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Financial Services Practice

Are Canadians Ready For Retirement?

Current Situation and Guiding Principles for Improvement

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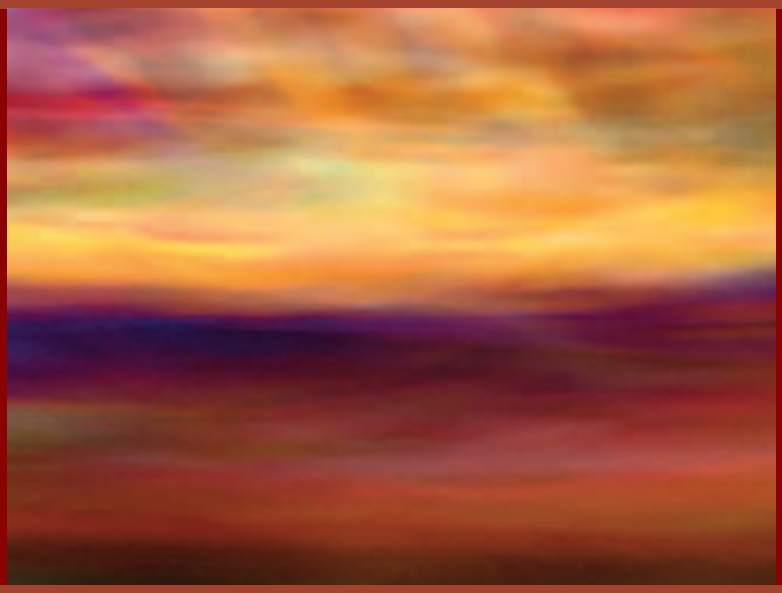
Contents



Introduction

Structural forces are putting unprecedented pressure on retirement systems around the world. Canada's retirement system, while more stable than many, is not immune to these forces. The country's population is ageing rapidly, with the share of the population over 65 increasing from 11 percent in 1990 to 22 percent in 2030, adding strain to pay-as-you-go retirement programs. The stock market has offered limited returns since its peak 12 years ago and experienced unprecedented levels of volatility, depressing the returns of funded retirement schemes and individual savings. Finally, over the past 30 years, life expectancy in Canada has increased by more than three years, while the average age of people entering the workforce increased by more than one year and the average retirement age decreased by more than two years. As a result, the ratio of years in retirement to working years grew from 36 percent in 1980 to 53 percent on average today.

Many countries have responded to similar forces by adopting pension system reforms, from the National Employment Savings Trust in the U.K. and the Pension Protection Act in the U.S., to increases in retirement age in several European countries. Given the transformative forces challenging Canada's retirement system, it is timely to assess the state of retirement security for the nation's population, and consider potential solutions.

There are two important measures of the sufficiency of a retirement system: the absolute minimum income any retiree can achieve; and retirees' ability to maintain their pre-retirement standard of living. The latter measure is the facet of the retirement system that is currently most challenged by demographics, recent market performance and by the increasing ratio of retirement years to working years. This paper therefore provides an analysis of the state of Canadian retirement security based on the concept of standard of living replacement, or retirement readiness. It will also examine the most challenging forces affecting retirement readiness and explain how they differ across population cohorts. Finally, the paper will look at potential levers for improving retirement readiness for all Canadians. However, it will not look at the absolute minimum income any retiree can or should achieve.

The majority of Canadian households are well-prepared and on track to maintain their standard of living in retirement. Many will also have the opportunity to leave an inheritance. However, close to a quarter of households are not on track to generate a retirement income sufficient to maintain their standard of living when they move out of the workforce.

In 2011, McKinsey & Company conducted a detailed analysis of Canadian households' balance sheets and implied retirement readiness based on an extensive survey of more than 10,000 working-age households.[1] This analysis shows that the majority of Canadian households are well-prepared and on track to maintain their standard of living in retirement. Many households will also have the opportunity to leave an inheritance. However, close to a quarter of households are not on track to generate a retirement income sufficient to maintain their standard of living when they move out of the workforce. Although each segment of the popu-

[1] *Working-age households* have been defined as households where at least one individual draws employment income and is aged between 25 and 65.

lation has households that are not on track, there are significant variations in retirement readiness – and in the drivers of readiness – by age and income cohort. The share of households that are not on track varies from as little as 4 percent for the lower income and higher age cohort to as much as 41 percent for the higher income and higher age cohort.

Several measures could help get more Canadian households on track for a secure retirement, ranging from an increase in workplace or personal retirement savings to actions enabling Canadians to work longer or to a strengthening of universal retirement benefits. Each of these measures would affect cohorts of Canadians differently, depending on age, income, employment status and other factors. Given the complexity of this multifaceted problem, a single lever is unlikely to serve as a complete answer and could result in unintended consequences. A mix of solutions, each targeting the challenge faced by individual cohorts, is far more likely to be effective.

