

Building pensions for the future

Making promises you can keep

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Introduction

Multinational companies typically sponsor a variety of different pension plans in the countries in which they do business. These plans usually include both Defined Benefit (DB) and Defined Contribution (DC) plans. The global economic crisis has simultaneously exposed significant weaknesses in both types of plans, driving pensions up the list of priorities for CFOs and CEOs.

Although companies with DB plans have clearly experienced the most immediate and significant consequences of the crisis, companies with DC plans may also be facing a problem that is greater than they yet realise. While DC has been seen as a cost-effective pensions mechanism that mitigates risk for the sponsor, it now appears to be allowing the creation of a new set of issues.

In this AEGON Global Pensions white paper, we address the impact of the global economic crisis on the pensions of multinational companies, examine practical ways in which companies can improve their international pension provision and advocate the use of a holistic framework to ensure adequate and sustainable pensions for the future.

Dealing with DB

In evaluating their pension plans, many multinational companies will have to start by reviewing the design and management of their DB plans, as DB plans provide promises to plan members that have proven to be costly, and therefore difficult to keep. These companies need to carefully examine what kind of promises they wish to make and how they will deal with the associated risk. This white paper highlights possible solutions that have been used by both corporate sponsors and trustees.

Creating a sustainable DC pensions system

For many companies, the intrinsic risk of DB plans has led to the adoption of DC-based pension provision. This white paper addresses the growing concerns around the adequacy of DC pensions. These concerns are shared by sponsors and plan members, as, in the future, companies may be faced with employees who simply can not afford to retire. If we wish to create DC plans that will provide adequate retirement income, we will have to change much about the way DC plans are designed and managed. In particular, we will have to find ways to remodel DC plans to have specific characteristics that have typically been considered natural to DB systems, including high levels of participation and contribution, dynamic investment strategies and elements of guarantees.

Focus on Pensions Process Management

Having discussed the design of both Defined Benefit and Defined Contribution pensions, we highlight an area that is sometimes overlooked: the day-to-day management of international pensions. As with any other area of business, pensions need to be managed well. And increasingly, multinational companies view pensions as a part of their business, to which regular business principles apply.

In the aftermath of the crisis, we need to address the issues of DB, improve the way that DC systems work, and implement efficient and flexible pension processes.

1 Pensions under pressure

The economic crisis has had a major impact on pension plans. Of all pension plans, however, Defined Benefit plans have been the most in the news. Although it has long been known that DB plans pose a risk to the companies that sponsor them, the present crisis has also highlighted the fact that this risk is ultimately shared by both the company employees and plan participants.

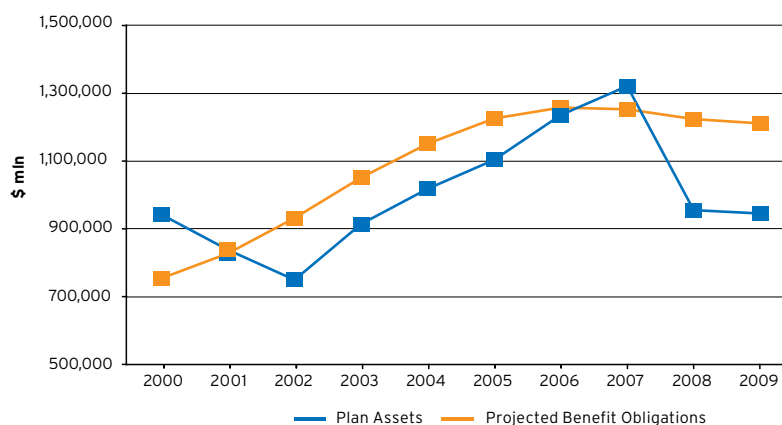
DC plans, in contrast, have generally been considered only as a risk to employees. However, the effects of the crisis on many DC plans should serve as a wake-up call to many companies to start paying more attention to their DC plans. A potentially toxic combination of increasing longevity, poor investment strategies, insufficient contribution rates and inadequate communication to members (coupled with unrealistic expectations) may build up to form a DC legacy problem for both employees and their employers.

The crisis appears to have exposed the weaknesses of all types of pension plans, creating a very difficult situation for the companies sponsoring them. For companies with international operations, the problem is even more complex: as every country has different rules and regulations, their pension plans have all been affected in different ways.

Defined Benefit – understanding risk

Over the past year and a half, the sponsors of DB plans have experienced something approaching a ‘perfect storm.’ The collapse of global capital markets, the rapidly worsening business environment and improving life expectancy have had a devastating effect on many pension funds, placing enormous pressure on the companies that sponsor them.

Figure 1: Underfunded pension funds in the USA



This figure illustrates the plan assets and liabilities of the 100 largest US public companies as compiled in the Milliman index. After taking five years to recover from the stock market crash at the beginning of the decade, the US stock market fell to a funding ratio of 78% early in 2009.

(Source: Milliman Inc)

In the USA, this dramatic development has had a significant negative impact on companies, who have been forced to address their pension shortfalls at a time when they were already feeling the effects of the crisis on their business activities. In effect, company pension plans have weakened US companies and hindered their ability to act - precisely when they could least afford it.

