C.D. Howe Institute
Backgrounder
www.cdhowe.org No. 110, January 2008
The Pension Papers

Safe Harbours:

Providing Protection for Canada's Money-Purchase Plan Sponsors

William B.P. Robson

The Backgrounder in Brief

Fear of lawsuits may inhibit employers from steering employees into defined-contribution pension plans and RRSPs, and from guiding them into sensible choices for investing and withdrawing their money. Safe-harbour provisions that reduced this threat would help employers act in good faith to enhance the retirement incomes of Canadians.

About the Author

William B.P. Robson is President and CEO at the C.D Howe Institute.

The C.D. Howe Institute

The C.D. Howe Institute is a national, nonpartisan, nonprofit organization that aims to improve Canadians' standard of living by fostering sound economic and social policy.

The Institute promotes the application of independent research and analysis to major economic and social issues affecting the quality of life of Canadians throughout the country. It takes a global perspective by considering the impact of international factors on Canada and bringing insights from other jurisdictions to the discussion of Canadian policy. Recommendations in the Institute's publications are founded on quality research conducted by leading experts and subject to rigorous peer review. The Institute communicates clearly the analysis and recommendations arising from its work to the general public, the media, academia, experts, and policy makers.

The Institute began life in 1958 when a group of prominent business and labour leaders organized the Private Planning Association of Canada to research and promote educational activities related to public economic and social policy. The PPAC renamed itself the C.D. Howe Research Institute in 1973 following a merger with the C.D. Howe Memorial Foundation, an organization created in 1961 to memorialize the Right Honourable Clarence Decatur Howe. In 1981, the Institute adopted its current name after the Memorial Foundation again became a separate entity to focus more directly on memorializing C.D. Howe. The C.D. Howe Institute celebrates its 50th Anniversary as the gold standard for Canadian public policy research in 2008.

The Institute encourages participation in and support of its activities from business, organized labour, associations, the professions, and interested individuals. For further information, please contact the Institute's Development Officer.

The Chairman of the Institute is Tim Hearn; William B.P. Robson is President and Chief Executive Officer.

* * * * * *

C.D. Howe Institute Backgrounder© is an occasional publication of the C.D. Howe Institute. Its purpose is to comment briefly on policy issues of concern to Canadians. James Fleming edited the manuscript; Diane King prepared it for publication. As with all Institute publications, the views expressed here are those of the authors, and do not necessarily reflect the opinions of the Institute's members or Board of Directors.

To order a hard copy of this publication, please contact: Renouf Publishing Co. Ltd., 5369 Canotek Rd., Unit 1, Ottawa K1J 9J3 (tel.: 613-745-2665; fax: 613-745-7660 e-mail: order.dept@renoufbooks.com), or the C.D. Howe Institute, 67 Yonge Street, Suite 300, Toronto M5E 1J8 (tel.: 416-865-1904; fax: 416-865-1866; e-mail: cdhowe@cdhowe.org). Quotation with appropriate credit is permissible.

$5.00; ISBN 0-88806-731-3;
ISSN 1499-7983 (print); ISSN 1499-7991 (online)

A major shift is taking place in the types of pensions available to Canadian workers. Defined-benefit (DB) plans, in which the employer shoulders the risk of making good on benefit payments, are covering relatively fewer workers. Increasingly, employers are offering employees money-purchase plans, which include defined-contribution (DC) plans and group RRSPs. The share of employed Canadians covered by DC plans is on the rise, and the number of Canadians contributing to RRSPs in a given year exceeds membership in all registered plans (Figure 1).[1]

Some experts bemoan the decline of DB plans; others argue that DB promises were never reliable and that money-purchase arrangements are more transparent. There is no disagreement, however, about one problematic fact: many participants in money-purchase arrangements, especially group RRSPs, will likely save, invest, or withdraw their funds in sub-optimal ways that leave them worse off in retirement than they could have been. Many employers would like to enhance their employees' retirement prospects, and those who offer matching contributions to induce their employees to join and save in these plans demonstrate that desire in a material way. But with pension-related litigation on the rise, employers who would like to encourage their employees to save, invest and withdraw more wisely may nevertheless pull back for fear of lawsuits. "Safe harbours" for such employers — legal protection for good-faith actions to foster smart employee choices — could improve the outlook for Canadians who will do most of their retirement saving in such plans.

