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FUTURE DIRECTIONS FOR PENSIONS

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It is now nearly 10 years since the pension industry in Canada entered into the tunnel of the reform process - and it hasn't always been a "tunnel of love". There have been many bogey-men springing out on an innocent and unsuspecting public, and it is only now that we are seeing the light at the end of the tunnel.

A large part of the Pension Reform process will have been completed and in force by January 1, 1987 - not only for the Canada Pension Plan, but in the legislation for private sector pension plans, and the framework for individual retirement savings - provided the current legislative timetable is adhered to.

In order to see where pensions are heading in the next decade, perhaps we should look at which bogey-men (some benevolent and some not) joined the train - and which missed it.

I'll call the first one "Money Purchase", and it joined the train at the "Lazar Report" stop in 1979. It came on board disguised as "A Simplifying Idea", but it frightened the daylights out of actuaries, and it should have scared the older workers on board the train into switching on the lights!

Maybe I should explain that 95% of pension plans are what we call "Defined Benefit" Plans, - that is, where the benefit at retirement is a defined percentage of earnings for each year of service - typically 2.0%, in the richest plans.

However, in a "Money Purchase" or "Defined Contribution" Plan, the worker pays his contributions to the pension plan every payday, and the employer matches them. Nice and simple! - just like your contributions to your own RRSP!

But that means you don't know till you get to retirement, what level of pension you will have, because it will depend on

(a) how much interest and capital appreciation is added to your account in the meantime;

and (b) what the level of bond and stock prices will be, when you want to retire and take a pension.

So really this means that the worker/pensioner will have to assume the whole of the investment risk both before and after retirement - and the employer can walk away from all the headaches and responsibilities that are his for a Defined Benefit Plan. And the actuaries - well, they wouldn't be needed for a Money Purchase Plan, because it is so simple. But if they point out the disadvantages they are suspect as self-serving - Catch 22!

So "Money Purchase" is still on the train, and the main disadvantages are:

1) Disproportionately larger pensions are provided for workers who join a plan when young, and very little for those who don't get into a plan until late in life;

2) This leads to a wrong set of priorities for the use of the limited resources put into the plan;

3) Then there are the risks of the investments not matching inflation, or going sour in a world wide recession, or depression, - risks that have to be borne by the active members and pensioners, not the employer.

The next bogey-man looked different to different people. It was the expansion of C.P.P., which would have meant the contraction and possible eventual disappearance of private plans.

Fortunately, - or otherwise, - according to your point of view, the next corner exposed us to large government deficits, and frightened the politicians into dumping that bogey-man in the first lake!

The private sector - meaning Bay Street and large industry, heaved a big sigh of relief - because they had been afraid that their biggest source of new capital (over $100 billion in Canada now) would have dried up, and they would have been in danger of becoming state-owned enterprises, as only governments would have the money to invest in their shares.

So, now what we're left with is the present 'status quo' level of C.P.P. benefits - apart from a few minor cosmetic improvements to sugar the pill of higher contribution rates. Not as much sugar as some of us had expected, but so far no one has really tasted the pill. Wait till January 1987 - when the increased contribution rates - coupled with the higher ceiling on earnings - raise the annual contribution rate from $419.40 to $457.90 each side - employee and employer - a 9.2% increase in that particular tax.

Of course, this increase was long overdue, or the Provinces would have had to start paying back some of the money they had borrowed from the Fund, and had presumably invested against the inevitable excess of benefit payments over contributions, which had been forecast (by actuaries and others) ever since the Plan started in 1966. Whether they had really invested it, or might have had to raise taxes in order to be able to repay it, is a moot point.

Just be aware that the proposed level of increased contributions still allows the Fund to be run down to 2.3 years outgo, - from the present level of 5.4 years outgo. Getting to be quite a thin cushion to protect us from the hard seats of the Retirement Benefit train.

I just keep my fingers crossed, and knock on wood, that my son's generation will be willing and able to pay the contributions and taxes that are needed to ensure that my C.P.P. and O.A.S. pensions don't have to be cut back from the level promised - whether explicitly - or surreptitiously - by de-indexing them!

Now what were these cosmetic improvements to C.P.P. that sugared the pill at an expected cost of about $500 million for 1987.

1. More flexible retirement ages: any time between 60 and 70 with adjustments downwards if you retire before 65;

2. Increases in disability benefits;

3. New rules for credit splitting on marriage breakdown, and pension splitting on retirement;

4. Survivors benefits will no longer be allowed to be terminated on remarriage.

One item that hasn't made it on to the train so far is the Homemaker's Pension. Apparently, it has not been possible to obtain a consensus - or the technical difficulties are too great. That, being interpreted, means 'The cost is too high'!

The next bogey-man was one that I personally wanted to see on the train, and tried very hard to have included. I thought it was an honest friendly one, but so many people didn't understand it fully, and got quite agitated at the so-called cost.

I refer, of course, to mandatory escalation of pensions to protect their purchasing power, - "Indexing" to C.P.I. - and I am sorry to say that a certain Western provincial government was the one that was finally responsible for pushing it off the train.

