# "The Canadian Model: Moving From Sustainability to Sufficiency"

Notes for remarks by:

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Good afternoon, and thank you Jean-Claude for that kind introduction.

At the Canada Pension Plan Investment Board we often have the privilege of meeting with delegations from other countries and organizations who come to learn about what I will simply call for now, the "Canadian model".

Today is special because not only do we have social security professionals from over 60 countries, but we have in attendance Canada's Chief Actuary, Jean-Claude Ménard, as well as many of Canada's – and the world's – foremost pension experts, as well as representatives of many of our stewards: these are the Ministers of Finance from participating Provinces and the Federal Government who jointly oversee the CPP Investment Board.

Welcome.

As you may be aware, Canada has received a fair measure of recognition during the financial crisis for the strength and stability of its financial system. This is rightly a source of pride for Canada and it calls to mind a less heralded but equally significant achievement; and that is, the successful reforms of Canada's national pension plan 12 years ago.

Through foresight, political courage and ingenuity, Canada's provincial and federal governments worked together with stakeholders including contributors and beneficiaries, employers, labour and academics to craft an enduring solution. This great example of federal/provincial cooperation has served to ensure the sustainability of the Canada Pension Plan – which next to universal healthcare is arguably Canada's most important social program.

Those of us at the CPPIB can't take any credit for this accomplishment. What we <u>can</u> do is share some of what we have learned from our experience of managing the CPP Fund to

help inform the debate currently underway across Canada – and elsewhere around the world – over how we can now move beyond the issue of pension *sustainability* to tackle the question of retirement savings *sufficiency*.

In other words, how can we have a retirement savings system that is *both* sustainable *and* sufficient; adequate to fund a secure and dignified retirement, but also affordable?

This question of sufficiency in Canada has taken on a greater importance over the past year for reasons that are clear. Quite simply, our population is getting older and many of us haven't saved enough for retirement. In addition, private sector pension benefits are in decline as plan sponsors have cut back on defined benefit plans and markets have cut into defined contribution plan assets.

We know from statistics and research that Canadians are concerned about whether they have enough retirement savings. According to a 2007 study by the Canadian Institute of Actuaries, only about one-third of Canadian households are currently saving at levels that will generate sufficient income to cover their non-discretionary expenses in retirement. Further, approximately 11 million Canadian workers have no access to a workplace pension plan at all.

At a time when only 28% of Canadian baby boomers are confident that they will be financially secure in their old age, this is an important and timely issue.

Federal and provincial governments have recognized these concerns and work is underway to identify the extent of any sufficiency gap in Canadians' retirement income.

This discussion is not something Canadians should fear. Canada embarked upon a similar discussion about pension reform 12 years ago and we are now much better off for that experience. Success a second time through can help ensure retirement security for ourselves and our children, and can give Canada an even stronger competitive position than it enjoys today.

In my remarks, I'd like to briefly share Canada's experience in addressing the sustainability of its national pension plan. With that as context, I would then like to offer some perspective on potential solutions being discussed with respect to the question of sufficiency within this country, and put forward a somewhat new idea for consideration.

The problems we face are not simple, but solutions exist. Our policymakers implemented successful pension reforms 12 years ago and we have every confidence they can and will succeed again.

First, a bit of context.

In 1996, the CPP was projected to become insolvent by 2015. This past July – some twelve years after the refinancing reforms - the Office of Canada's Chief Actuary reaffirmed its view that Canada's national pension plan remains sustainable with a 9.9% contribution rate over the 75 year period covered by its 2007 report. This is despite a recent finding that Canadians are living – and will therefore be collecting CPP benefits – longer than originally projected.

So what are the benefits of a national pension plan such as the CPP, and how might they be applied to the sufficiency challenges before us?

To recap, the CPP is a mandatory, contribution financed, national defined benefit plan that provides replacement income for 17 million Canadians with benefits that are fully indexed and fully portable. The CPP Investment Board manages the assets of the Fund not needed to pay current benefits – assets which do not belong to the government and are segregated from general revenues. It operates at arms length from government, free from political involvement and with a professional management organization accountable to a financially sophisticated Board of Directors. It has a singular commercial mandate – to maximize investment returns without undue risk of loss – and can invest with a high degree of certainty about the future cash inflows to the Fund. And due to its partial-funding structure, the Fund has an effective amortization period of 75 years.

These attributes yield a number of significant advantages for those who bear the Plan's risk: the contributors and beneficiaries themselves.

