A world tour of defined contribution

Don Ezra's keynote address to the NAPF: UK defined contribution schemes: Why so little progress?

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The speech that is reproduced below was delivered - under the title "UK Defined Contribution Plans: Why So Little Progress" - by Don Ezra, Russell's Co-Chair, Global Consulting, to the annual investment conference of the National Association of Pension Funds (NAPF) in Edinburgh, Scotland on 11 March 2011. In it Don explores the aspects of the defined contribution (DC) system that he considers best, wherever they are found: from the U.S. to Australia to Switzerland to the UK. As always with Don, it carries a positive message: that we all know what it takes to build an effective DC system, and we just need to go do it.

Keynote address:

Good morning! I'm very conscious of what an honour it is for me to be asked to talk to such a distinguished and influential group. So my goal is to do justice to this time slot, and give you something to chew on – a perspective on defined contribution schemes, with colour commentary drawn from what's happening in other countries, where defined contribution has taken hold to a greater extent than it has here. Specifically, I'm going to draw on the experience in Australia, the United States and Switzerland, and I'll look at the Netherlands for a different perspective.

It's a good time to assess what is being done to make DC the retirement substitute for DB.

You'll notice that part of the title I was given for this talk is "Why so little progress?" I think that was meant to be deliberately provocative. I think there's much more progress than meets the eye. The obvious analogy is an iceberg: the amount that's visible, above the surface, isn't all there is. There's a lot more below the surface, consisting of things that are being discussed and investigated, and are likely to break the surface when they're required.

"When they're required" is probably very soon. The fact is that the overwhelming majority of UK defined benefit plans are soft-closed. There are already approximately as many active DC-scheme members as there are active DB-scheme members. So, even though we aren't yet at the stage where DC assets exceed DB assets (which is the stage in Australia, America and Switzerland), Britain is headed in that direction.

So it's a good time to assess what is being done to make DC the retirement substitute for DB. And I'm going to assess it under three headings: saving, investing and decumulating. I was delighted that yesterday Professor Merton laid the foundation for some of what I'm going to talk about. I mentioned this to him, and he said, "I'm happy to

be your warm-up act." First time in my life a Nobel Prize winner has told me that! I'll take it, even if it was tongue-in-cheek!

If you had a late night last night, let me help you up front, in case you lose your concentration later. My theme is going to be that there's considerable hope. We know we need to nudge savers into a mind-set in which they plan earlier for retirement, and we need to provide them with sensible default options and simple rules of thumb that will have some chance of registering with them and improving their behavior and outcomes. The good thing is that experience around the world offers a future path.

Let's start with saving.

The single most important lesson I've learnt in my career is that retirement is expensive.

At this conference I'm preaching to the converted when I say that the single most important lesson I've learnt in my career is that retirement is expensive. But even though we know it, the fact is that around the world, governments, employers and individuals typically don't behave as if we know it.

Retirement is expensive because of longevity and our desire to retire while we're still active. That's a relatively new idea. In agrarian societies people didn't retire, they worked all their lives. Not hard labour all the time, of course; they lived in families, and younger generations took up the burden as the older ones got tired. But no *right* to retirement.

That first came about in 1889, when Bismarck introduced the first government pension: a small amount paid from age 70. At the time life expectancy at birth was 45, so this was not exactly offering most of the population a long, prosperous retirement.

It was only about 60 years ago that we started, as a society, to demand a post-work phase of life that would be as comfortable as the working phase, a bit shorter, and much more leisurely. Actually, the 1993 Nobel Prize winner in economics, Robert Fogel, did his own calculations about the work-to-leisure ratio after we start working; allowing for some leisure time each working day, he points out that 100 years ago the work-to-leisure ratio was 80/20; now he says it's 40/60.

You know: that's expensive! And here's why. There's better than a 50/50 chance that one member of a 65-year-old couple will survive past age 90. You need to save a lot to finance the continuation of a modern lifestyle for that length of time.

