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DC in focus

Watson Wyatt Worldwide

Key issues and challenges emerging from DC pension provision

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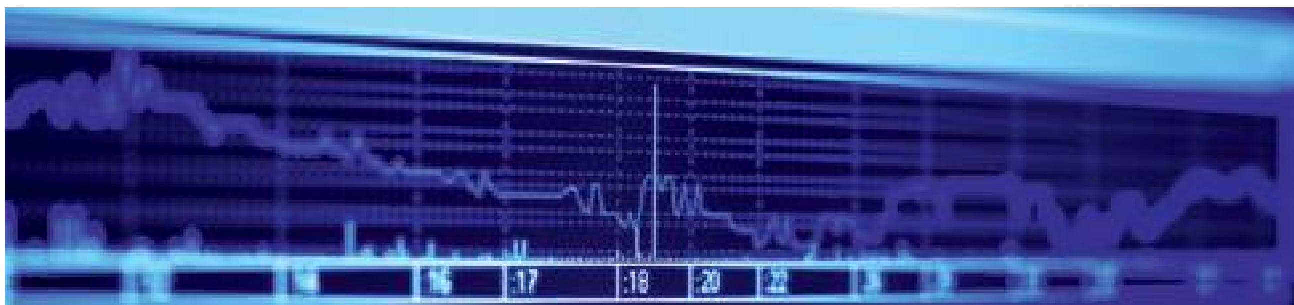


Welcome

As the growth of defined contribution (DC) 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 evolvement 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 the key issues and challenges emerging from DC pension provision setting out latest thinking and identifying emerging best practice.

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 covered 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

Thank you and kind regards

Gary Smith

DC and the **financial crisis**

Guy Winter

The current financial crisis is bringing DC pension schemes firmly into the spotlight. It has also drawn attention to the dangers, risks and opportunities of DC pensions for employers, trustees, employees and providers alike.

Recent events in the market should therefore act as a wake up call. As a result, it may lead many members, employers, trustees and providers into unchartered waters. Over the coming months there will be a lot of debate about the future shape of DC pension provision. As part of this process it will be important to embrace the observations that can be made and lessons to be learnt from previous crises. In reality, it is likely that DC will emerge from the current crisis in a stronger shape than it went in.

While DC pensions require individuals to make a large number of financial decisions, many recent studies have found employees typically score very poorly on financial IQ tests. Watson Wyatt research has further shown how pension understanding varies across different groups in the population (according to pay, education, age and gender). Some common behavioural responses to risk are:

- Losses loom larger than gains: it is more unpleasant to lose £100 than it is pleasant to gain £100.
- Inertia: individuals seldom revise or monitor their pension plans.
- Default options matter: individuals find choice difficult and often opt for the default.
- Overconfidence: individuals typically assume more knowledge than they have. They ascribe successful outcomes to their skill, but blame failures on bad luck or others.

In the case of the latest financial crisis there are concerns about how members will react as the size of their potential

...employees generally do not understand or review their pension situation and as such could be far more exposed to the recent events in the market than they expected.

losses become more apparent. The majority of members opt to follow the default option, which typically has a high exposure to equity and hence they are likely to have seen large falls in value. Yet, our research has found that people place too much trust in the default many believe that as it is chosen by the employer or trustees that this implies some level of active management and monitoring. Additionally, employees generally do not understand or review their pension situation and as such could be far more exposed to the recent events in the market than they expected.

Compared to the crash at the beginning of this decade, the recent decline in the stock markets has been observed across the globe. It has also been acknowledged that the effect on retirees is likely to be significantly more severe than in the previous crisis due to the increase in DC provision in the UK.

Given the lack of financial understanding, the general dislike of financial losses and that (without education and support) employees are generally risk averse, there must be a concern that some employees will sell equities and there will be a knee-jerk drift to conservatism.

In the short term, evidence suggests that this is unlikely to happen (for instance, inertia will limit switching activity as typically employees revise their pension investments infrequently). However, as individuals move to new jobs and are prompted to make investment decisions, there is the risk that they will opt for more conservative choices and shy away from risk in the aftermath of the latest crisis.

