TIME FOR ACTION

CPP Expansion: A critical part of the solution

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Debate has intensified on how best to help Canadians plan for retirement with adequate retirement income, and rightly so. Approximately 60% of Canadians moving towards retirement are expected to lack savings to make ends meet during their retirement; about half are expected to still carry a mortgage[1]. There is a fundamental issue that Canadians appear to be suppressing and that is the fact that a majority need to increase their actual savings along with developing a sufficient understanding and importance of commencing retirement savings early in one's career. This article offers a practical approach as one part of the solution to move the needle towards solving Canada's retirement savings dilemma while addressing the concerns of stakeholders. Consequences of not addressing this intergenerational issue will have a major impact on the standard of living for a majority of Canadians as well as economic ramifications due to a reduction in this demographics' consumer spending. Although this article focuses on leveraging the CPP,

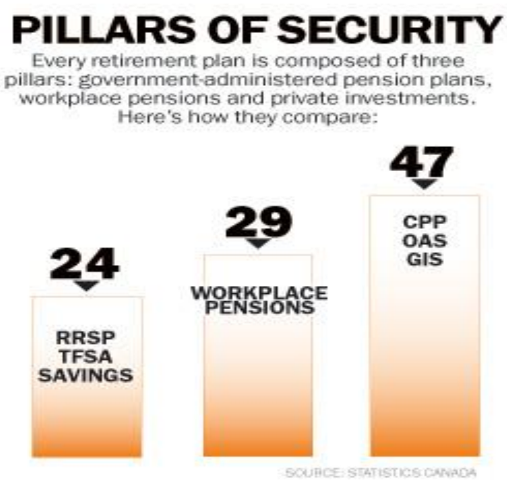
[1] According to a recent BMO study, 54% of working Canadians expect to retire with a mortgage.

Canadians should not become solely reliant on government-administered programs to fund their retirement. We would also encourage the need to increase education on the financial concepts related to funding retirement and the broader concept of enhancing financial literacy. There are many stakeholders who are looking for answers to this dilemma including federal and provincial governments, workers, employers and taxpayers.

Defining the Problem – Inadequate Retirement Savings and Income

Canada has many retirement vehicles available for individuals and employers supporting financial planning for retirement. The three pillars of the Canadian retirement savings system are well documented as:

1. Company sponsored pension plans;
2. Personal tax-assisted savings plans; and
3. Government-administered programs; CPP, OAS and GIS.



Percentage comparisons out of 100%

The problem exists that a majority of Canadians are only covered by one pillar, government-administered pensions. This clearly was not the intention of the three pillar framework but unfortunately it is the reality for too many Canadians today, with the trend indicating that a significant number are expected to become more dependent on government plans in the future.

Pillar #1 – Company sponsored pension plans

In the private sector, only 4 out of 10 employees are covered by a company pension plan[2] and even fewer employees are covered by a defined benefit ("DB") plan. To make matters worse, the trend continues in

[2] Statistics Canada – 61.2% do not have a company sponsored pension plan (May, 2012)

Canada to restrict entry, or to close DB plans and shift employees into far less generous defined contribution ("DC") plans. Results from a recent survey reveals that plan sponsors have already introduced de-risking measures since the 2008 economic crisis[3]. The most popular measure has been to modify DB plan design, which involves cutting back on ancillary benefits, higher member contributions or converting to a DC arrangement. Many large companies that have a DC pension plan either have outdated contribution formulas or offer too little in contributions to support adequate income levels during retirement. Furthermore, due to the voluntary aspect of these plans, participation rates often fall well short of 100% despite matching contributions from employers. Smaller companies may have DC plans or sponsor group RRSP plans but these tend to be hampered by lower contributions, high administration fees, the voluntary aspect of such plans and, in the case of RRSP's, allowing access to these funds prior to retirement. Many Canadians seem to be holding out hope that new plan designs, such as target-lifecycle benefit pension plans and shared-risk pension plans, will boost retirement incomes. Many experts suspect that these new savings vehicles won't actually create a significant number of new pension plans but instead will replace existing DB and some DC plans.

Pillar #2 – Personal tax-assisted savings plans

Individuals have many options to plan and save for their own retirement: Registered Retirement Savings Plans (RRSP), Tax Free Savings Account (TFSA), personal savings and in future, Pooled Retirement Pension Plans (PRPP). Similar to DC plans, these retirement vehicles are voluntary and primarily self-managed. Typically, the majority of individual investors tend to be unsophisticated and risk-averse which can lead to relatively poor long-term investment returns resulting in lower retirement income. While the trend towards improved plan designs and increased education of individuals can assist in improving investment decisions, individual investors do not generally have the ability to achieve long-term performance returns that are close to those achieved by professionally managed DB plans; estimated to be lower by 100 – 200 basis points.

