



national
union

pensions
backgrounder #6

Workplace
Pension Plans

Part 6 in a Series

The full series of pension backgrounders are contained in the National Union's Pensions Manual, Fourth Edition—available from the National Office

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BACKGROUND #6

Workplace Pension Plans

- What is a Workplace Pension Plan or a RPP?

A workplace pension plan is an arrangement by an employer, a union or a joint arrangement between the employer and the union to provide pensions to retired employees in the form of regular (usually monthly) payments.

A workplace pension plan in Canada is also commonly known as a registered pension plan (RPP), meaning that it has met the requirements of and has been registered with the Income Tax Act and the applicable provincial pension legislation for the jurisdiction in which the majority of plan members work (see Backgrounder entitled *Legislative Framework Governing Pensions*).

Both employee and employer contributions paid to a RPP are not deemed as income under the *Income Tax Act* and investment earnings are tax exempt until such time as benefits commence to be paid.

- Workplace Pension Coverage in Canada¹

The percentage of Canadians who belong to a RPP is declining. Only 33.6% of all Canadians of working age are covered by a pension plan and the percentage continues to decline – 35.4% were covered a decade ago. In terms of the paid workforce, the percentage of workers who were covered by a pension plan in 2005 was 38.5% – this represents a steady decline in coverage of 7.5% from 1991 when pension coverage of the paid work force stood at 46%.

Changes in coverage from 1977 to 2005 were very different for men and women. The biggest decline occurred among men. In 1977, more than one-half (52%) of male workers were covered. This proportion dropped over the entire period, although most dramatically from 1991, to 38.3% in 2005.

The decline occurred in the private sector, where coverage fell from about 44% to 25.9%.

The situation was quite different for women. As a result of legislative changes allowing part-time employees to join a RPP, as well as the increase in the number of women in the workforce, the female coverage rate rose substantially from 1987 to 1993. However, starting in 1993, the rate edged down slightly, from just over 42% in 1993 to 38.7% in 2005.

Coverage also differs greatly in the public and private sectors. Since 1977, the workplace pension coverage rate for the private sector has been steadily decreasing, from 35% in 1977 to 25.9% in 2005. In the public sector, the coverage rate has always been much higher. In 2005, over 84% of workers in that sector were covered by a workplace pension. Coverage in the public sector actually increased over much of the earlier part of this period, from 1977 to 1991, but has since been dropping.

We also know that the best assurance to belong to a workplace pension plan is to be a union member – 83% of unionized employees are covered by either a pension plan or a group RRSP, compared to just 33% of non-union workers.

In 2006, there were approximately 15,130 active registered pension plans in Canada, covering nearly 5.7 million members.

Over 95% of these plans are governed by the respective federal or provincial pension standards legislation.

There are, however, a small number of workplace plans (under 25) that are not subject to pension regulatory legislation and have their own acts regulating their operations. These plans are mostly for federal government employees and most provincial and some broader public employees employed under a provincial jurisdiction. The majority of National Union members who work for provincial governments or the broader public sector are in a workplace pension plan that is governed by its own separate legislation.

Over 11,000 RPPs sponsored by employers and unions (the largest number of workplace pension plans) are managed by life and health insurance companies. These plans cover approximately one million workers. Life and health insurers' RPPs usually consist of small- and medium-sized plans, as larger plans are often funded through trustee arrangements.

••• Types of Workplace Pensions

The two major types of registered pension plans are called Defined Benefit and Defined Contribution (the latter is also called Money Purchase). There are also plans that combine the features of defined benefit and defined contribution plans.

Defined Benefit Plans (DB)

These are pension plans in which retirement income is defined by a formula that provides regular paid benefits based on earnings and years of service.

There are two types of defined benefit plans: *Contributory* or *Non-Contributory*.

