Pension De-risking Strategies: Capital Accumulation and DC Pension Plans

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This is the third in a series of three articles that discusses pension plan de-risking. The first article discussed general risks of defined benefit (DB), defined contribution (DC) and capital accumulation plans (CAP). The second article did a deeper dive into DB risks and mitigation strategies. This article will delve into specific CAP and DC plan risks faced by plan sponsors, employees and other plan beneficiaries; and review possible de-risking options.

CAP and DC Pension Plans – where do the risks lie?

Readers are reminded that CAP and DC plans typically require employees to contribute a fixed amount or percentage of their earnings into a retirement savings account. Often, the employer makes a matching contribution. The difference between CAP and DC plans is that the latter are typically tax-advantaged retirement vehicles (such as registered retirement plans or RRSPs) whereas CAPs can include both tax-advantaged and regular 'unregistered' savings. Therefore, DC plans are a subset of CAP. With CAP retirement plans, whether registered or unregistered, capital is accumulated over the plan members' working careers via employee and employer contributions, plus the investment returns earned by the assets. CAP plans have emerged as the most common type of savings vehicle offered to newly hired employees. It is important for employees to acquire a good understanding on how their plan functions early in their careers, so they can proactively manage their risks to achieve favourable investment outcomes.

With CAP plans, the employee is responsible for selecting the investments for their accumulated funds and the returns achieved. Therefore, the cumulative investment returns earned on the selected CAP funds will reflect investment choices made by the plan member and, of course, the general investment returns earned by the financial markets during the holding period. Therefore, this 'investment risk' is borne by the member.

A useful way to understand the inherent risks of CAP plans from the viewpoint of the employee (member) is to look at two key periods: (1) the asset accumulation period; which is typically during the employees working career until retirement, and (2) the asset decumulation period, when assets are drawn down during retirement to replace employment income. Therefore specific plan member risks are associated with both the asset accumulation and decumulation time periods.

The employers (plan sponsors) on the other hand face a different set of risks. They are exposed to risks associated with their fiduciary responsibilities as the Plan's Trustee or Plan Administrator under the CAP pension administration process. Human Resources usually plays a key role in managing the CAP plan as the sponsor's communicator to employees, and integrating pension plans as a key component of their company's overall compensation package. A competitive pension plan can definitely assist in a company's recruitment and retention efforts as they search across a variety of demographics for skilled employees.

CAP risks faced by employers and plan sponsors

Risk #1 – Fiduciary risks that could result in lawsuits against the plan sponsor

CAP plans inherently transfer investment and longevity risk onto employees. Consequently, these plans require a higher level of investing and personal financial management knowledge by employees than would be expected of their counterparts in a DB situation where pensions can be calculated with certainty based on years of service and final average salaries. Although it is incumbent upon CAP plan members to educate themselves, there is also a significant fiduciary risk to the plan sponsor to ensure that employees have been given all the opportunities and tools to wisely and cost-effectively manage their own investments. Therefore, any perceived shortfall in CAP plan administration or governance may become a reason for unhappy stakeholders to file a grievance or lawsuit against the employer/plan sponsor for breach of fiduciary duty. CAP plans are still relatively new pension schemes and there is less legislation and jurisprudence to guide CAP plan sponsors, although the Canadian Association of Pension Supervisory Authorities has published CAPSA guidelines #3 and #8 which are highly recommended as a minimum standard of pension administration. The law will no doubt continue to evolve in this area as more cases are brought before the courts, so plan sponsors would be well advised to ensure that proper attention is paid to their fiduciary responsibilities for clear communications, competent administration, good governance and educational opportunities for plan members.

Risk #2 – Difficulty recruiting employees if the pension plan is perceived as uncompetitive

Prospective employees may perceive the CAP pension schemes offered by certain employers as less generous as those of other employers or of the more traditional DB pension plans. This may result in the employer being unable to recruit the calibre of employee it needs for its business. Employers definitely have an interest in being competitive in the labour markets with their employee benefits packages, including a competitive pension plan; and communicating the advantages of CAP plans versus the traditional DB plans. For instance, employers can point out that CAP plans may have matching contributions from the employer, create pension assets that are entirely under the control of the employee, and plan mobility if the employee changes companies, moves to another province or stops working altogether.