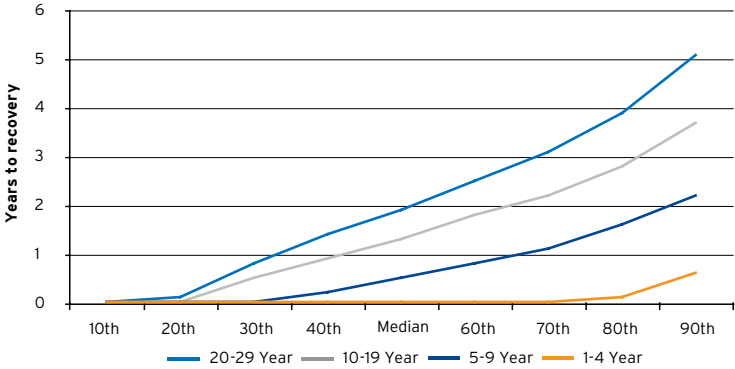
For example, the underfunding of pension funds in the USA has had a major impact on General Motors and Chrysler, adding to the enormous financial difficulties faced by both companies. By jeopardising the long-term prospects of their sponsoring companies, the DB pension funds ultimately threaten their own continued existence. In the UK, similar situations have arisen. At British Airways, pension fund trustees have been helping to remedy the situation by handing back a guarantee in order to help British Airways to survive the crisis (and continue to sponsor the pension fund).

Defined Contribution - individual pain

As the crisis developed, many companies who had already switched from DB to DC plans must have been quietly satisfied with their decision. This is not to say that DC plans have performed better, just that sponsoring companies have not had to bear the pain.

While the woes of DB plans have been part of the public debate almost daily, DC plans have silently caused a considerable amount of personal anguish. As DC plans typically offer more individual investment choice, the crisis has affected people differently. In general, the crisis has affected people who are closer to retirement much more than those for whom retirement is still a long way off (as they have longer to recover from the steep decline). Many workers depending on DC pension provision have seen their funds decline, forcing them to reconsider or even postpone their retirement plans.

Figure 2: Suffering separately - recovery times for 401(k) account balances



This chart shows the recovery times for 401(k) account balances for plan members with different tenures in the plan.

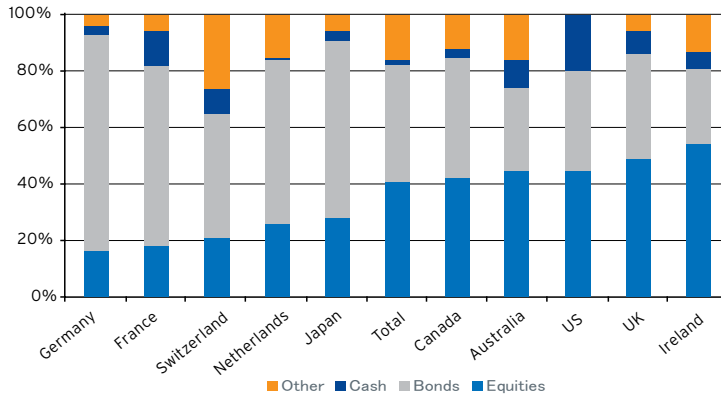
Under certain assumptions, of the members who have been in the plan for between 10 and 19 years, the 10% worst off will need almost four years to get back to their pre-crisis account balances.

(Source: VanDerhei, 2009)

How long will it take the plan participants to get back to the pre-crisis level? The chart shows that the impact varies widely, even within the same tenure groups. The main factors are the percentage of equity-related holdings and the ratio of annual contribution to account balance. Participants who have been in the plan longer are generally affected more because of their higher account balances.

DC-based pension plans place the burden of risk entirely on the plan participant. As the chart above demonstrates, the relative risk increases for participants nearing retirement who have a significant holding in equities. While most specialists and financial planners would typically recommend decreasing the risk in the portfolio approaching retirement, studies in the USA indicate that not many people actually do decrease their exposure to risk, with 44% of the oldest active DC participants (aged 56-65) having 70% or more of their savings invested in equities. The impact of the crisis on this group will have been immense.

Figure 3 : Balancing risk and return - asset allocation by country



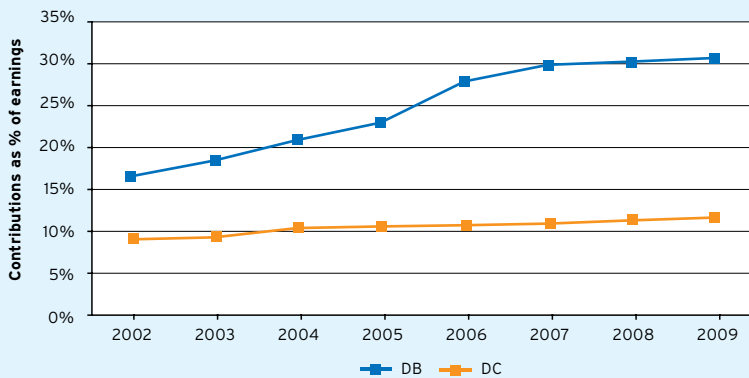
This chart illustrates how investor behaviour in pension plans differs across countries. These statistics, from a 2009 study, show the asset allocation in DB and DC pension plans and the tendency in the English-speaking countries to seek out high risk/high return strategies, while continental Europe and Japan play it safer.

(Source: Watson Wyatt, 2009)

The growing divide - DB and DC in the UK

Contributions into DB schemes have risen significantly over the last years, increasing the burden on sponsoring companies in times when they can probably least afford it. At the same time, DC contributions are significantly and consistently lower than DB contributions. If we wish to create a pension system that will provide adequate pensions, this issue needs to be addressed.

Figure 4: DB and DC contributions in the UK.



(Source: Association of Consulting Actuaries, 2009)

2 DB plans – promises and risk

Throughout the world, DB Plans, their trustees, sponsors and other stakeholders are performing a difficult balancing act, trying to reconcile commitments to retirees with the current financial state of the pension fund and of its sponsoring company. At the core of this balancing act are the promises that have been made to members of the funds. While these promises were made with the best of intentions, they can unintentionally cause a great deal of damage. They create risks that are often simply too large to handle - and have created expectations that may not be met.

