

The Future of DC

An investigation into the current views
of UK companies on Defined Contribution pension provision

An independent market research study by Continental Research sponsored by SEI

Executive Summary

The pension's landscape in the UK has evolved over the last five years with increasing numbers of companies choosing to close their Defined Benefit (DB) Schemes in favour of Defined Contribution (DC) schemes. Employers who have made the decision to move to DC are faced with complex decisions around the level of oversight and support they should provide to employees.

SEI recently commissioned independent research firm, Continental Research, to interview 100 executives responsible for managing their organisation's Defined Contribution (DC) pension scheme¹. The participating executives managed schemes ranging from under £10m to over £500m in assets with an equal split between those with Contract based DC schemes in place and those with Trust based DC schemes in place.

The survey was designed to gain further insight into the challenges these executives face specifically around selecting the correct DC scheme, ongoing management of the scheme and what they believe are the best practices and ideal models for management.

On a high level, the survey reveals that UK employers would like to provide strong oversight and desire the governance of a Trust Based DC solution but regulatory pressures and the difficulties of recruiting trustees are forcing them to consider Contract based DC. Executives polled expressed concerns about Contract based DC solutions specifically around the amount of guidance provided and the complexity of choice for members.

Key Findings

Contract DC – Too much choice and no one to turn to

The survey reveals that executives believe that Contract DC schemes are chosen mainly to suit the interests of the company rather than the needs of employees with only one out of the five reasons given for selection relating to the benefit for employees. The survey reflects that Contract DC is seen to be cheaper, require less management time and remove the requirement to provide trustees. Trusteeship was seen as a major burden with 58% stating that relieving this burden was an important consideration in their choice.

However, whilst the survey reflects that Contract DC is attractive to employers respondents stated a keen awareness and concern that the interests of their employees are not well served. Despite stating it as a reason for their choice of a Contract scheme it appears that investment choice has proved a hindrance rather than a help with respondents stating that the breadth of investment choice provided to members in Contract DC is too confusing. 48% of respondents believe their employees are not sufficiently informed to make investment decisions and 60% admit that they personally, as the key company contact for pensions, are not qualified to deal with pension's issues.

It is worrying to see that that such a high proportion of employers recognise that the pension scheme they are providing is inadequate but feel compelled by the burden on the company associated with Trust DC to continue down the Contract route.

¹ 100 executives responsible for company pension schemes were interviewed by telephone in March 2007. All companies had DC schemes and a proportion operated both DC and DB

Trust DC - Difficulty in recruiting and training trustees

The survey reveals that Trust DC is chosen largely by paternalistic employers who wish to retain decision making, provide customised communications and use pensions as a tool in attracting and retaining employees. However, respondents expressed serious concerns around recruiting and training trustees to a satisfactory level of competence. Over a third (34%) of respondents stated that they were finding it hard to find sufficiently experienced trustees and only slightly over half (54%) felt that their existing trustees were well trained and competent.

It appears from the survey that unless some way of alleviating the challenges around Trustee recruitment and training can be resolved more and more schemes will feel forced to consider alternative scheme options. It is clear that many companies still believe they should be providing support to their employees but feel challenged by the regulatory burden being imposed.

Need for a better default option

Previous research² by the NAPF suggests that 94% of members select the default investment option when it is available. This means that the provider's choice of default fund will have a major influence on the returns earned by the scheme. Many defaults are still based on indexed funds which, though providing low risk, also by their nature provide lower return opportunity than actively-managed funds. In the light of this, the need for a superior default option is obviously paramount and this is supported by the survey results which reveal that 2 out of 3 respondents feel there are shortcomings with the current default options available stating that there is scope for a better default choice.

As the employer is ultimately responsible for the choice of provider for a Contract scheme and the trustee body is responsible for the choice of provider for a Trust scheme the nature of the default fund should be an important factor in decision making. The research reflects that there is a need for the industry to review the default options currently being made available to assess new ways of providing default options that are low risk but also provide consistent potential return.

DC Pension Provision – A worrying future

The survey reveals a worrying statistic in relation to views on future pension provision for employees. Almost one third of all respondents from both Contract and Trust schemes were not confident that their DC scheme would provide their employees with an adequate pension in retirement.

