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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
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
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
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
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
TFSA	Tax-free savings account
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 regards 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 are important because they provide guarantees to investors. They help investors reach 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 represent information fairly, and to know the limits to advice.

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 focussing on segregated funds and annuities in particular.

1.1.1 Concept of investing

Investing occurs when money is used for the goal of making more 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 that will be repaid to the investor plus a profit. That profit is called the “return.”

Many investment options 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.

Compounding usually refers to earning interest on an investment. When the interest is paid, it is reinvested in the investment. The next interest payment is based on the principal and interest already received. 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

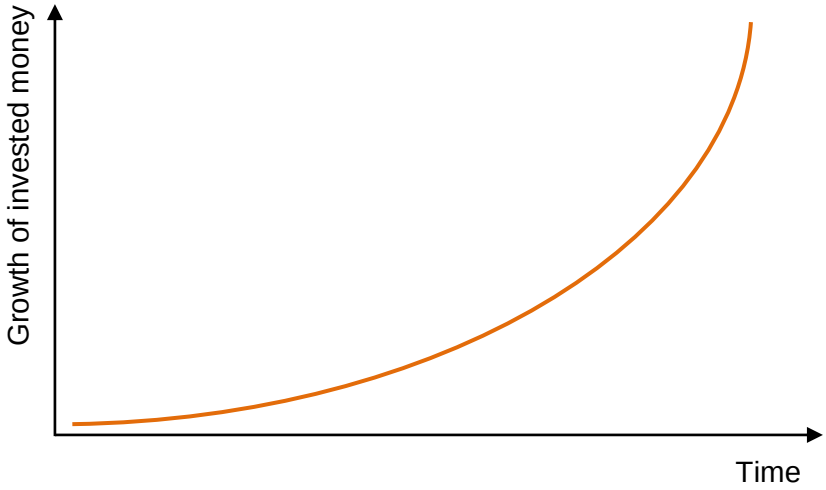
YEAR	INTEREST IS RECEIVED ON:
1	Principal
2	Principal plus interest earned in year one
3	Principal plus interest earned in years one and two
4	Principal plus interest earned in years one, two and three
5	Principal plus interest earned in years one, two, three, and four
–	Etc., until the investment matures,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

There is also a scale of risk for investments, which tells the investor 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, very low risk, and the top of the scale, 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 with a speculative investment is very uncertain of receiving back any of the invested money. 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.

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.

EXAMPLE

If the annual nominal return on a Canada Premium Bond (CPB) is 2% and the annual rate of inflation is 1.2%, then the real rate of return on the bond is 0.8% (2% – 1.2%).

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 manages risk. It is based on the idea that, by combining asset classes and investments within those classes, investing risk will be lower and overall returns will be higher, as compared to investing all in one security.

Another form of diversification uses foreign investments to take advantage of different economic conditions in other countries.

Segregated funds are a good example of a diversified investment. Each segregated fund is invested in a wide range of investments specific to its type of segregated fund. 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).

It is very difficult for an individual investor to achieve meaningful diversification unless he invests in a fund-type investment. Most investors simply do not have enough investment capital to be able to achieve diversification on their own.

1.1.2.5 Liquidity

Liquidity describes how easily an investment can be converted into cash. It is also used to describe how easily and quickly an asset or investment can be sold without affecting its value.

An investment that has characteristics of liquidity is called a “liquid investment.” Blue-chip stocks are one good example of a liquid investment since they are stocks of large, well-established, and financially sound companies. They can be sold quickly usually without a decrease in value.

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 a quick sale often translates into a sale at a lower market price than could otherwise be obtained.

Liquidity is essential when a part or all of an investment 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 to create income due to an unexpected job loss. When such a need arises, the investor must be able to 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.

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 a specified pension 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 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 5 years, given the current annual interest rate of 3%. The present value of $5,000 in five years based on 3% interest 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.

1.1.3.2 Future value

The future value (FV) calculation provides the value of a current investment at a future date, given the interest earned on the investment. It 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, he can determine how much that amount will be worth at retirement with 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 the known 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 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.

1.2 Investment objectives

Investors have many reasons for investing and saving. Their reasons are called "investment objectives." It is important for investors to articulate their objectives 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. Long-term objectives are 10 years or more and medium term is the period between 3 and 10 years.

An example of a short-term objective would be saving for a new car or for the down payment on a home. One of the most common long-term objectives is saving for retirement.

Investment objectives for individual clients are very different from those for groups. While the individual focuses on his specific needs, a group plan focuses on the needs of the group administrator, which is usually an employer. Its goal is often to offer a group retirement plan as an employee benefit. 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) — Higher/post-secondary education costs for a child or grandchild.
- Registered disability savings plan (RDSP) — Income for a disabled dependent.
- 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).

Non-registered accounts are also available for savings and investing. They have flexibility for deposits and withdrawals (unlike registered accounts).

It is important to recognize that the account itself is like a shopping bag. The bag is empty until savings go into the bag. Savings lead to investment choices and those 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 those investments are not performing adequately to meet the retirement objective. Those investments can be removed from "the bag" and replaced with others to achieve the account performance that will satisfy the investment objective.

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 very little risk. They appeal to investors who are not risk takers. For the most part, their returns reflect their low degree of risk and are lower than investments that are not guaranteed.

Guaranteed investments provide great peace of mind to their investors. Investors know what they will receive from their investment, and when. Investors with guaranteed investments have 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 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 retirement is near or because they have already retired. These individuals do not have the capacity to recover from investments in which their 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 when retirement occurs.

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.

Time horizon questions are closely related to the concepts 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, returns can be classified as interest, dividends, or capital gains. Foreign income, including foreign dividends, is taxed as interest.

Interest is taxed at the same rate as income earned from working.

Dividends, paid as a result of owning stock in qualifying Canadian companies, receive a dividend tax credit. They are taxed at a lower rate than interest.

Capital gains are also taxed at a rate lower than interest.

The lowest-risk investments tend to pay interest. Those that pay dividends tend to be riskier. 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.

In addition to being taxed at a lower rate, another tax advantage for investments that may earn capital gains is capital losses. A capital loss is received by investors if the return on their investment is negative. Therefore, if an investor loses money on an investment, he can receive 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. This reduces the amount of taxable capital gain and tax to be paid on that gain. Capital losses may be used by the investor in the year they are received, carried back to the three previous years, or carried forward indefinitely to be used against capital gains earned in the future.

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 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 a life insurance company product. 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.

All investor money is pooled in the fund. This includes deposits made by individuals and groups. Those deposits form a large pool of money that the segregated fund manager invests 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.

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.

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 than mutual funds, charged as 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.

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 equities, 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 equities since dividends can result from owning equities.

Funds offered by different insurers may have very similar names. The Canadian Equity Fund offered by XYZ Insurance Co. might not be the same as The Canadian Equity Fund offered by ABC Insurance Co. Each fund holds stocks of companies. The same companies may be represented in each fund though the amount of stock each fund holds will most likely not be the same.

The reasons so many funds are created is to provide a choice 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. It is stated as a percentage and it can be a positive number, such as 5%, that shows a profit has been created, or a negative number, such as -5%, that 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 its 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 the past to predict the future.

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 policy owner will receive a minimum of 75% of the sum he has invested. This guarantee is a minimum return since the amount the policy owner 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 of 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 unless they make a withdrawal. All returns are reinvested in the fund on an ongoing basis, as they are earned.

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.

Those 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 they come to withdraw from their registered contract, they will find all growth in the fund is taxed as interest, regardless of how it was earned. All types of investment returns in taxable registered accounts are taxed as interest. Tax-free savings accounts are an exception because they are 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 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 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.

Guaranteed investments plus segregated funds and annuities provide protection against market losses. Non-guaranteed investments can fall to zero value in the market and there is no recourse or protection available against market losses.

1.3.2 Annuities

Annuities are investments that have proven to be very reliable as a source of income. They are easy to understand, highly secure, widely available, and investor protected.

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 fix the annuity rate. They are variable. Each guarantees a minimum payment. One variable annuity links to investment performance. The other variable annuity links to the rate of inflation and increases payments in step with rising inflation.

1.3.2.1 Advantages and disadvantages of annuities

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

- Ease of understanding;
- Steady income stream;
- Two variable forms (a variable annuity and an indexed annuity) for investors who want to increase payments;
- 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.

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;
- 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

A life annuity and a joint annuity are sold only by life insurance companies. A term annuity is sold by both life insurance companies and other financial institutions, such as banks.

Compared to segregated fund investing, a person buying an annuity has very few choices about the investment. He selects the type of annuity 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 ("payout") or a form used for savings ("accumulation"). 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 Return and guarantees of annuities

The annuity payment is guaranteed for the duration of the annuity unless the contract is a variable or indexed annuity. These forms of annuity provide a minimum guarantee but may supplement that amount with an additional return. The variable annuity pays above the minimum based on performance of the equity markets. The indexed annuity is increased in step with increases in the inflation rate.

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 measurement of increase in the Consumer Price Index (CPI) that measures the cost of goods and services. It generally sees prices increase and partly explains why 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 if inflation increases the cost of living. The annuity payment buys less and less. The longer the annuity payment is received, the greater the inflation impact.

1.3.2.6 Investor protection

Assuris also 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 stocks is buying ownership in a company or companies. He becomes an owner of that company in proportion to his investment, no matter how miniscule. As investors believe that the fortunes of the company will rise, the value of the investment increases. The opposite is also true.

Information about share value is widely available through Internet sites. It is essential for investors to become very knowledgeable about a company in which they are investing.

Stock is issued in two forms: preferred stock (or shares) and common stock (or shares). Preferred shares must pay a dividend before the dividend payment is made for common shares. They also do not usually have voting rights.

Segregated funds include stocks in their equity, balanced, and growth funds. Those stocks may be Canadian or foreign. Understanding stocks leads to a better understanding of these funds.

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. Dividends are not guaranteed.
▪ 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	

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;
- 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 the 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. There is a vast amount of choice.

In order to buy stocks an investor needs an account with an investment dealer that provides trading services (buying and selling), or a discount broker. Discount services are also available online.

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.

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;
- Capital losses, when stocks are sold at a loss.

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 one of the least risky forms of stock ownership. The most risky are penny stocks.

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 firms. Forms of risk are discussed later in this Chapter.

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 expenses associated with the failure of a dealer. Included are members of the Investment Industry Regulatory Organization of Canada (IIROC), and members of the Bourse de Montréal and the Toronto Stock Exchange.

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.

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 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. Bonds are a debt obligation that must be repaid.

Bonds are issued with a fixed “maturity date,” the date when the bond comes due and the issuer must repay the full principal amount to the investor. 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.

In return for borrowing the funds, the issuer guarantees the repayment of the face value of the bond to the investor. The issuer also compensates the investor by making regular interest payments. The interest rate is called the “coupon rate” of the bond and is typically payable twice a year.

Bonds can both preserve and increase capital and can provide a predictable stream of payments in the form of interest income.

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 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 virtually guaranteed for government bonds. 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 try to meet bond obligations for the same reason. However, there is a greater chance payments will not be made for a corporate bond than with government bonds.

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.

1.3.4.2 Where and how to buy bonds

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

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

1.3.4.3 Types of bonds

Canadian government bonds are issued by the federal government, provincial governments, and municipal governments and are typically denominated in Canadian dollars. However, bond issuers from other countries may issue bonds in Canada, in Canadian dollars. These are known as foreign bonds. A Eurobond is another type of bond. It is issued by a foreign country in its currency for sale in other countries, such as bond issued by the US in US dollars for sale in Japan.

