Pension Planning Principles for an Inflationary Environment
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There are not many areas where our current inflationary environment can give cause for thanks, but it has, at least in Canada, forced us into a fundamental re-examination of pension plans. This cannot be other than a healthy process. It would be fair to say that for too long we continued to design pension plans without due regard to the changing social and economic environment. Most of Canada's current pension debate is being focussed on establishing the basic principles of pension plan design against which we can put in place a pension plan system more geared to current reality. I say "most" because unfortunately there is somewhat of a tendency in certain quarters to be tackling this issue in a patchwork fashion. I view it as essential that the debate and subsequent action be based on strengthening the foundations upon which we build pension plans as opposed to building further extensions to a somewhat shaky existing structure.

To the extent that within our own Company we have also been debating quite vigorously these same issues, what I would like to present is a summary of the consensus we arrived at internally. We are at the present time testing out our conclusions externally and we would very much welcome the reaction of our international colleagues here at this Conference. The principles that we have developed encompass more than a direct accommodation of inflationary pressures, but rather than break out any one part I have preferred to present our total conclusions. From these follow quite logically we believe what one's reaction to those inflationary pressures should be.

Introduction

From 1945 to 1975, the private sector consistently improved its pension plans, reflecting the increasing prosperitty of Canada, the longer period of retirement and a steady swing from the view that pensions were a reward for loyalty towards the view that they are deferred pay.

Since 1975, however, this evolution has slowed down due partly to tighter financial controls imposed initially by Wage and Price Controls and by companies themselves, and subsequently to a wait-and-see attitude brought about by the many Government studies.

It is felt by many that it is time for the private sector to reassume its position of leadership, firstly to meet today's social and economic environment, and secondly to forestall further government direct intervention.

Accordingly, the following set of principles has been developed to which it is believed most companies could and would subscribe. Each such company would apply these principles in its own way and at its own pace, but it is important that not only should commitment be made to their application, but also that this action be very visible. Otherwise there is considerable danger that Government will expand the universal, partly funded Canada and Quebec Pension Plans substantially; this in turn would have significant impact on our capital markets, which currently are supported by Private Pension Funds to the extent of $70 billion. This impact would probably take two forms: a reduction in total savings and a greater degree of investment decisions being made for political rather than economic reasons.

Recent Government studies have concluded that only a small modification is required to the present welfare programs for senior citizens. Whether or not this conclusion is endorsed, any problem that does exist for the currently retired should be directly addressed by Government through the existing programs of Old Age Security Pension, Guaranteed Income Supplement or the already existing welfare programs. The key here is that the problem, if it exists, should be tackled directly rather than by adjusting the total pension delivery system with its corresponding wider impact.

Assuming that Government maintained such a program which ensured that nobody, however unfortunate or improvident they may have been, is forced to live below a certain standard of living, it is believed that the present levels of the Canada and Quebec Pension Plan benefits provide an adequate minimum level of employment related extra pension. Furthermore, support should be given to the internationally accepted philosophy that the provision of retirement income is three-tiered, a combination of universal government benefits, employment related private benefits and individual saving.

The Federal Government has made it quite clear that it believes that the Private Pension Sector — the second tier — has lost its commitment to meet our continually changing social and economic needs. Even if this perception is totally false, it must be addressed in a positive manner by the Private Sector.

It is believed that the opportunity to accrue retirement income benefits should be made available to as many employees as possible, in two ways. Firstly, employers with existing plans should expand the availability to accrue such benefits to as many classes or employees as possible, for example to include "permanent" seasonal or part-time employees. Secondly, more companies should actually be providing some form of opportunity for accumulation of retirement income, whether it be by way of pension plan, savings plan or other accumulation vehicle.

However, a system of mandatory pension plans for the private sector is not favoured. The ability of the private sector to custom design programs to meet the particular needs of both employer and employee is too important a concept to be discarded. Nevertheless where as part of a particular program that has been developed for the accumulation of retirement income, a pension plan has been put in place, it is believed that such a pension plan should be designed in conformity with the following principles.

Principle # 1

Retirement benefits accruing under a pension plan form part of the total compensation package earned by current employment, as opposed to a reward for loyalty or long service.

This means that, for a year of work today, the compensation package consists partly of immediate direct salary and partly of an income payable from a defined retirement age.

In the case of a money-purchase plan, the deferred component would take the form of the allocation of a specific amount to each member's account in the pension fund.

In the case of a defined benefit plan, the deferred component would take the form of the right to a pension determined by specific formula.

Principle # 2

The right of a pension plan member to receive his earned retirement income, during his lifetime after retirement, is inalienable.