It should be of serious concern that such a high proportion of employers are running schemes that they themselves feel are inadequate. If adequate pension provision will not come from company pensions or the government as the public are led to believe the question must be asked where will it come from?

² NAPF 2006 Annual Survey published 19th February 2007

Survey Results

Companies choose their DC scheme for different reasons. But for both types, expectations are not entirely met.

I. Contract based schemes

Why choose?

The interests of the company are primary in this choice of scheme as judged by the importance placed on different factors. Although the highest rated factor relates to employees, 4 out of the 5 reasons are benefits to employers:

% rating factor 'Very or fairly important'	
Give employees maximum choice	76
Reduce management burden	74
Best low cost option	70
Avoid burden of trusteeship	58
Needed scheme quickly	32

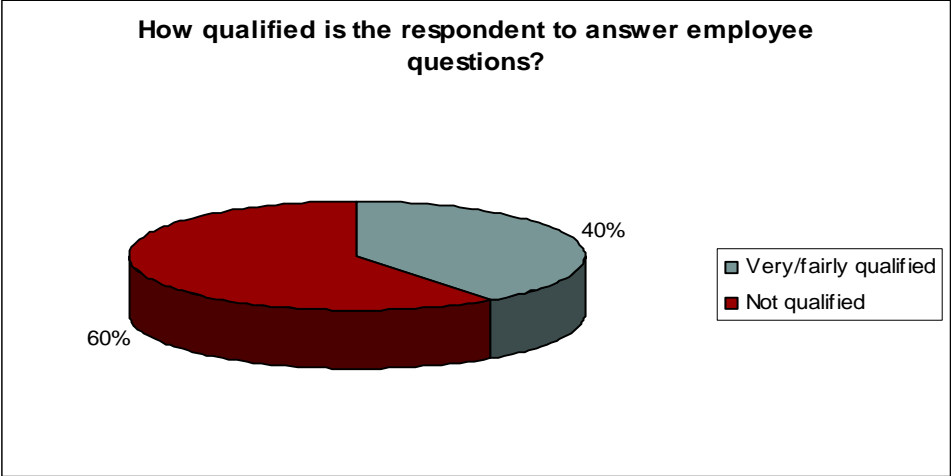
Criticisms: complexity of choice

Looking at the criticisms made of Contract schemes, it appears that the expectations of giving employees maximum choice are more complex than anticipated. Respondents feel that this plethora of choice is too confusing.

% agreeing with criticism	
Too many investment choices have caused confusion amongst our employees	40
There is no one for employees to turn to for help in decision making	34
Our provider's record keeping can be poor	26
We feel that the communication and education provided for employees have been inadequate	24
We have been disappointed in the investment performance of our provider	14

Limited advice

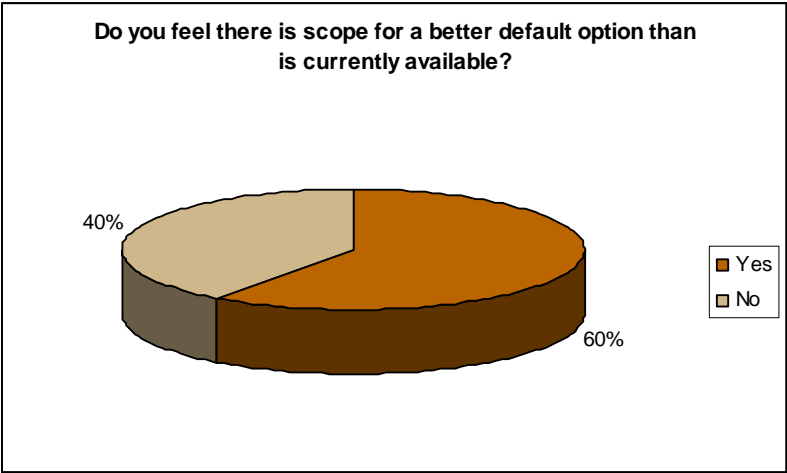
The concern that employees have 'no one to turn' to is underlined by the next question which asked how qualified the respondent was, personally, to answer employee questions. Almost 2/3 described themselves as 'not qualified'.



