Pension security:
replacing a myopic tradition
with far sighted reform

An address by

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Thank you, Jo-Anne, and good afternoon Minister Wynne, head table guests, members and guests.

Pensions... *[pause]* If anyone had told me when I joined Teachers' in 2001 that pensions would be front page news every day in national media around the world, I would have said they were dreaming! But here we are, eight years later, and it isn't a dream at all:

Today, in fact, it's unusual ***not*** to see a pension story in your morning paper and for good reason. Pensions affect everyone: Employees. Taxpayers. Employers. Corporations. Governments. Non-working Canadians. It's tough to find an individual or an organization untouched by "the pension question."

As such, a very public debate has emerged. It is a debate addressing retirement security, pension affordability, realistic contribution and benefit levels, social responsibility, retirement ages … in other words: our future.

God willing, it's going to be sometime before we endure another federal election in Canada. But when we do, I believe that pensions for Canadians may be *the* issue that defines the campaign. I further believe that Canada's pension champion will emerge from that debate. As Tommy Douglas and national medicare defined public debate in the 60s, the natural gas pipeline and C.D. Howe in the 50s and Brian Mulroney and free trade in the 80s, Pension Reform could be the defining issue of the first decade of *this* century. What remains to be seen is *who* Canada's pension champion will be… And whether or not he or she will be successful in leading Canadians to badly needed change.

Based on discussions I have had with officials in Ottawa, there is little disagreement about the election debate potential of this issue.

I'm here today to talk to you about that debate. And I will do so in the context of three main issues:

- First, I'll look at today's pension reality.
- Second, I'll address the silver lining of the economic crisis, which raised the volume on the pension debate and the corporate governance issues Teachers' has been talking about for years. And
- Third, I will discuss the increasingly important role of pensions in the economy and Canada's leadership within that framework

First, the pension reality.

Let me start with a look at our own membership at Teachers', because we are at the leading edge of the demographic wave - we reflect the reality of a graying Canada.

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. We currently have a 1.6-to-1 ratio of active-to - retired members and are moving to a steady state of 1-to-1 over the next decade or so. To put that into perspective, that ratio was 10-to-1 in 1970.

We have 356,000 members, including 111,000 pensioners, 173,000 working members and 72,000 inactive members. We administer one of Canada's largest annual payrolls, at $4.2 billion. We receive $2.3 billion in contributions annually. So 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 27 years at retirement. They are expected to receive their pension for 30 years, and a survivor pension will be paid for an additional five years. The average full starting pension last year was $42,000.

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. 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 longevity rates are very different. In fact, we have 2,300 pensioners in our membership who are over the age of 90. And that includes about 80 who are over *100* years of age. 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 when they retire.

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.

Benefits under Defined Contribution plans, on the other hand, depend entirely on the market value of the funds in your 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 have been ravaged this past year – in other words, they no longer have enough “gold’ for the “golden years”.

Teachers’ plan is jointly sponsored by the Ontario Teachers’ Federation and the Ontario Government. The teachers themselves make half of the contributions and the government, or taxpayers, make the other half. Together the OTF and the Government

determine contribution rates and benefit levels. They make the decisions when shortfalls and surpluses occur. In the case of shortfalls, they must either reduce benefits or raise contribution rates or both. Surpluses are happier decisions – increase benefits or reduce contributions.

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 a bit ahead of the pension maturity curve, the partners have had to make some difficult decisions sooner than some other plans. But they are the right decisions, made in our members' best interest.

And 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 80% of the Canadian private sector workforce the C.D Howe Institute says has *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.

And that is troubling. Let's face it, we would all love to be rich. But what we really do *not* want to be is poor, especially in old age when we are supposed to be enjoying ourselves!

Also troubling is the private sector's increasing move 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 the sponsors by:

- Short-sighted tax rules and court decisions that effectively prevent 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.

In fact, 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.

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 will 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.

