



# Centre stage

Defined contribution schemes are being thrust into the spotlight, giving governance a much more important role, finds **Maggie Williams**

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## THE PROLOGUE

Once the Cinderella of the occupational pensions world, defined contribution (DC) schemes are now no longer the bit-part player to defined benefit's (DB) romantic lead. DC is now the fastest developing form of workplace pension and with that increased focus comes higher profile governance responsibilities for trustees – who need to learn their lines fast.

"The whole pensions industry has been encouraging trustees to 'think DC' in

terms of governance," says Lorraine Harper head of pension scheme management consulting at Hewitt Associates. "At the highest level that means thinking about administration solutions, risk to members and investment strategies."

Whether you are exclusively responsible for a DC scheme, or have joint responsibility for a defined benefit (DB) scheme and a DC scheme – generally termed a 'hybrid' arrangement – those points of focus remain the same.

## ACT I: SAVINGS AND BENEFITS

### SCENE I: THE CONTRIBUTION RATE

“The biggest impact on member benefits comes from contribution rates and fund choices,” says Brian Henderson principal in the DC consulting team at Mercer. “Contribution adequacy is not discussed enough by trustees.”

Contribution adequacy refers to whether or not the contributions being made into the member’s pension will buy them a sufficiently large annuity to fund a comfortable retirement. It covers both the percentage of salary contribution made by the employee, and also that made by the employer. The structure of the scheme will generally determine how those two interlink – in some instances the employer will contribute a fixed amount and the employee can choose the level of their contribution. In others, the employer commits to matching the employee’s contribution, up to a certain level. For example, if the employee commits to contributing 8 per cent, the employer will match it with a further 8 per cent. Not all sponsors offer to match employee contributions, but many do – and it’s an important part of a good-quality scheme. Establishing an appropriate contribution rate, and the division between the sponsor’s payment and the member’s payment, is critical to other parts of scheme design such as the fund range, so ensuring that employers and employees are contributing appropriately,

and understand the importance of doing so is vital to good scheme governance. Richard Warne, global strategy director, institutional at Aviva Investors says: “Because there is no employer covenant, there is a higher dependence on the trustees to get the investment strategy right, and that includes the contribution rates as well as the fund choices.”

Decisions on the contribution rate will be scheme-specific and need to take into account both the willingness of members to contribute and employers’ willingness to match that contribution. Trustees also need to make sure that employees are aware of the employer contribution – and encourage members to take it up.

That is more difficult than it might appear. “Getting members to take up matching contributions is a big challenge,” says Emma Douglas, head of DC sales at BlackRock. “It might keep the finance director happy in the short term if members don’t take up that extra money, but it’s not good practice in the long run for members.” Not taking up the employer contribution could mean the difference between a good pension at the end of a member’s working life and a very poor one. Consider the difference that a pension of 8 per cent member-only contribution would buy, and that of a 16 per cent member-plus-employer contributions. “It requires some tough messages and the need to communicate reality,” says Douglas.

### SCENE II: THE FUND RANGE

The majority of DC schemes offer members a default fund – into which their pension contributions will be invested unless they actively choose an alternative. And typically 80 per cent or more of a scheme’s members will invest into that default fund. That makes good design of the default fund essential. However, until relatively recent times, little attention has been paid to how members’ investments have been handled. A regular read through the money pages of daily newspapers will reveal horror stories of members with funds invested in 100 per cent equities until a few years before

retirement – with the inevitable result that their savings collapsed as the stock market fell in 2008.

“The big decision to make with the default fund is about asset allocation,” says Douglas of BlackRock. “Limiting volatility (ie the amount that a fund’s value fluctuates) is very important. Managers need to be able to generate returns that are above inflation, because members don’t want to lose money.”

To address that problem, Diversified Growth Funds (DGFs) are beginning to attract a lot of interest as default funds. These typically invest in a variety of different asset types but change the percentage of each asset in the fund over time to reflect market conditions and the behaviour of those assets. See our article in the Mar/Apr 2010 edition of *Engaged Investor* for further information on DGFs.

In terms of governance, the broader message is that simply dumping members into a poorly-designed equity-only fund is no longer acceptable. It’s dangerously easy for trustees to think that because a poor investment decision only affects individuals’ retirement pots that the impact is less than a poor decision in DB where the resultant loss will show up on the sponsor’s profit and loss sheets. But, for the retirement prospects of those individuals, the impact is massive – and ultimately that cost will fall back on the sponsor when members are unable to retire.

To address the problems of poor investment choices a group of senior practitioners from across the pensions industry has created a set of ‘best practice’ guidelines for DC governance, under the auspices of the Investment Governance Group. See the boxout on page 30 for further details.

