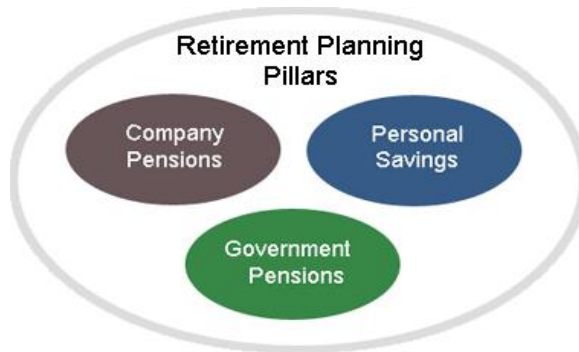


Company Pension Plans in Canada

This article provides an introduction to company pension plans as well as a discussion of several issues currently facing company pension plans in Canada.

Company pension plans are considered one of the three pillars of retirement planning, together with government pensions and personal savings. Understanding what to expect from a company pension is essential to effective retirement planning.



According to 2008 figures from Statistics Canada¹, only 38% of paid workers had a company-sponsored pension plan as part of their compensation. For those who are covered, the two main types of company pension are the Defined Benefit pension plan and the Defined Contribution pension plan.

The Types of Pension Plans

A **Defined Benefit pension plan (DB Plan)** offers an employee the security of knowing what to expect at retirement. A monthly retirement income is specified up front (based on a formula set out in the plan). It is up to the employer to contribute enough to the plan to ensure that sufficient funds are available in the future. How much an employer must contribute will vary based on the changing market value of their investments. Thus, the investment risk is on the employer. The funds for all pension plan members are pooled into one investment plan and controlled by a plan administrator. The income that a retiree will receive is based on the set formula, usually dependant on years of service and income, for example, the average of their last five years' earnings.

In contrast, in a **Defined Contribution pension plan (DC Plan)**, an employer specifies how much will be contributed to the plan on a regular basis. Investment of the funds is generally directed by the employees from a selection of investment options available within the plan. This is similar to managing a personal RRSP. The amount a retiree will receive will vary based on the amount contributed and the performance of the invested funds over time. The DC Plan offers more flexibility for an employee than a DB Plan but puts all the investment risk on the employee.

A summary of the key differences between DB and DC Plans is given in the appendices of this article.

Who Contributes

Contributions to a pension plan are made by the employer alone or the employer and the employee with contributions by both employer and employee being the most common arrangement. Rules for contributions are specific to each plan and may include matching cash contributions (either dollar amounts or percentages).

In Canada, pension plan funds are held in trust, separate from the company. This means that the funds are held by an independent plan administrator. Once in the plan, the pension assets are not available to the company to draw on.

Tax considerations: Employee contributions are tax-deductible, like an RRSP contribution. Employer contributions reduce the amount of RRSP room an employee has available.

What does the employee receive when retiring?

If the plan is a DB Plan, the employee will receive the specified monthly income for the rest of their life. Most plans allow for payments to continue to their spouse or common law partner and some may also allow for inflation adjustments.

If they have been part of a DC Plan, at retirement they will receive all of the funds which they have contributed, those which their employer has contributed, as well as all accumulated investment income. At retirement, they have the choice of transferring the DC Plan funds to a locked-in RRSP, a Life Income Fund (LIF) or an annuity. These choices are explored in more detail in our [RRIF vs. Annuity article](#). Retirement income will depend on the option(s) chosen.

Tax considerations: A pensioner pays tax on the pension/annuity benefit received or the registered plan withdrawal(s) made.

