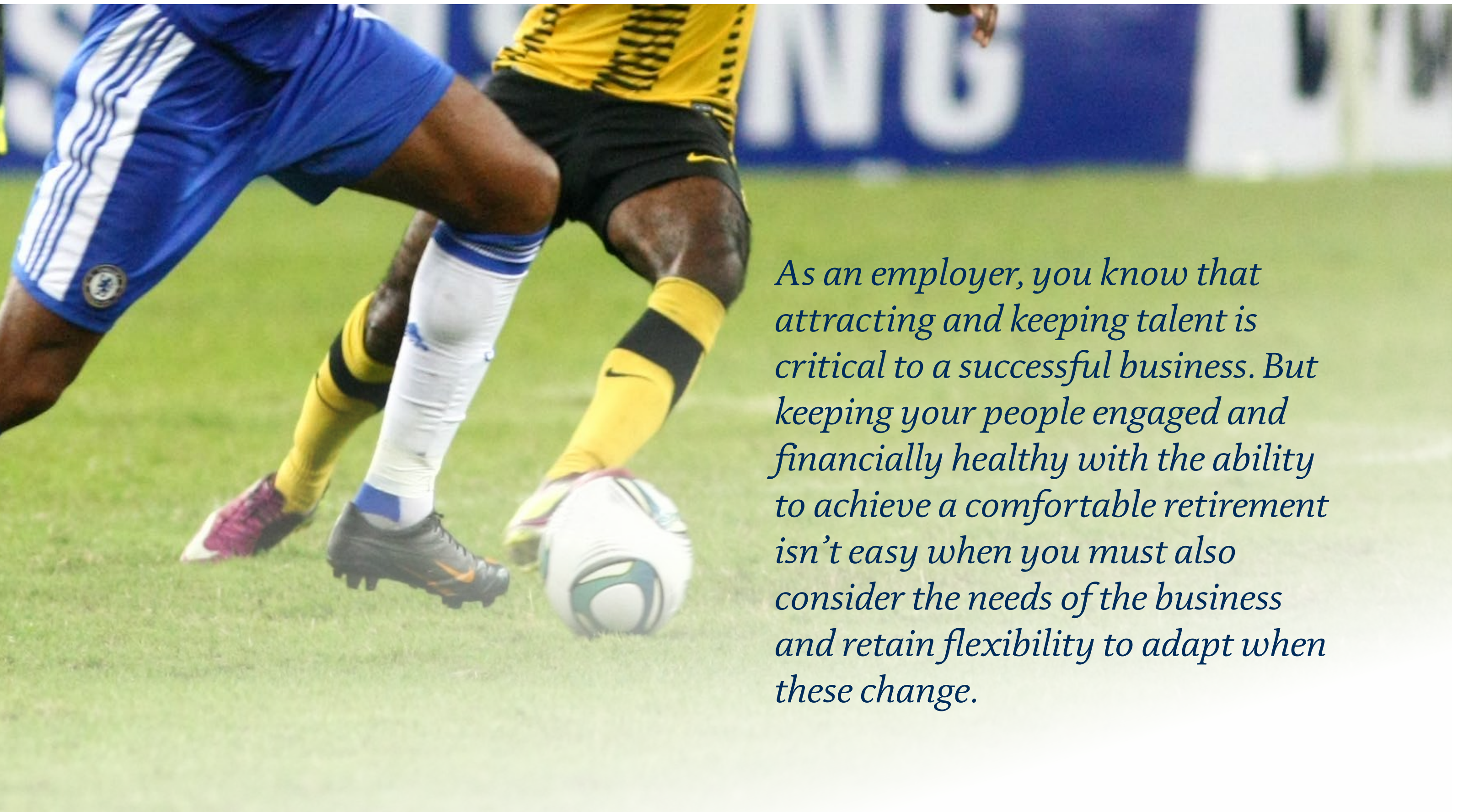
The DC Retirement World

What employers need to know

AUTUMN 2019

How to attract talent and grow your business

Find, keep and pivot the people you need to drive your business forward



As an employer, you know that attracting and keeping talent is critical to a successful business. But keeping your people engaged and financially healthy with the ability to achieve a comfortable retirement isn't easy when you must also consider the needs of the business and retain flexibility to adapt when these change.

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On top of this, the retirement landscape is ever changing, and keeping up with new regulations and legislation can be a minefield.

Our latest publication focusing on the DC retirement world aims to help you as employers to tackle the conflicts and endless decision making needed to get the best value from your scheme and to support your employees to ultimately reach better, more personalised outcomes.

I hope you find the articles interesting and thought provoking. Please do get in touch if you would like to discuss any of them.

Here's how this issue breaks down:

1 Attract talent

11%
Average DC contribution rate

But there are large variations by sector - find out more from Simon on page 3

25%
Average DC contribution rate for FTSE 100 CEOs

Find out more about managing the potentially public fall out of this from Ming on page 4

2 Keep them engaged

45%
Of employees feel that financial pressure affects their ability to perform their job[1]

Heidi discusses how you can find what makes your employees tick on page 5

3 Managing costs and returns

0.4% pa
Average master trust cost

Though the range is large – 0.2% to 0.75%. John discusses how you can manage your costs on page 7

10.4% pa
Average three year return

And there are many new developments that provide better risk/return portfolios – Sam covers these on page 8

4 Help them let go

1/3
Of the UK workforce is made up of over 50s[2]

63% of these plan to retire later than previously expected. Alex discusses the implications of this in his article on page 9

[1] Neyber's DNA of Financial Wellbeing 2018 report
[2] Age UK's Later in Life in the UK 2019 report

How competitive is your pension offering?

