

DC PLANS

Understanding And Managing Stakeholder Risk

By: Tony Ioanna & Ivor Krol

This past decade has witnessed a significant increase in the number and size of Capital Accumulation Plans (CAP), particularly DC pension plans, Group RRSPs and DPSPs. After all, one of the key benefits for plan sponsors by going the CAP route is that a substantial portion of the risk inherent to a pension plan, most notably investment risk, is transferred to the plan participant. However, the plan sponsor still maintains the fiduciary responsibility of ensuring that the tools, information, and options used by plan participants to manage their newly inherited responsibilities are accurate and comprehensible.

Unfortunately, there is a growing gap between the unique needs of CAP stakeholders and the products and services that are being offered as a means of mitigating the risks associated therewith. In this first article, we will examine the nature of this disparity characterizing the CAP market.

The Rudiments of a Pension Plan: Have we forgotten?

In order to truly understand the problem, one needs to return to the fundamentals underlying any form of pension plan, be it Defined Benefit, DC, or any CAP for that matter.

As individuals, we spend a large portion of our lives working as a means of supporting ourselves and our families. In most cases, due to the natural course of things and the socio-economic tendencies of our time, these labour force activities cease and we embark upon the retirement stage – a period that is meant to be one of relaxation and enjoyment. However, the quality of life that will eventually be enjoyed during this phase is ultimately dependent on an individual's ability to replace the labour income that was being earned prior to retirement. This is where a pension plan or Group Savings Plan plays a crucial role.

A CAP is a vehicle that allows individuals to save a percentage of their salary through employee and employer contributions (present) in order to finance their lifestyle during retirement (future). Put differently, part of today's salary has to be deferred to a future time when there will be no more labour income. These contributions are invested in order that assets may grow tax-free (in most cases), thereby increasing the chances of having a large enough nest egg to meet the plan members' retirement income objectives. Hence, the reason why pension plans exist is to provide a means for the employee to attain the appropriate degree of salary/income replacement at retirement that will maintain the standard of living to which he/she has become accustomed while employed.

Therefore, by definition, all of the crucial decisions that must be made by CAP participants (contribution amount, retirement date, investment selection, asset allocation, etc...) must be geared towards this fundamental objective.

With this in mind, the question now remains whether or not the standard products and services offered to CAP members allow them to properly determine and monitor their income replacement objectives. In general, the answer is no.

Are Investment Returns the Key to a Successful Retirement?

Arguably, the most analyzed variable in the context of DC plans is the investment return. Did equities outperform bonds? What was the return on the balanced fund or the 2035 retirement date fund? Is my investment portfolio optimal? Unfortunately, while the members' overall portfolio return will have a direct impact on the amount available at retirement, it is not an appropriate variable when it comes to quantifying the status of their future income replacement at any particular point in time.

For example, let us assume that a balanced fund realized a loss of 15 per cent in 2008 and that two individuals had their plan assets invested in this fund. Let us further suppose that the first individual has three years of plan participation and has accumulated \$10,000 in assets and the other individual has 30 years of participation and has accumulated \$500,000 in assets.

While both individuals lost the same percentage of their total plan assets, the impact on their future ability to generate an adequate retirement income is completely different. The younger member can more easily absorb the 2008 investment loss because many years of future contributions remain and the account value is small; the older member unfortunately has neither the luxury of time nor many years of contributions remaining to make up the losses. In this example, the action required by both individuals in order to ensure that they are still 'on-track' with their retirement objectives is quite different and, unfortunately, cannot be properly assessed by analysing investment returns.

Bad or Lacking Information Leads to Wrong Decisions

As previously mentioned, it is the plan member who bears the majority of the risk in a CAP and who is ultimately responsible for the key decisions. Therefore, it is only natural that specific tools and information are required in order to assist the member in carrying out these responsibilities in a confident and informed manner. Since the objective of the CAP is to provide an adequate income at retirement, then what the members really need is a way of measuring the impact of their decisions today on their potential retirement income of tomorrow.

During a June 2009 hearing on 'Examining Target Date Funds' carried out jointly by the Securities Exchange Commission (SEC) and Department of Labour (DOL) in the United States, one of the key conclusions was that the plan participant's contribution rate is the most crucial element in achieving a "successful retirement." Unfortunately, the most recent Benefits Canada CAP Member Survey found that only 40 per cent of respondents had an excellent or very good understanding of the contribution amount required in order to retire with enough money to fund their desired lifestyle. This finding is not surprising when one considers the type of information that CAP members are generally given to work with, as well as the manner in which it is presented. A member cannot make alterations to their funding and investment strategy in a truly informed fashion if they have no way of measuring the impact of these changes on their potential retirement welfare.

A CAP member's greatest risk is the risk that he/she does not yet know! The fact that plan members only enrol once in their company retirement program means that they rarely retain essential information regarding the key aspects of their plan and often forget how to stay on-top of their retirement planning. This is why the education, information and tools that CAP sponsors provide to their plan members are extremely important and must help them make the right decision, not hinder their comprehension and engagement.

In the second instalment of this three part series, we will examine what can theoretically be done in order to align the information that plan participants receive with their need to ensure that they are 'on-track' with their retirement income objectives.

(Part I of III)

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