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Improving Defined Benefit (DB) plans within the Canadian Pension Landscape

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SUMMARY

Your pension doctor has checked-up defined benefit (DB) plans within the three main areas of the Canadian Pension Landscape

1. **OAS (Citizenship** approach**) & GIS (Robin Hood** approach**)**
   a) **Diagnostic:** a large portion of OAS benefits is paid to persons who do not deserve them because eligibility to benefits is based on residency tests rather than a need or a right.
   b) **Prescription:** an extreme OAS **diet,** i.e. a **gradual** 30-year starvation, while revamping **immediately** the GIS, which would gradually reduce total OAS and GIS annual payments by at least 20%, i.e. $10 billion. Similar to, but much more gradual than, the 1996 Budget **Seniors Benefit**.
2. **CPP/QPP (Confucius** approach**)**
   a) **Diagnostic:** due to CPP/QPP maturation, the proportion of GIS beneficiaries stagnates around 35% since 2010 (was 56% in 1973).
   b) **Prescription: vitamins**, i.e. any **increase in the CPP/QPP 25% retirement pension rate** would reduce the 35% proportion of GIS beneficiaries, thereby alleviating the seniors poverty rate (issue: low level of the **minimum hourly wage**)
3. **Private employer-sponsored pension plans (freedom** approach**)**
   a) **Diagnostic:** DB plans' sustainability, i.e. affordability, solvency & cost fluctuations issues
   b) **Prescription:** the following two **vaccines**:
      - my **guidelines on DB plans design** would reduce costs and improve intergenerational equity;
      - my sound and simple **financing policy** (slide #7) would essentially stabilize costs, ensure solvency & help moderating the proliferation of **viral** Target Benefit plans.

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Pensionable age (entitlement to an unreduced retirement pension)

a) **Diagnostic:** pensionable age generally lacks uniformity within the pension landscape, and is too low & unfair.
b) **Prescription: plastic surgery**, i.e. the pensionable age should be synchronized with the calendar of birth (CYB), **as more recent generations live longer,** e.g. 65 years + 2 months for each year by which the CYB exceeds 1950

Objectives of pension plans

Retirement Income Security

1. **Alleviation of poverty among seniors**
   - Seniors poverty rate: Statcan: 4% OECD: 7%
   - GIS take up rate: 35% (was 56% in 1973)
   - GIS recipients' annual income:
     - minimum: about $14,500
     - maximum: about $20,500

2. **Maintenance of pre-retirement standard of living**

A- Private pension plans
Strengths of DB plans

DB pension plans provide better retirement income security than Target Benefit (TB) and Defined Contributions (DC) plans, RRSP, Tax-Free Savings Accounts (TFSA), etc. because their:

1. **investment and longevity risks are pooled,** i.e. not borne exclusively by members, be it individually or collectively.

2. **pension benefits (accruals & indexation)** are:

   a) generally **payable for life** and **guaranteed**, excepted:
      - **accruals** in NB, and in case of employer's bankruptcy;
      - **indexation;**

   b) **set equal to a %** of pre-retirement salary (**maintenance of standard of living**).

Weaknesses of DB pension plans

1. **Discriminatory** and/or **costly benefit provisions**, e.g. final average salary, survivor benefits, uniformity of, and age/service formulas applying to, pensionable age (of entitlement to unreduced retirement benefits)
2. **Inadequacies of federal and provincial pension-related legislation**
   a) While the Income Tax Act (ITA) allows surplus to reach 125% of liabilities, OSFI allows **contribution holidays** (**CH**) as soon as surplus reaches 105% of liabilities. **CH**s, a sure financial disaster recipe, are allowed under most if not all provincial laws.
   b) Although federal and provincial (except NB) laws allow accrued benefit reductions **only on future service** , indexation is not deemed to accrue because it does not relate to service.
   c) Some actuarial valuations of DB plans are based on a **solvency** approach (as opposed to **ongoing**), which produces valuation results (cost and liabilities) that are:
      - unduly **volatile** from one valuation to the next;
      - too **conservative** (high) when current interest rates are low, and too **liberal** (low) when interest rates are high.

Effect of weaknesses of DB pension plans

1. National participation rate **is low** (about 25% for DB plans), mainly due to:
   a) pension cost volatility; and
   b) no employer is compelled to sponsor a plan for its employees.
2. **Volatility, affordability and sustainability**, i.e. the total cost (normal contribution rate plus special payments for the amortization of an actuarial debt) fluctuates too much and becomes too high if and/or when:
   a) plan provisions are too generous and/or discriminatory;
   b) longevity increases more than expected;
   c) plan's financing policy is inadequate (contribution holidays, solvency payments, etc.)
3. Unlike CPP/QPP, private DB plans' benefit "promises" are unavoidably affected by the risk of the sponsoring **employer's bankruptcy**, especially under solvency valuations when interest rates are low, as this unduly reduces the funded ratio.

