KPA ADVISORY SERVICES LTD

POLICY PAPER

April 2023

MAKING CANADA ONE OF THE WORLD'S TOP PENSIONS COUNTRIES:

WHAT IT WILL TAKE

Keith Ambachtsheer

In an ageing world, the design and management of a country's retirement income system is becoming an increasingly important strategic determinant of its future social and economic performance. The Mercer CFA Institute Global Pension Index ranks Canada's system #11 out of 44 countries, ahead of many countries, but behind the Nordic countries, Netherlands, Australia, and the UK. What will it take for Canada to catch up with, or even surpass these top countries in pension system quality? This Policy Paper shows that while the answer to this question is obvious, it will take extraordinary leadership efforts to get us from here to there. The Paper addresses both the 'what must we do?' and 'how do we do it?' questions. While I am its sole author, the Paper has benefited greatly from expert comments and suggestions on earlier versions.

The Canadian Pension Fund Model

The 'what must we do?' answer does not involve changing the universal *OAS*/*CPP*/*QPP* benefit components of Canada's retirement income system. Instead, it follows from Canada already having one of the best occupational pension systems in the world for public sector workers. Globally admired as 'The Canadian Pension Fund Model', it efficiently converts regular contributions into lifetime retirement income streams for its public sector members.[i] At the same time, Canadian Pension Fund Model investment organizations are at the leading edge of converting retirement savings into sustainable, wealth-producing capital. They not only play this role as owners of publicly-traded securities, but also as active participants in private equity, real estate, and infrastructure markets around the world.

The Canadian Pension Fund Model originated from the great management philosopher Peter Drucker's 1976 book "The Unseen Revolution". He foresaw the young, outsized 'boomer' generation of the 1970s eventually becoming an outsized generation of retirees. He advocated creating pension organizations with two key features: 'Legitimacy' and 'Effectiveness'. Ten years later, Ontario Treasurer Robert Nixon launched his Rowan Task Force, tasked with finding a better way to manage Ontario's public sector pension plans. A year later, the Task Force tabled its Report "In Whose Interest?". It recommended restructuring public sector pension organizations so that they could pass tangible 'legitimacy' and 'effectiveness' tests, as Drucker had advocated in 1976.[ii]

Together, Robert Nixon and *Ontario Teachers' Federation* President Margaret Wilson decided to actually implement the Report's recommendations, leading to the *Teachers' Pension Act* of 1990.

Three people were key in turning the *Act*'s good principles into good practices at the new *Ontario Teachers' Pension Plan*: first Board Chair Gerald Bouey (retired Governor of The Bank of Canada), first CEO Claude Lamoureux (a senior insurance company executive), and first Chief Investment Officer Bob Bertram (a senior corporate finance executive). Together, they brought the Canadian Pension Fund Model to life, reflecting Canadian ingenuity, leadership, and collaboration at its best. As *OTPP*'s successes became increasingly understood and acknowledged, it was only logical for other Canadian public sector pension organizations to adopt the *OTPP* model.[iii]

A 2012 lead article in *The Economist* publication titled "Maple Revolutionaries" lauded the Canadian Pension Fund Model as "*having won the attention of Wall Street, which considers them rivals, and of institutional investors, which aspire to be like them*".[iv]

Expanding the Canadian Pension Fund Model to the Private Sector

Now back to the question 'what will it take to make Canada one of the world's top pensions countries?'. The answer should now be obvious: *make the Canadian Pension Fund Model available to Canada's private sector workers and retirees*.

Some numbers are instructive here. In 2021, *OTPP* paid $6.9 billion in retirement benefits to 151,000 retired teachers. That works out to about $46,000 per retiree. How much capital would a private sector worker have to accumulate to generate a $46,000 annual pension? Using the *CRA*'s minimum withdrawal rate on RRIFs of 4%, the answer is a retirement savings pool of $1.15 million. In contrast, *Statistics Canada* reports that in 2019 two-thirds of Canadian households nearing retirement held registered savings in individual accounts, with a median balance of about $100,000. In addition to it being a tenth the size of a typical public sector plan reserve for a retiree, there are two other problems for private sector workers: 1. There is a large pool value range around 'typical', with many workers having minimal retirement savings as they enter their 60s, and 2. Without longevity insurance, there is considerable risk that retirees will outlive the retirement savings they do have.