As long ago as 1962, I wrote a paper to the 17th International Congress of Actuaries, where I went as far as to say that a pension that did not give a promise of maintained purchasing power was a "fraud on the pensioner". Ask the C.N. Pensioners what I mean!

I have maintained for over 20 years, and I have a lot of economic support for the argument - back to Irving Fisher's 1930 book 'Theory of Interest' - that excess interest rates above a normal non-inflationary level of 3% or 4% are in fact an inflation premium, and as such belong as of right to the member of the plan - be it active worker or pensioner.

That brings me to the next problem, because a fight has broken out on the Retirement Benefit Train. It is over the vexed, but still topical question, "Who does the Plan surplus belong to?" With the correct perspective I have just mentioned, the answer is simple:

> "There ain't no surplus until full escalation of benefits to both pensioners and active members has been committed - and provided for fully in the funding program. And not only for active members and pensioners. What about those who leave service before retirement?"

There has been a big debate in Britain in the last year or so, as to whether escalation should also be included in calculating the Transfer Values that are payable to members who terminate. Otherwise, the employee who changes jobs a few times in his career gets a lot less pension than the one who stays with the one employer for the whole of his pensionable service. Is it all right to steal from terminating members, - just because everyone is doing it?

And before you strip out the so-called surplus, perhaps you should recognize the need for a healthy contingency cushion to protect against adverse economic circumstances. - World wide recession, 1930's style or the 1980's version, and what will be the next one? In Alberta, downturns due to the National Energy Program, oil price drops, and whatever is next?

In current conditions, with the T.S.E.300 Index over 3000, I would have an investment reserve of at least 20%, if I had the surplus available.

Some company managements ("pension fund sponsors" is the current buzz-word) - and their advisers - have very short memories when it comes to stripping surplus from pension plans. Was it less than 5 years ago that many of the Fortune 500 companies had deficits in their pension plans greater than the Net Worth of the employer?

Now, however, outside factors, such as falling interest rates and economic recovery, NOT internal skills, have given rise to substantial increases in bond prices, as well as in common stock or equity prices, in the short term - and everyone wants to take out the "surplus". I said "take out", but is it really "stealing"? You tell me! Perhaps the Court in the Dominion Stores case in Ontario will give us the answer to that question.

In the case of a "Money Purchase" Plan, it would be quite clear that the whole Fund belonged to the Members - and they should get the benefit of any surpluses, since they shoulder the downside investment risks. But is that the correct, - or the only, - criterion for determining who owns the surplus? What should apply in a Defined Benefit plan - which is contributory, for instance. And is a Non-contributory plan ('employer pay all') any different?

Is it right for the employer to take out the surplus when he "feels like it" or "needs it" - just because he takes the investment risk in bad years. Would there be an investment risk at all if all excess interest above the base rate - the one considered appropriate for non-inflationary conditions - were to be earmarked for escalation of pensions?

If any surplus generated by employees' own contributions is accepted as belonging to the members, what is so different about surpluses that arise from that other bit of their remuneration, the bit they asked (allowed ?) the employer to put into the pension plan on their behalf, - mostly for tax reasons? Is it really deferred wages? If so, whose?

Is there really a 'bona fide' trust, and are the contributions really alienated from the Employer - as is required for registration of the plan - if he can change the Trust Deed to get money out of the plan, when his own actuary says there is a surplus. What about an actuary to look after the interests of the Members? - one who can't be fired by the employer - when he disagrees with what the employer wants to do.

And is it legitimate for surpluses to be "created" by using a higher nominal rate of interest to value the liabilities (and hence reduce their apparent present value) while at the same time ignoring the moral liability to protect the purchasing power of the pension promised? A friend of mine in Britain - a respected economist, Arthur Seldon, wrote a book twenty years ago called 'The Great Pensions Swindle" - how right was he?

I am not giving answers, you see, - I am raising questions, so that the Great Pensions Debate can proceed with a little more light, - and a little less heat!

But let me tell you a little secret! In his latest bulletin from Gordon Capital Corporation, Donald Coxe agrees with me that the costs of - future Escalation, - and Pension Reform improvements, - and a Contingency Margin, - should all be taken into account, - BEFORE developing a Surplus Reduction Strategy!

His reasons are just different from mine. He wants to -

"keep government hands out of private cookie jars."

His words, not mine!

Of course, there are some "Ordinary Canadians" on the Pensions Train - as Ed Broadbent would say. These are the less spectacular changes that have been part of the consensus, and will eventually find their way into all the Pension Benefits Standards legislation across Canada. I'll just list them, but really - like all 'Ordinary Canadians' - some of them are quite Special.

1. Portability and Vesting: It is now proposed that all benefits, from 1987 on, will become the property of the member after 2 years in the plan (Alberta will be 5 years). Of course, that means the benefits will be locked in, or taken in pension form at retirement, even if transferred to another employer's plan or to your own RRSP. For benefits accrued before 1987, the existing rule - age 45 AND 10 years service - will still apply.

2. Eligibility for the plan must be after 2 years service and part-timers must be allowed to join, provided they have earned 35% of the YMPE ceiling during the 2 year waiting period. In 1987, the YMPE ceiling will probably be $26,700, and 35% of this will be $9,345.

