Why ‘decumulation’ is a challenge in CAPs

Decumulation is challenging and risky for both CAP sponsors and members

Capital Accumulation Plans (CAPs) are now the preferred choice of most employers. Decumulation is an important phase of saving for retirement: it is the process of the drawing down (de-accumulating) CAP pension assets to generate pension income. A CAP account has the same objective as a DB account: to accumulate sufficient assets to pay for the pension[1]: a CAP account is simply a personalized DB account. Unlike a DB plan however, a CAP member is responsible for managing the CAP account and bears all the risks e.g. longevity, funding, investing and inflation risk. A CAP pension therefore depends on the members ability to achieve the appropriate level of ‘funding’ via contributions and growth of the investments.

Most of the emphasis in CAPs is on the accumulation stage i.e., before retirement when contributions and investments create funding for employees’ retirement. The decumulation phase is complex and challenging but generally gets less attention from sponsors. Since many DB sponsors also offer a CAP as well as a DB plan, they are obligated to provide members with appropriate CAP information and tools.

Decumulation – the challenge

Managing any type of pension program is a challenge even for professionals, sponsors, or pension committees. Therefore, the task facing the average CAP member is particularly difficult since there is no risk sharing and, CAPs do not have the flexibility of DB plans. Retirees who are still in a sponsor’s CAP also tend to be are ‘out of sight – out of mind’ and may be older. As a person ages their interest and ability to manage a pension account may also diminish. Communications and education are challenging and expensive. The assumption that an average CAP member will be capable of managing a pension account is a bit of a stretch.

When employees retire or leave an organization, their CAP account is often transferred to a recordkeeper (a financial institution): the member is no longer part of the employer CAP program. In most cases the members are not informed, at the outset, they will not remain in the employer’s CAP program. A record keeper’s program usually has higher fees arbitrarily set by the recordkeeper, over which the member has no control. The attention and communication the member is used to, as an employee, will also decline. Record keepers have significant financial and legal resources. Members in these plans however are anonymous. It is therefore more difficult and costly to seek legal recourse from a financial institution than from an employer who has a closer relationship with the employee if there are problems.

Information and Tools

CAP members need information similar to that used in a DB plan in managing their retirement account. The CAPSA Guidelines recommend that CAP sponsor provide certain information, tools, and investment choices to help develop expertise and assist in both the accumulation and decumulation phases.

The following information is part of overseeing a CAP account.

- Federal and provincial pension legislation and regulations.

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[1] A DB plan provides each member with a specific pension per the terms of the plan. It consists of individual member accounts managed by as sponsor (the employer). The sponsor makes the contributions and oversees the investments and overall funding. The sponsor must ensure there is enough money for pension payments.

- Federal and provincial tax rules with respect to CAPS i.e., Locked in Retirement plans (LIRAs, RRSPs, PRPPs, RRIFs and TFSA) and CPP, OAS and GIs or other government sponsored programs.
- The terms and conditions of the sponsor's pension programs.
- A basic understanding of how to fund a pension.
- Retirement planning and forecasting tools to set and monitor savings goals.
- Information about the mature of investments and the specific options available in the CAP.
- Investment option performance and benchmark information and history.
- General life expectancy information for both the member and a spouse
- A financial plan with a comprehensive tax component

An employee should be aware of the terms of an employer's pension program(s) i.e., both the employer and employee responsibilities. This is often overlooked. For example, does the employee remain a plan member when retiring or leaving the organization, what are the fees and the impact before and after retirement, what happens to the account when you retire, how is a spouse treated with respect to continuing education information, etc. An awareness of government retirement programs such as CPP, OAS, GIS etc.is also useful for estate and tax planning.

Hiring an advisor to assist in understanding and developing a retirement plan should be promoted. Members are often reluctant to do this because of the cost i.e., "penny wise pound foolish". Sponsors could encourage a member to select and pay for an advisor by offering full or partial reimbursement for the annual advisor fees.

'Funding' a CAP - A key issue

In many cases a CAP account represents an employee's only retirement saving - it is effectively their personal DB Plan. Accumulating sufficient retirement assets or 'funding' retirement can be intimidating since it unique to each individual.

Funding is not emphasized nor closely monitored in a CAP despite the fact it is critical. Members are reminded that saving for retirement requires a long-term perspective - "you are in it for the long term". Members therefore need to know where they stand at each stage, so they act appropriately e.g., increase their contributions, modify their retirement expectation, or add riskier investments. The tools to monitor the level of assets needed for requirement (the funded position) and the current funded status may not be provided or are not understood.

Unlike a DB plan sponsor, a CAP member cannot make additional tax-deductible contributions to offset loses or an insufficient level of assets. This is a huge disadvantage for CAP members.

CAP Investment choices

DB plans can invest in a wide variety of diversified public and private investments which complement the specific objectives of the plan. DB plans can invest in pooled funds or make direct investments in companies, partnerships, real estate, infrastructure, hedge funds, etc. This flexibility provides diversification opportunities which can increase returns and reduce risk exposure. Investment and longevity risks are also spread over long periods unlike the case of a CAP member.

A CAP sponsor provides a limited number of investments choices. They address the overall membership demographics and assume common savings objectives vs. any one individual. Selecting investments is therefore a challenge since the investments have to address a variety of issues in both the accumulation and decumulation stages. Generally, only 8-15 pooled options that are provided from the total investment options available from a recordkeeper. These options are pooled funds are often not the

‘best in class’ in terms of returns or risk. Having too many investments may cause problems because it may confuse the plan members and, it makes communication and education more difficult and costly.