Contributory means that both the employer and employees contribute to the funding of the pension plan. Federal and all provincial pension legislation provide for a 'minimum employer 50% contribution rule', meaning the employer must pay for at least 50% of the cost of the pension earned. Generally on termination or retirement, employee contributions in excess of 50% of the value of the accrued pension must either be returned to the employee, transferred to another pension plan, RRSP or a Life Income Fund (LIF) used to purchase an annuity from an insurance company, or used to increase the pension benefit.

Non-Contributory means that only the employer contributes to the pension plan.

Most public sector pension plans, and all defined benefit plans covering members of the National Union, are contributory pension plans, as both employer and employees contribute an equal amount.

There are different types of benefits provided depending on the benefit formula of the defined benefit plan. The following are the typical formulas:

Best or Final-Average Earnings

Pensions are based on the plan member's service and average earnings over a stated period (often three or five years and usually during a period close to retirement).

For example, the plan could provide a pension based on 1.5% of average earnings during the plan member's last five years on the job, multiplied by years of service. A plan member who had worked in a job for 20 years, earn-

ing an average wage of \$40,000 over his or her last five years, would get an annual pension of \$12,000 under this assumption ($\$40,000 \times 20 \text{ years} \times 1.5\%$).

The common formula to calculate benefits from a best-average earnings plan can range anywhere from a plan member's best three years to the plan member's best six years (which might or might not be identical to the plan member's last years on the job).

Career-Average Earnings

The benefit is based on a percentage of average career earnings. A typical formula is a pension equal to 1.5% of the employee's earnings in each year. An integrated formula (see section above) generally provides for 2% of the employee's earnings in each year but that percentage is reduced as a result of the integration with CPP.

A plan member whose career average earnings were \$30,000 over the 20 years he or she had worked for an employer, for example, would obtain an annual benefit of \$9,000 ($\$30,000 \times 20 \text{ years} \times 1.5\%$).

A feature often provided in career average plans is base year upgrades. These upgrades mean that a member's pensionable earnings on an annual basis will be higher for the years before the base year because a member's pensionable earnings are usually higher in that year than what was actually earned in the previous years. If the base year is upgraded or moved forward to a year closer to the present, the pensionable earnings will be further increased. Regular base year upgrades can mean a career average plan is closer to operating as if it were a best or final average earnings plan.

Flat Benefit

This type of pension is typically defined as a stated dollar amount for each year of service. For example, the plan might provide \$50 monthly, for each service year, to obtain an annual benefit of \$12,000 ($20 \text{ years} \times 12 \text{ months} \times \50). The pensions are commonly integrated with CPP retirement benefits by providing bridge benefits from retirement to age 65.

Bridge Benefit

The benefit level of a DB plan also depends on whether or not the plan includes a supplement in the form of a 'bridge benefit'. Bridge benefits begin at any time during a period after the commencement of early retirement until the member reaches age 65.

There is a ceiling on the amount of bridge benefits which may be paid from a defined benefit plan. The maximum amount of monthly bridge benefit payments is restricted to the total of the CPP and OAS benefits the member would be able to receive if she or he were age 65 at the date the bridge benefit begins. If the plan member, however has not reached age 60, or has not completed ten years of pensionable service, the maximum bridge benefit is reduced by:

- one-quarter of one percent for each month by which the bridge benefit begins prior to the member reaching age 60; and
- 10% for each year of pensionable service less than 10.²

For a person who has accrued the maximum permitted lifetime pension, or is close to that level, the maximum possible bridge benefit will again be reduced so that it does not exceed the member's CPP retirement benefit, prorated by the member's pensionable service.

It should be noted that this is a brief overview of what is a difficult concept to explain in general terms. Individuals should be encouraged to check to find out how the integration formula and the bridging period are applied in their own pension plan.

Integrated

This is probably one of the most difficult pension concepts to explain. An integrated formula adds an additional component to the DB pension benefit formulas outlined above. In such a plan, benefits or contributions are coordinated with the benefits or contributions of Canada's universal public workplace pension plan – CPP.

With integration, the combined benefits from both plans are equivalent to what a plan member would have received from the workplace plan alone. In turn, the workplace pension benefit is reduced by roughly the same amount that the member would expect to receive at age 65 from CPP. Since the introduction of the CPP program in 1966, most pension plans of public sector workers are integrated with CPP.

