



**Pension Reform in Canada:  
Getting from Denial to Acceptance**

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## **Introduction: the five stages of dealing with bad news**

The key theme of my contribution to this conference is the need to get over false nostalgia for a “golden age” of pensions – the heyday of the classic single-employer defined-benefit (DB) plan – that really never was. I think those plans were built on a false premise: that sizeable premiums in returns on financial assets different from those that would match pension liabilities – returns that became more certain as time horizons extended – would allow guaranteed deferred compensation at low cost. We need to put that hope, and the problematic compensation arrangements it fostered, behind us if we are to focus on a critical task for the future: fostering work-related pension plans that will give the average saver low-cost accumulation and annuitization, without the agency problems that have undermined the classic DB plan.

That summary makes clear, I hope, my motive in choosing a title from pop psychology. For those of you not up on pop psychology, I’m drawing on the five stages of dealing with catastrophic loss outlined in Elisabeth Kubler-Ross’s 1969 book “On Death and Dying.” While clinicians have reservations about this taxonomy, the idea that catastrophe puts us through, in turn, denial, anger, bargaining, depression, and acceptance has entered popular imagination. Anyone who has recently tried to start a car with a dead battery or get a balky laptop computer to show presentation slides probably has a recent five-stage episode fresh in mind.

## **The bad news about DB pensions**

The plight of the classic single-employer DB pension plan in Canada is more complicated than a dead car battery or laptop, partly because there’s no consensus on the problem. We tend to regulate and litigate compensation, and deferred compensation all the more, because of the extra information and agency problems that can creep in when payments are well off in the future. So a lot of regulation, tax provisions, and case law have accreted around pensions, and many people understandably look at regulation, taxation and case law to figure out why these plans are in trouble and how we help them out.

I would argue that the problem – the catastrophic news – is that the faulty premise of these plans. The premise was that employees could give up modest current compensation and get a rich and secure deferred compensation. How? In the private sector, the idea was that a long-term investor could ride out equity-market cycles and earn returns several percent above those available on a portfolio that matched the liabilities of a typical pension plan.

Why did people think that? The immediate post-war period provided some compelling numbers. Rapid growth of the working-age population *and* rapid growth of output per worker drove rapid real growth. And yields on high-quality debt were low – around 3 percent nominal for the first decade, and rarely much above 5 percent for the decade after that.

Economic growth exceeding returns on low-risk debt means good times for holders of residual claims. At the beginning of that period, holders of lower-priority claims such as common shares got a current yield that reflected higher perceived risk after the turbulence of the 1930s and 40s. Dividend yields on common shares were higher than bond yields. The go-go 1950s and 1960s turned that view upside-down: the premium of dividend over bond yields reversed and common shares earned compound returns well above low-risk, fixed-income instruments.

So the view spread that investors with long time horizons could reap a reward by investing in equities. Consultants helped set up pension plans based on this idea. Employees and their representatives gave up

little for their employers' rich promises. Managers assumed that risk diminished with time. And accommodating regulators and accountants built projected returns well above the low-risk rate into pension-plan balance sheets.

The story of the recent “perfect storm” of demographic and economic developments afflicting DB plans has been well told elsewhere. My summary would be the old maxim that when things look too good to be true, they usually are. And people who criticize the move to more market-oriented pension-plan valuations are shooting at a messenger who took too long to arrive. We now have the catastrophic news. My hope is that Canadians will move quickly – if not easily – through denial, anger, bargaining and depression. We need acceptance, and the clearer, forward-looking vision that goes with it, to get on with reforms that will:

- Address policies that needlessly aggravate the DB problem;
- Make the world of RRSPs and other money-purchase plans more congenial for the majority of Canadians who, for the foreseeable future, will save for retirement in them; and
- Foster the growth of new pooled occupational pension plans that will make more realistic promises at reasonable cost.

### **Denial**

Saying that many pension experts and advocates are in denial is not putting up a straw man. The Arthurs Commission in Ontario is a current example of an official effort with a mandate explicitly to promote DB pensions. David Dodge has held them up as the desirable model. And many regulators and advocates want more accommodative reporting and funding requirements to make the bad news easier to ignore.

