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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 Defined Contribution (DC) pension provision continues in the UK 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.

Some of these articles were first published in a regular column, 'DC Debrief', exclusively written by Watson Wyatt for *Pensions World*, which is published by LexisNexis Butterworth. The others were first published in either *Pensions Week* or *Professional Pensions*.

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



Growthspurt

Will Aitken

DC schemes have shot up rapidly and before long they will need new clothes to cover investments

Early on, DC was often set up with no members and no assets. There is an emerging realisation that these unsophisticated arrangements, implemented in an immature marketplace, are generally failing to deliver the desired outcome for employers, trustees and members.

With plans growing and an ever increasing proportion of employees now DC members, there is a trend towards an improvement in UK scheme quality. New ideas and best practice have evolved rapidly as deficiencies in design and delivery have become clear and employers and trustees alike have developed a greater appreciation of the risks and issues involved.

Redesigned

Newer DC schemes and those that have been recently reviewed and redesigned tend to have higher employer contribution rates and we expect this to continue. The Watson Wyatt FTSE 100 DC Survey 2006 found the average employer contribution increased to 9.4 per cent of salary, up from 8.5 per cent in 2004.

We are also seeing quite an investment choice revolution which has greatest potential for influencing a pensions' ultimate size, bar contribution rates. Yet too many members do not understand how these choices can impact on their retirement plans. An appropriate default investment can help, but will not be right for everyone. Having the bulk of the membership passively investing in a default, however well designed, can carry significant risks. When it comes to DC investment, there is a growing realisation that 'less is more' and the key to successful member engagement is to provide simple investment solutions.

In trust based DC, the advent of investment gateways to effectively deliver a strategy, is really opening up the possibilities for more innovative investment choice such as 'white labelled' funds. Instead of offering an explicit global equity fund from manager A, say, a scheme specific growth fund could be constructed. The member does not have to understand what an equity is and whether a global or UK equity fund is better. They just need to know they are in a

“ When it comes to DC investment, there is a growing realisation that ‘less is more’ and the key to successful member engagement is to provide simple investment solutions. ”



growth phase. Should the underlying manager's star wane, it could be easily replaced without disrupting the member's holdings.

Up a size

'Unbundling' is another area of potential improvement that schemes are adopting. It permits greater administrative control and offers trustees access to a bespoke solution. Scheme assets have grown to a size that makes an 'unbundled' approach more financially viable than it was when the scheme was set up with probably little or no assets.

To derive maximum return from their pensions spend, employers should embrace communication and member engagement. Recent Watson Wyatt research from the US shows that members' perception of the quality of their scheme has a greater link to the

quality of communication than it does to the contribution size. The process of education and engagement should not be underestimated. DC communication is evolving into a more critical and complex issue. Employers and trustees are beginning to recognize this and adopting a much more dynamic, multidimensional approach.

Improvements will not end here. Over the next few years, technology will improve further, members will see their assets grow and will begin to demand more. Investment thinking will continue to develop apace and new products will emerge to manage risks. We can certainly expect to see further improvements in DC for some time to come.

Article published in *Pensions World*, March 2007.



Reap what you sow

Adrian Ash

Employers need to plant the seed of a total reward framework to deliver a bumper crop of employee benefits.

Historically employers had a primarily paternalistic attitude: 'Trust us. What we do will be okay for you.' Today there has been a shift to personal responsibility: 'We will trust you (the employee) to decide what is right for you.' Most organisations are now striving to achieve a compelling reward package that makes them stand out. Flexible benefits are regarded as a requirement to compete rather than a way of moving ahead of the competition.

Digging deeper

What the employee gets from their employer is a better understanding of their overall financial position in general and their benefits in particular. As part of that contract, the firm will not necessarily impose or make decisions for its staff, but

rather help them understand their options and make their own choices. Many companies have established new DC pension arrangements, leading to them being firmly positioned within the total reward framework, aligned with any flexible benefits provisions. But how does greater flexibility sit within a total reward offering?

Employees expect to access their pension, benefits and wider rewards through a single access point. A portal approach allows them to see the total value of the employment deal and explore policies underpinning different elements.

What makes for a successful DC integration within a flexible reward environment? This question can be looked at from both an employer and employee perspective. For the latter it requires

- Integrated communications that do not contradict each other. Life assurance rules, contribution rates and eligibility criteria must be checked for consistency with pensions and other benefit arrangements.
- Seamless access to helplines and personal data. This should ideally be online with a single sign on point, making it easy for employees to obtain information and make informed decisions.

- The ability to change contributions and investment choices within a flex enrolment period needs to be aligned with existing pension provisions a secure data flow so that if services are not provided by a single supplier, changes are reflected across every system and as close to real time as feasible.

