

VISION

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Reforming Canada's Retirement Income System

*C*anada's retirement income system could be on the brink of its biggest change since the introduction of the Canada/Quebec Pension Plan in 1966. Momentum is building as one province after the other – as well as the federal government – contemplates reform measures that cut across all three pillars supporting the retirement income system. Given that the stakes are high, our readers are encouraged to participate in the process. This issue of Vision analyzes the most significant initiatives under consideration.

ACRONYMS USED IN THE *VISION*

“DB” means defined benefit as in DB pension plans.

“DC” means defined contribution as in DC pension plans.

“CAP” means capital accumulation plans and along with DC pension plans, it also includes group RRSPs, DPSPs and Tax-Free Savings Accounts (TFSA).

“C/QPP” means Canada or Quebec Pension Plan, or both, depending on the context.

“YMPE” means Year’s Maximum Pensionable Earnings under C/QPP.

“OAS” means Old Age Security (pension).

“GIS” means Guaranteed Income Supplement.

“ITA” means Income Tax Act.

Momentum is building for change within the Canadian retirement income system. Consider the developments since the beginning of March 2010:

- The federal government announced that it will be conducting a series of cross-Canada town hall meetings on how best to reform Canada's retirement income system.
- Governments in British Columbia, Alberta and Manitoba have launched their own pension consultation papers; seeking public input on specific changes being contemplated to strengthen the system. B.C. and Alberta in particular may take action on their own if a Canada-wide consensus does not materialize soon.
- In its March budget, Ontario reiterated its commitment to play "a leading role in a national effort to review the state of the current retirement income system, its future sustainability and options that could strengthen it for tomorrow's seniors".
- Nova Scotia released a discussion paper on pensions, a follow-up to the recommendations contained in the 2009 report by its Pension Review Panel.
- The Canadian Institute of Actuaries also entered into the fray with a White Paper on Government-Facilitated Retirement Plans.

This activity will culminate in a meeting of the Finance Ministers in May 2010 during which retirement issues will be a key agenda item.

This series of consultations differs from the pension reform reviews that took place in 2007 and 2008 in that the various governments have now narrowed their focus to a few specific initiatives on which they are seeking public input. Among those initiatives are a possible expansion of the Canada/Quebec Pension Plan and possibly even the addition of a new component to our traditional 3-pillar retirement income system.

RESOLVING THE PENSION DISCONNECT

To begin, we need to maintain a healthy perspective on the country's pension problems. In our January 2010 *Vision*, we concluded that the Canadian retirement income system is literally world class and pointed out that,

- “(a) Canada has nearly eradicated poverty among its seniors,
- (b) we have made more progress in this regard in recent years than virtually any other developed country and,
- (c) our seniors are appreciably better off than our younger citizens.”

Studies and surveys released since January reinforce this conclusion. Jack Mintz delivered a report to Canada's Finance Ministers in December 2009, entitled *Summary Report on Retirement Income Adequacy*¹. Mr. Mintz concludes that "Canadians are by and large doing relatively well in ensuring that they have adequate savings for their retirement".

A February 2010 survey by the TD Bank Financial Group reveals that 70% of retired Canadians say their retirement is exactly or mostly what they were expecting, compared to only 47% of Americans who felt that way.

Notwithstanding this data, most Canadian pension plan sponsors continue to believe there is a retirement crisis. It seems that the primary reason for this view is the dismal state of occupational pension plans. Pension coverage in such plans is abysmally low with only one private-sector worker in four participating in a plan. Moreover, that one person in four is either in a DB plan that is battling major funding deficits or in a DC plan where participants are still smarting from major investment losses in 2008. Even public sector pension plans are not immune as employee and employer

¹ Delivered Dec. 18, 2009 to the Ministers of the Research Working Group Steering Committee, available on www.fn.gc.ca.