The State of Retirement Readiness in Canada

The structure of the Canadian retirement system is supported by four pillars, each of which plays a critical role in preparing households for a secure lifestyle when they leave the workforce.

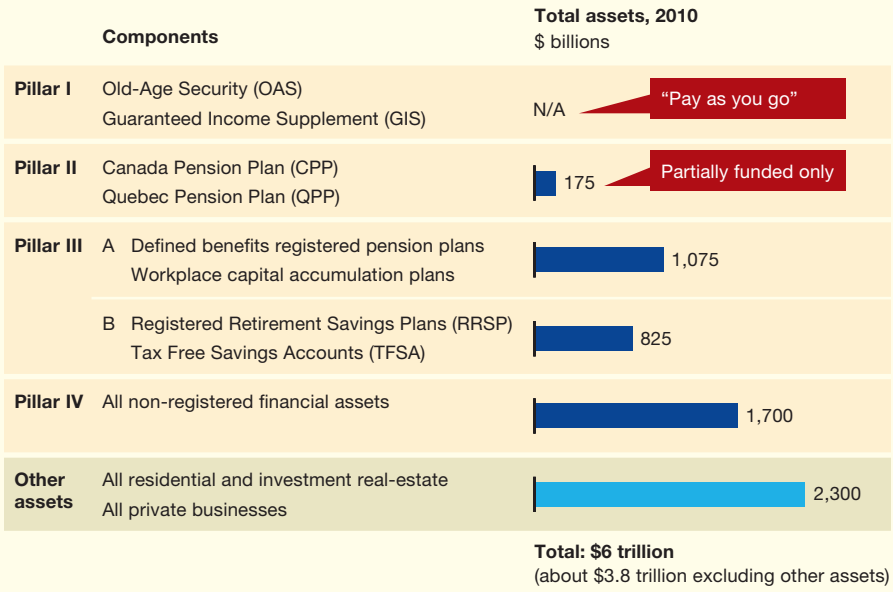
- **Pillar I:** Universal income-tested public benefits (Old Age Security and Guaranteed Income Supplement)
- **Pillar II:** Mandatory public workplace coverage (Canada Pension Plan and Quebec Pension Plan)
- **Pillar III:** Workplace and personal registered savings (employer-sponsored plans whether defined benefit or defined contribution and individual registered retirement savings plans)
- **Pillar IV:** Additional non-registered savings (e.g., bank deposits, brokerage accounts)

The four pillars are relatively balanced. While Pillars I and II provide some level of retirement income universally, a high rate of defined benefit (DB) penetration and individual registered savings contribute in roughly equal parts to sizable Pillar III assets. Pillar IV is roughly equivalent in assets to Pillar III. While Pillar III is more important than Pillar IV for most households, the wealthiest households rely more on Pillar IV assets due to the absolute limit on Pillar III contributions (Exhibit 1, page 6).

These pillars do not include home equity and other non-financial assets. While some households consume a percentage of home equity and non-financial assets in retirement, these assets have not been considered in the retirement readiness assessment, in an effort to take a more conservative perspective.

Exhibit 1

The pillars of the Canadian retirement system



Source: Statistics Canada, CPP, QPP

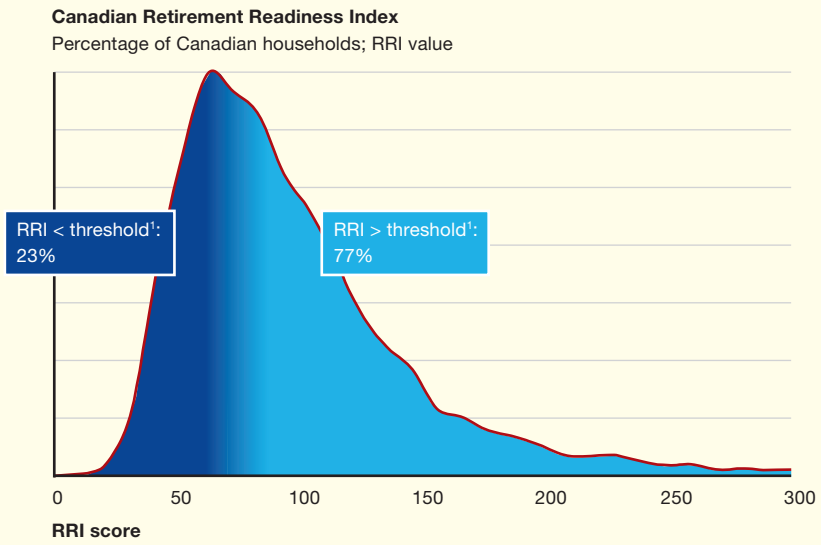
While most households are on track, one quarter of Canadians is unprepared for retirement