Once members come to take benefits from their DC pension fund, our research indicates that the vast majority annuitise (typically choosing single-life level annuities). As the at-retirement market is a maze of complexity, it will be essential that employers and trustees provide members with the necessary help and support to manage their at-retirement choices including getting the best possible terms for the annuity format they have selected especially as workers become more reliant on their DC pension.

In certain situations, the impact of declining stock portfolios and annuity rates could leave individuals with a lower retirement income than they anticipated. As a result, employers could be faced with the distinct possibility of employees postponing their retirement and working for longer.

In the current environment, with the threat to jobs looming larger than pension declines and with few workers approaching retirement relying exclusively on their DC pension, there is not likely to be a great focus on declining pension funds. But in the long term, with DC a more important part of retirement income, it is hard not to foresee renewed calls from workers for more protection to be built into their DC pension plan.

In conclusion

The latest crisis has fired a warning shot across the bows of pension provision. DC is the future and we must invest time and energy nurturing and developing it to be better, stronger and more fit for purpose. If we do not, company-sponsored pension provision may simply die. DC will have to improve.

Effective plan design lessons from behavioural finance

Bob Farmer

DC is now the standard model for UK pension provision and for better or worse, is here to stay. The trend towards DC is also beginning to form a part of statutory provision with the advent of Personal Accounts as a compulsory vehicle for the 'unpensioned imminent.

There has been much focus on the need for plan sponsors to offer or at least facilitate some form of financial education for members and prospective members, in the light of concerns about their engagement in the DC process. In part, this recognises one of the flaws inherent in DC arrangements, which is the expectation that the member will act rationally in making provision for his financial future and is sufficiently well informed to make the correct choices anyway. Recent behavioural finance studies and related experience are beginning to demonstrate this is not proving to be the case.

In a typical DC arrangement, the member has a critical input in three distinct phases of his pension career, which are accumulation, consolidation and de-cumulation. The question for the plan sponsor is what affects member behaviour and how can it best be optimised?

A 'typical employee, if there ever was such a person, would be a net spender in his earlier career, using debt to support expenditure and lifestyle. As he moved to middle age the emphasis would shift towards becoming a net saver, able to accumulate assets with a view to supporting family and retirement.

In the early years, the biggest problem that an individual faces is one of savings momentum. People often understand the benefit of doing something and may have an idea of what to do, but ' not just now. How many of us make the resolution to join a gym, but are not so quick in actually going there?

In the DC context, this behaviour can manifest itself in two ways; low take up of membership and also in minimal, often default-based contribution rates, with few if any subsequent increases.

Compulsorily membership will undoubtedly help with the first part of this dilemma as studies have already shown. A US report (Madrian and Shea, 2001), confirmed that where the member had to ‘opt-in , the default non-membership prevailed with participation at 37 per cent. For new hires, auto-enrolment was instituted as the default, with members having the scope to opt-out, resulting in 86 per cent participation.

Whilst auto-enrolment addresses the low take-up rate, it also contributes somewhat to the members lack of ownership of the contribution-rate decision. When faced with the difficult question ‘how much to pay , or ‘when , no decision is the member s easiest choice. Evidence has shown that auto-enrolled members will tend to stick with the default contribution, whereas ‘opted-in members are more likely to vary their rates. One approach to this issue is to build in some form of automatic increment to capture the member s agreement to save more in the future (‘   but not today!), and perhaps align this with salary increments to offset the perceived cost to the member.

In the DC context, this behaviour can manifest itself in two ways; low take up of membership and also in minimal, often default-based contribution rates, with few if any subsequent increases.

The investment decision is another area where the typical member will look for the simplest decision. Faced with too difficult a choice or too many choices, the member will often opt-out of making any decision and fall into the default, if such is available. The way choices of this type are presented to a member can bring about some surprising outcomes.

In one experiment (Benartzi and Thaler, 2001) members were offered a range of only five funds. It was found that members investment allocations were strongly influenced by the way the choices were presented to them. Where more equity funds were included, equity investment was the more popular choice; where fixed-income funds were the majority, fixed-income was chosen instead. Likewise, when offered different choices of a range of risk-based funds, the middle-ground option would always prove the most popular. The conclusion being that ‘avoiding the extremes seemed to be the main driver for the members investment choice rather than any evidence of a strategy-based approach.

