MERCER

MERCER DEFINED CONTRIBUTION PENSION AND WORKPLACE SAVINGS SURVEY

APRIL 2012

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ABOUT OUR SURVEY

We conducted two surveys in late 2011. The first focused on employers and includes data from over 300 companies, covering 19 industry sectors, well over a million employees and more than £14 billion in assets under management. The survey represents all types of DC pension arrangement, with an equal weighting of both trust and contract based plans. Given the scale and breadth of reach of the survey, it is, in our view, the most representative DC survey carried out by anyone in the UK to date.

We also conducted an employee survey to enable us to match the employee perspective to that of the employer. This gives employers the opportunity to consider whether their plan design correlates with the employees' perception of what is important and thus valued. Around 1,500 employees across a range of income, regions, roles and ages participated in this survey.

We are all well aware of the current economic situation, both in the UK and beyond its shores. The blame has been firmly laid, by many commentators, at the doors of our financial institutions. This is a double whammy for UK pensions, with both employers and employees feeling the pinch; at the same time, trust in those financial institutions is at an all-time low. Add to this the seemingly unstoppable improvements in people's life expectancy and the persistently low interest rates, which are continually increasing the cost of buying a pension, and you have a perfect storm. Corporations and individuals know they either need to save more, work longer or retire on less (and probably all three), but finances are tight. We see, in this survey, that employer contributions have levelled off over recent years, and employee contributions are dropping.

Against this backdrop it is reassuring to see that much is being done to ensure that schemes are well run, offer good investment options (particularly for those employees who are unlikely to engage with their Defined Contribution (DC) pension) and, for more engaged participants, a greater focus on communication and education.

Employees are looking to their employers (who they say they trust and regard highly as sources of information) not only to facilitate their retirement savings, but also to provide further flexibility to help them with their short and medium term savings needs. While many employers do not currently have this on their agenda, we are seeing some forward thinking employers starting to enhance their reward packages in this way.

In terms of pension schemes themselves, we have seen many trustees taking positive action to improve their arrangements, both in terms of the investment options they offer and also in the way they communicate and interact with members. Where schemes communicate well we see higher member understanding and appreciation, thus helping employers get value for money (a key objective for most) from their pension scheme spend. Members still view pension arrangements as a significant and valuable part of their reward package and empowering members goes to further demonstrate and support this.

On top of the economic issues, 2012 will see one of the biggest ever shake-ups of UK pensions with the start of auto-enrolment. Three of the top four challenges highlighted by companies relate to auto-enrolment, with most employers grappling with the enormity of the challenge and many already starting their planning. As more employers begin to make the changes required to comply with their new duties, it is possible that we will start to see resource bottle necks from consultants, pensions providers, payroll system providers, etc. Employers must take this seriously now and not underestimate the time required for planning, design and implementation.

KEY FINDINGS

- Top challenges – three of the four top challenges for employers relate to auto-enrolment; though value for money and employee engagement are also significant issues.

- Contributions – after a decade of continued increases, employer contributions have stalled at 2009 levels, and employee contributions have actually fallen.

- Projected retirement income plunges – over half of employees now expect to work beyond age 66, and many younger employees expect to work beyond 70.

- Investment – 93% of schemes use a lifestyle strategy as their default, while 60% have reviewed their default in the last two years.

- Communications – employers who actively encourage participation and engagement have a greater likelihood of members having a good understanding of their pension benefits, improving value for money from the employer perspective.

- Employee satisfaction – there is a disconnect between how employers rate the success of their DC plans and the employee view. The most important success factor for employers was that their DC plan was valued by their employees, and 83% of employers thought they were achieving this. However, 25% of employees were dissatisfied with their employers' pension plan.

- Wider savings – employees would like more choice over the benefits currently offered by their employer. Employers see this as a low priority, another 'disconnect'.

- Provision of benefits – employees expect their employers to facilitate provision of benefits, but not to be paternal in this regard.

SURVEY FINDINGS

CHALLENGES

The main challenge identified by employers for DC plans is getting HR and payroll systems ready for compliance with the auto-enrolment requirements. The second biggest challenge is achieving a sufficient degree of employee/member understanding.

The other two top four challenges are also auto-enrolment-related, with concerns over increased costs due to higher take-up rates and over the redesign of contribution structures. That said, over half of employers are only at the consideration stage for changes in line with auto-enrolment requirements, with a quarter having taken no action at all.