Holistic future

From the employer's perspective, the challenges revolve around the HR model. Many companies have moved to a shared services environment. When assessing the best way of integrating pensions and flexible benefits within a holistic total rewards framework, firms must:

- ensure that all aspects of transactional activity are moved to the administration layer of a service centre where they will be handled by trained service representatives
- establish that any provider self service tools integrate efficiently and provide the right level of employee and member access within the 'tier zero' design
- focus not just technology but also the administrative processes for pensions and benefits so they align with the organisation's HR model.

Winning organisations are seeking to effect flexible reward programmes that truly capture and express their brand and create total reward solutions that are more than the sum of the parts. Effective delivery is the key.

Article published in *Pensions World*, February 2006.

“ **Employees expect to access their pension, benefits and wider rewards through a single access point.** ”



A matter of **trust**

Nick Cook

A common misperception is that all DC pension arrangements are moving towards a 'contract' based stakeholder or group personal pension basis and that the days of running a 'trust-based' occupational scheme are long gone. This is definitely not the case, particularly amongst larger employers.

Watson Wyatt's FTSE 100 DC Survey 2006 reveals that over three-quarters of DC plans are occupational trust-based schemes. An increase on last year from two-thirds, as well as an increase on the 2004 results. This trend may in part be attributable to the fact that the composition of survey respondents has changed, but it also demonstrates that occupational trust-based schemes remain overwhelmingly popular amongst larger employers. Why should this be so?

Of course it is true that for many employers contract-based arrangements will be the more appropriate vehicle. The low cost, 'bundled' solution where one provider deals with all the required services has many attractions. However, this is not always the best solution and there are a number of reasons why larger employers might prefer trust-based solutions. These are explored further below.

Circumstances

Our FTSE 100 DC Survey 2006 reveals that almost two-thirds of trust-based DC schemes are established as a DC section under the existing trust of a defined benefit (DB) scheme. Where there is an existing trust-based structure that can be utilised when establishing a DC arrangement, this can be attractive to the employer and its employees, particularly where DC members understand and value the fact that their benefits and interests are being monitored by a board of trustees. Additionally, this approach could be the only viable option where a DB scheme is closing to future accrual to be replaced with a DC arrangement, and where the ceasing of contributions to the existing trust would result in the winding up of the DB scheme with unpalatable 'employer debt' consequences.

Flexibility

Employers' preferences will be driven by the flexibility that is required from their pension arrangements. Whereas the 'bundled' nature of contract-based products provides a

simple 'off the shelf' solution, larger employers often want the flexibility and control afforded by being able to contract with different organisations to provide pensions administration, investment management and communication services. Indeed, larger employers are often well placed to provide the administration services themselves. This 'unbundled' structure is generally only available under trust-based arrangements and makes it possible to utilise a 'best of breed' approach to service provision, combined with the flexibility to change individual components of service provision under a scheme if the need arises.

Investment options

Another key differentiator between contract-based and trust-based arrangements is the investment choice that is offered to members. Our FTSE 100 DC Survey 2006 shows that most occupational schemes continue to offer a focused range of investment options – typically between 6 and 15 funds. This is significantly less than the number typically offered under contract-based arrangements. Many employers offering contract-based arrangements do not restrict the investment options available from their providers, despite most providers offering this facility. This means that it is not uncommon for members of contract-based arrangements to be faced with a mind-boggling number of investment options. In excess of 50

investment funds is quite common, and a few providers that spring to mind offer well over 100 investment options under its GPP contract.

An extensive choice is very often not valued by employees. In fact a bewildering choice may act as a disincentive to join or, at best, place an over reliance on default investment options which by nature are not designed to serve the best interests of all members.

It is clear that members need better choices and not more choices. Trustees of occupational DC arrangements are well placed to offer tailored, well targeted investment solutions to their members but until now have experienced problems in trying to do so. Most investment managers do not have appropriate DC products and services and/or will not accept small investment mandates.

Also, the lack of uniformity in UK investment managers' dealing cycles means that any switch of assets between investment funds, and in particular investment managers, can leave a member 'out of the market' for some days, and exposed to the risks of adverse market movements.

However, recent developments now mean that an unbundled DC arrangement can address these issues by introducing an open-architecture investment gateway, or fund platform, between their administrator and investment managers. There are a

number of such providers in the market and their use can result in

- Access to a broader range of investment options (and the use of 'white-labelled' funds).
- Trustees being able to select specialist managers by asset class on a 'best of breed' basis.
- Reduction, or even elimination of 'out of market' exposure on fund switches between managers.
- Potential for enhanced operational efficiency through the interface between scheme administrator and investment manager.

