

## **Pension Reform**

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Distinguished Chairman and Commission members, thank you for the opportunity to present a brief on pension reform.

Also thanks Government of Ontario for recognizing the pension crisis in Ontario (and Canada) and initiating this Commission.

I am not here to speak to you as a long-time pension expert. I am here as speak to you, from a combination of personal experience as a recently retired individual and, what I learned about what pensions are and could be from my studies toward Chartered Financial Analyst and opportunistic reading on pensions. I retired after almost 30 years as an envied individual for being employed by what was a relatively generous employer, which then fell on some difficult times.

## Pension System Issues

- Rapid Disappearance of DB plans (closed, capped, terminated)
  - Integrity of DB pension plans
  - Participants forced from a flawed DB to a more flawed DC pension system (higher cost, self-managed, investment risk transfer to worker, optional contributions, no longevity risk sharing)
  - Single employer vs. 5-10 employers over working life
  - DB pensions too closely tied to fate of employer/sponsor
  - Political sustainability of the growing gap between those who are and are not eligible for “public sector” pension
- ➔ **DB plans can and should still be fixed for remaining members, but are beyond repair for non-members**
- We can do better than DC with a fresh approach!**

The problems with the pension system are that they are:

-DB plans are an endangered species

-many of those still in existence have questionable integrity, and are serving fewer and fewer individuals

-participants are being forced from a flawed to a more flawed system

-is it politically sustainable to have a growing gap between those who are and who are not eligible for “public pensions”- “Public sector” pensions are generous & secure; generous and secure are not terms often associated with private sector plans

## Purpose of Brief

- **DB Pension Plans** (non-public sector):  
Issues and solutions for remaining members  
**Securing existing commitments**
- **Straw-man for a future pension system**  
Key parameters for next-generation system:  
**Participation, Cost, Shared Longevity Risk, Flexible Post-Retirement Income, Portability, Transparency and Independent of Employer**

After a quick enumeration of pension plan issues, my presentation is composed of two sections:

1. the demise of the DB plans and possible mechanisms to secure existing commitments
2. a proposal for a fresh start to a pension system of the future

## Integrity of DB Pension Plans

- Lack of transparency on funded status (% funded? What it means?)
- Non-existent or inadequate pension insurance
- Low priority in case of employer/sponsor bankruptcy
- Sponsor over-contribution discouraged (pension/accounting rules)
- Commuted value (CV) not fully transferable to RRSP
- Assumptions in calculation of CV, esp. in underfunded plans
- Dismantling of non-public system of DB plans irreversible

Non-standardized assumptions on discount rates, return rates, compensation rate increase, other actuarial assumptions (age, turnover, longevity, etc)

Multi-national sponsors report consolidated status and contributions; plan status of relevant sub-entities (e.g. Ontario pensioners) is not available in a timely fashion or at all.

Ontario is only province with even minimal pension insurance (\$1000/mo max- not shortfall)

On sponsor bankruptcy and underfunded status (i.e. no insurance company will undertake liabilities in exchange of plan assets), pensioners have to line up with unsecured creditors. What about in case of sale or merger of the sponsor?

When plans are underfunded, sponsor is responsible for shortfall; when plans overfunded there are disputes as to the ownership of excess.

Accounting rules: assumptions affect cost and balance sheet liabilities and how much of these are carried on/off balance sheet

Assumptions for calculating CV not properly justified; on retirement CV only partially transferable to tax-deferred plan, yet PA formula prevented RRSP contr.

How to insure a fair calculation of CVs for underfunded plans, both for remaining and departing pension plan members

Given the rate at which DB pension plans are being closed/capped/terminated, the dismantling of the DB pension plan system may be irreversible

## DB Plan Solutions

- Standardize assumptions for funded status of pensions
- Mandate timely disclosure of funded status (YE + 3mos) and set more aggressive targets for closing funding shortfall
- Increase DB pension plan insurance (from \$1000 to 4000/mo. Max)
- Modify rules to encourage/penalize sponsor to over/under-funded status
- Make pension underfunding a secured creditor in bankruptcy
- Change PA formula to reflect plan underfunding (pro+retroactive)
- Fair CV calculation for those leaving and staying in plan
- Full transferability of CV (and LIRA) to RRSP

The challenge of the commission is to identify the key elements toward fixing the DB pension system and persuading the politicians that it is essential to secure/protect the existing/remaining commitments to plan members

Mechanisms to insure that shortfalls in funding status are made visible early and corrective action can be taken in a timely fashion:

