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DC in focus



Key issues and challenges

emerging from DC pension provision

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Welcome

As the growth of DC (defined contribution) pension provision continues both in the UK and US as well as across Europe and beyond, the inherent issues and risks involved in running such schemes are increasingly being recognised. In the UK, specifically, we are beginning to see the emergence of a new, redefined and all round more effective DC pension plan.

Over the last year or so, there has been an almost unprecedented evolution and development of innovative thinking and best practice around the design and operation of DC plans – and it continues to evolve and develop. For anyone interested in running a DC plan, there is much to consider and keep abreast of.

In this publication, some of our leading DC associates consider and discuss some of the key issues and challenges emerging from DC pension provision – setting out some latest thinking and identifying some emerging best practice in this increasingly important area.

Most of these articles were exclusively written by Watson Wyatt for *Pensions World*, which is published by LexisNexis Butterworth. All articles have been reproduced by kind permission of their respective publishers.

I hope that you find these articles interesting, thought-provoking and valuable reading.

If you have any questions, or would like to discuss any of the areas discussed in this publication then please do not hesitate to speak to your usual Watson Wyatt contact or, alternatively you can contact me on **+44 (0) 20 7222 8033** or email me at gary.smith@watsonwyatt.com

Thanking you and kind regards.

Gary Smith



Doors closing

Will Aitken

Watson Wyatt presents an open and shut case for switching from DB to DC schemes.

The recent *Watson Wyatt FTSE 100 survey* found that less than 20 per cent of the UK's biggest companies still offer defined benefit (DB) to new hires. Comparatively few employers have taken the step of totally closing DB schemes, continuing to offer the option to existing employees. Closing a DB scheme to future accrual is a major step for any employer and one that will often be met with opposition.

Given the option, most employees would continue in a DB scheme for as long as possible, citing certainty of benefits as the reason for doing so. But if schemes could close to future accrual in the future, is this the right thing for employees to do? Let us look at some situations that individuals might find themselves in.

Getting in

Alex starts service with an employer aged 25 and joins its 60ths DB scheme, retiring from the same scheme at 65. Brian joins an employer aged 25 and enters a DC scheme where combined contributions are 15 per cent.

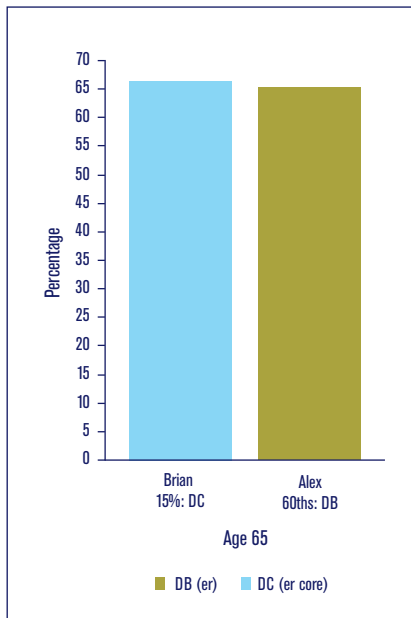
Figure 1 (overleaf) shows that projected benefits at age 65 for the two are almost identical at around two thirds of final salary. In both cases, we have ignored state benefits, contracting out and salary offsets and assumed employee contributions are 5 per cent.

Assumptions are 7.8 per cent for investment growth pre-retirement, 4.45 per cent after retirement, salary growth of 4.45 per cent and inflation at 2.95 per cent.

Of course, Alex and Brian's benefits will only be comparable if they continue to accrue benefits in the same way. Brian can be reasonably confident of this, as there is a fair chance he will find an employer offering a similar DC deal if he changes jobs. If not, he knows what he should pay in additional contributions.

Not so Alex. He needs to make two huge predictions about his future: firstly, that he will never change employer (because he is unlikely to find another open DB scheme). Secondly, even if he never leaves, he must be convinced that his employer will never cease future DB accrual.

Figure 1 | Ratio of pension income per annum to pre-retirement gross earnings



Let us look at a third scenario. Colin joined a 60ths DB scheme aged 25, which closed to new entrants five years later. At 45, the employer ceased future DB accrual offering a replacement DC scheme with a 15 per cent combined contribution. For Colin, DC accrual from 45 to 65 is projected to produce a replacement ratio of just 23 per cent. We project that Colin will get 25 per cent from the DB service and so he might receive 48 per cent of his final salary in total.

