CISRO / OCRA

Segregated funds and annuities

Life Licence Qualification Program (LLQP) Exam Preparation Manual

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FOREWORD

This Manual is an exam preparation tool for future life insurance agents registered in the Life License Qualification Program (LLQP). Its contents will help candidates develop the competency targeted in the segregated funds and annuities module of the LLQP Curriculum: *Recommend segregated funds, individual annuities and group pension plans adapted to the client's needs and situation.*

Chapter overview page

The first page of every chapter outlines the Curriculum module competency components and sub-components that will be covered. Highlighting which of the evaluation objectives are addressed in each of the manual's chapters serves to identify the contents that are essential to attain these objectives.

It is thus recommended that candidates regularly review the competency components and sub-components in order to contextualize and assimilate them as they read each chapter. This will help develop an understanding of the nature and scope of the evaluated competency. Candidates must have fully understood the knowledge, strategies and skills covered in each chapter in order to successfully pass the corresponding module of the LLQP licensing exam.

In this text, the masculine form is used for both men and women.

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LIST OF ABBREVIATIONS

ACB	Adjusted cost base
ALDA	Advanced life deferred annuity
APS	Attending Physician's Statement
AVC	Additional voluntary contributions
CAP	Capital accumulation plan
CAPSA	Canadian Association of Pension Supervisory Authorities
CCIR	Canadian Council of Insurance Regulators
CDIC	Canada Deposit Insurance Corporation
CESG	Canada Education Savings Grant
CIFSC	Canadian Investment Funds Standards Committee
CIPF	Canadian Investor Protection Fund
CISRO	Canadian Insurance Services Regulatory Organizations
CPB	Canada Premium Bond
CPI	Consumer Price Index
CPP	Canada Pension Plan
CRA	Canada Revenue Agency
CSB	Canada Savings Bond
DAP	Disability Assistance Payment
DBPP	Defined benefit pension plan
DCPP	Defined contribution pension plan
DPSP	Deferred profit sharing plan
DSC	Deferred sales charge
EAP	Education Assistance Payment
ETF	Exchange-traded fund
FEL	Front-end load
FINTRAC	Financial Transactions and Reports Analysis Centre of Canada
FMV	Fair market value
FTC	Fair Treatment of Customers
GIC	Guaranteed Investment Certificate

GIS	Guaranteed Income Supplement
GLWB	Guaranteed Lifetime Withdrawal Benefit
GMWB	Guaranteed Minimum Withdrawal Benefit
GRRSP	Group registered retirement savings plan
HBP	Home Buyers' Plan
HELOC	Home equity line of credit
HIO	Head of an international organization
IIROC	Investment Industry Regulatory Organization of Canada
IPC	Investor Protection Corporation
IPP	Individual pension plan
ITA	*Income Tax Act*
IVIC	Individual variable insurance contract
KYC	Know Your Client
LDAP	Lifetime Disability Assistance Payment
LIF	Life income fund
LIRA	Locked-in retirement account
LLP	Lifelong Learning Plan
LRIF	Locked-in retirement income fund
LRSP	Locked-in RRSP
MEPP	Multi-employer pension plan
MER	Management expense ratio
MFDA	Mutual Fund Dealers Association
MPP	Money purchase plan
MTR	Marginal tax rate
MVA	Market value adjustment
NAVPU	Net asset value per unit
NAV	Net asset value
NOA	Notice of Assessment
OAS	Old Age Security
PA	Pension adjustment
PAD	Pre-authorized deposit or debit

PCMLTFA	Proceeds of Crime (Money Laundering) and Terrorist Financing Act
PEFP	Politically exposed foreign person
PEP	Politically exposed person
POA	Power of attorney
PRB	Post Retirement Benefit
PRIF	Prescribed retirement income fund
PRPP	Pooled registered pension plan
PRRIF	Prescribed registered retirement income fund
PSPA	Past service pension adjustment
QPP	Québec Pension Plan
RDSP	Registered disability savings plan
REIT	Real estate investment trust
RESP	Registered education savings plan
RLIF	Restricted life income fund
RLSP	Restricted locked-in retirement savings plan
RPP	Registered pension plan
RRIF	Registered retirement income fund
RRSP	Registered retirement savings plan
SERP	Supplemental Executive Retirement Plan
SIN	Social Insurance Number
SWP	Scheduled withdrawal plan
T-18	Term annuity-to-age-18
T-90	Term annuity-to-age-90
T-100	Term-100
TER	Trading expense ratio
TFSA	Tax-free savings account
VPLA	Variable payment life annuity
VRSP	Voluntary retirement savings plan
YMPE	Year’s maximum pensionable earnings

CHAPTER 1
INVESTMENT AND SAVINGS

Competency components

- Assess the client's needs and situation;
- Analyze the available products that meet the client's needs;
- Implement a recommendation adapted to the client's needs and situation.

Competency sub-components

- Determine the client's situation, investment objectives, and investor profile;
- Articulate the client's needs based on the risks that could affect his financial situation;
- Analyze the advantages of segregated funds in comparison to other types of investments in regard to the client's needs;
- Propose a recommendation adapted to the client's needs and situation.

1
INVESTMENT AND SAVINGS

Segregated funds and annuities are investment and savings products marketed to individual and group prospects and clients. Segregated funds are exclusive to the life insurance industry. Only licensed life agents can represent segregated funds. Some annuities are also exclusive to the life insurance industry. Others are sold both by licensed life agents and by other financial institutions, such as banks.

Segregated funds and annuities provide guarantees to investors. They can help some investors reach their financial objectives, such as retirement.

Many options are available for those who save, and have the desire to invest those savings. Every option has features suitable for some investors, but not others.

The life agent has a duty to clients to identify which investment is in their best interest, to represent information fairly and to know the limits on the advice he is authorized to give.

1.1 Investment and saving principles

There are certain time-honoured principles that apply to investing and saving. It is essential to understand these basics, which are the foundation of all investing and saving, before focusing on segregated funds and annuities in particular.

1.1.1 Concept of investing

Investing can only begin when an individual has savings in the bank or has the ability to set money aside from income that can be earmarked for savings. You may find that some coaching is required to get your client on the path to saving, so that investing can begin and wealth is accumulated.

How can saving be simplified and encouraged? There are some old stand-by methods that have stood the test of time. They include:

- **Pay yourself first:**
  Make savings an item on the budget, just like any other expense. This reduces the temptation to spend. For instance, a pre-authorized contribution (PAC) or pre-authorized deposit (PAD) to a savings or investment account is a highly effective way to build savings.
- **Save 10% of take-home pay:**
  Exactly as its name says but the percentage may need adjustment according to individual circumstances.
- **Save exceptional payments:**
  Save money received from an income-tax refund or a work bonus.

- **Set up savings buckets:**
  A savings bucket has a dedicated purpose. It is rewarding to see savings goals for specific objectives being reached and can reinforce savings habits. Buckets could include retirement, holidays, or big-ticket items such as a car.
- **Budgetting:**
  Budgetting is crucial for managing day-to-day finances and allocating a sum for saving.

When savings have accumulated or can be earmarked, then it is time to start considering how to grow that money through investing.

Investing is the process of using savings to purchase investment products with the goal of making money. A business invests money in new equipment, for instance, that will help it make more products faster or cheaper. The business profits from its investment. The goal of individual investors is to invest a sum, called principal or capital, in an investment product that will be repaid to the investor plus a profit. That profit is called the return.

Many investment products are available for individual investors. Some investments guarantee that the full amount invested will be repaid plus a profit. These investments include Guaranteed Investment Certificates (GICs), and some bonds. Other investments do not guarantee that the amount invested will be repaid. These non-guaranteed investments include stocks, mutual funds, and real estate.

EXAMPLE

Jean is 78 years old and depends on the returns from her investments to generate income to support her in retirement. Her investments, combined with her pensions, allow her to live comfortably. Jean feels that she cannot afford to risk her invested money in an investment that would not pay both her principal plus the stated return. Therefore, Jean chooses guaranteed investments to ensure that she will not experience losses.

Where do segregated funds and annuities stand in respect to such guarantees? This chapter and this manual describe how these insurance investments provide guarantees, to whom, and when.

1.1.2 Investment basics

Some investment basics are fundamental to understanding how investing works, how returns are generated for investors, and how investors manage risk.

1.1.2.1 Compounding (compound interest)

Compounding is a concept that is basic to investing. It is a very powerful investing tool.

Interest on an investment may be paid daily, monthly, quarterly, or annually. The investment may permit withdrawal of the interest or for the interest to be added to the value of the investment. When it is added (or reinvested), the value of the investment grows. At the time of the next interest payment, interest is calculated and paid on the total investment value. That value is a sum of principal plus interest previously paid. As a result, the investor earns interest on interest. This form of interest is called compound interest. It achieves escalated investment growth as Table 1.1 shows.

TABLE 1.1

Investment growth escalated by compound interest

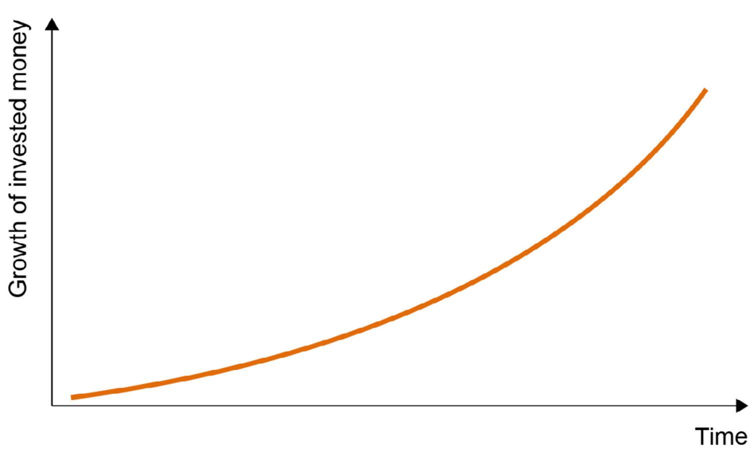
YEAR	INTEREST IS RECEIVED ON:
1	Principal
2	Principal plus interest earned in year one
3	Principal plus interest earned in years one and two
4	Principal plus interest earned in years one, two and three
5	Principal plus interest earned in years one, two, three, and four
–	Etc., until the investment matures, or the investor ends the investment.

Compounding is especially effective when it is applied over a long period of time. Diagram 1.1 shows how the compounding effect accelerates.

Time is money's best friend. That is why advisors recommend that individuals start saving as early in life as possible so that the benefits of compounding can be realized to their full potential.

DIAGRAM 1.1

Growth of invested money over time



In order for compounding to work to its maximum potential, all investment returns must be reinvested. Withdrawals diminish or eliminate compounding.

Unfortunately, compounding also has a negative side since costs can also compound. Debt, in which an outstanding unpaid balance is charged interest, also compounds.

1.1.2.2 Investment returns

All investments have one of three types of return. Returns can be positive and reflect a profit earned from the investment. Returns can be neutral, in which the investor receives the sum initially invested plus any fees paid. He is back where he started. Returns can also be negative. In this case, the investor will not receive back all the money invested. This is a risk of investing.

The return is often expressed as a percentage of the amount invested. In those cases, it is called rate of return. It can be a positive number, such as 10%, or a negative number, such as -10%.

EXAMPLE

Salim invests $10,000 but receives $11,000 when he sells the investment. The $1,000 profit ($11,000 – $10,000) is a 10% rate of return ($1,000 ÷ $10,000).

In some cases, investors may be informed of the expected rate of return on an investment before they invest. In others, it is impossible to tell investors what to expect because the return cannot be accurately predicted. This is a characteristic of a risky investment.

There is also a scale of risk expressed for investments, which is a guide to the investor about how likely it is that he will receive all his money back. The scale of risk plots the amount of risk an investor takes on in a range between the bottom of the scale, which is very low risk, and the top of the scale, which is extreme, called speculative, risk.

An investor with a very low risk investment can be very confident that he will receive back all his invested money.

Speculative investments are the most risky. An investor who makes a speculative investment knows that he may not get back all the money he has invested. There is a very high degree of risk that he will experience a negative return and lose money. However, there is also a possibility of very high returns and earning a significant profit.

Moderate or balanced risk investments are in-between the two ends of the risk spectrum.

Why would an investor consider risky investments? Risky investments provide the opportunity for far greater positive returns than those with lower risk. This concept underlies investment risk/return theory. It is based on rewarding those who are prepared to risk their money with a better return. Investors who are not willing to risk the loss of their money receive a lower rate of return.

Returns are classified as nominal returns or real returns. A nominal return is the stated or advertised rate. For example, a savings account is advertised with a 2% return. That is its nominal return.

Real return is calculated as the nominal return on an investment minus the rate of inflation. It can be positive (showing a profit) or negative (showing a loss).

EXAMPLE

In 2020, if the annual nominal return on a Guaranteed Investment Certificate was 3% and the annual rate of inflation was 1.8%, then the real rate of return on the bond was 1.2% (3% – 1.8%).

In 2022, if the annual nominal return on a Guaranteed Investment Certificate is 3% and the annual rate of inflation is 5%, then the real rate of return on the bond is -2% (3% – 5%).

1.1.2.3 Asset classes

Asset classes are categories assigned to investments that have similar characteristics and are governed by similar laws and regulations.

The three main asset classes are stocks (also called equities), bonds (also called fixed income or debt), and cash (also called money market instruments). Two other classes are often added. They are real estate and commodities.

Each type of asset class has its own risk and return features. Asset classes are fundamental to the investment concept of diversification.

1.1.2.4 Diversification

Diversification is a strategy used in investment portfolios and pooled investments. It combines asset classes and investments within those classes to spread out investing risk. Therefore, diversification in a portfolio lessens risk – based on the well-known theory of not putting all your eggs in one basket.

Diversification can be accomplished in many ways. It could be through buying stocks of a wide range of industries or companies, and bonds with varying interest rates. Another form of diversification uses foreign investments to take advantage of different economic conditions in other countries. This spreads risk over national and foreign investments and their respective economic conditions.

When an investor buys into a pooled investment, like a segregated fund, he automatically receives the benefit of diversification. Each segregated fund is invested in a wide range of investments specific to its type. For instance, a bond fund is diversified across a broad spectrum of bonds in its portfolio that mature at different times, have varying degrees of risk, and make payments at different interest rates.

Other investments that offer similar diversification include mutual funds and Exchange-Traded Funds (ETFs).

When an investor buys one stock or bond, or ten, or even one hundred, he is not receiving the full benefit of diversification.[1] Risk is centred on performance of those individual investments: if they lose value, there are not sufficient offsetting investments to compensate for losses.

Therefore, it is very difficult for an individual investor to achieve diversification unless he invests in a fund-type investment. Most investors simply do not have enough investment capital to be able to achieve adequate diversification in a portfolio of their own stocks and bonds. Those that do often rely on investment professionals for frequent advice.

1.1.2.5 Liquidity

Liquidity describes the ability to cash in, or sell, an investment quickly at or near its current market price.

An investment that has characteristics of liquidity is called a liquid investment. A savings account is a liquid investment because some or all of its value can be quickly accessed for use.

An investment that does not have characteristics of liquidity is called illiquid. Real estate is often cited as an example of an illiquid investment since considerable time could elapse between the sale of a property and receiving its proceeds.

Liquidity is essential in an investment when a part or all of its value will be used to provide an emergency fund to an investor. An emergency fund is a portion of earnings set aside for emergency purposes, such as when there is a sudden need for income due to an unexpected job loss. When such a need arises, the investor must be able to quickly and easily sell his investment and obtain its highest market value.

1.1.3 Time value of money

The present value of money is one aspect of the principle known as the time value of money. The future value of money is the other. It is very important to understand the differences between the two.

Both principles are based on the potential for invested money to increase in value over time due to interest being earned. They do not consider investment growth due to other factors, such as capital gains.

1. Investopedia. *The Illusion of Diversification : The Myth of the 30 Stock Portfolio.* [online]. [Consulted May 18, 2022]. https://www.investopedia.com/articles/stocks/11/illusion-of-diversification.asp

1.1.3.1 Present value

Understanding present value (PV) and being able to calculate a present value sum is essential to many financial planning activities. Present value works backwards from a future date. It answers the question of how much is needed now to achieve a future savings goal. Therefore, it would be used to help a person determine how much needs to be saved today to yield specified retirement savings at a future date. Likewise, a parent who must meet future post-secondary education costs for a child could be provided with that information from a present value calculation.

Present value tells us that if $5,000 is needed at a future date then less than $5,000 needs to be saved today because today's sum will earn interest and grow over time. The higher the interest rate, the lower the initial sum of investment needs to be.

The present value calculation is performed when the future sum is known, the future date is known when the sum is needed, and when the interest rate between today and the future date can be specified.

Present value is generally calculated using a calculator, through an online resource, or with software provided by insurers. It applies to both a sum of money and cash flows. The formula for the calculation is:

$$PV = FV \div (1 + \text{interest rate})^n$$

FV is the known future value and n is the number of periods for the calculation.

EXAMPLE

Julie wants to know how much is needed today to provide $5,000 in five years, given the current annual interest rate on savings of 3%. The present value of $5,000 in five years based on 3% interest earned is:

$\$4,313.04\ (PV = \$5,000 \div (1 + 0.03)^5)$

Julie needs to invest $4,313,04 at 3% interest today to equal $5,000 in five years' time.

As interest rates rise, the amount needed for investment to arrive at the same end sum ($5,000) decreases. If Julie wants $5,000 in five years, given a 4.5% annual interest rate, she only needs to set aside $3,994.26 now:

$\$3,994.26\ (PV = \$5,000 \div (1 + 0.045)^5)$

1.1.3.2 Future value

The future value (FV) calculation answers the question of how much a sum invested today will be worth in the future. Therefore, if a future retiree has a certain amount saved for retirement purposes now, he can determine how much that amount will be worth at retirement in ten years using a future value calculation.

The calculation is performed when today's amount of investment is known, the future date is known, and the interest rate between today and the future date can be specified.

Like present value, future value is generally calculated using a calculator, through an online resource, or software provided by insurers.

The formula for the calculation is:

$$FV = PV \times (1 + \text{interest rate})^n$$

PV is today's known sum (present value) and n is the number of periods for the calculation.

EXAMPLE

Sam has $5,000 today and wants to know the value of that sum in 5 years, given the current annual interest rate of 3%. The future value of $5,000 in 5 years' time at 3% annual compound interest is:

$$\$5{,}796.37\ (FV = \$5{,}000 \times (1 + 0.03)^5)$$

Sam will have $5,796.37 available for his needs in 5 years if he invests $5,000 today at 3% interest.

As in the previous example, a higher interest rate works in favor of the investor.

This is because Sam's savings grow greater over the five years, thanks to the higher interest rate. He will have $6,258.98 in five years when he invests his $5,000 at 4.5% interest.

$$\$6{,}258.98\ (FV = \$5{,}000 \times (1 + 0.045)^5)$$

1.2 Investment objectives

Investors have many reasons for investing and saving. Their reasons are called their investment objectives. It is important for investors to articulate their objectives to their agent since the purpose of investing and any time constraints will be the basis for many investment decisions.

Investment objectives can be classified as short term, medium term, or long term. A short-term objective is a goal to be reached in three years or less. Medium term is the period between three and 10 years and long-term objectives are 10 years or more.

An example of a short-term objective would be saving for a holiday next year. Medium-term objectives could include saving for a new car or for the down payment on a home in five years. One of the most common long-term objectives is saving for retirement, which might be many years in the future.

Investment objectives for individual clients are very different from those for groups, such as a group of employees covered by a pension plan. While the individual focuses on his specific needs, a group plan focuses on the needs of the group administrator, which is usually the employer. Its goal is often to offer an employee benefit by providing a retirement pension to their group. By providing a plan that helps to attract and retain quality employees, the plan serves the goal of the employer.

Knowing the client is the key to understanding his investment objectives.

1.2.1 Account purpose

Many forms of accounts are available to meet investment objectives. It is important to align the proper account with the appropriate investment objective.

Here are some forms of accounts available and their purpose:

- **Registered retirement savings plan (RRSP):**
  Retirement.
- **Registered education savings plan (RESP):**
  Post-secondary education costs, usually for a child or grandchild.
- **Registered disability savings plan (RDSP):**
  Income for a disabled dependant.
- **Tax-free savings account (TFSA):**
  Tax-free investment growth.
- **Registered pension plan (RPP):**
  Retirement savings for members of a group.

These accounts are all examples of registered accounts. Registered accounts are individually registered in the account owner’s name with the Canada Revenue Agency (CRA) to provide tax benefits.

Non-registered accounts are also available for savings and investing. They have flexibility for deposits and withdrawals (unlike registered accounts). Although not registered with CRA, returns must be reported to CRA for tax purposes.

It is important to recognize that the account itself – whether registered or not – is simply like a shopping bag. The bag is empty until savings go into the bag, and those savings are invested. Investors typically shop around for the best investments for their savings. Their investment choices determine account performance.

Therefore, a person cannot be dissatisfied with owning an RRSP, for instance, since the RRSP is simply the account type. He can be dissatisfied with the types of investments he has selected within the RRSP because they are not performing adequately to meet his retirement objective. Those investments can be removed from the account and replaced with others to achieve the account performance that will satisfy his investment goals.

1.2.2 Financial goals

A financial goal is a dollar figure associated with an investment objective. For example, an investment objective is retirement at age 60. The financial goal is to have $800,000 saved in an RRSP at age 60 so that retirement can begin.

Financial goals are a target that investors can work towards. They are a powerful motivator to begin saving and investing, continue saving and investing, and monitor investment performance.

1.2.3 Need for guaranteed investments

A guaranteed investment is an investment that makes a guarantee to its investors. The guarantee may be to pay back some or all of the money invested at a future date. That guarantee might be enhanced by also guaranteeing that a specified return will also be paid to the investor.

Guaranteed investments are safe investments. They have less risk than investments that do not provide a guarantee. They appeal to investors who are not risk takers. For the most part, their returns are lower than investments that are not guaranteed.

Guaranteed investments offer investors great peace of mind. Investors know the minimum amount they will receive and when they will receive it. With some guaranteed investments, such as annuities, there is no need to monitor investment performance or be concerned about ups-and-downs in the stock market.

Investors who have pre-determined obligations, such as the need to pay university tuition for a child at a set date in the future, can rely, for example, on guaranteed investments to meet their obligations.

Finally, guaranteed investments are often the preferred investment choice for those whose ability to earn an income from working is restricted. This is often because these individuals are either nearing retirement or have already retired. They do not have the capacity to recover from losses on investments where the principal may not be repaid. They need their principal returned because they are no longer able to regenerate that sum through employment.

1.2.4 Time horizon

A time horizon is a future event when invested money will be needed to meet financial objectives. For example, the time horizon for someone saving for retirement is the date of retirement.

Time horizons are unique to each individual and objective. It is possible for an investor to have many different time horizons based on different objectives. He may have a time horizon for buying a new car, buying a second home, starting a business, paying for post-secondary education, and retiring. As a result, he may have a different time horizon for each saving or investing account.

In general, those who have a long time horizon have the ability to invest more aggressively, or with more risk, because they have more time to make up for investment losses that may be incurred as a result of assuming higher risk.

The time horizon is closely related to the concept of the time value of money, both present value and future value. Calculating such values provides answers about how much is needed for investment now to meet the stated time horizon or how much will be available at the stated time horizon.

EXAMPLE

Martin has just received an inheritance of $200,000. His time horizon to retirement is seven years. If he can assume he will earn 4% per year, in 7 years' time his inheritance will be worth:

$$\$263,186 \ (FV = \$200,000 \times (1 + 0.04)^7)$$

1.2.5 Tax-advantaged investing

For tax purposes, investment returns are classified as interest, dividends, or capital gains. Each form of return is taxed differently. It is important to know that even though taxation varies, returns are usually the objective of investing. Even though interest is taxed at the highest rate, an investor does not want to avoid receiving interest due to the tax he will pay.

Interest is taxed at the same rate as income earned from working. There are no tax advantages to receiving interest. Foreign income, including foreign dividends, is taxed as interest. The marginal tax rate of the investor applies to interest income.

Dividends are paid quarterly by companies from their earnings to their stock owners. Not all companies pay dividends, and there is no guarantee that a dividend will be paid. Investors with stock in qualifying Canadian companies who receive dividends may benefit from the dividend tax credit. As a result of the tax credit, which reduces tax, the dividends are taxed at a lower rate than interest. The investor's marginal tax rate is applied to the balance after the credit has been applied.

Capital gains result when the sale of capital property, such as stocks, is higher than its adjusted cost base, which is primarily the cost of purchase. Capital gains tax is the lowest rate of investment taxation. Only 50% of the capital gain is taxed at the investor's marginal tax rate.

Another tax advantage for investments that earn capital gains is capital losses. If an investor loses money on an investment, he incurs a capital loss.

Although a capital loss means an investor has lost money on his investment, half the capital loss can be deducted from taxable capital gains on other investments. The loss must be used first against capital gains in the year the loss is incurred. However, if capital gains are unavailable or insufficient in that year, the capital loss may be applied against capital gains in any of the three previous years, or in any future year. This reduces the amount of taxable capital gain and the tax to be paid on that gain.

The lowest-risk investments tend to pay interest. Those that generate capital gains are the riskiest. Therefore, the investor who chooses the riskiest investments can benefit from the opportunity to earn a higher rate of return and from the tax advantages of these investments.

1.3 Types of investments

A life agent license allows sales of segregated fund and annuity investments. These are just two possible types of investment in the total universe of investments. Investors may be satisfied learning only about these investments. However, it is far more likely they want to compare many investments to identify the investment most suitable for their objectives and risk tolerance. For instance, an investor may want to compare segregated funds with mutual funds.

Therefore, it is necessary for the agent to understand other investments. This allows the agent to make useful and accurate comparisons of investments to best serve client needs.

Having an understanding of other types of investments also allows the agent to better understand segregated funds. For instance, an agent who understands stocks and stock market behaviour can better explain equity segregated funds to investors.

1.3.1 Segregated funds

The legal term for a segregated fund is an Individual Variable Insurance Contract or IVIC. This term is rarely used and segregated funds are most often simply called segregated or seg funds.

Segregated funds are created and sold by life insurance companies. However, not all life insurers offer segregated funds. Those that do go through a process to develop a fund and get the necessary approvals from regulators for the fund. Once all approvals are in place, the fund is open for investment. The date when the fund begins operations is its inception date.

Insurers keep their segregated funds separate from other company assets, which is why the funds are called segregated.

Insurers manage their segregated funds on an ongoing basis and provide relevant information to potential and existing investors. They are required by law to set aside financial reserves so they can meet their contractual obligations for maturity and death benefit guarantees.

People buy segregated funds to benefit from the guarantees they offer for return of capital. This makes segregated funds less risky than mutual funds. Segregated funds are also highly valued because, in the event of the death of the policy owner, the proceeds bypass probate. Probate fees are charged in all provinces except Quebec on assets of a deceased. They can pose a significant charge to an estate.

Money is pooled in the fund from the deposits of policyowners. Deposits are made by individuals and groups. Those deposits are invested by the segregated fund manager according to the type of fund that has been created. For instance, the money invested in a bond fund is used by its manager to invest primarily in bonds.

Insurers offer many types of segregated funds to match up with the investment objectives of individual investors.

Segregated funds are available as investment options for non-registered accounts and registered accounts, such as an RRSP.

1.3.1.1 Advantages and disadvantages of segregated funds

Segregated funds offer some unique advantages compared to other forms of investment. They also have many features in common with other fund-type investments. This overview is an introduction to the reasons people buy segregated funds. It also introduces some of the disadvantages to be taken into consideration regarding segregated funds. Details on these advantages, and disadvantages, appear in the following chapters of this manual.

Unique advantages of segregated funds:

- Maturity and death benefit guarantees;
- Ability to reset provided in some contracts;
- Possible creditor protection;
- Right to designate a beneficiary and bypass probate;
- Tax benefit received when capital losses are incurred;
- Investor protection provided by Assuris.

Some advantages segregated funds share with other fund investments:

- Wide variety of funds available;
- Ease of investment;
- Vast amount of information available on funds, both before and after purchase;
- Diversification provided;

- Professional management provided by the fund manager;
- Liquidity;
- Ease of switching from one fund to another;
- Ease of redemption (making a withdrawal or surrender of the contract);
- Ability to create an income stream from account value;
- Available for registered (such as RRSP) and non-registered accounts.

Some unique disadvantages of segregated funds that are not shared by other fund investments:

- Minimum 10-year term-to-maturity for the maturity guarantee to apply;
- Often higher fees charged to investors than mutual funds, in the form of the management expense ratio (MER);
- Possible age restrictions on deposits.

Some disadvantages segregated funds share with other fund investments:

- Too many choices of funds and often little differentiation between choices;
- Sales charges, and ongoing fees charged as the MER.

1.3.1.2 Where and how to buy segregated funds

Segregated funds are sold primarily by life insurance agents and brokers. Some segregated funds are also sold by investment dealers but those dealers act as agents of the life insurers; the investment dealers are only a sales channel.

Investors must be knowledgeable about their segregated fund investment. To ensure they have all necessary details, the agent provides an information folder before or at the time of purchase. The information folder describes the key benefits of the contract. It also provides information about the fund itself, such as fees the investor pays and past performance.

When the investor is prepared to make the segregated fund investment, he will complete an application, usually with the agent's assistance.

The application is taken by the agent and sent to the insurer. The insurer prepares the segregated fund contract. That contract is a legal document that describes all the terms of agreement between the investor and insurer. It is finalized when the contract is signed and the investor has made a deposit to the account. The contract is an insurance policy, and the investor is the policy owner.

1.3.1.3 Types of segregated funds

Many types of segregated funds are offered. They may be specialized by asset class to include only stocks, or only bonds, or only money market instruments. They also may be based only on real estate, or only on commodities. They may be specialized geographically, for instance to invest only in equities of a specific country, such as Canada, or region, such as North America.

Instead of investing in a single asset class, funds may combine asset classes, such as stocks and bonds. Such funds are often called balanced funds. Balanced funds may represent investment in a single country or across regions.

Some segregated funds invest in other segregated funds. These are called funds of funds.

Other subcategories of funds are also available, but they are based on the main asset classes. A dividend fund, for instance, is based on stocks since dividends can result from owning stocks.

Funds offered by different insurers may have very similar names but be quite different. The Canadian Equity Fund offered by XYZ Insurance Co. will not be the same as The Canadian Equity Fund offered by ABC Insurance Co. Each fund holds stocks of companies and the companies may vary fund to fund. Even when the same companies are held in each fund, the percentage of the fund invested in those companies will not be the same.

The availability of so many types of funds allows investors to choose from among levels of risk and rates of return. Some funds are riskier than others. Some funds have a higher rate of return than others. Each is designed with specific investor objectives and risk tolerance in mind.

1.3.1.4 Returns and guarantees of segregated funds

The return the segregated fund investor receives is a result of fund performance (increases or decreases in the value of investments in the fund minus fees). The return is reported after fees: if a fund earns 7% and fees are 3%, 4% is the investor's return. The return is stated as a percentage and it can be a positive number, such as 5%, which shows a profit has been created, or a negative number, such as -5%, which shows a loss in the value of the investment.

The investor is able to monitor returns for the most recent month, 3 months, year-to-date, 1 year, 2 years, 3 years, 5 years, 10 years, and since the fund's inception. It is a well-known truth of investing that past results do not indicate future performance. In other words, an investor is only certain of one thing: what has happened. He can never rely on past returns to predict future returns.

Investors are able to limit negative returns from their segregated fund investments due to the maturity guarantee and death benefit guarantee.

The maturity guarantee states that when the contract matures the investor will receive a minimum of 75% of the sum he has invested. This guarantee is a minimum return since the amount the investor receives is the greater of the maturity guarantee or the market value of the fund.

EXAMPLE

Lee invests $1,000 in a segregated fund contract with a 75% maturity guarantee. The maturity guarantee is $750 ($1,000 × 75%) when his contract matures).

Scenario 1

The market value of the contract at maturity is $620. Therefore, Lee receives the maturity guarantee of $750.

Scenario 2

The market value of his contract at maturity is $1,440. Therefore, Lee receives the market value of $1,440.

There is also a death benefit guarantee provided in segregated fund contracts. If the life insured, called the annuitant, named in the contract dies during the term of the contract, the beneficiary receives a minimum of 75% of the sum invested. If the market value of the contract is higher than the 75% guarantee, the beneficiary receives the market value.

EXAMPLE

Jane invests $1,000 in a segregated fund contract with a 75% death benefit guarantee. The death benefit guarantee is $750 ($1,000 × 75%).

Scenario 1

When Jane dies, the market value of her contract is $700. Therefore, Jane's beneficiary receives the death benefit guarantee of $750.

Scenario 2

When Jane dies, the market value of her contract is $910. Therefore, Jane's beneficiary receives the market value of the contract ($910).

Together these guarantees limit losses. An investor knows that the maximum amount of loss he could face is the difference between the sum invested and the guarantee amount.

EXAMPLE

Stephen invests $10,000 in a segregated fund with a 75% maturity and death benefit guarantee. He is guaranteed to receive a minimum of $7,500 ($10,000 × 75%) at maturity or if he dies. The most he can lose over the total period of the contract is $2,500 ($10,000 – $7,500). Therefore, if he has the intention of holding the fund until its maturity, he can choose to invest in more risky funds and try to achieve a higher positive return. However, he also knows the most that can be lost.

The returns segregated fund investors receive are earned as interest, dividends, foreign income, and capital gains. Investors do not receive the annual return as cash. All returns are reinvested in the fund on an ongoing basis, as they are earned.

An investor may choose to hold his segregated fund investment in a non-registered account, a registered account, or both.

Investors with non-registered accounts are allocated the return as it is earned in the fund. For instance, capital gains earned in the fund are reported to the investor as capital gains (the investor also receives capital losses, if they occur). The amount reported to the investor as the return must be included in each year's income tax filing.

Investors with registered accounts do not report returns for tax purposes every year. They earn returns the same as those with non-registered accounts but their returns are reinvested in the contract. However, when the time comes to make a withdrawal from their registered contract, investors will find that the sum they receive is taxed at the same rate as income from interest, regardless of how it was earned. In other words, they do not receive the tax benefits of a capital gain or loss, or the dividend tax credit. This is true for all taxable registered accounts. A tax-free savings account is an exception because it is not a taxable account.

EXAMPLE

Robert invests $10,000 in a Canadian equity fund held in his registered retirement savings plan (RRSP) account. Every year the fund grows in value as a result of buying and selling stocks of blue-chip Canadian companies. The growth is all in the form of capital gains earned by selling stocks at a profit. At the end of the contract, Robert's contract is worth $14,324. This sum is now available to him in cash that he can withdraw. If Robert withdraws money from the account, the withdrawal will be taxed as RRSP income, which is taxed at the same rate as income from interest.

1.3.1.5 Risks of investing in segregated funds

While segregated funds are a relatively lower-risk investment, at contract maturity an investor still risks the loss of up to 25% of his investment, the difference between the amount invested and the minimum maturity guarantee.

Prior to contract maturity, an investor can lose up to the sum invested since the maturity guarantee does not apply.

The investor must also be prepared for the minimum 10-year term of the investment. The investor may be unable to take advantage of other investment opportunities during those 10 years.

1.3.1.6 Investor protection

Consumers are protected against insolvency, or bankruptcy, of the insurer that holds their segregated fund contracts through Assuris, a non-profit organization that protects policyholders if their life insurance company fails.

This means that if the insurer itself goes bankrupt, the invested money is protected, up to certain limits, by Assuris. The investor is protected against total loss of his principal. The details of the protection Assuris provides are covered later in this manual.

Assuris does not provide protection against market losses. Protection against a loss in the value of an investment is provided by the guarantees of certain investments, like the 75% segregated fund maturity guarantee. Non-guaranteed investments can fall to zero value in the market and there is no recourse for the investor.

1.3.2 Annuities

Some investments return the principal invested, plus any profit as a lump sum, to the investor. An annuity is different in that it produces a stream of payments over a period of time. Annuity payments are a combination of the investor's principal and interest paid by the insurer. For this reason, annuities are considered to be a very reliable source of income. They are highly secure, widely available, and protected by Assuris.

An annuity is created through a contract between the annuity provider (usually an insurance company) and an investor. The investor's principal is used to fund the contract. The investor names the person who will receive the income payments. This person is called the annuitant. The annuitant may also be known as the annuitant grantee or payee. It is important to carefully read the definitions of the annuity contract, since the wording of the different parties might be different from one contract to another or from one insurer to another.

The amount received by the annuitant is called an annuity payment. The annuity payment is based on an annuity rate offered by the insurer, which is largely the prevailing interest rate at the time the investment is made. However, larger sums of principal invested in an annuity receive a higher annuity payment than lower amounts. The annuity payment is also affected by the age and gender of the annuitant. Annuity rates vary between providers.

When the annuity payment at the time of purchase is fixed, that payment will be received for the duration of the annuity. It is guaranteed. If interest rates rise, the annuity payment does not increase. Likewise, if interest rates fall, the annuity payment does not decrease.

Several types of annuity do not have fixed annuity rates. Their payments are variable. Each guarantees a minimum payment. One form of variable annuity links to investment performance. Its payment will be the minimum payment plus any additional payment as a result of its investment performance. The other form of variable annuity, called an indexed annuity, links to the rate of inflation and increases payments in step with rising inflation. Therefore, its payment is a minimum payment adjusted for any increase in the inflation rate.

People buy annuities because of their dependability: they can count on their regular annuity payment. Annuities also relieve the annuitant from any decisions about their investment after initial choices are made. Investors need not worry that they could mismanage their money and possibly experience losses. In effect, the annuity payment is like a pension payment.

1.3.2.1 Advantages and disadvantages of annuities

Some advantages of annuities have already been introduced. The comprehensive list of advantages includes:

- Steady income stream;
- Two variable forms: a variable annuity for investors who hope to increase payments through stock market increases and an indexed annuity for investors who want to increase payments in step with the rising cost of living;
- Choice of payment frequency (monthly, quarterly, semi-annually, or annually);
- No need for investment decisions;
- No need to monitor performance;
- No worry about outliving one's money when a life annuity or joint and last survivor annuity is purchased;
- If the annuity is prescribed, less tax may be due in the early years of payment;
- Investor protection of insurance annuity contracts through Assuris;
- Available for registered (such as RRSP) and non-registered accounts.

Like all investments, annuities have certain disadvantages. They are:

- Lack of flexibility (changes cannot be made to the annuity contract);
- Interest rate risk: if interest rates rise during the contract, the contract continues annuity payments based on the initial, lower annuity rate;
- Penalties to surrender or withdraw from the contract;
- Loss of principal for an annuitant with a life annuity if death occurs before all the capital paid to buy the annuity has not been paid out in benefits;
- The amount of money needed to fund an annuity (often not less than $50,000);
- If the annuity is non-prescribed, there may be a greater tax liability in the early years of payment.

Details on these advantages, and disadvantages, appear in the following chapters of this manual.

1.3.2.2 Where and how to buy annuities

Life insurance companies sell all forms of annuities. Other financial institutions, such as banks, are restricted to sales of term annuities only.

Compared to segregated fund investing, a person buying an annuity has very few choices about the investment. He selects the type of annuity, the amount of funding, a payment schedule, and is offered an annuity rate. The annuity can be held in a non-registered or registered account.

1.3.2.3 Types of annuities

The different types of annuities available are the subject of Chapter 3 where they are reviewed in depth. This overview introduces the generic names for what is available. Insurance companies adapt these generic names for marketing purposes.

Annuities are fundamentally available in a form that pays an income (called a payout annuity) or a form used for savings (called an accumulation annuity). Payout annuities are the most common.

Payout annuities are available in three forms:

- **Term annuity, also known as a term certain annuity:**
  Lasts a specific period of time, such as 20 years.
- **Life annuity:**
  Lasts for the life of the annuitant. When the annuitant dies, the annuity ends.
- **Joint annuity, also known as a joint and last survivor annuity:**
  Used by couples so that when one spouse dies, the surviving spouse continues to receive an income from the annuity. When the surviving spouse dies, the annuity ends.

1.3.2.4 Returns and guarantees of annuities

The annuity payment is guaranteed for the duration of the annuity unless the contract is a variable or indexed annuity. As discussed, these forms of annuity provide a minimum guarantee but may supplement that amount with an additional return.

1.3.2.5 Risks of investing in annuities

Interest rate risk is the primary risk of an annuity investment. If interest rates rise after the contract is finalized, the investor cannot benefit from the higher rate.

The investor may also be subject to inflation risk. Inflation is the increase in the Consumer Price Index (CPI), which is a measure of the cost of goods and services. The CPI generally sees prices increase and illustrates how goods and services cost more year after year.

The annuitant who does not have an indexed annuity that keeps pace with the rate of inflation finds a sure loss of purchasing power over time. As the cost of living goes up, the annuity payment which is the same amount over its entire contract buys less and less. The longer the annuity payment is received, the greater the inflation impact.

1.3.2.6 Investor protection

Assuris provides protection for annuity owners and annuitants against the insolvency of life insurance companies. All annuity contracts sold by insurers will be Assuris-covered. The details of the protection Assuris provides are covered later in this manual.

1.3.3 Stocks

Stocks are also known as shares or equities. An investor who buys stock in a company is buying ownership in that company. He becomes an owner of a share of the company in proportion to his investment, no matter how small. When investors believe that the fortunes of the company will rise, the value of the investment increases. The opposite is also true.

Information about stock value is widely available through websites. Investors need to learn as much as they can about a company in which they intend to invest.

Stock is issued in two forms: preferred stock (or shares) and common stock (or shares). Preferred stocks must pay a dividend before the dividend payment is made for common stocks. They also do not usually have voting rights, and therefore a preferred stock owner has no say in the management or operation of the company. Common stock owners have voting rights that allow them to express their wishes in regard to the company at the annual general meeting.

Agents who earn their securities license can sell stocks, but agents who sell segregated funds will find stocks are part of their equity, balanced, and growth funds. Those stocks may be Canadian or foreign. Understanding stocks leads to a better understanding of these funds.

People buy stocks to participate in their growth in value (e.g., $1,000 worth of Apple shares bought in 1997 at $160.40 would be worth $162,589.90 in June 2022), lower rate of taxation, and to receive dividends. Some buy stocks to take advantage of strategies for derivatives, such as options.

The growth or upside of owning a stock is unknowably large – as witnessed by the increase in Apple shares, no one could have predicted in 1997 the development and consumer dominance of the iphone, ipad, and Mac computers. The loss or downside can be a total loss of invested capital.

1.3.3.1 Advantages and disadvantages of stocks

The main advantage of stock ownership is the ability to benefit from gains in a stock's price. There is no ceiling on how high a stock's price can rise, in theory. Other advantages include:

- **High degree of transparency in stock market investing:**
  Stock prices are available for anyone to see through the stock market on which the stock is listed, such as the Toronto Stock Exchange.

- **Dividends:**
  Each stock owner of record as of a certain date receives the dividend (a dollar or part-dollar amount per share, e.g. $0.50/share) after the dividend has been declared by the company directors. The dividends may benefit the investor by the dividend tax credit. However, many stocks including those of some of the largest companies, like Amazon, do not pay dividends.
- **Opportunity to attend annual meetings of the corporation:**
  Owners of voting shares can vote on matters of concern, such as a change in management or management salaries.
- **Favourable tax rates for capital gains and capital losses:**
  Capital gains tax is the lowest rate of taxation to be paid on an investment return. A capital loss reduces a taxable capital gain.
- **Available in self-directed registered (such as RRSP) and non-registered accounts.**

Disadvantages of stock ownership include:

- Possibility of loss, even total loss, of principal invested;
- Possible absence of diversification in the portfolio that exposes the investor to risk;
- Need to monitor price movement and identify when to buy and sell;
- Not all companies pay dividends and there is no guarantee that dividends will be paid;
- Commissions charged on every trade;
- Liquidity issues if stocks must be sold at a time when the price is depressed but the investor needs money;
- No naming of a beneficiary on a non-registered account;
- No creditor-proofing;
- No ability to rescind a sale.

1.3.3.2 Where and how to buy stocks

Stocks are listed on stock exchanges, such as the Toronto Stock Exchange (TSX). Each listed company is traded under its ticker symbol, which is an abbreviation of the company's name, such as BMO for the Bank of Montreal. Investors have a large number of companies from which to choose.

In order to buy stocks an investor needs an account with an investment dealer that provides trading services (advice and recommendations with buying and selling provided on a commission basis), or a discount broker (buying and selling provided on a reduced-commission basis). Stock trading is available online in a do-it-yourself approach or through traditional channels, such as an account at a dealer.

An application is completed by the investor to satisfy the Know Your Client (KYC) requirement for those who sell stocks. KYC information assures the sales representative that the investment is within the financial capability and risk tolerance of the investor. KYC should be reviewed annually and if there is a material change in the circumstances of the investor, such as retirement.

1.3.3.3 Returns and guarantees of stocks

Returns on stocks are in the form of:

- Capital gains, when stocks are sold at a profit;
- Dividends, when declared by the Board of Directors.

There is no guarantee that either a capital gain or dividend will be received. Any money invested can be lost.

1.3.3.4 Risks of investing in stocks

Stocks run the spectrum of risk. Blue-chip stocks are the stocks of large, well-known, and well-established companies. For example, in Canada, Canadian National Railway is considered a blue-chip stock. Blue-chip stocks are one of the least risky forms of stock ownership. The most risky are so-called penny stocks. They are stocks valued at less than $5 that are typically illiquid and highly speculative. Penny stocks may include well-known companies, such as Bombardier, in addition to smaller firms that are not household names.

An investor in stocks can experience market risk, industry risk, and the risk of loss of principal invested. This loss can be total. Currency risk can diminish returns if an investment is made in foreign currency. Forms of risk are discussed later in this Chapter.

Derivatives, such as options, exist to help mitigate risk of stock ownership. They are advanced investing strategies and beyond the scope of this manual.

1.3.3.5 Investor protection

Similar to the protection provided by Assuris on the life insurance side, investor protection for stock investors is provided by the Canadian Investor Protection Fund (CIPF) in case of investment dealer insolvency.

CIPF protects accounts held by its members to specified limits if the dealer becomes insolvent. This does not protect against a decline in the value of the investment; it only covers losses associated with the bankruptcy of a dealer. CIPF member firms are investment dealers that are the members of the Investment Industry Regulatory Organization of Canada (IIROC).

It is important to understand that no protection is available for declines in the market price of stocks. If the market price of a stock goes from, say, $100 to $2, investors in that stock have no protection from losses sustained. Their only recourse to try to limit their loss on a declining stock is to sell the stock, if a willing buyer can be found.

1.3.4 Bonds

Stocks are an equity investment. Bonds are a debt investment. This is because bonds represent a debt between a borrower, who is the bond issuer, and a lender, who is the bond investor. Bonds are also called a fixed-income security.

Many segregated funds focus on bonds or include bonds as part of their portfolio. Therefore, an agent who understands bonds will also have a better understanding of bond funds.

Issuers of bonds fall into two broad categories: governments and corporations, both national and international. When an issuer needs money, it issues a bond, which is purchased by investors. The investor, in effect, is lending money to the issuer and the bond is the IOU. The bond market in Canada is huge. In 2020, it was about $1.9 trillion. In 2021, the federal government alone issued $172,5 billion in bonds.[2]

Bonds are issued with a fixed maturity date. On that date, the borrower (the issuer) repays the full principal amount to the lender (the investor). The period of time between the issue of the bond and its maturity date is called the term-to-maturity. Bonds are issued with a wide range of terms-to-maturity – from one year to 30 years.

An investor can sell a corporate or government bond before its maturity date to another investor, and an active market exists for buying and selling bonds. This is called the secondary bond market.

In return for using the investor's funds for the term of the bond, the issuer makes two promises to the investor. First, during the term-to-maturity period, the issuer will make regular interest payments to the investor. The interest rate is called the coupon rate of the bond and is typically payable twice a year. Second, the issuer will repay the full face value of the bond to the investor at maturity.

Bonds that are issued with a high credit rating can preserve and increase capital as well as provide a predictable stream of payments in the form of interest income. A high credit rating indicates a low chance of the issuer defaulting on payments to investors.

1.3.4.1 Advantages and disadvantages of bonds

Bonds are issued by a wide range of domestic and international business and government entities. Therefore, an investor can choose among credit ratings, issuers, terms-to-maturity, and coupon rates (i.e., interest rates) to build a diversified portfolio of bonds with the aim of delivering higher returns while reducing overall risk. Managers of bond funds follow such a strategy.

Repayment of the face amount and interest payments are guaranteed for government bonds issued by many countries because the issuing government has government revenue at its disposal to meet its obligations. Countries such as Canada, the U.S. and the nations of the European Union are able to make such guarantees. On the other hand, countries struggling with political or economic uncertainty may represent a risk of default. This could include countries such as Turkey, Egypt,

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2. Statistics Canada. *Federal government borrowing continues to rotate debt offerings towards longer time horizon*. [online]. [Consulted May 6, 2022]. https://www150.statcan.gc.ca/n1/daily-quotidien/220311/dq220311b-eng.htm

Brazil, or Argentina. A government that could not meet its bond payments as they became due would experience a total loss of international investor confidence.

Corporate bond issuers make a commitment to repay their investors for the same reason – they need investor confidence so they will be successful when they need to borrow more money via bonds in the future. However, there is a greater chance payments will not be made for a corporate bond than government bonds since a corporation's fortunes can change quickly, and a corporate issuer might not have the necessary capital at its disposal to repay investors. Breaking the promise to repay investors is taken very seriously. Corporate bonds run the spectrum of risk and investors who are prepared to take a higher risk are rewarded with higher interest payments from the bond.

Bonds are purchased by more sophisticated investors to balance typically large portfolios. Coupon payments made by bonds can also form a regular income stream.

Investors are apprised of their risk by the credit rating given by bond rating agencies. Canadian government bonds are rated amongst other bonds with the highest credit ratings, due to the Government's ability to pay interest and repay the principal.

There is a lack of transparency in the buying process that puts bond investors at a disadvantage. An investor may not necessarily get the best price, and by overpaying, total return is diminished. Also, terminology used to describe prices and yields of bonds can be confusing to average investors.

1.3.4.2 Where and how to buy bonds

Bonds are available through advisors licensed by IIROC and some members of the Mutual Fund Dealers Association (MFDA) who are licensed as Limited Market Dealers.

Many financial advisors do not have direct access to bonds because their licenses do not permit them to offer these types of securities.

1.3.4.3 Types of bonds

Bonds are issued by all levels of government in Canada and by Canadian corporations for investors in Canada to buy. Foreign countries and corporations also issue bonds that may be purchased in Canada:

- Canadian government bonds are issued by the federal, provincial, and municipal governments and are typically denominated in Canadian dollars. Federal government bonds are ranked the highest, provincial bonds lower and municipal bonds lower still.
- Foreign bonds are issued by foreign countries in Canada, in Canadian dollars.
- Eurobonds are issued by a foreign country in its currency for sale in other countries, such as a bond issued by the United States in US dollars for sale in Japan.

Government of Canada Bonds

The Government of Canada is the largest single issuer of bonds in Canada. It issues bonds in its own name and in the name of federal Crown Corporations, such as the Farm Credit Canada and the Export Development Corporation.

Fully guaranteed by the Government of Canada, the bonds are available for terms from one to 30 years, in denominations as low as $5,000. The level of interest is fixed until maturity, and payments are made semi-annually.

These bonds can be sold at any time.

Provincial bonds

Provincial bonds are issued by the provinces and provincial government agencies. The principal and interest of provincial bonds are guaranteed to be paid when held to maturity. The bonds are also highly liquid and can be easily bought and sold.

Municipal bonds

Municipal bonds account for a small percentage of the Canadian bond market. Their ratings vary because their credit quality is dependent on the ability of the municipality to generate tax revenues, among other factors.

Like other government bonds, municipal bonds may be sold at market value prior to maturity, and a large secondary market exists for buying and selling such bonds.

Corporate bonds

Corporate bonds are issued by companies looking to shore up or expand their operations. The risk associated with a corporate bond is almost totally attributable to the creditworthiness of the company.

Foreign bonds

Just as governments and corporations in Canada issue bonds, so too do the governments of other countries and multinational companies. Their creditworthiness is a result of the political and economic stability of the issuer.

1.3.4.4 Returns and guarantees of bonds

A bond issuer pledges to repay the face amount of the bond at maturity and make interim interest payments to the investor.

There are many factors that affect the return of a bond. They include:

- Interest (coupon) rate;
- Maturity date;
- Credit quality;
- Price.

Interest rate

Bonds pay interest that can be fixed, floating, or payable at maturity.

A fixed-interest rate bond is the most common. It pays interest at a rate that is stated as a percentage of the face value of the bond. This interest is usually paid semi-annually. Most bonds pay interest in this way.

EXAMPLE

A bond with a $1,000 face value, bearing coupons with a 3% rate, would pay $30 in interest a year ($1,000 × 3%), $15 on each of two payment dates.

Maturity

The maturity date of the bond is the future date on which the face value of the bond is repaid to the investor. Maturity dates are often categorized as short-term, medium-term, and long-term:

- Short-term bonds mature in 3 years or less;
- Medium-term bonds mature in 3 to 10 years;
- Long-term bonds mature in 10 years or more.

A bond does not have to be held to maturity. It can be sold in the secondary bond market at the current price for that bond. The market price for a bond is not the same as its original face value.

Typically, investors in long-term bonds are rewarded with a payment of a higher interest rate as compensation for tying up their principal for a longer period.

Credit quality

Bonds are rated based on the issuer's capacity to meet its financial obligations, whether that issuer is a government or a corporation. The highest-rated bonds are called investment-grade bonds. They have an AAA rating.

On the other end of the risk spectrum are bonds that are most likely to default on repayment. They are called high-yield bonds because they pay a high rate of interest, but are also known by the name junk bonds because of their low rating, typically BB or lower.

The return on investment-grade bonds is much lower than bonds with a higher risk of default because of the correlation between risk and return. Fundamentally, lower risk investments have a lower rate of return, and higher risk investments have a higher rate of return.

Price

The initial investor pays the face value of the bond. This is called par. If interest rates change, so does the market price for the bond. When the price rises above face value on the secondary market, the bond is said to be trading at a premium. When the price falls below face value, the bond is said to be trading at a discount.

An investor who sells a bond at a higher price than the one initially paid generates a capital gain. On the contrary, an investor who sells a bond at a lower price than the one initially paid realizes a capital loss.

1.3.4.5 Risks of investing in bonds

Bond investors are exposed to a number of risks. These include interest rate risk, reinvestment risk, inflation risk, credit risk (as discussed), and liquidity risk. Currency risk can affect returns on foreign bonds. These forms of risk are discussed later in this Chapter.

1.3.4.6 Investor protection

Investor protection for bond investors is similar to that for investors in stocks through the CIPF.