This last point is, I hope, easiest to dispose of. Another maxim applies here: what gets measured gets managed. Balance sheets of plans with big asset-liability mismatches will show more volatility. If people want more security, they should match better. And if discounting your obligations at the low-risk rate makes them look expensive, fine. Guarantees cost money. Higher than low-risk returns are something you book when – we should really say “if” – you earn them, not before.

I'd argue, in fact, that denial still affects financial reporting. Ontario regulations don't require the balance sheet to reflect the indexed portion of pension benefits. They should – and until we have more real-return securities to discount them, the RRB yield is the apt market measure. Valuing indexed liabilities at that rate produces startling numbers – the last actuarial valuation of the federal public-service plan showed that at the then-current yield of 1.73 percent, the plan was worth more nearly 33 percent of pay. That is the cost of that guarantee – a good thing for taxpayers to know.

### **Anger**

Since those taxpayers who have money-purchase individual accounts cannot contribute more than 18 percent of pay, I'll use that point to segue to the next stage: anger. Mounting evidence that the classic DB plan is disappearing in the private sector is making some of its advocates louder in asserting its superiority.

It is true that many workers with individual retirement accounts do not know how much to save, invest poorly, pay high fees, cash out ineptly, and outlive their assets. But arguing that these defects make the case for the old DB model is to let emotion overrule reason. The misleading promise of DB pensions – combined with perverse tax law, regulation and court decisions – led to underfunding. And underfunding led to broken promises. Not every Ontario steelworker got the implicit return on foregone current

compensation that his plan promised. Other DB plan members are discovering that their pension is worth less, or is less secure, than they thought. There's anger at bargaining tables and in court rooms.

## **Bargaining**

So what about the next stage: bargaining? Let me deal mainly with the bargaining actual and would-be DB plan sponsors and participants might undertake with policymakers. What might they ask for?

If we stay agnostic on the equity premium and related issues, and take for granted that plan managers will, or even should, mismatch assets and liabilities, a number of tax laws, regulations and court decisions need revision.

On the tax side, we need higher – or no – limits on overfunding of pension plans. Fluctuations in asset prices and discount rates like those over the post-war decades will cause a plan with a “standard” asset-liability mismatch that is unconstrained by contributions to show assets well over 110 percent of liabilities on a regular basis. Tax laws that forbid contributions when assets are above that level will cause such plans to have more frequent and larger deficits.

Tougher would be to get contribution limits on both DB plans and RRSPs raised. At the risk of reverting to anger, I'll ask rhetorically why, if the federal public service gets pensions worth more than 30 percent of pay, they limit the rest of us to 18 percent?

Bargaining the legal status of surpluses is also tougher. Pension obligations ought to be in law what most of us would say they are in fact: title to periodic payments, not the assets that back them. But that case has to be made courtroom by courtroom and legislature by legislature.

Other less happy kinds of bargaining with policymakers are also in prospect. Some sponsors and participants want government bailouts. Ontario has a guarantee fund, and a sad story it has been. Pressure for a federal one has not gone away. The US Pension Benefit Guaranty Corporation looks to me like a back-door to nationalizing declining industries. The recently established UK fund seems quickly to have created a larger subsidy from well- to badly-run plans than expected, with the prospective premium cost worsening the disincentive to creating new DB plans.

Others want infrequent reporting, long amortization periods, and valuations involving smoothing and judgement. As I remarked earlier, this also is wrong-headed. You can't manage risks you can't see. In Canada, the distribution of realized equity premiums over overlapping ten-year periods since 1970 shows an average difference between total equity and long-bonds returns of 1.4 percentage points, with a standard deviation of 3.8 percentage points. The realized premium over these 10-year periods was negative more than one-third of the time.

People who insist that the future offers big premiums on equity – or infrastructure or real estate – have also to confront the fact that prices for these assets are being bid up because other people believe the same thing. In the long run, real growth in the economy constrains real returns on our saving, and we need to make sure that pension managers react to disappointments of their more extravagant hopes in a timely way.

## **Depression**

A common objection to high-frequency reporting of pension-plan balance sheets using current interest rates and asset values is the volatility it will add to the bottom line. Reducing that volatility will require managers to match assets more closely to liabilities. And – the influence of the equity premium on

thinking being what it is – closer matching will raise the apparent cost of the benefit. So a DB pension becomes a less attractive part of the compensation bargain – and we move on to depression.