If a member of a workplace pension starts to receive benefits at age 65, the process is straightforward. The pension she / he receives at retirement is already integrated with CPP.

However, if there is a gap between the date a member's pension starts and the date CPP integration occurs, it will affect the integrated pension. The intended result of integration is to reduce the pension benefit by an amount that approximates a plan member's CPP benefit. If the plan member's pen-

sion starts before it's integrated, it will also include an amount equivalent to the plan member's CPP benefit. This is referred to as bridge benefits (see section above).

Non-integrated (or Stacked)

Non-integrated refers to a defined benefit plan that does not explicitly take into consideration the additional pension benefits that are provided from Canada's universal public workplace pension plan – CPP. Benefits under just a plan are 'stacked' rather than integrated with the CPP at age 65 when an individual qualifies for an unreduced benefit under that plan. This means that a retired member will receive a constant stream of pension income, without any adjustments for CPP entitlement at age 65.

Ancillary Benefits

The main purpose of a pension plan is to provide a regular income to individuals and their families who retire and are no longer in the workforce. There are other benefits that can be included that are secondary to the main purpose of a pension plan – these are called ancillary benefits.

Ancillary benefits can include the following:

- immediate vesting;
- termination benefits;
- pre- and post-retirement death benefits;
- disability pensions and accrual of benefits with a waiver of contributions during periods of disability;
- bridging benefits and temporary benefits payable before full OAS and CPP / QPP benefits are payable;
- optional forms of pension benefits such as joint and survivor;
- accrual of benefits during pregnancy and parental leave(s); and
- inflation protection.

Each of the terms noted above are defined in the Glossary at the end.

••• Defined Contribution Plans (DC)

These are sometimes called a 'money purchase' plan. In a defined contribution plan, an employer will contribute a fixed amount of a percentage of an employee's earnings to a pension fund account for the employee's credit. The employee may or may not be required to contribute.

Like defined benefit plans, the contributions are specified, but in contrast to defined benefit plans, the benefits are unknown until the employee retires.

The accumulated value of the contributions at the time of the employee's retirement, plus earnings on those contributions, are used to calculate the amount of monthly pension income the employee will receive. The value of an employee's pension account upon his / her retirement will depend on how well the funds have been invested, the performance of the stock market and fluctuation of interest rates throughout an employee's work career. It is the current accumulated value and forecasted future interest earned on that accumulated value which determines the amount of the monthly pension benefit.

The pension account upon an employee's retirement is often to purchase an investment vehicle to provide a regular monthly income. The most common investment vehicle purchased is an annuity. There are two kinds of annuities – a life annuity which provides monthly benefits for the life of the retiree and a fixed term annuity which provides regular monthly benefits for a defined period of time.

The other two common investment vehicles an individual DC pension account will purchase to provide monthly retirement benefits are a *Registered Retirement Income Fund (RRIF)* and a *Life Income Fund (LIF)*.

A RRIF is a tax-sheltered fund set up with the proceeds from the pension account from which the retiree is required to make a minimum annual withdrawal based on his / her age. This withdrawal is part of retiree's taxable income for the year. The money in the RRIF continues to grow tax-sheltered until withdrawn as income.

A LIF is similar to a RRIF in that it provides monthly retirement income payments on a predetermined basis. There are however two major differences between a LIF and a RRIF.

While both require that a retiree take a minimum payment amount out of the plan each year, the LIF also places a ceiling on the retiree's withdrawals by imposing a maximum annual withdrawal. The other distinction is that retirees may control the investments in their RRIF during their entire lifetime.

A LIF (except in Quebec) requires that retirees purchase an immediate life annuity (which must include a 60% spousal survivor benefit, unless their spouse waives this requirement) by the end of the year in which they celebrate their 80th birthday.

Regardless of what vehicle is chosen to purchase a monthly retirement benefit from a DC plan, the investment risk (whether it's the current or future value of the plan) lies solely with the employee.