For example:

DB Plan: Let's take the case of an employee making \$40,000 per year who joins a DB Plan at age 35 and retires at age 65. The terms of the plan are:

- the employee contributes 7.5% of annual salary
- at retirement he receives 1.5% x years of service x best-5-average salary

The contributions and benefits would be calculated as follows:

- $\$40,000 \times 7.5\% = \$3,000$ contributed per year
- $1.5\% \times 30 \text{ years of service} \times \$40,000 \text{ (average salary)} = \underline{\$18,000}$ (in today's dollars) per year throughout retirement

Assumption: \$40,000 salary grows at rate of inflation but all values are stated in today's dollars

DC Plan: Let's look at a similar employee making \$40,000 per year who joins a DC plan at age 35 and retires at age 65. The terms of the plan are:

- employee contributes 4% of salary matched by the company also contributing 4%
- employee contributes an additional 3% of salary matched by the company contributing an additional 1.5%

The contributions and benefits would be calculated as follows:

- total combined contribution is 12.5% of the employee's annual salary per year
- $\$40,000 \times 12.5\% = \$5,000$ contributed per year (\$2,800 employee, \$2,200 employer)
- The retirement income will depend on the actual rate of return achieved on the investment over the 30 years in the plan and the life expectancy of the retiree. Possible results (stated in today's dollars) are:
 - \$17,500/year to age 83, assuming an investment rate of return of 6%
 - \$13,500/year to age 83, assuming an investment rate of return of 5%

Assumption: \$40,000 salary grows at rate of inflation but all values are stated in today's dollars

What if the employee leaves the company before they retire?

When they leave a company prior to retirement, the employee has the right to take any pension contributions they have made along with the investment returns earned on these contributions. The right to receive the value of an employer's contributed on their behalf will depend on whether the employee is vested. Vesting occurs after a person has been part of the plan for a specified amount of time in accordance with pension legislation. In Canada, this varies by province and is between two to ten years. Once a person is vested with a plan, they are entitled to receive the value of their own contributions plus those of the employer along with investment returns earned on both.

There are three options for those leaving a company with a vested pension:

1. Leave the funds in the plan and collect the pension benefits (based on the appropriate formula) at the time of retirement.
2. Transfer the funds to a new pension plan, if the new pension plan allows this.
3. Transfer the amount into a locked-in RRSP. A locked-in RRSP is similar to a regular RRSP except withdrawals are not allowed until the employee reaches retirement age.

How much will the employee receive if the pension is vested and funds are transferred out?

- In a DC Plan, the amount is straightforward. It is the combined employee/employer contributions plus investment returns.
- In a DB Plan, the eligible amount, or commuted value, must be calculated based on the entitlement formula and predictions of future value. Thus, it will depend not only on how long an employee has been part of the plan but also on how long until their retirement date. The further away from retirement they are, the less they get because the present value of benefits grows quite slowly early in an employee's career and accelerates significantly in mid-career.

Tax considerations: Since the funds remain in either a company pension plan or a locked-in RRSP, no taxes are payable at the time they leave the company. The commuted value received from a DB Plan is often less than the loss of RRSP room over the years. This can be adjusted based on calculations by the plan administrator.

Management of a DB Plan

When a DB Plan is set up, the company decides on various options and policies for that plan. These include:

- The retirement income formula
- Retirement age and early retirement options
- Vesting rules
- Whether retirement income will be indexed

For example, eligibility for full pension benefits may be based on age *plus* years of service. If indexing is included, it may be only partial indexed to inflation or pension benefit increases may be applied at discretionary intervals. These policies are usually described in a plan booklet which is available to members.

Administration of a plan includes keeping members informed of their retirement expectations. Yearly statements are issued which typically specify the current years of service to date and the projected pension payable if employment continues to retirement age.

Plan administrators also determine the amount which the company must contribute on an ongoing basis to meet future commitments. At any given time, the pension plan may hold more (be in surplus or overfunded) or less (in deficit or underfunded) than will actually be required to meet current pension obligations. The law requires that deficits be made up by the pension sponsor within a given period of time. This has traditionally been five years in Canada. With the market downturn of 2008, many pension plans went deeply into deficit because of large investment losses. In fact, for most of the past decade, DB plans in Canada were 10-20% underfunded on average. In early 2009, DB pension plans in Canada were 41% underfunded on average². In 2009, regulations in several Canadian jurisdictions were revised to give companies up to 10 years to make up their shortfalls³.

Although it may sound beneficial for a plan to maintain a pension surplus during good times in order to offset possible market losses, tax regulations discourage any surplus in excess of 10%. Also, employers with pension plan surpluses have sometimes been obliged by regulators or the courts to use the surplus pension funds to enrich pension benefits. These combined factors have discouraged companies from building surpluses (cushions).