The CIPF protects accounts held by its members to specified limits if the dealer becomes insolvent. There is no protection against loss of value.

1.3.5 Savings accounts

When people think of saving money, often the first thing that comes to mind is a savings account at their bank or credit union. Savings accounts offer convenience and, usually, a very low rate of interest. Some accounts are offered as high interest and these typically have requirements or restrictions in order to receive the better rate. Interest earned in a savings account is automatically deposited to the account.

Some people use savings accounts as an investment due to fear of loss of money in other investments and for its accessibility. There is no waiting for funds; a withdrawal can be made at any time.

1.3.5.1 Advantages and disadvantages of savings accounts

A savings account is a source of immediately available cash, with the benefit of interest on the account balance paid at specified periods of time. An account is easy to open and money can be easily deposited and withdrawn.

There is often no minimum amount needed to open an account or keep one open. Some financial institutions apply a fee or penalty to withdrawals on savings accounts, especially a high-interest savings account. This acts as an incentive to save money in the account for investing or other purposes.

Savings accounts may be advertised with a relatively higher interest rate to attract customers. This promotional rate may not last long. The interest rate that actually applies to the account should be checked periodically.

Savers may find the interest rate on their savings account is less than the rate of inflation. Therefore, the money accumulated in savings accounts is subject to inflation risk when the account is used as a long-term investment. The result is that purchasing power is eroded over time.

The interest earned in a savings account is taxed at the highest rate charged to investments. This is a disadvantage compared to other investments that pay dividends or receive a capital gain/loss.

However, the savings account is a valuable short-term vehicle in which to build savings in even small increments. Those savings can then be redirected into other investments.

1.3.5.2 Types of savings accounts

There are two basic forms of savings accounts: the traditional savings account and the high-interest savings account.

The traditional savings account offers a very low rate of interest but sometimes has lower fees and no restrictions on withdrawals.

A high-interest savings account offers higher rates of interest that, in some cases, can rival investments such as Guaranteed Investment Certificates (GICs) or money market funds. In exchange for their higher interest rates, there may be a requirement for contributions or a minimum balance, and withdrawal privileges may be restricted.

1.3.5.3 Returns and guarantees of savings accounts

Returns on savings accounts are in the form of interest. Account owners may receive an annual statement from their financial institution with the total amount of interest earned during the year. This must be reported on the investor's annual tax return.

Guarantees are based primarily on the strength of Canada's financial institutions, and their ability to immediately cash out an account.

1.3.5.4 Risks of holding savings in a savings account

As mentioned above, holding savings in a savings account exposes the account owner to inflation risk.

1.3.5.5 Investor protection

The Canada Deposit Insurance Corporation (CDIC) is a federal Crown corporation that insures savings accounts at member institutions, such as banks, up to $100,000.

1.3.6 Guaranteed Investment Certificates (GICs)

GICs are one of the most popular investing options thanks to how easily they can be bought, absence of fees and their guarantees. People also buy GICs because they are familiar and easily understood. Non-registered GICs can be bought online, further increasing the ease of investing.

A GIC is an investment classified as a term deposit. It is based on the investor loaning a sum of money to the institution providing the GIC. The institution guarantees that the investor will receive the principal plus the promised rate of interest at the maturity date of the GIC, except when the GIC is linked to stock market performance.

GICs are offered in a variety of terms-to-maturity.

1.3.6.1 Advantages and disadvantages of GICs

Advantages of GIC investing include:

- Guaranteed return of principal and interest as promised;
- Variety of products available to give investors choice;
- Available for as little as $500. This helps young investors or investors just starting out who have not yet amassed a more sizeable nest egg for investing;
- Convenient, easy to understand, and easy to buy;
- Penalties for early redemption are waived if the investor dies during the term-to-maturity;
- No out-of-pocket fees.

Disadvantages include:

- Low rates of return;
- Return is paid as interest income and taxed accordingly;
- Subject to probate fees on death, unlike their insurance equivalent called accumulation annuities;
- Interest rate risk;
- Inflation risk;
- Significant penalties charged to the investor who needs access to the funds in the GIC prior to its maturity date.

1.3.6.2 Where and how to buy GICs

GICs can be purchased from financial institutions including:

- Banks and trust companies;
- Credit unions;
- Caisses populaires;[3]
- Insurance companies;
- Investment dealers;
- Specialized GIC deposit brokers.

An application is completed, supplemented with a proof of deposit.

1.3.6.3 Types of GICs

Different types of GICs have distinctive characteristics. The fixed-interest GIC is the GIC that most people think of when GICs are offered. Call these plain-vanilla GICs. Features that are added to the plain-vanilla product will carry additional costs to the investor, such as a lower interest rate.

Fixed-interest GICs

The return on a fixed-interest GIC is a specific guaranteed interest rate. Interest payment options include simple interest that is paid annually and interest that compounds annually and is paid at maturity. Even if the interest is not paid in any one year to the investor, it needs to be declared for income tax purposes.

Cashable/Redeemable GICs

A cashable or redeemable GIC allows the money deposited to the GIC to be received at a date earlier than the maturity date. However, the cost of this feature is that interest rates are lower than those offered on non-redeemable GICs.

Escalating GICs

An escalating GIC increases interest rates on its anniversary date. A variation on this form of GIC allows the investor to cash out some or all of the funds on each anniversary date or a specified number of days thereafter.

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3. A co-operative organization offering banking services. Caisses populaires are not members of CDIC, so CDIC does not insure deposits. Caisses populaires participate in alternative deposit insurance arrangements under provincial laws.

Variable-interest GICs

If general interest rates increase over the term of an investment, so does the interest rate of the GIC. Therefore, interest rate risk is lessened.

Market-linked GICs

This form of GIC links a portion of its return to the performance of a specified equity market index, such as the S&P/TSX Composite Index. In most cases, market-linked GICs are not cashable before their maturity date. Returns are capped, and, in some cases, investors receive only a portion of the investment returns generated by the actual performance of the equity markets.

Foreign currency GICs

A foreign currency GIC is issued in a foreign currency, such as U.S. dollars, and pays fixed interest. It is purchased by investors who believe the Canadian dollar will fall in value against the currency in which the GIC is issued. Therefore, on maturity of the GIC, the foreign currency received is worth more Canadian dollars.

Insurance GICs

The accumulation annuity is also known as an insurance GIC. Available exclusively from insurers, this form of GIC offers benefits based on its issue as an insurance contract. These benefits include bypass of probate and creditor protection. These annuities are discussed in detail later in the manual.

1.3.6.4 Returns and guarantees on GICs

GICs guarantee return of principal and interest at the stated maturity date. Their returns are in the form of interest.

1.3.6.5 Risks of investing in GICs

The GIC investor faces interest rate risk and inflation risk. These risks are described in full later in this Chapter.

1.3.6.6 Investor protection

The Canada Deposit Insurance Corporation (CDIC) insures Canadian-dollar GICs, held at a CDIC member institution, up to $100,000, in each deposit category. Therefore, up to $100,000 in coverage is provided for a GIC that is separate from coverage for an RRSP, RRIF, TFSA, etc.

Insurance GICs (accumulation annuities) are protected by Assuris, the organization that provides investor protection to Canadian life insurance policy owners.

1.3.7 Mutual funds

Mutual funds are created on the basis of investors' money being pooled into a fund that is owned and managed by a mutual fund company or financial institution. Segregated funds are created on the same basis but are owned and managed by an insurer. Most banks, credit unions, and mutual fund companies offer conventional mutual funds that are known as open-end funds.

A mutual fund may be structured as an open-end fund or a closed-end fund. An open-end mutual fund distributes units in the fund to investors proportional to the amount they have invested. A closed-end mutual fund issues a fixed number of shares; this type of mutual fund will not be covered in this manual.

New open-end mutual fund units are continually issued as investors deposit money into the fund, while units are eliminated (redeemed) when investors decide to leave the fund.

There are thousands of mutual funds available for investment. The challenge for the investor and his financial advisor is to narrow down the choice to one fund, or perhaps several funds, that will be the most suitable for the investor's investment objectives.

People buy mutual funds because they are often sold by advisors in financial institutions as an alternative to GICs that offer greater growth potential. While this may be true, matching one or two mutual funds, of the thousands of funds available, to the needs and limitations of the investor takes knowledge, skill and patience. The advisor should explore the characteristics of funds to ensure suitability to client needs. The client should understand:

- How mutual funds make money;
- What makes them go up in value;
- The total fees to buy, hold, and sell their funds;
- The risks of their investment;
- How easily their investment could be redeemed as cash.

Agents sell mutual funds when they earn their securities license or mutual funds license. These agents may be called dual-licensed.

Investors in a mutual fund pay fees to participate in the fund. There are three types of fees:

- The management expense ratio (MER), which is expressed as a percentage of the fund's assets. It is an annual fee charged by the fund to cover compensation paid to the professional managers of the fund, to pay trailing commissions to advisors, operating expenses of the fund, and taxes. The managers make the decisions about what to invest in, when to buy and sell holdings within the fund, the allocation and diversification of holdings, and many other factors that affect returns. The MER is deducted from fund performance before the performance is reported to investors.[4]

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4. Canadian Securities Administrators. *Canadian securities regulators adopt ban on trailing commissions for order-execution-only dealers*. [online]. [Consulted May 6, 2022]. https://www.osc.ca/en/news-events/news/canadian-securities-regulators-adopt-ban-trailing-commissions-order-execution-only-dealers

As of June 1, 2022, some mutual funder dealers eliminated the trailing fee charge.

- The trading expense ratio (TER), which measures the trading costs of the fund. It is also expressed as a percentage of assets. A higher TER is evidence of more frequent buying and selling of holdings by the portfolio manager. It is deducted from fund performance before performance is reported to investors. The TER is also charged annually.
- A sales charge, also called a load, that may be applied against the amount of investment at the time units are purchased or redeemed. When applied at the outset of the investment it is called a front-end load. Alternatively, the load may be applied when units of the fund are sold. It is then referred to as a back-end load or deferred sales charge (DSC). A DSC declines over a period of years until it is eliminated.

  As of June 1, 2022, all provinces and territories will prohibit fund organizations from charging a DSC on new sales but redemption schedules for sales prior to the ban will run their course in Ontario. This means clients could face DSCs until 2028 or 2029.

  Some funds are sold on a low-load basis in which there is a lower fee charged at redemption. Funds are also available with no loads.

A standardized risk classification methodology is used for conventional mutual funds and exchange-traded funds (ETFs). This methodology is based on using standard deviation as the risk indicator to determine a mutual fund's investment risk. The standard deviation equates to one of five levels of investment risk: low, low to medium, medium, medium to high, and high. This approach provides consistency across all fund risk assessments and makes it easier for investors to compare the investment risk of different mutual funds.

As shown in Table 1.2, the risk levels comprise a scale. The Fund Facts document received by investors reports where a mutual fund falls on the scale.

TABLE 1.2

Five levels of fund risk

STANDARD DEVIATION RANGE	INVESTMENT FUND RISK LEVEL
0 to less than 6	Low
6 to less than 11	Low to medium
11 to less than 16	Medium
16 to less than 20	Medium to high
20 or greater	High

EXAMPLE

Using the standardized risk classification methodology, New Global Balanced Fund has a standard deviation of 10. This means the fund has a low to medium investment risk level. Georges is seeking a fund investment with this level of risk. Therefore, New Global Balanced Fund could be suitable for Georges based on the fund's risk level and Georges' risk tolerance.

1.3.7.1 Advantages and disadvantages of mutual funds

Mutual funds offer many of the same advantages as segregated funds including:

- Wide variety of funds available;
- Ease of investment;
- Vast amount of information available on funds both before and after purchase;
- Diversification;
- Small minimum purchase required; some funds allow an initial investment of $500 with minimum deposits of $25;
- Professional management;
- Liquidity;
- Ease of switching from one fund to another;
- Ease of redeeming units.

Mutual funds provide the advantage of a variety of withdrawal plans for the account owner. These are called systematic withdrawal plans. The investor may, of course, redeem his investment as a lump sum whenever he chooses, but may also redeem a specified amount per withdrawal to spread out redemptions over a period of time.

Disclosure to clients on fees is required by Client Relationship Management 2 (CRM2). CRM2 requires mutual funds to provide additional written communication to clients, an annual report on costs and fees, and an annual report on performance. This disclosure is intended to ensure investors thoroughly and accurately understand their fund investment.

Some of the disadvantages of which investors should be aware are:

- Mutual funds are not intended to be a short-term investment and investors must be prepared to hold units for a long period of time to achieve desired returns;
- No protection against losses, like that offered by the guarantees of a segregated fund;
- Tax complexities arise in non-registered accounts that require investors to monitor fund activity;
- The fees, such as MER, can erode returns significantly over time.

1.3.7.2 Where and how to buy mutual funds

Mutual funds are offered for sale through banks, credit unions, caisses populaires, insurance companies, investment dealers, and mutual fund companies. They can also be purchased online with some institutions. There are two steps that must be completed prior to purchase.

First, a New Account Application Form is completed in which the investor specifies the fund in which he will invest, and Know Your Client (KYC) information is gathered by the sales representative. The KYC information is used by the advisor to align investor characteristics, such as risk tolerance, with the proposed investment.

Next, disclosure requirements must be satisfied to ensure that the investor understands the details of the fund he is contemplating purchasing. This requirement is met by the mandatory delivery of the Fund Facts to the investor, and providing him with an option to request a simplified prospectus of the fund and an annual information form (AIF).

Fund Facts outlines the potential benefits, risks, and costs of investing in a mutual fund, in language investors can easily understand, at a time that is relevant to their investment decision. They are intended to confirm suitability for the investor, both at the time of purchase and on an on-going basis.

Mutual fund companies are required to prepare and file a Fund Facts for each class or series of each of their mutual funds and to post the Fund Facts on their website. They are required to deliver the Fund Facts to the investor before he buys.

A simplified prospectus of a fund is a document that is filed with the appropriate regulator that provides full disclosure of material facts that have, or might have, an impact on the market value of the fund.

The AIF supplements the information in the simplified prospectus with information that may be of assistance or interest to some investors.

When the purchase is made, the fund units are bought at their market value. When the investment is redeemed, the units are sold at their market value. Money market funds are an exception. They do not have a market value. Instead, their units are redeemed at a fixed value.

1.3.7.3 Types of mutual funds

The types of mutual funds available parallel the types of segregated funds available.

The Canadian Investment Funds Standards Committee (CIFSC) categorizes funds into five broad asset classes:

- Cash, including funds in the money market;
- Fixed-income;
- Equity;
- Commodity;
- Other.

Funds are further assigned a geographical classification or identified as a developed or emerging market.

A detailed description of the fund types is provided in Chapter 2.

1.3.7.4 Returns and guarantees of mutual funds

There are no guarantees for the mutual fund investor.

The return for a mutual fund is determined based on its net asset value (NAV) per unit and any distributions made by the fund. The NAV is the total net asset value of the fund divided by the number of outstanding units. Distributions are a combination of earnings generated by securities within the fund and capital gains resulting from buying and selling those securities. Non-registered account owners may receive their distributions in cash or reinvest them in the fund.

EXAMPLE

If the units of a fund increase in value from a total of $1,000 to $1,200 over the course of a year due to distributions, the investment is worth $1,200 at year-end. The return is calculated by the investor's year-end value minus initial investment ($1,200 – $1,000) to equal the investor's profit of $200. That profit is then divided by the initial investment ($200 ÷ $1,000) to show the return, which is 20%. The distributions - or the profit - are automatically reinvested in the fund.

An investor who wants to find the best long-term performer in a class should compare returns for at least the last five years between similar funds. In other words, the results of a bond fund must be compared only with the results of a similar bond fund. However, if the investor is simply motivated to find the best return, he could compare five-year results between different asset classes. For example, he might compare a bond fund with an equity fund.

1.3.7.5 Risks of investing in mutual funds

There are many risks of mutual fund investing and some risks are particular to the asset class to which the fund belongs. Cash-based funds face interest rate and inflation risk. Equity-based funds face market risk and industry risk. Fixed-income funds face interest-rate risk. Currency risk can be experienced by funds in which there is foreign investment.

These forms of risk will be described later in this Chapter.

1.3.7.6 Investor protection

There are two investor protection funds available to mutual fund investors. Both can be accessed in the case of dealer insolvency. They do not cover market losses.

The protection is provided by the Canadian Investor Protection Fund (CIPF), mentioned earlier, and the Investor Protection Corporation (IPC) of the Mutual Fund Dealers Association (MFDA) that insures MFDA members. MFDA members are firms that distribute Canadian mutual funds.

The maximum amount of coverage is $1 million for each general account. There is no protection for market losses.

1.3.8 Exchange-Traded Funds (ETFs)

Exchange-Traded Funds (ETFs) are a type of pooled investment fund in which investors receive shares in the type of fund in which they invest. Mutual funds and segregated funds also pool investor deposits but issue units instead of shares.

People who buy ETFs may be slightly more sophisticated investors than those who buy GICs or mutual funds because ETFs are bought and sold on a stock exchange, and therefore the investor needs a brokerage account at an online vendor or traditional broker. Investors are motivated by the lower fees of ETFs compared to mutual funds.

ETFs are the investment product sold by robo-advisors, such as Wealthsimple. Robo-advisors are online investment advisors who use software to automate many tasks that were traditionally performed by portfolio managers. Clients complete an online questionnaire to specify their goals, time horizon and risk tolerance. The results of that questionnaire determine the best ETF approach. The software of the firm continually monitors the investor’s account and rebalances the account automatically to maintain the correct asset mix. This hands’-off approach translates into lower fees for the investor who does not want access to personal assistance.

ETFs are available in an indexed form and an actively managed form through traditional investment dealers who act as account managers. They guide investors in their choices.

The indexed form mimics the returns of an underlying index, such as a stock market index. Indexes exist for many asset categories, for instance equities on the S&P/TSX Composite index, bonds, commodities, or real estate in Canada and abroad.

The actively managed form sees the manager choosing investments for their contribution to a stated investment objective, such as capital growth.

There is typically a cost to ETF investors when they buy and sell their shares. This comes in the form of a sales commission, which is similar to the commission charged when an investor trades stocks. Although some ETFs are available without a commission, firms that offer commission-free ETFs will compensate for the absence of commissions in other ways. They may impose the purchase of a specified number of units or a dollar value per trade or require the investor to a sign up to their online investing platform.

Like mutual funds, an MER is also charged against ETF shares, however the MER is significantly lower than the MER of mutual funds or segregated funds. Also, like mutual funds, a trading expense ratio (TER) is charged. Active ETFs incur the highest TERs because more trading results in a higher total trading cost. Investors may also be charged a trailer fee by the financial advisor managing the ETF on their behalf.

1.3.8.1 Advantages and disadvantages of ETFs

Some of the advantages of ETFs include:

- Diversification;
- Convenience of trading like stocks;
- High degree of transparency with holdings disclosed daily;
- Lower MER than mutual funds and segregated funds;
- No sales load;
- Professional management;
- Ability to react rapidly to market developments and speculation on short-term price movements;
- Ability for advanced trading transactions such as limit, stop loss, margin and short sale orders, options, and sector rotation;
- Exposure to commodities provided to small investors.

Some of the disadvantages of ETFs include:

- A commission is usually charged on buy and sell orders;
- Low liquidity for ETFs that are not frequently traded or not traded in high volumes;
- Fees include both MER and TER;
- Complexity of the investment: the litmus test for investment suitability is the ability of the investor to describe how his money is invested, how growth is achieved, and the conditions under which his principal and returns are received. If an investor is unable to answer these questions about an ETF, then it may not be suitable for him.

1.3.8.2 Where and how to buy ETFs

ETFs are currently sold by ETF Facts. This document contains all the information the investor needs to base his buying decision on, and provides consistent disclosure about the investment, like Fund Facts does for mutual funds. However, since ETFs are traded on an exchange, additional content addresses trading and pricing characteristics. A prospectus is available to investors upon request.

To make an ETF investment, the investor either opens an account with a securities firm, discount broker, robo-advisor or uses an existing investment account. If a discount broker is used, the applicant must find the correct exchange and stock ticker symbol for the desired ETF.

1.3.8.3 Types of ETFs

ETFs are available to track currencies, industries, commodities, style (such as growth, value or market capitalization), bonds, dividends, or real estate in Canada and abroad. Still other, more exotic, ETFs are available. For example, inverse ETFs move in opposite direction of an associated exchange index or indexes. Inverse financial sector ETFs, for example, profit when the financial sector declines. Volatility-linked ETFs are bets for or against volatility in the stock market.

Index-based ETFs track their target index in one of two ways. A replicate index-based ETF holds every security in the target index because it invests 100 percent of its assets proportionately in all the securities in the target index. A sample index-based ETF does not hold every security in the target index; instead the sponsor chooses a representative sample of securities in the target index in which to invest.

Actively managed ETFs do not mirror an underlying index. They have a benchmark index, used as a standard to monitor performance. Managers, however, have the ability to change sector allocations, time trades, or deviate from the index as they see fit. Actively managed ETFs must disclose the identities and weightings of the component securities and other assets held by the ETF each business day on their publicly available websites. This provides a level of transparency unique among fund investments.

1.3.8.4 Returns and guarantees of ETFs

There are no guarantees for ETFs.

Investors buy and sell shares at market price, and this price changes throughout the trading day. Valuation occurs daily.

The performance of an ETF may not exactly mirror the performance of its underlying index. Sometimes the holdings in the ETF are not exactly the same as its underlying index or in exactly the same proportion. This can account for a difference in return between the actual index and the ETF.

Distributions are received by investors in the form they are earned – interest, dividends, or capital gains.

Cash distributions are paid monthly, quarterly, semi-annually or annually.

Capital gains are distributed in December.

1.3.8.5 Risks of investing in ETFs

ETF risk is classified in the same manner as mutual funds, and is expressed as low, low to medium, medium, medium to high, and high. These levels are based on a range of standard deviation, which is a formula measuring returns. It demonstrates that the highest risk is experienced in those funds with the highest standard deviation.

ETF risk is a result of the index or industry that the ETF emulates, or where the underlying index is based. Therefore, they have market risk and may have industry risk and currency risk.

ETFs may also experience liquidity risk if the fund is not broadly based. ETFs that have narrow categories or are country-specific may be thinly traded. Severe economic conditions could dry up trading for such ETFs.

1.3.8.6 Investor protection

The CIPF protects accounts held by its members up to specified limits if the dealer becomes insolvent. There is no protection against market loss.

1.3.9 Real estate

Real estate for investment purposes is not the purchase of the principal residence of the investor, or other property used strictly for personal use. Investment real estate includes residential, commercial, and industrial properties that the investor buys and, in turn, rents or leases to occupants.

An investment in real estate offers the investor the opportunity to gain from an increase in the market value of the property, and to earn rental income. Equity can grow rapidly if rental income is applied against an outstanding mortgage.

1.3.9.1 Advantages and disadvantages of real estate

Investing in real estate adds diversification to an investor’s portfolio of investments.

Real estate offers the following advantages to an investor:

- Potential to earn a steady rental income;
- Potential to earn a capital gain on the sale of the income property and benefit from the tax advantages accorded to capital gains thanks to the capital gains exemption;
- Potential to see an increase in property value due to general real estate market conditions or due to improvements in the property that the investor makes;
- Easily purchased investment;
- Physical asset that can be used as collateral to secure borrowing.

The disadvantages of investing in real estate include:

- **Need to fund the down payment for the land or property:**
  This can be a significant sum depending on the value of the real estate being purchased.
- **Need of the investor to provide evidence of financial stability and strength:**
  He must be able to prove to the holder of a mortgage on the property that he can personally make mortgage payments if rental income dries up.
- **Commissions charged on real estate sales by sales agents are high and greatly reduce the sale proceeds:**
  Other fees, such as a land transfer tax, may also be charged.
- **Value is subject to market conditions:**
  Just as prices may increase, they may also decrease.
- **Obligations of becoming a landlord:**
  Real estate investor-landlords have many legal requirements and obligations to their tenants.
- **Ongoing expenses in the form of property maintenance, property tax, and landlord insurance:**
  The property must be kept up to preserve the investment, and to meet obligations to renters. Tax must be paid to local authorities based on the value of the property, and insurance will be required to protect against claims that result from premises liability, fire, smoke, water damage, and vandalism. These expenses must be tracked over the entire period of ownership to reduce the capital gain on the property.
- **Government speculation tax:**
  Jurisdictions have implemented a tax on foreign nationals and unoccupied residential properties.

1.3.9.2 Types of investment real estate

Real estate investment properties include residential, commercial, and industrial properties.

Residential properties include all forms of homes that people rent or lease in which to live. They include condominiums, apartment buildings, and single or multi-family homes.

Commercial properties are those used mainly for service businesses, such as a restaurant or office building.

Industrial properties tend to be large buildings and facilities in which manufacturing and related businesses generally operate.

Investment real estate also includes the ownership of land. This is property that is undeveloped but expected to be developed at a future date.

1.3.9.3 Returns and guarantees of real estate

There are no guarantees provided to real estate investors.

Returns are in the form of rental income, which is taxed like interest income, but certain expenses are allowed to be deducted from gross rental income. A capital gain (or capital loss) may be generated if the property increases in market value (or loses market value) at the time of sale.

1.3.9.4 Risks of investing in real estate

Real estate poses some of the greatest investment liquidity risk. An investor who needs the money invested in real estate must hope that a likely buyer can be quickly and easily found. Otherwise, he has little option but to start reducing the price of the property until the price has dropped to a point at which he will attract a buyer.

Market risk can be experienced in the real estate market if prices fall where the property is located, if buyers lose their appetite for certain types of properties or if the entire market falls.

A real estate investor may experience interest rate risk on the mortgage for the property. If interest rates increase during the term of the mortgage, such as five years, the higher interest rate will be charged at the time of renewal. This could mean a higher mortgage cost, which might not be able to be offset by charging higher rent. Interest rate risk is detailed further in this text.

1.3.9.5 Investor protection

There is no investor protection for real estate investors.

1.3.10 Canada Premium Bonds (CPBs) and Canada Savings Bonds (CSBs)

Canada Premium Bonds (CPBs) and Canada Savings Bonds (CSBs) were two well-known types of savings bonds offered by the Government of Canada to residents. Their sales were discontinued as of November 2017 and in 2021, all remaning outstanding CSBs reached maturity. These bonds are only of historical interest.

1.3.11 Cryptocurrency

Cryptocurrency, like Bitcoin, and also called cryptos and alt coins, is used both as a form of payment and for speculative investment. It is a digital currency in which cryptotokens are used by participants to transfer value.

Cryptocurrency is bought and sold through online exchanges. There are hundreds of exchanges and as of March 2022, 18,465 cryptocurrencies, with new currencies steadily being introduced. Cryptocurrency can also be earned through a process called mining, which requires an enormous amount of computer power and technology.

People buy cryptocurrency as a means of buying goods without an audit trail or regulations. It is therefore an ideal medium of exchange for criminal activity including money laundering and terrorist financing. Transactions occur instantly; the cryptocurrency exchanges charge a fee on sales transactions. Investors also buy cryptocurrency simply to hold and wait for its value to increase.

At the start of 2022, the market value of all cryptocurrencies was $US1.6 trillion. In November 2021, it had been $US2.9 trillion. In June 2022, it was $US971.6 billion, a decrease of almost 14% from the previous day. Such swings in value are the norm, not the exception. Bitcoin reached $US1 in value in 2011; in June 2022 it was $CDN30,198.20. Its all-time high was $CDN88,497.17.[5]

Some cryptocurrencies are available for purchase with dollars while others require cryptocurrency. The buyer creates an account on an exchange, and then transfers his coins to a wallet that is specific to the buyer. An online wallet is called a hot wallet, and may be susceptible to hacking and theft. A cold wallet is a physical device like a USB drive; it is more secure than a hot wallet. Transfers are recorded in a public ledger.

Investing in cryptocurrency is extremely risky – prices rise and fall dramatically. Most advisors would conclude that an investor be prepared for complete loss of a cryptocurrency investment.

1.3.12 Group plans

Groups that offer savings and investment plans to their members include employers, associations, and fraternal organizations. Group plans are most often associated with employers. They participate as the subscriber or administrator of the plan. The subscriber/administrator contracts with a group plan provider, such as an insurer, in order to offer a plan to employees. The employees participate in the subscriber's plan to accumulate savings for retirement. Participation by the employee may be mandatory or optional.

A group plan satisfies a very distinct objective for each of its two participants. An employer uses a plan, perhaps together with other company benefits, to attract and retain employees. A potential employee sees the group plan as a point of differentiation when weighing up a salary-plus-benefits package offered by the employer during hiring. Then, as an employee, the plan is a way to save money for retirement.

There are six fundamental types of group savings plans, and their features and characteristics are described later in this manual.

1.3.12.1 Advantages and disadvantages of group plans

The advantages or disadvantages of a group plan depend on how well each type of plan available meets the objectives of the participants and this depends partly on the type of plan adopted. These details are provided later in this manual.

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5. Coinbase. *Bitcoin price*. [online]. [Consulted June 13, 2022]. https://www.coinbase.com/price/bitcoin

1.3.12.2 Where and how to buy a group plan

Group plans are available from many providers; insurance companies are one source.

The group administrator coordinates a plan between the plan provider and plan members. The group administrator:

- Enrolls new members;
- Removes those who are no longer employees;
- Ensures contributions are met;
- Processes withdrawal requests;
- Communicates plan details to members and management;
- Ensures each member receives an annual pension plan statement.

Establishing a group plan requires the plan owner, which is usually an employer, to choose a type of plan that is suitable for its employees and the financial capacity of the firm.

1.3.12.3 Types of group plans

Group plans available for savings and investment purposes include the following:

- **Defined benefit pension plan (DBPP):**
  A DBPP pays a specified pension at retirement to plan members.
- **Defined contribution pension plan (DCPP):**
  A DCPP, also known as a money purchase plan, does not pay a specified pension at retirement to plan members.
- **Group registered retirement savings plan (GRRSP):**
  The sum available at retirement depends on earned income on which the RRSP contribution limit is based.
- **Deferred profit sharing plan (DPSP):**
  A DPSP shares a portion of company profits earned by the employer with employees.
- **Tax-free savings account (TFSA):**
  A TFSA allows an investor to earn tax-free investment income. The sum available depends on the amount saved and how it is invested.
- **Pooled registered pension plan (PRPP):**[6]
  A PRPP is a retirement savings plan for small business employees and the self-employed in which the sum available at retirement is not specified in advance.

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6. PRPP legislation varies from one province to the other. In Québec, the equivalent of the PRPP is the voluntary retirement savings plan (VRSP).

1.3.12.4 Returns and guarantees of group plans

As a plan member, and perhaps an employer, make contributions to a group plan, that money is prudently invested so that, when the time comes, the member will receive the proceeds of his plan. Regardless of how invested contributions grow over the period they are in a plan, all withdrawals from registered plans are taxed as interest income.

The only group pension plan that offers a guaranteed income on retirement is a DBPP. However, DBPPs can only guarantee the expected retirement income to members if their plans are fully funded. A fully funded plan is one in which the sponsor (e.g., employer) has made all the contributions to the plan for all plan members according to its actuarial obligation. Some employers have pension shortfalls because they have not made the required contributions. This means their pension liabilities are greater than their ability to pay. Pensioners could receive less than the amount of pension promised to them.

1.3.12.5 Risks in offering a group plan

The employer commits financially to make contributions and to pay the cost of administration. If business conditions change and company profitability suffers, meeting corporate commitments to pension contributions may be difficult. This could result in underfunded pension plans.

1.3.12.6 Risks in participating in a group plan

If a plan member (e.g., an employee) is responsible for making his own investment decisions (as he would in a DCPP or a GRRSP), then he faces the risks that come with investing, such as interest rate risk, inflation risk and market risk.

Also, the savings in a group plan are locked-in until retirement. This means that withdrawals cannot be made before retirement. All provinces provide unlocking provisions in the event of financial hardship or other proven need, but the retiree must prove that the funds are needed. This is a good reason for an individual who is enrolled in a locked-in plan to also save in a plan that can provide immediate access to funds, such as an RRSP or a TFSA.

1.3.12.7 Plan member protection

Pensions are administered provincially/territorially through the financial institutions commission or ministry responsible for the pension benefits act of the jurisdiction. The rights and benefits of plan members are protected through the Acts.

Some safeguards exist against corporate insolvency and inability to meet pension promises through the agencies that administer pension legislation in their province or territory.

However, there are companies that have failed to meet their pension obligation and have left their members with nothing. Their savings are gone. Some jurisdictions provide a guaranteed minimum income to plan beneficiaries who experience shortfalls due to underfunding. For example, in Ontario, the Pension Benefits Guarantee Fund insures pensions up to $1,500/month.[7]

1.4 Risks of investing

There are many risks of investing. Some can be controlled by the individual investor and some cannot.

1.4.1 Economy as a whole

Economic risk (which also includes political and legal risk) is the possibility that an investment will be affected by macroeconomic factors. Such factors include a change in government regulation or political upheaval that intervenes in all aspects of a society.

Pandemic risk must be considered part of economic risk due to the societal impact caused by a worldwide epidemic and its aftermath. As 2020 and 2021 proved, the global economy may be affected by a pandemic.

Economic risk cannot be managed by an individual investor. It is very difficult to predict and can have a significant impact on investment returns.

1.4.2 Equity risk

Anyone who invests in stocks listed on the stock market, directly or indirectly through equity funds, faces equity risk. Stock prices are established in the market and represented by stock trading exchanges such as the S&P/TSX Composite Index.

The market price of all stocks is in a constant state of flux, rising and falling according to supply and demand. Equity risk is the risk of loss because the stock price falls.

1.4.3 Inflation risk

Inflation risk is also known as purchasing power risk. Inflation is the increase in the cost of goods and services as measured by the Consumer Price Index (CPI). Inflation affects everyone. For people in their working years, an inflation rate may exceed wage increases. This is true for many in 2022. The result is that people cannot buy the same services or products as they could previously. When demand for goods decreases, companies reduce their output. Doing so increases unemployment since less employees are required to produce lesser goods. Meanwhile,

7. Financial Services Regulatory Authority of Ontario, *Pension Benefits Guarantee Fund (PBGF)*. [online]. [Consulted May 6, 2022]. https://www.fsrao.ca/consumers/pensions/pension-benefits-guarantee-fund-pbgf

fewer goods often drives up their prices due to the principle of supply and demand. Inflation truly is a vicious cycle.

It is very important for an agent to bear inflation risk in mind in recommendations, especially when dealing with younger clients who anticipate many years before retirement or their death. The longer the time horizon for investing, the greater the impact of inflation can be.

Also, those living on fixed incomes, such as retirees, strongly experience inflation risk. Although many private pensions from employers have a cost-of-living increase embedded in their plans, most retirees do not enjoy the benefits of a private pension. Their retirement income is sourced primarily from withdrawals from savings and investments.

Inflation is one of the factors in calculating the real return of an investment. Investment returns become more accurate when inflation is factored in.

Some investments' rate of return is lower than the rate of inflation. When this happens, the investor experiences a return that in turn causes a loss of purchasing power. That means he must spend more to buy an equal amount of goods and services in the future. Prices have increased but his income is less than the cost of the goods he needs to buy. The investor must face some hard decisions that can include taking out larger withdrawals (and thereby depleting his account faster than anticipated), finding a less expensive alternative, buying less, or going without.

Inflation is made more serious because it compounds year over year. Prices are inflated on inflated prices and so on. This is why long-term investments with low returns are particularly vulnerable to inflation risk.

Investments with low returns or returns that are tied to a specified rate of interest are affected by inflation. These include investments such as cash in savings accounts, GICs, bonds, and money market funds. Segregated funds that experience inflation risk are money market funds, and those invested in bonds. Annuities also experience inflation risk when they are issued with a low interest rate.

Equities are not immune from inflation risk. Fear of inflation causes stock market volatility which in turn affects equity funds and equity investors.

EXAMPLE

Assume that the average rate of return on a one-year Guaranteed Investment Certificate (GIC) on sale today is 2.20%. The inflation rate as of May 2022 is 6.7%. Therefore, if we assume the inflation rate will be the same for the next year, the real rate of return on the GIC is 4.5% (2.20% – 6.7%). The GIC is losing significant purchasing power.

1.4.4 Interest rate risk

Interest rate risk is experienced when an investment is locked in at a low interest rate. The investor will not be able to take advantage of higher interest rates if interest rates begin to climb. Interest rate risk is experienced with inflation risk.

In mid-2022, interest rate risk is a reason for falling residential real estate prices because buyers cannot afford large mortgages at higher interest rates. Banks and other mortgage providers stress test potential buyers before offering a mortgage to ensure the buyer can financially tolerate higher interest rates. Buyers are failing the stress test and simply finding the larger mortgages more than they wish to spend. Less demand for housing results in falling prices and can slow the construction of new homes. This can have a major ripple effect through the economy.

EXAMPLE

Assume that the interest earned on a three-year GIC is 3.00%. The interest rate that applies to GICs increases to 3.40% nine months after the GIC is purchased. The investor cannot benefit from the rise in interest rates. He is tied to the lower rate for the balance of the term.

Interest rate risk also occurs in bond pricing. As interest rates rise, bond prices decline – and vice versa. Therefore, the market value of a bond is less in a rising interest rate environment.

Interest rate risk is inherent in all investments that pay fixed rates of interest. This includes GICs, accumulation annuities, payout annuities, savings accounts, and bonds.

1.4.5 Market risk

Market risk is the risk that the total financial market will decline due to uncontrollable events. Diversification does not provide protection against market risk since many or all asset classes could be negatively affected. Events that can precipitate market risk include an economic event or a recession, pandemic, a major natural disaster, or a terrorist attack.

EXAMPLE 1

The financial crisis that began in 2007 was an example of how an economic event gave rise to market risk. The events that started that year and continued through to the end of 2008 caused all asset classes to decline. Massive government intervention was needed to prevent a total economic collapse.

In 2007, many U.S. homeowners owed more on mortgages than their properties were worth. This led to many foreclosures on residential real estate in the U.S. People simply walked away from their houses and mortgages, leaving the financial institutions holding those mortgages without incoming mortgage payments. This event became known as the sub-prime mortgage crisis. Real estate as an asset class was seriously negatively impacted. The loss of mortgage payments by financial institutions also affected the entire financial system because many investment dealers and banks had created financial products based on sub-prime mortgages.

In September 2008, the U.S. Congress rejected a $700 billion Wall Street financial rescue package for the financial services firms affected by the sub-prime mortgage crisis. This sent the Dow Jones Industrial Average down 778 points. Thus, equities were affected as an asset class.

Most investors felt some degree of impact from this crisis.

EXAMPLE 2

When the coronavirus pandemic started seriously impacting North America in March 2020, creating fear and uncertainty, there were negative effects on both the equity and bond markets. On March 12, 2020, the S&P/TSX Composite Index had its biggest single-day decline since 1940, losing 12.34%, a loss of 1,761.64 points. The bond market had already plummeted during February and early March, reaching its low point on March 9. Losses were not restricted to the North American markets; markets around the world all reacted to the uncertainty of the pandemic with huge declines.

These losses turned out to be temporary and in April 2022, the TSX reached an all-time high; by May 2022, the market had reversed and had lost over 5% for the year due to increasing interest rates, war in Ukraine, and continuing coronavirus lockdowns in China. Investors do not like uncertainty and national and international events of the year showed a high degree of uncertainty as to what happens next for the price and availability of products, including oil.

Real estate in 2021 continued to show ever-increasing market prices in many locations, although as interest rates started to climb in 2022, prices started to fall.

This series of events brought on by the pandemic illustrates how unknown and unpredictable forces can control markets and how investors can experience market risk.

1.4.6 Liquidity risk

Liquidity risk is the risk that an investment cannot be easily and quickly converted into cash. It also describes the risk that an investment cannot be sold without affecting its value.

Real estate is a prime example of an asset with liquidity risk. Annuities also have liquidity risk. Some annuities can be surrendered, but a withdrawal penalty charged by the insurance company along with market value adjustments will reduce the value of the investment.

1.4.7 Foreign exchange risk

Foreign exchange risk, also known as currency risk, is the risk that there is a change in price of one currency against another. It is experienced by investors or companies that invest or have assets or business operations in foreign countries.

Investment funds that invest in specific foreign geographic locations, such as the U.S., face this form of risk.

1.4.8 Credit risk

Credit risk (also known as default risk) is the risk that a borrower will fail to repay a loan or other financial obligation. It is particularly relevant to corporate bond issuers. Borrowers with the highest credit quality, such as the Government of Canada, have low credit risk. When credit quality is low, as is the case for low-rated bonds, credit risk is very high.

Low credit risk = High credit quality = Lower returns

High credit risk = Low credit quality = Potentially higher returns

Credit quality is rated by firms including Moody's and Standard and Poor's. They provide bond ratings and ratings for many other investments and financial institutions.

Insurance companies that offer exceptional financial security receive a top rating, such as AAA. Insurance companies rated C are the lowest-rated class and can be regarded as having extremely poor prospects of offering financial security.

1.4.9 Industry risk

Industry risk is the risk faced by specific industries, such as technology or mining. For example, the retail industry could experience consumer indifference to products, an inability to control costs, or a disruption among suppliers.

Investments that experience industry risk include those that focus on specific industry investing, such as mutual funds.

1.4.10 Other investing risks

There are many investing risks, both general and specific. Agents and investors must be knowledgeable about the risks associated with investments to determine if such risks are within investor risk tolerance and risk capacity.

CHAPTER 2
SEGREGATED FUNDS

Competency component

- Analyze the available products that meet the client's needs;
- Implement a recommendation adapted to the client's needs and situation.

Competency sub-components

- Analyze the types of investments that can constitute a segregated fund and that meet the client's needs;
- Analyze the advantages and limitations of segregated funds in comparison to other types of investments in regard to the client's needs;
- Propose a recommendation adapted to the client's needs and situation.

2
SEGREGATED FUNDS

Segregated funds are an investment that is exclusively created by life insurance companies. Their key characteristics have been introduced in Chapter 1 and will now be examined more closely.

Segregated funds are offered through an insurance contract and they come with guarantees that protect their value. They are a suitable investment for those who want investment income or growth through exposure to the financial markets and, yet, want to limit risk.

Segregated funds are an alternative to other fund investing and they provide many advantages to their investors.

2.1 Advantages of segregated funds

The following advantages of segregated funds are discussed in the next pages:

- Guarantees;
- Growth secured by reset;
- Funding flexibility through ongoing deposits;
- Ease of monitoring value;
- Guaranteed income;
- Professional management;
- Diversification;
- Tax benefits;
- Switches between funds;
- Ability to withdraw (redemption);
- Exemption from probate fees;
- Investor protection;
- Protection from creditors;
- Absence of medical underwriting;
- Right of rescission.

2.1.1 Guarantees

Segregated funds provide two guarantees that protect the investor from the loss of principal: a maturity guarantee and a death benefit guarantee.

The maturity guarantee applies on the maturity date of the contract. The minimum maturity date is ten years, never less, from the time the first deposit (or premium) is paid to the insurer, although some contracts offer maturity dates much longer than ten years. A contract never matures before ten years. The maturity guarantee ensures that, on the maturity date, an amount that is equal to at least 75% of the amount the policy owner deposited to the contract is paid out.

The death benefit guarantee applies throughout the entire term of the contract. It applies whenever the annuitant dies during the contract, and is equal to, at least, 75% of the sum deposited to the contract.

Withdrawals from the contract reduce the sum on which the guarantees are calculated. The minimum guarantee percentages (75%/75%) remain the same and they are applied to the lower balance of the contract after the withdrawal is made.

To best understand the guarantees, it is important to understand the roles of the parties to the contract.

There are three parties:

- The first party is the person whose money (the principal) is deposited to the contract. This is the policy owner. He makes the investment decisions pertaining to the contract. He may also make withdrawals. The policy owner receives the policy proceeds when the contract matures and, therefore, is the person who benefits from the maturity guarantee;
- The second party to the contract is the annuitant. If the policy owner buys the segregated fund contract in an RRSP or a RRIF, the policy owner must be the annuitant of the policy. If the policyowner buys the contact in a non-registered, also called a taxable, account, the annuitant can be any person named by the policy owner. The annuitant is the person on whose death the death benefit is issued;
- The beneficiary is the third party to the contract. The policy owner names the beneficiary of the contract. If the annuitant dies, the beneficiary receives an amount that is equal to, at least, 75% of the initial deposit. Therefore, the beneficiary benefits from the death benefit guarantee.

The minimum maturity guarantee and death benefit guarantee is 75% of deposits based on a 10-year term-to-maturity. Some contracts are structured to offer 100% guarantees. Often these contracts are based on a longer term-to-maturity, such as 15 years. Some segregated funds extend the maturity date to age 100 of the policyowner.

Maturity and death benefit guarantees may be equal (75%/75%), or the maturity guarantee may be less than the death benefit guarantee (75%/100%). If the value of the contract at maturity or death is less than the guarantee, the insurer makes up the difference so that the amount paid out is equal to the guarantee. This is often referred to as a top-up.

The life insurance agent assists the investor to choose a contract that provides the guarantees and term-to-maturity most suitable to his needs and objectives.

The key pieces of information needed to understand how the maturity and death benefit guarantees apply and when they are paid are:

- What is the value of the principal, or premium, invested by the policy owner in the segregated fund? (This is the sum on which the guarantee is based.)
- What is the guarantee: 75% or 100%? (This percentage is applied to the principal and determines the amount received on maturity and on death.)
- What is the market value of the contract at maturity or death?[8] (This is the sum that dictates whether a top-up is needed to equal the guarantee.)

2.1.1.1 Maturity guarantee

As previously mentioned, segregated funds are issued as an insurance contract with a minimum 10-year term-to-maturity. Some funds have a longer term-to-maturity, but none are shorter than ten years.

The maturity guarantee gives the policy owner the peace of mind of knowing that, no matter how the fund performs, the sum he will receive at maturity will be at least 75% of the amount he invested.

This provides what is known as downside protection. It limits investment risk by establishing a minimum contract value payable at maturity. However, there is no maximum to what the value may be. This is called unlimited upside potential.

On maturity of the contract, the policy owner has two options. He may withdraw the value of his investment or he may extend the contract and leave his investment in place. In either case, the insurer determines the market value of the contract and compares that sum against the contract maturity guarantee:

- If the market value is greater than the guarantee value, the policy owner receives the market value;
- If the market value is less than the guarantee value, the policy owner receives the guarantee value.

Therefore, on maturity, the policy owner never receives less than the maturity guarantee, as illustrated by Table 2.1.

8. The market value is the worth of the segregated fund units held by the policy owner at a point in time. Market value is determined as: unit value x number of units owned. Valuation will be explained later in this Chapter.

TABLE 2.1

Determining value received at maturity

MARKET VALUE OF CONTRACT AT MATURITY	AMOUNT RECEIVED BY POLICY OWNER
Higher than guarantee value	Market value
Lower than guarantee value	Guarantee value

When the market value is less than the guarantee value, the insurer makes up the difference between the market value and the guarantee from its financial reserves. In effect, the insurer tops up the market value to equal the value of the maturity guarantee.

This top-up is paid to the policy owner in cash if the contract is terminated. If the contract is extended, the top-up is attributed to the account so that the value of the maturity guarantee may remain the same moving forward.

The maturity guarantee applies only on the maturity date of the contract.

Therefore, if a policy owner withdraws some units before the contract matures, he receives the market value of the units at that time. If the withdrawal is made and a sales charge applies, the applicable charges will be deducted from the withdrawal.

The market value of the units may be greater than, equal to or less than the value of the units when the deposit was made. There is no guarantee in regard to their value when surrendered.

A partial withdrawal or full contract surrender before the maturity date does not receive the benefit of the maturity guarantee. As mentioned previously, withdrawals reduce the sum protected by the guarantees but do not change the percentages of the guarantees.

EXAMPLE

Michael invests $10,000 in a segregated fund with a 75% maturity guarantee. The guarantee at maturity is $7,500 ($10,000 × 75%).

Scenario 1

At maturity, the fund has a market value of $8,360. This is greater than the maturity guarantee and it is the sum Michael receives.

Scenario 2

At maturity, the fund has a market value of $6,360. This is less than the maturity guarantee. Michael receives $7,500, which comprises the market value plus a guarantee top-up of $1,140 ($7,500 – $6,360).

Scenario 3

At maturity, the fund has a market value of $13,200. This is the sum Michael receives without need for the maturity guarantee.

Scenario 4

After four years Michael surrenders the contract. The fund has a market value of $7,120 and this is the sum Michael receives. Michael does not receive the benefit of the maturity guarantee because he has surrendered the contract before its maturity date.

2.1.1.2 Death benefit guarantee

The death benefit guarantee is a promise made by the insurer that the beneficiary of the segregated fund contract will receive at least 75% of the sum deposited to the contract if the annuitant of the contract dies during the term of the contract. Up to 100% may be paid; this percentage is set out in the contract.

The death benefit is received by the beneficiary.

The guarantee, whether 75% or 100%, is a minimum. The amount paid to the beneficiary as the death benefit is calculated the same way the maturity guarantee is calculated. It is based on the amount deposited to the contract, its market value at the time of death and the death benefit guarantee under the contract. The beneficiary receives the greater of market value or the death benefit guarantee.

If the market value is less than the guarantee, the insurer makes up the difference between the two amounts. Similar to the maturity guarantee, the amount contributed by the insurer may be referred to as a top-up because the insurer tops up the lesser value in order to fulfill its contractual promise.

There are four advantages to the death benefit guarantee:

- The beneficiary is protected from fund losses throughout the term of the contract, just like the maturity guarantee protects the policy owner.
- The guarantee applies from day one of the contract. Segregated funds are a long-term investment but if there is a drop in market value in the short term and death occurs, the decrease in value is accommodated by the guarantee.
- Segregated funds do not require medical underwriting. Therefore, an older person or a person in ill health does not need to be concerned about poor market conditions at the time of his death. The guarantee gives him peace of mind that his beneficiary will receive at least 75% of deposits.
- Like the maturity guarantee, there is no upper limit to how much the beneficiary might receive if market conditions are favourable and unit values are high at the time of death.

The death benefit may also be reduced by a sales charge. Some insurers waive these charges when the contract ends due to death.

The value of the investment is further enhanced because it will not be subject to probate fees if there is a named beneficiary that is not the estate of the deceased.

EXAMPLE

Keith is the policy owner and annuitant of a segregated fund contract with a 75% death benefit guarantee. Keith funded the contract with a $10,000 bonus he received from his employer. The death benefit guarantee is, therefore, $7,500 ($10,000 × 75%). His wife, Patricia, is the beneficiary of the contract. Keith dies during the ninth year of the contract.

Scenario 1

At the time of Keith's death, the market value of the contract is $12,640. Patricia receives that amount since it is greater than the death benefit guarantee of $7,500.

Scenario 2

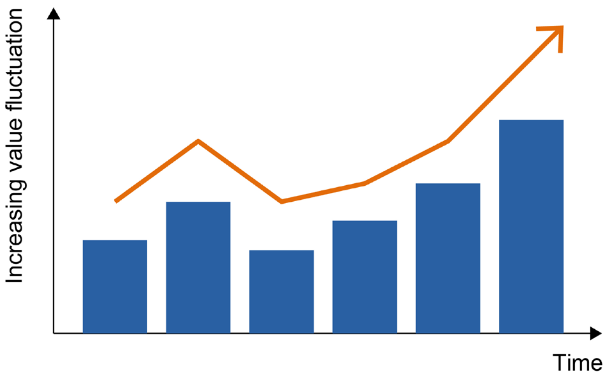
At the time of Keith's death, the market value of the contract is $6,300, which is less than the guaranteed amount ($7,500). Patricia receives the death benefit guarantee of $7,500, which represents the market value of $6,300 plus a top-up of $1,200 ($7,500 – $6,300).

2.1.2 Growth secured by reset

Market values of fund units go up and down. There is no predicting when values might change or by how much. All fund investors hope to see their units continually rise in value. Typically, increasing values, if plotted on a graph, look like steps or a series of ever-higher mountain peaks. Diagram 2.1 shows an increasing value with fluctuations.

DIAGRAM 2.1

Fluctuation in market values of fund units



Segregated funds are unique in that they offer investors a chance to lock-in an increase in value during the term of the contract in a process known as reset. So, when the value of the contract rises due to fund performance and it achieves a new high, the investor can set the contract value at that higher level. If losses subsequently occur in fund value, there is no impact on the investor because he captured his gains at the higher value. This process can be repeated over and over (limited by the conditions of the contract), ratcheting up the contract value at ever greater worth.

This is a unique feature of segregated funds and the ability to participate in gains and hold onto them moving forward has incredible potential for the investor.

There is a downside to reset. It also has the effect of increasing the maturity and death benefit guarantees and changing the contract's maturity date. The new maturity date of the contract is ten years from the reset date.

Both the policy owner, through the maturity guarantee, and beneficiary, through the death benefit guarantee, can benefit from reset.

EXAMPLE

An investor deposits $20,000 in a segregated fund. The 75% maturity and death benefit guarantees are $15,000 ($20,000 × 75%).

If the market value increases to $50,000 in the fourth year of the contract, the guarantees will now amount to $37,500 ($50,000 × 75%) if the contract is reset.

Some insurers offer an automatic reset on segregated fund contracts in which the insurer automatically locks-in growth of the account value. Others put the decision to reset into the hands of the policy owner. Regardless of who resets the contract, the maturity date is extended when it is reset.

Therefore, reset may be attractive to an investor who is oriented towards fund growth and increasing his investment returns. However, reset may not appeal to an investor who has a strict 10-year time horizon for his investment.

Not all insurers offer reset on their segregated funds. If reset is available, and it is up to the policy owner to make the reset decision, he does not have to reset the contract because he may not want to extend its maturity date.

EXAMPLE

Hassan deposits $5,000 to a segregated fund contract with a 75% maturity guarantee and 75% death benefit guarantee. Each guarantee is worth $3,750. ($5,000 × 75%). After two years, the market value of the contract is $7,000. Hassan's contract offers reset and he chooses to reset the contract. This increases the maturity and death benefit guarantees to $5,250 ($7,000 × 75%) and resets the maturity date of the contract. His contract now matures 10 years from the reset date (12 years from the time of the initial deposit).

There may be limitations to reset, such as an additional fee charged annually to contracts in which reset is permitted. Also, an insurer may offer reset on the maturity guarantee separately from the death benefit guarantee. If so, the investor could choose to reset the maturity guarantee but not the death benefit guarantee, or vice versa.

The insurer provides information regarding the number of resets allowed and the mechanisms to request or accept a reset in the information folder provided at the time of sale of the fund.

2.1.3 Funding flexibility through ongoing deposits

The principal deposited to a segregated fund contract is called the deposit or premium. It can be contributed as a lump sum or as a series of deposits.

When a series of deposits is made, the maturity guarantee may be applied to the individual deposit dates or to the date of the contract.

