

PENSION DISCUSSION PAPER #2

*Defined Contribution “Pensions”:
Costs to Employers, Risks to Employees*

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In *Pension Discussion Paper #1*, we examined the potential costs of our defined contribution (DC) plan to NUFA members. This follow-up Paper focuses on the expenses that must be picked up by the employer (in our case, the Board of Governors). At first glance, there appear to be no additional costs to Nipissing. That is, after all, the main reason why employers have tended to prefer DC over defined benefit (DB) plans, because a DC plan puts all the risks on the shoulders of workers. While that is true, DC plans also increase employer outlays, but they do so in ways that are not so obvious at first glance.

We look at three potential cost-drivers: (1) delayed retirements during “normal” times, as a result of the basic flaws inherent in both the accumulation and “decumulation” phases of DC plans; (2) delayed retirements as a consequence of crises in the financial markets; and (3) legal actions brought by disgruntled retirees against their former employers. In the course of examining these cost-drivers, we also highlight the risks entailed by workers in DC plans who choose to retire before age 70.

1. Business as Usual

Let’s begin by examining the expenses paid out by the university in “normal” times. The costs of DC plans arise from the fact that it is *extremely risky for members of these plans to leave their jobs*, and that risk has only accentuated in the last decade or so.

This seems to be confirmed by anecdotal evidence from Western University (the only large postsecondary institution in Ontario with a DC plan). In 2013, there were just 18 retirements at Western, from a bargaining unit of over 1,400 faculty. Professors in DC plans, it appears, are not rushing out the door to collect their (non-) pensions, particularly in the era that began in 2008 with the mega-meltdown. Meanwhile, over the same period, there have been no discernible changes in the retirement patterns at Ontario universities with DB

plans.¹ This evidence, then, suggests that DC plans produce counter-cyclical retirement patterns; that is, “when the economy is soft and employers would like workers to retire to lower costs, workers will have deflated DC asset values that may encourage them to keep working” (Brown and McInnes 2014, 15).

It is unlikely that any faculty members in a DC plan could retire comfortably at age 60, given that the starting age for these workers is typically in their mid-to-late 30s. The amounts in their Capital Accumulation Plans (CAP) would be far too low, and those amounts would be required to fund up to 30 or 35 years of retirement in Life Income Funds (LIF) that would likely be empty after 20 years (remember, there are significant minimums that must be withdrawn every year). This situation would be different for a faculty member in a DB plan like the Colleges of Applied Arts and Technology (CAAT) plan. An individual, say, at the top step of Nipissing’s Associate Professor rank who began work at age 35, and had 25 years in the plan, might be able to walk out the door with a pension of about \$55,000. They could take a reduced Canada Pension Plan (CPP) of perhaps \$7,000, with an Old Age Security (OAS) benefit of close to \$7,000 added to their income at age 65.

Meanwhile, retiring in a DC plan at age 65 is possible but still carries considerable risk. You would need to plan for a retirement that might be 25 to 30 years long. You would be leaving a secure position, with a high salary, to gamble your retirement income on the ups and downs of the financial markets. In contrast, the CAAT member we met in the previous

¹ Personal communication from OCUFA, 9 July 2014.

paragraph, now with 30 years in their plan, might have a pension of \$65,000. They would also receive a “regular” CPP and OAS, which could add \$20,000 to their income, giving them up to \$85,000 of mostly inflation-protected pensions, guaranteed for life.

Given the serious drawbacks of DC plans, why wouldn't just about all “DCers” simply laminate their lecture notes, dust off their Pierre Cardin bow ties and Stella McCartney scarves, and keep working into their 70s? For most of us, this would be the least risky moment to retire, when we would be as financially secure as we could hope to be as DCers (and still have a bit of time left to enjoy our “senior years”). For starters, we are legally required at age 71 to move our CAP funds into a LIF and start drawing down income (and paying tax on it). At this time, we would receive our greatly enhanced OAS and CPP pensions, both of which are fully indexed. Our CAP funds would also have benefited from another 5 or 10 years of tax-sheltered (employer and employee) contributions and another 5 or 10 years of tax-sheltered investment returns. This would provide us with more income to move into our LIFs, and those LIFs would not have to last as long, perhaps 20 to 25 years. In addition, the extra salary we made over this half-decade or decade would enable us to maximize the assets in our private, “rainy day” savings accounts.