- standardized assumptions remove temptation to use excessively liberal assumptions to minimize shortfall
- timely disclosure of real status of pension plan at granularity meaningful to Ontario plan members

Mechanisms to secure/protect existing commitments to DB plan members:

- increase Ontario pension plan insurance \$1000 to 4000 (may be paid by employer and/or employees)
- make pension plan shortfall a secured creditor in case of bankruptcy
- fix Pension Adjustment (PA) formula which prevented employees from making RRSP contributions, based on "assumed" employer pension plan contributions (estimated after tax damage to my retirement plan is a back-of-the-envelope number of about \$100,000 ; even assuming only a \$50,000 after tax vs. forgone \$100,000 pre-tax RRSP contribution over 29 years of employment, using a 5% fixed income return in each and then kept in RRSP/RRIF for 35 years)
- fair Commuted Value(CV) calculation and full transferability to RRSP
- RRIF: minimum withdrawals need adjustment to reflect life expectancy

## Forced from DB to DC Plans

- Canadians are being Herded from Bad/Dying DB to a Worse DC Pension System

	DB Pension Plans	DC Pension Plans (RRSP+taxable)
Professional mgmt.	Yes	No
Low cost	Yes	No
Market risk borne by	Sponsor	Individual/Pensioner
Longevity Risk borne by	Sponsor	Individual/Pensioner
Systematic saving/contribution	Yes	No
Access to full market returns	Yes	No

Ontarians(Canadians) are being herded from inadequate DB plans to even more flawed DC plans:

- no professional investment management
- much higher cost
- no longevity risk sharing (life expectancy of the population is increasing, but also 50% of retirees will live past life expectancy by definition)
- no mandatory contribution
- no full access to returns available from the market(due to excessive management and administrative costs, improper asset allocation)

Ottawa Citizen quoted Conference Board of Canada/ Association of Canadian Pension Management

- DB coverage dropped from 44% to 34% between 1992 and 2003
- 41% of companies with DB-like plans changed design in past two years or expect to change in next year
- 33%/55% of public/private companies expect to change from DB to DC for some members' future service
- 53% of DB plans are underfunded

Slide 7

The Impact of Investment Expense Ratios on Pension Adequacy					
	0%	0.4%	1.5%	3%	5%
	Effective Expense Ratio				
Annual Savings (over 40 years)	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000
Final Savings (after 40 years)	\$777,000	\$707,000	\$551,000	\$400,000	\$272,000
Annual Pension Payment	\$45,000	\$41,000	\$32,000	\$23,000	\$16,000
Working Income Replacement Rate	90%	82%	64%	46%	32%

SPRING 2007 • CANADIAN INVESTMENT REVIEW

Keith Ambachtsheer and Rob Bauer "Losing ground: Do Canadian mutual funds produce fair value for their customers?"

Note: What does access to full market returns mean?

The difference between a 3.0% and 0.4% expense ratio on the invested dollars in a DC pension plan will result in an annual pension of \$23,000 vs. \$41,000, given otherwise identical plan contributions and returns. Not a pretty picture!!!

## Basic Criteria for *Future Pension System*

- Minimum **mandatory** systematic **contribution**
- **Low cost** for “full” benefit of **market returns**
- Market risk borne by employee/pensioner
- Individual longevity risk covered by longevity insurance (risk shared by the population)
- **Overall longevity risk borne by all of retirees**
- **Transparency and Portability** ( indep. of employer)
- Government administered-privately managed

Mandatory contribution set to a level to secure the approximately 70% of final income (contribution of about 10% of gross income for 25 year old, increasing 1% a year for late starters or decreasing expected corresponding benefit)...additional voluntary pre-tax contributions allowed up to say 20%

Same capital market returns are available to all, but must minimize cost of asset management to harvest available returns from capital markets

Employee bears market risk, so special handling is required in the five “transition” years prior to retirement

Overall longevity risk borne by entire population, but individual longevity risk (50% of the 65 year olds live past the current 17 year life expectancy) by mandatory longevity insurance at age 65. (cost is about 5-7% of assets)

Full portability achievable by (employer independence) Government administration and private asset management

Full transparency of costs, fees and forecasted pension for a given level of contribution as a function of age and range of returns