Government bonds have the highest credit ratings, because the ability to pay interest and repay principal is guaranteed by the government’s power of taxation. Among Canadian government bond issuers, federal government bonds are ranked the highest, with provincial bonds lower, and municipal bonds lower still.

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 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 financial condition, management, and specific assets backing the bond. The highest rated bonds have Aaa ratings, and the lowest are the junk bonds.

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, the bond is said to be trading at a premium. When the price falls below face value, the bond is said to be selling at a discount.

An investor who sells at a premium generates a capital gain on the sale. Selling at a discount produces a capital loss.

1.3.4.5 Risks of investing in bonds

Bond investors are open to a number of risks. These include interest rate risk, reinvestment risk, inflation risk, credit risk (for corporate bonds), 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, i.e., through the CIPF.

The CIPF protects accounts held by its members to specified limits if the dealer becomes insolvent.

1.3.5 Savings accounts

Savings accounts are offered by all financial institutions. They offer convenience and a very low rate of interest. Interest earned in the account is automatically deposited to the account.

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 offer a low interest rate. They 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.

The low rate of interest earned is a disadvantage to those who use such an account as a long-term investment. They will quickly find their savings are subject to inflation risk since the inflation rate could exceed the interest rate on the account. Their purchasing power will be eroded, and more so as time passes.

However, the savings account is a valuable short-term account 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 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, 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.

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)

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;
- No out-of-pocket fees.

Disadvantages include:

- Low rates of return;
- 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;[1]
- 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.

1. 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.

Fixed-interest GICs

The return on the GIC is a specific 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 early cashing out of funds. 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.

Variable-interest GICs

As general interest rates increase over the term of an investment, so does the interest rate of the GIC.

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

One form of annuity, called an 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 include bypass of probate and creditor protection.

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, with a term-to-maturity of 5 years or less, up to $100,000. Insurance GICs are protected by Assuris, the organization that provides investor protection to Canadian life insurance policy owners.

1.3.7 Mutual funds

Like segregated funds, mutual funds are created on the basis of investors' money being pooled into a 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.

A vast number and type of mutual funds are available for purchase. An investor has a choice of thousands of mutual funds.

Investors in a mutual fund pay an annual fee to the fund to cover compensation paid to the professional managers of the fund. This is the management expense ratio (MER), which is expressed as a percentage of the fund's value.

The professional investment 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.

Sometimes, a sales expense or commission, called a "load," may be applied against the initial amount of investment. When applied at the outset of the investment it is called a "front-end load." Alternatively, the sales commission 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). With a DSC, the rate of the commission declines over a period of years until it is eliminated. Some funds are sold on a no-load basis.

Before 2017, fund managers could select the level of risk for their funds for investors. In theory, Fund Manager A could determine that the fund under his management is low risk. Meanwhile, Fund Manager B could determine that the fund under his management was medium risk even though it was precisely the same as the fund of Fund Manager A. Investors were at the mercy of the fund managers and their determinations when attempting to align their personal risk tolerance with fund risk.

As of 2017, a standardized risk classification methodology was adopted for conventional mutual funds and exchange-traded funds. This methodology is based on using standard deviation as the sole risk indicator to determine a mutual fund's investment risk level. The standard deviation formula takes time and returns into consideration to provide a range of deviation. That range equates to one of the five levels of investment risk: low, low to medium, medium, medium to high, and high. Those levels comprise a scale as Table 1.2 shows; where a mutual fund falls on the scale is reported in its Fund Facts or ETF Facts.

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
0 to less than 6	Low

EXAMPLE

Using the new 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.

This new approach provides consistency across all fund risk assessments and allows investors to more readily compare the investment risk levels of different mutual funds.

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;
- 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;
- Tax complexities require investors to monitor fund activity;
- Trailing commissions, or trailer fees (also called “service fees”), are paid annually by the fund manager to sales agents. Trailer fees are typically higher for funds sold with a front-end load, and for equity and balanced funds. The fee is a percentage (usually 0.25% to 1%) charged against the market value of the customer’s total assets;
- An MER is charged by mutual funds for professional management services of the fund. Like the MER charged by segregated funds, this fee can erode returns significantly. The MER is determined by annual operating expenses divided by the average dollar value of assets under administration. Operating expenses vary widely depending on the type of fund.

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.

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 investor receives a simplified prospectus of the fund or funds in which he is interested. The simplified prospectus provides full disclosure of material facts that have, or might have, an impact on the market value of the fund. It also includes the annual information form of the fund, and its current financial statements.

Mutual fund companies are required to prepare and file 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 within two days of buying a conventional mutual fund.

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.

Fund units may be bought or sold (redeemed) at any time at their market value. Money market funds 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 will be 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%.

Returns of similar funds should be compared for at least the last five years to give a more accurate picture of long-term performance. It is essential for the investor to compare historical returns only between similar funds. In other words, for a meaningful comparison of performance, the results of a bond fund must be compared with the results of a similar bond fund.

1.3.7.5 Risks of investing in mutual funds

The risks of mutual funds 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 Canadian Investor Protection Fund (CIPF) mentioned earlier and the Investor Protection Corporation (IPC) of the Mutual Fund Dealers Association (MFDA) insure MFDA members.

The maximum amount of coverage is $1 million for each general account.

1.3.8 Exchange-Traded Funds (ETFs)

Exchange-Traded Funds (ETFs) are a type of security investment available in an indexed form and an actively managed form. An ETF investor buys shares in the type of fund in which he or she invests.

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 Toronto Stock Exchange, 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.

The name “exchange-traded fund” describes how this form of fund trades, that is, it trades the same as shares on a stock exchange.

Investors have to pay a commission to buy ETFs. There are also MER fees, which are lower than the MER of mutual funds or segregated funds.

1.3.8.1 Advantages and disadvantages of ETFs

Some of the advantages of ETFs include:

- Diversification;
- Convenience of stock trading;
- 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:

- Trading fees: commission is paid on buy and sell orders;
- Possible wide swings in value for ETFs that track a specific industry or sector;
- Low liquidity for ETFs that are not frequently traded or not traded in high volumes;

- 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. It is questionable whether many ETF investors could pass this test.

1.3.8.2 Where and how to buy ETFs

ETFs are currently sold by prospectus. The prospectus provides all the information on which the investor bases the buying decision. As of December 2018, an ETF Facts will be provided with an ETF order; it is similar in content and style to Fund Facts but provides additional information on ETF trading and pricing.

The investor either opens an account with a securities firm or discount broker 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 ails.

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 over time. 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.

1.3.9 Real estate

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

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:

- Ability to earn a steady rental income;
- Ability to earn a capital gain on the sale of the property;

- Ability 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 fall.
▪ Obligations of becoming a landlord	Real estate investor-landlords have many legal requirements and obligations to their tenants.

1.3.9.2 Types of investment real estate

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 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.

Market risk is another element of risk. It occurs when the real estate market declines overall.

A real estate investor may experience interest rate risk on the mortgage for the property. An increase in interest rates is also an increase in mortgage rates.

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, however all bond holders will receive their guaranteed payments on redemption or maturity.

1.3.11 Group plans

Groups that offer savings and investment plans to their members include employers, associations, and fraternal organizations. Often, the programs offered are pension plans that help plan members accumulate savings for retirement.

1.3.11.1 Advantages and disadvantages of group plans

The advantages and disadvantages for a group plan administrator (i.e., the employer) offering a group plan differ from those experienced by group plan members (i.e., the employees) who participate in such a plan.

Advantages for the group plan administrator:

- Offering of a valuable employee benefit;
- Range of plans available tailored to the objectives and financial capability of the employer;

- Ability to change the type of plan offered and its terms;
- Contributions made by an employer to a deferred profit sharing plan (DPSP) are fully tax deductible to the employer and are not subject to payroll tax;
- Contributions made by an employer to a defined contribution pension plan (DCPP) or a define benefit pension plan (DBPP) are fully tax deductible to the employer.

Advantages for group plan members:

▪ Easy enrolment in the group plan	
▪ Element of forced savings	Once a member enrolls, contributions to the plan are made automatically through payroll deduction. A member is not able to interfere in the contribution process. He is forced to save.
▪ Fees for the account paid by the group administrator	This saves the member money.
▪ Better potential rates of return than can be achieved in an individual plan	This is due to the power of group buying.
▪ No active investment decision-making for those enrolled in a DBPP	Decisions are made by the employer alone.
▪ Receiving a Pension Statement every year	This is a very important document that details contributions, returns, and may predict future income.
▪ Employer contributions required by some plans	Therefore, a plan member receives a valuable employment benefit by participation.
▪ Investment choices if plan members belong to a DCPP	Such plans usually provide a default option for saving. For those who want a choice beyond the default option, a suite of investment products is available.
▪ Online access to their group plan account	Members can thus monitor progress and results.
▪ Access to many investment tools and learning opportunities	These are provided for free by the employer.
▪ Assistance at termination or retirement	At that time the plan member is informed of his options and, if necessary, funds can be switched from one group plan to another or to individual management.

Disadvantages for the group plan administrator include:

▪ Requirement to meet pension obligations when a defined benefit plan is offered	If the plan has a deficit, the employer must make up the shortfall.
▪ Group registered retirement savings plan (GRRSP) contributions are subject to payroll tax	Therefore, GRRSP contributions have an added layer of expense.

Disadvantages for plan members include:

▪ Restricted investment choices	A specific fund or investment may be unavailable to the group plan member.
▪ Inability to control plan changes made by the employer	A DBPP sponsor may choose to convert the plan to a DCPP. Employees who knew their amount of retirement pension as a defined benefit pension plan lose certainty in regards to how much pension they will receive.

1.3.11.2 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 suitable for the investment objectives of the plan members and the financial capacity of the firm.

1.3.11.3 Types of group plans

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

- Defined benefit pension plan (DBPP) — A DBPP pays a known sum to members at retirement.
- Defined contribution pension plan (DCPP) — Also known as money purchase plans, the sum paid by a DCPP at retirement to plan members is not known in advance.
- 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) — An employer is able to share a portion of company profits with employees through a DPSP.
- Tax-free savings account (TFSA) — A TFSA allows an investor to earn tax-free investment income.
- Pooled registered pension plan (PRPP)[2] — A retirement savings plan for small business employees and the self-employed.

1.3.11.4 Returns and guarantees of group plans

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. Some employers have pension shortfalls. This means their liabilities are greater than their ability to pay. Pensioners could receive less than the promised amount of pension.

Some jurisdictions provide a guaranteed minimum income to pensioners who experience shortfalls due to underfunding. For example, in Ontario, the Pension Benefits Guarantee Fund insures pensions up to $1,000/month.

Despite how invested contributions grow over the period they are in a plan, all withdrawals from registered plans are taxed like as interest.

1.3.11.5 Risks in offering a group plan

The employer commits financially to plan contributions and 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.

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

1.3.11.6 Risks in participating in a group plan

If a plan member is responsible for making investment decisions (as in a DCPP or a GRRSP), then risks of investing, such as interest rate risk, inflation risk and market risk, will be faced by the plan member.

1.3.11.7 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.

As mentioned previously, some safeguards exist against corporate insolvency and inability to meet pension promises through the agencies that administer pension legislation in their province or territory.

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.

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

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

Some investments' rate of return is lower than the rate of inflation. When this happens, the investor experiences a loss of purchasing power. That means he is unable to buy an equal amount of goods and services in the future. Prices have increased but the amount of cash the investor has available is less than needed to pay the new, inflated, prices.

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

Investments that experience inflation risk include cash and cash equivalents, such as a money market fund and all those with guaranteed returns, such as GICs and bonds. Annuities also experience inflation risk. Segregated funds that experience inflation risk are money market types, and those invested in bonds.

