The strength of CAPs in Canada's retirement market

How collaborative reform can lead to a stronger pension system for Canadians

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THE
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About the author

Bill Kyle's career in the Group Retirement business spans over 30 years. In his current role as Senior Vice-President, he has overall accountability for Great-West Life's Canadian Group Retirement Services business. His experience in the industry includes advising employers on plan creation and design, conducting education meetings with plan members, administration of Defined Benefit (DB) and Capital Accumulation Plans (CAPs), and creating member education material.

In his extensive work with regulators, Bill has served as Industry Chair of the joint CLHIA/FSCO Pension Committee, as a member of the Joint Forum of Financial Market Regulators CAP Guideline Industry Advisory Committee, and as a team leader to help draft the CAP Guidelines. He is currently a member of the Ontario government's recently created Advisory Council on Pensions and Retirement Income.

Retirement solutions that never stop working

Great-West Life administers over 17,000 group retirement plans with total plan membership of over 1.2 million, representing nearly 30 per cent of CAPs in Canada. In the U.S., Great-West is the fourth-largest retirement plan record keeper and its sister company, Putnam Investments, LLC adds to the organization's North American presence in this market. Together we serve over 6,000,000 members.

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The strength of CAPs in Canada's retirement market

How collaborative reform can lead to a stronger pension system for Canadians

Over a period of just a few years, dramatic changes have taken place in the employer-sponsored retirement plan arena. While it's well known in the industry, some Canadians may be surprised to learn that Defined Benefit (DB) plans are declining and many are no longer open to new members. At the same time, Capital Accumulation Plans (CAPs) such as Defined Contribution Pension Plans, Deferred Profit Sharing Plans (DPSPs), Group Registered Retirement Savings Plans (GRRSPs) and Group Tax-Free Savings Accounts (GTFSAs) are growing in popularity.

Recently, concern has been expressed in the media over access to coverage, the cost of CAPs and the level of income they provide. Much of this commentary demonstrates a general lack of understanding with respect to these plans.

CAPs have earned their place in the employer-sponsored retirement market.

Even as the current debate about Canada's pension system progresses, a successful model of collaboration between government and interested stakeholders already exists. The Joint Forum of Financial Market Regulators developed and implemented CAP Guidelines with a process that serves as an excellent model. Stakeholders can use this model to identify and implement improvements that would encourage new plan creation and help ensure income adequacy for retiring Canadian workers.

A collaborative approach to retirement market reform can lead to a strengthened pension system for Canadians. A promising starting point in the current discussions is the move by the Federal and Provincial Finance Ministers to create a study group led by Ted Menzies, Parliamentary Secretary to the Federal Finance Minister. This effort includes the preparation of study papers being co-ordinated by Jack Mintz of the University of Calgary.

An objective, practical, fully-considered review of the issues, goals and available approaches will enable an open dialogue involving all stakeholders and can lead to effective solutions. CAPs have earned their place in the employer-sponsored retirement market.

This briefing document describes:

- The current Canadian employer-sponsored retirement environment and how it has evolved
- The need for reform, the issues and an overview of proposed solutions
- What's working well, including the strength of CAPs
- Enhancements that would encourage plan creation and help ensure retirement income adequacy
- A model for developing and implementing change, including a 401(Canada) plan, which recognizes Group RRSPs as a formal plan type, with unique characteristics and one set of rules, including:
  - Automatic enrolment – Plan members maximize the benefits of tax-deferred compounding and any employer contributions
  - Automatic escalation of contributions – Savings increase as members draw closer to retirement
  - Longer vesting periods – Employers can encourage staff retention
  - Flexible contribution rates – Employers can adjust their contributions if circumstances change (with adequate notice to members)
  - Approved default options – Members who don't choose an investment are more likely to have their contributions invested appropriately
  - Locking in – Members can't make withdrawals that will significantly reduce their retirement savings in the long run
  - Sponsor held harmless if complying with CAP Guidelines – Encourages new plan creation
  - Tax treatment of employer contributions to non-pension CAPs should receive same tax treatment as pension plan contributions – Encourages plan creation and employer contributions

Comparing CAPs to DB plans

	Types of Capital Accumulation Plans			
	Group registered retirement savings plan (GRRSP)	**Deferred profit sharing plan (DPSP)**	**Defined contribution registered pension plan (DCRPP)**	**Defined benefit registered pension plan (DB RPP)**
Advantages	■ Sponsor has flexibility to tailor plan rules ■ Members prefer funds that aren't locked-in on termination ■ Maximum flexibility for the payout of plan proceeds (i.e. cash, transfer to another RRSP or RRIF, term annuity or life annuity) ■ Not subject to pension legislation ■ Future benefits dependent on contributions, amount of time in the plan and investment returns	■ Sponsor retains considerable control ■ Sponsor contributions tied to company profitability ■ Maximum flexibility for the payout of plan proceeds ■ Not subject to pension legislation ■ Future benefits dependent on contributions and amount of time in the plan and investment returns	■ Sponsor has more control to ensure the accumulated value of the plan is used for retirement income ■ Pre-set eligibility and sponsor contribution levels demonstrate an ongoing commitment to members and is a predictable cost ■ Future benefits dependent on contributions and amount of time in the plan and investment returns	■ Locked-in benefits provide retirement income to ensure members don't outlive their savings ■ Members may make additional voluntary contributions, which are excluded from the locked-in provisions of the plan ■ Easy for members to estimate future pension benefits
Considerations	■ Member doesn't have to use accumulated value for retirement income ■ Part-time employees can be eligible, without special requirements ■ All sponsor contributions vest immediately with the member	■ Member doesn't have to use accumulated value for retirement income ■ Part-time employees can be eligible, without special requirements ■ Sponsor can opt to cease or reduce contributions	■ Multi-jurisdictional plans must comply with all applicable provincial requirements ■ Low flexibility for plan rules – changes require amendments and must be within legislative requirements ■ Part-time employees in eligible classes must be included ■ Additional reporting	■ Multi-jurisdictional plans must comply with all applicable provincial requirements ■ Actuarial reviews required ■ Sponsor's balance sheet must account for defined benefit obligations ■ Sponsor responsible for varying degrees of investment and mortality risk (as determined by plan design) resulting in a less predictable cost

The state of the Canadian retirement market: count CAPs in

Effective reform is strengthened by knowledge of all the issues. Unfortunately some commentators have confused a decrease in DB pension plan membership with a decline in employer-sponsored retirement plans. While formal pension plan coverage in the private sector has dropped from 31 per cent to just over 24 per cent over time, this statistic doesn't mean employers and employees have given up on retirement plans.