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A question to you all – when was the last time you reviewed your pension contribution levels and checked that your pension offering meets both your needs and the needs of your workforce?

No doubt you carried out some sort of review in the run up to your auto-enrolment (AE) staging date, and some of you may have repeated this in April 2018 and April 2019 when the AE minimum contribution rates increased. In many cases this was just to ensure you meet the minimum requirements and consequently tended to focus just on increasing lower level contribution scales rather than being a full review.

However, when considering your whole contribution structure, can you honestly say, hand on heart, that your pension benefits are better than your competitors, or that your current scheme design helps with retaining existing staff and attracting new talent?

If you can't answer this, then maybe it's time to review your scheme. In many cases your pension costs will be a significant amount of your total benefit spend so it is important that your scheme design is fit for purpose and future proof.

You may find that your pension spend is highly weighted to a particular cohort of employees, perhaps due to generous legacy arrangements still being in place, or that your main benefit scale is actually lower, or higher, than industry norms.

There are many surveys on the internet that give information about average DC contribution rates (from our LCP contribution database it's around 11% in total for DC schemes), but how do you know what's relevant to you and your workforce? For some of you it may be clear cut, but many of you reading this will be responsible for employees that may span several industry sectors, such as IT, manufacturing and financial services. Average contribution rates between sectors can vary widely.

Clearly, benchmarking is important, but crucially it's even more important to benchmark against the right thing. To help with this, we have created our LCP contribution benchmarking database – at the time of writing the database contains details of over 500 pension schemes, covering a range of different scheme types, industry sectors and sub-sectors as well as by contribution structure (fixed percentage, matching and age, service and grade related).

Using our database, we have helped many clients consider scheme design, ranging from a simple contribution benchmarking exercise to a full scheme review. The latter often incorporates how the pension package fits in with other benefits that form part of an employee's overall remuneration.

Case study - the background:

One of the most challenging cases involved a scheme which has a complicated age and service related contribution structure which was not going to be AE compliant from April 2019 for younger members. We were asked to propose several ideas that addressed this, whilst simultaneously simplifying the scheme, managing costs and importantly not upsetting any existing employees. On top of this the Annual Allowance is a real issue for many employees so increased contribution levels could have significant tax implications.

Our solution:

- Introduction of a minimum 2% employee contribution for all
- An increase in core company contributions (including additional matching contributions)
- Increased flexibility for members to elect back to lower contribution levels
- An amendment to the company's Annual Allowance policy to help more employees avoid unnecessary tax charges.

So what should you do?

1. **Benchmark your scheme design**
   - Does it meet your objectives?
   - Is it competitive?
2. **Consider making changes to your scheme design** so it is attractive to potential new employees and rewards employees you want to retain
3. **Don't forget other non-pension benefits**. Pensions are important but it's the wider remuneration package that leads to happy employees. You could be paying too much on pensions and this could be used elsewhere.

Now is the right time to take a step back and make sure your contribution structure is fit for the future.

Executive pensions in the spotlight

Are you wearing a red or amber top?

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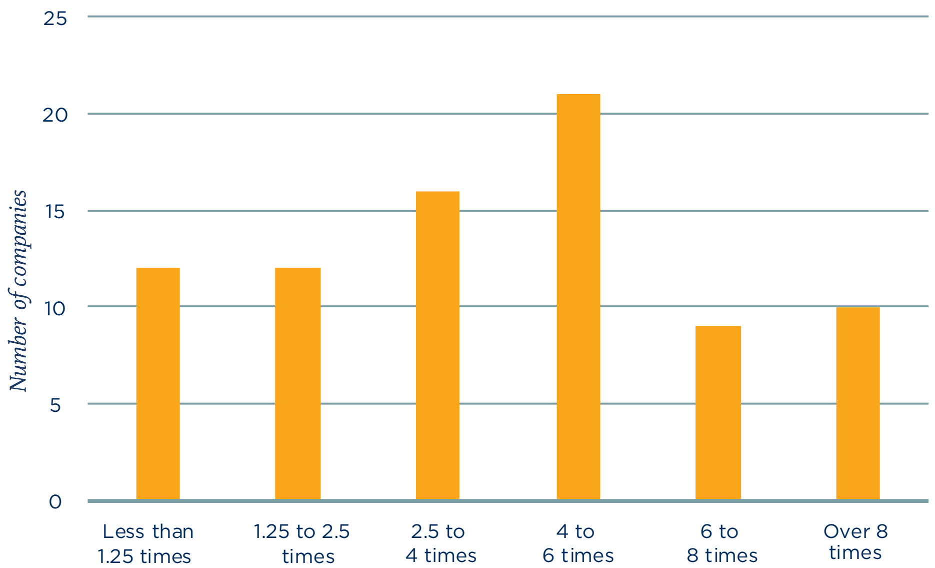
Is a CEO's job 117 (CIPD, 2019) times harder than the average employee's job? If you use pay as a measure, it seems that is the case.

In addition to this, executive pension arrangements also tend to use higher rates than the equivalents for most employees. This compounds the presentational and perception problems, and the combination appears to have broken the Investment Association, BEIS[1] and Work and Pensions Committee's backs.

