



EXCLUSIVE INTERVIEW:

Today I'm pleased to be talking to Keith Ambachtsheer, President and Founder of KPA Advisory Services. Keith is also Director and Adjunct Professor of Finance of the Rotman International Centre for Pension Management at the University of Toronto.

We are going to get his take on whether Canada will still be on the right road to increasing pension coverage and cost-effectiveness if the Duncan/Flaherty proposals for pension reform tabled at the June First Minister's conference in PEI become a reality.

Thanks for joining me today.

My pleasure, Sheryl.

Q. Keith, can you briefly summarize the proposal in the pre-PEI conference exchange of letters between Federal Finance Minister Flaherty and Ontario's Finance Minister Duncan?

A. I think the big thing that people noticed generally — and certainly it got most of the media attention — was the apparent willingness to look at the Canada Pension Plan (CPP). The code word that was used was “enhancing” the CPP. Well that still leaves a lot of room for what that ultimately might mean, and I'm not sure how well-defined those enhancements currently are.

Your listeners may know that the next step in this process is working groups both on the “what enhancement means question” for the CPP and on the other broad stream that they have now called “pension innovation.”

Again, pension innovation can mean many things. They have taken certain things off the table in terms of what it does not mean. It does not mean creating a Canada Supplementary Pension Plan (CSPP) which I wrote about in a C.D. Howe Report a couple of years ago.

But it still has some promising aspects as to what it could mean, so I think the challenge now is to turn broad agreements into a more specific set of ideas that are supposed to be ready for presentation at the next Finance Ministers' meeting in December.

Q. You are suggesting that what is coming off the table is a national or provincial supplementary pension plan based on personal accounts and auto-enrolment. Do you think that's a good idea? Are they going to get where they want to go using a private sector approach?

A. As I mention in my letter (*Ambachtsheer Letter*, July 2010), the footwork that went on reminded me of the soccer final between the Dutch and the Spanish — a bit of dirty play.

There is a concept in the U.K. that looks very much like my CSPP idea. It's a national pension plan called NEST that is supposed to cover all the non-covered workers in the U.K. It had auto-enrolment — at least until the new government came in and this now will be re-examined.

But what happened is that the insurance industry called NEST a failure and a disaster. Without doing their own due diligence, the federal finance officials picked up on this and started using the same language, when in fact, according to the CEO who I know quite well, things are on track and on budget. So I think the way the CSPP proposal got taken off the table was “a little bit of dirty pool.”

Having said that, the idea that you can combine some of the principles — and auto-enrolment is not gone by any means — the idea that all employers who do not currently offer a pension plan need to facilitate their workers being in something, is still on the table.

It's interesting that Australia has just taken a major look at their DC personal accounts-based pension system and came to the conclusion that it is too expensive, too inefficient, and that competition is not working. They have come up with what I think are some very creative proposals around how you can combine oversight and a requirement for each provider of a retirement income solution to meet certain criteria and certain standards.

I think this offers an interesting way for Canada to go where you end up with a situation with some rules around auto-enrolment and the requirement for employers to participate. You have private sector delivery but you also have (which was the key thing in Australia), an independent trustee process that is both objective and qualified to ensure that the outcome is low cost and in fact meets beneficiaries' needs. If we take that idea, there is no reason I can think of why we can't make it work in Canada.

Q. One of the recommendations is to improve financial literacy and disclosure. Do you think that will result in improved savings and better investment choices by Canadians?

A. Well, what I wrote in my piece is that financial literacy is like motherhood. It's impossible to be against it. But I think we also have to pay attention to behavioural economics and behavioural finance research about not having too high a level of expectations about what education can do for people when they are faced with a very complex financial challenge if they don't have a pension plan.

There are a whole lot of pieces you need to put together in order to get a post-work standard of living that you are happy with. It's not easy, and what behavioural finance research has shown is the benefits of guiding or nudging people into the right direction with default options, i.e. pre-designing and automatically having things happen.

You know in Australia, 80% of workers end up in whatever is the default option. That's what they choose to do.

Q. What are the pros and cons of enhancing CPP coverage? Is there a right way and a wrong way to modify CPP?

A. I think that the more the enhancement idea gets explored in detail, the more challenging it becomes as to how to actually do something substantive that isn't hugely complex. Even in my own discussion with some of the people who are closer to the mechanics of the CPP, more questions have been raised.

I think what you generally want to do is to increase coverage. What I mean by that is that you want to cover more income. Currently the yearly maximum pensionable earnings (YMPE) is about \$47,000 and that's the end of it. So 25% of \$47,000 is \$11,750 and that's where the current formula peaks out.