Risk #3 – Employees delay retirement because of uncertainty over post-retirement income

Employees who rely on CAP pension schemes can be expected to have difficulty deciding precisely when they have accumulated sufficient assets to be financially comfortable in retirement. This can cause employees to remain on the job longer due to them not knowing the amount of funds required to save for their retirement. This is the $64 thousand dollar question as the amount of funds required to retire is unique to each employee. This amount also depends on whether additional income or assets are available to the employee and what the cost will be to maintain their desired standard of living. In addition, the post-retirement earnings power of these assets depends on financial market conditions at the time of retirement and the general valuation levels of the equity markets. The result may be that employees delay retirement to accumulate more pension assets, but this may not be in the plan sponsor's best interests, particularly if there are performance concerns with the employee. The employer may even feel compelled to terminate an underperforming employee who has delayed his/her retirement, potentially triggering legal action or severance costs.

Strategies available to plan sponsors to de-risk CAP pension plans

Strategy #1 – Ensure an effective governance framework is in place

In view of the plan sponsor's fiduciary responsibilities for the pension plan, it is critical that this aspect be well managed to minimize the risk of being legally pursued for breach of fiduciary duty. Therefore the plan sponsor should create an appropriate and functioning governance framework, which ensures, for example, that all players in the CAP pension plan process are competently discharging their responsibilities, there are quality investment performance reports and general communications to plan members, and the pension plan is being administered in full compliance with applicable legislation. A good governance process will greatly reduce the plan sponsor's exposure to legal claims for breach of fiduciary duties.

Strategy #2 – Provide quality communication and education regarding investing and personal financial management

The plan sponsor is responsible for designing and overseeing the structure of the CAP pension plan, including the available investment options and the administrative rules surrounding the investment process. It is important that the plan sponsor provide accurate and high quality information to members about plan features so that they are well understood and can be acted upon to produce favorable outcomes for plan members. To enable plan members to take the fullest advantage of their employer's CAP pension scheme, it is important that the plan sponsor make opportunities available to plan members to acquire knowledge of investing and personal financial management so they can make well-informed choices and implement effective investment strategies.

Strategy #3 – Provide appropriate and diversified investment choices for plan members

As discussed above, the plan sponsor designs the structure of the CAP scheme, including the choice of available investments. It is important that the plan sponsors offer investment choices that will meet the objectives of different investment strategies. As a minimum, there should be appropriately diversified offerings within the main asset classes. This will ensure that most investment strategies that could plausibly be developed can also be executed within the structure of the plan sponsor's CAP plan.

Strategy #4 – Have a balanced-risk default investment option

Despite the best efforts of employers to provide investing education opportunities to their plan members, there will likely always be a subset of the employee population that is unwilling or unable to make their own investment decisions. In order to protect these members from the worst consequences of neglecting their CAP assets and to provide additional protection to the plan sponsor from breach of fiduciary duty, plan sponsors should consider having an appropriate default investment option such as a balanced fund or a target retirement date portfolio. Such options represent medium risk portfolios that offer potentially attractive returns, but with good defensive characteristics that protect portfolio values.

Strategy #5 – Ensure investment management fees paid by plan members are reasonable

The returns on invested assets consist of gross returns (i.e. capital gains, interest & dividend income) minus investment management fees. Plan sponsors have an implied fiduciary responsibility to ensure that the management fees associated with their investment choices are not excessive. Therefore, the plan sponsor should monitor investment managers' performance in terms of 'value for money spent on management fees'. For example, if an investment product has higher than average management fees, there should also be an expectation of higher than average investment returns and/or a portfolio risk reduction benefit. Plan sponsors should also consider allowing retired members to defer and manage their CAP assets within the same plan as employees. If yes, offering cost-effective management fee products to pensioners will help maximize their post-retirement investment returns, which reflects well on the employer as plan sponsor.

Strategy #6 – Encourage /assist plan members to contact independent financial advisors

In addition to offering educational opportunities and materials to its members, plan sponsors should also consider encouraging plan members to obtain independent professional investment advice. Incentives to do so could be offered such as partial or full subsidies towards the cost of such independent advice. In many plans, this can be negotiated as a free service to members. This will further enhance the plan members' confidence in their pension planning by enabling them to validate their plans with unbiased external advisors.

CAP risks faced by Employees

Risk #1 – Insufficient capital set aside for retirement

The objective of CAP plans is to accumulate sufficient capital as a key component in meeting a plan member's financial needs in retirement. Therefore, one of the drawbacks of a CAP is that after spending thirty to forty years working and contributing to a CAP pension plan there may not be enough accumulated capital to maintain one's desired lifestyle in retirement. Inadequate accumulated capital can happen due to many reasons, including not contributing the maximum funds permitted under the plan, not taking advantage of available employer contributions, poor investment choices and/or weak financial market returns during the plan member's asset accumulation phase. Managing one's own expectations of retirement and the standard of living during this phase of life is important.

