Comments on: CSA Notice and Request for Comments:

Scholarship Plan Prospectus Form

March 26, 2010

Group scholarship Plans[1] carry particular risks to the subscriber that are not, in general, found among other investments:

- The risk of not being able to contribute according to the prescribed schedule(s) for the number of units the subscriber signed up for during the term to maturity. Generally, the subscriber risks losing any claim on investment income. The subscriber may also voluntarily withdraw and lose all of the investment income and some of the contributions.
- The risk that after maturity the beneficiary does not receive the full scholarship amount, or no amount at all.

Unfamiliarity with the nature and magnitude of these "group plan risks" may cause people to underestimate them and to subscribe when a better appreciation of the risks would give them pause, or to make a larger financial commitment than is prudent in their case. It seems to this observer that the odds are stacked in favour of subscribing in any event, as people generally do not foresee that they may experience significant financial difficulties in the medium term, and expect that their children will participate in post-secondary studies before their academic potential and performance are known. The salesperson will emphasize the gains from participating in the group plan, and this may further induce people to sign up to a group plan.

Clearly, potential subscribers should be informed about the two group plan risks and their magnitude. Scholarship plans have not been forthcoming on this in their prospectuses. The proposed regulations, in particular those for the plan summary, provide for the information potential subscribers need to have. I congratulate the regulators for demanding disclosure of the nature and magnitude of the two risks particular to group scholarship plans. The proposed content of prospectuses strikes me as a satisfactory response to the second recommendation of the 2008 Review of RESP Industry Practices to which I contributed.[2]

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[1] To distinguish the group scholarship Plan as a whole from the plan of the individual subscriber, the Plan as a whole is capitalised in this text.
[2] Review of Registered Education Savings Plan Industry Practices. Report prepared for Human Resources and Social Development Canada by Informetrica Limited, 2008 (available on HRSDC website).

The quantitative measures proposed are appropriate. In particular, it is important to take a longitudinal perspective, and indicate the risk of not reaching maturity, whether through voluntary withdrawal, default or in other ways.

According to the proposed format, the risk of not reaching maturity and the risk of not receiving a full scholarship payment are treated separately. The risks cannot be added, since the second risk is measured as a share of the plans that reach maturity, and not as a share of all those who subscribed.. Interestingly, if readers of the prospectus add the two risks without making allowance for the fact that the second risk is measured over a smaller number of subscribers than the first, and think of the risk of not getting a full scholarship payment as being a share of all subscribers, they overstate the total risk of not receiving the full benefit from participation in the plan. I see this as a good thing, given the biases in the other direction I mentioned earlier.

While I fully support the thrust of the proposed treatment of risks in the plan summary in prospectuses, I see a number of difficulties in applying the new standard of disclosure. Let me discuss these and make suggestions as to how to deal with them.

First, the two group plan risks should be measured for specific cohorts of subscribers for which good information is available. Cohorts should be defined by year in which plans mature, not by the year in which plans opened. Providers group plans by maturity date, and investment income is pooled among plans with the same maturity date. It will be convenient to use this same grouping to calculate group plan risks, and it also seems appropriate.

Second, the risk of not reaching maturity can be calculated in two ways. Obviously, it can be calculated readily for cohorts whose maturity date has passed. The total number of subscribers is known for such cohorts, as is the number of subscribers who reached maturity, and the survival rate can be derived as a ratio from these two numbers, while the drop-out rate is the complement of the survival rate. Let us call this the first method.

The risk of not reaching maturity can also be inferred from annual rates of termination. The regulatory proposals seem to ask for this method, as they require that an annual rate drop-out be stated and that it be accumulated over the average lifetime of plans. It is important to note that this method gives only an estimate of the share of plans that do not reach maturity. As well, great care has to be taken to make correct estimates. Not long ago prospectuses indicated changes that took place in all plans during the past accounting year. A drop-out rate calculated for all plans can be misleading when the number of subscribers is growing rapidly. A large share of the plans then is new or rather young, and may be less at risk of being closed than older plans.

I would suggest that for this calculation plans also be sorted into maturity-date cohorts, and that all plans that at some point entered that cohort be counted as the "size of the cohort". The risk of failure can be calculated for the final year before maturity by dividing the number that failed by the size of the cohort, and similarly for the year previous to that, and so on as far back as needed. An overall average, weighted by the size of each cohort in the calculation can then be calculated, and this would be the

average annual failure rate. The total longitudinal failure rate, i.e. the risk of not reaching maturity, can be calculated by adding the failure rates for all years before maturity. Let us call this method 2.

