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Financial Services Practice

Building on Canada's Strong Retirement Readiness

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Introduction

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Demographic shifts and rising life expectancy have created a common perception among Canadians that they face a retirement crisis, and that millions will be forced to significantly lower their standard of living when they leave the workforce. Yet McKinsey's latest research on the subject shows that a strong majority of Canadian households are actually on track to maintain their standard of living in retirement.

This robust retirement readiness does, however, leave 17 percent of the nation's households financially unprepared for retirement. McKinsey research reveals that most of these households fall into two groups, meaning that the challenge is quite narrow, and that the best way to address it would be a targeted approach that leaves the rest of the system intact and maintains fairness for all Canadians.

This report is based on a 2014 update to McKinsey's initial retirement readiness research, conducted in 2011.[1] Since then, the macroeconomic context has evolved significantly. Canada's recovery from the financial crisis has been strong, with GDP growing at 2.2 percent annually between 2011 and 2014, residential real estate values continuing to rise, and equity markets returning to above 10 percent in most years following 2008. However, like most Western countries, Canada has an aging population, with the proportion of people over 65 expected to increase from the current 15 percent to 23 percent in 2035. Baby boomers have started to retire, putting increasing pressure on the existing system. But Canadians have been retiring later—the average retirement age shifted from 61.2 in 1997 to 62.1 in 2010 and further to 63 in 2013. The age of eligibility for the Old Age Security/Guaranteed Income Supplement (OAS/GIS) will gradually increase from 65 to 67 over 6 years, starting in April 2023. Also, OAS payments can now be deferred voluntarily to receive a higher payment in retirement and the Canada/Quebec Pension Plans (CPP/QPP) have been adjusted for individuals retiring before or after 65 years of age. These changes reflect the current economic environment and indirectly encourage people to work longer.

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The new survey was deeper and broader than the original, and analyzed the situation of approximately 9,000 working households and approximately 3,000 retired households. This report presents the results of the updated analysis, explaining how retirement readiness differs across population cohorts. It then highlights the focused nature of the problem, and proposes criteria for evaluating possible solutions. Finally, it describes how the various retirement system stakeholders can act collectively to bring even more Canadians into the ranks of the retirement ready.

[1] See *Are Canadians Ready for Retirement? Current Situation and Guiding Principles for Improvement*, McKinsey & Company, April 2012.

Retirement Readiness In Canada Today

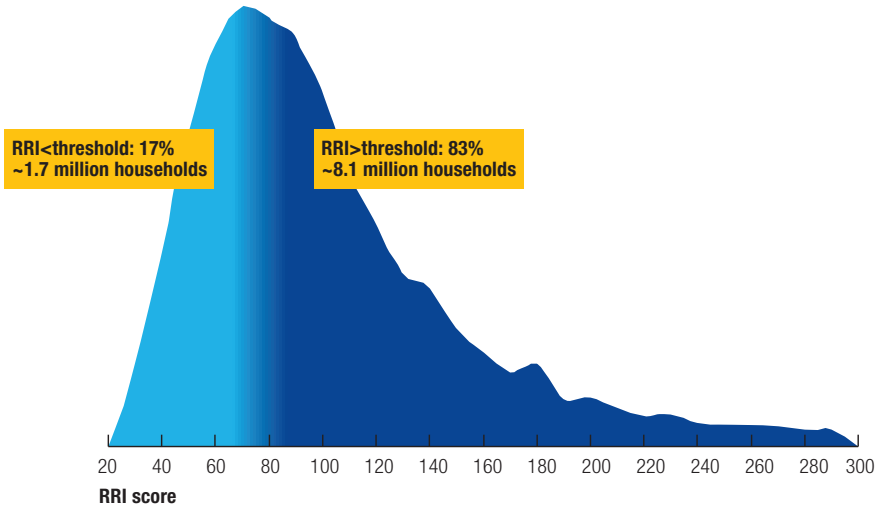
According to McKinsey's latest research on retirement readiness in Canada, four of every five of the nation's households are on track to maintain their standard of living in retirement. These are enviable numbers, but they still leave 17 percent of households at risk of having to lower their standard of living when they stop working. The research reveals that most of the unprepared households belong to one of two groups of middle- to high-income households: those that do not contribute enough to their defined contribution (DC) plans or group RRSPs and those that do not have access to an employer plan and have below-average personal savings.[2] Targeted solutions to address the lack of readiness in these groups could strengthen Canada's already robust retirement readiness. However, these solutions should be balanced in such a way that they maintain the fairness of the system for all of Canada's households.

