FOCUS · The challenges of saving for retirement in a low interest rate environment

All-time low interest rates have become the most characteristic trait of the financial environment over the last few years. An analysis of the causes and consequences of this phenomenon is complex and multifaceted. Among the most directly involved sectors, of note is the case of long-term savings products to cover contingencies such as retirement, disability and death. A period of unexpectedly low interest rates represents a very significant challenge for both savers and for the financial institutions providing such products.

There are two broad families in the extensive catalogue of long-term pension and insurance products. On the one hand, defined contribution plans (DC) where savers (and, if applicable, the promoter) define the contributions to be made and the capital or benefits to be paid out at retirement (or when another contingency occurs which entitles the beneficiary to be paid) depend on the return achieved by these contributions during the period in question. In the case of defined benefit plans (DB), on the other hand, the benefit that will be received by the saver (or beneficiary) is established in advance, while contributions are determined using an actuarial formula. The supplier of the product (pension fund management firm, insurance company, etc.) guarantees the saver will receive the agreed benefit; i.e. a specific return.

Throughout a large part of Europe, and specifically in Spain, DC plans are the most widespread product. In these, savers assume the impact of the return being higher or lower than expected. Consequently the slump in the internal rate of return (IRR) for sovereign bonds is not good news for savers: if they want to maintain the same purchasing power in retirement, they will have to save more and/or shift towards types of assets with a higher expected return (such as corporate bonds and shares), trusting that the higher inherent risk will not materialise once they retire. The financial intermediaries managing and selling these products also face a difficult challenge: duly advising clients and managing pension fund portfolios to achieve, as far as possible, the objectives of their clients without incurring undue risk.

DB plans are widespread in the US and some European countries such as the UK, particularly company pension plans, through which companies guarantee their workers an income on retirement. With this kind of product, the supplier (company, public body, financial institution, etc.) assumes the impact of the return being higher or lower than expected. Unfortunately this impact is acquiring worrying levels in some sectors and jurisdictions. One way to illustrate this is by calculating the coverage ratio, which is merely the quotient between the market value of the assets in the pension fund and the present value of the future payments pledged. The sharp fall in interest rates has shot up the present value of liabilities so that, for instance, it has been estimated that the coverage ratio is barely 50% for funds promoted by municipal and state bodies in the US. The European Insurance and Occupational Pensions Authority (EIOPA), the regulator in Europe, has calculated that DB company pension funds are in a reasonably healthy situation (with a coverage ratio slightly above 100%), with the notable exception of the UK (80%). However, this coverage ratio could fall if low interest rates continue for several years and the promoters of these funds make use of certain clauses that allow them to limit their contributions or reduce the pay-outs they make.

This complex panorama of DB products is triggering significant movements in the sector. Especially in the US, employment-related funds can be seen asking companies for larger contributions, which could push down wages and/or reduce profits and, ultimately, investment. Funds also seem to be reducing their exposure to bonds (traditionally forming the core of their portfolios) and moving towards equity and alternative assets such as hedge funds and private equity. But possibly the most significant move is the overall tendency, for different countries and groups of promoters, to abandon DB plans and prioritise DC type products. This does not resolve the challenge of saving for retirement in a world of low interest rates but merely transfers the sphere of responsibility onto the shoulders of investors. In such a context it is absolutely crucial to have good advice and for retirement investment portfolios to be managed properly. And planning early for retirement is vital.