Which of the two ways of calculating is to be preferred? To address this, consider the following:

a. Plans started at different times. Some Plans are relatively young and have virtually no plans that reached maturity. This makes it impossible to calculate the drop-out rate exactly, and the rate will have to be calculated according to method 2.

b. It seems to me that the risk of not reaching maturity may be higher later in the saving period than in the years immediately following entry. It seems reasonable to suppose that new subscribers know their financial situation and generally make a commitment that they can meet, given present circumstances. Their financial situation may change as time passes: they may lose a job, the family may break up or become larger through birth or adoption. The subscriber may take on other financial commitments that come with a greater penalty for not being honoured than the group scholarship plan. If this is so, it is important that a quantitative estimate of the risk of not reaching maturity be based on the years before maturity as well as on the early years. It seems impossible to do this with relatively young Plans.

c. All group scholarship Plans have been around for many years, but, as just noted, some Plans are young and replace earlier Plans, while others have continued to exist but have been changed over time. For older Plans it is possible to calculate the longitudinal failure rate using method 1. Providers may object to this because the statistics include performance of many years ago when plans were different in ways that may have affected the failure rate. The risk rates so calculated would then not fairly represent the risk that a new subscriber faces. As well, sales practices are not the same as before. Regulators have asked for better training and better management of salespersons, and providers have introduced certain controls that may make it less likely that people subscribe to more units than they can maintain over time. Accordingly, the risk of failure to reach maturity may be lower for prospective subscribers than past performance indicates.

d. The drop-out rate is not constant from year to year. It seems reasonable to assume that it varies with economic conditions. As the economy passes through a recession, unemployment among subscribers may increase, and this may lead more of them to close their plans or default on contributions. The measures of risk presented in prospectuses should of course reflect this reality. They will not always do so if the estimates are based on data for a single accounting year. If the year happened to be a good one for the economy, the longitudinal risk is likely to be understated, whereas a bad year for the economy might lead to too high an estimate. It would not be helpful to the potential subscriber if the estimate of the risk of not reaching maturity jumped up and down from year to year. Accordingly, estimates of this risk should be based on performance over at least a few years.

Because of lack of information about the performance of group scholarship plans in the past, it is not known how significant these various issues are in practice. It would seem that any approach will have to be a compromise, and a compromise risks being not satisfactory to any of the providers. Perhaps a risk measure based on a number of recent years (perhaps 5?) would be best. It could be based on early years

as well as years before maturity. Even this will not overcome the problem that some Plans are of recent vintage and have no or little experience with subscribers in the years close to maturity.

There is another approach that gets around the problem of representing the risk inherent in each of the plans in a fair and even manner, and it is to require each prospectus to include a measure of the risk of not reaching maturity based on the performance of the combined plans. The regulators could ask for the necessary information from all plans, calculate a measure, and require each prospectus to display it prominently in the plan summary, with text prescribed by the regulator.

This approach meets the basic need to tell the potential subscriber how large is the risk of not reaching maturity, on average. This risk is significant for each of the Plans. If it varied greatly among the Plans, it would not be appropriate to present the average, and each provider should be allowed to present their own estimates. However, if the risk is of similar magnitude in each of the five existing Plans, and cannot be fairly represented because of the issues discussed earlier, then an average is appropriate. It gives the potential subscriber the information they need to contrast the group scholarship plan with other saving vehicles that do not come with a requirement to contribute over time.

Third, providers should be free to argue that their plan has lower risks to subscribers than the historical record of all plans indicates. However, these arguments should not be included in the plan summary. They should be valid and reflect non-trivial differences between the historical plans and the plan being offered in the prospectus. And it should be clear that to the extent the risks are indeed lower, the rewards offered by participating in the Plan are also reduced.

Fourth, the risk of a subscriber dropping out voluntarily because of a change in financial priorities or a financial crisis is not unique to group scholarship plans. The issue is that the consequences are more severe than with other types of investments. However, providers may argue that this risk should be separately dealt with and that it should also be made public for other types of Registered Education Saving Plans. It is possible to make such measures public, but the Government of Canada is not able to do so.

Finally, scholarship payments take many forms. In many plans they are tailored to the duration of the study. In some plans the subscriber may choose the number of payments. The several payments are not necessarily equal, and, based on my reading of prospectuses two years ago, it is not clear that a person who opts for two payments gets the same value as a person that opts for three payments, even if the prospectus claims that this is so. For these reasons it seems to me that it is difficult to determine what is and what is not a "full" scholarship payment. Would a payment of 90% of the maximum amount per unit be considered a full scholarship payment? Would payments for studies of different duration be compared on an actuarial basis, using some discount rate?

The scholarship payments are perhaps the most difficult part of the scholarship Plan to understand. Based on the work I did on the appendix to the Review mentioned in footnote 2, I would argue that this area is not sufficiently well known to determine the best way to present risks to subscribers. Perhaps the risk of not getting a full scholarship is the best way. Or perhaps ranges of payments should be mentioned with the related probabilities. I would suggest that the regulators ask providers to present to

them data on all scholarship payments made in recent years, in such a way that the total pattern of payments in plans that reach maturity can be determined and analysed. Here too, the option of requiring that information be provided about all Plans taken together may be worth considering.

In conclusion, let me repeat that I am fully in support of the thrust of the proposed Plan Summary as presented in your notice of March 26. My intent in this submission is to point out some of the problems that will be encountered with the quantitative measures of risks that are proposed. I hope that you will find these comments helpful in preparing for when you square off with the providers about these measures, as I don't doubt you will.

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