

Leaving a Legacy

Baby boomers played a large role in retooling the Canadian retirement system. What challenges and rewards will subsequent generations inherit?

BY CHRISTOPHER CARTWRIGHT

Pension planning these days often involves managing the past as well as the future. Pension plans are inherently long-term creations, and the promises of our predecessors, written in plan texts, remain in effect for this generation to manage—or find a way to dismantle.

If we step back, we can view the old and new pension commitments as part of a generational conversation. As John Maynard Keynes put it, “The importance of money flows from it being a link between the present and the future.” In pension plans, money also connects us to the past. We can see the legacy of those who came before us, and we can ponder the legacy we will be leaving to those who follow us.

What Legacy Did the Boomers Inherit?

At the outset, the generation that experienced the Depression and fought a world war was more concerned with just making it to retirement age than the prospect of retirement itself. Life expectancy at birth in the early 20th century was barely age 60. The notion of a long, comfortable period of “endless vacation” was not yet a realistic goal.

This was a time when there was not much of a social safety net and to live a long life was to be condemned to poverty. In the absence of the care provided by extended families, seniors—particularly widows—were among the poorest, with little opportunity to improve their lot. Our predecessors aimed to fix that problem and build a framework to prevent another generation from facing the same threat. Like a three-legged stool, the Canadian retirement system depends on three similar but separate components that we’ll define as government programs, employer-sponsored plans and personal resources. Let’s look at each pillar in turn.

The Role of Government

Out of the Depression came a number of national institutions that we now take for granted: the Bank of Canada, a national unemployment insurance program and deposit insurance. The expanding role of the government continued after the Second World War with the introduction of many new measures aimed at improving the financial security of Canadians:

- universal old-age pension (1952);
- lowering the age for Old Age Security (OAS) eligibility from age 70 to age 65 (1965);
- the Canada and Quebec Pension Plans (CPP/QPP) (1966);
- the Guaranteed Income Supplement (1967);
- medicare; and
- indexing of OAS (1972).

The launch of the CPP was an exceptional example of government intervention. With benefits covered by incoming contributions on a pay-as-you-go basis, it contrasted vividly with the then-prevailing notion that you don’t live on credit: if you want something, you save for it. 1966 may have been

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a turning point, as this was also when credit cards first began to appear.

Occupational Plans

The creation of the CPP instantly relegated employer-sponsored plans to supplementary status and cast doubt on the viability of private pensions. Nonetheless, the second leg of the retirement stool also underwent a major expansion. Large employers, in particular, did their part during the economic boom times, fuelling the growth of the defined benefit (DB) pension plan.

It’s worth examining the thinking underlying the approach to retirement planning in the pre-boomer days. Private pensions were often regarded as a reward for long service, at a time when it was not unusual to spend an entire career with the same employer. The regulation of vesting standards reflected this view, with benefits secured by law only upon attaining age 45 and 10 years of service.

In an era of light regulation and “Father Knows Best,” it was expected that plan sponsors would make all of the decisions, take all of the risks and enjoy the benefits of any risk-taking. It was assumed that employers had deep pockets and were not taking any chances that they couldn’t easily handle.

It may be an oversimplification, but the unspoken expectation was that growth never ends, profitable businesses can continue to expand forever and benefits programs can always be improved in the next round of collective bargaining. In short, there was a mindset that things always get better. No one imagined that employers’ pension promises could imperil their balance sheets.

As for personal resources dedicated toward retirement income, the significant milestone came in 1957 with the creation of the RRSP—a way to defer current income taxes to the lower-income retirement years. Until then, the primary tax-favoured personal investment vehicle was the family home.

In summary, the generation prior to the Second World War built up public and private pension plans to lift seniors out of poverty and set the foundation for a comfortable retirement for all.

