

what if?

perspective

DC – a ticking
time bomb?

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Introduction

So, you have closed your final salary scheme to new employees, and perhaps set up a defined contribution (DC) plan for new joiners. At least that is the company's pension headache covered in the long-term. Well, maybe not. This article suggests that, unless appropriate action is taken, employers could wake up to an HR nightmare not too far down the road as and when these new joiners come to retire, or, at least, start to realise that their dreams of a comfortable retirement will not be realised. The problem is not just an HR issue either, it could involve the company stumping up cash at a time when the Finance Director is looking to tighten the purse strings.

So what is the problem?

DC plans transfer all the investment risk to employees and 'empower' them to take control of their retirement savings. This employee empowerment could indeed be part of a wider cultural shift within an organisation to give greater flexibility, control and personal responsibility to individual

employees. This global shift in the employer/employee relationship reflects, amongst many other things, the changing demands of an ever increasingly skilled workforce who are becoming considerably more mobile and less in tune with the traditional work and retirement patterns.

However, whilst employees are demanding more flexibility and choice, employers should not be fooled into thinking that this is entirely the right thing to deliver. Empowerment is great if you have the ability and know-how to deal with it, but unfortunately most UK employees do not. They need all the help they can get to deal adequately with it. Given full empowerment, particularly in relation to retirement savings, the majority of employees will not cope and, quite frankly, most will not even know where to start. We are already seeing this where DC provision is in place.

Far too often the level of retirement savings being made by these employees, if any is being made at all, is woefully inadequate

to ever have any chance of providing a sustainable level of retirement living.

If this is allowed to continue, then companies will soon begin to experience the effects of a workforce which cannot actually afford to retire. So what would happen if the workforce could not afford to retire in the future?

In this situation, employees are likely to turn to their employers for support, either by allowing them to continue to work or by blaming their employer for letting them under-provide and not giving them enough help and assistance to support them in the choices and decisions they had to make. The problem will be a particular concern for employers where there is a strong union presence. A union backlash when these employees simply cannot afford to retire, is a certainty.





In particular, the three major areas of concern in relation to DC pension provision are:

Problem 1 – Low take up rates

A recent survey ⁽¹⁾ showed that only 66 per cent of employees eligible to join occupational DC plans take the option up. It is no good having a DC plan if no one is joining it – companies will still need to face up to the HR issues when these non-joiners reach retirement age and cannot afford to retire.

Problem 2 – Contribution rates are too low

Many DC plans offer only modest employer contribution rates – particularly without a matching commitment from employees. Member contribution rates, even where they attract a matching contribution rate from the employer, are also typically low. With little money going into DC accounts it will be unrealistic to pin hopes on strong future investment market performance to rescue members from low retirement incomes.

Problem 3 – The DC pensions lottery

Unfortunately, even members of DC plans who are wisely squirreling away more into their DC accounts are still at risk. The employees who understand the issues will be keeping their fingers crossed that they will not fall foul of investment market conditions. This can happen in one of two ways:

- **Falling values of DC accounts.** With members taking all the investment risk and their future retirement income depending heavily on achieving a good rate of investment return, a more moderate outlook for future investment markets could see the hopes of employees enjoying a comfortable retirement come crashing down
- **Rising annuity prices.** Annuity prices are linked to long-term interest rates. Generally speaking, the lower long-term interest rates become, the more expensive it will be for the member to buy an annuity or pension at retirement. Annuity prices are also linked

to life expectancy, so members of DC plans also directly feel any changes in views on this issue. However, this problem seems to be very much one way traffic at the moment, with life expectancy on the up and annuity prices rising accordingly.

Let us consider an example

As an example of this final problem, consider a member with a DC fund invested purely in UK equities (a FTSE All-Share tracking fund to be more precise). Suppose he retired in March 2000 (being age 57) having a DC fund worth £200,000. Based on annuity prices at the time, he was able to use this fund to buy a reasonable retirement income of around £9,300 per annum which will increase at 3 per cent per annum (to broadly protect his income against price inflation), and ensure his wife inherits half of this should she outlive him.

