

Retirement Perspective

Thought-provoking insights on retirement and pension issues facing multinational companies



Common themes, cultural differences: Defined contribution plans in Europe

by *Tim Burggraaf*

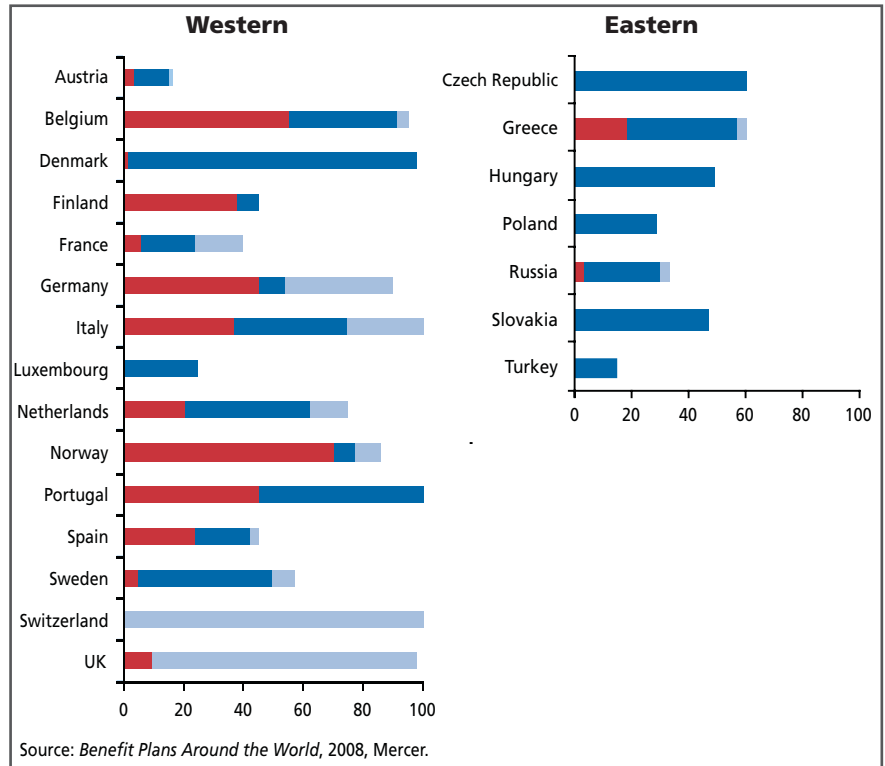
As noted in the previous article, many multinational organizations are wary of moving forward with a Pan-European pension plan. However, a number of these organizations are moving toward a more consistent benefits philosophy across Europe in order to help to create a “branded” benefits culture. In this article, we will discuss defined contribution (DC) plans across Europe and introduce some common themes as well as cultural differences that will help multinational plan sponsors find opportunities to streamline their DC plan designs and plan management practices across borders.

The table below reviews the pension landscape across Europe, demonstrating some of the key market differences in sizes, proportions and types of pension schemes.

Individual Article

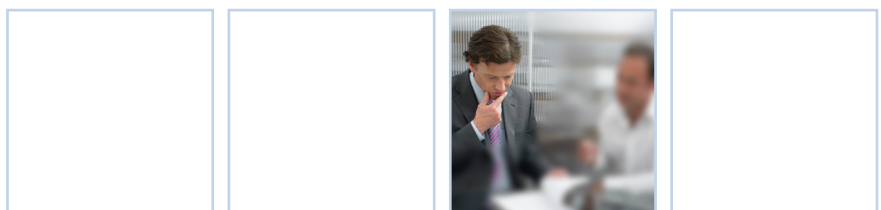


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DC plans from an accounting perspective: Is it really a DB or a DC plan?

If you compare the pension landscape across Europe using the charts above, it suggests a wide variation in occupational pension schemes. But are the approaches to providing retirement security across Europe really that different? Often pension schemes are classified as defined benefit (DB) or DC based on accounting principles, but in actuality the programs are quite similar.



“Although a DC plan might be considered a DB plan based on accounting principles, we may well still ask: What actually is a DC plan from a design and operations perspective?”

Based on European IFRS accounting principles, a pension plan is treated as a DC plan if the “economic substance” of the plan is derived from its “principle terms and conditions” (if we had applied FAS rules, they would have produced a very different perspective). IFRS also expects that “the enterprise’s legal or constructive obligation is limited to the amount that it agrees to contribute to the fund.” This implies that the “actuarial risk and investment risk fall on the employee.”¹

Even though these definitions leave room for interpretation about what is and what is not considered a DC plan, some common debatable exceptions are specifically covered. One such exception is the existence of guarantees, which a number of countries in Europe have introduced as a “safety net” for member retirement security. If a guarantee is one of the plan’s elements, even though the plan otherwise has all the characteristics of a DC plan, it should be treated as a DB plan for accounting purposes. This explains why countries such as Switzerland claim that they can have no “true” DC plans (and are listed in the chart above as having either DB or hybrid plans), but in reality these plans have quite limited balance sheet exposure, similar to DC plans.