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How much do we need to save for that? We don't exactly know. It depends, among other things, on the return you earn. In the long term, 80 to 90 percent of what we draw as a pension comes from investment returns, and only 10 to 20 percent from our savings. Depending on whether equities return 6 or 7 or 8 or 9 percent a year on average, the amount we need to save varies enormously. That's why it's tough to say exactly how much we need to save.

But whatever it is, it's still expensive. This has nothing to do with whose responsibility it is to fund retirement. How responsibility is allocated across governments, employers and individuals is a political issue, for society to decide. But we'll fail if society thinks that it's inexpensive; that it's easily accommodated along with all kinds of other spending priorities; that a little bit of adjustment will get us there.

The fact is that most of us don't save enough to be able to retire at the same standard of living, without taking a considerable amount of investment risk. We *need* to take investment risk to have any chance of success. And even if that risk pays off, which isn't certain, many of us still won't be able to sustain our lifestyle in retirement, if we retire at 65 or earlier. I'm an example. I'm 66 and still working part-time. We might choose to blame the markets for that. But for most of us, the truth is that we didn't save

enough, and we'll either have to turn down the spending dial, or retire well after 65, or retire gradually – just like agrarian times, again.

The thing is, though, in agrarian times they knew how to do it right. They had lots of children, they put them all to productive work, and they worked themselves as hard as they could, and as long as they could. We want it all, but softer.

That's why retirement is expensive. And that's why the principal problem is encouraging people to save enough, rather than relying on inflated expectations of prospective investment returns.

Auto-pilot options, as they are being called, have had remarkable success.

The first thing is to get people to save at all. How do we do that? Here are some lessons.

The Australians simply make it compulsory. They have a state-provided age pension, but their national scheme is really a compulsory second pillar, with a compulsory 9% annual contribution rate from the employer. Most individuals add nothing when they're young, and as much as they can as they approach retirement, averaging a further 3%. The national scheme has replaced most second-pillar voluntary workplace schemes. It hasn't yet been in place for a whole generation, but already the discussions concern whether the minimum contribution needs to be raised by perhaps 3% or 6%.

In America there's a substantial voluntary second pillar, covering about half the workforce. The typical DC contribution rate is 6% from the employee, half of it being matched by the employer, for a total 9% contribution. That simply isn't going to be adequate. What's more, participation used to be voluntary; so of course employees, focused on immediate spending priorities, typically didn't participate. A lesson learnt there relies on psychology; specifically, the human being's tendency to inertia and its consequence for what is now being called "choice architecture."

You know about that book "Nudge," written by two academics, Richard Thaler and Cass Sunstein (and Sunstein is now President Obama's "regulation czar," as the press likes to call him). There's an angle you may not be aware of. Many people think it's about paternalism, nudging people to do "the right thing." It's not – it's more subtle. Its premise is that, if people are given a chance to think about things, after education, they typically reach sensible conclusions. But a lack of education, a lack of time to think, and inertia together combine to make their actions highly inappropriate and quite different from what they themselves acknowledge they ought to do. The solution is to build the action *they would choose* into the choice architecture, by making it the default option.

People should save for a rainy day before they save for a sunny day.

So, as has been noted many times in this conference, automatic enrollment and automatic escalation of the contribution rate every year are now taking hold in American DC schemes, as the default option. Anyone can elect to do otherwise, but it has to be a conscious, explicit election. True to form, the vast majority accept the default option. Auto-pilot options, as they are being called, have had remarkable success.

What we find in America, though, is that the system has what's called "leakage": participants withdraw money for emergencies. And even ignoring hardship withdrawals and loans, their experience is that roughly half the people changing jobs cash out their DC assets when they move. And that defeats the purpose of retirement saving. I have a personal perspective on that. I think people should save for a rainy day before they save for a sunny day. Or, to change the metaphor, think of putting money into different jars: a vacation jar, an emergency jar, a retirement jar. Fill the emergency jar (I've seen advice that suggests you ought to have six months' worth of spending available before that jar is considered filled) before you start putting money into the retirement jar. Perhaps the age and earnings limits should be somewhat higher than the traditional values above which workers enter the scheme.

