Navigating the perfect storm

Employee Benefit Strategies in the age of uncertainty

May 2009

STANDARD LIFE

Introduction

A perfect storm of circumstances has forced the UK's biggest companies to rethink fundamentally their employee pension schemes. This issue has national impact and represents one of the biggest sea-changes in pension provision in a generation.

As a consequence, a fundamental shift is taking place in our concept of what retirement means. The received wisdom of retirement as an event, rather than a process, is being challenged and new strategies are being developed to accommodate the radically different perceptions of retirement today from previous generations.

The nation's pension funds have been put under severe pressure in recent years by tougher investment markets, new laws and accounting rules, and an ageing population. With Britain's over-65s now outnumbering the country's under-16s for the first time we live in an age when the commercial organisation of finance and saving is no longer fit for purpose. The tidal wave of pension reform is set to hit the Baby Boomers, Generation X, and Generation Y at different times and with different force.

This paper contends that major employers will successfully meet and afford current and future demands by adopting a strategy based on tailored employee wealth programmes backed by targeted and well-resourced communication, education and engagement programmes.

A fundamental shift is taking place in our concept of what retirement means

The challenge

For the first time, a substantial portion of those approaching retirement does not want to stop working. Research commissioned by Standard Life into the 46-65 year old Baby Boomer generation, confirmed that they want a future that is active and may involve remaining in work, but on their own terms.

The challenge for government, society and the financial services industry is how to enable them to remain productive to answer the dilemma of our ageing workforce.

Employers therefore need to reassess fundamentally their options regarding pension and benefit provision in order to ensure that their offering meets the prevailing demands of the marketplace.

Employees in turn are increasingly looking for greater flexibility in the pensions packages offered to them.

Both trends are receiving considerable scrutiny in the run up to the introduction of personal accounts in 2012 and are the guiding principles which employers must take into account when reassessing their strategic approach to benefits.

Outdated preconceptions associated with retirement must be abandoned. Baby Boomers see retirement as moving forward to embrace new opportunities rather than quitting the world of work.

Employers can no longer base their employee financial planning on traditional defned retirement products that are structured and presented in such a way as to support people in slowing down and disengaging from society.

The debate has now moved well beyond the simple, if stark choice between exposure to massive risks inherent in costly defined benefit (DB) schemes or switching to defined contribution (DC) schemes. Instead they must move away completely from the notion of pensions towards a concept of holistic long term savings and flexible retirement.

In the new era of employee benefit provision the key to success is placing individual responsibility and employee ownership at the centre of any strategy while fostering a collaborative response involving the employers, employees, advisers and providers.

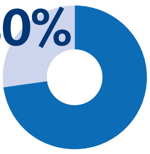
Crucial to a positive outcome will be a far greater emphasis on communication, education and engagement. Based on our practical experience these factors will become central rather than peripheral.

If all parties are to emerge from the pensions crisis then there is a compelling need to overcome the complacency, apathy and confusion that currently dominate employee mindsets.

Employers and employees alike will benefit hugely from the implementation of an innovative and flexible employee wealth programme supported by a properly conceived and executed education and communication programme.

The pensions crisis: key figures

80%



Recent research has shown that some 80% of employers are concerned about their ability to honour their cash funding commitments to their current schemes.

(Src: PwC Pensions Report 2009)

Recent Activity

In the past year defined contribution plans in the UK have lost up to 40% of their value, while those in the US have declined by some $2 trillion.

(Src: George Magnus, UBS, author of the Age of Aging)

£163bn

£182bn

The total FTSE350 pension deficit has ballooned from £163bn to £182bn in the first three months of the year. Clearly this is not sustainable for employers or employees and innovative solutions, drawing on global best practice, offer compelling and attractive solutions for employers, employees and the State alike.

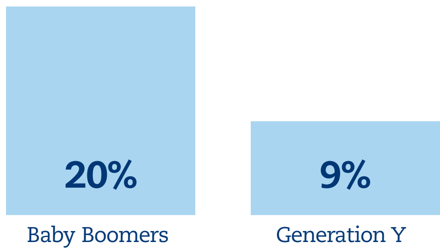
(Source: Hymans Robertson)

90%

A major survey by Aon Consulting in 2008 found that 90% of employees either have no idea about, or substantially underestimate, how much their employer spends on benefits.

(Source: Aon Consulting)

Group Pension membership



The number of Baby Boomers (46-65 year-olds) in group pension schemes is around 20% while just 9% of Generation Y (18-30 year olds) enjoy this cover.