Not only will the crisis itself have a strong and long-lasting effect on pensions, but it also serves as a prelude to other potentially greater threats. As people live longer and the balance between retired and working life shifts, demographic developments are slowly but steadily increasing the pressure on both state and private pension plans.

Multinational companies with DB plans are faced with the task of finding ways to moderate the risk they face, to manage it better or to remove it completely. The solutions that are available differ by country, and there may be opportunities to learn from the experiences in different countries.

DB systems

The analysis presented in this chapter is based on three major DB countries: the USA, UK and Netherlands. While there are many similarities between the countries, there are also striking differences - differences that have to be navigated by the multinational sponsor.

Country	DB*	Final/average pay	Indexation	Protection Fund
USA	44%	Mostly final pay	No	PBGC
UK	61%	Mostly final pay	Mandatory	PPF
NL	91%	Mostly average pay	Conditional	-

* Assets in DB arrangements as a percentage of total.

(Sources: AEGON and Watson Wyatt 2009)

Widespread acceptance of average pay formulas and conditional indexation has made Dutch DB more adaptable to adverse conditions and less onerous for employers. This has helped DB continue to be the dominant type of pension arrangement.

By contrast, in the UK, and the USA, many sponsors have turned to DC as their primary pension plan. In the future, the DB/DC asset split will continue to move strongly in favour of DC, as most DB plans are closed to new members or even for new accruals from existing members.

Changing DB design – qualifying your promises

The risks in DB pensions stem from the promises that are embedded in the pension plans. In a stable economic environment and with the support of a strong sponsor, the core DB mechanism works well. However, in times of crisis, when promises are in danger of being undermined, trust evaporates and the defined benefit mechanism begins to be counterproductive.

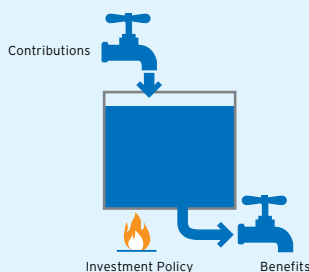
One way to deal with this risk is to go to the heart of the matter and stop making promises at all. This is in fact what many companies have done when they simply abandoned the DB system and moved to DC plans. Another possibility would be to retain DB but to qualify the promises made, so that the plans could be adapted in adverse conditions. From the perspective of the international corporate sponsor, changing the rules of their DB plans is more difficult, as they are, to a large extent, governed by local legislation and regulation on pensions.

The UK is a good example of a country where the regulatory pressures on DB plans have made it very difficult for companies to maintain them. In the Netherlands, by contrast, more scope is allowed for trustees, employers and employees to design flexible structures.

In the aftermath of the crisis, trust in the DB system has been shaken, as it has become clear to sponsors, members and regulators that many promises have been made that are proving difficult to keep. If we wish to maintain an element of DB-based pensions for the future and restore trust in the system, it is important for the system to have sufficient flexibility to adapt to the changing environment.

Risk sharing in the Netherlands

In pure DB (as represented in the diagram), the benefits tap below is always open at a predetermined, fixed rate. The contributions tap on top and investment policy are used to try to make sure that the benefits continue to be paid.



In Dutch-style DB, the benefits tap is not necessarily fixed, and can be opened and closed. This is primarily used for conditional indexation. A more recent invention is what is often called Collective DC. This is where the contributions tap is fully fixed and payouts are varied as necessary. The employer experiences the benefits of DC but the employees still benefit from the DB-like collective nature of the plan. However, if the plan cannot afford it, indexation is either reduced or skipped, and, in extreme scenarios, the benefits could actually be cut.

The Dutch flexibility makes DB more financially sustainable, resulting in a more robust and enduring DB system than in countries like the UK and USA. However, future payouts may be more flexible than members perceive them to be. There is a mismatch between expectations and actual risk. This is currently cause for debate.

In the Dutch environment, this system has worked well. One reason has been the trust that Dutch plan members generally have in their pensions institutions. The Dutch pension system is well entrenched in the Dutch system of consensus in the labour market. Traditionally, employers and employees work together to create a balanced solution for all. This is also the environment within which the Dutch industry-wide pension funds were created. However, this also means that the Dutch model is not easy to export to other countries.

Managing DB risk

Although there is a clear trend of companies moving to reduce their pensions risk, DB risk is likely to remain a reality for many sponsors for years to come. Some companies will retain their DB risk by choice - viewing the DB system as providing them with a competitive advantage in attracting and retaining employees, and are willing and able to accept the risks. Other companies, who have transferred from DB to DC plans, will retain the risk by default, as their legacy DB plans, although frozen, will continue to affect the company balance sheet.

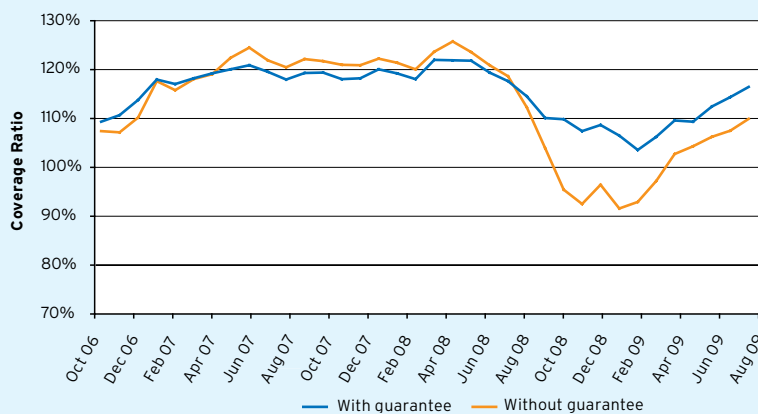
Managing DB risk properly is therefore central to creating a sustainable pensions system. It is important to emphasise that not all risk is necessarily bad risk. In many cases, the pension fund or the sponsor has to find an appropriate balance between risk and return. Striking this balance is one of the major challenges being faced today by corporate sponsors.

