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Pensions Institute

DELIVERING DC?

Barriers to participation in the company-sponsored pensions market

A Pensions Institute report for Pension Practitioners, Employers, and Policymakers

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Delivering DC?

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Foreword

In January this year, the Pensions Institute moved to Cass Business School. This provided an opportunity both to rebrand and to think anew about the work we should undertake.

Building on our international reputation for academic research, we decided to start a new series of reports that focus on pensions issues of direct relevance to pension practitioners, employers and policymakers.

The first report in the series investigates the problems with delivering defined contribution pensions to the employees of small and medium-sized enterprises (SMEs). This is a key target for the government if its plan to change the balance between state and private provision from 60:40 to 40:60 is to succeed.

The report shows that providers and advisers are finding it increasingly uneconomic to market to these companies and are withdrawing rather than redoubling their efforts. This is an important and difficult issue for both government and private sector providers.

I am delighted that Debbie Harrison and Alistair Byrne have taken the lead in producing this report. I hope it will be the first of many such reports that dig beneath the surface to discover exactly where the problems lie in the pensions market and to make recommendations to resolve these difficulties.

I should stress that the views expressed in the report are those of the authors and not necessarily those of the Pensions Institute, which itself takes no policy position.

Professor David Blake
Director, Pensions Institute
October 2004

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Distribution Technology
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Friends Provident
FTSE International
Gissings
Hargreaves Lansdown
Hewitt Bacon & Woodrow
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Scottish Widows
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Preface

This is the first Pensions Institute report for pension practitioners, employers and policymakers. It provides primary research and analysis of the barriers to participation at adviser, provider, employer and employee levels in the company-sponsored defined contribution (DC) pension market. In these pages you will discover how the market works in practice, rather than in theory.

An important feature of this research is that it is based on interviews with a wide range of organisations, conducted on the understanding that information provided and opinions expressed would be quoted on a non-attributable basis. This methodology enables us to “tell it how it is” rather than report the diluted attributable responses that would have emerged after interviewees had consulted their public relations, compliance, and legal departments.

As such the findings and recommendations of this report are at times uncomfortable and controversial but we hope they will shed light on what have hitherto been perceived as inexplicable gaps in information and understanding, for organisations as diverse as the Department for Work and Pensions, the Treasury, the National Association of Pension Funds, and the TUC.

In the light of our findings the government must understand that if no changes are made to the way company-sponsored pensions are delivered in the smaller and medium sized business market it will not succeed in significantly extending pension provision and has virtually no chance of achieving its ambition to change the 40:60, private/state benefit dependency ratio, to 60:40 by the year 2050. Our evidence demonstrates that the government has not recognised where the real barriers to participation lie for smaller and medium sized companies, and that it does not consider seriously the views of advisers that work in, and understand, this tough market.

Our objective is to identify where the real barriers to participation lie so that the government, employers and practitioners can work together to improve the design and delivery of DC pension schemes. We believe providers and advisers may be able to achieve these objectives by adopting the recommendations set out in this report. Whether these organisations are able to extend best practice to the smaller employers, particularly those with predominantly lower paid employees, is questionable unless we can make multi-employer schemes genuinely attractive for all parties concerned.

For employers, the decision to improve take-up is extremely problematical. Advisers and providers are not interested in schemes where the employer makes no contribution but in any contribution-matching scheme (where the employer and employee pay an equivalent or similar rate) the cost implications of higher employee participation are significant and immediate. We believe many employers – and in particular finance directors – will only seek to increase take-up on a voluntary basis if it can be demonstrated clearly that their investment will reap dividends in terms of employee satisfaction, appreciation, and continuing service. This is one of the biggest challenges we face. For right or for wrong, the assumption that pension schemes help to recruit and retain good staff has been questioned and dismissed by many of our interviewees.

Our research focuses on smaller and medium sized enterprises (SMEs) and the providers and advisers that service this vast and diverse market. In the following pages we set out our definition of SMEs but broadly these are companies (both quoted and private) and partnerships below the FTSE 350 index, which denotes the unofficial market division for consultants, insurance companies and asset managers. In practice the "solutions" offered to larger companies – particularly those presented by major consultants to the FTSE 100 companies – are simply not available to SMEs. As one such consultant succinctly explained: "There's not enough money in it".

Pension problems are not exclusive to SMEs: far from it. However, the management and cost implications of pension provision for smaller and medium sized employers are very different from those that affect the larger companies. FTSE 350 employers – and equivalent private and foreign companies that are not listed on the London Stockmarket – have a commercial reputation to maintain. They wish – indeed need – to be seen as socially responsible employers. These companies have a very wide range of stakeholders and customers to consider. They are likely to have a much broader choice of options and resources to enable them to withstand financial problems with defined benefit (DB) schemes. At the same time they can afford to invest significantly in the promotion of their new defined contribution (DC) schemes. Clearly these factors are recognised by the advisers and providers that operate in this lucrative segment of the market.

This unofficial market segmentation has serious implications for the government's pensions policy. We suggest that if this divide cannot be breached, for reasons of commerce and profit, then at the very least it should be explicit and publicly debated, so that policymakers keen to increase pension participation among SMEs can develop workable solutions with the organisations that actually operate in this market.

Throughout this report our approach is to identify and assess the current problems, to offer observations and insights, and to recommend pragmatic ways forward. We do not believe there is a range of perfect models for the design and delivery of DC that would draw the universal support of employers, policymakers and practitioners, and so sensible compromises must be agreed – again by those prepared to do the work.

We hope you will find this report illuminating in its fresh approach to contemporary pension problems.

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Executive Summary

The key messages of this report are as follows:

The government must understand that if no changes are made to the way employer-sponsored DC pension schemes are designed and delivered in the smaller and medium sized company market it will not significantly extend pension provision and has virtually no chance of achieving its ambition to change the 40:60 private/state benefit dependency ratio, to 60:40 by the year 2050.

Our evidence demonstrates that the government has not recognised where the real barriers to participation lie for smaller and medium sized companies, and that it does not consider seriously the views of advisers that work in, and understand, this tough market.

At present a complex and interrelated series of factors denies access to affordable and effective company pension provision to millions of people in the low-to-average earnings bracket in the smaller and medium sized company market. These factors include:

- The finance director's reluctance to pay a company contribution to its pension scheme. FDs are not convinced by the traditional rationale for running a pension scheme, namely that it helps to recruit, retain and motivate high-quality staff. Given this lack of conviction, for FDs the pension scheme does not represent a measurable return on investment.
- The barriers imposed by the government's means testing system, which discourages employers, advisers and providers from promoting membership to low-to-average earners.
- The withdrawal of advisers and providers from companies with fewer than 50-100 employees due to negligible profit margins.
- The fact that where providers do sell to "less attractive" smaller companies, with low-to-average earning employees, they impose an above-average annual management charge to compensate for the lack of economies of scale.
- The commission war among pension providers, which started with the introduction of stakeholder schemes in 2001, encourages advisers in the SME market to select only those providers that pay above-average commission rates. Several major pension providers that either do not pay commission or do not pay sufficiently high rates, are ignored by advisers.
- Companies selected for their commission terms also provide the main default investment option – typically a managed unit linked fund – in which 80%-90% of members invest from the date they join the scheme to the date they retire. These funds do not adhere to clear performance benchmarks, nor do they necessarily provide relevant risk profiles for the long-term and the changing requirements of members over the course of their working lives.
- The lack of "at retirement" services for members, most of whom accept their provider's annuity, which could offer an income 25%-30% lower than the best available rates.

The following eight summaries relate to the main research sections that start on page 18.

1. Finance directors actively discourage high employee participation rates

In smaller companies finance directors hold the pension purse strings, with human resources (HR) playing a very secondary role. Finance directors (FDs) are not convinced by the traditional HR argument that pension schemes attract, retain, and motivate staff, and in many cases impose strict limitations on the target employee participation rate in their defined contribution (DC) schemes. This point is confirmed by advisers, consultants, and pension providers to the very large schemes as well as to SMEs. In this respect the FD represents a very significant barrier to wider private pension participation in the company-sponsored market.

The restriction on participation is highly relevant to the control of cash flow and payroll costs. Where the employer offers a contribution match, the company incurs costs that increase directly in proportion to the number of employees who join the scheme.

It is important to appreciate that the finance director is not opposed to costs per se, but to costs that do not deliver a measurable benefit to the company. Independent financial advisers, employee benefits consultants, and pension providers are unanimous in their view that it is impossible to demonstrate the link between the availability of an attractive pension scheme and reduced staff turnover or improved staff performance. This is a fundamental problem and one that the government and pensions industry must address if we are to encourage, rather than force, further employer support.

Unless we can convince finance directors that an employer contribution to the pension scheme provides a good return on the investment, empty stakeholder boxes will continue to represent only the more visible part of the problem. It is clear from our research that employers that appear to provide an attractive scheme, in practice can ensure low take-up through lack of endorsement, lack of time for communications, and by imposing a high minimum employee contribution rate. Under the current voluntary system it is very easy for employers to obey the letter of the law while ignoring its spirit.

We note that while pensions for the workforce may not be a priority for finance directors, we understand that they usually secure individual advice for themselves and key executives.

2. Means testing, market forces and the threat of regulatory penalties deny millions access to schemes

Between 4.5m and 7m employees, corresponding to 16% - 25% of the working population, effectively are excluded from the opportunity to save in company schemes due to two separate but interrelated issues:

- There is a widespread fear on the part of advisers and employers of mis-selling the company scheme to lower earners who might be better off claiming means-tested benefits in retirement. This all-pervasive fear results in the exclusion of employees who would more than likely benefit from scheme membership. The perception of the means testing system as complex and impenetrable is as much a problem as the way the system actually works in practice.

- Providers and advisers are withdrawing at a rapid pace from the smaller employer market due to the lack of profit. Typically providers are moving to an implicit minimum of 50 employees. Where a high proportion of employees are on national average earnings or less, this minimum is likely to be about 100. The exclusion on the grounds of low earnings extends to the individual market too.

The government has been shielded from appreciating the extent of disenfranchisement because the insurance companies that traditionally have provided products in the retail and small company market are unlikely to admit in public that they operate a covert exclusion policy, since this would harm their reputation as "household names".

Our research also reveals the stark fact that employees in companies considered relatively unattractive by providers (as a result of low overall numbers and a low earnings profile) have to pay a higher annual management charge (AMC) than employees in more "profitable" schemes.

3. The first "DC boomer" generation will hit retirement in 3-6 years. We do not have the systems in place to cope

At-retirement planning for SMEs is under-researched and inadequate. The first "DC boomer" generation will start to hit retirement between 2007 and 2010. This group includes employees in their 50s who were persuaded or required to switch from the company defined benefit (DB) scheme into the new defined contribution (DC) scheme as early as 1990, when advisers first started recommending these DB-to-DC conversions.

The major DC-boomers are those currently in their mid- to late-40s. In 15 years' time this generation will hit retirement and the need for advice on annuity purchase and the use of open market options (OMO) will increase significantly.

In the light of these facts we believe practitioners and employers should address urgently how best to deliver the OMO to all employees with DC funds. It makes no sense to promote DC without ensuring that each individual has access to the optimal annuity at retirement, both in terms of rate and design. At present those with comparatively small funds – less than £50,000 – are unlikely to be offered the OMO on attractive terms. (The average annuity purchase currently is about £40,000.) Instead they will be restricted to the annuities offered by the pension provider, which may not offer enhanced and impaired life rates.

This means that the 25%-30% improvement that can be achieved by using the open market option is denied to more than half of those with DC pension arrangements, while those with a health condition or relevant lifestyle feature may be missing out on even greater enhanced and impaired rates.

4. The commission system creates bias in the scheme choice and design

There is no doubt that the smaller benefits consultants and corporate IFAs that serve the SME market are strongly biased towards contract-based group personal pensions (GPPs) and stakeholder schemes.

None of the advisers interviewed offers "risk-sharing" schemes such as career average or cash balance. This is partly because these schemes are complex to administer and require ongoing actuarial input. But it is also because they are difficult to communicate to members. Where the adviser is paid a commission that is based on the total employee/employer annual contributions, achieving a high take-up rate among members is essential in order to obtain maximum remuneration. DC is much easier to communicate to employees than risk-share schemes and therefore provides greater potential for higher employee participation and the associated sales commissions.

5. Insurers pay "crippling" rates of commission to buy market share

At the time of writing only seven of the 35 stakeholder providers whose schemes are open to new business were genuinely active in the SME market on a national scale. These providers admit they pay "crippling" rates of commission in a bid to buy market share. These commissions can be worth up to 35% of the total employer/employee contributions paid during the first year. Such up-front remuneration levels cannot be met out of the provider's annual management charge, which typically is 0.8% but often less.

We predict that competition and the pressure on profit margins will trigger mergers that will reduce the stakeholder/group personal pension provider market to about five companies in total – nationally and not just within the SME market. The economics of running low premium, high volume business suggest a small number of very large players is the most likely long-term outcome.

6. Commission bias leads to unsatisfactory and inappropriate investment default options

The vast majority of employees (85%-90%) passively accept the provider's default investment option. Typically this would be a life office managed unit-linked fund, tracker fund or a with-profits fund. Members who opt for the default fund rarely switch, and so they will remain in this fund until they retire – that is, for young joiners, for up to 40 years.

The life offices that pay high rates of commission and subsequently provide these default funds are not among the top performing asset managers. Their managed unit-linked funds – the most common default option – are designed with reference to peer group benchmarks that hug the index, rather than match the risk/reward requirements and investment horizons of scheme members. In addition, there is considerable variation in the "lifestyle" mechanism that switches the individual away from equities and into safer, less volatile assets in the few years before retirement. This will also have a significant impact on the outcome.

These factors raise questions about the screening processes being used by advisers and about the due diligence they undertake to ensure that the default funds they select are the most suitable for the majority of a scheme's members.

Advisers say they recognise that asset allocation is a major determinant of the resulting retirement income yet they also admit that they are "not particularly interested" in the finer details of the default fund, provided it offers "average" returns over 3-5 years, measured within the life office managed fund sector.

7. An employee contribution level above 4%-5% is a barrier to participation

While policymakers recognise the need for higher contribution levels to help individuals achieve an adequate retirement income, for many employees anything above 4%-5% is a significant barrier to take-up.

Raising the employee contribution rate to improve prospective retirement incomes, therefore, is likely to be counter-productive and could result in people leaving the scheme. This is an important and difficult issue for the government to tackle in its debate over voluntary vs. compulsory contributions.

Probably the most compelling strategy to solve this problem is where employees agree to direct part of their future wage increases into their pension plans. The (limited) US evidence suggests the Save More Tomorrow ™ (SMART) idea works well. The key contributing factor is "money illusion" – that take home pay never falls – and the scheme uses the inertia shown by many pension scheme members to positive effect. Even if employees are prepared to allocate 1% of salary from their annual pay rise over a period of a few years this will have a very meaningful impact on the resulting retirement income.

If methods of raising the participation and contribution rates are not implemented, the state (i.e. the taxpayer) will have to pick up the tab in terms of means tested benefit claims in the years to come. It is the future taxpayer therefore who faces the consequences of the current problems with poorly designed and poorly funded private sector pension schemes. This, of course, is what the "pensions timebomb" is really about.

8. Communication rather than scheme design is the key to take-up; regulation of advice is a barrier

The fear of inadvertently offering regulated advice is a barrier to communications for both the employer and the adviser. The fact that the difference between regulated advice – which must have a due diligence audit trail – and non-regulated generic advice, is not understood or even recognised by the employee, drives a coach and horse through this aspect of the regulation system.

