

**Leadership in pension funding innovation:
Adapting to today's demographic reality**

An address by

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To

C.D. Howe Institute of Canada

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Thank you, (xxx) and good afternoon everyone.

It is a pleasure to join you today, especially given the role the C.D. Howe has played in so many important Canadian accomplishments and firsts - continental free trade, the deficit reductions of the 1970s and 1980s, the development of effective monetary policy, the reform of the Canadian and Quebec pension plans, lower and more competitive tax rates, and the development the Tax Free Saving Account. Research and tenacity have resulted in Canadian innovation. So perhaps I'm preaching to the converted, but that's what I'm here to talk to you about today: innovation in retirement financing that can help us as a society build a more solid foundation for the future.

A very public debate has already emerged. It is a three-pronged debate, addressing pension coverage for Canadians, cost, and funding sustainability ... The subtexts of retirement security, pension affordability, realistic contribution and benefit levels, intergenerational fairness, social responsibility, and retirement age, echo through both.

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, at what we can do about it.

First, the pension reality.

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 2009 recession – in other words, they no longer have enough “gold’ for the “golden years”.

PAUSE.....

Because we are at the leading edge of the baby boom wave, our membership reflects the reality of a graying Canada to come. Let me give you a snapshot.

At Teachers' we have over 300,000 active and retired teachers depending on us for their future or ongoing retirement security. As such it's my job, and that of my nearly 900 colleagues, to ensure we are well-positioned to meet the challenges that face us. I believe we will be successful, because I know that our sponsors, the Ontario Teachers' Federation and the Ontario Government, are committed to ongoing leadership on members' and on taxpayers' behalf.

Teachers' is what is considered a "mature pension plan." 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 1.1-to-1 ratio over the next decade or so. To put that into perspective, that ratio was 10-to-1 in 1970 and 4-to-1 in 1990.

Our maturity affects our risk tolerance. We simply do not have enough active members amongst whom to share material losses should they occur... So, for example we have had to reduce our allocation to public and private equities, the highest risk/reward asset class, to 45%. This is lower than most other pension plans.

As I said, we have more than 300,000 members. And let me stress the fact that our individual members are scheduled to contribute an average of 13% of their salary annually to the plan. That is matched by the government, bringing total saving for retirement to 26% of salary. We administer one of Canada's largest annual payrolls, at \$4.7 billion. We receive only \$2.8 billion in contributions annually, however. That's a considerable gap, and it means the first \$2 billion we earn every year is automatically earmarked for paying the difference between what is *contributed* and what is *distributed*. But more importantly, it means that the investment growth of that nearly \$2 billion must be foregone. And it is the investment returns on those contributions that fund the pension plan.

The average age for our new retirees today is 59. Each will have worked about 26 years at retirement. They are expected to receive their pension for 32 years, and a survivor pension may be paid for an additional three or so years. The average starting pension in 2011 was \$45,500. And as I said, it is a Defined Benefit. It is jointly sponsored by the Ontario Teachers' Federation and the Ontario government, who together determine contribution rates and benefit levels.

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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 life expectancy was 61. So, on average, you were dead for nine years before you could receive your pension! In 1951, a means-tested pension was made available at age 65 ... when average life expectancy was 68 and a half. When the Canada Pension Plan was introduced in 1966, life expectancy was 72.

That was then. Today's life expectancy rates are very different. Think of it this way: World life expectancy has more than doubled over the past two centuries. According to the World Health Rankings, a Canadian woman who is 60 years old in 2012 can expect to live to age 86, while today's 80-year-old woman can expect to celebrate her 90th birthday.

In the case of Teachers', we now have 2,600 pensioners in our membership who are over the age of 90. And that includes 102 who are over *100* years of age ... our oldest collecting member is 108 years old. I checked, and Hallmark doesn't even make a card for that! But in all seriousness, it highlights the issues of benefit sustainability and intergenerational equity – making sure that pension funds are there for today's younger teachers ... and those who haven't even been born yet ... when they retire.

