The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

November 2021

IMPROVING THE GLOBE'S RETIREMENT INCOME SYSTEMS:

HOW ARE WE DOING….AND HOW CAN WE DO BETTER?

"With aging populations, low or negative interest rates for longer, and uncertain investment returns in the future, the financial well-being of our future retirees cannot be left to chance."

David Knox
Lead Author, Mercer CFA Institute Global Pension Index

"Pension reform will be an ongoing societal challenge, and we are confident the Mercer CFA Institute Global Pension Index will help catalyze important actions in the months and years to come."

Margaret Franklin
President, CFA Institute

How Are We Doing?

The 13th edition of the ***Mercer CFA Institute Global Pension Index*** (*MCGPI*) has just been released. Titled "Pension Reform in Challenging Times", the report notes that while there are a few well-designed and managed national retirement income systems (RIS) in the world, many could and should do better. The *Index* currently covers 43 countries with 65% of the globe's population. Out of the 43 countries, only 3 got A grades for their RIS. There were also 3 B+ grades, 10 Bs, 5 C+, 14 Cs, and 8 Ds.

Each country's *MCGPI* grade is based on a weighting of metrics in three RIS categories: 1. Adequacy, 2. Sustainability, and 3. Integrity. As the category titles suggest, the Adequacy metrics assess the amount of income the RIS replaces for a country's retirees and how well it is distributed among them. Sustainability metrics assess how resilient a country's RIS is to changing economic and demographic circumstances in the decades ahead. Integrity metrics assess how well a country's RIS is managed and regulated. The overall *MCGPI* grade is a weighted composite of the three category grades.

The distribution of the 43 *MCGPI* grades suggest there is plenty of room for most countries to 'do better'.

How Can We 'Do Better'?

CFA Institute President Margaret Franklin noted that an important purpose of the analytics behind the *MCGPI* is to provide 'how can we do better?' insights. These insights can be categorized by using the 3-Pillar RIS framing proposed by the *World Bank* in its 1994 study "Averting the Old Age Crisis":

Pillar 1: state-sponsored, tax-supported, universal base pension
Pillar 2: workplace-related, prefunded, collective pension/retirement savings arrangements
Pillar 3: individual retirement savings/insurance arrangements

With this framing in mind, here is a summary of the new *MCGPI* Report's 'do better' recommendations:

- Total RIS: 1. Set out clear success metrics for the total RIS and reforms to it; 2. Reduce the gender gap in pension outcomes; 3. Increase workforce participation by older workers.

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- Pillar 1: 1. Tie pension eligibility age in the state pension to life expectancy; 2. Review indexation rules.
- Pillar 2: 1. Increase worker coverage and savings rates in well-managed collective pension/ retirement savings arrangements; 2. Reduce retirement savings leakage; 3. Raise scale and governance quality in pension management organizations.
- Pillar 3: While the *MCGPI* Report made no explicit reference to this Pillar, it did so implicitly with its recommendations for Pillar 2 above. Research confirms that, left to their own devices, most workers neither save adequately for retirement, nor invest their pension pots efficiently. The combination of these two problems results in material retirement income shortfalls for many workers in 'do-it-yourself' Pillar 3 arrangements.

Three recommendations in a recent *World Economic Forum* report on RIS design echoed those of the *MCGPI* Report set out above. They were: 1. Provide a 'safety net' pension for all, 2. Improve ease of access to well-managed Pillar 2 pension/retirement savings arrangements, and 3. Support initiatives to increase contribution rates into these arrangements.

Saying is one thing, doing another. Which countries and organizations have been leading the way in 'doing better' along the lines set out above? That is the question we address next.

Strengthening Pension Pillar 2 in the UK and the USA

A material increase in the 'Adequacy' category of the UK pension index in the new *MCGPI* Report prompts the question: 'why'? The answer is directly linked to two key Report recommendations: "Increase worker coverage and savings rates in well-managed collective pension/retirement savings arrangements"…..and "Raise scale and governance quality in pension management organizations". This was the intent of the 2008 UK Pensions Act which legislated compulsory auto-enrolment of all workers without a Pillar 2 plan into a qualifying retirement savings arrangement. Employees would have an opt-out option. After four years of preparation, auto-enrolment was phased in over the course of 2012-2018. An important part of the pre-2012 preparation was the creation of the *National Employment Savings Trust* (*NEST*), which would become the default manager of this new stream of retirement savings.

