An Exaxe White Paper

Pooled Retirement Pension Plans
Gateway to compulsory pensions?

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intelligent solutions for life & pensions

PRPPs - Gateway to compulsory pensions?

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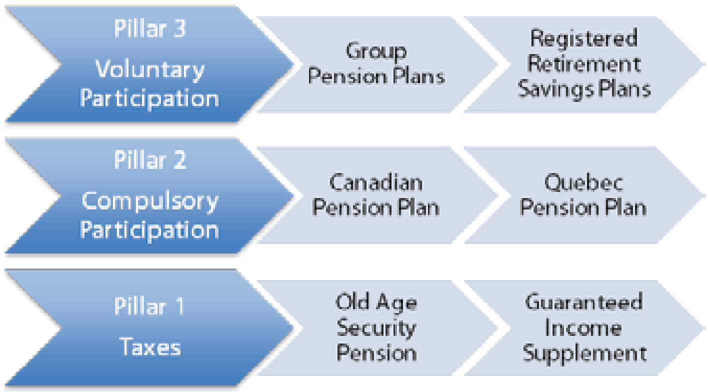
Global Pension Crisis

Like most western countries, the level of pension savings in Canada is a major issue for the Canadian government.[1] Increasing longevity is driving concerns about how Canada can manage to provide for its senior citizens in the future, as they live longer and therefore require greater amounts of money to sustain themselves in their retirement.

Canada instigated a three-pillar approach to pension provision, which consists of a basic non-contributory pillar, a second pillar of statutory contributions and a third voluntary pillar.



Given the dramatic increases in longevity to date and the fact that these increases are forecast to continue, Canada needs to look at the options it has to ensure that an ever increasing section of the population does not sink into pensioner poverty. According to HSBCs current advertising campaign, two-thirds of the people who have ever reached 65 are alive today.

In other countries, a heated debate is taking place on how to cope with this issue. In Australia, they have already made superannuation contributions compulsory, with employers contributing twelve per cent of each employee's salary into a superannuation fund to be drawn on in retirement. They are already considering increasing this amount to ensure greater pension pots.

In the UK, they are now auto-enrolling all workers into pension schemes, albeit with the opportunity for the employee to opt-out. The majority of all western countries are considering, or have already started, increasing the state pension age to delay retirement and increase the average working lifespan. Are the Canadian authorities heading down the same route?

Enter the PRPPs

The arrival of the Pooled Registered Pension Plans (PRPPs)

1. Summary report on Retirement Income Adequacy Research - Jack M Mintz 12/18/2009 http://www.fin.gc.ca/activty/pubs/pension/pdf/riar-narr-BD-eng.pdf

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brings a dramatic change in the pension saving landscape. The essence of the change is to make it possible for those in smaller firms and among the self-employed to enjoy the benefits of scale that are enjoyed by members of larger pension schemes, thereby encouraging them to join. By pooling their contributions in designated registered schemes, the members can benefit from the economies of scale achieved by the larger corporate schemes.

This should result in better returns, enticing more people to start saving for their own retirement rather than relying upon the state. The PRPPs are aimed at firms with less than 500 employees and firms that currently have less than 10% of their workforce in pension schemes.

The idea behind the PRPPs is excellent. For too long people who didn't work for the government or for large corporations were effectively excluded from attractive, efficient pension savings vehicles. The provision of easy access to good pension schemes for the private sector is vital as it is reckoned that only one third of workers in the private sector are covered by a registered pension plan or a group RRSP (Registered Retirement Savings Plan).

PRPPs can significantly expand the numbers saving, particularly because employers must facilitate savings via payroll deduction into the plans, which makes it much easier for employees to contribute and to maintain their contribution level. Another positive aspect of the PRPP regulation is that the government avoided the populist trap of insisting upon employer contributions, which has been shown to drive wages down. In effect the employee always pays and making it clearer will give employees more ownership of their pension and will hopefully make them focus more on the pension provider's performance, i.e. how the funds are being managed and what charges are being levied. Without this engagement by the ultimate owners of the products, market forces will not deliver the quality of service that is required in this area.

