The Trustee toolkit downloadable

How a DC scheme works 2014

Tutorial two: Contributions

By the end of this tutorial you will better understand:

- the different types of contribution structures in DC schemes
- how trustees can work with employers to mitigate the risk of members making inadequate contributions

This tutorial is part of Scenario one.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at www.trusteetoolkit.com

The Pensions Regulator

Introduction

The Tutorial: 'Good member outcomes' introduced you to the risks that might affect the outcomes for a DC member. The risk we consider in this tutorial is that members may make inadequate contributions.

Generally, the employer decides the default contribution levels for members. Where a scheme is an automatic enrolment scheme, contributions must meet the minimum scheme qualifying threshold. Many employers offer members the opportunity to vary contribution levels. The trustee can play a useful role in:

- ensuring that any contribution flexibility offered by the employer can be accommodated in the scheme rules and is supported by effective processes and communications to members
- highlighting to members the relationship between contributions and good outcomes at pension age
- encouraging members to obtain financial advice and, where appropriate, take advantage of arrangements that result in higher contribution levels

Here you will learn about the most common contribution arrangements and how trustees and the employer might choose to deal with the risk of inadequate contributions.

Contribution structures

The most common type of arrangement in DC schemes is for the employer to pay a percentage of salary for each member. Members normally contribute a percentage of their salary as well. However, how this works will vary from scheme to scheme.

The Pensions Regulator is keen that all schemes offer 'flexible contributions' so that members can adjust how much they wish to contribute to their retirement savings.

Most schemes offer a combination of the following options.

Matched funding arrangements

Some employers offer to make additional contributions when members increase their monthly contributions above the default level. These additional employer contributions can be on a like-for-like basis or may use a different ratio (for example the employer pays an extra £2 for every additional £1 paid by the member, subject to a cap).

Additional voluntary contributions (AVCs)

In most schemes, members also have the option to make additional contributions, either on a regular basis or as a one-off lump sum payment.

Auto-escalation

In these arrangements, members commit to increasing their percentage contribution automatically, for example annually.

Salary sacrifice

Under these arrangements, the member can elect to give up part of their salary for increased employer pension contributions.

Definition of pensionable salary

Pensionable salary may or may not include overtime, bonuses or other additions to the basic salary. It may be limited to a maximum amount for a particular scheme. There may be variations on the amount of pensionable salary to be taken into account, for example offsets from salary may be applied.

Qualifying earnings

In order for a scheme to be a qualifying scheme for automatic enrolment, there must be minimum levels of contributions which are based on 'qualifying earnings'. Qualifying earnings may be calculated in a different way from 'pensionable earnings'. For example, they must include elements such as overtime and bonuses.

Fixing points

Pensionable salary may be fixed for a year at a certain point during that year, or may vary as pay varies.

Flat rate

Contributions are a flat rate monetary amount.

Service-related

Contributions rise with the member's length of service with the company.

Focus on risk

Many members may need to make contributions above the scheme default level in order to meet their retirement expectations. Members may be unaware that they are not saving enough to achieve the level of income in retirement that they would like.

What is the role of trustees in managing this risk?

- Working with employers to make sure that flexible contribution structures are clearly communicated to members.
- Helping members understand that their level of contributions is key to determining the size of their pot at their chosen pension age.

Case study: Inadequate contributions

Dervla is the Pensions Manager (who works on behalf of the employer) at British Clockworks, where a DC scheme has been running for 10 years and is being used for automatic enrolment.

The company has low staff turnover and 90% of employees are enrolled in the scheme. The employer pays the same percentage of salary for all members and provides an option for them to make additional contributions once a year in January.

Scheme review

Whilst carrying out a review of the scheme with the support of the trustees, Dervla became concerned that contributions were quite low and raised the issue with the trustees. The trustees are not responsible for setting the level of member or employer contributions but they often work closely with the employer on these issues.

Evaluating the risk to members

Dervla asked the scheme's advisers to use the scheme's data to assess the size of annuities that typical employees would be able to buy if they carried on saving into the scheme at their current rates.

This research showed that members would, on average, retire on a pension of 35% of their current salary including state pension. Dervla was alarmed because she realised that most of these people are likely to envisage a much higher level of income at retirement. She also knew that many would be forced to carry on working into their 70s unless they had other large sources of income or capital.

Assessing the take up of options

Dervla also reviewed whether members were using the option of paying additional contributions in January each year, and found that none had used this facility for at least three years.

Trustee discussion

Dervla discussed the issue with the trustees at their next meeting. The employer has a small budget to increase the employer's contributions and provide additional support to the scheme so Dervla and the trustees discussed how best to use this budget and other tools to encourage members to review the level of their contributions.

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The solution

The following options are discussed as a solution. Which three do you believe would best mitigate the risk to good member outcomes?

1. Change the option to pay one-off contributions to quarterly
2. Improve member communications to improve member understanding
3. Increase the employer contributions only
4. Offer an increased matched funding arrangement

Answers are at the back

Implementing the changes

The trustees and the employer (led by Dervla the Pensions Manager) worked together to implement the agreed changes. Tasks included:

Tasks to be implemented

- the trustees arranging for the scheme's rules to be reviewed and if necessary updated by the scheme lawyer to allow for contributions to be paid quarterly and for matched funding
- the employer (payroll) changing processes to be able to make changes to contribution rates for employees every three months rather than annually
- the employer (HR) updating the information that they provide to employees about benefits
- the administrators of the scheme accommodating the changes to the contribution structures and ensuring that the correct contributions were paid
- changing the annual statement issued by the scheme to show the projected pension as a proportion of salary (for employed members)
- signposting financial planning tools offered by the scheme provider which allow members to model the results of different contribution rates
- the auditors checking the contributions of a larger selection of members annually to ensure the correct amounts were being received by the scheme, and
- the trustees monitoring how many members take advantage of the changes and assessing whether further action is necessary to understand why take up may remain low

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Taking account of risk and cost

If amendments to the scheme's contribution structure are under consideration then it will be necessary to assess the risk and cost of changes and:

- liaise with payroll teams and administrators to check that they can support it effectively and efficiently. A more complicated arrangement may lead to errors
- how often a member should be allowed to change their contribution levels
- consider if there are other options, like an alternative pension arrangement, which could be used for additional contributions

Answers

The solution

The correct answers are the first, second and fourth answers.

Although increasing the employer contributions may have an impact, it would be smaller than offering a matched funding arrangement where employees also increase their contributions.

The current facility to pay one-off contributions is restrictive and not every member would be able to afford this in January. Changing this option to quarterly may encourage more members to make use of this option.

However, without improving the member communications to publicise these changes and help members understand that the level of contributions is key to determining the value of their pot at their chosen pension age, the changes are unlikely to be taken up by members.

So these three options were agreed.