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Impacts of Cyclical Downturns on the Third Pillar of the RIS and Policy Responses

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Executive Summary

Between the second quarter of 2008 and the first quarter of 2009 Toronto Stock Exchange (S&P TSX) composite index fell 51%. Over the same period house prices fell by 6%. By themselves, these and other asset price changes over the same period reduced the average wealth of Canadian families by 11% and average retirement assets by 14%. Defined contribution (DC) plans would have lost 27% of their value, and registered retirement assets would have dropped 26%. The unemployment rate rose from 6.0% before the recession to 9% at its peak. While there has been partial recovery of asset prices since, not everyone has benefitted from that, and these changes suggest that cyclical downturns can have important impacts on the third pillar of the Retirement Income System (RIS). This paper explores such impacts in the Canadian context.

The paper begins with a review of the recent history of recessions, pensions and retirement saving. Not all cyclical downturns are the same. Recessions may or may not be accompanied by a stock market collapse (1981-82 and 2008-09), and a large fall in the stock market is also possible without there being a recession (2001-02 in Canada). A general financial crisis is rare - - the last major financial crisis prior to 2008-09 was in 1929-33. Effects of such a crisis on the third pillar are stronger than from a decline in the stock market by itself.

The fraction of the male labor force covered by employer pension plans fell from 43% in 1976 to 28% in 2010. In contrast, female coverage has *increased*, from about 28% in the 1970s to 32% in 2010. Both men and women have seen a shift from DB to DC plans, exposing their retirement incomes more to market risks, but this trend slowed down for women around 1990. In 2010, 21% of men with a pension plan were in DC plans while the figure for women was just 14%. Importantly, Canadian families have also become wealthier over time. Mean wealth, including pension wealth, rose from four times disposable income in 1990 to six times income in 2010. Correcting for changes in age composition there was about a 40% increase, which is of course a positive for retirement preparedness.

Assets and wealth holdings in Statistics Canada's 2005 Survey of Financial Security (SFS) are projected forward to 2008 in order to allow estimation of the impact of asset price effects of the 2008-09 recession on the level and distribution of household wealth, including pension assets.. This exercise shows that on average family wealth declined by 11% in the recession but then more than recovered, climbing 13% from the trough in 2009 to the end of 2010. However, retirement assets fell 14% and only rose 12%, so did not fully recover in this period. The reason for the difference is that housing is an important element in overall wealth, and house prices more than rebounded from their 6% fall during the recession in the subsequent year, partly due to low interest rates. Asset losses were higher for those more exposed to the stock market, such as older workers and retirees who were DC plan holders or had substantial RRSP saving. Another vulnerable group were those aged less than 45, who have higher relative debt than older groups

and whose net worth therefore can decline considerably when asset prices go down due to a leverage effect.

The results are translated into impacts of the 2008-09 recession on expected retirement incomes of families with a major earner between ages 50 and 64. Workers are assumed to continue in employment until age 65 when they retire fully and take up their CPP/QPP benefits. Average predicted initial retirement income for this group is \$49,000. Of this amount, 18% is from RRSPs and other investment income, while the rest is about equally divided between RPP, CPP/QPP and OAS/GIS income. The recession is estimated to have reduced expected retirement income by an average of 3.4% for DB pensioners and 11.0% for DC plan holders. The 38% of families with no DB or DC coverage lose just 3.8% of retirement income because over 70% of that income comes from CPP/QPP and OAS/GIS which are not directly affected, and also because GIS rises when other income declines. There is significant individual variation in these results. For example, it is estimated that the decline of retirement income would be greater than 10% for 62% of DC plan holders, 7% of DB pensioners and 15% of those with no DB or DC coverage.

In order to analyze unemployment and early retirement effects of recessions on retirement incomes, the paper goes on to examine a hypothetical economy that is hit once a decade by a significant recession. For DB plans, unemployment caused by recessions can reduce pension income by up to 20 – 25% if it strikes late in the working lifetime and has a strong effect on final average pay. Early retirement has similarly large effects, ranging up to 40-50% for workers forced to retire 8 – 10 years early. Unemployment and early retirement effects on DC plans may be somewhat smaller than effects on DB pensions. However, if a DB worker's years of service exceed the required minimum and final average pay is not affected, there can even be a zero effect on pension income. In the DC case, timing also seems to matter more. Spells of unemployment early in the career tend to have a large effect. For DC plan members recessions can have a double impact through forced early retirement and reduced asset values. Putting the two effects together, pension losses of 40% or more are possible.

Finally, exploratory modeling of policy alternatives is performed, concentrating on two possibilities: enhancement of CPP/QPP, and a case where PRPPs are widely adopted. A difference between the CPP/QPP enhancement and PRPP approaches, in terms of the risk/return tradeoff, comes out. PRPP encourages more private saving and a buildup of more DC-like or RRSP-like assets. This may raise expected retirement income, but it also reduces the resilience of retirement incomes to stock market crashes or slumps. CPP/QPP enhancement does the opposite, providing a lower expected rate of return but increasing “recession-proof” retirement income directly and crowding out other savings that are recession-vulnerable.