But the question remains, will the provision of better value pension products on its own be sufficient to increase the numbers saving for a pension in Canada or will the government and provinces be required to take stronger action by moving to a compulsory or semi-compulsory system?

Enforcing participation abroad

Outside of the Nordic countries, Australia has been the prime mover in forcing participation in pension savings in the western world and its open economy more closely resembles Canada's. In Australia, the compulsory approach has resulted in almost total pension coverage of the working population.

The success the Australians have had in increasing pension saving has attracted much interest around the world. However, ominously, one of the key issues that the Australian government noted during a recent review is that there has not been a sufficient increase in the financial awareness of the general population with the result that over 80% of all members had their money in the default investment option and that only one quarter of those have actively chosen to be there.[2]

Thus while the regulator has been effective in ensuring the prudential regulation of the superannuation funds, the charges and retail service levels have not been regulated by proper competition due to the members lack of engagement with the system. Research, by Roy Morgan, shows that over 80% of those who do switch super funds actually do so because they have changed job, rather than because of fund performance or management.[3]

This research does not augur well for a voluntary approach. It is hard to see how to engage people with the need to save if even those who are forced to do so, remain indifferent to the actual products they possess.

Using inertia to increase coverage

The UK have also embarked upon a move to increase pension savings, although they have eschewed the compulsory approach in favour of a softer enforcement of pension saving through their auto-enrolment / National Employment Savings Trust (NEST) initiative, which is going live in a phased manner from 2012.

The UK approach enforces auto-enrolment in qualifying pension schemes for all employees of firms of 5 workers or over but it allows the individual workers to opt-out. NEST has been setup to provide a low cost pension scheme (it is a non-profit making organisation). It is hoped that many of those who would not actively join a pension scheme will end up in the scheme because they will not actively leave it; thus using a passive investor's inertia to boost the amount of retirement savings.

2. Australian Super, 'Review of the Australian Super's default investment option,' February 2010.
3. Roy Morgan (2010), Superannuation and wealth management in Australia, Report May 2010, pp.47.

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The opt-out is seen as key at the start for political purposes although there is a widely held belief that it will be abolished later, once the scheme is up and running in order to consolidate the numbers saving and extend the scheme further across the population. This will be almost certain if the numbers opting out increase significantly above the 20 -50% forecast by the UK Department of Work and Pensions.

Could Canada follow the compulsion route?

In looking at the pension landscape in Canada, it is noticeable that there is a very mature infrastructure in place for the provision of plans to a large sector of the population. PRPPs are designed to expand this to ensure that the vast majority of the population have access to a reasonable low-cost pension with a wide range of fund / asset choices.

Once this is in place, the only question will be whether availability will be sufficient to encourage the majority of the population to start taking responsibility for their retirement by starting to save or whether further measures will be required to make it happen.

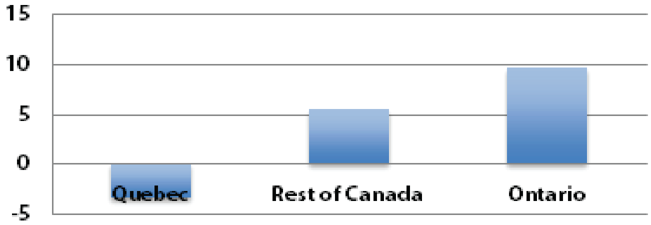
It is notable that the regulations for PRPPs allow individual provinces to introduce auto-enrolment and that Québec has already announced a decision to take this line. Québec is following the UK model, allowing employees to opt out of the scheme and hoping that the general lack of interest in pensions will mean that a large majority stay in the scheme by default.

However, this means that the Québec government is taking the approach that those who are not sufficiently engaged with the need for personal pension saving will be relaxed enough to permit the deductions to be made from their pay for something they don't believe in. Is it not far more likely that they will immediately seek to opt-out from something they don't believe in when the direct cost to them is so high? Surely the general population will see this as a special tax for living in Québec, unless the other provinces follow suit quickly?