[2] Access to employer plan is based on primary income earner. Savings are based on household level.

Exhibit 1

There is a wide dispersion of retirement readiness scores among Canadian households

Distribution of Canadian household Retirement Readiness Index (RRI) – 2014[1]



Note: RRI thresholds applied (based on historical analysis): 80 for lowest-income quintile; 65 for all other quintiles

[1] Eight percent of households have an RRI greater than 300 and are not shown

Source: McKinsey Retirement Readiness Survey 2014

Survey results

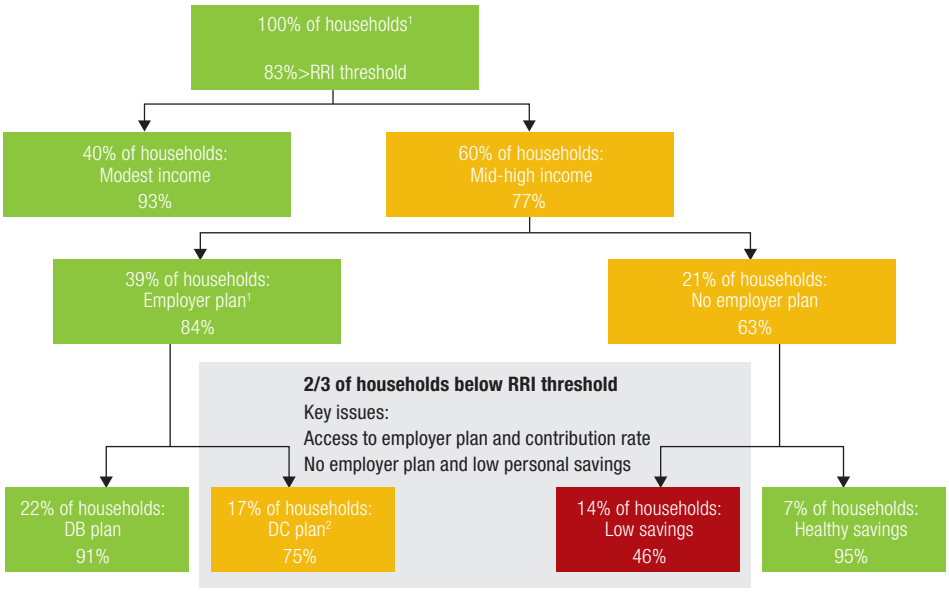
McKinsey's Retirement Readiness Index[3] (RRI) measures a household's ability to maintain its standard of living in retirement. For Canadian households, RRI takes into account the four main pillars of retirement savings: universal retirement income programs (e.g., OAS/GIS); publicly funded pension plans (CPP/QPP); privately funded retirement plans (e.g., employer retirement plans, RRSPs); and non-registered private savings. (See sidebar, "The structure of the Canadian retirement system," page 15.) In the 2014 analysis, 83 percent of households scored above the minimum threshold on RRI.

The fact that 83 percent of Canadian households are on track for retirement is not surprising given the nation's strong universal social programs and the considerable wealth of Canadian households. For example, a couple with two income earners and a constant combined income of $40,000 or less throughout their working life would be able to maintain their standard of living in retirement based solely on income from GIS, OAS and the CPP/QPP. Additionally, public data show that Canadian households had a combined net worth of about $8 trillion in 2013, which translates to a median net worth of over half a million dollars for households approaching retirement. However, there is a wide dispersion of retirement readiness scores among Canadian households (Exhibit 1), and two segments of the population in particular

[3] See Appendix A for more details on the Retirement Readiness Index and its methodology.