In the current environment, where mark-to-market is the norm, CFOs are faced with increasing volatility. In addition, improving mortality rates are creating a longer term concern. It is important that funds and sponsors have a range of tools at their disposal in order to be able to modify the risk profile of their funds. In the last couple of years, many such tools have come to the market - and development is still continuing.

Dutch 'guaranteed contract' and how it has performed during the crisis

DB solutions with built-in guarantees have proven their worth during the crisis. The Dutch pension market has developed a solution, the 'guaranteed contract', that is unique in the worldwide pensions markets. Under a 'guaranteed contract,' an insurance company offers a DB plan that has downside protection while also giving the freedom to choose an investment mix and to profit from potential gains. The guaranteed contract applies not just to accrued benefits, but to ongoing accrual, as well. The contract runs for five years. All liabilities that accrue over those five years will be guaranteed, for which a premium is paid. After five years the contract may be renegotiated.

Figure 5 : Coverage ratio guaranteed contract



(Source: AEGON)

The chart demonstrates the value of such contracts. It is a stylised example in which the pension fund has a 75/25 equity/bonds asset allocation. When the stock market was still doing well, the asset base in the contract increased accordingly, to the benefit of the members. When the crisis hit and asset levels decreased, the guarantee came into effect, providing both sponsor and employees with a level of security.

The simplest example of a de-risking tool is a pension buyout, in which the pension fund transfers all of its liabilities to an insurance company. The insurance company takes over the full responsibility for paying out benefits to the members. A more recent invention is the 'buy in,' in which the fund transfers the risk associated with a selected group of its members to an insurance company.

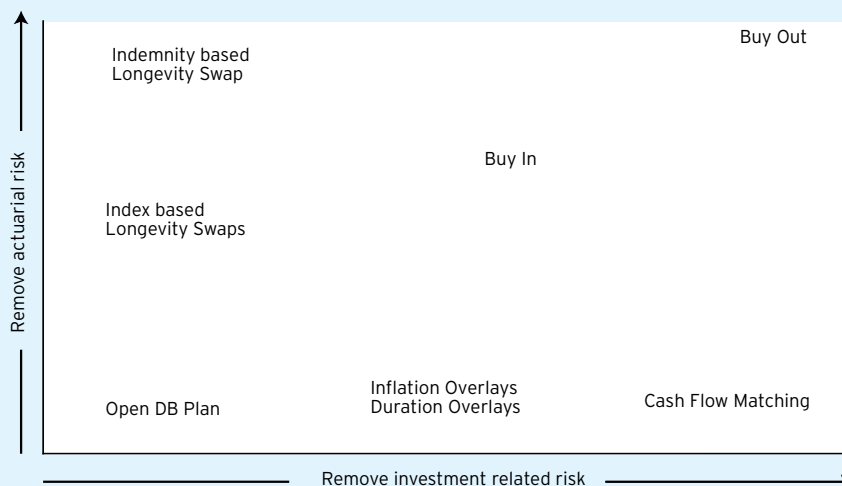
Buyouts and buy-ins can be seen as bundled solutions, in which different risk factors - interest rates, inflation, and longevity - as well as the interaction between them are transferred to a third party. Other mechanisms allow for an even more selective approach to types of risk. Longevity swaps, in which parties exchange longevity risk only, are particularly new development in this field. The market for this type of product is still emerging and promises to grow significantly over the next few years.

All of these instruments explicitly make specific guarantees and protect against clearly defined risks, which in turn helps decision makers to assess the best strategy to meet their needs. In addition, the instruments all involve transferring risk to third parties (either capital market participants or insurance companies) who are willing and able to absorb the risks. Assessing the value of these risk transfer mechanisms is a core element in creating an effective pension strategy both for legacy and active DB plans.

DB Risk Management - Tools

Overlays and cash flow matching address investment-related risks (horizontal axis). Duration overlays are asset management instruments that capture the main risks associated with interest rate movements. They are not as precise as cash flow matching, and do not hedge all scheme-specific risk. The advantage is that the instruments benefit from economies of scale and liquidity.

Figure 6: De-risking instruments



(Source: AEGON Global Pensions)

Along the vertical axis, we have instruments that address the actuarial risk, most notably longevity risk. Index-based swaps trace the developments of longevity indices or mortality tables and therefore capture the risk of generic increases in longevity. Indemnity-based swaps capture the longevity risk in the population of the fund itself.

This diverse set of solutions allows funds and sponsors to specify what risks they wish to retain and what risks they wish to transfer to others and at what price.

3 If DC is the future, we need to strengthen it

Many companies have turned to DC plans as an effective way to mitigate risk (and often also to reduce costs). If we look at DC plans, however, we see that they have also been greatly challenged by the recent crisis. DC plans represent a relatively straightforward mechanism for saving for the future. Nevertheless, some major improvements will need to be made, if we wish to establish a system that will provide adequate pensions for major sections of the population.

The adequacy of present-day DC plans will have an impact on companies in the future. Fortunately, companies are in a position to help remedy the problem. In this section, we identify four key areas in which companies can take action to improve the provision of DC pensions: contributions, investment policy, the phase, and communication and education.

