Making promises you can keep – building pensions for the future

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The financial and economic crisis has had a profound and ongoing impact on pension plans around the world. Neither Defined Benefit (DB) nor Defined Contribution (DC) plans have been able to escape unscathed – and the crisis has served to expose and magnify the differences between these two pension systems. Now that the dust seems to be settling, it is time to see what lessons can be drawn.

Looking at the experiences of many companies through the crisis, it may be time for companies to promise less but, at the same time, do more to ensure that they can meet the promises they do make. If we look at the impact of the financial crisis on company pensions around the world, we can draw some useful conclusions for corporate pension plans of the future.

Defined Benefit plans – sharing risk

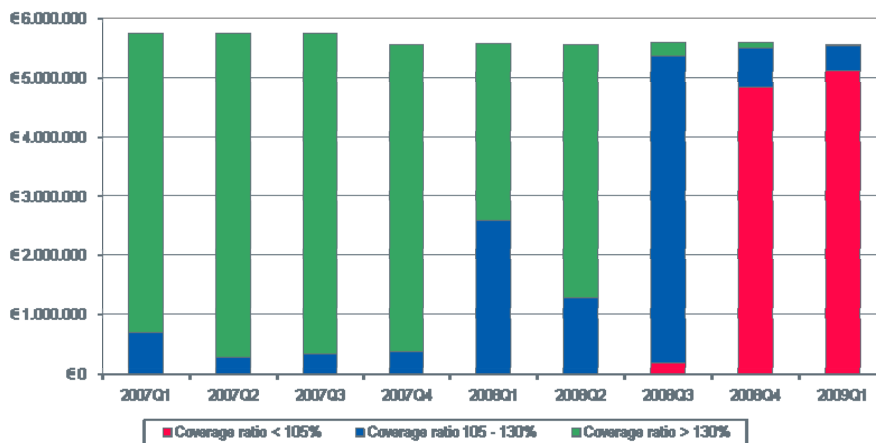
Over the last 6 to 12 months, Defined Benefit plans have captured the financial headlines almost daily. The pensions collapse has had a significant impact on companies with DB plans, weakening their balance sheets and reducing their financial room to manoeuvre precisely when they most needed it. For many companies, pensions have now become one of the CFO's top concerns.

In the US and UK, DB pension plans primarily look to the plan sponsor to ensure the adequacy of plan funding levels or, if funding levels have fallen, to ensure that adequate funding is restored. If the sponsor is unable to provide financial support to its pension fund, both countries have systems in place to provide protection of some kind to pension funds. In the US, the Pension Benefit Guaranty Corporation (PBGC) was created as a safety net for DB plans in trouble. Financed through premiums that US DB plan sponsors are obliged to pay, the PBGC takes over if the 'primary' plan sponsor goes bankrupt. In the UK, the Pension Protection Fund, established in 2004, fulfils a similar role.

Although the PPF and other protection funds seem to function well under normal circumstances, the crisis has revealed that such funds have limitations. Indeed, in extreme circumstances, the protection funds themselves may ultimately prove incapable of providing support when it is most needed. Over the past year in the UK, the PPF has seen an increase of large plans being absorbed, including such household names as Woolworth and The Royal Doulton. However, the resources of protection funds are limited and one can question whether the PPF is fit for purpose in times of extreme crisis. Paradoxically, in such times, the PPF may actually be seen to increase the risk to other pension funds as premiums have to rise. Ultimately, the PPF may have to consider cutting benefits or even turning to the government – and taxpayers – for support.

Pressure valves

The Netherlands has taken a different approach from many other countries concerning DB pension plans. In the Netherlands, there is no national pension protection fund. Instead, the Netherlands has introduced a legislative framework enabling amendments and reductions to be made to pension benefits should a fall in the coverage ratio make it necessary. As a result, almost all funds have now decided to forego indexation for the time being. If required, the next step would be to reduce nominal commitments (that is, to reduce the benefits promised in addition to the freeze in indexation). Although this extra step has not yet been taken by any fund, it is certainly on the table at many trustee meetings.



Source: Dutch Central Bank.

The Dutch system of sharing risk mitigates the risk of DB plans for company sponsors, making the plans more sustainable for the long term. It acts as a pressure valve, giving the pension plans much needed flexibility in times of stress. The presence of this pressure valve enables the Dutch DB system effectively to moderate DB promises in times of need, making the system better able to withstand shocks and ensuring long term adequacy and sustainability of pensions.

However, the Dutch system is not infallible. An important issue is that members may be unaware that their benefits can potentially be reduced, if necessary. In effect, the 'Defined Benefit' is less well defined than members may suppose. Although this is clearly beneficial for the long-term existence of the fund, it could have an adverse effect on employees who expect to receive a certain level of benefits. Since Dutch pension funds have never actually cut benefits, it is not known how members will react should such a scenario unfold.

