

PENSION REFORM

A New Bias:

An Unprecedented Opportunity To Initiate True Reform

By: Warren Laing

In an effort to articulate the nature pension reform in Canada might take, significant work has already been completed. The media, government committees (both federal and provincial) and various organizations in the private sector have submitted a range of options and opinions that is equalled only by the range of biases those same options and opinions represent.

Despite dissimilar beginnings, what is common is a belief that Canadians aren't saving enough for their post-work lives. Despite partialities, what is shared is a fundamental understanding that the current system, if left unchanged, will face significant shortfalls. Debate persists on the severity of the problem. Dialogue, surely will continue on the immediacy of any action. The form this action takes, however, remains the most contentious point of any discussion be it on paper, on panels, or around our kitchen tables.

Setting form aside, for the moment, the motivation behind this considerable body of work is clear – Canada must embrace pension reform if we are to successfully navigate the challenging waters of post-work life in front of us. This fundamental appreciation for change supersedes even the actual structure change will take. The simple, widespread acknowledgement that change is required opens the door to invention, a door we best walk through with a revitalized integrity of purpose and intent.

As a country, we have an unprecedented opportunity to reshape the face of retirement. That face, however, if it is to truly represent an innovative, long-term solution, cannot characterize the biased interests of any one organization or committee no matter how articulate that bias may be.

In its most holistic expression, true reform, therefore, must reflect the needs of individual Canadians while addressing the collective needs of our nation. The starting point for this paper then, is to introduce a new bias, a bias that starts and ends with the needs of all working Canadians.

If elections are to be won because of this new bias, let each voter cast their ballot.

If companies restructure to profit fairly from this citizen-centric approach, let us all welcome commerce.

The national framework in which this new bias lives recognizes one fundamental tenet: All working Canadians deserve to retire well ...

All working Canadians do deserve to retire well

Unfortunately, 'well' expressed through the needs of the average Canadian, is becoming increasingly elusive. That elusiveness stems from a number of factors encompassing behavioural, economic and demographic conditions:

- The complexities of investing options coupled with the lack of fiduciaries to make sense of it all.
- Limited access to discretionary asset management (investment decisions are made by the highest level of investment manager on behalf of investors).
- The current fiduciary risk for employers who are or would like to implement a supplementary group retirement savings plan.
- Canadians' growing inability to save enough for their post-work years.
- An educational emphasis on creating layman investors versus a multigenerational push toward the merits of saving more, more often.
- An increasing reliance on weakened, voluntary third pillar vehicles to supplement mandatory CPP contributions.

- A shifting population that sees a dramatic rise in both the aged and visible minorities.
- A misplaced faith that a fund's size alone leads to greater efficiencies and better investment returns.
- An embedded cultural belief that government will ultimately bail us out.

These factors, combined with what Baldwin refers to as, 'the asymmetry of knowledge between consumers and sellers,' have created an environment that leaves many Canadians – be they Hansen's \$30-\$100,000 cohort in the private sector planning to retire in 20 years, Statistics Canada's 1/3 of all 45-64 year olds, or C.D.Howe's 3.5 million workers, 'on an inadequate retirement saving track' – with insufficient savings to maintain a decent post-work standard of living.

Pillars one and two: a solid foundation

Hansen, in his January 2010 report, 'Options for Increasing Pension Coverage among Private Sector Workers in Canada,' states, '...the CPP has been cited by the OECD as exemplary world-wide for its financial sustainability and Canada compares favourably internationally in terms of future income security for its lower income citizens.'

This positive assessment is shared by Mintz, Baldwin and others. However, when mid to upper incomes are evaluated – the \$30,000 to \$100,000.00 cohort identified by Hansen – that solid foundation remains just that, a good base to build on.

Baldwin's 'Research Study on the Canadian Retirement Income System,' prepared for the Ontario Ministry of Finance in October 2009, states, '...at average wages and salaries, there is a significant gap to be filled by third pillar income to eliminate the difference between what is available from OAS, C/QPP and GIS, and a replacement rate target of 70 per cent. As earnings increase beyond the level of average wages and salaries, the gap to be filled continues to increase.'