DC systems

In essence, DC systems throughout the world are quite comparable and display more similarity between countries than DB systems. While the USA and UK are transitioning from DB to DC, countries like Australia have established significant DC pension provisions from the beginning.

	DC%*	Contributions	Investment choice	Guaranteed structures	Life Cycles
USA	56%	Voluntary	Wide	Yes	Yes
UK	39%	Voluntary	Wide	No	Yes
NL	9%	Both	Average	Yes	Yes
France	25%	Both	Limited	Yes	Yes
Australia	88%	Mandatory	Wide	Yes	Yes

*Assets in DC arrangements as a percentage of total pensions assets.

(Sources: AEGON and Watson Wyatt 2009)

The US/UK model of offering a wide choice of investment funds has been adopted by many countries, with some continental European countries still significantly lagging that trend. Most countries offer some sort of guarantee, the UK being the notable exception. Life cycle strategies are accepted throughout the world.

Save more

In many countries where DC is highly developed, it is based on voluntary participation and voluntary contributions. Unfortunately, when contributions are not mandatory, other matters may take priority. This issue is being recognised both in the UK and in the USA where auto-enrolment is high on the political agenda, and seen by many as an important and necessary mechanism to overcome employee inertia and strengthen DC pension provision. For this reason, the proposed Personal Accounts to be introduced in the UK in 2012 will include auto-enrolment (although people will still be able to opt out).

Auto-enrolment is an example of how behavioural finance has gained importance in the thinking around the future of pensions. By studying how and why people make investment decisions, we can better understand how to help them save for the future. Another example of using behavioural finance in this way is the SMART - Save More Tomorrow - concept introduced by Thaler and Benartzi, in which new participants sign up to a contribution level that will automatically increase over time. Participants are more willing to contribute in the future than they are to contribute today.

Using behavioural finance may help sponsors to encourage their employees to save more.

In particular, sponsors need to find ways to:

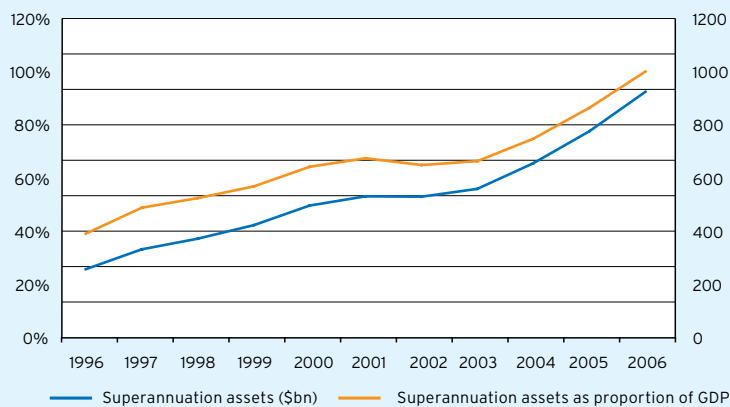
- Increase participation - the more people participate, the better coverage one creates
- Increase contribution levels - sponsors and employees should be prepared to put more money aside
- Begin earlier - starting early is one of the best ways to ensure adequacy.

Some countries have adopted mandatory participation as a means to increase contribution levels. The first country to experiment with a mandatory, funded DC programme was Chile, followed by other countries in Latin America and Central and Eastern Europe. The question is whether mandatory participation and contribution provide an answer for more developed pension markets.

Australian superannuation schemes

In 1992, Australia successfully implemented the superannuation system, a mandatory, earnings-related pension scheme, as the public old-age pension was considered insufficient for providing adequate retirement income.

Figure 7 : Superannuation assets in Australia



(Source: Australian Prudential Regulation Authority)

Above a certain income level, employers in Australia are obliged to make superannuation contributions of 9% of their employee's wages to a fund that is chosen by the employee. These mandatory contributions are placed in individual accounts. Additional voluntary contributions by employers and employees are possible, and individual choice was introduced in 2005.

Setting a mandatory contribution rate is not without difficulties. If the contribution is too high, companies (particularly small to medium sized companies) will complain of the burden. If it is too low, there is a risk that companies will decrease their pension benefits to the minimum level. Is it possible to pick the right level of mandatory contributions?

Invest better

DC pension plans place the burden of making investment decisions on the shoulders of employees. Unfortunately, individuals make many mistakes in constructing investment portfolios as part of their DC plan.

The most important decision members will have to make is the level of risk they are willing to take. There is a trade-off to be made between desired return and potential risk, and it is not easy to judge. Choosing the optimal balance between risk and return is clearly a question of personal preference, and not even professional investors have undisputed answers. However, unlike professional investors, individual plan participants need help to understand the issues involved and in translating their preferences into sound investment decisions. There is a clear role for employers and trustees to help members understand the consequences of the choices they make.

There are three aspects of decision-making for DC plan investments that require the involvement of sponsors and trustees. Although significant improvements have been made in these areas, further improvements can still be made.

Choice

Creating a DC investment portfolio involves choice. Members should be able to choose between a number of alternative investment vehicles. The question is how much choice is appropriate. There are remarkable differences between countries in this respect. The USA and the UK have taken the path of offering a very wide choice of investment funds. In some instances this has probably been taken too far. Most individuals are not equipped to make a choice between hundreds of investment funds. In recent years, this excess of choice has prompted the introduction of guided open architectures and default funds. This trend is likely to continue and provides a good example for other European countries.

In contrast to the UK and the USA, most of continental Europe is still squarely on the other side of the spectrum in providing very little choice. By offering more (but not too much) choice, companies can help their employees become more involved and to take more responsibility for their pensions. Having everything decided for you does not help individuals to become involved, nor does it foster competition amongst providers.