However, the real story here is much the same as under pillar #1: there is a lack of coverage as most Canadians do not take advantage of tax-assisted savings plans and in particular the RRSP. Some facts to highlight the lack of coverage that RRSPs are providing Canadians:

- 2 out of 3 people do not have RRSP savings
- 50% of all contributions to RRSPs are by the highest 10% of earners[4]

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[3] Morneau Shepell April 2014

[4] Canadians that make at least $150,000 per year

- 94% of available RRSP contribution room is unused

Pillar #3 – Government-administered programs; CPP, OAS and GIS

The Canada Pension Plan (CPP), Old Age Security (OAS) and Guaranteed Income Supplement (GIS) are plans that provide income support to seniors in their retirement years. The CPP collects contributions and pools the investment and longevity risks of most Canadians to provide a certain level of income during retirement. The CPP is a mandatory retirement program that is funded by payroll taxes (premiums) on employment earnings up to the year's maximum pensionable earnings limit (YMPE) of $49,000 for 2014. Employers and employees contribute rate equally at 4.95%, and the self-employed contribute at a rate of 9.9%. Contributions go directly to assets designated to fund the CPP benefit promises and are managed by the CPPIB. The target income replacement ratio for someone retiring at age 65 is about 25% for individuals earning up to $52,500 in 2014; which is a maximum of $1,038 per month, with the average Canadian taking home $633 per month.

Created in 1997, the Canadian Pension Plan Investment Board (CPPIB) operates at arm's length from governments, to invest the funds of the CPP to help ensure its long-term sustainability while also being strictly accountable – through policies, regulations, and enabling legislation[5]. CPPIB is a professional investment management organization that invests the funds of the CPP on behalf of millions of Canadian contributors and beneficiaries and is recognized worldwide as a leading standard for national pension plans. The critical purpose of the CPPIB is to help provide a foundation upon which millions of Canadians can build financial security in retirement. Net of expenses, the CPPIB targets a return of 6% (a real rate of return of 4%); the average rate of return over the past 10 years has been 6.7%.

The OAS pension is a monthly payment available to most people 65 years of age and older who meet the Canadian legal status and residence requirements. In 2014, eligible recipients receive a maximum monthly benefit of $552; forecast expenditures for 2014 /15 from general revenue - $33.5B. Beginning in 2023, over a six year period, the age criteria will gradually increase to age 67 by 2029.

There is another layer of benefit, a social safety-net, called the Guaranteed Income Supplement (GIS) which is a means-tested benefit for seniors with very low retirement income.

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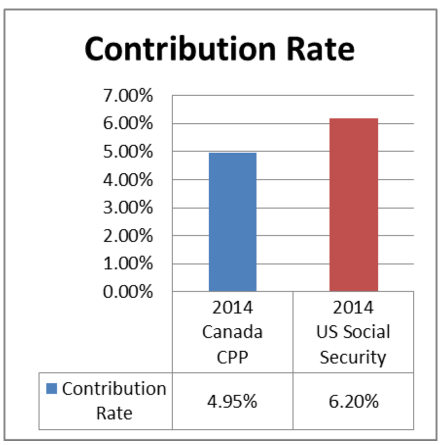
[5] CCP Investment Board http://www.cppib.com/en/home

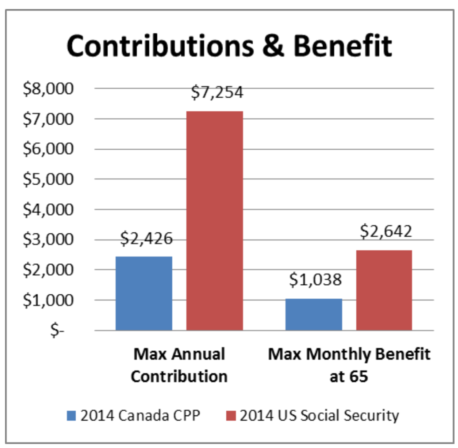
According to Statistics Canada, about **47% of all retirement income** comes from CPP, OAS, and GIS. If company-sponsored pension plans continue to decline or provide less retirement savings to working Canadians then the dependency on government administered programs can be expected to increase.

How does CPP stack up against US Social Security?

US employees and employers pay 6.2% on annual earnings up to $117,000 into Social Security (4.95% / $49,000 in Canada). In the US both also pay 1.45% of earnings into Medicare with no earnings limit. At maximum earnings, US employees and employers pay $7,254 for Social Security compared to $2,426 for Canadians.

