Putting Pension Back Into Defined Contribution Plans

By: Dr. John Por

Measured by the replacement ratios they deliver, defined contribution plans have fallen short of their original promise to deliver defined benefit plan benefits.

If my observations at the 2014 DC Summit at Whistler, BC, are any guide, HR and pension professionals are greatly ill at ease with this fact. They are deeply committed to the welfare of their employees – including retired ones. Yet, even a limited discussion on the efficacy of our current DC arrangements revealed a great deal of discomfort.

Solutions are hotly debated, but before any action is taken, it is vital that we pause to examine how and why DC plans are ailing and how we can make them better retirement vehicles.

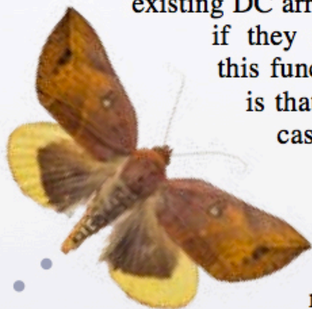
In this article, I argue that:

- The shortfall is due to original DC designs and practices adopted two to three decades ago when existing capital market returns were at historic highs and the experience with DC plans was modest.

- The current typical DC arrangement is a product of piece-meal changes over time, guided by a confluence of factors nobody could have seen at their inception. Furthermore, the existing regulatory framework and newly-identified behaviour biases (heuristics) have kept DC arrangements from adapting to new circumstances and needs.
- In order to 'fix' DC arrangements, we must first acknowledge the reality of their current design and try to move them towards income generation. This will require us to apply a different 'framing' (as behavioural economists call it) to the situation.

An Objective Look

Who hasn't heard the phrase 'form follows function?' The 'function' of a pension plan is to provide retirement income! If so, it is worth analyzing the 'form,' the actual features of existing DC arrangements, to see if they do indeed fulfill this function. The answer is that this is rarely the case.



Today, DC plans are thought of merely as saving plans and not as retirement income generators. This is a serious issue as approximately 60 cents of every retirement dollar will come from returns earned after retirement. Without addressing the cost-efficient conversion of assets into income (i.e. decumulation), the danger of significantly lower retirement incomes looms large.

My studies and observations of DC plans go back to the mid-1990s. At that time, Cortex (of which I was the founder) developed a method of articulating a sponsor's investment principles and beliefs (SIP&B for short). This has since become standard industry practice.

The idea was to infer and make visible what sponsors must have believed in order to run their investment programs. Of course, nobody 'believed' these 'implied beliefs,' as they did not exist. But that was the point! As investment programs had been gradually modified through a myriad of features added individually over time, it meant the program no longer had a coherent, conscious design. That begged the question: Why run such a program? To help sponsors redesign their programs, we then asked them what they actually believed and worked from there.

Now almost 20 years later, it is time once again for reflection and to apply the same scalpel to a new organ. Let's boldly state the implied or apparent beliefs behind our existing DC plans. Our DC arrangements are designed as if we believed:

- DC assets exist to grow with no direct or indirect relationship to retirement incomes. Success is measured by achieved rate of returns and standard deviation.
- While pension systems shift consumption from one's working life into retirement and cover a period of 65 to 70 years, only the 35 to 40 years of employment (but not the next 20 or so after retirement) are worthy of corporate and professional attention.
- DC members are rational decision makers, who after proper instruction will have the capacity to act in a role similar to that of a pension fund CIO. This instruction, in the form of quarterly newsletters and occasional written pieces (only an infinitesimal number of DC members avail themselves of seminars or face-to-face education or use websites), are sufficient to turn them into such CIOs.
- The nine to 10 per cent combined savings rates of typical DC plans (which replaced DB plans en masse only 15 to 20 years ago) will yield DB-comparable replacement ratios.
- DC assets can be turned into incomes at fair prices by the individual retirees on their own.
- Financial intermediaries (banks, money managers, insurance companies, brokers, etc.) will, through market forces, voluntarily introduce practical, cost-effective, and transparent products and solutions that individual members can use to convert their assets into income on their own.
- Individual members have the ability to overcome the information asymmetry and agency problems inherent in face-to-face negotiations with financial intermediaries.

These implied beliefs are truly heroic! Our research over the past five years has failed to identify even a handful of industry professionals who would accept even one of the above. The adage that consensus is what people profess in chorus, but not hold in private, has never rung more accurate.

Furthermore, in a recent survey, 75 per cent of CFOs believed employees are not and never will be capable of dealing with decumulation issues.