EXAMPLE

Assume that the average rate of return on a one-year Guaranteed Investment Certificate (GIC) on sale today is 1.39%. The inflation rate for the last year is 1.20%. Therefore, if we assume the inflation rate will be the same for the next year, the real rate of return on the GIC is 0.19% (1.39% – 1.20%). The GIC is barely keeping ahead of inflation.

1.4.3 Interest rate risk

Interest rate risk is experienced when an investment that pays interest is tied to a specific interest rate. The investor will not be able to take advantage of higher interest rates if interest rates begin to climb.

EXAMPLE

Assume that the interest on a three-year GIC is 2.20%. Interest rates increase to 2.40% 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.

1.4.4 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 recession, a major natural disaster, or a terrorist attack.

EXAMPLE

The financial crisis that began in 2007 was an example of 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, its single-worst point drop ever. Thus, equities were affected as an asset class.

Most investors felt some degree of impact from this crisis.

1.4.5 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 the value of the asset or investment.

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

1.4.6 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 have assets or business operations in foreign countries.

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

1.4.7 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 bond issuers. Those 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 junk bonds, credit risk is very high.

Credit quality is rated by firms such as Moody's.

Moody's has provided bond ratings since 1909. It also rates many other investments and financial institutions. Its top rating is Aaa for insurance companies that offer exceptional financial security. Insurance companies rated C are the lowest-rated class and can be regarded as having extremely poor prospects of offering financial security.

1.4.8 Industry risk

Industry risk is the risk faced by specific industries. For example, the retail sector 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.

1.4.9 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.

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 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;
- Guaranteed income;
- Professional management;
- Diversification;
- Tax benefit of allocations;
- 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 market losses: a maturity guarantee and a death benefit guarantee.

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

The death benefit guarantee applies throughout the entire term of the contract. It ensures that if the policy owner or annuitant[3] dies, the beneficiary receives an amount that is equal to 75%, at least, of the initial deposit.

The minimum guarantee, and one that is available across the board, is 75% 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.

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 its value is equal to the guarantee.

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 deposit, or premium, invested by the policy owner in the segregated fund?
- What is the market value of the contract at maturity or death?[4]
- What is the guarantee: 75% or 100%?

3. The policy owner is the person who owns the contract because he pays the premium or account deposit. The annuitant is the person on whose life the contract is based (and who will eventually receive the contract payment). The annuitant may or may not be the same person as the policy owner.
4. The market value is the worth of the segregated fund units held by the policy owner. Market value is determined as: unit value x number of units owned. Valuation will be explained later on in this Chapter.

2.1.1.1 Maturity guarantee

As previously mentioned, segregated funds are issued as an insurance contract with a minimum ten-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 market performs, the value of 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 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.

TABLE 2.1

Determining withdrawal value 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. A partial withdrawal or contract surrender before the maturity date does not receive the benefit of the guarantee. Also, the maturity guarantee is reduced by withdrawals made during the term of the contract.

A policy owner who surrenders his contract before maturity receives the market value of the units minus any sales charge that may apply if the surrender occurs during the period the sales charge is applied. 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.

If a policy owner withdraws some units before the contract matures, he receives the market value of the units. If the withdrawal is made during the period the sales charge applies, the applicable charges will be deducted from the withdrawal.

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

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.

The amount the beneficiary receives is the death benefit.

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 guarantee of the contract. The beneficiary receives the greater of market value or 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 three advantages to the death benefit guarantee:

- The beneficiary is protected from downside market risk 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.
- Like the maturity guarantee, there is no limit to how much the beneficiary might receive if market conditions are favourable and unit values are high at the time of death.

Withdrawals made during the contract could reduce the amount received by the beneficiary because the sum on which the guarantee is based will be less. However, if market value is higher than the guarantee at death, then there will be no impact of the withdrawal since the beneficiary always receives the greater of market value or guarantee.

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

The payment is tax-free to the beneficiary. Its value 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

Not all insurers offer reset on their segregated funds. When it is offered, reset allows the policy owner to take advantage of an increase in market value. This has two effects: it increases the value of guarantees and changes the contract's maturity date.

As market value of the contract climbs, reset establishes the value of the contract at this higher sum. In turn, this increases maturity and death benefit guarantees and bases them on the higher market value. 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.

Reset also changes the maturity date of the contract. The new maturity date of the contract is ten years from the reset date.

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.

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.

2.1.3 Funding flexibility through ongoing deposits

The sum deposited to a segregated fund contract is called the deposit or premium. It can be made as a one-time lump sum amount or as a series of deposits.

When a series of deposits is made, the maturity guarantee may be applied to the 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 every year on January 1 for 3 years.

At the end of 10 years, her maturity guarantee is $1,500 (1 × ($2,000 × 75%)).

At the end of 11 years, her maturity guarantee is another $1,500 and totals $3,000 (2 × ($2,000 × 75%)).

At the end of 12 years, her maturity guarantee is another $1,500 and totals $4,500 (3 × ($2,000 × 75%)).

2.1.4 Guaranteed income

A segregated fund contract may be structured to create a guaranteed income stream. Such a contract is available in two forms. One pays income for a specified period of time, i.e. the Guaranteed Minimum Withdrawal Benefit (GMWB) plan, and the other pays income for life, i.e. the Guaranteed Lifetime Withdrawal Benefit (GLWB) plan. The segregated fund may be issued in a form that pays income or this feature may be added to an existing contract.

Like all segregated fund contracts, income benefit plans provide a maturity and death benefit guarantee. They are differentiated by the guaranteed income they provide.

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

2.1.4.1 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. There are two phases to these 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 or bonus 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 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 received, 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 are 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. However, it never decreases below its guarantee.

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 longer time. This is similar to the payment made from a life annuity compared to a term annuity.

Lifetime income appeals to those who are concerned about outliving their financial resources or who seek an income stream during retirement. This is also similar to the reasons clients choose life annuities.

2.1.5 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.

2.1.6 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. It is very unlikely all diversified assets in a segregated fund could lose value at the same time and to the same degree.

2.1.7 Tax benefit of allocations

Segregated fund investing creates value for an investor in two ways. First, as we have seen, the market value of the investment may increase. Second, an investor may receive allocations from a fund. Mutual funds distribute income; segregated funds allocate income.

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.

It is essential for the investor to know the value of units when they are assigned if he wishes to follow performance and monitor their increase in value. An increase may indicate that a reset is in order. As stated earlier, this monitoring is part of the life insurance agent's responsibility towards the investor.

The number of units assigned to the investor does not change unless he makes an additional deposit or a withdrawal. However, unit value changes. It increases and decreases in step with the value of assets held within the fund.

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 offered by an insurer. 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.

Allocations are another way an investor benefits financially from his segregated fund. Investment growth is generated in the form of interest, dividends and capital gains. These earnings are not distributed to investors in the form of cash. If an investor wants cash from the fund, he must make a withdrawal by redeeming fund units.

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 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. They can be used in the year they are received or in the previous three years. They can also be carried forward indefinitely. Capital gains are taxed at a lower rate than other investments, and dividends from Canadian corporations are also taxed at a lower rate than interest due to the dividend tax credit.

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).

2.1.8 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. 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 deferred sales charge (DSC) to an FEL. The insurer will state their policy for fees on switches in the information folder of the fund.

2.1.9 Ability to withdraw (redemption)

The investor enters into the segregated fund contract with the intention of seeing the contract mature in at least 10 years, i.e. the term of the initial guarantee. However, his financial circumstances can change during the ten-year 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.

If the contract is issued with a DSC, the charge in force at the time of the withdrawal applies to the amount withdrawn. It reduces the amount the investor receives. For example, if the DSC applies for six years and is stated at 2% in contract year four, then 2% is charged against the amount of the withdrawal made in year four.

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 potential gain may be included as income in the year it has been received.

2.1.10 Exemption from probate fees

Probate is the process in which the will of a deceased 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 against the value of a deceased’s estate. Only Québec does 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 Ontario, 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.

2.1.11 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.

2.1.11.1 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.

2.1.12 Creditor protection

When a person or entity, such as a business, is owed money by another, that person or entity is a creditor. A creditor may make a court claim for money owed if the borrower fails to make good on payment. Segregated funds provide the potential for protecting contract owners from the claims of creditors.

They do so 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.

2.1.13 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.

2.1.14 Right of rescission

The right to cancel a contract is known as the right of rescission.

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.

2.2 Types of segregated funds

There are numerous funds from which an investor may choose to invest in a segregated fund. 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 may be 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.[5]

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

5. Canadian Investment Funds Standards Committee. *Fund Categories, Mutual Fund Categories, Canadian Money Market category.* [online]. [Consulted June 12, 2017]. http://www.cifsc.org/canadian-money-market/

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 securities share two characteristics. They pay a specific return periodically and they return principal invested at maturity.

Fixed-income funds may be categorized as “short-term” or “long-term.” This describes when the holdings in the fund mature. For instance, a fund is described as short-term when it matures in less than 3.5 years. A long-term fund matures 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.[6]

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.

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 increase in value.

Stocks held in an equity fund may be diversified or concentrated in a particular sector, such as financial services. Higher levels of risk are experienced when an equity fund is concentrated in one sector. Such a concentration means the fund is then susceptible to industry risk in that sector.

Fund growth is achieved by a combination of reinvesting dividends paid on fund holdings and through the increase of the share prices of the stocks held in the fund.

There is a higher degree of risk with an equity fund than with many 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.

6. Canadian Investment Funds Standards Committee. *Fund Categories, Mutual Fund Categories, Canadian Fixed Income category* [online]. [Consulted June 12, 2017]. http://www.cifsc.org/canadian-fixed-income

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 another category of equity funds that translates into the marketplace in the form of large-cap funds, mid-cap funds or small-cap funds which invest in the corresponding type of company. Therefore, a small-cap equity fund in Canada invests in Canadian companies that are considered small-cap.

The market capitalization of the company is determined when all outstanding shares are multiplied by the value of a single share.

The larger the market capitalization, generally the lower the investing risk.

Market capitalization can vary significantly between countries. For instance, in the U.S. a large-cap company is valued at $10 billion or more whereas it is valued at $5 billion or more in Canada.[7]

2.2.4 Income funds

Income funds are based on the stability of bonds, with the regular interest income they pay and their possibility for capital appreciation. Income funds are not restricted to bonds and some 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 one of the lower-risk fund types. Returns to investors are also correspondingly low.

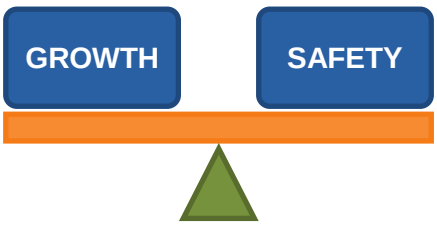
7. Advisor.ca. *A cap-size view of Canadian equities*. [online]. Updated October 12, 2010. [Consulted June 26, 2017]. http://www.advisor.ca/investments/market-insights/a-cap-size-view-of-canadian-equities-3069

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 2.1

Investing in balanced funds



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 Dividend funds

A dividend fund invests in companies that have a history of paying steady and rising 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 in bonds.

Dividend funds are considered low to medium-risk.

2.2.7 Mortgage funds

The securities in a mortgage fund are 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.

2.2.8 Real estate funds

Real estate funds must invest at least 90% of their assets in retail, commercial, industrial and residential properties.[8] 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.

8. Canadian Investment Funds Standards Committee. *Mutual Fund Categories* [Consulted June 12, 2017]. http://www.cifsc.org/real-estate-equity

2.2.9 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 management fees that are charged to the fund.

This form of investing is known as passive investing because there are virtually no decisions required of the investment manager. He simply mimics the index chosen for his particular fund and maintains the same securities in the same weight.