Exhibit 2

Two segments of Canadian households face challenges in retirement



[1] Based on primary income earner's current coverage

[2] Including group RRSPs

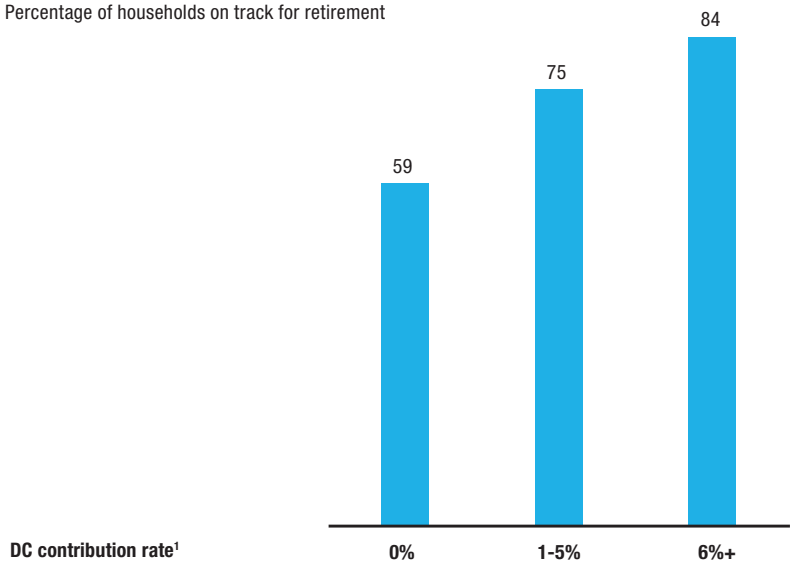
Source: McKinsey Retirement Readiness Survey 2014

Exhibit 3

Households contributing more than 5% to their DC plan are more prepared for retirement

Comparison of retirement readiness to DC contribution rates

Percentage of households on track for retirement



[1] Total contribution rate from employer and employee; 31% of employees don't contribute, 11% contribute between 1-5% and 58% contribute more than 6%

Source: McKinsey Retirement Readiness Survey 2014

remain exposed (Exhibit 2). RRI results for the major groups were as follows:

- Ninety-three percent of **modest-income households** are on track to maintain their standard of living in retirement, primarily because they will receive a high rate of income replacement from public sources (Pillars I and II). That said, maintaining consumption in retirement does not necessarily translate into a comfortable life. In fact, some modest-income households may experience poverty in retirement. This is particularly true for single seniors[4] receiving lower government benefits compared to couples.
- **Mid- to high-income households** show a mix of readiness levels. Almost all of those with a **defined benefit (DB) pension plan** are on track (91 percent); DB plans continue to provide strong protection for retirement (assuming they will pay the promised benefits). No significant difference in retirement readiness was found between those households with public sector DB plans and those with private sector DB plans.

  Most households with access to a DC plan or group RRSP are on track (75 percent). Although this is a strong rate, it is 8 percentage points below the national average. The 25 percent of households not on track generally do not participate in their plans or have low contribution rates. Overall, 31 percent of households with access to DC plans or group RRSPs do not contribute to them, and another 11 percent contribute 5 percent or less.[5] Households contributing more than 5 percent to their plans score significantly higher on RRI (Exhibit 3).

  Sixty-three percent of mid- to high-income **households with no employer pension plan** are on track. However, there are two distinct subgroups: "savers," households **with an above-average savings rate**, are far more prepared (95 percent) than **"non-savers," those with a below-average savings rate** (46 percent). This leads to differences in a number of financial metrics. For example, half of the savers get financial advice, compared to 27 percent of non-savers. Savers use an RRSP or TFSA account more often (95 percent) than the non-savers (76 percent), with more than twice the average balance. Also, savers are more likely to own their homes and, on average, have paid down a larger portion of their houses. These characteristics are all linked to more financial security in retirement (Exhibit 4, page 8).

A targeted issue

The minority of Canadian households that are not on track for retirement are impacted primarily by three decisive forces: lack of access to employer plans, low contribution rates to these plans, and low personal saving rates among those without access to an employer plan. Specifically, the two groups of households most at risk for a financially strapped retirement are mid- to high-income households that have access to a DC plan or group RRSP

[4] One of the many drivers of poverty among single seniors is the drop in benefits for the surviving spouse when the primary income earner dies; benefits can shrink significantly for the surviving spouse if he or she has not worked.

[5] Refers to combined contribution rates from employee and employer. Rate is of gross salary.

Exhibit 4

Overall, savers are more prepared than non-savers

Comparison of households[1] without an employer plan

	Low personal savings	Healthy personal savings
RRSP/TFSA		
Usage	76%	95%
Average balance	$88,000	$194,000
Primary residence		
Ownership	76%	82%
Average value	$352,000	$459,000
Equity	56%	69%
Financial advice usage	27%	49%

[1] Based on primary income earner's current coverage

Source: McKinsey Retirement Readiness Survey 2014

Exhibit 5

Sensitivity analysis of RRI

Inclusion of real estate[1]	Percentage on track	Real return on asset	Percentage on track	Failing of DB plans	Percentage on track
0	**83**	2.5	82	**No failing**	**83**
30	87	**3.5**	**83**	10% fail	83
100	90	4.5	84	20% fail	82

[1] Percentage of real estate value included in retirement income (assuming the value is annuitized)

Source: McKinsey Retirement Readiness Survey 2014

but do not contribute enough, and mid- to high-income households that do not have access to an employer plan and have below-average personal savings.