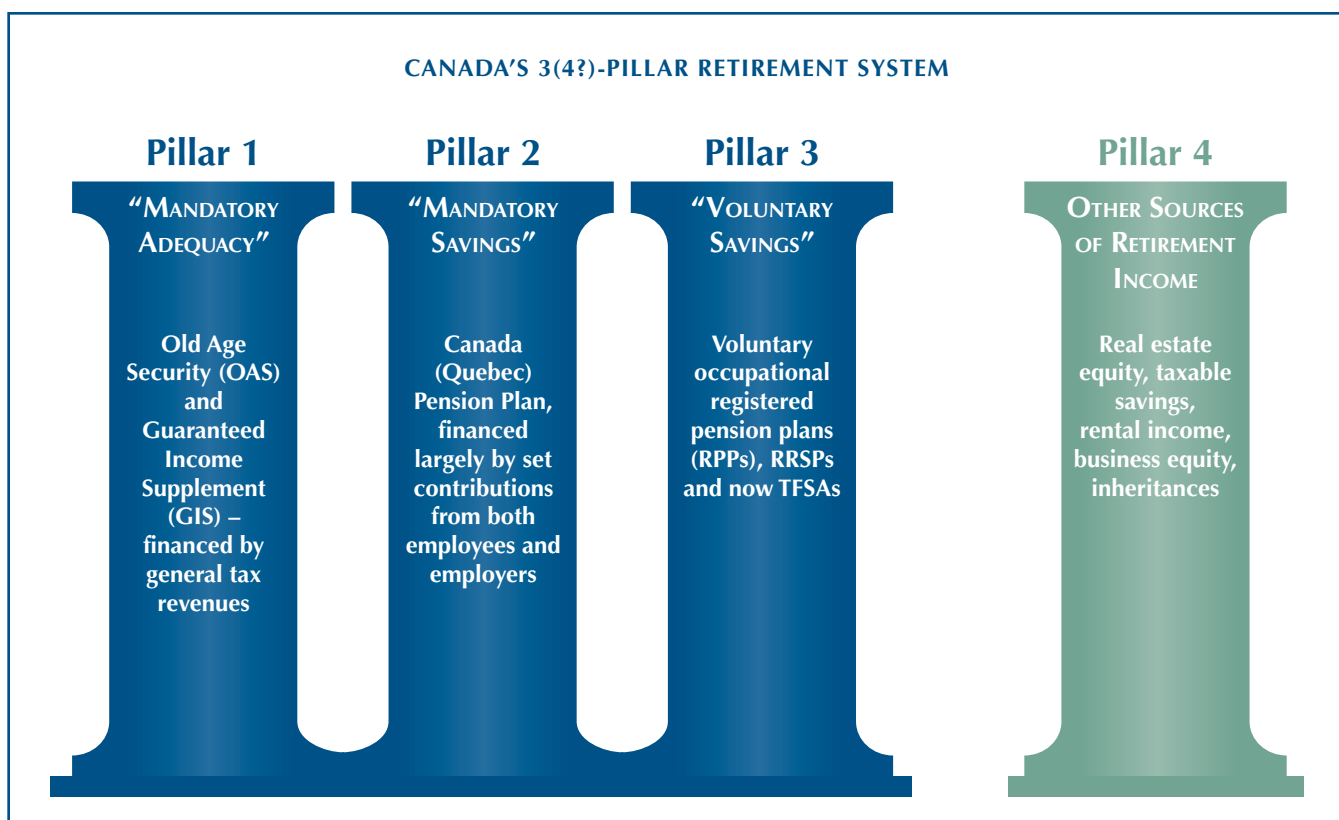
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contribution rates have climbed steadily to double digit levels, a situation which may not be sustainable.

These conflicting views on the health of our retirement income system can largely be reconciled. Occupational pension plans are indeed in sorry shape and require fixing, but most Canadians are saving enough through other third-pillar vehicles and through a virtually unseen “fourth pillar” (see chart) to make up for the deficiencies of occupational pensions. The other reason for optimism is that the retirement income targets Canadians should be striving to achieve may be lower – and hence more attainable – than previously thought.

THE EVOLVING 3-PILLAR SYSTEM

The chart reflects Canada’s traditional 3-pillar retirement income system. It also shows an additional box that we have informally labeled “Pillar 4”. While conventional retirement models do not always take into account the types of assets in Pillar 4, research shows that Pillar 4 is larger than Pillar 3, and by a wide margin. In fact, real estate equity and taxable savings alone (Pillar 4 sources) add up to more than double the value of all Pillar 3 assets². This goes a long way to explaining why our seniors are doing better in retirement than one would think.



