How plan sponsors can blend DB features into their DC pension plans

Jennifer Paterson | October 12, 2018

Imagine there was an option to assemble the ideal retirement savings plan: a pinch of automatic features, a teaspoon of benefits guarantee, a cup of pooled investments, stirring the best elements of a defined benefit pension into the structure of a defined contribution plan.

It may not be as simple as combining ingredients, but as the move from DB to DC continues, and more Canadians face the challenges of adequately preparing for retirement, how can plan sponsors incorporate DB features into their DC pensions?

Make it automatic

There's capacity for automatic features in at least two areas of DC plan design: enrolment and escalation, says retirement author Don Ezra, noting these are typically default options so plan members can choose to opt out. "You can always improve on them, but as default features, to get people in and started, those . . . are essential."

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From a union perspective, Corey Vermey, director of pensions and benefits at Unifor, says it would embrace default auto-enrolment and auto-escalation. "It's certainly my impression that the further DC plans migrate back along the path to defined benefit, the more likely it is that plan members will see secure and adequate retirement incomes."

In the DB heydays, plan enrolment was mandatory for employees, but the move to DC also marked a move to voluntary plans. Since that time, there's been a slow migration back to mandatory enrolment and contributions, says Janice Holman, a principal at Eckler Ltd. "DC has progressed, I would say, from voluntary to auto-enrolment. The next step is to try to get people to contribute. Some clients are actually going to mandatory for the contributions that would be matched."

Automatically escalating pension contributions is another option. Randy Bauslaugh, national chair of McCarthy Tétrault LLP's pension and benefits practice, estimates the average employee contributions to DC plans are in the neighbourhood of four or five per cent, which he says just isn't enough.

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"We know that, in order to provide a reasonable replacement rate of income in retirement, you need to be saving more like 20 per cent," he says. "And I think the more you can make a defined contribution plan operate like a defined benefit plan, the more cost-efficient it will be and the better benefits it will deliver."

As well, in any conversation about contributions, it's important to shift the focus to retirement income, says Rosalind Gilbert, an associate partner in Aon Hewitt's retirement and investment consulting practice in Vancouver. "Everybody has to understand that if you're only putting in 10 per cent, you're not producing income that's the same as if you're putting in 20 per cent; it's just not possible," she says, referring to the previous DB cost.

"I think part of this would be reorienting everybody's thought process on DC to say, 'What is the ultimate retirement income?' as opposed to 'How big is my pot of money getting?'" she adds.

More investment governance

While DC members decide how their money is invested, usually based on a range of available options, DB plan members don't have to worry about making investment decisions or tracking investments because it's being managed for them.

To close the gap from an investment perspective, one option is to move to collective or multi-employer plans, says Robert Brown, a professor emeritus of statistical and actuarial science at the University of Waterloo. He notes there are simply assets that an individual DC plan member can't invest in. "I can't go out and buy infrastructure. I can't go out and buy the 407. But I can if I've got $100 billion," he says.

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"You just get higher rates of return, lower expense ratios, more spreading of risk, more diversity of the asset portfolio. All of those can be achieved through collective DC, but they will never be achieved through individual accounts."

Vermey also believes the key piece is moving the investment function into a more appropriate format, which he sees as a collective investment pool. "Ideally for us, we would suggest if you could return to a collective investment pool, you will have undone some of the damage that's being inflicted on secure and adequate retirement prospects by relying on an individualized approach," he says. "And generally, I think the industry is aware that the majority . . . of plan beneficiaries haven't seized the opportunity to control, haven't utilized that autonomy to enhance, retirement outputs. So there still is a role, we would say, for a collective approach to that."

PENSION MEMBERSHIP UPS AND DOWNS

2012
DB plans
4,477,452
DC plans
1,003,310

2013
DB plans
4,422,838
DC plans
1,030,319

2014
DB plans
4,401,970
DC plans
1,036,747

2015
DB plans
4,380,386
DC plans
1,097,211

2016
DB plans
4,203,840
DC plans
1,128,297

Source: Statistics Canada, 2017

The first step for DC plans to operate more like DB plans is to offer members no investment choice whatsoever, says Bauslaugh. "It should be an administrator-directed investment program — no individual investment choice, managing the money like you would in a DB plan. You're pooling it, you're not giving anybody any choice. The more you can manage the money like you would in a defined benefit scheme, the better."

On the other hand, Joe Nunes, executive chairman at Actuarial Solutions Inc., suggests a middle ground, referring to one of his large plan sponsor clients that only offers one investment option. "There are definitely administrative and governance advantages to this approach, but plan members lost the opportunity to select an investment risk level that suits their personal circumstances," he says. "To me, the middle ground is a DC plan that only offers a range of lifecycle funds."

