Pension champions or pension chumps?
The choice is ours.
The time is now.

An address by

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Thank you, [xxx], and good morning, everyone.

As a nation, we in Canada have led the world in healthcare, free trade and energy distribution. Now it's time for our generation to lead the world once again … this time in pension funding and retirement financing. Doing so will only follow considerable debate, discussion and of course, differences of opinion. But that is how good decisions are made and consensus is reached … It's how the public is educated and engaged. And it's up to us, as pension professionals and industry leaders, to lead the discussion and engage this issue's stakeholders.

A very public debate has already emerged, as we all know. And it is a two-pronged debate, addressing pension coverage for Canadians on the one hand ….. and funding sustainability on the other …. The subtexts of retirement security, pension affordability, realistic contribution and benefit levels, social responsibility, and retirement ages echo through both.

That is why I am so glad to join you this morning for this timely and important pension summit.

I'm going to talk to you today about the pension debate in the context of two main issues:

- First, I'll look at today's pension reality.
  and
- Second, I will discuss the increasingly important role of pensions in the economy and Canada's leadership within that framework

First, the pension reality.

As everyone in this room knows, pension plans come in two basic flavours: Defined Benefit, or DB, and Defined Contribution, or DC. The Teachers' plan is a Defined *Benefit* plan. That means pensions are based on a formula of service and age. The pension benefit is *predetermined,* is not contingent on investment performance and is an obligation of the sponsor – or in Teachers' case, sponsors.

Benefits under Defined Contribution plans, on the other hand, depend entirely on the market value of the funds in a person's account at the time of retirement. They work exactly the same way as an RRSP. The day you retire, you open the box to see how much money you have to live on for the rest of your life. If markets have been bad, your retirement lifestyle will be less than if markets have been booming. We all can name friends who have had to postpone their retirement because their savings were ravaged by the recession – in other words, they no longer have enough "gold' for the "golden years".

Now. let me give you a snapshot of our membership at Teachers', because we are at the leading edge of the demographic wave - we reflect the reality of a graying Canada.

As you may have seen in the media coverage of our annual results last week, Teachers' is what is considered a "mature pension plan." That is to say we have a declining number of active members *contributing* to the fund compared to the number of members who are *collecting* pensions from the fund. We currently have a 1.5-to-1 ratio of active-to-retired members and are moving towards a 1.2-to-1 ratio over the next decade or so. To put that into perspective, that ratio was 10-to-1 in 1970.

Our maturity affects our risk tolerance. We simply do not have enough active members among whom to share material losses should they occur, so we have only a 40% equity allocation, for example.

We have 289,000 members, including 114,000 pensioners and 175,000 working members. And let me stress the fact that our individual members contribute an average of 11% of their salary annually to the plan. That is matched by the government bringing their total saving for retirement to 22% of salary. That ranks pretty well against David Dodge's study released last month.

We administer one of Canada's largest annual payrolls, at $4.4 billion. We receive $2.7 billion in contributions annually. That's a considerable gap, I'm sure you'll agree .. and it means that the first $2 billion we earn every year is automatically earmarked for paying the difference between what is *contributed* and what is *distributed*.

The average age for our new retirees today is 58. Each will have worked about 26 years at retirement. They are expected to receive their pension for 30 years, and a survivor pension may be paid for an additional five years. The average starting pension last year was $42,900. And as I said, it is a Defined Benefit. It is jointly sponsored by the Ontario Teachers' Federation and the Ontario government. Together they determine contribution rates and benefit levels.

Let's take a look now at some pension history in Canada.

Pension plans - public and private – were devised when "retirement longevity" was an oxymoron. Pensions were meant to bridge the gap between work cessation and death … a short distance, given life expectancies at the time. According to demographer

David Foote, Canada chose a retirement age of 70 in the 1920s, when the life expectancy was 61. Understand what they had in mind: on average, you would be dead nine years before you started to receive any pension!! In 1951, a means-tested pension was made available at age 65 … when average life expectancy was 68 and a half. The Canada Pension Plan was introduced in 1966; life expectancy then was 72.

That was then. Today's life expectancy rates are very different. According to Statistics Canada's latest data, life expectancy at birth in 2007 was an average 80.7 years, with an *additional nearly 20 years for those who make it to 65*. Let me say that again slowly. If you were born in 2007 and you have not died before you are age 65, then more than half of you will live to over 100 years of age.