Common Problems in Self-Directed Retirement Saving

To illuminate where safe-harbour provisions might help plan sponsors, I review several problems that can arise when participants in money-purchase plans control their contribution rates and investment choices — and ways plan sponsors might mitigate them.

Problem 1: Potential participants do not join. Current cash requirements may keep employees out of plans — even when the employer offers matching contributions.[2] To address this problem, employers could make automatic enrolment the default option, so non-participation becomes an active decision.

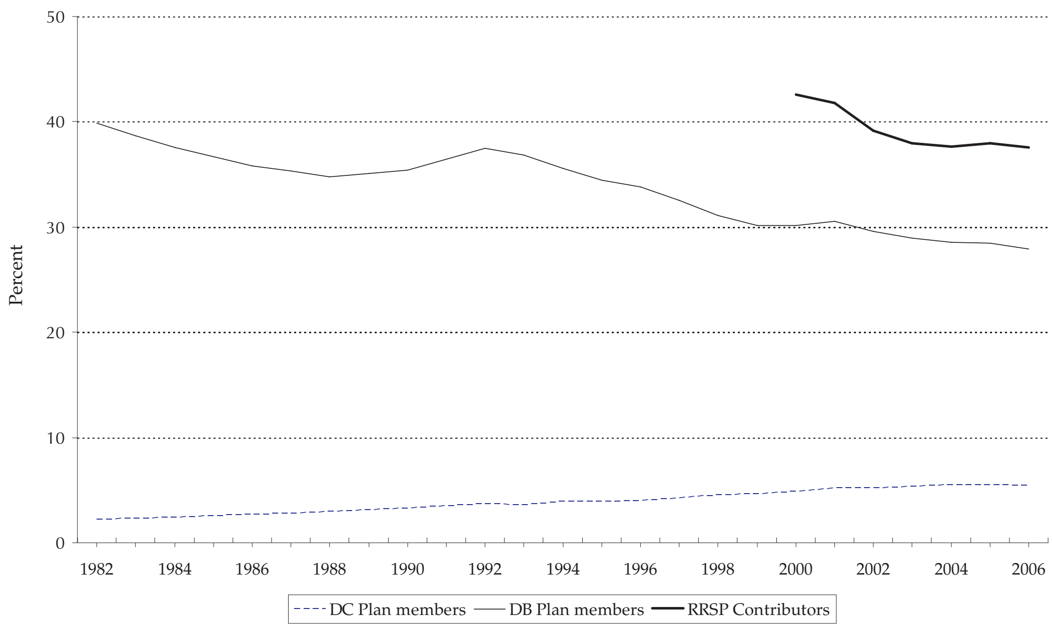
Problem 2: Participants do not save enough. Once people are in a plan, seemingly compelling short-term needs may stop them contributing as much as they could — possibly leaving part of a matching contribution on the table. To address this problem, employers might set a default contribution rate that applies unless the

I thank Keith Ambachtsheer, Bob Baldwin, Colin Busby, Bob Christie, Bruce Gordon, Martin Guest, Yvan Guillemette, Zaheed Jiwani, Nick Le Pan, Tammy Schirle, Jack Selody, Gretchen Van Riesen and Diana Woodhead for comments on an earlier draft.

1 The comparison of plan membership to RRSP contributors is highly imperfect: many RRSP contributors are members of pension plans, and many RRSP holders do not contribute in a given year. Unfortunately, existing data limit our ability to make more meaningful comparisons.

2 A seminal reference on non-linear discounting is Laibson et al. (1998). US experience (discussed further below) has shown that making enrolment the default choice strongly affects behaviour.