Poor default option

Respondents were also very critical of the default option.

Q: Research has shown that most employees choose the default option which is often an indexed option, with low risk and also low return. Do you feel that there is scope for a better default option than is currently available?



II. Trust based schemes

Why choose?

Respondents were asked to rate the importance of different factors in choosing a Trust scheme. A concern for employees is reflected in the importance placed on customisation of communication and taking responsibility for decision making:

% rating item very or fairly important	
Ability to provide customised communication to help members make choices	80
Retaining decision making provided by Defined Benefit schemes to benefit employees	78
Attracting and retaining staff	72
Contract schemes offering a confusing range of choices and not being sufficiently well monitored	48

Criticisms: finding trustees difficult and too much admin time required

The main problems for the company with a Trust based scheme were finding trustees and the excessive administrative time required.

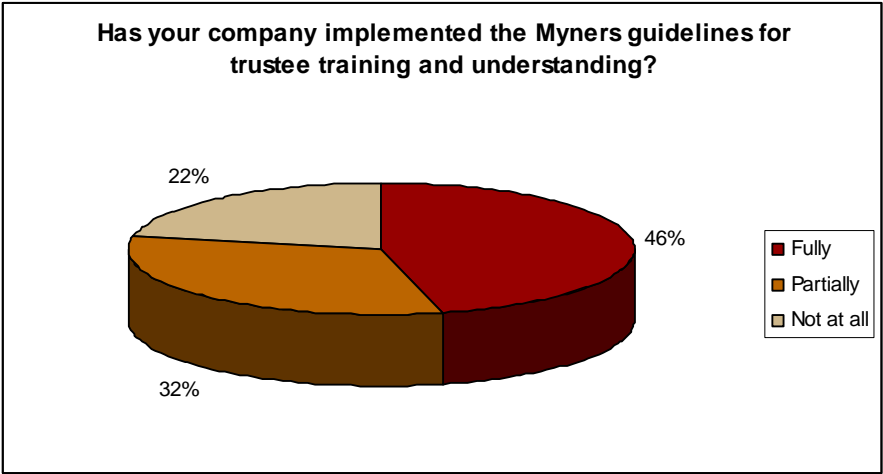
% agreeing that these factors were a problem in practice	
We are finding it increasingly difficult to find sufficiently experienced trustees	34
This type of scheme has turned out to take more administrative time than we expected	32
We have been disappointed in our provider's investment performance	20
Our employees have expressed concern about the scheme	16
The record keeping of our provider has been unsatisfactory	16

Trustees not sufficiently experienced

In addition, only slightly over half judged their trustees 'well trained and competent' and less than half had fully implemented the Myner's requirements. (Almost a quarter had not implemented any).

Competence of Trustees	
Our Trustees are well trained and competent	54%

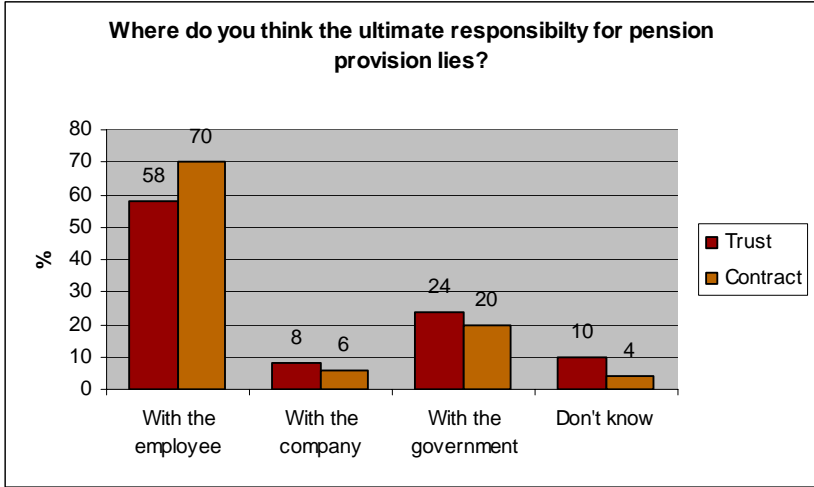
Q. The Myner's Report in 2001 recommended that steps should be taken by companies to ensure trustees have the skills necessary to make decisions regarding the pension fund. Specific recommendations included a greater investment in training and paying for their work. Has your company implemented the Myner's guidelines in relation to trustee training and understanding?



