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4 Decades On – How Well Has the Corporate Defined Contribution Pension Regime Fared! (Part I of a Series)

An accidental discovery of a loophole in a piece of legislation of one of the world's most robust and highly regulated financial markets is today credited for the current corporate Defined Contribution (DC) models as we have them presently.

What was a routine pursuit of a tax efficient portfolio construction mechanism by an astute financial planner for one of his high net worth clients landed him on a page of a tax legislation act that was to inform and shape the design of DC arrangements globally for decades to come.

Four decades down the road, and with all that we know of today, it is fair to sit down and evaluate the extent to which this discovery has had an impact on workers with respect to their retirement savings. The timing of this assessment of value-add of the DC regime is optimal on two counts. Firstly, in retirement savings management, the emphasis is always on the long term. No one would argue that four decades is not long enough to justify an assessment of the regime now. Secondly, after forty years, we now have the first cohort of DC-only members coming out of employment into retirement. So we have a real measure of the results of what contributing into a DC scheme yields.

But to give meaning to assessment of value in a retirement savings context, we need to start by referencing to one of the many frameworks of value assessment. For our purposes, we will stick with the simplistic 4-Es Framework. As the name suggests, the framework assesses value across four elements of the 4-Es acronym. The first E, Effectiveness, measures the extent to which the objectives of a system or regime are achieved and also assesses the size of the measured difference between actual impact versus intended objectives. Equity, the second E, evaluates whether the benefits were distributed fairly as intended. The next E, Economy, focuses on the extent to which the regime has succeeded in minimising the cost or resources used while taking into account the quality of the end product or service. Last but not least, Efficiency, assesses the relationship between the outputs produced and the resources used to produce them.

With the stage set of how we are going to assess how well the DC regime has fared we need to remember that DCs, in most markets including ours, were in fact a replacement of Defined Benefits (DB) arrangements. While there is no assessment of DCs that can be pronounced complete without reference to DBs it is also fair to say the two models are quite different with different design structures. So we will attempt here to avoid being narrow in our approach thus refraining from coming up with the usual list of pros and cons of DCs vs DBs. Instead, we will focus on purely the motivations that were presented as arguments for the need to transition to DCs en masse.

DCs would be a much cheaper option for the delivery of retirement benefits, we were told. Consequently, that would also increase coverage of retirement benefit provision, it was argued. That they are a simple and easy to understand solution – "the savings pot" analogy – so would encourage both employers and employees to participate in one fund or another became a common argument for their speedy adoption.

Their simplicity would increase members' appreciation of their employers and would help raise morale amongst employees leading to improved productivity that employers would immediately and directly benefit from. It certainly would be a win-win situation – the advocates of the regime made the emphasis clear.

The motivation did not stop there. It was further impressed upon us that a DC regime would come with it the freedom and flexibility that employees had for long been yearning for on aspects related to their retirement savings arrangements. For the first time, it was emphasised, employees would be able to easily choose their preferred contribution rate, the allocation split between risk benefits and retirement savings, and very importantly, the investment portfolios that they would want to invest in – this, amongst a battery of many other options that employees would have and would exercise. Flexibility entailed that members could try and test a number of different options along their career and settle for one that would be most in sync with their retirement plans.

Full ownership, total control, and transparency were also some of the motivations submitted for this ground-breaking turn in the history of retirement savings management. Furthermore, in a world that was fast embracing the ideologies of individualism and capitalism, and steadfastly starting to frown at communism and socialism, the notion that DCs would largely eliminate any form of subsidisation across members became the icing on top of the cake.

The learned industry practitioners of the day even went further and made the claim that DCs would produce comparable, if not better, benefits than DB plans.

Of course, to the employers it was a much easier sell – transitioning to DCs would help do away with the open-ended nature of DB liabilities.

Looking back in time, stretching our minds to where we were then, where we wanted to be, and the road we have travelled ever since then, experience seems to be telling a different story. Of course, with hindsight everyone is an expert, but we need to evaluate what we knew then, what we ought to have known, and what we know now, if we are to fairly assess how well the corporate DC regime has done.

Observing the paths taken by most DC funds over the past forty years affirms that, even where workers contribute consistently and preserve, DC plans produce subpar results. By their nature, DC funds invest in conservative investment strategies in an effort to "play it safe" and appease members. The point missed with this approach is that too much risk aversion is actually way too risky for pension funds.

In fact, DC funds have continued to treat investment risk as a fate, while in reality it is simply a choice; the choices that trustees take are what ultimately determine what members retire with. For instance, there is too much focus on minimising liquidity risk by investing especially in listed instruments when in fact pension funds, as long term investors, do not necessarily need that much liquidity all the time. Investing in illiquid assets, and getting compensated for it through the liquidity risk premium, is like being rewarded for a risk exposure that never really was.