Comparing DC plans across Europe from a design perspective

Although a DC plan might be considered a DB plan based on accounting principles, we may well still ask: What actually is a DC plan from a design and operations perspective? And what interesting DC design characteristics might we look at to leverage across borders? Generally, we find that what employers are looking for in DC plans can be summed up in the following definition:

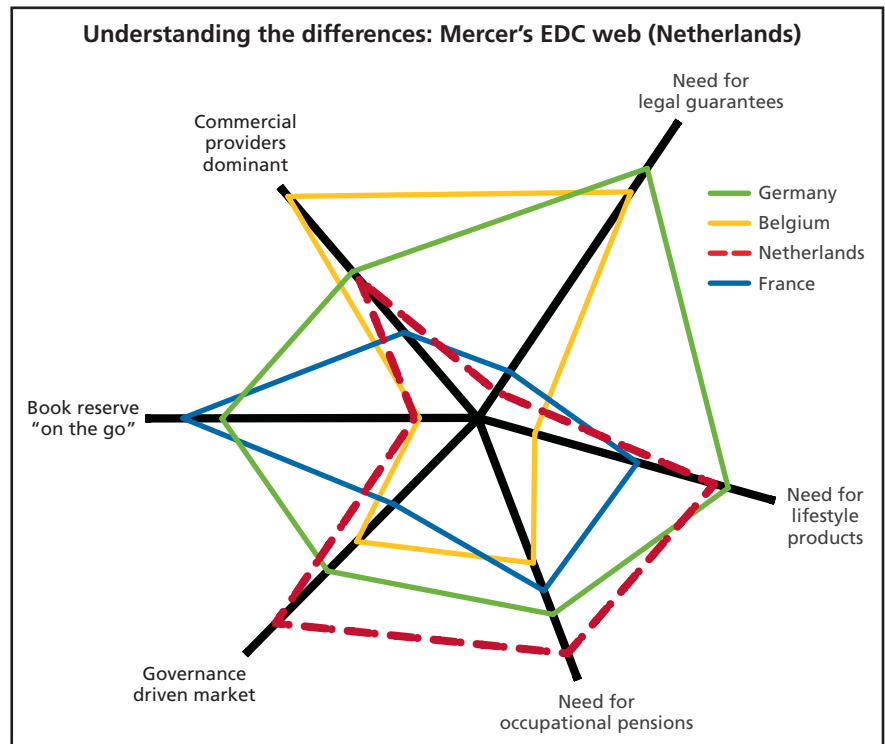
DC plans are pension plans that accrue a pension capital of which the actual level is by definition unknown at the start and consists of contributions and investment returns, reduced by costs and/or premiums. The accumulation of pension capital could be used to either acquire annuities or provide a lump sum payment at retirement, depending on local legislation.

When using this definition, it seems perfectly clear that there is much commonality among DC plans in Europe. Accepting this definition of DC plans, we can look for commonalities and indeed differences in the perception of DC plans across Europe. Some of the key issues when comparing DC models include:

- Need for legal guarantees
- Need for lifestyle investment funds
- Need for occupational pensions
- Whether the market is governance-driven
- Whether the market is driven by commercial providers
- Whether the market is abolishing book reserve systems

¹ IFRS, section “Distinction between Defined Contribution Plans and Defined Benefit Plans,” par. 25.

Mercer has developed an interesting way to compare and contrast these issues in different countries. When these issues are placed on various axes and each country is represented by a line connecting those axes, the country comparison chart looks rather like a spiderweb diagram, as displayed below:



For example, the DC diagram shown above displays that DC markets in Germany and Belgium both score high on the need for legal guarantees. It seems logical to combine activities around this theme in those countries. However, the issue of guarantees seems to have little impact to DC markets in the Netherlands and France. It clearly is not an issue for every European country. When the diagram is used this way, differences across Europe are visualized easily.

Multinational plan sponsors, for whom a specific collection of countries matters (rather than the whole of Europe), can identify differences and common themes very quickly by comparing the relevant countries using this methodology. They can then better understand how the design and management of country-specific DC schemes relate to that of other countries and look for opportunities to standardize design or practices as well as to benefit from economies of scale. If design consistency is attractive in order to simplify plan features and administration, to facilitate cross-border transfers or to move to a more consistent benefits philosophy, it may be worth modifying designs or practices in different countries to make them a closer match with the other countries.

But is it really feasible to expect Europe to move into a "one-size-fits-all" DC market or to expect multinational organizations to adopt a single DC plan design across Europe? Other regions, such as Australia, Asia and the Americas, seem to be making a good attempt at sharing a common set of core values ("pension culture") within their respective regions, even though these values can change over time. However, in Europe, it seems that the differences in pension cultures can vary significantly from one country to another.

