



DC governance survey 2009

The future of **DC** governance

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The future of DC governance

The financial crisis has placed **defined contribution (DC)** pension provision firmly under the spotlight. The dramatic falls in fund values observed for most members during 2008 have been drawing attention to the **risks inherent** in DC pension provision and focusing attention on how employees, employers and plan fiduciaries can better manage their DC pension plans.

For the first time, a large proportion of employees will see their pension savings shift dramatically **with** financial markets. As a result, it is unlikely that governing bodies will be able to put off consideration of DC issues in the future.

The current fresh and increased focus on the governance of DC pension plans raises a number of questions. What does governance mean in the context of a DC pension plan, both now and in the future? What are the core characteristics of best practice governance and what are the costs and benefits of good governance?

To answer these questions, during the first quarter of 2009 the Watson Wyatt Pension Research Forum undertook a survey of pension and HR managers and trustees involved in running DC pension plans for over 60 large employers across the UK and Ireland. Complementing these survey responses, we also carried out interviews with five large DC plans to explore the issues surrounding governance in more detail.

The role of governance

There are two clear drivers for better DC governance; to minimise risk and to maximise the value of the pension plan. This applies equally to the sponsoring employer, the fiduciary and the member. An employer would therefore wish to both minimise the risks they face from their pension plan and get the best value or return from their pension spend. An employee would also wish to minimise the risks they face, whilst maximising their pension income. And finally, a fiduciary is likely to wish to minimise their risks, and, because of their duties to the membership and the sponsoring employer, they will also wish to maximise member outcomes.

Nevertheless, these objectives are not without tensions. In many cases, DC plan fiduciaries may wish to assist members in terms of communication, financial education, and so on (that is, help provide a better member outcome) but are possibly wary due to the risk of being seen to give advice to the member (that is, place them at too much risk).

Our research therefore explored the extent to which fiduciaries felt they could or should;

- manage the risks that employers and fiduciaries face
- manage the risks that members face
- add value to member retirement outcomes.

Figure 1 outlines a basic framework by which we can define the potential governance of a DC plan.

In Figure 1 we have characterised two forms of governance;

- **Operational** – managing the basic day-to-day running of the plan and essentially ensuring it meets with all relevant legislative and regulatory requirements.
- **Qualitative** – ensuring the plan functions in the interest of its members and seeks to improve the ‘member experience’. This is essentially the degree to which the fiduciary actively seeks to add value and increases member outcomes.

The extent to which governance **should** include these qualitative aspects and what role fiduciaries believe they should take in governing a DC pension plan is a matter of considerable debate and was explored in detail in the interviews.

