



The AMBACHTSHEER Letter

Sustainable Pension Design • Effective Pension Management

November 2024

HOW DO WE PAY BETTER PENSIONS TO MORE PEOPLE?

WHY THE VARIABLE PAYMENT LIFE ANNUITY MAY BE OUR BEST ANSWER

“William Greenough created the variable payment life annuity in 1952 while CEO of TIAA-CREF, naming his creation the College Retirement Equity Fund (CREF). Fortune magazine described CREF as “the biggest USA development in pensions and insurance since the passage of the Social Security Act in 1935.”

“CREF accounts have provided 65% more lifetime income in retirement than taking the industry rule-of-thumb 4% withdrawal rate.”

Investopedia and TIAA Website

By the mid-1960s, UBC was the last large Canadian university to still have TIAA-CREF as its pension provider. In a 1966 study, three alternatives were proposed: 1. Continue with TIAA-CREF, 2. Create a UBC DC Plan with a minimum benefit feature, 3. Create a UBC DB Plan. Option 2 was chosen, with the variable payment life annuity (VPLA) being the ‘minimum benefit feature’. The VPLA remains uncommon in Canada because federal tax authorities decided in 1988 not to permit accumulated retirement savings to purchase an uninsured annuity, which they deemed the VPLA to be.

The UBC Faculty Pension Plan History
1967-2017

“The challenge of converting capital into lifetime income in DC plans is well known, with many plan members underspending their retirement savings as they are uncertain how long their money needs to last. We wanted a solution that would give members confidence to maintain their living standards knowing they will never run out of money. In our research, we came across the Canadian VPLA model, and the ART Lifetime Pension is based on similar principles. It is transparent, easy to understand, and designed to be used alongside social security benefits and traditional drawdown accounts.”

Brnic Van Wyk, Head of Asset Liability Management
Australian Retirement Trust

“The ‘Tinbergen Rule’ is the idea that if policy makers have certain goals they want to achieve, they must have an equal number of instruments that they control in order to direct policy towards achieving those goals.”

Investopedia

Pension Plan Design and The Tinbergen Rule

Dutch economist Jan Tinbergen (1903-1994) became the first Nobel Laureate in Economics (1969) “for having developed and applied dynamic analytical models of economic processes”. In the course of this work, he formulated ‘The Tinbergen Rule’ defined in the *Investopedia* quote above. An example of the Rule would be that if policy makers want to achieve the twin goals of full employment and low inflation they will have to use the twin policy instruments of monetary and fiscal policy to achieve them.

What about funded pension plan designs where younger participants want affordability and older participants want payment-for-life certainty? Logically, 'The Tinbergen Rule' requires that a pension plan with these twin goals will need an affordability instrument for younger participants and payment-for-life instrument for older participants. From a life-cycle perspective, the practical implication is that younger workers (and possibly their employers) contribute regularly into an investment fund with a high-return generation focus, and when they eventually become older workers, begin to purchase lifetime income in a lower-risk investment fund with an embedded longevity risk pooling mechanism.

The Evolution of the 2-Pot Pension Idea in Australia

The quote sequence on the front page of this *Letter* provides a sense of the timeframe in which these pension plan design ideas have been playing out. TIAA CEO Greenough's idea of combining equity returns and lifetime income in the *College Retirement Equity Fund* goes back 72 years.¹ UBC's idea of offering separate return generation and lifetime income funds in their *Faculty Pension Plan* goes back 57 years. The implementation of this 2-Pot Pension idea by the large-scale pension provider *Australian Retirement Trust* (2.4 M members, AUS\$320B AUM) goes back 4 years. Here is how ART describes the *Lifetime Pension* offering on its website:

- When you buy a *Lifetime Pension*, your money goes into a pool of funds with other *Lifetime Pensions*.
- This pool is invested in the *Balanced Risk-Adjusted* investment option for income accounts.
- Your payments come from this pool.
- Everyone's payments are adjusted yearly to reflect the pool's investment performance, fees, and other factors.
- This makes sure the pool can keep paying everyone an income for life.
- Payments are expected to increase over time, but may go up or down.
- Once you open up your *Lifetime Pension*, you have six months to decide if it is right for you. After this, it is a permanent purchase.
- Learn more about the *Lifetime Pension* at one of our seminars for members and their guests.