What if Colin had opted for 15 per cent DC contributions at age 30? The DC benefits from age 30 to 65 are projected to replace 53 per cent of final

income. We reckon that with the five years of DB service, Colin will receive 58 per cent of final salary in total. So by opting for DC at age 30, Colin would receive around 20 per cent more pension than by clinging onto DB for as long as possible.

Getting out

None of this is new. We know that 15 per cent contributions paid at a younger age are more valuable than 15 per cent paid later in life. We also know that no employer can guarantee that DB accrual will never cease and that no employee can be sure that they will never change jobs.

But do employees keen for the theoretical certainty of DB pensions truly consider these points? Is 20 per cent less pension a price worth paying for greater certainty? Does Colin know that he might find a degree of certainty from state pensions?

We rarely discuss these factors with employees who, given a better understanding of the uncertainties and the potential merits of a good DC scheme, might make an earlier switch to DC, leaving them better off in retirement. From an employer's perspective, this approach could still reduce DB cost volatility, one of the key drivers for closing such schemes. Crucially, if DB accrual ever ceases in future, it will also protect employers from future claims that employees were misled.

Conclusion

- switching from DB to DC mid career is rarely good news for employees
- changing to DC at an early opportunity may produce greater benefits
- employees need to understand that DB accrual may not last forever and DC might be a better long-term option.

Article published in *Pensions World*, January 2008.



Fancy a **bit** of risk?

Gary Smith

Have you had enough risk today?
Perhaps you cannot get enough of it?
So how do you like to get your risk?
Do you go skydiving? Or swimming
with sharks?

Or do you simply run a contract-based pension scheme and do not bother to look after it?

The trouble is, if you do, it is not just you who is bearing the risk. And that does not really seem fair, does it?

Some employers setting up DC pension schemes choose to go down the contract-based (for instance, stakeholder or group personal pension) rather than the trust-based route. There can be many reasons for this decision and avoiding the need for

trustees, and all that goes with it, is very often one of them. But if employers think that, by opting for a contract-based scheme, they can simply get rid of the need for governance or scheme management, they really should think again.

The Pensions Regulator clearly believes that a contract-based DC pension scheme, like any other type of pension scheme, benefits from oversight and periodic review. In their recent guidance on the subject they give several examples of where it can add value and how it can minimise risk to both employees and the employer. In this regard, the regulator certainly wants to encourage employers to adopt and apply voluntarily what it believes to be good practice.

This is not about the legal position on exactly what, if any, responsibilities an employer has with regards to a contract-based scheme. Rather than viewing governance as an overhead or an obstacle to overcome, employers should see it has real and significant business benefit. A compelling business case can easily be made for employers needing to maintain some management control over their organisation's DC pension scheme regardless of whether that scheme is delivered through a trust or contract-based arrangement.

Providing a pension scheme for employees often requires a major financial commitment by an employer – very often

amounting to millions of pounds a year. It is not unusual for pensions to be the second largest component of an individual's remuneration package, after salary. With this level of financial investment and such high prominence in an employee's remuneration package, are employers really happy to leave success to chance? Any other business investment of such magnitude would receive considerable management focus and have very clear, measurable objectives and goals against which the success of the investment will be assessed.

All this sounds very good but in a competitive world with significant resource constraints, what specifically is the benefit of devoting management time to the pension scheme? What is the possible downside of not maintaining management control? There must be very good reasons why an organisation is prepared to spend so much of its financial resource on providing a pension for its employees. These will undoubtedly include the fact that individual employees value this benefit – even if they do not always entirely understand it. It often boils down to a comfort factor for individuals, just knowing that a potential retirement income is building up for them while they are working. But what if that comfort factor begins to be undermined by poor experiences? For example, mistakes, undue delays in money being invested, undue delays in receiving information, or a complete lack of information –

“ Pro-active scheme governance can add real value and make the pension scheme actually work for a business. ”

then the value of this investment by the employer is much reduced.

At a minimum, the governance structure should manage the scheme to an extent where such poor experiences are few and far between and, where they do happen, they are sorted out and steps are taken to ensure they do not happen again. It could, and probably should, go further than this. Pro-active scheme governance can add real value and make the pension scheme actually work for a business.

Furthermore, if you undertook a risk assessment exercise for a contract-based pension scheme, you would identify a long list of potential risk areas. These can range from general management risks, through to risks associated with the scheme provider's administration and investment funds, through to member communication. Once identified, many of these risks can be minimised by regular review and monitoring of the scheme's operations, where issues can promptly be identified or anticipated and suitably addressed or rectified before they become major problems.