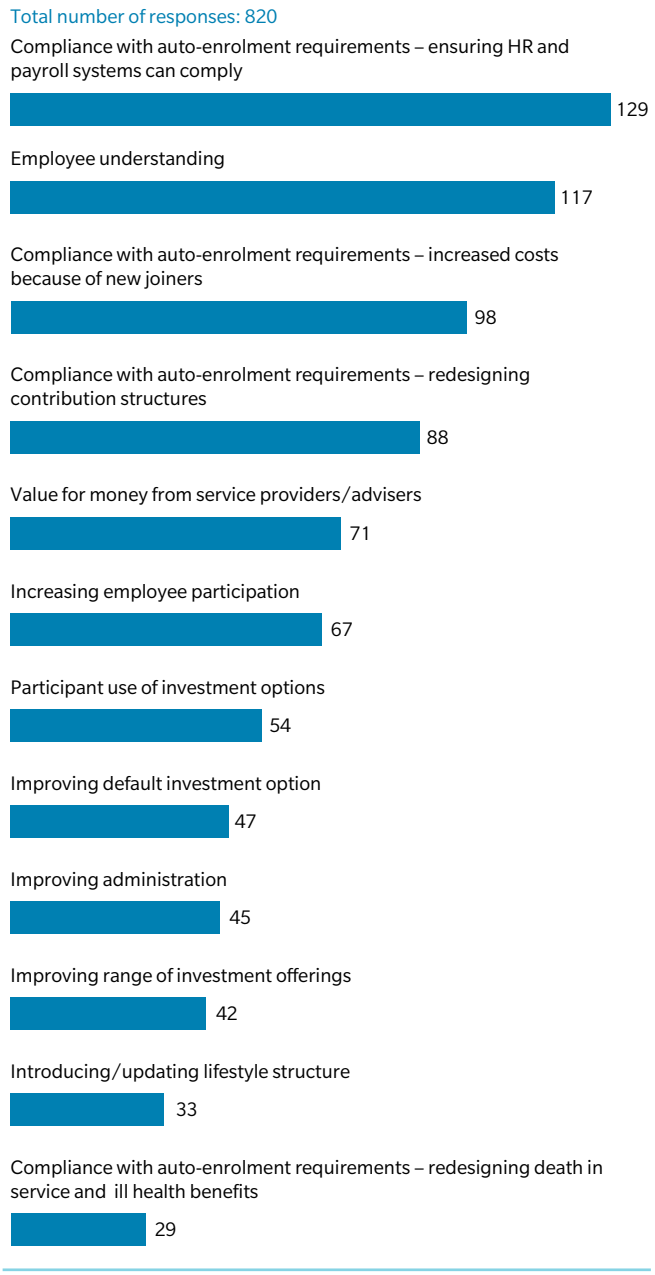
AUTO-ENROLMENT – THE NUMBER 1 CHALLENGE

As noted, three of the top four challenges identified for pension schemes relate to auto-enrolment. This is no surprise given the imminent roll-out from October 2012.

Importantly, employers are most concerned that their HR and payroll systems will not be able to cope with the detailed changes that are required by the legislation. As nearly 60% of employers have pension membership levels below 80% of eligible employees, it is not surprising that employers are concerned about the workload, as well as the changes required to their systems.

Figure 1

What challenges is your DC plan currently facing?



Our survey also shows that nearly 70% of employers expect to use their current plan to deal with auto-enrolling non-joiners, and nearly two-thirds of employers expect to change their contribution designs to allow for the increased overall cost. This is likely to lead to a reduction in contributions for future joiners, but in some cases an overall reduction for all members (including current members). Two-thirds of employers are thinking about using the phasing opportunity to slowly introduce contributions for current non-joiners. Clearly, this will moderate the immediate financial impact of auto-enrolment, and could also serve to increase long-term membership levels (and thus long-term employer costs), as the paying of increased contributions is eased in for employees and thus they are less likely to opt out.

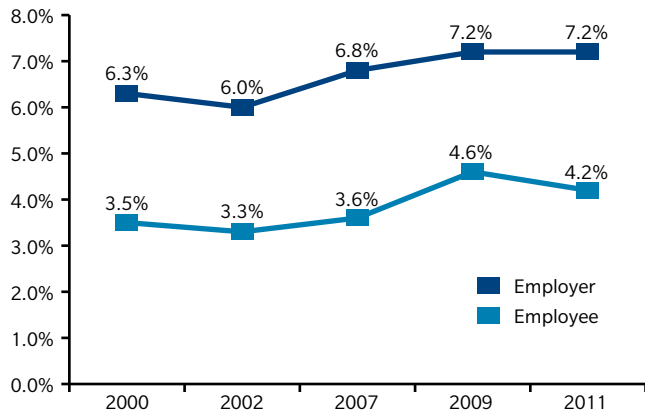
CONTRIBUTION RATES

Pension contributions to DC plans have grown over the last 10 years. However, the results of our latest survey show that actual employer DC contributions have levelled off at an average of 7.2%, whereas average actual employee contributions have dropped slightly from 4.6% to 4.2%.

We continue to see higher levels of contributions for main board and other senior executives. These tend to be 15%, 20% and 25%, often dependent on an employee contribution of 5%.

Figure 2

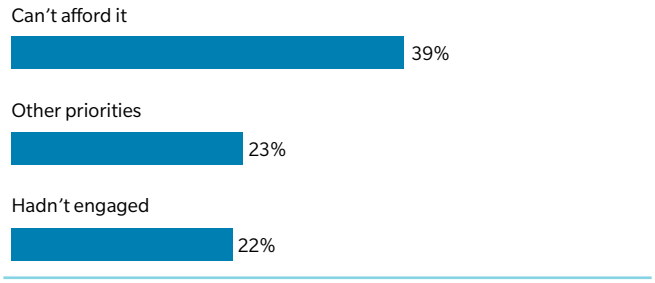
Trends in contribution rates



Overall, 76% of employees agree that retirement planning is an important issue, though 73% consider that they cannot afford to do more for retirement. Furthermore, while most employees who are eligible have considered joining their employer's pension arrangement, 54% of all individuals who have chosen not to join have done so because they cannot afford to. This may indicate that employees are more engaged in the necessity of retirement planning than current take-up levels imply.