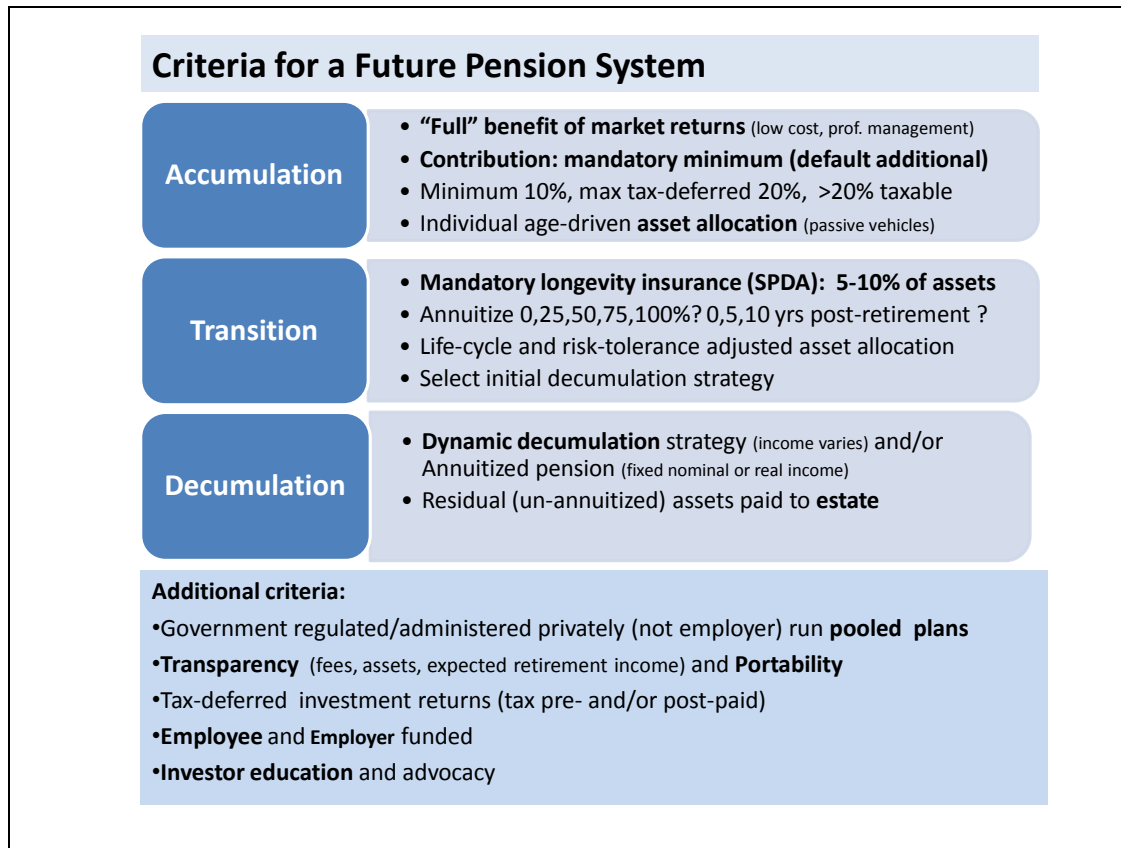
## Canada is Trailing in Pension Reform

	Australia	New Zealand	Sweden	Netherlands
Participation	Mandatory	Deafault=In	Mandatory	Mandatory
Contribution	9%	4% - 8%	16+2.5%+opt.	% for 70% sal
Contributor	Employer	Employee	50:50	Em'yer+Em'yee
Invest. Mgmt	Private	Private	2.5%+Opt. Private	
Invest. Admin	Private	Gov't+Private	Government	
Government	Reg'n+Overs't	Reg'n+Collect \$	Admin+Pricing	
Transparency	Full	Full	Full	
Fund Access		Age>65	Only >16% part	
Fund Selection		Default avail.	85% go default	
Investm't Risk	Employee	Employee	Gov't	Employee
Longevity Risk	Employee	Employee	16% gov't	All participants
Decumulation	Lump Sum(LS) or Life income	Lump Sum(LS) or options	16% Inc. only 2.5% LS or opt.	Indx.Life.Inc

Other countries have taken steps to secure their population's adequate retirement income using parameters similar to those articulated in the "Basic Criteria for Future Pension System" in previous slide.