Most commonly the guarantee is based on the deposit date or dates. Each deposit has its own maturity guarantee (of 75% or 100% of deposit value), the length of which is based on the term-to-maturity in the contract (ten years or more). Therefore, deposit one has a maturity guarantee that applies from its deposit date, deposit two has a maturity guarantee from its deposit date, deposit three has a maturity guarantee from its deposit date, and so on.

EXAMPLE

Sandra has a deposit date-based segregated fund with a 10-year term-to-maturity. She deposits $2,000 as an initial deposit and then $2,000 every year thereafter on January 1 for two years for a total of three separate deposits.

At the start of her contract, her maturity guarantee is $1,500 (1 × ($2,000 × 75%)) in ten years.

At the end of 11 years, her maturity guarantee is $3,000 (2 × ($2,000 × 75%)).

At the end of 12 years, her maturity guarantee is $4,500 (3 × ($2,000 × 75%)).

2.1.4 Ease of monitoring value

An investment in a segregated fund provides the investor with an assigned number of units. The number of units assigned at the time of purchase is a result of how much is invested and their fair market value. Every fund has its own unit value. This is also true of mutual funds.

It is essential for the investor to know the value of units when they are assigned if he wishes to follow performance and monitor changes in value. An increase may indicate that a reset is in order. A decrease could suggest a fund switch is in order.

EXAMPLE

An investor invests $1,000 in ZYX fund, in which units have a market value of $10; he is assigned 100 units ($1,000 ÷ $10). If the market value of the units increases to $12, his investment will be valued at $1,200 ($12 × 100).

A unit value is determined for each fund. The value is called the NAVPU or net asset value per unit (the term NAV, or net asset value, is also used). It is calculated as:

$$\text{NAVPU} = \frac{\text{total value of assets – liabilities}}{\text{number of units outstanding}}$$

The NAVPU is determined on each valuation day. For a fund investing in Canadian equities, a valuation day is a day that the Toronto Stock Exchange is open. Therefore, if a valuation shows an increase in NAVPU, the market value of the investment has increased.

Unit values increase and decrease in step with the value of assets held within the fund. However, the number of units assigned to the investor does not change unless he makes an additional deposit (in other words, he buys more units) or a withdrawal (by selling units).

Allocations are another way an investor benefits financially from his segregated fund. Segregated funds allocate taxable income and realized capital gains and/or losses to non-registered contract owners. Investment growth in a fund is generated in the form of interest, dividends and capital gains. These earnings are not distributed to investors in the form of cash. Instead, the allocations change the adjusted cost base of the units but not their NAV. Interest, dividends, and capital gains increase the ACB. Capital losses decrease the ACB. The change to the ACB is tracked by the insurance company.

If an investor wants cash from the fund, he must make a withdrawal by redeeming fund units.

2.1.5 Guaranteed income

A segregated fund contract typically returns its value on maturity in a lump-sum payment. Alternatively, a contract may create a guaranteed stream of payments. This feature may be added to an existing contract or be part of the conditions upon issue. Such a contract is available in two forms: the Guaranteed Minimum Withdrawal Benefit (GMWB) and the Guaranteed Lifetime Withdrawal Benefit (GLWB).

Like all segregated fund contracts, these withdrawal benefit plans provide a maturity and death benefit guarantee. They are differentiated by the regular payments they provide, which is often compared to income because of the regularity with which the payments are made. This is one reason that withdrawal benefit plans are attractive to retirees.

Not all insurers offer contracts that can provide regular withdrawal benefits. Also, there are many features, options and restrictions that differ between these plans as offered by different insurers. Due to their complex rules and requirements, they may not be suitable for all investors who seek income.

2.1.5.1 Guaranteed Minimum Withdrawal Benefit (GMWB) and Guaranteed Lifetime Withdrawal Benefit (GLWB)

Both the GMWB and GLWB plans are based on an initial deposit or deposits by an investor to a segregated fund contract. The GMWB provides a regular income over a set period of time. The GLWB pays income for life.

Investors may begin making withdrawals immediately after entering into a contract, or they may choose to wait before starting to make withdrawals. Those who wait have two phases to their plans: a savings phase and a payout phase.

The savings phase is a period of accumulation. During the savings phase, investors receive the potential for increase in fund market value. They also earn a credit every year in which a withdrawal is not made. The credit is based on a percentage of the initial deposit. For instance, the credit may be 5%. The value of the initial deposit plus the annual credits form a base on which a guaranteed minimum withdrawal is based. Any withdrawals during the savings phase reduce the value of the initial deposit and thus of the corresponding credits and final guaranteed minimum withdrawal amount.

The payout phase starts when regular withdrawals begin. During the payout phase, the investor receives an annual income based on the guaranteed minimum withdrawal balance created during the savings phase. As withdrawals are made, the value of the contract declines. However, the annual income guarantee is not affected. It is also insulated against poor market performance of the fund so that the same annual income is received even if the market value decreases.

Extra withdrawals can be made that exceed the guaranteed income payment. They may be penalized with fees and, like all withdrawals, reduce the base used to determine future guaranteed income.

The payout value may be reset every three years. Reset creates a potential for increased income if the market value of the contract has increased, provided additional withdrawals have not been made.

The payout also increases if more premiums are contributed after the initial deposit.

The amount received is based on the payout beginning at a specified age and lasting for either a specific period of time, such as 20 years or for life. A lifetime payout will be at a lower rate than if income is taken for a specified period because the contract value is stretched over a potentially longer time. This is similar to the payment made from a life annuity compared to a term annuity.

One of the risks faced by retirees is the risk that they might outlive their financial resources. This is called longevity risk. Lifetime income appeals to those with this concern and is why individuals buy guaranteed lifetime withdrawal plans, and life annuities. Both products address longevity risk.

2.1.6 Professional management

Segregated funds employ professional investment managers to provide investment management and advice. These managers are compensated by fees, which are part of the management expense ratio (MER) charged against fund assets to investors.

The investment managers are hired by the insurance company offering the segregated fund or funds. The insurer retains the right to appoint or change a manager. A management change is reported to investors.

The fund manager is a highly educated and well-trained investment professional. The average investor has neither the time nor the expertise to compete with the typical fund manager. By leaving investment decisions in the hands of the fund manager, the average investor can achieve his investment objectives without having to be actively involved in the day-to-day management of his investments, thereby eliminating the obligation to make ongoing decisions.

This never alleviates the life insurance agent’s responsibility to work with the client to ensure his objectives are being met in the fund investment. The agent must be prepared for regular client meetings in which performance and other factors about the fund will be discussed.

2.1.7 Diversification

Segregated funds are highly diversified investments. This means their managers use a wide range of investments suitable to the type of fund. For example, an equity fund is highly diversified because it holds shares of many companies.

Diversification is a key to investing success. It lessens risk for the average investor since risk is spread over all the investments held in the fund. And, even in the unlikely event that all diversified assets in a segregated fund were to lose all their value, the segregated fund investor would be protected to a maximum loss by his maturity and death benefit guarantee.

2.1.8 Tax benefits

Segregated fund investing offers several tax advantages compared to mutual funds.

The ACB of a segregated fund is tracked by its insurer and there is virtually no possibility for error. This simplifies annual tax reporting unlike a mutual fund in which the investor must take responsibility for reporting transactions.

The interest, dividends and capital gains earned in a fund are reinvested in that fund. They increase unit value and increase the investor's adjusted cost base (ACB) per unit. The ACB is a calculation that determines the tax cost of an investment to its investor. Increasing the ACB reduces tax when the units are sold.

The investor with a non-registered account receives the earnings on a flow-through basis. This means interest earned in the fund is reported for tax purposes to the investor as interest, dividends earned are reported as dividends, and capital gains and losses earned are reported as such. Capital losses are used to reduce capital gains in the year in which the loss occurs. If a loss cannot be fully used in that year, it can be carried back to the three previous years or forward indefinitely. This gives the investor the ability to choose when to claim his capital loss.

Finally, but not to be overlooked, is that proceeds of segregated fund death benefits are probate free when a beneficiary is named. Probate, though not precisely a tax, operates as a tax on the value of an estate remaining after death.

EXAMPLE

Henry invests $1,000 in WWW Seg Fund Series B on September 1 in his non-registered account. He is assigned 200 units on the basis that each unit is worth $5 ($1,000 ÷ $5 = 200). At the end of the year, a $100 allocation is made to Henry's policy and the unit value is fixed at $6 due to fund growth. Henry now has 200 units worth $1,200 and each unit is worth $6 ($1,200 ÷ 200). The ACB of Henry's policy is now $1,100: the initial $1,000 investment plus the $100 allocation.

The $100 allocation Henry received is reported on a tax slip issued by the insurer to Henry as $50 in interest and $50 in capital gain. The interest is taxed at Henry's marginal tax rate. The capital gain is also taxed at his marginal rate, but only 50% of the gain is taxable ($50 × 50% = $25).

If Henry's marginal tax rate is 36%, he pays $18 tax on the interest he receives ($50 × 36% = $18). He pays $9 income tax on the capital gain ($25 × 36% = $9).

2.1.9 Switches between funds

A lot can happen to an investor during the term-to-maturity of a segregated fund. He can become more risk-averse or more risk-tolerant. He can become frustrated with performance that is lower than expected or dissatisfied with a high MER. Switching from one fund to another may alleviate investor concern and a new fund may better suit his objectives. Whatever the reason, the investor who wants to switch his account value from one fund to another may do so with a segregated fund investment, aided by the life insurance agent who recommended the fund investment.

The investor who contemplates a switch must be provided with the same information documents for the new fund as were received at the initial purchase before the switch occurs. This includes both the information folder and Fund Facts for the new fund.

When the switch is being made, the value of the existing fund units is determined on the valuation date, which is either the day of the switch request or the following day. This is the sum that will be used to acquire units in the new fund. There is typically a minimum amount that can be transferred.

Contract guarantees are not affected by fund switches.

The number of switches the investor may make per year without incurring a switching fee may be limited. Individual funds state their switching policy in the information folder provided to the investor. An investor may incur a tax liability when a switch is made.

An investor who switches funds where each fund charges the same load, e.g. a front-end load (FEL), will not incur a fee for the switch. However, there may be a fee for switching between funds with dissimilar loads, e.g. a no-load fund to an FEL. The insurer will state their policy for fees on switches in the information folder of the fund.

2.1.10 Ability to withdraw (redemption)

The investor enters into the segregated fund contract with the intention of seeing the contract mature in at least ten years, i.e., the term of the contract. However, his financial circumstances can change during this period and he may find he needs to make a withdrawal from the contract to receive cash in hand. A withdrawal is also known as redemption.

The investor may make a withdrawal at any time. This provides him with investment flexibility.

The withdrawal process begins by the investor informing the insurer that issued the fund contract of the amount he wishes to withdraw. The investor redeems the number of units that will provide the desired sum of money based on their market value. The market value is determined at the valuation day following the request. The investor receives the money from the insurer within days of the valuation date.

The maturity guarantee and death benefit guarantee of the contract are reduced as a result of the withdrawal because the investor has fewer fund units. The insurer calculates the new guarantees according to the terms of the contract.

A withdrawal may trigger tax. The contract owner receives a tax reporting slip from the insurer so that the withdrawal may be taken into consideration in the tax return for that year.

2.1.11 Exemption from probate fees

Probate is the process in which the will of a deceased person is proven to be valid and the person appointed as executor of the will is accepted. It occurs in the provincial home court of the deceased and is finalized when Letters Probate or an equivalent document is issued.

Probate fees are a charge by the province or territory against the value of a deceased's estate. Only Québec and Manitoba do not charge probate fees. There are great differences between both how much each province charges as the probate fee and what assets are included in the estate for the purpose of probate.

Probate fees must be paid by the estate of the deceased before any property can be inherited as specified in the will. They can significantly reduce estate value in a province, such as B.C, that does not put an upper-end cap on probate fees.

Some exceptions apply to the requirement to pay probate. Probate fees are not charged to trusts or when a surviving spouse inherits assets. Probate fees also do not apply when the beneficiary of a segregated fund contract is not the estate. A named beneficiary receives the proceeds from the contract probate-free. This includes the spouse, parents, children and grandchildren of the contract owner or annuitant. The ability to put the proceeds into the hands of the beneficiary without going to probate is one of the single most important benefits of segregated fund ownership. Potentially thousands of dollars in probate fees can be saved.

However, there will be no saving if the estate is named as beneficiary. If the estate receives the proceeds, it becomes part of the total estate value and subject to probate fees.

Also, segregated funds are redeemable on each valuation day. Therefore, the account value can be received by the beneficiary within days instead of the months it takes when an estate must go through probate.

2.1.12 Investor protection

Assuris steps in to provide investor protection when an insurer becomes insolvent and cannot meet its financial obligation to pay guarantees.

Assuris facilitates a quick transfer of policies from the insolvent insurer to another insurer that has the financial capacity to honour guarantees and benefits.

2.1.12.1 Guarantee exceeds market value

Assuris protection is needed only when the guarantees of the segregated fund investment at maturity or death are higher than the market value of the fund. When market value is greater than guarantees there is no need for Assuris participation since the market value can fund the obligation of the guarantees.

Assuris guarantees a segregated fund contract owner will retain up to $60,000 or 85% of guarantees, whichever is higher. In other words, it allows a segregated fund contract owner to retain 100% of his guaranteed investment if it is equal to or smaller than $60,000. For investments valued at more than $60,000, contract owners will retain 85% of guarantees.

EXAMPLE

Mark has deposited $100,000 to his segregated fund account and the contract has a 75% maturity guarantee. Therefore, Mark is guaranteed to receive $75,000 on maturity. When his insurer is unable to pay the maturity guarantee due to insolvency, Assuris coverage is applied. Mark is going to receive the greater of $60,000, or $75,000 × 85% ($63,750).

Therefore, Mark receives $63,750 since it is greater than $60,000.

2.1.13 Creditor protection

A creditor is a person or business to whom money is owed by a borrower, i.e. if I loan money to you, I am your creditor. A creditor may make a court claim for money owed if the borrower fails to make good on repayment. Segregated funds provide the potential for protecting contract owners from the claims of creditors – in other words, if the segregated fund policy owner owes someone money, that person cannot claim the value of the segregated fund to repay the debt.

Segregated funds provide this protection because they are insurance contracts and claims are not successful if the spouse, parent, children or grandchildren are named as beneficiary in the contract, if the beneficiary is irrevocable, or if the account is a registered account.

A person must not, however, try to avoid creditor claims by investing in a segregated fund. For this reason, it is necessary for the segregated fund contract to be acquired for the purpose of investment, not for the purpose of avoiding creditors.

2.1.14 Absence of medical underwriting

There is no medical underwriting of an application for a segregated fund contract. This means that the health of the contract's policy owner or annuitant is not assessed because guarantees are based on the strength of the investment and not a person's life.

It makes no difference to the contract if the policy owner or annuitant has a health condition or shortened life expectancy at the time of application. If the policy owner or annuitant dies during the contract, the death benefit guarantee ensures the beneficiary receives the guaranteed minimum payment.

Therefore, a policy owner or annuitant does not need to be concerned about the risk that he may die at a time when the contract has temporarily lost value. His beneficiary will receive the greater of the guaranteed proceeds or the market value of the contract.

2.1.15 Right of rescission

The right to cancel a contract is known as the right of rescission. All insurance contracts provide this right.

An investor may cancel or rescind the segregated fund contract in writing within the specific time limitation set by the insurer providing the contract. Two days is the usual length of time permitted. The investor receives the lesser of the amount of premium paid or value of fund units on that date if it is a valuation date. If it is not a valuation date, then the value on the next valuation date applies. By comparison, there are no rescission rights with mutual funds or ETFs.

2.2 Types of segregated funds

There are numerous segregated funds offered to investors. As stated in Chapter 1, the Canadian Investment Funds Standards Committee (CIFSC) classifies all fund investments into categories by asset class. Its five asset classes are:

- Cash;
- Fixed income;
- Equity;
- Commodity;
- Other.

This is a helpful starting point to understand the many types of funds since each class shares certain characteristics.

Also, many funds have sub-categories that narrow their investment objective. Analysis of fund holdings and quick facts in the Fund Facts document tell the bottom line about objectives and suitability.

However, the actual names of funds often bear little relationship to the asset classes and categories defined by CIFSC. For instance, a fund called a Creative Portfolio does not reveal its asset class in its name. The agent must dig into details about top investment holdings in the fund to better understand how the fund may be classified so that comparisons against similar funds will be accurate.

Proper classification is important so that funds can be correctly compared and aligned with investor risk tolerance. For instance, if an investor has a low tolerance for risk, then he will not be suited for a fund classed as an equity fund. His better choice will be a lower-risk fund, such as a bond fund invested in government bonds.

Each fund is highly diversified. Top holdings are described in the Fund Facts document or information folder. Other holdings for each fund may be too numerous to list.

2.2.1 Money market funds

Money market funds must invest at least 95% of their total net assets in cash or cash equivalents, such as Government of Canada short-term bonds or Treasury bills.[9]

Money market funds are the lowest-risk funds and, correspondingly, have a low rate of return.

2.2.2 Bond funds

Bond funds are a fixed-income type of fund. These funds must invest a specified percentage of their holdings in fixed-income securities such as bonds and Treasury bills.

Fixed-income funds may be categorized according to the duration of the bonds held by the fund. For instance, the bonds in a short-term bond fund mature in less than 3.5 years. Bonds in a medium-term fund mature between 3.5 and 9.0 years, and bonds in a long-term bond fund mature in 9.0 years or longer.

Fixed-income funds are described in the currency of the security held in the fund, e.g. Canadian dollar-denominated securities in a fund refer to a Canadian fixed-income fund.[10]

Fixed-income funds are generally low-risk and have a low rate of return. Some funds may invest in securities with a lower credit rating in order to achieve a better return. These funds may be called high-yield. High-yield bonds are also known as junk bonds and such funds carry much higher risk than traditional bond funds.

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9. Canadian Investment Funds Standards Committee. *Mutual Fund Categories, Canadian Money Market category*. [online]. [Consulted May 18, 2022]. http://www.cifsc.org/canadian-money-market/
10. Canadian Investment Funds Standards Committee. *Mutual Fund Categories, Canadian Fixed Income category* [online]. [Consulted May 18, 2022]. http://www.cifsc.org/canadian-fixed-income/

2.2.3 Equity funds

Equity funds are also known as growth funds. They invest in stocks of publicly traded companies and income trusts to generate dividend income and capital gains.

An equity fund may be diversified across different types of businesses or concentrated in a particular sector, such as financial services. Even when focused on a specific industry sector, the fund will have many holdings in that sector and will be highly diversified. However, higher levels of risk are experienced when an equity fund is concentrated in one sector even though it will be diversified in that sector. Such a concentration means the fund is susceptible to industry risk in its sector.

Fund growth is achieved when stocks held by the fund are sold at a higher price than their purchase price and by reinvesting dividends paid on fund holdings. The increase in price is the capital gain on the stock.

There is a higher degree of risk with an equity fund than with other types of funds. Stocks and stock markets are highly volatile: price swings can be significant. Company fortunes and prospects rise and fall in part due to factors that cannot be predicted, such as investor mood and sentiment. This makes the profitable buying and selling of stocks challenging for even the most experienced investment manager. This is the nature of equity risk.

EXAMPLE

Here is a sample list of top equity holdings for a fictional Canadian equity fund:

Holdings	Proportion of fund
Bank of Montreal	7.02%
National Bank of Canada	5.75%
Royal Bank of Canada	5.70%
Quebecor	5.23%
BCE	4.90%
Suncor Energy	4.38%
Sun Life Financial	4.07%
Goldcorp	3.92%
Power Corporation	3.75%
Rogers Communications	3.33%

2.2.3.1 Equity funds by market capitalization

Market capitalization, or cap, is a category of equity funds that give an investor the opportunity of fine-tuning their risk level to company size. The larger the market capitalization, generally the lower the investing risk. The cap is simply a range that shows how large a company is.

Large-cap funds, mid-cap funds, and small-cap funds are the most common. However, there are also mega caps ($200 billion +), micro caps ($50-$300 million) and nano caps (less than $50 million)11. For example, Royal Bank of Canada is a large-cap company with a market cap of $140.64 billion (May 2022); Air Canada is a medium-cap company with a market cap of $6.04 billion (May 2022) and Extendicare is a small-cap company with a market capitalization of $649.33 million (May 2022).

2.2.4 Income funds

Income funds are based on bonds, and growth is derived by the regular interest income the bonds pay and their possibility for capital appreciation. Some income funds may also hold high-quality stocks. When stocks are included in the income fund portfolio, the unit owner may receive both dividends and capital gains from his investment.

Both government and corporate bonds may be held in income funds.

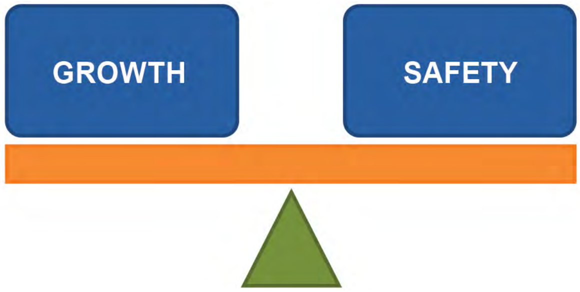
Income funds are a lower-risk fund.

2.2.5 Balanced funds

As the name suggests, balanced funds aim to strike a balance – in their case, between stocks (and the growth potential they represent) and fixed income (and the safety the category represents). So, to attain the balance illustrated in Diagram 2.1, these funds invest in stocks and bonds.

DIAGRAM 2.2

Investing in balanced funds



11. CanadaStock.ca. *The Difference Between Small and Mega Cap Stocks*. [online]. [Consulted May 18, 2022]. http://www.canadastock.ca/Common/small-medium-large-capitilization.html

Balanced funds are also known as balanced growth or balanced income funds. A balanced growth fund emphasizes stocks. A balanced income fund emphasizes bonds.

The risk associated with these funds depends on how the balance is weighted. Stocks are higher-risk; bonds are lower. When there is an even split, risk is averaged out. Balanced funds suit an investor who wants some exposure to stocks but is not prepared for the volatility of stocks alone.

EXAMPLE

Here is a sample list of top holdings in bonds and stocks for a fictional balanced fund:

Holdings	Proportion of fund
Government of Canada bond	4.25%
Canada Housing Trust bond	3.98%
Royal Bank of Canada	3.85%
PotashCorp	3.43%
Province of Ontario bond	3.35%
Bank of Montreal	2.99%
CIBC	2.86%
BCE	2.79%
TD Bank	2.55%
Province of Québec bond	2.24%

2.2.6 Target date funds

A target date fund combines equity and fixed-income investments. Its objective is to decrease risk over time.

At the time of the investment, the investor picks a target date – usually the date he intends to retire, but it can be any date or any age. Over the duration of the investment, the asset allocation gradually and automatically shifts from a higher to a lower level of risk as equities, such as stocks, are replaced with fixed-income products, such as bonds. It is not uncommon for risk tolerance to decrease with age because later in life an investor generally has very limited ability to make up for investment losses. Therefore, a target date fund is a good choice to see an investor into retirement and beyond.

Target date funds are often a default option for anyone who is in a pension plan and they are a popular choice among less sophisticated investors thanks to their easy-to-understand concept.

2.2.7 Dividend funds

A dividend fund invests in companies that have a history of paying dividends. A dividend is a distribution of a percentage of company profits by the Board of Directors to company shareholders. They are not guaranteed, but the obligation to meet dividend payments is taken very seriously by a company and its investors.

Dividends received from Canadian corporations are taxed at a lower rate than interest income as a result of the dividend tax credit. This increases investor appeal.

A dividend fund may also invest partly in bonds.

Dividend funds are considered low to medium-risk.

2.2.8 Mortgage funds

A mortgage fund holds residential, commercial and industrial mortgages.

When mortgages have a higher degree of risk because the underlying assets are riskier, mortgage funds are categorized as an “Other” asset class. Low-risk mortgage funds are a type of fixed-income fund.

Default risk is associated with a mortgage fund. It is experienced when mortgage holders default on, i.e. fail to make, their mortgage payments.

2.2.9 Real estate equity funds

Real estate equity funds must invest at least 90% of their assets in retail, commercial, industrial and residential properties.[12] They earn income from mortgages and have potential for capital gains as property values increase. Real estate funds own property; mortgage funds do not.

Some funds invest in real estate investment trusts (REITs), companies that, in turn, invest in real estate.

The risk of each fund will be a result of the types of properties in which the fund invests and their location. Real estate funds are particularly suitable for long-term investment because property values need to be given enough time to rise in value. Real estate is an illiquid investment. In cases when real estate values are low due to market conditions, investors may not be able to exercise their redemption privileges due to the illiquid nature of the underlying investments.

12. Canadian Investment Funds Standards Committee. *Mutual Fund Categories.* [online]. [Consulted May 18, 2022]. http://www.cifsc.org/real-estate-equity/

2.2.10 Index funds

An index fund is a mirror of an index, such as the S&P/TSX Composite index, that invests in the same stocks that are listed on the index. Therefore, if the index rises, the index fund will also rise. Its results will be slightly less than the actual index because of the fees that are charged to the fund.

This form of investing is known as passive investing because the investment manager mimics the index chosen for his particular fund and maintains the same securities in the same weight.

There are many indexes on which funds may be based. They include equities, bonds, commodities, currency, and real estate among others. The risk of a fund is a result of the underlying market the fund tracks.

2.2.11 Fund of funds

A fund of funds is, as its name indicates, a fund that invests in other funds. The purpose of this approach is to benefit from managerial expertise in other funds and to diversify. The fund manager decides which funds suit the portfolio based on the fund objective and he rebalances holdings as needed to maintain the objective focus.

The risk of the fund is entirely a result of the underlying funds in the portfolio and its investment objective.

2.2.12 Specialty funds

Some funds are created to appeal to specific investor wants and respond to investor needs. They are called specialty funds.

Specialty funds do not have the mass appeal or assets of their large segregated fund cousins, such as equity funds. However, specialty fund categories such as socially responsible funds fill important investment objectives for their investors.

Socially responsible funds provide an alternative for investors who for religious, political, environmental or moral reasons find the holdings of standard funds unacceptable for investment. Investors seek funds that align with their investment objective, such as the investor’s desire to invest in green energy. Investors are less concerned about the risk of the fund since their primary goal is to support a cause or belief.

Other specialty funds include emerging markets funds or funds that seek companies that are struggling financially. Once again, there are many specialty funds to choose from.

The risk of specialty funds lies with the fund’s objective and investment strategy used by the fund manager. Each one should be carefully studied to determine if its risk is suitable for the investor.

EXAMPLE

Here is a sample list of top holdings in stocks for a fictional socially responsible equity fund. Note that companies that produce liquor, wine, beer, cigarettes, and medical marijuana are absent from holdings.

Holdings	Proportion of fund
Royal Bank of Canada	4.97%
Manitoba Telecom Services	4.97%
E-L Financial	4.44%
Laurentian Bank	4.22%
Empire Company	2.66%
Leon's Furniture	2.65%
Apple	2.10%
Parmalat	2.05%
TD Bank	2.03%
OpenText	2.01%

2.2.12.1 Industry-specific funds

An investment manager who has an interest in a specific industry, or the belief that an industry will flourish in the economic conditions of today or the future, may create a fund that specializes in that industry. Such industries may be well-established or feature new technology, services or products. The landscape is constantly evolving.

Risk of industry-specific funds depends on the industry that forms the basis for the fund, its volatility and its prospects.

2.2.12.2 Geographically specific funds

Certain funds focus on the investments:

- Within a country, e.g. Canada;
- Outside the boundaries of a country, e.g. North America;
- Of a selection of countries, e.g. international;
- Of a region, e.g. Asia;
- Of part of a region, e.g. Asia except Japan;
- Of the entire globe.

Countries change in their appeal to investors over time. Some become very attractive investment opportunities while others lose their appeal. Funds with a geographical focus reflect such changes.

Political volatility is a risk associated with investing outside Canada and similar developed nations. Currency risk is another. An investor who seeks foreign opportunities should be well aware of the political situation and economic stability of the country or region in which he plans to invest. He should also monitor changes that might affect the investment, e.g., an election.

2.2.13 New introductions

Funds evolve over time based on consumer interests. New funds are created for a variety of reasons including to offer new investment opportunities or to provide new features.

Funds that have lost their appeal are closed and may be amalgamated with other funds.

2.2.14 Suitability of funds

Whereas those who recommend and sell stocks, bonds and mutual funds are being tasked with client-focused reforms to put best interests of their clients first, insurers and their intermediaries are expected to implement the principles of the Fair Treatment of Customers (FTC). In both instances, suitability of investments for the client is a priority.

FTC is relevant to the choice and recommendation of funds by the agent. He is required to act ethically and in good faith and is prohibited from engaging in abusive practices. The agent must meet the investment needs of the client without conflict of interest or influence by commission or incentives. He must be objective, honest, diligent and professional.

To do so, the agent will:

- sell products in a way that pays due regard to the interests of clients;
- provide clients with accurate, clear, non-misleading and sufficient information before, during and after the point of sale, to allow them to make informed decisions;
- minimize the risk of sales which are not appropriate to the clients' needs;
- ensure that any advice given is of a high quality;
- deal with clients' claims, complaints and disputes in a fair and timely manner;
- protect the privacy of client information.

EXAMPLE

Claude has met with Andre twice to introduce the concept of segregated funds and answer his questions. Andre is ready to proceed with $500,000 in proceeds from the sale of his principal residence. He wants the principal returned when the contract matures. As for performance, he would like to receive a net profit of 6% per year. This will form the bulk of his retirement income in 10 years since he does not have a pension from his employer.

Andre is a client who needs a combination of safety plus income. Neither need can be ignored and Claude's current incentive of achieving sales of the Huge Equity Fund must also be sidelined.

Claude's initial recommendation is a balanced fund based on Andre's needs. Claude documents his recommendation in his client file for future reference. Andre may, of course, reject the recommendation but Claude has satisfied his FTC requirements.

The life insurance agent's role is to be aware of his clients' needs to ensure funds, whether new or old, align with client needs, interests and objectives.

2.3 Segregated fund limitations

Even with the guarantees offered by segregated funds and their other benefits and features, like all other investments, they also have limitations. These limitations should be as well understood as benefits to ensure all client questions and concerns can be accurately addressed.

These limitations of segregated funds are detailed in the following pages:

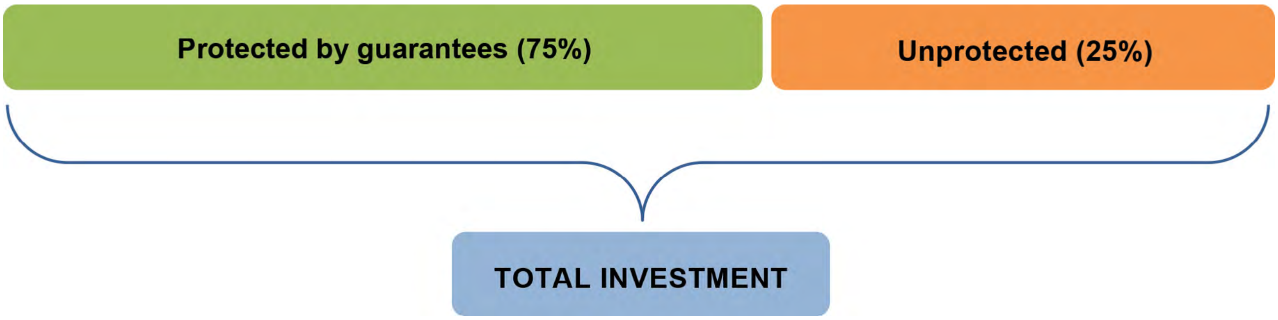
- Risk to capital;
- Sales charge;
- Management expense;
- Penalties;
- Age restrictions for acquisition.

2.3.1 Risk to capital

The principal risk of segregated funds is that the investor could lose up to 25% of his capital when the contract provides 75% maturity and death benefit guarantees. As Diagram 2.2 illustrates, even though the guarantees protect 75% of deposits, 25% remains unprotected.

DIAGRAM 2.3

Proportion of unprotected segregated fund investments



Another risk is the fixed term-to-maturity period of the standard contract. This makes segregated fund investing a long-term investment. If the investor needs to make a withdrawal before the contract matures, he does not receive the benefit of the maturity guarantee and receives market value for the withdrawal minus any outstanding fees and charges.

Risks associated with segregated fund investing depend on the types of investments held in the fund itself. For example, bonds are lower risk than equities. Therefore, a bond fund is lower risk than an equity fund.

2.3.2 Sales charge

The licensed agent works with the client in the development of the investment plan. When that plan includes a segregated fund contract, the agent spends time determining the most appropriate fund choice for the client, making a recommendation, perhaps revising the recommendation, preparing the application, delivering necessary documents and ensuring client satisfaction.

The agent may be compensated for his time, skill and effort through a direct charge paid by investors and indirectly through a trailing commission.

The charge paid by investors is called a sales charge or a load. A sales charge applied at the time of buying into a fund it is called a front-end load (FEL). When it is charged to redeem units, it is called a “deferred sales charge” (DSC). Currently, insurance regulators are eliminating both types of charges.[13] Agents should always review the fees or loads of a contract at the time it will be under client consideration.

As stated earlier, an investor who switches funds may find the load on the new fund is charged differently from the load on the existing fund. He may be required to pay a one-time fee to equalize the expense at the time of switching.

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13. Canadian Insurance Services Regulatory Organizations. *CCIR and CISRO statement on Deferred Sales Charges and upfront commissions in segregated fund sales*. [online]. [Consulted June 3rd, 2022]. https://www.ccir-ccrra.org/Documents/View/3687

2.3.2.1 Front-end sales charge

A front-end sales charge is exactly as its name suggests: a fee charged at the beginning of the contract, known as its front end that reduces the investor deposit. Insurance regulators are examining whether such a fee is appropriate, both for the conflict of interest challenges it presents and whether the fee is conducive to suitability. Agents should expect total elimination of the FEL by mid-2023.

2.3.2.2 Deferred sales charge (DSC)

The DSC is a percentage applied against the amount withdrawn from a segregated fund during a set period of time.

As noted previously, the DSC on mutual funds will be eliminated in 2022. To maintain a harmonized approach between mutual funds and segregated funds, it is anticipated that DSCs on segregated funds will also be eliminated.

DSC redemption schedules for sales made prior to the ban will be allowed to run their course in Ontario. This means DSC charges on mutual funds could apply up until 2028 or 2029 on funds sold through 2022.

2.3.2.3 No sales charge

Segregated funds that do not have a sales charge are called no-load funds. They may compensate for the absence of a sales charge by charging a higher management expense fee.

2.3.3 Management expense

The management expense is the combination of the management fee for a fund, its operating expenses and taxes. When these expenses are added together and expressed as an annual percentage of the total value of the fund, it becomes the management expense ratio (MER).

The management fee compensates the fund company for the cost of investment management by a portfolio manager, trailing commissions and fund oversight.

The operating expenses include administration, legal fees, marketing and other similar costs.

Tax is charged as the provincial HST rate that applies where the investor lives, and is charged on management fees and administration fees.

The MER of segregated funds is typically higher than the MER for an equivalent mutual fund. The MER of a segregated fund must maintain a reserve to uphold segregated fund maturity and death benefit guarantees. This is sometimes called the insurance charge.

MERs are charged whether the market value of the fund increases or loses ground. They reduce investor returns. Fund performance is reported after the MER has reduced the return.

EXAMPLE

If the value of units rises by 5% in a year and the MER is a 3% charge, the investment has actually only gained 2% (5% – 3%) and 2% will be reported to the investor. If the unit value falls by 5% in a year and the MER is a 3% charge, the value of the investment will actually have decreased by 8% (-5% – 3% = -8%) and likewise the investor will be apprised of an 8% loss in the value of his investment.

Higher MERs are associated with funds requiring more active management and decision making. Low MERs are charged by funds such as index funds that require less active management and decision making since the manager simply follows the index itself.

Over time MER expenses can significantly diminish returns. They are an important disadvantage of both segregated fund and mutual fund investing.

The MER of a fund can be changed at any time by the insurer. Investors must be notified of the change.

The effect of MER on returns is often underestimated by fund investors. It is essential they know what an MER increase will mean for future returns in dollars-and-cents, and not just on a percentage basis. This is good practice for agents and satisfies a requirement for disclosure.

2.3.3.1 Trailing commission

A trailing commission is a sales compensation fee incorporated in the MER. It pays the agent on a continuing basis for the advice he has provided for as long as the investor holds the fund. It is calculated as a percentage of the market value of the fund.

2.3.4 Penalties

The segregated fund contract is provided on the basis that there is a fixed term-to-maturity period. Withdrawals and surrender (termination) of the contract may be penalized by the insurer providing the segregated fund contract. The penalty, which is applied in the early months of the contract, is intended to deter clients from making withdrawals and surrendering the contract. Such penalties are applied against the value of the contract and reduce the sum received by the investor.

The policy of each insurer states their charges for withdrawals and surrender.

2.3.5 Age restrictions

There are age restrictions for both the last age to establish a contract and the last age at which a deposit can be made.

A segregated fund in a registered retirement savings plan (RRSP) is bound by the rules that apply to all RRSPs. Therefore, the youngest age will be the age at which the contract owner has earned income and meets the minimum age for the insurance contract, and the oldest age at which a contract can begin as an RRSP is 71; deposits can be made until December 31 of the year in which the contract owner turns 71. Then, the RRSP is converted to a registered retirement income fund (RRIF). A RRIF account sets the last age for authorized transfer, for instance from a roll-over of a spouse's RRIF, at 90. Segregated funds held in non-registered accounts and tax-free savings accounts (TFSAs) also set the maximum issue age limit at 90.

There are provincial variations between other types of registered accounts and age limits associated with each.

2.4 Segregated fund taxation

The taxation of segregated funds is a very complex subject. The following details are an overview. An investor should always seek tax expertise from a tax professional in regard to taxation of his segregated fund account. Agents should seek tax expertise from their in-house professionals or recommend the investor seek independent tax assistance.

Taxation of a segregated fund is based on two fundamentals:

- Whether the account is taxable, e.g. a non-registered account or registered, such as an RRSP/RRIF/RDSP/LIRA, or non-taxable, e.g. a TFSA.
- The form of investment income earned in the fund.

2.4.1 Tax on deposits

Deposits or premiums paid into a non-registered account or a TFSA for a segregated fund purchase are not tax-deductible. However, they are tax-deductible when paid into a registered account, except when the account is a registered education savings plan (RESP) or registered disability savings plan (RDSP).

2.4.2 Tax on allocations

Investment income can be earned in both non-registered and registered accounts as:

- Interest;
- Dividends;
- Capital gains or losses;
- Foreign income.

In a non-registered account, these forms of investment income are passed from the fund through to the investor. This is the allocation, as was explained earlier in this Chapter. The investor receives a tax slip from the insurer and reports the income on his annual tax return. The investor also reports the capital gain or loss on the switch of units and certain other events that occur within the fund. Each type of income is taxed differently; capital gains and Canadian dividends receive preferential tax treatment.

In a registered account, these forms of investment income are allocated to the investor but they are not reported for annual tax purposes. This is the nature of tax deferral provided by registered plans.

2.4.3 Tax on withdrawals

It is important to remember that the fund may be held in a non-registered or a registered account. Taxation differs significantly between the two accounts both for withdrawals and the guarantees.

When units of a non-registered account are redeemed for the purpose of a withdrawal, a capital gain or loss will be incurred. This must be reported on the investor's annual tax return. The amount of gain or loss is based on the adjusted cost base (ACB) of the units and their market value when they are redeemed.

When a withdrawal is made from an RRSP or a RRIF, the institution holding the account retains a portion of the withdrawal as an advance against future tax owing. This is called a withholding tax. Even though the investor does not receive 100% of his withdrawal due to the withholding tax, the full amount of the withdrawal must be declared for tax purposes. A reconciliation is made on the investor's annual tax return that takes into account the tax withheld against the tax owing. Tax is applied at the same rate as interest income.

The TFSA is an exception in that no tax is declared or paid when a withdrawal is made.

When an RRSP matures (at the end of the year in which the account owner turns 71), the account holding the segregated fund can be rolled into a RRIF account.

RRIF accounts require a minimum annual withdrawal. The first payment must be received no later than the year after the account was set up. Although tax is typically withheld on withdrawals by the financial institution holding the account, the annual minimum RRIF withdrawal should not be charged the withholding tax. Withdrawals in excess of the minimum are subject to withholding tax.

2.4.4 Tax on maturity guarantee and death benefit guarantee

Tax on the guarantees applies to the top-up sum contributed by the insurer if the market value of the units is less than their guarantees.

When the segregated fund is held in a non-registered account, any amount paid as a maturity guarantee or death benefit guarantee top-up is taxable as a capital gain. When the fund is in a registered account, top-ups are taxable as income.

A surviving spouse named as the beneficiary of a registered account can defer tax on the top-up if he rolls the proceeds into his RRSP or RRIF.

Top-ups for guarantees required for TFSAs are not taxable.

It is essential to check with a tax expert about taxation of top-ups.

CHAPTER 3
ANNUITIES

Competency components

- Analyze the available products that meet the client's needs;
- Implement a recommendation adapted to the client's needs and situation.

Competency sub-components

- Analyze the types of annuities that meet the client's needs;
- Propose a recommendation adapted to the client's needs and situation.

3
ANNUITIES

Annuities are an investment product purchased in the form of a particular type of contract. Life insurance companies issue all forms of annuities whereas banks and other financial institutions issue just one type of annuity, known as a term or term certain annuity.

Even though annuities are typically associated with regular income-type payments, there is another form of annuity that is a savings investment.

Annuities that pay an income are called payout annuities. They are differentiated by whether the payout begins immediately (immediate annuities) or at a future date (deferred annuities).

Payout annuities are structured on the basis of a deposit of investor capital to an annuity contract with a subsequent repayment of capital plus interest in regular payments to the person named in the contract as the annuitant. The regular payments are considered one of the most important features of annuities. Just as a working person depends on receiving employment income in a known amount on his regular payday, an annuitant depends on receiving an annuity payment on a regular, scheduled date.

The annuity payment received by the annuitant is a result of the quoted annuity rate that applies to his capital and the presence of guarantees. All factors affecting annuity payments will be addressed in detail in this Chapter.

The savings type of annuity is called an accumulation annuity. Accumulation annuities are also known as insurance GICs. They are also structured based on a deposit of investor capital but the capital plus interest is repaid to the investor as a lump sum.

Accumulation annuities provide investment security because 100% of invested capital is returned to the investor.

Annuity investing is highly suitable for investors seeking security.

3.1 Advantages of annuities

The advantages of annuities have been briefly addressed in Chapter 1. The following advantages are explained in more detail in this Section:

- Straightforward investment concept;
- Income security that can be adapted to the client's needs and situation;
- Creditor protection;
- Estate planning benefits;
- Annuitant protection (Assuris coverage).

3.1.1 Straightforward investment concept

The fundamental idea underlying both payout annuities and accumulation annuities is quite simple. It looks like this:

Capital invested in the annuity = capital plus interest paid out of the annuity

The payout annuity pays a regular income to its annuitant. It is the most common form of annuity and what most people think of when they think of an annuity.

A payout annuity appeals to an individual who wants to receive a regular payment from a lump sum of capital to invest. He wants to invest his capital without risk of loss, and, typically, looks to the annuity payments as a source of regular income, since his investment is repaid to him over time.

The investor decides who is going to receive the payment from the contract. This person is called the annuitant.

The insurer pays the annuitant on a regular schedule that has been selected by the contract owner. Each payment is comprised of a portion of the invested capital plus interest.

The starting point for payments to the annuitant to begin depends on whether the annuity is immediate or deferred. Once started, payments continue for life or the term of the contract. A life annuity ends on death of the annuitant. The term annuity ends on its maturity date.

This is the basic concept that underlies all payout annuities. Alas, annuities are rarely as simple as this because they have many nuances available to customize the product to individual needs.

An accumulation annuity does not pay an income. It is a form of term savings with a maturity date. At maturity, it may be converted into a payout annuity or surrendered without penalty and its proceeds received by the investor in a lump sum.

3.1.2 Income security

All annuitants enjoy the security of knowing when to expect their annuity payment based on the schedule selected in the annuity contract.

Annuities with a level, or set, payment provide income security because the annuitant also knows in advance how much each payment will be. This is guaranteed by the issuer. This knowledge allows the annuitant to plan his finances and spending. This is one reason why many investors choose annuities for retirement income.

Level payments are also a way in which the owner can control the amount of income to be paid to an annuitant when the annuitant is unable to manage personal finances on his own. For instance, a parent could establish an annuity for a mentally disabled child with the assurance that the child would receive a regular payment in a known sum.

Income security provided by annuities covers different types of income:

- Lifetime income;
- Spousal income;
- Temporary income.

3.1.2.1 Lifetime income

Payments are paid for the lifetime of the annuitant when the annuity is issued as a single life (or straight life) annuity.

A joint life annuity also pays an income for life. However, it names two annuitants, who are usually spouses. They may be joint annuitants or co-annuitants. Payments continue for the surviving annuitant after the first annuitant dies.

Lifetime income eliminates longevity risk and the worry of outliving one's money.

3.1.2.2 Spousal income

An income for a spouse can be created by a:

- Single life annuity in which a spouse is named as annuitant;
- Joint annuity in which both spouses may receive annuity income and at the death of one, the surviving spouse continues to receive the annuity payment.

Either form of annuity provides an income or retirement pension-equivalent to a spouse. This is helpful for a spouse who has not contributed to a retirement pension or savings plan at work and who, without the benefit of annuity income, would otherwise be without an income or whose income would be very low.

3.1.2.3 Temporary income

A term annuity provides an income to an annuitant for the term of time stated in the contract. The payment period may be as short as a few years or last for decades.

A term annuity is useful to bridge income between two dates, such as between the time when an employee takes an early retirement and the time his pension begins.

3.1.3 Creditor protection

The creditor protection available to annuity contract owners and annuitants is of particular interest to those who are self-employed, business owners, and professionals. These individuals are more likely to find themselves in situations in which creditors could make a claim against their assets.

The amount deposited to an annuity contract is protected against financial claims made by creditors of the contract owner when it is a life insurance contract that names specific beneficiaries rather than the contract owner's estate.

The intention of the law is to protect the dependents of the insolvent contract owner from creditor claims. Therefore, when a spouse, child, grandchild or parent is named as beneficiary or beneficiaries of the annuity contract, or an irrevocable beneficiary is named, the value of the contract cannot be claimed by creditors.

Some annuities offer unseizable benefits, such as annuities funded by transfer of a locked-in pension, coming from a locked-in retirement account (LIRA).

If a contract owner surrenders his term annuity and receives its commuted value, creditor protection would no longer exist for the sum received.

Finally, to benefit from creditor protection, the contract must have been purchased well before the owner's insolvency. This ensures the owner has not purchased the annuity to escape his financial obligations to creditors.

3.1.4 Estate planning benefits

Estate planning is the process taken to determine how the assets of an individual will be distributed after death. It can include naming inheritors and beneficiaries, and ascertaining tax liabilities.

Annuities offer a valuable estate-planning feature through the ability to name a beneficiary to a contract. Payments made to a beneficiary bypass the estate. Therefore, they are not subject to the probate fees charged on the assets of a deceased by provincial/territorial governments (except in Quebec and Manitoba). The beneficiary also receives funds quickly.

Annuities also provide protection of estate capital when structured into an insured annuity. This is because the insured annuity uses estate capital to buy a life annuity for its policy owner but replaces that capital with a life insurance death benefit.

3.1.4.1 Insured life annuity

An insured annuity is a strategy that uses combination of two separate insurance products: a permanent life insurance policy and a straight life annuity. This annuity gives an annuitant an income during life and restoration of the amount received by the annuitant to life insurance beneficiaries at death.

The insured annuity process begins when a proposed policy owner identifies the sum of money needed on his death to settle his estate including any bequests for beneficiaries. He acquires permanent life insurance, such as term-100 (T-100) or whole life insurance, with a death benefit equal to that sum. After the insurance policy is issued, he buys a life annuity. The annuity is funded with enough capital that its payment will, at a minimum, cover the life insurance premium. On death, the life annuity ends and the life insurance death benefit is paid to beneficiaries and/or the estate.

Beneficiaries do not receive the capital of the estate through the will but they do receive an equivalent amount of capital from the life insurance policy death benefit, tax free.

It is essential for the process to follow the steps in the order described: first, acquire the life insurance policy, then, buy the life annuity. If the proposed policy owner does not qualify for life insurance, the insured annuity strategy cannot be implemented.

EXAMPLE

Stephen, age 60, wants to leave his two nieces a legacy of $250,000 each on his death. If he puts aside the $500,000 now, he no longer has the ability to spend that money. Instead, Stephen purchases a term-100 life insurance policy with a $500,000 death benefit. He names his nieces as beneficiaries of the policy. Premiums for the policy are $1,000/month. Stephen then acquires a single life annuity using $200,000 of his savings. He receives about $1,000/month in an annuity payment. He uses the money to pay his life insurance premium. He has effectively bought an inheritance of $500,000 for the sum of $200,000. He still has access to $300,000 of his savings to use for other purposes, such as retirement.

3.1.5 Annuitant protection (Assuris coverage)

If an insurer that has issued annuities is no longer able to meet its payment commitments, the policies are transferred to another insurer that is willing and able to assume those payments. Assuris facilitates policy transfer and guarantees future payments to specified amounts.

An annuitant receives Assuris protection on a payout annuity on the payment in full when it is up to $2,000 per month. For example, if a promised benefit is a level $1,000 per month, the annuitant continues to receive $1,000 per month.

When a promised benefit for a payout annuity is more than $2,000 per month, the annuitant receives Assuris protection for the greater of $2,000 per month or 85% of the promised benefit. For example, if a promised benefit is $5,000 per month, the annuitant would receive $4,250 ($5,000 × 85%).

Assuris protects an accumulation annuity up to 100% of the contract value up to $100,000. Therefore, if an annuity value is less than $100,000, the policy owner receives all of his deposit value. If the annuity value is greater than $100,000, he receives $100,000.

3.2 Types of annuities

Annuities provide unique opportunities for customization to individual needs and circumstances thanks to the many types, features, and benefits available.

Many questions must be addressed in preparing a contract and selecting the type of annuity that will be best suited to the client's needs and expectations. They include, but are not limited to:

- Is the objective of the annuity to pay income or to save?
- How many lives will be covered?
- Will the annuity payments be made for a period of time or life?
- When will income begin?
- Will income be a level payment or variable?
- How will the contract be funded?
- Which form of taxation will apply?

Each of these factors is addressed in the sections that follow.

3.2.1 Purpose of the annuity

The two core forms of annuities, previously introduced, are the payout annuity and the accumulation annuity. The purpose of acquiring each is very different so it is essential the agent understands their fundamental differences to match the correct type with the client's needs.

3.2.1.1 Payout annuity

The purpose of a payout annuity is, as its name suggests, paying an income. The income stream is a blend of interest and principal created from the deposit of capital to the contract and is based on the annuity rate applied at the time the contract is issued.

Payout annuities are available as immediate (payments begin immediately) and deferred annuities (payments begin at a future date). Term life is paid to one annuitant for a period of time, straight life is paid to one annuitant for his life and joint life is paid to one annuitant for his lifetime and then to the other annuitant after the death of the first.

3.2.1.2 Accumulation annuity

An accumulation annuity is a form of term savings with a maturity date. An income stream is not created by an accumulation annuity. Its purpose is investment growth.

Accumulation annuities are similar to a Guaranteed Investment Certificate (GIC) but come with the beneficial features of a life insurance contract, such as the ability to name a beneficiary and creditor protection.

The accumulation annuity credits interest on deposits on a daily, monthly, or compound basis. Daily interest is not a guaranteed sum. In certain cases, interest may be guaranteed over a number of years, such as one year, five years or ten years, because the annuity deposit is used to buy a fixed-term investment at a guaranteed interest rate.

This interest applied to deposits in an accumulation annuity increases the value of the annuity.

Once it has matured, the annuity may be surrendered for its accumulated value or it may be converted into a payout annuity, which will pay a fixed amount based on this accumulated value.

3.2.2 Lives covered

Once the fundamental purpose for the contract is identified, the number of lives to be covered by the contract is established.

3.2.2.1 Single life contract

A contract may be issued to a person naming him or another person as the annuitant. If a person uses funds in his RRSP or RRIF to buy an annuity, he must be named the annuitant. The annuitant receives the income from the contract for a specific period of time or for life, depending on the duration of the annuity.

3.2.2.2 Joint life contract

A joint life contract, also known as a joint and last survivor annuity, pays an income over the lifespan of two people, usually spouses. The two individuals named in the annuity are known as co-annuitants. One individual, or both, receives the payments until one dies. Payments continue to the survivor until his death.

3.2.3 Duration of the annuity

An annuity is issued for a term (a period of time), a lifetime, or the lifetime of two people.

3.2.3.1 Term

An annuity issued to pay income to a specified age, such as to age 71, or for a specific length of time, such as 10 years, is a term annuity. All other factors being equal, the longer the term, the less received in each annuity payment.

EXAMPLE

Donald, age 65, deposits $100,000 to a five-year term annuity. He receives approximately $1,700 per month in his annuity payment. If the annuity was a 10-year term, he would receive about $900 per month.[14]

14. Life Annuities. *Male term certain annuity rates*. [online]. [Consulted May 9, 2022]. https://lifeannuities.com/term-certain-rates/male.html

When a term annuity ends, all payments cease because the annuitant has received the entire principal deposited to the contract with the interest earned on that principal.

If death of the annuitant occurs during the term, the balance of annuity payments is paid to a beneficiary.

A term annuity policy owner may have the choice in his contract between three different methods of paying out the value of the contract if the annuitant dies during the term. Each method has its own pricing structure:

- One method puts the monthly payments into the hands of the beneficiary for the period remaining in the term. In effect, the value is paid in instalments to the beneficiary and is sometimes called the instalment refund choice.
- Another method sees the beneficiary receive a lump-sum payment that represents the present value of all future payments paid as a cash refund. This is also known as the commuted value of the annuity or the cash refund choice.
- The final method pays the beneficiary what remains of the original deposit. For example, if the contract was funded with $100,000 and $75,000 had been paid out, the beneficiary would receive $25,000 ($100,000 – $75,000). This is known as a capital protection guarantee.

A term annuity-to-age-90 (T-90) is one option available to those whose registered retirement savings plan (RRSP) is maturing, and the RRSP account must be closed. Using some or all of the value in the RRSP to buy a term annuity continues tax deferral on the money.

A term annuity-to-age-18 (T-18) is available for financially dependent children younger than 18 who receive the proceeds from the RRSP/RRIF of a deceased parent or grandparent. The lump sum in the registered account is transferred to the child's annuity tax-free. The child can receive payments from the annuity until the day before he turns 19. Tax on the payments as they are received is paid by the child at his marginal tax rate.