Figure 3

Why have you chosen not to join your employer's scheme?



In relation to contribution rate design, the top three objectives are competitive positioning, targeting a particular level of benefits and targeting company expenditure. Employees still consider pension benefits a significant part of their remuneration package, so the concept of a pension plan being a recruitment and retention tool still applies.

Despite many schemes targeting a level of benefits as part of their initial design criteria, recent market volatility, lower contributions from employees and increasing annuity prices mean that these arrangements are very unlikely to produce the level of benefits originally expected. Individuals therefore need to start planning to work longer, pay more in themselves or consider less income in retirement – and perhaps all three. As an example, a 50 year old can currently expect to receive £145 less in monthly retirement income than was projected in 2009 (assuming a 12% total contribution rate and an accumulated pot of £200,000). For those in their 30s the pension may be roughly £100 less per month (assuming 12% total contributions and no

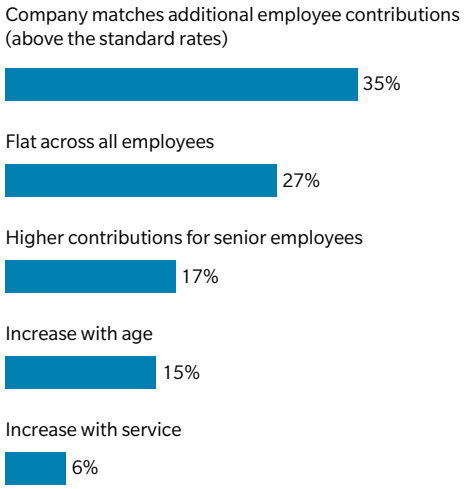
accumulated pension fund). This is reflected in the employee survey, with the majority of employees expecting to retire on less money than they would like, and over half planning on doing some form of work in, or delaying, retirement.

Despite the negative impact of inadequate benefits on future workforce planning, employers are unlikely to increase contribution rates in the current economic environment.

Approaches to contribution design have also changed since our previous survey in 2009, with a reduction in service and age-related designs in favour of flat rate structures. We believe that this change reflects concerns over age discrimination and a desire to simplify the scheme. The most popular approach is to provide a matching structure.

Figure 4

Type of contribution design



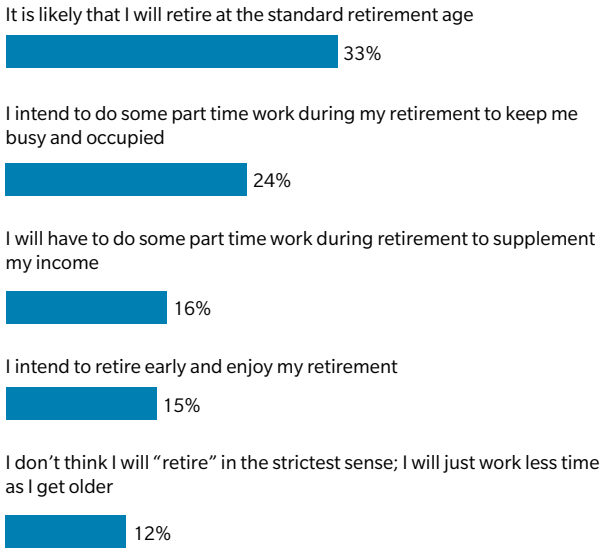
The number of schemes making employee contributions via salary sacrifice has also risen from 40% in 2009 to 46% in 2011. In some respects, it is surprising that more have not taken the opportunity to increase contributions or reduce costs via salary sacrifice.

RETIREMENT PROVISION

As already noted, individuals need to start planning to either work longer, take less income in retirement or pay higher contributions. Our employee survey showed that over half of individuals expect to continue some level of work into retirement and that the majority expect to have a level of income less than they would want to receive.

Figure 5

Which of these statements best applies to you?



The changes in legislation with regard to default retirement age and increased flexibility for drawing retirement income should help assist individuals with their retirement planning. However, while 80% of organisations have considered the impact of the removal of the default retirement age, less than 30% have considered what increased retirement flexibility may mean for them. It should also be noted that 57% of employers do not allow flexible retirement within their main scheme.

In general, employees seem to lack support when it comes to retirement, with only a third of companies meeting the costs of an annuity broking service at retirement. We believe that schemes should provide much greater assistance for individuals at this stage in their lives, as the impact of not "shopping around" could reduce a member's retirement income by up to 30%. Education in this area is also relatively low, with members not "shopping around" for the best annuity rates in over 40% of schemes. This is alarming considering the differential in annuity rates throughout the market.

