WELCOME

I am pleased to present the third edition of Pension Point of View, a newsletter sharing industry insights and ideas on pension trends and plan design relevant to the plans we administer.

This issue’s feature article adds some ammunition to the explosive debate on pension freedoms that allow plan members to unlock pension funds. Additionally, we scan data from an annual global retirement survey, as well as demystify the relationship between pension liabilities and credit ratings.

As always, I welcome your email with suggestions for future topics of interest to you.

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FEATURE

If plan members start demanding more choice and flexibility to access their pension pot, should plans allow it—or protect them from their own (very human) fallibility? READ HERE

FACTUAL SNIPPETS

Check out how more than 16,000 people in 15 countries feel about their ability to maintain a comfortable standard of living during their retirement. READ HERE

STATS AT A GLANCE

Canadian plans factor into the country’s financial security, but to what extent do they affect credit ratings? Let us put it all into context. READ HERE
Pension choice and flexibility: Whose money is it anyway?

“Never have so many lambs been ripe for the fleecing…anyone who thinks they will get a good deal by cashing in an existing annuity is living in cloud cuckoo land.”

This torn-from-the-headlines quote comes from the UK, where the trend towards increased individual pension responsibility is now a reality.

New pension freedoms allow defined contribution (DC) pension plan members from age 55 to take all their pension benefits in one lump sum.¹ The UK government is accused of trading on the financial ignorance of clueless savers who wind up paying more taxes (and end up poorer in later life) to spur economic growth without immediate cost to government. Some even say allowing retirees to cash in the pension pot taxpayers have paid into is a breach of the “generational contract.”

Reform supporters, in contrast, dismiss restrictive pension legislation as unduly paternalistic. After all, you know what’s best for yourself. You may need more money during earlier, more active retirement years, anticipate a lower-than-average life expectancy based on family history or work for a company whose uncertain financial situation may jeopardize your pension. And on it goes.

While there is merit in both views, because of their professional roles or personal beliefs, people often sit squarely on one side of the fence. In this article, we highlight easily overlooked arguments and evidence on the debate over pension flexibility² and shifting responsibilities. We look at conflicting retirement theories and the role of education, choice and plan design, and scan Canadian developments. Then, we’ll test YOUR retirement behaviour with an interactive quiz.

Why it matters

Inspired by trends observed elsewhere, pension plan members may increasingly expect more flexible plan provisions in favour of choice when it comes to accessing one’s pension pot.

Yet, the quest for more flexible provisions is tricky when retirement security is the trade-off. Where do you draw the line between an individual’s entitlement to choice and the responsibility of pension funds, employers or government to guide people in realizing adequate pensions?

Two schools of thought

Thinking about retirement savings has been influenced by traditional life-cycle theory—individuals trade-off current versus future consumption to smooth spending over their life cycle by saving during peak earning years.

The life-cycle-theory model assumes individuals:

- are rational planners seeking to maximize their self-interest or lifetime utility,
- have complete information, and
- understand the implications of all decisions.

Behavioural economics is a different school of thought demonstrating many—perhaps most—people make serious cognitive mistakes that are systematic and predictable. This is because the traditional life-cycle theory’s application requires three things to be true of ordinary folks. They:

- can solve complex mathematical problems,
- adequately model the future uncertainties in their lives, and
- have the willpower to implement the resulting savings plan.

Unfortunately, none of these requirements square with reality, argues the Dutch study Rational Pensions for Irrational People. For starters, traditional life-cycle theory does not take into account that, during their early and mid-careers, people often do not have the necessary income for retirement savings and are forced to save in the 10 years before retirement. Yet, saving abilities aside,

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¹ The lump-sum withdrawal is subject to income tax. To take advantage of the freedoms, DB members are typically required to transfer their funds to a DC arrangement. Source: Lane, Clark and Peacock (LCP) LLP—the LCP Group is a firm of consulting actuaries with offices in five countries.

² The reference here to flexible pensions is not to be confused with the meaning of ‘flexible pension plans” referring to optional ancillary contributions and benefits.
life-cycle theory’s greatest shortcoming may be its ignorance of
the most prevalent yet least tangible factor: human behaviour.

The late American economist Paul Samuelson reasoned, “God must
love those folk that behavioural scientists write about because
She created so many of them.” In the language of behavioural
economics, most people are operating under conditions of
bounded rationality and are often hampered by bounded self-
control; even if they understand the need and have the ability to
save more, they often lack the motivation or willpower to do so for
a variety of reasons.

**REASON 1**
**Why chocolate always wins**

In a Dutch study, a group was asked to choose a snack for a
meeting the following week. Most chose fruit. On the day of the
meeting, they were asked again. Most chose chocolate.

