SINK OR Swim?

Pension plans need to explore uncharted waters to stay sustainable

By *Nigel Branker and Idan Shlesinger*

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Pension plans are the topic du jour, even outside of HR circles. Funding challenges, retirement income adequacy, intergenerational equity and financial stability are only a few of the issues under discussion and in the media. But all talk and little action may be sounding the death knell for these programs. Unless pension plans can evolve relatively quickly to meet changing needs and circumstances, they face extinction.

Evolution requires movement along a spectrum that has typically seen plan sponsors situated at one extreme or the other. At one end is the DB plan, where the primary risk is funding cost volatility (usually borne by the plan sponsor); in return, the member receives low-risk benefit predictability. At the other end of the spectrum is the DC plan, where costs are foreseeable but the member bears a high degree of risk. Neither design is serving both plan sponsors and members well. The challenges of DB plans continue to fuel a decline in the number of participants—a 10% drop in the decade between 2001 and 2011, according to a recent fact sheet from the Office of the Chief Actuary—while DC plans offer no benefit certainty. Newly developed hybrid plan designs that share risk move closer to a middle ground.

Why Change?

There has been some progress toward a hybrid solution, but primarily at the DB end of the spectrum. This focus is not surprising: organizations that are philosophically predisposed to DB plans are grappling with ways to mitigate the inherent cost variability while still providing a fairly predictable benefit for members. This objective has been the genesis of target benefit plans, shared-risk pensions and other hybrids introduced to date.

However, there is another side to the hybrid pension story—one that tackles the issue from a DC perspective. The challenge is that there is seemingly little motivation for DC plan sponsors to move closer to the midpoint of the spectrum and assume more risk in exchange for helping to provide some level of benefit predictability for members. This raises a fundamental question: What is the employer's objective in offering a pension plan in the first place?

If the goal of a pension plan is an orderly approach to achieving a targeted retirement income level, then DC plans—which are more of a savings vehicle than a pension plan—miss the mark. While they provide an opportunity to set aside money for retirement, it is a challenge for most members to identify a target, track their progress toward that goal, modify their actions to stay on track and then convert their savings into any sort of predictable or adequate retirement income. In essence, DC plan members participate in the arrangement and hope for the best.

If a plan sponsor's objective is to support employee attraction and retention, a DB plan or hybrid model will usually prove more attractive than a DC arrangement. And if the motivation is to ensure adequate retirement savings—or comfort regarding a targeted income replacement—then a DC plan in its current form is likely not the route to take. Sponsors with these goals should be looking for modifications to their current DC plans, even if it means taking on marginally more risk to realize their aim.

New Growth

Developing a DC-focused hybrid requires an emphasis on three key shortcomings of traditional DC plans: contribution levels, investment options

and de-accumulation strategies. Several leading-edge DC plans have introduced innovations with respect to these components, and work is under way to create a full solution that provides more efficiency and benefit predictability to an otherwise DC structure.

1) Contribution Levels – For many DC plan members, saving for retirement is like driving blindfolded: they can't see where they're going and have no destination in mind. Anecdotal evidence shows that contribution rates usually remain unchanged for years at a time, and regular use of retirement planning tools to adjust contribution rates is the exception rather than the rule. According to the latest *Benefits Canada CAP Member Survey,* only 21% of members in 2013 say they have a formal, written financial plan that outlines at what age they will retire and the amount they will need to retire by that age.

The typical industry response has been to encourage auto-escalation—or, more bluntly, "no matter how much you are saving, save more." This concept suits the asset accumulation industry, but it misses the basic point: members shouldn't save more; they should save the right amount. *Oversaving* is as bad as *undersaving.* Plan members need a destination and a route—which may have some detours along the way—for getting there.

Consider DB plan funding. On a regular basis, an actuarial valuation compares the expected benefit cost with the accumulated assets and assesses whether the plan is on or off track. A plan that is on track requires a steady-state contribution. An underfunded plan needs higher contributions, and an overfunded plan can support lower contributions or even a contribution holiday.

DC plans can incorporate the same concept by defining a clear goal as a function of retirement income and tracking a path to achieve that goal. Advanced DC recordkeeping technology can automatically adjust member contribution rates to increase or decrease, within agreed-to parameters, in order to maximize the probability of retiring close to the desired goal. In stochastic projections recently performed by Morneau Shepell, such adjustments have been shown to significantly increase—from 48% to more than 63%—the probability of a retiring member achieving an income level close to his or her target.

Such an approach, which can be offered to plan members on an opt-in or opt-out basis, can be very effective. The question is whether it represents too much of a shift in responsibility for retirement planning from the plan member to a plan sponsor or third-party administrator—or if it is simply an acknowledgement that members need more help than they are currently getting.