Now, let us say instead he decided, with his DC fund of £200,000, to defer his retirement until March 2003. Even though the member was then three years older,



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after three years of bear equity markets and falling long-term interest rates he could then only retire on an income of around £4,600 per annum.

This issue does not just affect this one member, it affects everyone approaching retirement at that time, or at the time of any significant market downturn. Neither is this problem isolated to those at retirement age either, one of the potential reasons for low DC take-up rates at the moment could well be the de-motivation caused by poor recent market performance and rising annuity prices – widely publicised in the popular media – shaking the confidence of those early or mid way through their careers. Of course, this only helps to worsen the problem for the long-term.

So what is the impact on employers?

In the situation above, the employee is likely to try to remain in work to avoid retiring at market lows. This has already been observed in the US and indeed, a small UK-based survey carried out by Watson Wyatt in 2003 ⁽²⁾ had some provisional results suggesting that, at the time, employees close to retirement affected by the market crash were looking to defer retirement.

If a number of employees are looking to continue to work, there are both financial and HR implications for the employer.



Managing a workforce and succession planning in such an environment will be very difficult. Whilst experience is kept within the company, there may not be suitable jobs available for these employees (as their former proteges rise up the ranks), and even if some positions are available it leaves little room for fresh talent. Ultimately keeping these employees on the payroll could be unnecessary if the business expects to get little or no benefit from them. Enforcing retirement, even if legal, may not be a palatable option especially if the employee is claiming that the company failed to alert them or adequately equip them to make the right pension decisions.



The alternative option is to enhance the pension of these employees to a level where they can afford to retire. As well as setting dangerous precedents, the cash may not be available in any case, particularly as the issue is most likely to strike when markets are down and the economy is at a low in the cycle.

Watson Wyatt has carried out some projections which would suggest that if an employee aged 30, starting on a salary of £20,000 per annum, joining a DC plan, with annual contributions

of 10 per cent of salary, looking to retire on an income of £10,000 per annum plus State benefits from age 65⁽³⁾ (giving comparable income to a final salary scheme offering an accrual rate of 120ths), there could be more than a one in four chance that a cash injection of over £50,000 would be needed to bring the employee's income up to £10,000 per annum. Now, imagine the Finance Director's reaction when cash to supplement lower than expected benefits calls are made by a number of employees all retiring at the same time, just when equity markets have been poor and the economic outlook is gloomy. The employer's attitude could of course be 'it's not my problem', but if there is a continual stream of retirees coming out with poor benefits it surely will be.

So what can employers do to solve these problems?

There are a number of possible solutions to the problems outlined above and the main ones are discussed below.

One overriding issue, however, is the general lack of governance

or management around DC plans. To what extent, for instance, are the problems we have considered even recognised by employers? How wide a problem is it? Are employers monitoring benefit adequacy alongside their ongoing measurement and monitoring of service providers? What segments of their workforce are the most affected?

These are all critical issues that employers should be on top of as part of the ongoing governance or management of their DC plans – it is, after all, just basic risk management. Whilst not, on its own, solving any of the problems identified above, basic governance is an essential part of any solution.

Solution 1 – Greater employee communication and financial education

A common theme to all three problems above is the lack of employee engagement in pensions and retirement planning. To be fair, in a final salary pensions world it has not really been necessary for employers to overly worry about





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encouraging their employees to take control of their pension provision. So in the move to DC, this need may have been overlooked to an extent – particularly given that the new DC scheme may well have started out with no or few members and assets. The time has come for many though to wake up and grasp this nettle.

Employee engagement is becoming vitally important as employees are now expected to make significant, far-reaching decisions regarding their financial affairs. As a result, traditional disclosure-driven communication, whilst very effective up to a point, is simply not going to be enough in future. Effective pension communication has evolved to become a critical issue. Employers need to follow a strategy that delivers key messages to appropriate individuals, in effect a more dynamic, multidimensional approach is needed.