Smaller and medium sized companies defined

The primary focus for the government's pensions initiatives is to increase participation rates in the workplace where there is no cover or minimal coverage at present. A key target is the small and medium sized business or enterprise (SME), which is the subject of this report.

There is no single definition of SME and in practice advisers to smaller and medium sized companies tend to identify potential clients in terms of both the number of employees and the earnings profile.

However, the Department of Trade and Industry (DTI) classifies smaller firms as those that employ up to 250 staff and this is our preferred definition, although to accommodate the business strategy of the larger advisers and consultants in the SME market we included data and observations that relate to employers with up to 1000 employees.[1] According to the Office for National Statistics there are about 416,000 enterprises employing between 1 and 1000 people, giving a total of 11m employees.[2] The number of people employed at the end of Quarter 2, 2004 was 24m, and so the market for this report covers over 40% of this total.[3]

Many of these enterprises will grow in significance to the economy. As the Association of Consulting Actuaries points out, "The importance of pension trends in the smaller firms sector is therefore clear in terms of the coverage of employees and the potential of some of these firms to be the larger firms of the future."[4]

Advisers and employee benefits consultants defined

With the growth of company-sponsored defined contribution (DC) schemes across all sectors and in companies of all sizes, the traditional division between the retail and institutional pension markets and their advisers has broken down. This is particularly noticeable in the SME market where large firms of independent financial advisers (IFAs), which are remunerated by the pension provider in the form of sales commission, compete for business with the traditionally fee-based smaller and medium sized employee benefits consultants (EBCs).

While EBCs historically have worked on a fee basis whereby they are remunerated by their clients – the employers – today most firms in the SME market recognise that these employers either cannot pay large fees up-front due to cash flow problems, or simply will not oblige. Therefore the majority of EBCs in this market quote a fee but in practice accept sales commission in lieu.

A second differentiator that no longer applies is that EBCs traditionally have been authorised by the Institute of Actuaries, whereas IFAs are authorised by the Financial Services Authority. Many EBCs now recognise that DC can require individual counselling and have sought FSA authorisation in order to offer regulated advice. This can be in addition to or instead of IA authorisation.

In this report we use the term "adviser" to denote both IFA and EBC, except where the business culture is of specific relevance. We focus on 15 advisers in particular that have the potential to offer national coverage, although these firms vary considerably in size and scope. We have also interviewed the major consultants and consider the relevance of their views in relation to SMEs.

Providers defined

"Providers" refers to a range of financial institutions that are permitted to sell pension schemes and plans. These organisations perform a range of functions, for example:

- They receive and invest the contributions into a pension scheme or plan
- They administer the scheme or plan
- They provide an income in retirement in the form of an annuity or a drawdown facility.

Insurance companies and, to a lesser extent, unit trust and investment trust groups, offer the first two services. Only insurance companies can sell annuities in the UK, but a much wider range of organisations offers drawdown, as this does not involve annuity purchase.

Most, but not all, insurance companies and asset managers pay commission to intermediaries on group business.

The research

This section sets out our research in detail and provides extensive commentary from the marketplace. In addition, we offer comment and recommendations where appropriate.

The opinions and observations provided by interviewees are in italics and are quoted on a non-attributable basis. To help the reader place these comments in context we indicate the type of organisation quoted as follows:

EBC – employee benefits consultant
IFA – independent financial adviser
P – life office or other pension provider, for example an asset manager
O – other organisation, for example a regulatory, trade, professional or consumer body.

As we explained earlier and also discuss in Section 4, the distinction between IFA and EBC is somewhat arbitrary in the smaller company-sponsored pensions market. Nevertheless we decided to use these different classifications as this still has a bearing on the remuneration strategy and the products recommended to corporate clients.

Where we discuss the cost of a pension contribution to the employer for simplicity we use gross figures. In practice these payments would be tax-deductible.

We use the term "contribution match" to denote an employer contribution that is equal (or similar) to the employee's – for example a 5% of annual earnings employer contribution would be paid for every employee who joined and agreed to pay 5%.

Section 1. 1. Finance directors actively discourage high employee participation rates

1.1 FDs, not HR, hold the pension purse strings

There has been a radical change in the way pension costs are perceived and managed by employers compared with 10 and even five years ago. Few SMEs have a dedicated pensions department. Historically the company pension scheme was regarded as a human resources function and was seen as part of the benefits package used to attract, retain and motivate staff, and also as a retirement management tool. Today in many smaller companies in particular, the role of the finance director overrides that of the HR manager. FDs regard pensions as a company cost rather than a company benefit.

Advisers to SMEs confirm that increasingly they find themselves dealing directly with the FD. Given the cost and risk issues associated with the pension scheme, the MD and CEO may also be part of the discussion, with HR playing a very secondary role.

> *"If we are talking to HR they will be very enthusiastic about the pension scheme. FDs tend to be lukewarm at best."* IFA

Advisers report that finance directors like DC because it has a quantifiable cost but that this explicit price tag makes pension participation in the workforce an easy target for cost analysis and containment.

> *"The reason we get the opportunity to carry out a review of existing schemes is that we tell the FD we expect to be able to offer an alternative that will save the company money as well as improve value for members. It's the former rather than the latter that interests them."* IFA

Finance directors in SMEs regard cash flow and cost control as critical to the company's profitability. To help reduce the cost of pensions, in the majority of cases they expect the advisers to be remunerated by the providers' commission.

> *"The FD doesn't want to pay for advice and is more likely to be attracted to the commission-basis where the member bears the costs rather than pay a company fee."* IFA

FDs are also likely to restrict the amount of time the adviser is allowed to communicate the scheme to employees, as this takes staff away from their work.

> *"We explain we need at least three months to communicate to employees the closure of the old scheme, the start of the new scheme and all the complex issues that arise as a result. With DB to DC transition we need five months because most employees do not understand their DB scheme in the first place and at the same time they see a change in their benefits as threatening. The FD wants it all done in two weeks and expects a reduction in the cost if we reduce the communications process."* EBC

1.2 Advisers screen potential clients very carefully

Advisers in the SME market (see Section 3 below) are often described by the major consultants as commission-driven salespeople – the implication being that they could go anywhere and sell anything.

In practice it appears that advisers are very discerning in their selection of corporate clients and the attitude of the company's decision maker is a key issue. Clearly, it is in the adviser's best interests to sell to employers prepared to make a contribution and to support the communications process, although this is also true of the major EBCs in the FTSE 350 market.

> *"We find out very quickly about the benefits culture in the organisation. The pro-benefits conversations are likely to be with the HR manager, but in many of the companies we deal with HR doesn't have board representation. The HR manager reports to the finance director and so the FD has the whip hand."* IFA

In selecting clients, the age, financial sophistication, and average earnings level of employees is also relevant to the potential for a high take-up, as is the company structure and location. Where there is commitment to pensions at head office (which translates into high participation rates in that location), this often fails to follow through to the company's other sites. Where the site operates its own payroll and profit and loss accounts, the employer's contribution will undermine performance unless it is given special recognition and separated from the payroll accounting.

1.3 FDs want to see a return on investment

It is important to recognise that the finance director is not opposed to costs per se, but to costs that do not deliver a measurable benefit to the company.

> *"FDs can be quite happy to spend money on a sick-leave management service – usually a helpline to deal confidentially with employees' concerns. This is because the provider can demonstrate a cut in the number of employee sick days and therefore can put a monetary value on the savings. But with the pension scheme it is impossible to demonstrate the return on investment. Studies that try to achieve this go so far and then collapse in a heap."* EBC

> *"It's impossible to prove to FDs the cost benefits of the pension scheme. Unfortunately it is very easy to prove the opposite. If you ask employees whether they would like to have a pension scheme or would prefer an extra 5-10% of salary, they will always go for the cash in hand."* O

Employers that offer a contribution match incur costs that increase directly in proportion with the number of employees who join the scheme. For a company with 2000 employees earning national (full time) average earnings of £25,000 raising the participation rate from 30% to 90% would increase the cost of employer contributions from £750,000 to £2.25m assuming an employer contribution of 5% (in line with the average reported in NAPF 2003 Annual Survey, although in practice the employer contribution is less in the SME market.)

One of the problems finance directors have with DC is that the cost is not flexible.

> *"The employer's contribution is not a flexible cost on a month by month basis but it is fixed. Smaller companies often have short-term cash flow problems but they know if they delay a pension contribution payment they will get into trouble with OPRA [the Occupational Pensions Regulatory Authority]."* EBC

Advisers across the board say that with the employer's commitment they can achieve over 90% participation. Many employers say that they do not want this level of take-up due to the cost.

If the finance director is unconvinced by the argument in favour of pension contributions, he or she is likely to impose strict limitations on the target participation rate. In this way, the FD represents a very significant barrier to wider participation.

> *"We have to have a very serious discussion with the employer. We tell them that typically our worksite marketing proposition will take the participation rate from its current level of, say, 30%, to over 90%. Where there is an employer contribution this will have an immediate cost. We have to ask them how much they really want to pay."* EBC

> *"The employer needs to make it clear which sections of the workforce we should target. We have to be careful of anti-discrimination laws but we can vary the way we present from group to group."* EBC

> *"As an adviser we can lose a contract by being too successful."* EBC

The Department for Work and Pensions is examining whether automatic enrolment would increase participation significantly. Under this system employees are automatically enrolled in the scheme but can opt out. Several advisers already recommend automatic enrolment but report that few employers are keen to adopt the procedure.

> *"One of the easiest ways to secure a high take-up is to use automatic enrolment – so employees are in unless they make an active decision to opt out. FDs don't want this."* IFA

> *"No FD is going to agree to automatic enrolment. If it becomes mandatory there are ways to ensure that it is quick, easy and attractive for the employees to opt out."* IFA

Another initiative the DWP is piloting is active decisions. This is where the employer gives employees a short and fixed period of time during which they must decide to make a positive decision to join or decline membership. Employees are not allowed time to forget they have to make the decision or to make excuses by claiming they have lost the paperwork. Again, this practice is in use.

> *"Where we have the full support of HR and the company genuinely wants a high participation rate we can secure this by using active decision forms. These set out the benefits the employee is agreeing to forego. We make it sound important and that the decision has legal connotations. With the right wording it can be much easier and less worrying for the employee to sign a simplified enrolment form than to sign an agreement confirming their decision not to join. Unfortunately employers that let us take this approach are very rare."* IFA

Employers recognise that there are ways of making an apparently attractive scheme unappealing. The employee contribution level is a primary example.

> *"I was once asked to design a scheme that was very attractive from an HR point of view, so that the HR team could promote the fact that they offered a great scheme, but at the same time I was asked to ensure that not everyone would join. The solution was to have quite a high employee contribution, which always acts as a barrier to participation."* EBC

Even among the paternalistic larger companies the commitment to the pension scheme can be questionable. As part of their image such companies like to be seen to be offering attractive pensions but in many cases this is as far as it goes.

> *"These days most employers recognise that all they have to do is to offer a pension scheme. In practice there can be a huge gap between making a scheme available and actually promoting it in an effective way."* EBC

> *"In a lot of cases it would cripple a FTSE 350 company – let alone a smaller employer – if everyone joined the pension scheme. The true cost of 100% participation would be unaffordable."* EBC

1.4 The employer's endorsement represents a contribution of money and time

In practice participation rates are closely linked to the employer's, and in particular the finance director's, support and endorsement of the scheme. Advisers and providers require a strong commitment from the employer if they are to make a profit from the promotion and distribution of pensions in the workplace.

In this respect the objectives of the adviser and provider are aligned with those of the employees. For both parties we can identify employer commitment in terms of money and time as follows:

- The availability of an employer contribution (money). Without an employer contribution, advisers say they are not prepared to take on the client.
- The facility for learning about the scheme in group presentations, "surgeries" (where employees can make an appointment to discuss an issue), and one-to-one counselling sessions (time). Advisers report that employers vary considerably in terms of the time they are prepared to allow for staff to be away from their work.

1.5 FDs look after their own pensions

While pensions for the workforce may not be a priority for finance directors, they usually secure individual advice for themselves and key executives.

> *"We provide individual counselling for the FDs and key executives. They are responsible for choosing the default investment fund for the workforce but are unlikely to invest in it themselves. Instead they want an open architecture range of top funds."* IFA

Comment

We can now see why so many stakeholder boxes are empty, but this is not the only problem. It is clear from our research that employers that appear to provide an attractive scheme, in practice can ensure low take-up through lack of endorsement, lack of time for communications, and a high employee contribution rate. Under the current voluntary system it is easy for employers to obey the letter of the law while ignoring its spirit.

The TUC has recently conducted research to find out how often employers referred to their pension contribution in job advertisements. The TUC expressed surprise at the general absence of this feature and wanted to know why it is that so many companies do not promote the employer pension contribution. We hope the above goes some way towards answering the TUC's question.[5]

There are two points we wish to make in this section.

1A. Employers require empirical evidence of the return on investment in a pension scheme

Practitioners and the government must recognise that many employers no longer accept the traditional view that a generous pension scheme attracts, retains and motivates employees. In the modern labour market, an employee's value tends to be measured in terms of performance, not loyalty. As the consultant Hewitt Bacon & Woodrow pointed out in its 2004 DC survey, the top three objectives in setting up a DC scheme are purely financial: to reduce the company's exposure to risk, to control pension cost, and reduce pension cost.[6]

Finance directors want to see a return on investment. They require operational efficiency in all aspects of the company and this includes the pension scheme. If we retain a voluntary system then there is a clear need for research that can provide empirical evidence that membership of a pension scheme encourages staff to stay put.[7] We do not know if this is achievable.

To assist in this matter – and to improve their own accounting for company costs – employers should be encouraged to set clear targets for their annual pensions budget. The Association of Consulting Actuaries (ACA) 2004 report on smaller firms and their pension arrangements states that only one in three employers does this and where they do the target is low – averaging 7% of payroll, but with more than four in ten companies setting this target at 5% or less.[8]

The attitude of employers is driven partly by the acceptable norm for each sector. In an illuminating survey from RSM Robson Rhodes on company-sponsored pensions in the manufacturing sector, four in ten companies do not actively encourage non-joiners to participate, while over half of companies surveyed do not revisit scheme membership nor do they conduct or facilitate regular pension workshops.[9]

1.B Anti-discrimination rules may raise participation where the employer is reluctant

We are not convinced that if the DWP made automatic enrolment or active decisions mandatory that this would necessarily raise participation. Employers can and will find ways around this, simply by manipulating the wording of the forms themselves or by imposing a high employee contribution rate as a deterrent.

The question, therefore, is how can the government promote increased participation rates in situations where the employer is unwilling? Compulsion is one answer: the government could simply require employees to pay pension contributions for their employees, but this approach does little to engage employees in the process.

A better solution might be to create incentives for the employer to encourage employees to join the plan and to find a way to penalise them when they don't. In the US 401(k) market this is done quite simply by restricting the amount of tax advantaged pension contributions that highly paid managers can pay into the pension plan to a multiple of what the rest of the workforce contributes. If employees don't join the plan, or contribute only at low rates, managers can find their own ability to contribute severely limited.

There is no real equivalent in the UK. Employers have to contribute at least 3% of salary to a group personal pension (GPP) for each employee in order to avoid the requirement to designate a stakeholder pension for their employees, but the requirement of designation doesn't act as a sanction. The tax limits on pension contributions in the UK are high (and will get higher in April 2006) which confers almost unlimited scope on high earners to provide for their retirement on a tax-advantaged basis. The introduction of some kind of anti-discrimination rules could be an effective way of making sure those in the top levels of a company have a vested interest in raising participation throughout the workforce.

A number of US companies, "motivated" by anti-discrimination rules, have used design mechanisms that exploit the findings from recent studies in the field of behavioural economics to raise participation and contribution rates.[10] These mechanisms recognise the importance of such psychological traits as inertia and lack of willpower.