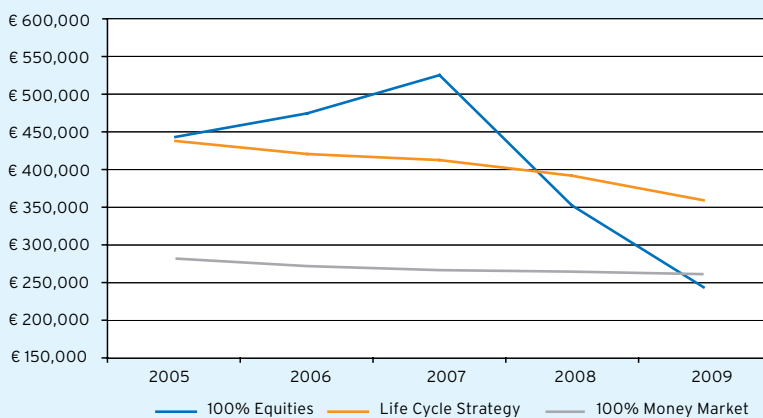
Life Cycle Investment Strategies

The usefulness of life cycle investment strategies is commonly accepted but implementation of these strategies is still patchy.

Lucky timing?

A 100% equities strategy for a DC pensions plan can have a devastating impact. In this stylized example, retiring in 2007 would have resulted in a capital sum saved of over €500K. A colleague retiring two years later, in 2009, would have a retirement income of less than half.

Figure 8 : Choosing the right investment strategy



This sort of risk is clearly unwise to take. Particularly when you realise that only two years before retirement, the outlook of the younger retiree would have looked much more positive. By the time the crisis hit, there would be no time to take corrective measures. The only recourse would be to continue working for another couple of years. This obviously has a major impact on the individual, and may also not be in the interest of the employer.

(Source: AEGON Global Pensions)

Utilising a life cycle strategy may provide more stable results. The employee who retires in 2009 is still worse off than the one who retires in 2007 but the difference is less extreme. More importantly perhaps, the end result is far more predictable. Two years before retirement, the life cycle strategy would have converted the entire portfolio into cash. The reason that the result for 2009 is slightly lower than for 2007 is that the 2009 strategy was affected by the dotcom crisis in the first three years of the century, at which time the 2007 strategy had already started to move out of equities.

While the example above shows the value of life cycle strategies, there are also deficiencies. In traditional life cycle strategies, portfolio weights only depend on the years left to retirement. Life cycle strategies should therefore be implemented on the basis of the objectives and restrictions of the individual member. Is the DC plan a top-up scheme and does the member have significant individual investments as well, or is this the only source of retirement income? These kinds of additional factors could be considered when determining portfolio weights.

In addition, life cycle strategies are typically rigid, whereas dynamically adjusted strategies may prove more effective. Suppose there is a DC plan member who has experienced a long bull market during which the DC savings have grown significantly. A sensible dynamic strategy may decide to convert some of the savings to bonds in order to safeguard the capital sum so as to provide an appropriate level of retirement income to allow the individual concerned to live comfortably in retirement.

Guarantees

The crisis has also reignited interest in investment structures that provide a guarantee to the plan member, and much further development can be expected in this area. There is an obvious attraction to downside protection when it comes to pensions. And pure, traditional DC systems seem to offer little of it.

Development of guaranteed solutions will not be straightforward. One potential solution is to use explicitly defined and priced guarantee structures. These make it obvious to the plan member that the guarantee comes at a price - the question is whether participants will sign up for them. The other possible solution is to employ structures in which the guarantee is 'embedded' into the DC plan at the plan or fund level. However, this may introduce transparency issues. Although guarantees are popular in continental Europe, their lack of transparency appears to be more of an issue in the UK. In addition, both possible solutions will make DC plans more complex and may introduce issues with transferability. Nevertheless, it seems certain that the pensions industry will develop solutions that will offer participants and sponsors downside protection for the future.

Recycling an old concept?

Continental Europe still uses safe DC solutions that have fallen into disuse in the UK. As the crisis has increased the interest in income security, some of these ideas might experience a revival of interest.

- In the Netherlands, some providers offer DC plans that allow for the instantaneous transfer of contributions to deferred annuities. In essence, every contribution is converted into a tiny, guaranteed stream of income. The member may also decide to convert half the contribution into guaranteed income, and the other half into investments.*
- In France, Belgium and others countries, DC plans make use of investment vehicles that are guaranteed by the insurance company and allow for higher returns (depending on investment returns). This concept, also known as profit share, has fallen into disrepute in the UK because of issues around transparency.*
- DC plans can simply offer a straightforward interest rate on accumulated assets, as if it were a savings account. This type of pension saving solution does not score well in terms of returns, but is very safe, easy to understand and flexible to use.*

Improve the payout phase

The most innovation in the provision of DC plans can be expected in the area of 'dis-saving' or 'de-accumulation.' As DC plans mature and pensioners increasingly come to depend on their DC plan as a primary source of retirement income, the annuity market will continue to develop further.

While it is difficult to predict the future shape of the annuity market, a number of items will be on the agenda.

- As people live longer and have additional sources of wealth and income, retirees might be interested in solutions that not only provide longevity protection, but also allow them to construct the right combination of equity participation and guarantees.
- A third area of interest is likely to be index-linked annuities, particularly if, as some economists predict, we will experience periods of high inflation.

However, the most dramatic improvement is likely to come from a holistic approach to the paying in and paying out phases of a plan. In most DC systems, the two phases are often managed separately from one another while, obviously, they just cover two phases of the same life.

