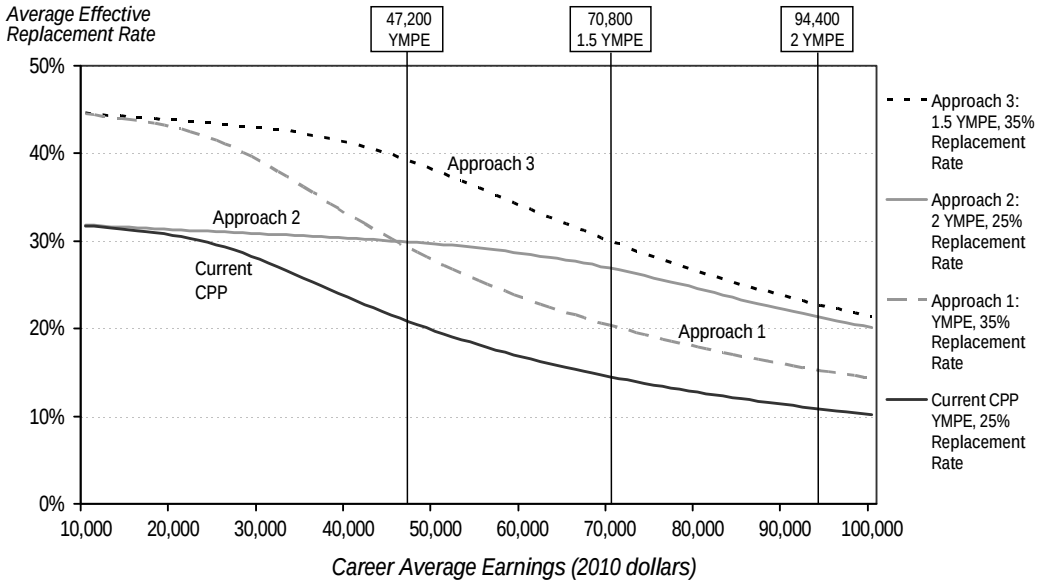
3. **Increase both the replacement rate and the earnings ceiling:** This approach would benefit all CPP contributors.

   It should be noted that 90 per cent of all CPP contributors have career average earnings of $64,200/year or less, while 50 per cent have career average earnings of $25,500/year or less, including periods of low or no earnings.[9]

Chart 8 illustrates the hypothetical effect of each approach on the CPP replacement rate at each level of career average earnings. Approach 1 would increase the current replacement rate for all contributors, but particularly for those with low- to middle-career average earnings. Approach 2 would increase the replacement rate most for those with middle- to high-career average earnings. Approach 3 would increase replacement rates for all earners, with middle earners benefiting from a proportionately higher increase.

[7] Office of the CPP Chief Actuary.
[8] Survey of Labour and Income Dynamics, 2007.
[9] Statistics Canada's LifePaths Model.

CPP Replacement Rate Versus Career Average Earnings: Three Approaches — Chart 8



Note: Earnings above the YMPE are not insurable. Therefore, the CPP replacement rate falls as lifetime earnings increase. The CPP benefit calculation does not include the child-rearing or disability dropout provisions.
Sources: Statistics Canada's LifePaths Model and Ontario Ministry of Finance's lifetime earnings calculation.

Potential Effect on Individuals

Approach 1: Replacement Rate 35%; YMPE $47,200

A person with career average earnings equal to the YMPE, or $47,200 in 2010, would experience an eight percentage point increase in her effective earnings replacement rate, from about 21 per cent to about 29 per cent.

A person with career average earnings equal to 1.5 times the YMPE, or $70,800 in 2010, would experience a six percentage point increase in his effective earnings replacement rate, from about 14 per cent to about 20 per cent.

A person with career average earnings equal to twice the YMPE, or $94,400 in 2010, would experience a four percentage point increase in her effective earnings replacement rate, from about 11 per cent to about 15 per cent.

Approach 2: Replacement Rate 25%; YMPE $94,400

A person with career average earnings equal to the YMPE, or $47,200 in 2010, would experience a nine percentage point increase in his effective earnings replacement rate, from about 21 per cent to about 30 per cent.