All of these changes in employment/retirement flexibility will have a long-term impact on workforce planning for employers and need to be seriously considered sooner rather than later.

Employers need to recognise that they run several risks if DC plans provide inadequate benefits including an ageing workforce, litigation and likely industrial relations issues.

INVESTMENT

While average contributions have levelled off over the last two years, we have seen a good number of employers making other enhancements which have significantly improved DC plans.

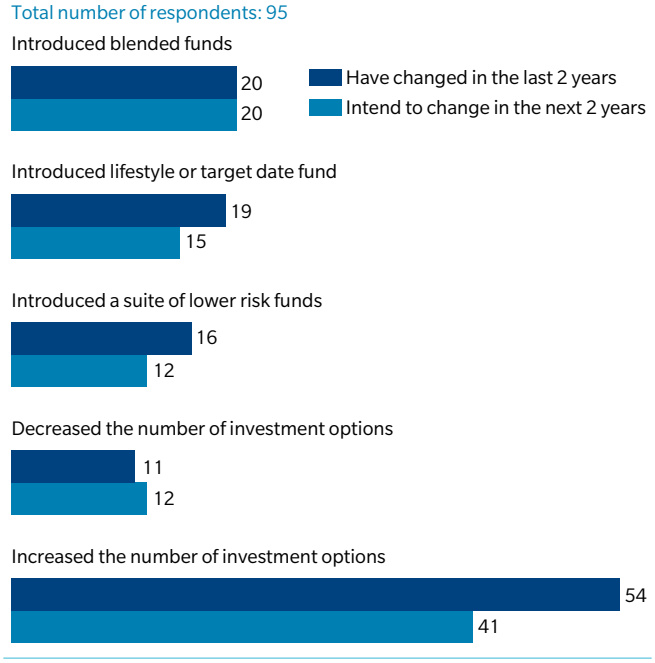
In the area of investment, nearly two-thirds of schemes are reviewing their default strategy to allow for improved fund opportunities and developments such as the introduction of diversified growth funds into lifestyle strategies. This should, in turn, serve to improve member outcomes. The focus on default funds is of particular importance considering that 79% of plans now have over 75% of their members invested in the default strategy.

We have also seen a significant shift in plans using lifestyle strategies as their default, with 93% of plans doing so now compared with 74% in 2009. Over the coming years we expect a gradual switch from the use of lifestyle funds to target date funds. This change should facilitate more active management in the switching process factoring in market movements, although lifestyle funds have done relatively well in the recent volatile investment markets.

Outside of the default fund, schemes have also been reviewing their wider investment offering, perhaps in response to market volatility or the development of investment options designed to increase member understanding, as we now see 45% of schemes offering risk/return graded funds.

Figure 6

Have you changed the number of investment options in the last two years and/or do you intend to change in the next two years?