A growing dependence on a weakened third pillar

Pillar three consists of what is currently a wide range of voluntary savings vehicles.

If pillars one and two provide a solid foundation, pillar three then, becomes the financial structure needed to narrow Baldwin's 'gap.'

The growing dependence on pillar three, currently at odds with the combined decrease in individual savings and employer sponsored pensions, creates both a problem and an opportunity.

David Dodge, in a recent article titled 'What level of pensions do Canadians really want' (*Financial Post*, March 18) points out that Canadians are saving far less than they need to if they are to reach a retirement income equivalent to Baldwin's suggested 70 per cent or even a more practical 60 per cent of pre-retirement income suggested by others. The combined RPP/RRSP savings rates currently sit at about seven per cent for employed Canadians under the age of 60.

'With the exception of the working poor, a high fraction of gross earnings – from 10 to 21 per cent for retirement at 65 – must be saved every year to provide for a 70 per cent replacement of earnings after retirement. This fraction is likely higher than many Canadians believe and higher than is set aside in most employer-based group RSPs or Defined Contribution plans. It is also higher than the effective contribution over time to many employer-sponsored Defined Benefits plans, and for high-income earners exceeds the annual limits placed on RRSP contributions.'

Jack Mintz, in his 'Summary report on Retirement Income Adequacy Research' (December 2009), identifies a disturbing downward trend in personal savings rates since the peak of 20 per cent reached in 1980, pegging today's number at five per cent just shy of Dodge's seven per cent.

Defining the actual percentage is less important. What is of great importance, however, is the undeniable truth that the notion of retiring well is unlikely to happen for a growing majority of Canadians if the status quo is maintained.

Experts tend to agree that waning pension coverage is a key contributor to future retirement income shortfalls. As Baldwin reports, 'Employer-sponsored pension plan coverage has been declining since the late 1970s, and has fallen from 46.1 per cent of paid workers in 1977 to 38.3 per cent in 2007.' Three out of four working Canadians have no pension plan what-so-ever (Hansen). Roughly 11-million people are completely reliant on their own ability to save.

That ability, as many have shown, is less than adequate.

It is this paper's view that the citizen bias suggested earlier, be elevated to a higher plane in assessing the merits of any third pillar pension reform if we are to increase the probability that all working Canadians retire well.

For starters, it is imperative that significantly more Canadians become engaged in some form of supplementary pension plan. The form that plan takes can take its lead from what is currently the gold standard, a DB plan.

Discretionary Asset Management: Bridging the gap between the 'haves' and the 'have nots'

Traditionally, DB plan members have had two distinct advantages over their DC counterparts; a post-work income guarantee and access to discretionary asset management. 'Guarantees' are quickly fading – witness Nortel, Ford and a slew of others. However, discretionary asset management – a professional money manager is entrusted with the authority to make financial decisions on a plan member's behalf – has consistently provided a 'running start.'

'*The Ontario Expert Commission on Pensions*' (October 2008) references a long term study conducted between 1995 and 2006 that highlights a cumulative performance advantage of 14 per cent (one per cent per year with a cumulative gain of 14 per cent) for traditional DB plans versus DC. Here too, the actual percentage is less important than the ideology of providing more Canadians with access to what is clearly an investment advantage.

All working Canadians deserve access to that same financial expertise.

What was once the realm of the privileged – DB plan members and the wealthy – should be considered as a fundamental tool in providing the means for every Canadian to retire well. In essence, bridging the gap between the 'haves' and the 'have nots.'

In describing the possibilities, Baldwin states, 'In its classic form, DB plans provide complete certainty of benefit promises and complete uncertainty of required contributions ... At the other extreme, classic DC plans provide complete certainty of contribution rates and complete uncertainty of benefits ... Given the emergence of new plan types that combine elements of DB and DC, it is less useful to think of DB and DC as a bimodal choice than it is to think of a spectrum of choice.'