Since inception, over 1200 members have bought a Lifetime Pension, contributing a collective AUS\$300M. Expectations are that participation will continue to grow as retirees become more familiar with this new option in the Australian superannuation system.

The Dutch Pension System in Transition: Too Much Too Fast?

Ten years ago, at the invitation of the Royal Economics Society of the Netherlands, we were invited to share our views on reforming the vaunted Dutch workplace-based DB pension system. The result was a paper titled "[Taking the Dutch Pension System to the Next Level: A View from the Outside](#)". In line with the logic set out above, the 2014 paper recommended moving Dutch workplace pension plans to the 2-pot Tinbergen model with its separate return-seeking and lifetime pension components. The paper also recommended increasing governance/organization design clarity in the organizations charged with managing these pension plans.

Counter to these recommendations, Dutch regulators instead continued to treat workplace pension plans as having a single balance sheet, the solvency of which should be aggressively protected. This meant regularly valuing accrued pension plan liabilities on the basis that the plan might be wound up tomorrow, and that plan assets would have to be sufficient to pay off all liabilities immediately. Any calculated balance sheet shortfalls on this basis would be addressed by reducing inflation protection or even reducing pension benefits payable.

Predictably, this rigid regulatory regime became highly unpopular as interest rates continued to fall, thus pushing up pension liabilities. On the one hand retirees wondered when and by how much their pensions might be cut, and on the other, the funds’ asset managers generated disappointing investment returns as they sought to reduce that possibility by favoring bonds over equities.ⁱⁱ

All this led to a vigorous pension reform debate, which in turn led to a political decision in 2023 to drop the single balance sheet DB pension design, and replace it with a number of DC-oriented design options ranging from simple DC to various ‘Solidarity DC’ options with such features as ‘solidarity buffers’ and differing life-cycle-based investment return allocation rules. So while in theory, Dutch employers can now move to the simple 2-pot Tinbergen pension model we recommended way back in 2014, too many other options continue to confuse and foster complexity in the transition process.

Back To the Unfolding Canadian VPLA Story

Since 1967, retiring *UBC* faculty members have had two income-for-life payout choices in their *VPLA*. Choice #1 was based on retirement assets earning an assumed 7% return; in Choice #2 the return assumption was 4%. The 7% return choice would lead to a higher starting payout rate, with payouts potentially flat over time or even declining if asset returns were to come in below 7%. Conversely, the 4% choice starts with a lower payout, with payouts potentially rising over time if asset returns were to exceed 4%.

Regardless of the payout choice, *UBC VPLA* money has been invested in the same balanced investment fund with a mix of equities, bonds, and real estate. Payouts are adjusted annually, based on actual return and mortality experience versus assumptions. Table 1 shows actual annual payout experience for a \$500K *VPLA* in selected years over the 1996-2016 period for purchasers still alive in 2016. Note that while the average annual payout over the 20-year period is about the same for the two payout choices, the payout patterns differ. The 7% return choice predictably pays out more than the 4% choice in the early years....while the roles reverse in the later years. This raises an interesting choice question: should one pattern be preferred to the other?

Table 1 Annual Payouts in Selected Years for a \$500K *UBC VPLA* Purchase under Two Return Assumptions

	1996	2001	2003	2007	2009	2016	AVE
7%	\$49K	\$65K	\$54K	\$60K	\$47K	\$49K	\$54K
4%	\$41K	\$56K	\$50K	\$66K	\$53K	\$67K	\$55K

Source: *The UBC Faculty Pension Plan*

Regardless of how the ‘rising or falling payout trend?’ choice question is answered, a key take-away from the *UBC* experience is that a \$500K *VPLA* purchase in 1996 made payments that varied modestly in the subsequent 20yr period, averaging some \$50K/yr to members still alive in 2016....with these payments continuing for as long as the member is alive post-2016. Note that the realized payouts in the 10% area far exceed the standard industry rule-of-thumb 4% withdrawal rate.

