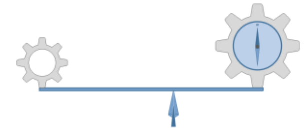
FINEPOINT SOLUTIONS INC.

How to think about the CPP – podcast notes

For The Canadian Money Roadmap (recorded 16 Oct. 2023)



What is the Canada Pension Plan, or CPP?

If you're like me, your first introduction to CPP was a deduction on your paycheque. Money for CPP was subtracted from your pay along with other things like income tax and Employment Insurance (EI) premiums. The CPP deduction is your contributions into the CPP program.

If you earn employment income, you are required to contribute into the CPP program.

- You pay one-half of the required contribution, and your employer pays the other half of the required contribution.
- Self-employed individuals have to pay both of those parts.
- The self-employed pay twice the amount that an employed individual is required to pay.

The amount an employee has to pay is 5.95% of their earnings, but only up to a maximum threshold. In 2023, the earnings threshold, which is called the Year's Maximum Pensionable Earnings (YMPE), is $66,600. Therefore, contributions of 5.95% are paid on your earnings between YMPE, and a fixed lower threshold called the Year's Basic Exemption (YBE). The YBE is fixed at $3,500.

What are those contributions for?

The purpose of the Canada Pension Plan is to make reasonable minimum levels of income available:

1. At normal retirement ages.
2. To people who become disabled.
3. To the dependents of people who die.

There are seven distinct benefits that the Canada Pension Plan provides:

1. Disability pension.
2. Disabled contributor's child's benefit.
3. Retirement pension.
4. Post-retirement benefit.
5. Survivor's pension.
6. Orphan's benefit.
7. Death benefit.

Each of these benefits has their own set of rules for determining if an individual is eligible to receive the benefit, and how much they are eligible for. What's important to know is that the contributions you make are for you and you alone. Your contributions go into your own personal CPP record. And this record – your own personal CPP record – this is what is used to calculate what you can get out of the Canada Pension Plan. When the time comes for you, or your dependents, to access money from the Canada Pension Plan, the amount of money that can come out is calculated based on what you put in. For the most part, the more you put in, the more you or your dependents can get out.

When you think about your retirement pension, your CPP contributions turn into money later in life.

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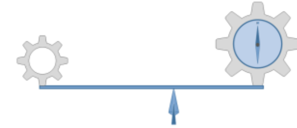

Let's start by talking about later in life, how should you think about getting money later in life, and the role CPP can play for your money later in life.

Just like early in life, later in life you're going to need to spend money in order to live. The difference between early in life, and later in life, is that early in life you can work to get the money you need to live. Later in life, it gets harder to earn money by working.

This means that later in life, you need to have other sources of money besides working. One such source is Old Age Security, which is another form of pension that is similar to CPP. Another source is whatever money you can get out of your personal savings. This is usually some kind of investment portfolio, and that portfolio is usually held in a RRSP, or a RRIF, or a TFSA, or perhaps some from a company plan like a Defined Contribution pension, or a LIRA.

In order to keep living later in life you have to spend money. Living equals spending.

- For that spending, you mostly know the amount you'll need, or you can set a target – this part is known.
- What you don't know is how may of those spends are needed.

Fast forward to your death, this will be your last spend.

- You don't know when it will be.
- But we know it will be your last spend.

When you think about later in life, the spending that you have to do as you live, and the sources of money you have available to do that spending, I want you to think about these 4 questions:

1. What do you know?
2. What's unknown?
3. What can you control?
4. How safe do you want to feel?

It's important to think about those questions because CPP has 3 features that make it particularly valuable as a source of money later in life.

1. Your money from CPP is guaranteed.
2. It lasts until you die.
3. CPP provides inflation protection.

Now, when you think about the role CPP can play for your money later in life, you will notice that CPP is more than just a dollar amount:

- CPP is a dollar amount, ***plus*** CPP is the peace of mind that those dollars will be there next month.
- CPP is a dollar amount, ***plus*** CPP is the peace of mind those dollars will be there until you die.
- CPP is a dollar amount that keeps its purchasing power because CPP grows with inflation.