In our case at Teachers', we now have 2,300 pensioners in our membership who are over the age of 90. And that includes 93 who are over *100* years of age … our oldest collecting member recently celebrated her 107th birthday. We jokingly call ourselves the Century Club. …. But in all seriousness, it highlights the issues of benefit sustainability and intergenerational equity – making sure that pension funds are there for today's young people … and those who haven't even been born yet ,,, when they retire.

Given that our liabilities are growing faster than our assets, our sponsors have been faced with making the decisions that shortfalls demand. They can:

- reduce benefits, or
- raise contribution rates, or
- both.

Surpluses are happier decisions – increase benefits or reduce contribution rates.

Our sponsors' recent adoption of Conditional Inflation Protection was a step in the right direction. It creates somewhat of a Defined Benefit-Defined Contribution hybrid: inflation protection is guaranteed to 50% – a DB concept. But inflation protection *above* 50% is conditional on the financial wherewithal of the fund – sounds like a DC concept to me… Because we are at the front end of the pension maturity curve, our sponsors have had to make some difficult decisions sooner than some other plans. But they are the right decisions, made in our members' best interest.

For example, they have established a Sustainability Work Group, with representatives from the Ontario Teachers' Federation, the Ontario Government, and our own management team. I emphasize that Teachers' is not in any short term financial crunch. We have close to $100 billion in assets and can pay pensions for decades without any changes. But our sponsors are committed to dealing with the issue of recurring shortfalls because what these shortfalls are telling us is that we likely need a <u>small</u> course correction <u>today</u> that will translate into a large difference some 70 years from now. Together, they are considering all such possible course corrections for the plan to safeguard its long-term viability and affordability. They will report with an action plan by this summer.

Their task is not an easy one. They are looking for solutions in an environment that is very different from the 1990s and early 2000s – when markets were flourishing and their potential seemed limitless. But as we have learned in recent years, concepts of unlimited growth are illusory. Markets crash, taking growth with them. Witness 2008: three years of good growth was erased from our fund.

I am confident that our sponsors will continue to make the right decisions on our members' behalf. As such, I am not as concerned for our members as I am for the 75% of the Canadian private sector workforce reported to have *no* employment-based pension plans whatsoever. And RRSPs have not proven to be the solution – average RRSP balances are woefully short of the levels they need to be in order to fund retirement.

Former Bank of Canada Chairman David Dodge and his co-authors sounded similar alarm bells earlier this year. As they state in their paper:

> "The longer the post-retirement period, and the fewer earning years over which savings accumulate, the higher the fraction of earnings that must be saved."

Not exactly a revolutionary mathematical concept and yet it seems to have caught people by surprise!

They go on to say that Canadians generally must decide to save *more* or save *longer*, or both, and on the other side of the ledger, decide to accept less, if they do not.

Dodge's assumptions were based on 30 to 37 contributing years. Thanks to that alliterative – if unrealistic – slogan, Freedom 55, and the reality of increasing longevity, many Canadians hope to be retired considerably longer than they worked. As a society, we need to re-set those expectations ... and figure out how to convert ourselves from a credit-hungry culture to a savings-savvy culture that can afford its retirement.

Dodge suggested that Canadians needed to save between 10% and 21% of their income annually to reach an acceptable income replacement target - remember, I said that teachers are saving 22% because they are required to, whereas only a handful of Canadians are availing themselves of the 18% limit under their RRSPs.

Let me return for a moment to the DB-DC debate and sound a word of caution: And that is that we must not allow "pension envy" to define that debate. There is a danger that this could happen, however, as the private sector increasingly moves toward Defined *Contribution* plans - and *away* from the Defined *Benefit* model - saying it is unaffordable.

It isn't that the DB model is *unaffordable* per se. It is that the DB model has been *made* unaffordable for plan sponsors by:

- Short-sighted tax rules and court decisions that have effectively prevented sponsors from saving enough in good times to offset losses in bad times, and
- Weak-kneed managements who, out of expediency, promised unrealistic levels of future benefits in order to dampen salary demands. Their strategy was to show good results today by pushing costs off to the next generation of managers – but the future has now arrived and pensioners are lined up for those promised benefits.

The truth is that DB Plans are far better vehicles for pension saving from both a security and a cost basis for both employees and sponsors.

A report by the US National Institute on Retirement Security finds that saving in a defined benefit pension plan can deliver the same level of retirement income at almost *half* the cost of a defined contribution scheme.