Let me give you an eye opening example. *The Economist* told the story of the late Gertrude Janeway, of the United States. Mrs. Janeway died in 2003. Until then, she had been receiving a \$70 a month Veterans' Administration pension. Not much, you say. Well maybe not.... Until you take into consideration the fact that her late husband was a soldier in the American Civil War ... which ended in 1865! She married him in 1927, when he was 81... and she was 18. So, as *The Economist* reported, that particular pension entitlement actually spanned *three centuries*.....

An extreme case, for sure. But it makes an important point, of which our actuaries and investment managers are acutely aware: we must consider the plan's long term *liabilities*, not just its assets.

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

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

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

Our sponsors' 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... So, for example, 60% inflation protection is now offered on benefits earned after 2009, and 100% on benefits earned before that.

Because we are at the front end of the pension maturity curve, our sponsors have had to make some difficult decisions – like adopting conditional inflation protection - sooner than some other plans. They are the right decisions, made in all members’ best interests. But they have not been able to solve the problem, because liability growth continues to outpace asset growth. More changes will be needed, to ensure that new and future members, as well as older and retired members, are sharing the funding risk fairly.

Let me stress that Teachers’ is not in any short term financial crisis. We have over \$120 billion in assets and can pay pensions for decades without any changes. Our team’s investment success is second to none in the world – literally. At 8.4%, our 10-year total fund returns as of the end of 2011 are the highest of the more than 370 pension funds around the world studied by CEM Benchmarking, the world’s leading authority on pension fund measurement.

And since inception in 1990, our returns have been over 10%... But still, as I said, we find ourselves dealing with recurring shortfalls, because the growth in our pension obligations is outpacing our asset growth. One thing we know for sure: investment success alone cannot fix this problem. We can't do much better than #1. The fix lies in plan design.

Let me explain what continues to push the cost of pensions up.

The first cause is demographics, that is, increasingly higher life expectancy, coupled with retirement periods that exceed careers, as well as reduced ratio of working to retired members. The second cause is low interest rates: today, a 1% change in the interest rate assumption has a \$25 to \$30 billion impact on the cost of teachers' pensions.

Pension finances are no different than consumer finances in this regard: you have to save more to pay for pensions when investment returns are lower.

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 small course correction today 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.

Their task is not an easy one. They're 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. For example, in 1990, real rate bond yields were 4.5%. Today they are less than 0.45%. And remember that I said that a 1% change at this level moves our liabilities by \$25 to \$30 billion. In 1990, the 10-year outlook for GDP was 3.1%. Now it's around 2.5%, assuming the economy will be able to fully recover over the next decade. Our 10-year real returns outlook then was 6.4%. Today it is 3.4%, with any luck.

As I said, when rates are low, it costs a lot more to pay pensions. At 4.0% interest rates, you need \$650,000 to pay for a typical \$40,000 pension. When that rate drops to 1.0%, the cost spikes to almost \$1 million.

As an aside, that is why it is important to understand the discount rate assumption when people are throwing around numbers about pension surpluses or deficits. At Teachers', we are using a rate of about 3% real or around 5.05%. Other Ontario plans use 4% real. And most US plans use over 6% real (or *unreal*, as I like to say!).

Some of those differences are explained by plan maturity – but some are just plain kidding themselves – and putting future generations at great jeopardy. Why is this? Maybe it's optimism. Maybe it's cowardice. Maybe it is political interference. But I'll tell you one thing it *isn't*, and that's *realistic*.

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 in a C.D Howe Institute study last year sounded similar alarm bells when they wrote:

“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.”

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 suggested that Canadians needed to save between 10% and 21% of their income annually for 30 to 37 contributing years to reach an acceptable income replacement target - remember, I said that teachers are scheduled to save 26% because they're required to, but that is only for 26 years.

[PAUSE.....]

Let me return for a moment to the DB-DC debate and sound a word of caution: 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 - claiming it is unaffordable. And politicians start embracing this idea to grab headlines...

The truth is that DB Plans are far less expensive vehicles for pension saving. I know that this flies in the face of conventional wisdom, but it is true.