Even where the accumulation phase succeeds, entry into the decumulation stage at the point of retirement is marred with confusion and loss of direction as members are left to their own to figure out how to live off their accumulated retirement savings. The DC regime, by design, is all about the accumulation phase. Both the paternalistic and holding-members-by-hand guidance given by funds is pulled from under the members' feet once they retire. Where advice is given at retirement, it is usually from self-interested parties pursuing their own agendas, and is often quite conflicted.

Certainly, DCs as we know them today deliver members to acute levels of desperation, vulnerability and despair at a time they need genuine, authentic and member-centric guidance the most. To really expect members to single-handedly plan, budget, invest and live off their retirement savings lump-sum calls for imagination of disproportional measures. It's simply tantamount to throwing them under the bus.

The law requires that at least two thirds of a member's accumulated fund credits be converted into a pension. No doubt, this is certainly a noble and prudent piece of legislation. Failure of the industry to innovate and come up with appropriate investment solutions for retirees has resulted in unintended consequences. Regardless of how disciplined and consistent members would have contributed during their entire career, ultimately their actual pension benefits are determined solely by the annuity rates applicable at the point of retirement. The notion of members delaying their retirement until it is beneficial to do so is misguided and flawed in two fronts – one, not only does it assume that members are good at timing the market, it further assumes that the market will recover within a fairly short period of time. Of course, neither of these assumptions can be relied on. Secondly, in an economy with such high unemployment levels, it assumes that employers would be comfortable with retaining their employees who are due for retirement at the expense of injecting new blood into their workforce. With technology fast becoming the biggest driver of productivity, employers' preference is usually more for the young and technology-savvy. It is also socially and medically not right to allow our elders to continue working because they are waiting for the annuity rates to move into territories that would provide them with a more decent income in retirement.

Where members' contributions make up the bulk of the total contributions, as is generally the case with most corporate DC plans, an "exempt-exempt-tax" system exacerbates the income distribution gap as retirement wealth is a lot more unevenly distributed compared to salary. Unequitable income distribution, poverty, and unemployment are three of the main scourges that the United Nations has identified for eradication if the world is to be a better place for all those that live in it. Yet we have DC regimes working counter to that on one of the aspects – unequitable income distribution. This is because the exempt-exempt-tax system favours the rich as they benefit the most from the tax incentives.

What certainly qualifies to be called predatory fees, charged by the many different service providers dotted along the value chain, have not helped the situation in any way. Any form of leakage from a member's retirement "savings pot" is one too many. While fees charged by individual service providers might appear miniscule on their face value – when aggregated they puncture a big hole into a member's "savings pot". This is especially so when we remind ourselves that, crudely speaking, for every 0.5% of assets in additional fees, a member's retirement "savings pot" is reduced by 20% over a forty-year career.

Furthermore, our assessment of value framework also allows us to look at the implications of any regime or system on the broader economy and society at large. Current DC regimes, with their focus on the listed investments space do not directly benefit the economy the same way as direct investment in infrastructure and private equity would do. This failure to effectively drive economic growth and create jobs is also a failure on addressing the second of the main plagues identified by the United Nations for permanent eradication – unemployment.

Ted Benna, the astute financial planner who discovered the loophole in the US Revenue Act back in 1979, and famed today as the "Father of the 401(K)" was quoted in 2013 as saying, "If I were to start all over from scratch today with what we know, I'd blow up the existing structure and start over". The corporate DC regime, as we know of it today, is modelled around the US 401(K) system. The only major difference is that, whereas our DC system is designed as a pooled arrangement, with the 401(K), employees are left to choose their own fund to participate in – more or less the same way an employee would choose the institution to bank with and through which they will receive their salary. Now if Ted Benna casts doubt on a system that he is personally credited for then everyone else should probably be out there searching for a better alternative.

As financial services technocrats, we are conscious of whom we listen to, but in the words of Franklin Roosevelt (1939) we draw inspiration, "No greater tragedy exists in modern civilisation than the aged, worn-out worker who, after a life of ceaseless effort and useful productivity, must look forward to his declining years to a poorhouse. A modern social consciousness demands a more human and efficient arrangement". Roosevelt was right for his time – but more importantly, he is right for our time too. We ought to do something.

In our Part II of this series we share with you more on whether there are any quick fixes to the current DC regime if we are to take more workers to a comfortable retirement. Our monthly "State of the Pension Fund Industry" Publication is aimed at inviting conversations from like-minded individuals with a view to engaging in forward-thinking-led discussions on how we can collectively improve the state of our industry.

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