This means that a member's earned pension rights should not be dependent on his continued employment. It therefore follows that, apart from any concession to administrative ease, pensions should be vested immediately.

Principle # 3

Retirement income benefits accruing under a pension plan must be preserved for the purpose for which they were intended: income replacement in retirement.

This, very simply, requires complete and immediate locking-in, without any dilution of the retirement benefit due to partial commutation.

This would not, and should not, preclude the provision for a transfer to other pension plans or to individual registered retirement savings plans, so long as the amounts transferred are in turn treated as solely for the provision of lifetime retirement benefits.

Principle #4

The right of entitlement to retirement income must be extended to the surviving spouse of a retired plan member.

This principle requires nothing more than the mandatory provision of survivorship benefits upon the retirement of a married member. This could be achieved either by:

(a) the plan providing that a percentage of the initial pension continue automatically to the surviving spouse, of any, without any reduction in the initial basic amount of pension; or by
(b) the plan providing that the amount of benefit is calculated by making an adjustment to the initial basic amount of pension. Spouses could jointly elect away from this form of pension.

The first alternative creates an additional cost to the plan, and provides a more valuable benefit to a married employee than to a single employee. Under the second alternative, the cost is borne by the married employee.

This does not require the splitting of accrued retirement benefits on marriage breakdown. The contingent existence of these benefits should generally be recognized in any overall settlement, but it would often be preferable for the employee to retain control of his retirement benefits.

The amount of the continuation of retirement income to the surviving spouse should not be less than 50% of the initial amount.

Principle #5

Plan members must be fully informed on a regular basis of their accrued benefit entitlements and other relevant information.

Sufficient information should be given in an appropriate form to enable each plan member to know:

(a) the extent of his accrued rights, under all possible events,
(b) what options are available to him,
(c) the risk of his not receiving his accrued rights due to inadequate funding.

It is believed that not only is this the basic level of information which employers should provide, but also the maximum level that should be required by legislation.

As discussed at the beginning of this paper, I have chosen to set down in full the principles we have developed in order to provide the complete background to a more detailed discussion of the sixth principle as it relates to indexing or maintenance of real value in an inflationary environment.

Principle #6

A pension plan must provide for the accrued retirement income benefit a reasonable degree of protection against inflation.

In times of higher than minimal inflation this would require for defined benefit plans the periodic adjustment of:

(a) benefit accruals under other than final earnings pension plans;
(b) deferred pensions of former employees; and
(c) pensions in the course of payment.

As regards the first situation, that of the benefit accrual, there should be some automatic mechanism to ensure that under a flat benefit or career average plan there is a periodic reasonable adjustment of the already accrued benefits to reflect the inflation that has taken place. There would be a number of possible approaches ranging from the automatic review inherent in a flat benefit negotiated plan to a formula approach, but a pure ad hoc approach would not be appropriate. The commitment should be made formally to the concept of periodic adjustment for inflation.

As to the method of adjustment, particularly for deferred and current pensions, there are two broad avenues of approach. Firstly, full or partial indexing can be provided related to an external index such as the Consumer Price Index; in this case the employer carries the financial risk. Secondly, the indexing can be linked to the inflationary investment gains made by the pension fund (or that part of the fund allocated to support the pensioner liability); in this case the pensioner carries the financial risk.

Specifically, as regards pensions in the course of payment it is recommended that the minimum level of indexing should be not less than one of the following:

(1) The annual increase in the Consumer Price Index less 4%.
(2) The interest earned on the pensioner portion of the fund in excess of 7% per annum.

As regards deferred pensions, it is recognized that the concept of granting indexing to a former employee is a difficult one for employers to accept. Accordingly, as a means of achieving the same objective it is recommended that an amount be available for transfer at the time of termination, calculated on a basis that would give effect to the same principle as outlined above for pensions in the course of payment.

Great concern has been expressed about the cost of full indexing of pensions in payment, but while the absolute cost is of course there, it is probable that few employers would face additional funding requirements in adopting any of the above minima. Furthermore, while future investment gains on the pensioner assets would be substantially reduced, or even removed, this reduction would be offset by the removal of the costs of existing ad hoc arrangements.

Money purchase plans are assumed to protect against inflation during the pre-retirement accrual period through the passing on of the higher investment earnings to the member. The provision of some form of inflation protection after retirement can be addressed by the selection of the appropriate form of annuity.

In conclusion, might I say how my colleagues and I would very much welcome the comments of those attending this conference as to the merits of these principles and as to any practical experience of their application.