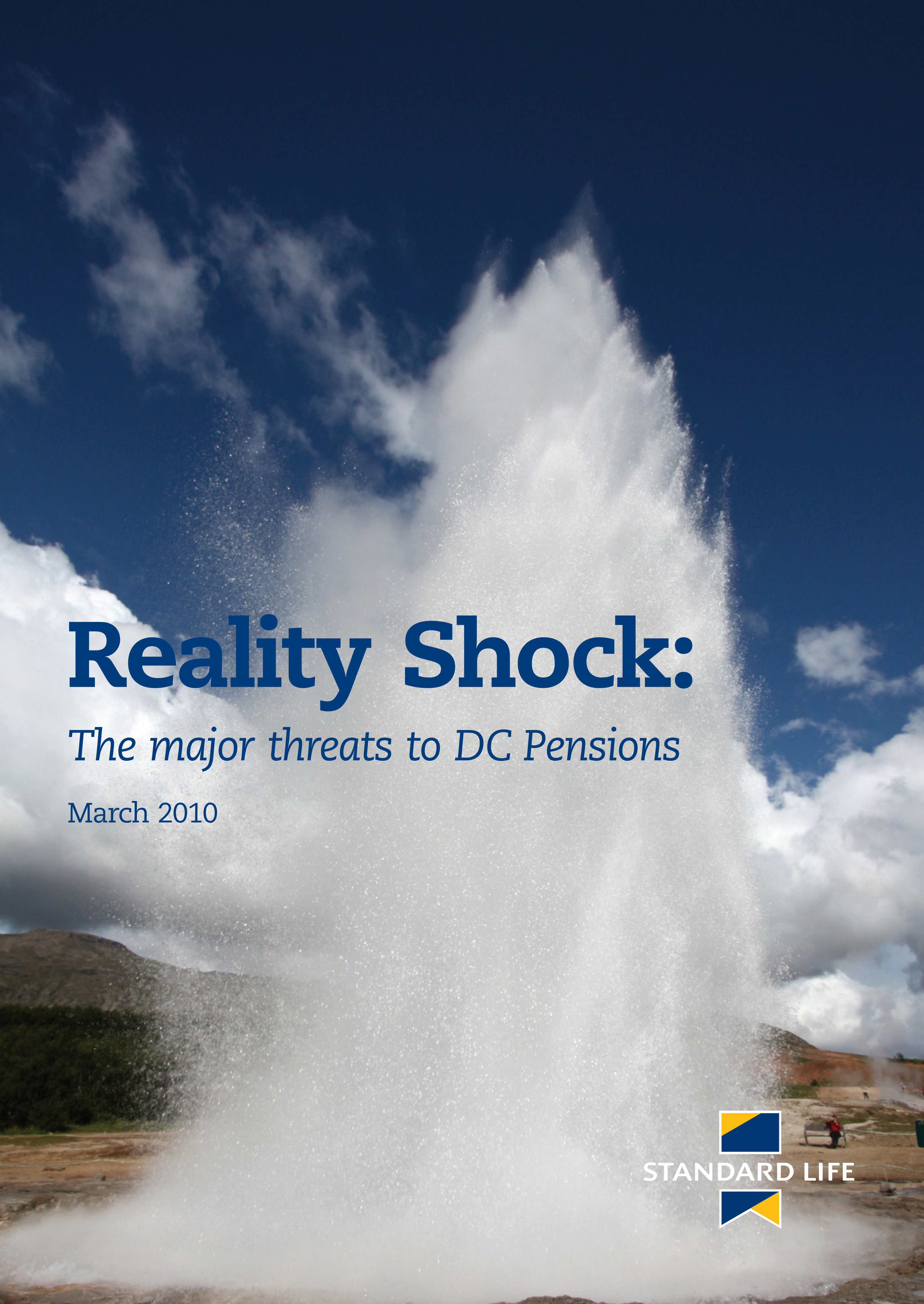

Reality Shock:

The major threats to DC Pensions

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STANDARD LIFE

Introduction

The law of unforeseen consequences is currently proving to hold true with regard to defined contribution (DC) pension schemes.