Today, after a decade of preparation and implementation, how are things turning out for this bold UK initiative? In short, very well. Over 10M workers and 1.6M employers are participating in the program, collectively contributing a minimum of 8% of pay. Importantly, 90% of enrolled workers have chosen to stay in the plan. *NEST* has been the major recipient of the new retirement savings stream. It is already managing over £10B for 9M members and 800K employers, with that amount growing by at least £5B/yr. for many years to come. *NEST* is the largest of a growing number of well-managed multi-employer master trusts operating in the UK, along with *The People's Pension* (5M members, 99K employers) and *NOW Pensions* (2M members, 30K employers).

Similar auto-enrolment initiatives are taking place in the USA at the state- and city-level. Out of 16 initiatives thus far, the three largest are *CalSavers*, *Illinois Secure Choice*, and *Oregon Savers*, with combined assets of $350M from 385K members and 37K employers. Many more state and city initiatives are in the planning stages. Collectively, these initiatives should eventually raise the Adequacy category of the USA's *MCGPI* score.

Strengthening Pension Pillar 2 in Canada

Like the UK and eventually the USA, Canada too will likely be getting an upgrade in the Adequacy category of its *MCGPI* score. Why? For two reasons, one obvious, the other less so.

The obvious reason is government-legislated benefit increases in the *Canada and Quebec Pension Plans*. The *CPP* and *QPP* are somewhat of a hybrid, falling between Pillars 1 and 2. They are Pillar 1 plans in the sense that they are universal (*QPP* for all Quebec workers, *CPP* for all workers in the rest of Canada). They are Pillar 2 plans in the sense that they are workplace-based, with employers and employees splitting the contributions 50-50. Plan funding has evolved from pay-go, to partially pre-funded, to the just-legislated benefit increase to be fully prefunded. The contribution rate will rise from 9.9% to 11.9% of pay to finance increasing the target *CPP/QPP* benefit from 25% to eventually 33% of average earnings.[i]

The less obvious reason for expecting an eventual boost in Canada's pension Adequacy score are two recent innovations in its financial services sector. We described the first of these innovations in our **June 2021 *Letter***. Through a unique longevity risk pooling mechanism created by *Purpose Investments*, its regulator-approved *Longevity Pension Fund* offers lifetime income to investors aged 65 and older. It can be used individually by single investors (i.e. Pillar 3), or collectively as the decumulation 'backend' to collective accumulation vehicles such as DC pension plans and Target Date funds. The product was just launched in June of this year. It will be interesting to see how it is received into 2022 and beyond.[ii]

The other Pillar 2 Canadian financial innovation relates to providing employers who cannot, or longer want to sponsor a traditional DB, DC, or Group RRSP plan an option to join a well-managed, collective Target Benefit plan by only committing to a predetermined fixed contribution rate. The innovator here is the Ontario-based *Colleges of Applied Arts and Technology* (*CAAT*) *Pension Plan*, which has opened its plan to private, public and not-for-profit employers across Canada. The Plan has a $15.8 billion asset base and is 119% funded on a going-concern basis, using a 4.95% discount rate. Its actual 10yr. annualized net investment return was 9.9%. The Plan's stated vision is to expand collective pension coverage across Canada through innovation, 'delivering both value to members and flexibility to their employers'. For employees this means predictable lifetime retirement income, conditional inflation protection, survivor benefits at no cost, early retirement options, and portability. For employers, the offering removes pension management costs and risks, provides contribution cost certainty, and phase-in contribution levels to ease change management. *CAAT*'s not-for-profit trust model uniquely means no bonuses for executives, and its joint governance model means members and employers have equal say in Plan decisions about benefits, contributions, and funding. The *CAAT* model is cost-effective, expected to deliver twice the retirement income compared to Pillar 3 models.[iii]