What about the difference in investment performance between Canada Pension Fund Model retirement savings pools and private sector retirement savings pools? Empirical evidence confirms the net returns on the former have on average been a materially 2.5%/year higher than those on the latter. Using the Drucker distinction between 'legitimacy' and 'effectiveness', about 1.5%/year is due to the 'legitimacy' effect (which largely relates to lower Canada Pension Fund Model implementation costs compared to Canadian retail mutual fund fees) and 1%/year is due to the 'effectiveness' effect (which largely relates to generating higher diversified net returns in private equity, real estate, and infrastructure markets through insourcing).[v] To appreciate the power of earning an additional 2.5% long-term return on retirement savings, consider this simple calculation: $1 earning a 1% annual return for 20 years compounds to $1.22, with $0.22 coming from investment returns. At a 3.5% return it compounds to a materially higher $2.00, with $1.00 coming from investment returns.

These comparisons provide strong support for expanding the Canadian Pension Fund Model to the private sector. If that had happened 30 years ago, most of Canada's private sector retirees would be receiving materially higher pensions today. However, while it is too late for that, shifting their accumulated retirement savings to the Canadian Pension Fund Model structure now, would still ensure that those savings would be managed effectively at low cost, and continue to pay retirement income as long as the retiree is alive. As for today's private sector working Canadians, not only could they count on their retirement income lasting as long as they do, but they could also reasonably expect that those pension payments will be materially larger than is currently the case.

Two Key Canadian Pension Fund Model Components

Saying is one thing, doing another. How could this proposed expansion of the Canadian Pension Fund Model into the private sector actually occur? The first thing is to understand the key components of the Canadian Pension Fund Model that must be created and assembled under the Drucker dictums of 'legitimacy' and 'effectiveness'. The 'legitimacy' dimension is not complicated: The pension plan must be structured to always act in the best interests of the plan risk bearers. This should be explicitly stated in the legal framing of the plan, and should be reflected in the composition of the plan's oversight body. There is considerable symbolism in the fact that the first Board Chair of a Canadian Pension Fund Model organization was a highly respected former Bank of Canada Governor.

Consideration of the 'effectiveness' dictum is a little more complicated. With the passage of time we have learned that both the traditional 'defined benefit' (DB) and 'defined contribution' (DC) pension plan designs are problematical. Both traditional designs are trying to achieve two key policy goals with one instrument, breaking the Tinbergen Rule that the number of policy goals should be matched by the same number of instruments designed to achieve them. Two pension plan goals are: 1. Affordability, and 2. Payment-for-life assurance. The two logical instruments to achieve these two goals are: 1. A Return Generation Instrument to achieve Goal #1, and 2. A Payment-For-Life Instrument to achieve Goal #2.[vi] Plan members start out with all of their retirement savings going into the return generation pool, with their assets transitioning to the lifetime payment pool as they approach retirement.[vii] Other 'effectiveness' dimensions requiring attention are scale economies, investment expertise, benefit administration/communication expertise, and strategy development and execution.[viii]

Three Possible Paths to Implementation

A final question: how is this Canadian Pension Fund Model transition to the private sector going to happen? There are three possible paths, all of which could be brought into play to accelerate the transition:

<u>Path #1: Existing Canadian Pension Fund Model Organizations offer their pension management infrastructure to private sector employers</u>: this option is already being successfully implemented by the *Colleges of Applied Arts and Technology (CAAT) Pension* organization. A key challenge is to design and manage a plan offering with separate accumulation and lifetime pension payment components.

<u>Path #2: A Government entity decides to create a Canadian Pension Fund Model Organization for private sector workers and retirees</u>: Ontario considered starting an *Ontario Supplementary Pension Plan*, but dropped the idea when the increase in *CPP* benefits was agreed to in 2016.[ix] There is discussion today in Alberta to leave the *CPP* and start up a new *APP*. Albertans would be far better served by the creation of an *Alberta Supplementary Pension Plan* which would provide Alberta private sector workers with pension benefits additional to those provided by *OAS* and *CPP*.[x] Similar initiatives with autoenrollment have been successfully launched in a growing number of US States, as well as in the UK.

