OVERVIEW

Designing in the dark

The occupational pensions sector is undergoing many changes across Europe. The resulting foggy picture means that future-proofing DC scheme design has become a precarious task

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Pressure on the second pillar in Europe has been ratcheting up over the past few years.

Slowing birth rates have resulted in fewer workers paying into state pension plans, while rising longevity has driven defined benefit into its own retirement home. This has all left the second pillar increasingly depending on the success of defined contribution (DC) schemes.

This reliance was recognised last summer by PensionsEurope when the federation released a guide outlining 14 key principles of good governance for workplace DC schemes. Writing in his introduction to the guide, PensionsEurope's chair Janwillem Bouma said that it was essential that individuals had confidence that workplace pension plans operate "in their interests, are robust, well run and offer value for money".

He noted that employers equally needed confidence in their DC plans. They wanted reassurance about their affordability, that they would not expose them to unforeseen risks, and that they would be flexible enough to match their business objectives.

To achieve this, PensionsEurope has said that countries must follow the 14 principles as a minimum requirement. Many of the federation's recommendations make perfect sense: highlighting the need for good communication, a responsible handling of pension fund members' decumulation phases, and value for money. The latter, however, is a principle that could potentially stifle member outcomes in DC.

Missing out on better investment

State Street Global Advisors senior DC investment strategist Maiyuresh Rajah says that with such a strong emphasis on keeping costs low, employers and providers are opting for a tick box, easy investment element to their schemes, particularly in fledging DC markets, such as The Netherlands. This usually begins and ends with a very basic default strategy that uses a crude high-risk-to-low-risk asset allocation lifecycle process.

That is an understandable development says Rajah, but it could mean that an entire tranche of early DC savers are missing out on better returns for their contributions.

"As DC markets become more mature they start looking at more sophisticated investment strategies," says Rajah.

"But what they should do is look at those from the start. What happens is that by the time schemes start looking at diversifying or mitigating risk in a better way,

there's a large section of members who have already built up assets and are close to retirement who haven't had the benefit of these investment strategies."

Rajah says that he doesn't want other countries to suffer the same fate as that of the UK, where the first entrants into DC missed out on better returns due to a low cost or cautious mentality.

"You don't need to wait for your DC scheme to grow, or for the market to pick up before you start incorporating these strategies. For example, you can have active allocation to manage diversification in an active way, but have passive building blocks to keep costs low, giving a pension plan a dynamic asset allocation feature."

Thankfully, he says, there are signs that the time lag between basic and sophisticated investment strategies could become significantly reduced. State Street has been talking to clients in the Netherlands about doing more to improve their approaches to DC investment.

The Dutch dilemma

It's no surprise that the Dutch are catching on to up-to-date investment practices on the DC front, given that traditionally, theirs has been the pensions system that many countries have looked to emulate.

At present, however, those looking for a steer on the future direction of DC from the Dutch may be a little puzzled.

As Pensioenfederatie general manager Gerard Riemen explains, reform of the so-called Dutch pensions contract is much needed, but the current political vacuum is stalling progress.

"We're very much in favour of collective schemes and risk-sharing of course, but on the other hand, we all realise that with longevity and very low interest rates, it's DB scheme," says Riemen.

THE UK COULD SOON BECOME THE FIRST PLACE IN EUROPE WHERE – FROM AN EMPLOYEE'S PERSPECTIVE – PURE PENSION SCHEMES BECOME A THING OF THE PAST

"Right now though, there is no direction for any reform as there is a political lull as we have a General Election on 15 March. So it all depends on what happens after that.

"We always need a coalition government and this time we expect to need at least four parties to make it happen this time. And if you look at the election manifestos of all the parties, it would be very difficult during the formation of a government to agree on pensions issues."

Nevertheless, Pensioenfederatie, along with the social partners in the Social Economic Council, have continued to work on pension reform. Riemen says that the federation has an idea on the direction that it will take and is very hopeful that soon after the election, the council will be able to hand a new proposal to the new government.

"It's still on the negotiation table but I think the council will go forward with some hybrid construction, so we won't be able to call it a classic DB or DC scheme."

Further clues on details of the new arrangement may be found in critical analysis of the current system. Last June, DNB, the Dutch pensions regulator, said that the past few years had exposed the vulnerabilities of the Dutch pension system. DNB called for new pension contracts that were based on personal pension accounts and individual lifecycle investment policies.

Another change that Riemen wants to see is allowing mandatory schemes to merge.

"That's a problem in the Netherlands and we hope that it will be solved, because if you have economies of scale then you have less governance problems and less pressure on administration and investment costs."

MILLENIALS, IN PARTICULAR, ARE BEING ENTICED TO LOOK AT PENSION SCHEMES THAT INVEST IN A MANNER THAT MATCHES THEIR WORLD VIEW

Changing face of saving

According to JLT Employee Benefits head of technical John Wilson, the UK is also heading towards larger collective pension fund arrangements, in the form of master trusts.

With a new Pensions Bill expected to become law soon, the number of providers, which was nearly at the 100 mark at one point, will be whittled down to alleviate concerns about governance and security of benefits. There will also be a push, says Wilson, to introduce 'Saving for Tomorrow' techniques into schemes. These involve member contributions rising automatically as they receive pay rises.

The bigger news in the UK however, is that of the changing nature of saving in the workplace.

"We have begun to detect a bit of an appetite from employers for wider saving provision in the workplace," says Wilson.

"So for example, for many younger people pensions are not a priority, but getting onto the property ladder is. Some of our clients have begun to recognise that and we have had discussions about adding other types of saving vehicles to the workplace pensions scheme, such as a lifetime individual savings accounts."

If this takes off, then the UK could soon become the first place in Europe where – from an employee's perspective – pure pension schemes become a thing of the past.

"There are the beginnings that this is the direction of travel for saving in the workplace in the UK," says Wilson.

Listening to what members want

This change in the UK, based on member aspirations, is the blueprint for future DC developments, says Rajah.

"We do a lot of research on what members want and then try to build solutions that we think are appropriate for them. And when we take that to clients and policymakers they're always interested to check out the data that we've gathered," he says.

"That shows that historically there hasn't been enough work done on the underlying member and trying to build upwards in that way."

Acting in tune with members has seen changes in investment in some DC schemes, particularly in Sweden. Mature schemes there have been taking on negative screening, the first step towards ESG strategies, as part of an overall plan to increase employee engagement.

Millenials, in particular, are being enticed to look at pension schemes that invest in a manner that matches their world view, says Rajah. "Whether that helps with engagement will have to wait and see, but that's probably an area that will grow." ■