Watson Wyatt has recently carried out some illuminating research into the whole area of employee engagement and this research has

proved to be one of the largest explorations into employee attitudes to pensions, savings and retirement in the UK to date. One key finding of this research was that lack of understanding and uncertainty about what employees need to do and what they are likely to get out of it is a key barrier to saving and engagement. So perhaps we can see some light at the end of the tunnel. If employees can be brought to understand the issues slightly more and begin to understand more about what they need to do and what they are likely to get out as a result, then we are likely to see a gradual increase in their engagement.

Furthermore, our research showed that the single most important development that employees felt would most improve their pensions communication is more practical examples and help on how to plan their finances. So the straightforward publication of information in isolation from other key factors, is not enough. Education and practical assistance is also required. Employers and trustees need to think beyond the simple traditional provision of a

scheme booklet and an annual newsletter if they ever hope to really get through to the individual and get them engaged. It is going to take provision of the right level of help, information and assistance at the right time, in the right way, to the right people.

In a DC world, as there are risks to the employer in forcing empowerment on its employees without providing the necessary support and assistance, the reality is no longer for employers to ask themselves “can we afford to communicate?” but rather “can we afford *not* to communicate?” So creating and delivering an effective employee communication strategy is one important stage in helping solve the potential problems of DC. This should at least improve take-up rates (mitigating problem 1) and is likely to lead to increased member contributions (mitigating problem 2). It will not, however, really be able to deal effectively with the third problem of poor investment markets – although it will help with employee understanding of the issue and hence employee expectations.



Solution 2 – Automatic enrolment

One of the key reasons for low DC take up rates is employee apathy. This can be avoided neatly by implementing an automatic enrolment process – so that members automatically join the plan unless they physically decide to opt-out. This solution would seem to work – a recent survey ⁽¹⁾ suggested that 91 per cent of members entered into a scheme automatically, remain in it. One of the downsides of automatic enrolment, however, is that there needs to be default options in all the areas that employees would usually need to make decisions – the key ones being investment and employee contribution rate.

Many employers and trustees are beginning to get nervous about their liabilities though in setting default options in DC plans, although this can, to an extent, be mitigated with appropriate levels of communication. The other downside to defaults is that it does not help with employee engagement – if employees do not have to think about what contribution rate to pay or where to invest then many will not and it will be even harder to encourage them to do so!

Having said this, automatic enrolment is a good partial solution and one that will effectively deal with problem 1 and, to an extent that appropriate defaults are set, problem 2. Problem 3 again will remain.

Solution 3 – Increase (or restructure) employer contributions

Problem 2 can of course be mitigated by increasing employer contributions and this may also go some way to helping improve take-up rates (mitigating problem 1), although only in conjunction with an effective communications strategy.

The exposure to poor investments markets (problem 3) of course remains.

Some employers are starting to take notice on this front. A recent survey indicates that the average employer DC contribution rate rose from 2003 to 2004 from around 6 per cent per annum of pensionable salary to 7.6 per cent per annum ⁽¹⁾. The solution of course costs money which the Finance Director may not have (or which he may not be willing to spend in this way).

An alternative to increasing employer contribution rates across the board is to restructure them. This could involve, for instance, focusing more contribution spend on those employees who give greatest value to the company or using pension contributions to support and encourage a broader message about the company's desired behaviour of employees. Contribution structures can be a very powerful tool in maximising the 'success' of a DC plan (however a company may wish to define 'success') and helping it achieve its strategic objectives.



“ ... DC is not a panacea and it does come with many problems and risks of its own ... ”

Solution 4 – Review investment strategy

Many DC plan members currently invest their accounts in a portfolio of equities until they get close to retirement, at which time they gradually start to move their account across into bonds and fixed interest investments – this is often achieved through an automatic investment programme called ‘lifecycle’. In many cases, this lifecycle approach is used as a default option – at least where a default is in place.