Pension contribution rate for FTSE 100 CEO relative to the average pension contribution rate paid to employees



Source: LCP's Accounting for Pensions 2019 report: average DC contribution rate for FTSE 100 CEOs 25%

[1] Business, Energy and Industrial Strategy Committee

New CEO pay reporting requirements come in next year, but the Investment Association (an influential trade body for asset managers overseeing £7.7tn in assets) has already increased the pensions scrutiny by updating its guidelines on giving an "amber top" or "red top" labelling to companies where executive pensions are not aligned with the pension benefit provided to the majority of their workforce. Shareholders can, and are, using their votes to signal discontent in relation to executive pay – and the scrutiny is only likely to increase.

What should employers do?

Key questions:

1. **Are you bringing in any executives on more generous pension provision than your other employees?** If so, it is likely that you will be "red topped".
2. **Are you paying more than 25% in pension contributions to your executives (or the tier just below)?** If so, it is likely that you will be "amber topped".

If the answer to one or both questions is "yes", then **what, if anything, do you want to do about it?**

Flexibility in your overall remuneration package, combined with the potential costs of alternative retirement provision, are likely to inform the extent to which the "red" or "amber" top classifications are a material concern for your organisation. Either way, you are likely to need to be able to **justify the approach you have taken**, to both your employees and external stakeholders – and so the position should be carefully considered.

What might the implications of amber topping and red topping be?

One possible option is that, to avoid negative connotations associated with being amber topped or red topped, companies choose to increase contribution rates for the whole workforce to be similar to the rates currently offered to executives. However, this would be extremely costly, and I can't see it happening.

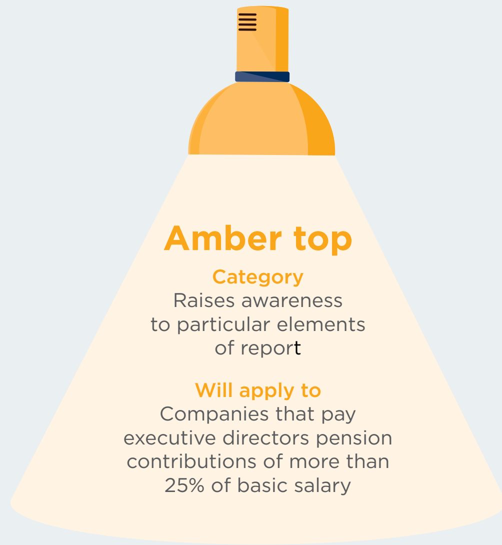
A more likely outcome is that the pensions for executives are reduced to be more in line with the current employee average. There are two core reasons for this:

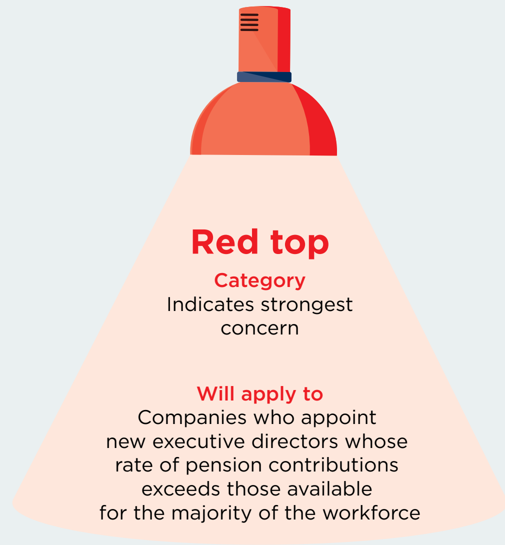
1. Pensions won't be the biggest source of executive pay (or even close). Pensions make up on average around 4% of their total pay, and is therefore something which might be relatively simple to adjust within the risk of losing business critical individuals.
2. Because of penal tax rates, higher earners are increasingly choosing to voluntarily opt out of pension provision altogether anyway.

Every company will have its own specific circumstances, but the mood music is clear - executive pensions are going to need a review no matter what.

What do "red" and "amber" tops mean?

The red and amber colour coding in the Investment Association's reports are used to highlight the severity of issues to be considered.





What makes your employees tick?

It's fair to say that the workforce of today is diverse and whilst this brings many benefits, it's also challenging for organisations. For example, the way you engage and communicate with a young employee is very different to the way you engage with a mature employee.