(Src: Standard Life: The Death of Retirement)

2012 and all that: beyond DB, DC and Personal Accounts

Following the recommendations of Lord Turner's pensions commission, radical Pension Reform will be introduced in 2012. This will require the automatic enrolment of employees into a Personal Account pension unless they are already part of an exempt pension scheme. Under its terms employers will be obliged to contribute 3% of band earnings, employees 4%, and the state 1% in the form of tax relief.

Personal Accounts have been seen potentially as a get-out-of-jail free option for employers. Critics argue that it reduces provision to a box-ticking exercise which does not wholly address the huge systemic challenges.

2012 may change the mix of employee benefit spend, with pension contribution being reduced towards the legal minimum but matched with a commensurate increased spend on other wealth benefits.

Certain commentators believe that pension reform will increase labour costs for those organisations which currently offer less generous pension provision. Many employers expect to fund their contribution by reducing costs elsewhere in the business, either through trimming basic salaries or targeting other benefits.

Indeed the majority of employers are unconvinced that automatic enrolment or Personal Accounts provides a viable solution to the pensions crisis.

If people do save for retirement, as a result of automatic enrolment into a good pension scheme, then many will simply reduce or eliminate their entitlement to claim means-tested benefits. If the Government continues to signal that generous means-tested benefits will be available for all, then a significant number of people will fail to save.

2012 may change the mix of employee benefit spend

Doomsday: why employers must explode the cherished myths about retirement

The opportunity and need for employers to provide leadership in educating and engaging with their workforces over pensions is particularly pressing in the light of the continuing widespread misconceptions among the workforce about their prospects at retirement.

It would appear that most people still have the aspiration to retire on an income equivalent to two-thirds of their working earnings, the traditional rule of thumb measure in the industry. Moreover there are concerns that the majority of people still think they are going to be able to retire earlier than they actually will.

These misguided but widespread assumptions are based on received wisdom that is now being challenged in the current environment.

The broad assumption that the substantial equity in your house could be capitalised and turned into a retirement fund no longer holds true. Research conducted last year by Standard Life revealed that the average home in the UK will provide only 16% of people's retirement income through downsizing their main property.

Indeed with average UK houses now costing seven times average UK salaries the delay in getting onto the housing ladder and the upsurge in renting, it can no longer be taken for granted that mortgages will be paid off by retirement.

Linked to this is the fact that ageing of the population means that houses will often have to be sold to finance the cost of long term residential care rather than to provide retirement income. A focus on employee wealth could take consideration of such offerings as long term care insurance as part of a holistic package.

People are still too ready to rely on their partners' pension to support them in retirement but with the pressures on the current system, it can no longer be assumed that current DC arrangements will be honoured even for existing pensioners. In the US, for example, huge employers such as General Motors, Motorola and Sears have all stopped contributing to their 401(k) group pension schemes.

The lessons from abroad

The experience of other nations, which have either already encountered the demographic pressures facing the UK or have implemented employee wealth strategies for post-retirement planning, is both illuminating and instructive.

In terms of population, the Japanese are 10-15 years ahead of the UK's age profile. It is no coincidence that Japan's prolonged recession, dating from the early 1990s coincided with the deflationary effect of an older population.

Older employees spend more cautiously as retirement looms and then spend their savings in retirement giving a compounded problem of weaker demand and lower savings levels.

In more mature DC markets which have already applied automatic enrolment, such as Australia, the US and New Zealand, they have moved beyond terminology based on pensions to a new frame of reference around employee wealth schemes. In Australia they refer to Super; in the US they have 401(k)s and in New Zealand they have Super Kiwi Saver. This reflects the underlying cultural shift in mindset away from retirement to a more holistic lifetime savings ethos.

The experience of Australia has shown, counter-intuitively, that automatic enrolment can lead to a levelling up of provision rather than a levelling down.

Employers have had to learn how to differentiate their benefit offerings post compulsion over the past 16 years. Telstra, the main telco in Australia, now provides members of its pension scheme with access to a range of savings options in addition to the pension. It is not a one-size-fits-all approach but is tailored to meet the different needs of various age groups.

Consequently Australian employees have substantially increased their voluntary contributions to the extent that they now account for half of all Super savings. In the mid-1980s, about 40% of Australians had a private pension. Now the figure is over 90% compared with about 65% of full-time workers in the UK.