III. BOTH TRUST AND CONTRACT BASED SCHEMES

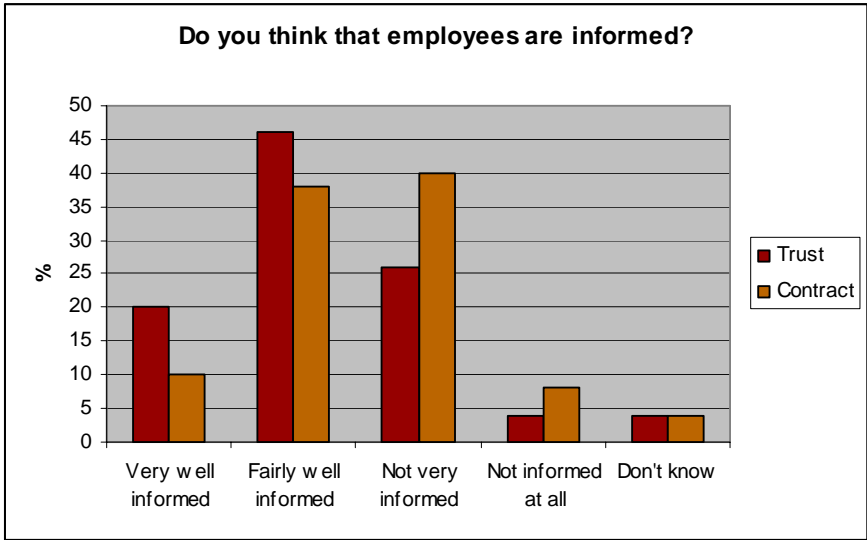
Who is ultimately responsible?

Having chosen a Defined Contribution scheme, it is perhaps not surprising that in both samples of managers the majority say that ultimate responsibility for pension provision lies with the individual. Both denied the company had this responsibility.



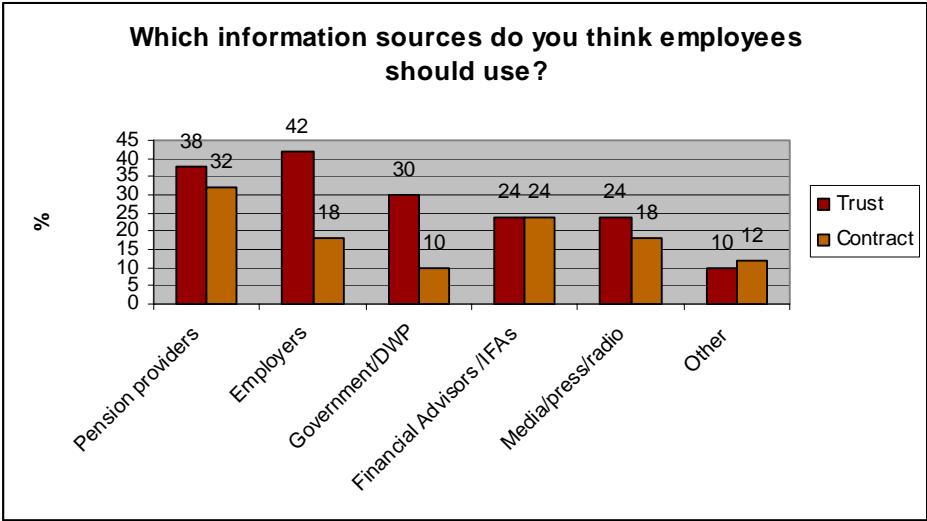
Are employees informed?

Companies with Contract schemes were least confident that their employees were very well informed to make decisions about their pension and investment for the future.