Providers cannot serve two masters: The merits of appointing a fiduciary

Baldwin's 'spectrum of choice' allows for discretionary asset management to be offered within what could be viewed as an enhanced defined contribution plan. Traditionally, DC plans have relied on plan members to select from a range of investment options. Ample time and carefully constructed education modules are dedicated to teaching plan members how to invest. In so doing, a plan sponsor believes they are passing on most, if not all, of the fiduciary responsibility to their employees.

Unfortunately, no matter how much training, no matter how many investment tools are provided, a fundamental disadvantage cannot be overcome—a plan member (one of those average working Canadians) may be an excellent machinist, but they are not trained to be an investment advisor. Likewise, a store clerk may be superb at their job behind the counter but is ill-equipped to select which investment option is right for her.

In other aspects of their lives, Canadians rely on experts. They have plumbers whom they trust to repair plumbing, they have dentists whom they trust to fill cavities, they have lawyers whom they trust to decipher the legalities of right and wrong. If Canadian workers are to experience that same level of comfort with their investments, they require the same trust with their financial provider. Discretionary asset management provides the conduit for that trust. As much as each plan member would sign over the authority for a provider to invest on his or her behalf, the plan sponsor too, by definition would call on that provider to be the plan's fiduciary.

The word fiduciary is derived from the Latin *fides* meaning faith and *fiducia* meaning trust.

A fiduciary, therefore, acts in the highest capacity of caretaker of another's rights, assets and/or well being. Once appointed, the fiduciary has an obligation to the sponsor and its plan members to carry out that responsibility with the utmost degree of good faith, honesty, integrity, loyalty and undivided service. Furthermore, an obligation is imposed to act reasonably in order to avoid negligent handling of the sponsor's interests as well as the duty to not favour anyone else's interest including their own.

Lest this definition sound altruistic and as such be dismissed as whimsy, fiduciary responsibility is a critical component to ensuring the average working Canadian and their employer reap the benefits of skilled, conflict-free advice.

In the U.S., a market much further along on the path to legislating fiduciary responsibility, Section 260.238 of the California Department of Corporations reads, 'It is improper to recommend to a client to whom investment supervisory, management or consulting services are provided the purchase, sale or exchange of any security without the reasonable grounds to believe that the recommendation is suitable for the client on the basis of information furnished by the clients after reasonable inquiry concerning the client's investment objectives, financial situation and needs and any other information known or acquired by the adviser after reasonable

examination or such of the client's records as may be provided to the adviser ... It is the duty of the adviser to inform the client if lower fees for comparable services may be available from other sources'.

From a provider's perspective, that means:

- no conflicts of interest either obvious or veiled
- complete transparency of fees
- full disclosure

Reflecting back on our desire for a new bias, one that starts and ends with the needs of the average working Canadian, a legislated fiduciary requirement for all providers would ensure that the interests of each employee would always come first.

They would indeed be one master well served.

Employers are people too: Recognizing a sponsor's needs to encourage participation

In '*Pension Reform in Alberta and British Columbia – the ABC Plan*' (2008), there is recognition that declining employer or sponsor participation is a direct result of a less than hospitable legal and tax environment, '... many employers in our provinces wish or are forced to "get out of the pension business" due to the significant administrative, legal, economic and regulatory challenges inherent in providing not only a DB plan, which can impose considerable risk on the employer who is obligated to deliver guaranteed benefits, but even a DC arrangement, which was once considered a simple, low risk alternative for employers'.

As much as this is a provincial observation, it illuminates Baldwin's national decline in employer participation mentioned earlier from 46.1 per cent in 1977 to 38.3 per cent in 2009.

In section 11.2 of the ABC plan, the recommendations are elegantly simple, '...a DC formula with generally matching employer and employee contribution rates. In essence, the ABC Plan design should provide the benefits to employers of DC cost certainty but include DB-like management and potentially, results, including best-in-class professional management, scale, investment expertise and very strong governance.' They go on further to recommend that, '...employers or employees contributing to the ABC plan do not have any investment choice. Rather, the panel recommends investment of the plan assets would be subject to the policy direction of the board of governors.'