If we continued to draw a salary past age 70, in addition to our LIF income, we would find ourselves in a very high tax bracket (which would also result in our entire OAS of more than \$9,000 per year being clawed back by the government). At this point, we would have strong financial incentives to head out the door. We could do so knowing that, if we were prudent, it's unlikely we would outlive the savings in our LIFs, and if we did, we would still have a well-stocked rainy-day fund to get us through our final few years, before we come face-to-face with the big, bright light.

This scenario of Nipissing faculty having to retire in their early 70s is fine for the few who are eager to work well past the normal retirement age. But this is not a good situation for the vast majority of faculty members, their colleagues, their students, and the broader academic community. It's also not good for our employer. As John McIntosh, Towers Watson's Canadian Plan Design Issue Leader, has noted, workplaces with DC plans "run the risk of having more 'hidden pensioners' – retirement-ready employees who are working out of necessity rather than by choice." He advises employers that they "need to find a balance between managing [pension] plan costs and the risk of employees not being able to retire" (Willis Towers Watson 2012).

There are other issues related to the timing of retirements that are particular to DC plan members. According to Ian Markham, Canadian Retirement Innovation Leader at Towers Watson, "many employees who rely heavily on DC savings are delaying retirement, making it more difficult for organizations to determine if, when, and how many older workers will retire, and how to manage their staffing needs. This has profound implications for employee engagement at all ages, as older workers stay put, taking career opportunities away from younger workers" (Willis Towers Watson 2011). As a public employer, Nipissing should be doing whatever it can to ensure that the next generation of scholars can find suitable employment. That objective is more likely to be realized by making retirement affordable for senior faculty.

2. Financial Crises

Because we are in a DC plan, the university likely experiences higher salary costs during "normal" times, compared to what it would pay if we were in a DB plan. These university expenses would almost certainly be even greater after a financial crisis, which would likely

have an effect on the retirement plans of DC members. There is, unfortunately, little research on this topic. Furthermore, data often are not comparable between professions or between countries (some of which have “gold plated” government DB plans while others, like Canada, have public pensions that cover only basic needs). The few studies I have reviewed, which usually consider large numbers of workers (outside Canada) across the occupational spectrum, suggest that sudden market crashes or sudden market windfalls do not delay or advance retirement decisions by more than a few months.

We need to be clear, though, that we lack solid data on the retirement patterns of *Canadian* university professors. This is unfortunate, because our occupation is rather odd (hence we cannot assume what actions professors will take from studies of broad groups of retirees). For starters, faculty tend to begin work in their mid-30s, so if they are to retire at 65 or earlier, they require dependable pensions. Our very steep salary curve is also unusual, perhaps unique. For instance, by 2019, a Professor at Nipissing at the top of the salary scale will be earning almost 2.3 times an Assistant Professor at the base of the scale. After decades that include many years of making very low incomes (due to the length of time needed to complete the education requirements of the job), paying back student loans, paying off a mortgage, and perhaps raising kids and getting them through university, it’s easy to see why faculty members making high salaries would be reluctant to quit in return for relatively small and unpredictable DC “pensions.” The financial rewards that come from holding a job, along with the costly realities of life, make it difficult to retire.