## ACT II: ADMINISTRATION

"A few years ago, everyone thought that as DB administration was so complex, DC administration would be a cinch in comparison," says Harper of Hewitt. In truth, DC administration isn't easier – it's simply different. For example, if trustees discover a mistake in their DB administration, such as missing contributions or an incorrect calculation, it's possible to rectify it over time. DC administration has to be right first time: each members' pot is a separate investment and so payments have to be correctly logged right from the start. If problems go undetected for long periods of time the cost and complexity of fixing them can be horrendous. "A serious problem could even mean getting the scheme reconstructed," says Harper.

Getting an administrator that truly understands DC administration and is able to carry out tasks such as reconciling payments effectively is absolutely vital. "You need to make sure that you go into the details of how things are being done with your administrator," says Nita Tinn of independent trustees ITS. "Ask how the lifestyling process (ie the way in which members' investments change over time to generate returns and/or reduce risk as they reach retirement) is happening, for example."

One of the cornerstones of good administration is high quality data. The Pensions Regulator's recent communications on record-keeping (see *Engaged Investor*, Jan/Feb 2010) have set out some clear standards and requirements for data and record-keeping, but these are just the basics. Holding good quality information about members not only means that their benefits are held and calculated correctly – it also means that you can target communications more effectively. And effective communication is perhaps the biggest governance challenge of all for DC scheme trustees.

### PROGRAMME NOTES: COMMUNICATION AND MEMBER UNDERSTANDING

While trustees might be responsible for the design of the fund range and the structure of the default fund, it is still ultimately up to the member to decide where to invest his or her money.

But how many members truly understand the funds in the range that they are being offered? Do they choose the default fund because it genuinely suits their needs, through inertia, or because they believe it to be the best simply because it's been chosen as the default fund? Do they appreciate their pension as an employer benefit, and do they understand what to do with it when they actually retire? Answering these questions – and a host of others – requires good quality communications. The DB-style approach of issuing an annual member statement just isn't appropriate in a world where members' pensions are influenced by their own decision-making. And, while websites for modelling retirement aspirations, videos explaining investment choices or even face-to-face sessions with members all have their part to play in improving communications, if they are not delivered in the

### EXPERT VIEW

## Adding value in DC fund governance

Dave Hodges explores some of the biggest challenges for DC trustees

The economic turmoil of the last two years has tested to the extreme the effectiveness or otherwise of defined contribution (DC) fund governance arrangements. What has really set this economic turbulence apart is the universal impact it has had on all asset classes and nearly all DC default funds with the member bearing the investment risk.

It's worth taking a step back to understand the original drivers for better DC governance – to minimise the risks and to maximise the value of the scheme. Research undertaken by Towers Watson\* shows that fiduciaries considered the two biggest risks in DC to be member understanding and investment fund choices. Interestingly the same research shows that fiduciaries consider the two biggest areas where governance can create value are member engagement and investments.

Turning to investment funds, added value will come from focusing on the default investment fund due to the high proportion of members using defaults. Generally, governance so far in DC has focused on ensuring that asset allocation is appropriate to the member's term to retirement. Thus most defaults are invested in a lifestyle option using passive funds. The severe economic turmoil has generated more focus on the default fund and whether greater value can be generated. This has ranged from 'tinkering' with the lifestyle phasing with some schemes extending the pre-retirement phasing to more fundamental reappraisals of the growth fund strategy. Increasingly we are seeing much higher demand for white labelled blended fund options. These have the advantage of diversifying both the asset allocation and the fund manager thereby reducing the risk profile without necessarily compromising performance. This also allows a more ruthless value approach to the passive versus active choice in different asset classes. For schemes that don't want to maintain blended funds we are

seeing greater demand for diversified growth funds and absolute return funds, again to reduce the risk profile.

Of course the biggest barrier to increasing active governance is the time and expertise available to those who hold this responsibility. However there are ways of lightening the load. The use of sub-committees is a good way of increasing the focus and lessening the time commitment for trustee boards. In many schemes where both the DB members and the DC members are overseen by the same trustee board, we have seen DC investment scrutiny coming under the gaze of investment sub-committees thus allowing alignments of investment strategy, expertise and leveraging the combined asset scale. Additionally the use of provider fund platforms allows the trustees to delegate the operational fund governance to concentrate on strategic asset allocation and performance monitoring. Of course if greater expert resource is required, fund expertise can be brought in to any governance committee through the use of external consultants.

Yet whilst there is always room for improvement, what remains consistent is the need for strong fund governance as an integral part of effective DC administration. ■

\*Source:

<http://www.towerswatson.com/united-kingdom/research/1422>

Towers Watson has published the sixth edition of our survey on the provision of DC pension arrangements offered by FTSE 100 companies. The survey is based on information from 95 companies and is truly representative in revealing DC trends for the biggest companies in the UK, allowing employers and trustees to benchmark their DC plans against those who historically have set the trends for the industry.



