Defined contribution pension schemes

Encouraging membership and effective contributions
Defined contribution pension schemes

With the continued retreat of the state from providing pension and other welfare benefits, the onus is more than ever on individuals to make their own financial provision for retirement. Some may receive help in the form of a workplace pension scheme of some description, to which their employer contributes; the new automatic enrolment requirements will make that the case for all employees by the end of the phasing-in period in 2017. Members will be looking to get the best outcome possible from their participation in such schemes, and employers will be looking to get a decent “return” for the business from their contributions.

In most cases (at least for a while, until new designs are more widely adopted), the scheme on offer is likely to be a defined contribution (DC) one. Members will still need to make decisions at various stages throughout the term of membership. If the member doesn’t make any of those decisions, DC schemes have a default process that will usually do so on the member’s behalf, but on “standard” bases that are unlikely to reflect the member’s actual situation.

Membership and contributions

The first two key decisions will be: “Do I become a member of the scheme at all, and if so, what level of contributions should I make?” These decisions are related: the justification given by many employees for not joining (or, after having been automatically enrolled, for opting-out) is an inability or disinclination to make the necessary contribution. Once automatic enrolment applies, a large number of employees will simply default to remaining in the scheme and accepting the “hit” on their take-home pay that the contributions will inflict.

After that, members have further decisions to make regarding investment of contributions (both from the member and the employer), and conversion of the accrued capital sum into an income. There are a number of tools available at those stages to help members improve the level of their retirement savings; ultimately, the biggest single influence on savings levels is simply the amount of money contributed to the scheme.

The effect of contributions

So, the level of contributions is vital to securing the good outcome being sought. The automatic enrolment regime brings with it minimum contribution requirements. When fully operational, the minimum will be 8% of earnings between £5,668 and £41,450 per annum (in 2013/14 terms), of which the employer will have to pay at least 3%.

Although better than nothing at all, contributions at these rates are hardly enough to secure a luxurious — or even comfortable — retirement. Even with contributions paid at the full statutory minimum rate throughout a working lifetime of 40 years, a member seeking an index-linked pension for themselves, with a 50% post-death spouse’s pension, will struggle to secure more than £4,500 annually from those contributions.
The meagre state pension, even under the recently-published proposals, will only provide around £7,488 a year in today’s terms. That gives a member an average annual retirement income of little more than a third of average earnings. To put this figure into context, analysis by the Pensions Commission suggested that for someone employed on average earnings the income replacement rate in retirement should be at least two thirds of their earnings just prior to retirement.

There is a very real need, therefore, to make larger contributions. Employers already committed to providing pensions have good reason to ensure that overall contributions are sufficient to provide a good outcome for the member (and, as a result, also for the employer itself). Those who do can expect:

• Improved recruitment and retention potential
• Improved ability to retire employees from the business, by ensuring sufficient retirement income (without which an employee will become “sticky” and may have to be “bribed” to leave)
• That the contributions the business will have to pay, in an automatic enrolment world, will give a decent “return” to that business

It’s also entirely reasonable to expect members to bear a material part of any additional contribution burden themselves. Making higher employer contributions contingent on increased employee contributions may encourage greater commitment.

Hurdles

But there are hurdles to overcome in getting the member to contribute more to the scheme. Key amongst those is affordability, whether actual or only perceived. Most people will have other calls on their income which require prioritization from a long list, including such things as student debt, mortgage or rental payments, family living costs, etc.

However, even in the age of austerity, many would be able to arrange their finances to make at least modest contributions above the automatic enrolment minimum — if they felt sufficiently motivated to do so. In some cases an appetite already exists.

DWP research conducted in 2009 found that nearly half of those who said they would remain in scheme membership when automatically enrolled would be willing to contribute more than the statutory minimum.

For others, motivation is likely to come from a better appreciation of a number of factors, including the likely size of the state pension they will receive, the unit cost of each pound of pension provided through the workplace scheme, and the effects of the timing of contributions, and the compounding of interest on those contributions over time.

There is a problem here, though. Unlike a defined benefit scheme, the structure of a DC scheme focuses attention on contribution rates and on accruing capital sums. A member who has a limited knowledge of financial matters, and knows even less about pension schemes, is going to focus on those two aspects, rather than on the eventual pension outcome, which is in any case highly unpredictable.

That will lead to flawed decisions: both the contribution levels and the accrued capital are likely to appear to be more valuable in eventual pension terms than they really are, thereby breeding complacency. As a result, it becomes harder to persuade a member to give priority to further pension contributions over other more immediate calls on income.

A question of focus

The solution is to focus the member’s attention on the eventual outcome — the likely size of the pension. By definition, under a DC scheme it is impossible to predict or quantify this with absolute certainty. However, it is possible to set a target benefit, identify a contribution regime that should, applying appropriate assumptions, achieve that result, and monitor progress against that target on a regular basis.
If contributions fall short of what’s needed to provide the target, the benefit itself can be lowered instead of increasing contributions. This helps reassure hard-pressed members: they can contribute higher amounts to increase their chances of a decent benefit, but they have the comfort of a safety valve should they need it.

**Encouraging better**

Some members will have a grasp of at least the principles, if not of all the details, behind effective retirement saving and will wish to make additional contributions. Others will be content to be entirely passive members, letting the scheme determine the contributions to be taken from their salaries. For both of these groups, effective tools include not only the “employer matching” strategy, but also the passive “save more tomorrow” system.

Under that system, a member agrees to contribution increases in future years on dates coinciding with salary reviews, so that increased contributions only reduce a salary increase rather than reducing the existing take-home pay the member has come to rely on. This system has produced good results in the United States, and in the relatively few cases so far tried in the UK. However, its effectiveness may be less assured in a future where automatic annual pay rises are no longer the norm.

All of these solutions require greater input from the scheme manager than is required in a conventional DC scheme, where the basis is set at the outset and members are left to manage their own membership details. Greater input implies greater costs. Depending on the structure of the scheme, it may be possible to share at least some of these costs with the member (this would be easier with a trust-based scheme). Certainly, given the benefit to all parties in achieving a good member outcome, there is a strong argument for the employer bearing at least some of those costs, if not all.

The government and other bodies, such as the Pensions Regulator, are currently looking closely at DC schemes and considering what might be done in the legislative and regulatory fields to improve outcomes for members. Investing more money is the key, and in times of economic hardship that is a difficult task. A more imaginative perspective and greater intervention in DC schemes, however, should bear fruit.

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