



Meeting the DC challenge

Pensions Age DC roundtable 2008 no.2

Our DC panel gathered together for the second time this year to tackle some of the pressing issues in the DC arena. Among those covered this time around included the threat to punish employers who encourage workers to opt out and new scheme design and marketing



DC roundtable

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Personal Accounts and opting-out

Chairman: It looks as if there will be some 'tough love' dished out over Personal Accounts with employers threatened with fines if they 'encourage' workers to opt-out. Is this a good thing?

Cox: Employees don't always act in their own best interests. The ultimate 'tough love' in this regard will be compulsion. The Government has said that it wants to see take-up levels rise to an appropriate level but I'm yet to see this clearly defined. It should mean that everyone is saving for their future. However, what is also appropriate is paying off debt and keeping up mortgage payments.

Barrie: People assume they will have the lifestyle their grandparents had in retirement – the approach to saving is going to have to change, so perhaps some 'tough love' would help. People

need to start thinking about where they are actually going to be financially come retirement time. But Personal Accounts are not a fix all for everything.

Hodges: 'Tough love' is the right phrase to use and the right course of action.

Barnard: The Regulator is not going to be able to police it. It couldn't cope a few years ago with insurance firms and people not paying their contributions.

Macro: 'Tough love' is fine if you say to people that we know what's best for you, but shouldn't we also be asking if some individuals should even be in the national scheme in the first place?

Carlina: 'Pension' is a dirty word now, so a strong approach is needed until we can change this view. Interestingly, ask people about retirement and they are more positive. It is no coincidence that we now talk about retirement saving rather than pensions.

Rowlands: The problem with allowing people to make their own minds up is that you can get employee engagement up, but that doesn't equal action. Communication and education has failed to increase saving rates because you can educate all you want but it has a marginal difference on what people then actually do. For many years the industry took the view that we needed to raise financial literacy but we now understand that clever people still make dumb decisions. The real answer is around how people make decisions.

Chairman: I don't see mobile phone companies educating their customers about how they work. They educate their customers about whether they deliver effective outcomes – such as a fair tariff. Perhaps it's less about assuming you need to educate people and more about nudging them to buy the right pension and save into it?

Cox: The risk with education, in a way, is that once it's started it has to be



Chairman: Graham Mannion is the managing director of **PensionDCisions** which provides independent benchmarking of investment and saving behaviour for DC plans. Previously he was a director at UBS Wealth Management in London where he originated and man-

aged £300 million in client assets. He was in the 2005 UBS Circle of Excellence. Prior to UBS, Mannion was an associate with McKinsey & Company in London, focusing on financial services. He started his career in Asia Pacific as an international manager with HSBC.



Panellist: Ann Flynn is a senior marketing manager with

Scottish Widows and has more than 20 years of experience in the pensions industry, with a core focus on the corporate market. She is responsible for the wide-reaching Scottish Widows communications strategy for the corporate pensions market, which continues to grow. Prior to joining Scottish Widows, Flynn held various roles with Aegon and in the adviser market, with a key focus on technical consultancy and also corporate pensions communications.



Panellist: Tony Barnard is a technical consultant at Gissings. He

started his pensions career in 1981, initially with NPI, and then with Swiss Life where he qualified as a fellow of the Chartered Insurance Institute. From 1994 to 2006 he worked for Alexander Forbes Financial Services (AFFS) moving from client manager to a technical role, researching and developing technical literature. Since joining Gissings in 2006, Barnard has been heavily involved in providing technical support to internal staff and a range of pension fund clients.



Panellist: Peter Cox is responsible for the **HSBC** bundled and

investment-only DC propositions, ensuring the processes and account management functions are compelling to large employers who take a positive approach to pensions provision. He has also been instrumental in constructing the scheme promotion package covering information and education. Cox joined HSBC Investments in June 2005 after more than 17 years experience in pensions. He previously worked for Zurich Employee Benefits.



Panellist: Louise Barrie is head of the defined contribution

client account team at **Legal & General Investment Management (LGIM)**, where the client managers have responsibility principally for clients with defined contribution arrangements. In addition to this, Barrie has personal responsibility for a number of defined benefit and defined contribution clients. She joined LGIM in 2005 and has over 17 years experience in pensions and investment markets, which was gained while working in the insurance and investment management industries.



Panellist: Lesley Carline joined **Xafinity Paymaster** in March 2007 as

head of client development within the specialist and public services unit. Her main responsibilities include the development of services for public sector occupational pension scheme arrangements. As well as having worked in the pensions industry for over 15 years, Carline is also a Fellow of the Pensions Management Institute (PMI), a student mentor for the PMI's student web and a Member of the Chartered Institute of Marketing.