We do have one Canadian case of retirees that seems fairly relevant to Nipissing, as it involves actual retirement delays by public sector workers. In 1977, the government of Saskatchewan set up a DC plan for its employees, the Saskatchewan Pension Annuity Fund

(SPAF). How did SPAF members respond to the most recent economic crisis? As it turns out, the “average retirement age in the three years following the 2008/2009 financial meltdown was 2¼ years higher than in the three years that preceded it” (Vettese 2015, 5).² Let’s assume that alterations to the retirement plans of faculty at Nipissing after a financial crisis would be the same as those of SPAF members.³

What would this cost the university? The small table adjacent looks at the Step 2 salary for a (potential replacement) Assistant Professor and the maximum salary for a (potential retiree) Associate Professor and Professor, as of April 2019. I have used this date because it is when the new steps in the salary grid will be incorporated into the full-time academic staff (FASBU) collective agreement. These figures allow us to highlight the growing costs of delayed retirements to the university.

<i>Rank</i>	<i>Income (\$) (April 2019)</i>	<i>Income (\$) multiplied by 2.25 years (to highlight the costs of delayed retirements)</i>
Assistant Professor (Step 2)	82,000	185,000
Associate Professor (maximum)	142,000	320,000
Professor (maximum)	173,000	390,000

² Vettese comments as follows on the consequences of these delayed retirements: “To some, this might be viewed as a weakness of DC plans. To others, it shows the resiliency of DC participants who understand the risks of DC plans and are prepared to cope with adversity.” This, it seems to me, is a rather lame attempt to make a silk purse out of a sow’s ear.

³ We obviously went through the crisis of 2008, but we have no data on how NUFA Members responded. Besides, our faculty numbers are probably too low to yield useful data.

The large table adjacent highlights the potential cost to the university of various combinations of Associate Professor(s) and Professor(s) postponing retirement for 2¼ years. It presumes that all other professors end their careers in accordance with the pre-crisis retirement pattern (a dubious and overly conservative assumption used to highlight what is likely the *minimum* costs to the university).

Let's go over a couple of examples. Row #1 assumes just a single Associate Professor would have broken away from the standard retirement pattern to keep working another 2¼ years. If this individual had in fact retired and was replaced with a newly-minted Assistant Professor, it would have saved the university \$135,000 over this brief time period (or an average of \$60,000 per year).

Let's look at another scenario. Row #6 highlights the costs of two Associate Professors and two Professors delaying retirement. If they instead left the university and were replaced with four Assistant Professors, the savings to the university would be a rather hefty \$680,000 (or \$302,000 per year).⁴

More realistically, these costs would not have to be absorbed over 2¼ years, as Nipissing likely would not have four faculty retirements in such a short time (from the group not in the Teachers' Pension Plan). Note also, though, that the necessity to postpone retirement would affect not just a few faculty members in their late 60s. Rather, the 2¼ years mentioned above was the *average* increase in the retirement age for SPAF members. A financial crisis affects *all* individuals enrolled in a DC "pension," including those in their 40s and 50s who will need to work longer than they had planned in order to make up for the losses endured as the result of a crisis (or worse, two or more crises). In other words, the costs to the

⁴ Rows #2 to #5 provide four further scenarios.

university would probably be smaller on an annual basis than I have calculated, but spread out over a longer time, perhaps even decades.

	Who is retiring?	Cost (\$) if the Member does not retire (for 2.25 years)	Replacement employee(s)	Minus (\$) the cost of replacement(s) (for 2.25 years)	Total savings (\$) (for 2.25 years) if this retirement/replacement scenario unfolds	Annual savings (\$) (The total savings divided by 2.25)
#1	One Associate Professor	320,000	1 Assistant Professor	185,000	135,000	60,000
#2	Two Associate Professors	640,000	2 Assistant Professors	370,000	270,000	120,000
#3	One Professor	390,000	1 Assistant Professor	185,000	205,000	91,000
#4	Two Professors	780,000	2 Assistant Professors	370,000	410,000	182,000
#5	One Associate + One Professor	710,000	2 Assistant Professors	370,000	340,000	151,000
#6	Two Associates + Two Professors	1,420,000	4 Assistant Professors	740,000	680,000	302,000