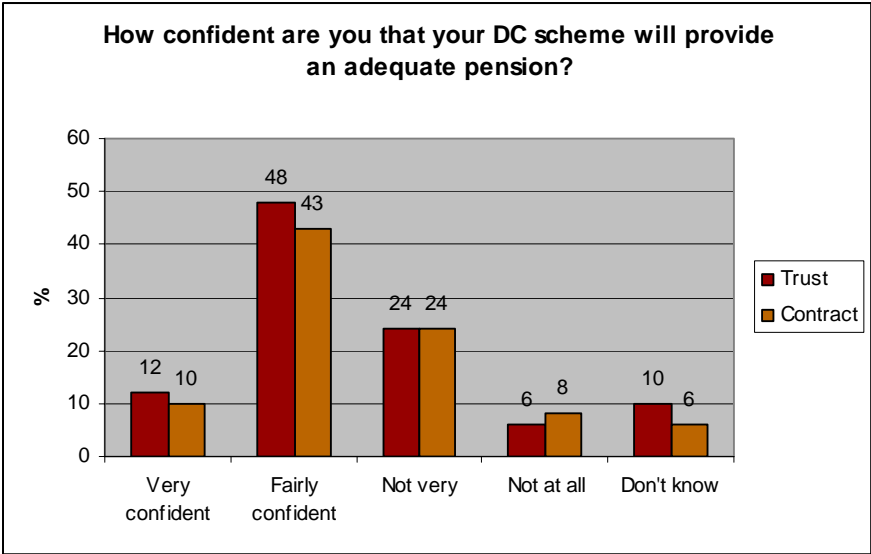
Who should provide information?

Companies with Trust schemes are much more likely to acknowledge an institutional responsibility (the provider, the company and the government) than companies with Contract schemes.



An adequate pension for employees?

Finally, an indication of the ambivalence felt towards DC schemes is reflected in the finding that almost 1 in 3 were not confident that the scheme their company provided (Contract OR Trust) would provide their employees with an adequate future pension.



Classification		
Job title	Trust	Contract
	%	%
Pension manager	30	14
HR manager/administrator	16	26
Payroll manager/administrator	20	6
Finance manager	4	20
Finance director	10	8
Other	16	18
Total Turnover		
Under £10 million	24	32
Over £10 million	44	44
DK	32	22
Size of Pension fund		
Under £200 million	62	62
£200 million - £500 million	8	2
Over £500 million	16	4
Refused	14	32
Types of Pension Scheme Operated		
Both Defined Contribution and Defined Benefit	54	30

Conclusion

The growing trend towards Defined Contribution pension schemes in the UK is unlikely to be reversed making it extremely important that this form of pension provision is fit for purpose. If, as the survey respondents reflect, the pension provision provided by the company is likely to be inadequate a situation will arise where the financial security of thousands of UK employees is in jeopardy.

It is our opinion from the research results that neither of the two forms of DC scheme currently available, Contract or Trust, provides the ideal solution for employers or members. It is clear that Contract is the most positive solution currently available for employers wishing to reduce their financial and governance burden but as the employers themselves admit it is not the best solution for members and is at risk of causing a crisis in the future as more and more members retire without adequate provision for their retirement. It is also arguable that Trust based DC provides the better option for members in terms of oversight and guidance yet currently the schemes entail too much of governance burden for employers.

The government, regulators and the industry face a collective challenge to try and address the problem of future pension provision. In our opinion there is little doubt that responsibility should not lie entirely with employers yet, as the survey reflects, if there was a way for them to provide more support for their employees without too much of a burden they would be likely to embrace it.

Glossary

Trust-Based DC Scheme - In **trust-based** occupational plans, the employee/member is a third-party beneficiary of a trust established by the sponsor/employer and governed by trustees. The employer that establishes a trust-based pension plan and the trustees who govern the plan are subject to a plethora of legal requirements. The trustees, moreover, are under a fiduciary duty to act in the members' best interests, including the duty to choose funds to offer to members, the duty to monitor the funds' investment performance, the duty to take appropriate action if those funds fail to perform, the duty to ensure that the plan is properly administered and the duty to ensure that members receive the right information about their benefits.

Contract-Based DC Scheme - In **contract-based** occupational plans, the employer chooses a provider to provide a pension plan for its employees. The provider's arrangement gives employees a set of investment choices from which they may choose to invest their retirement money. Employees participate in the plan by entering into a contract directly with the provider. The employer's responsibilities are typically limited to agreeing to deduct and remit employee contributions (and, where relevant, employer contributions) within the required period.

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