3.2.3.2 A single life or two lives

An annuity may be structured to pay an income over the lifetime of one person or two.

As stated earlier, when a single life is the basis for the contract, the annuity is called a single or straight life contract.

When two lives are covered in an annuity, the annuity is a joint and last survivor annuity. Payments may be issued to both annuitants or to one annuitant. When the first annuitant dies, payments continue or transfer to the co-annuitant, usually the surviving spouse. The contract may be structured to pay the co-annuitant 100% of what had been received by the deceased annuitant or a reduced percentage of the full payment. The reduced amount paid is usually 50%, 60% or 75% of the full payment.

EXAMPLE

Ted and Joan buy a joint and last survivor life annuity with $100,000. Ted and Joan are the policy co-annuitants and the contract is structured to pay Joan 50% of the full benefit upon Ted's death. Ted receives $450 per month as his annuity payment. Joan does not receive a payment. When Ted dies twenty years after receiving his first payment, payments are then issued to Joan and she receives $225 per month. When Joan dies after receiving payments for six months, the annuity ends. No further payments are made.

3.2.3.3 A shortened life

An impaired annuity is a form of life annuity. It is issued when the annuitant has a shortened life expectancy due to poor health because of a serious disease or deteriorating condition. This is true for both a single life annuitant and joint life annuitants when both spouses suffer from medical conditions.

Impaired life annuities are also called enhanced, age-rated, or accelerated annuities.

The amount of payment received by the annuitant is based on underwriting of his medical condition. The annuitant must provide a medical certificate proving substandard health.

Once impairment is proven, the annuitant pays less as a premium or receives a higher payment than someone of the same age and gender who does not have a health condition. This is because payments are issued over a shorter period of time corresponding to the shortened lifespan.

3.3 Funding an annuity

A policy owner has a choice of how to fund, or pay for, an annuity. A payment may be made in a lump sum or transfer of a lump sum, or payments may be made over a period of time as deposits.

An immediate annuity must be funded with a lump sum. It is necessary that the entire sum of capital is immediately on deposit with the insurer so payments can begin within the first year of the contract.

A deferred annuity could be funded with a lump sum or a series of deposits.

3.3.1 Lump-sum deposit

A lump-sum deposit is made when funds are transferred from a registered or non-registered account to the annuity. The deposit occurs once by transfer from non-registered investor savings and investments or from a registered account.

Agents must be alert to indicators that a lump-sum deposit is an effort by the purchaser to launder money or finance terrorist activity. They should read and bear in mind the guidance from FINTRAC (Financial Transactions and Reports Analysis Centre of Canada) specific to life insurance and annuity providers. It can be found online.[15]

The agent must follow FINTRAC client identification requirements when:

- an individual purchases an immediate or deferred annuity or segregated fund that costs $10,000 or more over the duration of the policy and the purchase is made with cash (not via a transfer of funds); and
- when the insurer is to remit $10,000 or more to a beneficiary over the duration of the annuity or policy.

If an agent receives $10,000 or more in cash in a single transaction or multiple cash transactions of less than $10,000 each that total $10,000 or more within a 24-hour period, he must submit a Large Cash Transaction report to FINTRAC. If the behaviour of an individual is suspicious, a Suspicious Transaction Report must be submitted regardless of the sum of money involved.

3.3.1.1 Transfer from a registered account

A typical circumstance in which a transfer of funds forms a lump-sum deposit to the annuity is when an RRSP is maturing, and the account owner chooses an annuity as a maturity option. Such a transfer is exempt from FINTRAC requirements. Transferring funds from an RRSP or RRIF continues the tax deferral on the amount that is transferred to a registered annuity contract. Therefore, there is no immediate tax consequence for a transfer. The policy owner and annuitant must be the same person when registered savings are the source of funding. He can choose a life or T-90 annuity.

Locked-in pension savings accumulated in an employer-provided or group pension plan can be transferred only to a life annuity. This includes funds in a locked-in retirement account (LIRA), life income fund (LIF), or a prescribed retirement income fund (PRIF).

When a spouse transfers locked-in savings from a registered pension plan, LIRA, or LIF to fund an annuity, he must acquire a joint and last survivor life annuity. This ensures that if the pensioner dies before his spouse, the surviving spouse will continue to receive an income. That spouse can waive the right to the annuity in writing.

3.3.2 Regular deposits

Regular deposits, or premiums, can also fund an annuity. Annuity payments cannot begin on any type of annuity until after the last deposit has been made.

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15. Government of Canada. *When to verify the identity of persons and entities – Life insurance companies, brokers and agents*. [online]. Modified June 1, 2021. [Consulted May 9, 2022]. https://www.fintrac-canafe.gc.ca/guidance-directives/client-clientele/client/li-eng

3.4 Annuity income

The contract owner of a payout annuity must choose on the application when the annuity income payments begin and whether they will be a level amount or variable amount.

The annuity income may begin immediately or at a selected future date when it is deferred.

3.4.1 Immediate income

A policy owner who selects immediate income for the annuitant deposits a lump sum to fund the annuity. This creates an immediate annuity.

The annuitant receives his first payment at the next payment date after the contract is finalized based on the payment schedule he selected. This may be the next month, three months, half year, or year.

3.4.2 Deferred income

A policy owner who selects income to be paid at a future date has a deferred annuity. There are two phases to the deferred annuity: accumulation and income.

During the accumulation phase, the annuitant either deposits a lump sum to the contract or pays regular premiums. Deposits held by the insurer in reserve for future annuity payments earn investment income.

The income phase begins at the end of the deferral period, for instance, ten years after the first deposit. A maximum length of time permitted for the deferral will be stated in the contract.

3.4.3 Level income

A level payment is a payment that is the same for the duration of the annuity. The annuitant knows exactly the sum to expect in each payment.

3.4.4 Indexed income

Indexed income is income that increases over its payment period. Indexing an annuity increases payments annually by a percentage selected by the policy owner. Therefore, income increases year-over-year to keep pace with rising costs. The maximum amount of yearly increase is capped, for instance at 4%. The purpose of increasing income is to keep it in step with inflation and address inflation risk.

If a person's cost of living increases due to inflation but his income does not, he has two choices. He can spend the income he receives and buy less. If he does this, he will have a reduced standard of living. His other choice is to maintain his standard of living. This will require more money coming in. If he makes this choice, he runs the risk of depleting his financial resources earlier than planned.

If investors deposit an equal amount to the contract, payments in the early years of the contract for the indexed annuity will be lower than an identical, non-indexed annuity. This is because the investor's capital must fund the future, higher payments. If the lower payments to begin are unsuitable for the investor, he will need to increase his deposit to the contract.

EXAMPLE

Gaston and Maurice each buy an annuity with $250,000 in capital.

Gaston buys an indexed annuity to keep his annuity income in step with inflation in the future. Maurice does not buy the indexed option.

Gaston is going to receive higher payments in the future. In order to fund these rising payments, the annuity issuer compensates by paying Gaston less now, compared to Maurice.

In the future, Gaston's payments will grow; Maurice's payments over the duration of the annuity will be the same as the first payment. Gaston's income will keep pace with rising costs; Maurice's will not.

3.4.5 Variable income

A variable income annuity is an immediate life annuity with the ability for the annuitant to earn market-linked returns. A market-linked return is a return linked to performance of a market index, such as the S&P/TSX Composite Index.

The annuitant who has a variable income annuity is paid on the basis of annuity units. He receives a set number of units at the time his deposit is made.

The contract owner chooses the investment mix on which unit value is based. He also selects a rate of return that must be attained before his income payments will increase. If the value of the units increases above the chosen rate of return, the annuitant's income increases. If the value of the units declines, the annuitant's income falls.

The variable income annuity mitigates interest risk and inflation risk since returns are intended to increase with the market. However, since the contract owner will face equity risk, he must have the required level of risk tolerance that matches equity investing.

3.5 Factors affecting annuity payments

Annuity quotes and payments are individualized for each annuitant. Rates offered to annuitants vary by insurer; policy owners will often comparison shop in order to find the best payment rate.

3.5.1 Annuity rate

The annuity rate is a dollar figure quoted to future policy owners based on the current interest rate and other factors that pertain to the annuitant and how the annuity contract is structured. In effect, it represents the return on the sum invested in the annuity.

EXAMPLE

Bernadette purchases an annuity contract with an annuity rate of $6,000 per $100,000. If she deposits $300,000 in the annuity, she will receive payments of $18,000 (($300,000 ÷ $100,000) × $6,000) annually.

The annuity rate also takes into consideration costs that are applied against the contract, such as commission and insurer expenses.

Rates differ between issuers since they do not all use precisely the same interest rate or calculation of the following cost factors.

3.5.1.1 Interest rate

The interest rate in effect at the time the contract is issued is a major factor in determining the payment to the annuitant. The interest rate assigned to the annuity never changes over its duration. It is based on the prevailing interest rate offered in other forms of interest-bearing investments at the time the contract is issued. The annuitant does not benefit from a higher payment if interest rates rise over the duration of the contract. This is the reason annuities have interest rate risk.

3.5.1.2 Age of annuitant

The age of the annuitant when payments begin is a significant contributor to the amount received as income from life annuities. The older the annuitant, the more paid since lifespan is a shorter period of time.

People are also living longer. This is reflected in mortality tables used by insurers to predict lifespan when issuing a life annuity. The companies want to ensure payments made to the annuitant or annuitants are adequately funded by the policy owner’s deposit. If the insurer miscalculates or an annuitant lives longer than anticipated, payments are made from the insurer’s financial reserves.

3.5.1.3 Gender of annuitant

Women receive a lower life annuity payment when all other factors are the same because, on average, they live longer than men. When the same amount is paid out over a longer period of time, each payment will be less than if the money was paid out over a shorter period.

3.5.1.4 Deposit amount

A progressively more attractive annuity rate is generally offered as the amount of deposit available to fund the contract increases. Insurers want to attract large accounts. To do so, they may offer a higher rate of annuity payment to those who have more to invest.

3.5.1.5 Payment schedule

Slightly more is received when the length of time between payments is longer rather than shorter. This is because the insurer has the unpaid sums at its disposal to invest. Since the insurer earns more, it rewards those who wait a longer time for payments by paying them slightly more. Therefore, a single annuity payment received at the end of each year is greater than the total amount received through 12 monthly payments.

3.5.1.6 Length of payment period

When the policy owner buys the annuity contract, he commits to deposit a set amount of principal to the insurer. The insurer doles out that principal plus interest over the period of time represented by the type of annuity chosen: term or life. The longer the payment period is, the lower the amount of each payment.

EXAMPLE

Rosario is 60 years old and healthy. He invests $100,000 in an annuity contract.

Scenario 1

He purchases a 10-year term annuity. Assuming it is paid to maturity, it will yield 120 monthly payments (10 years × 12 months). Based only on 10 years of payments, Rosario could receive a monthly payment of $833 ($100,000 ÷ 120).

Scenario 2

He purchases an immediate life annuity. The insurer's mortality tables indicate his expected lifespan is 24 years. The annuity is thus expected to yield 288 monthly payments (24 years × 12 months). Based only on 24 years of payments, Rosario could receive a monthly payment of $347 ($100,000 ÷ 288).

Therefore, the length of the payment period is a significant factor in determining the annuity payment.

When the length of the payment period is backed-up by a guarantee, the guarantee is a potential expense to the insurer. The insurer factors its cost into annuity payments and decreases payments to pay the potential guarantee.

3.5.2 Guarantees

Guarantees are an option for a life or joint and last survivor annuity contract if selected by the policy owner. They customize the contract to suit needs. They have a cost, which can increase the cost of the annuity for the policy owner (he would have to deposit more to the contract for an equivalent income) or decrease the amount the annuitant receives. Guarantees applied to an annuity ensure that some of the initial deposit will be paid out to a beneficiary during the time the guarantee is in place, and therefore, protect part of the invested capital.

3.5.2.1 Guarantee period and guaranteed capital

Annuities are funded with large sums of personal capital. A common minimum investment is $50,000. Therefore, ensuring the capital is returned to the investor or his beneficiary is very important to the investor. This is the basis for guarantees on annuities.

A term annuity is guaranteed for its entire term: the annuitant receives the annuity benefit and if he dies during the term, a beneficiary receives the difference between the sum invested and the amount paid to the annuitant. The three options available for a beneficiary are discussed with the term annuity topic.

A life annuity can be issued with or without a guarantee.[16] The guarantee is for a specified number of years, such as 5, 10, or 20 years. This length of time is referred to as the guarantee period. The annuitant receives the annuity benefit until his death. If he dies before the end of the guarantee period, his beneficiary receives a payment from the contract. This provides a guarantee on capital. The amount the beneficiary receives is the difference between the number of payments provided by the guarantee period and the number of payments the annuitant received. If the annuitant dies after the guarantee period, the beneficiary does not receive a payment.

EXAMPLE

Annette purchases a life annuity that is paid monthly with a 10-year guarantee period. She names her twin sister, Ava, as the beneficiary of the contract.

The guarantee ensures that the annuity will issue a minimum of 120 payments (12 monthly payments per year × 10 years). If Annette dies after receiving 100 payments, her sister Ava will receive the guarantee applying to 20 payments (120 – 100) either as a lump sum or in installments.

If Annette dies after ten years, Ava receives nothing.

The amount the beneficiary receives may be paid in a lump sum, corresponding to the current value of future guaranteed payments, or over time, in installments. When the lump-sum option is selected, the annuity is said to be commuted. Installment payments are paid to the beneficiary for the remainder of the guaranteed period.

16. This also includes impaired life annuities.

This guarantee brings peace of mind to the policy owner because he knows that a sum of money from the annuity is guaranteed to be paid out – first to the annuitant himself and, if he dies, to the beneficiary.

The guarantee period option does not apply to the total amount invested in the contract; rather it safeguards some of the investment. The type of guarantee that protects the total initial investment is called a capital protection guarantee.

Available in life annuities, the capital protection guarantee returns a sum to the beneficiary equal to the difference between payments received before the death of the annuitant and the initial capital. The annuity is called a cash refund annuity if the beneficiary receives a lump sum. If the amount is paid in installments, the annuity is called an installment refund annuity.

A life annuity without a guarantee is a risky investment. The annuitant of a single life contract could die after receiving his first monthly payment. If no guarantee was in place, no payment would be made to a beneficiary. The balance of the sum invested with the insurer would then belong to the insurer.

However, a life annuity without a guarantee also pays at a higher rate than when guarantees are added. The contract owner or annuitant(s) must weigh the return against the risk to decide which form of annuity is most suitable.

3.5.2.2 Guaranteed survivor income

Survivor income is guaranteed for two lifetimes by choice of a joint and last survivor annuity. However, a guarantee period can be added to the contract to again provide the assurance that a certain amount will be paid out from of the amount invested.

EXAMPLE

Tony and Jane buy a joint and last survivor life annuity with $100,000 with a 10-year guarantee. Tony and Jane are co-annuitants. Jane is set to receive the full amount of the benefit upon Tony's death. Tony and Jane's son, Roger, is the beneficiary. Tony receives $300 per month as his annuity payment. Jane does not receive a payment. When Tony dies two years after receiving his first payment, payments are then issued to Jane. Jane receives $300 per month until she dies three years later. Payments were made to Tony and Jane for a total of five years. Roger receives a sum equivalent to 5 years' payments because the contract has a 10-year guarantee, i.e. $18,000:

($300 × 12 months × 5 years)

He chooses to receive the amount as a lump sum.

Because annuity payments to a surviving annuitant extend the payment period, joint annuities generate lower payments than a single life annuity, all other factors being equal.

As an alternative to a joint and last survivor annuity, a spouse who is named as a beneficiary in a single life annuity contract with a guaranteed payment could receive income in the form of instalment payments.

3.5.2.3 Return of premium guarantee

Some insurers offer a return of premium guarantee as a rider to the contract. This ensures the full deposit to the contract is paid to the beneficiary if the annuitant dies before the first payment.

3.6 Limitations of annuities

Like all investments, annuities have disadvantages that must be weighed by the proposed policy owner against their advantages to determine if an annuity is an appropriate investment choice.

3.6.1 Risks

Annuities are insulated from many typical investment risks for the contract owner and annuitant when they are not issued in the variable income form. Once the contract is finalized including naming of a beneficiary, if applicable, the investor knows how much to expect, due to the promised annuity rate, and when, due to the timing and schedule selected in the application. No further decisions are required. The annuity is set with its Canadian issuer and for the most part, unchangeable. The lack of flexibility hampers flexibility to acquire funds for unforeseen expenses. Two other risks associated with annuities are interest rate risk and inflation risk.

3.6.1.1 Interest rate risk

Interest rate risk is often associated with annuities, especially when interest rates are low at the time the contract is drawn up. Contract owners rightfully worry that they may enter into a contract when interest rates are low only to see rates rise thereafter. A higher interest rate would pay a higher income. However, if a term annuity is issued when interest rates are high, its owner could find a reduced benefit if he renews his annuity when interest rates have fallen.

Interest rate risk can be managed during a period of low interest rates by using investment capital to buy a series of annuities instead of buying a single annuity. By spreading investment capital into two or three annuities, acquired over a number of years, the policy owner may be able to benefit if interest rates rise.

3.6.1.2 Inflation risk

Inflation risk goes hand-in-hand with interest rate risk. If the cost of living and interest rates climb, and the annuity is a life annuity or a lengthy term annuity, the annuitant will feel the effect of inflation. His annuity payment will have less buying power than if it kept pace with inflation.

This risk can be managed by acquiring an indexed annuity. Less is initially received in the annuity payment because the principal must be available to increase payments in the future.

3.6.2 Loss of capital

As stated previously, a life annuity contract without a guarantee period risks loss of capital for the contract owner. Even though the contract ends with death, any money invested in the contract and not paid out as benefits is not paid to the estate or a beneficiary. The insurance company retains the funds.

This risk is managed by adding a joint annuitant to the contract, and/or adding a guarantee period to the contract.

- A surviving joint annuitant continues to receive payments after the death of the first joint annuitant (providing both annuitants do not die at the same time).
- The guarantee period ensures a certain sum is paid from the contract although payments to the annuitant are less when a guarantee period exists.
- A beneficiary is named to receive a sum from the contract if the annuitant dies before the end of the guarantee period.

EXAMPLE

Nicholas, a widower with two grown children, receives an inheritance from his aunt in the amount of $450,000. He uses the money to buy an immediate single life annuity but he does not elect to include a guarantee period. Therefore, a beneficiary is not named.

One year after annuity payments start, Nicholas dies. Neither his children nor his estate can benefit from the remaining value of the annuity.

If Nicholas had opted for a guarantee period that named his children as beneficiaries, they would have received the value of the guarantee.

3.6.3 Restrictions on withdrawal or surrender

There is very little liquidity and flexibility with an annuity investment since there may be restrictions or penalties on withdrawing funds and surrendering the contract.

Payout and accumulation annuities are very different when it comes to withdrawals and surrender.

3.6.3.1 Withdrawals

A withdrawal is taking money from the invested sum; it would be separate from receiving the regular benefit. Payout annuities do not permit withdrawals.

A withdrawal may be made from an accumulation annuity. When this occurs, a market value adjustment (MVA) may be charged.

The MVA is a penalty calculated by the insurer that has issued the contract. The agent must inform the contract owner that a withdrawal may be reduced by the MVA.

The MVA is based on time, interest rates and expenses.

- The time is the difference between when the withdrawal is made and the maturity date of the investment;
- The interest rate factor looks at the guaranteed interest rate and the interest rate in effect at the time of withdrawal;.
- Expenses are the costs incurred by the insurer.

Withdrawals affect the amount available to fund annuity payments in the event of conversion of an accumulation annuity to a payout annuity upon maturity.

3.6.3.2 Surrender

When a policy is surrendered, it is terminated.

Any annuity funded by the transfer of locked-in funds from a registered pension plan, a locked-in retirement account (LIRA), or a life income fund (LIF) cannot be surrendered.

A term annuity may be surrendered for its commuted value. This means the annuity can be cancelled and the future annuity payments taken in a lump sum.

Surrender of a life annuity may be possible when annuity payments have not started. A portion of the investment capital deposited to the contract is returned to the policy owner. A contract cannot be surrendered after payments from a life annuity start.

An accumulation annuity may be surrendered at any time and its cash value is received by the policy owner.

In every case, the terms for surrender are described in the annuity contract. Penalties may apply and reduce the amount received by the policy owner.

3.7 Taxation of annuities

All annuity payments are a blend of investment capital deposited to the contract by the policy owner and interest earned on that capital.

Payout annuities are taxed depending on the type of income used to fund them and whether they qualify as being prescribed.

Accumulation annuities are subject to accrual taxation annually during the accumulation phase unless they are held in a registered account (the accrual method of taxation means income is reported for tax purposes even if it is not actually received). The accumulated value is only received through withdrawal or surrender, or by conversion at maturity to a life annuity, which then issues payments.

3.7.1 Taxation of registered payments

When an annuity is purchased with taxable registered funds, such as by transfer from a registered retirement savings plan (RRSP), the entire payment received by the annuitant is taxed as income in the year it is received. A deferred annuity purchased with registered funds is not taxed during the deferral period. Remember that with registered funds, the investor and the annuitant are one and the same.

Withholding tax is applied to payments when annuities have been purchased with funds transferred from a registered pension plan, LIF, LIRA, or deferred profit sharing plan (DPSP).

Withdrawals from a registered accumulation annuity are charged a withholding tax, except if the account is a registered retirement income fund (RRIF). Then, withholding tax only applies on amounts withdrawn above the annual minimum allowed amount.

3.7.2 Taxation of non-registered payments

A withdrawal from a non-registered accumulated annuity must be reported for tax purposes.

The interest portion of payments made from a payout annuity purchased with non-registered funds may be taxed as prescribed or accrual, also called non-prescribed, income.

Accrual income is taxed annually in the hands of the annuitant.

When an annuity is deferred later than December 31 of the year following the purchase date, it is taxed on an accrual basis. When income begins, the tax treatment switches to being prescribed only if the annuity qualifies.

Whether an annuity is prescribed or taxed on an accrual basis, the amount of income tax paid over the full payment period is the same. The timing of the tax is the difference.

3.7.2.1 Prescribed annuity

A prescribed annuity pays the same amount of interest and investment capital to the annuitant in every payment. Payments are thus said to be level. This is highly desired because the amount of interest to be declared for income tax does not change and tax obligations can be known and planned for. In the early years of the contract, less tax may be paid than would be paid for an accrual annuity.

There are a number of requirements that must be satisfied for annuity income to be prescribed. They include:

- Annuity cannot be indexed;
- Annuitant and policy owner must be the same person unless the annuity is joint life, with a spouse or sibling named as co-annuitant;
- Payments must begin no later than December 31 of the year following the purchase date.

EXAMPLE

Matthew buys an immediate term annuity in which he is also the annuitant. He chooses a monthly payment. The amount he receives in each payment is $800. The annuity meets all the conditions to be prescribed. Of each $800 payment, $650 is capital and $150 is interest. Matthew declares the annual interest of $1,800 ($150 × 12) on his tax return.

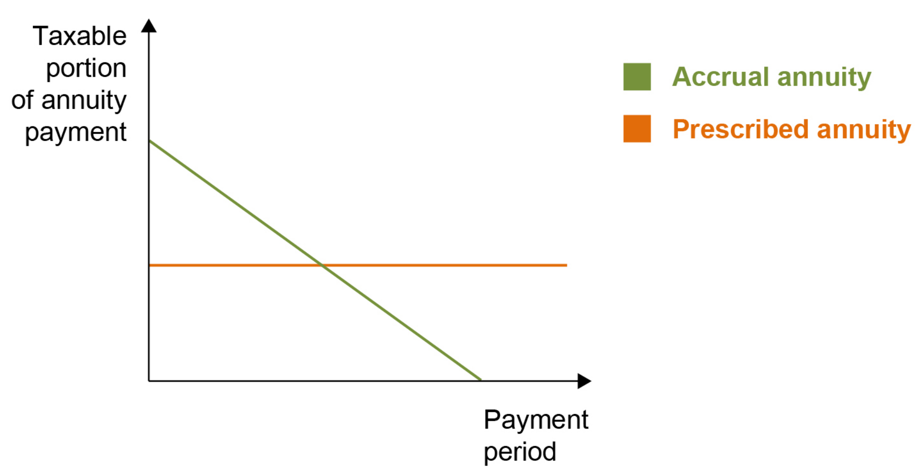
3.7.2.2 Accrual annuity

An accrual annuity payment is comprised of more interest than investment capital in its early years. Consequently, accrual annuities often have a larger amount of tax owing in the early years of payments compared to prescribed annuities. However, tax declines over time as the portion of each payment that is interest declines and more investment capital is paid.

Diagram 3.1 illustrates the difference in taxation levels between prescribed and accrual annuities.

DIAGRAM 3.1

Taxation of prescribed and accrued annuity income



Income tax on an accrual annuity is payable on interest earned in the year of purchase from the purchase date to the policy anniversary. Thereafter, income tax is payable on the interest received for the full year and reported on the income tax return for that year.

EXAMPLE

Peter wishes to invest in an annuity in order to receive payments five years from now. Depending on the type of annuity purchased, payments will be taxed on an accrual or prescribed basis.

Scenario 1 – Accrual annuity

Peter buys a deferred life annuity. He is the annuitant of the contract. His first monthly payment is to be paid in five years. The annuity does not meet the conditions to be prescribed because it is deferred beyond December 31 of that year. He is taxed on investment growth annually during the five years of deferral. Each of his payments is $800 when they begin, and is comprised of $100 in capital and $700 in interest. Therefore, of the $9,600 he receives for the year ($800 × 12), he pays tax on $8,400 ($700 × 12). After five years, each $800 payment is $400 in capital and $400 in interest. After ten years, the payment is $700 in capital and $100 in interest.

Scenario 2 – Prescribed annuity

Peter acquires an accumulation annuity contract. He is taxed on investment growth annually. Five years later, Peter decides to use the savings in his contract to transfer into an immediate life annuity in which he is the annuitant. Payments of $800 are to begin immediately. Since the life annuity meets all the necessary conditions, it is prescribed. The amount of tax he pays is level, i.e. it is equal throughout the payment period because each payment will be comprised of the same portion of capital and interest. If payments are comprised of $440 of capital and $360 of interest, on the $9,600 he will receive annually ($800 × 12), he will pay taxes on $4,320 ($360 × 12) for the duration of the payment period.

3.7.3 Tax on guarantees

The tax on guarantees paid to a beneficiary is not clear and guidance should be sought from the insurer issuing the guarantee payment.

3.7.4 Tax on surrender

When a policy is surrendered, tax applies on investment growth in the contract unless registered funds are the source of contract deposit. In that case, 100% of the amount received from the surrender is taxed at the same rate as interest in the year it is received. The agent should always seek the advice of the tax specialist of the insurer that holds the contract to be able to properly prepare his client for tax withholding and tax payable.

3.7.5 Tax benefits

Annuity income may be eligible for the tax benefits of income splitting and the pension income tax credit.

Income splitting allows 50% of the taxable income from a payout annuity contract with an insurer to be transferred to a spouse. Tax savings result because the annuitant reduces his income by the amount of transfer when the spouse pays tax at a lower marginal tax rate. Attribution rules may limit income-splitting possibilities.

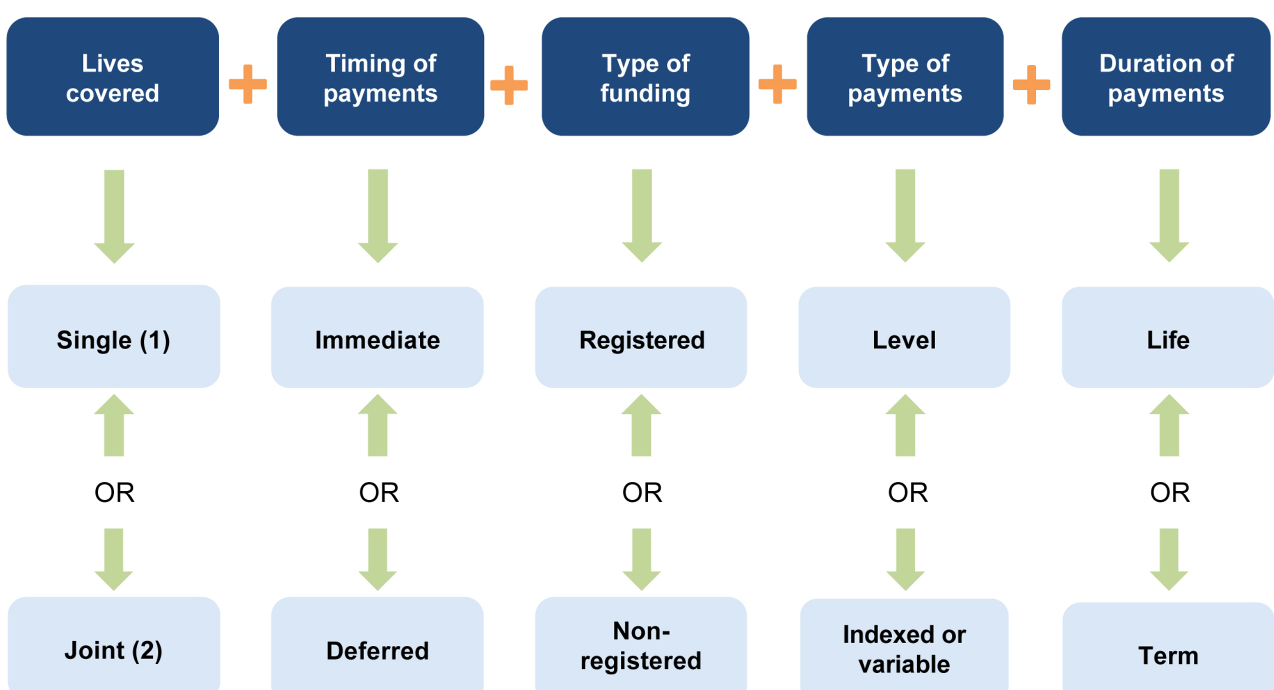
The pension income tax credit is a federal tax credit that is allocated if the taxpayer has eligible pension income such as the income paid by an annuity. The maximum credit is $2,000 annually. The tax credit is available to annuitants' age 65 and older. Those younger than 65 can take advantage of the tax credit if they receive payments from an annuity in a registered account that was owned by a deceased spouse or common-law partner.

3.8 Annuity classification

Annuities are classified according to their features, and potential limitations. Diagram 3.2 illustrates what characteristics define the various types of payout annuities frequently encountered in sales.

DIAGRAM 3.2

Structure of payout annuities



3.9 New types of annuities

Two new types of annuities were introduced in 2019 though the legislation is not yet enacted to make them available to investors: the advanced life deferred annuity (ALDA) and the variable payment life annuity (VPLA). Both are, as their names suggest, a form of life annuity but they differ from the life annuities already discussed. Their primary objective is unlike that of other annuities in that they are intended to provide Canadians with greater flexibility in managing their retirement savings.

These annuities will be new to the Canadian market. It remains to be seen if they will interest consumers. New agents should be familiar with these names and their main features.

3.9.1 Advanced life deferred annuity (ALDA)

An advanced life deferred annuity (ALDA) is a life annuity available to individuals who have an RRSP or a RRIF or who participate in a deferred profit sharing plan (DPSP), a pooled registered pension plan (PRPP) or a defined contribution pension plan (DCPP). More on these accounts and plans is provided later in this manual.

Key to this form of annuity is the ability to defer payments until the end of the year in which the annuitant reaches 85. Therefore, the ALDA addresses longevity risk and ensures that investors do not deplete their savings prematurely during retirement.

Also important to note is that the funds deposited to an ALDA are no longer controlled by the account owner. This lessens the need for decisions about investments at a time of life when people may lose their ability to make complex financial choices.

Payments are periodic, as with other annuities. The ALDA cannot be commuted or surrendered, or provide a guarantee. Thus, there is significant risk of loss of capital.

A lifetime limit of 25% of the value of the qualifying plan, to a total of $150,000 applies to ALDA purchases and will be indexed to inflation. Income received will not be included in calculating the minimum annual amount withdrawal from a RRIF, a PRPP account or a defined contribution account, after the year in which the ALDA is purchased.

EXAMPLE

Noor has an RRSP valued at $400,000. She is unlikely to need access to the entire sum at retirement because she plans on working as a consultant into her late 70s. Noor also expects to live until she is in her 90s since her mother, father and grandmother have all lived to their late 90s. She converts 25% ($400,000 x 25% = $100,000) of her RRSP to an ALDA to ensure that when she reaches 85 some additional funds are available to help her pay the costs she expects to incur to live independently in later life.

3.9.2 Variable payment life annuity (VPLA)

A variable payment life annuity is an option for a PRPP contributor or members of a DCPP. Transfers to fund the VPLA are made directly from each type of plan if the plan administrator has established a VPLA arrangement. A minimum of 10 retired members is required to implement the annuity.

The VPLA requires that periodic payments begin by the end of the year in which the member turns 71 or the end of the calendar year in which the VPLA is acquired. There are no guarantees.

This form of annuity may be subject to provincial pension benefits standards legislation.

CHAPTER 4
INVESTOR PROFILE

Competency components

- Analyze the client's needs and situation;
- Implement a recommendation adapted to the client's needs and situation.

Competency sub-components

- Determine the client's situation, investment objectives, and investor profile;
- Assess the appropriateness of the client's existing coverage in regard to his or her situation;
- Articulate the client's needs based on the risks that could affect his or her financial situation;
- Propose a recommendation adapted to the client's needs and situation.

4
INVESTOR PROFILE

An investor profile is a snapshot of the financial and personal factors that influence an individual's investment choices.

Just as a life insurance agent must be knowledgeable about the investments he sells, so too must he have knowledge of the person who is investing. This knowledge is acquired through the creation of the investor profile.

Every investor is unique. Some investing objectives are shared by many, such as the need to save for retirement. But how each person meets his objective or objectives is the result of individual characteristics and choices.

To develop the knowledge needed to create the investor profile, the agent must review:

- The assets and liabilities of the client to determine his overall financial situation;
- Personal factors that may affect the client's investment decisions;
- Client needs and objectives;
- Sources of income during retirement;
- Programs and savings plans that can help the client to save and meet his needs.

The profile, therefore, gathers a lot of information. These details are used to develop investment recommendations that align an investor with the investments most suitable to his needs. The agent should take into account all aspects of the client's situation that have a financial impact and not limit his analysis to the elements mentioned in this Chapter.

4.1 Financial situation of the investor

An analysis of personal finances begins with information about assets and liabilities. This information is gathered so the client's financial position may be evaluated through a net worth statement and a cash flow statement.

The net worth statement lists assets and subtracts liabilities. Among assets may be savings and/or investments that the agent can analyze for current suitability. He may find a need to bring forward recommendations to the client that, for instance, could increase returns or decrease risk. The result of compiling the net worth statement is to show whether the investor has a positive net worth (good) or a negative net worth (bad).

The cash flow statement lists income (inflow) and expenses (outflow). The bottom line reveals whether the investor earned more than he spent. A positive cash flow indicates that money is available for spending, saving and investing. A negative cash flow means that more is being spent than being earned; an unsustainable financial position.

4.1.1 Review of assets

Anything a person owns that has cash value is considered an asset. The single most valuable asset most people own is their principal residence. Personal assets also include other types of real estate, cash, registered and non-registered investments, government retirement pensions (CPP/QPP and OAS), employer pension plan savings, the cash value of life insurance, fine jewelry, art, cars and boats, and specialized equipment such as tools or cameras.

Assets are important for both the market value they contribute to net worth and the collateral they provide for the purpose of borrowing.

The purpose of reviewing personal assets is to see the plus side of the balance sheet or net worth statement. This shows the value of personal assets; it can show progress made in building worth. The cash flow statement shows the rate at which assets are being accumulated or used.

The following are some of the documents that provide information about an investor's personal assets:

- Income tax return;
- Registered retirement savings plan (RRSP) statements;
- Non-registered investment account statements;
- Employer-provided pension plan statements;
- Bank statements;
- Life insurance policies;
- Other asset sources.

4.1.1.1 Income tax return

Personal income is reported on the annual income tax return. After the income tax return is filed, the Notice of Assessment (NOA) is produced by the Canada Revenue Agency (CRA). Taxpayers in Québec receive an NOA from Revenu Québec.

The key information shown in the personal income tax return is:

- Amount of taxable income;
- How that income is earned;
- Use of tax credits and deductions, including registered retirement savings plan (RRSP) contributions.

The NOA summarizes:

- Total income;
- Amount of tax paid;

- Amount of tax owed;
- Tax credits received;
- Deduction room available for an RRSP;
- Unused net capital losses;
- Tax-free savings account (TFSA) contributions, withdrawals and unused contribution room;
- Other necessary repayments, carry-forwards and rebate information.

Income can be earned from many sources in addition to employment. It can be generated by a personal business, from retirement pensions, from disability pensions, from investments, or from spousal support, among others.

Dependability of the income is key to planning. For instance, business income could vary year-to-year but income from a Canada Pension Plan (CPP)/Québec Pension Plan (QPP) retirement pension would be stable, rising only in step with inflation or a change in legislation. From this information, the investor and agent know what can be counted on for income in future years.

Contributions made to registered savings plans illustrate the investor's current dedication to savings.

The deduction limit for RRSPs is calculated based on earned income. It shows whether contributions are currently maximized and is a basis for planning future savings.

Tax credits and other deductions reduce income tax. Charitable giving is reflected in the charitable donation credit. The pension income tax credit can show whether a strategy for splitting retirement income could be implemented since the tax credit must be claimed before income splitting can occur.

The taxpayer generally pays tax at his marginal tax rate (MTR), which combines federal and provincial tax rates. The MTR is the rate of income tax applied to the next dollar of income earned.

4.1.1.2 Registered retirement savings plan (RRSP) statement

Regular statements are issued by the financial institution where an RRSP is held. The statement is a summary of the account.

An RRSP statement can show many details including:

- Sum invested;
- Growth of the sum invested;
- How the sum is invested;
- Whether the account holds locked-in funds;
- Withdrawals.

An individual may have multiple RRSP statements because there is no limit to the number of RRSP accounts a person may have. However, annual contributions to all accounts, including a person's own RRSP and a spousal RRSP, are limited to the annual individual maximum, plus the available deduction limit, which includes the carry-forward of unused deductions from previous years. An over-contribution of $2,000 over and above this amount is permitted before penalties are incurred however this sum is not tax deductible.

It can be very important for an agent to see how the money deposited to the RRSP is invested. It could reveal investing expertise and knowledge, the investor's exposure to risk, portfolio diversification and maturity dates.

For instance, an investment such as a five-year Guaranteed Investment Certificate (GIC) has a five-year term-to-maturity. The agent or investor should not plan to access those funds in the GIC until after its maturity date because it may not be redeemable or penalties may be applied to the withdrawal.

An account with locked-in funds has restrictions on transfers and withdrawals. The money is locked-in because it has been transferred from a registered pension plan (RPP) or another locked-in account. Locked-in accounts will be addressed later in this Chapter.

Withdrawals from an RRSP may show the investor has had an exceptional expense or has a need to supplement his income. If withdrawals seem to occur regularly, a conversion of the account to a registered retirement income fund (RRIF) or annuity may be advisable.

The absence of an RRSP statement can also be revealing. It may show the investor does not understand the significance of having an RRSP or does not have funds available for saving in an RRSP. If the RRSP has been closed because the investor has exceeded the age limit for owning an RRSP, statements from other types of registered accounts may be available.

An agent uses the RRSP statement to discern the value of this asset in the overall assets of the investor.

4.1.1.3 Non-registered investment account statements

Just like an RRSP statement, a statement from a non-registered or taxable account will summarize the key aspects of this investment account. Unlike an RRSP, there are no limitations imposed by the *Income Tax Act* on either deposits to the account or withdrawals.

This statement provides additional detail about the investor's approach to investing and how much is available to contribute to net worth.

4.1.1.4 Pension plan statements

A pension plan statement, also known as a member's benefit statement, is issued annually by employers who have a registered pension plan (RPP) in place for their employees. In 2020 there were just over 16,300 registered pension plans in Canada representing about 6.5 million members.[17]

An employer pension is a valuable asset to members of the pension plan since the savings in the plan can provide a source of retirement income.

The statement may include the expected value of the pension to be received at the usual retirement age. Other information can include contributions made during the year and the expected retirement date. This information is fundamental to knowing how much will be paid and when.

Contributions made to an RPP by a member as well as pension adjustments (PAs) reduce his RRSP deduction limit.

4.1.1.5 Bank statements

Some people use bank savings as an investment. Therefore, it is essential to review the bank statements for a savings account to determine how much the bank account contributes to total assets.

4.1.1.6 Life insurance policies

Life insurance policies with cash value, i.e., whole life insurance and universal life insurance, are an asset due to the values that can be accessed by the policy owner. The cash may be received as cash surrender value or through a policy loan. Universal life insurance may also permit withdrawals to be made.

4.1.1.7 Other asset sources

There are many other assets that have worth, or contribute to worth. For instance:

- A business owner has asset value in his business in proportion to his share of ownership;
- An inventor or designer may have an asset in a patent or intellectual property and receive royalty income;

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17. Statistics Canada. Table 11-10-0106-01. *Registered pension plans (RPPs), active members and market value of assets by contributory status*. [online]. Revised June 29, 2021. [Consulted May 11, 2022]. https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1110010601

- A real estate investor may have income properties with equity and receive rental income;
- As mentioned previously, both CPP/QPP and OAS can be significant assets to their recipients. An online resource called the Canadian Retirement Income Calculator can help determine the contribution made by these plans.[18]

All possible assets should be compiled in the financial review.

4.1.2 Review of liabilities

While assets contribute positively to personal worth, liabilities reduce it. Liabilities are debt and financial obligations that must be repaid.

Sometimes a distinction is made between good debt and bad debt. Good debt is borrowing taken on in order to increase assets. For instance, a mortgage may be considered good debt under this definition. A loan taken for the purpose of investment might also be considered good debt. Bad debt is debt that depletes income and financial resources, such as credit card debt that arises from shopping, dining out and holidays. Regardless of whether the debt is good or bad, the borrower must be able to meet its repayment terms. Both types of debt should be included in the review of liabilities.

Debt, both good and bad, is a significant burden for Canadians. As of August 2021, Statistics Canada measured total household liabilities at almost $2.5 trillion.[19] Mortgages lead the way for the total amount of debt, followed by credit card balances.

Even a small increase in interest rates will increase consumer debt payments (while paradoxically increasing investment interest returns). Consumers need to prepare for such an eventuality by ensuring income exceeds liabilities with a margin for increasing costs.

The following documents, among others, provide information about an investor's personal liabilities:

- Mortgage statement;
- Line of credit statement;
- Credit card statements.

4.1.2.1 Mortgage statement

Just as a person's home is probably his single most valuable asset, his mortgage on that home is likely to be his single biggest liability.

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18. The Calculator is provided at https://www.canada.ca/en/services/benefits/publicpensions/cpp/retirement-income-calculator.html
19. Statistics Canada. *Study: Trends in household non-mortgage loans The evolution of Canadian household debt before and during Covid-19.* [online]. [Consulted May 18, 2022]. https://www150.statcan.gc.ca/n1/daily-quotidien/210823/dq210823c-eng.htm

A mortgage statement is issued annually by the financial institution that holds the mortgage on the property. Its key information is the amount owed, the principal and interest charge of each mortgage payment, the interest rate applied to the mortgage, the mortgage term and its amortization.

A reverse mortgage may have been issued on a home. A reverse mortgage is a payment of a portion of home equity to the homeowner in a lump sum or a series of payments. It is a liability that must be repaid if the owner sells the house or dies. There may be estate-planning considerations because the repayment of the mortgage will reduce proceeds from the property for inheritors.

4.1.2.2 Line of credit statement

A line of credit may be extended by a financial institution to an individual based on his creditworthiness or to homeowners based on the equity in their home. When a line of credit is based on the home, it is called a Home Equity Line of Credit or HELOC.

The statement issued by the financial institution will show the amount owed, the minimum monthly payment required and the interest rate charged against the amount of loan extended.

4.1.2.3 Credit card statements

Credit card statements are issued monthly when money is owed and detail charges incurred during the month, a separate charge for interest and cash advances, balance of the account and the minimum monthly payment.

4.1.3 Financial position of client

All the details on assets and liabilities are compiled to form a financial profile in the net worth statement. Income and expenses appear in the cash flow statement and are added to the profile. The result shows the possible amount available for investing.

4.1.3.1 Net worth statement

A net worth statement is developed by listing all assets at their market value and subtracting all liabilities. The final sum is the net worth of the individual or couple.

Net worth = value of all assets – value of all liabilities

A common goal of financial planning is to increase net worth in order to achieve financial objectives. This can be done by acquiring more assets, by increasing the value of existing assets (for instance, through a home renovation) and by decreasing liabilities.

The net worth statement is prepared as a benchmark against which goals can be fixed and future increases in worth can be measured.

EXAMPLE

Net Worth Statement for John and Jane H., as of (date)

Assets	
Home	$526,000
Cottage	$360,000
Two vehicles (owned)	$40,000
RRSPs	$105,000
TFSA	$3,300
Life insurance CSV	$22,000
Cash	$7,100
Total assets	**$1,063,400**
Liabilities	
Mortgage: home	$112,000
Mortgage: cottage	$86,000
Line of credit	$23,600
Credit cards	$8,900
Car loans	$5,300
RRSP loan	$4,400
Total liabilities	**$240,200**
Net worth	**$823,200**

4.1.3.2 Cash flow statement

The cash flow statement can be developed for a period of time as long as a year or as short as a month. It is most accurate when it is backed up with a budget based on actual spending patterns.

The cash flow statement lists all sources of net income (income after income tax) and subtracts all expenses including debt payment for liabilities. If a positive number results, money is available for spending, saving or investing. If a negative number results, a debt management solution may be required, savings may have to be used, or assets may need to be sold to pay down debt.

EXAMPLE

Cash flow statement for John and Jane H., as of (date)

	Month 1	Month 2	Month 3
Net income			
John's salary	$5,500	$5,500	$5,500
Jane's salary	$3,800	$3,800	$3,800
Total net income	**$9,300**	**$9,300**	**$9,300**
Expenses			
Mortgage payments: home	$475	$475	$475
Mortgage payments: cottage	$350	$350	$350
Line of credit	$35	$35	$35
Credit card payments	$600	$200	$1,600
Car loan payments	$400	*$0	$0
RRSP loan interest payments	$100	$100	$100
Child care payments	$850	$850	$850
RRSP deposit	$200	$200	$200
Insurance premium	$160	$160	$160
Cell phones	$90	$90	$90
Hydro, heating, water bills	$500	$500	$500
Clothing	$400	$200	$300
Food	$800	$800	$800
Entertainment	$400	$500	**$7,000
Misc.	$1,250	$1,250	$250
Total expenses	**$6,610**	**$5,710**	**$12,710**
Cash flow	**$2,690**	**$3,590**	**-$3,410**

* Car payments are finished; cash flow increases.

** Entertainment increases due to family holiday; miscellaneous costs are less for the month.

4.2 Personal factors that affect investment

There are many personal factors and preferences that motivate investing decisions. They are valid considerations in the development of the investor profile. They may include:

- Personal values;
- Health concerns;
- Legal considerations;
- Personal risks.

4.2.1 Personal values

Personal values affect both an approach to investing and the choice of investments. For instance, although saving for retirement dominates financial planning, it is not equally important to all people. Some may value saving for education over saving for retirement. Others again may value charitable giving over enlarging investment portfolios. Some will exercise their beliefs about values by choosing socially responsible investments. The agent must learn if values will affect decisions in order to develop appropriate recommendations.

4.2.2 Health concerns

It is said that one of the greatest threats to wealth is poor health. No one can predict if or when a life-changing illness or disease will occur. People of any age who contract a critical illness or who are severely and permanently injured may find they can no longer live independently and need to use their savings to pay for the cost of care. Older individuals may also find that they need care in their later years. The cost of home care or care provided in a facility can be high and diminish the value of an estate. It also introduces the risk of outliving one's money.

However, it can be too late to ensure funds are available for health care and/or independent living if the agent discovers this need when the client has already reached or is nearing the stage when care is required. Therefore, financial planning should take this personal factor into consideration well before the time that the money may be needed. This enables adequate savings to be earmarked for care in the event it is needed.

The need to fund care in later life is also an opportunity for life agents to introduce long-term care insurance. The need to fund expenses of illness earlier in life could be explored in a discussion about disability insurance, critical illness insurance and life insurance.

The risk of disability is one that should be assessed with other health concerns. Disability can have a devastating immediate and lasting effect on income and, concurrently, on wealth accumulation. The risk is best managed by ensuring that disability income insurance is in place for the income earners of the family.

Other health considerations that may impact the investor profile are the need to save to provide an income for a disabled child and the need to use financial resources to pay for care for aging parents.

Life insurance needs should be assessed to determine whether coverage exists and whether it is adequate for income replacement and/or estate purposes.

Another health concern of which an agent must be aware is the mental capability of his client to make good investment decisions. Mental capacity can be impaired due to disability or it can become impaired due to advancing age.

Demographics show that a huge population bubble – the Baby Boomers – are reaching their 70s. Some older adults have difficulty making financial decisions. Because of increasing lifespans, more and more clients are in their 80s and 90s. This is a period of life in which people must make rational and practical decisions about retirement income and their estates. Therefore, the agent must be prepared to guide decision-making based on the knowledge he has developed of the client. He must also be alert to signs that decisions being made are inappropriate.

4.2.3 Legal considerations

The investor profile must take into consideration legal obligations to others that have financial impact, such as:

- Family law considerations;
- Will;
- Power of attorney (POA).

4.2.3.1 Family law

A person in a married or common-law relationship (except in Québec, for common-law relationships), whether same sex or opposite sex, has a legal financial duty to his spouse when they separate and divorce. Family law, at its simplest, attempts to equalize the assets of both parties in these circumstances. This includes investment property. Therefore, both spouses have rights in regard to investments and their assets acquired during marriage.

A parent also has financial responsibilities to children, from both a previous marriage and a current marriage. If child or spousal support has been ordered, it must be paid and its cost factored into financial obligations and liabilities.

4.2.3.2 Will

Developing the investor profile calls for a review of the will to see what commitments are planned for the value of the estate. Will review is part of the estate planning process. Agents do a valuable service for their clients when they ensure a professionally prepared will is in place. Dying without a will costs the estate of the deceased time and money – and there is no certainty the wishes of the deceased will be honoured.

Bequests in the will must be backed up with the necessary financial resources including life insurance or they may remain unfulfilled. A surviving spouse can generally receive the assets of a deceased spouse on a rollover basis, meaning that any taxes are deferred until the death of the second spouse.

Meeting bequests made in the will takes careful planning. If investment proceeds are slated for a particular purpose, such as paying the capital gains tax on a second home, then the giftor will want to ensure enough money is going to be available for the inheritor of the property. Such cases may call for investments with guarantees so the giftor is assured his wishes may be carried out. Segregated funds are one choice. An accumulation annuity is another.

Life insurance is, of course, very important for fulfilling estate plans.

4.2.3.3 Power of attorney (POA) for property

Although there are provincial differences in power of attorney (POA), at its core, the POA is a document that nominates a person to make decisions and act for another when specified circumstances arise. It often accompanies a will but is invoked when the individual who has created the POA is unable to act for himself either temporarily or permanently. This often arises due to medical issues.

Developing the background knowledge needed for the investor profile should include whether a POA has been given, to whom, and what his powers are, in order to determine in what circumstances he should be consulted.

A POA may be issued to address end-of-life health decisions or property issues. This manual concerns itself with the POA for property.

The attorney in a POA is the individual named to assume decision making for another. It is not necessarily a lawyer although a lawyer could be named as attorney in a POA. It is often an individual known and trusted by the person making the POA (called the grantor).

An agent should decline being named as an attorney and must exercise caution when confronted with an individual who is presenting himself as an attorney for property. The attorney is granted many powers including switching and selling investments. Agents should be aware of the limitations on the attorney's powers, including a restriction on changing life insurance beneficiaries, except in B.C. Financial exploitation by attorneys is a major problem; POA fraud is a criminal offence.

4.2.4 Personal risks

Each investor faces personal risks that can affect his plans for savings and investing, such as:

- Low level of financial literacy;
- Risk of job loss;
- Longevity risk;

- Risk of bankruptcy;
- Risk of leveraging;
- Unforeseen expenses.

4.2.4.1 Low level of financial literacy

The Financial Consumer Agency of Canada[20] tells us that financial literacy is having the knowledge, skills and confidence to make responsible financial decisions.

- **Knowledge** is an understanding of personal and broader financial matters;
- **Skills** is the ability to apply that financial knowledge in everyday life;
- **Confidence** is the self-assurance to make important decisions; and
- **Making responsible financial decisions** is the ability of individuals to use the knowledge, skills and confidence they have gained to make choices appropriate to their own circumstances.

Financial literacy is theplans on ability to understand basic matters of personal finance. Many individuals across the spectrums of age, education and profession suffer from financial illiteracy. Never assume what a client seems to know or should know.

Financial illiteracy refers to a lack of knowledge and understanding about financial products. This can lead to unnecessarily low risk tolerance, which in turn leads to low returns on investments or unnecessarily high risk tolerance, which leads to investment losses.

To properly fulfill his duties to the client, the agent should assess client financial literacy. Any shortcomings can be remedied with the information necessary for the client to properly understand the strengths and weaknesses of investing and proposed plans as well as the effect of risk tolerance. Typically, an agent determines financial literacy by interactions with the client.

Here are three basic questions that are used as a standard test for financial literacy[21]: Incorporating them into a client conversation gave equip the agent with a sense of client knowledge, which can then be a basis for suitable recommendations.

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20. Government of Canada. Financial Consumer Agency of Canada. *Financial literacy background*. [online]. [Consulted May 11, 2022]. https://www.canada.ca/en/financial-consumer-agency/programs/financial-literacy/financial-literacy-history.html
21. Global Financial Literacy Center, Lussardi, A and O.S. Mitchell, *Three Questions to Measure Financial Literacy.* [online]. [Consulted May 11, 2022]. https://gflec.org/wp-content/uploads/2015/04/3-Questions-Article2.pdf

1) Suppose you had $100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow?

   A. More than $102
   B. Exactly $102
   C. Less than $102

   (tests knowledge of compounding);

2) Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, how much would you be able to buy with the money in this account?

   A. More than today.
   B. Exactly the same as today.
   C. Less than today.

   (tests knowledge of inflation risk);

3) Buying a single company's stock usually provides a safer return than a stock mutual fund.

   A. True.
   B. False.

   (tests knowledge of diversification).