One assumption that would have a significant impact on overall retirement readiness is the use of non-financial assets (e.g., home equity) as a source of retirement income (Exhibit 5). If 30 percent of

home equity were converted into retirement income, the percentage of Canadian households on track for retirement would increase to as high as 87 percent. The increase in readiness through inclusion of home equity would be even more significant for the two cohorts most at risk.[6]

In contrast, changes in assumptions such as the rate of return on assets and the rate of DB plan failure would only change the results marginally. This is consistent with the fact that the primary challenges facing the two at-risk groups of households are lack of access to retirement plans, low contribution rates and low personal savings.

A perception gap

When asked what their top three financial concerns are, about 60 percent of Canadians across income quintiles selected "not having enough money for retirement," even though our analysis shows that retirement readiness is only an issue for 17 percent of households. Furthermore, the correlation between households' retirement readiness and their level of financial worry is not strong.

The perception gap regarding retirement readiness can be explained in part by an overestimation of consumption needs in retirement. Historical Statistics Canada consumption survey data show that retired households on average spend about 67 percent of what they spent prior to retirement.[7] Contrary to the common perception, the majority of retirees in our sample said they reduced consumption in retirement by *choice* instead of by constraint. Fourteen percent of households currently retired are spending more in retirement; 53 percent are spending less but do not feel the need to spend more; and only 33 percent said they would spend more but feel financially constrained. This may explain why more people believe they will not be prepared for retirement: they overestimate how much they will need to maintain the standard of living they had before retirement. In addition, about half of working households could not estimate how much they would need to spend in retirement, which likely added to their anxiety. Public education about consumption in retirement could help reduce this gap between the perception and the reality of retirement.

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[6] The percentage on track for retirement increases by 6 percentage points for households with a DC plan or group RRSP that do not contribute enough, and 12 percentage points for households without an employer plan and with below-average personal savings.

[7] For example, if a household spends $30,000 per year on average prior to retirement, it will likely spend ~$20,000 per year in retirement to maintain the same lifestyle.

Toward a Balanced Solution

McKinsey's 2014 analysis of retirement readiness in Canada reveals that the challenge is a relatively narrow one. Those households still at risk belong primarily to two groups in the mid- to high-income cohort: those that do not contribute enough to their DC plan or group RRSP and those that do not have access to a DC plan or group RRSP and have low personal savings.

As Canada addresses the issue of retirement readiness for its populace, therefore, solutions should be targeted at those groups that need the most help, while avoiding unintended negative consequences. When evaluating potential solutions, it is useful to look at the impact in terms of four criteria: effectiveness, fairness, efficiency and impact on the economy.

- *Effectiveness.* Does a solution increase the retirement readiness of the most exposed households and mitigate key risks such as longevity and market risks? (See Appendix B for more detail on longevity risk.) For example, a mandatory increase in retirement contribution for all would be less effective than a selective increase for those without a DB plan or those not contributing enough to their DC plans nor saving enough.
- *Fairness.* Does the solution limit intergenerational and intragenerational transfers and continue to allow for personal financial choice? For example, mandatory auto-enrollment plans (whether public or private) could allow for households to opt out.
- *Efficiency.* Is the new approach cost-competitive for both pre-retirement saving and dis-saving after retirement, and does it minimize the administrative burden for employers? A straightforward increase in contributions for all employees, for instance, would be more efficient for employers.
- *Impact on the economy.* Does the solution limit concentration of savings and investments, minimize disincentives to work and save, limit impact on labour costs, and stimulate small businesses/startups? For example, a solution providing viable options for those employed by small businesses/startups to start building a retirement program without placing a burden on the employers would be beneficial for the economy; a solution providing an incentive for later retirement while imposing a penalty on early retirement could also minimize the disincentive to work and save.

A number of potential solutions have been debated and/or implemented across Canada, including a general CPP expansion, the Voluntary Retirement Savings Plan (VRSP) in Quebec, and the Ontario Retirement Pension Plan (ORPP). Each potential solution meets some of the four criteria while failing to meet others.

Solutions like a CPP expansion are supported by a solid track record, offering efficiency through existing economies of scale and facilitating intergenerational risk pooling. However, they may force those already on track for retirement to oversave. They may also hurt the economy by increasing labour costs.