How DB pension plans should be improved

A- Proposed financing policy

1. **Full prohibition of contribution holidays**, which are a sure financial disaster recipe.
2. **Setting the (unit credit) normal cost on a realistic basis** in order to minimize its volatility and optimize intergenerational equity, i.e.
   a) realistic assumptions erring on the safe side;
   b) no contingency reserve;
   c) ongoing rather than solvency basis;
   d) no asset smoothing;
   e) in case of bankruptcy of a DB plan sponsoring employer:
      - plan members should be granted priority over secured creditors to amounts covered by a deemed trust no matter when the security was granted to the lender;
      - the deficient investment fund should be maintained rather than used to buy annuities because:
        - the cost of future benefits is less expensive if paid from the pension fund at the time they become due;
        - after the sponsor's bankruptcy, the market value of the deficient fund would normally improve.
3. **Amortization over 15 years of current surplus or debt** through a generally small decrease or increase, respectively, in the normal cost, which:
   a) minimizes volatility of the **total** contribution rate (i.e. normal + amortization component) rate from one periodic valuation to the next (possibility of stabilizing employer's rate by fully imputing the amortization component to members);
   b) optimizes intergenerational equity.

How DB pension plans should be improved

(continued)

B- Proposed changes to DB plans design

1. **Avoiding any reduction in:**
   a) **accrued pensions** (e.g. **Target Benefit (TB) plans**, as done in NB on a retrospective basis), because this corresponds to a legalized embezzlement; and
   b) **indexation,** because the protection of the purchasing power of a retirement pension is one of the critical features of retirement security and the underlying plan provision does not generally affect the DB plan's solvency.
2. **Removing or improving discriminatory benefit provisions (any benefit change shall apply exclusively to <u>future</u> accruing pension benefits)**
   a) The **pensionable age** (entitlement to an unreduced retirement pension) should be synchronised with the calendar year of birth (CYB) because more recent generations live longer (e.g. 65 for CYB 1950, 65 + 2 months for CYB 1951, and so on); therefore "**age/service" rules** (e.g. "**55/30**") would disappear;
   b) The pension formula should be changed from "**final average salary**" to a CPP-like "**career average indexed salary**" formula;
   c) Entitlement to **survivor benefits** should not depend on marital status, and the survivor benefit amount should correspond to a uniform percentage of the actuarial value of the accrued pension upon retirement.

B1- Public DB plans: CPP & QPP

1. Even if all private DB pension plans were to be eventually improved as proposed herein, any exclusive increase in the CPP/QPP 25% retirement pension rate **(no changes in YBE or YMPE)** would be most efficient for purposes of alleviating seniors' poverty because:
   a) Due to CPP/QPP, the proportion of GIS beneficiaries gradually dropped from 56% in 1973 to 35% in 2010 when CPP/QPP matured.
   b) The penetration of employer-sponsored pension plans (DB, TB, DC, etc.), currently about 33%, is not expected to increase.
   c) Even if participation in CPP/QPP is essentially universal, their maximum annual retirement pension currently amounts to only about $13,000.
2. There is not much, if any, savings margin for low income earners but this issue should be addressed through gradually increasing from about $10 to $15 the **minimum hourly wage** rather than excluding, from a CPP expansion coverage, annual employment earnings under $25,000 or $30,000. Considering the **compelling** nature of any job, employers should be **compelled** to pay a decent salary that allows any employee to live in dignity and avoid poverty.
3. As a matter of **intergenerational equity**, any expanded portion of CPP/QPP should synchronise the pensionable age (entitlement to an unreduced retirement pension) with the calendar year of birth (CYB) because more recent generations live longer (e.g. 65 for CYB 1950, 65 + 2 months for CYB 1951, and so on).

1. For any senior’s annual income under the Low Income Cut-Off (LICO currently about $17,500), **OAS + GIS benefits**, furthered by some provincial programs such as Ontario GAINS, very well **contribute to the alleviation of seniors poverty**, but one does not really live in dignity with an total annual income not exceeding $20,000.
2. Eligibility to OAS benefits rests exclusively on **residency tests**, not on a **right** (as OAS program is not contributory) or a **need** (except for their applicable “clawback”).
3. Age 65 of entitlement to OAS and GIS benefits has recently for a while been improperly scheduled to increase almost suddenly from 65 to 67 years by 2023. **Pensionable age** (entitlement to an unreduced retirement pension) should rather be synchronised with the calendar year of birth (CYB) because more recent generations live longer (e.g. 65 for CYB 1950, 65 + 2 months for CYB 1951, and so on).
4. OAS and GIS programs should be **gradually** (e.g. over 30 years) amalgamated to provide exclusively and immediately a slightly higher decent minimum retirement income, similar to the Seniors Benefit envisioned by the federal government in 1996. This **could reduce total OAS & GIS costs by as much as 20% (about $10 billion annually)** compared to about 10% as per an almost sudden 2-year increase in its entitlement age.