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what if ?

Making DC fit for purpose

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Making DC fit for purpose

What if?

Conveys opinions of Watson Wyatt consultants about key issues affecting our clients. These pieces are intended to discuss ideas and present original perspectives. Accordingly, nothing in these documents should be construed to reflect the official position of Watson Wyatt or specific consulting advice.

Introduction

Defined contribution (DC) has rapidly become the dominant structure for private sector pension schemes in the UK and, in the last 12 months in particular, it has been stress-tested as never before.

As generations of employees are increasingly going to become reliant upon DC for their future retirement security and as DC is poised to grow in future at an even more accelerated rate, many people are beginning to question whether DC, as it exists today, is up to the job. What can be done to ensure that, going forward, DC is fit for purpose?

While many companies continue to operate defined benefit (DB) and other/hybrid pension structures, for the majority of companies, DC is now the most common pension arrangement available to new joiners. And it is likely to become even more dominant. Recent Watson Wyatt research suggests that half the DB schemes in the UK will close to future accrual in the next three years. This will impact around a million employees, the majority of whom will switch over to a DC pension plan.

When larger employers started enroling their new employees into DC pensions a trend which got into its stride in the mid 1990s it was by definition from small beginnings. Initially there were few members and little money under management. Consequently, DC pensions were below the radar for most senior management teams and too small to really engage the interest of many trustee boards, who still had large DB funds to manage.

But DC has come of age. Indeed, for many private sector employers, the majority of their employees now depend on a DC pension to provide their main source of income in retirement.

DC poses significant challenges for employers. While for most companies, attention remains focused on the major financial challenge of dealing with DB legacies, it is DC that has the potential to create employee management issues. For example, will older employees feel financially secure enough to be able to retire? What impact can that have on succession planning and career progression? Few people currently close to retirement are significantly dependent on DC pensions. But as more and more of the ‘DC generation’ gets into its fifties and sixties, these are issues that will rise to the top of the employee management agenda.

The trend of DB schemes closing to future accrual, with the existing active members moved to the DC plan, creates an additional pressure. This influx of ‘new joiners’ will typically be older, longer-serving and more senior than existing DC

members, and some will be aggrieved about the switch to what they will almost certainly perceive as an inferior pension scheme.

Against this background, can you really put your hand on your heart and say that your current DC plan, which was probably introduced some years ago, is really up to the job? Is the design, governance, investment structure and communication strategy of your DC plan suitable given the audience, the numbers and sums now committed to DC? This is something with which employers, fiduciaries, providers and advisers are now grappling. There are no easy answers, but making DC fit for purpose requires a review of all aspects of a DC plan:

- structure, delivery and allocation of cost
- contributions
- governance focus and role
- investment
- communications
- at retirement support and annuity purchase.

Structure, delivery and costs

A recent Watson Wyatt survey of DC provision within FTSE 100 companies found that two-thirds of DC plans are trust-based and the rest contract-based (group personal pension or stakeholder plans). But there remains, more widely, a trend to contract-based DC provision. This growing preference for contract-based DC is largely driven by a desire to cut operating costs and reduce the overheads of operating a trustee board.

However, this move may, in some cases, be misguided and may even backfire on the employer. The structure of a DC plan itself whether trust or contract has nothing intrinsic about it which makes it more or less expensive to run. The difference in cost is rather driven by the quality of the arrangement and the service that is required in other words, the approach adopted in areas such as communications, administration and investment choice; you get what you pay for. Trust-based plans can reduce their running costs by, for example, taking a traditionally contract-based approach to the treatment of deferred members or by looking at the charges that are applied to members (as opposed to the costs that the company pays).

Trust-based plans can appear to have higher running costs because they are often ‘unbundled that is, with separate investment managers and administrators. Bundled provider charges for contract-based plans are expressed as a percentage of assets under management while unbundled services (especially administration)

> “can you really put your hand on your heart and say that your **current DC plan**, which was probably introduced some years ago, is **really up to the job**?”

are charged at a service level. But the best value structure can change over time the balance can change as more members and funds under management are built up. Moreover, there is nothing to stop some or all of the operating costs of a trust-based plan to be expressed as a percentage of assets under management and for some or all of these costs to be borne by the member. This is something we may see more of.