Even though we have good intentions and may know what we
should do, we often find it hard to act in our best interest. We
seem hard-wired to place a higher value on immediate rewards
and payoffs—the lure of the present is more powerful than a
future reward. This phenomenon is known as “myopia” and it
explains why even education goes only so far in helping retirees
make good choices.

**REASON 2**
**The limits of knowledge**

Canada has no shortage of financial education tools, but little
is known about their impact on retirement planning. American
evidence suggests workplace-based education programs result
in increased financial knowledge, causing some employees to
alter their retirement plans. However, there is also evidence that
simply acquiring knowledge may do little to help potential savers
overcome bounded self-control and translate this awareness into
action, regardless of income groups.

For all we know, knowledge affects intention, but it is not
enough to significantly influence behaviour; education and
information by themselves do not adequately address myopia or its
close cousin—inefficiency.

**REASON 3**
**Paralysis through choice**

Inertia describes people’s tendency to stick with a decision even when
there are better alternatives. In retirement, this means that, once
made, savings decisions and investment choices are rarely altered.

Economists have traditionally assumed that more choice is better.
This view is now being challenged. It is clear that when there is “too much”
choice, people are discouraged from choosing anything; if they are forced,
they’ll simply pick something.

Some of you may recall the 1995 jam study: Under its first scenario, a
market booth with 24 jam varieties drew in 60 per cent of potential

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In one study, all participants of a financial education seminar
announced their intent to enrol in the company’s pension plan; yet, in the
end, a mere 14 per cent actually did. In another study, 68 out of 100
people agreed they were saving too little and 24 promised to increase
their savings within two months. Four months later, three people had
followed through.

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**More empirical evidence**

In an experimental study among Harvard staff (white collar non-faculty
employees) with many years of experience managing their personal
finances, even after receiving specific financial education, staff failed
to minimize fees after being given $10,000 each to allocate across
four S&P 500 index funds and told to keep the subsequent return net
of fees. Performance was only slightly improved by education; higher
education and/or income did not seem to affect behavioural biases.

U.S. research shows that auto enrolment increases participation rates
for both private and public sector plans to the range of 85 to 95 per
cent. This success supports the premise that people follow the path of
least resistance.
sampling customers, but only 3 per cent ended up buying jam. Under the second scenario, the market booth featured only six jam varieties, drawing in 40 per cent of potential sampling customers, yet 30 per cent bought jam.

**People often choose not to choose.**

**As a result, defaults affect behaviour.**

**An opt-out clause to make us stay put**

Behavioural economics aims to nudge people to make the right decision and mitigate the effects of myopia (immediate reward seeking) and inertia (sticking to the status quo). The nudging principle can be applied to exercising at the gym or saving for retirement; it persuades to act, while an escape hatch gives a psychological out. Research found that when people are nudged to join retirement plans with an opt-out clause, they usually stay put.

In Canada, nudges to target decision-making inertia through automatic enrolment are still less common for two possible reasons: (1) many DC plans and some group RRSPs require mandatory employee participation, and (2) legislative changes to accommodate automatic enrolment have been slow in the making. But, change is in the air.

**What’s happening in Canada**

British Columbia, Alberta, Saskatchewan, Ontario and Nova Scotia have all tabled or passed Pooled Registered Pension Plan (PRPP) legislation, and Quebec’s Voluntary Retirement Savings Plan (VRSP) came into force July 1, 2014. In Quebec, an employer with a certain number of eligible employees that is not currently offering a workplace savings plan is required to set up a VRSP. As for PRPPs, it is up to each province to decide if employer participation is mandatory. Either way, employers are not required to make contributions under either PRPPs or VRSPs. However, participating employers must auto enrol their employees, though employees can opt out under both PRPPs and VRSPs.4

Elsewhere, the introduction of variations of the target benefit plan—most recently in New Brunswick—marks a shift towards putting greater responsibility associated with plan risks on members. Opposing the trend towards greater flexibility is Ontario’s planned mandatory provincial pension plan.

Recent provisions at the federal level towards greater pension and retirement savings flexibility include the voluntary deferral of the old age security (OAS) pension for up to five years with consequent higher annual pensions, as well as raising the tax-free savings account contribution cap from $5,500 to $10,000.

**What about unlocking?**

Despite concerns about retirement adequacy, there is movement across Canada towards more flexible unlocking rules.

Several jurisdictions allow a one-time lump-sum withdrawal of 25, 50 or, in the case of Saskatchewan, 100 per cent of members’ pension funds.5 Yet, others prohibit one-time unlocking entirely, except in the case of shortened life expectancy. Other circumstances to permit unlocking include small-balance pension assets, financial hardship and permanent departure from Canada.

**More empirical evidence**

In 2014, 71 per cent of Canadian DC plans were mandatory versus only 13 per cent for group RRSPs. Source: Great-West Life survey.