Panellist: Paul Macro joined **Watson Wyatt** in August 2007

as a senior defined contribution consultant and member of the UK DC management team. This followed 17 years in senior DC roles at two other major employee benefit consultants. Macro's experience covers advice on all aspects of defined contribution plans including benefits strategy, plan design, communications, administration and investment. He also has significant defined benefit experience having qualified as an actuary in 1994.



Panellist: Mark Rowlands is head of corporate

partnerships at **AXA Life**. He joined the firm in 2004 to head up its business acquisition team and design and build a communication and education capacity for DC members. Rowlands has pioneered the development of behavioural finance research into workplace pensions and is now tasked with building a set of propositions utilising the latest research for clients and professional advisers. He has worked in the industry for nearly 20 years.



Panellist: Dave Hodges is client relations director at

Zurich Corporate Pensions, where he is directly responsible for Zurich's client relations and marketing. He began his career with the group more than 22 years ago in a variety of pensions sales and technical roles. After the Zurich merger in 1999, Hodges led the Zurich group pensions marketing team before taking up his role as head of group DC in 2002. He took on his current role at the end of 2006. He is a widely respected industry commentator.



continuous. If an individual is inspired by a presentation to the extent that they make a decisive fund choice other than default, for example, it will be important to ensure that they are similarly equipped to revise their choice as markets change or as they approach retirement. Statistics show that individuals don't rebalance when they should because the 'guiding hand' has ceased to be available.

Carline: Going back to 'tough love' and auto enrolment, quite a few companies have introduced auto enrolment and I've seen one company with a very transient population increase its take-up from 15 per cent to 45 per cent. But in auto enrolment the member is usually on the lowest contribution rate and apathy means that they will rarely bother to change it, unless they are in dire straits.

Flynn: There's a risk element to it isn't there? You put somebody on something that's too high for them, you then see them come back and say 'I couldn't afford that, why did you do that?'

Macro: In the past we've struggled getting people engaged who have actually chosen to join a pension scheme. Trying to get people engaged who have not even chosen to join, and who might not even know they are in the pension scheme half the time, will be much more difficult, and it beats me as to how we are going to do that. I'm quickly coming to the conclusion that education is not the answer and we could spend a lot of money on it and not get anywhere.

Barnard: What's going to have to happen is people are going to have to change their attitudes otherwise nothing will change.

Hodges: It's worth just reminding ourselves about the raw material we're working with. Some recent Zurich research showed that 84 per cent of young people have never had any financial advice at all and two thirds of all ages think that the credit crunch is some sort of myth.

Flynn: From research we've done over the last few years, one thing that always comes out is that people don't understand tax relief. That is such an obvious aspect of the product that we are trying to sell.

Carline: And when they do understand that they are getting tax relief on contributions, there is almost resentment that employers are getting tax relief on it as well. And the only part anyone gets excited about is the salary sacrifice because they feel they are almost cheating or getting one over on the government.

Default

Chairman: Is there an alignment that works for the customers themselves, the employers, and the providers? By providers differentiating their offerings in particular ways, it picks up and addresses some of these problems and helps the providers' bottom line.

Hodges: We're looking at what seems to be a very popular move in the industry to create blended funds, which achieve a greater level of diversity and have the capability of white-labelling them so that you can change fund managers more easily.

Barnard: The provider is in a difficult position. The onus is on the providers to come up with default schemes that work. We see examples where we are advising investment companies and

we're seeing 95 to 98 per cent of people in default funds. These are investment professionals who don't want to make a decision regarding their pension. There's pressure there.

Flynn: There should be governance of those funds, so that the provider is checking every year that they are still doing the right thing – given our current market conditions we're comfortable with them or, if not, we'll change them – and communicate that clearly.

Rowlands: Innovation will lead us. We're seeing a big increase in the use of blended funds or white-labelled funds. These are a type of fund of funds, so the end customer buys a growth fund and somebody, typically the investment consultant, provides the ongoing governance and, if needed, replaces one of the underlying managers. The end customer is informed but doesn't need to give permission or complete any paperwork.

Chairman: What's the right balance between at one end saying to an employee 'don't even think about the default', to at the other end saying, 'you should be making active decisions? 'Where's the right point in the spectrum? Is it important that the employee is seen to delegate to the default provider?'

Barrie: Lifestyle defaults are coming under fire at the moment, but we forget that the lifestyle strategy helps to prevent cautious people from putting all their money into cash too early, and also the adventurous people from putting everything into equities when they are close to retirement. So, fundamentally, until somebody comes up with a catch-all that will suit



everybody, a default lifestyle is still a good solution.

Cox: Individuals are not able to associate what they are contributing today with a tangible outcome in terms of pension tomorrow. They are simply seeing fund values going up and down and it's all bit meaningless in relation to expected income. As an asset management industry we must be more innovative in this regard. I do feel that guaranteed products would have an appeal and would encourage saving. Inevitably, there are behavioural issues when it comes to saving, such as the fear of regret – potential losses loom far larger in people's minds than any possible gains, so they don't do anything.