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The Boomers

As the boomers settled into their careers, conditions were already changing quickly. Women were taking their place in the labour force, and the baby bust was unfolding as fertility rates fell. After averaging less than 3% through the 1950s and '60s, inflation doubled to average more than 6% through the 1970s and '80s. For a time, double-digit bond yields made DB liabilities look unusually cheap. Over time, some would begin to see the discounted cost of liabilities and the ever-rising value of stocks as normal.

Rapid change in the economy was a challenge to the long-term assumptions on which the Canadian retirement system had been built. New initiatives and new solutions were called for. Thus, we saw the rise of defined contribution (DC) plans, which allowed for more investment flexibility, cost predictability and benefit portability in tune with volatile capital markets and a more mobile workforce.

“Deferred compensation” was the new concept that displaced the idea of rewards for long, loyal service. Vesting standards moved in the direction of immediate vesting. Investment risks and rewards shifted to the plan member—perhaps reflecting a distrust of paternalistic employers and a preference for the do-it-yourself approach.

Of course, the first wave of DC pension plans and group RRSPs coincided with a time when a 10% return could be earned “risk-free” by investing in five-year GICs. Later, “GIC refugees” would discover that such guaranteed returns were far from the historical experience of “normal.”

As managers of the legacy plans, boomers discovered that if conditions change or if the assumptions underlying the retirement system are overtaken by events, then the system itself could be in danger of collapse. Being in charge means being proactive.

For example, the CPP started with a 3.6% total contribution rate that was sufficient to cover the benefits paid, gratis, to the first pensioners. Over time, however, it was clear that such a deal was unsustainable in the long term. Paul Martin, the finance minister at the time, raised contribution rates and provided for the investment of contributions in a

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contingency fund rather than simply loaning them back to provincial treasuries. The changes brought contributions to 9.9% of earnings and put the CPP on a “steady-state” foundation, blending the pay-as-you-go model with the fully funded approach of employer-sponsored plans.

The optimism of the post-war boom years was severely challenged. As it turns out, economic growth is not automatic, continual and endless. Even the largest and most successful companies—such as Dominion Stores, Eatons, Canadian Pacific Airlines, General Motors and Nortel—are not eternal. They may be taken over, reorganized or even disappear entirely.

As pension plans mature, the liabilities can grow larger than the corporations that sponsor them. Volatile markets, combined with falling interest rates, mean that funding deficiencies can grow even faster—and, following Murphy’s Law, deficiencies will always happen at the worst possible time, when an employer is least able to cover a shortfall.

On the personal resources side, the recent introduction of the tax-free savings account (TFSA) represents the first significant innovation in a generation. While not specifically a retirement vehicle, it may still be the encouragement needed to strengthen the personal leg of the retirement stool.

What Legacy Will the Boomers Leave Us?

Boomers have strengthened the public leg of the stool by dramatically increasing contributions and overhauling the funding mechanism. They also determined that many of the employer-sponsored programs they inherited are unsustainable. Based on shaky assumptions, these programs must be scaled back. Finally, boomers have added to opportunities for individuals to better fend for themselves.

Those who are many years from retirement and just entering their prime earning years will likely need to get more involved in order to maximize the potential of their RRSPs and TFSAs. With fewer DB pension plans surviving and the single-employer career a distant memory, it is unlikely that a paternalistic company will promise to look after an employee’s lifelong needs in exchange for 30 or 40 years of loyal service. However, it looks as if employees will still be able to count on the public plans to be there, as first promised so many years ago.

The next generation of pension plan managers may have an easier time administering relatively simple capital accumulation plans. However, they will likely face bigger challenges in setting expectations and delivering adequate retirement payouts in an era of uncertain investment markets and ever-increasing longevity. Retirement in the 21st century will call for more heavy lifting by individuals, as companies reach the limits of what they can realistically do.

The core lesson to pass on may be adapted from a slogan the boomers embraced, back when every word from “The Establishment” was questioned: “Never trust anyone over 30... even when you are over 30!” **BC**

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