We should also mention that the above figures may underestimate to some extent the cost savings to the employer.⁵ For instance, the university may have chosen not to replace some (or even all) of the retiring professors if, let's say, their departments were overstaffed. For example, in Row #6, if the university had replaced just two of the four retiring professors, the savings would rise to *over \$1 million*. Furthermore, the university could postpone a hiring for a year or two in a department that was not overstaffed, in order to save some money during difficult times, while waiting out the economic storm. In addition, the cost savings would be even greater than those noted in the table, as the university's pension contributions for the new Assistant Professors would be, for instance, about half what they are for Professors who are near the top of the salary scale. Finally, the university undoubtedly has some expenses associated with administering our DC plan, which would need to be included in the cost total.⁶

3. Lawsuits

Lastly, there is a new concern appearing on the horizon that employers have to face, namely class-action lawsuits. These legal challenges have occurred mostly in the United States, but they are not unheard of in Canada.⁷ They are typically initiated by retirees who have had to pay uncompetitive administration fees, who have put much of their money in underperforming investments, who were subjected to unclear communications, or who were not

⁵ Note also that these costs are very rough approximations. In any cost-benefit analysis, savings would need to be precisely determined by an accountant or actuary and then compared with the increased employer contributions required in a DB plan like the CAAT plan.

⁶ In a DB plan such as CAAT, all administrative costs are covered by employer-employee contributions.

⁷ DB plans are not immune to lawsuits, though lawsuits against DC plans are much more common. Robson (2008, 4) says of DC pensions "that litigation over these plans in the United States is rife."

automatically enrolled in a plan when they were hired.⁸ Furthermore, it appears to be the case with DC “pensions” that employers are often “damned if they do, damned if they don’t.” Robson (2008, 3) maintains that

the prospect of litigation creates a dilemma for employers. Leave employees to make decisions on their own? A future lawsuit may reference the emerging “prudent expert” standard in pension matters, and allege that a sponsor breached fiduciary duty in not behaving paternalistically. Act paternalistically? A future lawsuit may allege that a disappointing outcome resulted from actions the employee would not otherwise have taken.

Colin Ripsman (2014), a principal at Eckler Ltd., has noted there are increasing fears amongst DC plan sponsors in Canada that lawsuits may spill across the border, “particularly as more people retire with savings that have grown primarily in DC accounts and their retirement income expectations are unmet.” As a result, Eckler recently hosted a roundtable, featuring a number of prominent pension lawyers, to advise DC plan sponsors on “how they can better protect themselves against potential legal action.” Amongst the “best practices” the lawyers offered their clients was this little gem: “The terms *retirement* and *pension plan* should be avoided in DC plan member communication. Instead, *capital accumulation plan* and *savings program* are preferable” (emphasis in the original). In the face of class action lawsuits, it appears we can finally lay bare the workings of the clever marketers and inch closer to the unvarnished, “pensionless” truth.

⁸ As for this last-noted reason to initiate lawsuits, we should point out that faculty in Western University’s DC plan are automatically enrolled when hired. This is not the case at Nipissing. According to Article 32.1(c) of the NUFA-FASBU collective agreement, our pension plan “is available to all Members on an optional basis on the first day of employment.” Robson (2008, 1) suggests that employers should consider making “automatic enrolment the default option, so non-participation becomes an active decision.”

4. Summary

This concludes our two-part discussion series on the drawbacks of defined contribution pensions. We have learned that:

- (i) NUFA members who are not in the TPP do not have a pension. Rather, we are enrolled in a “retirement savings program.”
- (ii) We (and the employer) are paying a significant amount in contributions, but NUFA members are ending up with a vastly inferior pension product compared to what we would be receiving if we were members of a defined benefit plan.
- (iii) In our DC plan, the decumulation options currently available mean that we may need to keep working into our 70s. This may be the only way to ensure that we don’t outlive the “benefits” delivered by financial products like LIFs and annuities.
- (iv) The overall costs incurred by our employer as a result of the DC plan might come close to matching the costs required to move us into a DB plan.

NUFA Special Membership Meeting

*Toward a Defined Benefit Pension for Non-TPP Members:
What Are Our Options? And How Do We Get There?*

Friday, September 16, at 1:00 p.m.

F210 (Fedeli Room)

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