Inertia is particularly relevant. US literature demonstrates that inertia on the part of pension scheme members is a significant barrier to joining, making the investment choice and selecting the contribution level, among other points.[11] Therefore, it is not just a question of how informed people are, but how motivated they are to do something about it. Auto enrolment and Save More Tomorrow ™ represent positive ways to avoid the inertia trap. Indeed, they can be used to get inertia to work in favour of continued participation.

We suspect that, given the finance directors' interest in their own retirement planning, they might be more amenable to processes that overcome inertia in the main workforce if this is the only way they can avoid the anti-discrimination rules.

Section 2. Means testing, market forces and the threat of regulatory penalties deny millions access to schemes

2.1 Fear of mis-selling and lack of profitability exclude lower earners

Millions of employees effectively are excluded from the opportunity to save in company schemes due to two separate but interrelated issues:

- There is a widespread fear on the part of advisers and employers of mis-selling the company scheme to lower earners who might be better off claiming means-tested benefits in retirement. This broad-brush approach also excludes employees who would benefit from scheme membership.

- Providers and advisers are withdrawing at a rapid pace from the smaller employer market due to inadequate economies of scale. For some providers the minimum is employers with at least 50 employees. In practice, where a high proportion of employees are on national average earnings or less, this minimum is likely to be about 100.

It is important that policymakers understand that the annual management charge (AMC) is extremely variable and will depend on the adviser's negotiating muscle plus the scheme profile, particularly in respect of the numbers of low earners who join the scheme. Providers consider the following key details: average age and salary, the number of employees, and the employer's commitment. It will set its AMC in relation to the expected volume of annual premium business and in relation to expected persistency (that is, how long it can rely on the annual contributions being maintained).

The stark fact is that lower earning employees, where they are offered membership, will generally have to pay a higher AMC than above average or even just average earners because they are less attractive to the provider.

2.2 Confusion over means-tested benefits encourages advisers to avoid all lower earners

Under the current means-testing regime – which includes the pension credit – employers and their advisers are deeply concerned that they may inadvertently mis-sell membership of the company scheme to lower earners who might later discover they would have been better off relying on state benefits. This issue is particularly serious where an employee pays pension contributions that might otherwise have been used to pay off his/her debts.

Our research indicates that as a conservative estimate the 6.6 million working age adults who earn £15,000[12] or less would need to build up a fund in excess of £100,000 by state pension age in order to buy a large enough annuity to take them out of the pensions tax credit bracket. This would provide an annual pension of about £4,800. To rise above all means testing benefits, including housing benefits, individuals would need a fund of about £160,000, which would provide a pension of about £7,500.[13]

There is very little chance that most employees in this earnings bracket will generate anywhere near such large funds. Those who build up smaller funds and who reach retirement while the pensions credit still applies will lose the benefit of up to 40% of their savings. For basic rate taxpayers this more than offsets the tax benefits of the pension plan.

While advisers can recommend with some confidence that older employees should not join the scheme if they expect to retire within the next few years, they point out that it is impossible to advise younger lower earners with any degree of confidence. If the government changes the pension credit – as it is expected to do – younger workers who have been advised not to join a company scheme could be seriously disadvantaged, as they will have lost the opportunity to build up private funds. There is also the prospect that a low earner becomes a higher earner later in life and thus has missed out on a potentially valuable early start to pension saving, irrespective of any change in the pension credit.

Employers, therefore, are concerned that there may be a backlash if employees lose out on means tested benefits in retirement. There might also be a trustee/employer legal issue where the DC is trust based (i.e., an occupational money purchase scheme). For their part, advisers see lower earners as a very high-risk area for their business.

> *"The issues for lower earners are complicated and the rewards are not worthwhile. It is actually cheaper to advise an employee on £30,000 than it is to advise an employee on £12,000. We are very quick to identify employees in the danger zone."* IFA

> *"We need to know if and when the pensions tax credit will end in order to advise those on lower and average earnings. Without this the government is sewing the seeds for another major pensions scandal – this time entirely of its own making, although of course it will be the advisers in the dock, not the DWP."* EBC

> *"A large number of employees are being disenfranchised for all the wrong reasons. Many of these people are keen to save for retirement and yet we have to tell them not to bother with the company pension scheme."* EBC

> *"Means testing is a barrier for the adviser and for the employer. Both have to blur what was hitherto a clear message about a great opportunity to save for retirement that includes an employer contribution."* EBC

> *"To communicate a scheme effectively we need to present a clear message. We need to be able to say that where the employer offers a contribution matching arrangement then it is almost certainly a good idea to join. The fact that we have to make exceptions to this argument muddies the water and introduces confusion and suspicion."* EBC

2.3 Companies with fewer than 100 employees are at risk of exclusion

Each IFA and EBC draws up a profile of its target client based on the organisation's business model and the number of trained advisers it can deploy. The smallest workforce likely to be targeted – assuming average earnings – has about 50 employees. Below this level it is not cost effective unless the company has comparatively highly paid staff – as is the case in the technology sector, for example. The largest corporate clients taken on by the IFAs and EBCs we interviewed had about 1000 employees, although this is the exception rather than the rule. The 100 – 250 employee workforce is more typical.

The number of employees is only part of the screening process. Employers with a high proportion of lower earners are unlikely to find an adviser willing to sell them a pension scheme.

> *"A company with less than 100 staff and with a high proportion of lower earners is a huge risk. We don't go there, even if some employees would definitely benefit from a scheme."* IFA

> *"The risks of getting it wrong are too high. If we assume today's legislation on means testing stays in place then we should be advising many employees not to join. If a company has less than 100 staff and a low-to-average earnings profile we regard it as high-risk no-go territory."* IFA

This trend towards exclusion is exacerbated by the fact that providers are also withdrawing from the smaller company market. Life offices lined up eagerly to offer their stakeholder products in April 2001[14], but the prolonged bear market and the increasing levels of consumer scepticism and distrust have dashed providers' hopes of finding a lucrative new market.

> *"As a leading provider in the mass market we went in to the stakeholder market with a product that would accept as few as five employees. This year we raised that to a minimum to 50 employees, irrespective of their earnings. We have not officially withdrawn [from providing] for smaller schemes because that would be a difficult move to justify in terms of our image, but in practice we simply ensure we are not competitive below this level."* P

> *"The major cost for providers is scheme-specific. Given the cost of installation is virtually the same for all companies it doesn't make good business sense for us to focus on smaller employers. The return on our investment is low and where there isn't a dedicated pensions manager the administration can be more complicated because whoever is dealing with the pension scheme has other jobs to do and cannot give it the time it needs."* P

The result of these two trends is to exclude many employees from company pension provision. This extends well beyond those who might do better under the state means-testing system because advisers and providers operate 'no-go' areas where they anticipate potential problems. We estimate that between 4.5m and 7m people, corresponding to 16% - 25% of the working population, are excluded due to this uncertainty and other disincentives to sell in the low premium market.[15]

The problem of the disenfranchised extends to the retail market where most advisers now target what they call the 'high net worth' client. We came across the following candid comment from a financial planner in a pensions trade publication:

> *"It is not my responsibility to spend my time with people who neither value the benefits of financial planning nor have any intention of paying a commercially realistic fee […]. I don't do poor people and I separate my charitable activities from my business practices […]."*[16]

Comment

2A. Clear reasons for lack of participation in smaller companies

The combination of these two factors – fear of mis-selling with reference to means testing, and the disincentive to sell to small employers – certainly goes a long way towards explaining the low levels of private pension provision among small companies. When considered in conjunction with the fact that many SME finance directors do not agree that pensions represent a good return on company investment this provides further explanation for the empty stakeholder boxes.

We suspect that the government has been shielded from appreciating the extent of disenfranchisement because the insurance companies that traditionally have provided products in the retail and small company market are unlikely to admit that they operate a covert exclusion policy, since this would harm their reputation.

At the risk of stating the obvious, in a free market economy there is no point in hoping that private pensions will be made available to lower earners and to employers with small workforces when in practice providers and advisers regard these as high risk, no-go areas on the grounds of poor profit potential and possible future mis-selling liabilities.

The government should take a close look at the cost of provision for smaller employers and consider whether it should provide more financial support for multi-employer initiatives such as the Building and Civil Engineers (B&CE) Benefits Scheme, the Pensions Trust (which provides a range of schemes for the charitable, voluntary, educational and social services sector), and the new scheme to be launched by the NAPF.

Rather than raise the stakeholder annual management charge cap further, we suspect that there are still too many small and inefficient insurance companies in the UK and that, however brutal, further competition that forces economies of scale, mergers and takeovers, is a better way forward than for the government to allow providers to increase their charges.

2B. The government must clarify the employee's position on means-tested benefits

With regards to means testing, we do not consider the wider political and social issues here but instead focus on the barriers to participation. If the government wants advisers, providers, and employers to help it meet its target of extending private pension coverage to 60% by 2050 (currently 40%) the DWP must clarify the position of lower earners and means tested benefits vs. private pension savings. Otherwise it becomes necessary to advise members on an individual basis on the means testing issue – or, what is more likely, ignore those that fall into the danger zone altogether.

The government estimates that 2.8m individuals who earn over £10,000 have access to a company-based scheme but have not joined.[17] This does not surprise us. Indeed we feel that the government is being naïve if is believes that £10,000 is the threshold at which private provision becomes attractive to the individual and that IFAs and providers will serve this market. Any consideration of compulsion or quasi-compulsion in the form of automatic enrolment, active decisions, and anti-discrimination rules, would miss the point entirely if it does not take full account of means testing and the confusion and uncertainty that surrounds it.

The government should also note that advisers currently recommend contracting in to the state second pension (S2P) across the board. According to Hewitt Bacon & Woodrow overall only 22% of DC schemes remain contracted out as a result of the trend for newer schemes to be established on a contracted-in basis. They note that this "…follows falls in the levels of rebates and the employers' desire to keep their sponsored arrangements away from the complexity of the state system."[18] Under the Labour government the government actuary has calculated the rebate of national insurance contributions on an actuarially equivalent basis and has stripped out the margins that previously were added to make the decision financially attractive.

In addition, advisers are concerned that they might be accused of recommending contracting out when the individual discovers later that the value of benefits built up via the rebates is less than the state pension forgone. This, plus the complexity of the state benefits system, makes contracting out for low earners yet another no-go area.

2C. Employees need information on pension contributions vs. debt repayment

The government might also consider providing information on debt repayment vs. pension contributions. This is particularly relevant given the current high levels of (both short- and long-term) debt at all ages and across all socio economic groups. Several providers and advisers pointed out that it is far easier for a lower earner to take out an unaffordable loan of £20,000 than it is to invest £20 per month in a stakeholder scheme. It is a very good point and one we hope that the government and regulators will take on board.

In this context it is important that the government considers how its advice to young people to begin saving as soon as possible for retirement conflicts with its desire to raise to 50% the number of young people who enter tertiary education. These young people emerge typically with £12,000 - £15,000 debt after a three-year course.[19] In an environment of low and volatile investment returns, the cost of servicing this debt may make this a more appropriate immediate priority – in which case the government, employers and advisers might accept that younger employees with student debt should not join a scheme until this is cleared.

Rather than forego the employer contribution this could be directed towards the student loan via the same PAYE system that deducts regular repayments from the ex-student's salary once he or she earns £15,000pa. Once the debt is cleared there could be an automatic switching mechanism so that the same amount automatically is contributed to the pension fund unless the person opts out. This is a similar concept to Save More Tomorrow TM, which directs pay rises into the pension fund. Both harvest money for the pension plan that the individual is used to managing without.

Section 3. The first 'DC-boomer' generation will hit retirement in 3-6 years; we do not have systems to cope

3.1 DC with the open market option misses the point

It makes no sense to promote DC without ensuring that each individual has access to the most suitable annuity at retirement, both in terms of rate and design. Despite the growing flexibility over the way retirement income is drawn from a DC arrangement we believe that annuitisation will remain the most appropriate vehicle for the majority. The retirement income, therefore, will depend partly on the fund size and partly on the annuity rate, which represents the conversion rate, pound for pound, between capital accrued and annual income purchased.

To ensure employees make the right choices at retirement the minimum requirement ought to be access to the open market option and information about enhanced and impaired life annuities. These points are valid for all fund sizes.

> *"It is essential that employees get the best possible rate for their annuity. Rates for standard annuities vary by at least 30% between the top providers and the less competitive companies. On top of this, employees with health or lifestyle conditions can get an additional 18% for a smoker's annuity [a type of enhanced annuity], while an additional 20-30% and more is available from impaired life annuities. If the company pension provider doesn't offer these types of annuity then employees will miss out again."* IFA

Where the employer is prepared to pay a fee, advisers can offer individual retirement income sessions.

> *"The employers pay us by fees and so at six months before retirement we see the individual employee and take them through their options. Where an annuity is appropriate we use the open market option and can secure the best contract. This would be on nil-commission terms."* EBC

For commission-based advisers meeting the employees' needs is more difficult. At present few schemes in the SME market have considered implementing a formal at-retirement service to members and subcontracting this to an annuity specialist who will work on a commission basis. For smaller funds an internet service offered on a limited menu execution-only basis is likely to be the only economic option.

> *"If you offer an online service to scheme members it is inevitable that there will be a lot of unprofitable quotations, either because the member is taking a look at what's available but does not plan to buy at that point in time, or because the fund size is so small it's impossible to make any profit from the process."* IFA

Where scheme membership includes higher than average earners, individuals with large funds will need advice on the more sophisticated annuities (investment-linked, flexible) and on phased retirement/drawdown. This point also applies to employees who have built up a reasonable retirement income in a DB scheme and have been in a DC scheme for the last few years before retirement.

"Some employees need access to investment-linked annuities. Where employees were members of a final salary scheme for many years and only joined the DC scheme in the last few years before retirement they may use these DC funds as a top-up, like an additional voluntary contribution [AVC] scheme and want to take more of an investment risk with the fund." IFA

What is clear from our research is that while there is some overlap, the top annuity providers in the conventional and specialist annuity market are not the same life offices as the SME pension providers. In some cases the pension provider is not competitive at all for annuities.

"The top annuity providers are Prudential, Legal & General, Canada Life, and Norwich Union. Also competitive for certain annuitants are Friends Provident, Clerical Medical, and Scottish Widows. Beyond these companies we would only go elsewhere if it was necessary to do full underwriting – for example for an impaired life annuity."

Comment

3A. "DC boomers" will be forced to buy second-rate annuities

The first "DC boomer" generation will start to hit retirement between 2007 and 2010. This group includes employees in their 50s who were persuaded or required to switch from the company DB scheme into the new DC scheme. DB to DC conversions for future accrual have been taking place since 1990. Towards the end of that decade the trend accelerated with the introduction of the accounting rule FRS17, which revealed a deficit in most DB schemes and which provided a rationale for companies to close their DB schemes and introduce a new DC alternative.

The majority of DC-boomers are those currently in their mid- to late-40s. These are the employees who took out one of the new personal pensions in their late 20s and early 30s when these plans were introduced in 1988 (although contributions could be backdated to 1987). At the time a huge government campaign encouraged employees to opt out of Serps and to invest the rebate of NICs in a personal pension. In 15 years' time, this generation will hit retirement and the demand for open market option advice will increase significantly.

In the light of these facts we believe practitioners and employers should address the delivery of the open market option to all employees with DC funds urgently.

