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## CPP changes could leave younger workers footing the bill, report says

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Policymakers may be misleading Canadians into thinking the expanded CPP is on firmer financial footing than it actually is, and if the plan investment returns stumble, younger workers may be at risk of footing the bill for older Canadians, says a report released Tuesday by the C.D. Howe Institute.

In June 2016, the federal and provincial finance ministers [announced they'd reached a deal](#) to expand the Canada Pension Plan to replace more of the income Canadians earn during their working years.

Under the [revamped CPP](#), working Canadians would contribute 1 per cent more than current rates for the “base” CPP benefit and an additional 4 per cent on newly-covered earnings above that amount. Employers would be required to match these increased contributions.

While the current CPP is designed to cover up to 25 per cent of the average industrial wage, the expanded CPP – or “CPP2” – would cover up to 33.33 per cent of the higher covered earnings amount.

### **The importance of investment returns to plan success**

The problem, say the authors of the C.D. Howe Institute’s report, William Robson and Alexandre Laurin, is that federal and provincial policymakers have described the CPP enhancements as “[fully funded](#),” but what this means in the context of CPP is not what most Canadians might think.

In the context of a defined benefit pension plan, a “fully funded” plan has assets sufficient to cover the present value of benefits earned by plan participants to date. In the context of the CPP, however, “fully

funded” means the plan’s investment returns are expected to offset the need for contribution increases as the number of contributors (working Canadians) falls in the coming decades, relative to the number of retired Canadians receiving CPP income.

Canada’s Chief Actuary has calculated that CPP2 will be able to pay the projected increased benefits from the higher increased contribution rates so long as the Canada Pension Plan Investment Board (CPPIB) is able to earn a 75-year average rate of return of 3.41 per cent, after investment management expenses.

If this assumed rate turns out to be too low, retirees could expect higher benefits or lower premiums (or both). Alternately, if this rate of return is not attained in reality, the C.D Howe report, entitled “*Bigger CPP, Bigger Risks: What ‘Fully Funded’ Expansion Means and Doesn’t Mean,*” says Canadians may end up with lower-than-expected benefits or higher-than-expected costs.

### **Who foots the bill for shortfalls?**

Achieving the projected long-term rate of return requires “a fair amount of investment risk and uncertainty,” said Mr. Robson and Mr. Laurin. In addition, they believe that low-risk, relatively secure assets – such as long-term government bonds – are not producing a rate of return that is close to the 3.41 per cent CPP minimum.

For example, they pointed to the rate of return for a federal long-term, real-return bond, which is currently yielding 0.7 per cent. “If the CPPIB were to invest in such an asset [to produce the required investment returns], and its yield stayed at that level,” the authors said, the contribution rates on CPP2 would need to more than double, or promised benefits would need to fall by more than half.

The CPP legislation provides that contributions can be increased in the future, if the provinces consent. Rate increases, however, are limited to not more than two-tenths of a per cent per year, which might not be sufficient to cover shortfalls, and if the provinces and the federal government cannot agree on contribution rate hikes, the rules about changes to benefit levels and contribution rates (which themselves will also be subject to provincial consent) have not yet been written.

### **A call for increased transparency**

For the report’s authors, the problems stemming from the increased investment risk embodied in the enhanced CPP are twofold: first, the plan might not hit its return targets and secondly, if the targets are not met, the actions policymakers can take to rectify any shortfalls are not yet set, which means younger working Canadians could be on the hook.

The bottom line? For the authors, CPP needs more transparency regarding its risk exposure – which its participants will bear the brunt of – and how the plan will respond if things don’t work out as expected.

“In fairness, if the investments do better than expected, the current generation might end up paying for benefits enjoyed by future generations,” said Joe Nunes, an independent actuary and president of Windsor-based Actuarial Solutions Inc. “Then again, if the investments do well, I am sure there will be political pressure to improve benefits as soon as possible, again pushing the risk of insufficient assets to a future generation.”

The C.D. Howe report recommends that the provinces and Ottawa consider developing safeguards to protect against CPP2 increasing contributions from (younger) working Canadians to cover shortfalls for older (retired) Canadians if the realized investment returns from the CPPIB don’t meet the minimum required threshold rates.

One option would be to adopt a “target benefit” model, in which benefits above a target amount (for example, 80 per cent of the base benefit) are protected, but benefits above this basic amount are allowed to adjust downwards in the event of a plan shortfall.

“The starting place for this discussion,” said Mr. Robson and Mr. Laurin, “needs to be understanding among the officials and interested Canadians that, in an uncertain world, even the Canada Pension Plan makes no guarantees,” as neither the base CPP nor CPP2 are, or will be, “fully funded.”