In fact, employers have maintained or created retirement programs by using CAPs such as Deferred Profit Sharing Plans and Group RRSPs. According to a study[1] conducted in 2008, 50 per cent of private sector workers are covered at work. By ignoring the presence of non-pension CAPs, any decline in workplace retirement coverage has been greatly exaggerated.

The reported drop in pension coverage represents a move away from DBs to CAPs. The trend only applies to the private sector, since only one per cent of public sector workers are covered by a CAP.

As the discussion on necessary pension reform continues, it is concerning that some jurisdictions have moved directly to solutions without considering the facts or issues that impact retirement savings plan coverage and adequacy. To suggest, as many commentators have, that availability and cost are the main reasons more pension plans are not being created indicates a lack of understanding of the true barriers to plan creation.

While formal pension plan coverage in the private sector has dropped from 31 per cent to just over 24 per cent, this doesn't mean employers and employees have given up on retirement plans.

[1]Baldwin, 2008

To claim that the cost of CAPs is a major contributor to a shortfall in Canadians' retirement income shows a lack of awareness of the competitiveness of CAP cost structure and the critical design features necessary to meet the needs of CAP sponsors and members. As shown later, the real issues impacting adequacy are: joining a plan early, making meaningful contributions, having a proper investment vehicle(s) and not making withdrawals prior to retirement.

The need for reform: understanding the issues

Critical factors need to be examined more closely during the pension reform debate, beginning with an overview of some of the proposed solutions to date.

Critical factors

Availability is not the issue it is being made out to be. Feature-rich employer-sponsored plans are available to even the very smallest of companies.

Cost plays a role in the income adequacy equation, but it's not a negative one. Rather, cost reflects the level of administrative and individual support required to effectively offer a particular plan type. In a CAP, costs are incurred for support focused at the member level. In DB plans, support costs are largely focused at the plan sponsor level.

50 per cent of private sector workers are now covered by a plan at work.

In fact, retirement savings vehicles can be seen as a continuum. DB plans are at one end with a minimal amount of individual service, education, advice or customization.

CAPs are the middle ground, offering the member individualized investment choice, service, education, customized product features and some one-on-one advice.

At the other end of the continuum are individual retirement and investment products, which offer the most customization and the most hands-on personalized investment selection and advice. A significant part of the value in these individual products is the role of the personal advisor, who helps the client design and implement a savings program and guides them over time to stick to the plan. This service is generally not available in a CAP.

Cost is not a barrier to CAPs

The cost of CAPs has been referred to as a significant barrier to access and coverage. Let's compare the two main employer-sponsored retirement plan options. As DB plans have declined and CAPs have become more prevalent, the support and features available to a CAP have evolved to meet the changing needs of plan members, sponsors and regulators. This has resulted in an excellent value equation. The price of a CAP is often significantly less expensive than that of a DB plan, despite the level of member support required.

The chart below shows DB costs compared to average Canadian CAP costs and equivalent U.S. 401(k) costs. The size bands were chosen to align with those evaluated in a U.S. 401(k) benchmarking study published by Deloitte.[2]

Current Canadian DB costs are difficult to obtain, therefore these costs have been estimated based on the services required to run a DB plan – requirements often overlooked in articles promoting the benefits of DB plans. These costs include actuarial reports, administrative charges, custody fees, member statements, and annual consulting fees.

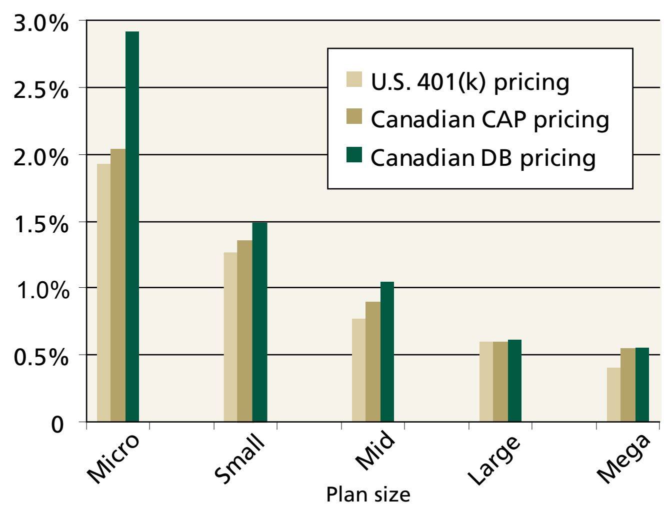
CAP costs include administration, member services, and investments. In the micro market, advisor services are almost universally used and these costs are bundled with the all-in cost. According to Deloitte, only 21 per cent of large plans use an advisor. In Canada, for larger plans this fee is typically paid separately to the advisor. However, to remain consistent with the Deloitte study these fees have been added to the all-in Canadian costs.

It might be expected that U.S. costs for CAPs would be significantly less than Canadian costs because the U.S. market is 23 times the size of Canada's ($2.3 trillion vs. $98.5 billion). Many commentators have assumed the larger U.S. market delivers lower costs through economies of scale, so it may be surprising to learn that Canadian costs are extremely competitive with U.S. plans.

[2]Defined Contribution/401(k) June 2009

Cost comparison for DBs and segregated fund-based CAPs

As shown below, cost is not the barrier it has been characterized to be in the creation of a CAP.