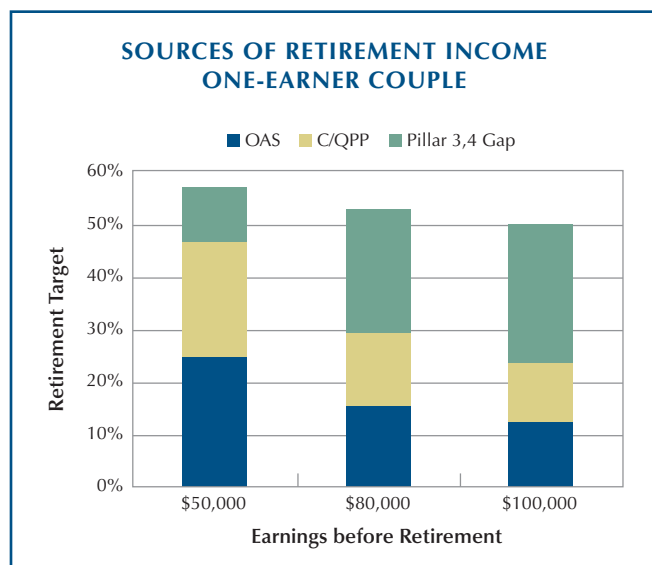
² See Table 1 of the Dept of Finance document *Ensuring the Ongoing Strength of Canada’s Retirement Income System* available on www.fin.gc.ca.

A REALISTIC RETIREMENT TARGET

The other reason we believe that the “crisis” is overblown is explained by recent studies on retirement targets. Conventional wisdom has long held that one needs retirement income equal to 70% of pre-retirement earnings (before tax) to maintain the same living standard after retirement. It is not as simple as that, and generally the target is not as high as that.

A recent paper³ by Keith Horner analyzes the retirement income targets needed to maintain one’s pre-retirement standard of living after retirement. Mr. Horner’s work shows that the target varies by income level and also by the individual’s circumstances: it is different for couples versus singles, homeowners versus renters, and one earner per household versus two.

For a two-parent family, the retirement income target is about 90% at \$30,000, but quickly scales down to 57% for those earning \$50,000 and 50% at \$100,000 (see chart).



Canada’s pension crisis boils down to how we can best help the middle-income earners.

The 90% target for the \$30,000 earner may appear to be daunting but as we learned in the last issue of *Vision*, Pillars 1 and 2 alone provide virtually all of the income needed to meet that target.

At the other end of the income scale are those Canadians earning over \$100,000 who are assumed to have the means to accumulate enough assets in Pillars 3 and 4 to meet their 50% retirement target.

That leaves the middle-income earners, specifically those who earn between one and two times the YMPE (roughly \$47,000 to \$94,000). It is this group that is most likely to face challenges in achieving retirement security, especially if they are not covered by an occupational plan. So far, they have been able to

manage for the most part, but the retirement income system can and should do more to support their efforts.

In large part, Canada’s pension crisis boils down to how we can best help the middle-income earners. Based on the consultation documents released by the various governments in March, the primary initiatives under consideration are as follows:

1. Increase the Pensionable Earnings Base (not the benefit rate) under the Canada/Quebec Pension Plan.
2. Introduce a voluntary Canada-wide Supplementary DC Plan.
3. Strengthen Pillar 3 by fostering innovation in the design of occupational plans.

Before examining these initiatives, let’s first review the guiding principles for reform.

³ Report for the Research Working Group on Retirement Income Adequacy, December 2009

CRITERIA FOR CHANGE

Given that our retirement income system is starting from a position of relative strength, any government-initiated changes should reflect that. In other words, the overarching principle should be *primum non nocere* – first, do no harm. To this end, we note the principles for change outlined by the federal government’s Department of Finance in its March 24, 2010 consultation paper⁴:

- a) The system should remain affordable for individuals and businesses.
- b) Costs incurred by governments should be appropriate and affordable, and sustainable over the long term.
- c) The system should function so that it does not transfer costs from one generation to another.
- d) There should continue to be an appropriate balance maintained between individual and government responsibility and an appropriate level of individual choice.
- e) The system should remain accessible to all Canadians.

We strongly endorse all five principles. They reflect not only the inherent strength of our current retirement income system but also the need to keep costs down so that we can remain competitive within the global economy.

Principles a) and b) are consistent with our assessment that the current system is generally working so changes should be incremental rather than revolutionary.

Principle c) implies the government is not contemplating a retroactive increase in the benefit level under the Canada Pension Plan since that would impose a financial burden on future generations of Canadians.

Principle d) reaffirms the importance of Pillar 3 and, implicitly, Pillar 4.