If you were for example to double the YMPE, then you are covering twice as much income so I think that has some merit in terms of at least creating a base for middle income workers as increasing above the Old Age Supplement (OAS) the amount of the government public sector pension that they are going to get for a lifetime that will be inflation-indexed.

I'm less taken with the idea of increasing benefits because that raises a whole series of questions about how to do that and how to do that fairly on a prefunded basis which is the current requirement of any enhancements. Well once you start figuring out how you would actually do that, it's hugely complex.

Q So going back to the idea of multi-employer plans operated by insurance and existing financial institutions, do you think if the right oversight was there and the auto features were built in including the obligation to enrol in companies that currently don't have plans, that that this approach could achieve the same objectives as a national or provincial supplementary pension plan?

A. There are two answers. The current track that we are on is the only option that is going to be seriously explored. What's interesting is that one of the new players in this pension reform drama is Alberta Finance Minister Ted Morton who has strongly opposed (in writing) any form of CPP enhancement beyond some minimal, at the margin possibilities.

But the more that he becomes informed about the behavioural issues, the more he realizes that you do need some form of government oversight of the private system approach for it to produce the kind of outcomes that we all want, which is low cost, well-designed systems that benefit the participants.

So I do think that there is a significant possibility that we will go that route, and if we do that we must keep the interest of the beneficiaries in mind throughout the process. As Jeremy Cooper said in Australia, "This is not about enhancing the financial services industry. This is about enhancing the benefits of the beneficiaries."

If we keep that goal in mind, I think we can do some very innovative things.

Q. You mentioned Australia earlier, but what kinds of things can we learn from jurisdictions such as Australia and the Netherlands about increasing pension coverage and enhancing the cost-effectiveness of converting retirement savings into post-work income?

A. The Dutch have done the cost effectiveness part reasonably well because most of the pension system is being managed by a small number of very large players like PGGM and APG. By the time you list the top dozen providers-- which now tend to be industry type arrangements -- you've pretty well covered most of the workforce.

They are all on a Canadian provided service called CEM Benchmarking so they all know what they are spending to provide these services and they do operate at very reasonable cost. But it's very collective and they've come from a formula that was what you might call "hard DB" to a much softer DB, recognizing that if you want sustainability you have to put flexibility into what you can afford to pay over time.

The Australians come from the other side because they come from what is effectively a personal accounts approach to retirement savings. They are now starting to recognize that they don't have those large scale institutions and that this is a problem. They actually look to Canada because there are some very good ones

in Canada and Europe – not just the Netherlands, but in Denmark ATP (like CPP in Canada) is a very well run, low cost system.

There are some very good models out there and what we are seeing now is that there is acceptance of certain success drivers of a good pension delivery organization and there is movement towards getting organizations to meet those five criteria for success. So that's a global effort and it's converging.

Interestingly, one of the ways it is converging is through their membership in the Rotman ICPM.

Q. You say there are five criteria for success. Could you run through those for us?

A. Yes, I can.

1. The first one is alignment of interest. The plan has to be run for the benefit of beneficiaries and it has to be legally set up so it can do that.
2. It has to be well governed. You can have a perfectly aligned system, but if it is badly managed, you will still get bad outcomes.
3. Sensible investment beliefs. Despite the fact that we have tens of thousands of brilliant investment experts, it's amazing how little large institutions have stood back and really said, "What is the opportunity set out there? What should we think about investing? What is the difference between long-term investing and short-term investing? Are we saying we are doing one, but doing the other? Also, risk management is required in the way that it meets the needs of the beneficiaries.
4. Right-scaled. What I mean by right-scaled is that you are neither too small nor too large. It's sort of an empirical question as to what the right range is but the view that I've come to is that for an organization to be sustainable and be able to attract the kind of resources it needs internally, it needs to be managing \$25 billion and up. Big numbers. On the other hand, I think once you get up into the \$200-\$400 billion as some of the really large systems in the world are, you maybe start to run into diseconomies of scale so to me a nice round number may be \$100 billion which has a plan membership of anywhere between 250,000 and 500,000 members. Those are I think the right-scaled systems for a lot of reasons.
5. The final one is competitive compensation inside the pension organization. In other words, if we want quality organizations we need quality people. To get them, we have to be competitive in the labour markets where these people are. Whether we like it or not, the investment market is a highly-paid market.

So if you can do these five things together, you will have a crackerjack pension delivery organization.

That's very interesting Keith. It will be fascinating to see how it all plays out and I'm sure you and the ICPM will be at the forefront of these developments.

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