Notes:

Plan size segments are as defined in the June 2009 Deloitte/ICI Defined Contribution/ 401(k) Fee Study (CAD to USD exchange rates assumed to be .90)

U.S. 401(k) pricing results are median all-in fees, as defined in the Deloitte study

Canadian CAP pricing results are based on preliminary results from the Fraser Group 2009 survey on CAP pricing, extrapolated to all CAP types and include operating expenses, GST and advisor compensation

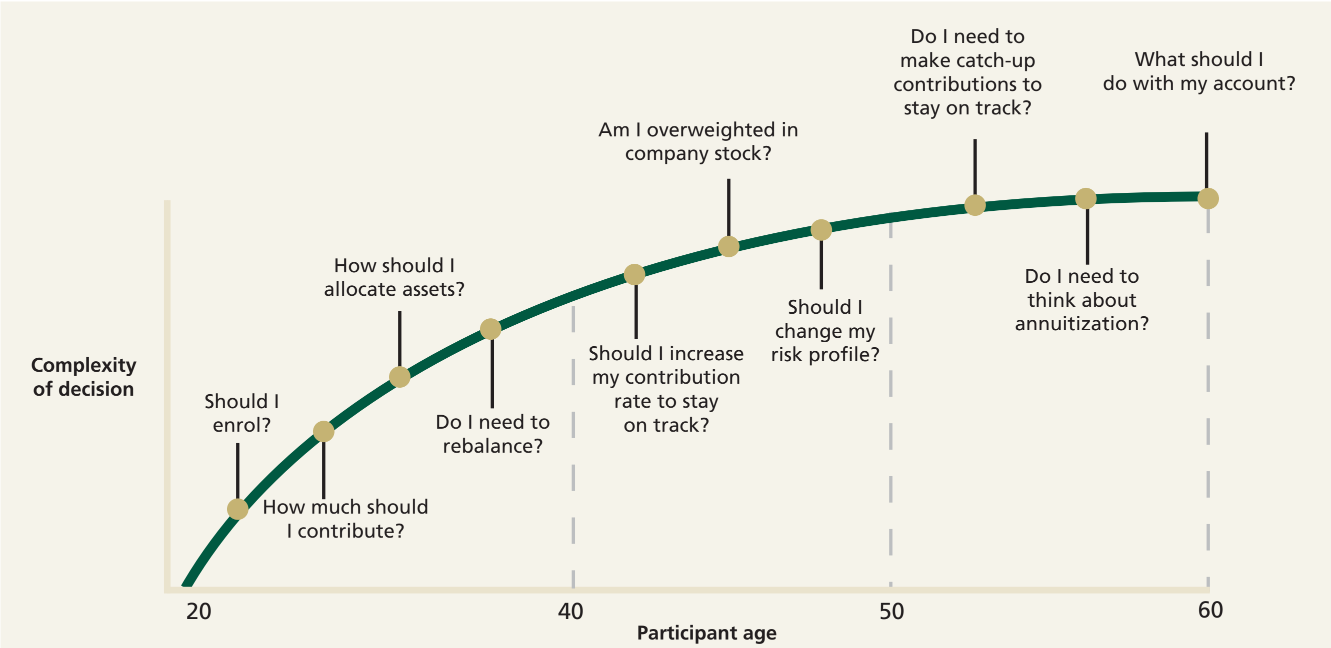
Canadian DB pricing results are estimates only and based on proprietary consulting fee schedules, benchmarked to the SEI Pension Plan Sponsor Fee Survey 2004 as well as expenses reported in financial statements filed with the Financial Institutions Commission of B.C.

The "Mega" segment expense is considered speculative for Canadian DB and DC plans due to the limited prevalence of this size of plan in Canada

CAP member touch-points

The graph and chart below show the key decision points a CAP member must make over time and how these decisions are supported in the absence of a personal advisor.

Typical decision points for a CAP investor



Source: Retirement Services Roundtable research

Member decision	Resources for members				
	1-800	Online resources	Printed resources	Live group or individual sessions	Member statement
Should I enrol?	✔	✔	✔	✔	N/A
How much should I contribute?	✔	✔	✔	✔	N/A
How should I allocate assets?	Advice or Information	✔	✔	Advice or Information	N/A
Do I need to rebalance?	Advice or Information	✔	✔	Advice or Information	System-generated messages and reminders
Should I increase my contribution rate to stay on track?	✔	✔	✔	✔	Data-driven graphs show the member's progress towards his/her goals
Am I overweighted in company stock?	✔	✔	✔	✔	System-generated messages and reminders
Should I change my risk profile?	✔	✔	✔	✔	System-generated messages and reminders
Do I need to make catch-up contributions to stay on track?	✔	✔	✔	✔	Data-driven graphs show the member's progress towards his/her goals
Do I need to think about annuitization?	✔	✔	✔	✔	n/a
What should I do with my account?	✔	✔	✔	✔	n/a

As shown above, a robust support model has evolved to support CAP members and help them manage their retirement accounts.

Questioning proposed solutions

Three solutions have been proposed most frequently during the pension reform debate:

1. Government-sponsored DC plans
2. Expanding CPP
3. Super fund

Each of these options, which may seem attractive at first glance, raise serious concerns among industry experts.

1. Government-sponsored Defined Contribution plans

Having governments offer DC pension plans is one proposal that has been put forward. It's unclear, however, what the true benefits would be, given that reasonably-priced programs are already broadly available to even the smallest of employers.

Some of the challenges for government-sponsored DC plans include:

Managing member expectations

If government chooses to offer a DC pension plan, the potential for confusion between the nature of existing guaranteed government pension programs such as CPP and OAS and a new DC pension plan is very high.

Participants in a government-sponsored DC plan wouldn't be entitled to receive a guaranteed pension amount when they retire. However there is a danger that participants may erroneously think that because of government involvement, there is some form of implicit or explicit government support which would mitigate investment losses and pension shortfalls if they arise. This could lead to confusion and disappointment.