Given the need to build a pension solution that is inclusive of all working Canadians, the ABC recommendations, applied on a national scale, would be a major step forward in recognizing the needs of plan members and their employers.

A 'modernizing' of pension standards to 'allow for more flexibility in pension plan products designed and offered by the private sector' as well as a 'modernizing of income tax rules to review and update, 'income tax limits that deter prudent retirement saving or limit participation,' as suggested by Hansen, would again encourage both employers and their employees to reassess their retirement objectives.

Ultimately, asset portability, not only from company to company, but from province to province as well, would dictate that this reform be shaped by national, not provincial, policy.

Preserving freedom of choice while steering Canadians in a direction that promotes their well being

Sunstein and Thaler in their paper '*Libertarian Paternalism is not an Oxymoron*' (University of Chicago May 2003) discuss human behaviour on a number of related fronts. The first deals with individuals and their inability to make the right choices. The second focuses on our natural tendency to accept opting out versus a more active opting in.

Their findings transcend borders as well as industries and give much needed insight into the ways in which our government, acting as the ultimate fiduciary for all Canadians, can legislate change that allows for freedom of choice yet ensures their financial wellness.

'The false assumption is that almost all people, almost all of the time, make choices that are in their best interest, or at the very least are better, by their own lights than the choices that would be made by third parties.' Choices that are highly personal and reflective of preferences – favourite colours, flavours or styles would counter this viewpoint. However, with more complex choices where inherent knowledge is absent, third-party involvement not only serves the individual better but removes all subjectivity.

Therefore, from an investment perspective, signing over the responsibility to a fiduciary accomplishes two goals; proper investment advice is made more consistently and more objectively and that advice is always in the best interest of that same individual.

On the second point, our difficulty in overcoming the inertia of opting in, Sunstein and Thaler argue that, ‘Freedom of choice is itself an ingredient in welfare. But sometimes it is a chore to choose ... But much of the time, especially in technical areas, people do not particularly enjoy the process of choice and a large number of options is a burden. By contrast, a thoughtfully chosen default rule, steering them in sensible directions, is a blessing.’

Our government must constantly balance the needs of the individual with those of the nation. Specifically, regarding pensions, if Canadians aren’t saving enough, should it fall on the shoulders of future generations to make up for this shortfall? Unfortunately, there exists a tacit understanding that when all else fails, our government will bail us out. This dependence on government not only creates an unnecessary burden on all tax payers – federal or provincial – but also robs Canadians of their desire to provide for themselves and their families. Pride is an underrated motivator.

Fortunately, if the findings of Sunstein and Thaler are to be believed, a government legislated supplementary pension plan which:

- allows qualified employers and employees to opt out versus opt in
- calls for a fiduciary to invest on behalf of plan members
- works for sole proprietorships, multi-employer plans, as well as large corporations
- is cost effective for both plan sponsors and plan members and locks assets in to prevent early withdrawals would be a welcome alternative to any future bail-out.

Size matters, to a degree

Much has been written about the merits of super funds. Theoretically, economies of scale, access to superior fund managers, researchers, and analysts should substantially increase as a fund’s assets under administration grow. In his ‘Summary Report on Retirement Income Adequacy Research,’ Jack Mintz agrees, but only to a point, stating, ‘Generally, as the fund gets larger in size, one would expect per asset costs to decline as fixed costs are spread over a larger number of accounts. Nevertheless, at some point, minimum efficient size may be reached whereby unit costs no longer fall with size since larger capital requirements to service investors are required. It is possible that diseconomies of scale can arise whereby unit costs rise with asset size when large organizations become inefficient in their operations.’

Furthermore, Mintz concludes, ‘...using Canadian pension fund data, (there is) little evidence of economies of scale in that there seems to be little correlation between costs and size of funds, in contradiction to the insurance company data. It might be that minimum efficient scale effects are attained once a fund reaches a certain size but the research is still inconclusive on this point.’