Voluntary plans have significantly lower participation rates: 79 per cent for voluntary DC plans and 51 per cent for voluntary RRSPs, compared to 98 per cent and 74 per cent for the corresponding mandatory provisions in Canada.

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3 PRPP regulations are yet to be completed.
4 A PRPP functions as a defined contribution (DC) pension plan. The main difference between a PRPP and a DC pension plan is that a PRPP will be administered by a financial institution rather than the employer. This plan-design feature is intended to reduce the cost and administrative burden on employers. PRPPs are also intended to shift the fiduciary liability of the employer to the financial institution offering the PRPP.
5 Subject to tax beyond the prescribed withdrawal threshold.
6 All jurisdictions incorporate some sort of needs assessment. No Canadian jurisdiction currently allows unlocking of pension funds directly from a pension plan for reasons of financial hardship, which would be onerous and complex for plan sponsors.
## Unlocking across Canada

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Shortened life expectancy</th>
<th>Small-balance pension assets (plan assets as % of YMPE)</th>
<th>Financial hardship(^1)</th>
<th>Non-residency (Canada)</th>
<th>One-time unlocking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federally regulated plans</td>
<td>Yes</td>
<td>≥55: 50%</td>
<td>Yes</td>
<td>Yes</td>
<td>50% at ≥ 55 yrs</td>
</tr>
<tr>
<td>British Columbia</td>
<td>Yes</td>
<td>Any age: 20%; ≥65: 40%(^2)</td>
<td>Yes (Sept 2015)(^3)</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Alberta</td>
<td>Yes</td>
<td>Any age: 20%; ≥65: 40%</td>
<td>Yes</td>
<td>Yes</td>
<td>50% at ≥ 50 yrs</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>Yes</td>
<td>Any age: 20%</td>
<td>No</td>
<td>Yes</td>
<td>100% to PRIF(^4) at ≥ 55 yrs</td>
</tr>
<tr>
<td>Manitoba</td>
<td>Yes</td>
<td>Formula</td>
<td>No</td>
<td>Yes</td>
<td>50% to PRIF at ≥ 55 yrs</td>
</tr>
<tr>
<td>Ontario</td>
<td>Yes</td>
<td>≥55: 40%</td>
<td>Yes</td>
<td>Yes</td>
<td>50% at ≥ 55 yrs</td>
</tr>
<tr>
<td>Quebec</td>
<td>Yes</td>
<td>≥65: 40%</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
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<td>Yes</td>
<td>Formula</td>
<td>No</td>
<td>Yes</td>
<td>Formula</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>Yes</td>
<td>≥65: 40%</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Newfoundland and Labrador</td>
<td>Yes</td>
<td>Any age: 10%; ≥55: 40%</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

Sources: TD Wealth; TaxTips.ca

1. Provinces that have financial hardship provisions may allow withdrawals on account of eviction, rent/mortgage arrears, medical expenses, rent and security deposits, foreclosure and low income. For 2015, low income constitutes annual earnings below $35,733; depending on other income sources, approved individuals may withdraw up to $26,800 per year.

2. The 40% provision at age 65 and over does not apply to DB plans.

3. BC’s new PBSA, which will come into force when accompanying regulations are proclaimed into law on September 30, 2015, allows financial hardship unlocking. The provision does not apply to registered pension plans but to RRSRs and life income funds only.

4. Prescribed registered retirement income funds (PRIFs) are available only in Manitoba and Saskatchewan for the purpose of accepting locked-in funds. This type of plan does not put a cap on maximum withdrawals. Different requirements exist in each province for the age at which the account can be opened, and unlocking provisions vary.
Equal access for all?

Clearly, there is no consensus on unlocking across Canada let alone on whether defined benefit (DB) members should enjoy the same flexibility privileges as DC members. A Mercer senior associate expressed support for aligning provisions: “If you are going to allow DC members to do it, I think on the face of it I’d be minded to let DB members do it as well.” After all, why should DC members be the only ones trusted with at-retirement choices?

In Switzerland for example, employees in DB schemes have no discretion in the accumulation phase; however upon retirement, they can choose between an annuity and a lump sum. One concern is that a rush for cash can put a strain on DB scheme funding levels, adding an “unnecessary” level of administrative complexity to the scheme. The head of pensions at Heineken UK in the context of the new pension freedoms adds, “The attaching risks, from both a trustee and company perspective, are unquantifiable.”

The bottom line

People say they love choice; it’s the human default. It is equally true that pension plan members tend not to concern themselves with administrative challenges. They may also brush-off arguments about an increased reliance on state benefits because people will underestimate the cost of retirement. But just try and ignore the evidence about people’s failure to act in their own best interest despite their best intentions.

As trends take hold, neither plan members nor administrators should lose sight of stakeholders’ motives when supporting shifting responsibilities in the name of greater flexibility. Plan administrators in particular may want to take to heart the lessons from behavioural economics when making changes for a sustainable pension scheme.