A person with career average earnings equal to 1.5 times the YMPE, or $70,800 in 2010, would experience a 13 percentage point increase in her effective earnings replacement rate, from about 14 per cent to about 27 per cent.

A person with career average earnings equal to twice the YMPE, or $94,400 in 2010, would experience a 10 percentage point increase in his effective earnings replacement rate, from about 11 per cent to about 21 per cent.

Approach 3: Replacement Rate 35%; YMPE $70,800

A person with career average earnings equal to the YMPE, or $47,200 in 2010, would experience an 18 percentage point increase in her effective earnings replacement rate, from about 21 per cent to about 39 per cent.

A person with career average earnings equal to 1.5 times the YMPE, or $70,800 in 2010, would experience a 16 percentage point increase in his effective earnings replacement rate, from about 14 per cent to about 30 per cent.

A person with career average earnings equal to twice the YMPE, or $94,400 in 2010, would experience a 12 percentage point increase in her effective earnings replacement rate, from about 11 per cent to about 23 per cent.

Discussion Question: *Do you favour a modest expansion of the CPP? If so, do you prefer an increase to the replacement rate, an increase of the earnings ceiling, or both?*

What do you believe is an appropriate replacement rate for the CPP? What is an appropriate earnings ceiling?

IMPLEMENTATION ISSUES

Contribution Rate

The extent of a contribution rate increase required to fund the new benefits would depend on the level of benefit improvement. While an increase in the retirement benefit over time is an objective, it must be done without placing undue hardship on employees and employers.

Discussion Question: *What do you believe is a reasonable increase in CPP contributions to secure enhanced benefits?*

Phasing In of Contribution Rate Change

To help transition to the new system, the contribution rate increase could be phased in, such as over a five-year period. Between 1997 and 2003, CPP contribution rate increases were phased in over several years as part of larger reforms that ensured the long-term sustainability of the plan.

Phasing in the rate increase would give employees and employers time to adjust to the increased contributions.

Implementation Period

Any expansion of CPP benefits would be fully implemented over a 40-year period.

The CPP retirement benefit replaces 25 per cent of career average earnings to a maximum, which accumulate at a rate of 0.625 per cent per year for 40 years (i.e., 25 per cent/ 40 years). Therefore, the full increase in the CPP benefit would occur 40 years after the date of implementation.

CPP Asset Management

CPP assets are managed by an arm's-length Crown corporation, the Canada Pension Plan Investment Board (CPPIB). As of June 30, 2010, the CPPIB had asset holdings of $129.7 billion.

Expansion of the CPP would result in a significant increase in these assets, which may be a challenge to manage. Alternative management models or approaches could mitigate the possible risks associated with such a large concentration of assets in the hands of a single investment management organization, such as allowing some choice in how or where contribution increases could be invested.

> ***Discussion Question:*** *Do you believe a single fund for an expanded CPP is appropriate? Should there be more than one fund? If so, should they be managed by the public or private sectors, or both?*

Potential CPP Contribution Rate Volatility

A fully funded CPP could have a more volatile contribution rate than exists under the current funding arrangement. Any deficit in a fully funded plan arising from a financial market downturn would have to be amortized, or paid for, over a period of, for example, 15 years or longer. Amortization of a deficit would thus require an interim increase in the CPP contribution rate over the chosen period.

Effect on Employment Pension Plans

Many employment pension plans take into account CPP benefits when calculating member benefits. An increase in CPP benefits would have to be considered by these plans.

Effect on Other Retirement Savings

Higher CPP benefits may induce employers to reduce future employment pension benefits, or individuals to reduce other savings, such as RRSP contributions.

> ***Discussion Question:*** *Do you think you would accumulate less private savings for retirement if the CPP was expanded? If so, would you prefer to save through higher CPP contributions or your own investment choices?*
>
> *What are your views about the implementation issues raised in this paper?*

PART II: PENSION INNOVATION

Strengthening Pillar 3 savings is a key element of enhancing Canada's retirement income system. Three approaches are set out below for consideration:

- new types of pension or retirement savings plan arrangements;
- changing the treatment of group RRSPs; and
- potential for establishing single-employer target benefit plans.