3B. Cost-effective ways to deliver the open market option

Without access to an online service those with comparatively small funds (less than £50,000) will find it very difficult to exercise the open market option and may be limited to the annuities offered by the pension provider. Even where the fund is large enough to make the OMO worthwhile we believe that in practice most will accept their provider's annuity in the same way that they accepted the default investment fund. According to the Association of British Insurers, two-thirds of people in contract DC schemes and with individual plans do not use the OMO. This means that the 25% improvement that can be achieved by using the open market option in effect will be denied to a very large number of employees, while those with a health condition or relevant lifestyle feature would miss out on even more beneficial enhanced and impaired rates.

Under pension tax simplification, which comes into force in April 2006, the de minimis fund size below which it is not necessary to buy an annuity is £15,000 (i.e. 1% of the lifetime allowance of £1.5m, which is the total fund that can be built up in the tax-favoured pension environment under pension tax simplification). Assuming the individual will take the 25% tax-free cash, this rule applies to those with a fund size of £20,000. We believe that from April 2006 all individuals with a fund of £20,000 or more need access to the OMO.

There are two options here:

- The Financial Services Authority could require providers in the SME stakeholder and GPP market to offer an OMO. At present they have to alert pension clients to the fact that the OMO is available but this may be obscured in the pack of information providers send out typically four months and again six weeks before the individual's selected retirement date.

- A better approach would be for the employer and insurer to delegate this responsibility to an annuity specialist. This is the model adopted by the J Sainsbury stakeholder scheme, which uses the Hargreaves Lansdown annuity facility. Other specialist annuity advisers can offer this service.

Annuity specialists say that to be cost-effective, services that offer the OMO to small funds must be execution-only, using a series of questions to ensure the quotation takes account of the fund size, the individual's age and state of health for example, but not other sources of income and savings. This limited service does expose the pension policyholder to certain risks but on balance it is far better than the current system where most policyholders automatically accept their provider's annuity.

3C. Wealth warnings required for annuity purchase deferment

In the light of the government's relaxation of annuity purchasing rules and its plans to make it possible to work past retirement age, individuals need to consider their options carefully. With DC it is not at all certain that deferring the annuity purchase and paying contributions for additional years will improve the fund size and will automatically ensure the individual is eligible for a better annuity rate. This is because markets can fall, interest rates and hence annuity rates can fall, and longevity is continually increasing. In contrast, an extra year of work in a DB scheme will lead to an increase in pension (so long as the sponsoring employer remains in business).

According to figures from Annuity Direct, an individual with a DC pension fund who delayed buying an annuity would have almost certainly lost out at any time over the period from 1998 onwards. The individual would have needed to achieve returns of between 6% and 9.5% to break even with the level of the earlier annuity rate and the income that would have been paid over the years of deferment.

DC, in conjunction with the government and EU anti-age discrimination legislation, confers the power on the individual employee to decide when to retire. In theory in future we can expect employees to select their retirement date according to when they can afford to retire. If they need to work longer – as will be the case for many – then we must ensure that they understand the risks of delaying the annuity purchase and of making further contributions that may not achieve the expected returns if markets are falling.

Section 4. The commission system creates bias in the scheme choice and design

4.1 Commission-based sales dominate the SME market

The growth of DC has had a marked impact on employee benefits consultants' business models, blurring the boundaries between these firms and the corporate IFAs. Probably least affected in the short term are the top three EBCs, Mercer Human Resources, Watson Wyatt, and Hewitt Bacon and Woodrow. These organisations actively target FTSE 100 companies, large public sector schemes and international corporations. Generally they do not target smaller companies, although they may have a significant number of smaller schemes on their books as a result of previous acquisitions of rival EBCs.

Any attempt to distinguish between consultants is somewhat arbitrary but we identify the next category as those firms that target the FTSE 100 but also operate in the mid-cap market and will consider smaller companies, both private and quoted, if the proposition is sufficiently attractive. This group includes Aon Consulting, Hymans Robertson, Lane Clark & Peacock, and Towers Perrin. In our interviews we noticed a considerable overlap between this group and the main players in the SME.

Medium sized and smaller consultants, and larger firms of accountants that have a comparatively small pensions department tend to operate solely in the sub-FTSE 350 markets, where they compete with the corporate IFAs.

Ten years ago, the competition between corporate IFAs and consultants in the SME market was far less marked. Today the market is fairly equally divided and the cultural differences between these two types of organisation are rapidly eroding. Several corporate IFAs are stepping back from the traditional one-to-one advisory model that characterises these organisations, while EBCs recognise the need to make a more transparent sales pitch than has been traditional. The EBCs still operate on a fee basis but in most cases will offset commission against their bill.

> *"We quote on a fee basis but in some cases we are prepared to take part of our remuneration as commission. Typically this would be for the first year, when we can take advantage of the high rates of commission providers are prepared to pay."* EBC

> *"We negotiate tough deals. Even allowing for a commission payment we can secure annual management charges of 0.7% to 0.8%. However this is not the case for smaller IFAs, which don't have the same economies of scale and collective bargaining power. For these companies the AMC would be at least 1%."* IFA

> *"We quote a fee but we don't mind offsetting commission. Also, we are prepared to operate on a risk share basis – in other words if the take-up is less than expected we may not get paid for all of our work."* EBC

4.2 Regulation and individual advice

Regulation is an important issue. Most EBCs traditionally were regulated solely by the Institute of Actuaries and therefore were not permitted to offer financial advice on a one-to-one basis (the consultants with an accountancy background generally are FSA authorised). The EBCs have taken one of three steps in order to operate in the DC market and to provide one-to-one advice where required, although in many cases this would be limited to the executives and directors.

- To operate solely under FSA authorisation.
- To set up a separate FSA-authorised unit.
- To adopt dual authorisation for the entire firm.

Corporate IFAs have a strong sales culture and a long track record in the DC market. Several offer a full DB service as well.

Regulation is relevant in the context of individual advice. FSA-authorised firms do not necessarily offer individual advice to all employees in their schemes and this appears to be a controversial issue. Those that do not offer one-to-one advice argue that for group business this is unaffordable and cast doubts on the ability of any adviser to offer this facility in practice to a large number of employees.

> *"We implement lots of new schemes but we don't go near the members. There is not enough commission to cover our costs within stakeholder pricing."* IFA

> *"Our client is the employer. We only deal directly with the individuals who are on the board or are key senior executives."* EBC

Others say that one-to-one sessions are essential to achieve a high take up rate and present this as a central feature of their service.

> *"In a greenfield site it may be enough to use negative affirmation [where the individual is automatically enrolled but can opt out] or group presentations, where individuals have pre-populated forms that just require a few ticks and a signature. However, in our experience one-to-one is the most effective way to implement a scheme, particularly where this involves a change."* IFA

> *"One-to-one counselling is not just about getting the employee to sign up – it also helps raise the average employee contribution by 25% to 50%."* IFA

We have no reason to doubt the advisers who say they offer one-to-one counselling. We have spoken directly to the pensions decision makers in a range of smaller companies and their reports of the one-to-one communications process support the advisers' claims. Indeed what distinguishes the larger advisers in this market is the communications facility that can offer individual advice for schemes with up to 1000 and, in one case, 2000 members.

It is important not to confuse individual generic advice with regulated advice. In practice these are very different services – an issue we examine in Section 8. In practice what most firms offer is the opportunity for individuals to ask questions, whether this is arranged for the entire workforce or is offered to those who want it after the initial group presentation and in regular "surgeries", typically twice or four times a year. While advisers are very careful to distinguish between regulated and generic unregulated advice, our research indicates that employees are unaware of the difference and see all such exchanges as specific. To put it bluntly, employees are unlikely to give much if any thought to regulatory distinctions.

Most of the advisers would expect to offer individual counselling to the senior executives, for obvious reasons, and this would be fully regulated advice.

There are several other relevant differences in business models among advisers. For example the fee-based organisations that do not accept commissions say that they have a clear financial commitment from the employer before they go in. However, paying a fee for advice does not necessarily mean that the employer is looking for a high participation rate.

Some advisers go for greenfield sites – smaller start-ups for example – but most seek to identify employers with an existing arrangement that they can review and follow up with recommend improvements and cost savings.

> *"Our business model is to grow through acquisition of new clients that have a benefits package but are not happy with the cost, its effectiveness, and the services of the provider. In these cases we are looking to improve the package. We find that employers are willing to listen because they have already made a commitment to pensions as an employee benefit. We avoid start-up businesses as these represent a very long-term return."* IFA

Both types of adviser would expect to find opportunities to introduce other workplace benefits, such as life assurance, income protection insurance, critical illness insurance, and private medical insurance. In terms of commission these products can be very lucrative, as they are not bound by the stakeholder annual management charge cap.

Smaller advisers to SMEs are critical of the approach adopted by the major consultants when they install a stakeholder scheme for a large company.

> *"The big consultants are not geared up to provide ongoing advice on stakeholders or group personal pensions. They tend to do the initial presentations and that's it."* IFA

> *"With the larger consultants and DC it's fire and forget. Once it's established the scheme is left to the insurance company to run. We believe employers that sponsor these schemes should have annual reviews of providers. We take a hands-on approach to monitoring schemes to check administration and investment."* IFA

4.3 Pension design for SMEs

Employers rely on their advisers for the design and delivery of their DC scheme. There is no doubt that the smaller benefits consultants and corporate IFAs that serve the SME market are strongly biased towards commission-paying, contract-based group personal pensions (GPPs) and stakeholder schemes. Although some firms can and do advise on occupational money purchase and on DB, their preference is for DC. The main proposition for these firms is conversion services for old-style DC contracts[20] to modern DC contracts, and from DB to DC; DB wind-up services; and investment solutions for schemes in deficit that cannot proceed to wind up until they have improved their funding levels.

A minority of the larger EBCs said they would be more likely to advise on a switch from final salary DB to a "contracted in money purchase" (CIMP) scheme where the employer wished to retain the paternalistic element of control and the role of the trustee.

> *"Switching to a CIMP can be quite straightforward as we can graft this on to the existing trust deed and other infrastructure. Where the employer is used to DB, the company will have in place trustees and be used to working with actuaries, administrators, auditors, solicitors and pension scheme accountants."* EBC

> *"Larger employers might still prefer a trust-based occupational DC scheme for reasons of control and to enable the trustees to select the investment choice."* EBC

Overall, however, the number of employers wishing to retain a trust-based scheme is limited and dwindling. Those with an existing trust-based DB scheme generally want to shed the risk and responsibility.

> *"Ten years ago even those without the DB infrastructure would have wanted their own trust-based scheme. Now they don't want the burden and see the advantages of a contract-based stakeholder scheme or GPP."* EBC

None of the advisers we interviewed offers 'risk-sharing' schemes such as career average or cash balance.[21] This is for a variety of reasons:

Advisers believe that where an employer wants to close a final salary scheme, there is little attraction in a different type of DB scheme.
Career average and cash balance introduce two complex issues that are absent in contract-based DC: the need for actuarial advice, and the element of discretion.

> *"I like the concept of career average and cash balance in theory but in practice our clients just wouldn't be interested. They want zero employer risk."* EBC

> *"We see cash balance and career average as a way for the major consultants to keep open the jobs for the actuaries. They are far too complicated."* IFA

In many cases an employer will operate several existing schemes – for example a traditional final salary DB scheme, a DC additional voluntary contribution (AVC) scheme, and an uncompetitive occupational DC scheme introduced in the late 1980s or early 1990s.[22] Multiple schemes are a very common feature where the company has been involved in merger and acquisition activity. The overriding objective for most employers in these circumstances is to sweep away the complexity and introduce a simple single option. Contract-based DC fits this agenda well.

The Pension Protection Fund (PPF) is expected to apply to all DB schemes including cash balance and career average structures, and this would act as a cost deterrent. The PPF's early estimate of the average cost to a scheme is about 2% of total contributions.[23] On a 5% contribution matching scheme that would represent an increase of 40% in terms of payroll costs.

Where the adviser is remunerated via commission, achieving a high take-up rate is essential. DC is much easier to communicate than DB and so is a better vehicle for achieving this.

"With DC we can explain to employees that this is just a glorified bank account with special tax breaks. The lack of understanding about pensions is so widespread that we have to keep the message really simple or employees won't join." IFA

"Good communications might achieve high participation rates for career average and cash balance but this would be in spite of rather than because of the scheme design." IFA

"A well known supermarket that offers a career average scheme based on 1.5% of salary per annum [equivalent to a 'sixtieths' scheme] found that one of the reasons staff left to join a rival supermarket was because the rival offered a 5% contribution into a contract DC scheme, which they perceived as a much better deal." P

4.4 Stakeholder vs. GPP

All of the advisers we spoke to had a strong preference for either stakeholder or GPP and it took us some time to discover why this would be the case. At face value it is difficult to understand why a GPP would be preferred over a stakeholder, as the fund choice does not vary significantly for the type of contracts offered to SMEs and the providers broadly speaking are the same for both products. Moreover, as a regulated product, stakeholder schemes offer the employer protection against future employee or employer dissatisfaction. With regard to the employer's liability position relating to stakeholder schemes, the Welfare Reform & Pensions Act 1999, section 3(8) states that employers do not have to "investigate or monitor, or make any judgment as to, the past, present or future performance of the scheme".[24]

The EBCs generally favoured stakeholder.

"We cannot understand why an adviser would recommend a GPP over a stakeholder, assuming the employer is willing to make a minimum contribution of 3%. Employers can be sure that a stakeholder offers fair charges, terms and accepts small monthly contributions. GPPs are not really any more flexible." EBC

"Stakeholders have the considerable attraction of being able to take in transfers from older DC schemes or DB schemes without the requirement that the individual receives regulated advice." EBC

"Stakeholders represent all round good value. We would typically use a nil commission scheme, as it offers great terms for the scheme members, albeit lousy terms for the provider's shareholders. Asset managers are generally more expensive and most don't do stakeholders." EBC

IFAs state that apart from liking the greater flexibility of the GPP, employers are not attracted to the stakeholder due to its poor image.

"Employers tell us they don't like the sound of stakeholder as they associate it with 'cheap'." IFA

However, another reason could be the higher remuneration it is possible for advisers to negotiate on GPP contracts. A stakeholder scheme provider can only make one charge – the annual management charge (AMC), which is capped at 1%, rising to 1.5% in 2005 (for the first 10 years of the contract's existence and then back to 1% pa). Fee based advisers and providers suggest that with a GPP insurance companies are able to increase the adviser's remuneration by making an additional payment, which they describe as a "marketing budget". Although our sources were very reliable, we cannot substantiate this point. Even in the most candid interviews with commission-based advisers and commission-paying providers this additional payment was never mentioned.

4.5 Actuarial expertise remains essential

Despite their strong bias towards contract DC schemes, advisers in the SME market will encounter a range of issues that require actuarial expertise. Many firms, including at least two corporate IFAs, have such expertise in-house but those that do not have to buy in the services of a third party where necessary. Several firms of actuaries now specialise in these third-party arrangements.

Actuarial services, therefore, remain a core function. Even where the employer decides to prevent the growth of DB liabilities by closing the scheme to all future accrual, the scheme is unlikely to be sufficiently well funded to afford to wind up on the full buy-out basis required since June 2003.[25] This means that in addition to introducing the new DC scheme, the employer would expect the adviser to manage the closed DB scheme and to advise on a suitable investment strategy. This is a highly complex area and requires scheme-specific asset allocation and investment strategies to manage the shorter-term cash flow requirements to pay benefits, while simultaneously using part of the assets to secure longer-term growth. The adviser would need to work with the trustees of the DB scheme to help maintain an appropriate employer contribution rate. Where the trustees include the finance director, as is common in smaller schemes, there can be conflicts of interest that require skill to manage.