Hansen offers up a counter argument. ‘It has been speculated that very large super-funds could result in inefficiencies due to lack of competition and over-size, or could have unknown impacts on the economy due to an overconcentration of assets under one governance structure. Problems with governance structure and representation have also been suggested. However, no supporting data have been found to validate these claims.’

Chart 1: Investment Returns Net of Fees

Pension Funds vs. Mercer Balanced Fund Median As of Dec 31, 2009

Institution/ Model Portfolio	Net Assets	* Asset Mix-Debt/ Equity	Annual Returns 2009	Annual Returns 2008	Annual Returns 2007	Annual Returns 2006	Annual Returns 2005	3 Year Annualized	5 Year Annualized
OTPP	96.4 Billion	27% / 73%	13.0%	-18.0%	4.5%	13.2%	17.2%	-1.1%	5.1%
OMERS	47.78 Billion	15% / 85%	10.6%	-15.3%	8.7%	16.4%	16.0%	0.6%	6.6%
Caisse des Depots	131.30 Billion	41% / 59%	10.0%	-25.0%	5.6%	14.6%	14.7%	-4.5%	2.7%
Mercer Balanced Fund Median	331 Million	42% / 58%	16.1%	-15.5%	1.5%	12.7%	11.7%	-0.1%	4.7%

** Real Estate, Commodities, Private Equity, Infrastructure is included in Equity*

** Interest Bearing Instruments, Real Return Bonds, Real Estate Debt is included in Debt*

Source: Mercer Investment Performance Survey of Canadian Institutional Pooled Funds

A third source, Mercer, provides some clarity by comparing the investment returns of three of Canada’s largest funds with those of a much smaller balanced fund median (see *Chart 1*).

The results are a good indication that smaller funds, all fees in, can generate returns that are comparable with their larger counterparts.

Perhaps all three views are correct. Size, in and of itself, is a contributing factor, but it is not the core reason for a fund's success.

More relevant are the dimensions of:

- Diversification: Even Mintz and Hansen would agree that spreading assets efficiently would increase the odds of a respectable return while decreasing the chances of having one basket, with too many eggs, overturning.
- Predictability: Given the long term horizon of any retirement product, generating consistent returns with nominal exposure to risk contributes to a plan member's peace of mind, knowing that they can rely on a reasonably predictive financial future.

The formula for long-term success is simple – achieve above median performance with nominal risk at the lowest price possible. Delivering on that simplicity consistently over a decade's long horizon, however, is the real challenge. That challenge lessens considerably once a 'minimum efficient scale' is reached and a comprehensive set of stringent rules are legislated.

The need for a national regulator

All Canadians will retire. That is only a matter of time. Retiring well, however is an increasingly complex and difficult contest. In order to increase the odds of 'well' happening, a government role is required to, as Hansen suggests, 'ensure that individual interests are protected and that all Canadians have the opportunity to save for their retirement in a cost-effective and efficient manner.'

The ABC plan reinforces this need for strong governance stating, 'above all else, operated under clearly understood rules and procedures by a governing fiduciary that possesses the necessary expertise to understand its role and the authority to provide the necessary management to oversee the plan's operations ... governance and administration of the plan should be performed by an organization at arm's length from government.'

Based on these assessments, this paper recommends establishing a national regulatory agency to set registration criteria and to oversee a special class of licensed investment counsel/portfolio managers (IC/PMs) who are required to provide discretionary investment management services to the plan member through either third-party life cycle funds and/or model portfolios comprised of third party mutual and index funds. These IC/PMs would act as a fiduciary on behalf of the plan sponsor.

Registration criteria could include:

- The IC/PM must enter a discretionary asset management agreement with each plan member.
- The IC/PM must be appointed to act as fiduciary, acting on behalf of a plan member, and as such be free of conflicts of interest.
- The IC/PM must only use prospectus mutual funds or index funds offered at arms length by third party providers.
- The IC/PM must have a Know Your Client form on file for each plan member.