The purpose of Pillars 1 and 2 should be to provide a basic level of retirement income security. Providing more than that is the purpose of Pillars 3 and 4. The phrase “appropriate level of individual choice” is especially welcome. It is tacit acknowledgement that beyond basic adequacy, Canadians should be able to choose current consumption over deferred consumption if they wish. This freedom would be lost if there were a major increase in the benefit rate under the Canada Pension Plan.

Principle e) seems to be anticipating the possible implementation of a supplementary Canada-wide CAP. (We address this further on.)

INITIATIVE 1 – EXPANDED CANADA PENSION PLAN

The consultation papers are seeking feedback on a possible expansion of the Canada Pension Plan (CPP). Quebec had already raised the question in 2009 with respect to the QPP⁵.

There are two basic ways to expand the C/QPP.

1. Leave the earnings base untouched and instead, increase contribution and benefit rates.
2. Increase the earnings base but not the contribution and benefit rates.

We would strongly argue against the first way but do support the second, with some reservations.

Increasing contribution and benefit rates under the CPP is the wrong strategy at the wrong time, for a number of reasons. It basically violates all of the principles a) through d). It would increase our national debt at a time when sovereign debt is threatening the

⁴ *Ensuring the Ongoing Strength of Canada’s Retirement Income System*

⁵ *Quebec proposed increasing the YMPE to \$66,500 but the question remains unresolved.*

creditworthiness and even the solvency of a growing number of developed countries. The cost increase may not be sustainable in the long term. Moreover, an increase in the benefit rate is not even required. We have already seen that low-income Canadians enjoy a high retirement income replacement rate.

An increase in the earnings ceiling, however, is a different matter. The C/QPP provides benefits, and requires contributions, on employment earnings up to the YMPE. In other developed countries, the earnings base for social security is considerably higher. In the U.S. for example, the earnings base is \$106,800. In this section, we will analyze a possible doubling of the YMPE – from \$47,200 to \$94,400.

Doubling the YMPE would go a long way toward improving the situation for middle-income Canadians without unduly infringing on their ability to choose current consumption over deferred consumption, as set out earlier.

What makes this solution attractive is that it addresses the pension coverage problem for middle-income Canadians without disrupting the current satisfactory situation for low-income Canadians, and without displacing any of the sources of retirement savings that currently exist within Pillars 3 or 4. It simply puts less strain on those sources.

Is a doubling of the YMPE consistent with all five of the guiding principles? Our assessment is that only principle a) – that the system be affordable – is a question mark, and even that may not be as significant an issue as one might think.

First, we suggest that the change in YMPE be implemented so as to affect future service only, with no retroactivity. Thus, additional benefits would be earned gradually over the next 40 or so years. This slow phase-in approach is different from the accelerated phase-in when the C/QPP was first established in 1966. At that time, full benefits were paid after just

ten years which provided a windfall for the first cohort of retirees at the expense of later generations. That was more appropriate then than it is now, given that pension adequacy is no longer the problem it used to be.

Second, the additional employer contribution that would need to be levied on earnings between one and two times the YMPE is closer to 3% of pay, not the 4.95% cost under the existing C/QPP. This is because the current higher contribution rate includes “catch-up” funding that would not apply to a prospective new benefit.

Third, employers’ overall pension costs need not rise if they already cover their workforce in an occupational plan. To the extent that the C/QPP costs more, the occupational plan could be changed to cost less. This offsetting is achieved automatically in situations where the registered plan is already fully integrated with the CPP. It can also be achieved in other plans – both DB and DC – with some formula changes for future service. While it might pose a plan design challenge, it is achievable.

The businesses that would experience a cost increase are those that at the present time provide no occupational plan at all. They would incur an increased cost on the portion of their payroll that is above the YMPE. The impact would vary from one company to another. In organizations where average earnings are near the YMPE, the extra cost would be minimal.

Interestingly, doubling the YMPE would not likely be welcomed by large public sector plans since it siphons future contributions away from those plans and directs it toward the CPP Investment Fund instead. (Of course, liabilities would also reduce by a like amount.) The CPP Investment Fund already has assets of \$125 billion (excluding the QPP) and would grow that much faster with a doubling of the YMPE. Is this a problem? It depends upon whether bigger is necessarily better. (See sidebar)

IS BIGGER BETTER?