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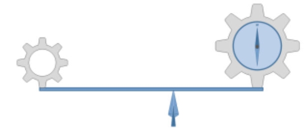

I believe that your pension from the Canada Pension Plan is so valuable that you should put effort into getting the most out of CPP.

So how can you do that? How can you get the most out of CPP? What specifically can you control?

CPP is also valuable because you get a choice. You have control over a very important CPP decision. That decision is the age you start receiving your CPP retirement pension. This decision is so important that I refer to it as your strategic CPP decision. There is a strategic CPP decision, and there are tactical CPP decisions. Right now, I'm going to focus on the strategic decision. The age you start CPP is strategic because your start date can really move the needle about how much money you can get from CPP. You get to be in control over how much your CPP retirement pension will shrink or grow, depending on how soon or late you want to start.

There is a lot of power in this choice.

- Going in, you didn't get a choice.
- Coming out, you get this important choice.

The age you start determines how much growth, ***and*** how much of the safety-adding features you'll get from CPP. Don't forget that part. You get a dollar amount, ***plus*** you get a whole bunch of peace of mind for your spending later in life.

What does this mean with numbers?

The basic starting age for the Canada Pension Plan is 65. Basic means the amount CPP is designed to provide to you, based on the amount, and how often, you contributed into the program. The more you put in, the more you get out. CPP is designed to provide you with 25% of your personal lifetime average earnings. That's what you should expect to get back out of CPP *as a basic starting point*.

There's another important point. *Nothing is lost to inflation with CPP*. All the money that you put into CPP – your contributions, and the earnings that are associated with those contributions – all that money is adjusted by wage inflation to bring it up to a current value in the year you start CPP. Once you start, the money you get from CPP maintains it's purchasing power by adjusting for price inflation each year in January. So *there are actually two inflations that CPP adjusts for* – wage inflation and price inflation.

There's another minor complication here because currently, extra rules are being phased-in as part of what's called the Additional CPP. For the Additional CPP, the numbers change and do different things, but the general idea is the same. The Additional CPP will increase the percentage of your personal lifetime average earnings that CPP is designed to provide to you, from 25% to 33%. But it will take 40 years for the complete transition to take effect. People who contributed into the Additional CPP, and who start their retirement pension before the end of the 40 year transition period, will still benefit from the Additional CPP. The income replacement for those individuals will be somewhere between 25% and 33%.

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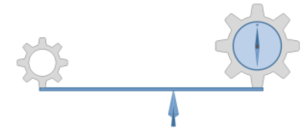

Coming back to your strategic decision…

The age you start CPP moves the needle because there are adjustments that will either shrink or grow your basic amount, depending on whether you start earlier than age 65, or later than age 65. You can start as early as age 60, or as late as age 70.

- Your basic amount will shrink more the earlier you start CPP compared to age 65.
- Your basic amount will grow more the later you start CPP compared to age 65.

The age you start moves the needle because these adjustments can be huge.

Your basic amount is reduced by 0.6% for each month earlier than age 65, that you decide to start taking CPP. This is a reduction of 7.2% per year, for each year that you start earlier than age 65. The earliest you can start CPP is age 60, and if you start at age 60 your basic retirement amount will shrink by 36%.

Your basic amount grows by 0.7% for each month later than age 65, that you decide to start taking CPP. This is growth of 8.4% per year, for each year that you start later than age 65. The latest you can start CPP is age 70, and if you start at age 70 your basic retirement amount will grow by 42%.

The tradeoff is:

- You can get money earlier, but if you do that you'll get less money.
- You can get more money, if you start later.

Now earlier might sound better, but so does more!

How can you decide?