Frankly, a structured approach to monitoring and managing the scheme's operations is a small price to pay for safeguarding, and maximising the return on, an organisation's financial commitment, as well as managing an organisation's risks.

So just because the Pensions Regulator is 'encouraging' employers to get more involved in overseeing and reviewing their contract-based pension scheme, rather than 'forcing' them to do so, do not think it is not important. Just ask yourself whether it is really fair to force your employees and fellow management team, even perhaps shareholders, to go skydiving or swimming with sharks just because you personally fancy a nice bit of risk or perhaps cannot get enough of it. What you do in your own life is one thing, what you do to others is surely different.

Article published in *DC World*, February 2008.



The missing **piece**

Jonathan Parker

Watson Wyatt fills in the retirement gaps between contributions and benefits.

How many times do we hear that the problem with DC pensions is a lack of engagement; members are just not interested in learning about equities and bonds and building portfolios. Engagement is a real issue for DC pension schemes but we are addressing it in the wrong way. Instead of trying to help people understand equities, bonds and the various other asset classes, we should express the problem in a more user-friendly way. By creating a clear relationship between the contributions a member pays, the investment options that are available and the ultimate income that might be received in retirement, we present a more meaningful puzzle for the member to solve.

We have tended to design and communicate investment options around asset classes rather than around potential

retirement income. Members are then encouraged to think about managing the risk of their 'portfolio' in a pure investment context, an area where few members are really comfortable making decisions.

The art of the possible

Our approach to member education and communication tends to focus on good investment techniques: balance your portfolio between different asset classes to achieve the best return you can, consistent with a level of risk that you are comfortable with. This approach requires us to educate members about asset classes and how to combine them into efficient portfolios (or 'macro-economic decision making' as my economics professor used to call it).

However, pension scheme members are not studying for economics degrees. They are concerned, though, about their retirement and the level of income that they might receive. They do not want to manage an asset allocation strategy but they do want to plan for their retirement.

We need to reframe the retirement planning question in a DC pension scheme context. We should stop trying to tell people how to manage a 'portfolio' and start helping them understand the relationship between the contributions they pay and the level of benefit they can expect. This process can be improved significantly by redesigning both the investment

options and the communication process that we use to explain them. Instead of providing asset class options, we need to delegate the macro-economic decisions to those better qualified to make them and design investment options that offer a clearer link between contributions and retirement income.

There are a growing number of financial planning tools that allow members to assess how much income they need in retirement, often expressed in terms of 'essential' income and 'nice-to-have' or 'desirable' income. As a member, if I have a range of investment options designed and communicated with reference to the level of income they are expected to provide, then I can use these tools to make my planning much easier (and more understandable).

Down to basics

At its most basic level, our DC scheme could have two investment options: one that is designed to provide a guaranteed (or near guaranteed) level of retirement income per unit of contribution and one that is designed to provide a higher level of income, albeit with more uncertainty (or provide a lower guaranteed income with the potential to receive significantly more).

The issue for members then becomes a question of balancing what they can afford now with what they want to receive in retirement and the level of uncertainty they can afford with respect

to their desired retirement income. I accept that some members may find this approach a bit restrictive, but the aspiring investment managers among us can play the markets as much as they want using ISAs, financial spread betting or the numerous other opportunities that exist for individuals.

The future success of DC pensions relies on our ability to redesign the investment options so that we can reframe the problem facing DC scheme members. We need to shift the emphasis away from investment decision making to a much more understandable issue: the relationship between contributions and retirement income.

Conclusion

- engagement is a problem with DC
- clearer explanation is needed of the relationship between DC contributions and benefits
- DC schemes could have two investment options: one offering a near guaranteed income and the other more income with greater uncertainty.

Article published in *Pensions World*, February 2008.



Manual labour

Richard Tuff

The automation of the trading process is key to dealing with increasing workload from DC investments.

Until recently the process for administrators of DC pension schemes to place trades with fund managers has looked very archaic involving a high degree of manual intervention.

Dealing instructions are sent via phone, email or fax from the administration team to the fund managers who all use different formats. Administrators are required to complete these different formats generally by hand. The fund manager then retypes the instruction into their system for trading. Confirmations are sent via email and/or post to the administrator who in turn types the trade details into their system.

These processes are open to error in a number of places as well as being time and resource consuming. With DC investments growing at their current rate and more

schemes offering members online switching facilities, the number of transactions being placed is spiralling upwards. Surely the solution to this escalating work load cannot be to employ more and more data entry personnel to support the existing manual processes?