Figure 1: *Retirement Saving Participation as Share of Employment*



Source: Statistics Canada, CANSIM, Tables 282-0008, 280-0016 and 111-0039.

employee actively chooses to contribute at a lower rate. Lest a high default level encourage opting out, employers might start participants at a lower initial rate, and move to the higher one at regular intervals.[3]

Problem 3: Participants invest unwisely. Participants may deploy the funds they do contribute inappropriately.[4] They may take too much risk. Or they may use daily interest accounts, money-market funds or GICs, accepting low returns for liquidity they do not use. Participants in group RRSPs also often use vehicles with high administration fees, undermining their returns and sacrificing contribution room.[5] To address these problems, employers might steer participants into life-cycle-appropriate portfolios and/or vehicles with lower administration fees.

Problem 4: Participants cash out ineptly. Many participants exit from retirement saving in group RRSPs with lump-sum or rapid withdrawals that expose them to outliving their assets or paying unnecessary tax.[6] To address this problem,

3 A related concern is that people may have trouble adjusting their saving rate when surprises in the return on their investments threaten a given target retirement income. A default contribution rate designed to address this problem might steer participants toward a target payout, rising if investment returns were lower than expected, and falling if they were higher.

4 Readers will readily bring examples to mind; a seminal reference is Benartzi and Thaler (2001).

5 Paying fees from outside an RRSP uses "uncapped" money, but is not an option for, say, mutual-fund investors.

6 Again, Laibson et al. (1998) is a classic reference.

employers might set a default annuitization option at the end of a career or a staged option as the end approaches.

Problem 5: Participants use their own untrained judgement or badly selected advisers in deciding whether to join, how much to save, how to invest, and how to terminate. To address these problems, all of which are related to the previous four — and which do not yield readily to simple investor education (Choi et al. 1998) — employers may make group and individual advisory services another default option.

The Dangers of Inaction

Many sponsors of money-purchase plans in Canada know about these problems. So do Canadian regulators: the Capital Accumulation Plan Guidelines (CAP Guidelines) from the Joint Forum of Financial Market Regulators provides a useful checklist of measures to address them.[7] The CAP Guidelines aim to clarify the rights and responsibilities of plan sponsors, service providers and participants, and ensure that participants get appropriate advice and help. Helpful though they are as a benchmark for good practice, and therefore for avoiding behaviour that might give rise to a lawsuit, the Guidelines provide no direct legal protection to those who follow them — indeed, they may end up serving as a guide to litigation, and therefore deter employers from venturing into this area.

So 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.

The evidence that all these problems do afflict money-purchase plans is convincing enough to make paralysis unpalatable in the face of this dilemma. Employers are already abandoning the DB option partly because of legal concerns; it would be a blow to retirement security more generally if they declined to sponsor even such basic money-purchase alternatives as group RRSPs as well. As the polarized debate and political deadlock over reforms to DB plans suggest, moreover, constructive action is likely to be easier before actual disputes and vested interests become major obstacles. Hence, the attractiveness of timely federal and provincial pension legislation providing legal safe harbours for employers who, in good faith, steer their employees toward wise choices in money-purchase plans.[8]

7 Joint Forum of Financial Market Regulators (2004). The CAP Guidelines cover defined-contribution pension plans and group RRSPs, as well as other saving vehicles such as Registered Education Savings Plans and deferred profit-sharing plans.

8 Defined-contribution plans fall under both federal or provincial pension legislation; group RRSPs are effectively governed by the Federal *Income Tax Act*.

US Experience and Initiatives

Because Canada's experience with money-purchase plans is not unique, experience abroad provides some useful lessons. In particular, the United States — where the move toward individual retirement accounts has gone further than in Canada — has recently refined its safe-harbour provisions.