The idea of smaller pension plans delegating the investment of their assets to jumbo-sized funds has been proposed with increasing frequency over the past 18 months. By jumbo, we mean funds such as the Caisse de Dépôt et Placement du Québec at over \$130 billion, the Ontario Teachers Plan at nearly \$100 billion or the OMERS fund at nearly \$50 billion.

The theory is that such funds enjoy economies of scale and access to a wider array of investments that enable them to generate superior returns. However, it is not that simple. Jumbo funds are subject to adverse market impact (i.e. buying a security increases its price, selling depresses it) and some promising investment classes such as small cap equity cannot be purchased in large enough quantities to make a difference. This suggests there is an optimal size beyond which returns start to suffer. The jury is out on this question.

INITIATIVE 2 – GOVERNMENT-SPONSORED VOLUNTARY CAP

This option is based on work by Keith Ambachtsheer and the 2008 report of the Alberta-BC Joint Expert Panel on Pension Standards. The basic purpose is to ensure that every paid worker has an easy way to save for retirement by payroll deduction without having to pay onerous investment management fees. The fee savings can make a significant difference in the level of retirement income. One might save as much as 200 basis points⁶ a year in fees in a government-sponsored plan versus a mutual fund which, over a lifetime, can translate into 30% to 40% more retirement income.

A government-sponsored plan can be configured in a number of ways. The following variation appears to be emerging as the preferred approach:

- The government would establish the plan but its ongoing operation would be delegated to an independent agency, with no government oversight.
- It would be a capital accumulation plan, probably like a group RRSP.
- Government would not be liable for investment losses.
- Employers would have to allow employees to make contributions by payroll deduction (similar to existing payroll deductions toward C/QPP).
- Participation by individuals would be voluntary – and could vary from year to year.
- Employers would not be required to make any matching contributions but could choose to do so (in lieu of maintaining a separate registered DC plan).
- Overall investment and other operating expenses would be no greater than 50 basis points.

Participation in such a plan could be further enhanced by an automatic enrolment feature whereby an employee would be required to actively decline participation. The U.S. experience with automatic enrolment shows this feature can be effective in boosting participation.

Also, it would be sensible to permit contributions only on annual earnings above a specific threshold such as \$30,000. Although the optics might not be attractive – appearing to deny access to lower income Canadians – this threshold would actually protect lower income Canadians since higher Pillar 3 income would reduce their income under GIS.

⁶ A basis point is one hundredth of one percent.

While a government-sponsored, voluntary CAP seems like a good idea not everyone is in favour. The insurance industry stands to lose to the extent that smaller and mid-sized employers fold in their DC plans and group RRSPs into the government-sponsored vehicle.

Investment firms would also be affected. They might argue that a government-sponsored plan would not invest as effectively as private-sector investment management firms. The management of the CPPIB – which has gone well so far – provides some assurance that this governance issue is manageable. Certainly, there would need to be safeguards to prevent the type of mismanagement that has befallen at least a couple of high-profile public sector funds in the past two years. A public-private partnership in which the insurers and investment managers play a role in managing the new plan might alleviate these concerns.

The main concern perhaps is dealing with participants' expectations should the fund suffer a loss in a given year. While the government will take pains to separate itself from the ongoing management of the plan, the participants who incur a significant loss might expect the government to make them whole. Given that other governments with CAPs have grappled with this issue (Australia and Chile, for example), we expect the problem is manageable.

Subject to resolving these concerns, we endorse the idea of a voluntary government-sponsored CAP since it would increase third pillar savings in a cost-effective manner.

INITIATIVE 3 – STRENGTHENING OCCUPATIONAL PLANS BY INNOVATION

It can be argued that occupational pensions are the linchpin of the third pillar. Over five million Canadians participate in registered pension plans, and millions more are covered by group RRSPs, which are essentially equivalent arrangements. Without occupational plans, millions of Canadians would find it more difficult to reach their retirement goals.

Canadians therefore have an interest in seeing that occupational pensions thrive. But which plans? The two financial crises in the past decade have heightened perceptions of risk thereby making traditional DB plans a non-starter for most private sector employers. Improving DC pension plans^{7,8} is more fertile ground but the transfer of risk to individuals with limited means and limited investment knowledge will be a perennial problem.

This leaves hybrid pension plans which are plans that include features of both DB and DC plans, but do not conveniently fit into either category. Hybrids could potentially do a better job than DB or DC plans when it comes to sharing risk between the plan sponsor and the plan members. The balance of this paper focuses on innovation via hybrid plans.