The ORPP, currently under debate, is similar to a CPP expansion but exempts select groups such as DB plan holders and the self-employed. Although the proposal would improve retirement readiness, it may have unintended consequences, such as leading modest-income households and households contributing enough to DC plans to oversave. It may also result in a low or even negative return to some Ontarians due to the clawbacks on federal programs (e.g., OAS, GIS).

Other solutions, meanwhile, like an auto-enrollment PRPP, more effectively address the most exposed households, offering higher coverage rates and en-

abling personal life tradeoffs. Moreover, the absence of a mandatory contribution for employers makes them easier to implement. However, these DC solutions may place high administrative burdens on employers and increase the risks (e.g., longevity risk) borne by individuals. High opt-out rates may also diminish the effectiveness of such solutions.

If the retirement challenge facing Canada were widespread, a universal solution might be the best course. However, given that the existing system works well for the majority of households, targeted solutions bringing marginal improvement in certain areas may be the more efficient way to address the issue.

Setting a Course For Full Retirement Readiness

The challenge for governments, retirement providers, employers, and individuals is to arrive at a solution that lifts the retirement prospects of those currently off track, while being efficient, fair, and good for the economy. In the context of a generally high level of retirement readiness and a current system that does not make retirement savings attractive to everyone,[8] the best course may be to proceed in a targeted way, taking into account the second-order effects of each proposed reform.

However, in the short term, the various stakeholders could consider taking actions to collectively make the retirement system more robust.

[8] The current system heavily taxes additional tax-deferred retirement income through clawbacks of government benefits, which potentially makes most solutions benefit governments more than the individuals in need. See Appendix C for a more detailed description of Canada's tax and benefit structure.

- **Governments** could continue to ensure the sustainability of the OAS, GIS, CPP and QPP programs, which are the foundation of the retirement system. They could make adjustments to respond to demographic shifts, seek solutions that help the segments of the population that run the risk of poverty in retirement, and address the policies that reduce the attractiveness of retirement savings for many Canadians. Whatever solutions governments implement to augment retirement readiness, they would want to preserve what works well in the current system.

Auto-enrollment could be used to increase overall plan participation rates, and regular financial education could help employees properly plan for their retirement.

- **Private providers** of individual savings and group pensions could consider innovative ways to better address the needs of their customers. For example, some retirees are counting on their own assets for the majority of their financial needs in retirement and therefore risk running out of money if they live longer than expected. Solutions that help retirees easily convert financial assets into annuities could help manage this risk, which will become increasingly prevalent as DC continues to grow. The industry could also develop ways to lower the administrative burden on employers, for instance, by simplifying investment options and contribution administration. This would benefit small employers and startups in particular, and increase overall plan coverage for the population.
- At a minimum, **employers** could provide access to a retirement plan for their employees. Those with plans in place would want to ensure those plans continued to be appropriate as circumstances changed. Auto-enrollment could be used to increase overall plan participation rates, and regular financial education could help employees properly plan for their retirement. Employers could also increase employee contribution rates by offering a contribution match if they did not already do so.
- Lastly, in a system that balances government-provided minimum guarantees with **individual** responsibilities, each individual has a critical role to play in ensuring his or her own readiness for retirement. Even with a retirement system as robust as Canada's, individuals risk a decline in their standard of living in retirement if they do not contribute sufficiently to their pension plans or maintain a reasonable level of personal savings. They could start by proactively and objectively educating themselves on the facts of their financial position. They could optimize contributions to RRSP and TFSA accounts in the context of a broader financial plan that bal-

The structure of the Canadian retirement system

Canada's retirement system is supported by five pillars (Exhibit 6).

- **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)
- **Pillar V:** Non-financial assets including real estate, farm equity, and small business ownership

Although Pillars I and II provide some level of retirement income universally, a high rate of defined benefit penetration and individual registered savings contribute in roughly equal parts to sizable Pillar III assets. While Pillar III is more important than Pillar IV for most households, the wealthiest households rely more on Pillar IV assets because of the absolute limit on Pillar III contributions. (As some households consume a percentage of home equity and nonfinancial assets in retirement, the RRI is calculated both without Pillar V assets and with part of Pillar V assets considered.)

