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/Report
CANADIAN EDITION

Assuming more responsibility for retirement: The reality of preparedness and building a sustainable income.

The BMO Wealth Institute provides insights and strategies around wealth planning and financial decisions to better prepare you for a confident financial future.

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The media today is full of reports about Canada's aging population. Baby Boomers represent one third of the more than 31 million Canadians, and it's estimated that 20 per cent of Canada's population will be over 65 by 2020. Soon, the huge Baby Boom generation will transition into retirement, significantly changing society's notion of that phase of life and how people can best prepare for it.

The approaching retirement of the boomer generation is focusing public attention on retirement income and asset management. A report by the Life Insurance Marketing Research Association (LIMRA) and the Society of Actuaries concludes that future retirees will be forced to take more responsibility for their retirement than previous generations. With this increased level of responsibility, Canadians will have to make key decisions about when they can afford to retire, what they should do with their assets and savings at retirement to create a stable income, how much they can afford to spend each year, and how they can protect themselves against uncertainties, such as the need for long-term care and death.

Unprepared for retirement

Numerous reports and studies indicate that aging Canadian boomers simply are not financially prepared for retirement.

One of the main reasons for this lack of preparedness is that fewer Canadians are covered by a registered pension plan (RPP). Between 1991 and 2004, the number of paid workers covered by an RPP declined to 39 per cent from 45.3 per cent. At the same time, the proportion of workers covered by defined benefit pension plans is declining. Individual and group RSPs are defined contribution plans, which transfer the risk of providing sufficient retirement income from the employer to the employee. More and more employers today are offering some form of defined contribution plans, which may result in employees having lower benefits at retirement than if they had defined benefit plans.

Canadians don't seem to be taking measures to compensate for insufficient employer pensions. A recent study by the Canadian Institute of Actuaries and the University of Waterloo concludes that two thirds of Canadian households expecting to retire in 2030 are not saving enough to meet necessary living expenses such as food, shelter, clothing, transportation,

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health care, energy and taxes. To generate sufficient income in retirement to pay for these expenses, retired Canadians will need some combination of Old Age Security (OAS), Canada or Quebec Pen¬sion Plans (C/QPP), home ownership, participation in a workplace pension plan, and savings through a Registered Retirement Savings Plan (RRSP) as well as non-registered savings.

Maintaining a secure income in retirement is one of the key challenges facing older workers today. A recent Statistics Canada survey has found that higher income workers will experience greater declines in their incomes by the time they are 75 than lower income Canadians, primarily because of the income maintenance impact on them from the public pension system (C/QPP, OAS and Guaranteed Income Supplement).

Helping Canadians prepare

Giving Canadians the opportunity to take more responsibility for their financial future increasingly is becoming a focus of government fiscal policy in Canada. The last two federal budgets have contained tax and other measures that allow and encourage Canadians to save more for their retirement.

For many years, Canadians were big savers of their money. In March of 1982, for example, they tucked away an average of 21.2 per cent of their disposable income. Since then, the rate of savings has declined steadily to the point where Canadians saved a mere 0.8 per cent of their disposal income in December 2007. "For many years Canadians were financially conservative, saving more than their counterparts south of the border," says Ian Niven, Managing Director of Investment Management with BMO Harris Private Banking. "But over the last several years, Canadians have been spending their money more freely. Their level of savings has dropped and the government would like to see them get back on the savings bandwagon. There has been a real attempt by the finance department to get people to invest and create their own financial nest eggs so they can become less reliant on the government for support."

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The most recent government initiative was the new Tax Free Savings Account (TFSA) in the 2008 budget. Starting in 2009, Canadians 18 and older will be able to put up to $5,000 a year in a TFSA in virtually any sort of investment, and all investment income generated will be tax-free, including when the funds are withdrawn.

TFSAs will have lots of appeal to Canadians. Seniors will be able to use these accounts to have access to tax-free income while not affecting their eligibility to receive the OAS. It also has appeal for those in their prime accumulating years and those who are actively building retirement assets.