Conclusion

Contract-based and trust-based DC arrangements can live in harmony and both have their merits and disadvantages. The much talked about trend to contract-based is undoubtedly happening amongst small to medium sized employers ... but definitely not amongst larger employers. The predicted demise of trust-based DC arrangements has not materialised and, indeed, they do offer many advantages to employers who are committed to offering a quality pension scheme to its employees. Indeed, for a variety of reasons, we can see that such arrangements are increasing in popularity, particularly amongst larger employers.

Article published in *Pensions Week*, April 2007.



Rules of engagement

Gary Smith

The balance of power is shifting, members are now in the negotiating seat and it is up to employers and trustees to ignite the fuse of interest in their retirement provision.

Many employers and trustees operating DC pension schemes are facing similar issues. Take up rates among eligible employees and contribution rates among members are low – too low in fact to realistically provide an adequate level of income in retirement.

In a recent poll of 50 pension managers, 36 per cent said that lack of member engagement was the biggest single issue they were facing in their DC scheme. The next was concern that many employees may not be able to afford to retire at their normal retirement age (32 per cent). More hard nosed

people may wonder what the problem is. What does it matter to a commercially focused employer?

Game of risk

This is a short sighted and dangerous view. Over the last five to ten years there has been a fundamental shift of risk from employer to employee as organisations move from defined benefit (DB) to DC arrangements. Many firms have built up potential HR risks by forcing pensions empowerment onto employees who are woefully unprepared and generally incapable of dealing with the decisions they have to take.

Companies will not be able to simply walk away from employees who have made inappropriate decisions because their employer made no effort to support them in understanding and/or making them. With the shift to employee empowerment comes a commercial need for the employer to provide suitable and appropriate support. Effective DC communication can maximise returns as well as minimise risks to the sponsoring employer. It can increase performance and an extra pound spent can be more valuable to an employer through increased employee appreciation, than an extra pound in contributions.

Mission objective

The common underlying problem that most UK employers have is that members are simply not engaging sufficiently with their scheme. Whose fault is that? Can employers and

trustees really put their hand on their hearts and say that they are doing everything possible? Some might question whether member engagement is a realistic objective.

Do not expect to make all members personal finance or pensions experts. You are doomed to failure from the start if you do. Some will become very knowledgeable but many will not. It is generally accepted that one can make all members aware of pensions or finance.

Engaging members into their scheme can have significant business benefits and help minimise the risks arising from disappointed or disaffected individuals, like those retiring on pensions considerably less than they expected or those investing in inappropriate funds. Member engagement can be achieved. It is a realistic objective. But we need to refocus and rethink the approach taken.

Article published in *Pensions World*, October 2006.

“ No longer is a member engagement program nice to have but rather business critical. ”

It is easy to say ‘we have tried and it has not worked’. We need to refocus and listen to members. They are generally crying out for more practical help and guidance – this does not mean ‘advice’. Achieving engagement means creating a positive member experience. This in turn requires a consideration of what the individual needs, wants and will experience through being a member. It goes beyond simple traditional disclosure led communication, like providing only a scheme booklet. It will involve giving the right level of help, information and assistance at the right time, in the right way to the right people.





High net worth?

Claire Hall

Online solutions mean DC members can fish for benefits information more easily but how can you stop red herring data from slipping through?

It is becoming increasingly common for DC scheme members to have online access to pension information via the internet or intranet. Administration providers recognise that employees are progressively more IT literate. They are removing the need for paper instructions and allowing employers to tailor their offering to fit their brand, communications strategy and desired member experience.

Offering a web enabled self service tool is cheaper than paying an administration provider to input data from paper. It allows employers to offer an arrangement that fits with their own communication methods. For example, if the employer provides Blackberries (hand held devices for sending and receiving email) to their staff they can be used to access information and target communications via text messages.

Techno trustees

The internet access opens up a host of opportunities for trustees. It enables targeted communications that fit the profile of the individual, as well as the ability to communicate complicated pension changes in a consistent and efficient manner. Another avenue is the promotion of financial education tools to aid members in their lifestyle choices. Members are free to access their pension information when it suits them; they do not have to wait for information to be processed and sent out in the post. All data can be found in one place and they are freed from the need to fill out complicated forms. Online communications also allow them to provide feedback which can aid future developments and new communication opportunities. Using the internet for DC pension information and communication has great advantages. But it is not without its pitfalls.

Fishy figures

Online delivery hinges on the internal processes and data quality within the employer, complemented by the processing model between the employer and the administration provider. Real time data can be viewed by the member to check personal details, run quotations and get an up to date fund balance. This gives the impression that everything is real-time. It means members are exposed to the company's underlying processing and data issues and herein lies a problem.

