INFLATION PROTECTION FOR PENSIONS IN CANADA

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High rates of inflation in the 1970s focussed attention on the need for inflation protection in pension plans, that is the need for adjustments to compensate pensioners in whole or in part for their loss of purchasing power due to inflation. Pension plans are designed to replace earnings upon retirement of an employee, so as to ensure, together with government benefits, reasonable continuity of income when earnings cease. If the pensions are merely level unindexed amounts, inflation can seriously impair the whole purpose of the pension plan.

A Canadian who retired in 1975 on a level pension would find his purchasing power reduced to only 47% of the original amount in the 10 years up to 1985. The expectation of life of a male at age 65 is about 16 years and in the last 16 years the Consumer Price Index in Canada has trebled. At current rates of inflation, 4.5% a year, a pension loses half its value in 16 years. Employees naturally regard these rates of depreciation as intolerable and call on the employer to make up the loss. Trade unions argue that pension funds can afford to increase the pensions because interest rates tend to rise in times of inflation; otherwise the funds develop surplus so that the employers gain while the pensioners lose.

Employers are generally sympathetic to their former employees' problems caused by inflation and usually raise pensions unilaterally. However, employers insist that such action should be voluntary, leaving them with discretion as to the amounts and timing of the increases. Guaranteed inflation protection, they believe, is inconsistent with the popular idea that pensions constitute "deferred pay", since it constitutes a retroactive increase in compensation, not legally required by the employment contract

or the pension contract. Until recently only a few employers entered into a contractual commitment to index pensions; such a commitment was often regarded as much like signing a blank cheque. Above all, employers were and are united in opposition to any legislation requiring them to index pensions.

Governments are less restrained than private employers in this regard. About 1973, when inflation rates began to soar, the Government of Canada added full indexation to the benefits under the Old Age Security Act, the Canada Pension Plan and Unemployment Insurance. (Even the tax brackets under the Income Tax Act were indexed.) Federal and provincial government employees, including public servants, teachers, the armed forces and the RCMP were also granted virtually 100% inflation protection for their pensions on an automatic basis - that is, the increases were promised in advance of the employee's retirement.

The question of requiring private plans to index was widely discussed at this time. Inflation protection was one of the four main pension issues identified at an important National Pension Conference in 1981 (the other issues were pension plan coverage, vesting and portability, and the position of women, all of which have been the subject of later legislation). The Conference led eventually to a federal-provincial consensus on pension reform, but mandatory inflation protection was not included in the consensus.

The erosion of pensions as a result of inflation after the employee retires can be remedied by three mechanisms.

Ad hoc adjustments

The commonest response of employers to severe inflation is to make ad hoc pension adjustments. Practically all employers of any size have followed this course, with adjustments that on average have raised pensions by about 50% of the increase in the Consumer Price Index. The partial adjustment is justified on the ground that since the government pensions of up to $880 a month for a single person are 100% indexed, the total income of the pensioner will not decline enough to cause serious problems.

The ad hoc system allows employers to choose the time and frequency of the adjustments and to defer an increase if cash is short. Also, the increases can be slanted to recognize hardship, for instance by awarding higher percentage increases to pensioners with low incomes than to those who are better off.

Ad hoc increases can be satisfactory for a pensioner of a stable company following a policy of regular adjustments. Nevertheless, the pensioner is at risk that the adjustments may not be continued due to adverse business conditions or to a change in policy following a corporate merger or takeover. Further, there are many small companies that do not raise pensions at all.

Negotiated indexation

It has been common for pensions in payment as well as accrued pensions of active employees to be increased as a result of union-management negotiations. Many negotiated pension plans are of the flat benefit type, providing pensions at retirement of say $20 a month for each year of service. When the agreement is renegotiated the pension level for future retirees may be increased from $20 to say $24; the pensions of retired employees are often raised as well as the accrued pensions of non-retired workers, but not necessarily by the same percentage.

In September 1987 the United Automobile Workers Union and Chrysler Canada (soon followed by Ford and General Motors) negotiated a settlement that for the first time indexed pensions in relation to the Consumer Price Index (CPI). Although the indexation was subject to limitations and only applied to the pensions of future retirees and to amounts of pension paid out during the term of the six-year contract, the contract was regarded as a major breakthrough.

Since then automatic indexation of pensions has been negotiated in a number of other industries. In some cases the increases are guaranteed for the pensioner's lifetime, not merely for the life of the contract.

Mandated indexation

As yet, no government in Canada has legislation in force that requires private pension plans to index pensions; but Ontario has expressed its intention to do so. The Pension Benefits Act 1987 states in Section 54:

> " (1) Pension benefits, pensions or deferred pensions shall be adjusted in accordance with the established formula or formulas and in the prescribed manner to provide inflation-related increases.
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> (2) Any formula or formulas for any inflation related adjustments to pension benefits, pensions or deferred pensions shall be established only by amendment to this Act."

Thus the Act states that inflation protection shall be provided but shall not be provided unless another Act is passed.