One of the advantages of DC pensions is the predictability around costs. However, for many employers the regulatory changes coming into effect from 2012, in particular auto-enrolment, are likely to make DC costs far less predictable, at least until things settle down. A challenge over the next couple of years for employers will be ensuring that the structure of their DC plan remains the most suitable in terms of delivery and cost post-2012. And there are some

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significant nuances which, for many employers, may make a trust-based structure surprisingly more attractive as a result of 2012.

Contributions

The biggest cost for employers running DC plans is of course the contributions. The trend in contribution levels to DC plans has been a gently upward one in recent years, but the recession will almost certainly have put a halt to that, at least for the time being.

The trend, according to Watson Wyatt research, was primarily in the direction of making matched contributions, with employers willing to contribute more to the pensions of those employees willing to make significant contributions themselves in effect those most likely to appreciate their employer s efforts. At the same time, there was a trend away from age and service-related contributions, in part driven by concerns about age discrimination.

The most important issue relating to contributions for employers in terms of making DC 'fit for purpose' is around likely replacement ratios. In effect, what sort of proportion of final salary can DC plan members reasonably expect to have as a pension at retirement age? Those employees that have come from a DB environment especially are, in many cases, going to be disappointed with DC. This is one of the attractions of weighting DC pensions spend in the direction of matched contributions it provides the opportunity for motivated employees to push up their overall pension contributions and feel supported by their employer in doing so.

Whilst likely replacement ratios were often considered when DC plans were initially designed and set up often back in the 1990s in many cases, they will not have been considered since, despite facing a very different economic outlook these days.

Until now, employers have largely been free to structure DC contributions as they see fit, but, in future, employers are going to need to ensure that their plan is compliant with the requirements of the 2012 pension reforms. There are two main issues to consider auto-enrolment and minimum contributions.

Employees between age 22 and State Pension Age must be auto-enrolled into a qualifying scheme as long as they are earning over £5,035 (in 2006/7 terms). There must be no inducements to opt out and re-enrolment is required every three years. These requirements include temporary and contract workers. To be a qualifying DC plan,

> As DC pension plan **coverage increases in terms** of numbers of schemes, membership and assets under management, so does the **need for a stronger fiduciary** role.

the minimum employer contribution will need to be 3 per cent on qualifying earnings (all earnings between £5,035 and £33,540 per year in 2006/7 terms). The employee will need to pay the balance up to 8 per cent. Contributions will be phased in over at least three years from 2012 with employer and employee contributions rising from 1 per cent each initially.

Governance focus and role

As DC pension plan coverage increases in terms of numbers of schemes, membership and assets under management, so does the need for a stronger fiduciary role.

Although the Pensions Regulator gives valuable guidance to those operating work-based DC arrangements, it remains the case that there is not a 'one size fits all' DC governance model. Plan and company DC governance structures will be influenced by many factors including:

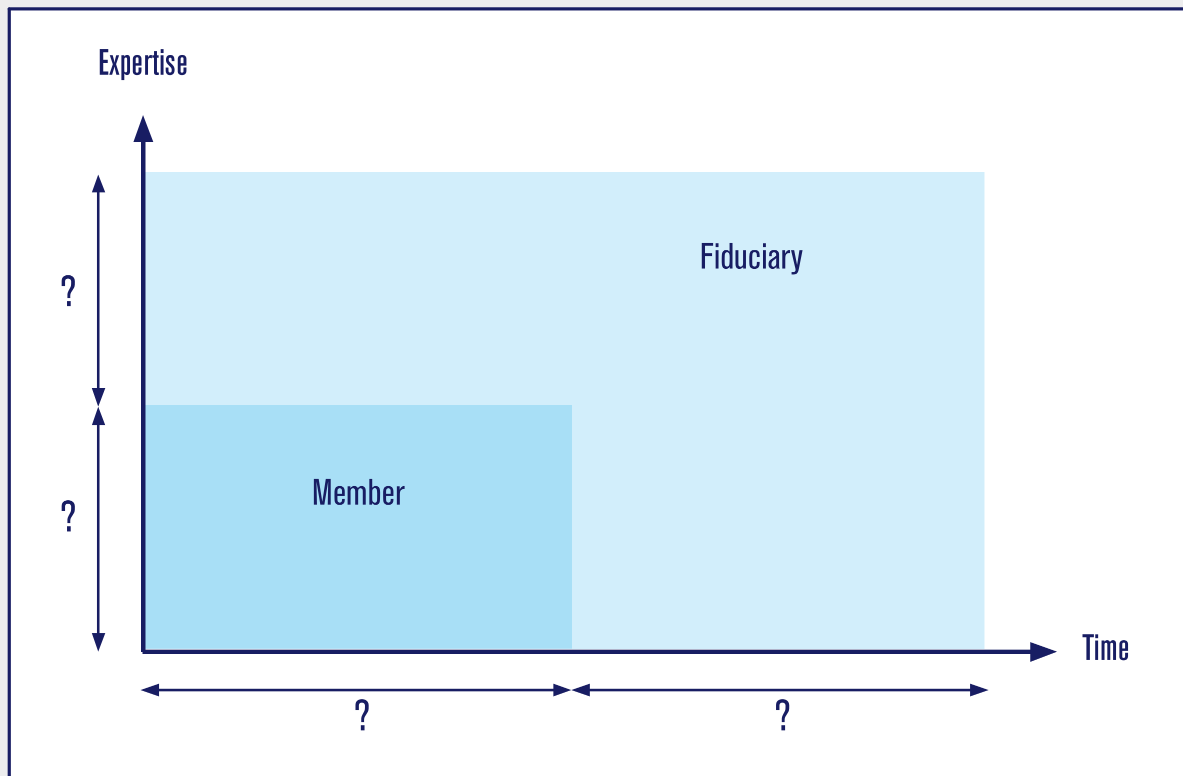
- the size of the plan
- the profile and needs of the membership
- the plan s objectives and corresponding 'success criteria
- the availability of time and resources
- the governance budget.

Governance is a combination of three factors; time, expertise and organisational effectiveness and it is the available level of each, and how they interrelate, that defines the level of governance capability.

Within reason, we do not believe that there is one single correct level of governance capability. The important point is that the fiduciary is clear on how much governance capability the plan has available and that the capability is focused to optimal effectiveness, with the plan s strategy being closely aligned to it.

Clearly, within a DC pension plan, the individual member bears the investment risk and should ideally take responsibility for his or her own retirement savings. Realistically, however, most members are unwilling or unable to make their own investment decisions and, even if they do, there is a practical limit to the governance that they can apply to their own investment arrangements. As a result, we believe there is a vital role in a successful DC plan for a plan fiduciary and that the fiduciary should enhance the members governance capabilities to a more appropriate level, see Figure 1.

Figure 1 | The fiduciary role in supplementing a member s governance capability



> Members should only **take on investment risk** if they have the flexibility to make adjustments to counter any negative outcomes.

Investment

Part of the motivation for the move from DB to DC has been to shift investment risk to the individual member and, along with it, investment decision making responsibility.

This risk has been very apparent in recent volatile times. It would be understandable for DC members to want to adopt a very cautious approach to investment. In itself, that is not a problem, provided that they understand that they will need to pay higher contributions if they are to hope to receive reasonable pensions at retirement. But that will only happen if employers reinforce the importance of paying high contributions. That in turn is only likely to be feasible if vast arrays of confusing investment options are scaled back to manageable levels, to permit greater emphasis to be placed on contributing.

The trade-off between the level of contributions being made into the retirement savings plan and the investment risk taken on through the investment strategy adopted clearly has implications for the member s retirement savings objective. In order to achieve a given target outcome, there are many combinations of level of contribution and level of investment risk taken that will provide the same expected outcome (or likelihood of achieving that target outcome) as shown in Figure 2.