- A mandatory national plan creates scale and certainty of cash inflows that permit the effective pooling of longevity risk, investment risk and timing risk. With no dependence on a plan sponsor, and so, no solvency risk, we are able to manage the Fund from a sustainability perspective – in our case, over the span of 75 years – rather than from the triennial solvency funding perspective of an employer-sponsored defined benefit plan. This is an enormous advantage.

- The contribution-financed nature of the fund eliminates the question of who gets the benefit of any surplus – or bears the responsibility for any deficit. All Fund assets belong to CPP contributors and beneficiaries, and any excess returns drop straight to the Fund's "bottom line" where they create a cushion against adverse impacts or permit the contribution rate to adjust downwards over time.

- CPP benefits are backed by a farsighted intergenerational risk-sharing formula to ensure sustainability should future events require a plan adjustment.

- By providing the certainty of a fully indexed defined benefit, the CPP provides a predictable level of income and eliminates the risk that beneficiaries will outlive this element of their retirement income.

- Finally, with our scale, partial pre-funding, certainty of cash inflows, and a long investment horizon, we have the advantage of being able to invest over the span of decades and generations, rather than quarters and years. As such, we are better-positioned to earn higher risk-adjusted returns than many other investors.

- Importantly, scale also means that our active returns can be generated at a far lower cost than can be purchased from commercial money managers, and at a fraction of

the cost individuals must pay for the management of their individual portfolios. This is significant for the simple reason that high investment fees erode investment returns.

But for all that, and while the CPP is clearly sustainable, it is only one component of Canada's retirement-focused savings framework, and is designed to provide a replacement income of only 25% of the average industrial wage, or just under $11,000 using 2009 figures. This is a solid foundation for Canadians of all income brackets, but in and of itself is not designed to provide Canadians with their sole source of retirement income. To assess the sufficiency of Canada's retirement system, we must consider three other components of the system.

First is the Old Age Security benefit and, for those receiving the OAS who also fall below certain income levels, the Guaranteed Income Supplement. These are poverty prevention tools financed out of general government revenue. A single individual eligible to receive the maximum under both programs can expect to receive approximately $14,000 annually.

Next are voluntary, tax-assisted and employment-based defined benefit and defined contribution pension plans. Defined benefit plans have traditionally been the preferred choice for providing retirement income for middle and upper income Canadians, but as is the case in many countries around the world, the availability of defined benefit plans is in decline across the private sector. There are a number of reasons for this, but fundamentally, defined benefit plans promising 100% guarantees have simply become too expensive for plan sponsors to underwrite.

The result has been a shift to lower cost defined contribution plans that transfer investment decisions – and various elements of risk – to the individual participants. These plans appeared promising when markets were up, but they have shown – and caused – significant stress, now that markets are down and the number of Canadians nearing retirement is surging.

Last are voluntary, tax-assisted personal retirement savings plans. In Canada, we call these Registered Retirement Savings Plans or RRSPs; in the US they are called Individual Retirement Accounts, or IRAs. Individuals make voluntary tax-deferred contributions to RRSPs , which grow free of tax until withdrawn in retirement. They primarily serve middle and upper income Canadians, especially those in the private sector without employer-sponsored pension plans. However, RRSPs have less than optimal participation rates, attract relatively high administrative and investment fees and place the burden of making investment decisions on individuals – many of whom readily acknowledge their lack of expertise in this regard.

We have already established 11 million working Canadians – or about two-thirds of Canada's working population – have no workplace pension coverage at all. Clearly, the current system isn't working as anticipated. While more encouragement and investor education can help, in our view there is a more fundamental change required to alter this retirement savings outcome.

In terms of what change is possible, there is no affordable option that can provide an instant remedy to 30-35 years of under-saving. That said, corrective actions taken now can only improve our situation, while inaction will only make matters worse.

I said earlier that only 28% of Canadian baby boomers felt confident about their financial security in retirement. That's the bad news. The good news is that late-stage baby boomers still have roughly 20 years to work, invest and save. Post-baby boom generations, it goes without saying, have much longer than that.

In terms of the overall policy objectives, which are probably similar to what you are considering in your own countries, I believe they are quite simple and broadly-accepted:

1. Canadians should be assured of securing a sufficient minimum income replacement rate across the system – or, put in the most basic terms, enough

money to retire with security and dignity. I will leave it to others to debate what that number should be.

2. Any changes we make should improve on the status quo by implementing new policies that result in more retirement savings and better individual choices and meaningfully reducing investment and administrative costs.

3. The solution should be easily portable between jobs, fair to both employees and employers, and provide a consistent investor experience across the system.

Three broad potential solutions to the problem have been proposed.