Ontario has published a 114 page consultation draft of a Bill to amend the Pension Benefits Act. The legislation is unlikely to be effective until 1991, with the first mandatory pension increase occurring on January 1, 1992. The draft Bill calls for deferred pensions to be increased, both before and after they commence, to the same extent as pensions in payment.

Under the draft Bill employers will only have to index pensions accrued for service after the effective date, so there is no requirement to improve pensions already earned or pensions that have commenced. To allay the disappointment of many pensioners and long-service employees, the government will provide incentives to retroactivity, described below.

The Ontario formula for the minimum pension increase is 75% of the CPI increase for the year, minus 1% (e.g. a 3-1/2% increase if the inflation rate is 6%); but the

pension increase is subject to a maximum of 5% in any one year. If the formula produces a pension increase exceeding 5%, the excess is carried forward to be applied in a subsequent year. Pensions may never be reduced, but if the CPI declines, the percentage fall will be carried forward and applied against the next CPI increase.

Indexation is only mandatory for pensions up to a limit, which is about $46 a month (in 1989 dollars) for each year of future service.

Indexation is mandatory for defined benefit pension plans, but not for defined contribution (money purchase) plans which, however, must offer a choice of a fixed annuity or an indexed annuity.

Retroactivity

A law requiring future service pensions to be indexed but with no application to pensions earned for prior service will hardly satisfy pensioners and employees near retirement. Yet there are two strong objections against making the law retroactive. First, the Ontario government has traditionally adopted the general principle (which makes good sense) that its legislation should not be made retroactive if such an action imposes costs on employers or others. Second, severe practical difficulties would arise in attempting to trace all the retired and terminated members of a company pension plan. Over the years a great many companies have been wound up, amalgamated or reorganized; many terminated employees have transferred the commuted values of their pensions to another pension fund or to a Registered Retirement Savings Plan; and many pensions have been purchased from insurance companies under group or individual contracts. To unravel these changes would be a herculean task.

In view of these difficulties the Ontario government will not make it compulsory to index pensions already earned, but instead will offer inducements to persuade employers to go retroactive. Thus employers are encouraged to extend the indexation to pensions already earned by active members, to pensions-in-pay and to deferred pensions of former employees. The provisions are highly complex and it is doubtful

if they will have much effect. As an inducement, if indexation is made retroactive the formula for the minimum increases will be lowered and the funding rules will be relaxed. Further, an employer would be allowed to withdraw $1 of surplus from a pension fund, for each $1 of surplus applied to provide retroactive inflation protection.

As this is written (September 1989) the Ontario government seems to be committed to its indexation proposals, but the details are so controversial and complicated that they will probably be modified before enactment.

Funding of indexed pensions

Two arguments against mandatory indexation have been heard from employers: first that legislation is not needed because most employers are granting ad hoc increases and second that the cost of inflation protection is beyond what business can afford. These two arguments are not as contradictory as they may seem, because of the funding implications.

Under Ontario's proposal, the indexation becomes an integral part of the pension benefit; the basic pension and the increases for inflation are united as one benefit. Accordingly, it appears that the cost of indexation must be funded in advance over the employee's working lifetime. By contrast, ad hoc increases can be financed separately from the basic benefit, on a practically pay-as-you-go basis.

Hence, even if ad hoc indexing and contractual indexing were to produce the same income for the pensioner, the latter method would require contributions to be made a great many years earlier (while the employee is active, not after retirement), so that the immediate cost impact on the employer would be much greater. Accounting practice also requires early recognition of the cost of any firm promises to index pensions. If inflation protection were contractual the employer would have to pay the cost must sooner with an obvious effect on his financial statements. Were it not for the funding consequences employers might be less adamantly opposed to mandatory inflation protection.

Employer reaction

Some employers have reacted to the pension legislation that has been enacted in the last few years by switching their defined benefit pension plans into defined contribution plans. In this way they can avoid most of the complications caused by the new rules on early vesting, portability, survivor benefits, employer's minimum contributions, solvency and other items; they will also avoid Ontario's proposed rule on inflation protection. Several hundred pension plans (mostly small) have been wound up and replaced by Group Registered Retirement Savings Plans (in which the employer makes direct contributions into the individual RRSP accounts of members of the group).

Among large companies with defined benefit plans, only a handful have made the switch. However practically all the new pension plans established since 1983 have been on a defined contribution basis - they are large in number but mostly very small in membership. It appears safe to say that nearly all employers of any size will continue to operate defined benefit pension plans.

Conclusion

To sum up, provisions to minimize the effects of inflation in pension plans are increasingly seen as necessary, not only by plan members but also, so long as indexation is not compulsory, by employers.

Three powerful forces are at work in Canada. High inflation has caused most companies to upgrade pensions periodically even if the plan documents do not require any such action. Second, a growing number of union contracts require not merely ad hoc pension adjustments but annual indexation by a formula using the Consumer Price Index. Finally, at least one provincial government proposes to require some degree of indexation by law.

As a result of these forces inflation protection, whether ad hoc or contractual, is now perceived by many people as essential in the operation of any satisfactory pension system. It seems likely that in a few years inflation protection of pensions will be taken for granted in Canada, just as are the once controversial issues of early vesting, portability, disclosure and unisex.