A member who does not wish, or does not have the flexibility, to take on investment risk will be relying on contributions alone to fund the savings accumulation, most likely resulting in a need to pay a higher level of contributions. This approach, however, would reduce the variability of the likely end point and the journey itself will be relatively smooth. If a high level of investment risk is taken,

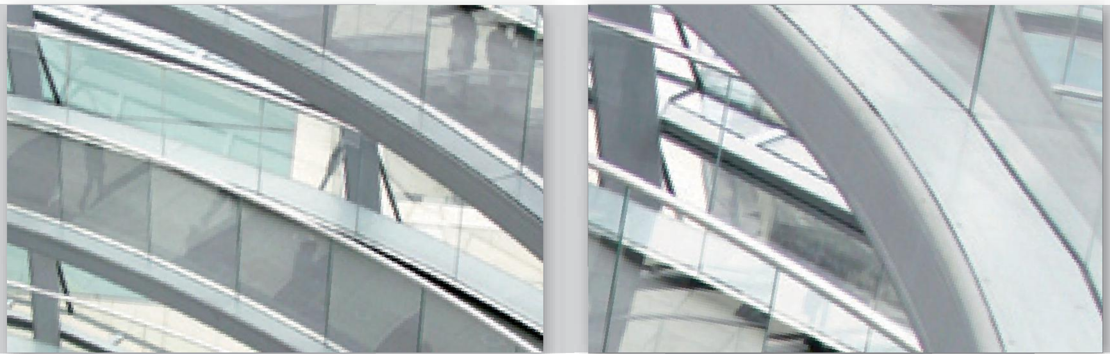
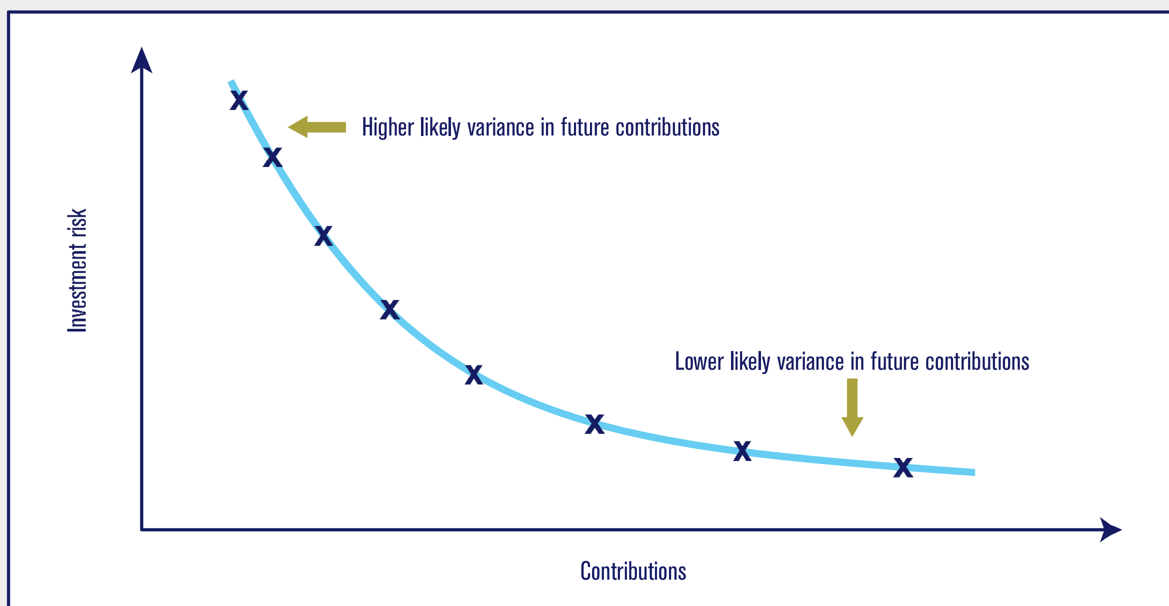


Figure 2 | Balancing contributions and investment risk



Combinations of contribution and risk which have the same level of expected pension at retirement

> A **greater focus** and understanding of members investment risk is essential to **improving** the investment proposition for DC plan members.

then the member may be required to make adjustments to future contributions or goals if the outcome is negative. Members should only take on investment risk if they have the flexibility to make adjustments to counter any negative outcomes.

There is no right answer for how to balance one against the other, but it is driven largely by member preferences and the ability of the member to take on investment risk, as well as their willingness and ability to contribute to the DC plan.