The answer is no. The industry has long believed it must be possible to automate the exchange of unit prices, dealing instructions and contract note data. The ultimate goal is to eliminate manual intervention entirely and improve the speed of transactions from a member's 'end-to-end' perspective.

Working together

As a consequence, the Investment Management Straight Through Processing (STP) Development Group (IMSDG) was established in 2004 by leading members of the UK funds industry. The objective was to work together to increase efficiency and improve services by developing common standards for administrators and fund managers alike.

One of its first actions was to agree a common industry language and format to enable messages to be sent and received electronically via an xml standard known as ISO 20022. The goal of the STP group was to prove that transaction requests, prices and confirmations could be passed electronically between fund managers and administrators with the messages being downloaded into each party's

system without manual intervention.

On 11 April 2007 history was made when the first STP deal was passed between an administrator and fund manager (Watson Wyatt and Barclays Global Investors). Since then the initiative continues to grow. What was once an industry dream is now a reality. What is there to stop this becoming the industry norm?

Speed and efficiency

Building a business case is probably the biggest hurdle. Developing ISO 20022 messaging is not a small undertaking; once the system is built, the pre-live testing is even more onerous. Will all DC administrators and fund managers be in a position to invest in this technology and make it pay?

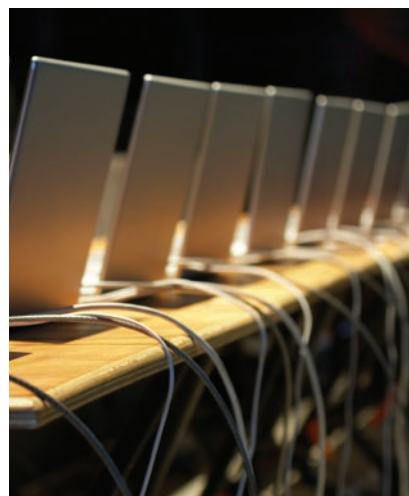
In time for many in the DC market, STP will be established as a minimum standard. This will deliver benefits to the members, trustees and the industry, namely

- the elimination of manual intervention on trades to greatly reduce the risk of incorrect data entry, misdealing and member dissatisfaction
- a speedier investment and disinvestment process
- with DC volumes growing, a scaleable solution that can contain costs more efficiently than a manual process.

“ ...trustees would be unwise not to include STP capability in their selection criteria, when choosing new funds or administrators. ”

With these benefits in mind, trustees would be unwise not to include STP capability in their selection criteria, when choosing new funds or administrators. It is therefore up to the industry to meet this need or face some painful consequences if they do not.

Article published in *Pensions World*, November 2007.





Attractive package

Gary Smith

Employers now have several ways of presenting company benefits to engage the interest of employees in retirement saving.

No one will have failed to notice that the workplace is changing. No longer do people seek a job for life but rather a job for now. Employers in the 'war for talent' are constantly seeking to differentiate themselves and make their employee benefits more attractive. Employees now have far greater choice and flexibility along with more responsibility. Coupled with the rise of DC schemes, employees are being given, with or without their consent, the opportunity or burden of determining their own financial future.

However, in spite of the growing maturity of the DC pensions market and the increasing levels of innovation, many employees are still failing to engage with pensions. This is frequently reflected in poor take-up rates, inadequate contributions and

lack of investment decision making, creating a real problem for employers who continue to allocate significant resources to DC schemes. In fact, evidence would suggest the reverse is true with employees appearing to prefer other ways of building up savings. How many times do you hear people say "My property is my pension"? We also know that current working patterns mean that employees are likely to build up a myriad of pensions and savings vehicles in their working lifetime. This lack of engagement is a worry for employers as it means their employees are unlikely to value the benefit on offer. We know from numerous focus groups that many employees regard pensions in isolation to other, more highly valued benefits.

Greater appeal

Employers can now create an integrated approach to help employees build up a financial plan for retirement rather than just offering a 'pension scheme'. The company may have a number of tools at its disposal for this purpose, including

- the pension scheme
- share plans
- cash allowances (which in turn can be allocated to medium to long-term saving such as an ISA).

From an employee's perspective, these and other savings methods will have different features and benefits that will

“ Changing work patterns and the new legislative environment create both opportunities and challenges for employers. ”

have varying appeal according to their age, needs and circumstances.

For the younger employee, the greater immediacy of ISAs and share plans may have more appeal than the long-term commitment that is a pension scheme. At the same time, employers often want to ensure their employees are making some provision for their long-term future. Fortunately, the post-A day regime offers some help as it is now much easier to integrate the different types of savings. For example, a younger employee could invest disposable income in ISAs or share plans initially and then consider reinvesting the proceeds into a pension scheme later in life, as a way of accessing tax relief on the contributions. Of course, it does involve giving up some of the accessibility and flexibility.