The correct answers are:

1. A. 2. C. 3. B.

Information must be appropriately communicated to the client, both in writing and verbally. An agent must be aware of language differences that impede understanding and, if appropriate, call on the use of an interpreter.

The use of financial and industry jargon and acronyms, such as talking about an MTR instead of marginal tax rate, should be avoided.

Educational resources are provided by insurers and other financial institutions, as well as financial regulators. Independent information can be accessed at sites such as the GetSmarterAboutMoney site.[22]

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22. Ontario Securities Commission. GetSmarterAboutMoney.ca. [online]. [Consulted May 11, 2022]. https://www.getsmarteraboutmoney.ca

4.2.4.2 Risk of job loss

Job loss due to layoffs or economic developments can have a devastating impact on plans for investing. If job loss occurs, the investor profile should be reviewed immediately. Saving plans may need to be put on hold.

4.2.4.3 Longevity risk

Lifespan is increasing. From 1995 to 1997, life expectancy at birth was an average of 78.4 years. By 2020, average life expectancy was 82.[23]

This means retirement savings must last longer. Longevity risk is the risk that a person continues to live past the point in time that savings are depleted. This is called outliving your money.

Longevity risk can be diminished by investments that provide lifelong income, such as a life annuity or a Guaranteed Lifetime Withdrawal Benefit.

4.2.4.4 Risk of bankruptcy

Bankruptcy can be experienced by an individual or a company. It is the inability to meet financial obligations to creditors.

The risk is mitigated by financial management and, for an individual, a careful selection of investments such as segregated funds that can provide creditor protection.

4.2.4.5 Risk of leveraging

Leveraging uses borrowed money to try and achieve a financial goal. Using this definition, some forms of leveraging, such as acquiring a mortgage in order to buy a home and develop the equity in the home, are quite common and safe.

When leveraging is used to invest in non-guaranteed investments, the borrower takes on significant risk: if the investment loses value, he can lose principal plus the amount of loan invested. However, the loan must still be repaid adding even more to the losses of the investor. Therefore, while leverage can magnify returns since it gives the investor a larger sum to invest, it can also magnify losses since the investor loses his savings plus the borrowed sum.

Knowledge of leverage being used is crucial to the investor profile since it speaks to investor goals and risk tolerance.

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23. Statistics Canada. *Table 13-10-0114-01. Life expectancy and other elements of the life table, Canada, all provinces except Prince Edward Island.* [online]. Revised January 24, 2022. [Consulted May 11, 2022] https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1310011401

4.2.4.6 Risk of unforeseen expenses

Unforeseen expenses are exactly what their name suggests: expenses that arise unexpectedly and, therefore, cannot be planned for. Medical expenses are one category of expense often overlooked due to the assumption that provincial health plans cover all bills. In fact, many health care costs are not paid by provincial insurance.

Investors should ensure they have an emergency fund to cover these expenses and should take immediate action if a large unforeseen expense arises that disrupts their savings and income needs.

4.3 Investor needs

The needs of the investor are fundamental to developing the investor profile because needs supersede wants. For example, an investor might want a 20% annual return on his investment but he needs a guaranteed 9% sum available to build and sustain a retirement nest egg. To build his savings, the investor needs lower risk investments as he approaches retirement that can be relied upon to meet his goal. This rules out investments generating a 20% annual return since higher returns are invariably linked to higher risk.

Needs, therefore, are the investor's motivation – their reason – for exploring investment options and part of the basis for making investment decisions.

The agent's role is to identify and understand needs that affect plans and decision-making. These include:

- Need for income;
- Need for retirement income;
- Need for tax efficiency;
- Need for emergency fund;
- Need for creditor proofing;
- Need for liquidity;
- Need for estate planning;
- Need for diversification;
- Need for investment management;
- Need for suitability;
- Other specific investment needs.

4.3.1 Need for income

Income is required to meet the costs of living and for saving.

Goals must be identified and assigned a dollar value to give meaning and purpose to savings plans.

If income is insufficient, or only sufficient, for paying living costs, then any plans for savings must wait until income increases or costs decrease.

4.3.1.1 Individual or household income needs

There are three categories of individuals in which there will be a need to assess individual income needs:

- Those who are unmarried and not in a common-law relationship;
- The widowed;
- Those who are separated or divorced.

Individual income needs must be compared against individual expenses to produce a realistic picture of an individual's financial situation. Couples should be assessed on the basis of household or family income, which encompasses both income earners, and household expenses. Care should be taken to include income needs associated with dependents, for both individuals and couples.

Income needs may be expressed for the present or the future. If an investor profile turns up a need for increased income in the present, the agent may want to review the budget of the individual to discern spending behaviour. Meeting future income needs should be the focus of the investment plan. Such a plan is based on objectives for the future.

4.3.2 Need for retirement income

Retirement income is the money needed to meet expenses in retirement. Retirement income replaces or supplements employment income when a person retires.

Income sources during retirement will include government retirement pension income, private pension income, investment income and personal savings for retirement. It may also include employment income since some retirees choose to continue work or to re-enter the workforce after retiring. Business income may continue during retirement. The business owner may not be actively working in the company but still receive a salary or dividends.

A major factor that can be easily overlooked when assessing how much income is needed during retirement is the income tax that will be due on amounts received. Therefore, spending should be based on net income, that is the income remaining after tax.

4.3.2.1 Income splitting

Income splitting is a strategy that can be explored to take advantage of the different marginal tax rates of spouses.

When income splitting occurs, income is apportioned between spouses so that some of the income is moved to a spouse who pays tax at a lower marginal tax rate than the other. By putting income into the hands of a spouse who pays tax at a lower rate, money is saved.

Some examples of effective income splitting include:

- **Opening a spousal or common-law partner registered retirement savings plan (RRSP):**
  This is called a spousal or common-law partner plan. The higher-income spouse contributes to the plan for the other spouse. This works for income splitting if the spouse receiving the contributions is in a lower tax bracket than the contributing spouse when withdrawals are made.
- **Splitting pension income for those 65 and older:**
  Up to 50% of the annual income received from a lifetime annuity, registered pension plan, RRSP annuity, registered retirement income fund (RRIF) or deferred profit sharing plan (DPSP) annuity can be allocated to a spouse. The splitting for tax purposes is done via the tax return.
- **Assigning Canada Pension Plan (CPP) benefits:**
  CPP can be shared between spouses who were contributors, or between spouses when only one was a contributor. Technically, this is called an assignment. Québec Pension Plan (QPP) sharing is also available for couples who are married or in a civil union, or living in a common-law relationship of at least three years' duration.

EXAMPLE

David receives $18,690 per year as a pension from his former employer. His marginal tax rate is 37%. He could pay as much as $6,915.30 ($18,690 × 37%) in income tax on his pension. David's wife, Beth, has a marginal tax rate of 29%. David splits his pension with Beth so they each declare $9,345 ($18,690 ÷ 2) as income.

David's income tax payable becomes $3,457.65 ($9,345 × 37%). Beth's income tax payable is $2,710.05 ($9,345 × 29%). Together they pay $6,167.70 in income tax ($3,457.65 + $2,710.05), a saving of $747.60 ($6,915.30 – $6,167.70) compared to the tax due if David did not split his pension income.

When income is split, there can be an additional advantage for the retiree who must repay Old Age Security (OAS) pension benefits. The OAS pension is entirely forfeited by the pensioner when net income reaches a specified level and partly repaid when income exceeds a threshold level. Therefore, if income is reduced by income splitting, then the amount of repayment, also called the clawback, may be reduced.

4.3.3 Need for tax efficiency

Income splitting is one way to reduce income tax. Using tax credits is another. Federal and provincial/territorial tax credits are available.

Some tax credits are non-refundable. They can reduce income tax but if the total credits exceed federal tax, a refund is not issued for the balance.

Qualifying for the pension income credit is a requirement for the spouse who receives the necessary pension income before income splitting can occur. Using the age credit is important for those who are 65 or older whose income is less than the annual limit; it can be transferred to a spouse for his use.

Using all tax credits to which a taxpayer is entitled, no matter how small the amount, can help to ease the tax burden.

4.3.4 Need for emergency fund

An emergency fund is a readily available sum generally equivalent to a minimum of three months' living expenses. It is to be used strictly for payment of unexpected expenses or to replace income that is suddenly lost. Having an emergency fund available will eliminate the need to use expensive ways to pay bills, such as a credit card cash advance.

The review of assets shows whether a sum has been set aside for emergency purposes. If not, the agent can assist the investor to create an emergency fund with a high degree of liquidity to be available as needed. Many individuals count on using their HELOC (home equity line of credit) for emergency purposes.

4.3.5 Need for creditor proofing

As seen in Chapter 2, a creditor is a person or company that is owed money by another. A creditor has rights and recourses to obtain repayment of the amount owed. An asset is creditor proofed when a creditor cannot legally obtain a debtor's asset or its value for repayment.

Creditor proofing should not be an exercise undertaken on its own or the sole reason an investment is chosen. An investment should first be selected based on how it meets the full scope of client needs. If creditor proofing is also available, it should be considered incidentally as a feature of an investment product.

If it ever appears in bankruptcy proceedings that investments have been chosen to credit proof their value and protect their seizure against payment of debt, the investments may be seized. An investment must be chosen for the contribution it makes to net worth, not avoidance of obligations.

4.3.6 Need for liquidity

Liquidity is a measure of how easily a person or company can access cash at the lowest cost, including converting assets into cash. It goes hand-in-hand with the need for an emergency fund.

Liquidity in some assets is important to protect a person in the event of a disaster or personal misfortune. For instance, if a person found himself in a serious medical condition while travelling without the benefit of travel medical insurance, he would need access to cash quickly to pay for needed medical care.

Liquidity is essential in the emergency fund. Cash must be easy and quick to access. This is a reason using a HELOC is a good choice for emergency purposes.

The review of assets will show if there is liquidity in the investor's portfolio.

4.3.7 Need for estate planning

Some people have a very strong desire to leave an inheritance when they die. The inheritance may be for children, family or friends, or for a charity. Such a need means careful estate planning so that bequests can be filled according to wishes. The net worth statement is very important to determine if assets are available for such purposes.

4.3.7.1 Charitable giving

An interest in charitable giving is shown by a person who gives to others and puts a priority on needs outside his personal interests, such as the need to fund cancer research or the need to create a scholarship.

Charitable giving is not always associated with estate planning and the death of a person who wants to donate to charity. Many people make charitable giving part of their lives and so it is very reasonable for them to continue their giving after death.

An individual with the desire to donate to charity will want assurance that the sum he has planned to give will be available.

A taxpayer can deduct up to 75% of his net income as a donation and receive the tax credit corresponding to the amount of donation and his marginal tax rate. In the year of death or year preceding death, up to 100% of net income can be claimed as a donation.

4.3.8 Need for diversification

A review of financial documents and investment statements may show a concentration of savings in a specific account or specific investment. As explained in Chapter 1, a lack of diversification opens up the possibility of risk and potential losses.

For instance, an investor who invests solely in Guaranteed Investment Certificates (GICs) runs inflation risk, since returns of GICs can be lower than the increase of the cost of living. That person will experience a loss in his purchasing power over time if he does not diversify into an investment that pays a higher return.

4.3.9 Need for investment management

The review of assets and knowledge of the investor may reveal an investor who makes his own investing decisions but is not suitably invested for his age, risk tolerance or objectives. He may run unnecessary risks due to the choices he has made. An investor could also display a high degree of financial illiteracy by failing to read or understand his savings and investment statements. Such investors may benefit from professional investment management, such as the management provided by a segregated fund.

4.3.10 Need for suitability

Suitability is a specific investment need that is very important to meet. It is a process undertaken by the agent, in which he compares the features of an investment to the investor's investment objectives, constraints, and risk profile. The agent's goal is to make a recommendation suitable for the investor based on the information and direction that the investor has given the agent.

Suitability evolves from needs' analysis and Know Your Client (KYC). The more information and better understanding the agent has about the client, the more likely he will be successful in assessing suitability.

The agent begins by seeking information from the investor about the purpose of the investment and his expectations, wants, and needs. The investor must be clear about his objectives and concerns. The agent should never rely on old or outdated information.

The agent then applies his knowledge of the client's objectives and limitations against investment characteristics. Through his research, for example, the agent arrives at certain funds that seem to align with investor needs. He brings those forward as recommendations to the investor. The investor may agree or disagree with the findings of the agent. If agreement is reached, then the investor may decide to proceed with the recommendation(s). If agreement is not reached, the agent must gain further understanding from the client about his reasons for rejecting the recommendation(s). The agent takes that information away and begins the research process again.

Suitability is established at the time an investment is made and it should be re-examined if there are significant changes in the life of the investor, such as retirement. It also needs re-assessment if characteristics of the investment itself change.

EXAMPLE

Luis, a licensed life agent, has a meeting with Miriam to discuss an investment strategy. Miriam, 62, has just inherited $1 million in life insurance proceeds from her husband's policy. Miriam has lived very carefully all her life and has never had so much money before to manage.

In conversation with Miriam, Luis discovers that she has zero risk tolerance. Miriam's primary concern, other than the safety of her capital, is to have additional money available to help her meet her retirement needs. She will retire in three years.

In assessing a suitable investment for Miriam, Luis considers her age, her risk profile, and her time horizon. He also notes her lack of investment experience. Luis recommends a deferred term annuity to Miriam that will start at her retirement. Discussions with Miriam will determine the appropriate term for the annuity.

4.3.11 Other specific investment needs

Many other specific needs may be uncovered in creating the investor profile. They can include:

- A need for tax-advantaged investing because of an investor's high marginal tax rate;
- A need to protect against the effect of inflation because the investor starts receiving fixed income at a relatively young retirement age and has an expectation of at least average life expectancy;
- A need to grow assets to meet estate planning objectives, which could indicate a need to assume more risk in the portfolio for potentially higher returns;
- A need to preserve capital to buy investments, such as an annuity for income purposes, and also to meet estate planning goals.

4.4 Government retirement pension income

The desire for a secure and adequate retirement income powers many savings plans and investing decisions.

Government-provided retirement pensions are the starting point for assessing retirement income. Their contribution to income, even though modest by the standards of some, is lifelong. Over a possible 25- or 30-year period of retirement, the input by government pensions can be quite significant – easily in the hundreds of thousands of dollars – and can relieve some pressure for other savings. The following government plans offer retirement pensions:

- Old Age Security (OAS);
- Canada and Québec pension plans (CPP and QPP);
- Guaranteed Income Supplement (GIS) and Allowance.

As mentioned previously, an online resource, the Canadian Retirement Income Calculator, is available to estimate retirement income.[24]

The criteria related to eligibility, contributions and benefits of government retirement income evolve over time and through federal budgets. Information provided here is meant as an indication only. It is important for the agent to remain informed of current dollar limits for payments.

4.4.1 Old Age Security (OAS)

Old Age Security (OAS) is a monthly retirement pension available for qualifying Canadians who are 65 and older and meet the requirements for legal status and residence in Canada. An individual may be automatically enrolled or he may need to apply to receive his pension. He may also defer starting his pension.

OAS provides additional benefits for low-income earners. These are discussed later in this manual.

4.4.1.1 OAS eligibility

It is not necessary to have ever worked to be eligible for OAS. On the other hand, OAS can be received by someone who continues to work.

The pension is available to qualifying Canadians whether they live in Canada or outside the country.

If living in Canada, an applicant must:

- Be 65 or older;
- Be a Canadian citizen or a legal resident at the time the application is approved;
- Have resided in Canada for at least 10 years after turning age 18.

If living outside Canada, an applicant must:

- Be 65 or older;
- Be a Canadian citizen or a legal resident on the day before leaving Canada;
- Have resided in Canada for at least 20 years after turning age 18.

It is also possible to qualify for OAS and/or a pension from another country if the applicant has lived in a country that has a social security agreement with Canada or has contributed to the social security system of that country.

24. The Calculator is provided at https://www.canada.ca/en/services/benefits/publicpensions/cpp/retirement-income-calculator.html

4.4.1.2 OAS contributions

Contributions are not made directly to OAS. The program is funded by general tax revenues of the Government of Canada.

4.4.1.3 OAS benefits

The amount of retirement pension is determined by how long the individual has lived in Canada after age 18. It is paid as a full or partial pension, depending on eligibility. The partial pension is proportional to the number of years of residency.

The benefit is adjusted upwards every January, April, July and October if there is an increase in the Consumer Price Index (CPI). It may stay the same if CPI does not change, but it never decreases.

The benefit can also be adjusted according to new legislation of the government. This is occurring in 2022 with an increase in the OAS benefit for recipients.

The pension can be deferred up to 60 months after becoming eligible and is increased for every month it is not received during that deferral period. The monthly payment is increased by 0.6% (7.2% per year) up to a maximum of 36% (7.2% × 5 years) at age 70. There is no requirement to start the pension at 70; however, there are no further increases to the amount received after age 70 except for increases linked to inflation.

EXAMPLE

In 2021, Helena decides to defer receiving her OAS pension for one year because she is still working and has no need for the additional income. Her monthly benefit increases 0.6% per month over the year for a total increase of 7.2% (0.6% × 12 months). If she had started the pension immediately, she would have received $618 monthly. By waiting 12 months, it will increase to $662 monthly ($618 + 7.2%) in addition to any adjustments for CPI.

The amount received as OAS pension is linked to income. The *Income Tax Act* establishes OAS payment thresholds: there are three levels of benefit.

- 100% of the benefit is received when a person earns less net income than the annual minimum threshold;
- A reduction to the benefit if he earns an amount between the minimum and the maximum threshold;
- No benefit if he earns more than the maximum threshold.

The thresholds change annually. Agents should consult the Government of Canada[25] website on a yearly basis to validate the current annual threshold limits.

4.4.1.4 Taxation of benefits

OAS benefits are taxable income.

When net income falls between the minimum and maximum threshold, a lump-sum OAS repayment may be triggered and paid with the income tax return for the year. The repayment, or clawback, is currently 15% of the difference between net income and the threshold:

Repayment = (net income – threshold) × 15%

EXAMPLE

Ben earns $81,000 of net income in 2019. His income exceeds the threshold for 2019 set at $77,580. Therefore, he repays $513 (($81,000 – $77,580) × 15%) of his OAS pension with his income tax return for 2019.

To avoid repaying large sums, future benefits may be reduced by a recovery tax whereby a reduction is applied to monthly benefits rather than charged as a lump sum.

A reconciliation is made annually taking income and threshold into account. If income falls below the minimum threshold, no recovery tax is charged.

4.4.2 Canada Pension Plan (CPP) and Québec Pension Plan (QPP)

The Canada Pension Plan (CPP) is a plan to which almost all workers between the ages of 18 and 70 and employers in Canada contribute. It provides a retirement pension, survivor's pension, disability benefit and death benefit. The Québec Pension Plan (QPP) is similar to the CPP for Québec workers and employers and replaces the CPP in that province. There are some subtle differences between the two plans, such as the Post-Retirement Benefit, which does not exist in Québec although contributions must continue to the QPP if work continues while receiving retirement benefits. The QPP also uses a different set of determinants in regard to the surviving spouse of a QPP pensioner.[26]

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25. Government of Canada. *Old Age Security payment amounts*. [online]. Revised May 5, 2022. [Consulted May 12, 2022]. https://www.canada.ca/en/services/benefits/publicpensions/cpp/old-age-security/payments.html
26. For more information regarding the QPP, please consult the *Ethics and professional practice (Québec)* (E-111) manual or Retraite Québec website: https://www.rrq.gouv.qc.ca/en/retraite/rrq/Pages/etre-retraite-rrq.aspx

4.4.2.1 CPP eligibility

To be eligible for a retirement pension, a worker must have made one valid CPP contribution. An application must be made; it cannot be submitted until one month after turning age 59.

4.4.2.2 CPP contributions

The amount contributed to the CPP is based on employment income. This is called pensionable earnings. The minimum income at which contributions begin is $3,500 per year in 2022. Those who earn less than this amount are not required to contribute. There is a maximum amount, above which contributions are not made, called the year's maximum pensionable earnings (YMPE).

Contributions are made at the rate of 11.4% of pensionable earnings in 2022. If employed, the contribution is split between the employer and worker. The self-employed pay the full amount based on net business income.

The more contributed to the plan, the more eventually paid as a pension (to a maximum).

A certain number of lowest-earning years can be dropped from the pension calculation so as not to drag down the average of all earnings and reduce the amount received in the pension. This is provided by the general drop-out provision.

The child-rearing provision is the equivalent for a caregiver who has no earnings or low earnings because he stayed home to raise his children.

Contributions to the CPP end when the pension begins, at age 70 or at death. It is possible to begin receiving the CPP retirement pension while continuing to work. In that case, contributions to the CPP resume by the employee and employer, or by the self-employed, and they go towards the payment of the Post-Retirement Benefit (PRB).

The PRB is a supplementary pension available to contributors. It is paid for life and added to the CPP benefit.

It is mandatory to make contributions to the PRB between ages 60 and 65 if work continues. At age 65 contributions become voluntary.

4.4.2.3 CPP benefits

Unlike OAS, it is highly unlikely that any two people would receive the same amount in CPP payments. The amount received as a monthly retirement pension benefit for an individual is a result of:

- The number of years contributions are made;
- The amount contributed;
- The age at which the pension begins.

The pension is increased annually based on an increase in the cost of living as measured by the Consumer Price Index (CPI).

The standard age to begin receiving the pension is 65. It can begin as early as age 60. When the pension begins early, the amount paid is reduced by the number of months the pension begins before age 65. The penalty for the early pension is 0.6% per month or 7.2% per year (0.60 × 12 months). If a pensioner begins the pension five years early, his pension would be reduced by 36% (7.2% × 5 years). When to begin the pension is a difficult question to answer and requires the recipient to consider his options very carefully. Starting early has a significant lifelong negative impact on income, while starting late requires the recipient to forgo his pension for as long as he waits. In fact, the majority of pensioners begin their pension at age 65.

EXAMPLE

Loreen will retire at age 60, in 2021. She would receive $657.90 monthly from the CPP at age 65. However, by beginning five years early she incurs a reduction of 36% (7.2% × 5 years). At 60, Loreen will receive $421.06 ($657.90 – ($657.90 × 36%)) every month as her CPP retirement pension. This is $236.84 per month ($2,842.08 per year) less than she would have received at age 65. She receives this lower sum until her death; it is only increased by the cost of inflation. A very simple calculation shows if she lives 25 more years, she has sacrificed $71,052 (2,842.08 x 25) in payments.

The pension can also be enhanced by waiting. Every month the pension is not received for a pensioner who is 65 or older increases his benefit by 0.7% (8.4% per year). A pensioner who waits the maximum of five years receives a 42% increase in the amount received (8.4% × 5 years). There is no further enhancement after age 70.

EXAMPLE

Joseph decides the time for retirement will arrive when he turns 69 in 2021. This is a four-year delay from the standard retirement age of 65. As a result of waiting his CPP retirement pension is increased from its base, which would have been $922.44 per month at age 65, to $1,232.38 per month at age 69 ($922.44 + (8.4% × $922.44 × 4 years)). Joseph enjoys an extra $309.94 per month by waiting. Again, the simple calculation shows over 25 years, he receives a total of an extra $92,982 (($309.94 x 12) x 25) by his four-year delay in starting payments.

Recipients of the PRB receive a benefit based on earnings, CPP contributions made in the previous year, and the age at which the PRB begins. The maximum benefit for one year is equal to 1/40th of the maximum CPP retirement pension. The benefit is in proportion to contributions: for example, if PRB contributions are half the maximum, benefits are half the maximum.

The CPP also provides a survivor's pension for the spouse and child or children of a deceased CPP contributor.

- The amount received by the spouse is based on his age, how long contributions were made, how much was contributed, and whether CPP retirement or disability benefits are already being received.
- The child's benefit is paid to age 18 or up to age 25 if the child is attending school, college or university full-time.

The CPP also pays a disability benefit when the contributor becomes severely disabled for a prolonged time and a death benefit when the contributor dies.

4.4.2.4 Taxation of benefits

The CPP benefit is taxable income.

4.4.3 Benefits for low-income earners

The Guaranteed Income Supplement (GIS) and the Allowance are monthly benefits paid to OAS recipients with a low income. These benefits are not taxable. A province may also offer a supplementary pension to its low-income retired residents.

Recipients of these benefits will most likely not have sufficient income to invest.

4.4.3.1 GIS eligibility, contributions and benefits

To receive the GIS benefit it is necessary to be living in Canada. An applicant must be a legal Canadian resident and meet the annual income test based on net income reported on the federal income tax return. The application must be made in writing.

Contributions are not made to GIS directly. The program is funded by government revenues.

The GIS benefit is available beginning at age 65.

The amount received depends on marital status and income. Income for a married couple is combined to determine the amount each spouse receives.

4.4.3.2 Allowance eligibility, contributions and benefits

The Allowance is available to those 60 to 64 years old and whose married or common-law spouse receives the OAS and is eligible for GIS.

It is not necessary to make contributions to receive the benefit.

As with OAS and GIS, other eligibility criteria include years of residency and income. The Allowance is paid as a set benefit.

An Allowance for the Survivor is available to those with a low income, who are living in Canada and whose married or common-law spouse is deceased.

4.5 Employer-provided retirement pensions

An employer-provided retirement pension is commonly called a company pension or private pension. Its purpose is to reward employees by paying a future retirement income. There are a number of forms a pension plan can take. These pensions are generically called registered pension plans (RPPs):

- Defined benefit pension plans (DBPPs);
- Defined contribution pension plans (DCPPs);
- Pooled registered pension plans (PRPPs).

All plans may be a combination of personal savings of the employee and contributions by an employer. Initially, the employer contributions to the employee's plan may be owned by the employer. After a period of time, their ownership is transferred to the employee. This helps to reward commitment to the employer.

Therefore, the savings in an RPP are a valuable asset for plan members. However, the majority of Canadian workers are not members of an RPP. They must fund future retirement costs personally by saving through other plans, such as a registered retirement savings plan (RRSP).

All public-sector employers provide a retirement pension to their employees, including doctors and all medical personnel, teachers, members of the police and emergency services, and so on. Employees of firms that are federally regulated, such as bank employees, may be members of a pension plan that is registered federally.

Private-sector employers that offer a plan must register their plan with their provincial pension administrator. The provincial legislation where the plan is registered governs its terms and conditions. All provincial RPPs are also subject to federal legislation, such as the *Income Tax Act*.

The plan sponsor, usually the employer, establishes and maintains the RPP.

The plan administrator is a person or third party that has ultimate responsibility for plan administration, such as enrolling new members, issuing pension statements and keeping records. An accurate record is necessary if a plan member dies, retires or ceases to participate.

Plan members receive a brochure or booklet explaining the terms of their plan when they join.

As described above, employer contributions to a plan may become the property of the employee after a period of time. At the end of that period, the employer contributions vest with the employee – that is, they are owned by the employee. In practice, vesting (the process by which contributions transfer from one to another) can happen at any time.

The rules are determined by the pension benefits act of each jurisdiction in which the plan is registered. In the best case, vesting is immediate and the employee receives both his and his employer's contributions as of the first contribution. Less favourably, vesting occurs when the employee is required to stay a certain length of time with the employer before he is entitled to both contributions.

EXAMPLE

Andrew has contributed to his employer's pension plan since he started work with the firm, five years ago. His employer has also contributed to Andrew's plan.

Andrew has recently been offered a more challenging position with a different employer. As Andrew changes jobs, he receives the value of all contributions made to his pension (his and his employer's) in addition to the investment growth on those contributions because his benefits are vested. He transfers the total sum into a locked-in retirement account (LIRA).

If Andrew had changed jobs before the vesting, he would only have been entitled to the sum he had contributed to the plan.

Pension plan contributions, whether made by the employee or the employer, and growth of those contributions due to investment returns are locked-in. Locked-in means that an employee cannot access the value of his RPP until he reaches the retirement age specified in the plan of which he is a member or satisfies the terms of the locked-in account to which he transfers his savings as a result of having changed employers. There are only a few, very specific circumstances, in which the funds can be unlocked.

Locked-in funds are created in defined benefit pension plans (DBPPs), defined contribution pension plans (DCPPs) and pooled registered pension plans (PRPPs). It is mandatory that savings in these plans are locked-in. Note that there is currently no pension legislation in Prince Edward Island that addresses locked-in accounts, so locked-in plans do not exist in the province.

Given the requirements and restrictions on the use of locked-in plans, it is important to understand them and what a person required to use a locked-in plan should expect. Locked-in accounts are covered in more detail later in this Chapter.

An employee who is leaving a firm with vested funds, but is not retiring, has several choices for his pension savings.

- He may continue in a company pension plan;
- He may be able to leave the value of the pension in his former employer's plan;
- He may be able to transfer the pension value to the RPP of the new employer;
- He may transfer the pension value to a locked-in account at a financial institution;
- He may use the pension value to buy a deferred life annuity.

An employee with a DBPP who never changes employers or who leaves his pension savings with an employer after he has left that employer to work elsewhere receives his pension from that employer during retirement. He has no need to transfer options or locked-in accounts.

An employee with a DBPP or DCPP whose new employer also offers a pension plan may be able to transfer the value of his pension to the new employer. He will be bound by the terms of the new employer's plan. Not all employers permit another pension to be transferred to their plan. The plan of the new employer may or may not be more advantageous than the original plan. Regardless, if the employee has chosen to transfer this pension to then new plan, he will now be a member of that plan. The transfer is made directly from one employer to the other.

An employee who is a member of a DBPP or DCPP may choose to transfer pension savings into a locked-in account when he changes employers.

There are two phases to locked-in plans: a savings phase for contributions and an income phase that issues payments. Each phase requires use of the correct type of account. Withdrawals cannot be made from the savings account. When the savings account is wound up, its value rolls into the income account from which withdrawals are made. Only locked-in savings can fund the locked-in income account.

A person who transfers his pension value to a savings-phase locked-in account needs a Locked-in RRSP (also called an LRSP) or locked-in retirement account (LIRA), depending on where he lives. The individual becomes his own pension fund manager and is responsible for investment decisions that will affect his future standard of living. He is in control.

The savings phase transitions into the income phase when the Locked-in RRSP or LIRA is converted to one of the following accounts that are structured to issue payments. This must occur no later than the end of the year in which the plan owner turns 71.

- Life income fund (LIF);
- Locked-in retirement income fund (LRIF);
- Prescribed registered retirement income fund (PRRIF) for those whose plans are registered in Saskatchewan or Manitoba;
- Restricted life income fund (RLIF) for those with a federally regulated pension.

An income stream is created because a minimum annual withdrawal must be taken from the LIF/LRIF/PRRIF/RLIF account and paid to the account owner. There is a limit to the maximum annual withdrawal, except the PRRIF, which has no maximum.

RPP contributors are not able to access the value of their locked-in plans before the age of retirement specified in their plan. The rationale for locking-in plan value is based on the employer's commitment to provide a retirement pension for employees. A pension can only be provided if funds are available in the pension account. If funds are not locked-in, withdrawals could be made, and the account value reduced or depleted – leaving less, little or nothing available when the individual retires.

It is possible to unlock the value of the RPP under certain circumstances. They include cases of financial hardship, shortened life expectancy (usually defined as two years or less) and a very low account balance.[27]

A life annuity may also be purchased from a life insurer by transferring funds from the Locked-in RRSP or LIRA. If the life annuity is chosen, it also pays a regular income to its annuitant.

An employee with a defined contribution pension plan (DCPP) has no option but to transfer his savings to a locked-in account when he retires. He cannot leave his pension savings with his employer. This provides a marketing opportunity for life agents to work with former DCPP members and help them to best invest their savings.

It is possible for an employee to end up with multiple pensions from multiple employers. For example, an employee who has a defined benefit plan with one employer and a defined contribution plan with another receives the defined benefit plan pension and a separate income from his LIF, LRIF, PRRIF or annuity representing the contributions made to the second employer.

EXAMPLE

Roger, age 58, had a defined contribution plan with his employer, in Regina, SK. It vested 14 years ago. Roger is laid off and decides to transfer his pension plan contributions to a LIRA, in which he can make the investment decisions. One year after being laid off, Roger accepts a new job. This employer provides a defined benefit plan pension. Roger joins the plan. On retirement, at age 67, Roger converts his LIRA to a PRRIF. He begins to make regular withdrawals from the PRRIF and receives a monthly pension cheque from his second employer.

Contributions to an RPP reduce the registered retirement savings plan (RRSP) deduction limit for the following year. This is called a pension adjustment (PA). The PA is reported to the employee on his T4 (Statement of Remuneration Paid) or T4A (Statement of Pension, Retirement, Annuity and Other Income).

EXAMPLE

Heather receives a T4 from her employer showing a pension adjustment of $4,366 for the previous calendar year. Her RRSP deduction limit for this year is $7,880. However, the pension adjustment reduces her deduction limit to $3,514 ($7,880 – $4,366).

27. Government of Canada. *Unlocking funds from a pension plan or from a locked-in retirement savings plan*. [online]. Revised January 7, 2022. [Consulted May 12, 2022]. http://www.osfi-bsif.gc.ca/eng/pp-rr/faq/pages/ulfpp-lrsp.aspx

4.5.1 Defined benefit pension plan (DBPP)

The defined benefit pension plan (DBPP) is considered the gold standard of retirement pensions. It pays an income on retirement that is known in advance, lasts for life, has a provision for the spouse when the employee dies, and is often indexed to increases in the cost of living. Therefore, it makes a reliable contribution to retirement income needs.

Fewer employers now offer this type of plan due to its obligations and expense.

A member of a DBPP makes no investment decisions and the plan sponsor chooses the investments that will produce the promised pension at retirement.

A DBPP is provided on a group basis to employees. It can be set up on an individual basis for business owners and directors and is then called an individual pension plan (IPP).

4.5.1.1 DBPP eligibility

A plan can be created for all employees of a company or a class of employees. For instance, unionized employees may be a class or non-unionized employees may be a class. When a pension plan is created for a class, every employee in that class is eligible to join the plan when he has worked the required length of time for plan membership.

A full-time employee is eligible to join a plan after two years of continuous employment, called service, unless the terms of the plan permit the employee to join earlier.

A part-time employee is eligible to join after 24 months of employment. He must meet one of two criteria (whichever is less): 700 hours of work or 35% of the year's maximum pensionable earnings (YMPE) in the preceding two years.

4.5.1.2 DBPP contributions

The plan sponsor chooses a plan that is contributory or non-contributory:

- Employees and the employer contribute to a contributory plan.
- Only the employer contributes to a non-contributory plan.

The employer's contribution to funding the pension plan is based on an actuarial estimation of the amount needed to fund future pensions.

When a plan is contributory, an employee may be able to make additional voluntary contributions (AVC) that will produce a higher pension. These contributions are deposited into a separate account that is structured as a defined contribution pension plan (DCPP) in which the employee makes investment decisions. Such two-tiered plans are called combination plans or hybrid plans.

An employee who is eligible for enrollment in his employer's DBPP can contribute for both current service and past service. This occurs if a pension plan is introduced by a sponsor; it recognizes employment retroactively.

The maximum contribution limit per year is set at $1/9^{th}$ of the sum available to contribute to a defined contribution pension plan (DCPP). This amount is determined by the *Income Tax Act*.

4.5.1.3 DBPP benefits

As stated earlier, the distinguishing feature of DBPPs is that the employee knows before retirement the amount of pension he will receive. When the employee reaches the specified age at which the retirement pension begins, the employer begins issuing monthly pension payments. They will last for the life of the former employee and pay a partial spouse's pension if the death of the employee occurs before the death of the spouse.

The amount received by the former employee is typically calculated in one of three ways:

- **By final average earnings:**
  Based on average earnings in the years leading up to retirement.
- **By career average earnings:**
  Based on average earnings during the entire period of plan membership.
- **Through a flat benefit:**
  Based on a fixed-dollar amount for each year of plan membership.

The rate at which benefits accrue cannot be more than 2% of a plan member's remuneration for the year to a maximum annual dollar amount.

Some plans increase the benefit fully or partially in step with increases in the Consumer Price Index (CPI). This helps to protect the benefit from inflation.

A member of a DBPP can elect to receive the commuted value of his pension at retirement or when employment ceases. The commuted value is a lump-sum payment representing the present value of the pension. The sum is calculated by an actuary taking many factors, such as interest rate and employee age, into account. Commuted values are locked-in and the sum must be transferred to another account that continues locking-in, such as a LIRA. When the employee receives the commuted value he becomes his own pension manager and through his choice of investments will try to create lifelong income for himself and his spouse.

Benefits can be jeopardized for members of DBPPs if the sponsor fails to make its necessary contributions to the plan. In this case the pension plan is said to be underfunded.

On death of a DBPP member, his spouse is entitled to receive at least 60% of the pension. If there is no spouse, a beneficiary may receive a lump-sum payment representing a commuted value of the pension.

4.5.2 Defined contribution pension plan (DCPP)

A defined contribution pension plan (DCPP) is also called a money purchase plan (MPP). The amount paid as retirement income for a DCPP member is entirely based on contributions and investment income that accumulate in the plan. The employer makes no commitments to the amount of pension that will be received. Therefore, the plan member does not know the income to expect during retirement.

Employers have come to favour the DCPP over the DBPP precisely because the employer is relieved of the need to provide a pre-determined pension to employees. Therefore, the cost of the plan to the employer is much less.

A member of a DCPP decides how to invest contributions. He will be provided with a menu of investment choices and a default investment option. The default option is used when the member does not make another investment selection from the available choices.

Therefore, the plan member is partly responsible for the sum available to him as a pension since the outcome of his investment decisions affects the final value of the plan. Of course, value is also determined by the amount and timing of contributions.

4.5.2.1 DCPP eligibility

Many employers require their full-time employees to join their DCPP plan, but other employers leave the decision to the employee. Part-time employees may be eligible to join. This information is obtained from the plan administrator.

There is no required waiting period for full-time employees. Part-time employees may be required to meet the same eligibility requirements as for a DBPP.

4.5.2.2 DCPP contributions

Contributions to a DCPP may be made by the employee and the employer. Employers are required to make a minimum contribution to their plan. Employee contributions are not mandatory and additional voluntary contributions may not be allowed.

There is no contribution to a DCPP permitted for past service.

The annual contribution limit is a dollar figure established by the *Income Tax Act*.

The employer provides the employee with investment information and the employee chooses the investment or is assigned the default option.

4.5.2.3 DCPP benefits

The retirement pension from a DCPP is a result of amount of the contributions, when contributions are made and investment performance. There are no guarantees as to how much will be received as a pension.

The pension is not paid by the employer that has sponsored the DCPP. At retirement, the funds in the plan must be transferred to a locked-in account.

As stated previously, if the retiree has not reached the age at which he must begin receiving income, he can leave his savings in a locked-in savings account. If he must begin receiving income, he transfers his pension account value to an income-paying locked-in account or life annuity.

4.5.3 Pooled registered pension plan (PRPP)

The pooled registered pension plan (PRPP) is the newest form of pension. In Québec, the plan is called the Voluntary Retirement Savings Plan (VRSP) and must be implemented if an employer has five or more employees and does not offer a registered pension plan.

Plans are provincially registered by administrators. After registration, administrators offer the plan to employers and people who are self-employed. The administrator is not an employer but a third party that provides the PRPP and is responsible for its operations.

A PRPP is a type of pension plan that is similar to a defined contribution plan, except that employer contributions are not mandatory. Its goal is to provide a low-cost retirement savings plan for those who are not members of RPPs or employer savings plans, such as a Group RRSP.

The plan is based on the concept of pooled contributions, which is a means of lowering member costs on fees.

4.5.3.1 PRPP eligibility

Full-time employees are immediately eligible to participate in a PRPP. Part-time employees can join the PRPP after completing 24 months of continuous employment. When they are eligible, employees are automatically enrolled in the plan chosen by a participating employer. An employee who does not wish to join the PRPP must opt out within 60 days of notification of enrollment.

4.5.3.2 PRPP contributions

Employee and employer contributions are not mandatory. They are made as a deduction from payroll earnings; this contribution at source helps encourage savings.

The maximum limit for an annual contribution is equal to the RRSP contribution limit.

Transfers to the PRPP can be made from an individual's RRSP, registered retirement income fund (RRIF) or deferred profit sharing plan (DPSP).

Contributions are invested according to the choices made available by the plan administrator.

4.5.3.3 PRPP benefits

Funds are locked-in, with the same restrictions as other locked-in pension savings. Therefore, retirement income will be determined by how much is saved, when contributions are made, investment performance and which transfer choice is used for the locked-in funds.

4.6 Employer-provided savings plans

Savings plans are made available to employees from employers as deferred profit sharing plans (DPSPs) and group registered retirement savings plan (GRRSPs). Savings in these plans are not locked-in. They are not governed by pension standards legislation.

4.6.1 Deferred profit sharing plan (DPSP)

A DPSP is offered by companies to share a portion of their business profits with employees who are plan members.

4.6.1.1 DPSP eligibility

The sponsor of the DPSP decides which employees are eligible for plan membership. Significant shareholders of the company and their close family members are not eligible.

4.6.1.2 DPSP contributions

Contributions are made only by the employer. There is no minimum required contribution; contributions have a maximum limit, which is the lesser of 18% of a member's annual compensation or 50% of the DCPP limit.

Vesting is provided in a maximum of two years.

The value of a DPSP is not locked-in, and a withdrawal may be made while the plan member is still employed.

The plan member controls how the value of the account is invested.

Contributions create a pension adjustment, that is, they reduce available RRSP contribution room. All withdrawals are taxable to the employee at the same rate as regular income.

4.6.1.3 DPSP benefits

When a DPSP member retires or moves to another employer, he can:

- Receive the proceeds of the plan as a lump sum;
- Purchase an annuity;
- Transfer funds to an RRSP or RRIF.

On retirement, a member can begin to receive income payments from the plan.

A plan member who is not retiring may also transfer the value of the plan to another RPP or DPSP.

4.6.2 Group registered retirement savings plan (GRRSP)

A GRRSP is identical to an individual registered retirement savings plan (RRSP), except offered on a group basis. Doing so enables members to pay lower fees on their group plan than they would pay on an individual plan. However, there may be fewer investment choices in a GRRSP.

A GRRSP also offers the benefit of being a payroll savings plan in which a member can enjoy the long-term advantages of regular savings.

Because the plan is an RRSP, RRSP features such as the Home Buyers' Plan (HBP) or Lifelong Learning Plan (LLP) may be available to plan members with a GRRSP.

4.6.2.1 GRRSP eligibility, contributions and benefits

There are no restrictions on GRRSP eligibility.

Contributions are made by the employee and can be made by the employer. Employee contributions are tax-deductible for the employee. Employer contributions are taxable income for the employee. Contributions to both personal RRSP and GRRSP cannot exceed an individual's total RRSP deduction limit for the year.

Plan value is not locked-in. Transfer options include:

- Member's personal RRSP or RRIF;
- Annuity;
- Cash.

4.7 Individual registered savings plans

Individual registered savings plans are personal investment accounts that are registered with the Canada Revenue Agency (CRA) by the institution that holds the plan's account. Registration with the CRA enables the plan owner to receive tax benefits that are not available in non-registered accounts.

Registered plans are available to save for:

- Retirement (in an RRSP and RRIF);
- Tax-free saving and investing (in a TFSA);
- Cost of post-secondary education (in an RESP);
- Costs of long-term disability (in an RDSP).

4.7.1 Registered retirement savings plan (RRSP)

Just as registered pension plans that are transferred into locked-in accounts have a savings phase and income phase, registered savings plans are similarly structured. Registered retirement savings plans (RRSPs) are the savings phase. The income phase begins when the RRSP matures (at the end of the year in which the plan owner turns 71) and its value is rolled into a registered retirement income fund (RRIF) or an annuity. The plan can be wound-up at any time and its value received in cash.

RRSPs are a voluntary savings program that were introduced to encourage saving for retirement through tax incentives. They may hold segregated funds when the RRSP is offered by life insurance companies.

There are three types of accounts available:

- **A managed account:**
  The investor decides between investments that are typically restricted to Guaranteed Investment Certificates (GICs), mutual funds – and segregated funds when the account is offered by an insurer.
- **A self-directed account:**
  The investor has a wide choice of investments including all those available through a managed account plus many others such as stocks, bonds and exchange-traded funds (ETFs).
- **A fully managed account:**
  A professional money manager creates and manages a customized investment portfolio. Only available to those with a large dollar value portfolio or sum available to invest.

There are three kinds of fees that can be charged against an RRSP by the financial institution holding the account.

- Administrative or trustee fees cover the financial institution's cost of looking after the account.
- Investment fees can be charged, depending on the investment, for buying, selling and switching investments.

- Account change fees may be charged for closing the account, changing the withdrawal schedule and/or making a lump-sum withdrawal.

A person can own as many RRSP accounts as he wishes. However, each account may charge an administration fee. To eliminate duplicate fees, account owners typically try to limit the number of their RRSP accounts. Regardless of the number of accounts, the maximum contribution limit for the year across all accounts cannot be exceeded.

An RRSP can reveal many characteristics of its owner:

- Investments in the account reveal his risk tolerance or the risk tolerance ascertained for him by a previous agent or advisor;
- The form of account (managed or self-directed) can show investment experience or investment knowledge;
- Contributions indicate dedication to savings and concern for retirement income;
- Contributions post-retirement indicate unused contribution room is available and, in the absence of contributing income from work, savings are being redirected from non-registered accounts;
- Contributions to a spousal plan may indicate a need to create a spousal retirement income, and/or a desire to split retirement income and reduce tax.

RRSPs provide the following tax advantages:

- The contribution made to the RRSP account can be deducted from federal and provincial income tax and may move the taxpayer to a lower tax bracket, thus lowering his marginal tax rate;
- The investment income earned in the account is not taxed until it is withdrawn. This leaves a larger sum in the account to invest and grow.

Those with RRSP accounts may use the value in their accounts for the Home Buyers' Plan (HBP) and Lifelong Learning Plan (LLP). Both plans allow the plan owner to make a tax-free withdrawal from the RRSP account. The HBP requires the withdrawal to be used when buying or building a qualifying home for the individual or a related person with a disability. The LLP withdrawal is used for the purpose of financing full-time education or training for an adult or his spouse.

Both plans limit the amount that can be withdrawn and specify the conditions for use of the funds and repayment. If repayment does not occur according to the terms of the plan, it can be added to taxable income as a penalty.

4.7.1.1 RRSP eligibility and contributions

In order to contribute to a personal RRSP, one must:

- Contribute before reaching the maximum age limit, which is December 31 of the year the account owner turns 71 years of age;
- Have earned income for the previous year;

- Have filed an income tax return for the previous year in which business or employment income was declared;
- Have contribution room available from a previous year because the account owner did not make his maximum contribution in that year. In this way, RRSP contribution room is carried forward to subsequent years, and is formally called the carry-forward provision.

Contributions can be made to an RRSP throughout the year. The CRA establishes a date, usually 60 days after December 31, as the cut-off date for contributions for the previous year.

The annual contribution limit is the lesser of:

- 18% of earned income for the previous year;
- Maximum dollar limit established for the year.

Earned income is income received from salaries and wages, employment bonuses, alimony, rental income and business income. It does not include income received from investments or pension benefits.

EXAMPLE

Sarah has been earning $40,000 per year in her job at a call centre for the last two years. She is able to save about $1,000 per year in her RRSP. She could contribute up to $7,200 per year based on her income ($40,000 × 18%). The $6,200 difference ($7,200 – $1,000) between her contribution and her contribution limit is not used. Thanks to the carry-forward provision of the RRSP, the difference accumulates and rolls over to be available in future years. In five years, based on her same income and level of annual contribution, Sarah will have $31,000 ($6,200 × 5) in contribution room.

An individual's annual contribution limit is reduced by:

- Pension adjustment: the amount contributed to an RPP or DPSP in the previous year;
- Spousal plan contribution.

In addition to the sum that can be contributed to an RRSP annually, the plan owner could use carry-forward contribution room that was created by not making the maximum contribution in previous years.

A one-time over-contribution of $2,000 is also permitted. The over-contribution is not tax-deductible and grows on a tax-deferred basis. If a plan owner contributes more than the permitted $2,000, a 1% penalty tax is applied monthly against the excess contribution.

When funds are transferred into an RRSP from a DPSP, GRRSP or another RRSP, the transfer is not considered a contribution.

4.7.1.2 Spousal RRSP plan

A spousal or common-law partner RRSP is funded by a spouse (husband, wife or common-law partner), who has earned income and RRSP contribution room, for the benefit of his spouse. The spousal plan is a way to move income from one spouse who has a higher tax rate to the other who has a lower tax rate during retirement. Splitting or attributing income in this manner can reduce the couple's total income tax.

Contributions to a spousal plan are based on the contribution room of the contributor and reduce his RRSP contribution room.

EXAMPLE

Julie has available contribution room of $9,600 this year for her RRSP. She sets up a spousal RRSP for her common-law partner, Tony. She deposits $2,500 to Tony's spousal RRSP. Julie's contribution to her own RRSP now cannot exceed $7,100 ($9,600 – $2,500).

When they retire, Julie will be in a higher tax bracket than Tony because she has pension benefits and other private income. If she had not set up the plan for Tony, all her RRSP withdrawals would be taxed at her marginal tax rate as income. However, through the spousal plan, withdrawals from Tony's plan will be taxed at his marginal tax rate, which is lower than Julie's.

If the spouse who has received funds into his RRSP from the other makes a withdrawal from the plan in the year the deposit is made or the two calendar years following that year, the amount of withdrawal (up to the amount contributed) will be added to the contributing spouse's taxable income in the year of the withdrawal. In other words, if the withdrawal is a combination of contributed money and growth on that money, only the contributed portion of the withdrawal is attributed back to the donor spouse, not the growth portion.

Having a spousal RRSP can extend the tax benefit of contributions past age 71 if the recipient spouse is younger. Contributions can be made until the younger spouse reaches the end of the year in which he turns 71, at which time his RRSP matures.

4.7.1.3 RRSP withdrawals

Withdrawals can be made from an RRSP at any time. The financial institution holding the account is required to hold back a portion of the withdrawal in a withholding tax. This represents an advance payment against tax, but will likely not be the full amount of tax that will be owed on the withdrawal. There may be more tax owed in addition to the withholding tax and the balance owing will be calculated when the income tax return is filed.

There are separate withholding tax rates for Québec and the rest of Canada. The withholding rate increases in proportion to the withdrawal, as illustrated by Table 4.1.

TABLE 4.1

Federal withholding tax on RRSP withdrawals[28]

WITHDRAWAL	FEDERAL WITHHOLDING TAX OUTSIDE QUÉBEC	FEDERAL WITHHOLDING TAX IN QUÉBEC
0 – up to $5,000	10%	5%
$5,001 – up to and including $15,000	20%	10%
$15,001 or more	30%	15%

Québec residents making a withdrawal from their RRSP (no matter the amount) must pay an additional 15% provincial withholding tax.

4.7.1.4 RRSP maturity

At the end of the year in which an RRSP account owner turns 71, he must transfer the funds in the account into an income-paying account so that tax continues to be deferred. Alternatively, he can cash out the RRSP and pay tax on the proceeds of the account.

Income-paying options, also called maturity options, include a registered retirement income fund (RRIF) account. Investments in the RRSP can be transferred in kind to the RRIF, in which case they are simply switched from the RRSP to the RRIF without having to be sold. This would be true if the RRSP was invested in segregated funds, for instance. The segregated funds are transferred from the RRSP to the RRIF.

The other transfer options at maturity are a term annuity to age 90 and a life annuity. Either option requires the investments in the RRSP to be sold so the cash can be used to pay for the annuity.

It is not necessary to pick only one option. Funds in the RRSP can be split across options, for instance, a RRIF and a life annuity. The plan owner may want some future flexibility in regard to income and this is satisfied by holding some cash in the RRIF. He uses the annuity to provide a guaranteed income stream for life.

4.7.1.5 Death of RRSP owner

An RRSP can name a qualified beneficiary, or a beneficiary (including the estate) to receive the account value when the RRSP owner dies.

28. Ontario Securities Commission. GetSmarterAboutMoney.ca. *Making RRSP withdrawals before you retire.* [online]. Revised August 20, 2021. [Consulted May 18, 2022]. https://www.getsmarteraboutmoney.ca/plan-manage/retirement-planning/rrsps/making-rrsp-withdrawals-before-you-retire/

A qualified beneficiary of an RRSP is the plan owner's spouse or common-law partner, or a child or grandchild who is financially dependent because he has physical or mental impairment. This choice of beneficiary continues the tax deferral of the account.

When a qualified beneficiary is named for the plan, the value of the RRSP at the time of death of the plan owner is transferred to the beneficiary and reported on the beneficiary's tax return for that year. If the beneficiary is a spouse who then contributes the amount received to an RRSP, RRIF, PRPP, SPP, or qualifying annuity in the year it is received (or within 60 days thereafter), the spouse can claim a tax deduction to offset the income received.

A financially dependent disabled child has the same transfer options as the spouse (RRSP, PRPP, SPP, RRIF, annuity) plus an option to contribute to a registered disability savings plan (RDSP).

Beneficiaries are not restricted to spouses or children; anyone can be named a beneficiary of an RRSP. In this case, the account will be collapsed. The CRA considers that the deceased account owner received the fair market value (FMV) of all the property held in the RRSP at the time of death. The tax return for the deceased will include this amount and any other proceeds received from the plan in the year of death. Therefore, it is included in the income of the deceased and tax is paid by the estate.

4.7.2 Registered retirement income fund (RRIF)

Registered retirement income funds (RRIFs) are an income-paying maturity option for RRSPs. A RRIF is funded by transferring the value of an RRSP account; no other contributions are permitted.

A RRIF continues tax deferral on the RRSP account.

Like an RRSP account owner, an individual with a RRIF account is responsible for making decisions about the type of account (managed or self-directed) he will have. The same investment options are available in a RRIF as an RRSP.

4.7.2.1 RRIF withdrawals

A RRIF account owner, who is called the annuitant, is required to make a minimum annual withdrawal from his account. There is no withholding tax on the minimum withdrawal, but it will be considered taxable income when his income tax return is filed for the year. A withholding tax applies to any amount of withdrawal in excess of the minimum.

The minimum withdrawal amount is a percentage of the account that increases with age, as illustrated in Table 4.2. The percentage charged is based on the value of the RRIF and age of the account owner on January 1. Withdrawals can be based on the age of a younger spouse and will make the account last longer if the minimum is withdrawn because a smaller percentage of account value is taken.

At the beginning of the coronavirus pandemic, in March 2020, the annual withdrawal requirements for RRIFs were temporarily reduced. This illustrates that changes can be made to such programs; they are not carved in stone. An agent should always ensure his information is accurate and up-to-date before sharing it with a client.