Defined Benefit Plans: Not guaranteed

Knowing what to expect at retirement is a main characteristic of a DB Plan. However, there are a few situations which may alter your expectations.

A company may change the terms of a pension plan or type of plan offered. For example, in 2008 Sears Canada froze their existing DB plan and introduced a new DC plan⁴. For affected employees, any benefits accrued in the DB plan when it was frozen remain in that plan until the employee retires. Any future contributions would be made to the DC plan only.

A company's bankruptcy may also affect pension recipients depending on the status of the plan at the time. If the plan is fully funded at the time of insolvency, there should be enough money to continue paying pensioners and to pay out a commuted value to non-retired employees. However, if the plan is underfunded, employees will receive less than the promised amount. In some jurisdictions, the government provides a guaranteed minimum income to retirees. For example, in Ontario, the Pension Benefits Guarantee Fund insures pensions up to \$1000/month.

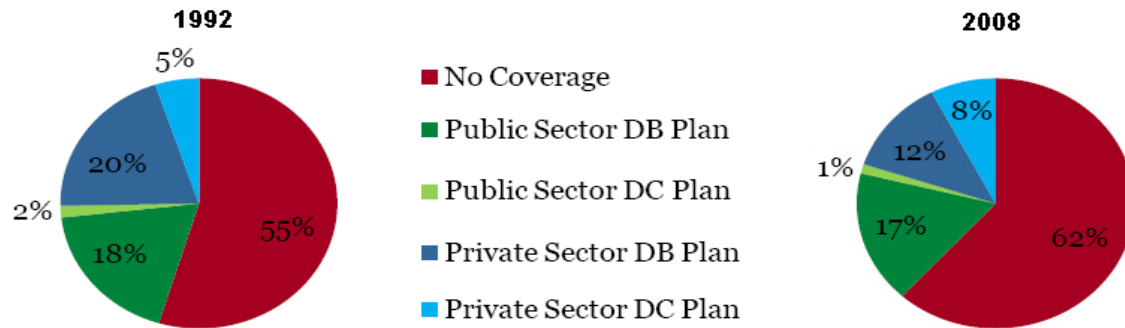
Defined Contribution Plans: Manage your risk

A DC Plan offers an employee more choice and flexibility in their investment than a DB Plan. This allows a knowledgeable investor to tailor the plan to suit their own investment goals and tolerance for risk. Someone who is less comfortable with investment decision must still be careful to put the same effort into pension plan investments as any other registered or non-registered investments they may have. This includes understanding their asset mix and risk tolerance.

Trends in Pension Plan Coverage

Over the past two decades, there has been a shift away from companies offering DB Plans toward DC Plans or other hybrid type plans. The public sector (government) is the largest provider of DB Plans in Canada. Approximately 2.6 million government employees are covered by DB Plans while about 200,000 have DC or other plans. In the private sector, 1.9 million workers have DB Plans and 1.2 million have DC or other plans⁵. DC Plans are more economical and easier to manage for smaller companies, which makes them more attractive in the private sector.

In 1992, 85% of people with a pension plan were DB Plan members while 15% had Defined Contribution or other types of plans. The percent covered by DB Plans fell to 77% by 2008, and rose to 23% for DC Plans⁶.



The graphs above show how a smaller percentage of workers receive company pensions today as compared to 1992⁷. In addition, while the public sector coverage has not changed very much, the private sector shows a significant shift towards Defined Contribution Plans.

In Summary

Some key points to consider when reviewing your retirement plan:

- Make use of pension plan brochures to learn what your company's plan offers.
- Review plan statements for a good understanding of how your investments are doing (DC Plan) or what your projected retirement income from this source will be (DB Plan).
- Consider your pension options when changing employers, taking into account the stage of your career and your retirement plans.
- On retirement with a DC Plan, make use of the different financial vehicles (RRSP, LIF or Annuity) to tailor your income to best suit your needs.

