Benefits CANADA

High inflation supercharging decumulation challenges

By: Michael McKiernan | February 10, 2023 | 08:55

Michael McKiernan

Finance's toughest problem just got a whole lot trickier, thanks to the quandary of inflation.

Legendary economist William F. Sharpe sealed his place in history when he collected the 1990 Nobel Memorial Prize in Economic Sciences for his work on investment decision-making, but in defined contribution pension circles, the emeritus professor at Stanford University is at least as well remembered for his extremely quotable description of decumulation as the "nastiest, hardest problem in finance."

Those words — which came from a 2014 interview — still strike a chord with Joe Nunes, executive chairman of Actuarial Solutions Inc., although he says they no longer tell the whole story for those struggling to strike the appropriate balance between their current and future income requirements in retirement.

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"Decumulation has been on everyone's radar for the last five or 10 years, but we've only made incremental progress on solving the problem. The reality is that it is very difficult to manage in a low-inflation environment. But when the rate gets up to the higher numbers we've seen recently, managing decumulation becomes almost impossible.

"It's a very uncomfortable time for someone who has already retired, having made certain projections about how much you would need to get you through the remainder of your life, because now you're in a situation where inflation is eating into your monthly budget," he adds.

Rock bottom to 'not earth shatteringly high'

According to Statistics Canada's consumer price index, the country's annualized inflation rate peaked at 8.1 per cent in June 2022, but has yet to drop back below six per cent. This is after three decades when the annual rate never crossed the three per cent threshold.

In response, the Bank of Canada ended a prolonged period of rock-bottom interest rates dating back to the outset of the coronavirus pandemic with a series of hikes between March and December 2022 that pushed its key overnight rate from 0.25 per cent to 4.25 per cent, the highest level since the 2008/09 global financial crisis.

Still, it's important to keep things in perspective, says Steve Eadie, a pension consultant with Robertson Eadie and Associates who also chairs the Ideal Canadian Pension Plan, a multi-employer collective DC plan. "I'm 63 now, so I'm old enough to remember taking on a mortgage in the 1980s at 15.5 per cent and thinking I'd died and gone to heaven. At that time, interest rates were almost up to 20 per cent and inflation was much higher than it is today. The last few years have been historic lows, so rates are higher now than we are used to, but not earth shatteringly high."

Read: ACPM calling on feds, CAP sponsors to increase focus on decumulation

For those at — or approaching — retirement, much will depend on the stickiness of higher inflation, says Eric Monteiro, senior vice-president of group retirement services at Sun Life Financial Inc., whose glass is half full on the matter. He's hoping the current spell is transitory and that inflation will return to lower levels within one to three years. "But the effects of transitory inflation are permanent. . . . The purchasing power you lost never comes back."

> **By the numbers**
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> **$1.5 trillion** — Total assets held by Canadians in registered individual retirement vehicles such as DC plans, RRSPs, DPSPs and RRIFs, according to Statistics Canada
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> **4.25%** — Bank of Canada's key overnight interest rate as of December 2022, the highest rate since 2008
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> **8.1%** — Canada's annualized inflation rate for June 2022, according to Statistics Canada's CPI

With higher interest rates, the story is more nuanced, he adds, noting it could actually have a bit of an upside because of the potential for higher returns from fixed income investments, as well as more attractive pricing on annuities — another key decumulation option for many retirees.

In the meantime, Idan Shlesinger, the former president of retirement and financial solutions at LifeWorks Inc., says individual retirees have relatively few options to deal effectively with inflation risk. Still, those who are able may wish to consider deferring their Canada Pension Plan and old-age security benefits, since these

payments are indexed to inflation. “If you can use other sources of income to bridge the gap, then you get more value by pushing your indexed pension payments as late as possible, where inflation has the biggest impact.”

However, he adds, none of these choices compares to the investment strategies indirectly available to plan members when they’re able to keep their funds inside a DC plan after they’ve retired. “In this environment, anything a plan sponsor can do to help stretch participation in the plan longer has a huge impact. An institutional investor can hedge more effectively against inflation by investing in real return bonds, infrastructure and other assets that are not really available to individual investors in any meaningful way.”