Index funds may be based on equity markets or bond markets. The risk of the fund is a result of the underlying market the fund tracks.

2.2.10 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.

2.2.11 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 ethical funds fill important investment objectives for their investors.

Ethical funds provide an alternative for investors who for religious, political or moral reasons find the holdings of standard funds unacceptable for investment. Investors who seek ethical funds look for fund holdings 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, when relevant.

EXAMPLE

Here is a sample list of top holdings in stocks for a fictional ethical 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%

2.2.11.1 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.

2.2.11.2 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.

2.2.12 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.

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:

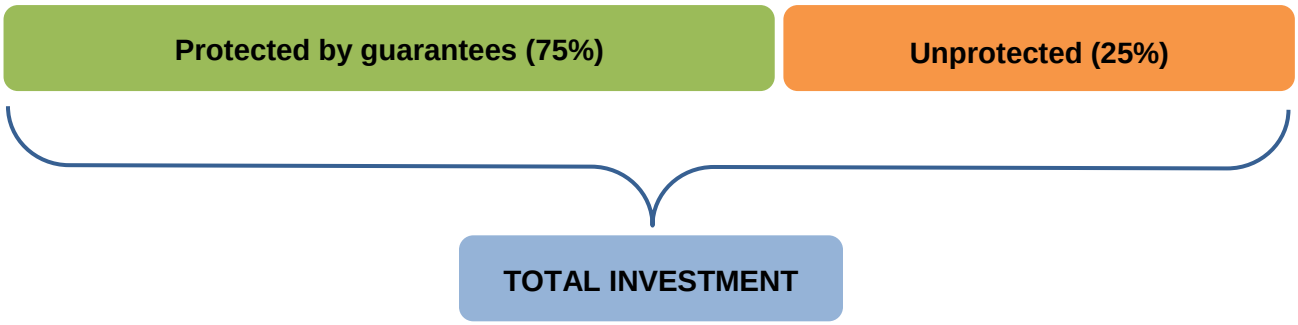
- Risk to capital;
- Sales charge;
- Management expense;
- Penalties;
- Age restrictions for acquisition.

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 2.2

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 sales charges, such as the deferred sales charge (DSC).

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.” When the sales charge is 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).

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.

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.

The front-end sales charge is also called a “front-end load” (FEL). The fee is charged to the client as a percentage of the amount he deposits to the segregated fund contract. It reduces the sum applied to the contract and reduces the amount of investment dollars that go to work for the client. The FEL also reduces the maturity guarantee and death benefit guarantee. The amount charged is usually negotiable between agent and client.

The investor who pays a FEL pays no further sales fee if he redeems units during the term of the contract.

EXAMPLE

Jose has $10,000 to deposit to a segregated fund contract with an FEL of 5% ($500). The contract value therefore begins at $9,500 ($10,000 – $500). This is the amount on which the guarantees are based.

2.3.2.2 Deferred sales charge (DSC)

The DSC applies over a set period of time to a full or partial withdrawal from a segregated fund.

The charge is a percentage applied against the amount withdrawn. It declines over a number of years until it is eliminated.

The DSC encourages investors to keep their investment and not to surrender the contract while the sales charge is in place. It also informs them of what to expect as a sales charge if they proceed with a withdrawal or surrender.

Each insurer has a schedule that lists the amount charged each year and the number of years the charge applies. Here is an example of how a DSC might appear:

EXAMPLE

Length of time after premium is paid	Charge
Less than 1 year	5.0%
1 – Less than 2 years	4.5%
2 – Less than 3 years	4.0%
3 – Less than 4 years	3.5%
4 – Less than 5 years	3.0%
5 – Less than 6 years	2.5%
6 years +	0.0%

Josephine deposits $10,000 to her segregated fund contract with a DSC. Two years later she needs some of the money. She withdraws $5,000. The sales charge applicable is 4%, according to the table above. Therefore, she pays $200 ($5,000 × 4%) as the DSC.

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 management fee for a fund, its operating expenses and the cost of paying for maturity and death benefit guarantees. 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 management company for the cost of a portfolio manager and fund oversight.

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

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.

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%). 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%).

Higher MERs are associated with funds requiring more active management and decision making, such as those that incur trading fees by buying and selling stocks. 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.

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 in the early months to deter clients from withdrawing. 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 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. Non-registered accounts and tax-free savings accounts (TFSAs) also set the 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.

Taxation of a segregated fund is based on two fundamentals:

- Whether the account is non-registered or registered, e.g. an RRSP;
- 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 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

When units of a non-registered account are redeemed for the purpose of a withdrawal or on contract maturity, 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 a registered account, it must be declared for tax purposes and the entire amount withdrawn is taxed at the same rate as interest income, except if the account is a TFSA in which no tax is declared or paid. The insurer withholds an amount specified by the Canada Revenue Agency (CRA) for RRSP withdrawals. On maturity of an RRSP (at the end of the year in which the account owner turns 71), the account value can be rolled into a RRIF account so that tax is only paid on withdrawals.

RRIF accounts require a minimum annual withdrawal. The first payment must be received in the year after the account was set up. Tax is typically withheld on withdrawals by the financial institution holding the account. However, the annual minimum RRIF withdrawal should not be charged the withholding tax. Withdrawals in excess of the minimum are subject to withholding tax.

TFSA accounts do not require payment of tax when a withdrawal is made because deposits are not tax-deductible and investment returns are non-taxable.

2.4.4 Tax on maturity guarantee and death benefit guarantee

The taxation of an amount paid as the maturity guarantee or death benefit guarantee top-up for a non-registered account is not currently defined under the Income Tax Act or by the CRA. There is lack of consensus among tax experts regarding whether these guarantees should be considered capital gain or income. The insurer must report to the investor the amount paid as the top-up. The investor will then determine with his tax advisor and the CRA how that amount is taxed.

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

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 providing for specific terms of payment. 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.

The various characteristics of annuities sold by life insurance companies are explained in this Chapter.

Annuities are usually structured on the basis of paying a regular income to the person named as annuitant in the contract. This is considered one of their most important features. Just as a working person depends on receiving employment income in a known amount on his regular payday, an annuitant can depend 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 and the presence of guarantees. All factors affecting annuity payments will be addressed in detail in this Chapter.

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

Payout annuities are funded by a premium or deposit to the annuity contract by the contract’s owner.

The contract owner chooses a schedule for payments (also called the “annuity benefit”) and the duration for payments, either for life (a life annuity) or a period of time (a term annuity). Once annuity payments begin, they generally cannot be stopped before the end of the payment period.

Each annuity payment is the same unless the annuity is indexed or variable. Most annuities are issued with a set, or level, payment.

The alternative to the payout annuity is the accumulation annuity. It “breaks the mold” for annuities because it does not pay an income. It is a form of savings with a maturity date. At maturity, it may be converted into a payout annuity or surrendered without penalty. Accumulation annuities are also known as insurance GICs.

Annuities provide investment security because they offer a high degree of dependability.

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:

- Easily understood 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 Easy to understand concept

The idea underlying payout annuities is quite simple. It is the most common form of annuity and what most people think of when they think of an annuity.

It begins with an individual who has a lump sum of capital to invest. He wants to invest it at a set interest rate and receive, in return, some of his capital plus interest every year.

Insurance companies offer an investment product called a payout annuity. The life insurance agent illustrates to the investor the many benefits of the annuity. As a result, the investor deposits his capital to the annuity and becomes an annuity contract owner. The investor decides who is going to receive the money from the contract. This person is called the annuitant.

The insurer pays the annuitant a portion of the capital and some interest earned in every regular payment. The payment schedule is selected by the contract owner.

Payments to the annuitant begin according to whether the annuity is immediate or deferred. 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 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.

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 annuities are a good choice 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. Payments continue for the surviving annuitant after the first annuitant dies.

Lifetime income eliminates 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 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 dependants 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

Annuities offer a valuable estate-planning feature through the ability to name a beneficiary to a contract. Payments are made to a beneficiary and bypass the estate. They are not subject to probate fees. The beneficiary also receives funds faster.

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 two separate products. It is a combination of permanent life insurance and life annuity.

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 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 able to make 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 continue to 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 perfectly suited to the client's needs and expectations. They include, but are not limited to:

- 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?

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 encompass all forms of annuity except accumulation annuities. They include immediate and deferred annuities, and term and life or joint life annuities.

3.2.1.2 Accumulation annuity

An accumulation annuity is a form of 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 as annuitant or naming another as 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.

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 $890 per month.[9]

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.
- Another method sees the beneficiary receive a lump-sum payment that represents the present value of all future payments. This is also known as the commuted value of the annuity.
- 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).

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 whose parent or grandparent dies, naming them as beneficiaries of their RRSP or registered retirement income fund (RRIF). 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 is paid by the child at his marginal tax rate.

9. Life Annuities. *Male term certain annuity rates*. [online]. Revised April 10, 2017. [Consulted June 12, 2017]. http://www.lifeannuities.com/term-certain-rates/male.html

3.2.3.2 A 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 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 or transfer of funds. 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 from non-registered investor savings and investments or by transfer from a registered account.

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. 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 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.

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.

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 the 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.

If a person’s cost of living increases due to inflation while his income does not, he has two choices. He can spend the income received and buy less. If he does this, he will have a reduced standard of living. His other choice is to spend more to maintain his standard of living. If he does so, he runs the risk of depleting his financial resources earlier than planned.

This feature is an expensive addition to a contract. Payments in the early years of the contract will be much lower than an identical, non-indexed annuity.

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 Toronto Stock Exchange (TSX).

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 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.

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 a 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, more or less, based on the prevailing interest rate offered in other forms of interest-bearing investments at the time the contract is issued.

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

There are three reasons for a guarantee to exist in an annuity contract:

- To guarantee that payments equivalent to what would be paid over a period of time are issued from the contract, which is known as a guarantee period, or a guarantee payment of the initial capital, which is known as a capital protection guarantee;
- To guarantee an income for a spouse;
- To guarantee that premiums are repaid.

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.

3.5.2.1 Guarantee period and guaranteed capital

A term annuity is guaranteed for its entire term. If the contract owner dies during the term, a beneficiary receives the remaining value of the annuity. The three options available for a beneficiary are discussed with the term annuity topic.

However, a life annuity can be issued with or without a guarantee period.[10] The guarantee period is stated as a number of years, such as 5, 10, or 20 years. If the annuitant dies before the end of the guarantee period, the beneficiary receives a payment from the contract. The amount he receives is the difference between the number of payments provided by the guaranteed period and the number of payments the annuitant received.

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 equivalent of 20 payments (120 – 100).

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.

These guarantees bring peace of mind to the policy owner because he knows the minimum sum that will be returned from his investment.

A life annuity is sometimes issued with a capital protection guarantee. According to this option, the beneficiary receives an amount corresponding to the difference between payments received before death 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. There would be no payment 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.

10. This also includes impaired life annuities.

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 as a result 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. Once the contract is finalized, the investor knows what to expect, through 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. While being an advantage, this exposes the annuitant to interest rate and inflation risks.

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.

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, even though the cost of the annuity is much higher than an annuity that is not indexed. This means that less is initially received in the annuity payment because the principal must be retained to increase payments in the future.

3.6.2 Loss of capital

A life annuity contract without a guarantee period risks loss of capital.

A policy owner who buys a single life annuity without a guarantee period runs the risk that the annuitant could die at any time and the balance of the capital would not be paid out. Those with a joint life annuity and no guarantee could die prematurely with the same outcome: a loss of capital.

This risk is managed by adding a guarantee period and beneficiary to the contract. Just as indexing an annuity makes the annuity more expensive to buy, so too does adding a guarantee period increase the cost of the annuity. Payments to the annuitant are less when a guarantee period exists.