A report by the US National Institute on Retirement Security finds that 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, like DB plans do, they're forced to accumulate more in their DC plan than would be necessary to fund an equivalent DB plan, which can be based on actuarial averages.
- 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 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.
- 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 around 50 basis points, including all fees to third parties. The extra 1.50% over a working lifetime is a huge cost - amounting to just under 30% of the total funds you could have for your retirement.

There is debate about how much savings these factors represent in aggregate or whether or not some of those advantages can be obtained under a DC format with financial engineering. That notwithstanding, it is the future social costs of shifting the entire risk to employees that has not been widely acknowledged. Members of such plans will likely retire with inadequate retirement incomes imposing enormous obligations on future governments (read: taxpayers) for further retirement income assistance.

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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 a panacea, either.

It's time to take a look at a hybrid model.... To a model that reflects today's pension reality and shares the risk more equitably between the employer and employee and amongst all members.

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.

The Dutch, for example brought ongoing sustainability to their pension regime by setting guaranteed pensions to a *career-average* compensation level, rather than a top-five-year average level, and without indexation. A good starting point. Employees then can purchase additional credits through a DC overlay should they wish – in other words, a DB-DC hybrid.

A recent Air Canada-CAW accord established a similar structure for flight attendants.

And in a very progressive move, the Province of New Brunswick recently amended their pension legislation to permit greater risk sharing between active members and retirees.

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We now are looking at the confluence of two major forces: boomers, such as myself and many of you, who are retiring ... and are used to getting our way ... with the fallout from the worst economic crisis in the lifetime of the majority of Canadians. As such, our 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 funding* stability.

Canada's retirement system has many strengths. But there are opportunities for improvement, especially for those individuals without workplace pensions. All Canadian workers should have the opportunity to maintain their desired post-work standard of living. They should be able to participate in low-cost, well-managed, collective pension arrangements. Canada's current public pension structure – Old Age Security, CPP, QPP – is a good start. But supplementary pension arrangements are needed.

With that in mind, the federal government introduced a framework for Pooled Registered Pension Plans a couple of years ago and which was tabled in the House last month. The federal government believes that this new defined contribution concept supposedly will improve the range of retirement savings options for Canadians. But from what we have seen so far, I fear it falls short of providing the level of retirement security our aging population requires. That is likely why the provinces have not moved forward as they are still trying to figure out how to make it work to address the underlying issue. Unfortunately, it smells an awful lot like a big RRSP (which have not worked). It does not address the question “How do we get people to save?” “How do we get costs down?” And since defined contribution plans place the investment risk on individual investors, it is still too much of a lottery.

Pensions, like any species that wishes to survive through time, must adapt to the environment. That means we must ensure that benefits and contributions are fair and correlated; that assets and liabilities can be balanced; that expectations are realistic and success is achievable.

And we must do all of this with both our younger (and even yet to be born teachers) as well as our older plan members in mind. As Administrator of the Teachers' Plan, we do not set contribution rates or benefit levels. But we do concern ourselves with risk and sustainability – in fact that is our responsibility as advisor to the two sponsors. In that respect the Teachers' Plan is also different in that our members are both the recipients of a guaranteed pension AND the co-guarantor of fellow members' pensions, including all retirees. Think of it this way: every young and future teacher has pledged their pension as collateral to guarantee all of the older members' and retirees' pensions. That is why we have to keep an eye on the level of intergenerational risk embedded in our plan.

By statute, the younger members are carrying the heavier risk burden in the shadow of possible future tail events. Contribution rate increases would impact them for longer. And because earned benefits cannot be changed, but only future ones can, the young will take the biggest reductions over time. That is to say that, in the event of a weak economy, they could pay much more for much less. As the administrator it is our job to ask: Is that fair? Of course times change and we must adapt to our new realities. But shouldn't we all adapt? Shouldn't that burden be shared among all generations at least somewhat.....

It is wonderful, of course, that society in general and our members in particular are living longer and longer. It is terrific news, but we need to adapt to this new reality just as we are in other aspects of living. I am glad to be part of a sector that can help make that change happen.

Thank you, and now I am glad to take your questions.

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