These forms should be updated on a regular basis to ensure life changes are reflected in their plan.

The IC/PM must have complete fee transparency, by negotiating the best MERs possible from each provider and pass those fees on, without loading, to the plan member and be required to publish a statement setting out all fees and charges including their own.

The IC/PM's only source of revenue should be the fees charged to either the plan sponsor or the plan member.

The face of Canada is rapidly changing: simplicity becomes all the more important

Baldwin points out that 1/3 of Canadians 45 to 64 are likely to end up with incomes that fall short of adequate minimums and/or incomes that will allow them to maintain their standard of living.

Canadians approaching retirement are now the fastest growing demographic in the country. The 55 to 65 cohort has jumped 28 per cent in the past five years to 3.7-million people (Statistics Canada).

Furthermore, 1/3 or 14.4 million people will be a visible minority within three decades versus 5.3 million in 2006. The largest concentration will be in Toronto where an estimated 63 per cent will be a visible minority by 2031 (Statistics Canada).

There is little question that Canada's future elderly will be a more robust, ethnic mix.

That collective will be linked by one common goal; a desire to retire well.

Naturally, that after work notion will take on different meanings.

However, the means to achieve that notion will rest in the hands of a government willing to address the commonalities of diversity while embracing the disparate cultural attitudes toward saving and investing.

All Canadians deserve to retire well: How do we ensure that what they deserve is what they actually get?

At the onset, this paper proposed a new bias; national pension reform that starts and ends with the retirement needs of all working Canadians.

The intent behind this citizen-centric approach is to reframe the arguments put forth by various government bodies and private sector initiatives. This reframing allows for an honest perspective from which to evaluate the plethora of material purposed to reconstruct a pension system that will only benefit from becoming more inclusive and more personally responsible.

With the average Canadian's retirement needs at stake, it is only fitting then that those needs be at the fore of any reform proposed regardless of its source. Overt or veiled, biases are prevalent throughout each argument-this paper's is no exception. However, each of these biases must take a back seat to the needs of a person and a people.

Discretionary asset management for the masses, therefore, serves the interests of what will hopefully be a greatly expanded investor base. Furthermore, having it reside in the private sector insulates tax payers from any expectation that government will be held accountable.

Providers that are mandated to take on all the duties and obligations of a fiduciary, again puts the needs of average working Canadians first and thusly, should be considered one of the building blocks of true reform.

Having a solid foundation – Canada's first two pillars – provides the necessary base on which to build a private sector solution strictly regulated and consistently applied nationally. For government to forego the possibility of expanding the CPP, it must receive assurances that the benefits of a private sector solution – healthy competition, product innovation and diversification to name but three – are closely monitored and driven solely by the needs of individual plan members and their sponsors.

Ted Menzies has stated, 'Individuals must take on more responsibility for ensuring they have enough to live on during retirement' (*Globe & Mail*, October 24th, 2010). In this context, a more comprehensive study of the concept of 'libertarian paternalism' put forth by Sunstein and Thaler and its application to Canadian pension reform is warranted. To be able to preserve freedom of choice while steering Canadians in a direction that promotes their well being creates a savings environment that is at once mandatory and yet allows for a voluntary opt out for qualified employers and employees.

This paper's view is that there is a fundamental desire shared by all Canadians regardless of ethnicity or cultural make-up to provide for themselves and their families. It is government's responsibility therefore, to recognize and embrace this characteristic while acknowledging that those same Canadians are ill-equipped to make the financial decisions that will grant them that desire.

In closing, the fundamental appreciation evident in all submissions, regardless of bias, that Canada's pension system must be re-examined is encouraging simply because it connotes the widespread understanding that reform is both necessary and imminent.

If Canadians are to move toward their retirement years with confidence instead of trepidation, a certain comfort will be afforded by the knowledge that their government has assured them that their needs framed the basis for both the immediacy of reform and the shape that reform ultimately takes.

All working Canadians do deserve to retire well.

We're counting on true reform to make sure what Canadians deserve, is what they actually get.

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