<u>Path#3: Private Sector Financial Services Providers create one or more new Canadian Pension Fund Model offerings</u>: The *Common Wealth* and *Purpose Investments* organizations have both launched services and investment options consistent with the principles of the Canadian Pension Fund Model. An important delivery consideration here is the structure of the 1.2 million Canadian private sector employer market, out of which only 3,000 have over 500 employees. Again, other financial services organizations with expertise in designing and managing separate accumulation and lifetime pension payment offerings could join in.[xi]

The efforts of these early innovative leaders should be applauded, as well as supported by governments and their regulatory agencies. Exceptional leadership efforts were critical to designing and implementing the Canadian Pension Fund Model some 30 years ago. It is no less the case today if Canada's private sector workers are to become beneficiaries of its power to generate adequate pensions at a reasonable cost. Much work still lies ahead to make Canada one of the world's top pensions countries.

Let's get on with it!

Endnotes:

Keith Ambachtsheer is Executive-in-Residence at the Rotman School of Management, University of Toronto, Director Emeritus of the International Centre for Pension Management, Senior Fellow at the National Institute on Ageing, and cofounder of KPA Advisory Services and CEM Benchmarking. He has advised countries and pension organizations around the world on pension design and management for over 40 years, and his written four books on the subject.

i. *The contributions-to-pension benefits conversion processes in Canadian public sector DB plans can be problematic if it is not clear how the imbedded investment and mortality risks in the plan are borne. For example, if the employer fully guarantees future pension benefits but funds the plan on the assumption that plan assets will earn a risk premium, future taxpayers are placed at risk to make up any shortfall without their consent.*

ii. *I was an advisor to the 1986 Rowan Taskforce, whose Report "In Whose Interest?" led to the creation of the globally-admired Canadian Pension Fund Model.*

iii. *See my articles in the Journal of Portfolio Management (2021) and the Harvard Law School Forum on Corporate Governance (2022) for more detailed expositions of the birth and evolution of the Canadian Pension Model. Respectively, they are titled "**The Canadian Pension Model: Past, Present, and Future**", and "**How Peter Drucker Revolutionized Canada's Public Sector Pensions System: Lessons for Americans**". For an American view of the Canadian Pension Model, see Lipshitz and Walter, (2020) "**Seeking Sustainability in American Public Sector Pension Systems**", Journal of Portfolio Management. Finally, the most extensive study documenting the superior investment performance of the Canadian Pension Model thus far was conducted by Beath, Betermier, Flynn, and Spehner (2021) "**The Canadian Pension Fund Model: A Quantitative Portrait**", Journal of Portfolio Management.*

iv. *The Economist. "**Maple Revolutionaries**", March 3, 2012.*

v. *For detailed evidence, see the cited articles in Endnote iii above.*

vi. *Importantly, employers do not have to be the risk underwriters of these payment-for-life pools. See Endnote vii below. The 2019 Federal Budget called these pools Variable Payment Life Annuities (VPLAs).*

vii. *For an early exposition of these evolving pension design ideas see my 2014 paper written for the Dutch Royal Economics Society "**Taking the Dutch Pension System to the Next Level**", and more recently, my December 2022 Letter "**Pension Plan Design and Management in the 21st Century: Why and How We Need to Change the Conversation about Pension Reform**". Also see MacDonald, Sanders, Strachan, and Frazer (2021) "**Affordable Lifetime Pension Income for a Better Tomorrow**", National Institute on Ageing and the Global Risk Institute.*

viii. *Once again, for detailed evidence, see the articles cited in Endnote iii above.*

ix. *The increase in CPP/QPP benefits from 25% of eligible earnings to 33% is being phased in over a seven-year period.*

x. *See the 2020 KPA Policy Paper titled "**The Alberta Pension Plan Proposal: What's In It for the People of Alberta?**" for more on this.*

xi. *For example, BlackRock has launched a LifePath Paycheck offering in the USA which has separate capital accumulation and lifetime income components.*

Published by KPA Advisory Services Ltd., Toronto, Canada

416.925.7525. www.kpa-advisory.com