Administrative support

Administering a DC pension plan requires expertise. Meeting sponsor and member expectations for investment choice, education, advice, reporting and on-site service, for each of the CAP member touch-points, is something that has been developed in the private sector over the past 20 years. It would be very challenging for government to establish this complex capability from scratch and a range of risks exists for this undertaking.

Limited assets equal higher costs

It will be expensive for government to offer DC plans and be competitive because almost all administrative costs of operating these plan types are driven at the member level. For some initial time period, a new government plan would have limited assets over which to spread these costs. The private sector already has sizable asset levels offering economies of scale to offset much of the fixed costs of serving members.

Level playing field

Any competing government DC plans would stifle the kind of healthy competition that has led to the advancement in products and services in the CAP marketplace. Innovation and competition have benefited Canadians, as demonstrated by the 70 per cent growth in CAP assets from 2000-2008[3].

[3]Benefits Canada CAP supplier directory 2000-2008

Private industry has done an excellent job of responding to market changes and has created cost-effective, feature-rich CAPs for sponsors who never could or can no longer afford DB plans. This has been accomplished without government support. If private service providers will be competing with newly-created government plan(s), there should be a level playing field. The administration costs of government plans should not be subsidized directly or indirectly by general government revenues, nor is it appropriate to expect private industry to subsidize government-sponsored plan costs by providing systems and expertise at artificially discounted rates.

If private service providers will be competing with newly-created government plan(s), there should be a level playing field.

2. Expanding CPP

Some commentators are suggesting expanding the CPP as a possible solution. Aside from the additional mandatory payroll tax to employers, the anticipated benefit provided by the CPP simply won't be attractive to future members of the plan.

If a new member of the CPP were to take the current required employer and member CPP contribution and direct it to a private plan earning four per cent a year, that member would achieve a significantly higher amount of retirement income – in some cases as much as double (see table on page 6). It's hard to believe that a new member of the workforce would find it acceptable to be forced to participate in such a plan.

These calculations yield similar results even for people joining the plan in their mid-forties, such as new Canadians.

3. Super fund

To lower costs of administering pension plans, the creation of a very large or "super" investment fund has also been put forward as a solution. This approach doesn't give consideration to individual investment risk. A super fund member who is close to retirement and whose benefit drops 18 per cent[4] due to a drop in the market may not be consoled by the fact he or she was in an "inexpensive" fund.

Also, a super fund isn't immune to investment issues such as asset write-offs and significantly negative rates of return. Nor is it guaranteed that the fund will be run efficiently.

[4]Jack Mintz – average 12 month drop in large pension fund market values as reported in the National Post "Beware the Super Fund," April 22, 2009

Assessment of the Canada Pension Plan for new entrants – 2009

				CPP model			Alternate model		
Entry age	Retirement age	Adjusted AMPE[1]	Total contributions	CPP monthly pension[2]	Estimated value of CPP pension at retirement[3]	Effective interest rate earned on contributions	Estimated alternate monthly pension	Contributions plus interest at retirement[4]	Percentage increase over CPP
18	70	$122,225	$394,590	$3,310	$486,718	0.94%	$7,427	$1,084,116	123%
	65	$110,703	$335,821	$2,306	$390,945	0.75%	$4,969	$837,664	114%
	60	$100,267	$282,756	$1,462	$285,181	0.05%	$3,308	$640,362	125%
25	70	$106,404	$313,942	$2,882	$423,801	1.49%	$5,160	$753,449	78%
	65	$ 96,373	$263,005	$2,008	$340,434	1.43%	$3,398	$573,071	68%
	60	$ 85,757	$217,032	$1,248	$243,513	0.73%	$2,216	$429,268	76%
30	70	$ 87,216	$263,005	$2,362	$347,493	1.54%	$3,924	$573,071	65%
	65	$ 76,473	$217,032	$1,593	$270,284	1.37%	$2,544	$429,268	59%
	60	$ 66,437	$175,557	$ 969	$189,223	0.55%	$1,626	$315,200	67%

Notes

1. Adjusted average maximum pensionable earnings is based on the last five years of YMPE at the time of retirement and adjusted for average career earnings and the low earnings drop-out provision
2. CPP monthly pension $= \frac{25\% \times \text{adjusted AMPE}}{12}$
3. Present value of blended annuity (male/female) calculated using standard pricing and indexed at 2% annually
4. Accumulated value of CPP contributions at retirement assuming a compound interest rate of 4%

Assumptions

Annual salary exceeds YMPE each year and increases 2% annually to retirement
YMPE (Year's maximum pensionable earnings) are $46,300 in 2009 and increase by 2% annually to match salary increases
YBE (Year's basic exemption) is fixed at 2009 level of $3,500
Total contribution rate (employer and employee) is 9.9% of insurable earnings (YMPE – YBE) each year and contributions are made twice each month
CPP pensions are indexed to CPI and the 15-year average CPI rate is approximately 2%
CPP contributions earn an interest rate of 4% in the alternate model

Today's marketplace

The decline of Defined Benefit plans

DB plans have always been impractical for small and medium-sized employers where a small change in plan demographics can significantly affect funding requirements.

More recently, even large employers have moved away from DB plans. Between 1991 and 2006, DB plans lost 193,000[5] members, despite significant growth in the Canadian workforce during that time. CAPs doubled during this same timeframe.

The decline of DB plans highlights the need to recognize CAPs as a viable alternative. Strengthening CAPs would benefit working Canadians. Concentrating reform on DB without recognizing or improving CAPs is to ignore a major global trend.

Two government-related causes have greatly influenced the disappearance of DB plans: complexity and the cost of unplanned features.

[5]Stats Can, Shifting Plans, 2009

Complexity

The various provincial and federal regulators of pension plans across Canada have been unable to harmonize the regulations and rules for DB plans. DB plan sponsors operating in more than one province have to expend significant resources to ensure proper compliance with the current patchwork of regulation that exists in Canada.