Decumulation options

The decumulation phase exposes perhaps the biggest differences when it comes to comparing DB and DC plans. "This is where the DB plan is much more effective in delivering a predictable lifetime income to plan members," says Nunes.

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This is complicated by legislative disparities, including in-plan annuities and variable benefits being permitted through DC plans only in certain Canadian jurisdictions. But despite these obstacles, Holman is seeing more DC plan sponsors starting to implement decumulation solutions for their members.

One of the options is annuities. "That's your DB tie completely — lifetime guaranteed income. It's extremely easy to understand . . . they don't have to worry about managing the assets, about market corrections, about their advisor, how much they're paying," says Holman, noting the challenge is in getting people to buy an annuity and especially to understand what they're buying.

"So part of that is also the support that's provided to the member at that time at retirement to have them understand what an annuity is, the advantages of an annuity. And they don't, so they stay with what's familiar, which is staying invested in the funds."

By their very nature, annuities are pure DB, says Bob Baldwin, an Ottawa-based pension consultant. "Until the early 1980s, most of the DC plans that existed in Canada, basically, were programs that bought deferred annuities for plan members. So, in fact, they had a DB element to them. They weren't typically indexed annuities, but by the time a plan member got to retirement age, they pretty much knew what they were going to get in the way of a retirement benefit, and in that sense, they were DB-like."

Another decumulation option is variable benefit payments, which is currently only allowed for DC plans in certain jurisdictions, including those that are federally regulated. Holman says members who exercise this option feel much safer, knowing there's investment oversight and they're in the same investments they've become comfortable with during the accumulation phase.

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"If they're in a target date that is a through target-date fund, then they can continue on that path to use the funds as they were designed," she says. "And obviously, there's a huge cost benefit to the plan members if they're able to do that instead of having to go into the retail world. So we really feel that both annuities and that variable payments right from the plan would benefit members significantly."

Decumulation is also where a collective DC plan is at its best, since it can carry collective mortality risks, says Brown. "If you can just get into a collective, whether it's DB or DC, you're going to be so much better off. I used to rail against the annuity marketplace, but if you figure out that they have to cover anti-selection from people who voluntarily want to buy an annuity, they have to have slightly more liquid assets than some of the other ways that you can manage the longevity risk.

"The annuity market is probably as good as the marketplace is going to get, but it's not as good as having your plan carry the longevity risk."

IT GOES BOTH WAYS

While most of Canada's large public sector plans at the provincial and municipal level are technically classified as DB, many have actually added DC features over the years, according to pension consultant Bob Baldwin. For instance, some plans have

Pre-retirement modeling, education

Other DB plan ingredients that DC plan sponsors can consider include offering members the use of retirement modelers, says Gilbert. "When you get to the bigger plans, I think more of them have customized modelling, and maybe in slightly more detail. I think a lot of the quick, online non-customized ones would have disclaimers left, right and centre to say, 'This doesn't include your spouse's income, this doesn't include tax, this doesn't include possible different dates to take your CPP' and that kind of thing. But I think support from an employer that lets people actually do a bit more customized retirement planning brings us closer to that focus on income."

Read: Why a little bit of retirement planning knowledge can be a dangerous thing

Considering the vast difference between DB and DC plans, employers should be adding in support for employees at the pre-retirement phase, says Holman, referring to workshops and one-on-one sessions, as well as unbiased annuity quotes.

"The more and more we can change the conversation, on the DC side, from a lump sum to the income conversation, that certainly helps," she says. "And it helps to do that even early in someone's career, so all along they're thinking of their retirement savings in terms of income, just like you would from a DB plan. Obviously, it's not guaranteed so there has to be some wording around that to make it clear what the benefit is and what they can expect."

made indexation conditional on the funded status of the plan, "which is basically a DC approach to indexation tacked on to a DB approach to defining the initial benefit."

The other area where DB plans are adopting DC elements is with respect to the age of retirement, particularly in government plans internationally. "We've now got a number of countries where the retirement age is contingent on a mix of demographic trends and financial changes," says Baldwin. "So again, it's an example of adding a DC component to a DB plan."

Comparing DB and DC plans from a governance perspective, it's more likely a DB plan takes a more formalized approach, says Gilbert, noting many employers got out of DB plans in part due to the cost and volatility, but also due to the time and energy it was taking them internally to manage the plan.

"I think it goes to that thing about employers not being in the business of running pension plans, they're in the business of running whatever their business is," she says. "So DC plans or group RRSPs not only provide cost control, but they were also looked at as being simpler, there's less regulation and so easier to manage, so maybe you don't need a formal board or governance structure.

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"But, from a governance perspective, there isn't a good reason for the governance of a DC plan to be non-existent or significantly less formal or robust," she adds. "The company still needs to manage risks, they're just different risks. There is always value in robust governance, it's just that the conversation has to shift to focus on risks that are applicable in DC plans rather than DB plans."

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