From the mid-1990s, employers stampeded out of their defined benefit (DB) schemes and into DC in a great escape from the escalating financial burden of their obligations under final salary schemes.

However they are now experiencing a severe reality shock. Since they were fleeing from a problem rather than embracing an opportunity, many employers neglected to devote sufficient time and resource to establishing processes and setting clear objectives for their DC schemes.

With the growing realisation that switching to group personal pensions is not a get-out-of-jail free card has come the awareness that DC presents its own particular set of challenges and issues.

In the current economic climate, myriad threats – at managerial, strategic and systemic level - present a clear and present danger to the successful achievement of positive outcomes for members in terms of their retirement provision.

With the rapid growth of DC schemes in the workplace, the time has come to focus clearly on managing their risks and maximising their value.

In this paper we analyse the nature of those threats and assess how employers must react in terms of reviewing and implementing best practice to ensure that their DC schemes remain competitive, effective and fit-for-purpose.

Insufficient saving

The government-funded Pensions Advisory Service has confirmed that many workers approaching retirement today are facing historically low payouts from their pension fund.

A Moneyfacts market study recently calculated that employees are likely to get just half the income they would have received if they had saved the same amount of money 15 years ago.

This was corroborated by a recent survey (Lincoln Financial Group) which concluded that more than 40% of the UK's population will run out of retirement income by the age of 85, while 11% will exhaust their funds by 70.

Whilst a downturn in annuity rates may be a contributing factor, the downward trend in take-up of group DC schemes is stark: only 55% of employees, on average, are joining.

Clearly, saving for retirement is becoming less of a priority. Employees under 50 are more concerned with paying off debt, meeting mortgage costs and covering the general cost of living.

In the current difficult economic climate, the most immediate pressures are job security, coping with negative equity and personal indebtedness. Pension contributions may be suspended to provide cashflow for the household.

Possible Risk Management Solution

There is compelling evidence that significant improvements in Communication & Engagement techniques will deliver positive results in terms of increased contributions and active investment choice. The latest Watson Wyatt Research on DC plans in the US found that effective C&E has a substantial impact in motivating participants to increase contributions to their plan.

The experience in Australia, where the focus is on Employee Wealth Schemes, indicates that embedding auto-enrolment leads to a levelling up of contributions rather than a levelling down.

Adopting a holistic approach to work place savings that provide for a flexible future, through employee wealth schemes, will appeal to a greater cross section of the workforce, especially younger employees.

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Poor investment choice and performance

If DC schemes are to continue to meet the needs and expectations of their members then it is vital to understand the mindset of individuals and gauge their risk appetite.

In DC schemes individual members are directly responsible for their own investment risk, and are obliged to make their own decisions. It is therefore crucial that rigorous processes are in place for the selection and review of investment managers and funds.

It is also important that the risks are understood by trustees, employers, providers, advisers and members alike.

Some funds might take on more risk than is appropriate in terms of aggressive exposure to equities at an early stage in the fund, whilst others may be overly conservative.

The 2009 Governance Survey found that 40% of DC schemes had not reviewed their statement of investment principles in the last three years.

According to Mercer, the majority of pensions professionals feel that the current trustee governance model is out of date and more than a third believe that slow decision-making is the greatest challenge that pension funds face.

The global financial crisis has revealed that established governance structures can slow down a pension fund's response to market changes and result in considerable losses.

Possible Risk Management Solution

The key is to provide confidence and reassurance for employees who do not take an active interest in their investment options. Innovative default fund designs, such as absolute return funds, may be more successful in meeting members' needs in terms of risk profile and asset allocation. Developing default funds that comprise a mix of bonds, equities, cash and other alternative investments such as hedge funds and commodities will enable an improved balance of risk and return for scheme members.

Importantly, whatever the options, they need to be communicated in a way that can be easily understood by the layperson.

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Pensions Reform in 2012

Companies are increasingly concerned over the affordability of auto-enrolment as a threat to existing DC schemes, and are predicting high opt-out levels. According to the Association of Consulting Actuaries, almost 60% of employers intend to review provision ahead of the proposed introduction of automatic employee enrolment in 2012.