This situation has created a compliance burden from a risk and resourcing perspective, adding costs that plan sponsors have become more and more unwilling to pay. When added to existing accounting complications and ownership-of-surplus issues, DB plans are increasingly unattractive to plan sponsors.

Cost of unplanned features

In addition, provinces have imposed significant costs on plan sponsors by requiring pension plans to incur additional liabilities that the plans were never designed for. These expenses make DB plans cost-prohibitive and place Canadian DB plan sponsors at a competitive disadvantage compared to firms in other countries, including the U.S. and the U.K.

A few examples of some of the Canadian-only costs that the original DB plans were never designed to fund include:

- "Grow-in" benefits – certain members qualify for enhanced early retirement benefits based on prescribed factors
- Required distribution of surplus on partial wind-up of the plan
- Ontario Regulation 8(1)(b), requiring employee consent to surplus distribution, even when the employer owns the surplus
- Required annuitization of members' funds in a partial plan wind-up

Influencing factors

Two troubling trends will influence the discussions about pension reform: comparatively rich public sector pensions and the funding risks inherent in remaining private-sector DB plans.

DB member risk

The remaining DB plans in the private sector are not without significant risk to plan members. Some commentators are quick to note the issues associated with CAPs such as the inability to guarantee a specific retirement income, but few have credited CAPs for the fact that they're always fully funded. Each member's account balance is held outside the employer to the credit of the plan member.

Compared to a CAP, a member's DB funding risk in the event of plan sponsor insolvency is significant. In events of severe financial stress or bankruptcy of the employer, the risk has extended to members who have already retired. The risk isn't theoretical for DB plan members; this stark reality has become very obvious during the most recent economic downturn.

Public service pensions

The decline of DB plans in the private sector has created a dichotomy between private sector and public sector retirement plans in Canada. As corporations and the general public become more aware of this situation, there will likely be rising concern that their tax dollars are funding very generous retirement plans for public employees that are unattainable for most others in the Canadian workforce.

One study estimates that public service DB plans represent a benefit equal to 33 per cent of pay[6], as compared to a typical DC plan at 5 per cent.[7]

This situation could add momentum to the trend away from DB plans.

[6] CD Howe, Ill Defined Benefits, 2007
[7] Benefits Canada 2008 Benchmark Study

Evolution of Capital Accumulation Plans

Until very recently, the promotion, creation, support and evolution of CAPs have been the purview of small employers and a handful of service providers and benefit specialists. Efforts to create a legislative and regulatory environment to encourage plan creation and support cost-effective administration of these plans met with little success.

As the costs and challenges of administering DB plans accelerated, many large plan sponsors moved to CAPs, which heightened the focus on these plans. This focus and the current discussions about pension reform offer an opportunity to implement some longstanding recommendations for CAPs.

A plan for small and medium-sized employers

Small and medium-sized employers found it impossible to create and administer DB plans because the costs were too high and unpredictable.

CAPs proved to be much more attractive for these plan sponsors. For the employer, costs were predictable. CAP members understood and appreciated the benefits of having a measurable amount held safely in their name. This amount was portable if the member found a new job and the amount grew every year. (Until the mid 1990s, few CAP contributions were invested in equities).

Group annuities

Prior to the 1960s, DC pensions were funded using annuities. Each year's contribution purchased a paid-up deferred annuity. The member's pension grew in building blocks with each year's pension purchase being added to the amount bought in prior years.

These plans were fully insured for the benefit amount, since investment growth, expenses and mortality were all factored into the annual purchase price. Volatility and longevity issues were non-existent, because the benefit amount was constant and the member could not outlive his or her pension. These plans only required an annual statement that confirmed how much pension had been purchased that year and provided the accumulated amount of pension purchased to date.

Deposit account

During the 1970s, sponsors and members started to question these annuity-based pensions. They thought higher retirement incomes could be achieved through a deposit account in which the member would have a cash balance that was invested in one fund. The fund was overseen by the employer, much like a DB fund. These vehicles gained popularity as interest rates rose. People forced cash-outs of their previously fully-guaranteed pensions because "they didn't increase in value every year".

The deposit account plans were relatively easy to administer because the sponsor made all the investment decisions and each member was allocated his or her share of that year's fund growth on the annual statement. However, it was difficult to communicate to members how the investment vehicles worked and how the annual growth was allocated to each participant.

Member investment choice

As equity markets performed well through the '80s and '90s, members demanded the right to make their own investment choices and to have a wide variety of equity-based investment options available. This change from employer-controlled to member-controlled decisions dramatically changed the support requirements for these plans.

Investment information, education and transactions all had to be provided at the member level and on a daily valued basis. As member demands accelerated, service features expanded to include on-site education, print support materials and full-service websites. These websites now provide 24/7 access to transactions and plan information, along with tools to help members make decisions, as required in a CAP.

Statements are sent quarterly or semi-annually that include personalized recommendations based on system-generated analysis of the member's account, including investment selections and age. They provide prioritized direction for actions the member can take to enhance his or her retirement outcome.

Estimating required retirement income

In a CAP environment, members are challenged to translate their account balance into a retirement income. Statements have evolved to include scenarios that estimate the likelihood of achieving a certain retirement income. Calculations are based on each member's selected investments and use 40 years of historical investment return data. With this information, members better understand the nature of their retirement plans, and are more likely to actively follow and manage their accounts.

Effective investments

Investment options have evolved to better serve the many plan members who don't have the knowledge or desire to actively manage their fund choices. Investments are now available to optimize risk and return using the efficient frontier theory, to rebalance regularly and to offer multi-fund manager portfolio construction. With these features included, plan members can easily select appropriate investment vehicles to match their individual investment risk tolerance and goals. Options also exist to shift the investment mix automatically to a more conservative investment mix as the member ages.

Full service access

All of these improvements have occurred without government involvement. These features are fully accessible to very small plans, with a minimum annual contribution (for the plan) of as low as $15,000. Even at that size, plan sponsors receive full administrative support and members have access to group education sessions and all the product features already mentioned. Depending on the service level selected, members can also benefit from personalized individual investment selection advice based on the investment options available in their plan.

