

Research: DB & DC Pensions

The Achilles heel of DC plans

In the third in a series of articles, Amin Rajan argues that DC plans risk sparking a gigantic mis-selling scandal

Of the total \$4.5trn of DC assets in the US, some \$2trn have been wiped out in the last 12 months, according to a recent report from the Congressional Budget Office. No comparable data are available for Europe. But anecdotal evidence suggests that losses in Europe are no better.

No wonder there are mounting doubts about the viability of DC plans as they increasingly replace DB plans in all the pension markets around the world. Currently, total pension assets in Europe are estimated at €3.5trn. Around 75% are in DB plans and the rest in DC plans, according to our latest study*. The headlong growth in DC plans has been due to a combination of restructuring as well as organic factors (see diagram).

The trend towards the closure of DB schemes is well established in the hitherto strong DB markets such as Ireland, Switzerland and the UK. There, DB plans are being closed to new employees and DC plans are superseding them in response to the emerging funding crisis and new accounting rules. Additionally, in the Netherlands, pure DB schemes have been renegotiated to acquire a more hybrid form under which DB plans also have a DC element beyond a certain level of income. In Denmark, for example, DB plans have been turned into DC plans which are administered collectively, with some schemes investing only in deferred annuities. And in Germany, the traditional book reserve schemes are now being converted into DC plans with various guarantees on contributions and returns.

Alongside this restructuring, there is also organic growth resulting from the creation of new schemes (Italy), the extension of the existing state schemes (Sweden and Poland), and the rebranding of traditional funds (France). Governments everywhere have been promoting new DC plans so as to ease the mounting burden on welfare budgets from ageing populations. Another contributory factor is the mistaken belief that the grass is greener on the other side.

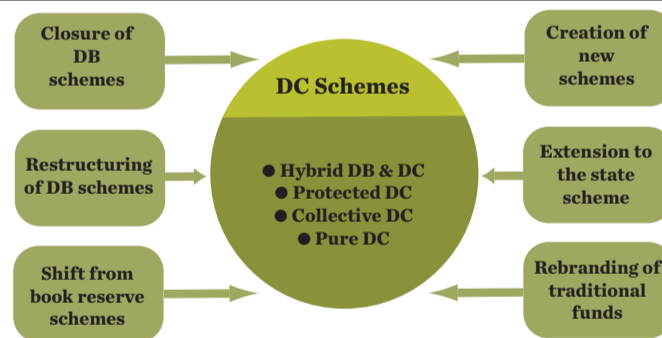
An inconvenient truth

This remorseless shift towards DC plans will accelerate as the current bear market drives down funding levels below the statutory minimum in DB plans across Europe. Those 80% of plans under the regulatory watermark have attracted huge media headlines. In comparison, fault lines that have been long developing in four areas of the DC landscape have hardly received a mention.

The first one relates to investment choices. As the number of DC plans has multiplied, issues around optimum asset allocation and acceptable returns have come to the fore, in those plans that are classed as 'private' or 'contract-based'. Typically, such plans entirely transfer the asset choices along with their risks to the individual. The same observation applies to the so-called 'trust-based' DC plans, notwithstanding the oversight and advice they offer via dedicated boards of trustees. Their investment choices have fared no better despite pooling all the risks.

The second area relates to plan administration with respect to private plans. Typically, they do not have auto-enrolment: members have to opt-in as a matter of personal choice. This has produced unacceptably low enrolment rates: usually less than 50% across Europe. They

Growth in DC schemes due to restructuring and organic effects



are also conditional: employers only put money on the table when employees match the contribution; often making the contributions smaller than warranted. The investment choices on offer are overly conservative for young employees: they involve insurance contracts, indexed funds and bonds, or cash-plus products; resulting in a slow build-up in the size of individual retirement pots.

The third area relates to fiduciary responsibility. Until 2006 there was a dearth of products across Europe that are now sold under the generic headings of life-cycle products, life-style products or target-date retirement funds. But their success requires an infrastructure of advice which is notable by its absence. Plan sponsors – especially those who have closed their DB plans – are unwilling to accept any fallout resulting from wrong choices: a question of once bitten twice shy. Instead, they expect asset managers to take on a fiduciary role on a

scale which few are able or willing to discharge currently.

The final area relates to investment returns. In private plans, poor asset allocation decisions had delivered mediocre returns prior to the current financial tsunami. Similarly, in trust-based plans, the over-emphasis on deferred annuities had delivered mediocre returns, not to mention the counterparty risk which has emerged like a bolt from the blue, as the latest mark-to-market rules have wreaked havoc on the balance sheets of investment banks and insurance companies in the current climate.

In hindsight, two things are clear. First, most DC plans – private or pooled – do not have the inbuilt shock absorbers to withstand major market downturns, which tend to punish all asset classes indiscriminately. Even supposedly safer insurance-based deferred annuities have been exposed to counterparty risks that were unimaginable until the collapse of Lehman Brothers and AIG.

Second, DC plans can only work in the long term with two requisites in place: capital protection and growth upside. But these are mutually inconsistent. Few fund products currently cater for both. Capital protection requires conservative investment choices that produce low returns. They also require the use of expensive derivatives which often drive down the post-fee returns.

Capital growth, on the other hand, requires aggressive investment choices with high embedded risks. At the time when the correlation between asset classes has gone through the roof, the trade off between protection and growth is as acute as it has ever been. Striking a balance has proved a high-wire act.

Key imperatives

Asset managers will have to direct the central thrust of their next wave of innovation towards providing products with inbuilt shock absorbers and a better balance. Without innovation, DC plans will follow DB plans into oblivion.

For sure, many asset managers are now doing two much needed things. First, they are developing a new generation of target date retirement funds – or variants of them – that take into account the unique personal, professional and financial circumstances of individual members. Second, they are providing the necessary quality, simplicity and flexibility to incorporate members' changing profiles as they progress through their working lives.

These improvements have been widely welcomed. But they fall short of providing a cushion against violent market events – like the two in this decade – which have taken a heavy toll on years' of accumulated gains. Nor do they enjoin asset managers to accept a fiduciary 'duty of care' towards their clients.

Under the latest legislation in the US, as a quid pro quo, asset managers have been accorded 'safe harbour' status by law in order to avoid litigation in the event of unsatisfactory outcomes. In Europe, there are no plans as yet to offer such a blanket cover. No wonder there is still a lot of resistance amongst employers to offer DC plans for reputational reasons, especially in France, Germany, Italy and Greece.

Of course, asset managers cannot act on all the reported shortcomings of DC pensions. But they must do one thing do to ensure the long-term viability of DC plans: namely, design products that improve the trade off between capital protection and growth whilst shielding the gains from periodic market melt downs.

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