Tying it all together

Changing work patterns and the new legislative environment create both opportunities and challenges for employers. They have a number of strategies at their disposal or under development which would

help employees build a financial plan for retirement, including:

- providing access to a group self-invested personal pension scheme as a means to hold company shares in a tax efficient environment
- offering corporate sponsored savings plans such as ISAs, using their buying power to bring down the cost of investing
- sponsoring financial education to help employees understand how to pull this all together.

While it is unlikely that all employers will want to go down this route, there are real competitive advantages to be gained by providing access to a package of integrated savings vehicles that offer flexibility for individuals to cater for their personal circumstances.

Article published in *Pensions World*, December 2007.





Group SIPPs – a viable option?

Will Aitken

Group SIPPs are becoming a hot topic of pension conversation, particularly the possibility of combining a Group SIPP with a share plan.

Approved share plans offer an extremely attractive method of saving for all parties. When maturing shares are available to employees to keep or sell without tax penalty, tax rules allow the employee a further choice: to transfer shares directly into a pension scheme.

Employees could set up their own SIPP to accept shares but many companies are looking at establishing a Group SIPP to simplify this. Some are modifying share plan maturity documentation to allow employees to simply tick a box to opt to transfer their shares to a Group SIPP. Some are going further and

promoting Group SIPP rollover as part of the appeal of a share plan.

One form of share scheme is the Share Incentive Plan (or SIP). A SIP offers contribution structures similar to pensions (although with lower limits). Employees are able to contribute up to £1,500 pa (or 10 per cent of taxable earnings if less) to buy shares. Contributions are made out of earnings before tax and National Insurance are deducted (much like a pension arrangement operating by salary sacrifice). Employers are able to match employee contributions at any rate of up to two employer sponsored shares for each one that the employee buys. This matching structure is very similar to prevailing trends in DC pensions.

Example – a higher rate taxpayer

Let us look at the figures for a 40 per cent taxpayer who could pay into a pension arrangement or a SIP, but in either case would benefit from a two for one matching contribution from the employer.

If the individual chooses to pay pension contributions of £125 a month, the individual will pay £1,500, at a net cost of £885 (assuming salary sacrifice applies). The employer will pay £3,000 and the total pension fund will be £4,500 by the end of the first year (ignoring any investment returns). This is a five-fold return on the initial net employee investment.

If the same individual instead invested £125 a month in a Share Incentive Plan with the same two for one match, then at the end of the year, they would have the same five-fold return – a net £885 would now be worth £4,500 (ignoring investment returns).

But a SIP allows proceeds to be taken tax free after five years (or earlier on leaving employment as a 'good leaver'). Having obtained tax relief once on the SIP contribution, it is possible to get relief again on a pension contribution. If the individual wanted to use the proceeds of the share plan to boost their pension savings, the shares could be transferred directly into a SIPP after the five-year qualifying period without any clawback of the income tax or National Insurance savings and free of capital gains tax on any growth in the value of the shares. The employee could then choose whether to continue to hold the employer's shares in the SIPP or could diversify the investment.

Assuming no asset growth in the five-year period, shares worth £4,500 on transfer to a SIPP will currently be increased by £1,269 to reflect current basic rate tax relief at 22 per cent. In addition, the individual will qualify for a further 18 per cent higher rate relief through their tax return, which amounts to a saving of £1,038 (18 per cent of (£4,500 + £1,269)).



Combining Group SIPPs and approved share plans can allow employees to get tax relief on contributions twice and greatly boost their pension savings, while enabling employers to encourage share ownership.



So now, after a period of five years, the individual has a pension fund of £5,769, for zero cost to them! In fact, they have an extra £153 in their pocket (the initial £885 net cost, less the £1,038 tax rebate). This contrasts with a 'straight to pension' fund of £4,500 at a net cost of £885.

This route of contribution is attractive even for a basic rate taxpayer and where there is no contribution from the employer. Using the SIP to SIPP route, the employee contributions alone to a SIP for a basic rate taxpayer would produce a pension fund of £1,923 at a net cost of £1,005, while a 'straight to pension' fund would be £1,500 at the same net cost of £1,005.

Conclusion

Combining Group SIPPs and approved share plans can allow employees to get tax relief on contributions twice and greatly boost their pension savings, while enabling employers to encourage share ownership.

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