In conclusion

So where does this leave the evolution of your DC plan design? In many cases, the lack of momentum can be used in a positive way and the default decisions can be improved for the members benefit. Is there scope to better present the investment choices your members have, would a tiered approach to their choices help?

Shock news: the world turns for **DC providers**

Roy Edie

Providers of group DC pension arrangements have been placed under a range of pressures over recent months, though the causes of some of these strains can be traced back much earlier.

A shifting landscape

The significant factors impacting this business line relate to shifts in the landscape of the group pension market brought about by regulatory and legislative change.

The FSA s Retail Distribution Review (RDR) has caused providers to rethink their distribution models in anticipation of the impact of greater transparency around commission payments to advisers, especially initial commission. Providers ability to write initial commission business is also under pressure due to the constraints from markets and shareholders on the capital required to fund it.

The legislative framework is also likely to change the dynamics of the group pension market. The introduction of Personal Accounts in 2012 and the requirement to auto-enrol employees into pension arrangements will mean that smaller businesses, especially those that have historically not made contributions towards their employees' pension benefits, will for the first time have to find funding for most of their workforce. This may well impact the pension arrangement that is already in place, typically Group Personal Pension (GPP) and Stakeholder schemes. The providers of these arrangements may well see a reduction in the contribution flows to this business line as some employers decide to either level down their provision or move completely to Personal Accounts.

Gazing at the stars

These pressures are most applicable to the smaller end of the group pension market and consequently providers have increasingly looked towards the larger, corporate end of the market for new business opportunities. Hence we have seen that the marketing departments of group pension providers are increasing the emphasis on attracting corporate clients. The sentiment is that many of the remaining large employers

that continue to offer employees defined benefit (DB) pensions for future accrual are likely to review again whether this approach remains appropriate and as a result they may move to DC provision and seek bundled solutions. These larger employers offer providers the attraction of much greater economies of scale.

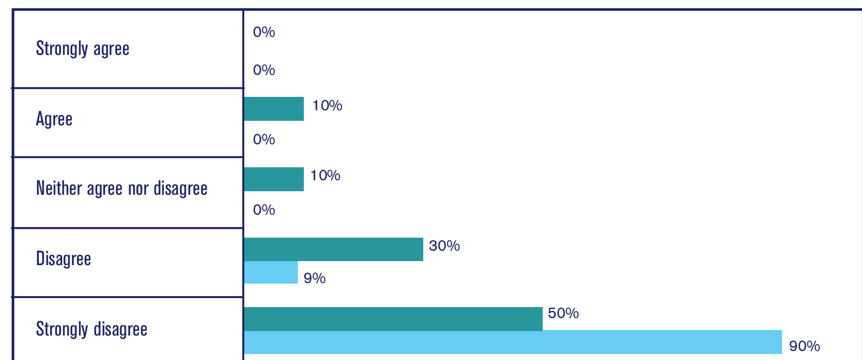
> **“...the requirements of the large corporate client are quite different from those of Small and Medium Enterprises (SMEs).”**

However, the requirements of the large corporate client are quite different from those of Small and Medium Enterprises (SMEs). Corporate clients are much more likely to require a tailored solution to meet their benefit requirements and are unlikely to settle for an ‘off the shelf solution. Those providers that identify this and create a proposition that is more of a menu of services than a pre-packed, shrink-wrapped product are closer to achieving a recipe for success when targeting the top table of corporate employers.

Proof of this commitment to the market was evidenced in a recent Watson Wyatt straw poll of the directors of the group pension divisions of ten leading providers. Concerned about the impact of the global slowdown on their steadfastness, we asked them whether the economic climate would impact their marketing spend on corporate pensions. A resounding 80 per cent disagreed that there would be any cut-back. An even more emphatic response was given when we questioned future commitment, with all disagreeing that there would be any reduction in emphasis, and 90 per cent strongly refuting the concerns.