In 2004, 4.9% of Canadians in workplace pension plans were covered by defined contribution plans.

••• Combination of Defined Benefit and Defined Contribution

In a combination plan, the pension is a combination of two types of benefits. Typically the employer pays for a defined benefit (for example, 1% of salary for each year of service). Added to this basic benefit will be a defined contribution arrangement, to which both the employee and the employer may contribute. This money is used to purchase an annuity, which is paid in addition to the basic guaranteed defined benefit.

Another type of combination plan is a 'hybrid' plan. In general, they are usually treated as defined benefit plans for tax, accounting and regulatory purposes. As with defined benefit plans, investment risk in hybrid designs is largely borne by the plan sponsor. As with defined contribution designs, plan benefits are expressed in the terms of a notional account balance, and are usually paid as cash balances upon termination of employment. These features make them more portable than traditional defined benefit plans and perhaps more attractive to a more highly mobile workforce. A typical hybrid design is the Cash Balance Plan, where the employee's notional account balance grows by some defined rate of interest and annual employer contribution.

••• Clear Advantages to a Defined Benefit Pension Plan

It is clear that the best form of pension is a defined benefit plan. Defined contribution plans are certainly better than no plan at all, for most workers, but they are unable to deliver the same level of benefits that a defined benefit plan can.

Less Risk / Greater Certainty – A DB plan provides less risk to a worker and greater certainty on how much pension income the worker will have in retirement. The reason for this is that a DB plan is first and foremost a pooled resource under which, if there is a shortfall in the fund, the employer as a plan sponsor must at least help make up the shortfall to ensure the promised benefits are available. A DC plan is simply an

accumulation of money, with no promised benefit. If the DB plan is short of money, the employer has to cover, or share in the task of covering the shortfall with the workers. If the DC plan does not provide enough for a decent retirement the employee is simply out of luck.

Additional Benefits – DB plans can provide for a number of benefits in addition to the basic pension, including enhanced early retirement benefits, survivor benefits beyond those required by legislation, portability, disability benefits and inflation protection.

While DC plans can also provide benefits in addition to retirement income, these additional benefits must be purchased by each individual at the time of retirement and will significantly reduce the monthly income available to retirees.

Lower Administration Fees – Because DB plans are centrally managed, the cost of administering the pension fund is shared among all beneficiaries, so less of the funds needed to pay retirement benefits are taken up by investment management fees.

In a DC plan, especially an individually managed plan, a larger proportion of an individual's account is absorbed by investment management fees charged by the pension industry, leaving fewer funds available for retirement income.

Most moves by employers to a DC plan also transfer the administrative cost to the individual worker. This potentially huge source of profits for the investment industry explains why they are so active in the push for conversion of DB plans to DC.

Guarantee – A DB plan offers a guaranteed income for life to retirees. A DB plan pays benefits for as long as a retiree lives and, in most cases, pays benefits to a surviving spouse for as long as he / she lives.

A DC plan carries no certainty that the benefit will be paid for the retiree's entire life; the retiree faces the real possibility of outliving the so-called retirement 'nest egg'. The only way to ensure a lifetime of benefits is to purchase an annuity, but an annuity comes at a real cost and reduces the monthly payments available.

Purchasing an annuity with survivor benefits is even more expensive and reduces the retirement income available. At a time of increasing life expectancies, DC plans provide no guarantee that they will have sufficient assets to cover living longer than expected.

DB plans are the best form of pension plans for workers. Workers are assured a certain retirement income for the rest of their lives and

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the risks and responsibilities associated with providing that guaranteed retirement income either rests with the employer or is shared equally between the employer and the workers.

¹ *Pension Plans in Canada* in **The Daily** (Statistics Canada: June 21, 2007)

² *Morneau Sobeco Handbook of Canadian Pension and Benefit Plans*, 13th edition, edited by Jennifer A. Greenan, (CCH Canadian Limited, Toronto: 2005)