TABLE 4.2

Minimum yearly withdrawal from RRIF

AGE ON JAN. 1	MINIMAL PERCENTAGE OF RRIF ACCOUNT THAT MUST BE WITHDRAWN YEARLY	AGE ON JAN. 1	MINIMAL PERCENTAGE OF RRIF ACCOUNT THAT MUST BE WITHDRAWN YEARLY
65	4.00%	81	7.08%
66	4.17%	82	7.38%
67	4.35%	83	7.71%
68	4.55%	84	8.08%
69	4.76%	85	8.51%
70	5.00%	86	8.99%
71	5.28%	87	9.55%
72	5.40%	88	10.21%
73	5.53%	89	10.99%
74	5.67%	90	11.92%
75	5.82%	91	13.06%
76	5.98%	92	14.49%
77	6.17%	93	16.34%
78	6.36%	94	18.79%
79	6.58%	95	20.00%
80	7.08%		

All withdrawals are fully taxable as interest. Regardless of how the account has been invested and whether capital gains and losses and dividends have been earned, the withdrawals are all taxed at the same rate as interest. Therefore, there is no tax advantage to investing in equities in an RRSP or RRIF. The advantage of equities lies in their potentially higher rates of return and their potential to increase overall account growth and value.

The minimum withdrawal does not need to be taken in cash. Just like an input to a RRIF from an RRSP can be made in-kind so, too, can an in-kind transfer be made out of the RRIF. In-kind means that the RRIF account owner can take his investment and transfer it to a non-registered investment account or tax-free savings account (TFSA). He does not need to sell the investment prior to transfer. For instance, to satisfy the minimum annual RRIF withdrawal, a mutual fund in the RRIF could be transferred into the TFSA. However, taxation applies as if the transferred sum was taken in cash.

There is no maximum on what can be taken from the RRIF account and this can provide the account owner with flexibility and the ability to meet unanticipated expenses. It can also cause the account to be depleted at a faster rate than anticipated, and is therefore subject to longevity risk.

4.7.2.2 Death of RRIF owner

Unlike an RRSP, a RRIF is oriented towards regular income payments. The person who receives those payments is the annuitant. When the annuitant dies, a successor annuitant of the account can receive those payments. The successor annuitant must be a spouse or common-law partner.

A successor annuitant has several choices for using the proceeds:

- He can replace the deceased as holder of the RRIF and continues to receive the payments made to the deceased; or
- He can transfer the assets in-kind into his own RRIF and continue to receive the payments made to the deceased; or
- He can roll the RRIF assets in-kind into his RRSP. Doing this does not affect the survivor's contribution room.

There are no tax consequences to the estate when there is a successor annuitant.

Alternatively, a spouse or common-law partner, plus a child or grandchild who is dependent because of a physical or mental impairment can be named as a qualifying beneficiary.

Just as anyone can be named a beneficiary of an RRSP, so too can any person be named beneficiary of a RRIF. A beneficiary will not have to pay tax income on any amount paid out of the RRIF if it has been included in the deceased annuitant's income. If a beneficiary is not named, the value of the RRIF becomes part of the estate and subject to probate fees according to the province in which the estate is based. The value of the RRIF is included as income on the RRIF-holder's final tax return and taxed accordingly.

4.7.3 Tax-free savings account (TFSA)

Tax-free savings accounts (TFSAs) are precisely what their name says: a savings account that is tax-free. That means the investment return earned by deposits to the account (e.g., capital gains), and withdrawals are not taxable. A TFSA can be used for any savings goal.

TFSAs can be opened by a person age 18 or older with a valid social insurance number.

A TFSA is a registered account. It is highly suitable for those whose withdrawals from registered savings have already been taxed, and who are seeking a means to avoid further taxation on their money. For example, a RRIF withdrawal is taxed. Its account owner may not need the entire withdrawal for living expenses. If the money is deposited to a non-TFSA and earns investment growth, the account owner will be taxed again on that growth. On the other hand, if the money is deposited to a TFSA, there will be no future tax.

4.7.3.1 TFSA contributions

Contributions to a TFSA are not tax-deductible.

There is an annual dollar limit for TFSA contributions. However, the amount contributed is not based on earned income (like an RRSP is). Therefore, a person who is not working and receives money can deposit the money to a TFSA. He would not be able to contribute to an RRSP because he did not earn RRSP contribution room.

EXAMPLE

Sandy retired last year. This year she is not working. Her aunt died during the year and left Sandy an inheritance of $50,000. Sandy cannot deposit the sum to an RRSP because she does not have earned income and has no available carry-forward contribution room. However, she can deposit it to a TFSA in an amount equal to her unused TFSA contribution room.

The TFSA account provides a wide range of investment options similar to those available in an RRSP including GICs, stocks, bonds, mutual funds and segregated funds.

Contribution room not used in any year is carried forward, like an RRSP.

Over-contributions have been known to occur when a withdrawal and deposit are made in a single year. Over-contributions are penalized. There is a charge of 1% per month on an excess contribution until a withdrawal of the excess is made. If an over-contribution is deemed to be deliberate, any investment gains on the excess are taxed at a rate of 100%. To ensure no penalty will be charged, it is best that no deposit be made in the same year as a withdrawal.

4.7.3.2 TFSA withdrawals

A withdrawal can be made at any time. It can be re-contributed in any year following the year of the withdrawal, in addition to the maximum dollar amount of contribution for that year.

No tax is due on the withdrawal.

Income earned in a TFSA and withdrawals from the account do not affect eligibility for federal income-tested benefits, such as Old Age Security (OAS) and the Guaranteed Income Supplement (GIS).

A TFSA in the common law provinces can name a successor holder to continue to receive benefits of the account if the owner dies and/or name a beneficiary. In Québec, the account value passes through the will to inheritors. If a spouse is named inheritor of the TFSA, he can roll the account into his personal account without affecting unused contribution room if the spouse does so within the allotted period of time, and with the requisite CRA form.

The successor holder must be a spouse or common-law partner. He becomes the account owner and the account continues.

A designated beneficiary can receive the account value and pay tax only on the growth of the account between the death of the account owner and the time of inheritance.

4.7.4 Registered education savings plan (RESP)

A registered education savings plan (RESP) is a registered plan to encourage savings that will pay towards costs of higher education. Although typically used for children, they can be used for a person of any age. Savings in an RESP account grow tax-deferred; contributions are not tax deductible.

The person who opens the plan is called the subscriber. The person who receives payments from the RESP is called its beneficiary.

People invest in RESPs to save in advance for the cost of post-secondary education, such as college or university, for their children. A plan can be opened immediately after a child's birth once a Social Insurance Number has been obtained. Contributing to a plan qualifies the plan to receive a generous government grant that does not need to be repaid if the child pursues higher education.

4.7.4.1 Types of RESPs

There are two providers of RESPs: financial institutions and scholarship plan dealers. The RESPs offered by scholarship plan dealers are beyond the scope of this manual. However, agents should be aware that the RESPs they can provide have many advantages, such as investment and contribution flexibility, that the scholarship plans do not.

Individual and family RESPs are available through financial institutions.

An individual plan has a single beneficiary. Anyone can open the plan and contribute to it. A family plan can have more than one beneficiary and each beneficiary must be related to the subscriber.

4.7.4.2 RESP contributions

There is a lifetime contribution limit per beneficiary of $50,000, regardless of whether the RESP is an individual or family plan. Contributions are not tax-deductible. Contributions must be made to the plan in order to qualify for the Canada Education Savings Grant (CESG) and the Canada Learning Bond.

The CESG is paid by the federal government to top up individual contributions. Regardless of the level of family income, the maximum basic CESG is $500 per year. The grant is not repaid to the government if the beneficiary pursues post-secondary education. There is a maximum amount per beneficiary that can be received from the grant over the entire period of account ownership. The application for the CESG is made by the financial institution in which the RESP account is opened. The CESG is an excellent opportunity to help save for post-secondary education.

An additional CESG may be paid into an RESP account for low-income and middle-income families.

If the total amount of grant for any one year is not received, it accumulates and can be carried forward until the end of the year in which the beneficiary turns 17.

The Canada Learning Bond pays an additional grant to low-income subscribers. Some provinces also offer savings incentives for post-secondary education costs.

Contributions in the plan account can be invested according to the products offered by the financial institution that holds the account. A wide variety of investment options are typically available. Tax is not paid on the value of the plan, including investment growth, until withdrawals begin.

4.7.4.3 RESP withdrawals

An RESP beneficiary (i.e., the student) receives withdrawals from the plan as Educational Assistance Payments (EAPs). EAPs are paid only when the student is enrolled in a qualifying educational program.

An EAP consists of a portion of the Canada Education Savings Grant, the Canada Learning Bond, any amount paid under a provincial education savings program and the earnings on the money saved in the RESP. Withdrawals are taxed in the hands of the beneficiary. Since most students have very little income, the EAPs are usually tax-free.

4.7.5 Registered disability savings plan (RDSP)

The registered disability savings plan (RDSP) is a registered savings plan introduced to help parents and others save towards long-term financial needs of a child or person with a severe and prolonged impairment in physical or mental functions.

4.7.5.1 RDSP eligibility

A disabled person is eligible to be a beneficiary who:

- Is eligible for the disability tax credit (disability amount);
- Is a Canadian resident;
- Is under 60 years of age (if 59, the individual must apply before the end of the calendar year in which he turns 59);
- Has a social insurance number.

4.7.5.2 RDSP contributions

Contributions are not tax-deductible. There is a lifetime private contribution limit for an RDSP of $200,000. There is no annual contribution limit.

Private contributions result from regular savings, lump-sum contributions such as an inheritance or life insurance policy death benefit, or a rollover from a deceased individual's RRSP, RRIF or RPP.

The federal government may pay a matching Canada Disability Savings Grant of up to 300% of private contributions, depending on the amount contributed and the beneficiary's family income.

There is a maximum annual grant and a lifetime limit. Grants are paid into the RDSP until the end of the calendar year in which the beneficiary turns 49.

The government may also pay a Canada Disability Savings Bond every year into the RDSPs of low-income and modest-income individuals, subject to a lifetime limit. The bond is paid into an RDSP even if no contributions were made to the plan. Bonds are paid into the RDSP until the end of the calendar year in which the beneficiary turns 49.

There is a carry-forward provision to the plan: unused grant and bond entitlements from the past 10 years can be claimed for existing RDSPs, or RDSPs opened in January 2011 or later.

The amount of Grant and Bond depends on the beneficiary's family income in those years. The Grant amount that is received also depends on how much is contributed to the RDSP.

Grants and Bonds are paid on unused entitlements up to an annual maximum.

4.7.5.3 RDSP payments

Only the beneficiary of the RDSP or his or her legal representative may receive payments.

There are two types of payments that can be taken from an RDSP.

The first type of payment is the Disability Assistance Payment (DAP). The DAP is a single payment. It can be received only if private contributions to the plan are greater than government contributions.

The second type of payment from the plan is called the Lifetime Disability Assistance Payment (LDAP).

The LDAP is a series of payments. Once the plan beneficiary requests an LDAP, these payments are made to the beneficiary at least annually until plan termination or death. This payment must begin no later than the beneficiary's age 60.

Investment income earned in the plan accumulates tax-free. However, grants, bonds and investment income earned in the plan are included in the beneficiary's income for tax purposes when paid out of the RDSP.

4.8 Investor profile

The sum of all information collected in the profile provides the big picture of the financial situation of the client. That picture comes completely into focus when:

- Financial results are analyzed;
- Needs are identified;
- Risks are determined.

4.8.1 Results of financial review

The financial review shows:

- How much has been saved;
- How much is available to meet current and future needs and objectives;
- Income restrictions, such as for locked-in accounts;
- Whether new plans and accounts need to be opened;
- The performance of current investments.

This review shows whether the current approach to saving and investing is suitable and will meet investor objectives or whether changes should be implemented. It provides quantitative information, more precisely the amounts available and needed.

A new strategy could be formulated as a result of this review to address weaknesses that have been identified and move the investor closer to his goals.

4.8.2 Results of needs review

The needs review is oriented more towards qualitative information, more precisely, what is important to the investor. The investor should prioritize his needs so that the needs can be combined with financial data and objectives can be set.

4.8.3 Determination of risk tolerance

Risk tolerance and risk capacity are the elements that form an investor's risk profile. It is essential for the agent to assess the risk profile accurately. To do this, the agent takes both elements into account and compares them against the risk of an investment. He analyzes the answers to:

"What is the client's attitude towards losing money from his investment?" (This forms the basis for determining risk tolerance.)

"Can he afford losses, and, if so, how much?" (This forms the basis for risk capacity.)

“What is the stated risk level of the investment?” (The objective is to match risk that is suitable for the investor with the risk of the product.)

Arriving at the answers to these questions requires the agent to understand some essentials about risk, and its closely related subject, investment returns.

Investment risk tolerance describes how an investor feels about the potential for a loss in his invested principal. It is typically stated on a spectrum. Zero risk tolerance is at one end of the spectrum and the highest risk tolerance is at the other; medium risk falls between the two.

Fund investments plot five measures on the risk scale: low, medium-low, medium, medium-high, and high. An investor indicates which of those measures matches up with his personal risk tolerance or his agent guides him to the correct match through a needs’ analysis. Therefore, when it is determined that an investor has medium-low risk tolerance, the most suitable investment for him is one that is rated as medium-low or lower.

Gauging an investor’s risk tolerance is a risky business! Many psychological factors come into play and it is dodgy to rely solely on the investor’s own opinion of his risk tolerance. Individual investors are well known to significantly and consistently overestimate their risk tolerance. They are also prone to saying one thing and doing another. This is shown by investors who say they have low risk tolerance but invest in medium-high or high-risk investments, like an equity fund. Rating risk tolerance requires an agent to take time in client discussions to try and understand investor motivation, fears, and hopes to try and arrive at an accurate assessment of where the investor really stands, and not just where he says he stands.

Risk tolerance is a factor that can change over time, and should be regularly reviewed in client meetings. A change in income, age, marital status, or occupation could increase or decrease the investor’s risk tolerance.

EXAMPLE

Alex believes that he can tolerate some risk in his investments, and when asked by his advisor, Morris, Alex states he has a medium-high risk tolerance. Alex’s interpretation of medium-high means he would accept up to an 8% loss in his invested capital. Morris’s interpretation of medium-high risk tolerance is up to a 15% loss in invested capital. If Morris proceeds to invest Alex’s money on this basis, Alex’s risk tolerance will be exceeded. Alex may result in taking on far more risk than he actually wants.

Furthermore, the agent cannot be guided by the risks that the investor adopts in his life or lifestyle choices as an indicator of financial risk tolerance. One body of research indicates that people who choose risk elsewhere, such as riding a motorcycle or skydiving, will adopt an equal level of risk in their investing choices. Other research suggests the two – life choices and financial choices – are entirely separate and high tolerance in one does not translate into high tolerance in the other. This latter view is the more conservative approach, and one that is safer to adopt when counselling an appropriate level of risk.

Investors may also have differing degrees of risk tolerance for differing investment objectives. Some objectives, like saving for retirement, may be non-negotiable when it comes to how much loss the investor is prepared to accept. Others, like saving for a holiday, may present a higher tolerance for risk.

The investor's time horizon should be associated with his risk tolerance: typically, the shorter the time horizon, the lower the tolerance for risk. This is because time is the best friend of money – the more time available for investing the better the probability that invested money will grow and earn a positive return. When time is short, the investor does not have the luxury of waiting for a loss to turn around. He cannot afford to lose. Therefore, his risk tolerance is zero or very low.

EXAMPLE

Sally and Mark are saving for their retirement, which they now anticipate will happen in three years. When they retire they will be depending on their retirement savings in their RRSPs since neither has a private pension. It is essential that their savings are not diminished and, correspondingly, they do not want to incur investment losses. If they did, they would have to delay retirement because they would need to work longer to make up for those losses. Therefore, they have zero risk tolerance.

Investors are known to accept or, even, pursue risk, sometimes at a level unsuitable to their actual tolerance for losses, because higher risk investments may pay better returns than low risk investments. This is the basis for the investing principle that states that risk and return are directly related. According to this principle, the higher the risk, the higher the return and vice versa: the lower the risk, the lower the return. Investors are, in effect, rewarded for taking on added risk. However, the investor must understand that investments that pay higher returns are more likely to lose money.

An investment portfolio can be structured to be low risk and it will focus on safe investments. Returns will be modest but, likely, dependable. As risk in a portfolio increases, so too do the potential for greater returns and greater losses.

Suitability in assessing investor risk tolerance and risk capacity is key. As individual investments are carefully selected that are suitable for the investor, the portfolio will also be suited to the investor's risk profile at that point in time. As time passes, the individual investments and the portfolio may lose suitability and adjustments should be made to bring it in line to re-establish suitability.

EXAMPLE

Paul is saving for his retirement in ten years. Achieving a better rate of return on his investments now could mean an earlier retirement date or more money available to him and his wife during retirement. He realizes that a low-risk investment right now will barely keep ahead of the rate of inflation, and he makes the decision to risk investing in a blue-chip Canadian equity fund, rated as medium risk. Therefore, Paul has medium risk tolerance. The fund's historical rate of return over the preceding ten years is 9%. There is no guarantee that rate of return will continue, and Paul could suffer significant losses if the equity markets have a downturn. However, by holding his savings in a segregated fund he is protected against losses to a maximum of 25% of his investment.

The other aspect of the risk profile is risk capacity. Capacity is a measure of how much the investor can afford to lose without impacting his objectives or lifestyle. Risk capacity is an especially important consideration for investors who are approaching retirement or retired. They no longer have the ability to replace money lost in an investment because they are near the end of their careers or living on a fixed income. Those who cannot afford losses should restrict investing to the most safe, low risk, guaranteed investments. An investor who can afford to lose principal because he still has earning power will be able to participate in investments with more risk if he has the risk tolerance to do so.

Even though an investor may have the capacity for risk, he may not be risk tolerant. The two risk factors – tolerance and capacity – are measured entirely separately from each other; one should not influence an assessment of the other.

EXAMPLE 1

Tim has significant assets: a home valued at $3.3 million, a generous pension based on his executive salary, an RRSP with a balance of over $800,000 and non-registered accounts valued at $2.7 million. Even though Tim has a high capacity for risk because, by any measure, he is a wealthy man, he has low risk tolerance. He invests in low-risk to medium-low risk investments, because he is not comfortable with the idea of losing any of his hard-earned savings.

EXAMPLE 2

June is retired and living on government retirement pensions and savings of $25,000. June keeps her savings in a high interest savings account at her financial institution. June has both zero risk tolerance and zero risk capacity.

Some indicators of risk tolerance are:

- Account and investment statements indicate investment experience, knowledge and acceptance of volatility through existing investments;
- Acceptance of risk is demonstrated in the analysis of personal risks;
- Accounts in place and their level of funding show an approach to being risk-ready;
- Age and circumstances indicate an ability to recover losses.

4.8.4 Investor profile goal

The agent demonstrates his capability by methodically working through all the elements of the investor profile in order to make recommendations based on facts and requirements. Suitable recommendations are the result of the agent's analysis and the goal the agent must seek.

CHAPTER 5

SEGREGATED FUND AND ANNUITY RECOMMENDATION

Competency components

- Analyze the available products that meet the client's needs;
- Implement a recommendation adapted to the client's needs and situation.

Competency sub-components

- Analyze the types of investments that can constitute a segregated fund and that meet the client's needs;
- Propose a recommendation adapted to the client's needs and situation.

5
SEGREGATED FUND AND ANNUITY RECOMMENDATION

When the individual investor profile is complete, the time arrives for the agent to recommend the most appropriate segregated fund and annuity investment. The agent must weigh many factors in developing the recommendation and ensure the client-investor understands the rationale underlying the choice or choices presented.

Recommendations for groups are also prepared by the agent. This aspect of the agent's role is addressed later in this manual.

Regulators have set out guidance to address the fair treatment of customers by agents.[29] It encompasses concepts such as ethical behaviour, acting in good faith and the prohibition of abusive practices. Treating customers fairly means:

- Developing, marketing and selling products in a way that puts clients' interests ahead of the interests of the agent, insurer and intermediaries;
- Providing clients with accurate, clear and sufficient product promotional material before, during and after the points of sale that allows them to make informed decisions;
- Providing information to clients during the lifetime of their contracts which allows them to make informed decisions;
- Avoiding, or managing, any conflict of interest that would affect the fair treatment of customers;
- Minimizing the risk of sales that are not appropriate to the client's needs;
- Ensuring advice is relevant;
- Dealing with client claims, complaints and disputes in a fair and timely manner.

The fair treatment of customers should be the objective of every agent. Agent actions should support the principles listed above and in the full guidance, which is available online.

The recommendation for purchase may be presented as a single recommendation, or as a comparison between a primary recommendation and secondary choices, or as several options.

Every recommendation will have pros and cons. These must be disclosed in the reason-why letter that an agent prepares and is a requirement for agents from both regulators and insurers. The agent must discuss the information in the letter with the client to help him understand the product recommendation and record it in his client notes. This ensures that the rationale behind the decision is available should the recommendation be questioned in the future.

29. Canadian Council of Insurance Regulators. *Guidance – Conduct of Insurance Business and Fair Treatment of Customers*. [online]. [Consulted May 16, 2022]. https://www.ccir-ccrra.org/Documents/View/3377

5.1 Finding for a segregated fund

When the needs' analysis is completed, as shown in Chapter 4, the agent may find a set of client characteristics that shows the best recommendation to bring forward is a segregated fund. For instance, the client wants an investment with the benefits of an insurance contract and the ability to tap into the performance of the capital market. His needs indicate a long-term investment is most suitable. He is not seeking income from this investment, at this point in time or for the minimum duration of a contract. The agent properly concludes that a segregated fund investment should be recommended.

There may be other factors that lead the agent to conclude the segregated fund recommendation is most appropriate, such as the guarantees offered or the ability to bypass probate. He must analyze benefits and limitations in view of his client's needs and make a thorough comparison of funds suitable for those needs.

5.1.1 Fund analysis

As shown in Chapter 2, the agent has a wide selection of funds from which to choose to develop his recommendation. He must be methodical and accurately analyze what is available to arrive at an option or options, based on the client's investor profile. This involves staying up-to-date on new fund introductions and other similar developments through various industry channels. The agent should read industry journals and the marketing materials provided to him. He should also seek out the product wholesalers for their input. It is not adequate to rely on old standbys alone.

The agent's analysis and subsequent recommendation should have nothing to do with the rate of commission or trailing fees offered by the fund. Client suitability is the only standard by which to judge whether a fund is a good match for client needs. Analysis should be based on current information, and it should be provided to the client in a timely fashion. Each insurer has information readily available on their funds and the agent may choose to supplement these details with other research.

Third-party sources of information, such as that gleaned from the Internet, must be considered very carefully. Sources must be verified as being accurate. The agent may wish to obtain approval from his compliance officer before presenting any of this type of information to the client.

Information provided to the client can be fact-based and/or opinion-based. The agent should be clear with the client about which information is factual and which is his opinion.

Every client is unique and presents an individual set of characteristics. An analysis coordinates these characteristics with fund details to arrive at a fund that is the best match.

5.1.2 Supporting the segregated fund recommendation

The agent must determine which factors of the product are of greatest importance to client needs based on the investor profile. Chapter 4 provides a thorough breakdown of those considerations.

The agent must be able to prioritize those needs, as well as the segregated fund features that fit those needs. For example, if the client is most concerned that he will lose capital invested, then the maturity guarantee should be at the top of the agent's features' list for that client. The agent can show that full protection of capital is provided by some funds through a 100% guarantee. Moreover, if the segregated fund is being acquired for estate planning purposes, then bypass of probate may be of greatest importance to the client in those provinces where probate applies.

After prioritizing needs against features, the agent reiterates to the investor the characteristics of the fund that align with his objectives. The agent focuses on the primary benefits that make the recommendation a suitable choice and points out limitations. Other factors of lesser importance can rightly take a back seat in the recommendation. However, the client needs to see the whole picture in order to understand the choice or choices that are presented.

5.1.3 Making the recommendation

When a suitable recommendation is ready to discuss with the client, a meeting is required in which the agent can substantiate his findings and the client can ask questions and provide direction. Prior to the Covid-19 pandemic, such a meeting would typically be held in person: the agent brings his written documentation for discussion and a client sign-off would be completed with the agent present if an application is completed. During the pandemic, the in-person approach has been largely replaced with the online virtual meeting, phone meetings and electronic signatures.

A virtual meeting, such as Zoom, needs planning and organization to be successful. It starts with both parties being able to manage the technology to login, enter a password, access supporting documents, provide an electronic signature (when necessary) and logout. The Internet connection must be good enough to support the meeting without pauses and disconnecting. Some people do not have the necessary computer skills and the agent will be required to send documents by courier and complete the discussion with the client over the phone. This can put the agent at a disadvantage because he is unable to read the visual cues the client might show, like nodding in agreement or shaking his head in disagreement.

An agent may find that a hybrid approach is best: sending physical documents and meeting virtually to discuss what was sent. Clients who are willing to receive documents online should be provided with them prior to the virtual meeting to ensure the documents are received, and better yet, reviewed before the meeting.

There is considerable etiquette to be followed for a virtual meeting. Agents should research the rules before they embark on meeting virtually.

When the client needs to issue payment, this is now best accomplished by an electronic transfer from the investor's account to the account you specify to receive the funds. Problems can arise when the amount of payment exceeds his daily transfer limit, or he may lack the wherewithal or confidence to make the payment electronically. In such a case, a cheque is issued for which you should send a courier for pickup. You do not want to force the investor into going to a post office and transacting with employees and other customers to mail or courier the cheque.

The need to meet virtually eliminates the physical signature on documents. Electronic signatures (e-signatures) are now the order of the day. An electronic signature can be provided in a number of ways, including:

- a physically signed document that is then scanned and transmitted;
- a scanned signature pasted into an electronic document;
- a typed name;
- a signature created using a stylus or finger on a touchscreen;
- clicking an electronic confirmation.

Some people are reluctant to use such electronic formats, fearing that their signature could be copied and used elsewhere or that the document could be modified after signing. Secure electronic signature technology uses algorithms and encryption to determine the authenticity of the signature, and the signed document. It is available from different providers.

When relying on e-signatures, the agent will not be aware of undue influence or duress being applied to the client, whether the client is a victim of fraud or identity theft, or if the client has mental capacity issues. The client could feel that he did not have the opportunity to ask questions or request more information about the document he is signing. The agent must be alert to any red flags that might indicate a lack of consent and must never proceed unless fully satisfied that the client understands his obligations.

Even though the relationship may be digital, it will be more important than ever to ensure the agent keeps hard copies of meeting notes and relevant documents in his client file if decisions made or actions taken are challenged in the future.

5.2 Segregated fund recommendation

Based on his analysis, the agent brings forward his recommendation and is able to back up his conclusion to the client. The recommendation made to the client must focus on fund specifics. The agent seeks consensus with his client that the recommendation is sound based on information gathered and needs expressed. The client makes the final decision. The next step is to proceed with the application.

If the client's decision is contrary to recommendations, the agent should document the client's reasoning and seek input from his manager about proceeding.

If a client returns to the agent in the future for a subsequent investment, an assessment of needs and objectives must start afresh. An agent must never assume that previously identified needs can underlie another recommendation. Each investment must be analyzed separately to determine the best available product is brought forth.

Every segregated fund recommendation should include the following elements, which are addressed in the next sections:

- Identification of fund and its characteristics;
- Deposit and funding;
- Value of guarantees;
- Contract maturity date;
- Principal risks of recommendation;
- Reset;
- Contract riders;
- Fund taxation;
- Fund sales charge;
- Fund management expense ratio (MER);
- Fund details;
- Fund penalties.

5.2.1 Identification of fund and its characteristics

The recommendation will identify the insurer that provides the fund, e.g. XYZ Life, and how the fund is invested, e.g. equity, income, bond or other. The agent ensures that the investor understands that he is investing in a pooled investment concentrated as per its type, i.e. stocks, bonds or other, and how returns in the fund are achieved, i.e. capital gains, dividends and/or interest.

"Like" must be compared to "like" in the recommendation when comparing performance, management, and fees, i.e. a balanced income fund to another balanced income fund. If two different types, i.e. a balanced income fund and a balanced growth fund, are recommended, the rationale must be provided for each type.

5.2.2 Deposit and funding

The investor must reveal how much he intends to deposit to the contract or how he proposes to fund the contract. A minimum is specified for each fund for both lump-sum deposits, which include transfers, and periodic deposits. Some insurers also have a maximum amount permitted for the premium.

The agent follows the client's lead in regard to the sum being invested and should not push for more than what has been deemed appropriate through the needs' analysis. The first-time client may need to develop a comfort level with the agent and the product before making a larger financial commitment.

The premium is allocated to fund units at their net asset value (NAV) on the valuation day that applies to the lump-sum or periodic deposit.

The number of units received may not be the same across all recommendations since the number depends on the NAV per unit of each fund. Receiving more or less units of one fund over another is not an indicator of fund quality or performance.

The NAV per unit of a fund forms a benchmark against which future performance is monitored. It is essential that products with similar characteristics be compared in the recommendation. When different elements enter into the comparison, they must be stressed as a differentiator.

The following example shows how the same amount of deposit results in the investor receiving a different number of units.

EXAMPLE

Lump-sum deposit: $10,000

Fund type: Balanced income

Recommendation	Guarantees (maturity/death)	NAV per unit	Units received by investor
A	75%/75%	$12.89	$10,000 ÷ $12.89 = 775 units
B	75%/75%	$11.16	$10,000 ÷ $11.16 = 896 units
C	75%/100%	$11.47	$10,000 ÷ $11.47 = 871 units

Recommendation C has a different guarantee structure and this has to be pointed out to the investor.

There are other potential differentiators between the funds to form a further basis for comparison, and they will be addressed later on in the Chapter.

5.2.2.1 Lump-sum deposit

A lump-sum deposit is a one-time deposit that may or may not be accompanied by subsequent periodic deposits. If there are no subsequent periodic deposits, the maturity guarantee of the contract is based only on the single sum deposited. Thus, if the investor has a 10-year time horizon for an investment, it is appropriate to recommend a lump-sum deposit to take full advantage of the guarantee if funds are readily available.

The investor needs to satisfy the minimum deposit stated for the fund.

The sum for deposit is received via a personal cheque from the client or a transfer from another financial institution or pension plan.

5.2.2.2 Transfers

A transfer of money is initiated by the firm that will be receiving the money when funds are being transferred from one institution to another. Relevant details are needed from the client including the name of the organization or company from which the money will be transferred, an account number and contact details. An investment statement provided by the client can be very helpful for obtaining accurate information.

If a registered account is the source of transferred money, then the contract is set up as another registered account to continue its tax deferral. The same is true for locked-in accounts: a transfer from a locked-in account must go to another locked-in account.

Non-registered funds can be transferred into a registered retirement savings plan (RRSP) account or a tax-free savings account (TFSA) and will be a contribution for the year. Sufficient contribution room has to be available for the amount being transferred. If contribution room is exceeded, tax penalties will apply.

5.2.2.3 Periodic deposits

Deposits made on an ongoing basis must meet the minimum requirements set by the fund manager.

The cash flow statement for the client, described in the previous Chapter, indicates whether the sum he proposes to invest is appropriate and manageable.

As with lump sums, periodic deposits can be made to both a non-registered contract and an RRSP contract and TFSA contract. Deposits received throughout a year are RRSP/TFSA contributions for which the investor has to have available contribution room.

As seen previously, periodic deposits may create a series of maturity dates and maturity guarantees: one guarantee for each deposit or group of deposits. A client may invest to align his needs with the maturity dates of his deposits. This would be true if an investor wanted to receive maturity proceeds for each year he is retired between ages 60 and 65, at which time his pension would begin. However, if long-term investment growth is the reason for the investment, the multiple maturity dates of the deposit-based contract may not be significant to the investor.

EXAMPLE

Chris has a segregated fund contract set up on the basis of periodic deposits that provides a 75%/75% maturity and death benefit guarantee. At the end of each month for a year, he deposits $250 to the contract. Therefore, each of the 12 deposits is guaranteed at $187.50 ($250 × 75%) on each of its 12 maturity dates. Chris's time horizon should correspond to the series of maturity dates.

Since the net asset value per unit rises and falls, each deposit may acquire a different number of units.

5.2.3 Value of guarantees

The agent may wish to recommend a set of guarantees for each of the maturity guarantee and death benefit guarantee based on what he has learned about the client, including the client's tolerance for risk. Some clients may agree to invest in relatively higher-risk equity funds because they know that the principal sum invested is protected by the two guarantees. Once the choice is made, an actual dollar value of guarantees can be ascertained on the basis of the financial commitment the investor makes or will be making.

The agent may also wish to point out that guarantees apply at the rate offered by the recommended fund, either 75% or 100%. If a switch is made from one fund to another during the contract, the guarantee may change if the new fund has a different rate for its guarantees.

5.2.3.1 Maturity guarantee

The maturity guarantee is automatically provided in all segregated fund contracts as 75% or 100% of deposits at maturity. It should be reiterated to the investor that deposits are guaranteed to the percentage selected for maturity. It is good practice to state the percentage in the dollar value of the guarantee. If the market value of the account is greater than the guarantee due to fund performance, the investor receives the market value.

The investor loses the benefit of the maturity guarantee if he surrenders the contract before its maturity date. He also will find that the guarantee is adjusted if a withdrawal is made. The percentage of guarantee (i.e., 75%) remains the same after a withdrawal but it is based on the new, lower balance. Again, the dollar value of the adjusted sum should be stated.

The agent who recommends a fund with one guarantee or the other has to be able to substantiate the decision and compare the effect of a lower or higher MER, in addition to other fund attributes, to make a thorough analysis for the client's benefit.

The agent calculates the value of the guarantee and informs the investor of the sum that could be obtained as a result of the guarantee to reinforce this benefit of the segregated fund contract.

The agent will also want to stress to the investor that, while the maturity guarantee protects the investor against poor performance, the upside for growth is unlimited. Some funds have higher potential for growth than others. This is related to their risk and an assessment of risk is detailed in the information folder and Fund Facts for each fund.

5.2.3.2 Death benefit guarantee

Just like the maturity guarantee, the death benefit guarantee is an automatic part of the contract and is a feature of all segregated funds. The agent may feel strongly about which guarantee (75% or 100%) the investor should have and this forms part of his recommendation. It helps the investor to know the dollar amount that would be received.

This guarantee can have great value in the peace of mind it brings to those whose health is impaired at the time the contract is taken out, or to those who are older.

5.2.4 Contract maturity date

The minimum maturity date is 10 years from the deposit date, and this date should be stated to the client in actual time, i.e. the month, day and year for maturity based on an initial deposit such as May 16, 2032 (e.g. if the deposit was made on May 16, 2022). The client should also be shown the relationship between a higher guarantee or guarantees and an extended maturity date – some segregated funds that offer 100% guarantees require a 15-year period to maturity. Again, use an actual date to make the time less abstract, so May 16, 2032 would become May 16, 2037.

Although the minimum term-to-maturity is 10 years, many insurers specify a minimum 15-year term. This detail will be set out in the contract. Be aware of it and ensure the client knows. This is part of an agent's disclosure requirements.

5.2.5 Principal risks of segregated funds

The risks of segregated fund investing are expressed in a warning that appears on the cover or face page of a contract that states in bold type:

> Any amount that is allocated to a segregated fund is invested at the risk of the contractholder and may increase or decrease in value.[30]

Thus, the investor is alerted to a possible danger.

How does the risk arise? Fundamentally, the risk of a segregated fund results from how the fund invests the deposits it receives from investors. As we have seen, each fund is highly diversified within its category. Each investment within each fund has its own individual risk. The risk of individual investments is averaged out (that is, diversified) to produce the overall risk for the fund itself.

Fund risk is plotted on a scale with six classifications: very low, low, low to moderate, moderate, moderate to high, and high.

Even those funds at the bottom of the risk scale will go up and down in value because of changes in interest rates, economic conditions and business markets linked with that category of funds.

Funds are also subject to specific risks, based on their type. For instance, a bond fund is highly susceptible to interest rate risk but has little market risk. An equity fund, on the other hand, has higher market risk and equity risk and low interest rate risk.

30. Canadian Life and Health Insurance Association Inc. *Guideline G2 – Individual variable insurance contracts relating to segregated funds*. [online]. [Consulted May 16, 2022]. https://www.fsco.gov.on.ca/en/insurance/ivics/Documents/Guideline_G2.pdf

In developing a recommendation, the agent should take into consideration:

- The risk assessment of each recommended fund;
- The forms of risk associated with the recommended products, e.g. exposure to equity risk and inflation risk;
- The risk tolerance of the investor.

5.2.6 Reset

The reset feature allows the investor in a segregated fund to lock in, at specified intervals (e.g., once a year), increases in the market value of the investment. If market value has declined at a reset date, then the reset feature is not utilized.

Not all segregated funds offer reset. A recommendation that includes a fund that provides reset and one that does not must show the cost of reset. That cost may be apparent through a higher management expense ratio (MER).

There may be other aspects of reset that need to be compared between recommendations, such as number of resets permitted in a year or whether reset is automatic or on client instruction.

The recommendation needs to show the client how reset extends the maturity date, and increases the maturity guarantee and death benefit guarantee of the contract. Concrete examples should be provided of the effect of a hypothetical reset on the actual deposit amount and date.

EXAMPLE

Nassir's agent, Farah, recommends a segregated fund contract that will have a 10-year maturity date from April 23, 2020. Nassir has a $5,000 premium available and wants a 75%/75% guarantee structure. The average rate of return on the recommended fund is 5.02% annually over the past 10 years. The maturity date of his contract will be April 23, 2030 – one month after his 65th birthday. The cash paid out then will help him delay both his Canada Pension Plan (CPP) (or Québec Pension Plan – QPP) and Old Age Security (OAS) benefits, in order to receive the deferral bonus on both. The contract would have an automatic reset every two years on its anniversary date.

The first reset would be April 23, 2022. This locks in growth; however, the maturity date of the contract would advance to April 23, 2032. Based on this addition of two years to the initial maturity date, Nassir will have to begin his government retirement benefits sooner. This means they will be paid at a lower rate.

Considering that resets will be automatic, Nassir and Farah should estimate before he enters into the contract whether he is better to take the resets and extend the contract or consider another fund with a 10-year term-to-maturity for which resets are voluntary rather than automatic.

5.2.7 Contract riders

The recommendation must address whether an income rider should be added to the contract. If an income rider is added in the form of a Guaranteed Minimum Withdrawal Benefit (GMWB) or Guaranteed Lifetime Withdrawal Benefit (GLWB), the characteristics of the rider have to be thoroughly described.

These riders are not widely available, so comparisons between providers or products may be difficult to make. This should also be pointed out to the investor.

5.2.8 Fund taxation

Taxation of the fund will depend on whether the contract is set up as a registered or non-registered account. Taxation rules are pre-determined by income tax legislation so no point of recommendation can usually be made on this basis.

As a reminder:

- Deposits to a registered contract will generate a contribution if the contract is an RRSP or TFSA;
- RRSP contributions are tax-deductible;
- Taxable allocations of the returns generated by the fund will be declared and will increase the adjusted cost base (ACB) when the account is not registered;
- Withdrawals are taxed very differently depending on whether the account is registered or not.

The agent may point out the primary form of return earned by the recommended investment, e.g. interest, and compare tax advantages of receiving allocations of capital gains or dividends over interest when the account is not registered. Allocations and taxation were reviewed at length in Chapter 2.

5.2.9 Fund sales charge

A sales charge or load is paid by the investor.

As discussed previously, FEL and DSC sales charges for segregated funds may be eliminated because they do not align with the fair treatment of customers.

DSC redemption schedules for mutual fund sales made prior to the ban will be allowed to run their course in Ontario. This means DSC charges could apply up until 2028 or 2029.

5.2.10 Fund management expense ratio (MER)

The management fee covers management and operating expenses and taxes. Trailing commissions are paid from the management fee. The amount charged as a trailing commission is clearly disclosed in the Fund Facts for each fund that all potential investors receive.

The management expense ratio (MER) of a fund is the percentage of expenses relative to the average value of its assets. MER is not based on performance and it is charged regardless of performance.

MERs vary between funds and have a financial impact because they reduce the return on investment. The higher the MER, the greater the reduction in return to the investor.

Fund performance is reported net of MER and returns received net of MER; in other words, if a fund has a reported return of 4.2% and an MER of 2.8%, the real return on the fund is 7.0% (4.2% + 2.8%). However, the investor earns 4.2%.

EXAMPLE

Roberta has invested $10,000 in Fund A with an MER of 3.5% and $10,000 in Fund B with an MER of 1.5%. Both funds have a reported 5.0% rate of return.

Fund A: The real rate of return, before MER, is 8.5% (5.0% + 3.5%). The fund manager earns 8.5%, keeps 3.5% and pays Roberta 5.0%.

Fund B: The real rate of return, before MER, is 6.5% (5.0% + 1.5%). The fund manager earns 6.5%, keeps 1.5% and pays Roberta 5.0%.

However, if a fund with a higher MER performs much better than a fund with a lower MER, the investor may quite happily pay the higher MER since his investment is growing at a better rate.

EXAMPLE (cont.)

If instead of a 5% return, Fund A has a reported return of 6.2%, the real rate of return is 9.7% (6.2% + 3.5%). The fund manager earns 9.7%, keeps 3.5% and pays Roberta 6.2%.

5.2.11 Fund details

It is an agent's responsibility to discuss and explain the contents of the information folder including Fund Facts to the investor.[31]

The information folder and Fund Facts provide important details about each fund. Fund Facts are particularly useful because they are individual outlines of each fund. Their information is provided in such a way to facilitate comparison between funds; they are brief summaries of the many details each fund entails and written to be easily understood.

5.2.11.1 Delivery of Fund Facts

Fund Facts are part of the information folder and are delivered to a prospective investor before the application for the contract is signed. They can be delivered in person or electronically via email or through an online site. The client must acknowledge that he has received the information folder in writing or in conversation with the agent.[32]

Providing Fund Facts is mandatory as part of the disclosure process that accompanies a sale.

5.2.11.2 Delivery of financial statements

The financial statements show selected key financial information about a fund and are intended to help the client understand the fund's financial performance for up to five years, depending on the fund's inception date. They are not provided with the information folder. Clients may submit their request for financial statements to the agent or directly to the insurer providing the fund.

All funds release annual audited financial statements and semi-annual unaudited financial statements.

Clients with a more sophisticated understanding of investing may appreciate the additional level of detail provided in the financial statements.

5.2.11.3 Total value of fund

This dollar figure, shown in the Fund Facts for the fund, reveals how much is invested in the fund. It is relevant because it is the figure on which the MER is based. Funds with a higher total value can potentially offer a lower MER. This benefits the investor since the MER erodes returns.

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31. Canadian Life and Health Insurance Association Inc. *Guideline G2 – Individual variable insurance contracts relating to segregated funds*. [online]. [Consulted May 16, 2022]. https://www.fsco.gov.on.ca/en/insurance/ivics/Documents/Guideline_G2.pdf
32. Ibid.

5.2.11.4 Fund units, net asset value per unit and market value

The number of units outstanding and the net asset value per unit are shown in Fund Facts as at the date specified. Market value of units will be the current value, or value as of the most recent valuation date.

Over its lifetime, a segregated fund may be divided, in which case unit values will decrease, or funds may consolidate, in which case unit values will increase. Neither event changes the market value of the fund.

This data is used for comparison in the recommendation and is not an indication of the quality of the investment.

5.2.11.5 Date of inception

This is the date on which the fund began operations. Funds with long track records offer more history by which investors can assess overall fund performance. Funds with longer histories have experienced various market conditions and have more reliable performance data.

Therefore, a client with a lower risk tolerance will appreciate a recommendation that includes a fund with a longer record since he may see historical lows and highs in addition to typical results.

5.2.11.6 Performance data

Performance data is always historical: what has happened over a specified period of time. It may be useful to compare funds, but must never be used to predict what will happen in the future.

Moreover, many requirements must be satisfied for performance data to be included in advertisements for funds and it is essential that an agent not revise this data in any way.

Performance is stated as an average return and year-by-year return.

- The average return states how much a $1,000 investment with the most basic guarantee (75% maturity/75% death benefit) would be worth and its annual average return as a percentage for the years shown.
- Year-by-year returns show the fund's annual performance in a chart format. It also states the number of years of positive performance and negative performance. For example, the fund was up in value for six years and down in value for four years.

Where a segregated fund invests in real estate, the purchase and sale of real estate in the fund is described for the previous five years.

Funds with a history of less than one year do not report performance data.

5.2.11.7 Fund manager

Some performance credit, or blame, can be assigned to the manager of the fund. The fund manager appears on the Fund Facts, although the document does not show how long the same manager has been in place.

If a fund shows a track record of good long-term performance but the manager has only been with the fund for the last year, it may be wise to question whether the results will hold up. Likewise, if results align with management tenure – good results over the five years with the same manager – it may be fair to conclude that the manager has some impact on results. Finally, if one manager seems to have a record of performance across funds, that data may be important in the decision-making process because that manager may be partially responsible for fund results.

Fund managers are regularly reviewed and can be changed if they do not meet expectations of the insurer.

5.2.11.8 Portfolio turnover rate

The portfolio turnover rate is expressed as a percentage of the fund's holdings that have been replaced during the previous year. The turnover rate is related to the MER because high turnover translates into higher expenses due to buying and selling costs. A low turnover indicates a buy-and-hold investment philosophy, and correspondingly lower costs for trading. A lower MER can improve investor returns.

5.2.12 Fund penalties

The recommendation for a segregated fund investment should be accompanied with a reminder of the long-term nature of the investment, regardless of which fund or funds are selected.

Fund penalties should be pointed out and reference made to how they will be calculated, but should not be a basis for comparison since the agent does not want to imply approval to withdraw from the fund or surrender the investment prematurely. Both activities should be discouraged.

Some charges or penalties include:

- Account closing charge;
- Frequent switching charge;
- Fees to set up registered accounts;
- Short-term trading fee;
- Unscheduled withdrawal or switch fee.

5.3 Finding for an annuity

An investor seeking income, in a relatively straightforward product, is a likely candidate for a payout annuity. Those looking for a very conservative non-income paying investment without the limitations of segregated funds, such as the 10-year term-to-maturity, sales charges and annual MER, will be potential candidates for an accumulation annuity.

As is the case for segregated funds, the agent must satisfy the principle of suitability for annuities. He must analyze benefits and limitations of an annuity investment in view of his client's needs and make a thorough comparison of annuities suitable for those needs.

The agent's analysis leads to a recommendation that he backs up to the client in the reason-why letter. Documentation of the recommendation is key in order to show alternatives presented, if ever questioned in the future. The client agrees that the recommendation is sound based on information gathered and the needs he expressed and makes the final decision. This, too, should be recorded in agent notes. The final step is to proceed with the application.

5.3.1 Annuity analysis

In Chapter 3, the following questions were posed in assessing an annuity to understand its features, benefits and limitations:

- Is the annuity being created to pay income or for savings?
- How many lives will be covered?
- Will the annuity payments be made for a period of time or life?
- When will income begin?
- Will income be a level payment or variable?
- How will the contract be funded?
- Which form of taxation will apply?

Now, for the annuity recommendation, these questions become:

- Does the client need income or savings?
- Is it sufficient for the client to be covered or should it be the client and his spouse?
- Is the income need temporary or lifelong?
- When does the client need income to begin?
- Does the client need level income that he can count on or is variable income better?
- How will the client fund the contract?
- What will be the tax impact on the client?

The agent has many products to analyze to look for appropriate answers to these questions and formulate a suitable recommendation.

It may not be possible to arrive at a recommendation that ticks all boxes on the client's list of needs and circumstances. In this situation, the agent can proceed with the best available recommendation while pointing out its advantages and shortfalls. An agent's ethics may be tested if the most suitable recommendation means the loss of the sale because the agent cannot provide the best annuity for the client or the annuity product itself is not the best choice. Regardless, the only course of action available to the agent is to be honest and explain to the client the rationale for the recommendation.

5.3.1.1 Current offerings

The agent needs to keep himself apprised of new product introductions and innovations. It is never appropriate to rely on former decisions or only on knowledge of a stable of long-standing products. Every decision should be based on a review of what is currently available, which may include the new and old.

5.3.2 Supporting the annuity recommendation

Once the agent has determined which investment factors are most important to client needs, based on the investor profile, he may find that the characteristics of annuities make them the preferred choice, rather than segregated funds. For instance, if income is a prioritized need, then an annuity may be the best recommendation. It may also be suitable to acquire both a segregated fund to protect some of the investor's capital while enabling growth and an annuity for its income stream.

Most importantly, the agent must have a sound basis for his annuity recommendation that is a result of client needs weighed against product features. Limitations need to be reviewed. All factors relevant to the decision should be presented so the client understands the reasons the annuity is the best investment considering his objectives.

5.4 Annuity recommendation

A logical starting point for the recommendation is the type of annuity best suited to the client. Once the purpose of the annuity has been determined, the agent and client must determine how the deposit will be made, when payments will begin, the payment schedule, whether payments will be level or variable, and the guarantee period best suited to manage the risk of the investment.

Every annuity recommendation should include the following elements, which are addressed in the next sections:

- Type of annuity and its characteristics;
- Timing of payments;

- Annuity rate;
- Value of guarantees;
- Principal risks of annuity recommendation;
- Annuity penalties.

5.4.1 Type of annuity and its characteristics

There are two fundamental types of annuities: payout or accumulation.

A payout annuity is recommended when income is indicated. The agent must also recommend how long the income should be paid: either a term or life.

- Term requires a choice of time periods, i.e. 10 years, 20 years or to a specified age, such as age 90.
- Life requires a recommendation of lifelong income for the client alone, leading to a personal contract, or the client and his spouse, leading to a joint and last survivor contract.

A prescribed annuity, in which the same amount of interest and capital is received by the annuitant in every payment, is generally considered preferable to an annuity taxed by the accrual method. Structuring the annuity so that it will benefit from being prescribed can also be incorporated into the recommendation.

The agent has to be aware of requirements for payout annuities funded by a transfer from a registered or locked-in account, such as age limits and minimum withdrawals. These requirements take precedence over client needs and wants and must be fulfilled.

An accumulation annuity is recommended when the analysis indicates the suitability of an investment-return approach. The agent also recommends a suitable maturity date for the annuity, based on the time horizon of the investor.

5.4.1.1 Minimum and maximum investment

A minimum investment for each type of annuity is stated by the insurer offering the product; a recommendation cannot be based on less than this amount. A maximum may also be specified by the insurer.

The client must have funds available in cash or by transfer.

5.4.1.2 Maturity date

A maturity date applies to both a term annuity and an accumulation annuity. Determining the length of time until the maturity date depends on the income need to be satisfied by the term annuity, and the time horizon for the accumulation annuity. If the accumulation annuity is not being used to save for a specific event and therefore does not have a time horizon, the agent determines the reason for acquiring the annuity and matches a maturity date accordingly.

If there is a need for higher income, a shorter term-to-maturity for the term annuity should be recommended since payments will be higher when they are made over a shorter period of time.

If the need is to create a stop-gap source of income (also called income bridging) for those who have stopped working and are not yet entitled to full retirement benefits, then the length of the term annuity should be aligned with the period of time between when the individual stops work and starts receiving his pension.

EXAMPLE

Jane has been employed as a senior executive at a manufacturing firm for 19 years. At age 60, she is given a package from her employer that consists of a lump sum equal to 5 years' salary providing she leaves the company immediately. She has a pension with her employer in which retirement benefits are available at age 65. Jane accepts the package and uses the lump sum to purchase a five-year immediate term annuity. About the time her annuity payments end, her retirement pension begins so her income remains constant from the time employment ends and retirement begins.

5.4.2 Timing of payments

Payments from a payout annuity may be recommended to begin immediately or at a later date, known as a deferred annuity, based on the client's need for income.

5.4.2.1 Immediate payments

An immediate annuity, in which payments begin on the next scheduled payment date, could be recommended to an investor who has funds available and an immediate need for an income stream.

If a registered retirement savings plan (RRSP) at maturity is being converted to an annuity, annuity payments must begin in the year following. They cannot be deferred to a later date.

5.4.2.2 Deferred payments

Deferred payments are suitable to recommend to an investor who wants to accumulate deposits in the contract prior to starting income or who wishes income to begin at a future date.

The future date may be an obvious one, i.e. when retirement begins, or another time as determined in the investor profile.

5.4.3 Annuity rate

The annuity rate depends on how much money is invested, the interest rate, and the length of the contract. The rate offered by the insurer for the recommended annuity will be in force for the duration of the annuity once the contract is finalized for an immediate annuity or when payments begin for a deferred annuity.

Annuity rates vary between insurers, and agents who have the ability to shop around for best rates can incorporate those rates in their recommendation.

There are many annuity calculators available on the Internet for the do-it-yourself investor that can show some very advantageous annuity rates. The agent's recommendation is a combination of benefits for the investor that includes the offered annuity rate, but is not based on the annuity rate alone.

Annuity rates used by insurers are different for fixed-income annuities and variable income annuities.

5.4.3.1 Fixed-income annuity

A fixed-income annuity in which each payment is equal is best suited to an investor without the risk tolerance needed for a variable income. An investor who wants or needs income security is well served by a fixed rate of payment.

5.4.3.2 Variable income annuity

An investor who has risk tolerance for the ups-and-downs of the stock and bond markets may prefer a variable income annuity over one that provides a fixed income. His payments rise with a rising market or fall with a declining market.

A recommendation for a variable income annuity should take the age of the investor into account since losses incurred at an older age are more difficult to make up than when a person is younger.

An indexed annuity sees payments increase based on the schedule provided in the contract, in step with increases in the cost of living. There is a significant price premium for adding the indexing feature when purchasing an annuity over a longer term and a recommendation would properly show the cost for an annuity that is not indexed in addition to the indexed annuity.

5.4.4 Value of guarantees

Guarantees customize an annuity contract to suit the needs of the policy owner. They increase the cost of the annuity for the policy owner and consequently decrease the amount the annuitant receives. On the other hand, they provide the policyholder with the assurance that a minimum amount will be paid to the beneficiary in the event the annuitant dies before the end of the guaranteed payment period.

5.4.4.1 Life annuity guarantees

The guarantee period of a life annuity minimizes investment risk for the investor. He can be assured that, in the event the annuitant dies during the guarantee period, a sum representing the balance of the guarantee will be paid to a beneficiary. Therefore, the guarantee ensures a minimum return from the investment during the guarantee period. Death of the annuitant after the end of the guarantee period does not generate a payment to the beneficiary.

The recommendation can address risk tolerance by proposing a longer guarantee period for a client with low risk tolerance. The longer guarantee period produces a lower income payment to the annuitant. This must be balanced against the likelihood of the beneficiary receiving a payment when the annuitant dies.

A higher risk tolerance may indicate a shorter guarantee period. The shorter guarantee period rewards the annuitant by making higher payments but puts the beneficiary at risk since he may receive nothing if death of the annuitant occurs after the guarantee period ends.

