Group Retirement Services

Dynamic Pensions: Pooling risk reaps rewards

The decumulation landscape in Canada is primed for innovation. The 300,000 Canadians who retire each year[1] generally use existing decumulation products for retirement income. While it's possible to build a decumulation strategy using these products, they do have some important limitations.

Calculating the cost: Retiree trade-offs with current decumulation strategies

Annuities provide guaranteed income for life. In exchange, annuitants pay fees up front and lock-in at a fixed income rate that may not keep up with the cost of living, even when indexed. With annuities, retirees risk not leaving an inheritance. Early death may mean that the contract terminates unless the annuitant opted for a death benefit.

Traditional Registered Retirement Income Plans (RRIFs) and Locked-in Retirement Funds (LIFs) do offer market exposure and potential investment growth. However, with these products, income is not guaranteed. Planning and managing investments with a withdrawal strategy throughout retirement is part of a holistic planning process, often requiring advice from a professional. There is a risk with these products that a retiree may overspend or underspend their savings. Active management can also become more difficult with age. The prevalence of dementia increases from less than 1% for those age 65 to 69, to about 25% for those 85 and older.[2] Access to professional advice can help mitigate this risk.

Other retirement products (such as Guaranteed Minimum Benefits[3]) have failed due to complexity and cost.

What is decumulation?

Decumulation refers to the drawing down of retirement savings to create retirement income, with the goal of maintaining a specific lifestyle. There are many complexities for retirees to consider leading up to and through this phase, including: investing appropriately, maximizing tax efficiency, health care, long-term care and leaving an inheritance. During this phase, retirees also need to consider whether to draw on other income sources, such as home equity or government sources.

Dynamic Pension pools to meet the needs of a dynamic retirement landscape

We believe Dynamic Pension pools (DP)—also known as Variable Payment Life Annuities (VPLAs)—will offer a more balanced and cost-efficient solution, and higher income for retirees if implemented correctly. The key benefit of Dynamic Pensions is that they offer lower cost income for life, trading income guarantees for market participation. This results in potential growth of payments because they are mapped to mortality credits and investment returns. Essentially, DP pools are a hybrid of traditional annuities and RRIF/LIFs. DP pools combine the best features of current decumulation options to create an entirely new income product. These features will allow retirees to optimize their retirement income, harness potential market growth and benefit from longevity pooling, while ensuring a sustainable income stream for life.

[1] Will Canadians retire themselves into a recession? Capital Economics, August 2022.
[2] Dementia in Canada. Canadian Institute for Health Information, June 2018.
[3] GMxBs refer to the guaranteed living and death benefits associated with variable annuities. Guarantees may include guaranteed minimum death benefits, guaranteed periodic reset values, guaranteed income benefits and guaranteed minimum withdrawal benefits.

The best of both worlds:

DP pools offer higher income through ***longevity pooling*** and ***investment growth***

	Annuity	**DP pools**	**RRIF / LIF**
Pros	• Stable lifetime income • Certainty of income makes budgeting easy • Not subject to risk of cognitive decline	• Cost-effective lifetime income • Ability to participate in the market • Lower risk of underspending or overspending • Less exposure to cognitive decline risks due to fewer decisions required	• Ability to stay invested; upside potential can address inflation • Control over level of income • Access to assets for unexpected expenses • Ability to leave assets to estate
Cons	• High cost of guarantees • Typically, no inflation protection, but indexation is available at a cost • No access to capital • No participation in the market	• Variable payments can pose budget challenges • No access to capital • New product may be difficult to explain, and uptake will depend on adequate scale	• Risk of underspending or overspending • Investments must be actively managed • Sequence of returns risk

Volatility / Variability of payments / Level of active management required

Lower ←→ Higher

Size matters; there's strength in numbers with DP pools

Benefits payable from a DP are dependent on the pooling of both investment and longevity risks across a group of retirees. As enacted, the Income Tax Act will enable only members of Defined Contribution (DC) and Pooled Registered Pension Plans (PRPPs) to access DP pools.