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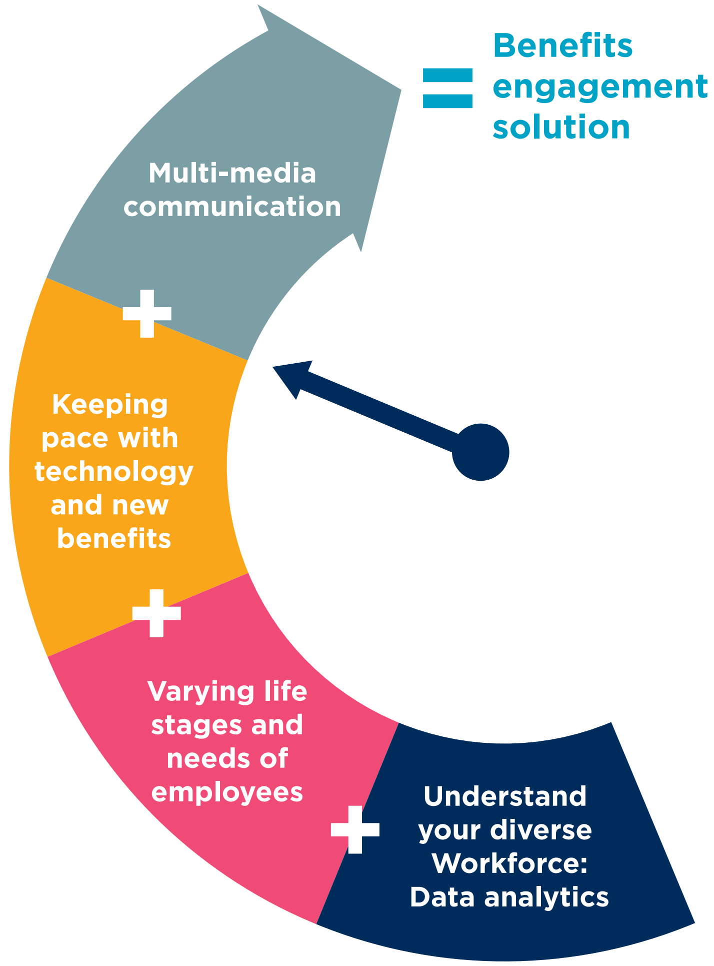
A great example would be saving – all employees, regardless of life stage have a need for saving; short, medium or long-term. If you launched a savings benefit and you focus solely on the long-term retirement need – engaging the youngsters is going to be a challenge. Likewise, focusing solely on the short-term need is not going to be helpful for those getting closer to later life.

The use of data when it comes to strategy and decision making is very powerful. You already compile a range of insights but how well do you actually use them? By looking at absence patterns it may enable you to spot trends that you weren't aware of – one of our clients found a spike in absence towards the end of the month showing their employees were struggling to pay for travel close to pay day. By running some money management sessions and promoting discounts on everyday expenses such as groceries through their existing voluntary benefits platform, these issues can be minimised for employees. Are your employees struggling to afford travel costs just before payday? Do you know what issues are keeping them awake at night?

The best way to engage your workforce and ensure the benefits you offer are relevant, and the messages you use are received in the way you wish them to is to, 1) look at your data, and 2) speak with your employees - ask them what they value and why, ask them how they like to receive information.

This can be done via surveys, through their line management structure, or through face to face events and wellbeing sessions. Focus groups are a really useful way of ascertaining feedback from employees in a safe environment – delivered in the right way, these can be a goldmine of information and the first step on the ladder of employee engagement.

Keeping pace with technology and 'new benefits' can feel like a minefield but by taking a bit of time and really understanding what's going to work, you can actually save time and money implementing things that could be a distraction or could cause more harm than good when it comes to your workforce wellbeing.



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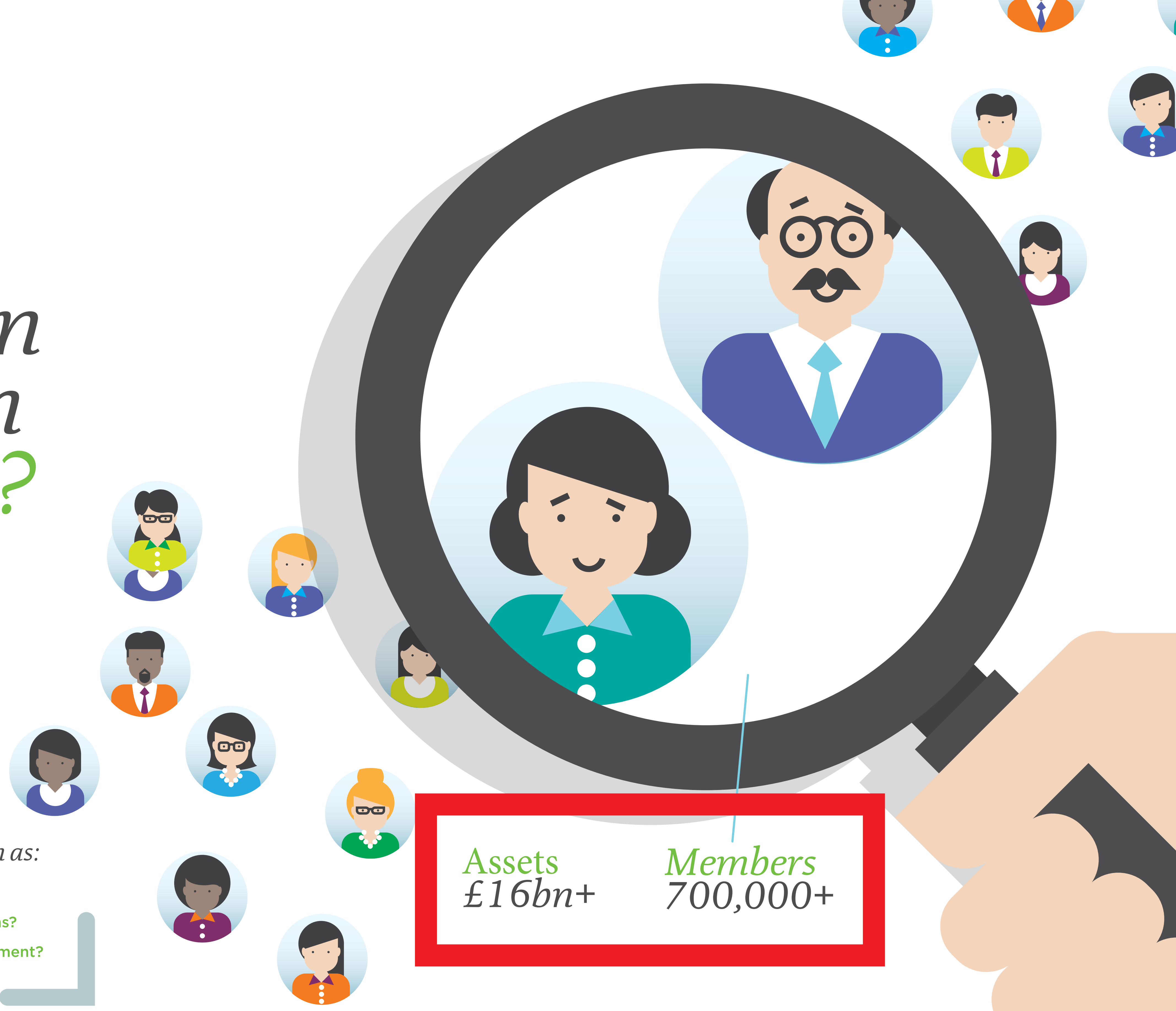
LCP Horizon now has new features. Our latest technology can help make your life easier and help you better understand your members choices.



