RETIREMENT

Could this pension solution help Canadian retirees turn their DC savings into a lifetime of low-cost income?

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CONTRIBUTED TO THE GLOBE AND MAIL
PUBLISHED 1 HOUR AGO

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One of the largest defined contribution (DC) pension plans in the world has adopted a made-in-Canada solution, giving members the option to turn their DC savings into what they badly need in retirement: a low-cost lifetime pension income.

Australia's QSuper – a century-old plan with more than $100-billion (Canadian) in assets – said last month that it will offer its 600,000 members a "ground-breaking" decumulation option. Decumulation is what comes after members leave the workforce, where retirement savings are used to provide retirement income.

QSuper designed its lifetime pension income option based on the variable payout life annuity (VPLA) in the University of British Columbia (UBC) faculty pension plan.

Other Canadian pension plans looking to add such an option are out of luck, though. A change in tax policy back in 1988 blocked DC pension plans from providing lifetime payouts to their retiring members by stipulating that such benefits must be provided through annuities purchased from a licensed provider, such as an insurance company.

That policy change was meant to prohibit DC plans from making promises about fixed lifetime payments that they may not be able to keep. VPLAs do not actually make such promises, so it seems likely they were swept up in the changes. In any case, UBC's arrangement was grandfathered, but no new VPLAs have since been allowed.

Thirty-three years later, VPLA-like options are recognized as the solution to the decumulation dilemma for DC plans around the world. As more and more retiring Canadians continue to face the complex challenge of turning savings into lifetime retirement income, there is an urgent need to reintroduce them into the Canadian pension landscape.

WHY VPLAS WILL HELP

In a VPLA, retiring DC plan members voluntarily direct some of their savings to purchase a variable lifetime pension and receive automatic monthly payments for the rest of their lives. The goal of VPLAs (explained here) is to help people maximize their retirement income by creating a pension plan structure where the financial risks are shared among the retirees.

The underlying principle is that VPLAs can deliver higher lifetime monthly payments with substantially less risk than attempting to manage savings on one's own over a potentially long and uncertain retirement. In fact, it is like a defined benefit (DB) pension plan, with the biggest key difference being that there is no guarantee by a provider – instead, the mortality premium (that is, the capital of those who die) and investment returns are shared equitably among the surviving members. Members receive a variable income stream that is expected to be higher than that of traditional annuities. So VPLAs are not for everyone, since pension payments may fluctuate from one year to the next. However, retirees are generally able to handle some fluctuations in retirement income. In any case, it's preferable to shouldering the financial risk alone – and far better than outliving their savings.

Not only do VPLAs offer a safer way to turn retirement savings into lifetime pensions, but they also offer retiring Canadians an opportunity to stay in a pension plan pool, benefiting from economies of scale, reduced fees and professionally managed assets with stronger purchasing power and better capacity to diversify investments. All in all, VPLAs offer good value for money and peace of mind. VPLAs also do not require seed capital and solvency reserves, resulting in limited – if any – financial burden on pension plan sponsors.

Despite the promise of low-cost secure lifetime pension income, retirees may hesitate because of a fear of dying early and losing any leftover funds, which remain in the VPLA pool for the benefit of the remaining members. QSuper demonstrated that a simple design tweak will satisfy most people: adding money-back protection. If a member passes away before receiving payments equal to their original purchase price, then the difference is payable as a death benefit to their beneficiaries or estate. Since relatively few retirees die young, and the investment returns on the purchase price stay in the pool, this feature is a relatively cheap promise to make.

THE CANADIAN DECUMULATION DILEMMA

For nine out of 10 private sector workers in Canada, traditional DB workplace pension plans – which ensure an ongoing stream of lifetime retirement income – are out of reach. To bridge the gap, Canadians have been instructed to save more, whether in DC plans, registered retirement savings plans or some other arrangement.

As Canadian baby boomers move into retirement, they have only two payout options: buy a life annuity in the retail market or move their registered savings into a registered retirement income fund (RRIF). Retail insurance-based life annuities have traditionally been unpopular and remain so today, as the continuing low interest rate environment makes them more expensive than ever.

Nearly all retiring Canadians move their savings into RRIFs – however, that means they also face the additional challenge of managing their assets through retirement so they won't run out of money.

WHY IT MATTERS

Considering retirement can last several decades, with changing expenses and unpredictable financial markets, it's not surprising that eight out of 10 Canadians say they would prefer a pension plan that delivers a lifetime retirement income over a higher salary.

But turning accumulated lifetime savings into lifetime *income* is more than just a challenge. It's a tremendously difficult task that threatens the financial security and mental health of a large portion of the elderly population.

Restoring VPLAs in Canada requires a legislative intervention that is purposeful and deliberate, and the inclusion of VPLAs has been proposed in both the 1999 and 2021 federal budgets. But time is ticking, as Canadian baby boomers are now moving into retirement in record numbers.

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