A DB Plan fits the traditional view of company-provided, guaranteed retirement income and there are still many DB Plans in Canada. As DC Plans become more common in the private sector, it is important to understand what type of plan you have and how to incorporate it into your overall retirement strategy.

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¹ <http://www40.statcan.ca> Proportion of labour force and paid workers covered by a registered pension plan (RPP)

² <http://www.mercer.ca> Canadian Pension Plans Pummelled in 2008

³ <http://www.cbc.ca> Ont. gives pension plans extra 5 years to fund shortfalls

⁴ <http://www.cnw.ca/en/releases/archive/February2007/05/c4782.html> Sears Canada Announces Re-design of its Retirement Program

⁵ <http://www40.statcan.ca> Registered pension plans (RPPs) and members, by type of plan and sector

⁶ <http://www40.statcan.ca> Registered pension plans (RPPs) and members, by type of plan and sector

⁷ <http://www40.statcan.ca> Registered pension plans (RPPs) and members, by type of plan and sector

Appendix A: Comparing Defined Benefit Plans to Defined Contribution Plans

	Defined Benefit (DB) Plan	Defined Contribution (DC) Plan
Pension Amount Expected	Benefits are determined by a formula and benefit levels are guaranteed.	Benefits are determined by the contributions and the individual's investment earnings.
Contributions	The employee's contributions are set. The employer is responsible for contributing as much as necessary to provide the promised benefits.	Employer and employee's contributions are set.
Understanding the Plan	A DB Plan is a promise of future payment. Its current value is unclear, unless you are close to retirement.	A DC plan is easier to understand. The employee has a balance and, once the pension is vested, the money in the plan is theirs (though the funds are locked-in, preventing withdrawals before retirement age)
Changes in Salary	Salary increases affect pension benefits because the benefit is generally determined by final average salary.	Salary changes affect only future contributions since employer's matching contributions are often capped at a percentage of current salary.
Inflation	Most public sector DB Plans are fully or partially inflation protected. Most private sector plans are either purely fixed (no increase) or allow for discretionary increases which are generally less than inflation.	The retiree must decide how to withdraw accumulated savings and whether to allow for regular inflation-like increases (e.g. by purchasing an inflation-indexed annuity).
Investment Risk	Assuming the employee stays with the employer until retirement, fluctuations in the investment market should not impact them. The employer must make up any shortfalls in the plan.	The investment risk is shifted to employees. The plan balance is theirs and investment gains or losses impact them directly.
Plan Risk	There is a risk that the employer could go bankrupt (anytime before the end of the employee's retirement) and they may not get the full pension amount that had been promised.	The balance in the plan is the employee's (subject to rules when they can be withdrawn). Once the pension is vested, the employer's regular contributions are theirs as soon as paid in. The employer's future health doesn't impact what is already in their plan.

	Defined Benefit (DB) Plan	Defined Contribution (DC) Plan
Flexibility / Changing Jobs	When an employee leaves a DB Plan, they get a commuted (or discounted) value based on their age. The further away from retirement they are, the less they get.	With a DC Plan, a member knows the plan's worth at any given time and so can easily predict the pension savings that can be taken with them when changing jobs. If their pension is vested, they retain their full DC Plan balance if they change jobs.
Longevity	Benefit levels are guaranteed for a retiree's lifetime. Retirees generally have the option of providing survivor benefits.	The length of payments depends on how investments are managed, especially the choice of RRIF/LIF vs. Annuity (see article on this site).

Appendix B: When Is One Type of Plan More Beneficial than the Other?

Defined Benefit (DB) Plan	Defined Contribution (DC) Plan	Reason
Employees hired mid-career who stay with the employer for the rest of their career	Employees who leave the plan at a young age	A young person's DB Plan pension value will be discounted much more steeply, even if they leave the job after the same number of years as an older employee. With a DC Plan, there is less time for an older employee's funds to grow and compound.
Employees with a longer life expectancy	Employees with a shorter life expectancy	DB Plans guarantee payments for life so someone living a long time receives more payments.
Employees with significant pay increases over their career	Employees with more consistent income levels over their career	Salary increases later in the career boost the entire DB Plan pension benefit even if early career salary was comparatively low.