With CAP plans, employees are responsible for selecting investments from a menu of investment choices offered by the plan sponsor. However, selecting an investment strategy that strikes the best balance between investment return potential and portfolio risk is not intuitively obvious to everyone.

Risk #2 – Uncertainty whether sufficient capital been accumulated

Once employees are well into their careers and begin to look forward to their retirement years, they will ask themselves "How much capital do I need to retire?" This is a simple question but the answer can be complex. In fact, much of the advice that is offered by investment industry experts can be confusing and contradictory. The lack of a clear answer to this question can influence workers to stay in the labour force longer to build up more retirement savings for fear of having insufficient capital and retirement income. The answer to the question of "how much is enough?" depends not only on the target capital amount, but also on the economic outlook at possible retirement dates for factors such as inflation rates, interest rates and the overall health of the economy. The optimism or pessimism of the outlook can change quickly based on economic, geopolitical and natural events and can therefore trigger 'eleventh hour' changes to planned retirement dates.

Risk #3 – Managing and drawing down on assets post-retirement

The previous three risks fall into the category of 'accumulation risks', as they are linked to the capital accumulation period during an employee's working years. However, when the important decision to actually retire is made, the pensioner is faced with the question of how best to manage the decumulation period, which is when accumulated capital will likely need to be drawn down by the pensioner in replacement of his employment income. These are referred to as 'decumulation risks' and are primarily the risks associated with an unsustainably high rate of withdrawal of the pension assets, and the risk of an inappropriate investment strategy for those assets not yet withdrawn. The risk mitigation objective would normally be to ensure that sufficient assets are available for the lifetimes of the plan member and his/her surviving spouse.

Strategies plan members can use to de-risk CAP pension plans

Strategy #1 – Get educated about investing and personal financial management

Young employees who are currently entering the workplace and joining CAP plans will begin setting aside assets towards their retirement very early in their careers. It is important that they make wise choices early on so they can fully benefit from a powerful financial lever that works in their favour, time! Plan members should maximize their use of time by educating themselves at the earliest opportunity about investing; including issues such as the risk/return profiles of different asset classes, tax issues and appropriate investment strategies at different stages of their lives. There is a wealth of information available from a range of sources including plan sponsors, educational institutions, external advisors, investing websites, magazines, libraries, etc.

Strategy #2 – Make a plan to define your savings target, investment plan and expected returns

Once assets have begun to be accumulated, plan members must decide how best to allocate their capital between different asset classes. This is when time spent acquiring investment and personal financial planning knowledge will pay off. It is entirely realistic for a non-financial person to acquire sufficient knowledge to make well-informed investment decisions. If plan members lack confidence in their abilities to make sound investment decisions, it is appropriate to seek expert advice from impartial advisors, even if fees need to be paid because the benefit of wise investing will greatly outweigh the cost of obtaining good investment advice.

Strategy #3 – Ensure adequate 'asset' diversification

Everyone has heard the old adage 'do not put all of your eggs in one basket!' Well, the investing equivalent of this traditional wisdom is to ensure adequate diversification of the investment portfolio. Diversification spreads risk across many different assets and asset classes. This will achieve a much safer and less volatile investment portfolio, one that is better able to withstand shocks to specific industries or companies.

Strategy #4 – Seek alternative sources of post-retirement income

Unlike traditional defined benefit plans which provide recurring pension payments of known amounts, earnings from CAP plans cannot be predicted in advance. Consequently, there may be considerable uncertainty whether income from a CAP plan will be adequate. If plan members are worried about this, they would be wise to develop during their working years alternative sources of post-retirement revenue to supplement income provided by CAP plans. This could consist of income from investments made outside of employer pension plans and other sources of revenue such as professional income, rental or small business income, part-time employment such as a Marshall at the local golf course!

Conclusion – Yes, you can effectively de-risk your CAP, now is the time to start!

The previous discussion illustrates several ways that both employees and employers can manage the risks associated with CAP pension schemes. The decline of traditional defined benefit pension schemes in favour of CAP plans has shifted much of the investment and longevity risk from employers to employees, plan members and beneficiaries. In order to secure the best outcomes from CAP plans, employees should educate themselves about investing and personal financial management, and to make full use of the available time to set aside assets, invest them wisely and earn compounding investment returns to maximize accumulated asset values.

Employers can manage their plan sponsor risks by reviewing their fiduciary obligations; starting with an effective pension plan governance process, supported by a well-designed CAP platform that provides quality investment offerings; effectively communicating with employees and other plan members such as pensioners and surviving spouses; incorporate employee investing and personal financial planning educational sessions and negotiate acceptable or low management fees.

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