Now we have NEST, the National Employment Savings Trust[1], preparing to receive money, and from next year, at the start of a staged four-year process, many employers will have to provide either their own scheme or access to NEST. It's a start. How it works, the extent to which it will displace the second pillar or become a big part of the third pillar (individual savings), we have yet to see. We already know that it will have competition, from the Danish ATP, from the Mercer consortium (if I can call it that), and I'm sure there are or will be others.

My theme in everything I say today, though, is that we *know* how to make NEST, and workplace pension schemes generally, work successfully. We have all the knowledge we need in the portion of the iceberg below the surface. Making it happen, though – that's tough, because affording retirement on the terms we want is so expensive. The first time you confront it, there's denial and anger: Greece, France; less dramatically so far, America and now the UK. Progress is always going to be a huge struggle.

Let's turn to the second issue: successful investing.

I know the exact probability that educational pamphlets will help the average participant to become an investment expert. It's not 10 percent, not 5 percent, not 1 percent – it's precisely zero.

This is not only near to our hearts; it's also at the heart of retirement provision.

In a book I co-authored a couple of years ago, called "The Retirement Plan Solution," we put in something we called the 10/30/60 rule. If there's one thing readers remember from the book, that's it. We showed that, if you start saving at 25 and withdraw money from age 65 until age 90, roughly 10 pence in every pound you withdraw is money you originally saved. Roughly 30 pence comes from investment returns in the accumulation phase and a startling 60 pence from investment returns in the decumulation phase. I think we were a bit optimistic in our assumptions. Re-calculating the numbers with lower returns and with declining investment risk exposure over time, it's closer to 15/35/50. But the point is the same: investment returns over a lifetime demonstrate the awesome power of compound interest. (Incidentally, I've heard a quote attributed to Einstein, to the effect that the most powerful force in the universe is compound interest. But I've never found a reliable source for the quote, and I think it must have been made up by a very imaginative actuary – and I don't accept that that's an oxymoron.)

Investment governance is far more difficult with DC schemes than with DB schemes, because the inexpert participant now becomes part of the governance structure. And inexpertise shows. I follow annual studies by Towers Watson and others that show that, on average, DC schemes earn lower returns than DB schemes. That simply means that opportunities for retirement income are being wasted.

At first the Americans turned to investment education to bridge the knowledge gap. I've been quoted – perfectly accurately – as saying that I know the *exact* probability that educational pamphlets will help the average participant to become an investment expert. It's not 10 percent, not 5 percent, not 1 percent – it's precisely zero. Just as the average citizen will never become a doctor, a lawyer, an engineer, a pilot, by studying pamphlets. These are professional disciplines, as is investing.

What the Americans have got wrong is that they've confused investment education with financial education. Financial education is basic. It ought to be taught in schools. It's about budgeting. It's about making choices when you don't have enough money for everything. It's about saving, for some of us, or borrowing, for too many others. And so it's also about the return on savings, and the cost of credit. That leads to compound interest, which few people ever understand.

Reading, 'riting, 'rithmetic – those are accepted as the essential elements in a school curriculum. The three R's, we call them – evidently spelling isn't an essential element.

[1] NEST (UK): http://www.nestpensions.org.uk/schemeweb/NestWeb/public/home/contents/homepage.html

How about routine budgeting – or call it resourcing: I don't know, I can't think of a catchy word beginning with R. That too, not just the first three R's should be an essential part of our school education. It's a life skill, and most people will need it more than they need – I don't know – geography or trigonometry.

It's *financial education* that everyone needs. It's the basic food; it's the "meat and two veg". *Investment education* is the icing on top of the cake. We need the "meat and two veg" first. We should get it in school. But we don't. That's why a diet of icing won't keep us healthy.

That means, once again, that default options become particularly important. I'm delighted to say that Americans now know that. And, because they came late to that wisdom, they have jumped past the Australians, who for years have used a standard 70/30 equity/fixed mix as their most popular default, and are finding it hard to move away from that. The Americans have designed what goes under various names, but is most often called a "target date glide path." Here's how it works. You know this.