Figure 1 | DC governance

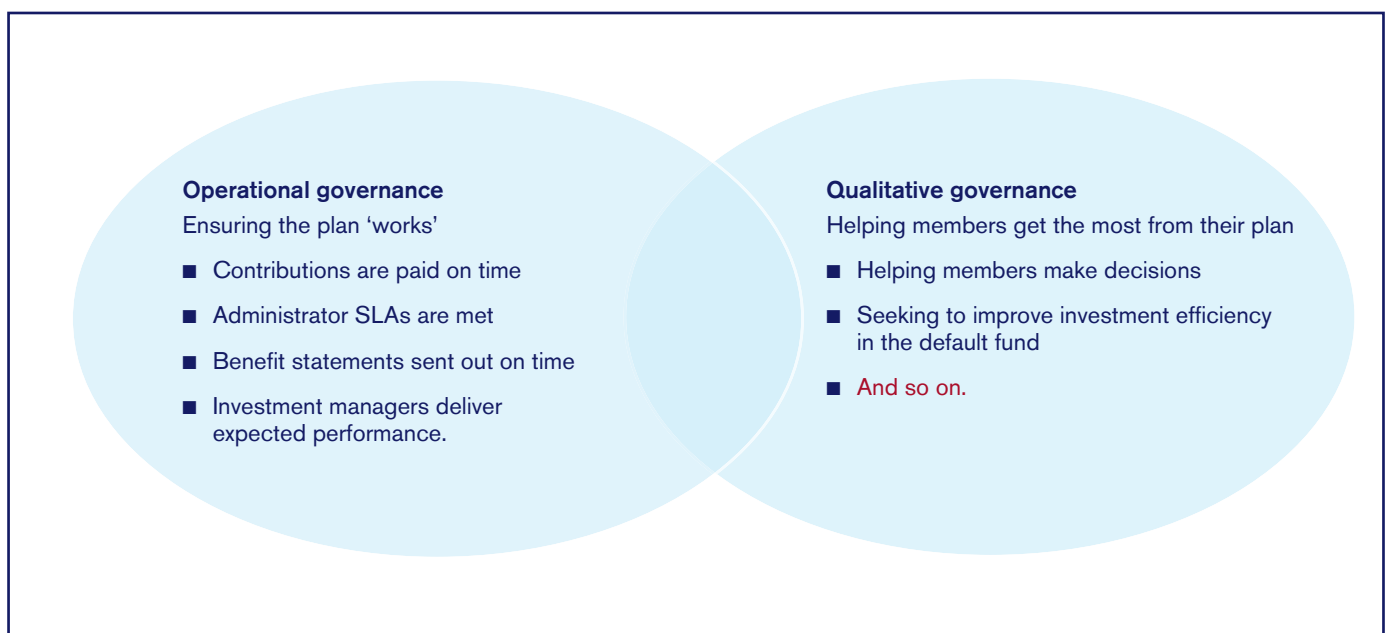
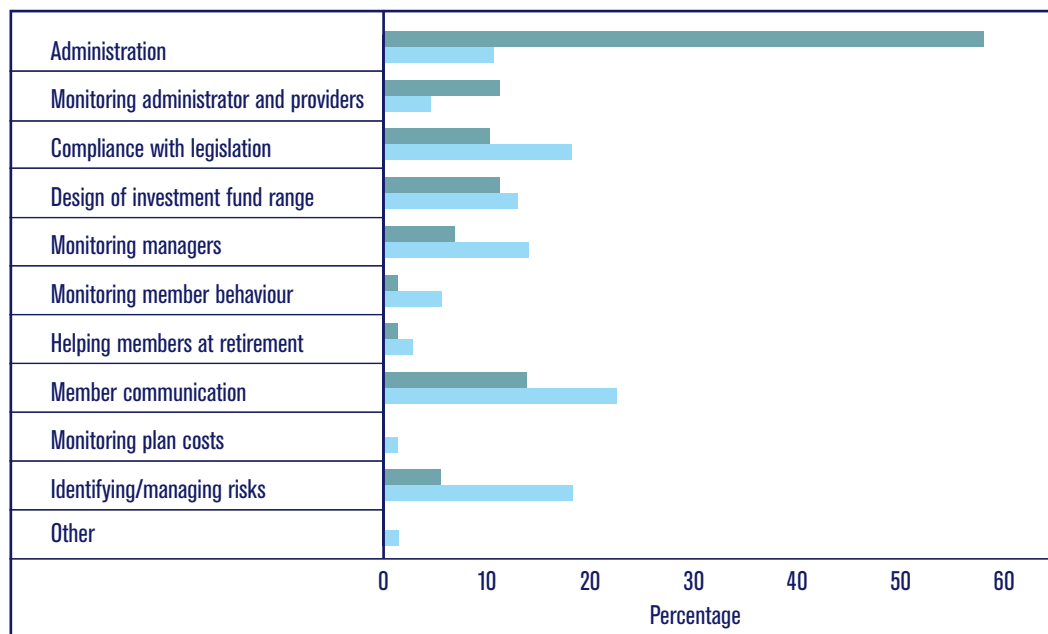


Figure 2 | The shape of governance, now and in the future



Source: Future of DC Governance Survey (2009), Watson Wyatt Worldwide

In both the survey responses and case study interviews, the typical focus of current governance activities was on operational activities rather than qualitative approaches. A key driver for this focus on operational governance is to minimise the risks (cost, time, irritation and so on) of administrative errors. As well as a desire to ensure the plan runs smoothly, a second driver for the operational focus for many fiduciaries was the continually changing legislative and regulatory environment. For many fiduciaries, trying to keep up with this constantly evolving legislative and regulatory environment occupies time that could otherwise be spent on more strategic objectives.

