

DC PLANS

Understanding And Managing Stakeholder Risk In The DC Environment

By: Tony Ioanna and Ivor Krol

In Part 1 of this three part series, we revisited the fundamentals of a CAP in order to expose the mismatch between the information that most plan participants are provided with to assist them with their retirement planning and their underlying retirement objectives. In this second article, we will continue to examine what can be done to align decision-making tools with DC plan participants' needs in order to mitigate the risk for sponsors and members alike.

A Theoretical Solution: 'Actuarial' Valuations

CAP participants need a way of assessing the impact of their current decisions on their potential retirement welfare. What is therefore required is a means of effectively tracking and illustrating the evolution of each plan member's assets relative to their final salary/income replacement objectives. In order to accomplish this, we can borrow a page right out of the Defined Benefit pension plan handbook.

While DB and DC plans differ greatly in many respects, there is fundamentally no difference in their purpose which is to provide an adequate pension during retirement. When it comes to DB plans, the funded status is periodically evaluated to make sure that assets cover future benefits. If there is a deficiency, specific actions are taken; likewise if there is a surplus. This formal process of comparing assets to liabilities on a periodic basis is referred to as an actuarial valuation and is required by law as a means of ensuring that DB plans are being adequately funded. Since it is the DB plan sponsor who bears the majority of the funding risk and cost, the results of the valuation (good or bad) are taken directly into account on the employer's balance sheet and income statement.

When it comes to a DC plan, the roles are reversed. As opposed to the plan sponsor bearing the aggregate risk of all participants as in a DB plan (and the corresponding liability), each individual CAP member is responsible for the risks associated with their own unique situation. While no tangible liability exists per se, each individual, whether they are aware of it or not, has his or her own implicit income replacement objective at retirement. Therefore there is a direct parallel between a DB plan and a DC plan with the caveat that, in a DB plan, the benefit is known whereas in a DC plan, the benefit is targeted. Nonetheless, this fundamental similarity implies that, as in the case of DB plans where assets are measured against liabilities, individual DC assets need to be periodically measured against a specific salary/income replacement objective.

The only way to ensure adequate funding is to be aware of the funded status and take appropriate action when things are not 'on-track.' This is a particularly crucial exercise for those CAP members who contribute the maximum amount to their plan as contribution limits may prevent them from being able to make up investment losses through supplemental contributions. This is contrary to a DB plan where the employer is obliged to make deficit amortization payments in whatever amount necessary to restore the plan's funded status.

Complete Risk Profile

In addition to requiring a clear picture of their funded status on a periodic basis, CAP members also need to adequately quantify and understand the risk associated with the decisions they make during the accumulation phase. However, this risk needs to be expressed in terms of the possible impact on the plan member's income

replacement and not the traditional measures of asset class volatility or portfolio downside. This is because the real risk that a DC plan member must attempt to manage is an inadequate retirement benefit. While the fund return is an integral part of this, it is the confluence of investment returns, contribution levels, the market value of assets, the targeted retirement age, and mortality risk that ultimately determines retirement welfare. An inadequate contribution rate can be more devastating on potential retirement income than a poor investment selection. Fully understanding the impact of a contribution rate of two per cent instead of six per cent, investing in bonds instead of equities, or the decision to retire at 55 instead of 65, can only be achieved if the expected outcome and the worst-case scenario related to income replacement are quantified and analyzed at the same time.

Since the complete risk profile of a DC plan participant is measured in terms of income replacement, it is important to recognize that each and every plan participant in a CAP has a unique risk profile. It is practically impossible for two individuals to have the same value of assets, the same investment policy, the same contribution rate, the same age, and the same target retirement date as well as the same life expectancy at the same point in time. Because all of these factors jointly influence retirement well-being, no two individuals can have the same complete risk profile. This means that any information presented to plan participants regarding their worst-case income replacement or funded status scenario must take into account their unique and individual situation if it is to be useful. Any attempt to bundle members together under the same risk umbrella because of perceived similarities such as investment risk aversion is ultimately and inherently flawed.

Risk Mitigation

The only way for a CAP member to mitigate the main risk associated with retirement is to monitor, on an ongoing basis, the impact of the key decisions made during the accumulation phase on potential salary/income replacement and make the appropriate adjustments as required. By providing periodic valuations that illustrate expected salary/income replacement and downside risk under their actual structure, each and every participant will know precisely where they stand, where they are headed, and at what risk. There can be no ambiguity or surprises if the right information is communicated in a clear manner. Furthermore, the incidence of retirement shortfalls can be greatly reduced if action is taken when the funded status is shown to have deteriorated. Consequently, plan sponsors who provide their members with such tools will be able to feel confident that they are fulfilling a good portion of their fiduciary responsibilities because members will have at their disposal the most relevant and appropriate information possible which in turn will enable and encourage them to become engaged with their retirement planning.

In the last article of this three part series, we will examine the notion of DC valuations from a practical standpoint and explore some of the hurdles that need to be overcome in order to maximize the effectiveness of such a retirement planning tool and make it easy for members to use. ■

(Part 2 of 3)

Tony Ioanna is vice-president, DC practice, eastern region, and Ivor Krol is an analyst, financial risk consulting, with Aon Consulting.