Suppose you're really sophisticated and really understand and can quantify your risk tolerance. (Sounds like Monty Python, doesn't it? "Make jolly sure you get it right, and you can rid the world of all known diseases!") And suppose you also conclude that 70/30 is the right asset allocation for you. Well, for any constant allocation (like 70/30), the target date glide path can improve your risk-reward trade-off. Because you're contributing for many years, your wealth increases over time, so you don't have a constant amount exposed to market risk. If you take more risk when your financial assets are smaller, and less risk as your financial assets increase, there is some glide path, some declining equity exposure over time that gives you the same expected outcome as a constant allocation, but a lower downside risk. What you're doing is creating a much better allocation of risk over your lifetime.

It's financial education that everyone needs. It's the basic food…investment education is the icing on top of the cake.

There are other ways of explaining it, based on financial capital and human capital. It comes to the same thing.

This wisdom is now baked into the default option at most American DC schemes. I commend it to you.

Mind you, there isn't a single glide path that's optimal for everyone. Just as there isn't a single level of allocation that's optimal for everyone. Americans haven't cottoned on to that, yet. One day they'll offer a choice of glide paths in the same scheme. And they'll offer glide paths that allow for mid-course corrections, depending on whether the markets have done particularly well or particularly badly after the glide started. That would be "conditional asset allocation." But let's leave all that for the future. Those are advanced versions of glide paths. So too would be putting relatively illiquid investments into the default portfolio. Never mind. Just installing Version 1.0 is a big step forward.

And again I say: we know this. We just have to do it.

The third topic: decumulation.

Remember the 10/30/60 rule? (Or 15/35/50, if you prefer.) That tells you that decumulation is the most important phase of all. And in America and Australia, they have ignored it. It's as if, when a participant retires, they're saying, "Oh good, that's another problem gone." And they're only just beginning to realise, as a country, that that's another problem just starting. In this most important area, Britain is the most advanced nation. Everyone can take this leaf from your book. Here's what others do, and why.

In America and Australia, it's a lump-sum culture. For the Aussies it arises because, amazingly, they used to tax lump sums far less than ongoing income; so it became a

no-brainer to take lump sums. It's also very appealing to savour the lump-sum amount: so much more exciting than the much smaller annual income. A professor friend of mine captured it perfectly when he quoted a regretful friend of his who had just bought an immediate annuity: "Yesterday I was a millionaire. Today I'm living on 70,000 a year." (And that was when interest rates were much higher!)

"Yesterday I was a millionaire. Today I'm living on 70,000 a year."

Most people haven't a clue how little income is generated by a given lump sum. And that was true even in the days of high interest rates, let alone today. Check it out on your own friends and relatives, as I have. You'll be stunned by what they think, and they'll be stunned when you tell them what the actual number is. I explain it as the rule of the £20 note: very roughly, every £1 a year, inflation-indexed, that you want to withdraw from age 65 requires you to have a £20 note in your fund. Tim Jones, of NEST, told me that he explains it as the £1,000 rule, because if you think in terms of £1 a week, it needs to be backed by assets of £1,000. Yes, I know the £20 rule is very approximate. But most people would guess that rather than a £20 note, the rule is a £5 or at most a £10 note. And that's why they draw down their capital much too fast, and end up either turning back their spending dial or living on welfare.

In Australia they changed their tax laws a couple of years ago to encourage programmed withdrawals. In America they are now seriously considering making it mandatory to report, every year, not only the account value but also an estimate of the income it would produce at the scheme's normal retirement age. Anything to force participants to realise, as early as possible, that saving for retirement is about replacing income, not just building up a lump sum. In our book we say that the essential ingredient, before we can say that DC Version 2.0 has arrived, is a focus on retirement income.

The Swiss force DC schemes to convert lump-sum accumulations into retirement income streams at guaranteed conversion rates. For a male aged 65, the conversion rate started at 7.2 percent a year in 1985, so you'd get 72,000 a year from a lump sum of a million. The conversion rate was scheduled to go down, from 2005, until it reaches 6.8 percent in 2015. That's still pretty high. There was a heated national debate on a referendum to reduce it to 6.4 percent in 2016. Yes, they had a referendum on that – and three-quarters of the population voted "no." Never mind investment returns and increasing longevity. That's unsustainable.