A holistic approach to saving and 'dis-saving' will also allow for phased retirement strategies. In the future, people will go through a middle stage of employment, perhaps between the ages of 55 and 75, when they are no longer working the way they used to, but they are also not fully retired in the traditional sense. They may be working part-time or on a freelance basis. Pension plans and annuity programmes should cater to these retirement strategies, especially as they provide a useful strategy for dealing with an aging population.

A holistic approach can also have a significant impact on the investment strategy. The first step is to look at the fund that the life cycle strategy uses as it is approaching retirement. This fund is often chosen to have a high correlation with the price of the annuity: a high duration bond fund. Such a fund makes sense, as predictable retirement income is more important than a predictable capital sum.

This approach can be taken one step further. When designing life cycle strategies and determining the glide path of weights, the objective should be to optimise risk and return in terms of future retirement income. In thinking about guarantees in DC, it would be wise to consider structures that provide guaranteed levels of retirement income, as opposed to guaranteed capital sums. And when indexation is relevant, these analyses can be done in terms of projected real retirement income.

By taking this approach we seem to be reverting to ideas that formed the basis of traditional DB systems: predictable, possibly guaranteed retirement income, indexation, investment strategies that focus on return early in life and on risk later on, and high, if not mandatory, participation.

Communicate and educate

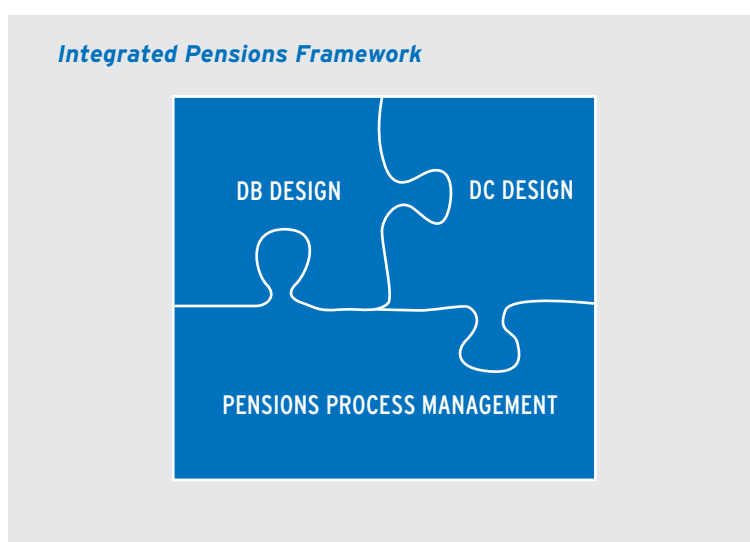
DC plans place the burden of risk on the shoulders of the individuals. At all stages of the plan, the individual needs to make decisions and balance interests. Should I enter the plan? How much should I contribute? What investment strategy is appropriate for me? Do I know what type of fund I should invest in? Do I want a guarantee? Do I need a guarantee? What options are available to me in the phase? Are there any tax efficiencies to be gained?

These are not easy decisions to make and individuals require help that is tailored to their personal needs and situation. Although the company sponsoring the DC plan cannot make the decisions for the individual members, it can present the individual with sensible solutions as discussed above. The individual can also be helped to understand the trade-off between risk and return, and provided with tools to help give insight into the consequences of their decisions. This is also an area where there is a need for government support, as both education in general and financial literacy in particular are essential if people are to make educated decisions on investing for their futures.

4 Pensions process management

On a strategic level, multinational organisations will have to develop a view on their DB and DC plans - and each of these presents a different set of issues. Both DB and DC plans are capable of providing adequate pensions. Many companies now favour DC, but in others DB is still very relevant; in most both DB and DC coexist. It is therefore important to introduce a framework that will allow for proper management of both.

For both DB and DC plans, companies are focusing more on management, organisation and processes. Driven by international legislation and the ever-present need to remain competitive, companies are increasingly looking to adopt a more integrated approach to managing their pension plans.



Below, we identify four key elements that can help your company to develop and implement a successful - and sustainable - pension policy: effective delivery, continued engagement, exploiting cross-border opportunities, and planning for change.

Ensure effective delivery

In addition to deciding on pension strategy, it is now also a good time to make a decision on how you wish to deliver your pensions. Efficient and convenient processes are the key to providing retirement plans that are appealing to both employers and employees. By transferring these processes to a third party specialised in the provision of pensions, companies can focus better on their business needs. To be effective, it is important that outsourcing covers all elements of a company's pension plans, both DB and DC, and that transitioning and delivery are seamless.

Flexible and effective delivery

In various countries, solutions have emerged that help trustees and sponsors to run the fund efficiently. The market solutions differ considerably across countries, yet the solutions seem to have a number of drivers in common.

Trustees and sponsors are looking to ensure effective delivery of their pensions through processes that are both cost efficient and of high quality - and that meet all regulatory requirements.

Investment flexibility is another key element - enabling pension funds to change asset managers as the need occurs. Investment Fund Platforms and Fiduciary Management focus on asset processes more than on record keeping, while Total Retirement Outsourcing deals with both.

While these solutions transfer some of the operational aspects of pension management, the plan sponsor maintains control. These solutions enable the plan sponsor to create an integrated pensions management framework that provides efficiency today and flexibility for the future.

USA	Total Retirement Outsourcing	Outsource all operations, communications, record keeping and investment management activities
UK	Investment Fund Platforms	Employ bespoke set of investment funds created for a single pension fund
NL	Fiduciary Management	Transfer manager selection, ALM and operational processes around investment management process

Be engaged

Although the benefits of de-risking and outsourcing are clear, this does not mean that companies should take a 'hands off' approach to pensions. Pensions directly affect the relationship between a company and its employees. For companies with DB plans, the need for control is evident, as they must have a clear strategy on how much risk they are willing to take. However, companies with DC pension plans also need to retain control of their company pension plans. One of the major problems of DC pension plans revealed during the crisis is that many companies have been too 'laissez-faire' in their attitude to these plans. It makes good business sense to remain closely involved with pension provision and to remain firmly in control of strategy and implementation.