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.

When the guarantee period ends, there may be another period of time preceding death of the annuitant in which the loss of capital risk occurs. This risk cannot be mitigated.

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

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 the time of withdrawal 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 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.

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.

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. 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

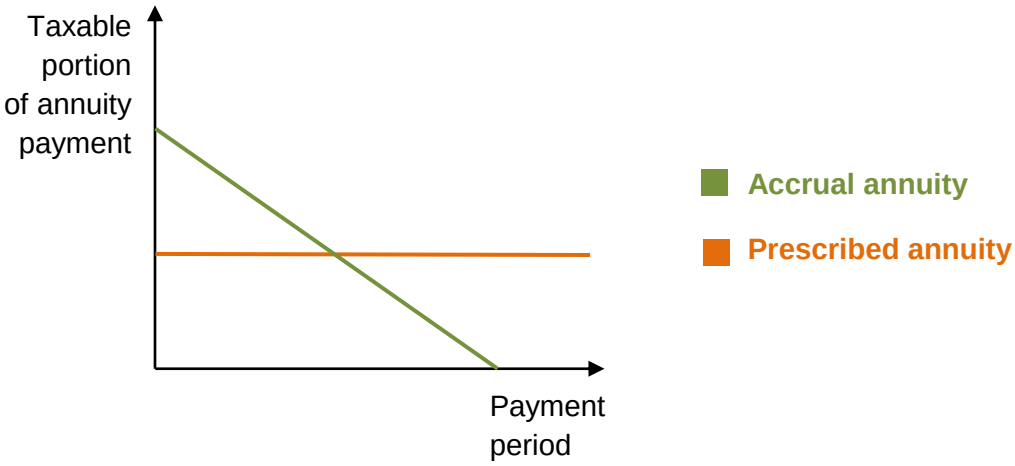
An accrual annuity payment is comprised of more interest than investment capital in its early years. Consequently, accrual annuities often have a larger amount of tax owing in the early years

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 depends on whether the beneficiary of a guarantee receives the proceeds of the contract in a continuing income stream or as a lump sum.

When the proceeds are paid as an income, the taxable portion of the payment received by the beneficiary of an annuity would be the same as for the deceased annuitant.[11]

If the beneficiary receives the proceeds as a lump sum, he will pay tax on any portion of the sum that exceeds the adjusted cost basis of the contract.

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 and the spouse pays tax at a lower marginal tax rate. Attribution rules may limit income splitting possibilities.

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11. Standard Life. *Taxation of personally owned non-registered prescribed annuities*. [online]. Revised July 2008. [Consulted June 14, 2017]. https://advisors.standardlife.ca/en/pdf/reference/taxing/5998.pdf

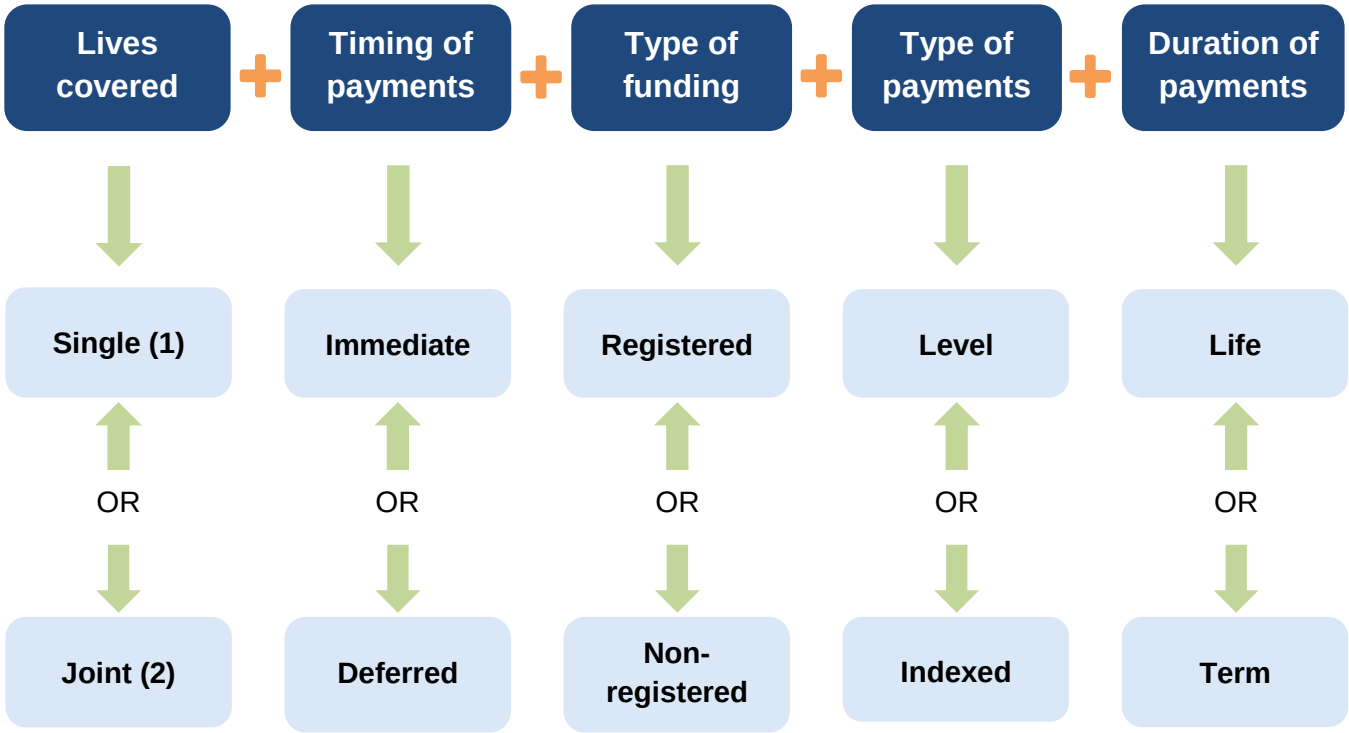
The pension income tax credit is a federal tax credit that is allocated if the taxpayer has eligible pension income such as the income paid by an annuity. The maximum credit is $2,000 annually. The tax credit is available to annuitants' age 65 and older.

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



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 can 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's 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 together a vast amount of information. The agent should take into account all aspects of the client's situation that have financial impact and not limit his analysis to the elements mentioned in this Chapter. These details are used to develop an investing strategy that aligns an investor with the investments most suitable to his needs now and for the future.

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. Net worth is the value of an individual's assets after deduction of his liabilities. Cash flow helps determine how much money is available for spending, saving and investing.

4.1.1 Review of assets

Anything a person owns, that has cash value, are assets. The single most valuable asset most people own is their home. Other personal assets include investments, a vehicle, fine jewelry, art and specialized equipment such as tools or cameras.

Assets are important for both their value 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 following elements, among others, provide information about an investor’s personal assets:

- Income tax return;
- Registered retirement savings plan (RRSP) statements;
- Non-registered investment account statements;
- Pension plan statements;
- Bank statements;
- Life insurance policies;
- Other asset sources.

4.1.1.1 Income tax return

Income is reported on the annual income tax return, which must be filed personally and separately for incorporated businesses. 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. 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 a key consideration when choosing investments and planning on using investment income due to its impact on the net amount available for retirement.

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 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.

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.

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 non-registered statement will summarize the key aspects of an 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 pension plan in place for their employees. In 2015, there were approximately 17,000 registered pension plans in Canada with over 6.2 million members.[12]

An employer pension is a valuable asset since it 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 an individual as well as calculated 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, including 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.

12. Statistics Canada. *Table 280-0016. Registered pension plans (RPPs), members and market value of assets, by type of plan, sector and contributory status*. [online]. Revised July 20, 2017. [Consulted June, 26, 2017]. http://www5.statcan.gc.ca/cansim/a26?lang=eng&id=2800016&p2=33

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;
- A real estate investor may have rental properties with asset value and receive rental income.

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. 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.

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.

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 mortgage statement can also show a reverse mortgage to be in place. A reverse mortgage is a payment of a proportion of home equity to the homeowner in a lump sum or a series of payments. It is a liability that may have estate planning considerations because the home equity received by the deceased homeowner will need to be repaid by his estate.

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 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 whose assets and liabilities are listed.

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**

4.1.4 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 and potential child and spousal support. 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 ethical investments. The agent must learn if values will affect decisions in order to develop ultimately appropriate recommendations.

4.2.2 Health concerns

It is said that one of the greatest threats to wealth is poor health. This is true for people of advanced age, or those who contract critical illnesses or are severely and permanently injured, who find they can no longer live independently and who need to pay the cost of care from their savings. That cost can be significant and it can 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 this purpose if the agent discovers this need when the client has already reached or neared the stage that 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 later years.

The need to fund care also opens the door to an introduction of long-term care insurance and critical illness insurance.

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 60s. Some older adults have difficulty making financial decisions. Increasing lifespans also present clients who are in their 80s. 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.

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.

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.

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 proceeds.

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.

Bequests in the will must be backed up with the necessary financial resources or they may remain unfulfilled. A surviving spouse can generally receive all 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 an inherited 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. A life annuity with a beneficiary is another.

Life insurance is, of course, very important for fulfilling estate plans.

4.2.3.3 Power of attorney

Although there are provincial differences in power of attorney, at its core, the power of attorney is a document that nominates a person to act for another when specified circumstances arise. It often accompanies a will. For example, a power of attorney for property can designate a person to take care of investments on behalf of another in a situation where suitable decisions cannot be made or implemented by the investment owner.

Developing the background knowledge needed for the investor profile should include whether a power of attorney has been given, to whom, and what his powers are, in order to determine in what circumstances he should be consulted.

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.

4.2.4.1 Low level of financial literacy

Financial literacy is the 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 can underscore 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.

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.

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 that of the Investor Education Fund.[13]

4.2.4.2 Risk of job loss

Job loss due to layoffs or economic developments can have a devastating impact on investing. There is little clients can do to protect themselves from such risk, but an emergency fund could help mitigate the impacts of such a situation. If job loss occurs, the investor profile should be reviewed immediately. Plans may need to be put on hold before permanent changes are implemented.

4.2.4.3 Longevity risk

Lifespan is increasing. From 1995 to 1997, life expectancy at birth was an average of 78.4 years. In 2014, men who are 65 will live to 84 on average, while women will live to 87.[14]

This means retirement savings must last longer. If savings run out during a lifetime, one is said to have outlived his money.

Longevity risk can be diminished by insurance, specifically 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.

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13. Ontario Securities Commission. GetSmarterAboutMoney.ca. *Make informed investing decisions*. [online]. [Consulted July 16, 2017]. http://www.getsmarteraboutmoney.ca
14. The Globe and Mail. *Why it’s time to stop planning your 100th birthday party*. [online]. Revised April 15, 2014. [Consulted July 16, 2017]. http://www.theglobeandmail.com/report-on-business/economy/canadian-life-expectancy-gains-expected-to-slow/article18031842/

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 ground, he has lost that amount of his principal plus he owes the amount of the loan. 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.

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 100% annual return on his investment but he needs a guaranteed sum available as 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 100% 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;
- 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 regular input of 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 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 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:[15]

▪ 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.

15. Susan Yates. *Retirement Income: Building Towards Answers*, CLIFE Inc., 2012, p. 101.

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," is 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 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.

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. The amount owed is the creditor's credit to the person, the debtor (borrower). A creditor has rights and recourses to obtain repayment of the amount owed. An asset is creditor proofed when a creditor cannot legally obtain the 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, he would need access to cash quickly to pay for needed medical care.

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. The cash flow statement shows the rate at which assets are being accumulated or used.

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 funds 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 are 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 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.