US retirees eligible for full benefits receive $2,642 per month (at age 66), approximately 2.5 times that of their Canadian counterpart receiving the CPP maximum of $1,038 per month (at age 65). This is not surprising as the annual maximum contribution in the US is almost three (3) times higher than the maximum in Canada. This significant difference is a combination of the higher contribution rate of 6.2% to 4.95% and the maximum eligible earnings at $117,000 compared to the Canadian maximum at $49,000.





It is acknowledged that a portion of the difference in contributions in Canada is made up by the OAS pension, a taxpayer funded benefit.

In summary, Canadian businesses must remain diligent in managing costs in a competitive global economy; it should be recognized that the US employer cost for Social Security and Medicare is significantly higher than in Canada. US employers are far more fearful of the costs of medical benefit plans which often adds to employee carrying costs[6]. ***The point being that the carrying cost of employees to US businesses are far***

[6] The employee carry cost of medical benefits plans in the US depend on the wage rate and participation by the employer

higher than in Canada. This indicates that Canadian businesses could be in a position to absorb a small increase in costs today before the retirement savings dilemma creates a potentially critical problem for government, individuals, taxpayers and the economy.

While some may fear negative effects of CPP expansion on small businesses, strong arguments have been made against the expansion of CPP due to increased costs to Canadian businesses as well as reduced disposable income for individuals. The comparison to US Social Security takes much of the sting out of those arguments and is quite frankly**,** illuminating.

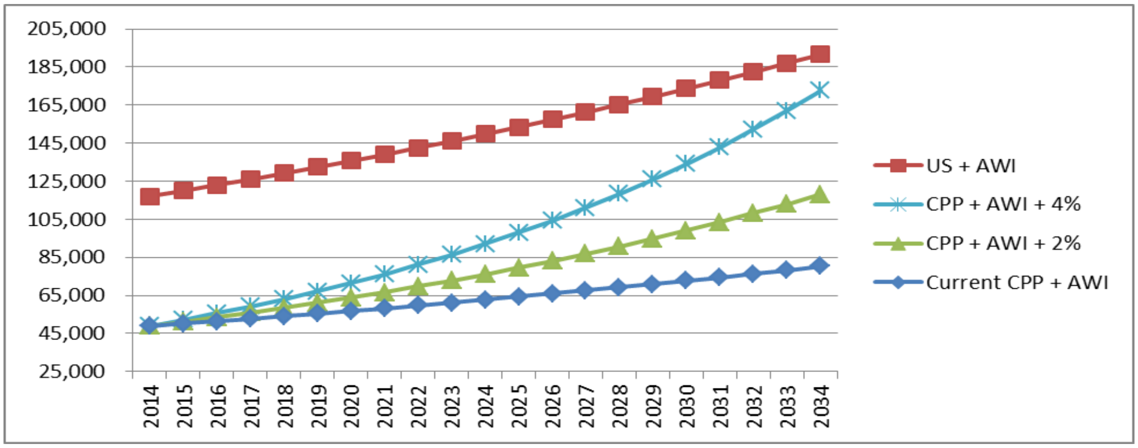
CPP EXPANSION: a critical part of the solution

A modest expansion of benefits provided under the CPP will improve retirement income for millions of Canadians that will be dependent on *Pillar #3 – Government-administered programs*. A modest increase in contribution rates over an actuarially determined amount of time, coupled with higher performance returns under a professionally managed fund, enables the CPP to support a modest increase in future benefits while migrating to a sustainable, funded increase in benefits. The simplicity of this proposal is the ease and low-cost of implementation across the country - the current infrastructure is already in place as all businesses have a CPP deduction field in their payroll systems!

Hence, there is an effortless middle ground between "rapid expansion" and "status quo". When adjusting CPP contributions one can adjust the Yearly Maximum Pensionable Earnings (YMPE) and/or the contribution rate. We advocate the following practical and moderate approach to expanding the CPP:

- ***Yearly Maximum Pensionable Earnings***: continue to increase the annual YMPE by the Average Wage Index (AWI), estimated at 2.5%; plus increasing YMPE by an additional 2% - 4% per year over and above the AWI. Incremental annual cost for individuals and employers; AWI + 2% would add $48.51 in 2014, AWI + 4% would add $97.02. This amount would gradually increase over time *(see graph below)*.
- ***Contribution Rate***: we also advocate a gradual increase in the contribution rate from the current 4.95% to a rate closer to the US Social Security rate of 6.2%. For instance, a .05% rate increase in 2014 would add $24.50 to contributions by individuals and employers. A gradual rate increase combined with small increases in the YMPE would improve future benefits for retirees whose earnings have been below the YPME, and still only add moderately to contributions.
- ***CPP benefit***: future increases in CPP benefits would be based on an actuarial solvency funded basis; coupled with age eligibility moving to 67, aligning with the OAS age change.