Barrie: What we forget is that guarantees cost money at the end of the day. If the Government wants to produce a product which is going to cost 30bps, you're not going to be able to achieve that with a number of levels of guarantee – it's just not tenable. I agree with the idea of putting in a downside stop for people getting close to retirement. We've got to start concentrating more on the back end, making sure that people are in the right place closer to retirement and beyond.

Carline: Default funds and lifestyle strategies have received quite a bit of flack in recent months but we shouldn't forget why they were introduced in the first place. They are there to protect the members from themselves. We know that one size does not fit all, but the premise is simple to explain. We can develop the strategies to be more sophisticated and suited to the individual yet still keeping the premise the same.

Hodges: People talk about the high amount of individuals in default as some sort of sign that people don't want to engage in fund choice. We did some research on this and a significant proportion of individuals have made an active choice on the default. Defaults are incredibly important in the early stages because members don't engage when they are young. The research suggests that it is only when savings hit your salary level that people start to get interested.

Rowlands: There are a number of urban myths surrounding defaults and when people become engaged in investment decision making. There's not a shred of evidence that people wake up when assets are equivalent to their salary and say 'I'd better work out what I'm going to do'. People still make stupid investment decisions, but it doesn't mean they are stupid; we need to understand what drives human decision making and apply this understanding to design better solutions for people.

Macro: The vast majority of default funds seem to be in passive global equities – now there's not a lot of management going on there. We need to be managing the approach to the default more actively.

Barrie: In a multi-manager default, who's managing the strategy itself? Who's picking the managers? Who's deciding who ought to be in that default fund? That's what we really need to work at.

Rowlands: The issue here is that this has been driven by consultants and clients seeking to reduce risk, in this case, manager selection risk. There was a phase about five years ago where the consultant community were

“A significant proportion of individuals have made an active choice on the default” - Hodges

saying the correct default was 100 per cent passive and it started off being 70:30, then it became 60:40 and then it became 50:50. Now everyone is thinking that it is probably not the ideal solution, we need new defaults. New solutions are emerging where the default is an investment solution with ongoing governance, rather than a passive-only approach.

Macro: Of course current thinking moves over time, but all too often changes only apply to new schemes or new entrants. What about existing arrangements? Plus, it's all very well consultants and providers coming up with new solutions – they are there – but it takes those running schemes to understand them and introduce such practices. We're seeing reluctance to do that.

Flynn: It's another partial change that has happened in the industry, but the real challenge and change comes in moving people to accept that it is a good concept and that they should be adopting it.

Barnard: Pension providers are very willing to add funds – if they believe you have a good governance procedure in place – they continue to add funds. But how often do they actually remove funds? We had a product provider in on Monday who has got a brand new contract and one of the bizarre things about the contract was that it had 300 funds. You can see senior consultants glazing over and thinking, 'You know, this is a brave product provider to say,



right, we don't need 150 of these funds'. Who is going to be the first product provider to do it?

Decision making

Chairman: How do we protect against knee-jerk reactions to bear markets?

Carlisle: Perhaps we need to again have a good look at whether or not we are putting the right information on benefit statements?

Macro: Or we may well be giving members too much short-term information, leading to overload.

Barrie: At the end of the day, who's reading a benefit statement? Credit crunch or no credit crunch, the older generation for whom it is important probably do look at it. But the bulk of members will probably file it – if you're lucky.

Flynn: But you will get some people who will act on events like the current credit crunch and take the wrong course of action.

Hodges: In default funds you have got a very broad range of people and you will always have individuals that do silly things – we know this. What you have to do is to act in the general interest and try and increase value for the general good.

Rowlands: There's an interesting case in the States where behavioural decision-making academics are trying to reduce inappropriate decision making. They have looked at how to present fund information in a falling market. There have been pilots where they've changed the way they present the fund information, so instead of presenting it left to right, starting with short-term performance, they do the

“Who's reading a benefit statement? The bulk of members will probably file it – if you're lucky” - Barrie

reverse, which means that it's a good feeling to start with and it reinforces the message that pension savings are for the long-term.

Flynn: That's a hugely powerful method and it can help avoid these wrong decisions. We've been guilty of allowing regulators dictate what we have to say. We haven't thought about it in terms of the end consumer. For the industry, it is starting to happen now and, clearly, we are starting to think about that customer rather than what the Regulator is going to do to us if we don't present it properly.

Barnard: We're all guilty of when we send out that benefit statement to 2,000 people, we're assuming that everyone's going to want the same information. Should we actually be targeting different parts of the membership? Your 25 year-old might just want basic information, but a 45 year-old might want a lot more.