Some current DB plan participants would probably be better off letting the sponsor lay their obligations off on an insurer while the plan is still a going concern. But they might get 80 cents for every dollar they're currently expecting – a depressing prospect. So they'll hang on, risking a smash and litigation that leaves them with less than 80 cents on the dollar – another depressing prospect.

The fact that the last stronghold of the classic DB plan is the public sector is also depressing. The accrual patterns that promote early retirement and push hidden costs forward will persist in the public service, health, education and so on even as they disappear elsewhere. Taxpayers will get a larger bill than they're expecting, since government financial statements understate the true costs of compensating their workers. The people who make the rules, moreover, don't play by the rules they make.

That is particularly depressing because most Canadian workers will end up in individual money-purchase accounts, where they will save too little, invest badly, and draw their saving down ineptly. The public sector workers who could improve the environment for those plans have less first-hand experience of them, and no direct interest in improving them.

### **Acceptance**

Getting a handle on depression and beginning the transition to acceptance and moving along may be easier if we understand that the problems of DB plans are not confined to Canada. They are also widespread in the United States and the United Kingdom. Moreover, more than just a few economic and financial accidents and policy mistakes got us where we are now. Recent financial-market trends have put many DB plans on a better financial footing, and regulatory and tax changes would help. But the decline in coverage of employer-sponsored DB plans began many years before the crisis that started us into the five stages I've just outlined. So rather than struggling with denial, anger, bargaining and depression, people concerned with the future of work-related pensions in Canada ought to be thinking about alternatives.

### **The sixth stage: innovative response**

The most persuasive element in the case for the DB model is the difficulty most people have in saving, investing, and annuitizing. People as individuals and as participants in a more efficient economy gain from pooling and delegating the management of these things to specialists.

The good news, though, is that the classic DB plan is not the only conceivable way to get these things. For example:

- Money purchase plans can have default contribution rates – either fixed, or escalating, or connected by formula to a target payout rate – that will protect unsophisticated workers from saving too little.
- Money-purchase plans can pool the saving of workers in many employers, creating the economies of scale that give access to non-retail investments and lower administration costs.
- Money-purchase plans can provide default investment vehicles, protecting unsophisticated investors from trading too much and taking inappropriate risks. One such option would be a share of a saver's contributions automatically invested in a bond portfolio that tracks annuity prices, adding a DB element to the plan.
- Money-purchase plans can have default immunization and annuitization options, protecting

unsophisticated savers from market risk as they approach retirement and unsophisticated dis-savers from outliving their funds. With scale, moreover, such plans can annuitize internally or get better terms from annuity providers.

This list is not just hand-waving: plans with one or more of these elements exist already, both in Canada and abroad. In my view, the constructive response to the bad news about the classic DB plan is to focus on making those options more widely available to Canadians who, if they save for retirement at all, do it in individual and group RRSPs. Keith Ambachtsheer has advocated models drawing on Dutch and Australian experience, arguing that mandating coverage can get us past the coordination problems that currently prevent potential users and providers from getting together. While I think mandatory coverage merits consideration, my preference would be to work two fronts:

- Legislate “safe-harbour” provisions that would protect plan sponsors who provide plans with default contribution rates, investment vehicles and annuitization from lawsuits launched by (former) participants who, despite good faith efforts on the sponsor’s part, ended up disappointed.
- Regulatory harmonizations that would facilitate the emergence of these plans on a national scale.

### **Recap**

To close, let me underline that seeking to recreate a “golden age” of DB plans that never existed would be to return to denial. More anger, fruitless bargaining, and depression would surely follow. Far better would be to think about a sixth stage for dealing with the bad news on pensions: innovations to help Canadians pool their resources and save for retirement, cushioned against not only from financial risk and longevity risk, but from agency risk as well.

We’ve got challenges in managing the existing DB problems. But we must not let policymakers fixate on the plans that most resemble their own: doing so would neglect the wellbeing of the majority of Canadians who will do most of their retirement saving in money-purchase plans. A key task is fostering the growth of pooled hybrid plans that will offer more realistic promises than classic DB plans and better returns than RRSPs.