3. The normal form of pension must be one that continues to a surviving spouse in at least 60% of the previous amount paid to the member, with no termination on remarriage.

4. On marriage breakdown, the settlement will be governed by provincial law, but that generally means an equal division of benefits accrued during the period of the marriage.

5. If the Plan has a minimum number of members, and if the employees ask for it, they can elect a member to the management committee of the Plan. The minimum number varies from 20 in Manitoba to 50 under the Federal and Quebec legislation. Alberta has still to publish its new Pension Regulations, promised in the Throne Speech, and this may deal with this matter, but so far it is not in the draft of 1986 Bill 12.

6. The employer will be required to pay for at least 50% of the member's benefit from a defined benefit plan for service after 1986, - for example, on leaving service, retirement or death. However, this requirement will be waived under the Federal P.B.S.A. if the plan provides for escalation of deferred pensions on leaving service, - up to at least 75% of the Consumer Price Index. We nearly got mandatory escalation in there!

7. Interest on employee contributions will have to be at a reasonable rate, and this will be prescribed by the Regulations, when published.

8. And finally the really controversial one: - Equal pensions must be paid to men and women retiring under the same circumstances from money purchase plans. This appears to require the use of UNISEX mortality tables - which the opponents say discriminates against men - as the women will get the same pension, but on average will enjoy it for about 5 years longer! The Federal Act even tries to eliminate all reference to AGE! - as a famous actuary has said, 'A feat comparable to singing without breathing'!!

So far, I've been talking about changes that have already appeared in proposed legislation. The final form may still change a bit as regulations are drafted and legislative assemblies debate the issues. Now would be a good time to put pressure on Alberta to insert manditory escalation of pensions into their proposed bill. - - Before an election is always a good time to get goodies!

What we're still waiting for - with bated breath - is the large package of legislation from Ottawa, which has been expected since December - Dec. 1985, that is! It is said that this will codify the rules that have governed the registration of private pension plans - but never were incorporated into legislation - they are still in the form of an Information Circular - No. 72 - 13R7.

It is also expected that a formula will be announced to determine how much "contribution room" will be used up by "Defined Benefit" plans, out of the increasing amounts allowed for RRSP contributions. The proposal is still for the latter to be increased steadily for those who are not in a "Defined Benefit" plan:

from $ 7,500 in 1986
to 9,500 in 1987
11,500 in 1988
13,500 in 1989
and $ 15,500 in 1990

- including both the employee's and the employer's contributions to "Money Purchase" plans.

What we don't know is whether the level will stay at $2,000 or $3,500, or some graded scale, for those in "Defined Benefit" plans.

What we do know is that, whatever the final form of this anticipated legislation, it will be an assurance of employment for actuaries for a few more years!

Another thing you can probably be sure about in Alberta is that the new legislation will not impose on the Public Sector plans, the same financing requirements that are applied to Private Sector Plans.

It is now some 20 years since I first argued, with a Provincial Treasurer of Alberta, that he should start funding the plans for Alberta Teachers, Municipal and Government Employees. At that time, I was told that the promise of the Government of Alberta should be enough!

If you are government employees in Alberta today, I think you should be considering very carefully what security there is for your pensions.

For example, should some of the Heritage Fund money be transferred into the Public Sector Plans - before it is all given back in grants or concessions to the Oil Industry?

After all, the surplus in the good years was partly due to the lack of funding of the Public Service Pension Plans.

At the very least, prudent financial and accounting disciplines should ensure that each year's accruing cost of pension benefits should be set aside in the Pension Funds, so that there are not huge unfunded liabilities left for future generations to pay - or fail to pay!

Now, if you want me to put on my wizard's hat, and speculate about the future, I think I would highlight two things that I haven't talked about directly.

First, I see a trend, - as members of pension plans start to recognize that it is their benefits that are involved - for them to become more active in directing, or at least having a say in, the investment decisions of their plans. This will happen whether or not there is a trend to Money Purchase Plans.

There is a new awareness in Canada that the large pool of capital that represents pension benefits can be an important element in developing and creating new jobs. The government recognized that by providing an incentive for plans to invest in Canadian small businesses in the May 1985 Budget.

Not much use has been made of that incentive so far - and fund managers had better beware - because the Government is monitoring the situation. My guess is that if not enough use is made of that provision - there will be some more compulsion in next year's Budget.

Secondly, the other investment matter that we in Canada have just become aware of, is the growing concern in the U.S. and Britain that investments can and should reflect the moral and ethical views of the investor. In the case of a pension plan, I submit that this should be the member or pensioner.

VanCity Credit Union has recently started its Ethical Growth Fund - mainly for its own members' RRSP contributions, and one of your members is currently involved with me in establishing a Pooled Fund for Pension Plans, which will employ Socially Responsible Criteria to evaluate the investments.

There is strong evidence from the U.S. experience that this will improve the rate of return obtained, not diminish it.

The large pool of investment capital that is tied up in Pension Funds could be a great force for good in improving the quality of life on this planet. That to me is the end of this particular tunnel.