An online resource called the “Canadian Retirement Income Calculator” is available to estimate retirement income.[16]

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 pension paid to most Canadians who are 65 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.

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.

16. 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 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 every January, April, July and October if there is an increase in the Consumer Price Index (CPI).

The pension can be deferred up to 60 months after becoming eligible. The monthly payment is currently increased by 0.6% for every month (7.2% per year) up to a maximum of 36% (7.2% × 5 years) at age 70. There are no further increases after age 70 except for inflation.

EXAMPLE

In 2014, 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 $551 monthly. By waiting 12 months, it will increase to $590.67 monthly ($551 + 7.2%).

4.4.1.4 Taxation of benefits

OAS benefits are taxable income. The OAS pension is linked to income. The *Income Tax Act* establishes OAS payment thresholds: there are three levels of benefit. When a person earns less net income than the annual minimum threshold, he will receive 100% of his OAS pension. If he earns an amount between the minimum and the maximum threshold, he will find his OAS pension is reduced. If he earns more than the maximum threshold, he forfeits the entire pension and receives no OAS.

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 $75,000 of net income in 2014. The applicable threshold for the OAS pension is $71,592. Therefore, he repays $511.20 (($75,000 – $71,592) × 15%) of his OAS pension with his income tax return for 2014.

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.

Agents should consult the Government of Canada[17] website on a yearly basis to validate the current annual threshold limits.

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, 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 the 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.[18]

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 was $3,500 per year in 2017. Those

17. Government of Canada. *Old Age Security payment amounts*. [online]. Revised October 3, 2016. [Consulted June 26, 2017]. https://www.canada.ca/en/services/benefits/publicpensions/cpp/old-age-security/payments.html
18. For more information regarding the QPP, please consult the *Ethics and professional practice (Québec)* manual or Retraite Québec website: http://www.retraitequebec.gouv.qc.ca/en/Pages/accueil.aspx
For more information regarding the CPP, consult the Government of Canada website: https://www.canada.ca/en/services/finance/pensions.html

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 were made at the rate of 9.9% of pensionable earnings in 2017. 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

The amount received as a monthly retirement pension benefit 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).

EXAMPLE

Loreen will retire at age 60, in 2017. She would receive $657.90 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%)) as her CPP retirement pension.

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 five years receives a 42% increase in the amount received (8.4% × 5 years).

EXAMPLE

Joseph decides the time for retirement will arrive when he turns 69, in 2017. 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 at age 65, to $1,232.38 at age 69 ($922.44 + (8.4% × $922.44 × 4 years)).

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 and a death benefit when the contributor becomes severely disabled for a prolonged time or 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 pension is commonly called a “company pension” or “private pension.” Its purpose is to reward employees by paying a future pension income. There are a number of forms a pension plan can take. These pensions are generically called “registered pension plans” (RPPs). More specifically, the following types of RPPs are addressed here:

- Defined benefit pension plans (DBPPs);
- Defined contribution pension plans (DCPPs);
- Pooled registered pension plans (PRPPs).

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).

Employers that provide an RPP include those in the public sector and the private sector. All levels of 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 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. Once an employer registers a pension plan, it can offer the plan to qualified employees. However, a pension plan can be converted from one type to another or it can be terminated. The decision belongs entirely to the sponsor.

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 record. 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.

If an employee leaves an employer before retirement, he has the right to receive all his contributions plus investment returns earned on those contributions.

Vesting is a feature of RPPs that benefits employees. It occurs either after a period of time when contributions are made, such as two years, or after a certain age is reached, depending on the jurisdiction in which the plan is registered. Vesting puts ownership of both employee and employer contributions into the hands of the employee. Therefore, if an employee changes employers after the pension is vested, he continues to own the pension contributions of his employer in addition to his own 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) because his benefits are vested. He moves those contributions 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.

However, vesting does not mean unrestricted rights to use.

An employee cannot cash out the value of his RPP when he leaves his employer to work elsewhere or when he retires. The value of the RPP, consisting of contributions and investment growth on those contributions, is locked-in. Locking-in is a term that describes the limitations put on the access to the money in an RPP. It applies to defined benefit pension plan (DBPP), defined contribution pension plan (DCPP) and pooled registered pension plans (PRPPs).

It is possible to unlock the total 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.

There are two phases to locked-in plans: a savings phase and an income phase.

An employee who is departing a firm but is not retiring has several choices for his locked-in pension. During the savings phase he can:

- Leave the value of the pension in his former employer's plan;
- Transfer the pension value to the RPP of the new employer;
- Transfer the pension value to a locked-in account at a financial institution;
- Use the pension value to buy a deferred life annuity.

A person who transfers his pension value to a locked-in account at a financial institution will move his funds to a Locked-in RRSP (also called an LRSP) or locked-in retirement account (LIRA), depending on where he lives. These accounts are covered in more detail later in the Chapter.

Investment decisions for these accounts are made by their account owner. The types of investments available are the same as those available in an RRSP account.

The key benefit of the locked-in account is that it continues to add investment growth to the contributions in the account. Savings build. Withdrawals are prevented. Tax continues to be deferred.

An employee who never changes employers or who leaves contributions with the employer after he has gone to work elsewhere receives his DBPP pension from that employer during retirement. He has no need for transfer options or locked-in accounts. However, an employee with a defined contribution pension plan (DCPP) must transfer his contributions at retirement to a locked-in account.

RPP contributors are not able to access the value of their locked-in plans before the specified age of retirement. 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 retirement finally arrives.

The savings phase transitions into the income phase when the Locked-in RRSP or LIRA is converted to another form of locked-in plan that is structured to issue payments. This must occur no later than the end of the year in which the plan owner turns 71.

Options available for the income phase of the RPP include the following accounts. They are established at a financial institution:

- 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.

A life annuity may also be purchased from a life insurer by transferring funds from the Locked-in RRSP or LIRA.

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. Withdrawals can begin at the retirement age set by the terms of the pension plan. There is a limit to the maximum annual withdrawal, except the PRRIF which has no maximum.

If the life annuity is chosen, it also pays a regular income to its annuitant.

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), as seen earlier. 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).

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.

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, the plan 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 1/9th 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 after death of the employee.

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.

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.

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 responsible for the sum available to him as a pension since the outcome of his investment decisions determines the final value of the plan.

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 suitable for his risk tolerance and how close he is to retirement.

4.5.2.3 DCPP benefits

The retirement pension from a DCPP is a result of amount of the contributions, the length of time 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 is not ready to begin receiving income, he can continue to save in a locked-in account. If he is ready to begin receiving income, he will transfer his pension account value to an income fund 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” means they do not compete with other demands on 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, the length of time 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). These plans do not have the locking-in provisions of employer-provided pensions. They are not governed by pension standards legislation. The following employer-provided savings plans are addressed here:

- Deferred profit sharing plans (DPSPs);
- Group registered retirement savings plans (GRRSPs).

4.6.1 Deferred profit sharing plan (DPSP)

A DPSP is offered by companies to share 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 are capped at 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. Registered retirement income funds (RRIFs) are the income phase.

RRSPs are a voluntary savings program that were introduced to encourage saving for retirement through tax incentives. They are offered by many financial institutions and may hold segregated funds when offered by life insurance companies.

An RRSP account owner has responsibility for decisions about how his contributions are invested. 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.
▪ 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.

There are three kinds of fees that can be charged against an RRSP. 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. 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 that is reduced to a single fee if accounts are consolidated. 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;
- The form of account (managed or self-directed) can show investment experience or lack of investment knowledge;
- Contributions indicate dedication to savings and concern for retirement income;
- Contributions post-retirement indicate a continuing stream of earned income;
- 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.

Those with RRSP accounts may use the value in their accounts for the HBP and 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 age limit, which is December 31 of the year one 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, or have available contribution room.

Available contribution room arises because the account owner has not made the maximum RRSP contribution in a previous year. This is called the “carry-forward provision.”

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.

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.

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 over-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 RRSP spousal plan

An RRSP spousal or common-law partner plan is funded by a spouse (husband, wife or common-law partner), who has earned income and contribution room, for the benefit of his spouse. This plan is a way to split income for a couple during retirement between one spouse who earns more and the other who earns less. Splitting income reduces total income tax for the couple.

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 obligated to hold back a portion of the withdrawal in a withholding tax. This represents an advance payment and not the full amount of tax that will be owed on the withdrawal. There may be more tax owed in addition to the withholding tax, the balance 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[19]

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%

Moreover, Québec residents making a withdrawal from their RRSP (no matter the amount) must pay an additional 16% provincial withholding tax for Québec.

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 to continue tax deferral. Otherwise, he can cash out the RRSP and pay tax on the proceeds.

Transfer options, also called “maturity options,” include a registered retirement income fund (RRIF) account. Investments in the RRSP can be transferred in kind, in which case they are simply switched from the RRSP to RRIF without having to be sold. The investments in the RRSP can also be sold and the cash transferred over 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 one option exclusively. Funds in the RRSP can be split across the options. The plan owner may want some future flexibility in regard to income and apply some of the RRSP account towards a RRIF. He uses the annuity to provide a guaranteed income stream.

4.7.1.5 Death of RRSP owner

A beneficiary should be named for the RRSP account. If a beneficiary is not named, the value of the account is included on the final income tax return, and it will be included in the calculation of probate fees in the provinces where they apply. (They do not apply in Québec.)

19. Ontario Securities Commision. GetSmarterAboutMoney.ca. *Making RRSP withdrawals before you retire.* [online]. Revised June 19, 2017. [Consulted June 26, 2017]. https://www.getsmarteraboutmoney.ca/plan-manage./retirement-planning/rrsps/making-rrsp-withdrawals-before-you-retire/

Naming a beneficiary eliminates probate fees on the value of the account. If the beneficiary is the spouse, a financially dependent child or grandchild younger than 18, or any financially dependent child or grandchild who is infirm, then the RRSP can roll over tax-deferred to a registered plan in the name of the beneficiary.

If certain conditions are met, the RRSP may be rolled over on death of the account owner to a Registered disability savings plan (RDSP).

4.7.2 Registered retirement income fund (RRIF)

Registered retirement income funds (RRIFs) are a maturity option for RRSPs. The purpose of an RRIF account is to pay retirement income (even though income can begin before retirement). A RRIF is usually funded by transferring the value of an RRSP account.

A RRIF continues tax deferral on the RRSP account.

Like an RRSP account owner, an individual with a RRIF account has responsibility for decisions about investment. The same options are available in a RRIF as an RRSP.

4.7.2.1 RRIF withdrawals

An RRIF owner is required to make a minimum annual withdrawal from his account. There is no withholding tax on the minimum withdrawal, but it will be entirely taxable when filing the income tax return. 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.

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 income. Regardless of how the account has been invested and whether capital gains and losses, interest 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. The account owner can take the investment “in kind” and transfer it to a non-registered investment account or tax-free savings account (TFSA). For instance, to satisfy the minimum 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. Withdrawals above the minimum have withholding tax applied. The rates are the same as the RRSP withholding tax rates.

4.7.2.2 Death of RRIF owner

Just as it is important to name a beneficiary for an RRSP, a beneficiary should be named for the RRIF account to avoid probate fees on the account value at death. (As mentioned previously, these do not apply in Québec.)

Taxation of RRIF proceeds on the final income tax return can be avoided if the beneficiary is the spouse, a financially dependent child or grandchild younger than 18, or any financially dependent child or grandchild who is infirm. Like an RRSP, the value of a RRIF can be rolled over on death of the account owner to a RDSP under certain conditions.

A spouse who is named as successor annuitant receives RRIF payments in a seamless transition from the former recipient. If the spouse is not successor annuitant, the RRIF is collapsed and its value rolled into his RRSP or RRIF.