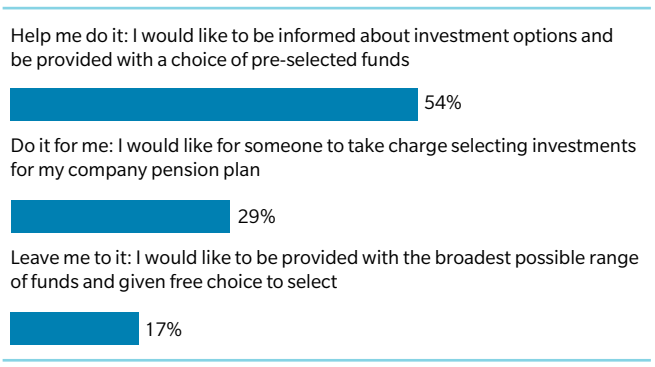


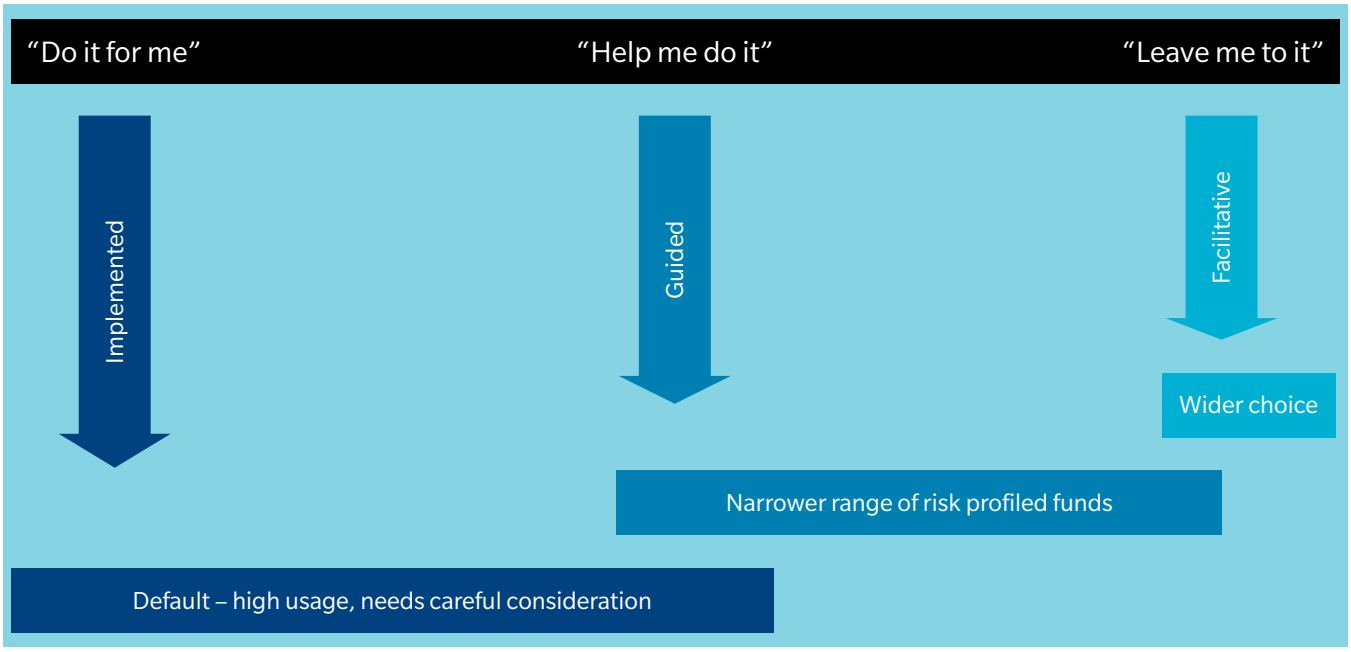
We strongly recommend that the employer considers specific membership profiles when making changes to investment strategies; their employees' financial awareness and understanding should be factored into the type of investments offered. Our survey showed that over half of members want some level of assistance with their investment decision making, and nearly a third simply want the decision made for them, although this is not reflected in the actual actions taken by members where the vast majority simply access the default fund.

When helping clients design a suite of investment options for their membership, we recommend a tiered approach. This has the advantage of offering a suitable amount of information and options for different members.

Figure 7

Which of these statements best describes your approach to selecting investments in your company pension plan?



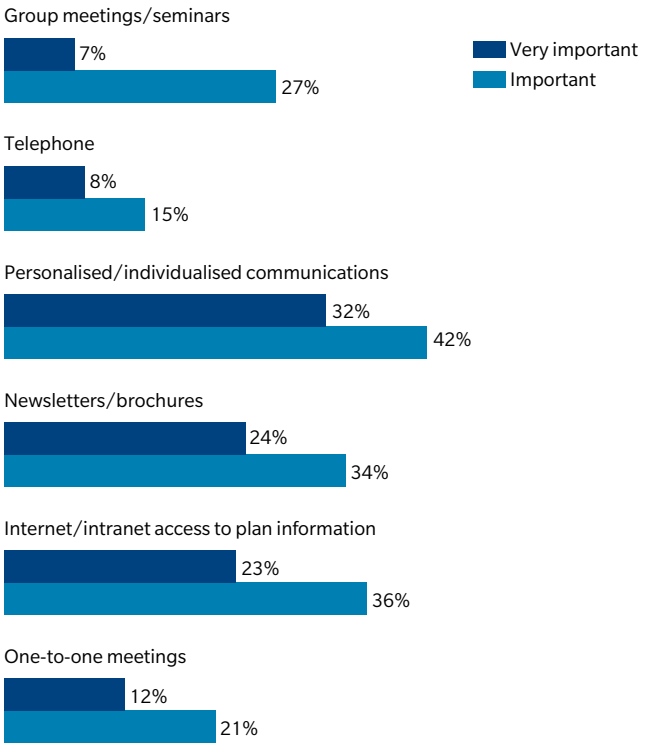


COMMUNICATION AND EDUCATION

The most important method of communication for DC plans has been identified as face-to-face and verbal interaction. This ties in with the employees' view that the three most trusted sources of information on pension benefits involve "human contact", number one being the pension or benefit specialist in the place of work, closely followed by independent financial advisers then colleagues, relatives or friends.

Figure 8

How important are the following methods for communicating your DC plan?



However, for group meetings and seminars to be effective in introducing long-term behavioural changes, they need to be held regularly and consistently rather than presented in single pushes.

Interestingly, although the vast majority of individuals use social media-based communication in their personal life, the most commonly used social media in their professional life is LinkedIn, and then only 17% of employees surveyed use this. We also note that members indicated that they are not that interested in using social media to manage their financial affairs.

Similarly, only a quarter of employers consider web-based communications as very important. Commonly, this reflects the fact that not all employees have access to a computer in the workplace, but it also supports evidence from providers that the take-up of websites and online tools has been relatively low, and is certainly not matched by the typical usage levels experienced by social media. Any employer planning to use these routes to improve engagement should consider how this will complement other methods of communication.

Around 20% of employers provide financial education to all their employees for pension investment matters. Less than 10% provide general financial planning advice to their workforce (although 10% of respondents noted that they are likely to offer this soon).

Separately, over a quarter provide assistance/advice to employees affected by the Lifetime or Annual Allowances. Given the significant reduction in the Annual Allowance from £255,000 to £50,000, effective in 2011, and the reduction in the Lifetime Allowance in 2012, there may be a greater call for guidance on these matters as they affect more individuals going forward.