It says the overall cost to employers and their workers was 45% lower for DB plans than it was for Defined Contribution plans. There are four main reasons for this:

- Individuals in a DC Plan must plan to live a long life – out to the maximum on the actuarial table as you don't want to run out of money part way through your retirement! Because individuals can't pool longevity risk, they are forced to accumulate more in their DC plan than would be necessary to fund an equivalent DB plan, which can plan based on actuarial averages. DB Plans avoid the "over-saving" problem by pooling longevity risks of large numbers of individuals.
- Because DB plans are ageless, they can perpetually maintain an optimally balanced investment portfolio. Individuals, on the other hand, must downshift dramatically in order to lower their risk/return allocation as they age. Transaction costs of such rebalancing are very high.
- By pooling their savings in a DB Plan, the participants can afford to engage professional investment advisors – something that the average worker with a DC Plan or RRSP cannot afford. When I compare the returns I have realized in my own self-managed RRSP with those of Teachers', I know I could use some expert advice.

- Costs – DC Plans and RRSPs are usually invested in retail products that carry large administrative fees – sometimes as high as 2% per annum. Contrast that with the cost at Teachers' of only 15 basis points. The extra 1.85% over a working lifetime is a huge cost - amounting to just under 40% of the total funds you could have for your retirement.

As we said in our submission to Ontario's Arthurs Commission on pension reform: The social costs that the private sector's shift to defined contribution plans will impose in the future have not been widely acknowledged. Members of such plans may retire with inadequate retirement incomes. Their combined individual defined contribution shortfalls will likely dwarf the valuation shortfalls of defined benefit plans, possibly imposing obligations on future governments (read: taxpayers) for further retirement income assistance.

We also told the Arthurs Commission that defined benefits have only become more expensive because our legislators have made them so …. with arcane rules and regulations and inflexible structures.

Given the funding challenges that we face, and the retirement financing role we play in this country, we need our elected officials to do what they can to ensure we can compete on a level playing field. I must say that we at Teachers' were pleased to see the Ontario Government signaling in its recent budget that it plans to deal with two other outdated rules:

- the maximum 30% ownership rule, and
- the requirement for jointly sponsored pension plans to fund under the solvency test.

It is noteworthy that the Arthurs Commission recommended both of these rules be dropped. They recognized that they harm our competitiveness, add extra costs and serve only obsolete policy considerations.

In the case of the 30% rule, for example a US or German or Asian pension fund could come into Canada and buy 100% of a local corporation …. But because of this outdated rule, we have to either bow out of the race, or construct costly, complex, time-consuming structures that eat into our rate of return. This is not a theory. This is a day to day reality that does nothing but cost teachers and taxpayers money.

And by the way, the 30% rule dates back to the 1932 Canadian and British Insurance Companies Act …. 1932, when male life expectancy was 60 and pension plans were "dumb money" invested passively in government bonds……… Times change. So should the rules.

So, we as a society are in a pickle: Defined *Benefit* plans are being terminated and replaced by Defined *Contribution* plans which are inadequate.

But a wholesale shift from pure DC to pure DB is not necessarily a panacea, either.

It's time for a new model. For a hybrid model.

The recent market chaos should be a wake-up call to everyone – companies, governments and citizens – that our current pension system needs to be overhauled. As a society, we cannot afford to ignore the need for progressive pension thinking.

I believe we could take a lesson from the British, the Dutch and some Aussies.

The British acted on the Turner Commission Report in 2001 with major undertakings.

- First, they increased their universal plan to a livable pension.
- Second, they extended workplace pay-as-you-go pensions to all workers.
- And third, they established a national arm's length pension plan organization.

Similarly, the Dutch also undertook a national overhaul. Their new model is an amalgamation of pension funds, merging smaller and larger funds. This allows the smaller funds to share their investment risk and reap the benefits of alternative asset investments. The Dutch also bought ongoing sustainability by setting guaranteed pensions to a *career-average* compensation level, rather than a top-five-year average level, and without indexation. Employees then can purchase additional credits through a DC overlay should they wish – in other words, a DB-DC hybrid. Brave moves, all.

It is our view at Teachers' that there will never be a better time than *right now* for Canada to undertake similarly visionary pension reform. The economic storm clouds that started in 2007, turned to recession in 2008 and whose impact will be felt for years to come, have made discussions like this possible. Governments, corporations, labour – everyone has seen the damage wrought on so many pensions and other investment accounts.

There was a silver lining to these economic storm clouds and it was two-fold:

- First, it brought a halt to those obscene subprime shenanigans south of the border. Too late to stem the rivers of red ink they caused, yes. But a halt nonetheless.