Dave Hodges, Client Relations Director at Zurich Corporate Pensions



## EXPERT VIEW

# Good DC governance

## Derek Watson identifies some key factors of defined contribution governance

It seems that every article and statistic published recently about defined benefit (DB) schemes conclude that they're in terminal decline and that employers are looking to defined contribution (DC) arrangements as an alternative. With this migration, there also seems to be a shift from the trust-based environment to the contract-based one.

By moving to a DC arrangement, it's widely accepted that many of the risks (including investment and longevity) are transferred to the member. But what about the governance risk? Is this being considered carefully enough when the decision to move to DC is being taken?

In a DB scheme the risks lie, in decreasing order, with the employer, the trustee, the member and, least of all, with the investment manager. In a trust-based scheme, the risks are more evenly shared, whereas in a contract-based scheme, the risks are almost entirely transferred to the member. The differences on how the risk is proportioned between the different types of schemes are largely down to governance.

Governance in trust-based DC schemes is certainly less onerous than it is for DB schemes but the responsibilities remain far-reaching. For example, trust law doesn't make any distinction between DB and DC so the fiduciary duties remain the same.

Trust-based DB and DC schemes have many other similarities, including the need to:

- hold regular trustee meetings and clearly minute decisions
- look after the best interests of the members
- make sure professional advisers continue to provide an efficient, cost-effective service to the members.

Having said that, there are also some fundamental differences between the two, in particular between the governance responsibilities that each has. For example, under a DC arrangement,

trustees don't have to deal with funding issues. Nor do they have to face the challenge of setting valuation assumptions and the governance requirements related to this.

One of the other key responsibilities that DC scheme trustees face relates to investments and the funds they will allow their scheme members to access, including:

- what degree of investment choice should be offered to members
- whether to have a default fund for members who prefer not to choose their own investment strategy
- whether to offer a lifestyle approach to asset allocation
- the roles of active and passive investment management
- the interaction between the investment choices in the scheme and other key decisions over joining mechanisms, contributory rates and annuity purchase
- how to communicate with members on investment issues and how to engage them in the choices they have to make
- how often investment managers should be reviewed.

Most scheme members aren't comfortable with investment issues and few receive appropriate individual advice. Governance under a trust-based DC arrangement offers some investment protection as the trustees will take professional advice when agreeing the funds that the members will have access to.

I've no doubt that the migration from DB to DC will continue but perhaps a more considered approach to governance needs to be taken when deciding upon trust-based or contract-based scheme alternatives. ■



## THE SEQUEL: INVESTMENT GOVERNANCE GROUP

In recognition of the increasing importance of good governance for DC scheme investments, a group of senior pensions industry figures has developed a consultation paper on best practice in DC investment, under the auspices of the Investment Governance Group (IGG).

In essence, this offers a set of guidelines that mirror the Myner's Principles – the set of guidelines for DB decision making established by Paul Myner in 2001 – but aimed specifically at DC schemes. A consultation period on the IGG's paper closed in early May.

The paper is broken down into four main parts:

1. A framework of legal and regulatory requirements, with a focus on what trustees (and others) must do to improve transparency, accountability, fund governance and decision-making.
2. A set of principles for investment decision making. While not legally binding, the paper proposes a 'comply or explain' approach to the guidelines.
3. A check-list of best practice guidance, to help schemes meet the aims of the principles.
4. A table of accountabilities that shows the responsibilities of each decision maker within the DC structure (including trustees) at each decision-making stage.

Industry response so far has been mixed, with Standard Life branding the guidelines 'elitist' and biased towards trust-based schemes.

right way and at the right time, they won't have the desired effect.

Providing generic member education can make minimal difference – "inertia and accepting the status quo are very much in evidence in the DC world," says Douglas of BlackRock. "Members are surprisingly complacent," agrees Tinn of ITS. "Even when they receive information they often don't respond to it. The type and quality of information is vital."

Getting the messages, timing and form of delivery correct comes down to knowing your members as well as possible. Information such as members' ages, and whether or not they are married should be accessible from your administrator, but that won't tell you whether members would prefer to receive communications online or on paper – or if they read the communications that you send them already.

Using the internet for information and for collecting member information such as fund choices is an alternative to paper – but certainly not a complete solution. Warne, of Aviva Investors says: "For online tools, take-up rates are woefully low. We are looking at single percentages." He says that Aviva has recently introduced a new DC-specific communications tool for the schemes that it supports. The package includes videos as well as other online tools to educate and support members. "It has raised engagement rates, but to around 25 per cent. That's still not enough."

Cracking member communications sits at the heart of good DC scheme governance and is a huge subject of critical importance for the trustees of all DC schemes. That's not just because it affects members' investment decisions, but because it's also a vital element of making sure that trustees have done their job properly. Says Harper of Hewitt: "The Pensions Ombudsman is seeing more cases relating to DC pensions. You need to make sure that you have a proper audit trail for your communications – and a proper risk strategy for your scheme overall." ■

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