You decide by coming back to the 4 questions that I want you to think about as you consider the spending that you have to do as you live later in life. Those questions are:

1. What do you know?
2. What's unknown?
3. What can you control?
4. How safe do you want to feel?

Ask yourself,

- How much of your expected spending can CPP cover?
- How much more of your expected spending can CPP cover if you start a bit later?
- Would you rather feel safe for all your living spends or for your last spend, even if you don't know how many living spends there might be?

Here's a couple ways to put some numbers to those questions.

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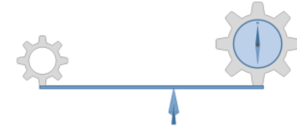

Lifetime Loss

Get an estimate of the lifetime amount of CPP you can expect to receive. To do this, the most objective starting point is the life expectancy for your age, from appropriately calculated tables. This helps to take emotional influences out of getting a good number to start with. This is what I think you should do. Get a good starting number based on a middle part of how long people of your age are expected to live.

Then compare how much you expect to get from CPP over your lifetime:
- When you start receiving CPP at age 70
- When you start receiving CPP at age 60.

This is the Lifetime Loss method. The Lifetime Loss method was introduced by Bonnie-Jeanne MacDonald in a paper she wrote in 2020.[1] It's called the Lifetime Loss method because it shows the lifetime amount you give up by starting CPP earlier, compared to starting CPP later. The amount of Lifetime Loss can be huge.

Bonnie-Jeanne reported that Lifetime Loss can be around $100,000 for an individual who will get the middle-of-the-road (median) amount of retirement pension from CPP. My experience with clients is very similar.

Lifetime Loss will generally be much larger for younger people because of the Additional CPP. CPP is going to replace a higher proportion of an individual's lifetime earnings going forward, from 25% to 33%. If your CPP retirement pension is larger, your expected Lifetime Loss will also be larger, all things equal.

You can also do Lifetime Loss analysis to compare any two ages you want, not just for age 60 compared to age 70.

If you want to compare other life expectancies, you can do that too. For example, you may have personal reasons to expect a lower life expectancy.

CPP Coverage Ratio

Another way to put numbers to those questions, is your CPP coverage ratio. Your CPP coverage ratio is simply the percentage amount of your spending that CPP can cover alone. Its useful to break up spending into two parts: needs and wants.
- Perhaps you believe that CPP covering only a small portion of your needs is enough to feel safe.
- For others, the percent covered will need to be even more to feel safe, if that's possible.

[1] MacDonald, B.J., (2020). Get the Most from the Canada & Quebec Pension Plans by Delaying Benefits: The Substantial (and Unrecognized) Value of Waiting to Claim CPP/QPP Benefits. National Institute on Ageing, Ryerson University.

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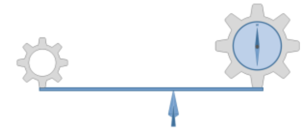


What you need to feel safe is a broader financial planning question rather than a CPP analysis question. What a good CPP analysis does is it gives you accurate information to use in your financial planning. It's the whole garbage-in/garbage-out thing. I believe CPP is so valuable that you should have the most accurate retirement pension estimate possible to use in your financial planning.

These numbers – an accurate CPP estimate, Lifetime Loss calculations, and your CPP coverage ratio, these numbers provide a good starting point to have a conversation about your spending later in life, and the 4 questions that I think are important for you consider.

1. What do you know?
2. What's unknown?
3. What can you control?
4. How safe do you want to feel?

I believe that you have a better chance of getting the most out of CPP when you have accurate numbers, and when you think about your spending later in life together with answering those 4 questions.

The strategic CPP decision

There are 3 reasons why I think choosing your CPP start date is a strategic decision:

1. CPP is already paid for when you make the start date decision.
2. CPP specifically addresses the risks you'll be facing for your spending later in life.
    - CPP is guaranteed – no market risk.
    - It last until you die – no longevity risk.
    - CPP provides inflation protection – keep purchasing power.
3. You're in control over how much your money from CPP will shrink or grow.

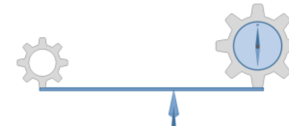
#2 and #3 have been discussed. Address #1, CPP is already paid for.

