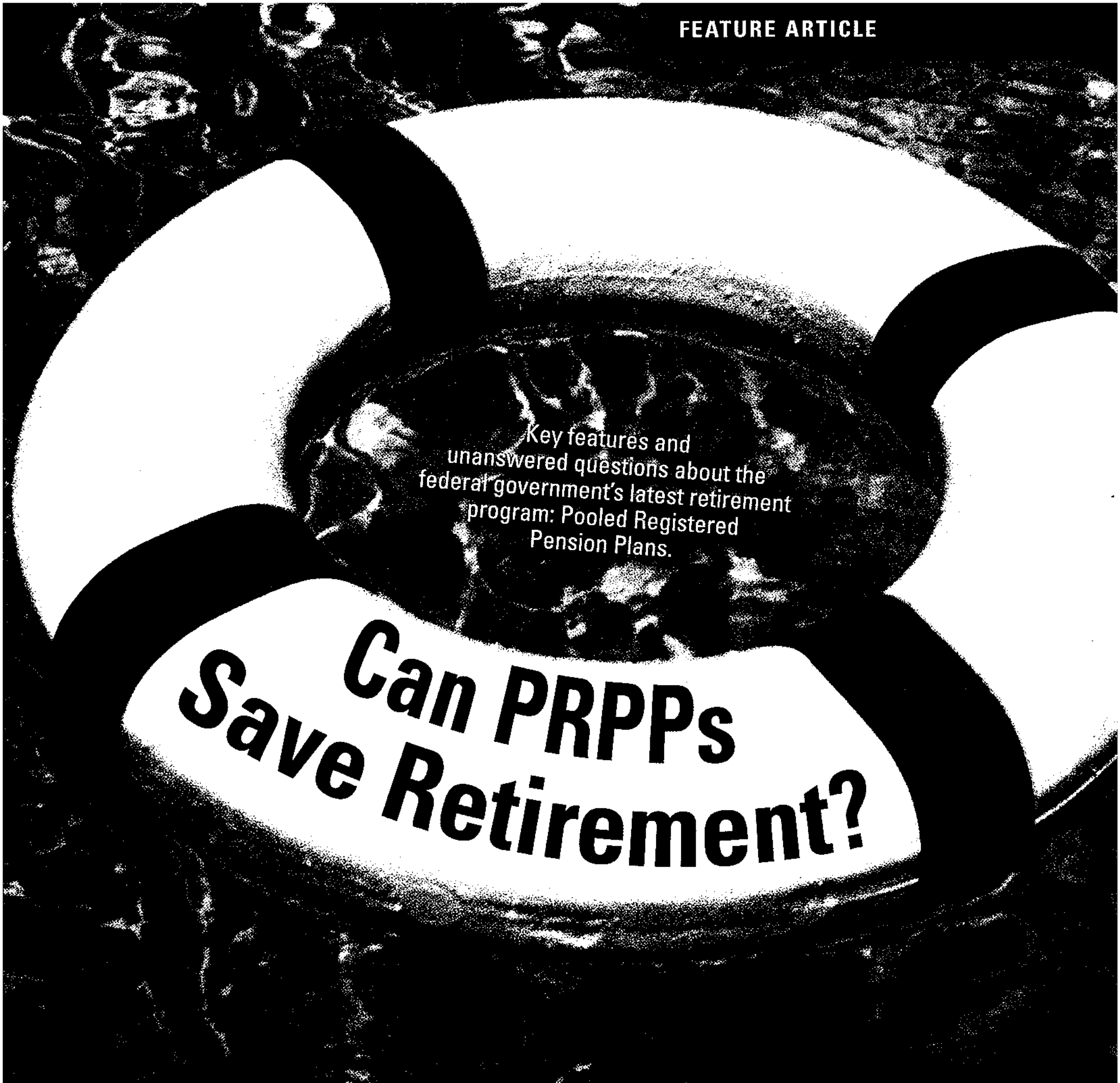

Can PRPPs Save Retirement?

Key features and unanswered questions about the federal government's latest retirement program: Pooled Registered Pension Plans.

by | **Simon Archer**

There is broad consensus that low- and middle-income workers in Canada will face a decline in their standard of living when they retire.

Separate reports from three pension experts—Keith Horner, Michael Wolfson and Bob Baldwin—have each come to the conclusion that Canadians with incomes between $30,000 and $100,000 are not saving enough for retirement.

Horner evaluated several options for addressing this problem, including expanding the Canada Pension Plan (CPP) and creating new defined contribution (DC) pension arrangements. Baldwin's report was an assessment of retirement savings for the Ontario government. And Wolfson published his analysis for the Institute for Research on Public Policy on the potential for a drop in retirees' standard of living.

Options for Reform

Aside from the reform of existing occupational pension plan regulation, there have been two types of proposals to fix the problem of saving for retirement. The first is to expand the CPP to roughly double the current benefit. This proposal has been promoted by the labour movement and has attracted the support of ten provinces, and initially, Minister of Finance Jim Flaherty. However, in late 2010, Flaherty reversed his support and instead endorsed a different, private sector proposal: the Pooled Registered Pension Plan (PRPP).

The federal government has since abandoned any pretense of considering expanding the CPP and has instead aggressively promoted the development of PRPPs. The broad contours of PRPPs were described in policy papers released by the Department of Finance in June and July 2011. Then in November 2011, the Harper government tabled Bill C-25, which is enabling legislation creating PRPPs in the federal jurisdiction (only), and in December 2011, tabled consequent amendments to the Income Tax Act.