Due to the negative views of Canadian pension regulation and tax authorities, decades have passed without efforts to duplicate the successful *UBC VPLA* experience in Canada. However, at the same time, the lifetime income requirement problem facing millions of Canadian retirement income savers has become increasingly visible. With most of these retirement income savers not members of a registered pension plan, would it be possible to offer them a lifetime income solution through the mutual fund rather than the pension fund channel?

Through the initiative of *Purpose Investments* CEO Som Seif and colleagues, the answer to that question today is ‘yes’, with the launch of the *Purpose Longevity Pension Fund (PLPF)* in June 2021 with initial payout rates ranging from 6.15% (for 65-67yr olds) to 7.4% (for 74-76yr olds). Over three years later, the *PLPF* is performing as expected and today offers new investors distribution yields of 6.6% to 8.7%, depending on the age cohort. After the portfolio posted double-digit returns for the year ending September 30, the *PLPF* expects to raise its monthly distribution levels for 2025 by an average of 3% (to be confirmed). This could lift the payout rate to around 9% for the oldest cohort as they begin to turn 80, with the expectation that this rate should, on average, continue to rise as they age. Moreover, the funding level ratio will have improved year over year, providing investors with a buffer to uncertain markets and more likelihood of raises in the next few years.ⁱⁱⁱ

There is more good news for Canadians, with institutional interest in the *VPLA* model rising rapidly. For example, Saskatchewan’s *Public Employees Pension Plan (PEPP)*, administered by *Plannera Pensions and Benefits*, expects to launch its *Lifetime Pension* in Spring 2025. As Canada’s largest DC plan, this initiative by *PEPP* is an exciting development. According to its newsletter: “by pooling longevity risk, the new *Lifetime Pension* provides dependable monthly income for life, regardless how long you live.” Also, once *VPLA* rules come into effect in Ontario, *CAAT Pension Plan* intends to add a *VPLA* that would enable members on retirement to convert all, or a portion of their accumulated retirement savings into a lifetime income stream. *CAAT* expects there will be strong interest in this new offering by members and their employers.

It looks like an important missing piece in Canada’s retirement income system will be materially expanded in 2025.^{iv}

Keith Ambachtsheer

Endnotes:

- i. A recent *TIAA* pamphlet titled “[Retirement Income Solutions: Delivering Lifetime Benefits](#)” describes *TIAA*’s current offerings in the lifetime income space. The 6-page document is surprisingly unclear in its messaging of what these ‘solutions’ actually are. For example, words like ‘guaranteed’ and ‘fixed annuity’ are used without a full description of what they actually mean. The possibility of earning additional income is mentioned without a clear explanation of where that additional income would come, nor how much it might add up to.
- ii. This regulatory derisking protocol cost Dutch pension funds and hence the Dutch people many billions of Euros. For example, the 10yr 2013-2022 annual return range for the globe’s largest 25 pension/sovereign wealth funds compiled by *Global SWF* was 13.3% to 2.4%, with an 8.0% median. The two Dutch funds in this group (*APG* and *PGGM*) ranked last at #24 and #25, with 10yr returns of 4.6% and 2.4% respectively. Had these funds achieved just the median group investment return of 8.0% over the last 10 years, their asset values would be materially higher than those being reported today.
- iii. Full disclosure: I am a member of *Purpose Investment’s Longevity Pension Advisory Board*.
- iv. Removing all legal prohibitions to offering the *VPLA* as legitimate lifetime pension income arrangement must be part of this broader Canadian adoption process in 2025.

The information herein has been obtained from sources which we believe to be reliable, but do not guarantee its accuracy or completeness.

All rights reserved. Please do not reproduce or redistribute without prior permission.

Published by *KPA Advisory Services Ltd.*, 1 Bedford Road, Suite 2802, Toronto ON Canada M5R 2B5
416.925.7525. www.kpa-advisory.com