DC in the post-Budget 2014 world

This presentation considers the impact of the budget changes announced in 2014 on the provision and management of defined contribution schemes. It considers first the issues that Trustees and providers of DC schemes should be considering and moves on to the longer term impacts of the changes.

For Trust Based DC Schemes, the overriding objective for Trustees is to ensure the best outcomes for members. They need to operate within the bounds of the Trust Deed and Rules, but Trustee governance can change outcomes. Members will achieve the best outcomes if they understand the Scheme, the choices that they can make and the potential options that they will want to take advantage of at retirement. This can all be enhanced by a good communication program, which needs to be appropriate in terms of the message it is giving, the form of communication, when it is delivered to members, i.e. at which stage of their working life, and how often it is delivered to the membership in general.

One of the main items that will affect outcomes is a member's investment strategy. A balance needs to be made between having too many options that members won't be able to decipher, and too few that restrict the choices that members can make. In general, the self-select range of funds should not be too extensive as they could increase the Trustee governance requirements. However, the new choices that members will have at retirement mean that current default strategies that target annuities and cash will not be appropriate for some of the choices that members will make. In addition, income drawdown is not generally been offered within schemes, and most schemes probably do not want to administer it going forward.

The current rules force many members to buy an annuity with 75% of the fund that they have built up. The new rules allow all members to take cash, subject to a tax charge, buy an annuity and/ or operate some form of income drawdown.

What has been/ should be the immediate response to this? Most, if not all, default strategies have been designed to target the purchase of an annuity. If, as expected, a significant portion of those funds that were historically used to purchase annuities, are now used for other means, the default strategy is inappropriate. Whilst it is not possible to predict member decisions, an analysis of the demographic and financial position of the membership can assist in the choice of an appropriate default. It may therefore be appropriate to review both the membership of the Scheme, and the investment options available, including the default. Trustees should be aware of potential log jams if everyone is trying to do reviews at the same time. This could be at both advisors and providers.

Members should have flexibility and choice to each tailor their savings to their risk appetite, but it is recognised that, amongst other things, budgets are constrained and governance is getting harder. Soon a Chairman's statement will also have to be available on an annual basis, covering amongst other things default funds and Trustee Knowledge and Understanding. Trustees may rebalance their budgets and spend more time and money on governance, and less on items such as active investment management. This is in addition to the other items that have been driving DC governance, including the DWP, TPR and NEST.

A typical membership analysis can establish the proportion of members who are willing to engage in their investment choices, either fully or in a limited way, and those that will always go for the default. As the choices are now three-fold, the proportion of members taking the default is expected to decrease. An analysis of the membership should then help with the review of investment strategy both in terms of the number of options to offer, and which options to offer.

The analysis will help to determine what communication and changes are needed for the current default. While it is unlikely that a full review can be performed and communicated before April 2015, it is important to communicate to members the objectives of the current default, and what it was designed for. It is also best to find out which members could be affected in the short term, i.e. those close to Normal Retirement Date or those close to age 55.

Additional strategies could be considered as long as they are communicated effectively – but it is unlikely that smaller schemes will have the governance budget for this. It is even more important therefore that they spend their budget on communicating the objectives of the current default and signposting the options available to members at retirement. It is also more important to make the default more robust to all three retirement choices.

In the medium term the market will evolve and the experience of members' decisions will be forthcoming. Trustees should recognise that anything they do now should be reviewed in 2 to 3 years once this extra information and potential extra products have been launched.

The changes now mean that it is important for Trustees to consider the process through retirement – even if they do not offer any facilities in-scheme post retirement. It is also important to recognise that pensions form a part of long term savings and tax planning, and so the employer may take more ownership of the communication and may take the opportunity to look more holistically at pensions in the context of other employee benefits. Members may need more help from professionals, despite the guidance guarantee – this will depend on how the guidance guarantee works in practice.

In conclusion, the changes mean that Trustees need to reassess the objective of the scheme from first principles. They have a duty to ensure best member outcomes, so an analysis of the membership and a change to the investment strategy will probably be appropriate. Member communication will be central over the coming years, and this should be engrained in the Scheme. We will need to guide clients in this area and help them navigate the various products that come available and the information that floods the market. DC Pensions are no longer Pensions – they are long term savings and members should take charge of them alongside their other finances.