HOW DO EMPLOYEES VALUE THEIR PLAN?

The following table shows the top success factors as rated by employers when it comes to DC plans, and also how employers rate themselves on their delivery.

Success factors for DC plan*	How well are you doing against these factors?*
1 Valued by employees	2
2 Providing adequate benefits	3
3 Supporting business and HR strategies	5
4 High participation rates	4
5 Attracting employees	8
6 Cost predictability	6
7 Retaining employees	9
8 Low running costs	7
9 Meeting compliance requirements	1
10 Providing employee flexibility	10

*Where 1 is the most important and 10 the least

The employee perspective when it comes to these success factors is worth noting. Around a third of plans have membership levels below 50% of those eligible to join – this suggests that plans are not particularly valued in many organisations. However, we also asked employees how satisfied they were with various benefits being provided by their employer. Half of employees were either satisfied or very satisfied with the retirement savings and pension plan, and only a quarter were either dissatisfied or very dissatisfied.

There is a potential conflict here as employers believe their employees value their DC plan. Therefore, employers would be well advised to engage with employees to get a better understanding of their perspective of what's important.

WIDER SAVINGS

The following chart (Figure 9) shows that pension is still the most valued form of long-term benefit provided by an organisation. However, if we compare Figure 9 to Figure 10, showing the results of the employer survey of what organisations currently offer or plan to offer in the future, it is clear that employer and employee objectives are not aligned.

Figure 9

Which of the following long-term savings options would you value the highest?

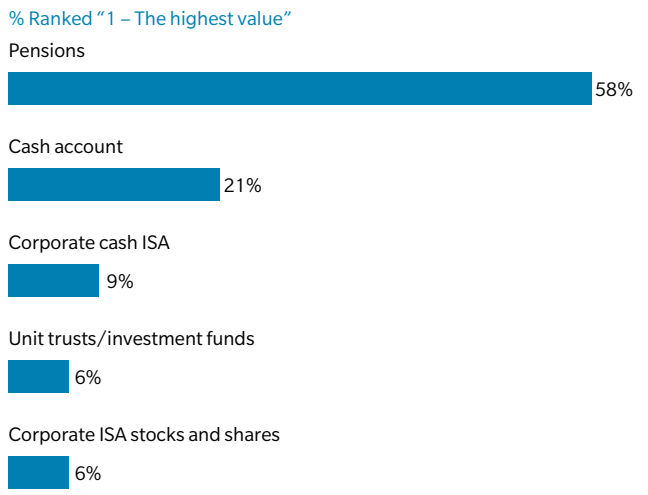
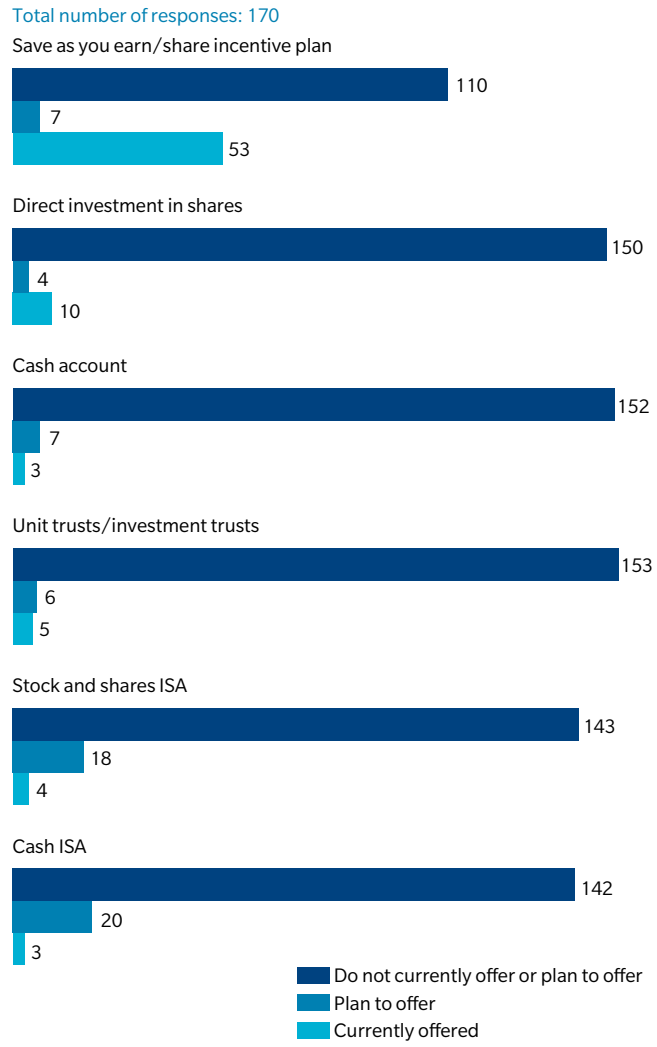