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- Are members actively changing their elected contributions?
- How are members taking advantage of flexibility at retirement?

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LCP Horizon
Insight into action

The cost of competition

Is running your DC scheme costing more than it needs to and exposing you to unnecessary risks?

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In my view the DC scheme market place has never been more competitive with new entrants to the master trust market and mergers of many traditional providers increasing scale and competitiveness.

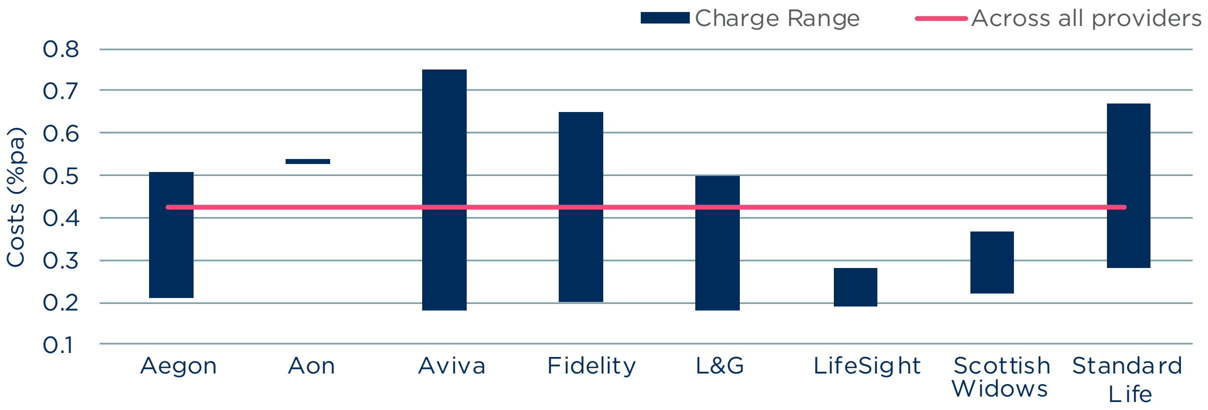
The charges offered by providers are lower now than they have ever been, and employers and members can benefit from this competitive market.

In the past many occupational DC pension schemes operated on a basis where the employer met the running costs and the member paid the investment costs. New DC schemes are very rarely set up on this basis these days. Generally, in the new world all the costs are paid by the members /employees.

Could you pay less?

A quick review of some of the master trusts Chair's Statements shows the range of charges applying to the default funds. Importantly from this chart you can see the lowest offered by each master trust scheme. This gives an indication of just how competitive charges are.

Range of charges for standard default funds for master trust schemes



Source: Master trust providers' 2017 / 2018 accounts / Chair's Statement

Notes: Charges shown are the range of charges applicable for each provider's main default investment fund used during the growth stage of a lifestyle or a longer vintage target date fund if applicable.

It is perhaps not surprising that the chart opposite appears to reflect the provider's position in the market place. Providers that compete for a wide range of schemes of varying quality show the largest variation in the charges they make for running a scheme, whereas providers that compete for only higher quality schemes show a much smaller variation in charges. It will be interesting to see how this chart changes over time, as the master trust market matures.

As costs have been coming down, a switch to the new world is now easier than before. But some employers continue to run schemes on the old model, unaware that there is scope for savings. Even if your scheme is paid for by your employees, when was the last time it was reviewed? As costs have come down, are your employees paying more than they should be?

Clearly low charges are not everything and there should not be a mad rush for the lowest cost. But at the same time as charges have been reducing, propositions and offerings have got more comprehensive and services have generally improved, so it could be a win win. New technology and communications have featured strongly in proposition development, with video benefit statements, smart phone access to accounts and more member friendly tools and support. With this choice comes complexity and potentially confusion for members, but providers have also been developing their guidance and advice offerings for members wanting to access their benefits.

Could a different structure benefit your employees?