In addition, the members will require advice on what best to do with their accrued benefits in the closed DB scheme. This is a potentially fraught area for advisers, as the firm's client is the employer, not the employee. It may be tempting for the adviser, with the support of the employer, to encourage employees to take a transfer from the DB scheme to the new DC arrangement. Such transfers may not be in the employees' best interests. Nevertheless there is a strong incentive to encourage these transfers, as this will reduce the employer's long-term liabilities and significantly increase the adviser's commission.

> *"If we wanted to, we would find it very easy to promote transfers. Most employees assume that they will transfer automatically when they hear the DB scheme is being closed. It comes as a surprise to them to find they have the option of leaving their benefits in the closed scheme and that this might be in their best interests."* IFA

Comment

4A. Dual regulation is complex and an administrative burden

The financial services regulators need to keep pace with market developments and move towards a single regulatory system for all types of pensions advice. In the past, there was a much more obvious divide between the retail and small company pensions market, which was predominantly DC (with a minority of DB schemes invested in insurance pooled funds), and the institutional market, which was DB. According to the EBCs, advisers 'sold' DC, while consultants 'advised' on DB, leaving the choice to the client, and in particular to the trustee. The advisory model is still relevant in the FTSE 100 market, and to a lesser extent for FTSE Mid-250 companies but it is not common among SMEs.

4B. The commission system encourages participation in difficult markets

Clearly, commission payments must be reasonable in the context of a low return economic environment. They must also be transparent. The EBC charging structure, which sets out a fee and then deducts commission, may be more transparent than the structure used by the IFA.

Despite these observations, we feel it is time that advisers and consultants accepted that in the corporate market – and particularly the SME market – regulated advice is synonymous with regulated selling. The purely commission-based firms are the sole operators in the toughest sectors where coverage is poor. Without these IFAs the extent of disenfranchisement would be even greater than it is at present. If the government or certain sectors within the pensions industry find the commission basis for sales unpalatable they must come up with alternative ways to reach employers that are not fully committed to private pensions.

Having said that we are concerned that there are no "rules of engagement" for commissions and other forms of adviser remuneration paid on non-stakeholder contracts. This is potentially detrimental to the market as a whole and prevents providers that have a brand commitment to offering value for money from participating in certain sections of the market. We understand the FSA is considering this issue.

4.C Transfers

We were also very concerned to discover how readily employees assume they must take a transfer of benefits out of a DB scheme that is closed to future accrual and into the new DC scheme. In our research we came across cases where 100% of employees had transferred DB cash values to the DC scheme. This is a complex issue, however. In theory we find it hard to accept that it could be in the interests of the entire workforce to transfer but in practice, given the current concerns over employer solvency and underfunded schemes, there could be a case for this practice for smaller employers where attractive transfer values are offered. If so the rationale for transfers from an employer's closed DB scheme to the new DC arrangement needs to be clarified – particularly given that the adviser's contract is with the employer.

4D. Shared risk schemes

While shared-risk schemes such as career average do not appear to be offered on a single-employer basis in the SME market, this structure is sometimes argued as feasible for multi-employer schemes, where the economies of scale make the additional complexity affordable. Unlike in the Netherlands, here in the UK, with a few notable exceptions, we do not have a culture of industry-wide schemes and so it is difficult to judge this matter.

The NAPF has devoted a great deal of time to studying the best model for a multi-employer scheme for smaller companies and is likely to favour a low level career average revalued earnings scheme with a discretionary DC top-up. This is similar to the structure used by larger companies in the US, where employees are offered a very basic level of benefit via a risk share scheme but also access to the 401(k) (company-sponsored DC) scheme as a top up. However, in the US, the smaller companies generally opt for pure DC for the same reasons as here in the UK. In the Netherlands, there is a trend away from DB and towards DC due to similar funding problems to those we have experienced in the UK.[26]

We would urge the NAPF to ensure there is an adequate funding allocation to communications for its multi-employer scheme, as this will be a difficult structure for employers and employees to understand. Some of the multi-employer schemes in the UK's voluntary sector and in the building industry that have the employers' support do not have a particularly good record on securing adequate employee contributions and we suspect that communications is an issue here.

While it is understandable to want to direct as much as possible into the individual employee's pot, an under-communicated scheme will not achieve its objectives in terms of take-up. So there remains a critical trade off between communication costs and net contributions invested. Moreover employees will not understand the scheme and will not appreciate the value of the employer's investment.

We also wonder how many smaller employers in practice will want to take on the DB legislative burdens, including the Pension Protection Fund (PPF) and the new Pensions Regulator.

Section 5. Insurers pay "crippling" rates of commission to buy market share

5.1 Fierce battle among providers for top-five status

About seven of the 35 stakeholder providers whose schemes are open to new business are genuinely active in the SME market on a national scale. These are all insurance companies. They provide the administration and, importantly, the default investment fund.

The line-up is as follows:

Axa
Friends Provident
Norwich Union
Scottish Equitable
Scottish Life
Scottish Widows
Standard Life

Clerical Medical is expected to re-enter the commission-paying stakeholder market after withdrawing in 2001 due to new business strains. HSBC is a strong player in the SME market but sells purely to its corporate banking clients.

Cooperative Insurance Society (CIS), Winterthur and Zurich cropped up as preferred providers for one of the fee-based EBCs. These companies subcontract the asset management.

Two big names are missing from this list, namely Legal & General and Prudential. While these companies were well thought of, advisers say that these providers tend to prefer to deal directly with the employer and the employees rather than operate through an intermediary. Commission is an important issue here. Prudential confirmed that it does not pay commission on its group plans. L&G does pay commission (although advisers said otherwise) but does not offer the high rates available from the companies listed above.

L&G and Prudential are used in winding-up cases where it is necessary for the scheme to buy out liabilities with immediate and deferred annuities.

The providers listed are favoured by advisers because they meet the following criteria, which firms say they assess on a strict formulaic basis and review annually:

Scalability. Few providers offer the required level of services and are prepared to make them available to SMEs.

Administration. This is the key to successful implementation. Insurers have a very mixed record on this function, even where they have made a substantial investment in their systems.

Streamlined joining facility. All providers now offer this process, which substitutes a simple and short consent form for the lengthy application forms that previously were thought essential. The employee signs a single A4 sheet, which the adviser has pre-populated with details provided by the employer (age, date of birth, national insurance number etc). Typically this form authorises the deduction of contributions from payroll and for these to be directed into the default option, except where the individual wishes to make a different choice.

Communications literature and presentation material. However, many advisers use their own booklets and material.

IT capability. Many employers want internet/intranet facilities so individual web access is essential. However there are some who prefer a paper-based model, so it is a question of matching the provider to the client.

Financial strength and commitment to the market for the long term.

Parentage. Advisers seek reassurance that the commitment of the provider is matched by the commitment of its parent company.

Adviser remuneration (commission and "marketing budget"). This will bias the choice of provider towards the medium-sized life offices, which traditionally have distributed largely or solely through advisers, and which pay very high rates of commission.

Contract charges. Less of a priority – these are fairly similar across the market. Contract terms. Again a fairly homogenous market.

Fund choice and investment performance. Advisers expect the provider to run the main default option and, where necessary, to offer open architecture to give access to alternatives for more sophisticated members.

Marketing and educational support.

Investment houses do not generally operate in the SME market. Only three companies were mentioned as possible providers selected on rare occasions:

- Fidelity
- Invesco
- Newton

Of the three companies mentioned above only Invesco is a registered stakeholder provider. Asset managers tend to pay commissions to advisers in the retail market but operate on a fee basis for group business. They also tend to have a comparatively high minimum monthly premium for GPPs. As a result these companies tend to be used by the fee-based advisers and only then for the larger clients. Generally these asset managers focus on the FTSE 350 as their main target market. Where they offer in-house administration (Fidelity, Invesco) they are well placed to deal directly with the employer rather than operate via an intermediary, although the UK company pensions market is still very much an intermediary-controlled market.

The number of providers offering stakeholder and GPP schemes is likely to shrink.

> *"Experience suggests that a proportion of these companies will not ultimately be able to compete in the new environment. It is believed that the entire company-sponsored market may end up consisting of around 10-15 companies and a number of additional "niche" providers. While any scheme we would establish would be arranged so that we could change the provider at any time without penalty, clearly we will try to avoid having to make unnecessary changes by attempting to ensure that the chosen provider is likely to remain in the unfolding stakeholder pensions marketplace."* IFA

This is a conservative view of the expected consolidation in the market. The major consultants and analysts suggest that ultimately there will be between five and seven providers in the stakeholder/GPP market as a whole, not just in the SME sector. The Treasury recognises this in its June 2004 report on stakeholder schemes, where it discusses the impact of the charge cap on a company's decision to enter the market or not. "If fewer providers enter the market, those that do will be able to establish larger shares of stakeholder sales; costs may therefore fall as these firms benefit from economies of scale."[27]

5.2 Commission levels are unsustainable. Further rationalisation and economies of scale are required

Despite the 1% cap on the annual management charge that applies in the stakeholder market and that is widely adopted for GPPs, providers agree that they are paying "crippling and unsustainable" rates of commission to advisers in order to win market share. Commission can be worth up to 35% of the total employer/employee contributions paid during the first year. On these contracts there would be no return (claw back) of commission if the business tails off in future or switches to another provider.

> *"These rates are not sustainable for insurance companies in their present weakened financial state. They will have to come down even if providers move to the new 1.5% annual management charge cap that can be used from 2005."* IFA

"This is a very competitive market. All of the seven main providers are very hungry for new business and have invested heavily in their products and services. These companies have a business model that is predicated on being a top five provider. It's going to be a case of survival of the fittest." EBC

Interestingly most fee-based EBCs are also very commission-conscious.

"If we offset commission against our fee then it is to the benefit of our client to opt for a company that pays a high rate of commission." EBC

Providers are well aware that the current commission rates are unsustainable.

"Commissions are bound to fall and this will make it increasingly uncompetitive to extend pension provision to smaller companies. There will be a vacuum where no adviser or provider will go." P

"We've got to find a better match between immediate costs and immediate income. The real world has caught up with us – we can't keep on investing in business that will not give us a return for 15 years." P

"The government still thinks that insurance companies have lots of money and can afford to run loss-leader business in the smaller company market and in larger companies with predominantly lower earners. This might have been true in the run up to the introduction to stakeholders but it is no longer possible for us to serve these customers." P

Over the next two years providers say they will be reconsidering their target market.

"The providers with a tough business model – like Prudential and Legal & General – have had no qualms about abandoning smaller companies. Those providers with a tradition of serving SMEs are now being forced to rethink their business model. It's unfortunate but we will certainly be following the lead of Prudential and L&G and we expect our competitors to do likewise." P

Comment

5A. Life offices must review their business models

At first we thought the suggestion that life offices were being pressed to pay such uneconomic levels of commission against their better judgment looked like special pleading on the part of the industry. In the US mutuals like Vanguard and Fidelity make a profit on annual management charges of less than 0.5%. However, the US pension giants have access to a market that is five times the size of that in the UK and have spent huge sums on their IT and administration. These economies of scale and the extremely efficient use of technology are missing in the UK, which, in the SME market in particular, is characterised by a comparatively large number of smaller players and uneven administration. In the UK Fidelity only works in the large cap market and does not pay commission to advisers on its group business. In the US these companies often go direct to employers so there is no intermediary.

Once again we would stress that we do not seek to criticise commission-based remuneration per se. However, it is clear that the high rates of commission major advisers can command in the SME market will further undermine the financial strength of the insurance companies at what is already a critical time following the expense of introducing uneconomic stakeholder schemes, problems in the with-profits market, and the impact on reserves of the prolonged bear market of 2000-2002.

There can be no doubt that differential levels of commission have a direct impact on provider selection. We must recognise two facts here, however. First, it makes absolute sense for providers working within stakeholder pricing models to seek to achieve a significant share of the market. Only with the economies of scale this confers can they remain competitive in what would otherwise be an unprofitable business. Second, advisers need a financial incentive to encourage high employee participation. The view from the market is that the current charging structure does not allow life offices to pay levels of commission that reflect the amount of work undertaken by the advisers and so providers are believed to be holding out in the hope that weaker providers will be forced to withdraw. This could prove to be a Pyrrhic victory if the survivors are seriously weakened by the battle.

To provide further guidance on this point we would need to examine each provider's profit projections on new group business. Stakeholder providers in the mass market are unlikely to break even for about 12 to15 years, due to the low charging environment and the new business costs, including adviser commission.[28] However, some may have more robust profit projections if they can secure schemes where the average earnings are high and therefore the premiums are more substantial. In these cases it is possible for a provider to write thin margin business without undermining its long-term profitability.

Investment managers could play a much stronger role in the SME market but are only used where either the consultant works on a fee basis or the manager has agreed commission terms in order to work with specific advisers. In practice, asset managers like Invesco and Fidelity, which have considerable experience in the DC market, focus on larger companies and say that they do not currently seek business from the advisers in the SME market.

5B. Further rationalisation of the market expected

The expected rationalisation in the life office sector is in accordance with our research on the DC models used in other countries. In particular the Australian experience with its DC model, the Superannuation Guarantee, demonstrates that a low-cost mass-market scheme can work but requires a small number of very large providers to achieve the necessary economies of scale to drive down charges. Changes in Australia included the dominance of the four largest banks, which purchased fund management operations, followed by consolidation in the middle insurance market, where numbers halved.

Sweden's recent experience with the introduction of its compulsory Premium Pension has demonstrated the inefficiencies of offering over 80 asset managers. The system is being reassessed to discover the economically viable number of asset managements that can operate in this market but in the meantime institutions are pulling out voluntarily because they cannot make a profit in the low AMC environment without sufficient volume business.[29]

Section 6. Commission bias leads to unsatisfactory and inappropriate investment default options

6.1 One-size fits all approach fails to meet employees' needs

Investment default options are mandatory for the current stakeholder market although the Department for Work and Pensions sets no guidelines for this feature. Although the range of structures and asset allocations across the entire stakeholder market is very varied,[30] in practice, in the SME market advisers settle for the managed unit-linked funds and, less frequently, index funds of the pension provider.

The form of the default option is crucial to the potential outcome because about 85% of members choose it and stay with it until retirement.[31] Advisers do recognise that the asset allocation of the fund is a major determinant of the outcome, yet they also admit they are not particularly interested in the finer details of the default fund provided it offers "average" returns over 3-5 years.

The large managed unit linked funds offer near-passive investment – that is, they follow the index very closely with minor deviations – and they follow peer group allocations. An annual management charge of 1% (with the option to rise to 1.5% in 2005) appears high for essentially passive investment management although advisers can negotiate this down to 0.7% - 0.8%.[32] We note, however, that rates below 1% are only available to the larger advisers that generate volume for a particular provider.

> *"The annual management charge is a commercial issue and will depend on how much the employer is prepared to pay. We can negotiate charges as low as 0.5% where the employer pays us a fee. Where employers ask for a commission basis this will be higher – at about 0.8% to 1%. Clearly then, under the commission structure, the employee bears both the investment risk and the charges."* EBC

Providers assess each potential new scheme on its merits.

> *"We do not have a single charge for each provider's default fund. It will depend on the size of the case. When we are seeking quotes for a new client we send providers a detailed account of the employee profile in terms of overall number, age profile, and earnings range, among other factors. The provider will use this data to determine the AMC."* IFA

Benefits consultants in general preferred to use index-tracking funds for the default option.

> *"The life office managed funds are so close to being passive that it is not worth paying for active management and the associated risks. We almost always recommend lifestyled passive funds as the default options."* EBC

> *"We tend to offer lifestyled trackers as the default option. If we receive a fee the annual charge will be 0.5% - 0.6%. If the employer prefers us to receive a commission from the provider this will increase the AMC to between 0.7% - 0.8%."* EBC

The overriding consensus among advisers is that employees will opt for the default choice and will remain there until retirement.