Firstly, at a minimum, we have an opportunity to make the current system of voluntary, employment-based pension plans more cost-effective for plan sponsors and more attractive for plan participants. By achieving genuine uniformity of federal and provincial pension regulation across all types of retirement plans, be they defined benefit or defined contribution, we can increase the attractiveness of the current voluntary system. By ensuring that individual retirement savings arrangements have the same tax-sheltering currently enjoyed by final average defined benefit plans, we also have an opportunity to increase participation rates and contribution levels in defined contribution programs and individual RRSPs.

This would likely increase retirement savings, which is good, but mostly at the higher income levels. It would not, however, ensure sufficiency because participation would still be voluntary, individuals would continue to bear the investment risk, and it would not provide the kind of scale or asset-pooling needed to reduce investment and administrative fees.

We should definitely make changes like these to improve the status quo, but in our view, they will not be enough to make our retirement system sufficient.

The second approach includes a number of variations.  Among the ideas being proposed are the creation of new regional or national defined contribution plan options. In the most discussed proposals, initial enrolment in these plans would be mandatory for all workers without workplace pensions, with the subsequent ability for these workers to opt-out of the plan if they choose.

There is a growing body of research that suggests that an ability to opt out versus a requirement to "opt in" will significantly increase participation rates.  This, in turn, should provide the scale needed to enable private sector providers to reduce asset management and administration fees. Alternatively, a new organization modeled after the CPP Investment Board could be established to provide low-cost asset management services to plan participants and oversee administrative services.

This approach certainly has significant merit, in our view, but it also still has the same underlying issues inherent in any defined contribution arrangement, namely:

- Contributors would be individually subject to market risk during their contributory years, and especially to the prospect of not having enough savings to ensure an adequate level of retirement income if they reach retirement age after a period of poor investment returns such as we have recently experienced;

- Likewise, contributors would individually bear the risk of outliving their savings; and

- The task of explaining investment options and investment performance to millions of individual account holders would be demanding and could still fail to generate suitable investment choices and outcomes.

A third possible option would increase retirement income by adding a pure supplemental pension benefit on top of the existing CPP.  This approach would maintain the CPP's core benefits just as they are today but target the supplemental layer solely for pension

benefits. Consequently, any additional contributions would provide proportionately greater pension coverage than the existing core CPP.

This approach would take advantage of already existing administrative and investment capabilities, provide the pooling of risks that are inherent within a defined benefit system, and also preserve the very clear risk sharing arrangement embedded within the CPP. As a reminder, the government does not act as sponsor of the CPP – it is solely the beneficiaries and contributors who benefit from or shoulder responsibility for results, be they demographic, economic or investment related, that may be different from the projections used by the Office of the Chief Actuary. A supplement to the CPP would also be a very cost effective way to provide a relatively predictable stream of retirement income. We have estimated that private sector insurers in a voluntary annuity market would have to charge a contribution rate of at least 11% to deliver income benefits comparable to those delivered by the CPP. This amounts to 1.1 percentage points more than the current contribution rate of 9.9% for all benefits provided by the CPP – the cost advantage for a pure pension supplementary layer would be even greater.

It could be theoretically possible to expand this CPP supplemental plan to meet the full 50, 60 or 70 per cent income replacement rate that might be established as the policy objective. In practice however, this would not likely meet the affordability test and would have other implications such as possibly crowding out other workplace pension arrangements.

Instead of treating the three options I have outlined as alternatives, another concept that policy makers may want to consider is a hybrid of all three. One possible hybrid approach could include addressing the disparity in existing pension regulations, providing a supplemental CPP pension-only benefit as an expanded, mandatory pension program and then providing an easily accessible set of regional or national defined contribution plans as a further, voluntary way to accumulate retirement savings for example.

In this hybrid approach, there would still be flexibility for individual companies to create pension arrangements tailored to their specific objectives as well as for individuals to make choices according to their own goals and preferences.  There is also ample opportunity for both the public and the private sector to provide the administrative, servicing and investment components for the various elements of Canada's retirement system and still achieve the policy objectives I outlined earlier in my remarks.

That said, we recognize that proposing solutions is the easy part. The hard work belongs to policy makers who must bring to bear all of their wisdom and expertise to make the specific decisions required to fashion an effective and practical response to one of the most significant demographic, political and policy challenges of our time.

Having seen them succeed once, I am confident they can do it again and we at the CPPIB stand ready to provide whatever insight or assistance they might wish to seek from us.

As was the case with the CPP reforms 12 years ago, the key to success is to start with a good, robust debate about the policy objectives and alternate solutions, combined with the willingness and intent to choose a course and move forward.  In solving its own retirement income sufficiency objectives, Canada may also provide a relevant model for other countries around the world to consider.