HR systems are rarely perfect and require a certain amount of manipulation by those using them. For example, payroll staff sometimes need to create dummy data (such as incorrect dates of birth and national insurance numbers) to cheat the system into paying new employees. They are doing nothing wrong but may not realise that this information may be passed by automated feed to the administration provider and automatically loaded onto its database making it visible to the member via the online application. When it was input manually onto administration systems it was easier to pick up data that was obviously false. In an automated environment data is loaded directly without being visible.

Another example of internet access causing a problem is with DC schemes offering member investment selection with more than one fund manager. The UK investment industry does not offer harmonised dealing times. It is difficult to tell members that, depending on the assets they had and where they want to move them to, updating their account could take anything between four and ten working days. The key to an effective online solution is appointing a provider that offers a flexible product and the expertise to be proactive in assisting with data issues and resolution with the company HR and payroll departments.

Article published in *Pensions World*, August 2006.

“ **The key to an effective online solution is appointing a provider that offers a flexible product...** ”



Darwin on DC

Andy Parker

When a strategic decision to set up a DC scheme has been made, one of the first decisions is whether the services to be provided for the new scheme should be 'bundled' (all services through one provider) or 'unbundled' (services through a number of different providers).

Origins

If a contract-based scheme (a stakeholder or group personal pension) is chosen then it will be 'bundled'. If the trust-based route is selected then the scheme could be either 'bundled' or 'unbundled' (or perhaps even 'semi-bundled').

The decision at outset is typically based on a few deciding factors:

- the number of members (could well be none and hence no assets)
- often a lack of experience of operating DC schemes
- cost minimisation
- simplicity in scheme design.

From this beginning, the 'bundled' solution is often selected using the services of an insurance company, with the latter underwriting the initial costs in the hope of longer term gain as the scheme membership and assets grow. A profitability model will usually be used by providers to determine what the charges need to be (usually expressed as a percentage of assets under management) and how long it will take to recoup the initial and ongoing costs and expenses.

Evolution

As schemes mature, the question of the suitability and/or need for a 'bundled' product should come back into focus. Membership numbers will have increased and assets under management grown. Is the packaged solution still the most appropriate? Is it still offering value for money? Trustees should not be slow in ensuring that the services provided

remain 'de rigueur' and cost effective for the scheme they are now, not the fledgling operation they once were.

The Pensions Regulator continues to provide guidance to DC trustees to help them improve their own knowledge and as a result, hopefully, the quality of their DC schemes. Trustees should now have a better understanding of what it takes to operate a DC scheme and can therefore consider in more detail exactly what it is they, and their members, require from a service provider(s). This experience of scheme specific requirements was obviously not available at outset.

Survival of the fittest

A strong governance process will help trustees to set out what it is they are looking for in the operation of their scheme. A review of exactly what is required may well now throw up different answers to those given when plan design was considered at outset. Cost should no longer be a barrier to choice and it should now be possible to determine:

- the areas in which a scheme administrator needs to be strong
- the investment solutions which best fit with the membership's demographics or which should be considered for the future
- the communication styles which work best for their membership

- the way in which the service providers need to report back to the trustees to enable them to perform their governance role effectively.

It will then be necessary to review how best to attain the desired objectives.

- Is a specialist administrator required to meet with the tailored scheme approach?
- Is the desired approach to dealing with 'best in class' investment managers still only aspirational, or would the flexibility afforded by an Investment Gateway be more appropriate?
- Would an independent communications consultant be better placed to provide a bespoke communications programme, if this is what is required?

'Unbundling' the services may further enhance a quality DC scheme; separating some of the services from the 'bundled' product provider (that is, 'semi-bundling') may fit well as an alternative.

A change to an 'unbundled' approach will offer a greater degree of 'future-proofing' for the scheme, since future changes will only then need to focus on the particular area for change, rather than needing a wholesale change of provider.

However, ignore the advances made by product providers at your peril. The changes in, and flexibility of, product design have been significant over the last few years, with many providers now offering a menu of services from which trustees can select (with the pricing reflecting the services taken up). The product will ultimately be constrained in what it can offer, but it is essential to work in partnership with the product provider where inefficiencies or incomplete services exist.

Conclusions

As schemes grow and develop, their requirements and the services they require from their providers will change. In some cases, the change can be catered for through discussion with the current provider. In others, the scheme may simply have outgrown its 'bundled' beginning and it may be an advantageous time to move to an 'unbundled' approach.

Many DC schemes which were set up a few years ago have now reached a critical point in their evolution and some serious thought needs to be given to the most appropriate structure for taking it forward into its next stage of life.

As Darwin said 'It is not the strongest of the species that survives, nor the most intelligent. It is the one that is the most adaptable to change'.

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