This current focus on administrative issues can be seen in Figure 2, where we consider the top areas in which fiduciaries focus their governance activities. This shows that the majority of fiduciaries currently spend the largest proportion of their time on administrative issues and

monitoring their administrators and providers. Yet, looking into the future, fiduciaries want to focus more on qualitative activities. Figure 2 highlights a desire to have a greater focus on investment (monitoring managers and the design of fund ranges) and member communication as well as on managing plan risks.

“ ... the typical focus of current governance activities was on operational activities rather than qualitative approaches. ”

In our case study interviews we found a similar view of the shape of governance in the future. Fiduciaries increasingly believe they should be doing more to help members, but primarily through a greater focus on investment – this was felt to be the area where governance could add the most value and where members struggle most. There was an acceptance that members generally have trouble understanding pension issues and there was a desire to spend more time and effort on communication and providing members with sufficient tools to make the right choices. Nevertheless, there was a concern about the risk of going too far in helping members to actively make decisions, with a reluctance to be seen to be giving advice.

Consistent with this gradual shift to more qualitative governance, we found underlying fiduciary core beliefs that pointed towards a desire to take a leadership role, to an extent, in guiding members, as opposed to a pure facilitatory role. This can be seen in Figure 3, which shows the results from our survey, in which

we asked fiduciaries to state where their core beliefs lay on a spectrum between two extremes. On the left hand side, we can see the fiduciary as playing a leadership and guidance role, on the right hand side, one of facilitation. Obviously, the spectrum of answers and responses may vary across different groups of employees – but fiduciaries largely reported they were more comfortable in guiding members than leaving members to individual choice. This shows that fiduciaries are largely moving beyond the pure theoretical view of DC as being entirely down to the member to make their own decisions and choices regarding investment and savings towards recognising the practical reality that many members have great difficulty in understanding pensions and making investment decisions.

The view on what DC governance should look like in the future is, then, a nuanced one. Currently there is a heavy focus on operational activities. In our interviews, it was suggested that this is due to a number of factors: the relative immaturity of many DC pension plans, the presence of a

Figure 3 | Governance objective

Range of expected outcomes						
Outcomes to fall within acceptable range decided by fiduciary	6%	44%	34%	11%	5%	Outcomes to be entirely a result of member capability, time and luck
Investment choice						
Only offer a small number of focused investment options	19%	41%	18%	20%	2%	Investment options to cater to as wide a range as possible

defined benefit (DB) pension scheme or section often overshadowing and crowding out any governance focus on the DC plan, and that the evolving legislative and regulatory framework diverted attention away from more qualitative issues. However, in the future, trustees, HR and pension managers see a movement towards more qualitative focus on improving the deal for members – principally focused around investment and member communication.

Nevertheless, there remained a wariness about governance extending to other areas (such as helping members make active choices and providing financial education) in the current environment – though ‘safe harbour’ type legislation was felt by some as a potentially attractive means of allowing fiduciaries to do more.

Fiduciary value

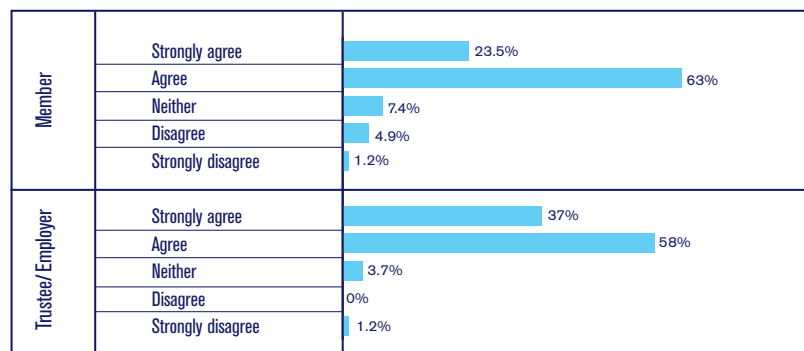
Does governance add value? Whilst the current focus of governance is mainly operational and functional, respondents, both in our survey and in the interviews, strongly believe that good governance delivers real value.

Figure 4 highlights the belief that good governance assists in managing the risks faced by both trustees/employers and members, with around 90 per cent of respondents thinking this way.