I think a lot of CPP thinking is backwards. I mean literally backwards, as in too much emphasis is put on the past rather than your future.

There's a lot of CPP thinking that demands an answer to the question, ***"where did the money go?"***

For example, some individuals want to get a rate of return from the contributions they put into CPP. Those individuals advocate for getting money out of CPP as quickly as possible, and this is often expressed as a preference to start taking CPP as early as possible, at age 60. Those individuals feel like CPP is bad deal if they don't get a certain rate of return.

Remember, you didn't get a choice about having to make those contributions in the first place. Why do you want to compete, and compare, with the actions of their your past self, especially when your past self didn't have a choice?



Needing a rate of return ignores your future needs, and it ignores the value of CPP's special features:

- CPP is guaranteed
- It lasts until you die
- CPP provides inflation protection.

Don't forget, with money from CPP, you not only get a dollar amount, you also get a whole bunch of peace of mind about your spending later in life.

The breakeven age is another example. Similar to Lifetime Loss, the breakeven age compares the money you get if you start CPP at age 60, with what you get if you start at age 70. Remember the trade-off.

- You can get money earlier, but if you do that you'll get less money.
- You can get more money, if you start later.

The breakeven age is the point in time where those two cumulative amounts of money are equal. The breakeven age is most often interpreted as you're only better off delaying your start date for CPP if you live longer than the breakeven age.

This kind of thinking is also demanding an answer to the question, ***"where did the money go?"*** It's a race to get to that age so you can say, ***"I got it,"*** without thinking about what your needs later in life might be after that point in the race.

On the other hand, Lifetime Loss answers ***how much you expect to lose by winning that race***.

I want you to think about answering a different question. I want you to think about answering, ***"where will the money come from?"***

- ***Where will the money come from*** later in life as you need to spend.
- ***Where will the money come from*** takes us back to:
    - For your spending later in life, you mostly know the amount you'll need.
    - What you don't know is how may of those spends are needed.
- ***Where will the money come from*** also takes us back to the 4 critical questions to ask:
    1. What do you know?
    2. What's unknown?
    3. What can you control?
    4. How safe do you want to feel?

In my opinion, Lifetime Loss and your CPP coverage ratio are better numbers to look at when answering, ***"where will the money come from,"*** and making your strategic CPP decision – the start date decision.

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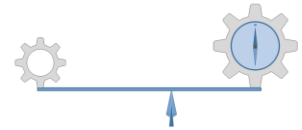

Integrating CPP with an investment portfolio

Your investment portfolio is another place where some of the money can come from.

Remember the special features of CPP: CPP is guaranteed, it lasts until you die, and CPP provides inflation protection.

What are the features of an investment portfolio? An investment portfolio is not guaranteed. An investment portfolio has market risk. There's baggage – the market risk, and there's also opportunity – an investment portfolio has the potential for growth. And in the case of stocks, or equities, that growth can be pretty exciting.

The conventional wisdom about investment portfolios for individuals thinking about later in life is that they should reduce the amount of market risk in their portfolios. In doing this, you transform your portfolio from one that has more growth potential, to one that's supposed to provide regular, safer, money for later in life.

The conventional wisdom can be said another way that means the same thing. When thinking about where the money will come from for your spending later in life, you should rely less on sources with more market risk, and you should prioritize having more sources that are safe.

A way to achieve this rebalancing is by using your investment portfolio to pay for spending ***while you grow CPP instead*** by starting CPP later.

What's accomplished when things are done this way?

- You reduce market risk at the point in time that the conventional wisdom says you should.
- When you do ultimately start receiving CPP you can cover more of your spending because your CPP amount with grow.
- You get more safety-adding features.
    - You get a larger dollar amount, ***plus*** you get a whole bunch of peace of mind for your spending later in life.