Flynn: Look for example at the credit crunch. It would be an ideal opportunity to get messages into benefit statements for members/customers to say these are things we need to think about long-term, it's not short-term.

Hodges: The interesting challenge on defaults is more in the contract-based world with the legal and contractual limitations we have. When there is no trustee body the provider has little ability to move people without their consent, even though it may well be in their best interests to move.

Macro: It struck me as also being very much an issue for trust-based schemes. Many trustees have declined to move existing assets even though they've said future contributions should go elsewhere, leaving the decision to the individual, which they just won't make. Perhaps trustees need to be more decisive, or implement investment approaches which allow them to do this more easily, such as white-labelling.

Carlisle: But are our systems really sophisticated enough to do it?

Chairman: At the moment, the governance around asset allocation decisions seems to be just not there, although it might be in certain cases at the product provider level. In terms of people asking themselves if they've picked the right product, there seems to be a bit of a gap there.

Flynn: But will TPR step in and fill that gap?

Hodges: That's why so many defaults are passive. Putting aside the debate about whether active or passive generates greater value, there is also less to go wrong. It may just be a computer generated investment model, but it is straight forward.

Macro: Yes, passive management takes away the manager selection, but it doesn't take away the asset allocation, which we all know is much more important. People are also often given the impression that passive funds are safe, which if they are equity based, they blatantly aren't.

Cox: An example of different asset allocation can be seen in a number of diversified funds. Disappointingly, some seem to be simply glorified



“Employers who run DC schemes now need to get their heads around what their actual objectives are prior to the introduction of Personal Accounts.” - Cox

managed funds whereas others are genuinely diversified with non-correlated asset classes, yet they all have this diversified label on them.

Chairman: What is everyone’s view on whether there is a gap in expectations and how can we fix it?

Rowlands: My own sense is that there is a gap. Employees tend to under value the cost to the employer and over estimate their quality of life in retirement. Engagement should move to being about communicating the value of what’s been sponsored by the employer. Pension scheme design needs to evolve to add automation; this is the most effective way to close the gap. We talked about ‘tough love’ earlier, I prefer to use the phrase ‘nudged’, which is taken from a book by Dick Thaler. This concept has been picked up by politicians and policy makers in both the US and the UK.

Flynn: So how do you make that link though to the bottom line for the employer? That’s a difficult challenge because you can say ‘we’ll do these different things’, but then how do you provide the empirical evidence to say how well it has worked?

Hodges: The part I always find really surprising, is that employers do not sell the value of what they are providing to their own employees.

Barnard: We are seeing the distinction

between companies that have had a DB scheme and those newer companies that have never had a DB scheme. We’re finding that companies that move from DB to DC seem to stay at a very good contribution level – so it’s not unusual to see 15-20 per cent employer contributions going into some of those schemes. When we come across newer companies that have never had a DB scheme, trying to convince them of the need for reasonable levels of contributions is very difficult.

Carline: There is also this differential between employer contributions for trust/contract-based schemes. The contributions made by employees to both types of scheme were more or less the same, however, research has shown that employer contributions into trust-based schemes are far in advance of contract-based. What message does this send to employees?

Barrie: We’ve got to put the question in the context of what will happen in the next three or four years, in terms of how employers engage with the advent of Personal Accounts, or not, as the case may be, and how many of their schemes actually won’t exist come 2012? How many disengage and say, ‘as far as pension provision is concerned, the Government can deal with it?’ I think it is all around reminding employers that providing a pension is a valuable part of the employment package, and if they don’t want to provide a scheme at a minimal level, then you certainly need to for the upper echelons who will appreciate the benefit. We, potentially, see two markets – employers who accept basic pensions provided by the Government through and employers who wish to promote a pension as a means of staff retention.

Macro: This could lead to a fundamental change in the market. What’s the provider’s view on that because people likely to opt out of their own provision and go to Personal Accounts are going to be the relatively small contract-based?

Hodges: Our main market is employer sponsored arrangements anyway so we haven’t got a big base of small retail pension schemes. All of our employers pay at least the Personal Accounts level of contributions at the present time. The key to us in terms of our existing portfolio is to ensure we differentiate sufficiently from a Personal Accounts scheme proposition to offer a credible alternative.

Macro: Is that positive or negative? For those employers that open up their pension scheme to all with the level of current contributions, then this is positive – but what about those employers who spread the current cost of contributions across a wider base, often described as levelling down? You will end up administering lots of smaller accounts.

Flynn: And higher turnover because you are tapping into all populations of the workforce – those are some of the issues that we are starting to take notice of.

Cox: Employers who run DC schemes now need to get their heads around what their actual objectives are prior to the introduction of Personal Accounts. Take-up rates, the possible effect on staff retention and initial recruitment all need to be considered. They need to think about how they promote the scheme as well, in order to obtain some value and recognition out of what they have committed to. Decisions need to be made.