There are currently over 11,000 DC plans operating in Canada with over $94 billion in retirement assets.[4] However, only a handful of Canadian DC plans have the scale to enable an "in-plan" DP solution. In addition, PRPPs are currently not broadly utilized, and therefore also lack the necessary scale. As of June 30, 2021, PRPP assets amounted to just $350 million held by just over 100,000 members.[5]

Only about 1 in 3 Canadians have access to a workplace pension plan (a DB, DC or PRPP). Many Canadians also hold savings through RRSPs, TFSAs and other vehicles. Valued at well over $2 trillion[6], these other savings represent the lion's share of Canadians' retirement savings. Making these savings eligible for DP pools will significantly improve pooling and scale, and consequently lower the income volatility and cost for retirees. This effect is amplified where a pool has a positive mortality experience, and investment growth which surpasses long-term assumptions.

The table below demonstrates the positive impact of a larger pool on the volatility of income with respect to mortality adjustments.[7] The experience improves significantly with greater pooling and scale.

Size of retiree pool	Income volatility in year 20	Income volatility in year 30
10	± 37%	± 75%
50	± 11%	± 64%
100	± 8%	± 35%
1,000	± 2%	± 10%

Improved retirement readiness will help reduce the burden on publicly funded retiree benefit programs. It will also benefit public policy, in that funds can be redirected to other social programs.

Expanding allowable money types will improve scale

Currently, only DC and PRPP savings are eligible

DC + PRPP

$93 Billion / 2.3 Million canadians

Opening the DPPs to all canadians and all money types will optimize pooling, and improve outcomes for retirees

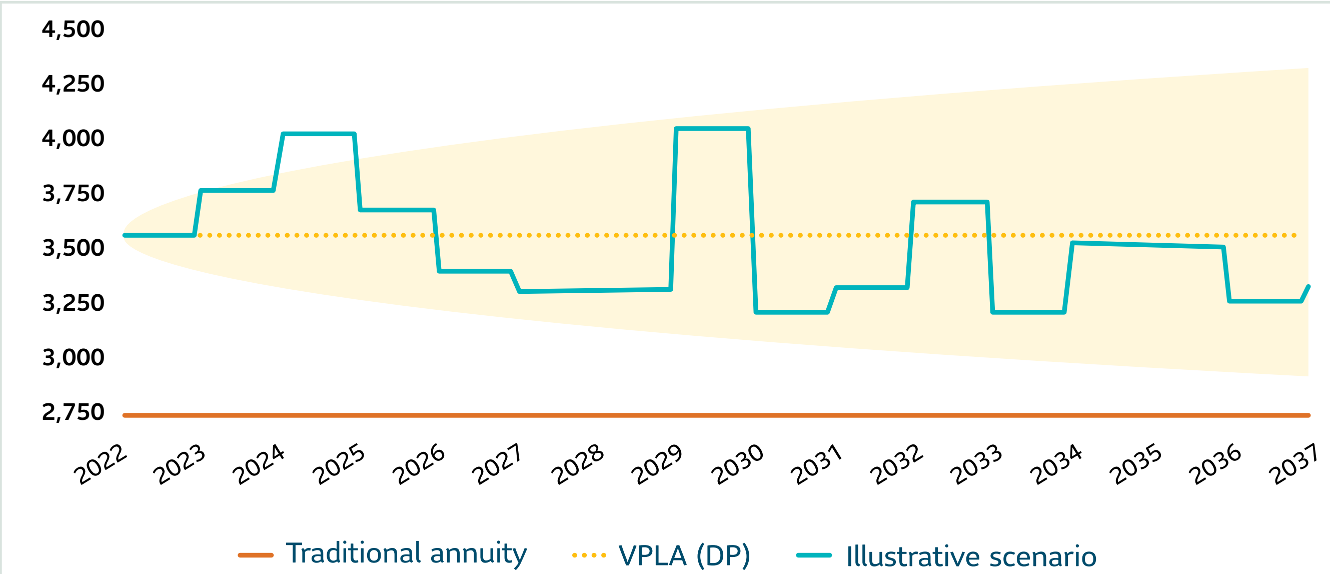
All other savings

$2.2 Trillion / 20 million+ canadians

[4] Household Balance Sheet, 2021. Investor Economics, September 2021.
[5] Ibid.
[6] Pension Satellite Account, Pension Assets at market value. Statistics Canada, December 2021.
[7] Sun Life actuarial analysis of size of VPLA pool, mortality adjustments and projected income volatility.