New Types of Pension or Retirement Savings Plan Arrangements

As outlined in the introduction and overview sections of this paper, there has been growing concern about the sufficiency of voluntary retirement savings in Canada (low private-sector pension coverage, significant unused RRSP "contribution" room, and low rates of household savings). It is also increasingly recognized that there are some important limitations (such as availability and cost) in the structure of voluntary retirement savings. Various ideas have been proposed to make it both easier and less costly to save for retirement. Most would involve changes to the federal *Income Tax Act* (ITA) and pension regulations.

For example, a central proposal under discussion by governments is eliminating the current federal ITA requirement that only allows for pension plans in an employer-employee relationship. Eliminating this employment relationship requirement could make pension-type arrangements available to millions of Canadians who do not currently have pension coverage, especially to employers and employees of small and medium-sized businesses, and the self-employed.

The basic idea is to allow financial institutions to establish and administer defined contribution plans with participation from multiple employers to increase the potential for economies of scale and lower costs to members. If these types of plans reduce the administrative and fiduciary responsibilities of employers, more employers might be induced to offer their employees coverage. Making such plans accessible to the self-employed would provide coverage to these Canadians who currently lack access to pension plans.

The basic features generally proposed for such plans include:

- defined contribution plans — contributions are fixed and members' benefits depend on the investment return on contributions;
- plans could be open to multiple employers, employees without a contributing employer, and the self-employed;
- assets could be pooled, but individuals would have their own accounts and their assets could be transferred to another plan; and
- plans could be portable nationally to aid labour-market mobility.

There are important decisions to be made around possible plan models, and these will influence design options, including governance, regulatory and supervisory systems.

If financial institutions are allowed to sponsor and administer such plans, this could transfer much of the administrative and compliance burden from employers. However, traditional pension plans are legally required to operate solely in the best interests of plan members. If for-profit financial institutions are allowed to sponsor and administer these plans, safeguards would be necessary to ensure that the best interests of plan members are addressed.

Discussion Question: *What measures do you think could be taken to help ensure that plans are operated in the interests of pension plan members?*

What measures might be required to adapt such plans for the circumstances of self-employed members?

If sufficient scale economies are achieved, group plans can generally produce lower costs and fees. However, the extent to which possible new arrangements might deliver lower fees depends on a number of factors. The degree of competition among service providers — whether too much or too little — will influence fees. For example, strong competition can drive efficiencies, but can also raise costs through increased marketing and add-on of new features. Options that increase choice and/or flexibility for both employers and employees could increase plan administrative and investment costs.

> ***Discussion Question:*** *Are there any measures that could help ensure that cost efficiencies are achieved and that members benefit from lower fees?*

It has been suggested that there should be automatic enrolment in a plan but with the ability to opt out. In the economics literature, this is called a "nudge" and studies have shown that this dramatically increases participation rates.

> ***Discussion Question:*** *Should members be able to voluntarily opt in or be enrolled automatically and have the ability to opt out?*

In traditional pension plans, contributions are locked in before retirement to help ensure that the promised pension benefit is realized and individuals do not outlive their savings. Experience with Group RRSPs and simplified pension plans suggests that employers prefer their contributions to be locked in while individuals prefer having the flexibility to withdraw contributions before retirement. Flexibility increases the risk of inadequate retirement savings and also imposes a cost on the plan, since administrators must manage for this contingency.

> ***Discussion Question:*** *Should all contributions be locked in until retirement age?*

Changing the Treatment of Group RRSPs

The section above outlined a proposal for strengthening Pillar 3 savings by making employment pension plans more accessible and workable for diverse parties — employers, employees and the self-employed. In the meantime, some stakeholders have pressed for discussion of an issue that has emerged as a result of the existing environment for workplace pensions: the rapid growth of Group RRSPs. Group RRSPs have become a popular alternative to RPPs, but their treatment for contributions, premiums and payroll taxes is the same as for individual RRSPs, which differs from that of RPPs.

Some stakeholders have suggested that contributions to Group RRSPs should be treated the same as contributions to RPPs, i.e., they should not be included in earnings. The discussion about changing the treatment of Group RRSPs should address whether this flexibility would help achieve the objective of increasing savings for retirement.