Other important changes introduced in the last two years include income splitting for seniors, raising the RRSP age limit to 71 from 69, measures that encourage older workers to stay in the workforce and continue to receive partial pensions and accrue further pension benefits, and measures that give people on government assistance incentive to get into the workforce and establish careers. "The government has finally broken down and adapted to the reality of what's going on in retirement today," says Niven.

With more people entering retirement and the average life span of Canadians getting longer, the focus of retirement planning is quickly becoming one of managing risk and creating a predictable income rather than just accumulating and managing assets. "One of the numerous misconceptions about retirement planning is that all you have to do is maximize your RRSP or save enough, invest for growth, and your retirement will be fine," says Moshe A. Milevsky, Associate Professor at the Schulich School of Business, York University, and a member of the BMO Bank of Montreal Advisory Council on Retirement. "The truth is, that is just the beginning. We are entering an era of personal financial risk management which will overshadow the era of personal wealth management."

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Building a predictable retirement income

The expanded life expectancy of boomers means they will most likely be spending more in retirement as well. Most retirees can't afford to lose capital during retirement because they don't have time to make it up. Prudent financial planning would dictate that people become more conservative as they approach retirement and maintain this strategy in it. Building a steady, predictable and sustainable income stream is vital for maintaining quality of life in retirement.

LIMRA has found that 76 per cent of Baby Boomers have no plan in place to convert their lump sum retirement assets into a steady stream of predictable and sustainable income. What can be done? Researchers at the University of Pennsylvania and Brigham Young University have found that lifetime annuities can fund a secure retirement with lump sums of assets that are 25 per cent to 40 per cent smaller than an individual would need if he or she were using other types of investments. An annuity is a promise to pay an income for life for a specified period of time. It provides guaranteed income payments in exchange for an up front lump sum deposit for as long as the annuitant lives. “Including annuities in an investment portfolio is probably one of the most effective methods to provide guaranteed income,” says Milevsky. “It’s important to recognize that an investment in an annuity is permanent. Therefore, people usually do not invest all their assets in annuities but rather tend to allocate a portion of their portfolio to a fixed-income type of solution to cover their day-to-day expenses.”

There are many options of annuities. They can be indexed for inflation, offered on a single or joint life, and can be purchased with either regis¬tered or non-registered money. Term certain annuities provide investors with a guaranteed regular income for a selected period of time. But once that period is over, payments cease and the contract ends. Prescribed annuities offer some preferential tax treatment if you are investing in annuities using non-registered funds, and accelerated annuities offer higher income payments for people with serious health conditions. Annuities can also have a last survivor feature to provide income for a surviving spouse.

There are numerous other investment options available to help Canadians maximize their income in retirement. Income from corporate dividends is taxed more favourably than interest income. Preferred shares, income trusts and closed income funds offer fairly attractive yields while vehicles such as convertible debentures and equity-linked notes offer investors a combination of income and the potential for capital appreciation.

Life-cycle funds are a relatively new class of mutual fund in Canada that mature on a specific date in the future, typically five years or longer, that coincides with an important event such as retirement. As the target end date approaches, the overall asset allocation of the fund automatically adjusts to become more conservative, helping investors take advantage of market growth opportunities at the beginning while protecting the value of the fund as it gets closer to maturity.

A call to action

As the demographic landscape changes and more and more Canadians enter the retirement phase of their lives, retirement planning will take on a new meaning. No longer will Canadians be concentrating on accumulating assets for some future date. They will be using accumulated assets to fund the next phase of their life. Concerns will shift from savings plans to managing market returns, maintaining purchasing power, creating lifetime tax efficient income streams and managing withdrawals. This added complexity means Canadians should consult a professional financial advisor to determine which of the many options available on the market suit their present and future needs, because the decisions they make today will influence the way they live in the future.

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