At present, there are some exciting new developments in the DC investment world around the physical delivery of investment funds, through ‘investment gateways’ (giving access to best-of-breed fund managers through obtaining collective bargaining power), as well as in the types of funds themselves. In particular, the development of CPPI (Constant Proportion Portfolio Insurance) funds. The concept behind these funds is that they are managed according to a set of pre defined asset allocation rules. The funds aim to protect asset values by holding a variable proportion of risk free assets

as well as holding exposure to risky assets, in such a way that they provide a degree of downside protection to members while retaining the upside.

Regularly reviewing a DC plan’s investment strategy and considering some of the new and exciting developments which very often are explicitly trying to deal with the problems identified, is clearly not only best practice, but also makes sound business sense. An appropriate investment strategy can help deal with problem 3.

Solution 5 – Review the benefit design

The final possible solution, (which should be considered where the potential problems identified are of

significant concern and have signs of widespread relevance amongst employees), is to review the company’s pensions strategy and benefit design.

For many companies, the key reason why they switched to DC-style pension provision was simply the fact that it was not final salary! However, given its importance in the typical benefits package, it would seem to make sound business sense to consider and agree a clear set of strategic pension scheme objectives – even if there are constraints around the level and predictability of costs. In setting these objectives, issues such as the those identified in this article should be carefully considered.



It may be that actually a scheme design that takes the best elements of DC and final salary may be the most appropriate to meet a company's strategic objectives. Such a scheme design may, for instance, better share the investment market risks between the employee and the company. One example might be a cash balance scheme where the employee might build up an account on retirement equal to, say, 20 per cent of final pay through some form of defined formula, but with the employee using this lump sum to buy an annuity on retirement. The employee bears the risk of rising annuity prices whilst the employer bears the risk of



pre-retirement investment risks. There are many different varieties of 'middle ground' solutions like this, which place a greater or lesser degree of risk with the company that may well be worthy of consideration and potentially be a better fit to the company's strategic objectives.

Conclusion

Over the last few years many employers have switched their pension provision for new employees away from final salary and onto a DC basis, with this sometimes being a largely knee-jerk reaction to expensive final salary schemes. Clearly, in some cases well considered and informed decisions have been made, with both the finance director and HR director being involved, and with the decision making process having regard to clear strategic objectives, which support the business strategy. However, DC is not a panacea and it does come with many problems and risks of its own – some of which we

have discussed in this article. There are a range of possible solutions to these problems – again the key ones have been discussed here – but the first step must always be to ensure adequate and effective governance or management is put in place around the DC plan. In practice, no one single solution will deal with all the problems and a combination of the potential solutions discussed here is likely to be the most appropriate way forward. Whatever is the right way forward for companies though, the critical point is to recognise the need to act now to avoid the next pensions crisis and stop the DC time bomb from blowing up in their faces.

In practice, we expect many companies will maintain DC plans for many years to come although, even if this is the case, it does make sound business sense to have clear strategic objectives against which to measure and monitor the 'success' of the plan. Those companies



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looking to maintain DC should consider a combination of solutions 1 to 4 to tackle some of the problems, with effective communication being at the forefront.

The successful employers will be those who make well considered and informed choices having sought buy-in and input from both finance and HR directors, and as a result, have clear strategic objectives against which they regularly measure and monitor the plan's success as part of their governance or management of the plan. These successful employers will recognise that DC is not a panacea and it is not the only alternative to final salary. However, it is also clear that DC can be made to function effectively by taking certain appropriate steps.

References

- ¹ The NAPF Annual Survey 2004.
- ² The Watson Wyatt Scary Markets Survey undertaken in May 2003 of over 4,000 participants aged 50 to 64.
- ³ Assuming future wage growth of 1.5 per cent per annum above price inflation, and that the member buys an annuity protected against inflation with a 50 per cent widow's pension on death. Retirement income of £10,000 per annum, and cash injection of £50,000 are in current price terms.

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