Group RRSPs are likely to continue to play an important role in Pillar 3 savings, but if pension innovation is successful in creating viable alternatives to registered employer-sponsored pensions, employer interest in them may decline.

Potential for Establishing Single-Employer Target Benefit Plans

To help address the issue of declining single-employer pension plan coverage, Harry Arthurs, in his report on behalf of the Ontario Expert Commission on Pensions (OECP), proposed that a sponsor of a single-employer pension plan could enter into an agreement with a union, or comparable organization representing plan members, to establish a jointly governed target benefit pension plan (JGTBPP).

Target benefit plans are plans that aim to provide a "defined benefit" but are funded through fixed employer contributions. If the fixed contributions are not sufficient to provide the target benefits, accrued benefits can be reduced.

Ontario recently committed to explore with interested stakeholders (including Finance Canada, pension officials in other jurisdictions, and the Canadian Institute of Actuaries) the feasibility, design and implementation of jointly governed, single-employer "target benefit plans" for employees who are represented by unions or "union-like organizations."

Arthurs stressed that such plans should:

a) have an appropriate governance structure in which member and retiree representatives make up at least half of the governing body;

b) be funded on a similar basis as many multi-employer and jointly sponsored plans (note: these rules are currently under review as part of the second phase of pension reform); and

c) be required to provide disclosure materials to plan members and retirees that clearly explain the nature of target benefits and the risks related to potential benefit reductions.

Other than the current requirement for solvency funding, nothing in the existing *Pension Benefits Act* rules would preclude the creation of a JGTBPP consistent with the OECP's recommendations. There are, however, tax treatment issues that require consideration before this model is advanced. Under the federal ITA, employer contributions to a *multi-employer target benefit plan* are treated the same way as contributions to a defined contribution plan. However, contributions to *a single-employer target benefit plan* would likely

be treated as a defined benefit plan contribution. The application of pension adjustments (PAs) based on the federal ITA rules for defined benefit plans would mean less RRSP contribution room available to JGTBPP plan members than if a DC plan treatment were applied. This could be a serious disadvantage to plan members if targeted benefits are reduced and they have had limited opportunity to build individual tax-assisted savings via an RRSP.

Some stakeholders have suggested that the single-employer target benefit model should be available to organizations that do not have unions or union-like organizations, and that the employer should be allowed to administer the plan, without a joint employer-employee governance structure. In this type of arrangement, where employees would have minimal or no direct representation, issues around designing adequate governance structures and ensuring transparency for employees and retirees become even more critical.

FEEDBACK

We would appreciate receiving your feedback on a possible modest CPP expansion and on pension innovation no later than November 29, 2010. Please submit comments to Pension.Feedback@ontario.ca, or send written comments to:

Ministry of Finance
Retirement Income Security Submission
c/o Communications & Corporate Affairs Branch
3rd Floor, Frost Building North
95 Grosvenor Street
Toronto, ON
M7A 1Z1

GLOSSARY

Accrued/Earned Pension (Accrued/Earned Benefits): Amount of pension (or pension benefits) credited to a plan according to an individual's service, earnings, etc., up to a given date.

Administrator: The person or persons responsible for managing the pension plan and the pension fund. In most cases, the employer is the plan administrator (although the employer may hire a third party to administer the plan on its behalf), but the plan administrator can also be a board of trustees, pension committee, insurance company or some other body established by law.

Canada/Quebec Pension Plan (C/QPP): Mandatory, publicly administered, defined benefit pension plans that provide a basic level of earnings replacement for all Canadian workers. The CPP applies to workers in all provinces and territories other than Quebec, while the QPP applies for Quebec workers. The CPP and QPP are funded by employer and employee contributions and investment earnings.

Capital Accumulation Plan (CAP): A capital accumulation plan is a tax-assisted investment or savings plan that permits plan members to make investment choices from options offered within the plan. Examples of CAPs include Defined Contribution Pension Plans, Deferred Profit Sharing Plans, Group Registered Retirement Savings Plans and Group Tax-Free Savings Accounts.

Career Average Earnings (Ontario Ministry of Finance): Sum of earnings from age 18 to 65 (converted to 2010 dollars using the Consumer Price Index) divided by 47 years.