The other category of employers that are likely to be impacted by the introduction of auto-enrolment are those larger employers that have historically had low take up of their pension arrangements. A significant proportion of these organisations will be employers with lower paid, younger and more transient workforces, such as the retail and catering industries. Employers in these sectors will be concerned by the impact of automatic enrolment on their costs and are likely to strongly consider levelling down their provision or moving to Personal Accounts. The varying impact of this legislative change on different sectors of the UK s employment market means that the

Figure 1 | Marketing commitment



■ The global slow-down will result in you cutting back sales and marketing initiatives for corporate pensions during 2009
■ Current market conditions have caused your business to reduce its commitment to corporate pension provision

pricing actuaries of group pension providers need to adjust their models to ensure that any new business that they do write is likely to be profitable beyond 2012. Providers will not want to take the risk of writing schemes now, which merely move to Personal Accounts later. If they do offer terms to employers in these sectors, then those terms are unlikely to be attractive.

A change in the relationship

Auto-enrolment will also cause another shift in the dynamic between employer and provider. Historically, group pension providers have directed communications towards attracting employees and encouraging them to sign up to the employer s scheme. With the introduction of auto-enrolment this will become unnecessary as the members will join by default. Instead, the emphasis from the provider will change towards ensuring members do not opt out of the scheme.

Hopefully this change in the relationship may result in a steadier flow of messages from provider to individual throughout their life as a member of the scheme, emphasising the benefits of the arrangement and encouraging engagement and long term financial planning on their part. Providers may also be encouraged to highlight the potential consequences of not remaining in the pension scheme and portraying images of the abject poverty members could suffer in retirement if they were to opt out.

In conclusion

The world of group pensions has turned and as a result this has caused a change in the target client-base of many players in the DC market. Although conditions may appear to be relatively tough for providers, they remain committed to investment in corporate pension propositions so that they can attract the large corporate employers that will be looking for bundled solutions. The move to auto-enrolment will encourage providers, and anyone else involved in communication to members of DC pension schemes, to revisit the way that messages are presented.

“The world of group pensions has turned and as a result this has caused a change in the target client-base of many players in the DC market.”

Pensions reform from 2012 lining up to the challenge

Saqib Hussain

The 26 November 2008 was a significant date for pensions, as the Pensions Bill completed its journey through Parliament and gained Royal Assent. It marks an important change in the delivery of pension provision for millions of employees in the UK. It is this piece of pensions reform which, from 2012, will impose a duty on all employers to auto-enrol employees into a pension scheme that either meets a set minimum criteria ('a qualifying scheme), or the new Personal Accounts scheme.

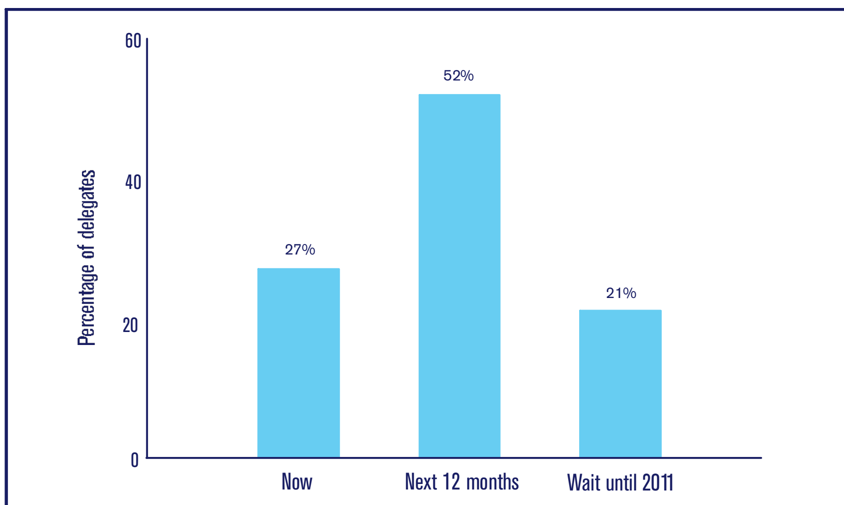
Watson Wyatt's '2009 FTSE 100 Defined Contribution (DC) Pension Plan Survey highlighted that a third of FTSE 100 companies said they had not yet considered the implications of 2012 on their pension scheme. Of those that had, 12 per cent said they would have to increase employer costs and 12 per cent said they expect to change their definition of pensionable earnings. For non FTSE 100 employers the percentages are likely to be higher and the impact of pensions reform potentially more significant.

