

The Long Run

Sustainable DB plans can provide a solution for Canada's pension woes

By Karen Hall, André Choquet and Troy Milnthorp

Over the last couple of decades, many plan sponsors have de-emphasized retirement programs within their compensation strategies. As a result, in Canada and around the world, there has been a significant movement away from DB pension plans toward DC plans. Statistics Canada's 2006 data indicate that only 17% of Canada's private sector workforce has DB pension coverage. The popularity and apparent success of this transition to DC has left some in the pension industry wondering about the sustainability and affordability of DB plans in today's world.

In fact, DB plans are both sustainable and affordable, once measures are taken to address their current challenges. But are these plans worth preserving? The answer lies in determining the most effective means to help people provide for their retirement income needs.

Make It Affordable

At some level, all retirement programs are the same: individuals and employers put money aside today to build up a pool of assets with the intent of drawing from that pool later in life. If the pool is sufficient, retirement plans work out. If the pool is insufficient, resources are depleted and consequences can be dire.

Both DB and DC plans are helpful in providing a source of funds in retirement. However, DB arrangements are better positioned to deal with two fundamental issues that complicate DC arrangements: financial literacy and longevity.

Financial Literacy

Those growing a DC-based retirement nest egg need to make a number of critical accumulation decisions relating to:

- retirement income needs;
- contribution amount;
- mix of registered and non-registered vehicles (to maximize tax effectiveness);
- asset mix;
- particular investments within that asset mix; and
- monitoring investments and making adjustments.

The situation is even more complicated after retirement as individuals must also make de-accumulation decisions such as:

- when to withdraw;
- from which registered or non-registered vehicle to withdraw

- (to maximize tax-effectiveness);
- how much to withdraw;
- how to ensure the nest egg lasts for a lifetime;
- how much to leave in an estate, and how to pass it on most effectively; and
- how to prepare for the higher medical and caregiving expenses that may be required nearer the end of life.

These are not simple concepts to communicate, and DC plan sponsors expend considerable effort on retirement communications. In Aon Hewitt's *Canadian Retirement Trends Survey 2010*, almost 60% of DC plan sponsors indicated that they were somewhat or very likely to communicate with plan members around retirement income adequacy, retirement considerations or the retirement process.

RETURNS VERSUS LONGEVITY

Life expectancy	15 years	15 years	17 years
Discount rate	6.5%	5.5%	6.5%
% change in assumption	n/a	1% reduction in discount rate; no change in life expectancy	two-year increase in life expectancy; no change in discount rate
Cost impact for non-indexed pension	Base case	7% more expensive than base case	8% more expensive than base case

Source: Aon Hewitt

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A sustainable DB plan should have some or all of these key features:

- compulsory participation;
- substantial member contributions;
- clarity around the allocation of risks between stakeholders;
- a predictable target benefit, based on a defined formula;
- inflation protection;
- equity between plan members (e.g., between members retiring early and members deferring retirement);
- a clear funding policy focused on achieving stable contributions, within a defined range;
- a mechanism for balancing benefit stability, contribution stability and member equity;
- investment decision-making that balances the need to remove investment and inflation risks through liability-matching investments and the need to reduce long-term plan costs through return-seeking investments; and/or
- an accounting strategy that will adequately manage profits/losses and balance sheet volatility.

Another tack that employers are taking is to adjust the “choice architecture” in their DC plans, paring down investment options and reviewing default options. This approach recognizes that financial literacy—as well as financial discipline—is a challenge for many plan members; therefore, it reduces the number of decisions they must make.

A DB pension arrangement removes many of these accumulation and de-accumulation decisions from the individual, at least with regard to that portion of his or her retirement income.

Longevity Risk

There is also the question of risk. Later in life, longevity—not investment return—becomes the overwhelming risk. The difference between using a retirement nest egg to support 10 years of retirement and stretching that same nest egg to last 30 years is massive. The table on page 38 illustrates the impact of investment returns versus longevity for an older individual. Note that living just two years longer has a greater impact than losing 1% of investment return per year for every year the pension is paid. The individual facing this risk has two choices:

1) Insure the risk by purchasing an annuity. This essentially means returning to a DB arrangement, with an insurance company providing the plan. While this may minimize longevity risk, it does so at a cost, which can be quite expensive.

2) Withdraw less or save more to ensure that the nest egg will last past the individual's maximum life expectancy. The result, of course, is that the nest egg will remain large and will eventually constitute a sizable estate on death. While this might be good news for potential heirs, it may be something of a moot point. Given current retirement savings trends, it is unlikely that many Canadians will be able to save enough before retirement and then spend so little during retirement that they will have funds left over.

In Search of Sustainability

While DC plans may have risks that are better addressed by DB plans, traditional DB plans also pose a number of challenges. The contributions/benefits equation has, in many DB plans, become

imbalanced. The old balance was based on higher interest rates, significant equity risk premium, more years spent in the workforce and fewer years spent in retirement. These have all shifted, and the balance has been lost.

In most cases, benefits have been guaranteed, leaving contributions to absorb all of the pressure. Greater success at sustaining DB plans can be achieved by allowing both sides of the contributions/benefits equation to be adjustable.

Benefits design needs to be rethought in terms of incentives that impact the ratio of years of contributing versus years of collecting. To the extent that this ratio is being reduced (e.g., through early retirement incentives), plans are absorbing unanticipated additional costs.

Asset/liability mismatch has not been reduced as plans have matured. Plans now have significant contribution leverage and financial statement volatility tied to asset/liability mismatch.


Many of the indexing mechanisms in plans are not paying for themselves, meaning that substantial indexing benefits have been collected by people who paid very little for them. Indexing designs often understate the costs, leading to insufficient contributions and ultimately setting the stage for potentially significant generational inequity.

DB plans have provided members with substantial benefit certainty. However, the price has been perhaps too much financial uncertainty for contributors and plan sponsors. The risk sharing between sponsors, contributors and beneficiaries is, therefore, perceived as inequitable.

Time to Reconsider

The good news is that many of the challenges can be, and are being, addressed by engaged stakeholders. Practical and effective tools are becoming increasingly available for reducing DB plan risks, addressing equity concerns and identifying the appropriate risk-sharing balance. For example, more DB plan sponsors are considering strengthening the linkages between investment and funding policies, and developing a path that takes on less investment risk as the plan's funding improves. Sponsors are also considering delegated investment solutions, in which the investment decisions and fiduciary operations of the plan are delegated to a third party to manage cost, risk and governance more effectively. The target benefit approach to

a DB plan, also under review by several plans, strengthens the linkages between funding and benefit policies and is another way of sharing plan risks among stakeholders.

A sustainable pension system is a healthy combination of a variety of vehicles, including social programs, DC pension plans, individual retirement savings and DB plans. Those committed to sustainable DB plans must push for structures and legislation that support affordable DB pensions and endure for the long run. 

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