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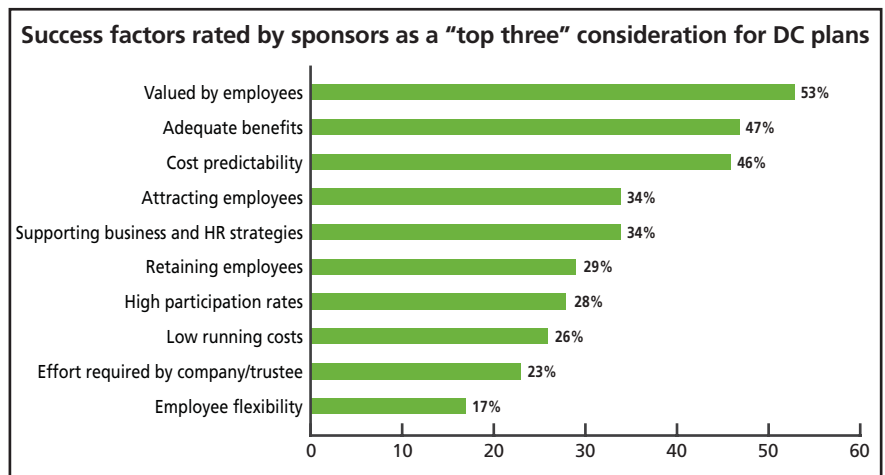
DC plans: Defined by different cultures

The differences between various DC models in Europe are seen as one of the main hurdles to developing a one-size-fits-all DC plan. Europe is historically divided into sectors that either have very strong DB traditions and strong state pensions or have very limited pensions. But even sectors with limited pensions are now generally moving or have moved into DC models of some kind (for example, in Eastern Europe). In fact, across Europe the trend to DC is certainly gaining momentum, with many new DC plans being introduced. Mercer’s 2008 European DC survey indicates that most of the DC plans in Europe are relatively new, having been in existence for less than seven years.

In countries with strong state pensions (which might now be under threat) or very limited pension plans, a newly introduced DC plan will not be seen as a deterioration of benefits. However, countries that have enjoyed a strong DB culture in the past are now being asked to move into generally less valuable DC plans. What’s important is that employees in these countries value their plans and are fully engaged. This issue of ensuring that employees value their DC plans, recently disclosed in Mercer’s *European defined contributions survey 2007/2008*,² was identified as the main objective of employers at this time. (See graph below.)

Another area of stressful change is that in some European countries, separate legal entities (such as pension funds or trusts) are traditionally being used and have autonomous boards that are appointed to guard the rights of the plan members. Unions usually play significant roles in such entities and focus on solidarity principles that are a key part of their DB cultures. Changing these cultures will take a lot of time (some say generations) and much communication with plan members. However, the object will be to make the necessary changes, keeping the best of the past culture in terms of strong governance while adapting to the DC environment.

DC plans: Defined as a duty of care



² This survey is still open to new entrants.

“Changing course is tough, sort of like turning an oil tanker: To change the direction of pension plans, employers must first monitor the right things and make the right changes early in order to be successful.”

A key focus in Mercer’s European DC survey was employers’ objectives. We found that the No. 1 objective for employers is making sure that their employees value the pension plan. Part of this involves communication, but communicating to employees will yield the desired result only if the plan is actually of good quality and if it is being managed properly. Thus employers will need a set of controls they can use in order to evaluate their plans.

In formulating these controls, employers must:

- Evaluate the quality (relative to the market) as well as the effectiveness of the plan, meaning the way the plan is managed
- Evaluate whether the plan will deliver the desired results, and if not, set up a fallback position
- Determine whether the investment risk and return profile is appropriate
- Determine whether to provide a proper level of contributions

Changing course is tough, sort of like turning an oil tanker: To change the direction of pension plans, employers must first monitor the right things and make the right changes *early* in order to be successful. The Mercer survey shows that 40 percent of plans monitor DC plan benefit adequacy annually and another 40 percent review adequacy every two to five years. Investment performance is typically reviewed more than once a year, according to the Mercer survey. To achieve their goals and meet their employees’ expectations that the plan will deliver adequate benefits, a decisive and effective plan management strategy must be crafted.

In countries such as Ireland and the Netherlands, which have moved into the DC space, we see regulators introducing some level of duty of care in DC plans in which employers must take some control, thus providing a legal basis for plan management. Although this could be seen as another burden for employers, in reality it is a way for them to achieve their goal of providing a highly valued plan. Indeed, even where these principles are not required by legislation, multinational plan sponsors should consider adopting them as best practice.

Toward a unified definition

DC plans exist across Europe, at least from a design perspective, even though many may be viewed as DB plans from an accounting perspective. An appropriate way to manage DC plans in Europe and move toward a more consistent benefits philosophy is to leverage similarities across Europe while being aware of different country perspectives to the plans. Although pension culture may vary, it’s clear from our survey that plan sponsors across Europe want members to value their DC plans. But this won’t happen without member engagement and strong plan management. Setting up a solid DC plan management framework with goals and measures (including a communication strategy) for each of the appropriate countries is critical. Mercer has developed models for success in each of these areas.

Tim Burggraaf is a principal in the retirement business. He is part of Mercer’s European DC Leadership Team and a global DC expert and is a member of several local and international centers of excellence in DC and Pan-European pensions.