# ACTUARIAL CHALLENGES IN DC SCHEMES: AN AUSTRALIAN PERSPECTIVE



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# OUTLINE

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- **Traditional DC input**
- **Hybrid scheme challenges**
- **Actuarial & shared skills**
- **How do these apply to DC?**
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- **Next steps**
- **Conclusion**

# A Note of Caution

In his seminal work ‘Disabling Professions’, Ivan Illich cautions humanity against the grasping greed of modern professions, whereby they have morphed from serving their communities into self-serving themselves.

In what follows, this caution is worth bearing in mind.

# Traditional role of actuaries in DB

- Traditional actuarial advice related to defined benefit (DB) plans
- Areas: benefit design, liability valuation, investment strategies, solvency, insurance, repatriation to employers, fund mergers and eventual closures
- Included hybrid schemes with a DC component, as well as accumulation schemes with defined pension on withdrawal
- GFC impact
- In defined contribution (DC) plans actuarial role non-existent or limited (to investment strategies, insurance, statutory certifications and unit pricing)
- Economic, demographic and public expectation changes have so the underlying models
- My hypothesis: greater actuarial involvement in DC plans is both necessary and desirable in the best interests of beneficiaries.
- While based on my Australian experience, it can and should apply to all DC regimes, *mutatis mutandis*.

# What has changed?

- Employer preference for DC certainty of paying contributions towards retirement benefits. DB poses volatile risks
- Traditional ‘life-time’ employment giving way to a large number of jobs in a worker’s career
- Need for portability of retirement savings across jobs
- Multiple memberships are more conducive to DC than DB
- Accounting standards: with changes in liabilities to be brought into employer accounts, employer performance could be overshadowed
- With all this, DC has become the norm
- Acceptance of market-related changes to retirement outcomes and the member exposure to risk considerably diminished
- Better risk management, additional capital support (not a feature of pensions industry) and the implications of more people moving into pensions have all demanded greater rigour.
- Paradigm shift

# Traditional DC

- In DC plans liabilities are automatically adjusted as asset values move up or down, as plan members bear the market risk
- Traditionally, corporate plans where employees serve for their whole lives have not encountered the data integrity issues that are now endemic in the era of fund choice and portability
- Ageing populations, the risk of members outliving their savings and the burgeoning size of unfunded social security benefits have focussed attention on securing better DC outcomes
- GFC showed that under extreme conditions, assets may not be sold at any price, may be frozen for years, and voluntary contributions will dry up.
- Compulsory contributions and tax concessions have increased the pressure for the industry to be better managed. Reviews galore!
- DC plans must adapt to preserve confidence and social cohesion

# Hybrid schemes

- Transition phase: hybrids dominate
- With DB and DC, scope for cross-subsidisation and equity issues
- Public offer funds and large master trusts need greater focus
- The Australian default product (MySuper) demands clear segregation from choice products, and ongoing attention to risk management.

# Actuarial & shared skills

- Actuaries are trained by studies and practice experience in skills that will be demand
- Asset liability mismatches
- monitoring investment strategies for relevance to solvency
- potential tax calculations
- holistic assessment of the inter-relationships of the various financial risks (Financial Condition Reports)
- Need to work with other professionals in shared areas: skills convergence across the broader finance professions
- Perfected through life, general and DB super industries, actuaries can adapt to emerging DC demands

# How do these apply to DC?

- Given the higher expectations, greater attention to benefit design will avoid costly errors
- Legacy issues are best avoided by planning at product design stage itself
- With investment choice the norm, and the introduction of the default option, careful planning of investment menus and switching options required
- To ensure segregation and equity, costs have to be estimated and recovery formulae adjusted, with adequacy balanced against simplicity
- Crediting rate / Unit pricing systems need to be rigorous. A sleeper issue
- GFC showed the importance of stress-testing for liquidity and asset valuations
- Operational risk modelling and the estimation of residual risk exposures to estimate risk reserves. As each fund has to estimate its own reserve expert advice is essential.
- Actuaries will need to take the input of other experts on matters such as tax and law.
- Actuaries need to upgrade their training to serve the new demands

# Regulatory imprimatur

- Actuarial advice in DC not generally mandated
- The current focus on improved risk management, will afford such advice to deliver value
- In Australia, work done by Darren Wickham of Mercers Sydney and the resulting Institute Guidance is noteworthy

**PRACTICE GUIDELINE [499.05]**

**FINANCIAL CONDITION REPORTING FOR SUPERANNUATION FUNDS**

# Next steps

- Either for each individual risk, or in a time series for select risks, actuarial assessment of financial impact can add value to trustees
- A comprehensive FCR undertaken say once in three years analysing the inter-relationships of various risks at a given point in time will assist pro-active planning
- Actuaries need to be practically trained by more experienced colleagues.
- Once the value of such professional assistance is known to the market, regulators will also place weight on such input and risk-rate trustees accordingly.
- The profession cannot wait for this role to be mandated
- With convergence of professional armoury, many analogous professionals may assist

# Conclusion

- The far-reaching Australian changes have afforded the opportunity for actuaries to play an important role in DC plans in securing the financial future of beneficiaries
- While the detail will vary, many of the considerations will apply in all national retirement agendas.
- Can the profession rise to the challenge?

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