Promises, promises

Promises are easier to make than to keep. Many self-administered, Defined Benefit plans and their sponsors have suddenly found themselves in a situation nobody had foreseen. In many cases, the risks have become too large for their sponsoring companies to bear – and the mechanisms for dealing with these risks may not be sufficient. For members, the crisis has shown that promises do not necessarily represent guarantees. They are always dependent on the money being there – 'I will stand by my promise for as long as I can afford to do so.' How can companies ensure that they can meet their promises?

Making promises you can keep

The crisis has shown that certain types of DB schemes can provide good downside protection. In many DB countries, pension buyouts are being used increasingly by companies that wish to remove the risk of their closed DB plans. By performing a buyout, the plan sponsors transfer the risk of their pension plan to an insurance company and ensure that the pension promises made to the members of the DB plan are kept. In the Netherlands, a similar type of downside protection can also be provided to an open DB scheme by an insurance provider. In a downturn, the insurance company continues to pay the agreed level of benefits as they are 100% guaranteed. The crisis has clearly demonstrated the value of this type of guaranteed protection for plan members.

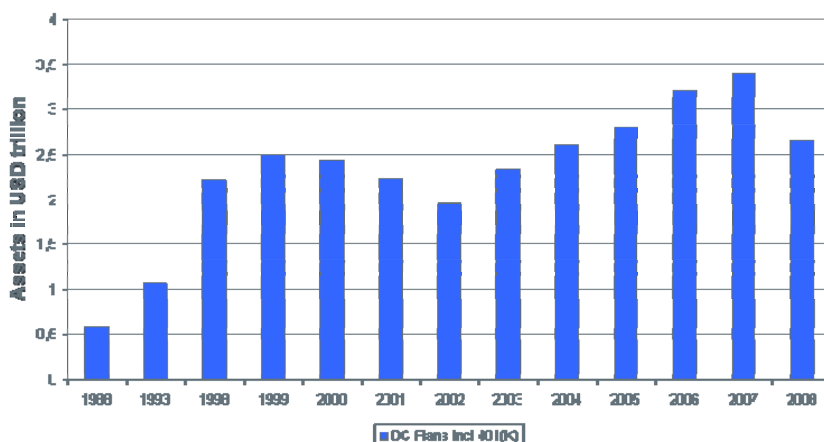
Shifting from DB to DC?

In the Netherlands, the Dutch DB system has meant that fewer companies have looked to move to DC plans. However, in the UK and the US, for many companies, DB plans no longer look as if they are sustainable in the long term. While the fundamental concept of companies providing secure retirement provision for their loyal employees is a good one, it was never intended to grow into something that could cripple companies and prevent them from profitably running their operations. It was never meant to be a major hurdle for mergers and acquisitions nor a potential cause of bankruptcy. To some extent, one of the unintended side-effects of increasing legislation and accounting regulations is that many companies are no longer willing or able to bear the risk – and cost – of DB plans.

As a result, may companies have turned to DC plans as an effective way to mitigate risk (and often also to reduce costs). However, if we look at DC plans, we see that they also have been heavily challenged by the recent crisis. Although, DC plans may represent a relatively straightforward mechanism for saving for the future, some major improvements will need to be made, if we are to create a system to provide adequate pensions for major sections of the population.

Defined Contribution plans – individual pain

While most of the news headlines have been filled with underfunded DB plans and struggling corporate sponsors, the silent victims of the crisis have been those with DC plans. While companies with DC plans have been spared a considerable amount of financial pain, many of their employees will have witnessed a sudden fall in their retirement savings.



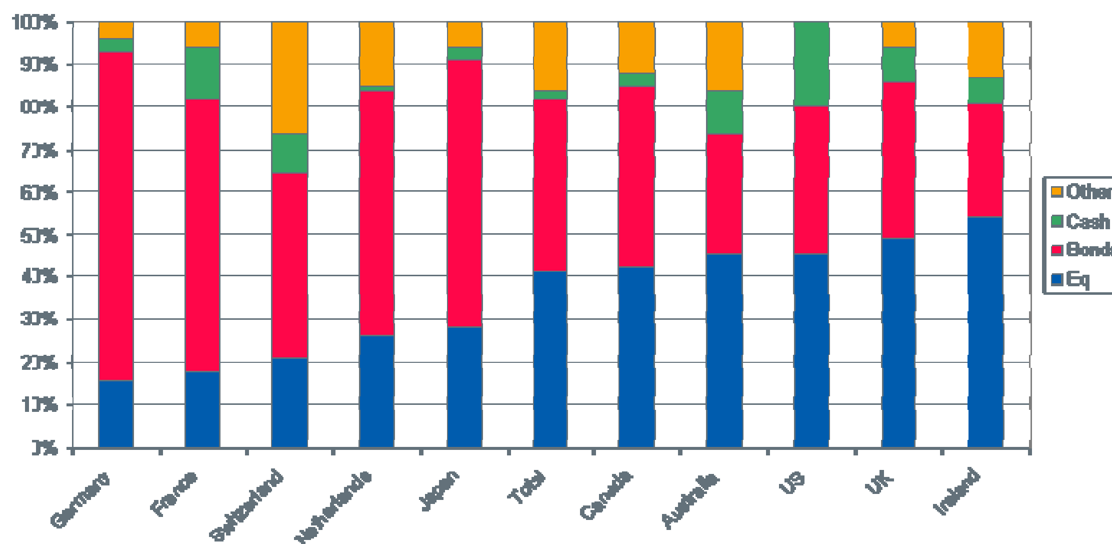
Source: RG Wuelfing and associates.