Exploit cross-border opportunities

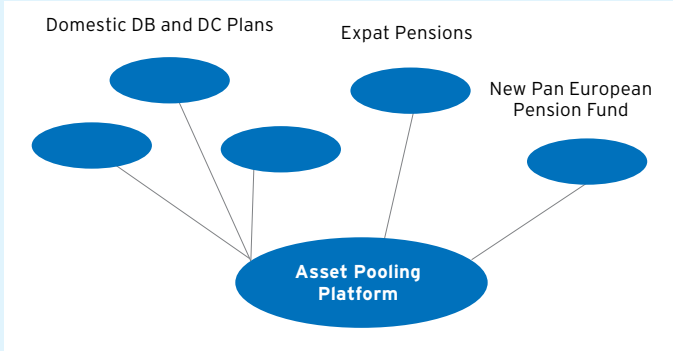
Over the last few years, multinational companies have started looking to create synergies and quality improvements in pension provision across their international organisations. Although the market for cross-border pensions is still developing, there is already a range of international solutions available, including risk pooling, expatriate pension plans and asset pooling.

As the market and international regulations develop, we can expect a continued shift towards more integrated pension solutions, such as integrated administration, servicing and the creation of Pan-European pension plans. In the meantime, multinational companies can already gain many of the advantages of integration by adopting a phased approach, creating an international pensions governance framework, pooling administrative data across countries or pooling assets.

Asset Pooling

One reason for multinational organisations to be interested in asset pooling is that it allows the sponsor to take the first step towards creating a cross-border pensions framework. Effectively, a 'future-ready' platform is established with common asset capabilities and structures that will allow for a smooth transition to future structures. Although true pan-European pensions funds have yet to be implemented, and their potential shape is still uncertain, an asset pooling infrastructure should have the flexibility to support future transition to these new structures (while still being able to maintain domestic legacy funds).

Figure 10: Flexible, future-ready platform



Similarly, a cross-border asset pooling platform can serve as an effective mechanism to enable a multinational company to transition from its current DB systems to a future platform of DC pensions provision. While DB assets might be the dominant element at the start, the balance would shift to the DC assets as time continues.

Plan for change

Like most other aspects of international businesses, pension provision is not static. Companies should take a long-term view and develop a strategy and infrastructure to manage their pensions. When dealing with multiple pensions plans in different countries (for example, when transitioning from DB to DC and/or in de-risking legacy DB plans), companies often choose to adopt a phased approach, integrating or aligning groups of similar pension plans or addressing smaller pension plans first before moving to larger pension plans. Multinational companies looking to make the most of their international footprint may also decide to align their asset management or to begin pooling their pension assets before looking to further streamline or integrate their pension provision.

Creating a pension system for the future

In times of financial crisis, DB plans must try to accomplish the impossible - meeting increasing liabilities with decreasing assets. For many companies, the risk represented by these plans has become too great a burden. In some countries, DB plans that share the risk among stakeholders or that are guaranteed by an insurance company may provide a credible solution. In other countries, many companies have chosen to move to DC plans as the best alternative. However, the present crisis has also highlighted the inadequacy of many DC plans. We must ensure that we take the opportunity now to address the weaknesses of many of today's DC plans in order to create a sustainable and fair pension system for the future.

5 Building pensions for the future - ten guidelines

Manage DB risk effectively

1. Be careful what you promise

Often it is legislation and regulation that stipulate the way that promises are made. Wherever you can, find a way to moderate the promises implicit in a DB plan.

2. Use de-risking mechanisms

The market provides a variety of mechanisms that trustees and sponsors can use to effectively manage risk.

Provide adequate DC

3. Save more

The first priority is to ensure that members start saving early and save enough. Sponsors, trustees and legislators should introduce appropriate mechanisms to enable this.

4. Invest better

DC investment strategies can be improved by offering a suitable degree of choice, well-defined life cycle strategies and guarantees, where appropriate.

5. Improve the payout phase

Improvements need to be made in the way that the payout phase matches retiree needs, with alignment between the accumulation phase and payout phase.

6. Communicate and educate

In order to be able to make informed decisions on how they can best manage their DC pension plan, individuals require expert assistance and advice. Education and communication are vitally important.

Manage the pensions process

7. Ensure effective delivery

Decide on the how you wish to provide pensions. Make sure proper processes are in place to run your pensions well. Outsource where appropriate.

8. Be engaged

Although the sponsor may decide to remove risk from the balance sheet and outsource specific tasks to providers, sponsor engagement remains critically important to a successful pension strategy.

9. Exploit cross-border opportunities

Increasingly multinational organisations are exploring opportunities to benefit from their footprint and global reach.

10. Plan for change

Pension provision is not static, and the future is uncertain. Develop pension strategies that are flexible and adaptable to change.

Acknowledgements

I would like to thank the following people for providing their much valued input and insight.

Martijn Tans

Russell Baird
Jeroen Bogers
Catherine Collinson
Wendy Daniels
Jean Louis Guillaume
Frans van der Horst
Alexander van Ittersum
Bas Knol
David Pilley
John Quinlivan
Frank Randall
Tony Read
Marine Regnault
Thurstan Robinson
Erik Schouten
Kate Smith
Heleen Vaandrager
Rachel Vahey

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AEGON, November 2009