The US *Employee Retirement Income Security Act* (ERISA) has long aimed to give sponsors of money-purchase plans who provide participants appropriate choices and advice some protection from liability for losses arising from those choices.[9] *The Pension Protection Act* of 2006 elaborated those protections for sponsors who automatically enrol employees and/or automatically raise contribution levels over time, as long as appropriate notice is given and opt-outs exist. It extended the protections related to inadequate or directed choice. It also focused on what advice to employees will satisfy prudential obligations. Some observers credit these changes with making automatic enrolment more common in the United States, and increasing the number of employers who automatically escalate contributions.[10]

On the cautionary side, the regulations giving further shape to the amended US legislation are not yet final; current drafts look highly prescriptive. The excessive detail of the draft regulations, moreover, reflects the fact that litigation over these plans in the United States is rife — much of it alleging excessive, poorly explained, or improperly structured fees, an area where the ERISA already contained safe-harbour provisions. The volume and variety of these suits guarantees different interpretations from different courts. Presumably, the US Supreme Court will settle some of these issues, but until then, uncertainty reigns south of the border — increasing the apprehension of actual and potential Canadian plan sponsors.

An Outline for Canadian Action

Rather than a deterrent, then, the unsettled US scene should be a spur to Canada to pursue its own measures. While the US provisions are helpful for illustrating the types of actions safe-harbour legislation can usefully cover, they risk becoming so prescriptive that they impede rather than aid well-motivated employers. And while the CAP Guidelines document best practices, they arguably set fiduciary standards without legal protections for those trying to meet them. How might Canadian legislators approach the problems outlined above?

First, they should address roadblocks to automatic enrolment, and give employers guidance about what kinds of automatic enrolment and contribution escalation features will be safe. Provinces that now require employers to get

9 Section 404(c) is the key part of ERISA dealing with safe harbours, and was a particular focus of the 2006 amendments.

10 Tyson (2007) cites a survey of 350 employers nationwide by Wells Fargo & Co. that showed 44 percent using automatic enrolment, and a survey of 1,000 401(k) and profit-sharing plans by the Profit-Sharing Council of America that showed a more-than-doubling of the employers that automatically increased contribution rates in 2006, to 39 percent.

employees' written authorization to make deductions for pension-plan contributions would need to change those provisions. Key criteria regarding auto-enrolment and escalation features would be the type and time-period of notice to employees that is required, and the means by which employees who do not wish to participate at all, or wish to contribute at some level different from the default, can opt out. US safe-harbour provisions in this area are over-detailed — specifying escalation schedules, for example. More useful are processes ensuring that individuals who know more about their own life expectancies and risk tolerance than their employers are not forced to save more than they consider appropriate.

Second, employers need protection as they seek to steer employees into wise choices. DC plans are not, in general, the main focus of concern in this respect: employers have considerable control over investments offered in them, and regulations generally constrain withdrawals from DC plans at termination and conversion of plan balances into income at retirement.[11] Group RRSPs are a different matter: many employees would benefit from guidance both while they are building their savings and when they begin to draw them down. As with enrolment and contribution rates, however, detailed rules will be unhelpful, potentially deterring employers from supporting plans.

Detailed rules could also stifle innovation. Over time, for example, new life-cycle accumulation vehicles will arise — automatically moving more of a participant's portfolio into bonds that match annuity price fluctuations as retirement approaches. More securitized investments in retirement-appropriate assets such as infrastructure and real estate will also become available. Prescribing portfolios is no job for legislators or regulators. More useful are processes, such as the CAP Guidelines' provisions regarding the frequency with which participants should be allowed to transfer their funds from one vehicle into another, that let participants avoid default options that do not suit them.

A particular focus of safe-harbour rules regarding portfolio choice will be the size and transparency of fees. Responding to past litigation, the 2006 amendments in the United States are intended to protect employers as long as fees received by an adviser do not depend on participants' investments, and to enhance the requirements for disclosure of fees to participants. Canadian safe-harbour protections could also usefully cover service providers — whose fees will be a natural target for discontented participants, and who ought to share responsibility with employers for ensuring that participants know how much, and for what, they are paying.

