The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

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HAS A 'SUSTAINABLE DB PLAN' BECOME AN OXYMORON?

LESSONS FROM CANADA, THE UK, AND THE NETHERLANDS

"Valuation, whilst important, is only part of the overall stewardship of the USS Pension Scheme. Of much greater importance is the process that underpins the valuation and the governance of the Scheme itself. It is these which drive the culture and tone of the interaction between the Stakeholders and therefore the way in which the valuation is conducted, and its outcome enacted………Currently at USS, it appears to be the other way around: the valuation and its methodology drive all else, including the relationship between the Stakeholders and between the Stakeholders and the Trustee…..".

Joanne Segars
Chair, Joint Expert Panel on the USS Pension Scheme, UK

"In the new system, pensions will no longer be guaranteed, shifting risk to participants…..and pension fund investments will no longer be constrained by a coverage ratio dictated by a discount rate for liabilities. Projected returns on investment will become the criterion for establishing members' expected pensions. The new Accord offers the chance for a better pension sooner than under the current rules. Pension organizations must merge earned pension rights with accruals under the new system. They will be allowed to adopt the new rules as of 2022, but no later than 2026…..".

Wouter Koolmees
Dutch Minister of Social Affairs

A Logical Sequel to our June *Letter*

Our **June *Letter*** argued that the time has come to rethink pension design, and that we should do so without getting mired in the tired and non-productive 'DB vs. DC' debate. Instead, at a national level, the *Letter* suggested thinking in terms of a tax-funded, sustainable, universal Pillar 1 base pension, supplemented by required participation in one of a number of effective fiduciary-driven Pillar 2 occupational pension/retirement savings arrangements. Participation in 'do-it-yourself' Pillar 3 arrangements should be left to people with sufficient knowledge of how financial markets work not be over-charged by commercial Pillar 3 service providers.

From there, the June *Letter* suggested thinking in terms of two types of Pillar 2 arrangements: 2-pot and 1-pot. The former offers separate retirement savings accumulation and decumulation pots. Participants accumulate assets in pot #1 during their working lives, and shift assets to pot #2 as they approach and enter the post-work phase of their lives. The goal of pot #2 is to produce a stable (but not necessarily guaranteed) income stream for life. The benefits of the 2-pot model are obvious: it is simple, flexible, fair, and can be designed to operate based on a series of default decision rules (e.g., for contribution rate, investment choices, how to shift from pot #1 to pot #2) for those people who do not want to make these decisions themselves.

Given these attractive 2-pot Pillar 2 pension plan features, why would anyone want to offer a 1-pot plan, with all participants, young and old, sharing one asset pool? The answer is that back in the 50s and 60s 1-pot DB plans also seemed easy to design and manage. From an employer perspective, economies were strong, workforces were young, financial markets offered attractive returns, and regulation was light-touch. From an employee perspective, pensions were not something that required deep thought….upon retirement, pension payments for life would just happen. Today, DB plans exist in a very different environment. From the employer perspective, economies are more fragile, the workforce has aged, financial markets no longer offer the high investment return prospects of the 50s and 60s, and pension regulation has become far more demanding. On the employee side, pension issues loom much larger today than they did 50+ years ago.

All this gets us to the topic of this *Letter*: are traditional 1-pot DB plans now doomed? Or can they be adapted to 21st Century realities?

Addressing the 1-Pot Plan Adaptation Challenge in the UK

The June *Letter* noted that the 1-pot *Ontario Teachers' Pension Plan* (*OTPP*) has adapted to 21st Century realities through five integrated factors:

- A plan design that shares funding shortfalls and surpluses fairly and transparently between plan participants.
- A clear split of the roles and responsibilities of the plan sponsors, the plan board of directors/ trustees, and plan management.
- The plan board is especially critical in enforcing the 'best interests/impartiality' rule. It must ensure the plan's design allocates risk and reward fairly between plan participants and that the plan's funding target is based on assumptions and risk exposures that are 'reasonable'. That means (a) they reflect current economic and plan maturity realities, and (b) they have a conservative bias.
- These board responsibilities have strong implications for board composition. In addition to understanding the implications of the 'best interests/impartiality' rule, it requires people with strategic thinking capabilities, and a collective skill/experience set that includes investment, actuarial, HR, IT, and communications/reporting.
- A regulatory regime that is principles-based rather than rules-based.

In contrast, it appears that the UK's 1-pot *Universities Superannuation Scheme* (*USS*) has not yet adapted to 21st Century realities. Here is our summary of how a Joint Expert Panel assembled to address the *USS* problems sees them:

- *USS* is a large 'going-concern' pension scheme with a relatively young membership and a positive cashflow, backed by 350 Higher Education employers with considerable collective financial means, and growing employee diversity.
- The scheme has a conservative (solvency-focused) funding policy which currently deems it to be underfunded and thus requiring additional contributions on top of already-high regular contributions.
- Details of the funding policy and its implementation are highly complex, poorly understood, and subject to considerable skepticism and mistrust.
- The *USS* people puzzle has seven pieces: the employer group (*UUK*), the employee union (*UCU*), the Joint Negotiating Committee (*JNC*), the *USS* Board of Trustees, the *USS* Executive Group, scheme members, and The Pension Regulator (*TPR*). These pieces have not been fitting well together.