However, in addition to managing risks, around 80 per cent of respondents also felt that the member outcome (income in retirement) can be improved by good DC plan governance, as seen in Figure 5.

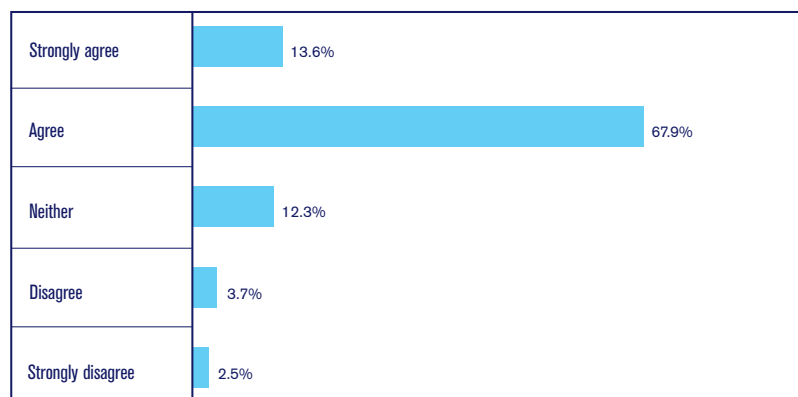
When we delved more deeply into how governance helped to manage risk, we found a number of factors. First, good governance helps to ensure that potentially costly mistakes and errors do not occur – this suggests that ‘prevention is better than the cure’. For example, the costs of a

Figure 4 | Governance and risk



Source: Future of DC Governance Survey (2009). Watson Wyatt Worldwide

Figure 5 | Governance and member income



Source: Future of DC Governance Survey (2009). Watson Wyatt Worldwide

mistake in a benefit statement (in terms of trust, reputation, HR issues as well the hard costs of having to reissue the statement) are sufficiently large that real attention to detail is required. Secondly, good governance allows more effective use of limited governance resource and budgets – so the benefit from good documentation (more formalised structures, delegated authority, and so on) is that it allows fiduciary time and budgets to be used more effectively. The features of what is considered good governance are

explored in more detail overleaf.

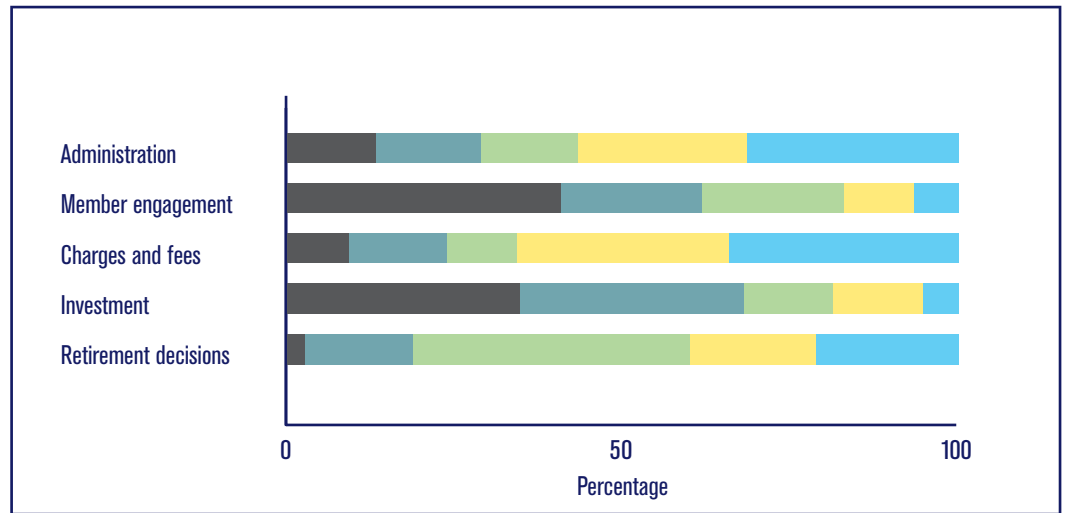
For the larger and more mature DC plan we interviewed there was an acceptance that when a DC plan becomes sufficiently large good governance processes are a necessity, rather than simply desirable. For some, their DC pension plan is now at that stage in its growth and development where good governance processes are

simply unavoidable if the plan is to function efficiently.