- Second, they helped move the pension issue to the front pages I mentioned at the outset. They have given rise to a pension debate that is gaining volume and that people are finally listening to. It has taken an economic crisis for people to accept that the concern is a real one. But that's OK. At least the debate has an engaged audience.

Fortunately, this ubiquitous pension dilemma is attracting the attention of smart people who are keen to find workable solutions. And that brings me to the second point I want to make today, which is the increasingly important role of pensions in the economy and Canada's leadership within that framework

With all of the attention pensions are currently receiving, comes opportunity. Toronto is home to three of the country's – and indeed the world's - largest and most innovative pension funds … and to Rotman's International Centre for Pension Management. As the director of this centre, Keith Ambachtsheer is a well-respected expert in the pension funding field. He has put forward a four-step plan to move the Canadian pension system forward, which he published recently, and which was covered in yesterday's Globe and Mail. In his newsletter he states:

"The research, debate and discussions that have taken place over the course of the last five years have now placed Canada in a position to lead the world in pension system design."

I agree whole-heartedly and firmly believe that Toronto is developing into a world centre of *pension excellence* – where thoughts, ideas and theories such as these and the recent proposals by the Canadian Labour Congress can be raised, refined and incubated … then hatched.

That excellence is being promoted by the Toronto Financial Services Working Group in its Partnership and Action Initiative. It is designed to mobilize Toronto's financial sector for global advantage, and would see Toronto established as a global hub of retirement financing solutions and risk management, among other financial sector services. I was proud to accept a seat on the Financial Services Leadership Council, which oversees this government/industry initiative.

I sincerely believe that the decision to position Toronto as a retirement financing hub is a brilliant move. Some of our best mathematicians, actuaries, administrators and investment professionals are working in Toronto's pension industry today. The smartest among them challenge each other to get even better. Talent attracts talent and success attracts success. And I believe that the critical mass will continue to grow and attract experts from other countries to come here … and that the Financial Services leadership

Council can play a critical role in that growth. It will help us to cultivate the pension innovation we need and the commitment to deliver it…. In other words, we can create a brain trust.

As I said, Canada's pension funds are well-regarded internationally for their innovation – the same reason they have become such an important force in the investment industry.

And that is why, as gut wrenching as this period in the markets has been, I have to say that I feel fortunate to be where I am. Pension plans now represent a new brand of financial institution –- we have the power to combine a large capital pool with a long term investment horizon, something that is extremely novel today.

We now are looking at the confluence of two major forces: boomers who are retiring … and are used to getting their way … with the fallout from the worst economic crisis in the lifetime of the majority of Canadians. As such, pension funds offer not just a measure of *market* stability, but a respected voice for pension reform … which could in turn lead to national *retirement* stability.

This situation has been brewing for years. Peter Drucker warned about it in the '60s. He said then that the current generation was postponing chaos for the future generations. And in his book <u>While America Aged</u>, Roger Lowenstein recounts the horror stories of politicians passing the buck (or lack thereof) to future generations.

Canada has done the same.

It is time Canadians stood together and said that trend stops now … people's retirement years are too precious to be jeopardized.   We must awaken society as a whole to the fact that there is simply too much at stake for continued inaction. We need to innovate. We need to save. Industry, academia and elected officials must agree on this and the path to get us there. And Canadians need to understand that they must take responsibility and save more for their futures. But they must have the right incentives to do so.

I agree with Lowenstein when he writes, "changing this pattern will require political courage and also realignment across society." I join him in his calls on business, government and labour to stop behaving like credit card junkies who can charge the bill to our kids and their kids …   and work together instead to craft the best possible pension solution for all parties and all ages.

To-date the changes to pension legislation have been at the margins – the length of time sponsors have to make up shortfalls, posting letters of credit to back deficits, changing some investment rules, and even amalgamating several funds to reduce costs and gain scale. These are all good ideas and will help those who are currently members of a pension plan. But they do nothing for the millions of Canadians who have no pensions.

And so I return to my original point: As a society, we have an opportunity right now to lead the way in delivering innovative and practical retirement financing solutions, as long as:

- Legislators clear the way with practical, current pension rules and restrictions
- Pension plan sponsors make tough decisions about rates and benefits
- Citizens take responsibility for saving for themselves
- The pension industry sharpens its focus on innovation

It's our choice: our generation can be the pension champions who resolved the problem … Or the chumps who squandered the retirement security of future generations.

Personally, I favour championships.

Thank you.

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