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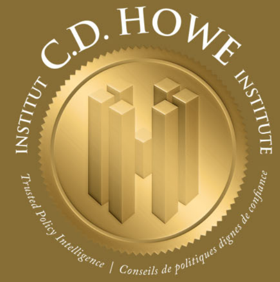

From: Bob Baldwin

To: Federal and Provincial Governments

Date: May 16, 2023

Re: **The Canada Pension Plan is in Good Shape, But Risks Not Widely Understood**

Last December, the Office of the Chief Actuary (OCA) presented the 31st actuarial review of the Canada Pension Plan to the Minister of Finance. As someone who reviewed the 30th report and characterized it as generating both "comfort and chills," I would say that the 31st report leans more towards comfort.

One reason is the small increase in the gap between the legislated contribution rate and the minimum contribution rate ("minimum rate").

If the OCA determines that the minimum rate exceeds the legislated rate, the default scenario – if federal and provincial ministers of finance fail to agree on an alternate solution – would be a termination of the indexing of base benefits (benefits in place prior to recent enhancements) and a minor increase in contributions. With respect to the additional benefits recently enacted, which include an increase in both the benefit rate and the level of contributory earnings, the default scenario envisions reductions in accrued benefits and in benefits being paid, along with a contribution rate increase (again, if the gap exceeds a specified threshold).

The legislated rate for base benefits stands at 9.9 percent of contributory earnings. The 30th and 31st reports estimated the minimum rates at 9.72 and 9.54 percent respectively.

The legislated rates for additional benefits are 2 percent for the increase in base benefit rate (implemented between 2019 and 2023) and 8 percent on the higher contributory earnings (to be implemented in 2024 and 2025). Between the 30th and 31st reports, the first additional minimum rate is set to decline from 1.98 to 1.97 percent, and the second minimum rate from 7.92 to 7.88 percent.

The decrease in the minimum rates can be attributed to slightly different factors for the two parts of the plan. For the base benefits, investment returns that exceeded assumed returns have more than offset changes in assumptions that would have raised the minimum rate calculation. It's worth noting that these investment returns include results from the first half of 2022. On the other hand, for the newly introduced additional benefits, small experience gains combined with changes in assumptions have contributed to the decrease in the minimum rates.

The decrease in the minimum rates provides some relief, but the actuarial report also highlights several concerns regarding potential risks to the contribution rate and/or benefit levels.

1. The actuarial report provides high and low cost assumptions as an alternative to the best estimate assumptions. For the base benefits, only one high cost assumption leads to a minimum rate above the legislated rate, while for the additional benefits, three alternative assumptions lead to that outcome. In both cases, low returns on investment have the biggest negative impact.
2. The report also highlights a 16-percent chance that the minimum rate will exceed the legislated rate based on investment experience alone by the time of the 2024 report. For the additional benefits, the probability of this happening increases to 37 percent.
3. Labour market developments are classified into low and high cost scenarios, reflecting the possibilities of high and low economic growth. In the low-growth scenario with slow wage growth, the minimum rate for the base benefits increases above the legislated rate, while for the additional benefits, it decreases. However, the increase in the base benefits' minimum rate outweighs the additional benefits' minimum rate decrease.
4. The report includes a qualitative discussion on the potential impacts of changes in earnings distributions, stagflation, and climate change.

When it comes to assessing the financial future of pension plans, many people tend to focus on long-term assumptions. However, given that the 31st report was released in the midst of the COVID-19 pandemic, it's not surprising that it also highlights the importance of preparing for short-term disruptions.

While there is always room for debate about the risk analysis and assumptions used by the OCA, I believe it has done a good job and is improving over time. While I may have some disagreements with certain assumptions, they are within the realm of informed opinion.

One key takeaway from the 31st valuation report is that there are significant risks to the CPP contribution rate and benefits at their current levels. Unfortunately, these risks are not widely understood and are often played down in public and political discussions. If these risks materialize without proper warning, it could lead to a significant backlash against the plan. Therefore, it is important to take corrective action to ensure that more Canadians are aware of the financial risks associated with the CPP. The OCA has provided the necessary information, so it is now the responsibility of the federal and provincial governments to engage with the public on CPP issues more broadly.

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