For DP pools to work optimally, we believe that DP pools should be open to all Canadians, and all money types—not just savings originating from DC plans or PRPPs.

The chart below illustrates potential payments from a traditional annuity vs. a DP. While both offer income for life, the DP offers higher income, with moderate volatility, represented by the shaded area.[8]



The University of British Columbia (UBC) VPLA: a success story

UBC believes that their responsibility to plan members does not end at retirement. As such, they have developed a robust retirement income program in partnership with Sun Life. It includes extensive tools and communications, to assist members with education and decision making at retirement. UBC members have access to two retirement income options, a legacy Variable Payment Life Annuity (also known as a DPP) established in the 1960s, and RRIF- or LIF-type payments.

For retiring plan members, the pros and cons of the two options are clearly presented as the member is making their income decision. For the DPP, two income levels are available (4% or 7%), and members are clearly informed that income from the DPP will fluctuate, and why. They also receive an annual notice that tells them what's changing.

Almost 36% of UBC retirees have elected to include DPP in their retirement income. The investment option is a low-cost balanced fund. In terms of the income rate elected, it is virtually equally split between a 4% income (41%) and 7% income (49%), and 10% with both options.

Anecdotally, retirees report high levels of satisfaction with the plan. This is likely due to the simplicity of the plan options, personalized illustrations, extensive communication and education efforts, and one-on-one support to members.

[8] The chart assumes $2750 in monthly traditional annuity income for a single-life male at age 65, and assumes that the VPLA would generate a 30% premium over a traditional annuity. The shaded area depends on the standard deviation of the return, assumed to be 7.5% annually in this example. This is expected to fluctuate as traditional annuity pricing reacts to daily changes in the interest rates, and VPLA pricing will change based on revisions to long-term investment assumptions. With the VPLA, the monthly payment fluctuates, adjusted to reflect actual investment and mortality experience vs. assumptions.

Retirees want it all: flexible features and guaranteed income periods

Sun Life conducted a VPLA Product Concept Assessment,[9] seeking to gauge interest in the VPLA and DP product features. Generally, respondents envisioned using DP pools in combination with another product such as a RRIF. They also expressed interest in joint and survivor payments, return of premium options, and a guaranteed income period. At the time of the study, inflation indexation was not cited as an important product feature.[10]

Other findings pointed to the importance of effective communications to avoid confusion or misunderstanding of how the product works. Specifically, respondents sought clarity on fluctuations in income, the extent of control over investments, the absence of residual funds after death and the impact of group mortality.

Driving the success of Dynamic Pension pools

Advice and education supported by robust planning tools and illustrations of potential outcome scenarios will be critical. Access to holistic advice will help members build an appropriate mix of income vehicles based on the member's priorities, such as liquidity, control of investments or legacy considerations. A periodic "adjustment notice" would inform members about payment adjustments.

Equally important as the product features is the plan sponsor experience, communications, and ease of administration. Beyond the benefits of pooling, an attractive feature for plan sponsors of the VPLA is that it shifts governance and risk management to the insurer. Further research and analysis are warranted to gain additional insight in these areas.

The future of resilient retirement income starts with DP pools

While the DP may not be a silver bullet, adding it to the decumulation product shelf will be a positive for retirees. It will add features that are not available through decumulation products available today.

Sun Life continues to be active in advocacy efforts and government consultations, particularly to advance universal DP pools access open to all types of retirement savings. We are partnering with regulators, peers, and industry bodies to help build education and awareness of the product. These discussions will guide how VPLAs fit with existing decumulation solutions, and how to help ensure its success through optimal pooling, attractive product features, effective communication, and easy administration.

As the largest Capital Accumulation Plan provider in Canada[11], Sun Life is well-positioned to draw on our expertise as a trusted leader in group retirement services and annuities. We aspire to become the retirement income provider of choice by giving Canadians the confidence to live a worry-free, sustainable retirement. We do so by advocating for, building and offering innovative decumulation products, solutions and advice that will deliver money for life.

[9] A hybrid qualitative approach was used for this study, including individual in-depth interviews, as well as moderated online discussions. Participants included 25 pre-retirees and 8 recent retirees. Field dates: July 6—16, 2021.
[10] The Concept Assessment was conducted in July 2021.
[11] 2021 CAP Suppliers Report. Benefits Canada, December 2021.