Take the federal Income Tax Act's 'excess surplus' rule, for example. This rule precludes further contributions to a pension plan once the plan's surplus hits 10%. In our view, this rule is counterintuitive. It limits the opportunity to enhance pension plan funding when the investment climate is conducive to growth.

At Teachers' we experience this obstacle not only as a plan administrator, but also as an investor in companies which face the same constraint in funding their own defined benefit pension plans.

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 current 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 continue today, have made discussions like this possible. Governments, corporations, labour –everyone has seen the damage wrought on so many pensions and other investment accounts.

I must say we were pleased to see that the federal and provincial finance ministers seemed to come out of their meeting earlier this week with an appreciation for the concept of such a hybrid, or overlay, plan. Premier McGuinty is right to insist that the feds take the lead here but, he is also right to say that Ontarians cannot wait forever. We all look forward to seeing more from this initiative, soon.

Like any great decline, it's not the fall itself, but the abrupt stop, that causes the damage. However, there is a silver lining to these economic storm clouds and it is two-fold.

- First, they moved the pension issue to those front pages I mentioned at the outset. They have given rise to a debate that is gaining volume and that people are 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 audience.
- Second, and separately, the recession has brought renewed attention to an issue we and other global institutional investors – pension plans and others – have long advocated *against*. That is super-sized executive compensation packages, such as those seeing corporate CEOs receiving 300 times as much as the average U.S. worker.

In our discussions with compensation committees of corporate boards we've heard that they are sympathetic to shareholders' views on such excessive compensation. They appear to understand our concerns and have started doing something about it. The Manulife board's recent decision to develop a "return on risk perspective", in which risk is being considered in setting compensation going forward, is an example of this. We did not agree with some of their past compensation decisions but we do think that they got this one right. It should serve to more closely align management pay with company performance.

Although I don't yet have Canadian statistics, according to the New York Times, the biggest US pay packet hits were in the financial services sector - which were down about 40% in 2008. Will today's trend towards lower compensation packages continue? As Stephen Davis of Yale's corporate governance centre said recently: "It remains to be seen whether these are annuals or perennials."

If this pay decline does continue, there remains hope that our schools' best and brightest won't automatically head straight to Wall Street and Bay Street. They might

consider other, more worthwhile careers. God knows the world doesn't need another credit default swap.

The pension dilemma is ubiquitous. It is attracting growing attention. Fortunately, it is attracting the attention of smart people who are keen to find workable solutions. With that attention comes opportunity. As 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 Toronto is developing into a world centre of *pension excellence* – where thoughts, ideas and theories can be raised and incubated and hatched. With our fellow large pension funds we are major ICPM supporters and will be an active participant, along with other world leading plans, at their symposium here in ten days.

Robert Fulford once said: "My generation of Canadians grew up believing that if we were very good, or very smart - or both - we would someday graduate from Canada." I like to think that the opposite is now true. Some of our best mathematicians, administrators and investment professionals are working in Canada's pension industry today. I believe that the critical mass will continue to grow and attract experts from other countries to come here.

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.

Think of it this way: As of year-end 2007, Watson Wyatt estimated the total value of pension funds in the world's 11 major economies was $25 trillion. To put that into context, the US GDP at the end of 2007 was about half of that, at $13.8 trillion.

In September, the head of Belgium's Association of Pension Funds went so far as to say that "pension funds worldwide create a lot of stability in the markets because we don't move in times such as now. We look long term and create stability because of the amount of assets in pension funds that support markets." Stability, of course, is a relative thing but pension plans *have* been called the financial industry's "investment cushion."

We now are looking at the confluence of two major forces: boomers who are retiring and are used to getting their way … with 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. In While America Aged, 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.

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 pension debate has 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: The pension challenge may be the defining issue of Canada's next federal election. Whether or not it is depends on whether or not the courage exists for our pension champion, whoever he or she may be, to raise and tackle the issue responsibly. The time for pension myopia is long past. We need our leaders to make decisions beyond the next political term, the next employment contracts, the next labour negotiation.

Because we all expect to retire one day. How comfortably we can do so depends on decisions being made – or not made -- today.

Thank you.