Trustees and sponsoring employers of DB pension schemes are accustomed to the concept of journey planning. Generally they have a clear understanding of how their funding and investment strategies are linked, and the impact of their chosen strategies on benefit security. The concept of journey planning is, however, less developed in the DC world, where it obviously applies at the individual member level. Members are probably more likely to achieve their retirement objectives if they have more clearly articulated goals and the level of interest, ability and tools to support their decision making along that journey. Through understanding and monitoring their progress against a target, members would be better placed to make more appropriate decisions in relation to investment risk – reflecting changes in their circumstances and adapting their savings and investment strategies as necessary.

A greater focus and understanding of members investment risk is essential to improving the investment proposition for DC plan members.

Investment could also be made simpler to understand. Some of this is about terminology: who outside the investment industry understands what 'Global Equity 50:50 Fixed Weights means? And some of it is about the huge array of choice available with some DC pension plans. Do you want Far East with or without Japan? To the vast majority of plan members, it is just not relevant.

Fewer, easier-to-understand investment options would make it simpler for members to revisit their decisions on a regular basis rather than be confused by an avalanche of incomprehensible choices. More choice leads to fewer decisions being made.

In fact, all this choice has historically pushed most members to the default fund. Although that, in itself, may not be such a bad thing, especially if the default adopts a well-designed lifecycling approach.

Lifecycling is about effectively managing a member s risk over time. Ideally a DC plan would take standard membership profiling data and tailor a 'glide-path strategy altering asset allocation with age and years to retirement. The essence of most glide-path designs is the way the asset allocation captures a return premium from risk at the younger ages before de-risking the DC pot in the run-up to retirement. This method is well-established and lifecycle strategies now have an 80 per cent or so share of most DC arrangements in the UK. Importantly, this approach appears to have provided a robust answer to the recent market volatility.

The trouble comes with the recognition that whilst it may be possible to design a suitable single default for a handful of members, it is quite another thing to expect a single default to be appropriate for several thousand members! As a result, it is becoming more appropriate to think about a default investment framework rather than simply a single default investment strategy.

Communication

Recent Watson Wyatt research found that only 18 per cent of employers feel that they are getting full value from their benefits spend. This low proportion may stem from the poor understanding that companies perceive their employees to have of pensions; only 27 per cent of employers surveyed were able to say that they were happy that their employees understood the pension benefits they offered.

> Recognising the need for **emotional engagement** with **DC pensions** needs to be at the heart of any proactive communications strategy.

Employers may point to the low levels of member engagement in DC pension plans and argue that they are not getting value for money. But it is usually more complex than it first appears. At one end of the spectrum, there are some employees typically older, but not necessarily who are actively engaged with their pension planning. This group strongly appreciate the plan and naturally take an interest in communications about it. Similarly, those who have recently moved over from a DB plan are likely to have a stronger interest in their pension, not least because they will be unfamiliar with DC decision making.

At the other end, many organisations have a substantial proportion of eligible employees who have not joined the DC plan. However, from 2012, auto-enrolment is likely to lead to higher take-up levels.

For those between these two extremes, there does often appear to be little engagement, with the majority of members slipping into whatever default settings there are and few taking direct interest in their pension savings. However, it is with this group that good communications can be most effective and valuable. They can help employees appreciate the value they are getting from the pension plan and enable them to see the employer s DC contributions as an important part of their total reward package. It also helps these employees take better decisions about contributions and investment choices.

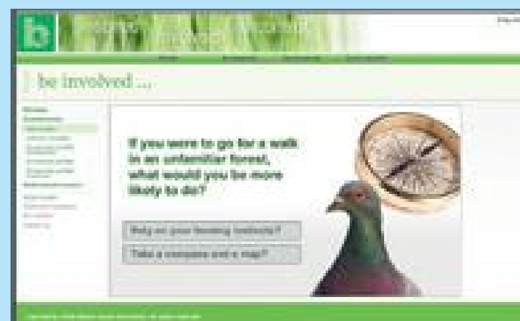
Ultimately, it is about balancing practical solutions with the need to counter the bad press that pensions get. Recognising the need for emotional engagement with DC pensions needs be at the heart of any proactive communications strategy. People need motivation and reassurance that, compared to everything else, company DC plans are a valuable way of saving.