This graph contrasts the current YMPE to proposed increases and to the US earnings limit over 20 years.



This table shows that Canadian workers, taking into account proposed increases to YMPE only, will still contribute less than US workers.

	Annual max contribution	YMPE	Monthly benefit
2014 CPP	2,426	49,000	1,038
* 2014 US SS	7,254	117,000	2,642
2034 CPP (AWI + 2%)	5,850	118,174	** tbd
2034 CPP (AWI + 4%)	8,547	172,659	** tbd
2034 US SS	11,887	191,718	** tbd

**US Monthly benefit age eligibility is 66 compared to 65 in Canada*
***tbd – Future Monthly benefit amounts would be based on an actuarial solvency funded basis*

Realistically, this proposed moderate approach to CPP expansion will not have a significant impact on the next generation of retirees (baby-boomers), but it will go a long way towards providing adequate retirement income for more Canadians. As such, an expanded CPP should begin as soon as possible.

Merits of an Expanded CPP

There are several strong reasons for expanding the CPP as a critical part of the solution to solving the retirement savings dilemma, including:

- As a non-voluntary expansion of CPP, all workers will receive expanded future benefits. This can provide an appropriate level of retirement income to the majority of Canadians who are not part of company-sponsored pension plans, and are unable to save effectively for retirement.

- From an economic perspective it provides continuity of consumption for pre and post retirement groups while promoting income security in old age. There may be incremental tax revenue created from jobs and economic activity as seniors have funds to utilize in their later years of life.
- Professionally managed, the CPPIB has access to large alternative funds that can secure higher returns improving plan performance and funding status. Fund size, as a percentage in the Canadian market, can be managed through CPPIB's mandate which allows investments outside Canada. In general CPPIB can generate higher returns on investments than the vast majority of Canadians can on their personal tax-assisted savings.

Concerns with an Expanded CPP

There has been much written on how a rapid expansion of CPP benefits would not be feasible since it would require large short-term contribution increases that could hurt small and mid-sized businesses, and likely, unaffordable for many Canadians. At the same time, the debate on how to solve the retirement savings dilemma continues while balancing the concerns of government, business and taxpayers.

Any solution to the Canadian retirement savings dilemma that goes beyond incentives to get individuals to save more of their own money comes with the following concerns:

- Economic concerns – now is not the time to increase payroll taxes as the economy is still not recovering at the desired rate and the additional costs of an expanded CPP may result in a less competitive environment, restricting economic growth
    - Above comparisons of Social Security in the US far exceeding similar costs in Canada suggests that Canada would remain competitive while addressing this problem.
- Employers may view this as an additional tax that can divert cash away from capital investment; company growth could be restricted resulting in reductions in future hires or pay increases.
    - We believe that a moderate approach to CPP expansion will not significantly affect employee or employer costs, and could be absorbed as indicated in our US / Canada comparison.
- Individuals – there is only so much disposable income available for living costs and savings; additional contributions for CPP will result in less money for mortgage payments, car payments, tuition, and other living expenses.
    - Understanding the need for individual disposable income, the moderate expansion approach supports minimizing this effect.
- CPP is not fully funded; increasing benefits could aggravate this situation.
    - Under this proposal additional CPP benefits are designed to be provided under a fully funded basis.
- CPPIB funds under management could become an overwhelming player in Canada's markets.

  - Combined with foreign market investment and increasing drawdowns of CPP funds due to Canada's aging population, we believe this risk is mitigated and CPPIB will not become an overwhelming player in Canada's markets.

Summary

Employer and individual contributions, and therefore CPP benefits, are low by comparison with the US. Some of the difference in retirement benefits is funded by taxpayers in the form of OAS and GIS. Changes enacted in the 1990's were very positive, by creating the CPPIB and increasing contributions. Although not the only solution, it is time to gradually increase CPP contributions again and eventually benefits. Inevitably this will not please those who argue there should be no additional costs to business, nor those who desire a more rapid increase in CPP benefits. However, moderate and gradual increases to contributions, whether through the yearly maximum pensionable earnings limit or contribution rates, and eventually benefits, will lead to a much needed improvement in the Canadian retirement savings system. It's time to take action on this critical issue for Canada, its workers, and taxpayers.

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