In a DB plan, there is virtually no member service requirement, because the employer makes key decisions such as how much to contribute and which investments to select. The employer uses specialized advisors for these decisions and members receive a basic annual statement.

In a DB plan, there is virtually no member service requirement.

Any comparison of cost and value between DB plans with low service requirements and CAPs, which have high member service needs, must recognize the significant differences between the two types of plans. This dramatic difference in service requirements between the two types of plans further underscores the excellent value proposition offered by CAP service providers in Canada.

What makes a successful plan

The relative merits of DBs vs. CAPs can be argued, but the reality for many employers is that a CAP solution is the only choice they have. For an increasing number of employers, CAPs have become the design of choice. By recognizing the value of CAPs, government can help create an environment that improves their effectiveness.

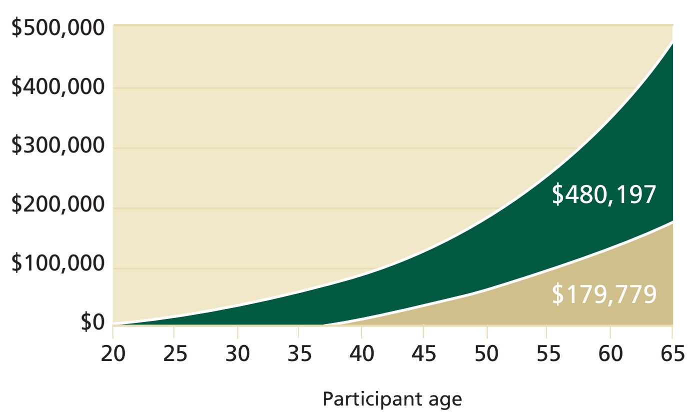
The success of a CAP depends on a number of critical factors, which combine to help determine whether a plan member will have adequate retirement income. These success factors include:

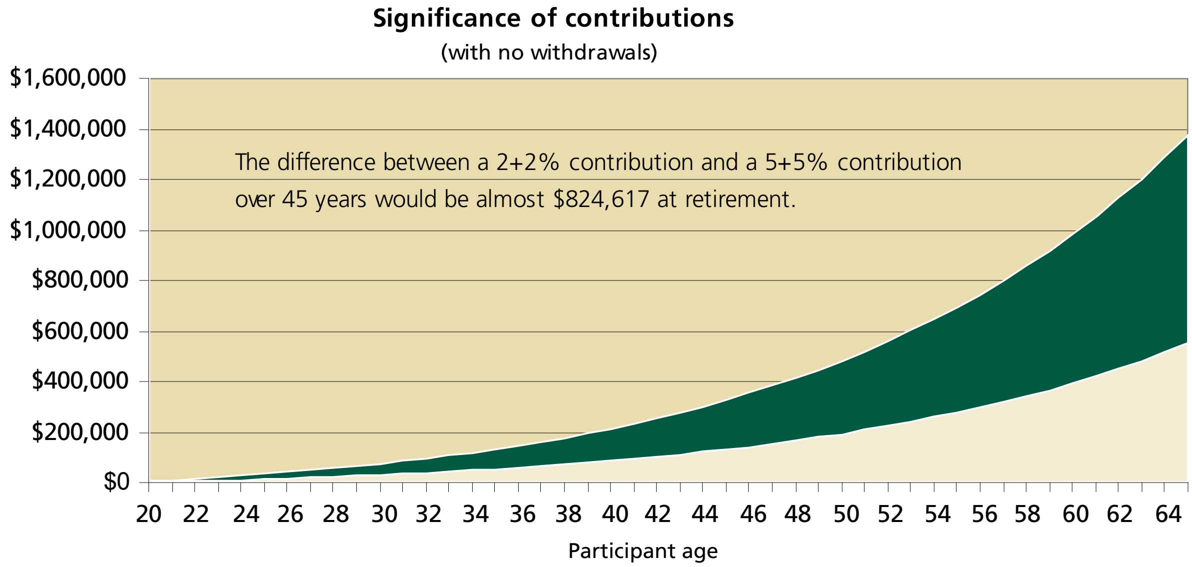
- Joining early
- Meaningful contributions
- Investment choice
- Impact of withdrawals
- Age-adjusted investment risk

Joining early

A worker must join a CAP early enough to ensure tax-free compounding works effectively for him or her. In the industry, joining a plan is called enrolment.

The chart immediately below shows how postponing enrolment affects plan savings in the long term. A member who contributes $2,000 a year and earns six per cent annually would have an extra $300,000 in savings by joining at age 20 instead of age 35.





Too many plan designs make participation optional. To ensure employees take advantage of this tax-free compounding, mandatory participation (automatic enrolment) is necessary. A 2008 study showed only 61 per cent of DC pension plans and 16 per cent of Group RRSPs have mandatory participation.[8]

Meaningful contributions

To provide adequate retirement income members must combine sufficient contributions over time with investment growth. Although members have tools to calculate how much they should contribute, few take the time to use them. In the 2008 *CAP Member Survey* by *Benefits Canada*, only 35 per cent of members said they used the decision-making tools provided by their plans. This lack of member engagement is the key reason design options such as automatic enrolment and automatic contribution escalation need to be offered.

Only 61 per cent of DC pension plans and 16 per cent of Group RRSPs have mandatory participation.

Employers can do their part by offering a meaningful "matching" contribution to the plan. When matching is available, it's critical that member contributions be sufficient to maximize the employer contribution. Establishing automatic escalation of member contributions can help build the contribution amounts to an optimal level. The chart at the top of the page highlights the impact of higher contribution rates on retirement income.

Investment choice

A plan member must choose an appropriate investment option that will maximize growth while recognizing his or her risk tolerance. While excellent investment options may be available in the member's plan, rules may allow the member to select other funds that may not suit his or her risk tolerance.