To some employers 2012 may seem a long way off. However, many are recognising a need to start dealing with the issue of having to auto-enrol their employees in to a qualifying scheme, as 2012 falls within their medium-term business planning cycle. An understanding of the financial and HR implications should be established now so that adequate planning can be made.

What are employers considering?

Following up on our DC survey, Watson Wyatt recently held some seminars, involving both FTSE 100 and non FTSE 100 employers, to discuss how they might respond to the challenges being presented.

Figure 1 | When do you think your organisation intends to consider the impact of pensions reform?



It was clear that the need to consider the implications of pensions reform, through the passing of the Pensions Bill, is making its way up the agenda for many employers. In fact, 70 per cent of the delegates indicated that they are either already considering these issues, or are likely to be doing so within the next 12 months (see Figure 1).

Employers now have an ideal opportunity to consider strategically the broader picture of workplace retirement savings and ensure that they have an effective benefits package suitably aligned to their business needs.

> **"Employers now have an ideal opportunity to consider strategically the broader picture of workplace retirement savings and ensure that they have an effective benefits package suitably aligned to their business needs."**

What are the key challenges employers face?

Set out below are some of the key challenges highlighted during the seminar and the actions employers are thinking of taking, either immediately, or in the run up to 2012.

Auto-enrolment

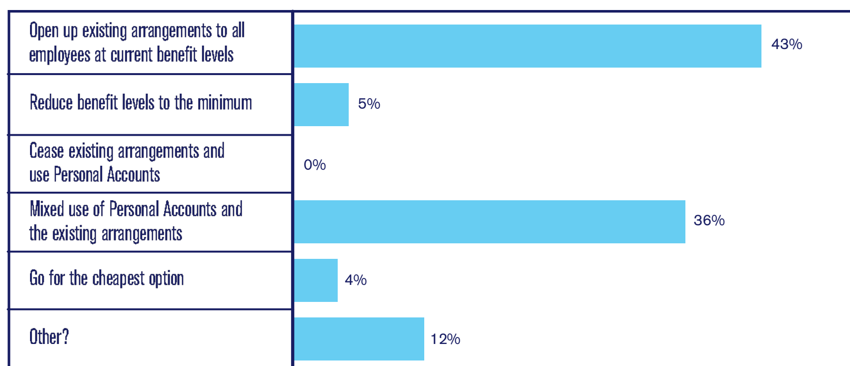
The main implication of the Pensions Bill is the new requirement for employers to auto-enrol employees into a pension scheme and pay a minimum contribution into that pension scheme. Most schemes do not use auto-enrolment, so there was an acknowledgement from many employers that they are likely to see their annual pension contributions significantly increase as take-up increases. A need to model the financial effects of auto-enrolment was seen as a critical action.

Plan design issues

Most schemes will need some degree of redesign in order to meet the minimum requirements set out by the Pensions Bill. 72 per cent of delegates indicated that they will review their DC scheme before 2012 to ensure that it is being run in the most cost effective way.

Other plan design issues included whether the Personal Accounts scheme itself can achieve an employer s objectives, the role of salary sacrifice and the cessation of contracting-out under DC schemes from 2012.

Figure 2 | How will your company react to the new requirement?



Investment

To be able to meet the auto-enrolment requirement, DC schemes will need to have a default investment programme. This will naturally bring more focus to the investment strategy adopted by many DC schemes. Many employers already use a default of some kind but there was recognition of the need to review the appropriateness of both the default being used and any lifecycle structure. The pensions reform requirements will be a catalyst for these reviews.

Engagement

Communication and engagement are critical in ensuring a successful DC scheme. There was broad recognition that after 2012, it will be more important than ever for employers to engage with their employees and play a role in raising employee awareness of retirement savings issues.