In 2008, all three of the provincial expert panels on pension reform identified the need for innovative new plan design but gave no roadmap on how to achieve it. The concepts of “defined benefit” and “defined contribution” are so deeply ingrained in the Canadian psyche that any plan design that falls outside of this neat categorization makes the regulators vaguely uncomfortable. That discomfort could be mitigated if we could agree on some fundamental criteria for judging acceptability that any plan – DB, DC, or hybrid – should have to meet. Without such criteria, pension innovation is likely to stall.

Hybrids could potentially do a better job than DB or DC plans when it comes to sharing risk.

⁷ William P. Robson, *Cutting Through Pension Complexity, Easy Steps Forward for the 2010 Budget*, December 2009.

⁸ James Pierlot, *A Pension In Every Pot*, C.D. Howe Commentary, November 2008.

CRITERIA FOR ACCEPTABILITY

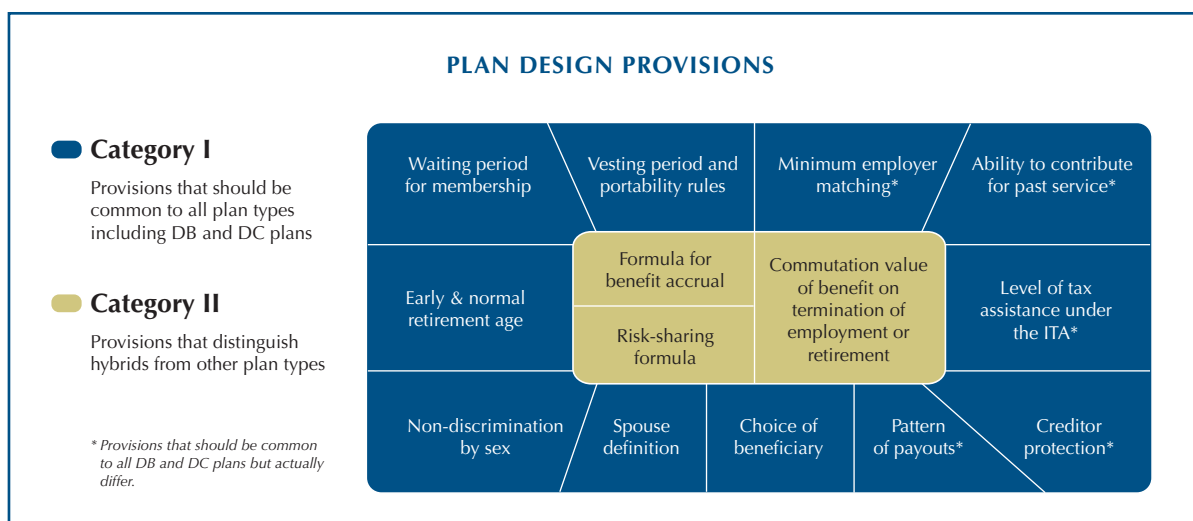
It is difficult to define what makes a given pension plan acceptable. To simplify the task, it helps to divide basic plan characteristics into two categories (see diagram).

Category I consists of features that in theory should be common to all plan types. Examples are the waiting period for entry, vesting and non-discrimination by sex. Category II features are those that distinguish a hybrid plan from other types of plans. If we can establish minimum standards for the Category I features, it allows us to focus only on the Category II features when assessing a given hybrid design.

There is no obvious reason why the standards for any of the provisions in Category I should be different between DB and DC plans and yet, some of them are (those marked with an asterisk). These anomalies make it more difficult to assess the acceptability of a given hybrid plan design. For instance, in a DB plan, the employer must fund at least 50% of the value of a pension benefit on termination. No such rule applies in a DC plan. How can one judge if a hybrid plan is acceptable if it meets the DC criterion but not the DB? [A compromise might be to require that every plan (including new hybrids) ensure that the employer funds at least 25% of the value of the benefit.] We would therefore recommend that the arbitrary differences in the standards for DB versus DC plans be eliminated first.