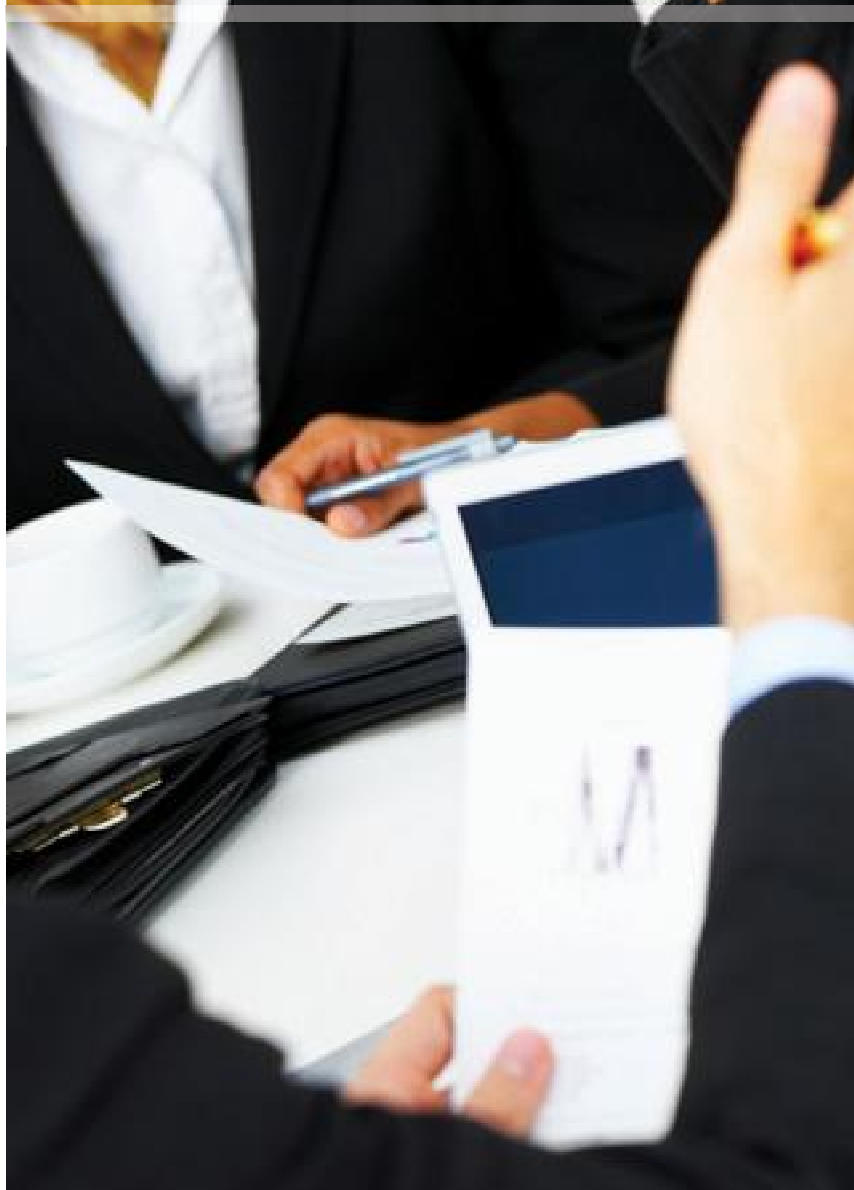
‘Be in touch’ – an online and interactive financial education and planning portal

Watson Wyatt’s ‘Be in touch’ portal is an online educational retirement savings portal for DC pension plan members. It is a simple, easy to navigate portal, offering a real hands-on experience providing information and materials targeting the financial literacy needs of DC plan members. The portal encourages and gives members the ability to ‘take control’ and manage their long-term financial future.

The portal comprises a series of materials intended to educate and inform employees, as well as a number of interactive planning tools encouraging employees to think about:

- their retirement objectives
- saving for the future
- their appetite for risk
- managing their retirement savings
- the conversion of their DC account into a retirement income.





At-retirement support and annuity purchase

An often overlooked aspect of DC pensions is the decumulation stage typically the purchase of an annuity. But the decisions made by DC members at retirement can have a significant effect on the level of retirement income that they will receive. DC members can potentially boost their retirement income by shopping around for their annuity and trustees and employers must ensure that their DC members are provided with the necessary help and support to do so.