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 made are not taxable.

TFSAs can be opened by any person age 18 or older with a valid social insurance number.

A TFSA is a registered account.

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 can name a successor holder to continue to receive benefits of the account if the owner dies and/or a beneficiary.

The successor holder must be a spouse or common-law partner. He becomes the account owner and the account continues.

The designated beneficiary receives the account value and the account is closed if a successor holder was not named, if the successor holder predeceased the account owner, or if the successor holder was not a spouse or partner.

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 and are supplemented by contributions from the federal government for children 17 and younger.

The person who opens the plan is called the “subscriber.” The person who receives payments from the RESP is called its “beneficiary.”

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.

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 private contribution limit per beneficiary, regardless of whether the RESP is an individual or family plan. Contributions are not tax-deductible.

The Canada Education Savings Grant (CESG) is a grant of money paid by the federal government that tops up individual contributions. It is not repaid to the government if the beneficiary pursues post-secondary education. The application for the CESG is made by the financial institution in which the RESP account is opened.

An additional CESG may be paid into an RESP account, based on net family income. Low-income and middle-income families receive enhanced CESG payments. Income brackets increase annually. There is a maximum amount that can be received from the grant over the entire period of account ownership per beneficiary.

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.

Low-income subscribers may receive an additional grant from the federal government in the Canada Learning Bond. 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 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.

Contributions are returned to the subscriber or beneficiary tax-free during the withdrawal period of the plan or when it ends.

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/she 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. There is no annual limit, up to the lifetime 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 as well. 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 (starting from 2008) 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 and risk tolerance have many variables for the agent to take into consideration. Yet, it is essential to gain an understanding of risk because all life insurance is based on the concept of risk management. Segregated funds and annuities are investment risk management products.

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 of risk. 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 will self-identify which of those measures matches up with his personal risk tolerance or his agent will guide 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 often state they have a higher degree of risk tolerance than is actually true. Investors are also prone to saying one thing and doing another. This is shown by the investors who say they have low risk tolerance but invest in medium-high or high risk investments, like an equity fund. Others may state a high risk tolerance but are only comfortable with a guaranteed (low-risk) investment. 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.

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 needs no losses, only growth. 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 pursue risk, sometimes by choice at a level unsuitable to their actual tolerance for losses, because higher risk investments may pay better returns than low risk investments. The potentially better return, earned as a higher percentage and/or tax advantage, entices the investor (who risks losing principal) to make the investment.

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.

When an agent comes to define an investor's risk tolerance the agent should also take risk capacity into consideration, in other words, how much can the investor afford to lose without impacting his objectives or lifestyle? Risk capacity is measured by the investor's ability to replace his losses. 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 as an investment advisor 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 module.

The Canadian Council of Insurance Regulators (CCIR) and the Canadian Insurance Services Regulatory Organizations (CISRO) have set out the principle that the product recommended for a client must be suitable to his needs. This principle is designed to promote consumer confidence in the life insurance industry. It means that the recommended product must be appropriate for the needs of the consumer as determined by the needs-based assessment done by the life agent and/or as identified by the client.[20]

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 discussed with the client and understood by him, and recorded by the agent in client notes. This ensures the thinking behind the decision is available should the recommendation ever be questioned in the future.

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, either now or in the future. 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.

20. J-P Bernier. *Sound Business Practices for Life Agents to Stay Compliant*, CLIFE, 2012, p. 16.

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 available funds.

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, outside Québec, if the segregated fund is being acquired for estate planning purposes, then bypass of probate may be of greatest importance to the client.

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.

5.2 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 what he is investing in, 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, 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 and 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 necessary 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 undoubtedly 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. 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.

Money transferred from another investment or savings account, registered or non-registered, can form the lump-sum deposit. 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 transfer of locked-in funds also requires a locked-in account in which the segregated fund investment will be made.

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 also 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, 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 guarantees: one guarantee for each deposit or group of deposits. In that case, a series of guarantee dates indicates a series of maturity dates. The time horizon for the client must match up to the longer maturity period for the contract because of the ongoing deposits. If the time horizon is an important consideration to the investor, it may not be suitable to recommend periodic deposits with a deposit-based guarantee. However, if 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. 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.

The 100% guarantee generates a higher fee for the management expense ratio (MER). 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 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 thus does not need to be recommended per se. However, the agent may feel strongly about which guarantee (75% or 100%) the investor should have and this forms part of his recommendation.

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. 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.

5.2.5 Principal risks of segregated funds

Risks of a segregated fund are plotted on a scale with six categories: very low, low, low to moderate, moderate, moderate to high, and high. This rating which represents the level of risk of the fund is determined based on historical volatility of a fund. The level of risk of a fund depends on its underlying investments. Usually, the greater the potential return, the greater the risk.

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 very high market risk and low interest rate risk.

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 market 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 affects the maturity date, 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, 2015. 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, 2025 – 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, 2017. This locks in growth; however, the maturity date of the contract would advance to April 23, 2027. 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.

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

The sales charge or load is specified by the fund as a front-end load (FEL), a deferred sales charge (DSC) or no load. It is paid by the investor.

The cost of an FEL can be calculated by the agent for the investor. It is charged once and reduces the sum being invested.

EXAMPLE

Mark proposes to invest $10,000 in the segregated fund recommended by his agent. It has a 5% front-end sales load. Mark's investment is reduced by $500 ($10,000 × 5%) so that his initial investment becomes $9,500.

The agent can also illustrate the DSC in dollar terms based on a potential withdrawal amount and the fair market value of the fund. A DSC is charged to every withdrawal according to the DSC schedule for the fund.

EXAMPLE

Allison has invested in a segregated fund that provides the following DSC:

Length of time after premium is paid	Charge for withdrawal or surrender
Within year 1	4.5%
Within year 2	4.0%
Within year 3	3.5%
Within year 4	3.0%
Within year 5	2.5%
Within year 6	2.0%
After year 7	0.0%

Scenario 1

In year 5 of the contract, Allison wishes to redeem a sufficient amount of units to receive a net amount of $25,000. Therefore, she makes a withdrawal on the following basis.

Since the withdrawal in year 5 is subject to a DSC of 2.5%, Allison will receive only 97.5% (100% – 2.5%) of units redeemed. If she wishes to obtain $25,000, she must therefore redeem units in the amount of $25,641 ($25,000 ÷ 97.5%). Accordingly, 2.5% of $25,641 represents $641 of fees and the balance ($25,641 – $641 = $25,000) is the amount Allison wants to receive.

On the other hand, if she wished to withdraw $25,000 from the account value, the amount received would be reduced to $24,375 by the 2.5% DSC ($25,000 – 2.5%).

Scenario 2

In year 5 of the contract, Allison must surrender her segregated fund due to an unexpected change in her financial situation.

The market value of her investment is $122,900.

Allison pays a 2.5% sales charge, equivalent to $3,072.50 ($122,900 × 2.5%) and receives $119,827.50 ($122,900 – $3,072.50).

The recommendation for sales charge is a test of advisor ethics since this fee is a commission the agent receives. However, the agent must recommend the fund or funds with the best set of characteristics based on the investor profile; the sales charge is one aspect of this set.

5.2.10 Fund management expense ratio (MER)

The management expense ratio (MER) of a fund is the percentage of management and operating expenses relative to the average value of each fund's assets. MER is not based on performance and it is charged regardless of performance.

Unlike the sales charges addressed in the previous section, trailing commissions are paid from the management fee that is one of the components that make up the MER. The amount charged as a trailing commission is clearly disclosed in the Fund Facts for each fund that all potential investors receive.

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 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.[21]

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.

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.[22] 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.[23]

Providing Fund Facts is mandatory as part of the disclosure process that accompanies a sale.

21. Canadian Life and Health Insurance Association Inc. *Guideline G2 – Individual variable insurance contracts relating to segregated funds*. [online]. [Consulted August 14, 2017]. http://www.clhia.ca/domino/html/clhia/CLHIA_LP4W_LND_Webstation.nsf/resources/Guidelines/$file/Guideline_G2.pdf
22. Canadian Life and Health Insurance Association Inc. *Point of sale disclosure – Implementation of new requirements for segregated funds*. [online]. [Consulted August 15, 2017]. http://www.clhia.ca/domino/html/clhia/CLHIA_LP4W_LND_Webstation.nsf/resources/Financial+Advisors/$file/Advisor_fact_sheet.pdf
23. Canadian Life and Health Insurance Association Inc. *Guideline G2 – Individual variable insurance contracts relating to segregated funds*. [online]. [Consulted August 14, 2017]. http://www.clhia.ca/domino/html/clhia/CLHIA_LP4W_LND_Webstation.nsf/resources/Guidelines/$file/Guideline_G2.pdf

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.

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 consolidated, 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 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 as well. 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 can back up to the client. 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.

If an analysis cannot lead to a satisfactory recommendation, the agent can proceed with the best available recommendation while pointing out its advantages and its shortfalls. Again, 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 for the agent is to be honest and explain to the client the rationale for this decision.

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 will 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.

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 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.

Many factors must be satisfied for a payout annuity to qualify as prescribed for tax purposes. A prescribed annuity, whereby the same amount of interest and capital is received by the annuitant with 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 suitable investments to be held within the annuity, based on the time horizon and risk tolerance 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. The recommendation is based on:

- The time horizon for the client to receive the income from the term annuity;
- The period for investment in the accumulation annuity.

If the need indicates 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.

Term annuities are an important stop-gap source of income (also known as providing income bridging) for those who have stopped working and are not yet entitled to full retirement benefits. When this is the intended use of the annuity, the recommendation should accurately show the period of time to be covered and the reason for a maturity date at what may be a relatively young age for a retiree.

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 form a recommendation for 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 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 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 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.

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 designed to pay 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, or when the annuitant is in poor health.

5.4.5 Principal risks of annuity recommendation

The principal risk of an annuity recommendation is an improved annuity rate, due to an increase in interest rates, which will be unavailable to those whose contracts are already set.

This risk can be managed by recommending that a series of annuity contracts be acquired over a period of several years, thereby laddering the sum available for investment and the income received.

Inflation risk is another 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 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.

Risk regarding variations in value takes precedence on the face page, or cover, of the contract with wording to the effect of "Any amount that is allocated to a segregated fund is invested at the risk of the contract holder and may increase or decrease in value."[24]

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;

24. Canadian Life and Health Insurance Association Inc. *Guideline G2 – Individual variable insurance contracts relating to segregated funds*. [online]. [Cited September 15, 2017]. http://www.clhia.ca/domino/html/clhia/CLHIA_LP4W_LND_Webstation.nsf/resources/Guidelines/$file/Guideline_G2.pdf

- 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 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. 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. 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. An agent may find a power of attorney appointed for a client who is ill, mentally incapable or absent from the country for a prolonged period of time. A power of attorney is when one person has been given the authority to act for another in specified or financial matters. The individual with the power of attorney 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.

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 at which 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;
- A successor owner can be named (if the owner is not the annuitant) to exercise the rights of the owner if he dies.

6.2.1.2 Naming annuitant and beneficiary

The owner of the contract enjoys the rights of ownership, such as the ability to assign the contract. 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 joint 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 amounts;
- 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. The rider includes a statement such as "Withdrawals in excess of the annual guaranteed or lifetime withdrawal amount may have a negative impact on future guaranteed payments under the GMWB."[25]

25. CI Investments/Sun Life Financial. *GMWB Rider election and payment direction form*. [online]. Revised February 2014. [Cited September 17, 2017]. http://www.ci.com/orderform/pdf/applications/swe_plus_election_payment_e.pdf

6.2.1.4 Client identification requirements

The agent has obligations under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (PCMLTFA)[26] to properly identify investors, who constitute 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. The agent must also determine whether the client is acting on instructions from a third party. These requirements do not apply when the account is registered.