"Although we are asked to provide a choice of funds our presentation focuses on the default option." IFA

"Where we use streamlined enrolment the contributions are invested in the default option. Members have the opportunity to change this but very few bother." IFA

This means that the open architecture fund choice is used rarely. Often it is just the executives and directors who take advantage of this facility.

"It's usually the FD who selects some more exciting external funds for the executives. Most staff won't bother with them." IFA

6.2 Lifestyle widely used but under-researched

Lifestyling structures, which gradually switch the member into safer assets in the run up to the expected retirement date, vary widely and there is no consensus over the most effective design. Some manage the switch over 10 years, others over five or three. Generally the switch is linked to the expected retirement date and does not take account of market movements,[33] nor does it cater for unexpected retirements, which can leave people in the wrong asset classes just before the annuity purchase. The absence of good quality research is a concern because lifestyling will be mandatory under the "Sandler" stakeholder scheme, which will be introduced in 2005.

The major developments for lifestyle are among the large consultants selling into the FTSE 350 market. Given the high fee basis it is unlikely that these will be made available to SMEs.

Advisers are pragmatic about lifestyle. They say that they recognise the flaws but if it works for 90% of the members then that's as good as it is likely to get.

"We struggle to get exited about lifestyle. Provided it starts to switch into safer assets five years before the retirement date we feel there is no point in arguing about the semantics." IFA

"The objective is to reduce volatility in the final years. We know we can't change the overall volatility of the investment period but lifestyle makes the outcome more predictable in the few years before annuity purchase." EBC

For the majority of members advisers assume the objective will be to buy an annuity at retirement. Where this is not the case they recognise that advice is vital before any switching takes place.

"Five years before the expected retirement age it's essential for members to think about how they are likely to take their benefits as this will dictate the investment strategy." EBC

Comment

6A. Asset management strategies matter

We do not find the advisers' attitude to asset management satisfactory but this is a criticism of the SME pensions sector as a whole, which appears to pay lip service rather than formally acknowledge the importance of asset allocation.[34] Given that the vast majority of members will passively accept whatever fund the employer or adviser sets as the default, the variations in asset allocation, investment style, quality of asset management, and lifestyling, present markedly different levels of risk, as measured in the range of possible pension outcomes, for the members of the scheme.

We are convinced that it is possible for providers to improve their managed unit linked funds in relation to group default options in the SME market. In September 2004 Scottish Life did just this when it introduced a much more sophisticated strategy that matches the risk profile and investment objectives of the managed portfolios (built from a range of core asset class funds) to the member's objectives and investment horizon. This followed the company's research, which revealed that in general managed funds suffered from poor performance benchmarks, poor risk matching of the fund with the investor's requirements, and poor governance. These issues were also raised by the first Myners Review in 2001.[35]

Our research[36] focused on the default options for stakeholder schemes but these are very similar to the defaults offered by group personal pensions. Of the 35 stakeholders open to new members – 19 offer a "balanced managed" type fund. This typically is invested in the range of 50%-60% in UK equities, 20%-30% in overseas equities, 10%-20% in bonds, and up to 5% in cash. The majority of the balanced managed funds are actively managed, but two use a passive approach. A further 13 schemes offer an all-equity fund as default – seven of these are UK only and five are invested globally. The global funds typically have a split of 70% UK equities and 30% capitalisation-weighted overseas equities. All but one of the equity-only funds uses passive management. The remaining three schemes offer a "with-profits" type fund as the default, where the investment returns that are credited to the member's account undergo a degree of smoothing from year-to-year. The with-profits funds are actively managed with an underlying asset allocation on average of 50% UK equities, 10% overseas equities and 40% fixed interest.

Lifestyle products switch from equities to a final pre-retirement allocation of 75% government long bonds – to hedge the interest rate element of the annuity purchase - and 25% cash to protect the portion of the fund likely to be taken as a lump sum. The most common structure is to start switching from the equity or balanced fund five years prior to retirement, moving progressively to a final year allocation of 75% long bonds (i.e. with maturity greater than 15 years) and 25% cash. A minority of stakeholder schemes use the same 75:25 final year allocation, but begin switching either eight or ten years prior to retirement (two schemes, respectively).

A number of schemes use alternative final-year asset allocations to the 75% bonds – 25% cash approach. One scheme starts switching ten years prior to retirement with a final allocation of 100% long bonds. The remaining two schemes offer lifestyle profiles that have a final-year asset allocation of 100% cash, one of which begins switching three years from retirement and the other which begins four years from retirement.

It is apparent from these different designs that an individual joining a stakeholder pension scheme and passively accepting the default investment arrangements can get a substantially different asset allocation and lifestyle profile depending on which provider the member or the employer/adviser, has chosen.

At a very minimum we feel that the adviser needs to tailor the choice of scheme default fund to the average assessed degree of risk tolerance of the employees. An established manufacturing company with a middle aged workforce is likely to require, and feel comfortable with, something very different from a new start-up technology firm with young, ambitious and well-paid employees.

The tendency for advisers to use the providers' managed funds suggests that they regard these as a "safe bet", whereas in practice the risk profile could be too aggressive for some employees and overly cautious for others.

In conclusion, the range of strategic asset allocation profiles in default funds raises questions about the selection processes being used by pension fund providers and sponsors and about the due diligence being undertaken to ensure that the default funds they choose are the most suitable for the majority of members.

Section 7. An employee contribution level above 4%-5% is a barrier to participation

7.1 A wide gulf exists between experts' recommendations and the amount members are prepared to pay

The focus on the risks associated with asset allocation and lifestyle switching must not deflect attention from the single overriding concern, which is that employees will pay too little into their plans to achieve a realistic private retirement income.

Unfortunately, while policymakers recognise the need for higher contribution levels, for many employees anything above 5% is a significant barrier to take-up. Even 5% can be too high.

> *"The biggest barrier to wider participation is the entry price for the employee. We find that even a contribution rate of between 4% and 6% is too much for most people. We just have to accept this. In some cases where we start with this level, employers decide to reduce it to encourage take-up."* IFA

> *"It's very simple. The employee contribution rate must be achievable or the employee won't join."* IFA

Advisers aim at comparatively low joint contributions and often settle for even less. For a stakeholder there is no requirement for an employer contribution but advisers say they will not take on clients that contribute less than 3%. To provide a GPP instead of a stakeholder, there must be a minimum employer contribution of 3%.

> *"We like to see an employer matching contribution of 5%, giving a total of 10%. This is not because 10% is a magic number in producing the right retirement income but because it is a nice round figure and employees seem to like this. Fractions are off-putting. Where we have an employer contribution of 4.2% employees find this puzzling and surprisingly this can act as a barrier."* IFA

> *"We will consider clients where they are prepared to pay a minimum contribution of 3%. Below this it is not economic for us to advise and we find it hard to gain the employees' attention. The first point we make in our presentation is to stress how much easier it is to save for retirement if your employer is making a contribution to your fund."* IFA

Non-contributory schemes are undervalued by the majority of employees and may only work for very senior employees who are financially sophisticated.

> *"The pension scheme is valued much more highly if the employee has to make a contribution[37]. For the employer, matching works well as only those who are committed to the company tend to join and so the employer only pays where there is the perception of a reward in terms of employee loyalty."* EBC

The employer contribution is a highly visible benefit and valued more by the average member than the tax breaks.

> *"The incentives offered for investing in a pension scheme are linked to the income tax system, so 40% taxpayers get 40% relief and everyone else gets 22% relief. There are two problems here: nobody understands the incentive system and it is not focused on the people the government most wants to save."* IFA

The employer contribution rate is strongly influenced by what is considered the average for the industry rather than by what is necessary to provide attractive pensions.

> *"The first thing the MD or FD asks is 'what is the going rate?'"* EBC

> *"The objective for manufacturing, the building and civil engineering sectors, retailers and leisure companies, for example, is that employers achieve a level playing field on rates of pay and benefits. In these sectors the employer contribution, where paid, will be comparatively low at about 3%. In knowledge-based sectors, like banking and consulting, we see employer contributions of up to 15% and these are often offered on a non-contributory basis, so the employees get the contribution whether or not they are prepared to add to it themselves."* EBC

> *"In manufacturing the dominant factor is the hourly rate of pay, not the benefits. These employees are not generally encouraged to think in terms of the value of the total benefits package."* EBC

Comment

7A. Pressure on employees to make higher contributions could prove counterproductive

According to the ACA survey on smaller companies the average combined contribution (employee/employer) for group personal pensions (GPPs) is 8.6%. For stakeholder schemes this figure is just 4.8%. "Employer contributions into defined benefit schemes average close to three times those made by firms into defined contribution and GPP schemes and six times those into stakeholder schemes."[38]

It is important to keep these types of comparisons in perspective as they are influenced by a range of factors. DB schemes certainly are paying a higher employer contribution at present but in many cases this follows years of contribution holidays and the significant use of surpluses in the 1980s and 1990s to fund early retirement and redundancy programmes. The removal of advanced corporation tax (ACT) relief in 1997, the bear market of 2000-2002, and increasing longevity have all put pressure on employers to raise contributions.

The disparity between GPPs and stakeholders is not difficult to explain. Bearing in mind our comments about the more flexible adviser remuneration available on GPP contracts, it is likely that this has created the market distortion between total GPP and stakeholder contributions. While EBCs do implement attractive stakeholder schemes, the stakeholder is also the preferred choice for employers that do not want to pay any contributions and therefore "average" contribution figures for these schemes are meaningless.

There is a wide gulf between the levels of contribution employees need to pay in order to retire on an adequate income, and what they are actually paying. Raising the employee contribution rate is likely to be counter-productive and may result in people leaving the scheme. This is an important and difficult issue for the government to tackle in its debate over the voluntary vs. compulsory arguments. In this context it is worth pointing out that compulsion in Australia started at a very low level – initially 3% for employers with phased increases over a period of years to 9%.

Whatever steps the government takes it may have to accept that a generation is going to reach retirement with very inadequate private provision. This will represent an increased cost to the government and therefore to future taxpayers.

We also favour the concept of employees agreeing to direct part of their future wage increases into their pension plans. The (limited) US evidence suggests the Save More Tomorrow ™ ("SMART") idea works well. The key contributing factor is "money illusion" – that take home pay never falls – and the scheme uses the inertia shown by many pension scheme members to positive effect. Even if employees are prepared to allocate 1% of salary from their annual pay rise over a period of a few years this will have a very meaningful impact on the resulting retirement income.

In the US, the results of Thaler and Benartzi's "real life" implementation of the SMART plan at a mid-sized manufacturing firm show considerable success.[39] The company's 315 employees were offered the chance to see an investment consultant and discuss their retirement provision and most agreed to do so. In many cases the employees were told their current savings rate was inadequate, but only 28% were willing to accept the advice and make an immediate increase in contributions. The rest of the participants were offered the chance to join the "SMART" plan, which would increase their saving rate by 3% a year starting from their next pay rise. Of the 207 participants who were unwilling to accept the contribution rate advice of the investment consultant, 162 (78%) agreed to join SMART, with 80% of these participants remaining in the plan through four pay rises. The average savings rate for these participants rose from 3.5% to 13.6% over the course of 40 months. Thaler and Benartzi also report encouraging results from other implementations of the plan, albeit that the constraints of real life implementation mean the data is limited and 'clean tests' are hard to achieve. In particular, the authors are unable to show whether or not the increased 401(k) contributions are offset by reduced saving (or increased borrowing) elsewhere.

7B. Retirement management issues ahead

The shorter-term cost savings achieved through poor participation rates will create longer-term staff management problems. One of the largely forgotten reasons for offering company defined benefit pensions is that they enable employers to manage staff retirements to suit their requirements and the economic climate. Companies that do not encourage staff to build up attractive pensions will find that the government's anti age-discrimination laws will make it very difficult for them to shed older unproductive staff, who need to continue working because they cannot afford to retire.

This will also be a problem for government. A lot of the unproductive workers end up on disability benefits, which in most cases are paid by the state – i.e. the taxpayer.[40] When they do retire, their accrued pension will be so low that they will become eligible for means-tested benefits – again placing a burden on the state and the taxpayer. Therefore it is the future taxpayer who faces consequences of current problems with poorly designed and poorly funded private sector pension schemes. This, of course, is what the pensions timebomb is really about.

DC does not confer the flexibility of DB as a human resources tool. It can be used to attract but its use as a staff retention tool is highly questionable. Nor is it a resource for restructuring – for example to provide early retirements on enhanced terms, so as a retirement management tool it is defective.

This does not imply that companies must rebuild the pension scheme as a retirement management tool. Many will prefer to make cash payments where this proves necessary. This practice is already evident for higher earners, particularly in the City, and could spread down the earnings scale where it is not possible to keep people economically active after age 65, for example in manual jobs where age is a genuine issue.

Section 8. Communication – and not scheme design – is the key to successful take-up; regulation of advice is a barrier

8.1 Current regulatory system undermines the clear message on private pensions

Given the bad publicity pensions have attracted in recent years and the impact of the bear market on DC funds, communicating a positive message is all the more essential and at the same time a tougher proposition. The perception of the pension scheme as a valuable and reliable company benefit has been eroded. The ACA reports that half of the smaller companies it surveyed said that the bad climate for pensions had undermined both the promotion of pensions and the perceived value of their schemes. "This is particularly worrying in a defined contribution world where higher pension contributions are needed to build more meaningful pensions than are going to be delivered at current contribution rates."[41]

Advisers encourage employers to allocate the right level of resources to communications.

> *"If the employer is prepared to contribute 10% on behalf of employees we encourage them to think of this cost as a 9% contribution and 1% communications spend. If the spend is 5% then the employer should see this as 4 plus 1."* EBC

It is important to remember that the adviser's client is the employer and not the individual employee; therefore it is the adviser's job to endorse the employer's financial commitment to staff pensions.

> *"An important part of our communications process is to promote the employer's commitment to the employees and to demonstrate how this commitment translates into financial benefits."* IFA

At the same time advisers are struggling with very low levels of financial literacy among employees. We should not underestimate this, nor overestimate the speed at which financial literacy taught in schools will feed through into the consumer market in general.[42]

> *"Very little research has been carried out on making DC schemes work in the SME market where funding is very tight. This is both tragic and pathetic given that we're fast moving into a DC pensions environment. A related key point is the almost non-exist level of financial education amongst the population at large."* EBC

Advisers feel that the government devotes too much attention to technical issues and does not recognise the importance of positive and enthusiastic communications.

> *"The government fails to grasp the importance of communications and instead focuses on pricing and technical details. Pensions need to be sold – and I say that as a fee-based adviser working in an employee benefits consultancy."* EBC

> *"Employees want to feel empowered to make a decision to join and to invest in the right funds. We have to work hard to achieve this level of confidence, particular if we are communicating a scheme change."* EBC

"We must not underestimate the difficulties of explaining a change from the complex contracted out money purchase schemes [COMPS] that were sold at the end of the 1980s and early 1990s to a modern group personal pension or stakeholder scheme. It is highly unlikely that members understood the COMP in the first place. Now we have to tell them that they are being offered the opportunity – or in some cases being given an ultimatum – to leave a scheme they didn't understand for something 'better'." EBC

"There are very few greenfield sites in the SME market. Employers that have an old-style DC scheme have a huge millstone around their necks. The government should consider giving a grant to employers that tried to do the right thing in implementing a COMPS. These employers and the scheme members have a much tougher job ahead than those that did nothing and have merely made a stakeholder available to staff since 2001." EBC

"DC to DC takes a huge amount of time to sort out. We have to review contract terms, the investment choices, and any early termination penalties, among other points. While major pension providers have changed their contract terms for the retail market, very few have changed the terms on their occupational schemes. There is no incentive for them to do this." EBC

8.2 Employees do not distinguish between regulated and generic advice

Employees do not recognise or understand the difference between explicit regulated advice and the implicit recommendations of non-regulated advice. Our research indicates that where an employer or an adviser provides generic advice about the benefits of joining and the merits of the default investment option, employees believe they have been given specific advice to join and to accept the default fund.[43]

In practice the difference between regulated advice – which must have a due diligence audit trail – and non-regulated advice, is not understood or even recognised by the employee. What this means is that the firms of advisers that give generic, non-regulated advice – which avoids the due diligence of FSA fully regulated advice – can provide a very clear steer, with the effect that employees feel they have been advised to join and advised to opt for the default fund.