One third of firms have also said that they will level-down pensions ahead of the new regime in 2012. While the advent of auto-enrolment will guarantee a cohort of new pension savers, it is likely to impact on existing schemes.

Perhaps the greatest threat in regard to pension reform is that employers fail to grasp the huge window of opportunity presented by the mass media coverage, and the resulting raised profile and awareness of corporate pension provision.

Possible Risk Management Solution

Proactive employers should prepare now to position their own offering as a preferred option. Otherwise there is a risk that insufficient and poorly targeted communication of the advantages of employer schemes leads to them being eclipsed as NEST dominates the debate.

Again, the Australian experience is that auto-enrolment in schemes leads to an overall leveling up of voluntary contributions.

Tax, legal and regulatory change

Threat from Increased Taxation: Just 6% of firms believe the Government is achieving progress in supporting quality pensions. (ACA, 2010)

On the contrary, according to PwC, 77% of companies providing workplace pensions felt demotivated by the Chancellor’s 2009 Budget.

Further, as a consequence of last year’s tax changes by the Treasury, higher earners on annual remuneration packages of more than £130k will effectively be forced out of their company pension schemes over the next 4-5 years. This affects the majority of directors in major corporations in the UK.

There is a substantial risk that their attitudes to providing a pension scheme for other staff could be adversely affected if they are not personally engaged.

Given the UK's huge current account deficit, there will be a trend towards rising taxes on business and individuals over the next few years. This may create a deteriorating climate for pension savings.

Threat from Legal and Regulatory Change: Uncertainty around DC provision has been greatly exacerbated by the possibility that a new government could make significant changes to the long term savings policy.

There are increasing calls for the scrapping of the default national retirement age. This could mean employees would no longer be compelled to leave work at 65.

Therefore employers must consider their own employment strategies in the light of this development and ensure that their pension scheme contains the appropriate mechanisms to keep staff working or motivate them to retire as required.

Possible Risk Management Solution

Introducing or enhancing an Employee Wealth Scheme will provide access to suitable savings wrappers for all sectors of workforce that are adaptable in an environment characterised by high tax and regulatory flux. Such schemes would include corporate ISAs for all scheme members, DC pensions for the majority and possibly more flexible and tax efficient vehicles for high earners.

Inadequate communication and engagement

Threat from poorly managed expectations: Since the onset of the credit crunch, DC pension scheme members have seen the level of their pension pot reduced by up to 40% at the nadir of the economic crisis.

A recent CBI survey showed that 69% of senior executives feel staff do not value their DC pension scheme as much as the company would like.

The Pensions Regulator confirms that lack of member engagement remains an issue; 35% of large schemes do not assess the effectiveness of their communications.

The typical scheme member is not an investment expert and financial literacy is low. Most employees are therefore passive investors and are invested in a default fund.

Given that limited financial knowledge militates against members developing a properly diversified portfolio, failure to provide sufficient choices in an easy-to-understand format could result in poor investment decisions or even complete disengagement.

Threat from poorly presented information: Most communications, such as Key Features Documents, are too complex and detailed, largely as a result of statutory and regulatory requirements.

The average employee has neither the desire nor the capacity to digest the technical intricacies of their DC scheme.

The Statutory Money Purchase Illustration is arguably the most important communication that individual members receive from their pension providers. However the information is often presented in a counterproductive fashion.

The reputational damage to with-profits funds exemplifies the negative result of setting investment expectations that are too high or unsustainable.

This experience would suggest that in maintaining the perceived integrity of the DC scheme it is better to set realistic expectations and deliver a pleasant surprise rather than over-promise and subsequently disappoint.

Possible Risk Management Solution

Implementation of a comprehensive and properly funded communication and engagement programme with pension scheme members is the key to addressing these risks. The engagement programme should include group-wide tools such as presentations, seminars and websites as well as member-specific information such as personal statements, income estimates and benchmarking.

Additionally, simpler disclosure of information rules, harmonised across all long term savings products, would ensure employers and scheme sponsors can communicate in a straightforward way.