Guess what's bound to happen? Initially the money to subsidise this rate will come from reduced interest credits in accumulation accounts – unless the credited rate falls below the minimum 2 percent a year that has to be guaranteed. Good luck sorting that out. It makes no sense to legislate away market conditions.

[Most people] draw down their capital much too fast, and end up either turning back their spending dial or living on welfare.

I think what Britain now has is the best concept I've seen.

It used to be: you have to annuitise, no later than age 75. For most people, that makes a lot of sense. Most couples don't have enough wealth to support their standard of living up to their joint and last survivor life expectancy, so annuitising gives them the highest income compatible with living to, or outliving, their life expectancy. I did a rough calculation. Take a couple each aged 65. If they don't buy an annuity, and want 95 percent certainty that they won't outlive their assets, they need to have 25 percent more assets than if they just live to their life expectancy.

Admittedly life annuities have roughly a 10 percent loading for expenses, contingencies and profits; but it still means that self-insuring costs 15 percent more than buying an annuity – and even then you're only 95 percent sure. So, for most people, buying an annuity makes sense. Of course, if you have so much money that you can live off the investment return alone, then longevity is not a financial risk for you. But few are in that position.

Now the new rule is going to be (and I know I'm grossly over-simplifying): well, if you have pre-annuitised income sources that guarantee that you'll stay off the welfare rolls (in other words, you meet the Minimum Income Requirement of £20,000 a year), then you can be much more flexible with your money. That's so sensible, because if you really do have more assets than you need to finance your standard of living via an annuity purchase, then forcing everything into an annuity purchase simply negates the bequest motive, and implicitly forces you totally into a lifetime fixed interest investment. As long as the retiree isn't going to become a welfare recipient, the tension between supporting a lifestyle and supporting the bequest motive is and should be a purely personal factor. The problem in Australia and America is the swelling of the welfare rolls by people who decumulated too fast, without buying an annuity. Britain will likely avoid that. Well done!

And now for something completely different: the Dutch show us that there's an entirely different way to run a DC system. They call it "collective DC."

Essentially, contributions are defined (hence "DC"). But instead of creating individual accounts and bringing individual participants into the investment governance mechanism by asking them to make investment choices, the assets are invested as a whole, as in a DB scheme. And an actuary calculates a unit benefit level that ought to be sustainable; and participants essentially then get that defined benefit. If there's a shortfall, it's the benefit that gives way – so it really is a DC scheme.

Collective DC really has a lot of appeal.

To reduce the probability of the huge disappointment of a benefit reduction, contributions are made at a level that ought to support a final pay–indexed benefit. The quoted official benefit unit is a career average, nominally fixed benefit. Reserves are established for the quoted unit according to Dutch DB rules, under which there has to be a surplus that varies with the amount of investment risk taken.

In most years, the career average base is raised (revalued) uniformly, and there's an inflation increase granted on pensions in payment – and these come from the surplus. Rarely (but it does happen – and it is happening right now), a few schemes get to below 100-percent funded on the current benefit, and cuts have to take place. The Dutch wail that their system is failing, even if their degree of fundedness (if that's a word) is the envy of the rest of the world. You still, of course, get the young-to-old cross-subsidy effect that every DB scheme has, but that tends to even out over a lifetime. Collective DC really has a lot of appeal.

There's nothing technically impossible about transferring their system to other countries. But there's a huge obstacle: culture. I wonder if in America or Britain there's a sufficient sense of shared endeavour ("we're all in this together"). The Dutch have it. The best explanation I've ever received as to why, came from the Dutch ambassador to America. He told me, quite simply, "In a country where the average height above sea level is minus three metres, we have no choice but to co-operate."

Let me end there.

We've touched down in a few countries on this world tour. We understand DC. In all three areas I've discussed – saving, investing, decumulating – we know what works. We simply have to make it happen.

And now, my personal cop-out. As for me, I'm a consultant and I have retired, or, as I prefer to express it, I have graduated (because there's still a lot of post-graduate work I'm doing). And therefore "making it happen," I'm glad to say, is your job. Get on with it, and Godspeed!

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