In New Zealand the re-engineering of the savings culture began with the launch of auto-enrolled Kiwi Saver. This has been a tremendous success with opt-outs of just 20% in its first year.

Automatic enrolment can lead to a levelling up of provision rather than a levelling down.

Innovation in the UK

While the focus of reform in the UK as a whole has been very much around Pensions Simplification and the recommendations of the Turner Commission, there are examples of ground-breaking and innovative solutions being actively pursued by UK corporations.

The DIY chain B&Q has a deliberate focus on recruiting older people. This emerged from the findings of a 1990 study into a store in the group, which was staffed entirely by over-50s. Academics from Warwick University discovered that the store had greater profits and lower absenteeism. B&Q recognises the value of age diversity with more than a quarter of its workforce over the age of 50 and employees being retained into their 90s.

Corporate SIPPs deliver a blend of innovation, service and quality, which allows employers to introduce cost-effective, flexible and sustainable pension arrangement for employees.

However most employers concentrate almost exclusively on accumulation issues - such as enrolment, administration and investment – while neglecting the hugely important area of what is now being referred to as decumulation. This is the strategy for using the money accumulated in the pension pot to support post-retirement lifestyles.

Annuities may no longer be sufficient to fund life goals. There is considerable risk attached to the current reliance on annuities as the main source of retirement revenue. Annuity rates are exposed to a number of factors such as prevailing interest rates and actuarial assessment of life expectancy trends.

As recently as last year certain annuity rates reached a six year high but the current economic crisis has seen them fall sharply. The forecast longer-term trend is for falling annuity rates reflecting the increase in longevity among the population.

Again this can only be successfully remedied if employers effectively communicate to employees the need to start planning early and engage with them on the services and products that encourage early saving.

Already the more proactive and forward-looking companies are providing solutions such as group SIPPs, group ISAs, stock option transfers and flexible benefits which represents progress towards providing for the flexible future to which most in the contemporary workplace now aspire.

Employers can benefit all stakeholders by doing more at corporate level to encourage people to engage earlier with saving into lifelong products and provide innovative solutions that will harness consumers' excitement for their future.

The road to salvation: key elements of successful benefit provision.

If employers want their group pensions and corporate benefits packages to create value and address the current and future needs of employees then it is crucial that they put in place employee-centred solutions rather than employer-driven offerings.

Achieving this requires a radical change in mindset and approach:

Treat employees as actively-participating consumers rather than passive members of pension schemes.

Take a holistic approach towards employee wealth management. This would offer an entire portfolio of benefits and services. This has the corporate pension at its core but also a corporate ISA, corporate share schemes (which can be rolled into the ISA or pension), savings and investment advice and the full range of flexible benefits.

Use effective communication and education strategies. Participation should not be confused with engagement; the process must be supported by communication and education programmes throughout the workplace in order to reap the optimum results.

Work with experts to deliver these programmes. Research shows that after a Standard Life communications programme, 97% of employees placed a greater value on their pension benefit; 74% felt more confident about their retirement planning and 72% said they would use online tools to manage their schemes.

Rethink obsolete ideas about continued promotion throughout an employee's career. Staff can accommodate themselves to new roles in the company that best suit their age and experience, such as training, mentoring and advising rather than frontline managerial roles.

Increase the proportion spent on communication. This expenditure will be highly geared and generate a far higher return in terms of perceived value of the package. Despite the need for effective communication, two-thirds of UK employers devote less than 1% of their total benefits expenditure to the communication and education aspect while only 15% use total rewards statements to communicate the benefits. Consequently engagement suffers and the true value of the package is not appreciated. Reassurance and information are important.

Focus education as much on the perceived value of the benefits as the practicalities. Much effort in the UK is currently targeted at populating the schemes. Automatic enrolment will free up this resource it can be used to help members make active investment choices and retirement decisions.

Develop user-friendly platforms. This allows employees to have a clear and accessible view of their employer-sponsored financial solutions as well as their own personal assets designed to meet their specific needs. This interface is vital if engagement is to be successful in the long-term.

From the employees' perspective the important elements are reassurance and options but employers can achieve this by a focus on wealth creation and by offering a platform that provides solutions that really excite and engage Baby Boomers, Generation X and Generation Y on their own terms.

In each case their complex financial needs can only be satisfied by combinations of financial products that allow flexibility in terms of investment and drawdown. However, employers who can deliver and effectively communicate such employee-centred solutions will have a considerable competitive edge in terms of workforce quality, engagement, motivation and productivity.

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