A key question raised was that of employees who may receive little or no financial benefit by being auto-enrolled into a pension scheme. This is because of the possible adverse effects this may have on means-tested benefits such as pension credits. How best to deal with these potentially affected groups of people will need to be carefully considered.

How are employers reacting?

Figure 2 highlights some of the options which delegates were asked to consider. 43 per cent thought that their organisation would use its current arrangements and benefit levels to meet the proposed requirements. Interestingly, no delegates thought that their organisation would cease to offer their existing arrangements and instead use Personal Accounts.

Organisations with poor take-up for their existing plans expressed concerns that offering their current arrangements unchanged from 2012 would cause them an unacceptable financial strain. Interestingly, in the voting results, only 5 per cent of delegates confirmed that they will consider 'levelling-down their existing benefits to some extent for auto-enroling new employees from 2012.

In conclusion

The pension reform requirements are a significant development, which have broad cross-party political support. Clearly there are still details that need to be worked through, which means delays may occur. However, enough is already known for employers to start seriously considering the issue of auto-enrolment and the use of either an existing pension scheme or the Personal Accounts scheme. Employers also need to start thinking about the financial and HR impact pensions reform will have from 2012.

DC investment **planning** the journey

Gary Smith

The financial crisis has highlighted an important issue relating to DC investment strategies, there has not been enough focus on the 'risk part of the risk/return balance. This article explores some of the key risk considerations in setting a DC investment strategy.

A DC plan s investment strategy and the corresponding levels of risk needs to be appropriate for its specific membership and, in order to develop a member-focused investment strategy, it is essential to understand a DC member s objective.

A DC member's objective can be defined through the level applied to, and the relative interaction of, three key metrics. The level of the expected retirement outcome, the variability in desired retirement outcome that would be acceptable (both in level of income and age of retirement) and the level of year-on-year volatility in accrued savings account that can be accepted during the journey. Investment risk can then be defined in relation to the chance of a member achieving his/her DC objective.

Do DC members typically take too much or not enough investment risk? The answer lies in a combination of three factors; flexibility, time horizon and time diversification.

In DC any negative investment outcome is borne by the member. So the issue is: does the member have the flexibility to cope with an adverse outcome? Younger members generally have greater flexibility to recover from adverse events than those nearer to retirement. A younger member who loses half their accumulated pension wealth due to adverse financial events has greater scope to adjust their savings pattern to make up this shortfall without too great a lifestyle adjustment.

When considering the argument that 'in the long run equities always outperform bonds, it is important to remember that, from history, the equity risk premium can be negative for long periods. The decision to invest in growth assets is dependent

> As DC plans grow, improvements to the investment strategy are essential...

on a member s preparedness and ability to adapt in negative periods, although by investing in a default lifecycle strategy they are delegating the investment demands to some extent.

A member may spend 40 years saving, so the level of assets and exposure to investment risk will tend to be concentrated in the last few years. Ideally a member should spread this risk more evenly over their savings life   reducing the proportion invested in growth assets in the years approaching retirement.

A long-time horizon alone is not sufficient to justify investment in growth assets, but we suggest that there are sound reasons for members to invest in growth assets at some point along their DC journey, just so long as they have the flexibility to cope with adverse outcomes.

A clear understanding of the plan s membership profile enables the design of a more focused investment choice/ default framework. It is helpful to recognise that there are broadly three categories of members in a DC plan based on their investment expertise as well as their willingness to be engaged.

There are the true-defaulters; members who do not have any financial expertise and/or have no interest in or engagement with their pension savings. The guided-selectors are members who have the potential to be more engaged in their pension savings and have some financial knowledge to support limited decision making and the self-selectors: members who are motivated and financially literate and are able and willing to take appropriate investment decisions.

Most plans currently tend to recognise and try to deal with just the first and third of the membership sectors described above, but we would suggest that a better DC outcome can be achieved by giving additional focus to the guided-selectors, who are likely to respond well to a more engaging investment choice/default framework.