Usually the need of the annuitant for income is considered before the beneficiary's eventual need for proceeds from the contract.

Age also enters the equation for the length of the guarantee period. Recommending a 20-year guarantee period for a life annuity acquired at age 80 may be overly expensive – and optimistic.

5.4.4.2 Return of premium guarantee

A return of premium guarantee, added as a rider to the contract, also is a risk management technique. It pays the beneficiary the full deposit to the contract if the annuitant dies before the first payment.

Recommending the rider is appropriate for those who have a low risk tolerance, when a deferred annuity is recommended, when the annuitant is in poor health, or to ensure return of principal invested to the estate.

5.4.5 Principal risks of annuity recommendation

The principal risk of an annuity recommendation is an annuity rate that improves in the future, due to an increase in interest rates. The higher rate will be unavailable to annuitants whose contracts are already set and, therefore, they will earn less than they would have received if they had had the higher rate.

This risk may be managed by recommending that a series of annuity contracts be acquired over a period of several years. This approach is called laddering. Each annuity has its own annuity rate but there is no guarantee that interest rates will rise. When interest rates rise, they tend to do so very gradually. To risk laddering and the hope of rising rates, annuity purchases would have to be stretched over a number of years.

Inflation risk is a significant risk to annuity investors. It is related to the issue of the set annuity rate and also the fixed payment rate. Inflation risk can be managed by an indexed annuity; the investor must decide whether its additional cost is worthwhile.

Finally, an annuity allows little or no flexibility for the investor. He loses control of his capital in exchange for the security of the income stream. This may be suitable for some investors, yet not others.

5.4.6 Annuity penalties

An annuity is a commitment, for a period of time or life. Although some annuities may permit a withdrawal or surrender, others do not. Payout annuities cannot be surrendered. However, accumulation annuities are generally redeemable, although penalties may apply. A term certain annuity may be surrendered upon approval of the insurer.

The ability to withdraw funds from the contract or surrender it prematurely should not be a basis for comparison or form part of the recommendation to buy. The recommendation must emphasize the commitment made by the investor and the guarantee made by the insurer to the investor.

CHAPTER 6
SEGREGATED FUND CONTRACT

Competency components

- Analyze the available products that meet the client's needs;
- Implement a recommendation adapted to the client's needs and situation;
- Provide customer service during the validity period of the coverage.

Competency sub-components

- Analyze the advantages of segregated funds in comparison to other types of investment in regards to the client's needs;
- Confirm the requirements that must be met to implement the recommendation;
- Validate the appropriateness of contract amendment, renewal and termination application in regards to the client's situation;
- Inform the claimant of the claims process.

6
SEGREGATED FUND CONTRACT

Only a licensed life agent can work with the investor to prepare and submit the application for a segregated fund.

The application is one step along the path to ownership of the investment. It is preceded by the recommendation of the agent in the reason-why letter and followed by the financial contribution to the contract. The finalized contract is evidence of the agreement between insurer and investor and obligates both parties to the terms of the investment.

6.1 Contracts

Contracts are legal documents that bind their parties to specified terms and conditions. Many forms of contract exist; the contract between an insurer and an investor for a segregated fund is an individual variable insurance contract (IVIC).

6.1.1 Individual variable insurance contract (IVIC)

The IVIC spells out the conditions for buying, terminating, withdrawing and receiving the benefits from the segregated fund investment. It is a document of disclosure intended to both reveal what the investor is buying and reinforce the risk associated with the investment.

The insurer makes these contractual commitments to the investor:

- Guarantees and benefits;
- Method to determine the value of benefits related to the market value of the fund and their surrender value;
- Percentage of premium allocated to provide the benefits related to the market value of the fund;
- When the value of the fund and benefits are determined;
- Fees and charges, or how fees and charges are calculated;
- Right to make changes to the contract.

The contract states what information forms part of the contract. It includes:

- Identification of the IVIC and the segregated fund;
- Management expense ratio (MER);
- Risk disclosure;
- Fees and expenses;
- Right to cancel;
- Statement of the accuracy of the Fund Facts information and the remedy for any error in the information provided by that document.

Finally, the contract states:

- The contract may be rescinded in writing to the insurance company, at the address it has specified, within two business days after the contract owner receives confirmation of the purchase;
- If the contract is rescinded, the contract owner receives the lesser of the amount invested or the value of the fund on the valuation day following the day the insurer received the request for rescission. Fees or charges are also refunded;
- The contract owner is deemed to receive a confirmation five business days after it has been mailed by the insurer.

All segregated fund contracts are required to provide this information. Thus, the investor is equally protected in his contractual rights regarding these details regardless of which insurer he chooses to invest with.

A contract may be attached to the application form or may be provided to the investor after the insurer receives the application. Delivery of a sample contract does not constitute purchase of the segregated fund. Purchase is confirmed by the effective date of the contract. The effective date is the valuation date following the receipt of the first deposit and when all contract criteria have been satisfied.

The contract is assigned a unique reference number. This number is used whenever instructions or information about the contract is conveyed between contract owner and insurer.

6.2 Investor requirements

The investor must provide the information needed for the contract to be prepared by assisting the agent in filling out the application. He must be accurate and truthful. He should also aim to make the decisions that will create the contract most suitable to his needs and objectives. Those decisions may be based on the life insurance agent's recommendations, or the investor may arrive at them independently. The agent proceeds on the basis that the investor understands the decision he is making and can appreciate its consequences. If the agent is unsure of the client's ability to understand a part or all of the contract, the agent should seek advice from his direct supervisor before proceeding.

The second requirement that must be met by the investor is to fund the account.

6.2.1 Application form

The application form is completed by the investor and the agent together; this may be together virtually. The investor, who is the applicant, provides the necessary information; the agent records the information on the form itself in its electronic or paper format.

Many details are collected; an application form is multiple pages in length. It requires enough time to complete so that information is recorded correctly and nothing is overlooked. The agent may need to explain certain aspects of the form so the investor fully understands his options and his commitment.

A circumstance could arise that prevents the investor from fully comprehending the application, certain aspects of the application or the agent's explanations. For instance, if the investor does not speak a language the agent understands, then the application should not be completed until steps are taken so that understanding exists. The agent may need to provide more information to the investor or provide a translator.

The investor must review all information on the form and correct any inaccuracies. Then, the investor and annuitant, if they are not the same person, both sign and date the application – electronically if need be. Their signatures confirm their agreement with the information. The agent must also provide specific information for the application to be processed.

An exception is made to the requirement for the contract owner to sign the application when the contract owner is represented by a power of attorney (POA) for property. An agent may find a POA appointed for a client who is ill, mentally incapable or absent from the country for a prolonged period of time. The individual with the POA can complete and sign the application on behalf of the contract owner. However, he may not have rights to name the beneficiary. A legal opinion should be sought in this circumstance.

Information must be recorded by the agent carefully since it will become the basis for the contract. The agent must also ensure that all information needed is gathered since an incomplete application will be rejected by the insurer.

At the time the application is made, the reason-why letter is prepared. The reason-why letter is one of the pillars of insurances sales suitability. The letter is prepared by the agent and provided to the client. It proves that the agent has addressed a relevant insurance need or needs by making recommendations to a client, together with the basis for the recommendations, and whether or not the client has accepted or refused those recommendations. The reason-why letter:

- Confirms facts;
- Verifies the instructions received from the client;
- Identifies the client's needs that the product meets and the needs that will be left uninsured;
- Documents that the sale is suitable and the reasons why it is suitable;
- Substantiates the client's understanding of his purchase.

The reason-why letter is not optional. The agent reviews it with the client, and both must keep a copy.

6.2.1.1 Registered or non-registered form

The segregated fund account can be non-registered or registered. Registered accounts are further categorized as locked-in or non-locked-in. There may be age restrictions when certain types of locked-in accounts can be established; however, there are no age restrictions for opening a non-registered account.

The account in which the IVIC investment is made must be accurately selected. For example, an investor who believes he will be enjoying the tax deferral of a registered account may be financially disadvantaged if the account is set up in a non-registered form.

To open a registered account, the contract owner needs to provide his Social Insurance Number (SIN) for tax purposes. A registered contract requires the owner to be the same person as the annuitant. Ownership of the contract cannot be transferred and the contract cannot be used as collateral.

A non-registered account, that is, an account not registered for tax purposes, may specify an annuitant who is not the contract owner. The owner may be an individual, a group of individuals or a corporation. The contract may be purchased until the date on which the annuitant turns 90.

A non-registered account has the following benefits:

- Ownership can be transferred according to the rules of the insurer that has issued the contract;
- It can be used as collateral for securing a loan by assigning the contract to the lender.

6.2.1.2 Naming annuitant and beneficiary

The owner of the contract enjoys the rights of ownership, such as the ability to select and switch funds. He names the annuitant and beneficiary to the contract.

As explained in previous chapters, the annuitant is the person on whose life the guarantees are based and whose death triggers payment of the death benefit. Once named, the annuitant may not be changed. However, in a non-registered contract, prior to the death of the initial annuitant, a contingent annuitant may be named to replace him if he dies. The contract continues until the death of the last surviving annuitant, and the death benefit is only paid out at this time.

The beneficiary receives the benefit of the contract after the death of the last surviving annuitant.

More than one beneficiary can be named. If this occurs, a percentage of death benefit must be allotted to each beneficiary.

When a spousal RRSP is set up, the owner and annuitant of the contract is the person who benefits from the deposits to the contract. The person who made the deposits to the plan does not have ownership rights. The recipient of the deposits names the beneficiary.

EXAMPLE

Jill sets up a spousal RRSP in the name of her husband, Jack, and makes contributions to it. Jack is the owner and annuitant of the plan and he alone can name its beneficiary.

After a contract owner has died, the insurer may release information about a contract to the beneficiary and to the owner's estate.

6.2.1.3 Rider election form

The rider election is provided only to those contract owners investing in guaranteed minimum withdrawal benefits (GMWB). It:

- Specifies that the GMWB is being elected;
- Provides a payment option (lifetime or to an end-date);
- Offers space to fill in the correct fund codes (must be those that offer the rider);
- Describes minimum initial deposit requirements;
- Gives a choice for payments;
- Instructs on the frequency of payments and how they are made;
- Establishes mandatory authorization by the owner and the agent.

Just as the segregated fund contract addresses investment risk from the outset, so too does the rider address the impact of excess withdrawals from a GMWB because they can significantly reduce the value of the contract. The contract owner may not receive his expected amount in payments in the future if excess withdrawals have been made.

6.2.1.4 Client identification requirements

FINTRAC was established by, and operates within the scope of, the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (PCMLTFA)[33] and its Regulations. The Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) is Canada's financial intelligence unit (FIU). The Centre assists in the detection, prevention and deterrence of money laundering and the financing of terrorist activities.

As discussed earlier, the agent has obligations under the PCMLTFA to properly identify clients and to keep records about the client and the transaction if the client is expected to deposit $10,000 or more to the contract over its lifetime or if a beneficiary will receive $10,000 or more over the duration of an annuity or policy.

33. Financial Transactions and Reports Analysis Centre of Canada. *Life insurance companies, brokers and agents.* [online]. Revised July 12, 2021. [Consulted May 17, 2022]. https://www.fintrac-canafe.gc.ca/re-ed/li-eng

The agent must also determine whether the client is acting on instructions from a third party. The agent is also required to submit a terrorist property report under specified circumstances to FINTRAC. These requirements do not apply when the account is registered.

Requirements are also specified for the agent if a large cash transaction is made as cash or a virtual currency (VC). A large cash transaction is a single cash deposit of $10,000 or more, or multiple cash deposits equaling $10,000 or more made in a 24-hour period. Note the specification for cash. Cash means cash – notes and coins – not cheques, not transfers, not a bank draft or other instrument.

When an account is opened, reviewed, or a suspicious fact is detected, the agent has to confirm whether the client is a politically exposed foreign person (PEFP), a domestic politically exposed person (PEP), head of an international organization (HIO) or a family member or close associate of one of these people. In general, a PEFP is a person who has held a government or judicial position in a foreign country. A domestic PEP is a person who holds – or has held within the last five years – a specific office or position in or on behalf of the Canadian federal government, a Canadian provincial government, or a Canadian municipal government. An HIO is the head or chief executive officer of an international organization set up by the governments of more than one country. If the client is identified as being high risk, you have specific obligations for the client, his family members, and close associates that apply to record keeping, establishing the source of funds, and obtaining the approval of senior management to keep the account owner.

FINTRAC has three methods to establish suitable client identification:

- Photo identification (applies to individuals who are physically present):
  - Must be issued by a federal, provincial or territorial government;
  - Name and photograph details must match;
  - Must be valid, current and authentic;
  - Must include a unique identifying number;
  - A foreign-issued ID is acceptable if it is equivalent to the Canadian-issued photo ID documents;
  - Some examples include a Canadian passport, permanent resident card, secure certificate of Indian status, provincial or territorial identity cards, a U.S. passport.
- A credit file:
  - The file must have existed for at least three years;
  - The name, address and date of birth must match the information provided by the individual;
  - Providers include Equifax Canada and TransUnion Canada.
- Dual process:
  - Two original, valid and current documents or information from independent and reliable sources must be provided;
  - Name, address and date of birth must match;

- Documents must be valid and current;
- Two sources are used as follows:
  - one source to verify an individual's name and address (such as a Canadian passport) and a second source to verify their name and date of birth (such as a birth certificate or permanent resident card);
  - one source to verify an individual's name and address and a second source to verify their name and confirm a financial account (such as a credit card statement);
  - one source to verify an individual's name and date of birth and a second source to verify their name and confirm a financial account.

Ontario, Manitoba, Nova Scotia and Prince Edward Island prohibit the use of their provincial health cards for identification.

Corporations and other entities must also supply acceptable identification, such as the corporation's certificate of corporate status, and the names of directors.

The agent must be completely confident that the person appearing in the identification papers is the same person making the application. If there is any suspicion that the applicant is acting for a third party, then a form for third party determination must be completed.

Any suspicious transaction or attempted transaction may be of interest to FINTRAC. Suspicious transactions are a combination of facts, context and money-laundering indicators.

- Facts are actual events, actions, occurrences or elements that exist or are known to have happened.
- Context is provided through general awareness of events in the client's business or community, knowledge of typical financial activities, regular know-your-client activities, information based on risk assessments and the background and/or behaviour of a client.
- Indicators are potential red flags that could initiate suspicion or indicate that something may be unusual without a reasonable explanation.

Suspicion itself has three thresholds. The lowest is simple suspicion in which a hunch or gut feeling leads an agent to believe that money laundering or terrorist financing is happening. Next is when there are reasonable grounds to suspect that there is a probability of money laundering or terrorist financing. The highest threshold is when there are reasonable grounds to believe and support the probability that money laundering or terrorist financing is occurring.

An attempted or completed suspicious transaction must be reported to FINTRAC. There is no monetary threshold to be met: if the agent is suspicious for good reasons, he must report the individual. The agent may wish to first bring the situation to the attention of a supervisor or manager.

All members of the financial services industry have a responsibility to follow the FINTRAC guidelines in an effort to curtail, with a goal of eliminating, money laundering and terrorist financing.

6.2.2 Funding the account

A deposit must accompany the application. It can be in the form of a cheque made payable to the insurer for a lump sum, by transfer, or by providing the date on which the first pre-authorized deposit will be made.

Pre-authorized deposits or debits (PADs) specify frequency (weekly, bi-weekly, monthly, bi-monthly, quarterly, semi-annually or annually), the date of the first withdrawal from the account and the regular subsequent date for withdrawals. Banking information for the institution from which withdrawals will be made and a personalized void cheque or stamped confirmation from the bank must be provided.

The deposit is allocated to the selected fund or funds. If more than one fund is chosen, the contract owner also indicates either the dollar amount of or percentage of deposit he wants applied against each fund.

In some jurisdictions, when locked-in funds are being transferred, the spouse must give consent to the purchase of the investment. The spouse has the option to release his rights to the pension contributions and subsequent account to which those contributions are deposited by providing a written waiver form.

An RRSP, locked-in retirement account (LIRA, also called an LRSP or locked-in retirement savings plan) contract can accept deposits until the end of the calendar year in which the contract owner turns 71. To continue tax deferral, the RRSP can be converted to a registered retirement income fund (RRIF) and the LIRA/LRSP converted to a life income fund (LIF) or life retirement income fund (LRIF), or prescribed registered retirement income fund (PRRIF) for Saskatchewan and Manitoba pension plan members.

If an account must be transferred from one form to another due to attained age, the insurer handles the change; the contract owner is set up in the proper account with the same fund and same unit value as prior to the switch.

There may be a minimum value required to open an account and for different forms of account; these should be verified with the insurer.

The investor is informed of the unit value for each deposit. This is true of single deposits and deposits made over time in a PAD plan. The unit value of the fund at the time of purchase forms a benchmark against which the future performance is monitored.

6.3 Agent requirements

The agent is required to meet expectations of the client and the insurer he represents for pre-sale activities, completion of the application, delivery of documents and post-sale service.

6.3.1 Meeting carrier expectations

The agent is expected to meet all expectations of the carrier for volume of business, client contact, accuracy in dealing with the carrier and clients, and necessary record keeping.

6.3.2 Document delivery

The contract must be delivered to the investor in person or through registered mail for the purchase to be completed and the contract issued. It includes other specified documents like the information folder, Fund Facts and contract confirmation. If a delivery receipt is part of the package of documents, it must be completed, signed and witnessed before it is returned to the issuing insurer.

Other forms may be required during the period the contract is in force if the client's situation changes or evolves, such as the change of beneficiary form and that used for a death claim.

6.3.2.1 Information folder

The information folder describes all the features of segregated funds and how they work. Specific fund details are provided in Fund Facts, which usually accompany the information folder.

The purpose of the information folder is to provide brief and plain disclosure of all material facts relating to the IVICs issued by the insurer.

One information folder is typically issued by the insurer for all the funds it provides although every fund has a unique identifier code. This is helpful to the agent since it means all relevant information is put into the hands of the investor at the same time; there can be no omissions.

An information folder may lead off with a summary of key facts, which is simply an overview of details provided again in the information folder itself.

6.3.2.2 Fund Facts

Fund Facts are the details of the particular funds offered by the insurer through its information folder. One is prepared for each fund as of December 31 of the preceding year. The information is presented consistently for every fund across all mutual fund companies so that comparisons can be easily made between funds. It is written in plain English to enhance client understanding.

It is essential for the agent to review the Fund Facts for the funds he has recommended with the investor to ensure the investor understands the recommendation and to answer any questions.

Here is a sample Fund Facts document:[34]

XYZ MUTUAL FUNDS

FUND FACTS

XYZ Canadian Equity Fund – Series B

June 30, 20XX

This document contains key information you should know about XYZ Canadian Equity Fund. You can find more details in the fund's simplified prospectus. Ask your representative for a copy, contact XYZ Mutual Funds at 1-800-555-5556 or investing@xyzfunds.com, or visit www.xyzfunds.com.

Before you invest in any fund, consider how the fund would work with your other investments and your tolerance for risk.

Quick facts

Fund code:	XYZ123	**Fund manager:**	XYZ Mutual Funds
Date series started:	March 31, 2000	**Portfolio manager:**	Capital Asset Management Ltd.
Total value of fund on June 1, 20XX:	$1 billion	**Distributions:**	Annually, on December 15
Management expense ratio (MER):	2.25%	**Minimum investment:**	$500 initial, $50 additional

34. *Autorité des marchés financiers. Mutual Fund Facts. An example.* [online]. [Consulted May 17, 2022]. https://lautorite.qc.ca/en/general-public/investments/funds/fund-facts/mutual-funds-facts

4

What does the fund invest in?

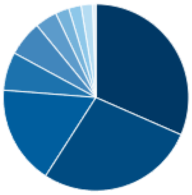
The fund invests in a broad range of stocks of Canadian companies. They can be of any size and from any industry. The charts below give you a snapshot of the fund's investments on June 1, 20XX. The fund's investments will change.

Top 10 investments (June 1, 20XX)

1.	Royal Bank of Canada	7.5%
2.	Toronto-Dominion Bank	7.1%
3.	Canadian Natural Resources	5.8%
4.	The Bank of Nova Scotia	4.1%
5.	Cenovus Energy Inc.	3.7%
6.	Suncor Energy Inc.	3.2%
7.	Enbridge Inc.	3.1%
8.	Canadian Imperial Bank of Commerce	2.9%
9.	Manulife Financial Corporation	2.7%
10.	Canadian National Railway Company	1.9%
Total percentage of top 10 investments :		**42%**
Total number of investments :		**93**

Investment mix (June 1, 20XX)

5



Industry

Financial services	30.4%
Energy	26.6%
Industrial goods	16.5%
Business services	6.4%
Telecommunication	5.9%
Hardware	3.7%
Healthcare services	2.3%
Consumer services	2.1%
Media	1.9%
Consumer goods	0.6%

How risky is it?

The value of the fund can go down as well as up. You could lose money.

One way to gauge risk is to look at how much a fund's returns change over time. This is called "volatility".

In general, funds with higher volatility will have returns that change more over time. They typically have a greater chance of losing money and may have a greater chance of higher returns. Funds with lower volatility tend to have returns that change less over time. They typically have lower returns and may have a lower chance of losing money.

6

Risk rating

XYZ Mutual Funds has rated the volatility of this fund as medium.

This rating is based on how much the fund's returns have changed from year to year. It doesn't tell you how volatile the fund will be in the future. The rating can change over time. A fund with a low risk rating can still lose money.

7

Low	Low to medium	**Medium**	Medium to high	High

For more information about the risk rating and specific risks that can affect the fund's returns, see the Risk section of the fund's simplified prospectus.

8

No guarantees

Like most mutual funds, this fund doesn't have any guarantees. You may not get back the amount of money you invest.

XYZ MUTUAL FUNDS

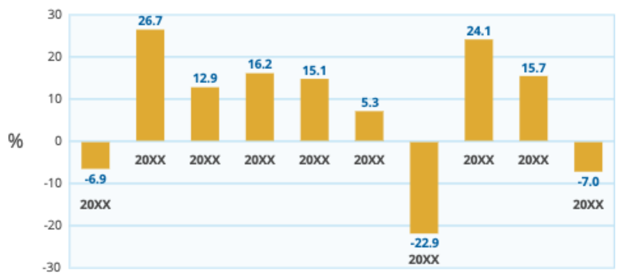
XYZ Canadian Equity Fund – Series B

9 How has the fund performed?

This section tells you how Series B units of the fund have performed over the past 10 years. Returns are after expenses have been deducted. These expenses reduce the fund's returns.

10 Year-by-year returns

This chart shows how Series B units of the fund performed in each of the past 10 years. The fund dropped in value in 3 of the 10 years. The range of returns and change from year to year can help you assess how risky the fund has been in the past. It does not tell you how the fund will perform in the future.



Best and worst 3-month returns 11

This table shows the best and worst returns for Series B units of the fund in a 3-month period over the past 10 years. The best and worst 3-month returns could be higher or lower in the future. Consider how much of a loss you could afford to take in a short period of time.

	Return	3 months ending	If you invested $1,000 at the beginning of the period
Best return	32.6%	April 30, 2003	Your investment would rise to $1,326.
Worst return	-24.7%	November 30, 2008	Your investment would drop to $753.

Average return

The annual compounded return of Series B units of the fund was 6.8% over the past 10 years. If you had invested $1,000 in the fund 10 years ago, your investment would now be worth $1,930.

12 Who is this fund for?

Investors who:

- are looking for a long-term investment
- want to invest in a broad range of stocks of Canadian companies
- can handle the ups and downs of the stock market.

! Don't buy this fund if you need a steady source of income from your investment.

A word about tax

In general, you'll have to pay income tax on any money you make on a fund. How much you pay depends on the tax laws where you live and whether or not you hold the fund in a registered plan, such as a Registered Retirement Savings Plan or a Tax-Free Savings Account.

Keep in mind that if you hold your fund in a non-registered account, fund distributions are included in your taxable income, whether you get them in cash or have them reinvested.

XYZ MUTUAL FUNDS

XYZ Canadian Equity Fund – Series B

How much does it cost?

13 The following tables show the fees and expenses you could pay to buy, own and sell Series B units of the fund. The fees and expenses — including any commissions — can vary among series of a fund and among funds. Higher commissions can influence representatives to recommend one investment over another. Ask about other funds and investments that may be suitable for you at a lower cost.

1. Sales charges

You have to choose a sales charge option when you buy the fund. Ask about the pros and cons of each option.

Sales charge option	What you pay		How it works
	in per cent (%)	in dollars ($)	
Initial sales charge	0% to 4% of the amount you buy	$0 to $40 on every $1,000 you buy	• You and your representative decide on the rate. • The initial sales charge is deducted from the amount you buy. It goes to your representative's firm as a commission.
14 **Deferred sales charge**	**If you sell within :** 1 year of buying 6.0% 2 years of buying 5.0% 3 years of buying 4.0% 4 years of buying 3.0% 5 years of buying 2.0% 6 years of buying 1.0% After 6 years Nothing	$0 to $60 on every $1,000 you sell	• The deferred sales charge is a set rate. It is deducted from the amount you sell. • When you buy the fund, XYZ Mutual Funds pays your representative's firm a commission of 4.9%. Any deferred sales charge you pay goes to XYZ Mutual Funds. • You can sell up to 10% of your units each year without paying a deferred sales charge. • You can switch to Series B units of other XYZ Mutual Funds at any time without paying a deferred sales charge. The deferred sales charge schedule will be based on the date you bought the first fund.

15 **2. Fund expenses**

You don't pay these expenses directly. They affect you because they reduce the fund's returns. As of March 31, 20XX, the fund's expenses were 2.30% of its value. This equals $23 for every $1,000 invested.

	Annual rate (as a % of the fund's value)
16 **Management expense ratio (MER)** This is the total of the fund's management fee (which includes the trailing commission) and operating expenses. XYZ Mutual Funds waived some of the fund's expenses. If it had not done so, the MER would have been higher.	2.25%
Trading expense ratio (TER) These are the fund's trading costs.	0.05%
Fund expenses	**2.30%** 17

More about the trailing commission

The trailing commission is an ongoing commission. It is paid for as long as you own the fund. It is for the services and advice that your representative and their firm provide to you.

XYZ Mutual Funds pays the trailing commission to your representative's firm. It is paid from the fund's management fee and is based on the value of your investment. The rate depends on the sales charge option you choose.

Sales charge option	Amount of trailing commission	
	in per cent (%)	in dollars ($)
Initial sales charge	0% to 1% of the value of your investment each year	$0 to $10 each year on every $1,000 invested
Deferred sales charge	0% to 0.50% of the value of your investment each year	$0 to $5 each year on every $1,000 invested

XYZ MUTUAL FUNDS

XYZ Canadian Equity Fund – Series B

How much does it cost? cont'd

3. Other fees

You may have to pay other fees when you buy, hold, sell or switch units of the fund.

	Fee	What you pay
18	Short-term trading fee	1% of the value of units you sell or switch within 90 days of buying them. This fee goes to the fund.
19	Switch fee	Your representative's firm may charge you up to 2% of the value of units you switch to another XYZ Mutual Fund.
20	Change fee	Your representative's firm may charge you up to 2% of the value of units you switch to another series of the fund.

What if I change my mind?

Under securities law in some provinces and territories, you have the right to:

- withdraw from an agreement to buy mutual fund units within two business days after you receive a simplified prospectus or Fund Facts document, or
- cancel your purchase within 48 hours after you receive confirmation of the purchase.

In some provinces and territories, you also have the right to cancel a purchase, or in some jurisdictions, claim damages, if the simplified prospectus, annual information form, Fund Facts document or financial statements contain a misrepresentation. You must act within the time limit set by the securities law in your province or territory.

For more information, see the securities law of your province or territory or ask a lawyer.

For more information

Contact XYZ Mutual Funds or your representative for a copy of the fund's simplified prospectus and other disclosure documents. These documents and the Fund Facts make up the fund's legal documents.

XYZ Mutual Funds
456, rue Répartition d'actif
Montréal (Québec)
H1A 2B3

Phone: (514) 555-5555
Toll-free: 1-800-555-5556
Email: investing@xyzfunds.com
www.xyzfunds.com

To learn more about investing in mutual funds, visit the AMF's website.

6.3.2.3 Confirmation

Confirmation by the investor is required to:

- Finalize purchase;
- Switch funds;
- Reset;
- Withdraw money from the contract;
- Terminate the contract.

Confirmation may be provided to the investor electronically or in writing. On occasion the client may be given the opportunity to provide instructions to the insurer verbally. These instructions are as binding as if they were written.

6.3.3 Ongoing service requirements

Sales activity for a segregated fund contract does not end with the confirmation of purchase. The wise agent recognizes the confirmation as just one step along the path of providing exemplary customer service.

6.3.3.1 Post-sale follow-up

The agent should follow-up with the client once the sales process is completed to see whether he is satisfied with the product and to answer any questions that may have arisen.

Keeping the lines of communication open between client and agent reinforces the agent's value to the client and can help to pave the way for additional business or recommendations.

6.3.3.2 Need to monitor client

The agent needs to inform the client that he must notify the agent or insurer of changes to his personal situation that might affect the contract in place. Such a change may be the need to change the beneficiary. The agent should also periodically check that all information, such as the client's address of residence, is up-to-date.

It would also be important to know if financial affairs of a client have transferred over to a power of attorney (POA), in which case the client could no longer provide directions for the contract.

6.3.3.3 Need to monitor product

New segregated funds are introduced continually, others are combined, and others are discontinued. Agents need to know their products well and keep on top of changes, such as a change in portfolio manager or the management expense ratio (MER), that may have a direct bearing on performance. Significant changes to a fund should be communicated to the client immediately and this is usually done by the insurer rather than the agent. However, the agent may wish to reinforce the impact, or lack of impact, of any changes to the client.

If there is a substantial loss in value of a fund, the client must be informed. Although no one likes bad news, providing the information shows that the agent is monitoring the fund and can answer questions and concerns that may arise as a consequence.

6.3.3.4 Annual review

At a minimum the agent should meet in person or virtually with the client once a year to review the selected investment and its performance. The agent should be prepared to discuss the return since the last review, whether good or bad, expectations, and his understanding for the reasons underlying performance. He should use this opportunity to check with the client as to whether there are changes in his personal situation of which the agent should be aware. This is also a time to ensure the investor is aware of any significant changes that have occurred in the fund if applicable.

6.3.3.5 Handling deposits

When a cheque accompanies the application, it must be handled securely and immediately sent to the insurer. There is no room for error in the handling of money and any other banking information. The cheque should show the contract number to which the payment is to be applied.

6.3.3.6 Making a fund switch

A fund switch is a change in investment from one fund to another : units are sold and the money used to purchase units in the other fund. Fund switches may be scheduled or unscheduled. An unscheduled switch is simply made by request to the agent or insurer. The switch may be requested because the investor wishes to rebalance the account or is dissatisfied with fund performance, for instance. The request can happen at any time. A minimum amount is required for the switch and the minimum balance for the fund must be met. Each insurer provides a number of switches a year for free. A withdrawal fee may be charged when switches exceed this limit.

Some switches will not be allowed depending on the sales charge or contract guarantees. It is also possible for a switch to act as a reset that changes both the maturity date of the contract and contract guarantees.

If units are switched within 90 days of purchase, a short-term trading fee may be charged or the switch may not be permitted. A short-term trading fee is a charge against the value of the fund, e.g. 2%. The information about the amount of the fee is in Fund Facts.

A scheduled switch is one set up on a regular basis, such as at the end of every year. There is no need for the client to make the switch request in this case. Fees are not charged when switches are scheduled. However, the insurer can cancel the switches or redirect switched funds. If this occurs, the investor will be notified in advance and provided with options for the future.

A capital gain or loss can be incurred by a switch to the extent the amount switched exceeds or is lower than the adjusted cost base of the units.

6.3.3.7 Resets

Similar to switches, a reset to a higher account value based on market value can be scheduled or unscheduled. However, unlike switches, not all funds allow reset to occur. When a reset is completed, the maturity date of the contract resets. For ten-year contracts, the new maturity date will be ten years from the reset date. Some insurers limit the age of the investor (or annuitant) at which a reset can be made, for instance to age 80. A reset at 80 would schedule contract maturity for age 90. The mortality rate in the years between 80 and 90 is very high so the insurer would very likely have to meet the death benefit guarantee obligation. If the death benefit is higher than market value, the insurer must make the top-up. This could become costly for the insurer.

An unscheduled reset is used by an investor to lock in a gain when he sees the value of his units have increased. The contract owner informs the agent or insurer of his wish to reset the contract and the request is processed. The number of resets per year may be limited by the insurer. Therefore, an investor could miss a market high if he has expended his allotment of resets for that year. However, attempting to time the market is rarely successful; far better to try and achieve steady modest gains in reset.

A scheduled, or automatic, reset may be restricted to the schedule set by the insurer, such as twice per year. No instructions from the contract owner are required. The reset is done only if the market value of the investment is higher than the unit's deposit value.

6.3.3.8 Change of beneficiary

Although the beneficiary is specified in the application, the need may arise to change the beneficiary if, for instance, the beneficiary dies or the contract owner decides a new beneficiary is in order. This can be done at any time by the contract owner providing the beneficiary designation is not irrevocable.

Naming a contingent beneficiary is always a good practice. The contingent beneficiary becomes the primary beneficiary if the primary beneficiary dies. This addresses a situation in which the annuitant and primary beneficiary die at the same time.

A revocable beneficiary can be changed by the contract owner at any time in a written request to the insurer or by completing a change of beneficiary form. An irrevocable beneficiary can also be changed if the beneficiary consents.

When the beneficiary is changed, the insurer must be notified in writing. The change will be effective the date of signing.

6.3.3.9 Renewing a contract

At the ten-year maturity of the contract, its value may be taken as cash or in the form of an annuity, or renewed for another period. When renewed, a new guarantee period begins. The new maturity date depends on the age of the annuitant when the contract is renewed. The initial contribution to the renewal contract is the total market value or the guarantee if the market value is lower. The death benefit guarantee continues.

The agent will be involved in recommending the renewal and ensuring proper documentation is prepared and delivered to the insurer in a timely manner.

6.4 Claims

The claim for value of a contract can be made:

- By the contract owner for withdrawal, surrender and maturity;
- By a beneficiary or an estate trustee (or equivalent) at death;
- By the person in control of the contract, when a POA for property is invoked, for withdrawal, surrender and maturity.

The claim sees the value of the contract or specified sum, if a withdrawal, paid minus any outstanding charges or fees. The agent should not attempt to calculate the amount that will be paid since he may be unaware of enhancements to or charges against the contract.

6.4.1 Claims process

The process for claims does not have to involve the agent since forms can be ordered directly from the insurer. However, the agent may choose to be involved to provide customer service to his client.

6.4.1.1 Claim forms

Both withdrawal and death benefit claim forms can be ordered directly from the insurer. They must be returned completed and signed with any attachments and information the insurer specifies.

Once forms are submitted, an insurance representative specializing in claims takes over handling the claim and issuing a cheque or cheques, or ensuring funds are transferred as requested.

6.4.2 Types of claims

Both tact and sensitivity are called for when the agent is involved in a death claim. Other types of claims are simply financial transactions that call for efficiency and privacy. A high degree of professionalism is expected from the agent who chooses to be involved in claims.

Different types of claims are discussed in the following sections.

6.4.2.1 Maturity claims and death claims

The maturity guarantee is claimed when the contract has matured, by the contract owner or person acting as POA for property.

The death benefit guarantee is paid at death of the annuitant to the beneficiary.

Both guarantee amounts are contractually obligated as a percentage of deposits, adjusted upwards by any resets and adjusted downwards by any withdrawals from the contract. If the market value of the account is not equivalent to the guarantee, the insurer will step in and contribute a sum equal to the difference between market value and guarantee.

The declaration of death is made by the beneficiary or estate trustee, who may be an executor, administrator or liquidator (in Québec). The contract number is provided in addition to the signature of the claimant and the agent's name and number. Proof of death or the Attending Physician's Statement (APS) is required. The death claim must be accompanied by an original death certificate. Additional documents may be required especially if the death occurs outside the country.

6.4.2.2 Termination and surrender claims

Termination occurs at contract maturity; surrender occurs before the contract has matured. Both activities constitute a claim and terminate the contract.

A contract may be terminated at any time by completing the withdrawal form providing the contract has not matured and annuity payments have not started. The contract owner at termination may choose to receive the value of the contract in cash, to buy an annuity, or another option provided by the insurer.

Locked-in accounts may be restricted as to whether the cash can be received and their value may have to be transferred to another locked-in account depending on the legislation of the province that applies to the funds.

6.4.2.3 Withdrawal form

The request for a withdrawal is initiated by the contract owner. The withdrawal form is used to both close the contract by withdrawing the total value of the account, and to make a partial withdrawal.

As discussed in the preceding chapter, charges may apply and the client must specify if the amount he wishes is net of charges, i.e. the actual sum he will receive, or the gross amount.

The form requires:

- Contract owner information;
- Identification of contract type;
- Selection of withdrawal options;
- Selection of form of payment, i.e. cheque, direct deposit or transfer to another product or institution;
- Instructions to set up a scheduled withdrawal plan (SWP), for instance when payments from a RRIF must begin;
- Selection of fund (by its number) from which the withdrawal is to be made;
- Specified amount to be withdrawn;
- Signature of contract owner and irrevocable beneficiary if one exists;
- Signature of agent with a date and time for client instructions.

Withdrawal options cover many circumstances beyond a partial or full withdrawal. The contract owner can also choose to:

- Set up or change a scheduled payment plan;
- Change the amount or date of scheduled payments;
- Change the allocation of scheduled payments;
- Change the banking information for scheduled payments;
- Stop the scheduled payments.

A minimum amount of annual withdrawal is required when the contract is a RRIF. When the contract is a LIF or a restricted life income fund (RLIF), it must be more than the annual minimum and less than the annual maximum.

6.4.2.4 Power of attorney (POA) claim

A power of attorney (POA) for property document appoints another person to act as a substitute decision-maker for all matters pertaining to the contract owner's property when the contract owner is unable to do so. As previously discussed, the individual granted POA for property controls the contract except, possibly, for the naming of beneficiaries.

The instructions for withdrawals or surrender made by the person with POA for property must be respected, and acted upon, as if he was the contract owner.

If the agent has reasons to suspect the person with POA is not acting in the best interests of the contract owner, he should discuss this with his manager or supervisor.

6.4.3 Factors affecting claims

The amount received in a claim may not be the amount anticipated by the contract owner. He must fully understand the effect of withdrawals, sales charges, guarantees and allocations.

6.4.3.1 Maturity and death benefit guarantee

The amount received at maturity or death can exceed the guaranteed amount when the market value of the contract is higher than the guarantee. However, if withdrawals are made from the contract during its term, guarantees are adjusted downwards in proportion to the account balance.

The timing of the maturity guarantee can also be affected when reset is used.

6.4.3.2 Allocations

When a segregated fund generates interest, dividends, capital gains or other sorts of income, that income remains in the fund and is reflected in its unit value. This investment income and these capital gains or losses are allocated to investors annually. This allocation increases or decreases the adjusted cost base (ACB) of a non-registered investment. Consequently, this income is not taxed again upon withdrawal.

CHAPTER 7
ANNUITY CONTRACTS

Competency components

- Implement a recommendation adapted to the client's needs and situation;
- Provide customer service during the validity period of the coverage.

Competency sub-components

- Confirm the requirements that must be met to implement the recommendation;
- Validate the appropriateness of contract amendment, renewal, and termination applications in regards to the client's situation;
- Inform the claimant of the claims process.

7
ANNUITY CONTRACT

Like all binding agreements that a life insurance agent has a role in creating, the annuity contract must be prepared with care. There are restrictions that the investor must understand before finalizing his purchase, especially for a payout annuity, because of the commitment the investor makes and the restrictions that apply. The agent needs to be absolutely sure the investor understands what to expect and what he will receive.

Many of the principles of the annuity contract are the same as the individual variable insurance contract (IVIC) discussed in the previous chapter. They include the attention to detail and professionalism required of the agent throughout the process of application, delivery, ongoing service, and claims.

7.1 Contract

Life annuities and term annuities sold by insurers are insurance policies. Policies are contracts that form a legal relationship between the client and the insurer. Certain terms in the contract, called general contract provisions, can apply to all policies while other terms will be specific to the type of policy issued.

Just as payout and accumulation annuities vary widely in their structure and purpose, so too will the contracts for each type of annuity be very different.

A contract for a payout annuity is a commitment for a specified term or life. When the contract has been issued it is final; no changes can be made except to change the person named as beneficiary. A free-look period applies after the contract is issued during which time the annuity can be cancelled. Thereafter, the investor cannot rescind the contract to receive a refund of his investment. The annuity rate that applies to the premium or premiums deposited by the investor applies for the duration of the annuity.

If an annuity rate has been quoted and used in an illustration of the income to be paid by the contract for an immediate annuity, that rate may be guaranteed for a period of time by the insurer. If there is no guarantee, income is calculated on the annuity rate in effect on the date the single or last of multiple premiums is received.

A payout annuity application specifies that income payments are made based on the annuity rate in effect, the type of annuity chosen and the frequency of payment selected in the application. The contract confirms this information.

The accumulation annuity contract has provisions that apply before the contract's maturity date and on or after the maturity date. It includes how interest is calculated and paid on the premium, minimum and maximum withdrawal limits, and how the contract is terminated.

Amendments and addendums can be attached to a contract. These customize the contract according to an individual's particular circumstances or needs. An amendment may be used to waive a contract provision, or to correct an error or omission. It is valid only when it is prepared in writing by the insurer and signed by the investor.

As with all applications for insurance products, the agent must ensure all information is provided accurately to the insurer for the contract to be prepared correctly.

The agent must be able to answer all investor questions clearly and factually. Uncertainty about any aspect of the future contract requires the agent to contact his manager or supervisor for clarification, or the insurer issuing the contract.

Addressing investor questions as they arise means the agent develops a robust understanding of the product that can be used in future dealings with other investors. In this way, the agent builds a solid basis of product knowledge that, coupled with understanding investor needs, allows the agent to provide exemplary service.

7.2 Investor requirements

The investor has two general requirements for both the payout and accumulation annuity contract:

- To assist the agent by providing all required information for the application form to be completed;
- To fund the contract.

Each form of contract also has specific requirements:

- The payout annuity contract directs the investor to select a schedule for payment with details of the financial institution and account where payments are to be made;
- The accumulation annuity contract requires its owner to make choices that centre on its term for investment.

7.2.1 Application form

There are significant differences between the application forms of insurers issuing annuities. Some incorporate all required information in the application itself and the application is multiple pages in length. Other applications appear to be much shorter, but they rely on the agent to complete additional forms that must be attached with the application itself to make it complete.

The wording of applications varies widely. Both applications for the two types of annuities (payout and accumulation) are very different and each insurer uses wording specific to its particular product. Often, an application includes definitions of terms that appear in the document. They should be reviewed by the agent with the investor to ensure mutual understanding.

Like the IVIC for segregated funds, the annuity application form is completed by the agent and investor together, whether virtually or in person. The application may be provided online by the insurer or in a printed format. The investor must be accurate and truthful in the information he provides; it is the investor's decision to follow the recommendation of the agent or to make his own choice of annuity product.

The recording of the information in the application should not be rushed. The agent needs to manage his time to allow the application to be completed with the investor in one sitting. He must not take away a partially completed application to fill in the missing details on his own.

Every application form needs to be carefully reviewed prior to meeting with the investor, as it is being completed, and after it has been signed and is ready for submitting to the insurer.

A mistake could be made while completing the application. When an application is in print form, a change can be made to correct an error, and both the investor and the agent initial the change as close to the changed information as possible. This is evidence that both parties acknowledge and agree to the change. A change to an online application can be made prior to submitting the document simply by deleting the incorrect information and inputting that which is correct. Consequently, the online application must be read with great attention to detail prior to transmitting in electronic format. An agent must never assume the application is correct; he must ensure it is by carefully reading all information including correct spelling of names and data copied from documents, such as a birth certificate.

Again, like the IVIC, an annuity application could be completed by a person who has power of attorney (POA) for property for another. Legal guidance is required if the person acting in the role of POA decides to name a beneficiary.

Neither the agent nor the investor has the right to modify, cancel, or waive any question on the application. Doing so can void the application.

An application is not finalized until it is accepted by the insurer.

As with the application for a segregated fund, a reason-why letter is prepared and reviewed with the client when the application is submitted. This letter does not confirm that the policy has been issued; it paraphrases what the agent has learned from the proposed client, confirms what was discussed and when and sets out the plan of action. It substantiates the reasons why the annuity is suitable for the client's needs. The letter must be easy to understand and brief. After the agent has reviewed the letter with the client to ensure its accuracy and gather his agreement with the proposal, he should make a copy for his client file and for the client.

7.2.1.1 Registered or non-registered annuity

A contract may be issued for a registered or non-registered annuity.

The contract owner and annuitant must be the same person when the annuity is registered. The registered contract is subject to all rules set by the *Income Tax Act* (ITA) for registered accounts which include:

- The age at which income may be paid from the account;
- Requirement for a minimum withdrawal;
- Withholding tax on withdrawals;
- What happens to the account if the account owner dies.

All withdrawals from registered accounts must be declared for tax purposes in the year in which they are made.

A non-registered account is not subject to Canada Revenue Agency (CRA) rules for contributions, withdrawals, or tax deferral; however, it is subject to the rules set by the insurer issuing the contract.

A non-registered annuity may be taxed in a prescribed or accrual (non-prescribed) form. While the prescribed form is preferred because the interest component of each payment is level over the life of the annuity, the many criteria for a prescribed annuity, some of which are described in Chapter 3, must be satisfied.

7.2.1.2 Naming annuitant and beneficiary

This is a straightforward part of the application in which the owner names his choice for annuitant and, if applicable, primary beneficiary and contingent beneficiary. The agent must note the following:

- The owner and annuitant must be the same person if the annuity is registered or funded with registered savings;
- Two annuitants must be named in a joint annuity: the annuitant and the joint annuitant (also called the co-annuitant). The joint annuitant becomes the only annuitant when the first annuitant dies. The beneficiary does not receive any proceeds until the death of the second joint annuitant and then only if the contract is structured with a guarantee period;
- A beneficiary must be named in the application when there is a guarantee period unless the annuity is a life annuity with no guarantee period. When no guarantee period exists, a beneficiary is not named and cannot be added to the contract at a later date;
- When some, or all, of the premium is derived from a locked-in pension, all or part of the death benefit may become payable to the spouse instead of the beneficiary. In this case, the spouse's information must be provided unless the spouse has waived his rights to the benefit in a spousal waiver form.

As in all insurance contracts, the beneficiary can be designated as revocable or irrevocable. The owner must understand the restrictions on the policy when an irrevocable beneficiary is named. Foremost among these is the inability to change the beneficiary unless the irrevocable beneficiary provides consent to do so.

A contingent beneficiary can also be named in the application. He becomes the beneficiary if the primary beneficiary has died before the annuitant(s). A contingent beneficiary is always revocable.

7.2.1.3 Owner identification requirements

Identification requirements for the owner of a segregated fund contract are described in the previous Chapter for compliance with the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*. They are also true for the owner of an annuity contract.

There are two exceptions to identification requirements. Identification requirements do not apply when:

- An immediate or deferred annuity is funded by a transfer from a registered pension plan or proceeds of a group life insurance policy;
- The contract is registered.

The owner of an annuity contract must also provide evidence of the age of each annuitant.

If the owner is a legal entity, its identity must be confirmed by specific documentation.

7.2.2 Funding the contract

Funding for the contract takes two fundamental forms: a new cash (or equivalent) deposit or transfer of existing savings.

Sources of funds include direct deposits from accounts and transfers made from both registered and non-registered savings:

- Personal savings or chequing account;
- Bonds;
- Guaranteed Investment Certificates (GICs);
- Tax-free savings accounts (TFSAs);
- Stocks, mutual funds, and segregated funds.
- Registered retirement savings plan (RRSP);
- Registered pension plan (RPP) contributions to a defined contribution pension plan (DCPP) or recognized participation amount from a defined benefit pension plan (DBPP);
- Registered retirement income fund (RRIF);

- Locked-in retirement account (LIRA);
- Life income fund (LIF) or locked-in retirement income fund (LRIF);
- Deferred profit-sharing plan (DPSP);
- Prescribed retirement income fund (PRIF);
- Restricted life income fund (RLIF).

EXAMPLE 1

Louise, 62, receives a severance package from her employer including a cheque for $45,000. Instead of seeking another job, Louise decides to retire. She decides to buy an immediate life annuity, with a 25-year guarantee period, that will provide income right away. Louise has significant RRSP contribution room due to unused contribution room in previous years. With the help of her agent, Louise sets up a registered annuity with the $45,000 she received after having deposited this amount in an RRSP. This RRSP contribution is tax deductible. The payments she will receive as annuitant of the policy will be fully taxable in her hands.

EXAMPLE 2

Sam, age 62, is tired of playing the stock market and decides to stabilize his invested money in an accumulation annuity. His money is held in an RRSP at an investment broker. In his annuity application, he specifies the money held by the broker be transferred into a registered annuity. This is not considered a new contribution so there are no tax implications. Sam can continue to deposit to the account up to the authorized contribution limit and these subsequent contributions are tax deductible. All payments Sam eventually receives from the annuity after it is converted to a payout annuity, comprising both the amount transferred and the amounts subsequently deposited, are fully taxable in his hands.

7.3 Agent service requirements

Time brings change. Once the contract has been delivered, the agent should view the service he can provide to contract owners as an ongoing activity, to both ensure changes are accommodated in the contract as necessary and to be alert for other product sales opportunities.

An outstanding service opportunity exists for agents who have clients with RRSPs that are maturing, or the clients are members of a DCPP who must transfer their retirement savings when they leave their employer. RRSPs may be held at the same financial institution with which the agent is affiliated or others.

One of the options available to all owners of an RRSP is to convert the value of their plan on maturity to a term to age 90 annuity or life annuity to continue tax deferral. If an annuity is a suitable choice, as determined by the needs' analysis, the agent has provided a valuable service to the client by presenting this option.

Also, a client may have more than one RRSP that is maturing. The client may be best served by conversion of one RRSP to an annuity and conversion of another RRSP to a RRIF to continue tax deferral.

As discussed previously, members of DCPPs must transfer the value of their savings at retirement to an account that will pay an income. Agents can offer LIF/LRIF/PRRIF/RLIF accounts and assist the retiree with investment and income choices.

Although annuities have been eclipsed in popularity by the RRIF, which is based primarily on investment in GICs and mutual funds, they are valuable as a maturity option due to their dependability as a source of guaranteed income. There is also no need for account management or ongoing decision-making as there is with a RRIF account. If interest rates stay at the higher level they attained in 2022 or rise further, there may be renewed attention paid to annuities since annuity rates should become more attractive than when interest rates were low.

7.3.1 Contract delivery

Contracts are not necessarily delivered in person by the agent. An insurer may mail or courier the contract to its owner. However, when it is possible and safe for the agent to deliver the contract, he then has a chance to once more reinforce the value of the product purchased and answer any further questions.

7.3.2 Ongoing service requirements

For the agent, servicing the annuity contract centres on ensuring the beneficiary designation remains true to the owner's intention and, for an accumulation annuity, possibly receiving deposits and managing maturity of the contract to determine whether conversion to a payout annuity would be appropriate.

7.3.2.1 Change of beneficiary

A beneficiary may be replaced by another because the contract owner changes his mind or because the named beneficiary has died. The contract owner can name whom he likes providing the beneficiary is revocable and there are no restrictions on the contract because it has been funded by a transfer of locked-in funds from a registered pension plan.

A change of beneficiary form is completed by the contract owner and signed to effect the change. When it is submitted, all previous beneficiary designations are revoked.

The completed form must be sent immediately to the insurer.

7.3.2.2 Handling deposits

Deposits may be received by the agent as cash, a cheque, or bank draft. All deposits must be handled securely and forwarded to the insurer without delay.

As discussed, cash deposits may be a transaction that falls under anti-money laundering legislation (*Proceeds of Crime (Money Laundering) and Terrorist Financing Act*). The agent will be familiar with those rules and follow them closely to ensure compliance.

The agent should provide a receipt to the client for any cash he receives as a deposit.

Cheques and bank drafts are made payable to the insurer. If the contract has been assigned a policy number, that number should appear on the cheque.

The agent has to take every possible step to make sure a deposit is not stolen or lost while in his possession. It must not be left in a briefcase or purse in an unoccupied vehicle, for example, and it should be stored under lock and key in the office, even for brief periods of time.

7.4 Claims

A claim is made to receive some or all of the funds held in a contract. The person who makes the claim is known as the claimant. The claimant may request help from an agent or the agent may volunteer to assist. A claim that is submitted properly, including necessary attachments, will speed up processing.

7.4.1 Claims process

The agent may provide the necessary claim form or information on:

- How to obtain the claim form;
- Documentation that must accompany the claim;
- Where the claim form must be sent for processing.

A claim form must be complete and include the claimant’s signature for processing to begin.

The agent may assist in preparation of the claim but, once the claim is submitted to the insurer, it is taken over by a claims representative and the agent is no longer involved. The representative issues a cheque or cheques, or transfers funds as requested.

7.4.2 Types of claims

Payout and accumulation annuities may see a claim on death of the annuitant if a beneficiary is entitled to proceeds.

A claim may be made by the contract owner for withdrawal or surrender of a term annuity or an accumulation annuity.

7.4.2.1 Death claims

Table 7.1 summarizes who makes a death claim in annuity contracts when an annuitant dies.

TABLE 7.1

Claimant for annuity death claims

TYPE OF ANNUITY	CLAIMANT
Term annuity, prior to end of term	Beneficiary
Life annuity, no guaranteed period	A claim cannot be made
Life annuity, with a guaranteed period	Beneficiary (during guaranteed period; no claim may be made after the end of the guaranteed period)
Joint and last survivor annuity, death of first annuitant, no guarantee period	Surviving annuitant
Joint and last survivor annuity, death of second annuitant, no guarantee period	A claim cannot be made
Joint and last survivor annuity, death of second annuitant, with a guarantee period	Beneficiary (during guaranteed period; no claim may be made after the end of the guaranteed period)
Annuity with return of premium rider	Beneficiary
Accumulation annuity	Beneficiary

EXAMPLE

Douglas has an RRSP that is maturing. He chooses a term annuity to age 90 as the option most suitable to his needs during retirement. He names his four children as equal beneficiaries of the contract. Douglas receives a monthly income from the annuity. When he dies at age 86, his children share equally the balance of the contract.

If the primary beneficiary has died prior to the annuitant, a contingent beneficiary may receive proceeds. If no living beneficiary exists, the claim is then made by the executor of the estate of the annuitant and paid to the estate of the annuitant. In provinces where they exist, probate fees could then apply since the proceeds become part of the value of the estate. No probate fees apply when a named beneficiary of an annuity contract receives the proceeds of the contract.

