Philip S. Shier, FSAI

Actuaries and Defined Contribution Pension Plans

Aon Hewitt

The old mantra

DB good

DC bad

The problems of Defined Plans around the world are well known

Can actuaries help to make Defined Contribution plans a good alternative?

Positive features of DC Plans

Simplicity

A savings account (but may only be able to withdraw at retirement)

Flexibility

Can easily change contributions and investment choices

Transparency

Real time valuations of accumulated assets

Ownership

No subsidy of employer or other members

Three key issues

Levels of contribution

Investment choice

Payout phase

Levels of contribution

Usually below what is required to give a “reasonable” retirement income

Difficult to make people save when younger (when it is most effective)

Danger of projected benefit illustrations – inflation, longevity, risk

Design approaches:

- Age related contributions
- Employer matching of voluntary contributions

Tax relief a significant driver

Investment choice

Too much choice?

Education – risk

Default options

Charges

Employer stock

Payout phase

Cash

Annuities – low returns, inflation linking, loss of ownership of capital

Drawdown facilities – should there be minimum or maximum levels of income?

Tax advantages?

Groupe Consultatif Actuariel Européen

A Joint Working Party from Pensions and Investment and Financial Risk Committees produced a report

Avoiding Pitfalls In Retirement:
A Report on Defined Contribution Pensions

Key Message

Improving longevity, volatile investment markets and inflation uncertainty can present significant risks for individuals retiring from a DC scheme. These risks can be mitigated by careful scheme design and product choice. Policymakers can help raise awareness of the risks and help members achieve maximum benefits by removing infrastructure barriers to efficient design and product pricing.

EFRP study published March 2010

Strong shift towards DC

€1.3 trillion in assets (biggest UK, Denmark, Switzerland)

58 million members (biggest Poland, Sweden)

Most contribution rates below 10%

59% give some investment choice: most offer 2-5 funds but some more - Sweden's Premium Pension System has almost 800 choices!

Majority in default fund in most countries (Sweden 90%)

More than half offer life-cycle or lifestyle funds

60% offer a guaranteed return

Costs vary – up to 125bps

Information – about one-third provide projections, but very few illustrate the uncertainty around these

OECD Publications

Much excellent work in this area e.g

Assessing Default Investment Strategies in Defined Contribution Pension Plans

(Antolin, Payet and Yermo) September 2010

- Relative performance of strategies depends on form of payout phase
- No “one-size-fits-all” default
- Best to have exposure to risky assets for most of accumulation period, switching to bonds in last decade
- Dynamic strategies can improve replacement ratios (if variable drawdown in retirement)
- Length of contribution period affects ranking of strategies

Ageing and the payout phase of pensions, annuities and financial markets

(Antolin) 2008

Defined Contribution (DC) Arrangements in Anglo-Saxon Countries

(Ashcroft)

IAA (through Pensions and Employee Benefits Committee) have agreed to undertake a joint project with OECD

OECD/IOPS Global Forum 2010 in Sydney in November – to examine innovative governmental policies intended to enhance the security and adequacy of DC retirement plans

InDCent Exposure - making DC safer for members (Eoghan Burns, Damian Fadden, David Harney) 2009

- The DC pension system in Ireland caters for the needs of over 200,000 scheme members, and is likely to grow rapidly as employers review DB sponsorship in the coming years. However, investment conditions over the past few years have been very difficult for DC members, particularly some of those close to retirement. The authors present their thoughts on the responses DC providers need to consider, including changes to core investment funds, improved risk mitigation tools, radically improved member communication and more pro-active trustee behaviour.

How risky does the public think their investments are? (John Caslin & Damian Fadden) 2009

- A report on the results of the first-ever nationwide survey of consumers' attitudes to risk, return and advice in relation to investing.

Default Investment Strategies and Life-styling (Brendan Johnston, David Kavanagh, Dervla Tomlin, Brian Woods) 2008

- This presentation aims to provide views and ideas that actuaries might find useful when designing, assessing or comparing default investment strategies with special consideration of the 'managed fund with life-styling' which is the most common default investment strategy in the Irish market

Risk Management

The defining feature of DC plans is that risk is transferred from the employer to the member

[Some residual risk on employer if retirement benefits fall short of expectations]

Actuaries can help individuals to understand/monitor/manage the risks in DC pension provision

- Contribution levels – illustrate the risk of poverty in old age
- Investment choice – identify most risk/least risk strategies and explain the interaction between risk and (expected) reward
- Payout phase – illustrate the impact of increasing longevity, inflationary pressures, appropriate investment strategies in drawdown phase

EU Green Paper published 7 July 2010

EU acknowledges that regulation to date has focussed almost entirely on DB

Significant increase in DC provision in EU (partly due to new member states)

Green Paper raises issues on DC provision:

- Better investment practice and scheme design can mitigate risk
- Improve quality of information provided
- Enable consumers to make informed choice
- Financial Education
- Independent Advice
- Mandatory/Auto-enrolment
- Default Options
- Regulation of payout phase

Questions posed in Green Paper

Does EU legislation need reviewing to ensure consistent regulation and supervision of pension schemes and products?

How could EU regulation/code of practice help achieve a better balance for pension savers and pension providers between risks, security and affordability?

Is there a case for modernising the information disclosure requirements?

Should the EU develop a common approach for default options about participation and investment choice?

Aon Hewitt