Plan fiduciaries then just need to consider what their true-defaulters 'look like in terms of their ability to take investment risk as well as their guided-selectors and self-selectors. Investment solutions with appropriate risk/return balances can then be designed for each of these three segments in mind, whilst trying to encourage the emergence of a guided-selector group of members who will make simple, incremental adjustments away from the default investment approach in order to begin to better personalise their investment strategy to reflect their own particular risk appetite. As part of this, plan fiduciaries should consider using lifecycle overlays. Lifecycle overlays are not necessarily designed to maximise returns, but rather to balance risk and return, and we believe that it does this successfully. It seeks to reduce risk as the capacity of the member to take risk diminishes.

As DC plans grow, improvements to the investment strategy are essential and, along with this, is a need to be more member-focused and more alert to the ability of members to take investment risk. Understanding the profile of the typical plan member and adopting a more engaging choice/ default framework are vital factors when considering the design and measuring the effectiveness of both the default strategy and additional funds being offered.

In conclusion

By establishing a retirement outcome target, developing a long-term savings journey plan, and being aware of their progress against this plan, members will be more focused and incentivised as well as better placed to take the actions required along their journey to ensure they have adequate savings on which to retire.

The **brave new world** of member engagement

Richard Veal

What is the worst possible environment for encouraging people to save and invest? When it comes to pensions engagement, the current climate makes the challenge of being heard about as tough as it gets. In a layperson s mind, the steady slaying of final salary is dragging all company pensions down with it. The danger is that people now assume pensions are a waste of time.

In a perverse way, the context of the financial climate does help bring the issues to the fore. Things are bad, so we have people s attention at least. The more worrying challenge is how this negative perception of pensions also influences their perception of risk. When it comes to money, most people equate risk with volatility through a completely natural emotional response; the more rational risk of missed opportunity takes second place for most of us. It also looks like those fears are founded in reality too. In the last year, the improbable and 'worst-case scenario seems to be exactly what has happened, so it is pretty hard to argue the case for just about any kind of investment right now. To paint an even darker picture in these tough times, employers have very little incentive to encourage people to save more, especially when they are matching contributions and trying to keep a business afloat.

Is there a brave new world when it comes to member engagement? There has to be. As an economy and a nation we have no choice but to go through this phase in our history. We are experiencing a sequence of events that is destabilising, rebalancing and ultimately rebuilding every aspect of the financial world, and company pensions are right in the middle of that change.

The strongest position we can take on member engagement is the value of company s DC plans as a smart way to save, and perhaps go further and position it as a smart way to invest. With the benefit of hindsight, there are more than a few

members out there looking at their fund values wishing they had paid more attention in class. Seeing the realisation of how dynamic a DC fund can be does, in fact, underline the fact that DC is all about investment. In fact, we can go so far as to say DC is not really about the pension at the end. It is all about the fund you create to give you options when you retire.

For most people, DC saving and investing as the cornerstone of a long-term saving plan makes a lot of sense. Highly tax-efficient, your employer does a lot of the work and you have the ability to choose how to play the game. When selling the merits of DC in this light it has a lot going for it. Even for high earners, the recent tax changes are not necessarily the death knell for DC, the impact of compounding needs to be taken seriously into consideration even at 50 per cent there are critical timing issues to consider before automatically dropping DC like a hot potato.

In conclusion

Engaging employees in the merits of DC today and in the future is very different to how it was even 18 months ago. Recent seismic shifts in the financial landscape highlight the fundamental differences between the old order and how things have to be from now on. In communicating and engaging people with occupational DC, we need to use the recent lessons to demonstrate how DC works and not shy away from the fact that the art of investing is all about commitment, risk and timing. Bolder communications could use recent (anonymous) examples of members who ignored their exposure at their peril. And, on the flip side, show what these members could have done differently to end up in a much better place despite market conditions. The benefit of knowing your lifestyle phasing position if you are 50 plus being an obvious example. Also, encouraging people to share their plans and experiences about investing in a similar way to the way we all compare notes on property would be much healthier for DC. If, as an industry, we can be a bit more open about the ups and downs of investing, employees and DC members would, perhaps, be more likely to appreciate their company DC deal and not dismiss it as the poor relation of final salary.

> **"DC is not really about the pension at the end. It is all about the fund you create to give you options when you retire."**

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