Even U.S. Congress is taking steps (Option 1 on chart 11) that are already further ahead than Canada:

- Default to auto enrollment
- Default to life-cycle funds (not money market)
- Contribution % is of TOTAL income, not some small portion as in CPP



“Market returns”= <0.4% management fees (not the 1.5-3.0% fees in DC plans) achievable with active asset-allocation with index funds

“Asset Allocation”= life-cycle funds, i.e. age-driven asset composition (80% determined by regulation with 20% discretionary)

Life-cycle and risk-tolerance adjusted asset allocation allows for Transition phase to make allowance for differences in retirement age preferences

Some advocate use of derivatives at start of Transition phase to minimize downside risk

Longevity risk: increased longevity risk for the population is shared by the population; increased longevity for the individual handled by longevity insurance

Longevity Insurance with SPDA (Single Payment Deferred Annuity) bought at age 65 for 5-10% of assets to insure an income stream is available starting at age 85

\$10,000 payment toward a no-bells-and-whistles deferred annuity at age 65 can buy today about \$8,000 annual payments for life starting at age 85; a low cost large scale implementation of such a scheme may lead to \$10,000 per year with possible even some indexation.

Choice of decumulation strategy (income profile) for unannuitized component, so long as individual assets not exhausted before 85, when SPDA kicks in

Dynamic decumulation: e.g. 4,5,6,7% withdrawal rates at ages 60,70,80,90

Full portability insured by employer independent plan, that is government administered but privately managed

Slide 11

	DB Non Public	DB Public	DC	Option 1 Minimum	Option 2 Realistic	Option 3 Best
Employer and/or Worker paid from pre-tax \$	Y	Y	Partial	Y	Y	Y
Income Guaranteed/Indexed	N/N	Y/Y	N/N	N/N	N/Market Ret'n	Y/Y
Participation: Optional, Default, Mandatory	M	M	O	D	M-minimum O-extra	M
Portability	Limited	Limited	"Y"	Y	Y	Y
Market Risk borne by Sponsor, Employer or Employee	Employer	Employer	Employee	Employee	Employee	Sponsor
Longevity Risk: Sponsor, Individual, Cohort	S	S	I	C	C	S
Full market returns (Low cost & Professional Management)	Y but NA	Y but NA	N	Y	Y	Y
Sponsor credit risk	Y	N	N	N	N	N
Variable contribution	N	N	Y	Y	Y	Y
Estate Value	Limited or None	Limited or None	Non-Annuitized residual	Non-Annuitized Residual	Non-Annuitized Residual	Non-Annuitized Residual
Availability	Limited (Non-public)	Full (Public employees)	Partial	Y	Y	Y

Among the current pension plans (those on the left) the Public-sector DB plan is the best.

Employers are herding Non-Public sector DB pension plan members to DC plans, to rid themselves of investment and longevity risk, and high cost of final year salary based plans.

Instead of herding employees to DC plans, Option 2 is a far superior solution without necessarily increasing employers' cost....some factors in Option 2 are same and all the rest better than the corresponding DB plan, except for the trade-of between who bears market risk(employer in DB vs. employee in Option 2) and having a residual estate value( in Option 2)!

Option 1 if the current direction in the US where Default= contribute and \$ go into life-cycle/target-date fund not GIC!

Option 3 also includes a Sponsor managed market risk protection, potentially achievable with derivatives...however this would be at the cost of somewhat reduced returns( and income stream)

## A Pension Plan Example

- Mandatory 10% contribution (50:50 Employer:Employee)
- Contributions buy shares in “fund”
- Age-driven asset allocation (Equity%= 110-Age)
- Age 65 mandatory longevity insurance (SPDA): use 5-10% of assets to buy of indexed life income stream starting from age 85 of the equivalent of about 4-8% of assets at age 65
- Balance of assets pay for annual income from an “optimal” decumulation strategy(e.g. 4,5,6,7% at ages 60,70,80,90)
- At death remaining un-annuitized assets paid to heirs

Mandatory contribution of 10% of gross income, with additional voluntary employee contribution

Employer independent, government administered plan with funds buying shares in life-cycle funds offered by private investment management companies approved by administrator

Mandatory longevity insurance allows for sharing individual longevity risk

Assets converted to income via a dynamic “optimal” decumulation strategy, including the option to annuitize part of the accumulated assets

Upon death, estate receives after-tax value of residual unannuitized assets.

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I hope that I successfully described the possible improvements to what's left of DB plans and the proposed "straw-man" is a good start to better pension system tomorrow

## References

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- "[The Turner Report: Which Model has the best Attributes: Sweedish, Kiwi or Australian](#)" Deloitte's pension experts consider the best model for the UK, November 2005
- [International Pensions](#) at Pension Rights Center