Assuming we can establish a common set of rules in respect of Category I features, we would then propose some simple criteria for acceptability of any pension plan, DB, DC or hybrid:

1. Any plan must meet the minimum standard set for each Category 1 provision, including the minimum percentage of the total benefit that must be funded by the employer.
2. Benefit accruals may be determined by any combination of the following factors – earnings, service, points (age plus service), contributions, company profits or revenues if it is a publicly traded corporation, returns on an actual investment portfolio or established external benchmark index, or yield on an established external bond index.
3. Member responsibilities must be communicated in an unambiguous fashion, including full disclosure on how member contributions can vary in the future depending upon external factors (such as a funding deficiency).
4. Plan sponsors must disclose all of the plan risks in terms that the individual member can readily understand. For example, a regular statement would show (among other things) the reduction in the individual’s pension benefit due to a funding deficiency in the event of insolvency occurring on the statement date. These disclosure requirements also extend to surplus ownership, fund expenses and any cross-subsidy between members.



The last two criteria underscore the importance of transparency. The clearer the “pension deal” the less need for detailed regulations to filter out unacceptable pension designs. Ultimately, any pension plan that a well-informed individual would want to join should be acceptable for registration.

The above criteria for Category II features are more stringent than is the case for many plans today. As others have pointed out⁹, the full implications of DB pension contracts are seldom fully explained. They suffer from fuzziness around surplus ownership, the ranking of pension debt in a corporate reorganization, allowable asset-liability mismatch, etc.

Under these new criteria for acceptability, even existing DB plans would need to improve their disclosure to maintain acceptability. For instance, the participants of traditional single-employer DB plans who receive regular statements showing their pension entitlement are rarely informed of what they would actually receive if the plan were wound up in a less than fully-funded state. The same holds true for multi-employer pension plans (MEPPs) where benefits can be reduced if the assets are insufficient, though many participants may not realize it. Target Benefit plans, which are essentially single-employer equivalents of MEPPs, suffer the same shortcoming.

The common thread is better disclosure, not only of theoretical entitlements but also *most likely* entitlements reflecting the prevailing funded status of the plan. This is especially important in the case of hybrid plans where the changes in an individual’s entitlement due to a change in funded position or other external conditions may be less obvious.

CONCLUSION

We believe that hybrid plans could help occupational pension plans to thrive once again. To be successful, the criteria for acceptability of a given hybrid plan needs to be well-defined. Those same criteria should

also be used to achieve more consistency in the rules that apply to existing DB and DC plans.

The big question is whether employers will embrace hybrid plans. To the extent that a hybrid plan has DB features, it will be riskier to the employer than a DC plan. Aversion to risk is higher now than at any time in recent history which means hybrid plans may be

a hard sell in the immediate future but public sentiment can change over time.

We see the immediate demand for hybrid plans coming from employers who have DB plans now and are trying to reduce their risk without wholesale conversion to a DC plan. Some employers with DC plans may also consider a hybrid if they have concluded that they can no longer lay all of the risk at the feet of the plan participants.

The Appendix analyzes a few possible hybrid plan designs under these new criteria.

The clearer
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the less need for
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filter out unacceptable
pension design.

⁹ Keith Ambachtsheer, *The Ambachtsheer Letter*, April 2009 – Can Corporate DB Plans Be Saved



APPENDIX

POSSIBLE HYBRID PLAN DESIGNS

Three hybrid plan designs are considered below – the first is already acceptable in the U.S. but not in Canada; the second is strongly recommended for Canada by all of the provincial expert panels, and the third is currently not acceptable under Canadian legislation.

CASH BALANCE PLANS

The concept of cash balance plans was created in the U.S. in the mid-1980s. These plans are true hybrids, with both DB and DC features. As with any DC plan, each member has an individual account and receives periodic statements showing the value of benefits earned. In a given year the member's account is credited with a fixed percentage of earnings, such as 5% of base pay. Interest is then added to the account balance but, unlike regular DC plans, the interest earned is based on some external index such as the CPI or T-bills, rather than on actual investment performance. Hence, the employer still bears some of the investment risk. At retirement, the member's account balance is payable in a lump sum that can be converted into lifetime pension that is either paid monthly out of the pension fund or is purchased as an annuity from an insurance company.

Cash balance plans are not acceptable under current Canadian pension legislation or tax law. This is not surprising given that they blur the line between DB and DC plans more than most hybrid plans. Is this an acceptable hybrid design under the proposed criteria? We contend that it can be, provided that the employer's share of the cost meets the minimum threshold described earlier. Also, it is critical that each member receive ongoing updates on entitlements and risks.