Given that DC pension provision is essentially personal, not all DC participants have suffered equally from the financial crisis. For younger workers, whose pension outlooks are determined more by their future than by the assets they have already accumulated, the effects of the crisis over the long term may not be that great (providing that their levels of funding are adequate). For others nearing retirement who have not made use of guarantees or life cycle strategies, the effects of this crisis may be catastrophic.

Not only do the outcomes differ per age group but there are also clear differences between DC plan holders in different countries. In several countries, DC participants have fared significantly better, as their DC plans were constructed with guarantees, made lower risk investments or used lifecycle approaches.

Another clear reason for the varying impact of the crisis on different DC Plans was the choice of DC plan investment portfolio. For example, Irish plans on average have been hit much worse than German or French plans, simply because of the different investment strategies adopted (Irish funds were much more heavily invested in equities). These differences in fortunes may offer us some useful lessons for the future.

Choosing risk – DC Pension funds investment profiles by country



Source: Watson Wyatt.

Preventing a DC legacy problem

Many companies have already chosen DC as the preferred model of pension provision, but the DC system as it stands today may well result in many individuals receiving inadequate pensions. It seems clear that many companies have taken too much of a 'hands-off' approach to DC pensions. In many cases, both the companies and their individual employees are not investing sufficient funds to provide for an adequate pension in retirement. In addition, the investment strategies chosen for the pensions savings are often inadequate. The current crisis should be a warning signal for companies and governments, as the economic problems that this will create may well come back to haunt the companies and states themselves.

While the underfunding of DB Legacy plans creates significant and immediate financial risks for the companies involved, the social issues arising from inadequate pensions may ultimately be more challenging.

Pension provision in the future – making promises you can keep

The answer to the DC Legacy problem lies in creating a DC system that will provide individuals with some of the advantages of the DB system but which removes the risk from the sponsoring organisation. In addition, individuals will need to be made aware that they will have to save more in order to pay for their future.

Save More

While the DB system may have suffered from promising too much, the DC system has suffered from lower participation and contributions. A long time before the present crisis unfolded, economists were expressing concern with the lack of discipline in DC contribution patterns and the consequences this would have.

The issue of low participation in particular has been recognised both in the UK and in the US where auto enrolment for DC plans is high on the agenda. Other countries, such as Chile, Australia, New Zealand and Sweden, have taken a more radical approach, and introduced mandatory participation and contributions. DC plans require a robust, transparent and realistic funding strategy.

Invest better

There is a delicate balance that needs to be found between risk and reward when creating an investment strategy for pensions. However, individual employees may lack the knowledge and expertise to invest in a prudent manner, and it has been well documented that individuals make many mistakes in constructing investment portfolios as part of their DC plans. Companies can assist their employees by helping them to design an appropriate investment strategy in order to help them achieve the level of retirement income they would like.

Given the different potential returns on funds, one approach is to design an age-related investment strategy that focuses on reward in earlier years and protection in later years. This kind of life cycle strategy can be achieved with target funds, deferred annuities and other guarantee mechanisms. In addition, employers and trustees can help employees to improve their DC plans by reducing the amount of choice or by offering high quality default funds – a wide selection of funds is confusing and most people do not have the knowledge or expertise to make an informed decision.

Communicate and educate

If individuals are to take more responsibility for their pensions, it is very important that they receive clear and appropriate information on their retirement savings. The freedom of choice inherent in DC plans needs to be used wisely, and it is essential that people understand both their aims and objectives in saving, and the risks that they are willing to take. Companies need to help their employees to navigate the complexities of financial planning.

Both governments and companies have an important role to play in order to ensure that we do not create a DC Legacy problem for the future. On the government side, this may even involve introducing financial and pension education into schools. On the company side, it should include the company taking an active and ongoing role in educating employees and providing them with professional advice and recommendations on how to manage their pensions.

The way forward

In times of financial crisis, DB plans have to try to accomplish the impossible – meeting increasing liabilities with decreasing assets. For many companies, the risk represented by these plans has become too much of a burden, and, although employees may believe that DB plans offer them retirement security, the present crisis has revealed that this is not necessarily the case.

In some countries, DB plans that share the risk among stakeholders or that are guaranteed by an insurance company may provide a credible solution. In other countries, particularly in the UK and US, many companies have chosen to move to DC plans as the best alternative. However, the present crisis has also highlighted the inadequacy of many DC plans. We must ensure that we take the opportunity now to address the weaknesses of many of today's DC plans in order to create a sustainable and fair pension system for the future.