Over to you

Do you exhibit “curious behaviours that can ruin your retirement?” Find out by taking this quiz from the Center for Financial Literacy at Boston College: http://crr.bc.edu/special-projects/interactive-tools/curious-behaviors-that-can-ruin-your-retirement/.

References


In this edition, we highlight findings from a 2015 global survey, *The Future of Retirement: A balancing act*, the tenth report in the series from the Future of Retirement programme (begun in 2005), represents the views of more than 16,000 people in 15 countries and territories. Click [HERE](#) for the full HSBC report.

**A life less comfortable**

One in ten (10%) working-age people globally expect they will never be able to fully retire. This view is particularly strong in Australia (16%), Canada (14%), Singapore (15%), India (14%) and the USA (13%).

Maintaining a comfortable standard of living during retirement is a real concern across the world; 38 per cent of women and 31 per cent of men—for a combined average of 34 per cent—report no confidence in their ability to support a comfortable lifestyle in retirement. Pre-retirees in France are the least confident, followed by Taiwan and Turkey. At the other end of the spectrum are India and Indonesia, where less than 1 in 10 working-age people say they are not confident about maintaining a comfortable standard of living in retirement.

Pre-retirees’ concerns are likely to be well-founded, with a quarter (25%) of retirees saying their current standard of living is worse than before they retired. This sentiment is particularly prevalent in Turkey (49%), followed by France (41%) and Australia (31%).

Almost half (49%) of pre-retirees expect to cut down on their everyday spending, and among retirees, 41 per cent report they are actually doing just that. With 85 per cent of working-age people saying that retirement is not their main saving priority, it may not come as a surprise that 65 per cent of retirees did not realize they weren’t adequately prepared for a comfortable retirement until they had fully retired. Globally, over a third (36%) wished they had started saving earlier to improve their standard of living in retirement; this is slightly below the Canadian average of 40 per cent.

Interestingly, both France and Australia, whose concerns over maintaining a comfortable retirement are well-above average, report below-average regrets about not having saved earlier.
Credit ratings and pension liabilities in context

Healthy, well-managed pension funds play a significant role in the Canadian financial system. They help reduce systemic risk and preserve financial stability thanks in part to pension funds’ typically long investment horizons paired with locked-in contributions.

At the same time, credit rating agency Moody’s warned that governments could “feel the pinch” of risky DB plans. Primarily referring to the U.S., Moody’s made it clear some Canadian provinces aren’t immune to a potential credit risk increase, unless pension reforms are addressed.

### STATS-AT-A-GLANCE

**Provincial net financial debt/asset as a percent of GDP (2014)**

<table>
<thead>
<tr>
<th>Province</th>
<th>Net Financial Debt/Asset (2014)</th>
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<tbody>
<tr>
<td>British Columbia</td>
<td>-5.5</td>
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<tr>
<td>Saskatchewan</td>
<td>-16.9</td>
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<tr>
<td>Alberta</td>
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<tr>
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</table>

Source: Moody’s Investors Service

An easily overlooked yet important factor when comparing pension liabilities in the context of credit ratings is how such liabilities are defined. To be sure, the provinces’ reported net pension liabilities are not identical to actuarial pension liabilities. Rather, they represent those liabilities for which provincial governments have legislated responsibility. And that degree of responsibility varies, depending in large measure—but not exclusively—on the plans’ respective governance models in each province.

Take Ontario, for example. The province is the sole sponsor of some pension plans but a joint sponsor in others, particularly its larger plans. Similarly, transitioning plans to a shared risk pension plan model, as New Brunswick has done in three instances since 2012, means governments may no longer carry any assets or liabilities for those plans. All of this affects credit ratings.
And then there is Saskatchewan, which began closing all of its DB plans to new members and transitioned to defined contribution plans in the 1970s, taking a “pay-as-you-go” funding approach. Enough time has passed since then to reasonably forecast the required annual payments to members. This may have been one reason why Moody’s didn’t hesitate to upgrade the province’s credit rating to Aaa in September 2014, regardless of Saskatchewan’s high pension liability ratio.

Pension liabilities are just one of the multiple variables used to determine credit ratings. Hence, the relationship between credit ratings and pension liability to revenue ratios (or provincial GDP to debt ratios, for that matter) is not linear. In other words, pension liability ratios do not necessarily correspond to—let alone explain—credit ratings.

### References


2014 Consolidated Financial Statements/Public Accounts of each province.

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**Provincial pension liability (asset) as percentage of total provincial liabilities (2014)**

<table>
<thead>
<tr>
<th>Province</th>
<th>Percentage</th>
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Source: BC Pension Corporation

**Provincial pension liability (asset) as percentage of provincial revenues (2014)**

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Source: BC Pension Corporation