DB plans invest in 10, 20, and 30-year bonds to match the future funding requirement (the plan’s ‘liability’). This is referred to as duration matching: it is a major feature of DB plans. CAP members are generally not aware of the role and importance duration matching. In addition, the fixed income investment options available to CAP members should but seldom include long term bond funds (bonds with 10-, 20- or 30-year maturities).

The majority of investment options in a CAP are often equities which have a key role over the long term, in growing the assets in a CAP account. CAP members are also often advised to take a ‘long term’ perspective when investing in equities. Members are ‘in for the long-term” therefore long-term returns, volatility (risk) indicators for equities and benchmarks should be provided. Long-term performance information is seldom provided. While 1-10-year returns, and volatility measures are often available but critical longer-term return and risk information is not provided. This promotes a short-term approach to investing. It is a major shortcoming for CAP sponsors given the long-term objective of retirement saving programs.

Passive or index funds can also be used investments options in CAPs. Passive funds attempt replicates the risk and return performance of an index by closely tracking the index with respect to returns and volatility. Balanced Funds maintain an asset mix that does not change significantly over time have a history of outperforming most actively managed funds. They also have lower fees. Passive investments generally Passive investments benefit both the sponsor and CAP members in terms of simplicity and performance. However, they are often excluded by the sponsor or are not available through the record keeper.

Balanced Funds are often used in a CAP as an investment and are often the default fund. A balanced fund invests in a mix of equities and bonds which are selected by the fund manager. The allocation to equites and bonds remains consistent over time. The objective of the fund is to provide reasonable and consistent returns. Balance Funds are fairly easy to understand and are intended to the simplify the investors involvement in making investment decisions. Passive balanced funds simplify investment decisions and should be effective over time particularly in the accumulation phase.

Target Date Funds (TDFs) or Target Risk Funds (TRFs) are now commonly included in CAPs, often as the default fund. Their objective is also to minimize investor involvement in making investment decisions in both the accumulation and decumulation phases. Target-date funds change the asset mix risk based on age and time intervals (usually 5 years). The fund manager adds fixed income (bonds) investments and reduces equity exposure. Each target-risk fund maintains a specific asset mix and risk level.

Target-risk funds focus on the level of risk taken in a portfolio. TRFs consist of a suite of funds with conservative" to “aggressive" risk exposures. The main differences between TRFs and TDFs is the investor is responsible for choosing a specific risk profile and associated fund remains in place until it is changed by the investor. Both TDFs and TRFs funds assume a specific asset mix is fits everyone. Neither TDFs nor TRFs guarantee a specific level of income.

Many of these funds are also relatively new and do not have longer term performance histories. Their effectiveness over the long term and in extreme market conditions, is untested.

Life Expectancy

Life expectancy has been increasing for both males and females therefore the amount of savings for a surviving spouse has to be considered. Information based on age, sex, work industry, whether not you are smoker etc., is readily available and should be made available to CAP members.

Financial Plan

Having a comprehensive financial plan while working, or in retirement, provides 'goalposts'- a way to measure savings progress. A financial plan should reflect the best estimate of all future cash requirements and must also have a comprehensive tax component. A financial plan is also useful when deciding when to take CPP. Without a financial plan you are 'running blind'.

Summary

The decumulation phase is neither simple nor straight forward: each person is a unique retirement situation. CAP members should work with an advisor and also have a financial plan. The concept of a CAP account being a personalized DB plan is important in understanding both the accumulation and decumulation phases and the issues.

Financial institutions attempt to offer solutions for the decumulation phase such as annuities, balanced funds, or target date or target risk funds. The 'solutions' assume a common interest amongst all plan members. In a low interest rate environment, annuities are expensive i.e., the amount of pension income you receive for the amount paid for the annuity is less. Target date and target risk funds assume people have common financial profiles and objectives which is often not the case. CAP members often incorrectly assume that TDFs or TRFs will guarantee a certain level of pension income.

Conclusion

While CAPs may appear to be simple and less expensive to administer, they are financially risky from both a sponsor and employee perspective. To assist Cap members in managing their retirement accounts the sponsor should encourage them to use an advisor of their choose, and to develop a financial plan. Communications should include retirees, terminated employees in the plan and spouses as well as working members.

Member communications and education in both the accumulation and decumulation phases should emphasize the funding process, life expectancy, and provide diversified investment options including long duration bond funds. Long-term investment and benchmark return and volatility performance information is essential and should also be available to CAP members.

The impact of fees should be clearly explained particularly in the case of DB to DC conversions or if CAP members are transferred to a record keeper when leaving an organization. Sponsor should try to negotiate lower fees for members transferred to a record keepers plan.

Sponsors must always act in the members' best interest and provide plan members with appropriate information, education, and tools. A sponsor cannot transfer its fiduciary responsibilities to another party or waive liability. It is therefore advantageous for retirees and former employees to remain in an employer's CAP as long as possible.

A CAP shifts all pension responsibilities and risks to the members: however, the sponsor has a significant on-going fiduciary role and responsibilities. In the case where a sponsor undertook or encouraged a DB to DC conversion, the risk of litigation risk is higher. CAPs are risky from a legal perspective since there is limited specific CAP legislation and juris prudence in Canada.

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