Figure 10

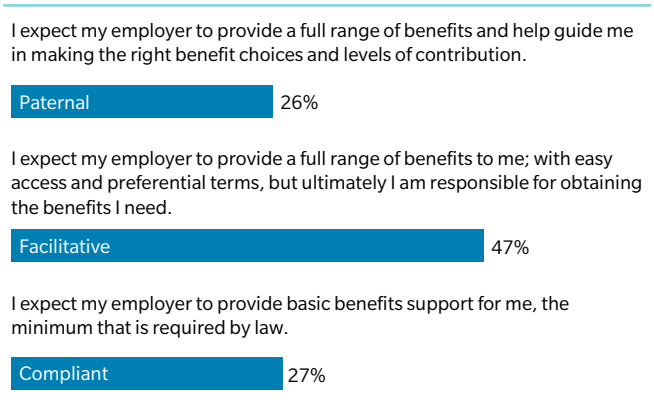
Which of these wider savings provisions are facilitated via your workplace?



Our survey confirmed that the number one savings option from the employee survey is pensions. However, over 40% of employees would value highly other forms of savings options such as cash accounts and corporate ISAs. In fact, over 70% of employees expect their employers, in the future, to provide access to a fuller suite of savings benefits, beyond that currently required by law.

Figure 11

What role do you expect your employer to play in providing benefits to you as an employee?

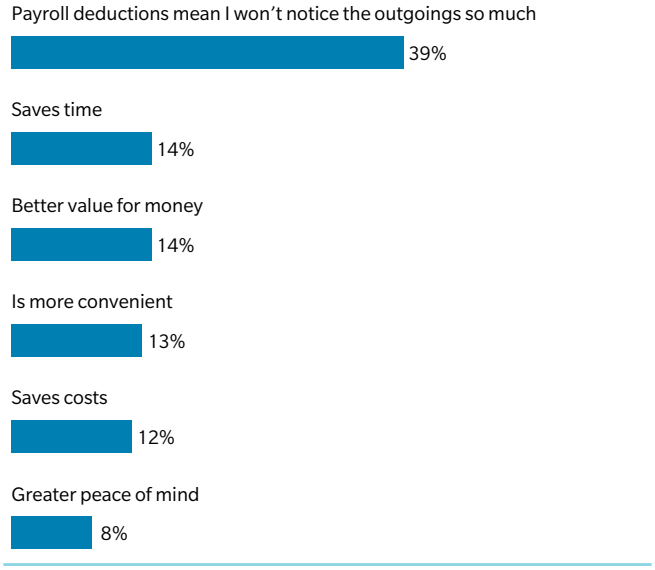


Organisations may want to consider that, in a large number of cases (44%), employees have indicated that they would be prepared to use some of their own money to choose the benefits that they consider important, or would like the opportunity to reduce some benefits in favour of others. The responses would strongly suggest that flexible employee benefits are valued highly by our respondents.

The advantage of being able to buy financial products in the workplace is the feeling that deductions made directly from pay are not as noticeable as individually made savings arrangements. It is clear that employees see this approach as an easier way of managing their finances and believe that an arrangement organised by their employer will represent some inherent cost savings/value for money.

Figure 12

What do you believe would be the advantages of being able to buy financial products in the workplace?

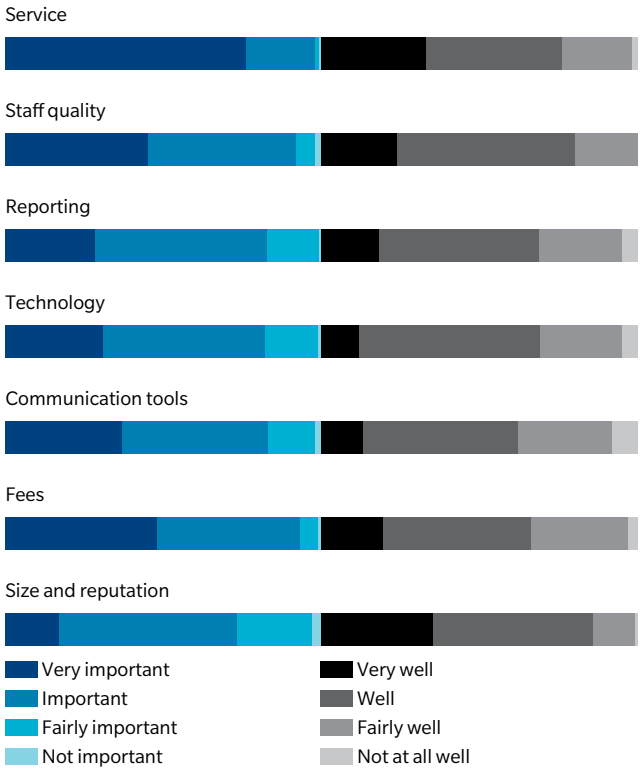


ADMINISTRATION AND GOVERNANCE

We asked employers about the administration of their DC arrangement. Seventy-five percent of respondents rated service as very important. However, less than one-third thought their administrator was performing very well in this area. Given the increased workload for scheme administrators as a result of auto-enrolment, we believe service levels could fall further at some providers. Plan representatives should be speaking to their administrators in order to understand how they are going to cope with the increased workload.