Exhibit 6

Canadian retirement pillars with asset size

	Description	Programs in place	Total assets, 2013 C$ trillion
Pillar I	Government-funded basic guarantee	Old-Age Security (OAS) Guaranteed Income Supplement (GIS)	N/A[1]
Pillar II	Mandatory public retirement plan	Canada Pension Plan (CPP) /Quebec Pension Plan (QPP)	0.2[2]
Pillar III	A: Voluntary group retirement plan	Defined Benefits Registered Pension Plans (DB)	1.2
		Workplace capital accumulation plans (CAP) - Defined contribution plans - Group RRSPs - Deferred profit sharing plans - Group tax-free savings account plans	0.1
	B: Voluntary individual retirement plan	Registered Retirement Savings Plans (RRSP) Registered Retirement Income Funds (RRIF) Tax-Free Savings Accounts (TFSA)	1.2
Pillar IV	Non-registered financial assets	All non-registered financial assets (e.g., stocks, bonds, mutual funds, life insurance)	2.1
Pillar V	Home equity and non-financial assets	N/A	3.6
			Total = ~C$8.4 trillion

[1] The OAS/GIS programs are not capitalized

[2] The CPP/QPP is only partially capitalized

Source: Statistics Canada; Department of Finance Canada; CPP; QPP; Canadian Institutional Investment Network; industry publications

ances savings with other financial needs and mortgage/debt repayments. If no employer pension plan is provided, they could aim to maintain a sufficient level of personal savings. Discipline, planning and saving form the foundation for any successful retirement system.

■ ■ ■

Despite the general perception of a retirement crisis in Canada, McKinsey's 2014 RRI survey confirms our earlier analysis showing that a strong majority of Canadian households are on track for retirement. However, 17 percent of households are not on track. Targeted actions rather than universal reform would help Canada address the lack of readiness of these households fairly and efficiently, while remaining a good steward of the economy. And, although a perfect solution may not exist, if all stakeholders do their part, Canadians' already high standard of retirement readiness would be strengthened and all households could have the opportunity to approach their retirement without the risk of running out of money to live.

Pooneh Baghai

Fabrice Morin

The authors would like to acknowledge the contribution of colleague Mei Dong to this report.

Appendix A:

The McKinsey 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. In Canada, the RRI takes into account all five pillars of retirement, including all financial assets held by households and part of home equity and other non-financial assets (the RRI base scenario excludes non-financial assets and another scenario is calculated with partial non-financial assets).

An RRI of 100 means that a household is on track to maintain the same level of consumption in retirement that it had before retirement. This level is defined by the annual real amount a household has available for consumption after taxes and fixed charges, assuming no legacy beyond home equity and non-financial assets. A household with an RRI above 100 could increase its consumption in retirement or maintain it and leave an inheritance. A household with an RRI below 100 would be forced to reduce its consumption in retirement or delay retirement.

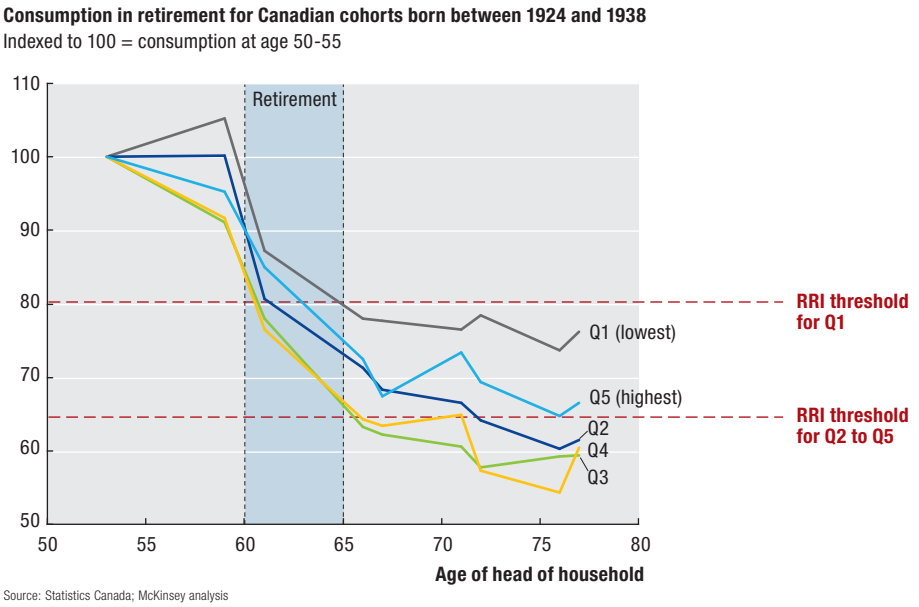
Based on a historical analysis of retired Canadian households' consumption, those below the RRI threshold of 80 for the first income quintile and of 65 for all other income groups have been defined as not being on a path to adequate retirement income (Exhibit 7, page 18). These thresholds are reflective of the average consumption adjustment sustained by current retirees based on historical Statistics Canada consumption surveys. These surveys show that current retirees that were in the lowest income quintile compress consumption in retirement to about 80 percent of their pre-retirement consumption level and that all other groups compress consumption in retirement to about 65 percent of their pre-retirement consumption level. The McKinsey 2014 Retirement Survey of retired households further confirmed that current Canadian retirees spend less than 60 percent of their pre-retirement consumption level and that the majority are not income-constrained. Fourteen percent of households currently retired are spending more in retirement; 53 percent are spending less but do not feel the need to spend more; and 33 percent said they would spend more but feel financially constrained.