What has been the response to the *CAAT* proposition? Since 2018, employer membership has grown by 192%, and includes an interesting mix of organizations ranging from large to small for-profit corporations, large to small industry and professional associations, and large to small not-for-profit charities. Total Plan membership grew by over 4K to 76K just in the first half of 2021, and based on ongoing momentum, further growth is projected for the rest of this year, into 2022, and beyond.[iv]

Purpose and *CAAT* are not the only two innovators on the Canadian RIS scene. For example, the *OPTrust* pension plan also has an outreach program, inviting other Ontario public sector and not-for-profit employers to use its pension management infrastructure. The *CommonWealth* organization describes itself as a 'retirement fintech', offering customized retirement income accumulation/decumulation and related advisory services to mid-sized and smaller employers across Canada. Finally, *Ontario Teachers' Pension Plan* has just bought *HomeEquity Bank*, issuer of the *CHIP Reverse Mortgage*. According to a press release, "*OTPP*'s record of delivering retirement solutions and a shared vision of making a positive impact on the lives of retired Canadians, makes it a natural partner for *HomeEquity Bank*."

Radical Pension Pillar 2 Change in The Netherlands

Despite being one of only three countries with an A-grade RIS, The Netherlands (NL) has decided to make radical changes in the design and management of its Pillar 2 pension plans. Our **August 2020 *Letter*** described these changes. In summary:

- The prime change motivator was the clash between a stringent solvency-focused regulatory regime and a continuous post-GFC decline in liability discount rates. The outcome of this clash was an ongoing decline in the solvency status of Pillar 2 pension plans, which in turn led to an ongoing series of missed inflation indexation updates and even a few actual pension cuts, and threats of further ones to come. These measures have been weakening Dutch plan member confidence in their pension plans.

- The legislated solution was to drop the solvency-focused regulatory regime, and move the NL Pillar 2 system to an individual retirement savings account basis, while at the same time also retaining a number of collective risk-pooling options.

Last year's *Letter* questioned the feasibility of actually implementing such radical changes to ongoing Pillar 2 pension plans. The essential problem is one of 'path-dependency', which constrains the paths reform options can take to those that are actually implementable within a reasonable period of time. As an alternative to the proposed radical reforms, we have been urging Dutch policy makers to study the Canadian evolution from hard-core DB plans to softer, more flexible, going-concern Target Benefit (TB) plans like the *CAAT Pension Plan* described above.

Where does the NL pension reform situation stand today (i.e., one year later)? Here are some responses from a cross-section of knowledgeable Dutch observers:

- *Many uncertainties remain….complexity and communication challenges are worrying……there is too much wishful thinking going on….trust is being lost…..*
- *The transition costs (e.g., to a new pension administration system) are higher than originally thought….*
- *With Pension Minister Koolmees gone, political inertia is rising…..*
- *The Dutch 'polder model' makes it difficult for anyone to break ranks….as a result, no reform alternatives are being considered….so apparently, despite its relative simplicity and ease of implementation, the Canadian TB model cannot be considered as a feasible Pillar 2 reform alternative in the Netherlands.*

Is this a 21st Century pension design version of 'a bridge too far'?

Three Conclusions

What are the 'takeaways' in all this? Here are three:

- Much could and should be done to raise the quality of retirement income systems around the world.
- To that end, promising initiatives are underway in a number of countries…..in some cases through government actions, in others through innovative industry initiatives.
- However, the Dutch pension reform initiative offers a cautionary tale. The logic of 'path-dependency' suggests that reform should be evolutionary rather than revolutionary.

In short, the *Mercer CFA Institute Global Pension Index* is indeed guiding important actions to improve retirement income systems around the world.

Keith Ambachtsheer

Endnotes:

i. Both the CPP/QPP unit benefit and the ceiling on wages covered are being increased, eventually raising the maximum CPP/QPP pension by about 50%.
ii. Purpose Investments is a KPA Advisory Services client, and I am a member of the Advisory Committee for its Longevity Pension Fund.
iii. Reported in "The Value of a Good Pension", published by HOOPP, NIA, and CommonWealth.
iv. CAAT Pension Plan is a KPA Advisory Services client.

Published by KPA Advisory Services Ltd., 1 Bedford Road, Suite 2802, Toronto ON Canada M5R 2B5
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