Quebéc's ageing population

Quebéc's precipitate action in pushing harder is due to the fact that it is facing a 3.5% decline in the workforce over the next 15 years, compared to a 5.5% increase across the other provinces, which makes their pension funding situation more acute.

Working population growth



Source: Institut de la statistique du Québec, United States Census Bureau, Statistics Canada and Ontario Ministry of Finance

Of course, increasing the retirement age can offset this increase and steps are being taken across the western world to extend peoples working lives by delaying the start of retirement payments, either by lifting the retirement age statutorily or by encouraging late retirement by increasing benefits for those who do.

An alternative to compulsory pensions is later access to pensions, which is one way to bolster the current system without needing to increase the funding. Increased longevity means that a man who was 65 in 1966 would live for 13 years on average but by 2020 the average 65-year-old man will live for 20 years. That extra 7 years is a substantial extra cost and could be met, at least partially, by extending the working life so that each individual contributes more and they also spend fewer years in retirement.

However, there does not appear to be any major desire in Canada at present to follow the US example; they aim to increase the retirement age to 67 by 2024. The state cannot afford to plug the gap. Which means that it is going to be very tempting for the provincial and federal governments to move to compulsory pension savings as the only way to prevent a dramatic increase in pensioner poverty over the next three decades.

Is product enough?

The establishment of Pooled Registered Pension Plans puts the foundations in place for moving to a semi or full compulsory system. Of course, having the correct products is not sufficient to allow compulsory pensions to be accepted by the general population.

Forcing people to pay into pensions feels like taxation, so the pension providers will need to engage the individual employees in order to ensure that they take ownership of the products and realise the importance of building a substantial pension fund to live on in their retirement.

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Subsequently, to engage the population, the life and pensions industry needs to communicate with it in the way that it expects. The life and pensions industry must also provide the levels of service that most people expect automatically from any service provider. This means utilising the newer technologies that are becoming part and parcel of everyone's day-to-day life.

Consumer technology

Radical changes in how people live and interact with each other have occurred over the last two decades. As a result, pension providers must now have systems that integrate with the modern lifestyle; using social media to allow people to monitor and manage their own pension savings as a matter of course.

Many pension providers are woefully unprepared for this aspect of servicing the customer, relying on antiquated systems that inhibit the type of real-time interaction consumers demand today. Unlike the banks, which have embraced real-time access, life and pension companies have in general over-relied on the distributor sector to handle the interface with the customer leaving a gap between themselves and the ultimate payer.

While PRPPs will still be distributed via third parties, consumers today will expect a lot of direct interaction with the provider to understand their retirement situation and to plan to improve it. They will expect to use smartphones and tablets to achieve this.

Conclusion

It is clear that PRPPs complete the jigsaw for the Canadian third Pillar for pensions. But whether the take-up is sufficient without compulsion remains to be seen. Where the Quebéc government has gone, other provinces will feel it is prudent to follow. It is only a short step from auto-enrolment with an opt-out to auto-enrolment without an opt-out. Given the scale of the problem in funding pension and the fact that longevity increases are not going to stop, it is hard to see how Canada can avoid merging Pillar two and Pillar 3 by moving to a fully compulsory system over the next decade.

About the Author

Tom is Head of Product Strategy at Exaxe with primary responsibility of overseeing product direction. Tom has extensive experience of managing web based insurance software from conceptual design through to commercial release and beyond. Tom has been leading the development of the Exaxe Internet insurance architecture since August 1999.

About Exaxe

Established in 1997, Exaxe (www.exaxe.com) helps Life and Pensions companies launch new products faster, administer post retirement products more efficiently and respond with greater flexibility to the marketplace. With Headquarters in Ireland and offices in United Kingdom and the Netherlands, we provide leading edge; front, middle and back office solutions specifically for life and pensions.

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