McKinsey analysis shows a wide dispersion of retirement readiness scores among Canadian households (see sidebar on page 9). While the median value of McKinsey's Retirement Readiness Index (RRI) across all Canadian households is close to 100, 23 percent score below the minimum threshold,[2] meaning they will have to significantly adjust their standard of living or delay their retirement if they continue on the same savings path (Exhibit 2). This percentage may seem low in a context where many in Canada are questioning the sufficiency of the retirement system. The RRI metric includes not only private savings but also public sources of retirement income (Pillars I and II). A large number of households get a high replacement rate from these public programs and need little to no savings to complement them. The next section will explore how retirement readiness

[2] A minimum replacement threshold of 80 percent for households in the first income quintile and 65 percent for all other households has been used based on a historical analysis of consumption in retirement (see sidebar on page 21 for details).

Exhibit 2

23% of Canadian households are not on track for secure retirement

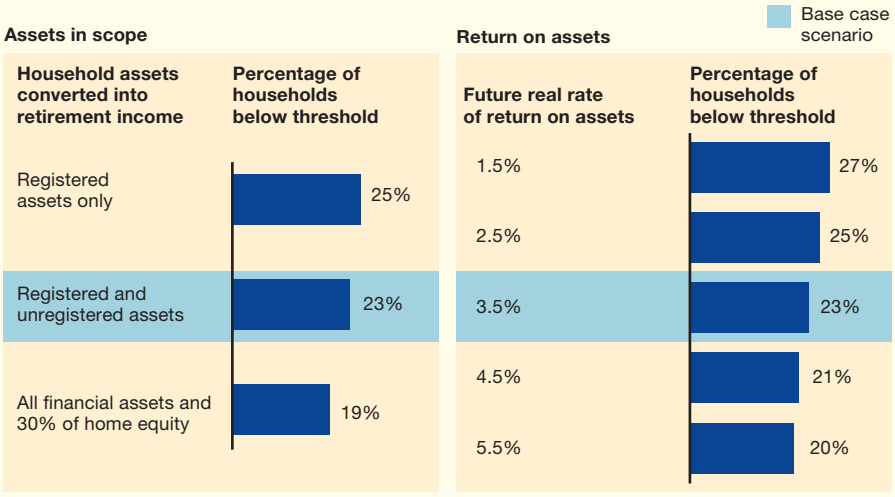


[1] Threshold is RRI=80 for the lowest income quintile (Q1) and RRI=65 for all other quintiles (Q2-5)

Source: McKinsey Retirement Readiness Index Model

Exhibit 3

Changes in assumptions on sources of retirement income and asset return do not significantly change the RRI outlook



Source: McKinsey Retirement Readiness Index Model

varies among various segments of the population; for example, the share of households below threshold can reach up to 40 percent of households in some segments.

The Retirement Readiness Index is a forward-looking measure, which assesses a future outcome based on the current trajectory of households. Like any projection, it relies on a number of assumptions regarding market performance and assets that households will use for retirement among others. However, the conclusion that roughly a quarter of Canadian households are not on track to maintain their standard of living in retirement holds under all reasonable scenarios for these key assumptions (Exhibit 3). For instance, the share of the population that is not on track varies only between 20 percent and 27 percent under a range of future real market return scenarios going from 1.5 percent p.a. to 5.5 percent p.a. Other factors, such as a faster-than-expected increase in life expectancy, could also affect retirement readiness, but to a lesser extent. Factors under the control of households, such as savings rate, have a much greater impact on retirement readiness.

As this is the first study of retirement readiness in Canada using this methodology, it is impossible to compare results over time. Since market performance has been low in the recent years and savings rates dipped before the crisis – albeit to go back up – the situation was probably marginally better 10 to 15 years ago. However, the difference is likely minimal given the wide variability in retirement readiness.

The Retirement Readiness Index

McKinsey's Retirement Readiness Index (RRI) is a measure of a household's retirement preparedness, defined as the standard of living a household will be able to afford in retirement relative to its peak working life standard of living. The RRI takes into account all four pillars of retirement, including all financial assets held by households, but excludes their home equity or assets tied up in privately owned businesses. An RRI of 100 means that a household is on track to maintain its standard of living through retirement as defined by the annual real amount a household has available for consumption post taxes and fixed charges assuming no legacy beyond home equity and non-financial assets. An RRI above 100 indicates that a household could increase its standard of living in retirement or maintain it and leave an inheritance. An RRI below 100 means that a household would be forced to reduce its standard of living in retirement or to delay retirement. McKinsey initially developed the Retirement Readiness Index to analyze retirement security in the U.S. ("Restoring Americans' Retirement Security: A Shared Responsibility," McKinsey & Company, 2009.)