To adapt *USS* to 21st Century realities, the Joint Expert Panel made a number of key recommendations.[i] This is our summary of them:

- Adopt a 'going-concern' mindset for *USS*, which permits using a higher funding discount rate[ii], thus reducing contribution rates to affordable levels. At the same time, the valuation process should be simplified, made more understandable, and lead to predetermined adjustments to benefits and contribution rates deemed fair by all Plan participants.
- Rethink how the respective interests of the employers, employees, and retirees are best represented. Clarifying the roles of the *JNC* and the *USS* Board of Trustees and ensure they have the requisite strategic thinking capabilities are especially critical.
- Rethink the processes through which all parties with an interest in *USS* are kept informed on how the organization creates value for them.

Note that these *USS* recommendations closely mirror *OTPP*'s 'adaptation' success factors listed above.

Addressing the 1-Pot Plan Adaptation Challenge in the Netherlands

The Dutch started discussing 1-pot pension plan adaptation to 21st Century realities at a national level soon after the 2007-2009 Global Financial Crisis. With the passage of time, it became obvious that the solvency-based *FTK* regulatory regime with its harsh pension cuts was increasingly unpopular, and hence increasingly politically unsustainable. So how to adapt? Somewhere along the line, a critical decision was made not to go the relatively simple *OTPP* adaptation route, which has now been recommended to *USS*. Instead, a far more radical and complex adaptation route was chosen.

Over the course of the last year, the details of that far more radical complex adaptation route have begun to emerge. Table 1 sets out how one Dutch pension expert summarizes them.

Table 1 THE NEW DUTCH PILLAR 2 PENSION CONTRACT

Accumulation Phase	Distribution Phase
• Fixed contribution rate • No pension entitlement accruals • Individual member 'capital accounts' • A collective 1-pot investment program • Fund return allocation per 'age cohort' including split of hedge and excess returns	• Pension payments based on individual member capital, life expectancy, and projected return • Payments are actual experience-dependent including split between hedge and excess returns • Micro longevity risk managed within each 'age cohort'

Pension plans have the option to establish a collective asset buffer up to 15% of the total asset pool, to be used to dampen changes in benefit payments. Plan members will receive annual information on their accumulated 'capital account' and their expected monthly pension based on three future scenarios. Pension management under the new contract can start as early as 2022 but no later than 2026.[iii]

If you are wondering how the new Dutch Pillar 2 pension contract will be made to work in practice, you are not alone. Here is a starting list of questions that come to mind:

- Where do investment return expectations come from in the new contract?
- What will be the basis for establishing 'age cohorts'?
- What will be the process for allocating fund investment returns among 'age cohorts'? Will that process be understandable/acceptable to plan participants? What if they don't agree with the allocation? Or simply won't agree to anything they don't understand? (e.g., what is the difference between a 'hedge return' and an 'excess return' and why does it matter?)

- How will the fund 'buffer' work? Will how it is used be understandable/acceptable to fund participants?
- How will the current collective fund asset pool be divided into individual member 'capital accounts'? What will funds do if individual members think the conversion process short-changes them and leads to legal challenges? Will Board members be able to discharge their fiduciary duty of 'impartiality'?

Maybe the most fundamental question of all is what happens if this bold Dutch adaptation experiment fails because it is too complex for plan participants to understand and for pension funds to implement? Should there be a Plan B?

Where Does Pillar 2 Plan Design Go from Here?

Sensibly, as we noted in our **February *Letter*** titled "Rethinking Retirement….Davos Style", retirement savings flowing into effective, fiduciary-driven, 2-pot pension/retirement savings arrangements continues to grow around the world. Good examples can be found not only in Australia, Canada, and the USA, but in the UK and the Netherlands as well.

But what about already-existing 1-pot DB pension arrangements with multi-decade histories? Can they adapt to be sustainable in the realities of the 21st Century? The *OTPP* case confirms it is indeed possible, but only with innovative strategic leadership. That is also the view of the *USS* Joint Expert Panel in the UK.

Finally, what are we to make of the Dutch decision to go where no country has gone before? Can you really convert an (admittedly problematic) collective 1-pot pension model into one with thousands of notional individual pots, all with their own allocated market-based returns, but with a collective buffer against adverse outcomes? Social Affairs Minister Koolmees appears to believe it. Others are not so sure. Time will tell who is right.[iv]

Keith Ambachtsheer

Endnotes:

i. *See the Reports of the Joint Expert Panel on the Universities Superannuation Scheme dated **September 2018** and **December 2019**, commissioned by the University and College Union and by Universities UK.*
ii. *The Joint Expert Panel suggests taking the weighted average of a higher discount rate for the accrued liabilities of active members and a lower discount rate for retiree liabilities.*
iii. *In addition to the New Pension Contract (NPC), a separate simpler DC arrangement called WVP is proposed for small employers.*
iv. *Minister Koolmees and his advisors may be underestimating the power of 'path dependence', which is the idea that past choices can place physical or psychological limits on the range of feasible future choices.*

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