CPP Benefit Calculation: The ratio of a worker's earnings to the YMPE is averaged for each year after the worker turns 18 until age 65. This time span is called the contributory period. (The contributory period is reduced for years of low or no earnings associated with child rearing specifically, and for up to seven other years for any reason.) The resulting fraction (or the value 1) is multiplied by the YMPE average for the year of retirement and the four previous years. The result is called the adjusted average pensionable earnings (AAPE). The annual retirement pension is 25 per cent of the AAPE. Thereafter, the pension increases annually with the Consumer Price Index. (Pesando, J.E. and Rey Jr. S.A., Public and Private Pensions in Canada: An Economic Analysis, Ontario Economic Council, University of Toronto Press, 1977.)

Defined Benefit (DB) Plan: A pension plan that provides its members with a predetermined pension on retirement, usually based on a flat dollar benefit per year of service or a percentage of salary/earnings and length of service.

Defined Contribution (DC) Plan: A pension plan in which contributions are predetermined, but the level of pension is unspecified. At retirement, the cash value of the pension is converted to an annuity to pay the pensioner a lifetime income.

Employment Pension Plan: See Registered Pension Plan (RPP)

Full Funding Provision: A means of financing a pension plan under which, for a given level of investment income, current contributions are sufficient to pay for benefit entitlements as they are earned. A fully funded plan has assets that are equal to its liabilities at a given point in time.

Guaranteed Income Supplement (GIS): A federal income support program that provides money in addition to OAS to low-income seniors.

Life Annuity: In the pension context, periodic payments (usually monthly) provided by the terms of a contract that will be paid for the lifetime of a person (the annuitant), or the person and his or her designated beneficiary. Annuities are normally purchased from insurance companies.

Locking In: A legislative requirement that vested pension benefits be used only for the purpose of providing a retirement income.

Multi-Employer Pension Plan (MEPP): MEPPs are pension plans covering workers employed by a number of employers, usually in the same economic sector. They are customarily funded by fixed contributions, often set in collective agreements; if contributions are insufficient to pay for the benefits provided, in most MEPPs, the benefits may have to be reduced. MEPPs are generally administered by boards of trustees, at least 50 per cent of whom must represent the active members of the plan.

Old Age Security (OAS): A monthly benefit available to most Canadians 65 years of age or older who meet the Canadian legal status and residence requirements, funded from federal government revenues. The maximum annual benefit is currently $6,259.

Pension: Generally, periodic payments that provide a regular retirement income for the lifetime of a person who is entitled to benefits under the terms of a pension plan.

Pension Benefits Act (PBA): The Ontario legislation that establishes minimum standards for registered pension plans.

Pensionable Earnings (CPP): The amount of earnings subject to CPP contributions each year. Pensionable earnings are equal to the difference between each year's YMPE and the YBE.

Registered Pension Plans (RPP): Employment pension plans that are established in accordance with the federal tax law and the applicable federal or provincial pension legislation, which sets the minimum standards for these plans.

Registered Retirement Income Fund (RRIF): Personal retirement income funds offered by financial institutions. RRIFs are used to provide an ongoing minimum flow of income and are subject to minimum annual income payment limits. RRIFs are governed by the federal *Income Tax Act*. In Ontario, money cannot be transferred from a registered pension plan to a regular unlocked RRIF.

Registered Retirement Savings Plans (RRSPs): Tax-assisted savings plans that are designed to encourage Canadians to accumulate additional savings for retirement. Contributions and investment earnings are tax exempt.

Replacement Rate (CPP): The proportion of earnings (to a maximum equal to each year's YMPE) that are received as a CPP retirement pension, averaged over the working life of a CPP contributor. The current CPP replacement rate is 25 per cent.

Year's Basic Exemption (YBE) (CPP): The YBE is the first $3,500 of earnings that are not subject to CPP contributions. The YBE has been frozen at $3,500 since 1998.

Year's Maximum Pensionable Earnings (YMPE) (CPP): The maximum earnings for which contributions can be made to the C/QPP during the year. Also referred to as the "earnings limit" or "earnings ceiling." The YMPE for 2010 is $47,200.

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