One interviewed plan said “we are running a business within a business – we now have 8,000 members and £400m in assets under management”.

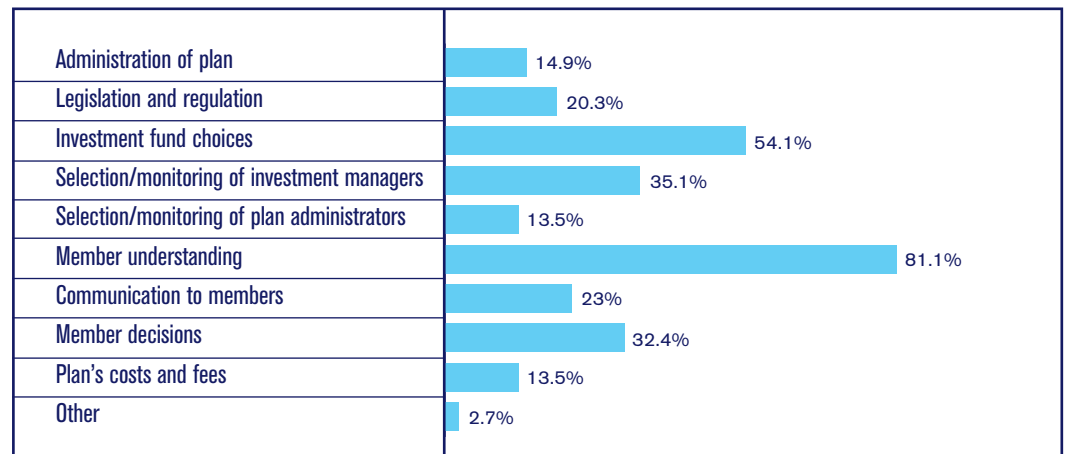
But does governance deliver real monetary value to members?

Figure 6 | What areas of governance add value?



■ 1st ranking ■ 2nd ranking ■ 3rd ranking ■ 4th ranking ■ 5th ranking Source: Future of DC Governance Survey (2009). Watson Wyatt Worldwide

Figure 7 | Key risk areas a DC plan faces



Source: Future of DC Governance Survey (2009). Watson Wyatt Worldwide

Both our survey and interview responses clearly felt that members' received appreciable value from good governance. **Figure 6** shows the areas in which fiduciaries feel governance can add most value to member outcomes. Two areas come out clearly ahead in terms of adding value – investment as well as communication and member engagement.

Member communication was felt to add value by improving member choices and encouraging member engagement. Investment was felt to be the area “where we can deliver real value”. Indeed, in one case a pension plan was able to demonstrate monetary value added – saying “we added over £500 per member last year” – with reference to how their plan's default investment return outperformed its benchmark. This was in addition to the lower fees that good governance was felt to deliver.

Whilst **Figure 6** addresses the key areas where governance can add value, **Figure 7** highlights the key risks a DC plan faces.

Member engagement and investment are rated as the most important risks employers

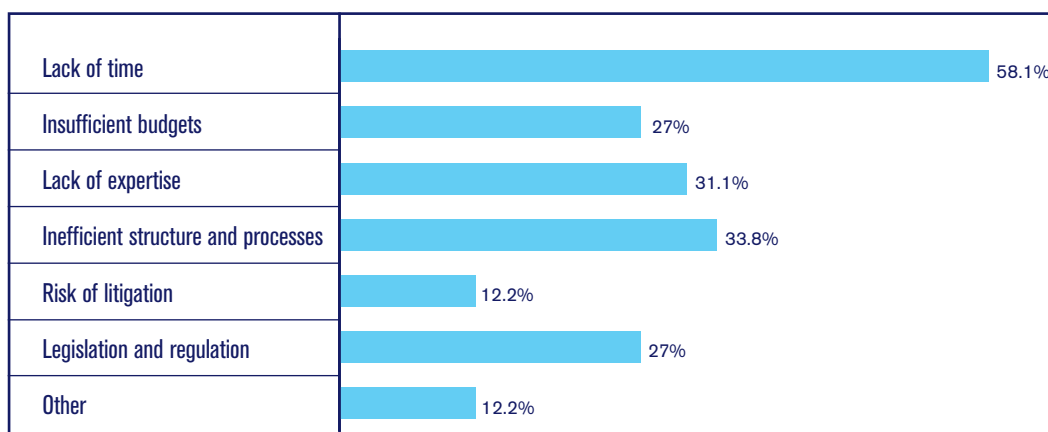
and fiduciaries face. Interestingly, this is consistent with the areas where most value can be added and where respondents to the survey would like to focus more attention, see **Figure 2**.