2) Investment Options – Traditionally, plan sponsors have offered their employees a menu of equities, bonds and other investment options, and have encouraged them to cobble together a portfolio. Guaranteed interest certificates (GICs)/ guaranteed investment annuities (GIAs) or money market funds were often offered as default funds. Such an approach often results in excessive amounts of assets in low-return investments, low diversification and underperforming plans. Many studies have demonstrated that DC plans significantly underperform DB plans of similar size in the same markets.

One solution that has been broadly adopted in recent years is a reduction in the number of choices, co-ordinated with the introduction of target-date funds (TDFs) or lifecycle funds. The basic concept is simple: create a diversified risk-based portfolio and gradually make that portfolio more conservative as the member approaches retirement. This approach has some merit:

- it reduces the often-paralyzing menu of investment options previously offered (in fact, sponsors should consider whether offering *any* investment choice is beneficial);
- it replaces poorly performing GICs/ GIAs and money market funds as the default, leading to more assets being productively invested; and
- it produces more diversified portfolios with less market timing.

However, the TDF still suffers from a basic flaw. It treats all members and accounts the same, dependent on only a single variable: time to retirement. The problem is, not all members should adopt more conservative investments as they get closer to retirement. In fact, Morneau Shepell's stochastic modelling has shown that, in many cases, automatically reducing risk exposure as members approach retirement often goes too far and results in a lower likelihood of achieving a target level of retirement income.

The reason for this result isn't hard to understand: reducing risk exposure also reduces expected returns. For members who are tracking well toward their goals, this reduction in exposure can improve their results marginally, since they are less in need of upside performance and will be exposed to less downside risk. However, for members who are *not* tracking well toward their goal, taking risk and returns off the table places them in a downward spiral, making it even less likely that their investments will recover to meet their goals.

A better solution is a program that monitors a member's path toward his or her goal and reduces risk exposure only when the member is ahead. This tactical reduction of risk exposure will help the member to zero in on his or her goal more often and can be effectively managed using portfolio recordkeeping techniques.

3) De-accumulation Strategies – At the point of retirement, DC plan members need to make an amazing transformation: convert a career of asset accumulation into a lifetime of income. Unfortunately, there is little support available for this transformation. Annuities are one solution, but they're expensive and, consequently, are seldom actually used. The more common approach is to transfer the accumulated assets into a life income fund, but this means that the individual bears all of the risk of hugely variable longevity with little or no protection.

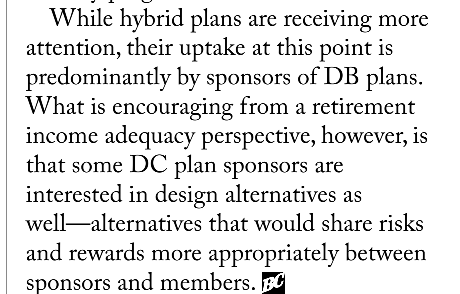
A more effective approach can be found in the pooling used by DB plans. Group life expectancy is easier to predict than individual life expectancy—and since the DB plan is simply grouping individual retirees together, the high expense loading (the amount of acquisition and other costs included in addition to the pure premium), profit margins (net income divided by revenues) and reserve requirements/anti-selection reserves (amounts required to ensure sufficient assets to provide payments) that exist in insurance company annuities are avoided. Unfortunately, this type of pooling directly out of DC plans requires some regulatory changes (which haven't happened yet) before being relevant to most Canadian plan sponsors.

In the meantime, there are other solutions to manage longevity risk more successfully. Members should start planning their retirement income goals with a basic level of income required to support their needs and an additional variable piece. The "core" component can be estimated earlier in the member's working lifetime, with mechanisms in place to ensure, with a high degree of certainty, that this goal is achieved through either asset allocation or more sophisticated approaches.

For example, the purchase of deferred annuities during a member's working lifetime is an emerging option. The variable part of the retirement savings goal can change as needs change, and members can react as necessary (e.g., postpone a vacation for a year and save more during that time). Of the three key aspects of DC plans that need to evolve, this one is most likely to get attention as more members retire from DC arrangements.

Just as DB pension plans must evolve to protect against cost volatility, it's critical that DC plans adapt to include more planned elements at an individual level. The danger if they *don't* is an entire generation with no plan for retirement, creating a burden on Canada's social security programs and a workforce risk.

While hybrid plans are receiving more attention, their uptake at this point is predominantly by sponsors of DB plans. What is encouraging from a retirement income adequacy perspective, however, is that some DC plan sponsors are interested in design alternatives as well—alternatives that would share risks and rewards more appropriately between sponsors and members.



Nigel Branker is a partner and leads the Ontario pension consulting practice, and Idan Shlesinger is managing partner, DC pensions and savings plans, with Morneau Shepell. nbranker@morneaushepell.com; ishlesinger@morneaushepell.com