The type of scheme employers are choosing to run has also changed. In the past if an employer closed their occupational pension scheme they perhaps moved employees into group personal pensions (GPPs) or even Self Invested Personal Pensions (SIPPs). A few years ago, these were seen as the future for workplace pension savings as members had full control, including their investments. The wide investment choice, with funds from different investment managers covering a range of assets and markets was considered a real benefit. But can you have too much choice? All the evidence continues to show most employees don't know where to start and just want to go into a well-run default investment.

One issue for many GPPs is that the investment fund range has been added to many times over the years resulting in duplicate investments and a lack of an overall strategy. A master trust by comparison has relatively few funds which could be seen as a major negative, but in my view, this is not the case. The master trust trustees are typically more proactive with managing the fund range and importantly the default investment strategy. This means investment offerings are kept up to date and are more about quality rather than quantity.

What should you do now?

The key is not to set and forget. Things change over time, such as costs, what providers offer, and even pension scheme structures, so you do need to **keep your offering under review.**

With pension arrangements such as a GPP or master trust, there is a temptation from an employer perspective to think that pension provision has been outsourced and so have any associated risks. It is true that some of the compliance aspects of running a scheme are managed for you, particularly with a master trust having its own trustees who are there to look after the members. But the reality is somewhat different. If employees aren't auto enrolled when they should be, or the wrong contributions are paid it will be the employer that will be pulled up about this by the Regulator not the pension provider.

Ultimately if the employee has not saved enough or understood the arrangement and can't afford to retire and leave the business, this will be a problem for the employer, not the pension provider. For these reasons it makes sense for employers to take some ownership of their pension arrangements and **ensure they get maximum value from their pension provider.**

The most common way to keep your DC pension offering under review is have a **small governance group** overseeing the pension scheme. This would typically be made up of employer and employee representatives and meet a couple of times a year. I help employers run governance groups and one of the things we help them do is think about their objectives. But I'd recommend you put a review of the costs you pay, and the benefits you get for them as your first priority.

Smarter, cheaper and more flexible

New DC investment options

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There are three key levers your DC savers can pull and they are:

1. Contributing more
2. Retiring later
3. Getting more out of their investment strategy.

To ensure your employees can retire when they want, without significant additional contributions, one of the questions you need to ask - are they getting enough out of the default investment strategy?

DC investment arrangements have evolved at an astronomical pace in recent years. Gone are the days of a passive equity fund de-risking into bonds and cash. But why the huge change? Are these changes adding value for employees and most important of all, are you capturing them in your investment offering?

What has changed?

In my view, the first catalyst to investment innovation was the Freedom and Choice regulations (2015). I saw this as regulatory confirmation that member retirement outcomes were outdated; for many members the best retirement outcome is rarely the purchase of an annuity. The change, allowing members to take their pensions savings as either drawdown, cash or as an annuity, began a drive to produce products catering for differing retirement outcomes.

The second catalyst has been the stark reality that over the past few years, DC pension contributions and assets have grown astronomically, driven by demographic and regulatory changes; nearly all new joiners to the workforce contribute to a DC pension, a fact rubber stamped by the introduction of auto-enrolment. This dramatic increase in the flow of money has driven innovation in investment products – DC is now many managers' best way of guaranteeing a constant income stream going forward.

How have investment products evolved?

- Products traditionally viewed as the domain of active managers are being systematically replicated in a passive format by **enterprising passive managers**. One example is the rise in popularity of multifactor equities, providing an investment style empirically proven to add value for fees comparable to traditional passive equity solutions.
- The rise in the prevalence of **illiquid investments** has provided companies the opportunity to offer members an asset class to pair with equities in the accumulation phase of a lifestyle. Illiquids provide DC members with a previously unavailable diversifier, with a low correlation with equities and a different return source – an illiquidity premium. The rise in the popularity of illiquid products has also stimulated developments at the investment platforms DC assets are hosted on to ensure that, should a fund gate, and investments and disinvestments not be allowed for a period of time, this can be accommodated in a lifestyle structure with no impact to members.
- Traditionally lifestyle funds allocated to bonds as a method of providing members with an annuity proxy in the run up to retirement. Again, innovation has provided solutions now that are more **focused targeting drawdown** and so rather than matching an annuity these funds focus on downside protection or stable returns. One of my Schemes has recently made an allocation to an illiquid High Yield fund for example that seeks to return a 5% absolute target on an annual basis as a method of further diversifying their fixed income exposure.

What about fees?

Competition between asset managers has also resulted in a reduction in fees to members. One of my clients has recently reviewed their fund range and platform provider and received a 0.11% discount on fees. This may not sound much, but when projecting forward member pots, the impact on their outcomes was an extra £10,900 – a significant difference. This highlights the need for regular reviews of the funds and provider you use.