Bill C-25

Under Bill C-25, employers are permitted to provide PRPPs to employees, but are not required to make any contributions themselves. Employers don't actually have much involvement with PRPPs—most of the key decisions are made by the financial institution that administers the PRPP. These institutions will have significant power over the PRPP itself.

A question not answered by Bill C-25 is who may administer a PRPP. We know from the policy documents that the drafters are considering banks and insurance companies, and may also be considering other large financial institutions—perhaps trust companies, pension funds and other banklike entities.

What we do know is that PRPP administrators must obtain a license from the federal financial services regulator, and that the regulator may take into account a number of criteria, including fees, which are discussed below. Some large public sector pension plans are seeking to ensure that they can sponsor PRPPs, which may result in conflict with banks and insurance companies that complain of an unequal playing field because pension funds don't have the same capital reserve requirements. Regulators will no doubt be concerned with the size, capacity and security of PRPP administrators.

Bill C-25 permits employees to be automatically enroled in a PRPP, and contributions may be automatically deducted at a predetermined rate. It is not clear who sets that contribution rate, but it appears that it is intended to be set by the financial institution. Employees will have the option of a one-time opt-out, an election that must be made within 60 days of enrolment. As the legislation is currently drafted, employees cannot opt out after this window. However, employees can opt to set their own contribution rate to zero by filing the appropriate form with the financial institution.

The key features to note here are automatic enrolment and opt-out provisions. This "choice architecture"—as it has come to be known in the literature—is thought to produce high levels of participation because employees will not opt out due to inadvertence or inertia. The behavioural psychology behind this insight has been qualified and sometimes challenged.

Contributions from employees (and employers, where they elect to contribute) are to be held in individual DC accounts and will be "locked-in." This feature is common to other pension plan arrangements, but not to Registered Retirement Savings Plans (RRSPs), which may be withdrawn anytime and subject to taxation. The locking-in of withdrawals is desirable from a policy point of view—it forces savings to be used in retirement, subject to limited "unlocking" for emergencies—but it may be a deterrent when compared to RRSP contributions. The difference will be the fees charged by PRPPs versus RRSPs. PRPPs are being promoted on the basis that they offer a low-cost alternative to existing retirement savings options. Bill C-25 does not say much, however, about how low costs will be ensured.

The government's objective appears to be to pool enough savings so as to permit low or institutional fee rates, rather than the retail fee rates offered in mutual funds. We know that retail fees in Canada are the highest in the world, between, say, 250 and 350 basis points. By contrast, occupational pension plan unit costs have been estimated at between 40 and 60 basis points.

Whether PRPP fees will be lower than retail fees is a key question, and by how much. If they are significantly lower, will that induce people to move their RRSP contributions to a PRPP? This is known as a "substitution effect," and no doubt PRPP administrators are considering the effect on their existing line of RRSP products. However, the real question about these fees is: Are high fees stopping people from saving for retirement in the first place? While lower fees are a good thing, it is unclear whether lower fees will induce new people to save for retirement.

Finally, Bill C-25 allows for a variety of investments to be made available. If investment options are offered and communicated to employees, the financial institution is absolved of any liability relating to those investments—a feature borrowed from U.S. law known as a safe harbour defence.

PRPP Prognosis

Will PRPPs expand pension coverage, are they affordable and do they produce adequate retirement income?

PRPPs could increase the number of people participating in workplace pension schemes, although how much depends on whether their provision is truly optional or mostly mandatory. This is turning into a key debate in early 2012—whether the provinces will enact similar legislation and require all employers to provide a PRPP (unless they already have a pension plan). Now that the federal government has promoted this private sector alternative to expanding the CPP, proponents are encouraging governments to make the PRPPs mandatory.

The Canadian Life and Health Insurance Association has illustrated the importance of mandatory provision. Their numbers suggest that without mandatory provision and enrolment, PRPPs might net 175,000 participants nationwide, but with mandatory provision and enrolment, perhaps three million participants. Most recently, the association has commissioned a survey of 800 employers that asked about their views on private sector pension plans. They concluded that a majority support making PRPPs mandatory, and would even consider contributing themselves.

BIO

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One of the criticisms leveled at expanding the CPP is that contributions are unaffordable. As the health insurance association noted, perhaps a little "mandatory" is a good thing if the objective is to increase coverage and ensure retirement savings—and ten Canadian jurisdictions agree. In addition, as studies have shown, the CPP is the most efficient form of fixed cost plan and has the added advantage of certainty of benefits, which is a key incentive for employees. Affordability is a tricky question that can't be assessed on a "mandatory/voluntary" basis. For example, CPP premiums were increased before and during periods of economic downturn, and there is no evidence of a correlation to, say, greater unemployment or adverse business outcomes.

Will PRPPs produce adequate retirement income? The variability of contributions and investment returns leads to a much more diverse set of savings outcomes at retirement age and, depending on interest rates, a wider range of annuity incomes generated from those savings. Notably, the PRPP legislation does not mandate low-cost annuities at retirement, which is a significant problem for retirees—depending on interest rates at the date of retirement, annuities can be expensive products.

Although we can model different scenarios, the retirement income in a PRPP is simply unknown until an individual worker reaches retirement. ⊗