In light of these results, why are we not seeing greater action in these areas? What are the barriers to focusing on the key risks and value drivers in DC pension plans? These issues are explored in **Figure 8**.

The key constraints that DC pension plans face are a lack of suitable resource – be that time, budget or suitable expertise – to accomplish the objectives that the fiduciary body would ideally like to achieve. Participants in our research were clear that, given the tight controls on employer budgets and a desire not to make occupational pensions overly costly **relative to** alternatives, this meant in reality being more effective and efficient within the current level of resources.

Two other barriers were seen as key. First, the continual flow of legislative and regulatory changes forces plans to focus on ensuring they meet these ever-changing requirements, rather than focusing on more

Figure 8 | Barriers to governance



Source: Future of DC Governance Survey (2009). Watson Wyatt Worldwide

strategic, added-value aspects. In our interviews, there was a view that some employers "... were waiting for developments in the DC market and Personal Accounts" and, until these issues were resolved, they would act as a barrier to a more qualitative form of governance.

Secondly, the influence of DB pension schemes or sections were seen as detrimental to DC plan governance. Typically, DB schemes demand a large amount of time and focus from fiduciaries and employers and this often crowds out time and attention to the DC plan. A common sentiment was that "DB overshadows DC" and that, for this reason, creating a separate DC fiduciary sub-group (when DC is a part of a DB scheme) with separate meetings was a key ingredient to obtain a greater focus on DC issues. Moreover, there was a view that "DC is fundamentally different from DB", and that it requires different skills, a different mindset and a different focus – simply transporting the DB model to a DC environment was generally thought inappropriate. There was, however, the view that as we move to an increasingly DC world, where increasing numbers of

employees and fiduciaries are DC members and the sums involved become large, this tension will ease and attention will increasingly focus to DC plan governance.

Against the backdrop of resource constraints, a continually evolving legislative and regulatory landscape and competition from maturing DB pension schemes, it is perhaps unsurprising that, in terms of governance ambitions, the large majority of DC plan fiduciary bodies just target the market average in terms of their governance objectives. This is shown in **Figure 9, where over 60 per cent of fiduciaries have an objective which is for their pension plan's governance to be comparable to other similar plans.** Moreover, many DC plans are currently relatively immature – they may have been established recently with mainly young, new workers as members – and the first step in such cases is often to adopt a governance plan that just meets market expectations.

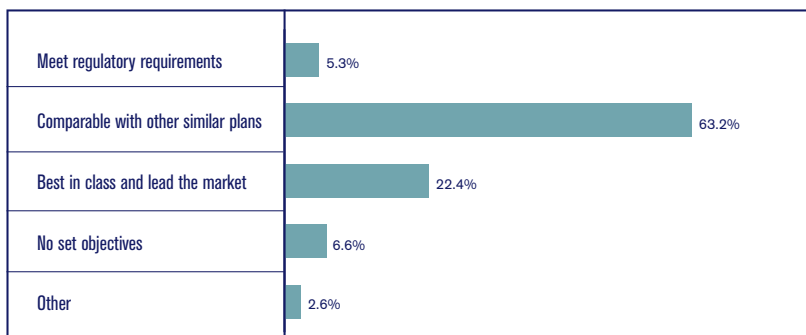
In many such cases, we found that governance objectives were implicit or unclear. Yet, amongst more mature plans (both in terms of the numbers of members and the size of assets) we found a desire to innovate more. Indeed in **Figure 9**, we can see a sizeable minority (nearly a quarter) who are aiming to be market leading.

Governance practices

So far our discussion has focused on fundamental questions concerning the future of DC governance: what the role of governance should be, how and why governance adds value and what the barriers are to improving DC governance.