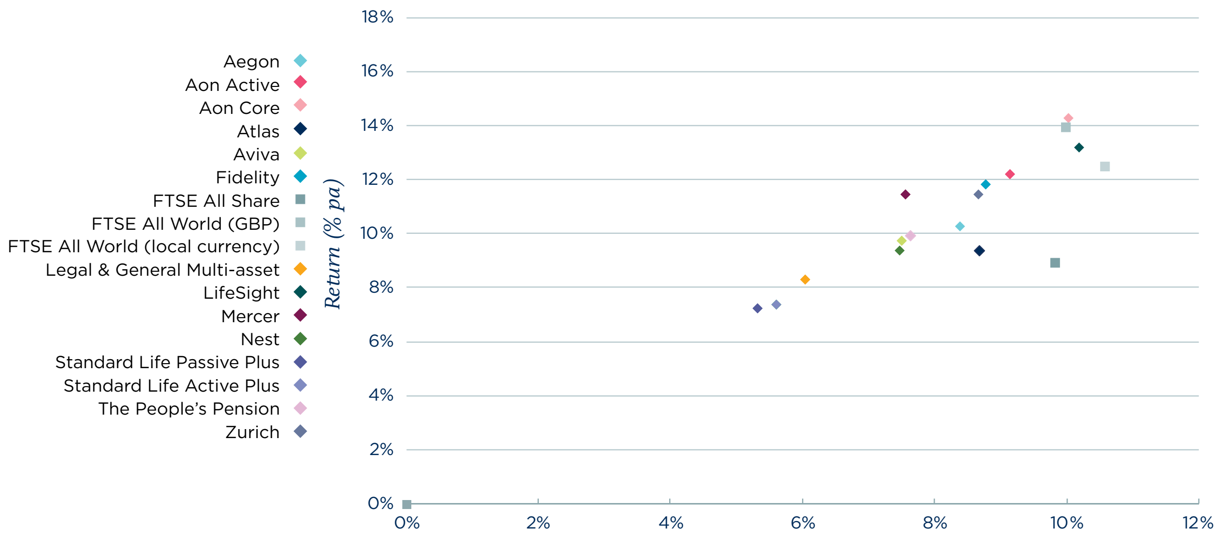
How should we capture these changes?

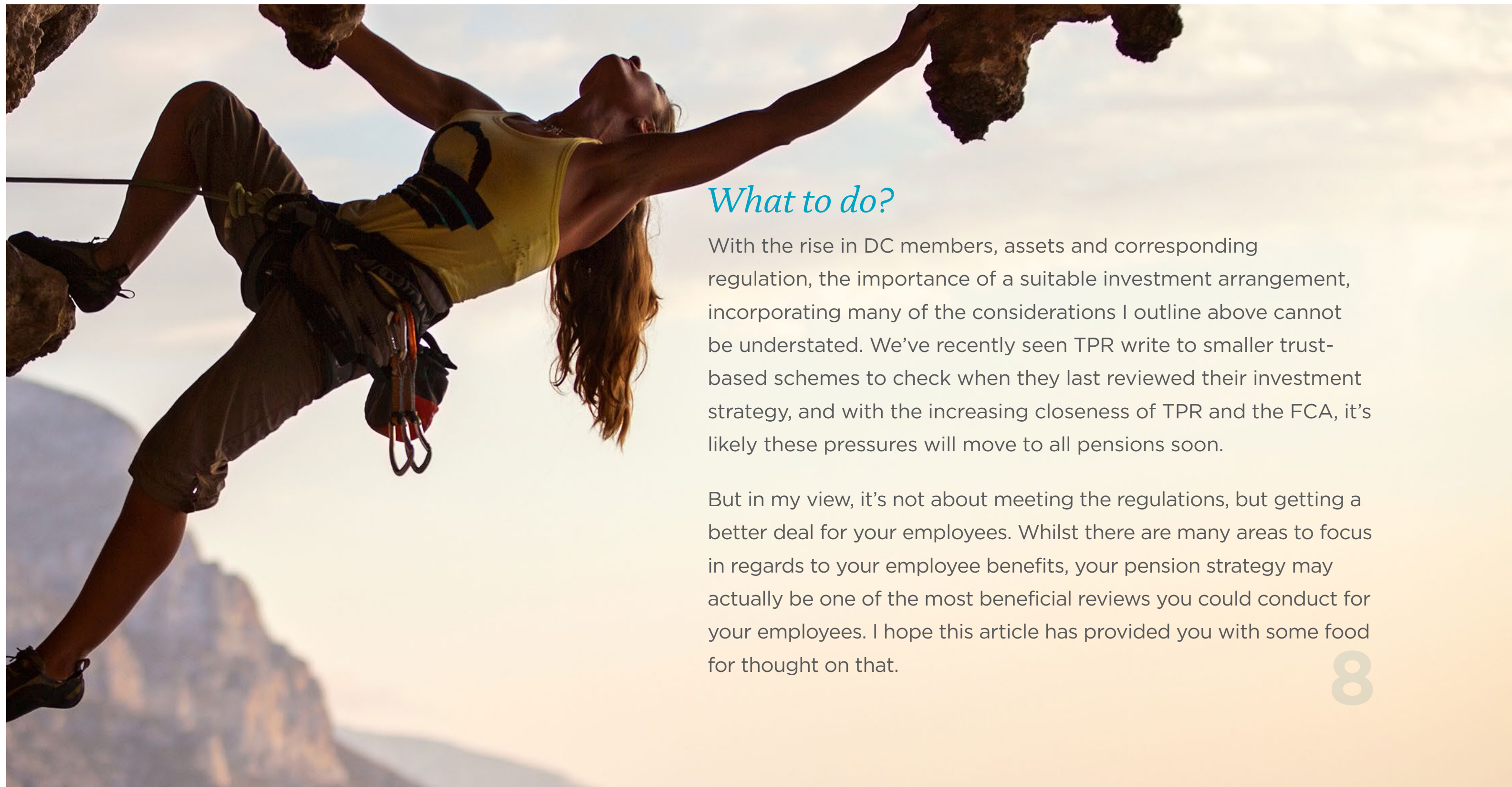
Many companies would regard it as their parental duty to members to ensure that their pension offering has, at a minimum, considered the above developments, especially with the proven value add aspect that they are having to member pots.

