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PRPP—Be Careful What You Wish For

by Guest Columnist….Gerry Wahl, ComprehensivePensionGovernance

The Minister of Finance recently proposed the creation of Pooled Registered Pension Plans (PRPP) rather than expansion of the CPP program. The PRPP targets the self-employed or lower - income private sector worker lacking any employee-sponsored pensions. The PRPP goal is to provide these groups with an effective and low cost retirement saving vehicle.

It is acknowledged that PRPPs require a high level of regulatory harmonization across jurisdictions. Other pension reform initiatives in the past 18 months have proven to be difficult and the proposed 12 month deadline to implement the PRPP may be very optimistic. A further complication is whether Western and Atlantic Canada will embrace this new concept when control and higher paying jobs underpinning PRPPs will likely reside in Ontario and Quebec.

While it's true that many Canadians don't have employer sponsored pensions, they do have access to tax assisted savings programs such as RRSPs and Tax Free Savings Accounts (TFSA). Do they take full advantage these programs? No. So it's questionable why they would fully embrace PRPPs.

The key argument supporting PRPPs is they have lower fees which encourage people to save. This is surprising as high fees aren't generally cited as a reason why taxpayers don't better utilize existing vehicles. Could it be that average workers just don't have enough spare cash to make necessary contributions? And assuming they did, would the fee and tax savings achieved by contributing to PRPPs be more significant than other existing programs available now?

Let's examine both arguments: (i) that PRPPs would result in lower fees and (ii) that financial institutions have a vested interest in lowering costs and fees.

Under the Capital Accumulation Plan (CAP) Guidelines, financial (con't pg. 2)

Watching a Dangerous Development

by George M. Klar…..President, Alternativ Solution Inc.

Every sport, whether it's baseball, soccer, football or hockey, comes with its own set of well-defined rules. Players who break the rules are penalized and if it happens too frequently, the team's chances of winning are impaired. Coaches needs to trust their players. So repeat offenders eventually get benched or cut from the team. It's just the right thing to do.

Similarly, 'trust' stands at the core of every financial transaction. But now, there's a movement afoot to alter the long-standing repayment rule in debt finance; one that's existed for hundreds of years. It relates specifically to debt obligations of sovereign nations or states.

Over the past few months, a number of trial balloons have been floated in the press suggesting the current risk sharing contract on debt securities be amended. Germany proposed that lenders should "share the risk" for any sovereign bond defaults. And recently, U.S. lawmakers have talked about amending legislation to let states declare bankruptcy, which they cannot do today. In my view, these are disturbing and dangerous developments that affect the fabric of investment theory and practice. Finance textbooks say that debt obligations of large industrialized nations' are essentially risk-free. They are deemed the most creditworthy borrowers because they can use tax revenue to repay debts, or alternatively, print (con't pg. 2)

Inside this issue:

A Great Cause:

Again this year, I'll be trying to raise funds in support of Alzheimer's Disease, which affects over half a million Canadians.

There has been an alarming global rise in dementia and experts say the figure will double. No one is immune.

New research from the Mayo Clinic indicates men are more likely than women to get dementia. Yet women bear the overwhelming burden for care-giving.

Working with Scotiabank as sponsor, the Baycrest Foundation as organizer and a bunch of great former NHL pros, you might get an email from me asking for support.

Want to help in the fight against Alzheimer's? Please...

CLICK HERE

....Cheers, GMK

institutions would assume a myriad of responsibilities and administrative duties. This includes investment selection, performance monitoring, member communication, education and delivering tools to help support plan member investment decision-making. Each PRPP participant needs the ability to create a 'suitable' asset portfolio consistent with their long term needs. However, the incredibly diverse PRPP membership means that a large number of investment options must also be available. This makes member investment decision-making less straight forward and communication and education even more complex. Inevitably, this leads to higher administrative costs.

Given the responsibilities under the CAP Guidelines, plan sponsors know that their overall DC administrative costs are high. The largest component of fees paid by Defined Contribution (DC) members is generally related to the record-keeper's administrative service, not investment management fees as is often assumed. High administration fees will be recovered somehow — probably via member fees. It is therefore questionable whether PRPP fees can be lower.

Financial institutions must manage their costs while still keeping in mind that they *"must always act in the best interests of the PRPP members".* Some conflicts of interest are bound to arise. For example, will the financial institution be allowed to offer their own in-house investment funds and platforms, or be required to offer the best performing funds on the market? This question gets even more complex if several financial institutions are involved, if passive and active funds are used or if Balanced, Life Cycle or Target Date funds are also included.

Since PRPPs are very similar to Defined Contribution (DC) plans, any sponsors experiencing significant administrative costs will undoubtedly be pleased, maybe even compelled, to transfer their DC plans to a PRPP.

A financial institution, as Administrator, would also relieve employers of most of their administrator fiduciary responsibilities and risks. This is a key difference and a compelling reason to replace a DC plan with a PRPP. Financial institutions and record keepers may therefore face the risk of losing DC plan clients in favor of PRPPs.

PRPPs are intended for smaller organizations or the self-employed, however it does not appear there are restrictions in terms of size of participating organizations. Nor does it appear that employers who already offer DC plans are precluded from transferring their plans to a PRPP.

Many CAP members have indicated what they really want is a savings vehicle which minimizes their involvement in investment decision-making, is not subject to market risk and accompanying market fluctuation. What they really want is guaranteed pension income. Without these features, its likely many workers or self-employed entrepreneurs will not join any new savings program.

Whether the PRPP mitigates the underlying concern that certain groups of Canadians are not saving enough for retirement is debatable. So in my view, hasty implementation of a complex program will probably end up being costly, and most importantly, ineffective. ◻

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Watching a Dangerous Development (continued)

money to repay their IOUs. This explains why the yields on advanced economies sovereign debt are normally at the lower end of the cost spectrum. By contrast, corporate debt is riskier because firms operate in highly competitive environments and are subject to the whims of the marketplace. They rely on profits and cashflow to pay back obligations, so investors need higher yields to entice them away from the safety of government bonds. When a firm goes into bankruptcy, it decimates shareholders and hurts lenders who might potentially recoup less than 100% of the debt's face value.

Amending debt rules will affect the 'sovereign risk-free' status. The fear is that heavily indebted nations may opt to relieve themselves of long-standing promises such as pension obligations. Any rule change produces winners and losers and in this case, the losers are the debt investors such as pension plans, endowments and financial institutions.

The proposals are not surprising given the pressing problems in the U.S. and Euro zone with their large accumulated debt balances. Greece came within a hair of defaulting last year. Without debt bailouts, it's likely a large sovereign default would have occurred. Over the last 3 decades, most sovereign defaults occurred in smaller developing nations such as Belize, Ecuador, Uruguay, Moldova, Peru and Ukraine. Their outstanding debt balances were so tiny the event was inconsequential. But larger defaults, as in 1998 when Russia defaulted on $78 billion, badly rattled global capital markets. It's worth noting that the accumulated debt of advanced economies are many, many times larger than Russia's. The world's largest debtor, the U.S., has raised its debt ceiling level 74x since 1962 (and will again in 2011). Imagine the reaction if the most trusted nations that owe trillions of dollars found a legal way to eliminate part of their debt obligations?

By explicitly changing how lenders get repaid on sovereign defaults, sovereign bonds become less desirable. Investors will want greater compensation for any potential loss in capital preservation. Yields would certainly rise, but other consequences are unpredictable. For now, the debt penalty box remains empty. But I wonder for how long? ◻