Finally, we turn to a more practical view of governance. How do fiduciaries regard their current DC practices? And how can DC pension plans improve their governance arrangements?

Figure 9 | Governance objectives



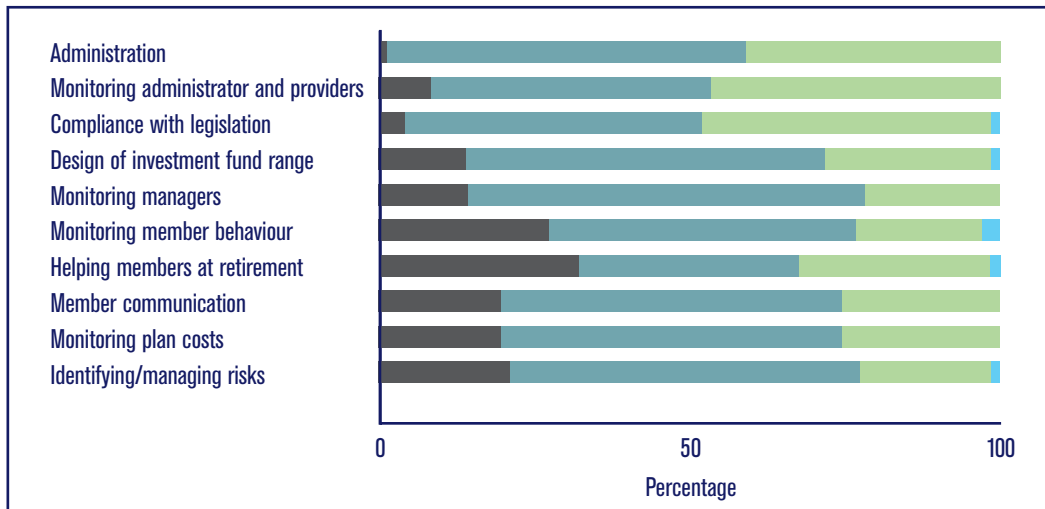
Source: Future of DC Governance Survey (2009), Watson Wyatt Worldwide

Current practices

In Figure 10 we report how fiduciaries rated their DC plan across a number of governance practices. Consistent with the predominant operational focus observed in Figure 2, we find that most plans believe they are good in operational areas, but less so in the areas we identified as producing fiduciary value (member engagement and communication, managing plan risks and monitoring and designing investment options). The area that is perceived to be most in need of attention overall is helping members at-retirement. This has received scant attention in the past, simply because the number of members reaching retirement from a typical DC plan has been small. Yet, this will swiftly become an issue which DC plans will need to address in the future.

“ The area that is perceived to be most in need of attention overall is helping members at-retirement. ”

Figure 10 | Current practices



■ Below average ■ Above average ■ Above average ■ Market leading

Source: Future of DC Governance Survey (2009), Watson Wyatt Worldwide

Best practice

How should DC pension plans improve their governance practices and what is a template for 'good' governance? Figure 11 provides an overview of the core best practice attributes identified by our research.

We found three areas to be critical:

- the governance structure
- the strength of leadership provided within and by the governing body
- the efficacy of the governance processes.

We discuss each of these areas in turn.

Governance structure

For effective governance to occur there should be clear structures with clarity on roles and responsibilities and the fiduciaries, in-house pension support and advisors should have a clear understanding of the plan's goals and their own objectives.

A number of plans we interviewed found that having a governance plan was invaluable here – as a document outlining structures, objectives, roles and responsibilities and terms of reference. In doing so, it allowed the budget to be used most effectively. This, in turn, is vital – resources allocated to the different DC practices should be appropriate to the pension plan objectives and capabilities.

Figure 11 | An overview of DC governance best practice

Structure	Mission clarity	Clarity of the mission and the commitment of stakeholders to the mission statement.
	Effective focusing of time	Resourcing each element of governance process with appropriate budget and required capabilities.
People	Leadership	Leadership being evident, with the key role being the chairman.
Process	Strong beliefs	Strong beliefs aligned with goals and informing all decision making.
	Budget framework	Frame the governance process by reference to a budget aligned to the mission statement.
	Fit-for-purpose	The effective use of external advisers who are governed by clear mandates, aligned to plan goals and selected on clear criteria.