Evolving objectives

In-plan decumulation goes against the traditional view of capital accumulation plans held by some employers, many of whom got into them as a way to reduce the liabilities associated with running a defined benefit pension plan, says Monteiro.

“Decumulation really is all about turning savings into income and a lot of plan sponsors see that as ‘not my problem.’”

Read: Saskatchewan amending pension legislation to include more decumulation options, solvency reserve funds

But the prevailing view from DC plan sponsors is evolving as the space matures and a critical mass of members near retirement, he adds. “Some are starting to change their CAP objectives to specifically state that the objective of the plan is to provide lifetime income and therefore decumulation is an important part.”

Even if plan sponsors don’t yet offer in-plan decumulation solutions, Monteiro says they’re more likely to take an active role educating and advising members on their post-retirement options or roll them over into group registered retirement income fund or life income fund accounts with the same record keepers that operate their accumulation products.

Either route is better than leaving retirees to fend for themselves in the retail space, he adds. “Typically, the answer for all problems at the bank is a mutual fund. They don’t have a great set of decumulation solutions to offer for the mass market, median and average member.”

> **Key takeaways**
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> • The high rate of inflation has enhanced the challenges of decumulation by eating into retirees’ expected incomes. On the bright side, higher interest rates could offer some respite by boosting fixed-income returns and reducing the price of annuities.
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> • As the DC space matures, more plan sponsors are paying attention to the issue and exploring ways to support their members after retirement, including building decumulation solutions into their pension plans.
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> • More decumulation options will be coming soon once provinces pass enabling legislation to allow for the creation of VPLAs and ALDAs.

Cases in point

At the University of British Columbia’s faculty and staff pension plans, members leave an average of 80 per cent of their assets inside the plan on retirement, according to Debbie Wilson, UBC’s director of pensions, who attributes the high retention rate, in part, to the comfort level members built up over years of interacting with the plan.

“The fees that our funds charge are typically much less than they would get in the marketplace, so it’s low cost and they can stick with the investments they are familiar with. They also know the plan has strong oversight from the board of trustees and that it is well managed. It does require extra work by the sponsor, but our trustees believe in helping people, both during their service and during retirement.”

Read: Report urges DC pension plan sponsors to focus on decumulation

Plan members choose between LIF- or RRIF-type payment accounts depending on whether their funds are locked in, as well as a variable payment life annuity, which pays out a monthly pension from a pooled fund, with the amount of the payment adjusted (up or down) once per year based on performance.

The UBC VPLA survived legislative changes in the 1980s when it was grandfathered before serving as the inspiration for fresh amendments to the Income Tax Act in 2019 that aim to allow other financial institutions to set up their own versions.

While further legislation is required at the provincial level before VPLAs can go into effect, Shlesinger says they’ll offer a great mechanism for individual retirees to pool both their investment and their longevity risk. “It mirrors a target-benefit plan, but without the sponsor acting as backstop. The great thing about a VPLA is that, once you get the legislation and regulations in place, a large plan sponsor or smaller ones in groups can put it into effect without a new financial product being created.”

The ICPP is already working on its own VPLA as a basic income option for members, with the aim of matching its annual adjustments to inflation over the long term. To limit anti-selection risk, Eadie says the ICPP plans to cap the annual pension payable from the pooled fund at $30,000 in today’s dollars. The plan will also pay out a death benefit until the number of members passes 100, in order to eliminate any associated moral hazard.

Read: A look at the Co-operators Group’s new decumulation offering

“You don’t want the remaining recipients to get a big windfall from another member’s death. It stops people trying to game the system.”

The 2019 ITA amendments also cleared the way for the creation of advanced life deferred annuities — a guaranteed lifetime annuity that allows payments to begin when the individual turns 85, rather than forcing them to start collecting at 71, when the price is much more expensive.

Jillian Kennedy, a partner at Mercer Canada, says it’s an exciting time to be involved in decumulation. “We welcome any new retirement income products, because we do need to see more options.”

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