Figure 13

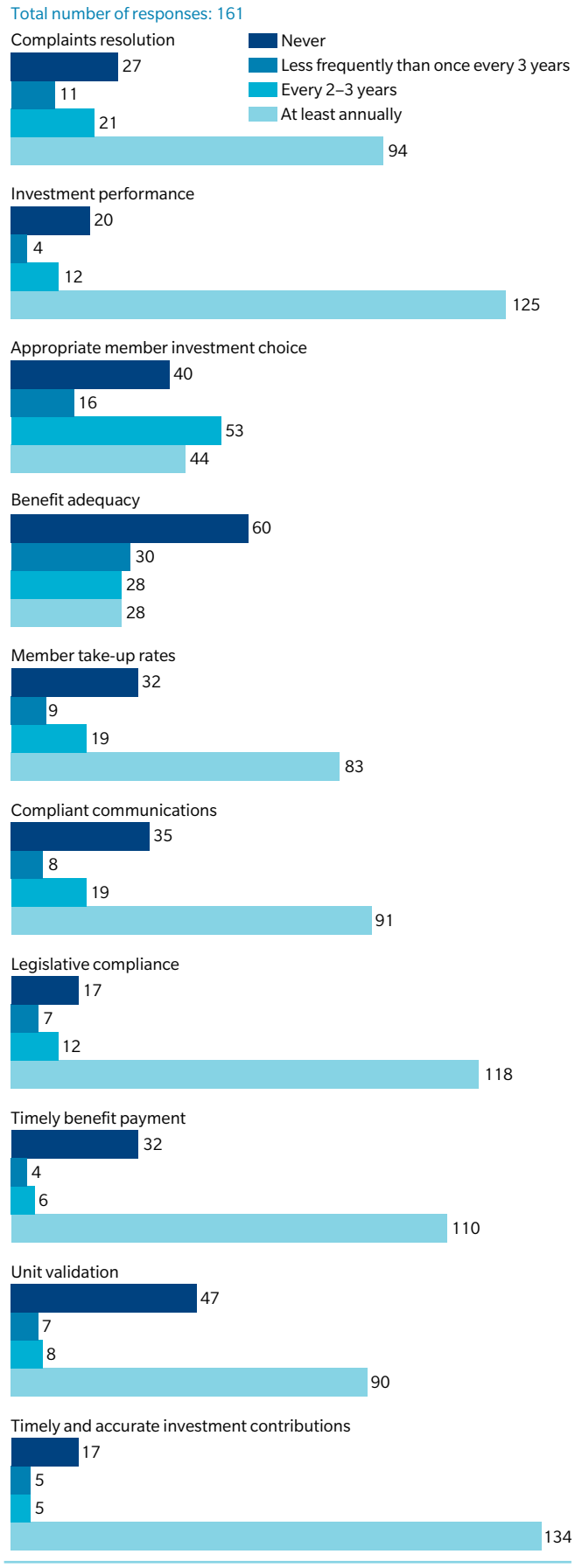
How important are each of the following factors when carrying out an evaluation of your plan administrator, and how well does your administrator perform against each of the following factors?



Turning to what policies schemes have documented, we see that over 50% of schemes have no policy covering their success factors and 46% do not articulate their plan goals and objectives. Many schemes regularly measure key factors such as contribution remittance and investment performance, but over a third have never considered the adequacy of their contributions. We believe it is crucial for sponsors to understand what members are likely to receive from their pension arrangements.

Figure 14

Which aspects are included in any audits you undertake for your DC plan?



SUMMARY

The DC world continues to be in a state of flux. The Pensions Regulator is sharpening its focus on DC schemes and a lot is changing with new investment strategies and improved retirement flexibility. Clearly, the priority for most organisations over the next few years will be the implementation of auto-enrolment. However, it is important that all stakeholders (sponsors, trustees and employees) consider their underlying pension and savings objectives and have clear strategies to achieve these. Where these strategies can be aligned, outcomes will be better all round.

Employers should also think about the legacy they will leave behind if contribution levels are inadequate. Employees who feel forced to work longer than they would like may be disruptive, and potentially less productive. Addressing contribution adequacy now could be a good long-term investment in workforce planning.

Employers can improve their arrangements in a number of ways without increasing the contribution rates, such as educating non-joiners regarding the benefits of saving early.

For those already in a scheme, much can often be done to improve the range of investment opportunities available, as well as the quality and price of funds. The provider market is very competitive in this regard and we have seen large reductions in member charges through negotiations or switching providers.

Finally, we would strongly encourage employers to consider employees' wishes and offer wider savings options. These may encourage those currently disengaged with pensions to save in a different form, paving the way to saving via a pension at a later date.

The starting point is to use data that is already at your fingertips to gain a better understanding of employee groups, perhaps supplementing this with workshops and surveys, to really understand what employees value in terms of benefit provision.

If you would like further information or sector-specific analysis, please contact either your usual Mercer consultant, Kevin Painter (kevin.painter@mercer.com) or Paul Macro (paul.macro@mercer.com).

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