RRI is consistent with other studies that have been done on the topic, after adjusting for assumption and methodology differences, including consumption re-

[9] For example, after adjusting for major assumption and methodology differences, our result (83 percent above threshold) is within 5 percentage points of the result produced by a retirement saving adequacy study conducted by Horner in 2009 and referenced by Mintz in 2013.

Exhibit 7

Historical consumption pattern by income quintiles



Source: Statistics Canada; McKinsey analysis

placement thresholds, tax rates, and investment rates of return.[9] The remaining minor differences between studies tend to be due to variances in data sources and granularity, which are harder to reconcile but do not lead to significantly different results.

Survey methodology

The analysis underlying this report is based on a refreshed survey conducted by Ipsos in July 2014. A sample of about 9,000 working-age households (i.e., between the ages of 25 and 65), with annual incomes between $10,000 and $250,000 per year was retained for the analysis. Responses were weighted by income, age, region and household composition to generate a representative view of the Canadian population. Separately, a sample of about 3,000 retired households was analyzed for consumption patterns in retirement. This paper focuses on the survey and analysis conducted for the working-age households.

To project the working-age households' paths to retirement, the survey gathered detailed information on the households' assets, debt and savings habits.

Retirement Readiness Index methodology

The RRI measures the ratio between the projected amount available for consumption in retirement and the consumption level pre-retirement. Disposable income in retirement is obtained by projecting the current assets and future savings of each household, assuming a long-term compounded real return on assets of 3.5 percent per year. Overall RRI and

percentage of on-track households are not sensitive to adjusting most assumptions (Exhibit 5, page 8).

Assets at retirement are then converted into annual income through retirement at current real annuity rates. Annuities insure each household against longevity risk. These annuities could be acquired over multiple years to manage market timing risk. Income from OAS, GIS, CPP/QPP, and DB plans (if applicable) are added to the annuity coming from accumulated savings. Income taxes are applied using the current tax tables in each province. Projections take into account the tax treatment of registered retirement plans.

Simulation of potential measures to improve retirement readiness

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

The survey data and the model could be used to simulate other potential measures or combinations of measures and to better understand their likely impact.

Comparison with results published in 2012

McKinsey initially published an assessment of the retirement security of Canadians in 2012 (*Are Canadians Ready for Retirement? Current Situation and Guiding Principles for Improvement*), based on the results of a survey conducted by Ipsos between December 2010 and January 2011. In the 2014 refresh, we leveraged our past experience to improve both the survey questions and the analysis methodology. The majority of the 6 percentage point increase (from 77 to 83 percent) in households on track for retirement is due to more representative data and improved analysis methodology.

The major differences between the results published in 2012 and those in this report are:

- The questions about pension plan participation were simplified and clear definitions of defined benefit and defined contribution plans were provided, leading to more accurate survey results that align closely with public data.
- Respondents were asked to provide information on both primary and secondary pension plans (e.g., from a previous employer), instead of just primary pension plans.
- A more realistic range of expected retirement age was captured in the 2014 survey, which led to an increase in the average expected retirement age.
- The tax calculation in the model was updated to account for differences in tax rates among Canadian provinces.

Appendix B:

Definition of Longevity Risk

Longevity risk is commonly defined as the risk of outliving one's financial assets. However, a more accurate definition includes three categories of risks.

