Pars Pro Toto[1]: On Current Pension Reform Efforts in Canada Re CPP Enhancement

By Saman Khodai

"The CPP, which is designed to replace about 25% of your average pre-retirement employment earnings up to a maximum amount [$51,100 as of 2013], is one part of your retirement plan."

Service Canada,
CPP Factsheet

The Political Pension Debate Cycle

Given CPP's clearly defined mandate, it is indeed remarkable to observe the media buzz surrounding the recent meeting of federal, provincial and territorial finance ministers at Meech Lake[2]:

> *"….CPP reform put back on the agenda", "….Way Forward" and "….Praise for developments as an important step with a future report that will move the yardstick considerably"*

Such headlines were visibly spotted in every major media, decidedly forming public opinion on this issue. What makes it that much more astonishing is the stance the Finance Minister himself took on the enhancement efforts by stating beforehand:

> *"….plans are expected to be placed on the table for discussion but not for implementation" and "....there will be no national consensus and therefore no deal"*

This lack of action – even for an enhancement of a relatively small scale – is usually blamed on a fragile economy based on a host of unfavourable macroeconomic data such as the unemployment rate, budget deficits and inflation to name a few. And these days, it can also be linked to the uncertainty over the so-called fiscal-cliff negotiations in the US or the unstable economic picture in Europe. Ostensibly, this course of inaction buys more time for reform while surreptitiously keeping an eye on future election dates.

This pattern is not novel at all and a key national policy issue is in this fashion metamorphosed into a subject that disappears from the public debate only to be periodically brought up into the spotlight by some *major* event such as pension shortfalls made explicit, boomers retiring, the demographic time bomb or dismal stock market returns. And no later than that point in time, the functioning of the entire pension system is questioned again and experts are asked to re-evaluate the system and come up with *ground-breaking* recommendations such as … a CPP enhancement!

Canada's Pension Landscape 101

A logical mind might ask what needs to be done to break this interminable cycle? Let's pause for a moment's time and step back: Isn't Canada's pension system globally viewed as a reference model for "pension reform" by organizations such as the World Bank, the OECD and the likes? Aren't policymakers, pension officials, politicians as well as scholars and researchers [such as myself] from all over the world striving to comprehend the system's design, its inner workings and the choice of modules?

[1] Latin for "a part taken or considered for the whole"
[2] Annual talks were held on Dec 17th 2012 at Meech Lake, Quebec, stirring numerous headlines on pensions in The Globe and Mail, Financial Post, etc.

The reason for all this does not lie with CPPIB's successful governance model and is certainly not due to some inexpedient cardinal ranking found in various reports.

Without any intention to discredit current reform efforts re CPP enhancement, Canada's pension system draws its superiority on a well thought-out architecture designed to deliver "diversification" in retirement income provision. In this landscape, retirement income is generated through several supporting pillars and via different drivers such as growth of the wage bill, financial market returns as well as general revenue.

Within this framework, it shocks me to observe how the CPP has increasingly become a synonym for *pensions* whereas CPP benefits – together with OAS and GIS – are per design meant to represent a mere floor. Income for retirement has to be topped up with workplace pensions (RPPs) and individual savings (RRSPs) in order to maintain a certain standard of living in retirement. These vehicles constitute the bulk of pensioners' income, particularly for middle and high-income earners for whom the relative role of CPP as a percentage of total retirement income abates.

The Way Forward

In this interplay of pension modules, any viewpoint deviating from CPP's current mandate of providing maximum 25% of pre-retirement income is fundamentally mistaken. Just as wrong is treating the CPPIB – the managing entity of CPP – as *the* safe haven best suited to absorb funds diverted from other pillars of the system[3]. By solely focusing on superior investment returns and lower management fees of CPPIB's investment process, such an undertaking undermines the very design of Canada's pension scheme. Additionally, this motion entirely disregards the perils of over-concentration of financial assets within a single entity[4].

A far superior solution to inflating the CPPIB's AUM out of proportion – an easy way out – is to make the other tiers of the overall system more effective. Initiation of this process has to begin with successfully communicating the fact that the current pension system has other elements in place beyond CPP. Further, the role and respective limits of each supporting pillar such as workplace pensions and individual savings have to be explicitly spelled out. And finally, on the path to fully utilizing the entire spectrum of vehicles to provide income in retirement, re-education will play a key role.

This right sort of education stands in stark contrast to what is commonly known as investment knowledge. For instance, every future retiree is commonly expected to answer a question such as "what is the risk level you feel comfortable with?" when sitting down with a financial advisor. This process is known to be futile and counterproductive by design with the *sole* function of re-distributing vast amounts of wealth from a large number of savers to a much smaller group of individuals active in the financial services industry.

The emphasis of education should be shifted from "requiring every future retiree to be an investment expert (just to be able to fill out advisors' questionnaires)" to "solely focusing on one and only one measure, target replacement ratio".[5] Derived from pension finance, this variable is an indicator of how an individual would fare in retirement relative to the pre-retirement living standard.

This single measure shall encompass all retirement savings across various system's

[3] In Australia where "Superannuation" assets hover around the trillion dollar mark (almost matching the country's GDP), this pool of capital is managed by <u>several</u> private yet publicly-regulated entities.

[4] An instrument to address the question at hand is the ratio of assets under management (AUM) to the size of the financial market, a simple yet useful proxy for concentration.

[5] This approach can also help reduce the flaws in the system when compared to increasing regulation and oversight.

pillars in addition to income floors provided by OAS and GIS. Periodic reviews will map future retirees relative to their target replacement ratio and allow for course correction in due time. While room for maneuver within the CPP portion is limited, aggregating the sum of investments under one umbrella will provide ample room for improvements by a) signaling to save more across pillars and, b) detecting dysfunctional elements of the aggregated portfolio.

In contrast to how challenging it may appear, the sights are not set too high when considering the tools made available today by technology.

Ascertaining whether suitable instruments comprise the portfolio, visualizing an array of risks associated with these instruments and determining the fee level at which individual components as well as the entire portfolio is managed, are enabled by the right choice of technology.

The Real Challenge

What is, however, very hard to overcome in this holistic approach is the vested interest of an entire sector to maintain the status quo with its totality of inefficiencies applying to any form of retirement savings other than CPP, comprising a minimum 75% of income for future retirees. Overcomplicating a not too complex issue, hanging on to opaque fees structures, charging individuals irrespective of performance etc. are just a few strategies to enable the old adage, “Charging too much for delivering too little”!

The sheer size and therewith power of the financial services industry in Canada as well as its oligopolistic market structure has, in my view, great explanatory power for this resistance to change. The logical consequence of this can be observed in reducing effectiveness of these pillars and their eventual paralysis in the worst case. It is therefore not surprising that the entire focus is diverted to the CPP when it comes to pensions … *Pars pro toto.*

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