SOCIETY OF ACTUARIES

Article from:

The Pension Forum

December 2012 – Volume 19, Number 1

Author's Response to Comments by Cynthia J. Levering

By Thomas J. Walker

I would like to thank Ms. Levering for the significant time and effort that she has put into this project. Her overview clearly outlined the essence of the Total Career Benchmark model, and I am very pleased with the conclusion that she arrived at. I will give a brief response with respect to each section of her commentary.

Ms. Levering's Key Elements section shows a very accurate understanding of both the goals and the tools included within the TCB model. In particular I appreciate her recognition of the role changes for the stakeholders and the goal to mitigate risk and increase understanding within the model. In the most recent draft of my paper I did make a change with respect to the requirement for voluntary contributions. This change specified that employee contributions could be non-mandatory on the portion of income up to the Average Industrial Wage (AIW) and/or until employer contributions reach a certain level. This was a change that I intended to make before submitting my paper and is to recognize that mandatory contributions should be smaller for low-income employees.

The Pros, Cons, and Questions raised in the commentary are consistent with those raised in the Judging Panel Review. In this response I will attempt to clarify which of the "Pros" was intended to alleviate the "Cons." This approach will also answer some of the questions.

With respect to addressing sustainability across generations and/or in the event of a market meltdown, the entire structures of ASPs and AAFs were intended to address this issue. This is the area that needs much more research. I have not yet received any comment that reduces my confidence in the workings of the TCB "tools" to handle these issues. In the paper I make many comments—particularly in Section 7 about these issues. I admit that my comments are not yet backed up because of the need for further research beyond the scope of my paper. In Section 2.7.6 I have added a sentence to highlight that in an extreme event the market downturn is shared nationally by the reduction in the number of Pension Units that provides the necessary tax shelter room to recover. Under the present Canadian rules this tax shelter recovery room is available only to DB plans.

One of the Cons states that the model does not address different retirement savings needs by income levels. I admit that detailed examples were not given, but variation by income level is referenced in Section 2.2, Tool Number 11, Target Career Average Pension Units, and also in the Lifetime Freeze Factors definition in the Glossary. In addition the Communications Example in the Appendices was intended to illustrate that employees at different income levels, within the same plan, may have different retirement savings needs. The TCB model is designed to provide the flexibility to adjust for changing conditions throughout a working and retirement lifetime. Several items in the Pros acknowledge this flexibility.

The TCB model, particularly the structure for AAFs and ASPs, is complex behind the scenes. The level of complexity can be significantly reduced by a comparison to our current "simple" system. I think that the first step should be to introduce Pension Units and Annual Service Factors into our system to help individuals and employers "picture their pension." A reference to this is now in Section 8.3.1. This would be an effective start to transition. Recalculating available tax deductions could be onerous but is doable with modern technology and available data—particularly if a significant proportion of prior years, likely all years prior to 1990 in Canada, and possibly those over a certain age are excluded. The total transition process will require more research.

As stated in the Cons it is true that individuals do still need to make decisions. However, the TCB tools are such that the rules and structure can be set up in a manner that guarantees that the decision aspect is primarily on the lower risk items and specific to individual needs. This is another issue that the standardization is intended to cover by having financial planners and advisors speaking a common language. The individuals with the greatest ability to make their own decisions will also be those with the lowest risk.

Employers can still have control over design and workforce management. The difference will, however, be strictly by quantity not quality. The difference from employer to employer will be much more transparent since the value of "deferred income" to an existing or targeted employee will be as obvious as the difference in "immediate income."

I see sending a signal about normal retirement age as a Pro rather than a Con. At some point, probably soon, it may be necessary to change the normal retirement age for the CPP. If the TCB model is in place, an increase in the normal retirement age will immediately increase the number of Pension Units in an individual's account and also reduce the cost to purchase new "punies."

Who bears what risk? I believe that it may be necessary to restate Pension Units as "target annuities" to help in this regard. My intention has always been that Pension Units are like "shares" in a company. A portion of the investment risk would be borne by the AAFs since they are providing Pension Units to the ASPs. The remainder would be borne by the members of the ASPs. This is an area where the additional research is absolutely critical both with respect to the structure of AAFs and ASPs as well as developing appropriate investment policies that recognize that each ASP, except the TOP plan, will be wound up at a future date that might change from time to time but is very predictable.

Market mechanisms, including risk and profits for AAFs and ASPs, are an area that will require much more research. The merging of the Age Specific plans after the Canadian Retirement Age will enable some additional risk management. Each plan's wind-up is implemented over a century. This merging also helps to minimize any bounces in the cost of Pension Units. It will no longer be necessary to plan for "hypothetical" wind-ups but for a certain, timed wind-up for all ASPs except the TOP plan. I have explicitly added to the paper the always intended fact that members effectively "own" the ASPs. In several sections reference is made to the "participation" aspect. The relative profits of AAFs and ASPs should be transparent since, as noted in the Pros, "the similarity of plan structures should allow easy scrutiny."

The monitoring of AAFs and ASPs is also an area in which more research is needed with respect to the structure and rules. For the trading of ASP units by AAFs it is very important to note that the group annuitant is the ASP. The units being traded would be units of one ASP for units of another. Therefore some AAFs could focus on "younger" ASPs while others focus on "older" ASPs. The employer's fiduciary responsibility is intended to be fulfilled once contributions are made.

The addition of more "autopilot features" would definitely help both in the transition and in the ultimate TCB system. A new autopilot feature could help alert individuals if there are "significant cohort longevity gains." The phasing in to the ultimate TOP plan is intended to address this issue, and the entry points would be regularly benchmarked, communicated, and updated. This is the critical behind-the-scenes complexity that emphasizes the need for actuarial risk management.

The "mandatory" aspects will definitely be a big issue in both Canada and the United States. Hopefully the phase-in can also include the "mandatory" aspect. Ideally a big part of the mandate for both individuals and employers will be an increased understanding by both that their future security depends on adequately fulfilling their role. For the markets this will hopefully include "innovative products needed in a timely manner, especially for disability benefits."

Any benefits, such as those for physically challenging jobs demanding a shorter working lifetime, which are over and above the standard benefits available to the general public, will have to be handled as "special cases" with any extra benefits administered and funded outside of the TCB model.

I wish to conclude by again thanking Ms. Levering for her insightful and very helpful analysis of my paper. Any future research or papers, which I truly hope will happen, on the TCB model will benefit from her response.