TARGET BENEFIT PLANS

All three expert panels singled out target benefit plans as a design that should be encouraged. A target benefit plan is a DB plan in which benefits can be reduced in the case of a funding shortfall. Note that benefits can be reduced while the plan remains a going-concern rather than just on plan termination. Target benefit plans already exist in the form of multi-employer pension plans (MEPPs) though at least one province, Quebec, does not allow benefits to be reduced in a MEPP. The expert panels generally suggested they be made available more broadly, such as in single employer situations.

The most serious problem with Target Benefit Plans is the same as with cash balance plans: the challenge of clearly communicating the pension deal. The temptation is to communicate the theoretical benefit (the accrued DB pension) rather than the actual benefit (the amount payable based on the existing funded status). To the surprise of many members, a number of MEPPs have had severe funding problems resulting in lost benefits. These situations indicate that plan participants do not always understand and accept that their pensions must be reduced in certain cases. Were it not for the endorsement of the expert panels, it is not obvious that target benefit should be any more acceptable than cash balance plans. We feel they would be acceptable only if there is complete and ongoing disclosure of pension entitlements and risks, and some assurance that the employer's share of the total pension cost meets the prescribed threshold.

MODIFIED DB PLAN

The final plan design is a hybrid that we will call a “modified DB Plan” for want of another name. A modified DB Plan behaves exactly like a conventional DB plan except that in the event of plan wind-up, all members receive a lump sum rather than an annuity. That lump sum would be determined using a discount rate derived from prevailing corporate AA (or possibly single A) bond yields rather than from government bond yields. As a result, the lump sum could conceivably be less than under a traditional DB plan. It would not necessarily be less, though, since a traditional DB plan can have a deficit on wind-up, forcing pensions to be reduced in any case.

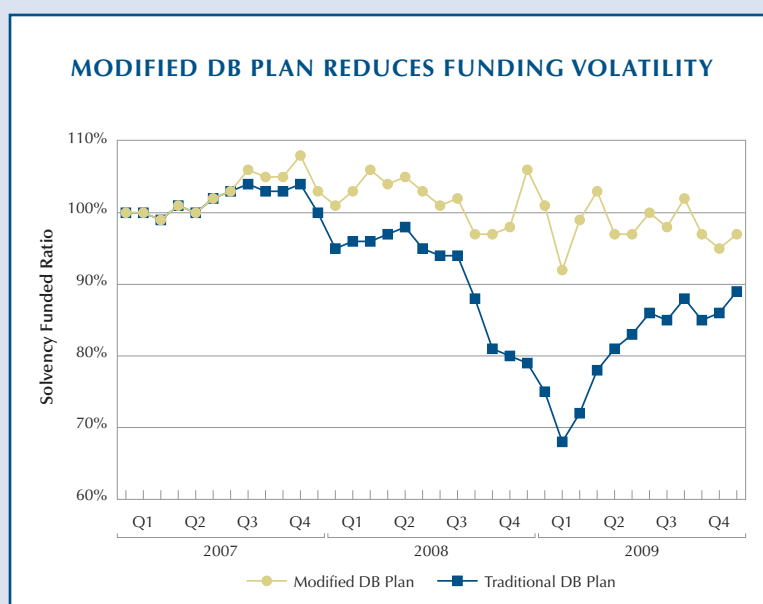
From the employer’s perspective, the appeal of a modified DB plan is clear. By providing a DB pension, it eliminates the problem of educating plan members to make intelligent investment choices. At the same time, it significantly reduces the perennial problem of funding surprises that tend to occur at the most inopportune times. Finally, it mitigates the volatility in pension expense, which may be the primary driver behind the worldwide decline in DB plans.

Even in the midst of the recent global financial crisis, the funded ratio under a modified DB plan would have remained close to 100%.

This is possible because of the choice of discount rate. Rather than trying to minimize volatility by matching assets to an immutable DB promise, the hybrid changes the pension promise to match the assets. The chart below shows the funded ratio of a conventional DB plan compared to the modified DB Plan assuming the same investment mix in both cases.

Under the modified DB plan, the solvency position will be less volatile since commuted values based on corporate bonds tend to fall when capital markets are depressed and rise in good times. This is shown in the chart below.

Should a modified DB plan be an acceptable hybrid design? As with the other designs, there would be no reason to dismiss it, provided that it meets the minimum threshold for employer’s share of the cost and for disclosure.



CONCLUSION

Hybrid plan designs hold the promise of introducing innovative new ways to share risk between employers and employees of saving for retirement. It is important that innovation not be held back by outdated views on what a pension plan is supposed to look like.

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