Remember:

1. What do you know?
2. What's unknown?
3. What can you control?
4. How safe do you want to feel?

I know some listeners don't like the idea of using their investment portfolio this way for a couple of reasons:

1. What if you die while you're delaying? In that case you didn't get anything out of CPP.
2. Spending more from your investment portfolio might mean less of an inheritance for your survivors.

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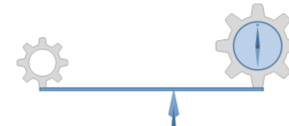

Let's start with #1, you might die while you're delaying your CPP start date. Yes, you might! In general, you can't control when you die. You also can't control that you had to contribute into CPP in the first place – CPP is already paid for. What you can control is how much safety is in the sources of money that you'll need for spending later in life, ***if you do happen to live***.

This is a very personal decision. I simply want everyone to understand what CPP can do for them, and then it is everyone's own individual decision.

Let's talk about #2, the potential size of an inheritance – your last spend. Remember what I said at the very beginning, this will be your last spend.

- You don't know when it will be.
- But we know it will be your last spend.

Using more from your portfolio in order to be able to delay starting CPP does prioritize having more safety for the unknown number of spends you might have to make later in life, over having more money for your last spend. Again, how you want to prioritize these two things is a personal decision.

I think it's also important that your listeners know that I don't always recommend that a client should start CPP later. I understand that an individual's own CPP start date decision is very personal, and that many considerations often need to be thought out. Thinking out these considerations and learning the numbers behind your options is exactly what financial planning is. I think the decision is very important. That's way I call it a strategic decision. I simply want everyone to understand what CPP can do for them, and then it is everyone's own individual decision.

Tactical decisions

Tactical decisions have two features:

1. Tactical decisions have a smaller impact on how much money you'll get from CPP, compared to the start date decision.
2. Tactical decisions may or may not be available for your personal situation.

Tactical decisions are important because they potentially let you squeeze out a little bit more by using CPP rules to your advantage, permitted you meet any qualification requirements.

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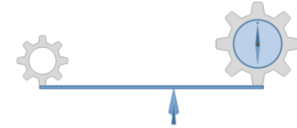

Tactical decisions include (not exhaustive):

- Opportunities around transition between the end of one calendar year, to a new calendar year.
    - Wage inflation vs price inflation indexing – YMPE (MPEA) vs CPI
- CPP sharing.
    - Possible income splitting between spouses. Income splitting means paying less tax, so this is a good CPP rule to use if you can for your personal situation.
- Child raising drop-out
    - Primary caregiver waiver.
- Post-retirement benefits
    - Choice to stop contributing after age 65. Cost-benefit analysis.

What's critical is that you give the most priority to the strategic decision. Don't make a poor strategic decision just because there's a CPP rule that will get you a little bit more. The CPP start date decision has potential to get you a lot more. You don't want to win the battle if it means you lose the war.

CPP upon the death of a contributor

The death benefit provides assistance to a contributor's estate with funeral expenses by providing a one-time, lump-sum payment.

- The one-time payment is fixed at $2,500.

The orphan's benefit provides assistance to the children of a deceased contributor while they are dependent children.

- Children of a contributor are considered dependent if the are under the age of 18, or between 18 and 25 if the child is attending school or university.
- The orphan's benefit is a monthly amount that is indexed to inflation.
- In 2023, the monthly amount for the orphan's benefit is $281.72.

The survivor's pension provides assistance to a deceased contributor's spouse or common-law partner, by providing a lifetime pension.

The calculation for the survivor's pension if different, depending on whether the survivor is aged less than 65, or age 65 and higher. In both cases, the calculation for the survivor's pension starts by calculating the contributor's retirement pension:

- Survivor <65 = (contributor's retirement pension x 0.375) + Survivor's flat rate
- Survivor 65+ = (contributor's retirement pension x 0.60)

There is a minimum qualifying period for these three benefits.

The minimum number of contributions is:

- Contributions for at least 1/3 of contribution period at time of death; but no less than 3 years.
- Contributions for at least 10 years.

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