EXAMPLE

Catherine received a monthly annuity payment from a life annuity with a 25-year guarantee period purchased by her husband before he retired from his senior level executive position. He wanted to supplement her Old Age Security (OAS) benefit so the annuity started when Catherine was 65. Since Catherine and her husband have no children, the annuity named Catherine's sister, Norma, as beneficiary.

Catherine's husband died several years ago and Norma died last year. Because Catherine suffers from advanced memory loss, she did not remember that she has an annuity and that Norma was its beneficiary so she did not name another beneficiary. When Catherine died this year, there was no beneficiary named in the contract to receive the benefit of the guarantee. Consequently, the balance of the annuity guarantee was paid in a cash refund to Catherine's estate.

7.4.2.2 Transfer of annuitants in joint contract

A joint and last survivor annuity contract names both a primary annuitant and a second, or co-, annuitant. The primary annuitant receives payments from the annuity for his lifetime. After his death, the second annuitant receives payment for life from the annuity.

The switch is initiated when proof of death of the primary annuitant is provided to the insurer.

7.4.2.3 Surrender and withdrawal claims

An accumulation annuity has flexibility that a payout annuity does not. The annuity permits both withdrawals, subject to minimum and maximum amounts, and surrender.

When the accumulation annuity is cashed in prior to its maturity date, a market value adjustment (MVA) may be made by the insurer, which penalizes the contract owner by reducing the sum he receives.

The amount of reduction due to the MVA is based on the amount of time remaining in the term of a guaranteed investment after the withdrawal or surrender, the interest rate at the time the investment was made, the current interest rate, and fees.

A surrender can be made at any time from an accumulation annuity. A term annuity may also be surrendered. In both cases, a penalty will be charged by the insurer according to contract terms. A life annuity may not be surrendered once annuity payments have started.

When a claim for surrender or withdrawal is made, it must in a form acceptable to the insurer.

7.4.2.4 Power of attorney (POA) claims

A person acting in the position of power of attorney (POA) for property may have a special form to complete as a third party in respect of the account. Again, the insurer will provide the proper form for use.

7.4.3 Factors affecting claims

When applicable, taxes are always withheld by the insurer according to the rules set out by the *Income Tax Act* when a contract is surrendered or a withdrawal is made.

The amount received from the claim and how it is paid will depend on whether a cash refund or installment refund has been chosen to protect annuity capital for the beneficiary of a life annuity, and whether a guarantee period is in place.

A claim cannot be made against a life annuity unless a guarantee exists. The beneficiary is entitled to the portion of the contract not paid to the annuitant representing the period between the start of payments and the end of the guarantee or the difference between the initial capital invested and the payments made up until the annuitant's death. The beneficiary has no further claim after the guarantee period ends.

EXAMPLE

Tara, at age 66, purchased a life annuity, paying $3,000 a month, with a 20-year guarantee period, and named her adult son, Rob, as the beneficiary of the annuity. Tara died 10 years later. Rob, as beneficiary of Tara's annuity, will keep getting $3,000 a month for 10 years, i.e., until the end of the 20-year guaranteed period.

CHAPTER 8
GROUP RETIREMENT AND INVESTMENT PLANS

Competency components

- Assess the client's needs and situation;
- Analyze the available products that meet the client's needs;
- Implement a recommendation adapted to the client's needs and situation;
- Provide customer service during the validity period of the coverage.

Competency sub-components

- Determine the client's situation, investment objectives, and investor profile;
- Assess the appropriateness of the client's existing coverage in regards to his or her situation;
- Analyze the advantages of segregated funds in comparison to other types of investments in regards to the client's needs;
- Analyze the types of group retirement and investment plans that meet the client's needs;
- Propose a recommendation adapted to the client's needs and situation;
- Confirm the requirements that must be met to implement the recommendation;
- Validate the appropriateness of contract amendment, renewal and termination applications in regards to the client's situation;
- Inform the claimant of the claims process.

8
GROUP RETIREMENT AND INVESTMENT PLANS

The previous chapters in this manual have focused on investing products and plans for a single client, or a client that is a couple, and the role of the life insurance agent working with such individuals.

In this chapter, the focus changes. The agent now becomes a service provider to a group sponsor or administrator and it is the group sponsor or administrator that is the client. The agent works with that client to achieve its objectives with the group it represents.

The group itself may be as small as a few people or number in the thousands. The group sponsor or administrator may have sought the expertise of the agent for other insurance products, such as group life or accident and sickness coverage. However, when the objective is savings and investment – typically for retirement income – the sponsor or its administrator then seeks the agent's recommendation for an appropriate plan.

The sponsor who offers such a plan is making a commitment to the group members and this commitment cannot be undertaken lightly. There are both considerable financial obligations for the sponsor and administrative costs incurred when a group plan is offered. The sponsor's rewards are the appreciation of the group members for the benefit the plan provides and the loyalty the plan engenders. This helps the employer retain its employees and avoid the expense of higher employee turnover. The plan may also enable the sponsor to attract employees.

In order to provide sound advice to a sponsor or administrator, the agent must be familiar with many aspects of group plans, including:

- Group structure;
- Plans available, including the client's existing plan, if applicable;
- Investment options;
- Recommendation process;
- Group documents;
- Service requirements;
- Claims process.

8.1 Group plan structure

A group plan is comprised of its sponsor, its administrator, its members and its insurer. The agent must be aware of the rights and responsibilities of each to ensure he provides appropriate service.

8.1.1 Group plan sponsor

A group plan is established and registered by its sponsor, usually an employer, with Canada Revenue Agency (CRA) and the provincial authorities concerned when it is a registered pension plan (RPP). It is subject to the requirements specified in applicable provincial pension benefits legislation. This includes compliance with filing certain reports, the possible need for an auditor's report, actuarial reports, and other reports as required by the jurisdiction in which the group plan is registered.

Alternatively, some group pension plans are federally regulated and are not subject to provincial legislation. They are provided to employees who work in an industry that is federally regulated, such as banking.

Registration with CRA ensures that the annual maximum registered retirement savings plan (RRSP) contribution limit is not exceeded since registered pension plan (RPP) contributions by an individual reduce the amount that he can contribute to an RRSP.

8.1.1.1 Role of plan sponsor

The sponsor's role in providing the plan to its group members is to:

- Design the pension plan according to its needs, yet within the sponsor's financial limitations;
- Set the benefit structure for members;
- Establish, amend, or terminate the plan;
- Ensure compliance with regulatory requirements for reporting;
- Address funding shortfalls or surpluses.

Final decisions about a group plan will be guided by the administrator and the life insurance agent but are, in the end, the responsibility of the sponsor.

8.1.1.2 Funding commitment by plan sponsor

A sponsor takes on the financial commitment to fund the group plan as a joint contributor with the group members, or alone on behalf of the group members:

- When the sponsor and the group member both contribute to a plan, it is said to have contributory funding. Defined benefit pension plans (DBPPs), defined contribution pension plans (DCPPs), group registered retirement savings plans (GRRSPs) and pooled registered pension plans (PRPPs) may all be contributory.
- When the sponsor alone contributes to a plan, the plan is non-contributory. A deferred profit sharing plan (DPSP) is non-contributory; other plans may also be non-contributory if the sponsor makes the decision to forego employee contributions.

When a plan has contributory funding, group member contributions are made through payroll deduction. Therefore, the contribution is made before take-home pay is received.

Contributory plans may see the sponsor offer a matching formula in which the sponsor bases its contribution on the one made by the group member. The sponsor can match 100% of the member's contribution, in other words a dollar-for-dollar contribution, or it can be a different percentage. The matching formula can be structured to:

- **Increase over time:**
  In this case the matching contribution increases the longer the employee works for the employer. This can decrease employee turnover and employee loyalty is rewarded.
- **Reward employees based on their value to the sponsor:**
  In this case, the matching contribution can vary for different categories of employees. Therefore, the most valuable employees are more highly rewarded for their service.
- **Create loyalty:**
  The matching contribution may apply after an employee has worked through a defined waiting period. This helps to retain employees and discourage new hires from seeking other employment opportunities.

Matching contributions can be changed or stopped at any time if they are not a condition of an employment contract or collective bargaining agreement.

The vesting provisions of a plan also impact funding requirements for the sponsor. Vesting describes who owns the sponsor's contributions to an employee's plan.

During a period of time called the vesting period, an employee who changes jobs does not retain the sponsor contributions to his group plan; the employee retains only the contributions he made. However, at the end of the vesting period, the sponsor contributions become the property of the employee. In some cases, vesting is immediate and the employee retains both his and his employer's contributions when he leaves. A shorter vesting period is more expensive for the plan sponsor because his contributions could leave with the departing employee after the briefer period of time.

Each jurisdiction establishes its own vesting period. Two years is frequently considered typical but vesting may be immediate or as long as three years.

EXAMPLE

Natalie begins her new job on September 1. Her employer plan, a defined contribution pension plan (DCPP), has a six-month waiting period. On March 1, her plan begins with a contribution made by Natalie, deducted from her payroll, and a 100% matching contribution by her employer.

The plan has a one-year vesting period. If Natalie changes employers before the end of the vesting period, she will retain the contributions she made to the plan. As for her employer's contributions, they will be retained by the employer. However, if she leaves after one year, Natalie will retain both her contributions and those made by her employer.

Natalie may be able to transfer her pension plan savings to her new employer. A locked-in retirement account (LIRA) is another transfer option available to her. If she decides on transferring to a LIRA, she can be in charge of the savings and will have investment options of her choosing available instead of being restricted to those offered within a group plan.

8.1.2 Group pension plan administrator

The group pension plan sponsor appoints the person or entity that is plan administrator. In Québec, for example, group plans containing more than 25 members must be administered by a pension committee. In many plans, the sponsor is also the administrator. When the employer acts as the plan administrator, it must take into account the best interests of the plan's beneficiaries and not act solely in its own best interests.

The pension plan administrator has financial and administrative functions. Those functions are performed by resources in the organization, such as human resources, or accounting, or a third party. When a third party is used, it is typically a firm that specializes in employee benefits and services. The agent works closely with the administrator throughout the entire process: proposal, recommendation, implementation, and follow-up.

For a DCPP, the role of administrator may be assumed by the plan sponsor, a board of trustees, a financial institution (for a simplified pension plan) or a pension committee as defined by pension benefits standards legislation.

8.1.2.1 Role of group pension plan administrator

The administrator is responsible for overall administration of the pension plan including:

- Management of the pension plan;
- Establishing a written statement of investment policy;
- Investing the fund assets in accordance with that policy;
- Creating and distributing other plan documents;
- Acting in accordance with applicable legislation.

The foremost task of the administrator is to administer the plan in accordance with the Act that governs the plan and its regulations. The administrator has a fiduciary duty to plan members. To fulfil that duty, he must act honestly, in good faith and in the best interests of members, former members, and others involved in the plan. The administrator must also use the care, diligence and skill that a cautious person would exercise when dealing with the property of another person.

The administrator knows the size and composition of the group and its needs. He is involved with the employer's payroll department in order to make any deductions required for the group pension plan by its members. He also describes the benefits of the group pension plan to job applicants and reinforces those benefits to members of the group. The administrator enrolls new members and withdraws members who quit the company, or retire. He is also the person group members can turn to for information, to initiate claims or to process withdrawals when he is changing jobs or retiring, or when changes are required.

The administrator is also responsible for:

- Measuring employee satisfaction with the plan;
- Monitoring industry trends, governance guidelines, and legislative changes to keep the sponsor apprised of new developments;
- Suggesting potential plan and investment recommendations;
- Assisting with plan sponsor governance activities;
- Reporting to the sponsor.

8.1.2.2 Data provided by group pension plan administrator

The administrator provides the data about the composition of the group to the agent to enable an application to be completed. He has access to the records of all members and is, thus, privy to sensitive financial details. This information is protected by privacy legislation and must be kept highly secure.

The group plan administrator ensures all the necessary information is provided to group members about the plan and their membership in the plan through the pension statement regularly provided to them. The statement details can include:

- Type of plan;
- Amount deposited to the plan;
- Accumulated earnings;
- Account balance of the member;
- Investment allocation;
- Net return on the account for the period covered by the statement;
- Current years of service;

- Projected pension payable;
- Normal retirement date;
- Earliest retirement date at which an unreduced pension may be received;
- Beneficiary details.

The statement also specifies that projections are estimates based on information provided by the sponsor and the actual terms of the pension plan are outlined in official by-laws.

When a group plan member leaves the group, due to a change in employment or retirement, the administrator must provide him with a written statement of his rights within a specified period of time. That statement tells the member:

- The total funds in the member's account as a result of his contributions, contributions by the employer, transfers, and additional voluntary contributions;
- Details about the pension benefits payable to the member;
- Options for transfer or withdrawal;
- Deadline for choosing an option.

8.2 Group retirement and investment plans

Group plans provide investment and retirement savings opportunities. These retirement and investment plans are available to many different types of groups, but they are associated foremost with employers. The group members are employees, which may include everyone from the top of the organization through to those at the bottom.

A group plan for savings and investment, specifically to assist with retirement savings, is a valuable employment benefit. This is especially true when the employer contributes to a plan on behalf of employees. The employee's pension savings can grow faster and larger thanks to employer contributions. Also, the value of a plan can be received by a spouse in the event of death of the plan owner or a beneficiary in the absence of a spouse.

Another benefit appreciated by employees is the disciplined savings aspect of payroll deductions for plan contributions. Saving by payroll deduction eliminates the temptation to spend take-home pay and save what is left over. Instead, saving is achieved by removing the contribution directly from earnings and then issuing the balance as take-home pay. There is no opportunity to spend money that is not actually received and withdrawal restrictions on locked-in savings further prevent access to money that is slated for retirement.

All members of a group plan enjoy creditor protection of their savings, except when the account is a tax-free savings account (TFSA).

Membership in a group pension plan also provides a future benefit to its members through the ability to split income with a spouse. When a group member receives pension income at age 65 or older and receives the pension income tax credit, he can split the pension income with his spouse. Splitting income is an important strategy to reduce income tax.

A group plan is customized to the needs and wishes of its sponsor. It chooses the most suitable type of plan and decides on the contributions and benefits according to its financial circumstances.

The agent's role during the sales process is to help the sponsor identify available options and create the plan that best meets its objectives, both for the present and for the foreseeable future. When a plan already exists, it should be analyzed for suitability so that a recommendation can reflect current conditions in light of needs.

8.2.1 Existing plan

The agent may find some sponsors without any form of pension or savings plan and others whose plans no longer meet needs or align with company resources.

An existing plan may not have sufficient appeal to attract the talent the company seeks, especially if a competing firm has a better group plan on offer.

There may also be good reasons to supplement one plan with another, such as providing a DCPP to all group members plus a DPSP that is based on company profitability for senior executives.

The agent must be prepared to analyze both the existing type of plan to provide comparisons against other similar plans and whether the benefits of the plan continue to be appropriate for its sponsor and members.

Some key factors of an existing plan that are analyzed are:

- Suitability of plan to sponsor objective;
- Cost of plan to sponsor;
- Investment options and their suitability for members;
- Rate of member participation;
- Compliance with regulators' requirements;
- Support to members by investment provider, such as a Website customized for the specific plan and navigation that makes it easy for members to monitor and change investments.

8.2.2 Plans available

Pension plans are one of two basic types: a single employer plan or a multi-employer pension plan (MEPP). A single employer pension plan is exactly as its name describes: a pension plan for a person who works for one employer.

As for the MEPP, it covers employees who work for two or more employers that are not affiliated with each other. Rules differ between jurisdictions for this type of plan. It is most commonly found in unionized work environments and contributions to an MEPP are made on a fixed contribution basis as determined in collective bargaining.

This chapter covers single employer pension plans only. Accordingly, agents who work in communities with a significant unionized workforce will want to acquaint themselves thoroughly with the MEPP rules that apply in that jurisdiction.

Some group savings and investing plans, such as DBPPs, are only available through a sponsor. Other plans, such as TFSAs, are available both through sponsors and to individuals who are not enrolled in group plans.

Group plans are intended to supplement personal savings; they are not a replacement. Contributions to group plans may reduce RRSP contribution room but group members should be encouraged to save outside their group plans to build savings for the future and take advantage of tax deferral on savings.

A sponsor may implement a single group plan, such as a DCPP, or various group plans. For instance, a DCPP could be combined with a GRRSP or a DPSP, to help the employer attract and retain top talent.

When a member of a group plan is offered a choice of two or more investment options within the plan, he is enrolled in a form of plan known by its umbrella term, a capital accumulation plan (CAP). Therefore, DBPPs are not CAPs because the member has no investment decisions to make. However, DCPPs, PRPPs, GRRSPs, TFSAs and DPSPs are all capital accumulation plans.

When a plan is a CAP, guidelines describe the rights and responsibilities of the plan sponsor, service providers such as the administrator, and members. These guidelines are standards intended to ensure that members of a CAP receive the information and assistance they need to make suitable investment decisions.

CAP guidelines supplement legal requirements for pension plans. They reflect the expectations of all Canadian pension, insurance and securities regulators.[35]

As discussed previously regarding their contribution to individual savings, these same plans must be considered from the sponsor's point-of-view:

- Defined benefit pension plan (DBPP);
- Defined contribution pension plan (DCPP);
- Group registered retirement savings plan (GRRSP);

35. Canadian Association of Pension Supervisory Authorities (CAPSA). *Guideline No. 3 – Guidelines for capital accumulation plans Consultation Draft*. [online]. Revised May 2022. [May 17, 2022]. https://www.capsa-acor.org/Documents/View/1904

- Deferred profit sharing plan (DPSP);
- Group tax-free savings account (TFSA);
- Pooled registered pension plan (PRPP).

Groups may also be offered a non-registered investment account.

The following group plans convert registered savings into a pension income stream for group members:

- Group life income fund (LIF) for savings created in a DCPP;
- Group registered retirement income fund (RRIF) for savings created in a GRRSP.

It is very important for the agent to understand that a group member receives retirement income when the savings he has accumulated in his group plan are transitioned into a plan that pays a pension. One exception to this is the DBPP in which the pension is paid by the plan directly. Other plans, such as a DCPP for example, may operate in a similar manner, accumulating savings, but many administrators require their members to take the value of contributions at retirement in a lump sum. To receive a pension and continue tax deferral, those funds are transferred to a LIF or an annuity; both make payments and in this way, a personal pension is created. If the retiree does not wish to start his pension, he can transfer the lump sum to a LIRA.

Table 8.1, provided later in this chapter, assists in understanding plan administrator responsibilities in the course of the transition process.

There are other pension plans that an agent may encounter such as an Individual Pension Plan (IPP) or a Supplemental Executive Retirement Plan (SERP). These plans are beyond the scope of this manual.

8.2.2.1 Defined benefit pension plan (DBPP)

The gold standard of RPPs, the DBPP pays a known sum to its members at retirement. The pension income is generally determined by employment income and years of service.

Contributions may be made by the sponsor alone (as noted previously, in a non-contributory plan) or by the sponsor and group plan member (a contributory plan).

The sponsor is fully responsible for ensuring that funding is adequate to provide the promised pension at retirement. If contributions are insufficient or investment performance has not met expectations, the sponsor must make additional contributions to cover the shortfall. Sometimes, a sponsor is unable to meet its financial commitment to its pension plan. Such a plan is described as underfunded. If the sponsor is insolvent it cannot be forced to fully fund a plan. In such a case, the pensioner-members receive a pension less than promised.

A pension plan may also have a value (due to contributions and investment returns) greater than its payment obligations. This is called a pension surplus. Sponsors are discouraged from building surpluses both by taxation of the surplus and because a company can be required by regulators or the courts to use a surplus to enhance pension benefits.

A DBPP may be terminated by its sponsor or converted to a DCPP. It can also be offered in addition to a DCPP in what is called a combination or hybrid pension plan. Required contributions are made to the DBPP but the group member can choose to increase his pension by making voluntary contributions to the DCPP.

The group plan member has no investment choices to make when he is enrolled in a DBPP. All investment decisions are made by the sponsor and/or administrator.

The sponsor's contributions are a tax-deductible expense and are not a taxable benefit to the plan member.

When income begins in retirement, it is paid as a joint and last survivor annuity for the member and, upon his death, to his spouse, although the pension received by the spouse is typically a reduced amount. A sponsor may choose to index payments to increases in the cost of living. Doing so affects plan pricing for the sponsor.

DBPPs were once the most common form of pension plan. This is no longer the case because some employers have recognized the significant ongoing financial commitment to the corporation created by pension contributions. This expense has been exacerbated by lower pension fund returns as a result of low interest rates coupled with increasing lifespans. The low returns in the funds and pension income that is paid for a longer period of time mean that sponsors are being required to make up shortfalls by special contributions between pension fund value and obligations. Many have taken advantage of their right to switch their DBPP to another form of pension that is less expensive, such as a DCPP.

EXAMPLE

Lifespans in Canada are on the rise, and this creates pressure on the sponsors of DBPPs who are committed to providing a pension for life for their plan members. For instance, the Ontario Teacher's Pension Plan is a well-funded DBP that provides generous benefits to its members, teachers in Ontario. It reported that, in 1990, the plan had 13 pensioners aged 100 or more. In 2020, there were 147. In 1990, the Plan expected a pensioner to receive his pension for 25 years. In 2020, the expected years on pension were 32. This illustrates the increasing financial pressure on a plan as a result of longer lifespans.[36]

36. Ontario Teachers' Pension Plan. *Funding Considerations*. [online]. [Consulted May 17, 2022]. https://www.otpp.com/content/dam/otpp/documents/otpp-2021-annual-report-eng.pdf

8.2.2.2 Defined contribution pension plan (DCPP)

A DCPP is also known as a money purchase plan (MPP). A DCPP does not create the same financial pressure on its sponsor as a DBPP for the simple reason that no set pension income is promised to members of a DCPP, so the sponsor is not responsible if a shortfall occurs. The members' pension is a result of the amount of contributions made, how long contributions are made, the choice of investments, and the performance of the selected investments.

DCPPs are gaining market share over DBPPs because of their reduced financial obligation on the sponsor. Some DBPPs are being converted to DCPPs and more sponsors are choosing to introduce a DCPP over a DBPP. This trend is likely to continue since many pension plan sponsors do not want to be responsible for pension fund returns and the fact that plan obligation values increase as lifespans increase, as occurs with DBPPs.

DCPP sponsors need not be concerned about investment returns or longevity of members; they set up a plan, make their specified contribution to the plan, and ensure ongoing compliance with regulators.

The administrator of a DCPP is responsible for educating all plan members about the details of their plan. Members are provided with investment information to make informed choices of their investments; providing this information is one of the sponsor's obligations set out in the CAP guidelines. Often, such education is provided by the insurer providing the plan in the form of online tools, a member-only website, mobile apps, newsletters, seminars, and other learning materials.

The DCPP sponsor has a minimum financial obligation for each plan member, set out in the plan as a percentage of member income, and plans accordingly. There is no requirement to increase contributions over time.

Sponsors have a number of ways to structure a DCPP for its members. They can make participation optional, require members to increase contributions over time, or restrict the number of investment options available.

Like the DBPP, sponsor contributions are a tax-deductible expense and are not a taxable benefit to the plan member.

The sponsor or administrator chooses investments that will be made available to plan members. Each member is generally responsible for choosing from among those investment options. In certain circumstances, the sponsor or administrator may choose the options for all members. The options may include segregated funds, mutual funds such as target-date funds (a form of mutual fund that becomes increasingly conservative as the date on which the funds are needed draws closer), and guaranteed investment accounts.

A DCPP can be very beneficial to the member who actively contributes, monitors and manages his investments. He can access available investment options, switch among investments according to his needs and investment performance, and can tailor investment risk to his personal risk tolerance.

On the other hand, some plan members may find the choice of investments both complex and confusing. This could lead to delayed decisions or a failure to make decisions. When a decision is not made or cannot be made with confidence, the default investment option may be used. This option, in almost half of DCPPs, is a target date fund. In Alberta, the default option is a balanced fund or a portfolio of investments that takes a member's age into account.

The sponsor or administrator assists members to make suitable investment decisions, particularly those whose level of education, investment experience, or level of literacy indicates that such help is required. However, the onus for investing is on the group member to achieve their retirement savings goal.

8.2.2.3 Group life income fund (LIF)

The DCPP creates a pool of retirement savings for its members. When a group member with a DCPP decides to receive retirement income, he is required to transfer his savings to an account that requires minimum withdrawals. His savings are locked in; this limits his choices to income-paying accounts that accept locked-in funds. One of those choices is a LIF.

The LIF can be set up by a person who transfers their pension savings, or it can be provided by the sponsor on a group basis. The group LIF allows continuity for the plan member and lower administration fees than the non-group alternative.

LIFs require annual minimum withdrawals and restrict the maximum that can be withdrawn. They are available in all provinces, but sometimes under different names. The percentages for minimum and maximum withdrawals differ between provinces.

The sponsor can present the group LIF as an additional advantage of employment to potential employees, a significant benefit for employees intimidated by the prospect of going-it-alone when retirement arrives and having to decide what to do with their pension savings.

8.2.2.4 Group registered retirement savings plan (GRRSP)

GRRSPs are a type of savings plan that permit contributions by both sponsors and members.

Anyone familiar with an individual RRSP, available through all financial institutions, finds a GRRSP easy to understand because the two plans are fundamentally the same.

Total annual contributions to a group RRSP and an individual RRSP are limited to the individual's RRSP deduction limit for the year (as provided by Canada Revenue Agency (CRA) in the latest Notice of Assessment).

EXAMPLE

Reginald works as an assembler for an electronics manufacturer and earns $60,000 a year. He participates in the company's GRRSP – both the employer and Reginald contribute 5% of his earnings to the plan.

Total contributions to the GRRSP are $6,000 ((60,000 × 5%) × 2). Since Reginald's income was the same last year, *i.e.* $60,000, this year's RRSP deduction limit is $10,800 ($60,000 × 18%).

As Reginald's contribution to the company GRRSP was $6,000 for the year, he can contribute up to $4,800 ($10,800 – $6,000) to his personal RRSP.

One of the differences between an individual RRSP and a GRRSP is that the GRRSP does not generally permit purchase of individual securities, i.e. stocks. However, fees for a GRRSP are usually lower than an individual RRSP.

Contributions made by the individual and the sponsor to the GRRSP vest immediately. Therefore, the GRRSP can be expensive for sponsors who have a high rate of staff turnover since their contributions will have vested and become the property of the employee whenever the employee departs.

There is an additional cost to sponsors of GRRSPs because their contributions are considered to be additional salary paid to members. Therefore, they incur payroll charges, such as Employment Insurance, on their contributions to the group plan.

Sponsors who offer a GRRSP make no financial commitment to an eventual pension for members. Like a DCPP, members control their investment activity and contributions; they are responsible for the pension they create.

A benefit of the GRRSP is that contributions are made through payroll deduction. This form of contribution typically makes saving easier.

Contributions by the employer are taxable as income to the employee and are tax-deductible by the employer.

The sponsor of a GRRSP incurs no obligations other than collecting and remitting contributions of plan members. Therefore, this plan may appeal to organizations with limited resources to devote to plan administration.

Maturity options are similar for individual and group RRSPs. Savings accumulated in a GRRSP must be transferred into a group or an individual registered retirement income fund (RRIF) or an annuity, the end of the year in which the account owner turns 71 at the latest, to continue tax deferral.

8.2.2.5 Deferred profit sharing plan (DPSP)

A DPSP plan is funded by employer contributions only. Contributions to the plan arise from profits. Years with lower profits may see the company suspend contributions. Therefore, a DPSP is most appropriate for those organizations with stable profitability to ensure that contributions to the group plan can be made annually and continually.

Employer contributions and fees are tax deductible for the business and are not a taxable benefit to plan members. Thus, employer contributions are not subject to payroll taxes on federal and provincial government plans.

This plan can be used to motivate employee productivity and performance since contributions are linked to business profitability. Employees receive a tangible benefit from their efforts; as the company profits, so do they. However, employees who own 10% or more of the shares of the company cannot be members of the DPSP, nor can those who are related to the employer or a specified shareholder.

One of the benefits of the DPSP is the ability of members to make partial withdrawals at any time. However, a plan sponsor can choose to restrict withdrawals while the member is employed.

The sponsor selects the available investment options and members choose from those investments. Once again, like the DCPP and GRRSP, the sponsor does not commit to providing a specified future pension.

A DPSP is often used in coordination with a GRRSP to which only members contribute. Employee contributions to the GRRSP are matched by employer contributions to the DPSP. DPSP contributions create a pension adjustment for members and therefore reduce RRSP contribution room. This arrangement is also possible with a DCPP.

EXAMPLE

Mark, a life insurance agent, has set up a meeting with a technology company to review their group savings and investment plan. The company set up their group plan, a DCPP, a few years ago, believing that the plan provided a way for the company to attract some of the best talent in their business, video gaming, without creating financial pressure on the company.

However, since that plan was implemented, the company has grown astronomically. It is enormously profitable, and expects revenues and profitability to continue to grow. There is no problem hiring; the company is sought out by applicants due to the strength of its product line and commitment to ongoing development.

The objective of the company is changing from using a group plan to attract employees to using a group plan to reward employees. Retirement income is not top of mind for employees right now since their average age is 36.

Mark proposes a DPSP for the company. The DPSP can easily be funded from corporate profits and it aligns well with the philosophy of this younger workforce who strongly believe company profits should be shared with those who help create those profits.

Mark illustrates the benefits of the DPSP in comparison to the DCPP and any disadvantages. If the company proceeds, it will continue to offer its DCPP plan since the DCPP continues to provide dependability in case the fortunes of the company change, and the DPSP will start once it has been properly registered and a contract issued to the sponsor.

Like a GRRSP, the money saved in a DPSP can be transferred to a group or an individual RRIF, or an annuity, to continue tax deferral.

8.2.2.6 Group registered retirement income fund (RRIF)

DCPP, GRRSP and DPSP members accumulate savings in their accounts. While the DCPP member's funds are locked-in, savings in GRRSPs and DPSPs are not. Therefore, these plan members need a registered account to which they can deposit their savings to continue tax deferral when they are ready to begin income. The group RRIF is a plan that can be set up by the sponsor on the members' behalf in order to transition registered savings into pension income.

A group RRIF accepts transfers directly from the GRRSP or DPSP and offers its members the same features as RRIFs available to individuals. It requires a minimum annual withdrawal but has no maximum amount a member may withdraw.

Savings in the GRRSP or DPSP must be rolled into the group RRIF (or individual RRIF) no later than the end of the calendar year in which the plan member turns 71. While a RRIF may be set up at any age, it is advisable to set one up only when retirement income is needed, because once a RRIF is set up, mandatory minimum withdrawals must be made every year, with the exception of the first year. Withdrawals from a RRIF are fully taxable as income.

The group RRIF enables sponsors to offer retired employees continuing service, such as information brochures, webinars, and investment seminars, in addition to lower fees than individual RRIF accounts.

8.2.2.7 Group tax-free savings account (TFSA)

The group TFSA is a newcomer to the group market but is rapidly gaining in popularity as the public develops a better understanding of the product and the entire concept of a savings account that is tax-free. Tax-free means:

- No tax deductions on contributions;
- No need for tax deferral;
- No taxation on withdrawals.

As with other group plans:

- Sponsors are not obliged to contribute; if they do, contribution is considered additional income;
- Sponsors are not responsible for providing a specified pension income to group members;
- A choice of investments is available.

The group TFSA limits contributions exactly the same way as individual TFSAs. Each taxpayer is allotted an annual contribution limit (the dollar amount of contribution permitted for the year plus any unused contribution room from previous years). That sum is available for his group plan contribution, his individual plan contribution, or a combination of both. In other words, one limit applies to the total of all contributions. The annual limit cannot be exceeded without stiff penalties.

An important benefit of the group TFSA (and the individual TFSA) is that contribution room is independent of other plans. Therefore, the maximum contribution can be made to a TFSA and an RRSP. Moreover, members benefit generally from lower investment fees as compared to individual plans.

Unique to the group TFSA, as compared with other group plans, is the ability of plan members to make tax-free withdrawals at any time, since contributions are not locked in. This provides flexibility for savings.

EXAMPLE

Darleen is the owner of a small, prestigious real estate firm that serves a niche market in a wealthy suburb. Her employees, all real estate agents, are at either end of the usual working age: either their mid-to late 60s or in their mid- to late 20s. They all earn significant six-figure incomes every year, and have enjoyed high earnings for the past number of years.

Darleen's financial success is a result of her agents' success and she wants a group plan that will recognize employees' lengthy service without creating a significant tax burden for them. She knows that they have all made maximum RRSP contributions and have no available contribution room. They all pay tax at the highest marginal tax rate.

Darleen needs to retain her long-standing employees. She knows from experience that the younger ones are not particularly loyal, but the older employees are. None of them plan to retire in the foreseeable future.

A group TFSA does not have a maximum age for contributions so, on this basis, is a good fit for Darleen's older employees. Darleen creates a group TFSA for her more experienced employees on the basis of their years of service: those who have worked for ten years or more for Darleen are eligible to join.

Darleen contributes the annual maximum to each employee's plan and is quite happy to bear the cost of contributions plus additional payroll taxes. The agents can take withdrawals from the account, whenever they wish, on a tax-free basis. This approach is very tax efficient for the members of the group plan.

8.2.2.8 Pooled registered pension plan (PRPP)

The PRPP is a relatively new type of group pension savings plan intended for individuals who do not have pension plans available through their employer or for those who are self-employed. They access the plan through licensed PRPP administrators. Administrators include some large life insurance companies.

PRPPs are available federally and in all Canadian provinces and territories. Québec has adopted an equivalent plan, the voluntary retirement savings plan (VRSP).

The PRPP gives smaller companies a pension plan to offer employees without the compliance requirements of other group plans. Plan members benefit from lower administration costs than through individual savings options and the portability of their rights; as members change jobs, the PRPP follows them.

Employers may contribute to the plan in addition to employees; contribution limits are the same as individual RRSPs. They make no commitment to a future pension. Contributions made by the employer are not included in the member's income, and they are not tax deductible for the member. Account values are creditor-proof. They are locked-in and can be cashed out only due to disability, loss of Canadian residency, or if the account is less than 20% of the annual year's maximum pensionable earnings (YMPE). Otherwise, when employment ends, they must transfer to a LIRA, LIF, another PRPP or used to buy an annuity. On death of the plan member, the spouse receives the account value or, if there is no spouse, a beneficiary receives the money.[37]

8.3 Group plan investment options

One of the significant benefits of group plans for members is the lower investing fees members pay in comparison to individual investors; this puts more of their savings to work as investments.

When the group investment is a segregated fund, the management expense ratio (MER) is less than what an individual would pay. The lower fee means a larger retirement fund can be built.

37. McCarthy Tetrault. *Is Anyone Interested in PRPPs?* [online]. [Consulted May 18, 2022]. https://www.mccarthy.ca/en/insights/articles/anyone-interested-prpps

EXAMPLE

10 years ago Janet's contribution to her DCPP was $4,000 for the year. She invested in the most growth-oriented segregated fund she could identify. The fund earned 10% annually and, because it was offered through a group plan, the MER was just 1% per year (net return of 9%, i.e. 10% – 1% MER). After 10 years, Janet's initial investment was worth $9,469.45 ($\$4,000 \times 1.09^{10}$).

If Janet had made the same investment outside the group plan, the MER charged would have been 2% per year (net return of 8%, i.e. 10% – 2% MER). After 10 years, Janet's initial investment would be worth $8,635.70 ($\$4,000 \times 1.08^{10}$).

Therefore, in 10 years, Janet was able to increase the value of her initial investment by $833.75 ($9,469.45 – $8,635.70) due to the lower management fees charged to the group.

Group members choose from the investment options made available by their plan sponsor. These can include segregated funds and annuities.

8.3.1 Segregated funds for groups

Segregated funds may be an option made available to members of pension plans in which the member makes the investment decision. Therefore, they may be offered to members of all plans except those enrolled in a DBPP.

8.3.1.1 Types of funds available

Like the segregated funds available to individual investors, there is an enormous amount of choice. For instance, bond, equity, target, balanced, or specialty funds may all be made available through a group plan.

However, the actual segregated funds offered to group members as an investment option in a customized group plan are picked, sometimes with the help of the agent, by the sponsor or administrator. They ensure that group members have a choice between funds that offer capital preservation, growth, or income alone, or in combination, such as a balanced fund would provide.

8.3.1.2 Advantages and disadvantages of group segregated funds

Segregated funds available to group members have a number of distinct characteristics compared to segregated funds available on a personal basis. Unlike segregated funds offered to individual investors, segregated funds for group members have no sales charges. This means savings can be invested in full, without a sales load. They also do not charge switch fees for group members.

Also, the MER on group-provided segregated funds is generally lower than the MER paid by individual investors. This is due to the primary disadvantage of group segregated funds; they do not offer a maturity or death benefit guarantee nor group plan special rates.

The absence of these guarantees increases risk of investment loss for the group member.

8.3.2 Annuities for groups

Annuities for groups are provided for the group itself, for group members, and for retiring group members.

8.3.2.1 Types of annuities available

Sponsors that introduce DBPPs face considerable risk in funding their future pension obligations. They must predict, with the help of actuaries, how much they should set aside in their pension fund for future pension payments. They are concerned with the future rate of return of the pension fund and retirees' longevity.

A way to manage that risk is for the sponsor to buy annuities from an insurer in a pension buy-in. An insurer sells annuities to the pension plan sponsor that have guaranteed payout rates that match the sponsor's pension obligation. The insurer then becomes the provider of the pension benefit. Therefore, the insurer takes over the risk of funding the future pension from the sponsor. The benefits promised to retirees are unaffected by the change in provider.

This concept of a guaranteed pension also applies to DBPPs for companies that wind up their pension plans because they go out of business. Their pension obligation does not end, even when the company shuts its doors. Their retired group members receive their pensions as expected from the insurer.

Members of a GRRSP may be provided with the investment option of an accumulation annuity for their savings. The annuity pays guaranteed interest for a fixed term or a date specified by the investor.

Members of a DBPP have a life annuity option when their contribution terminates at retirement. Members in a GRRSP and DPSP have the option of a term annuity or a life annuity. Life annuities may be available as a joint and last survivor annuity and provided with or without a guarantee period.

8.3.2.2 Advantages and disadvantages of group annuities

Annuities provided in the group context provide the same reliability of income as those provided to individuals. They provide security, stability, and peace of mind.

Their disadvantages are also the same; there is no flexibility for withdrawals and they cannot be terminated once payments begin. Pension payments are linked to the annuity rate at the time of purchase – since payments will not increase if interest rates rise, the annuities therefore carry interest rate risk and inflation risk.

8.4 Group plan recommendation

The agent must carefully formulate the recommendation for a group plan, just as he would do for an individual. Although he may be working and negotiating with one entity, the sponsor or administrator, he must never lose sight of the group members that this administrator represents. The agent should consider the demographics of members, their general level of skills and expertise, their education, and their degree of employer loyalty, as measured by employee turnover.

He needs to understand the objectives when the group is initiating a savings and investment plan for members, and what factors motivate a group with an existing plan who may be considering changes.

The agent has a disclosure obligation to his client, the sponsor. He must inform the sponsor of the insurers that he places business with, particularly the firm that is being recommended for the sponsor's policy. The agent should focus on those companies he places business with most often, or most regularly, instead of an exhaustive list of every single company with which he has dealings. In Québec, an agent who is bound by an exclusive contract with an insurer must disclose this fact to his sponsor-customer.

It is also necessary for the agent to inform the sponsor if there are financing arrangements in place between an insurer and the agent. This includes whether a loan had been provided by the insurer to the agent or if there is a commission advance on the sale. These types of arrangements can be viewed as a conflict of interest.

Otherwise, the sponsor must be provided with the basic information about how the agent is compensated for the sale – whether by commission or a fee, and if a bonus or travel incentive exists. Specific dollar amounts must be provided if the sponsor requests such details. The agent must also obtain written approval from the sponsor if he receives an increase in compensation after the sale is completed.

The agent must be prepared with executive-level presentations of his recommendations since the sponsor may want to question the agent directly about his suggestions, including:

- Plan specifications;
- Plan and investment recommendations;
- Pension credits and adjustments.

One important aspect of plan design is when or under what conditions a group member is entitled to receive a full or partial pension, since this will have a direct bearing on cost for the sponsor. The DBPP may specify a set age, i.e. 65, or it may specify a required number of years of employment (called service) or it may be a combination of age plus qualifying years of service that must be satisfied before the full pension can be paid. The generic formula of age plus service is called a qualifying factor. It is more commonly known by the actual number associated with a plan, such as the 85 factor. However, it does not have to be the number 85; at one time it was known as the 90 factor. It could just as easily be the 75 factor.

The employee adds together his age and qualifying years of employment with the sponsor. For instance, an employee who is 55 and has 30 years of employment meets an 85 (55 + 30) factor. If his pension required the 85 factor to be satisfied in order to qualify for a full pension, then this employee could retire with a full pension at age 55.

The plan may also specify a minimum age at which the full pension can be received. If the full factor cannot be satisfied, either because the employee does not have enough years of service or because he is too young, then a partial pension may be paid. The conditions for paying the partial pension will be described in the plan document.

8.4.1 Review of plan specifications

There are many aspects of group plans that enter into a recommendation and final decision. Key factors and related questions to be taken into consideration are:

- **Funding:**
  Will there be a sponsor funding commitment, and if so, how much annually? Will contributions be uniform across all group members? When will vesting occur?
- **Costs:**
  What are the annual costs of each type of plan to the sponsor, including contributions and administration? How will the sponsor determine the age at which a full retirement pension will be paid?
- **Sponsor characteristics:**
  Is the sponsor anticipating significant growth in its workforce? How does this impact the group plan?
- **Group members:**
  Is it more important to retain some members than others? How can the sponsor ensure members participate? Is the sponsor prepared for its commitment to educate members when the plan falls under CAP guidelines?
- **Administration:**
  Who will the administrator be?

8.4.2 Recommendation for a plan and its investments

Developing a recommendation requires the agent to comprehend the composition of the group in order to understand whose needs will be served and whether needs are short term or long term. For example, if the group is comprised of members for whom, on average, retirement is very distant, then a plan that provides retirement benefits alone may not be the best fit for that sponsor or its members.

When a group is more likely to be motivated by a plan that satisfies more immediate needs, then, for instance, a GRRSP could have much higher appeal since it may be used to assist in accumulating a down payment to purchase a home through the Home Buyers' Plan. The GRRSP may also fund adult education expenses through the Lifelong Learning Plan (LLP).

A group TFSA may also appeal because withdrawals are permitted; this flexibility for savings and withdrawals can be very attractive to those with short-term cash requirements.

A DPSP can have an immediate effect on employee morale and retention when employees receive deposits to their plan from their employer. Unfortunately, there could be a reverse effect if an employer is unable to make a contribution due to poor profitability, and especially if that condition is repeated consecutively over a number of years.

When the administrator and agent have reached certain conclusions and agreed on how to proceed, the agent develops his recommendation for the most suitable type of plan and its investments with the group specialists at the insurer or insurers he represents.

The group specialists have expertise in the many aspects of group plan structure and delivery. They also keep informed of changes in legislation and compliance requirements to enable the agent to prepare an accurate and comprehensive recommendation.

The sponsor must be prepared for its funding obligation and the effect that this funding has on profitability and shareholder expectations.

8.4.3 Pension credits and adjustments

Pension credits are created in plans every year except in GRRSPs, PRPPs and group TFSAs. The pension credit is a measure of the value of the benefit the member earned or accrued during the year. The fiscal year for participation in the pension plans is the calendar year, January 1 – December 31. However, a plan may be implemented at any point during the year. The method an employer uses to calculate pension credits depends on the type of plan and its provisions.

Pension credits for DBPPs, DCPPs and DPSPs are calculated to determine a member's pension adjustment (PA) for the year. The PA reduces the amount that a member can contribute to an RRSP or a PRPP in the following year.

Therefore, the formula for an RRSP or PRPP maximum contribution for a DBPP, DCPP or DPSP member is:

Contribution based on previous year's earned income
(to annual maximum) - pension adjustment =
this year's contribution limit

EXAMPLE

Ahmad's maximum contribution limit for his RRSP this year is 18% of his previous year's earned income. His earned income for the previous year is $48,000, so his maximum RRSP contribution is $8,640 ($48,000 × 18%). His pension adjustment for last year was $3,300 due to the contributions made to his DCPP at work. Therefore, he can contribute $5,340 ($8,640 – $3,300) to his RRSP this year.

Contribution room to an RRSP and PRPP can be increased by a pension adjustment reversal (PAR). If too much has been taken as a pension adjustment (PA) in a year – for instance, due to the plan member retiring or being terminated during the year – then the PA is recalculated. The difference between the full and the reduced PA is the PAR.

A sponsor may increase benefits of a plan, for instance, by crediting all members with additional years of employment or by retroactively increasing the benefit formula. This creates a past service pension adjustment (PSPA) for the member. A PSPA reduces RRSP contribution room. The administrator must calculate and report PSPAs.

When presenting his recommendation to a plan sponsor, it is important that the agent explain the tax effects of participation in the pension plan with the PA or the PSPA, if the plan is amended retroactively.

8.5 Group plan documents

The group application to the insurer may incorporate suggestions provided by the agent and insurer or may be the result of a sponsor decision. Many documents must be provided to the pension authority in the jurisdiction in which the plan is being registered by the plan sponsor.

Like all forms that the agent has a role in completing, those required to establish a group account must be filled out accurately and submitted in a timely manner to the insurer.

The insurer that manages the pension fund for the sponsor provides a regular financial report to the sponsor. The report keeps the sponsor informed of investment income and benefits paid to members. It also provides information on the allocation of funds among investment options and among the members.

8.5.1 Application

A group application is completed first by the administrator on behalf of the group. The application goes through underwriting by the insurer. When the application is accepted, the contract is then prepared naming the sponsor or the administrator as contract owner or holder.

Once the application for the group is approved group members can apply on their own behalf to join the plan as they become qualified. Members may not enroll until their waiting period has been completed.

All members entitled to participate in the group plan by virtue of plan design are accepted. For instance, a plan could be set up so that all employees who have worked for the employer for six months are entitled to join the pension plan and are automatically enrolled.

8.5.1.1 Member forms

Many forms to be completed by members are provided through their group administrator or a Website that provides secure member account access.

Membership enrolment is the first form for a member to complete. Members will thereafter receive a certificate of membership that details the many aspects of their plan. It includes an identification number.

Members have other forms available to meet their needs. At the time of enrolment, they may have forms to name, or change, a beneficiary or provide a waiver of a joint and last survivor pension or a waiver of a preretirement death benefit.

A member may also temporarily leave the plan due to disability or maternity leave. A leave of absence form is provided to accommodate a suspension of contributions for reasons specified by the plan. Using this form also means the member does not need to satisfy another waiting period to rejoin the plan after he returns to work.

Finally, at retirement, the plan member must provide a notification of intended retirement some months before retirement actually occurs. Income begins at the selected date, if plan requirements for minimum age or age plus service have been met.

8.5.2 Account transfer

Members with locked-in pension contributions may be required to transfer the value of their pension plan when they no longer work for the plan sponsor, due to retirement or a change in employers. The administrator facilitates transfers according to the instructions of the member.

Agents have a client service opportunity with those group members. If the member has – or will have – the opportunity or obligation to move his pension plan savings, the agent could initiate a discussion about transfer options in preparation for such an event. This conversation can develop from consultation with a prospect or client on any life, health, or investment product.

8.5.2.1 Transfer options

The sponsor follows the instructions of the plan member when he leaves the plan due to a change in employment or retirement. Options available for transfer depend on the type of plan and whether the plan member wishes to continue savings, and its corresponding tax deferral, or to begin receiving income from his savings through withdrawals.

Whether income may start partly depends on age at the time of transfer, since withdrawals may not be possible before a specified age.

A member from a DBPP who quits can transfer the commuted value of his pension into the pension plan of the new employer and be recognized for years of service under the new plan only if there is an agreement transfer between the two plans. The terms of pension plans are not all the same. The value of one plan may not be equivalent to another plan and a shortfall can arise. If so, the employee can contribute the sum needed to make up the shortfall in a lump sum within a specified deadline or pro-rate the amount of transfer.

Plans may also differ as to when a pension is available. A group member would likely not want to transfer commuted value from one plan that permitted retirement on a full pension at age 62 to another plan in which the full pension is provided at age 65.

The group member of a DCPP may also be offered entirely different investments if he transfers to another pension plan. Even if he finds the new range of options unsuitable, the transfer cannot be undone. Once the funds are switched, they are permanently embedded in the new plan unless the employee once again changes employers.

These many conditions must be carefully considered by the group member before a group plan-to-plan transfer is contemplated.

A transfer of accumulated funds to a locked-in retirement account (LIRA), or other self-administered plan, eliminates the problems associated with a group plan-to-plan switch. The account owner must be prepared to make investment decisions as he goes it alone. For best results, he should be knowledgeable about the investments available to him and be prepared to monitor his account regularly. He takes on the responsibility of creating the equivalent of the pension income for himself and his spouse.

Table 8.1 highlights the responsibility of the plan administrator when a plan member leaves his employer or retires. In either case, the administrator acts according to the employee's instructions.

TABLE 8.1

Plan administrator responsibility when member leaves his employer or retires

TYPE OF PLAN	WHEN EMPLOYEE LEAVES HIS EMPLOYER	WHEN EMPLOYEE RETIRES
Defined benefit pension plan (DBPP) or Defined contribution pension plan (DCPP)	Leave in the plan the member's pension rights or calculate the commuted value of DBPP pension or value of the DCPP and transfer to an option suitable for locked-in funds or to the new employer's group plan.	Begin retirement DBPP pension payments, or transfer the commuted value of DBPP pension or value of the DCPP to an option suitable for locked-in funds.
Group registered retirement savings plan (GRRSP)	Transfer value to the employee's individual RRSP, RRIF, or group plan of new employer. The plan may also be cashed out.	Cash out the value of the plan, or transfer the value of the plan to a GRRIF or RRIF, or buy a term or life annuity.
Deferred profit sharing plan (DPSP)	Transfer value to the employee's individual RRSP, RRIF or group plan of new employer, purchase an annuity (term or life annuity), or cash out the value of the plan.	Cash out the plan, or transfer the value of the plan to an RRSP, GRRIF, RRIF or buy a term or life annuity.
Group tax-free savings account (TFSA)	Transfer value to the employee's individual TFSA or cash out the value of the plan.	Transfer value to the employee's individual TSFA or cash out the plan.

8.6 Agent service requirements

Agents may initiate the process of implementing a group savings and investment plan by identifying potential sponsors, and meeting with them to illustrate the advantages of such a plan. Throughout the entire process of group sales and service, the agent facilitates matters, responds to the sponsor's needs, and is the point of contact and source of group information for the insurer while a quote is being developed.

8.6.1 Review plan with sponsor

The agent must seek regular input from the sponsor or administrator about the existing plan to retain and enhance the business relationship.

Reviewing a recommendation that has been made and not acted upon can be important in building group business. The agent's recommendation may have arrived at an inopportune time for the sponsor, and the sponsor may not have been able to reveal its reasons for inaction. Those reasons may have changed or been eliminated and the agent may find the sponsor becomes responsive to the idea of a plan in future.

8.6.1.1 Annual review

An annual review meeting, whether actual or virtual, gives the agent the opportunity to reinforce the value of the plan in meeting the sponsor's objectives. It is also vital to discover if those objectives are changing.

It is essential for the agent to stay informed of changes to group savings and investment products, such as the introduction of the pooled registered pension plan (PRPP), and how those changes could affect the sponsor's plan. He should also maintain a high standard of knowledge about pension trends to discuss impacts with the sponsor.

8.6.1.2 Change in circumstances

Just as important as providing information to a sponsor or administrator is the agent's service role in bringing information about a sponsor back to the insurer. The insurer needs to know about changes to composition of a workforce (both growth and shrinkage), financial circumstances of the sponsor, change in administrator, and other relevant details.

A sponsor may choose to wind up, or end, its pension plan. This requires filing the necessary forms with the provincial pension regulator. The value of the pension plan is held in trust for its members and cannot be accessed by the sponsor.

Other conditions under which a plan is wound up include:

- The sale of all or part of the business to a new owner that does not provide a pension plan;
- The business is downsized or closed;
- All or most members are no longer employed with the sponsor;
- Bankruptcy and insolvency of the sponsor.

8.7 Claims by group members

A claim from a group member is initiated to receive the funds in his plan. In order to make a claim, a group member needs to provide the group name and certificate or identification number to the insurer.

The appropriate claim form must be completed by the group member to enable the claim to be processed. If a group member dies, the spouse will be called upon for information to enable his claim to the pension proceeds. This type of claim needs to be handled efficiently since the surviving spouse may need to access the proceeds of the plan.

As discussed previously, forms may be accessed online or through the administrator. Whenever the agent is involved in the completion of forms, he needs to devote his full attention to detail, to ensure accuracy and completeness of information.

8.7.1 Claims for exceptional circumstances

Contributions to some group plans are the basis for locked-in savings. Withdrawals cannot usually be made by the group member when savings are locked in. Their purpose is to fund retirement income. However, there are some exceptions to the locking-in rule that allow the savings to be accessed earlier than they would otherwise be available or in larger withdrawal amounts. These exceptions vary by province and whether the pension is provided by a federally regulated industry, but fundamentally it is possible to unlock funds when:

- Life expectancy of the contributor is shortened;
- Financial hardship is proven;
- The member is no longer a Canadian resident;
- The balance of the account is less than a specified sum;
- Funds are being transferred to a life income fund (LIF) or restricted life income fund (RLIF for federal pensions) and a partial withdrawal is available.

Claims being made under any of these circumstances require that the necessary forms be completed by the group plan member.

CONCLUSION

Segregated funds and annuities are important investment products that help individual and group investors save, accumulate wealth and create retirement income. Their many benefits include their backing by Canadian insurers, which are among the most financially robust financial services companies in the world. This status can give Canadian investors great confidence in both the products and the companies that create the products.

The life insurance agent must always ensure that his recommendation of investments is in the client's best interests. To do this, the agent must understand the client and his investment objectives. Regardless of the agent's belief in the strength of the segregated fund or annuity investment, if the investment is not suitable and does not serve the client's needs, objectives, and risk tolerance, then the agent must not pursue his recommendation.

However, when the recommendation for a segregated fund or annuity is the right fit for the client, the agent can achieve a great deal of satisfaction in knowing that he has provided a valuable service and product to a client that can help achieve financial objectives.

Being in the business of providing investments also means the agent needs to keep on top of new developments in investing including the introduction of new products, new trends, new analyses, and new requirements for compliance. Reading this manual has been the start of the learning process. It leads to ongoing responsibility and rewards.

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