- Individual risk: The risk that an individual will live longer than average and as a result not have sufficient assets to maintain a stable living standard. For example, an individual may not be able to afford living expenses, home-care service or prescription drugs in old age above average life expectancy. Given that Canadian households have a significant portion of income in retirement annuitized, individual risk affects only a small fraction of households.
- *Systemic risk:* The risk associated with the increase in longevity in the general population. This could lead to, for example, DB plan or annuity product funding shortages because of errors in predicting the average life expectancy. (A difference of 1 year in life expectancy can result in an estimated 4 percent difference in annual benefit payout.) Data show that the increase in life expectancy for Canada is slow (about 3 years per decade). However, significant adjustments had to be made recently because of an underestimation of the future pace of longevity increases.
- *Demographic shift:* The risk posed by a declining proportion of the working-age population and an increasing proportion of the retired population relying on the benefits of unfunded programs. A shift of this nature could jeopardize the funding position of social programs such as OAS, GIS, CPP/QPP, and the provincial healthcare plans. The demographic shift is already underway, and the magnitude of the risk for Canada will be significant as the shift continues. Some social programs like the QPP have already increased contribution rates to cope with the demographic shift. However, it is worth noting that the increase in the funding of social programs is not driven purely by the demographic shift. For example, the increase in medical costs is attributed much more to the increase in staff costs, drug R&I costs, and the use of advanced technology.

Appendix C:

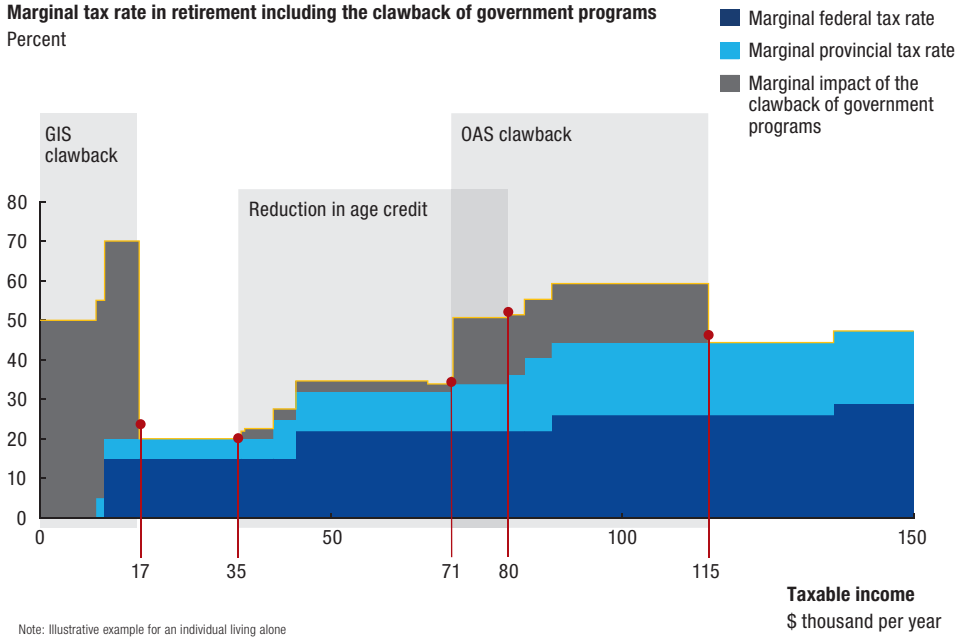
Disincentive to Save Given The Current Tax and Benefit Clawback Structure of Canada

Canada's tax system is designed to be progressive: higher income generally leads to constant or higher marginal rates of taxation. However, when clawbacks of social programs are considered, the marginal effective tax rate in retirement is very inconsistent at different income levels. For example, GIS benefits are reduced by 50 cents on the dollar in a low-income range and OAS benefits are reduced by 15 cents on the dollar in a mid-income range, leading to peaks of effective marginal taxation around the clawback thresholds of these programs (Exhibit 8). While clawbacks are conceptually a fair way to reduce public benefits as retirement income increases, the current thresholds and magnitudes of reduc-

Exhibit 8

Curve of federal and provincial taxes and clawbacks for Ontario

Marginal tax rate in retirement including the clawback of government programs
Percent



Note: Illustrative example for an individual living alone
Source: Department of Finance Canada; Ontario Ministry of Finance

tions may discourage Canadians from saving or working if they are about to enter these clawback zones.

In addition, multiple tax credits are clawed back as retirement income increases, like the age tax credit in almost all provinces. These tax credit reductions further contribute to the peaks and valleys of the total marginal tax rate curve and result in households having to make difficult decisions to avoid the peaks. The complexity of the system for Canadians planning their retirement is a concern. Adjusting the Canadian retirement system to be fair and simple could be an important step in further improving it.

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Financial Services Practice
February 2015
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