Next Steps

Regulation of money-purchase pension plans is jurisdictionally divided in Canada. Many pension advocates, moreover, see the problems of money-purchase plans that safe-harbour provisions would address as drawbacks serious enough to

11 I note in passing that the rules governing withdrawals from DC plans are restrictive enough to cause hardship to many retirees who need more flexibility — another illustration of the merits of framework legislation that helps employers and employees make mutually agreeable arrangements, as opposed to detailed prescriptions.

justify discouraging these plans. From that point of view, bolstering the classic single-employer DB plan or moving more energetically to pooled large-scale hybrid DB/money-purchase arrangements (Ambachtsheer 2007; Laidler and Robson 2007) would appear a priority — and one from which smaller improvements to the environment for money-purchase plans are a distraction. While these facts may mean that a national safe-harbour system is not in immediate prospect, the factors that are eroding DB-plan participation — legal and regulatory complexities, and growing awareness among sponsors that DB plans expose them to worse legal risks and more profound economic uncertainties than they knew — are not going away. So there is good reason to act soon.

A reasonable near-term step for policymakers motivated to improve the situation would be legislative or regulatory endorsement of the CAP Guidelines as a safe harbour for employers. Giving the Guidelines such standing would mean that they no longer raise the fiduciary bar without providing protection — which could deter employers from supporting money-purchase plans. It would also spur employers to ensure that their plans are up to standard — a desirable outcome, since the problems surveyed in this paper guarantee that the design and governance of most such plans in Canada could improve.

Money-purchase arrangements, and group RRSPs in particular, are where many — perhaps most — Canadians will do most of their retirement saving for many years to come. Their situation is far from ideal. To let fear of litigation paralyze employers who would like to improve it is unwise. Adding safe harbours to Canadian pension legislation and regulation would empower employers to act in ways that would enhance the retirement incomes of their employees.

References

Ambachtsheer, Keith P. 2007. *Pension Revolution — A Solution to the Pension Crisis*. Hoboken, NJ: John Wiley & Sons.

Benartzi, Shlomo, and Richard H. Thaler. 2001. "Naive Diversification Strategies in Defined Contribution Saving Plans." *The American Economic Review* 91(1): 79-98.

Choi, James, David I. Laibson, Brigitte Madrian, and Andrew Metrick. 2002. "Defined Contribution Pensions: Plan rules, Participant Decisions, and the Path of Least Resistance." In J. Poterba, ed., *Tax Policy and the Economy* 16, Cambridge, MA: MIT Press.

Joint Forum of Financial Market Regulators. 2004. "Guidelines for Capital Accumulation Plans." May 28. Available at http://www.jointforum.ca/JF-WWWSite/finaldocs.htm.

Laibson, David I., Andrea Repetto, Jeremy Tobacman, Robert E. Hall, William G. Gale and George A. Akerlof. 1998. "Self-Control and Saving for Retirement." *Brookings Papers on Economic Activity* 1998(1): 91-196.

Laidler, David, and William B.P. Robson. 2007. *Ill-Defined Benefits: The Uncertain Present and Brighter Future of Employee Pensions in Canada*. Commentary 250. Toronto: C.D. Howe Institute.

Tyson, Laura D'andrea. 2007. "Some No-Brainer Savings Ideas." *Wall Street Journal*, 30 October 2007, p. A18.