Based on a historical analysis of Canadian households that are currently retired, households below the RRI thresholds of 80 for the first income quintile and of 65 for all other income groups have been defined as not being on a path to adequate retirement income. These thresholds are reflective of the average standard of living adjustment sustained by current retirees based on historical Statistics Canada consumption surveys. These surveys show that current retirees that were in the first income quintile maintain approximately 80 percent of their pre-retirement consumption level and that all other cohorts of current retirees maintain approximately 65 percent of their pre-retirement consumption level. (See sidebar on methodology, page 21, for more details.)

Drivers of Retirement Readiness

The share of Canadian households unprepared for retirement greatly varies by cohort, and is driven by different forces. The extent of the retirement readiness gap varies greatly among socio-demographic segments (Exhibit 4, page 12). While 23 percent of Canadians are ill-prepared, this number drops to as low as 4 percent or reaches as high as 41 percent for different age or income cohorts. Surprisingly, the disparities are driven not just by income but by age as well, and there are some counterintuitive results. The root causes of these disparities in retirement readiness are better understood when looking at specific cohorts in the population, their savings behavior and their access to various retirement benefits and savings vehicles.

- Fifteen percent of households in the youngest and lowest-income group (see box A in Exhibit 4) are not on track to maintaining their standard of living in retirement. This is a materially better number than the national average of 23 percent, but well below the RRI for households in the same income quintile that are closer to retirement. Among the oldest households in the lower-income cohort (B), for example, only 4 percent are not on track. A deeper look at the projected sources of retirement income for each cohort shows that the difference between age groups is not based on savings but rather on Pillar I benefits; OAS and GIS provide material income replacement for the older groups. However, because OAS and GIS are indexed with inflation, which is typically lower than real wage growth,

there is a significant erosion of retirement readiness over time for lower-income households. The effect can be material: over the past 15 years alone, average real household income has grown by 22 percent.

- Among the youngest and highest-income group (C), 38 percent are not on track to maintain their standard of living in retirement. Universal retirement benefits (Pillars I and II) will not be sufficient to replace the standard of living of these households, which will therefore have to rely heavily on Pillars III and IV – workplace or individual savings. The households in this segment that are not on track are thus those who are not saving enough in the workplace or individually; many do not have access to a workplace savings plan and fail to supplement this gap through additional personal savings.
- Among the older and highest-income group (D), 41 percent are not on track, the highest percentage across all income and age groups. Their situation is similar to the previous group for whom workplace and individual

Exhibit 4

Retirement readiness by income and age

Percentage of households with RRI below threshold by income and age group

Income quintile		Age group 25-34	35-44	45-54	55-64	Average household income
Lowest	Q1	A 15%	9%	9%	B 4%	$20,000
	Q2	24%	14%	13%	14%	$40,000
	Q3	31%	E 19%	24%	23%	$60,000
	Q4	29%	27%	30%	33%	$90,000
Highest	Q5	C 38%	29%	34%	D 41%	$140,000

A Younger lower-income households
B Lower-income households nearing retirement
C Younger higher-income households
D Higher-income households nearing retirement
E Middle-income, middle-age households

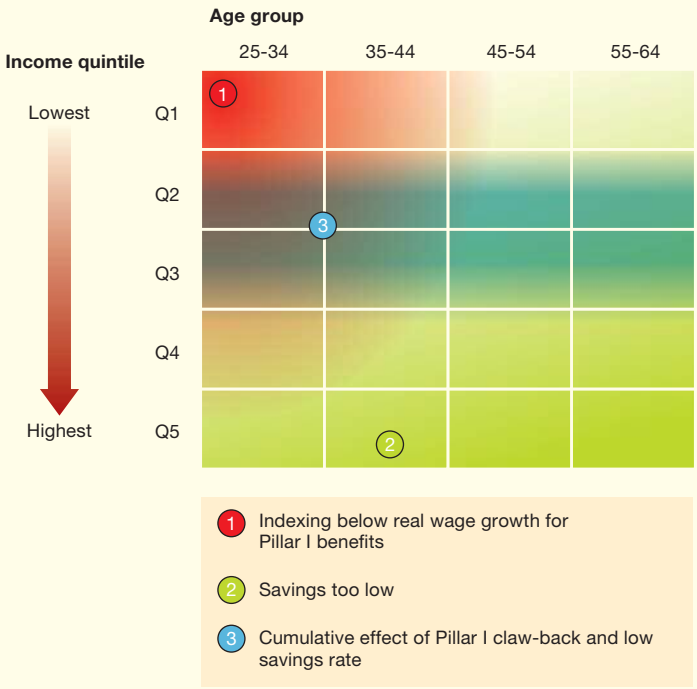
Source: McKinsey Retirement Readiness Index Model