From the individual's point of view advice is perceived in a broad context. Employees are generally unaware of the complexity of regulated advice and find it difficult to appreciate why the employer or adviser will not answer what appear to be straightforward questions, such as "do you think I should join the scheme?" and "should I go for the default option?"

Generic advice is taken as direct recommendations.

"We've seen examples of so-called generic advice that is so channelled that it becomes obvious to the employees what they should do. It is spurious to suggest that this isn't individual advice." IFA

"Everyone in this industry, including the employers, is worried about crossing regulatory boundaries inadvertently. People look for a scapegoat in advance in case something unforeseen goes wrong at a later date." IFA

The fear of offering regulated advice inadvertently, therefore, is a barrier to communications for the employer and the adviser.

8.3 Varied communication techniques essential

There is a high degree of consensus among providers and advisers that the wider the range of media employed to communicate the scheme the better. Some employees like a plain English booklet; some respond well to a video or intranet presentation; yet others will only really take in information on a one-to-one or small group basis.

No matter how sophisticated the campaign the objective is to put the employee in the position where he or she can answer the following questions:

- Should I join?
- How do I join?
- How much is the employer paying?
- How much should I pay?
- What do I invest in?
- What happens if I die?

Advisers report success in terms of high take-up by using a combination of the following:

- An employee survey, to make staff feel part of the process.
- Making the presentation during induction day, which locates the pension scheme as a key element of the company package, rather than as a separate item.
- The use of posters gets the employees' attention. These can announce the importance of a good retirement income and flag up the forthcoming change to the scheme, where relevant.
- Small group presentations work well and can be followed by one-to-one sessions and/or the opportunity to talk through issues informally with the adviser. The employer must be prepared to allow groups to take time off, and to allow the adviser to conduct back-to-back sessions so that the entire workforce can be covered within a matter of days or weeks, depending on the number of employees and sites.
- Presentation time ideally should be in working hours rather than after work. A half-and-half approach is acceptable, ie where the presentation session starts in the employee's working time but continues beyond this.
- The adviser's objective should be to achieve a high participation rate at this initial presentation, and so an important part of their work is to show employees how to complete the form and to leave enough time to help them where necessary. Until recently the forms resembled the lengthy self-assessment tax return but today this whole procedure is simplified where the adviser and employer use pre-populated forms in a streamlined joining process.

"The application process is the biggest barrier. Simplified enrolment is a great improvement but the employee still has to make the investment choice." EBC

"We recommend that all employees go in to the default investment option at the time of joining so they don't have to worry about investment. They can change their mind later." IFA

"We used to do 40 minute presentations. Now we do 30-minute presentations and spend 10 minutes on the application form, which employees collect on the way in. This is pre-populated with information provided by the employer so there is a minimal input from the individual." EBC

"We used to give people the forms and let them walk away with two or three weeks to decide. That didn't work. Now we urge them to fill in the form as soon as possible, preferably on the spot." EBC

- Where the employees are given a period of time to consider membership this should be short and a firm deadline imposed. A countdown to this deadline through email and poster reminders helps.

"If we can't get employees to sign up on the spot then we send out a card giving them a deadline that is very tight. We get twice the level of joiners this way than if we say membership of the scheme is an open-ended option." IFA

- Regular pension "surgeries", where the adviser is available once per quarter to answer questions, will encourage non-joiners to apply for membership. A plain English pack of information is a must.

"We always ensure the written communication covers everything in plain English, even where the whole process can be handled online. Some of the older employees are very keen to use the online facilities but they forget their passwords after a few weeks and go back to the scheme booklet. We also make sure there is a paper annual statement." IFA

- To cover technical issues advisers report that FSA leaflets are very effective, for example on transfers, annuities, and income drawdown (www.fsa.gov.uk).

"The FSA is happy to provide these in bulk for adviser presentations. Handing out leaflets written by the regulator is a great way to reinforce the message. It also provides us with a robust audit trail. We can hardly be accused of failing to give proper advice when we are using the FSA's own literature." EBC

- Video presentations are effective where the company has multiple sites and where there are shift workers, for example, that cannot attend the live sessions.

- Internet/intranet information sites are appreciated by many, but not all employees. The more sophisticated providers can offer full internet decision-making, for example members can change fund choice, increase or decrease the contribution. Clearly this does not work where employees do not have access to a terminal.

"Where we use online applications the technology must work. We took on a client whose existing scheme relied on on-line applications but the IT let it down and there was no support from the adviser. To re-establish confidence we installed the new scheme on a paper-enrolment basis. The employees had had enough of the online approach." IFA

"Many members will continue to prefer the complex issues surrounding pensions and benefit schemes to be explained via face-to-face personal consultations backed up by easy to understand paper based booklets and leaflets. However, we are finding that an increasing number wish to access these details via the internet." IFA

- Online planners that help employees to assess how much they need to save for retirement are proving increasingly popular.

- Dedicated help lines provided by the adviser or the provider.

"We can handle thousands of calls if we give staff a dedicated helpline number. This is a very efficient way of handling generic and technical queries. It's particularly helpful where employees are being asked to leave an existing scheme that is going to be closed to future accrual and to join the new DC scheme. Other difficult situations where the helpline is invaluable include any corporate activity, for example a takeover." EBC

- Including the value of the pension in total reward statements helps raise the scheme's value – and quantify the loss of benefit if the employee is not in the scheme.

The time frame is important. Advisers and providers to companies of all sizes report that a slow drip feed of eye-catching information over three months is far better than a single hit with lengthy documents. However, advisers were critical of insurance key features documents, which they say are too long and unfocused.

"We've found that brief announcement where the contents are well signposted are generally received better than more detailed, heavyweight documentation. At the other extreme, however, we find that the provider's key features and accompanying documentation rarely provide sufficiently rounded information for members to make truly informed decisions." EBC

8.4 Segmentation of workforce for communications media

Large consultants tend to target communications at different types of employee. They segment the workforce according to 'hard' facts, such as age, sex, and salary. Typically there might be three broad employee profiles:

- Young and in debt: age 20-40
- High family expenses: age 40-47
- Pre-retirement: age 47+

Communications and design specialists tend to segment according to soft data, such as the employee's attitude to money and to pensions – in other words the communications material is geared towards the way employees think. Their focus is on making pensions personal – using a phrase that employees can relate to, such as "salary for life", and making limited use of the company's corporate image, such as the logo and colours. However, the cost of the initial employee survey required to implement this would be about £25,000, while the agency's costs would double this.

Comment

8A. Generic financial education material required

It would seem to be a waste of resources for each provider and adviser to produce a full range of communications material. The use of FSA leaflets helps reduce cost and providing consistency in the information and presentation.

A good source of generic financial literacy information, guides, and "courses" is the Pre-Retirement Association, which is supported by a rather limited number of organisations at present. The PRA might be an ideal independent and charitable organisation to provide material directly to employers and to advisers and providers. The website is at www.pra.uk.com and the financial education material is at www.learnaboutmoney.org.[44]

8B. More detailed employee profiling essential

The closer profiling of employees based on segmentation that is used by the larger consultants and the communications agencies may have some useful messages for the SME. While the massive press and employee communications programme used by Barclays for its After Work pension scheme would be beyond the scope of smaller employers we feel that medium sized companies could make some use of the "hard profiling" – that is material focused on the age/income profile of the employees. We think that the larger IFAs and EBCs should be able to provide this.

8C. Online planners should be developed as a user-friendly aid

More work on online retirement planners is required as it is likely that these will represent an increasingly important feature of communications for SMEs. A well-designed online planner can help employees to understand the following:

- How much income they may need in retirement. Few people have any clear idea of what this should be and the two-thirds final salary model is arbitrary and in most cases unachievable.
- Their risk tolerance. The consensus among advisers is that the majority of employees have no idea how to judge this. If offered three choices or five, generally they will passively select the middle option rather than make an active selection.
- The level of contribution they should pay at the outset
- Regular checks to ensure contributions increase if necessary in the light of performance experience

Online planners that can be used by individuals without advice and with a very limited level of financial knowledge are in the developmental stages. So far, user-friendly internet models have tended to offer a very restrictive projection that takes account of the income that might be achieved based on future DC contributions. Some include the state pension. The more sophisticated models are suitable only for the more sophisticated investor or for use with the financial adviser's assistance. Dynamic Planner from Distribution Technology (www.distribution-technology.com), for example, is primarily designed to assist the adviser complete fact-finds more speedily, whereas Alexander Forbes Financial Services' planner (www.retireontarget.com) is designed to be used by individuals without technical support.

In 2006 the DWP aims to launch its own planner. This should accommodate previous benefits and take account of current state and private provision.[45]

Not all advisers are fans of these facilities, however. We acknowledge those that expressed concern over the "spurious sense of accuracy" they offer the user, which leads us to our next point.

8D. Standard projections do not show risks

Opinion is divided over how best we can illustrate risk and projections to the layperson. The standard projection rates used in DC pension statements and in retirement modellers are unrealistic since they assume constant investment returns and earnings growth up to age 65. However, the mid-range constant investment return of 7% permitted by the FSA for projections does appear to be a reasonably reliable average gross return for an investment 80% invested in equities.[46]

The FSA allows the use of stochastic or Monte Carlo modelling but at present these projections can only be shown in addition to rather than instead of the prescribed projections. Advisers feel strongly that providing two very different sets of projections would confuse rather than clarify the risks. The FSA currently is examining the options for alternative systems.

Some advisers point out that a range of projected outcomes is better than a single figure, albeit calculated on a more realistic basis. This is because setting out a range of figures helps to express the uncertainty of outcome, whereas there may be a danger that a single figure would be taken as a guarantee.

Clearly, we need to strike a balance. Projections must not give the impression of a guarantee but nor should they be so frightening or confusing that people are put off and do nothing. We do feel that such modellers should spell out more clearly that while projection rates attempt to deal with investment risk, there are other important risks including the assumed stability and indexation of the contribution payments, and the annuity risk in terms of the conversion from the accumulated fund to a regular income, which will depend on long-dated gilt yields, among other unpredictable factors.

Section 9. Conclusion

In this report we have identified where the real barriers to greater participation lie in the smaller and medium sized company pensions market and we have highlighted strategies that will help to overcome these obstacles.

We believe that the innovative methodology of this Pensions Institute Practitioner Report demonstrates that it is possible to make positive contributions to the consultation process by using an independent and multi-disciplinary approach, which combines academic standards of research with a uniquely informed understanding of the market.

We hope that in future the government, employers and practitioners will consider the important role of this type of research in their consultations and build on this methodology.

Glossary of terms

Accrual rate In defined benefit pension schemes this the rate at which a member's benefits builds up for each year – for example one-sixtieth of final salary.

Additional pension The generic term used to describe the state second pension (S2P), introduced in 2002, and its predecessor the state earnings related pension scheme (Serps).

Additional voluntary contribution (AVC) An investment used to top up benefits from a company pension scheme up to limits permitted by the Inland Revenue.

Annual management charge (AMC) The fund management charge.

Annuity Sold by insurance companies, these guarantee to pay a regular taxable income usually for life in return for a lump sum investment from the proceeds of a pension plan. Retirement annuities are priced on the basis of prevailing long-term interest rates and assumptions about the likely longevity of the person buying the annuity. Other things being equal a given level of annuity will become more expensive to purchase as long-term interest rates fall. This can be hedged by holding a portfolio of bonds that will increase in value as long-term interest rates fall.

Annuity rate The annual rate of income provided by an annuity in return for the investment of a lump sum (expressed as a percentage of the lump sum).

Buy-out cost The full cost of purchasing immediate and deferred annuities to meet a pension scheme's liabilities to its active and retired members.

Career averaged revalued earnings (or average salary) scheme A type of defined benefit scheme that links the accrual to average earnings over the full career (where the earnings in each year are uprated to the retirement date by the intervening price or wage inflation) rather than final salary.

Cash balance Members are credited with a cash amount, usually expressed as a percentage of salary, for each year of service. These sums are revalued over the period to retirement at a fixed and pre-set rate of return with a discretionary top up. On retirement the member's fund is used to purchase an annuity or the pension fund itself can provide this income.

Commission This is paid by the provider to the intermediary and is usually expressed as a percentage of the contribution. The initial commission often is a larger sum paid upfront whereby the provider takes into account the expected commission that otherwise would be earned over the entire investment period. 'Trail' commission is a smaller percentage of contributions paid from the first anniversary of the scheme implementation.

Commutation Swapping pension for tax-free cash.

Contracted in money purchase scheme (CIMPS) These are occupational money purchase (DC) schemes that are contracted in to the state second pension scheme, so that they pay benefits in addition to S2P. They build up a fund in the same way as a personal pension but in most cases the contribution and benefit rules are those of final salary schemes.

Contracted out money purchase scheme (COMPS) These schemes, sold in the late 1980s and early 1990s, are occupational money purchase (DC) schemes contracted out of the state second pension, so that they replace the S2P benefit. They build up a fund in the same way as a personal pension but the contribution and benefit rules are those of final salary schemes.

Contribution match We use the term "contribution match" to denote an employer contribution that is equal to the employee's – for example a 5% of annual earnings employer contribution would be paid for every employee who joined and agreed to pay 5%. It can also be used to denote a tiered employer contribution rate that rises in line with the employee's commitment to pay a higher rate.

Corporate IFA The Financial Services Authority-regulated independent financial advisers who sell group pensions in the SME market.

Default DC investment A predetermined investment option for defined contribution pension schemes and plans that makes the asset allocation and fund management choices.

Deferred pension A pension benefit – usually in a former employer's scheme – that will be paid when the individual reaches the scheme's official pension age. Defined benefit (DB) A type of occupational pension scheme that links the benefit to earnings.

Defined contribution (DC) A type of company and individual pension arrangement that invests contributions to build up a fund, which generally is used to buy an annuity at retirement. Also known as "money purchase".

Depolarisation Under depolarisation, to be introduced at the end of 2004, advisers are allowed to call themselves "independent" only if they make advice available, but not compulsory, on a fee basis to clients. Advisers who arrange ties with several product providers will be known as "multi-tied".

EBC Employee benefits consultant. Traditionally this would be an actuarial firm that provides a full range of employee benefits consulting and in most cases investment consulting as well. Fee based by culture, EBCs in the SME market usually are prepared to offset sales commissions against their fee.

Enhanced annuity An annuity that pays an above average income or rate because the individual has a lifestyle feature, such as smoking or obesity, that will lower life expectancy.

Fee Advisers who charge clients a fee relate their remuneration to an explicit time/cost scale. There is no relationship between the fee and the size of the annual contributions, as there is with the commission basis of remuneration. Commission usually is offset against the fee, although in some cases advisers can negotiate commission-free products, where more of the individual's contribution is actually invested.

Group personal pension (GPP) Although sold as a 'group' scheme, a GPP is a series of individual personal pension contracts. The grouping is relevant because it reduces costs.

Impaired life annuity An annuity that pays a higher than average rate because the individual has a lower than average life expectancy on account of some terminal illness such as cancer.