Because the average value of a DC pension account at retirement has so far been relatively low, the typical choice of an employee is still the traditional annuity, usually a single life level annuity. However, as DC matures and retiring individuals pension pots grow to significant sizes, a wider range of options becomes both more practical,

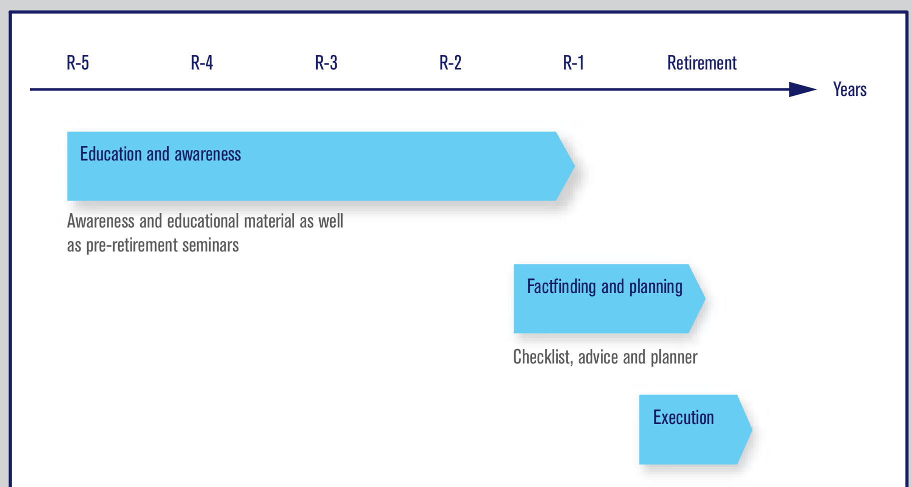
> There are three stages to a **suitable support** framework which employers and trustees will increasingly **need to establish**.

affordable and desirable. In addition to conventional annuities, DC members can consider enhanced unit-linked and with-profits annuities, as well as capital guaranteed annuities, variable annuities and income drawdown.

These alternative options are likely to remain less popular than the traditional annuity for the foreseeable future, but it is imperative that DC members nearing retirement are provided with the chance to consider their options and get the best possible terms for the approach to decumulation that they select.

As it is widely accepted that most employees are not financial experts, if they are to successfully navigate the at-retirement market they will generally need to be provided with a great deal of help and support. We believe there are three stages to a suitable support framework, shown in Figure 3, which employers and trustees will increasingly need to establish.

Figure 3 | Supporting members



Assistance should start early enough to enable members to consider fully both their current personal and financial circumstances as well as their future requirements. Only then will they be in a position to start formulating a view on which at-retirement options will be most suitable for them, enabling the member to make an informed decision.

Conclusion

DC pensions have much to recommend them. The costs are reasonably predictable, much of the process and administration can be outsourced, and they provide employees with a degree of direct control over their own pension savings. With solid contribution levels   with employees encouraged to make a significant commitment – and sound investment choices, they can provide a decent level of pension income.

But employers cannot set up a DC plan and assume it will just continue to perform adequately. For many companies a large number of employees are now in the DC plan. With further closures to DB future accrual and the 2012 regulations, that could become the majority of employees. Governance of DC needs to be proportionate with its new high profile role in a company's benefits arrangements. DC can be relatively low maintenance but to remain fit for purpose, there are regular and ongoing design and communication issues that employers and fiduciaries need to address to ensure they meet employees expectations and get genuine value for money.

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Watson Wyatt DC group

Watson Wyatt has unrivalled experience and understanding of employer-sponsored DC pension provision throughout Europe. Our specialist DC consulting team has been in operation for more than 10 years and over this time has worked for some of the world s largest companies across Europe consulting, administering and communicating DC schemes.

Throughout our network of offices, we offer consulting and operational support on all areas of DC pension provision. Whilst flexible, this service is built upon a consistent approach to DC in which the use and development of tools, processes and thought leadership are shared and coordinated, providing a more efficient and fulfilling experience for our clients.

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