savings is essential to maintaining their standard of living in retirement. However, in this case, it is not current savings but rather assets accumulated through past savings that is the determining factor of readiness. In this cohort, unprepared households have failed to save sufficiently or have accumulated too much debt.

- In the middle-age, middle-income cohort (E), 21 percent of households are not on track to maintain their standard of living, roughly on par with the national average. The primary challenge facing these households is the clawback of Pillar I benefits. In fact, for some households in this segment, Pillar I benefits are reduced by $0.50 for every $1 of retirement income they draw from non-public sources (Pillar III). The road to retirement savings can therefore be a steep climb as income increases. Unprepared households in this segment are not saving enough to compensate for the clawback of workplace and individual savings.

Exhibit 5

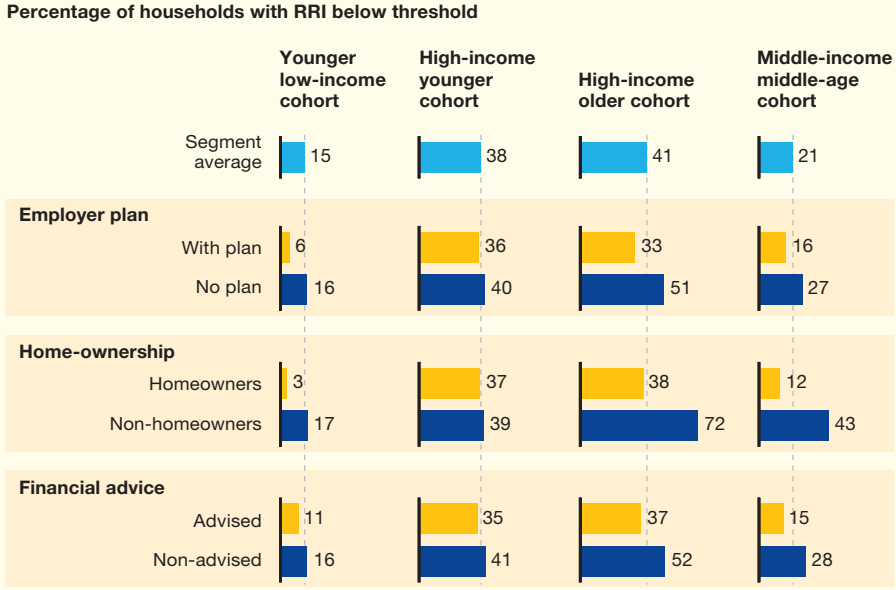
Drivers of low retirement readiness by cohort



Source: McKinsey Retirement Readiness Index Model

Exhibit 6

Households with an employer retirement plan, residential property or a financial advisor exhibit higher retirement readiness



Source: McKinsey Retirement Readiness Index Model

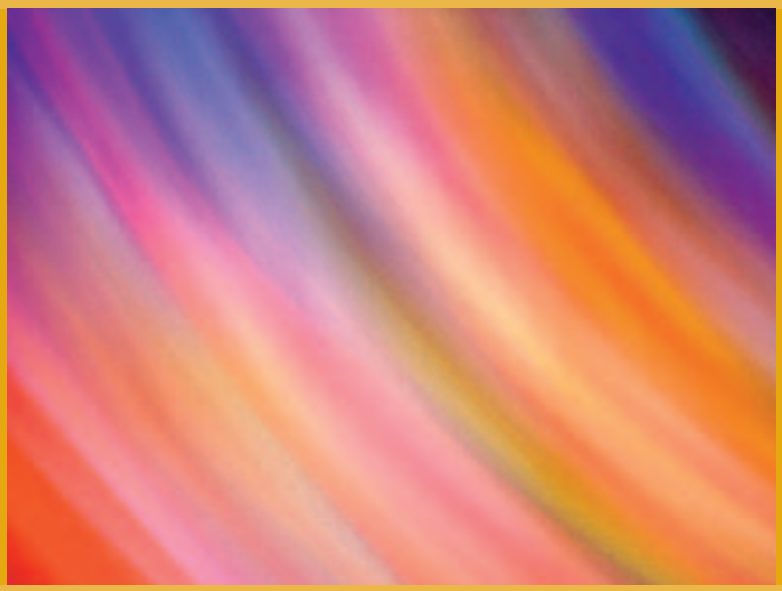
These differences in outcomes by age and income cohort can be explained (Exhibit 5). There are three distinct and discrete forces that play a major role: first, indexing below real wage growth for Pillar I benefits affects younger lower-income household; second, an individual and workplace savings rate that is too low affects middle and higher income households of all ages; and finally, steep clawback of Pillar I benefits combined with an increasing need for savings affects median income households.