The key attributes we found to be associated with strong governance structures are listed below:

- clear responsibilities, accountabilities and management
- clear set of objectives
- explicit decision-making processes
- effective allocation of resource to key activities
- separation of governing and managing functions.

Delegated decision-making (sub-committees, decisions by small numbers of fiduciary signatories, and so on) were found to be a particularly effective way of making efficient use of limited resources and reacting quickly to events. One concern is that as DC plans grow, decision-making will become unwieldy. Particularly important for those cases where the DC arrangement was part of a DB trust was to establish a separate DC sub-committee, possibly with separate meetings, to ensure the DC arrangement receives the attention it deserves and requires.

Leadership

In our research, we also found that plans with strong governance bodies all exhibited strong leadership, with the most important role being the chairman. This is typically supplemented by a strong executive team. In addition, our research highlighted that an independent person on the fiduciary body can be increasingly important. In a general sense, 'independence' was found to be important – it allows the independent person to ask difficult questions and challenge the prevailing views of the other fiduciaries as well as the employer. In addition, **the knowledge that an independent person often brought with them of what other pension plans were**

doing, and the expertise they had, were viewed as positive. More generally, we found it is important that the fiduciary body develops an appropriate mix of skills and expertise, consistent with its governance objectives.

The key attributes we found to be associated with leadership are:

- strong leadership
- skilled professionals with a variety of backgrounds and competencies
- strong management/executive team on board
- ability to identify and challenge.

Processes

Finally, our research identified strong processes as the third element of DC governance best practice. This begins with **a strong** vision on what the fiduciary body's objective is and this then informs the wider decision-making and focus of resource. The governance budget is then framed to be consistent with this wider objective and with the capabilities of the plan – there needs to be a consistency of governance objective, strategy, capability and resource. The governance plan was viewed as an important tool in achieving this, with one plan interviewed saying "our governance plan really means that our budget can be used more effectively".

The key elements of best practice governance we identified in terms of processes are:

- clear processes that can be developed to meet changing requirements
- ability to adapt to new market pressures, challenges and best practice
- identifying shortcomings and implementing changes to meet objectives.

To obtain the most efficient use of limited resources we found that plans were required to make the most effective use of external advisors. The advisor's expertise should be appropriate to plan needs and their role governed by clear mandates, aligned to plan goals and selected on clear criteria. Clarity of the advisor's role was critical to good governance. Building strong relations with advisors and fund managers was viewed as important by fiduciaries to create a level of understanding of the plan's objectives.

Conclusion

The financial and economic turmoil that occurred during 2008 placed DC pension provision under the spotlight and has fuelled the debate on what the exact role of the fiduciary should be in a DC plan and in managing the risks members, employers and they themselves face. Our research examined the likely future course of DC governance by surveying over 60 large DC pension plans in the UK and Ireland, whilst complementing these survey responses with detailed case study interviews.

We found that most DC pension plans in the UK and Ireland currently have an operational focus – ensuring that, operationally and administratively, the plan runs smoothly and conforms to legislative and regulatory requirements. Yet, there is a desire to focus more attention on investment issues and to increase efforts to promote higher levels of member engagement through communication, education and guidance – although fiduciaries are wary to go too far in these areas at the current time and in the current legislative and regulatory framework.

There are, however, constraints to this desire to 'do more' and 'do better'. Resources are typically felt to be currently insufficient or inappropriate to meet all the fiduciary aspirations and, with cost control typically an important issue for employers, are likely to remain so for the foreseeable future. Secondly, the focus on DB pensions for many fiduciaries and employers is diverting attention and resource away from their DC plans. And, finally, frequent regulatory and legislative changes are impeding a more strategic focus as fiduciary bodies react to these changes.

As a result, we conclude that DC plan governance will have to find ways to improve and become more effective within the current levels of resource – or perhaps even less in the future. Our research then highlights that fiduciary bodies focusing on developing more efficient structures and processes and ensuring the best use of resource, time and budgets is critical to delivering a governance model which is more appropriate for the emerging DC environment.

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