Poor administration and data management

According to The Pensions Advisory Service, poor administration and data processing are among the most frequently lodged complaints at member level.

Data integrity is a major problem in DC scheme administration, particularly in terms of bulk annuity business and buyouts of liabilities of DC schemes. Schemes often end up paying out too much, too little or to people who don't exist.

With investment platforms offering ranges of more than 1000 funds, providers have an enormous challenge in terms of correctly pricing funds.

The latest Capita Hartshead Pension Scheme Administration Survey (2009), found that almost half of schemes surveyed said they needed to undertake a formal exercise to improve the quality of their data.

Straight-through-processing (STP) for pension scheme administration has been heralded as the solution but currently only a handful of major players have fully automated systems, rigorous business processes and audit trails.

Record keeping, reconciliation and communication are all vulnerable in antiquated manual processing systems, which are coming under increasing pressure as the volume of DC transactions increases.

Likewise, properly designed Service Level Agreements between trustees and service providers are not sufficient on their own to overcome the threats from inefficient administration.

Possible Risk Management Solution

Employers could source management information from the scheme provider as evidence of good practice and to create an audit trail. They should also take steps to ensure that administrative practices are rigorous, robust and fit-for-purpose. Governance can foster a culture in which all responsible parties, from payroll to HR, approach DC scheme administration with the same care that they take with salaries.

Reviewing the quality of data on a regular basis is essential. Processes must be put in place to ensure scheme data is kept secure and up-to-date since errors can be extremely time consuming and expensive to rectify.

Unsatisfactory retirement options

Although DC schemes now have an established pedigree in the marketplace, the vast majority of members still automatically annuitise their pension fund at retirement, typically selecting single-life level annuities.

However, volatility in the marketplace as a result of the financial crisis has created a lottery effect with retirement income critically affected by retirement date. There is widespread awareness of this gambling element in securing income in old age, which may harm attitudes towards pensions.

Possible Risk Management Solution

Employers must ensure that members understand the choices that are available on retirement such as open market options and various types of annuities including income drawdown. This can be achieved by providing clear and well-communicated guidelines covering annuity purchase and the alternatives.

The growth in popularity of products such as group SIPP offers a wider range of flexible decumulation options than group personal pension or Stakeholder.

Irrational behaviour

The emerging discipline of behavioural finance has shed new light on the emotional component in investment decision-making. A rapidly increasing wealth of data in the field indicates that perfect information and awareness does not necessarily lead to rational or beneficial retirement investment decisions.

Individual investors are notoriously bad at timing investment decisions. Research in the US by Morningstar showed that, as a result of poor timing in the redemption of equity mutual funds, investors incurred a loss of more than $42 billion in the 12 months to the end of May 2009.

Inertia, procrastination, false sense of familiarity, fear of losing money and popular sentiment all contribute to individuals making poor decisions or, more often, failing to act when they should.

Such irrational behaviour has become a more serious threat in recent years given the greatly increased number of members of DC schemes and the substantial growth in their individual pension funds.

Possible Risk Management Solution

Employers can help improve their DC scheme members' investment decision-making by using a range of elements including employer match, automatic enrolment, contribution increases, the inclusion of blended or lifestyle funds and a limited fund selection. Regular and straightforward communication about DC scheme investment can contribute to employees feeling more positive about participation, improve understanding and enhance decision-making.

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Conclusion

While it is true that each of the threats identified in this paper constitutes a real and present risk to the successful delivery of DC scheme pension benefits to the workforce, it is also the case that these risks can all be mitigated, if not avoided, by adhering to leading edge practice in the areas of employee savings, pension fund governance, communication and engagement, asset allocation, fund design, straight-through-processing techniques and decumulation strategies.

Such an approach not only constitutes an effective risk management strategy but also serves to enhance the quality of outcomes for both scheme members and employers on the upside.

As the DC pension comes of age, the more innovative players are already in the process of developing the next generation model for excellence in DC scheme provision, both individually and collaboratively with providers and regulators. While this paper has sought to demonstrate that all the documented threats can be averted by rigorous processes and adoption of best practice, it remains the case that the greatest threats to DC schemes are complacency and inertia among employers.