Beyond income and age, a number of other socio-demographic factors come into play (Exhibit 6). For example, individuals with employer-sponsored retirement plans are likely to save more and to be on track to a secure retirement. Thus the prevalence of employer coverage in Canada is a significant factor in the overall higher retirement readiness in the country. Similarly, homeowners and households using a financial advisor also have a higher retirement readiness on average, after adjusting for the income and age effects. On the other hand, the data also show that non-homeowners,

single-person households or single parents are more likely to fall short of maintaining their standard of living in retirement.

Consumers have a limited awareness of their own situation

When asked to rate their confidence in having enough money to retire comfortably on a scale of 1 (strongly disagree) to 10 (strongly agree), Canadian households in our survey responded with an average slightly below 5. Overall, a household's level of confidence for retirement is not correlated at all with its RRI score. This suggests that Canadian households do not have a good understanding of their retirement preparedness.



Principles for Improving Retirement Readiness in Canada

The Canadian retirement system is in a stronger position than many of its global peers, but this relative strength still leaves nearly a quarter of the households in the country unprepared for a secure retirement. Addressing this challenge will take concerted efforts along several dimensions.

Four broad measures could improve the retirement readiness of Canadians: increasing workplace savings (Pillar IIIa), increasing individual savings (Pillars IIIb and IV), enabling Canadians to work longer and broadening universal coverage (Pillars I and II).

Lever 1: Increased workplace savings. A number of specific measures could be used to increase participation and contributions into employer-sponsored pension plans (Pillar IIIa), and thus put the affected households on a firmer footing for retirement. One generic example, for analytic purposes, focuses on the principles of broader access and higher savings: *Mandating auto-enrollment group coverage.* In this scenario, all Canadian workers would have access to a workplace savings plan (DB, DC, Group RRSP or equivalent) and would be automatically enrolled in the plan at a default savings rate, with an opportunity to opt-out or to contribute more. This would increase the percentage of Canadian households saving through the workplace, with the highest long-term impact on younger households, which will have a longer accumulation period.

Lever 2: Increased individual savings. The broad aim of the second lever would be to increase individual registered and unregistered savings beyond workplace savings plans (Pillars IIIb and IV). An example for the purpose of analysis would be to *Encourage individual savings through incentives and education.* As with the measures aimed at increasing group coverage, measures to increase savings would have a higher impact on younger households.

Lever 3: Enabling and encouraging Canadians to work longer. Delaying retirement is one of the few solutions open to older households with little time to accumulate enough assets for retirement, and one of the few ways to compensate for increasing life expectancy and later entry in the workforce. A number of measures could be implemented to *enable and encourage Canadians to work longer*; examples include increasing the official retirement age, introducing public benefit increases for late retirement (offset by public benefits reduction for early retirement) and incentives for employers to retain or employ older workers. Steps in this direction have been made through changes in CPP/QPP early and late retirement adjustments and through announced changes to the eligible age for Pillar I benefits.

Lever 4: Broader universal coverage. The final lever would include measures to increase or broaden universal benefits offered under Pillars I and II (OAS, GIS and CPP/QPP). One specific measure, focused on Pillar II, has been part of recent proposals to change the Canadian retirement system: *A fully-funded wedge increase in CPP/QPP benefits.* Increasing CPP/QPP contribution and benefits only for the upper half of the covered income band would alleviate the effects of Pillar I clawback for the most affected group without forcing lower-income segments to

Exhibit 7

The impact of measures to improve RRI varies greatly by age and income cohort

✓ Effective
✓ Effective only to some extent
✗ Ineffective

	Younger low-income cohort	High-income younger cohort	High-income older cohort	Middle-income middle-age cohort	All cohorts
I Auto-enrollment group coverage for all employees	✓	✓	✗	✓	✓
II Increase in private savings for all Canadians	✓	✓	✗	✓	✓
III Increase in the average retirement age of Canadians	✗	✓	✓	✓	✓
IV Fully-funded wedge increase in CPP/QPP contribution	✗	✓	✗	✓	✓

Source: McKinsey Retirement Readiness Index Model

save more and without introducing intergenerational transfers. Given the ageing of the Canadian population and the increasing strain it places on pay-as-you-go programs (OAS and GIS), this report does not model any increase in their coverage.