Members who don't choose an investment option may be placed in a default option. Often these default options assume that the member will only be in the default fund for the short-term. However, too many members aren't engaged – they don't make a subsequent investment decision, so these short-term holdings become long-term investments. Statistics on Canadian plan members investing in default funds are hard to find, but U.S. numbers show over 65 per cent[9] of members are invested in default funds. Having approved default options that can work for the long-term would address this issue.

Impact of withdrawals

The member must also leave the money invested in the plan so it can grow. Too many plans allow in-service withdrawals and the impact is staggering. Between 1992 and 2001, 66 per cent of tax filers aged 20 to 59 contributed to an RRSP, but over 25 per cent made at least one withdrawal. While all ages are equally likely to make a withdrawal, alarmingly, older members make larger and more frequent withdrawals and are less likely to pay them back.[10]

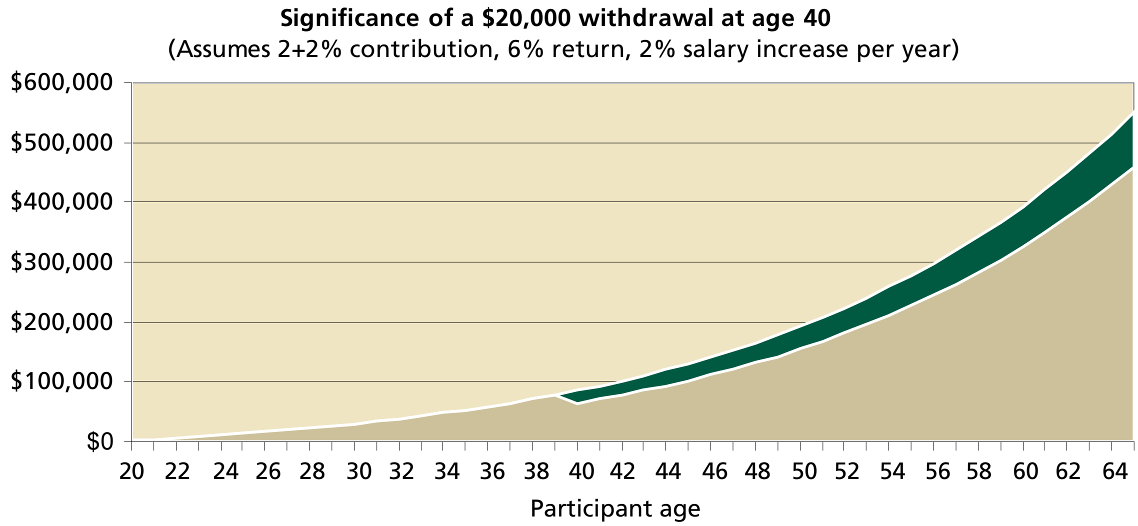
Older members make larger and more frequent withdrawals and are less likely to pay them back.

The chart on the next page illustrates the serious consequences for retirement fund growth of one $20,000 withdrawal at age 40, which costs the member almost $91,000 by retirement age.

[8]2008 CAP Benchmark Report, Benefits Canada

[9]Choi et al. For Better or For Worse: Default Effects and 401(k) Savings Behavior, 2001

[10]Giles and Maser, Using RRSPs before retirement, Perspectives, Statistics Canada December 2004



Age-adjusted investment risk

As a member approaches retirement, efforts should be made to avoid dramatic market fluctuations. Older plan members are looking to purchase an income that won't be outlived or be impacted significantly by market shifts or inflation. There are options available today but this is an area where there is room for imaginative future product development.

Barriers to new Defined Contribution pension plan creation

Feature-rich, cost-effective defined contribution pension plans are already available to even the smallest of companies. So why don't more sponsors offer these plans, especially when the perceived value by members is significantly higher than the actual cost? The chart at the top of the next page illustrates how much an employee would value a workplace retirement plan.

Small and medium-size employers may not realize what's available because they're focused on running their business. Advice from a benefits advisor often helps convince the employer that a retirement plan can work for their business, for their employees and for themselves as members.

A pension plan must be "sold" because employers are daunted by the complexity and restrictive nature of pension requirements, which were developed for DB plans but inappropriately applied to DC plans. It takes a great deal of knowledge and persistence to help an employer understand that a DC plan may be the best way to help employees prepare adequately for retirement at an appropriate age.

To an employer, the extra cost and complexity of establishing a pension plan may not be worth the benefits – they will simply opt to offer a Group RRSP. In this process the value of intermediation by an advisor is something that needs to be recognized.

What employers say about DC pension plans

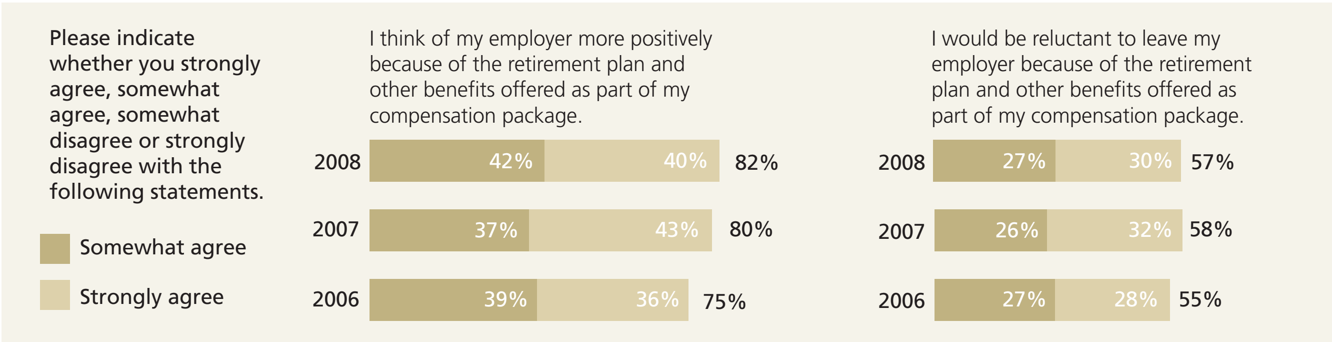
There are two tiers of objections that are often heard from sponsors. The first relates to why they don't want to establish any kind of retirement plan. These objections and potential answers include:

- *"I can't afford it."*
  - Employers don't appreciate that they can implement a plan as part of a wage increase and thereby reduce payroll taxes. When they hear the word pension, they think it's not something their business can afford.
- *"My employees just want cash."*
  - Employee research says otherwise.
- *"I'm not responsible for their retirement. I don't know that they'll even work here when it's time to retire."*
  - It's difficult to overcome objections from an employer who isn't particularly interested in the welfare of their employees. It can be pointed out that CAPs are a proven way to increase employee loyalty.
- *"I don't have time to deal with that."*
  - Demonstrate benefits to the business and help quantify the actual cost/benefit in dollars and cents. Explain that by investing in a retirement plan, the business saves on turnover, hiring and retraining costs, loss of organizational memory, and the opportunity cost of not recruiting the best employees.
- *"My business is my retirement." (owner-operators)*
  - It's not guaranteed that someone will pay the expected price for a business, when the owner wants to sell. Owner-operators need to build up savings over time.

A sample of objections we hear from potential sponsors who will establish a DPSP or Group RRSP but not a DC plan include:

- *"There's too much government involvement and reporting, such as estimating expected employee contributions, registration fees, Annual Information Returns and associated fees."*
- *"I can't commit to an annual contribution that must be maintained, regardless of how the business is doing."*

Attitudes toward DC/Group RRSP plan sponsors



Source: Benefits Canada CAP Member Survey 2008

- *"With unlocking and options other than purchasing a retirement income – what's the value of a registered pension plan?"*
- *"With the current short vesting rules I can't use a pension as a tool to retain my employees."*

Proposed changes

Change is needed to encourage plan creation and ensure retirement income adequacy.

- A national set of rules that recognizes the distinct nature of CAPs but addresses adequacy design issues and recognizes the fact that employers offer these plans on a voluntary basis would be very helpful. Sponsors need to benefit in meaningful ways in return for offering a plan and making contributions.
- Allowing variable contribution rates would also be received favourably by employers.
- The existing patchwork of DB rules applied to DC pensions is a major disincentive to pension plan creation. Many employers opt to establish Group RRSPs instead of pension plans, making it more difficult to address the key design issues that impact adequacy. Modifying existing pension regulation to make DC plans more appealing would represent significant progress.
- Holding the sponsor harmless if following CAP Guidelines would encourage more sponsors to offer retirement plans to their employees.

In the U.S. the move to CAPs has occurred faster than in Canada. As a result the U.S. has already had to deal with making CAPs work well. Canada should not miss the opportunity to learn from their experience.

The U.S. has created one set of rules under the *Employee Retirement Income Security Act* (ERISA) specific to 401(k) plans and holds sponsors harmless if they comply. These rules cover the choice of approved default investment options, allow automatic enrolment and provide for automatic escalation of contributions. All of these design factors significantly improve adequacy.

Launching a new plan type with an organized awareness campaign to educate employers would encourage plan creation. Giving provincial pension regulatory bodies a mandate to promote the creation of plans, as has been done in the past, could also help raise employer awareness.

Recommended process

While CAPs have become more visible they are still not well understood. Only now does there seem to be an appetite to change legislation to recognize the existence of CAPs and facilitate their creation and effectiveness. Despite this, pension regulatory bodies have managed to develop and implement best practices for running these plans.

The Joint Forum of Financial Market Regulators should be congratulated for their work with stakeholders to provide a common set of expectations based on industry best practices. The CAP Guidelines that they created have been extremely useful and universally adopted.

Sponsors and service providers should be commended for their contribution to the development of the CAP Guidelines and for their concerted efforts to run their plans in accordance with them.

As the current debate progresses, the successful process used by the Joint Forum to develop and implement the CAP Guidelines can serve as an excellent model. Using the Joint Forum's example, improvements can be identified and implemented that will encourage new plan creation and ensure income adequacy for retiring Canadian workers.

401(Canada)

Recognize Group RRSPs as a formal plan type, with one set of rules including:

Member:

- Auto enrolment of members
- Auto escalation of contributions
- Approved default options
- Locking in

Sponsor:

- Longer vesting periods
- Flexible contribution rates
- Sponsor held harmless if complying with rules
- No payroll taxes on employer contributions

Conclusion

Many of us in the group retirement industry believe that the imagination and creativity shown by the industry in developing CAPs over the years can, with regulatory support, build Canadian products that would successfully support Canadians in reaching their retirement goals. We're optimistic that the current attention on pension reform could move these required changes ahead.

The evolution of the defined contribution solution in Canada has come a long way. Regulators (through the Joint Forum of Financial Market Regulators) have acknowledged the unique nature of CAPs and implemented universally adopted standards, covering best practices for sponsors, members, advisors, and service providers. This accomplishment stands as a strong example of what can be achieved when industry and government work together towards a clear goal.

Within today's outdated regulatory framework, plan sponsors have worked diligently to engage their plan members and arrange for the support necessary to achieve the best retirement income possible for their employees. Service providers, through open competition, have evolved their product and service features to a level that is world class.

Despite these efforts, the retirement savings system in Canada needs improvement, with a particular emphasis on continuing to improve CAPs and encouraging more employers to consider them as an appropriate option for their employees. It's encouraging that this issue is making it to the top of the political agenda.

This critical issue will affect the well being of working Canadians and deserves the best efforts of all stakeholders to seek effective solutions. Hopefully the debate will foster an environment of awareness, leading to legislation that encourages new employer-sponsored plans and addresses adequacy issues. This new environment can be a huge step forward in ensuring sufficient retirement savings for working Canadians.

The infrastructure is already in place to effectively deliver better, made-in-Canada solutions. A meaningful improvement in coverage and income adequacy could be achieved much more easily than many people imagine.

Let's not waste the current opportunity!

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