Article from:

International News

September 2014 – Issue 63

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Growing Up

By Janice Holman

CANADA'S DC PENSION MARKET IS MATURING, AND MORE MEMBERS ARE NEARING RETIREMENT. IT'S TIME TO GET SERIOUS ABOUT THE PAYOUT PHASE.

Since the early 1990s, when pension plan sponsors began in earnest to convert their DB plans to DC, Canada has seen a sustained shift in the pension landscape. Between 1991 and 2006, according to Statistics Canada, the number of members covered by employersponsored DB plans shrunk by 4%, while DC membership grew by 93%. A similar change took place over the same time period in the U.K. Plan sponsors on both sides of the pond have responded to this trend by taking steps to improve the saving phase for DC members, but few have given much thought to the payout phase that follows.

Recent changes in both Canada and the U.K. should help to address this gap. But with workplace demographics shifting quickly and a wave of aging baby boomers moving into retirement, more needs to be done—and quickly—to prepare DC plan members to manage their income once they leave the workforce.

GROWTH SPURT

In recent years, the U.K.'s DC payout market has focused on ensuring that member incomes could be sustained throughout retirement. This was achieved by imposing significant tax consequences for withdrawing retirement savings above set limits and a requirement to guarantee a minimum level of income. The result was that a vast majority (approximately 90%) of retiring members used DC pension savings to purchase an annuity.

The U.K. government's 2014 budget, tabled in March, has radically changed this structure by removing surcharges on DC pension withdrawals, phasing in the removal of a guaranteed minimum pension and laying the groundwork for more flexible payout strategies. The key to the success of this approach lies in the government's promise to offer every employee free and unbiased financial advice at the time of retirement. Chancellor George Osborne said the moves were being made to bring the U.K.'s treatment of retiring DC plan members "into line with the modern world."

Canada—with its comparatively flexible approach to the DC payout phase—may represent the modern world that Osborne spoke of. But evidence suggests that Canadian DC plan members are not prepared for this flexibility.

In *Benefits Canada's* 2013 *CAP Member Survey*, about one-third of members admitted having a poor understanding or no understanding of how much they need to save for adequate income in retirement. In addition, 35% said they have poor or no understanding of longevity risk, and 37% indicated poor or no understanding of inflationary risk.

Also, there is currently little fiduciary oversight of the income conversion process. Members retiring from a DC plan in Canada typically receive an election package (also called a termination package) from the plan's recordkeeper. This package includes a list of payout product options—including the recordkeeper's product, which is generally at the top of the list—and significant marketing material but little in the way of information or tools to help members determine which products might work best for them. In many cases, the plan sponsor has very little involvement in the content provided in the election package or the products being offered.

This lack of guidance is evident in how DC pension assets are allocated at retirement. Based on Eckler's research, 50% to 65% of member assets are trans-

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ferred to other financial institutions. Another 35% to 50% of member assets stay with the recordkeeper, as members often feel too overwhelmed and uninformed to take action with their money. Unlike in the U.K., in Canada, less than 10% of members' assets are used to purchase an annuity.

Canadian DC plan members clearly want advice. According to Benefits Canada's 2012 CAP Member Survey, about half of members said they sought advice on what products and assets to put their money into during their retirement, while 58% said they needed advice on how much they could withdraw annually in retirement. The challenge with the flexible payout approach offered in Canada and other countries is locating sources of unbiased advice. Too often, the only advice readily available to retiring members is from the same financial providers whose products are being offered.

A TALL ORDER

Supervisory Authorities) released *Guideline No. 8: Defined Contribution Pension Plans*. Many plan sponsors will welcome this guideline with relief, as it clarifies and enhances member responsibilities in the management of their DC plans and savings. It makes members accountable for their investment decisions on an ongoing basis and requires them to continually review whether or not their savings will meet their retirement needs and goals.

This relief comes with a price tag, though, as the guideline also calls for increasing the amount of information that plan sponsors must provide to members. Most significant, it requires that sponsors offer retirement income illustrations and clearer information on products available for the payout phase.

Since the first step in effective payout is ensuring that members understand how much retirement income their accumulated savings can provide, the requirement to provide income illustrations is key. Countless surveys in recent years have indicated that many members don't know how much they need to save in order to pay themselves an adequate replacement income over a typical retirement span. Ongoing income projections offer members a regular opportunity to see what their accumulated savings would translate into as retirement income. It also ensures that members have the opportunity to increase their saving levels or adjust their retirement expectations to align with their projected retirement income.

Just as important is the requirement in *Guideline No. 8* that plan sponsors offer members information on payout products that will "allow them to make informed decisions which strike a balance between protection from the risks inherent in the various products and achieving target replacement rates." This will include reviewing the risk characteristics and fee structures of payout products along with methods to receive the payout, the expected levels of payout and the duration of the payout each product will provide.

Both of these new expectations put the onus on plan sponsors to carefully evaluate who is best positioned to provide this information to members. Sponsors will have to invest time and effort in reviewing the information they currently provide to members and understanding any biases that may be present. Plan sponsors may also need to take a more active role in the creation and distribution of this information, with less reliance on the recordkeepers.

INCH BY INCH

While changes in the U.K. have come by way of radical legislation, Canada's have come in the form of voluntary guidelines. Both have the potential to greatly improve the DC experience for their respective citizens. But both countries have more work ahead of them to ensure that members have access to unbiased information and an appropriate range of products for the payout phase.

Innovation in product development should focus on making sure members can choose from creative solutions that offer longevity protection and certainty of income, yet also include an element of flexibility. These products need to be priced fairly. And, while they may be very technically sophisticated, they need to be packaged in a way that allows the average member to understand the features and benefits. This includes products now being developed that can be offered during the saving phase and transitioned into the payout phase, giving members the benefit of seamless solutions that are made cost-effective by the plan sponsor's involvement.

With a significant number of employees set to retire in the coming years—nearly one in four working Canadians, according to Statistics Canada—*Guideline No. 8* is a necessary step to move more Canadians along the path toward adequate retirement income. For the many sponsors that transitioned from DB to DC plans in an attempt to shed pension income obligations, the demand for more DC plan sponsor involvement inherent in *Guideline No. 8* may initially be seen as unwelcome. But the success of DC pension plans hinges on the ability to move members through both the saving and payout phases—and the plan sponsor has a central role to play as fiduciary and unbiased intermediary in both.

A DC pension system that does not address the payout phase opens the door to a potentially huge—and negative—impact on an employer's bottom line. Workers who are financially unprepared or unable to retire will drive up costs on many fronts, including higher salaries and health benefits costs; decreased productivity from unengaged employees who want to retire but can't afford to; and demotivated younger employees who see few opportunities to move into jobs that continue to be occupied by senior workers. As Alan Higham of Fidelity told The Guardian about the U.K. pension changes recently, "The stakes are higher than ever—there is more to gain, and more to lose." □