Income drawdown This allows an individual with a personal pension fund to draw an income directly and keep the fund invested, rather than buy an annuity.

Initial commission See commission.

Investment-linked annuity An annuity that invests the capital in order to provide an income with a stockmarket link.

Large cap Companies with a high market capitalization, generally used to refer to those in the FTSE 100 index.

Managed fund In the insurance sector this is a fund defined by the Association of British Insurers, which has minimum and maximum parameters for asset class weightings. Such funds are run by a single provider that is responsible for asset allocation within the required parameters, and investment style.

Market capitalisation The stockmarket valuation of the company, which is calculated by multiplying the number of shares in issue by their market price.

Means-tested benefit A social security benefit that is only available where the individual can prove eligibility – usually by providing evidence that total earnings and capital fall below certain levels.

Mid-cap Companies with a mid-ranking market capitalisation. In the UK this usually refers to companies in the FTSE Mid-250 index

Minimum funding requirement (MFR) A method for valuing defined benefit pension liabilities (and hence the required asset levels) established by the 1995 Pensions Act. Shortly to be abolished.

Mis-selling An advised sale that does not meet the Financial Services Authority's standards. This is a regulatory offence and the FSA has statutory powers to investigate and impose fines.

Monte Carlo modelling See stochastic modelling.

Mortality A measure of life expectancy.

Multi-employer/industry-wide scheme A single occupational pension scheme to which the employees from a range of employers (usually in the same sector) have access.

Mutual A life office owned by its policyholders.

Open architecture A product/platform through which the provider offers access to the funds of a selection of external managers in addition to its own.

Open market option (OMO) The facility to take the DC pension fund from the provider in order to buy a more competitive annuity elsewhere.

Pension credit A means tested benefit for pensioners, which replaced the minimum income guarantee in October 2003.

Pension tax simplification On 6 April 2006 ("A-Day") the government will introduce a new simplified tax regime for all private occupational and personal plans. The new regime includes the following features:

- A single tax regime; the eight existing tax regimes for occupational and individual pension arrangements are reduced to one.
- Simpler guidelines for maximum contributions: there will be an annual ceiling on tax-favoured contributions of 100% of earnings up to a ceiling, initially set at £215,000.
- The lifetime allowance. Maximum benefits will be calculated over the entire career and tax-favoured treatment will only apply to those that do not to exceed the lifetime allowance, which is set at £1.5m for the 2006-2007 tax-year. Any pension funds in excess of this limit will suffer a tax charge of 55% (known as the recovery charge), although it is possible to protect larger funds built up before A-Day. To assess the impact, members of DB schemes, where the pension is expressed as a proportion of the salary at or near retirement, should multiply their accrued pension by 20, to convert it to a monetary fund. A final salary pension worth £75,000pa, therefore, is equal to the £1.5m cap.

Polarisation A regulatory system under which advisers were either tied to one provider for the distribution of one or more products or were independent financial advisers (IFAs), who could select products from the entire range available. Depolarisation replaces polarisation at the end of 2004.

Risk The chance of the actual outcome falling short of the expected outcome. In financial terms, risk is often measured by the standard deviation of the return on an investment. If the expected return is 10% and the standard deviation is 4%, then there is approximately a one-in-six chance that the actual return will be below 6%. For individuals we think of risk in terms of loss of capital, but also in terms of failing to achieve a personal investment objective.

Small cap Companies with a comparatively small market capitalization. Generally taken as those below the FTSE 350, which fall into the FTSE Small Cap index.

Small and medium sized enterprises (SME) SME is variously defined but typically this is a private or public company with up to 250 employees.

Smoothed managed fund Operates like a unit-linked managed fund but with a separate mechanism for a limited degree of smoothing the annual returns.

Statutory money purchase illustration (SMPI) The annual illustration of the retirement income, in today's prices, that a defined contribution pension plan will generate.

Stochastic (Monte Carlo) modelling A method for determining the possible distribution of outcomes from a process where the inputs determining the process fluctuate randomly over time. In the case of a portfolio of investment assets, the process is the accrual over time of gains and losses to the value of the portfolio arising from the random fluctuations in the returns on the assets held in the portfolio. Once the distribution of returns on assets is specified, artificial 'histories' of asset returns can be created by random drawings from the underlying distribution. Each history will result in a different value for the portfolio at the end of an investment horizon. At least 500 (and usually somewhere between 1000 and 5000) histories are needed to generate a reasonable distribution of portfolio values. The results are usually expressed in terms of key properties of the distribution such as the median (the value of the 50th percentile) and the first and fourth quartile values (the values of the 25th and 75th percentiles, respectively).

Tied agent Until late in 2004 the system of regulation demanded that advisers were either tied, where they could only sell the products of one company, or independent, where they could select products from across the entire market. See depolarisation.

Trail commission See commission.

Transfer value The cash value of a pension that is provided when a scheme member requests a transfer to a new employer's scheme or to a private plan. TVs usually refer to transfers from a defined benefit scheme, as here it is necessary to calculate the cash equivalent of the DB benefits accrued, which will be expressed as a proportion of salary.

Trust A legal structure that recognizes there are two owners of assets – the trustees, of whom there must be at least two and who have legal control of the assets (and are formally the legal owners), and the beneficiaries (who are the beneficial owners).

Trustee The legal owner and controller of the assets in a trust; the intermediary between the person setting up the trust (the settlor, in the case of a pension scheme, the employer) and the people benefiting from the trust (the beneficiaries, in the case of a pension scheme, the members).

Vesting (a) The process of transferring the ownership of assets in a trust to the beneficiaries. (b) The process of converting a pension plan into income or an income-generating arrangement such as an annuity; vesting also enables the individual to gain access to the tax-free cash.

With-profits annuity An investment linked annuity that links the income mainly to the returns achieved by the underlying with-profits fund.

With-profits fund A fund that invests in equities, bonds and property, pays an annual bonus or return and in addition pays a final or terminal bonus. Returns are smoothed to avoid significant fluctuations.

About the Pensions Institute

The objectives of the Pensions Institute (www.pensions-institute.org) are to undertake high quality research in all fields related to pensions, to communicate the results of that research to the academic and practitioner community, to establish an international network of pensions researchers from a variety of disciplines, and to provide expert independent advice to the pensions industry and government.
We take a fully multidisciplinary approach. For the first time disciplines such as economics, finance, insurance, and actuarial science through to accounting, corporate governance, law and regulation have been brought together in order to enhance strategic thinking, research and teaching in pensions.

As the first and only UK academic research centre focused entirely on pensions, PI unites some of the world's leading experts in these fields in order to offer an integrated approach to the complex problems that arise in this field.

Objectives

The Pensions Institute undertakes research in a wide range of fields, including:

- **Pension Microeconomics**
  The economics of individual and corporate pension planning, long-term savings and retirement decisions.
- **Pension Fund Management and Performance**
  The investment management and investment performance of occupational and personal pension schemes.
- **Pension Funding and Valuations**
  The actuarial and insurance issues related to pension schemes, including risk management, asset-liability management, funding, scheme design, annuities, and guarantees.
- **Pension Law and Regulation**
  The legal aspects of pension schemes and pension fund management.
- **Pension Accounting, Taxation and Administration**
  The operational aspects of running pension schemes.
- **Marketing**
  The practice and ethics of selling group and individual pension products.
- **Macroeconomics of Pensions**
  The implications of aggregate pension savings and the impact of the size and maturity of pension funds on other sectors of the economy.
- **Public Policy**
  Domestic and EU social policy towards pension provision and other employee benefits in the light of factors such as the Social Chapter of the Maastrict Treaty and the demographic developments in Europe and other countries.

Research disseminated by the Pensions Institute may include views on policy but the Pensions Institute itself takes no institutional policy positions.

1 The DTI statistics are drawn from the Association of Consulting Actuaries 2004 Smaller Firms Pension Survey: A Nation Divided, May 2004. For further details go to www.aca.org.uk
2 Office for National Statistics figures based on VAT-registrations show: 410,000 enterprises employing between 5 and 249 people, giving a total of over 8m people; 6,000 enterprises between 250 and 999 employees, totalling 3m people.
3 Source: Office for National Statistics.
4 ACA, Smaller Firms, p.6.
5 TUC press release dated 17 August 2004.
6 Hewitt Bacon & Woodrow, 'DC & AVC Survey 2004'. See 'Scheme Survey, p. 3.
7 Momentum, now part of Origen, included some interesting but limited data on pension scheme design and employee turnover in its 2004/5 Employee Benefits Survey. Tel: 01252 557404.
8 ACA, 2004 Smaller Firms Pension Survey, p. 12.
9 RSM Robson Rhodes Pensions Survey 2004. www.rsm.co.uk
10 See for example, Benartzi S. and R. Thaler (2004) 'Save More Tomorrow: Using Behavioural Economics to Increase Employee Saving' Journal of Political Economy 112:1 pp S164-S187.
11 See for example, Choi J., D. Laibson, and B. Madrian (2004) 'Plan Design and 401(k) Savings Outcomes' National Tax Journal Vol. LVII No. 2:1, pp275-298.
12 Source: Office for National Statistics. The ONS defines low earners as those earning less than 60% of median household income. In terms of low earners, 25% of full time employees earn less than £13,800 – close to 60% of NAE. Clearly the figure of 6.6m includes many very low earners and part-timers, who would automatically rely on state benefits.
13 The assumptions for these annuity rates are: male 65, spouse 62, 3% escalation, spouse's pension of 50%, paid monthly in advance, no guaranteed period. Source: Hargreaves Lansdown.
14 It is a statutory requirement for all employers with five or more employees to provide access to some form of pension scheme to all employees earning over the National Insurance lower earnings limit. The minimum requirement is to designate a stakeholder scheme where the employer has a contract with a provider and receives a designation certificate. Employers can avoid having to pay an employee contribution if they offer access to a stakeholder scheme, rather than a group personal pension, for example, into which they must pay a minimum employer contribution of 3%. The NI lower earnings limit for 2004-2005 is £79 per week, or £4,108 p.a.
15 According to the ONS, 25% of full time employees earn less than £13,780 pa – which equates to 4.5m employees, Over 7m people work for enterprises that employ less than 50 employees.
16 Source: Professional Pensions, 22 June 2004.
17 DWP, 'Simplicity, security and choice', p. 14.
18 Hewitt Bacon & Woodrow' DC & AVC Survey 2004', Scheme Survey, p. 4. Elsewhere, Mercer estimates the government would have to pay an additional £3.8bn a year in rebates to make them attractive across the board (source: press release dated 5 July 2004).
19 The maximum student loan in 2004-2005 is £5,050 for students living in London and away from home.
20 Many group personal pensions and contracted out money purchase schemes sold in the late 1980s and early- to mid-1990s had high initial charges and exit penalties, and offered inadequate asset management.
21 Career averaged revalued earnings schemes are a type of defined benefit scheme that links the accrual to average earnings over the full career (where the earnings in each year are uprated to the retirement date by the intervening price or wage inflation) rather than to final salary. This structure reduces the employer's exposure to volatility and to the impact of high salary increases in the employee's final years. With a cash balance scheme members are credited with a cash amount, usually expressed as a percentage of salary, for each year of service. These sums are revalued over the period to retirement at a fixed rate of return with a discretionary top up. On retirement the member's fund is used to purchase an annuity with an insurance company, or in some cases this is provided by the scheme. This reduces the employer's risk in the same way as CARE schemes but also reduces the exposure to wage inflation and, where annuities are purchased from an insurance company, to longevity.
22 During this period, insurance companies sold several thousand "contracted out money purchase schemes" (COMPS). These build up a fund in the same way as a personal pension but the contribution and benefit rules are those of final salary schemes. At the time it was beneficial to contract out of the second state pension (then called Serps) as the rebates of national insurance contributions were considered attractive compared with the value of state pension benefits given up.
23 This estimate is a very broad-brush figure as in practice the levy will depend on the specific scheme and the risks associated with the employer (i.e. the levy is risk-based).
24 Welfare Reform & Pensions Act 1999, Section 3 (8) reads as follows:
(3) Duty of employers to facilitate access to stakeholder pension schemes [...]
(8) An employer is not, whether before designating a scheme for the purposes of subsection (2) or at any time while a scheme is designated by him for those purposes, under any duty -
(a) to make any enquiries, or act on any information, about the scheme for any purpose not connected with
(i) ascertaining whether the scheme is for the time being registered under section 2,

(ii) ascertaining the persons to whom it offers membership, or (iii) enabling him to comply with subsection (3), or

(b) in particular, to investigate or monitor, or make any judgment as to, the past, present or future performance of the scheme.

25 To prevent solvent employers from walking away from underfunded pension scheme liabilities the Government now insists that schemes may only wind up if they secure all the accrued member rights through the purchase of immediate annuities for current pensioners, and deferred annuities for active (working) members.

26 Towers Perrin, Pension Financing in Europe: CFO Survey 2003. See also US consultant Greenwich Associates report, Stressful Problems, Possible Solutions on the Continent, (2003) which says that solvency ratios for pension funds in continental Europe are considerably lower than those in the US, UK and Canada. Of the Continental European companies surveyed a startling 57% were "technically insolvent" - in other words the liabilities far exceed the assets. Pension professionals from a range of countries who were interviewed for the report were adamant that employers should close their DB schemes and move to DC to reduce their costs and cap their exposure to increasing liabilities.

27 HM Treasury, 'Consultation on "stakeholder" saving and investment products regulation', June 2004, p. 48.

28 Source: Financial Times, 19 May 2002

29 Source: Financial News, 21 June 2004.

30 See D. Blake, A. Byrne, A. Cairns and K. Dowd (2004) 'The Stakeholder Pension Lottery: An Analysis of the Default Funds in UK Stakeholder Pension Schemes', Pensions Institute Working Paper (www.pensions-institute.org/workingpapers/wp0411.pdf).

31 Source: Financial Times, May 8/9 2004, p. M23.

32 To put this in context, the Pensions Trust has an annual management charge of 0.21%. For the B&CE stakeholder there is no AMC for construction workers until 2006. These organisations do not pay commission.

33 There are exceptions, for example the consultant Lane Clark & Peacock's 'DCisive' model.

34 We note that in the US it is common to see an asset allocation manager engaged for DC pension schemes. Such organisations offer a highly streamlined IT system that allows them to set and monitor asset allocation for each employee, using the basic funds provided by the scheme.

35 See 'Managed Strategies', Scottish Life, and the first Myners report, 'Institutional Investment in the UK; A Review', page 9 (point 44) and page 148 (point 3), www.dwp.gov.uk.

36 See Note 30.

37 This is confirmed by the 2003 Employers' Pension Provision Survey (conducted by the Department for Work and Pensions). Only 51% of the workforce joins non-contributory DB schemes (compared with 85% for contributory schemes); and only 27% of the workforce join non-contributory DC schemes (compared with 57% for contributory schemes).

38 ACA, Smaller Firms, p. 4.

39 See footnote 11.

40 3.1m people were claiming sickness and disability benefit in the second quarter of 2004 – double the number on unemployment and lone parent's benefits combined. Source: Financial Times, 16 September, 2004.

41 ACA, Smaller Firms, p. 17.

42 Research based on survey data from pension scheme members shows many have very limited knowledge about savings and investment issues. See, for example, A. Byrne (2004) 'Employee Saving and Investment Decisions in Defined Contribution Pension Plans: Survey Evidence from the UK', Pensions Institute Working Paper. (www.pensions-institute.org/workingpapers/wp0412.pdf)

43 For example, in one scheme we have studied, over 50% of the members who reported that they had received some form of advice about their pension cited their employer as a source on which they had relied. (Byrne 2004 cited above (www.pensions-institute.org/workingpapers/wp0412.pdf))