Couple this with innovations in lifestyle designs plus the importance of incorporating actual member demographics into lifestyle design, and a compelling case emerges for a regular review of the investment offering to members.

As you can see from the graph below, there is huge disparity in risk/return profiles for various off the shelf master trusts. So, whether you have your own bespoke lifestyle, or you use the standard offering of your master trust of group personal pension, you should check what it is doing, and if it's right for your employees. Time and time again we see lifestyles that are not fit for purpose, purely because they haven't been reviewed by the company recently, and the ideas, and fees, have moved on. Don't let this be you.

Risk vs Return of master trust defaults over 3 years to 30 June 2019





What to do?

With the rise in DC members, assets and corresponding regulation, the importance of a suitable investment arrangement, incorporating many of the considerations I outline above cannot be understated. We've recently seen TPR write to smaller trust-based schemes to check when they last reviewed their investment strategy, and with the increasing closeness of TPR and the FCA, it's likely these pressures will move to all pensions soon.

But in my view, it's not about meeting the regulations, but getting a better deal for your employees. Whilst there are many areas to focus in regards to your employee benefits, your pension strategy may actually be one of the most beneficial reviews you could conduct for your employees. I hope this article has provided you with some food for thought on that.

Maintaining the blend of employees you need

Are you prepared for the retirement barriers?

I won't be the first person to highlight this, but the amounts being saved within DC retirement pots aren't going to be enough for a large number of people to survive on in their retirements. Even for those fortunate enough to build up reasonable sized DC pots, the savings might still be insufficient to support or retain their expected lifestyles in retirement.

This will have noticeable consequences for employers over the coming years and employers should therefore start to seriously think about what they can and should do, in order to avoid a workforce planning minefield in 10 years or so, if not before.

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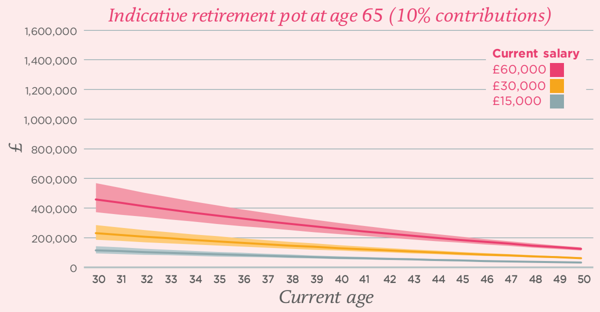
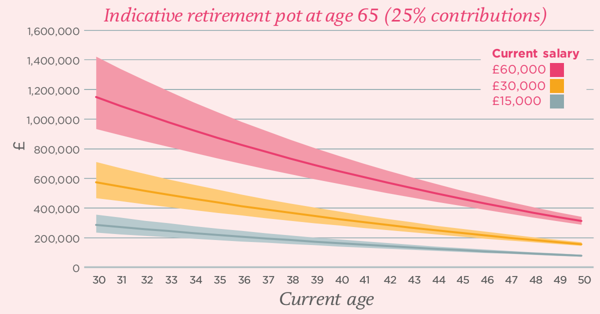
How are DC pot sizes going to impact your workforce?

Looking at a cross-section of example individuals over a variety of scenarios, the position is fairly depressing in all but the more optimistic scenarios for the future – as shown by the analysis below. The charts look at what retirement pots might be in today's money terms if DC investment growth is somewhere between 3% and 5% pa above inflation:





To put the figures in the images above into context, a retirement pot of £200,000 at age 65 might buy a pension in the insurance market of £5,500 pa. The maths then isn't too difficult for working out that, based on the salaries and projected pots of the example scheme members above, pensions are going to be far far less than pre-retirement salaries, unless significant DC contributions are being paid in. Even if your employees use their pots for income drawdown rather than buying an annuity, the pots can quickly run out in a world where average life expectancies are now well into the 80s.

Some individuals will have additional pension pots from previous jobs or from their personal savings. However, as time goes on more and more of your workforce are unlikely to have anything else meaningful from other sources for retirement. This is particularly the case for younger employees.

The State Pension will help in part, particularly for lower earners for whom the full State Pension of c.£8,500 (at current levels) is likely to form a large component of their overall retirement benefit. However - the State Pension age has already moved to 68 for some (with further rises to come?) Historically we doubt many employers have seen retirements taking place on average this late in careers.

So if fewer and fewer people can realistically retire and retain the lifestyles they want/expect then a fair assumption is that they simply won't retire and will instead continue to work for as long as they can (perhaps until at least State Pension age, and possibly beyond).

Workforce projections and planning therefore need to be scrutinised so that businesses are able to retain a healthy natural churn of workforce where older employees are able to retire and free up roles for the younger generation coming through the workforce, as well as permitting promotion opportunities for others. Undertaking a workforce retirement viability analysis, and taking action to improve the position (eg via increased education and better communications on pensions) can help companies to take action now (or plan for doing so) before any significant issues arise in the coming years.

LCP INSIGHT CLARITY ADVICE

VISTA

NEXT EDITION WINTER 2019/20

LCP Vista is a half yearly publication which keeps you informed with our latest investment thinking

Your signal in the noise

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Elizabeth Thompson, Allen & Overy

A really fantastic event. So relative, relatable and interesting.

Megan Lee, McDonald's Restaurants Ltd

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