Requirements are also specified for the agent if a large cash transaction is made. A large cash transaction is a single cash deposit of $10,000 or more, or two or more cash deposits equaling $10,000 or more made in a 24-hour period.

When a client deposits $100,000 or more, in any form, to a contract, the agent has to confirm whether the client is a politically exposed foreign person (PEFP). There is a 14-day time limit after the transaction has been made in which the PEFP must be reported. In general, a PEFP is a person who has held a government or judicial position in a foreign country or is a spouse or close family member of such a person.

Therefore, for individual non-registered accounts in which the agent has not had a previous relationship with the client consisting of at least two transactions, the agent is required to use an identification document with a unique identifier number that has been issued by a provincial, a territorial or the federal government. Some common documents that are satisfactory for identification are an original:

- Birth certificate;
- Driver's license;
- Passport;
- Record of landing;
- Permanent resident card.

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.

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26. Financial Transactions and Reports Analysis Centre of Canada. *Record keeping requirements for life insurance companies, brokers and agents.* [online]. Revised June 29, 2017. [Consulted August 7, 2017]. http://www.fintrac-canafe.gc.ca/guidance-directives/recordkeeping-document/record/li-eng.asp

Any suspicious transaction or attempted transaction may be of interest to the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC). The agent may wish to first bring the situation to the attention of a supervisor or manager.

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 representing contributions to a registered pension plan 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) or restricted locked-in retirement savings plan (RLSP) 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 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 so that comparisons can be easily made between funds.

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:[27]

27. Autorité des marchés financiers. *Funds facts An example.* [online]. [Consulted June 26, 2017]. https://lautorite.qc.ca/en/general-public/investments/investment-funds/fund-facts-and-prospectus/fund-facts/

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

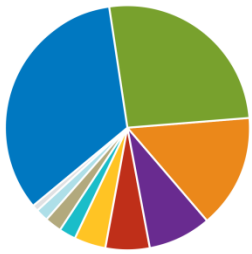
What does the fund invest in?

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		**42.0%**
Total number of investments		**93**

Investment mix (June 1, 20XX)



Industry	
Financial services	34.0%
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.

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.

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.

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

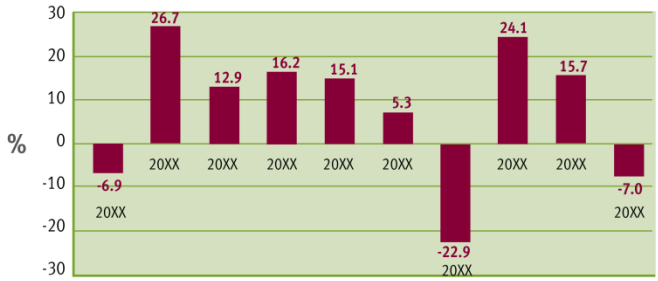
XYZ Canadian Equity Fund – Series B

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.

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

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.

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?

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.
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.

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)
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%**

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
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.
Switch fee	Your representative's firm may charge you up to 2% of the value of units you switch to another XYZ Mutual Fund.
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
123 Asset Allocation St.
Toronto, ON M1A 2B3

Phone: (416) 555-5555
Toll-free: 1-800-555-5556
Email: investing@xyzfunds.com
www.xyzfunds.com

To learn more about investing in mutual funds, see the brochure **Understanding mutual funds**, which is available on the website of the Canadian Securities Administrators at **www.securities-administrators.ca.**

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6.3.2.3 Confirmation

Confirmation 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, 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 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 on 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 with the client once a year to review the selected investment and its performance. The agent should come 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 he 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

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. It is usually made monthly or quarterly. 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 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 70.

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.

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 power of attorney 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. 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 power of attorney.

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 claim

A power of attorney document appoints another to act as a substitute decision-maker when a contract owner is unable to do so. As previously discussed, the individual granted power of attorney controls the contract except, possibly, for the naming of beneficiaries.

The instructions for withdrawals or surrender made by the person with power of attorney must be respected, and acted upon, as if he was the contract owner.

If the agent has reasons to suspect the person with power of attorney 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, guarantees are adjusted downwards in proportion to the account balance.

The amount received in the death benefit guarantee may also be less than expected if a front-end sales charge has been applied and death occurs shortly after purchase. The impact from a front-end sales charge is less likely to be evident in payment of the maturity guarantee since growth in the minimum ten-year period to maturity should have compensated for the charge.

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. 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 life annuity contract does not have an escape clause: the investor cannot rescind the contract and 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 role as an investment and the 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. 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 that is input 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 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.

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 dies. No amount is paid to a beneficiary until the death of all annuitants if the contract is structured with a guarantee period;
- A beneficiary must be named in the application except if the annuity is a life annuity with no guarantee period. When no guarantee period exists and, therefore, the annuity makes payments for the lifetime of the single annuitant or both annuitants in a joint contract, 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:

- Personal savings or chequing account;
- Bonds;
- Guaranteed Investment Certificates (GICs);
- Tax-free savings accounts (TFSAs);
- Stocks, mutual funds, and segregated funds.

A new deposit can be made to a registered contract if it has been set up as a registered retirement savings plan (RRSP) and the owner has available contribution room. That contribution room may result from the annual limit for contributions or unused contribution room from previous years. Contributions cannot be made to a personal registered account after the end of the calendar year in which the contract owner turns 71, and cannot be made to a spousal plan beyond the end of the calendar year in which the spouse turns 71.

EXAMPLE

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.

In addition to a new deposit or instead of a deposit, a registered account can be funded by the transfer of funds from an RRSP at the same or another financial institution. A transfer is not considered a new contribution of funds.

Registered funds from the following accounts may also be transferred to the registered annuity contract:

- 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

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. These 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 another maturity choice, such as a RRIF.

Although annuities have been eclipsed in popularity by the typical RRIF maturity option, which is based primarily on investment in GICs and mutual funds, they are gaining ground 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.

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 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 due to a change of heart by the contract owner or because the named beneficiary has died. The contract owner can name whom he likes providing 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.

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 claims

A person acting in the position of power of attorney 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. In the case of a guarantee period, the beneficiary has no further claim after the guaranteed 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 has changed. 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 reward is the appreciation of the group members for the benefit the plan provides.

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, and its members. 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 the 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 reduce the amount that can be contributed 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 objectives 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 plan (DBPPs), defined contribution pension plan (DCPPs), group registered retirement savings plan (GRRSPs) and pooled registered pension plan (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 the 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. Therefore, a shorter vesting period is more expensive for the plan sponsor because his contributions 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 service, 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.[28]

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;

28. Joint Forum of Financial Market Regulators. *Guidelines for capital accumulation plans.* [online]. Updated May 28, 2014. [Consulted June 22, 2017]. https://www.jointforum.ca/en/init/cap_accumulation/guidelines-eng%20final.pdf

- 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 payroll — 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, 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:

- Details about the balance of funds, i.e., total funds available, in the member's account;
- 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 that provide investment and retirement savings opportunities are often known simply as group pension plans. 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 beneficiary in the event of death of the plan owner.

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.

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 pension group plan also provides a future benefit to its members. 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 Website design 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 multiple 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.[29]

The following registered plans assist savings and investment for retirement:

- Defined benefit pension plan (DBPP);
- Defined contribution pension plan (DCPP);
- Group registered retirement savings plan (GRRSP);
- Deferred profit sharing plan (DPSP);

29. Canadian Association of Pension Supervisory Authorities (CAPSA). *Guideline No. 3 – Guidelines for capital accumulation plans.* [online]. Revised May 2004. [Cited August 3, 2017]. https://www.capsa-acor.org/en/init/cap_accumulation/GuidelineNumber3.pdf

- 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, those funds are transferred to a LIF; the LIF requires withdrawals and in this way, a pension is paid. 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, however.

8.2.2.1 Defined benefit pension plan (DBPP)

First introduced in Chapter 1, the DBPP plan is a form of registered pension plan (RPP) that pays a known sum to its members at retirement. The pension income is generally determined by employment income and years of service.

The sponsor of a DBPP commits to funding the amount needed to provide the promised pension at retirement. This is a sum determined by an actuarial evaluation and known by the sponsor and administrator.

Contributions may be made by the sponsor alone or by the sponsor and group plan member. The sponsor is fully responsible to ensure that funding is adequate to provide the promised pension. If contributions have been insufficient or investment performance has not met expectations and the plan is not able to meet its pension obligations, the sponsor must make additional contributions. A sponsor that is unable to meet its financial commitment has a plan that 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 an asset (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 life annuity. A sponsor may choose to index payments to increases in the cost of living. Doing so affects sponsor plan pricing.

DBPPs were once the most common form of pension plan. That is no longer the case because they are now under pressure due to low or negative pension fund returns and increasing lifespans. The low pension fund returns and pension income that are 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 value regarding plan members.

Sponsors must be prepared for the financial obligation of a DBPP.

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 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. 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 whenever the employee departs and become the property of the employee.

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) the year in which the account owner turns 71 at the latest, or an annuity, to continue tax deferral.

8.2.2.5 Deferred profit sharing plan (DPSP)

A DPSP plan is funded by employer contributions only. Therefore, it is most appropriate for those organizations with stable profitability to ensure that contributions to the group plan can be made annually and continually. While contributions to the plan come from company profits, their amount may vary from year to year; such contributions are optional for the employer.

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)

The GRRSP and DPSP allow members to create for themselves a pool of savings, just like that created by a member of a DCPP. 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 and 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.

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 may be made available in all Canadian provinces. Québec has adopted an equivalent plan, the voluntary retirement savings plan (VRSP). Each province is required to enact its own PRPP legislation before the plan can be offered.

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.

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.

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 × 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 × 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, 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 introduced 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 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 – payments will not increase if interest rates rise.

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 well 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. Some pension plans define this 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.”

To arrive at the necessary factor, whatever that number is, 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, 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? Will contributions be uniform across all group members? When will vesting occur?
- Costs — What are the 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

Although pension plans are most often associated with providing or enhancing retirement income, a sponsor may have other objectives in setting up a plan. A sponsor benefits when a plan attracts and retains top-quality employees. The employee benefits when a plan includes employer contributions and the convenience of workplace saving.

The agent needs to comprehend the composition of the group 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.

The investments provided as choices to group members are from the insurer's stable of group products. The sponsor, through the administrator, decides which investments fit the membership best. The agent may advise the administrator on products, especially if plans or products are proposed with which the administrator is unfamiliar, to ensure the administrator fully understands the options available.

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, an RRSP or PRPP maximum contribution for a DBPP, DCPP or DPSP member is:

Maximum contribution limit for year – pension adjustment for previous year

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.

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 also 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 follows the agent's recommendation and 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 deemed acceptable, 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, as they become qualified to join the plan. 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 provide a waiver of a joint and last survivor pension, a waiver of a preretirement death benefit, and a waiver of a survivor's benefit for a locked-in account.

During the period a member is enrolled, another form allows the member to change a beneficiary named to the plan. Other information changes may also be required.

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 (the "85 factor" for example) 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 rights 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 experience 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, and will pay higher investment fees and most likely an account fee, for independence from the group plan.

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 a 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 group process of 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 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.

A wind-up is typically a lengthy process and ill-perceived by affected group members since, in essence, a promise is broken even if that promise is for nothing more than the sponsor to provide a plan.

8.7 Claims by group members

A claim from a group member is initiated to receive the funds in the 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 have an urgent need for the continuing income of the group member.

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. They include 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 for individual and group investors to 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 puts the client's interests first. To do this, the agent needs an understanding of 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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