NOTES

Recent C.D. Howe Institute Publications

December 2007	Robson, William B.P. "Time and Money The Challenge of Demographic Change and Government Finances in Canada." C.D. Howe Institute Backgrounder 109.
December 2007	Chen, Duanjie. "Flaherty's Missed Opportunity." C.D. Howe Institute e-brief.
December 2007	Guillemette, Yvan. "Chronic Rigidity: The East's Labour Market Problem and How to Fix It." C.D. Howe Institute e-brief.
December 2007	Kotowski, Maciej. *Insuring Canada's Exports: The Case for Reform at Export Development Canada*. C.D. Howe Institute Commentary 257.
December 2007	Koning, John-Paul. "Why the Bank of Canada Act Needs Updating: A Lesson from the Sub-Prime Crisis." C.D. Howe Institute e-brief.
November 2007	Jaccard, Mark. *Designing Canada's Low-Carb Diet: Options for Effective Climate Policy*. Benefactors Lecture 2007.
November 2007	Banerjee, Robin. "Deals on Wheels: An Analysis of the New Federal Auto Feebate." C.D. Howe Institute Backgrounder 108.
November 2007	Freedman, Charles and Clyde Goodlet. *Financial Stability: What It Is and Why It Matters.* C.D. Howe Institute Commentary 256.
November 2007	Guillemette, Yvan and William B.P. Robson. "Realistic Expectations: Demographics and the Pursuit of Prosperity in Saskatchewan." C.D. Howe Institute Backgrounder 107.
October 2007	Macmillan, Kathleen E. and Patrick Grady. "A New Prescription: Can the BC-Alberta TILMA Resuscitate Internal Trade in Canada?" C.D. Howe Institute Backgrounder 106.
October 2007	Richards, John. *Reducing Poverty: What has Worked, and What Should Come Next*. C.D. Howe Institute Commentary 255.
October 2007	Guillemette, Yvan. "Breaking Down Monopolies: Expanding Choice and Competition in Education." C.D. Howe Institute Backgrounder 105.
September 2007	Mintz, Jack M. *The 2007 Tax Competitiveness Report: A Call for Comprehensive Tax Reform*. C.D. Howe Institute Commentary 254.
September 2007	Chen, Duanjie, Jack Mintz and Andrey Tarasov. "The High-Tax Handicap: How the World's Major Economies Shoot Themselves in the Foot with High Corporate Income Tax Rates." C.D. Howe Institute e-brief.
September 2007	Johnson, David. "School Grades: Identifying Alberta's Best Public Schools." C.D. Howe Institute Backgrounder 104.
August 2007	Vaillancourt, Francois, Dominique Lemay and Luc Vaillancourt. "Laggards No More: The Changed Socioeconomic Status of Francophones in Quebec." C.D. Howe Institute Backgrounder 103.
août 2007	Vaillancourt, François, Dominique Lemay and Luc Vaillancourt. "Le français plus payant : L'évolution du statut socio-économique des francophones au Québec." Bulletin de recherche 103.
August 2007	Robson, William B.P. "Stuck on a Spoke: Proliferating Bilateral Trade Deals are a Dangerous Game for Canada." C.D. Howe Institute e-brief.
July 2007	Smart, Michael. *Lessons in Harmony: What Experience in the Atlantic Provinces Shows About the Benefits of a Harmonized Sales Tax.* C.D. Howe Institute Commentary 253.
July 2007	Laidler, David. *Better Late Than Never: Towards a Systematic Review of Canada's Monetary Policy Regime*. C.D. Howe Institute Commentary 252.
July 2007	Chen, Duanjie, Jack Mintz and Andrey Tarasov. "Federal and Provincial Tax Reforms: Let's Get Back on Track." C.D. Howe Institute Backgrounder 102.
June 2007	Koeppl, Thorsten V., and James MacGee. *Branching Out: The Urgent Need to Transform Canada's Financial Landscape and How to Do It.* C.D. Howe Institute Commentary 251.
June 2007	Jaccard, Mark, and Nic Rivers. "Estimating the Effect of the Canadian Government's 2006-2007 Greenhouse Gas Policies." C.D. Howe Institute Working Paper.
June 2007	Jaccard, Mark, and Nic Rivers. "Estimating the Effect of the Canadian Government's 2006-2007 Greenhouse Gas Policies." C.D. Howe Institute e-brief.
June 2007	Laidler, David, and William B. P. Robson. *Ill-Defined Benefits: The Uncertain Present and Brighter Future of Employee Pensions in Canada.* C.D. Howe Institute Commentary 250.

C.D. Howe Institute
67 Yonge Street, Suite 300
Toronto, Ontario
M5E 1J8

Canadian Publication Mail Sales
Product Agreement #40008848