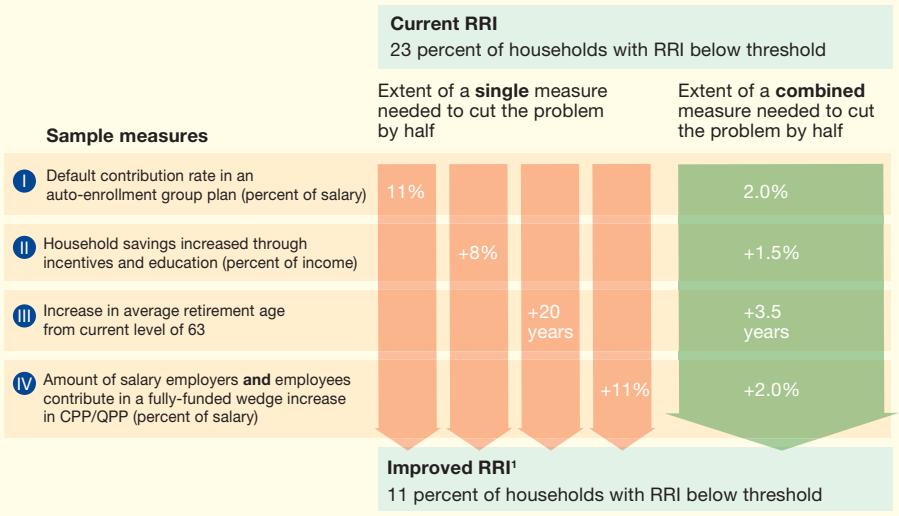
The impact of each of these levers varies greatly by age and income segment (Exhibit 7). In other words, using only one of the levers could be very effective for some segments of the population, but would be ineffective for others. The impact of specific measures can be assessed quantitatively.

A coalition of measures is likely to prove more effective than any single measure

A simple simulation of the potential quantitative impact on retirement readiness of these individual measures illustrates that they would have to be pushed to an extreme to improve the retirement readiness gap by as little as half (Exhibit 8). Indeed, because each measure can impact individual cohorts in distinct ways, a single measure can not address the needs of all cohorts. Furthermore, the hypothetical results for individual measures should be considered best-case scenarios, because they assume that any measure aimed at increasing savings (I, II or III) would result in *net* new savings, not displacement of existing savings.

Exhibit 8

Combined measures improve retirement readiness more effectively than single measures



[1] Hypothetical scenario in which share of households below threshold is cut in half

Source: McKinsey Retirement Readiness Index Model

On the other hand, a combination of measures at incremental levels could easily halve the number of unprepared households by effectively targeting cohorts with specific measures. Moreover, a portfolio of measures limits displacement of current savings by maintaining the existing balance between the various pillars of the retirement system and also reduces the risk of leading certain groups to "oversave," a potential result when one lever is applied to all cohorts similarly despite their different gap levels and needs. Yet, the simulation shows that cutting the number of Canadian households that are not on track would require material changes to the system.

This paper does not purport to analyze in full or recommend specific measures. They should each be studied thoroughly in terms of effectiveness, costs and overall impact on the Canadian retirement system. The point, rather, is to demonstrate that the portion of the Canadian population that is not on track to maintain their standard of living in retirement is made up of many sub-groups, and that solutions aimed at improving this situation will be more effective if they are multi-pronged.

* * *

Any analysis of the Canadian retirement situation should be considered in perspective. Compared with the challenges that many other countries are facing, Canada has a retirement system that is relatively sufficient and sustainable. However, it can be made even stronger. A significant minority of Canadian households are not on track to maintain their standard of living in retirement. This lack of preparedness does not have a single root cause – some households are unprepared because the public benefits are eroding over time; some are not saving enough (or have not saved enough); and others will be unable to compensate for the steep clawback of universal benefits. The only way to address this multifaceted challenge is with a multifaceted response.

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Methodology

Retirement Readiness Index methodology

The analysis is based on an extensive survey of Canadian households conducted between December 2010 and January 2011. To project their "path" to retirement, the survey gathered detailed information on households' assets, debt and savings habits. Responses were weighted by income, age, region and household composition to generate a representative view of the Canadian population.

The Retirement Readiness Index measures the ratio between projected disposable income in retirement and consumption level pre-retirement.