Landscape Has Changed

The world today is very different from the one in which our existing DC programs developed, yet our approach hasn't changed. At the time of most DB to DC conversions (in the midst of the longest and greatest market boom in history), capital market return expectations of seven to eight per cent looked rather conservative. The existing target 'median' combined contribution rates of nine to 10 per cent of payroll (equivalent to the level of sponsors' DB contributions then) is a product of that era. Today, this target is clearly insufficient to deliver a decent replacement ratio.

Once the switch to DC plans took place, the industry gradually lost sight of what they were designed for – income generation – and DC plans over time became perceived as nothing more than savings vehicles. So, given the DB structure, it made sense that sponsors were focusing on investments (as it was their pension promise to keep and their contribution to minimize). Assets-to-income conversion was a non-issue for DB plans. But DC plans are different financial instruments! Without addressing such conversion, even 'best practice' corporate savings efforts (design, investment line-up, education, monitoring, governance, reporting, etc.) become moot.

In fact, what started as a prudent measure of limiting corporate financial exposure, gradually became an unarticulated industry belief that 'creating pensions' was solely the members' responsibility. The heavy task of converting assets into income (decumulation) landed on the

inexperienced and unprepared shoulders of the members.

Up to that point, members had never been expected to do anything concerning their pensions. They retired and the promised cheque duly arrived the next month and every month. And while no one disputes that members need support to make proper investment decisions and such support is provided in the accumulation phase, this support, simply disappears at decumulation decisions which are far more complex and have far more impact than those in accumulation.

DC Plans Unchanged?

The status quo, which was based on the ephemeral experience of a previous era, has remained unchanged despite our collective subsequent experience to the contrary. Why is this?

The winner of the 2002 Nobel Prize in economics, Daniel Kahneman, discovered systematic flaws and biases (he calls them heuristics) that may offer one explanation. He suggests that as the original purpose and assumptions of a system fade, we diligently begin looking for rationalizations to avoid radical rethinking (which usually causes considerable short-term pain).

Another less visible, but probably more powerful, reason for the lack of change in DC programs is that when only mere compliance with the existing regulatory framework is required, systemic flaws are simply not revealed. These two reasons – biases (such as confirmation, status quo, framing, availability, and a myriad of others) and an uncertain regulatory framework – have conspired to keep our misconceptions and mistakes from being corrected.

In hindsight, the moment the task of income generation was shifted to the member, everything should have been rethought. Longevity risk, income adequacy, members' ability to make such decisions, and the sponsor's DC role should have been the new focus of thinking. Instead, we (this author not excepted) kept the investment focus. Reading the '2004 CAPSA Guidelines #3 for Capital Accumulation Plans' unearths no reference to retirement income or pension, the very purpose of such plans. In fact, based on those guidelines, the most reliable longevity protection, annuities, could not have been deployed as options. Their volatility as investment vehicles is extremely high and, therefore, they are not safe by the measures listed in the guidelines.

Clearly, what we have here is an acute case of what Kahneman calls a "framing" problem. By switching to DC plans, corporations merely wished to limit the size and volatility of their pension contributions. In practice, the switch resulted, by accident, in a confluence of factors that morphed into a time bomb, whose slow-fuse explosion is being felt today and will be for many years to come.

None of this was, or realistically could have been, foreseen 15 to 20 years ago. There is no villain in this drama. Most industry players, including members who decided to switch to DC plans, acted rationally based on the best information available at the time. Of course, what is thought to be the best information at any given time, inexorably turns out to be sadly outdated in just a few short years. But our collective 'optimism' and 'overconfidence' biases, coupled with self-interest, kept us from designing systems for the worst-case scenario.

DC plans can be made much better, and they must be, as such arrangements – rightly or wrongly – will remain the main retirement vehicles for millions of Canadians for many years to come.

The first step on the road to fixing them is evident. We must start with acknowledging that their purpose is to provide income for retirees. Without that first step, the rest of the road will surely prove a hard slog. **BPM**

Dr. John Por *is founder of the Decumulation Institute*

jpor@decumulation.ca

Delivering
long-term value

Fengate is your trusted advisor for long-term, customized investments in the real estate, infrastructure and private equity sectors.

Our team offers expertise in alternative investments, fund management, project financing, and facility and property management.

Trusted partner. Experienced investor.

Fengatecapital.com

FENGATE //
CAPITAL MANAGEMENT