- Disposable income in retirement is obtained by projecting the current assets and future savings of each household to retirement age. Assets at retirement net of any debt remaining at retirement are then converted into annual income through retirement at current real annuity rates. Income from Old Age Security (OAS) pensions, Guaranteed Income Supplement (GIS), Canada Pension Plans (CPP) and defined benefit (DB) plans (if applicable) are added to the annuity coming from accumulated savings. Income taxes are applied using the current tax tables. Projections take into account the tax treatment of registered retirement plans and assume that all households maximize their Registered Retirement Savings Plan (RRSP) or defined contribution (DC) plan before saving into their Tax-Free Savings Account (TSFA) and then accumulating assets in non-registered accounts.
- Consumption pre-retirement is measured as projected household income for the peak income year minus annual savings and mortgage payments, if any.

Assets are assumed to appreciate pre-retirement at a long-term compounded real return on assets of 3.5 percent p.a. This long-term average compounded annual return would require a slightly higher average annual return (~4.0 percent p.a. in real terms) to compensate for the effects of volatility. Sensitivities around this return assumption are shown in the first section of this document. Annuitization of assets at retirement insures each household against longevity risk. These annuities could be acquired over multiple years to manage market-timing risk. The methodology assumes that DB plans will deliver their promised level of retirement income. While there will be instances of employers going bankrupt with unfunded pension liabilities, we believe that the effect is more than offset on average by the fact that 80 percent of primary income earners with DB plans are homeowners, and that home equity has been excluded from the analysis.

Methodology (continued)

The RRI threshold for low retirement readiness has been set at 80 for first-quintile households and at 65 for all other households. The thresholds are based on an analysis of the standard of living adjustment sustained by current retirees based on historical Statistics Canada consumption surveys. The surveys show that current retirees replace between 65 percent and 80 percent of their pre-retirement consumption level (Exhibit 9). While this analysis provides a good indication of what an acceptable RRI threshold might be, it would be inaccurate to use it to make conclusions on the RRI of current retirees. Since many retirees continue to save in retirement and leave an inheritance beyond the value of their real estate, the average RRI of retirees would likely be higher than 65-80, as RRI measures spending capacity in retirement rather than actual spending.

Simulation of potential measures to improve retirement readiness

Levers that could potentially be used to improve retirement readiness in Canada have been simulated using generic measures on each dimension. These measures have been created for illustration purposes only, not to argue for any specific measure or combination of measures.

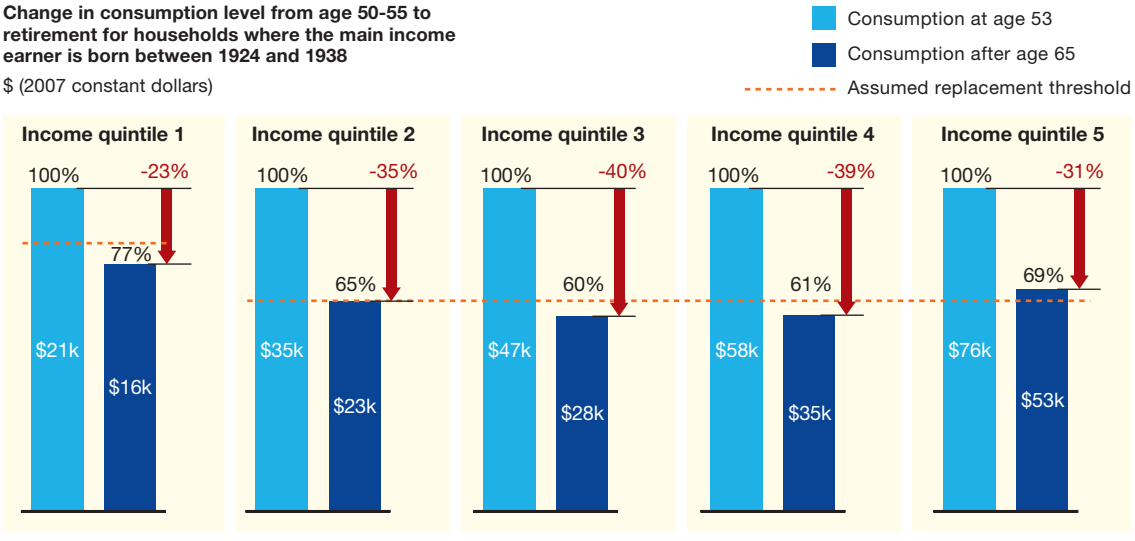
The survey data and the model that has been built as part of this exercise could be used to simulate other potential measures or combination of measures and to better understand their likely impact.

Exhibit 9

Historical view on standard of living adjustment in retirement by income group

Change in consumption level from age 50-55 to retirement for households where the main income earner is born between 1924 and 1938

$ (2007 constant dollars)



Source: Statistics Canada FAMEX (1982-1992) and SHS (1997-2008)

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