



29 September 2004

Smaller companies discourage workplace pensions; auto-enrolment will not solve the problem

New research published today by the Pensions Institute, based at Cass Business School, reveals that finance directors have taken control of the defined contribution (DC) pension purse strings and many impose strict limits on the number of employees that join, in order to reduce the company's pension costs. Advisers selling DC pensions in the smaller company market say that if the government introduces auto-enrolment employers will still find a way to keep employees out.

The report, "Delivering DC? Barriers to participation in the company-sponsored pensions market" finds that finance directors (FDs) will not support the government's agenda to reverse the state/private pensions ratio, currently 60:40, to 40:60 unless it can be demonstrated that there is a clear return on the money they spend in the form of employer contributions.

Debbie Harrison, the primary researcher for the report and a Senior Visiting Fellow of the Pensions Institute, says: "This point was confirmed again and again in our interviews with pension providers, advisers, and consultants to companies both large and small. Advisers say they can achieve a 90% take-up rate with the employer's support. Without the employer's support they usually withdraw from the potential sale. Clearly, the FD represents a very significant barrier to wider pension participation in the DC company-sponsored market. If auto-enrolment is made compulsory employers can and will find a way to make membership unattractive and to make it very easy for employees to opt out.'

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, and employer and employee levels in the smaller and medium sized company defined contribution (DC) pension market. Typically, small and medium sized enterprises (SMEs) employ up to 250 staff but the report also includes research on companies with up to 1,000 employees. Together these companies employ almost 50% of the working population.

"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," Harrison says. "This is one of the biggest challenges we face. For right or for wrong, the traditional human resources mantra that DC pension schemes help to recruit, retain and motivate good staff has been questioned and dismissed by many of our interviewees."

David Blake, Director of the Pensions Institute adds, "Surprisingly at present, despite the huge volume of consultation and research on private pensions, there is no conclusive evidence that a direct relationship exists between the employer's investment in terms of the company contribution and in allowing employees time to attend presentations; and an improvement in the recruitment, retention and motivation of high quality staff."

Alan Johnson, the pensions secretary, announced this week that the Pensions Bill going through Parliament would give ministers power to require employers who make a company contribution to the pension scheme to enrol staff automatically. Employees would still have the right to opt out.

Alistair Byrne, one of the report's authors and a Fellow of the Pensions Institute, says, "Our research indicates that employers who do not want to increase membership significantly will find a way around auto-enrolment and will make it very easy for staff to opt out. All they have to do is to sow seeds of doubt about the benefits of the scheme, set a high minimum employee contribution, and provide a simple consent form that employees sign to avoid joining up. Employers will benefit from the low level of consumer trust in the pensions industry - to the detriment of the minister's objectives."

Further significant problems for this market exist in scheme design, the report reveals. To succeed in providing adequate retirement benefits DC schemes need an appropriate level of employee/employer annual contribution, good investment growth, and the availability of competitive annuity rates at retirement.

The report exposes the fact that this type of scheme simply isn't an option for millions of employees working for SMEs. Moreover, the situation will get worse unless action is taken, it warns. Life offices and financial advisers in this market say that the lack of employer support is forcing them to withdraw from companies with fewer than 50-100 employees because they cannot make a profit.

Byrne comments: "This report shows that providers and advisers are finding it increasingly uneconomic to market to small and medium sized enterprises and are withdrawing rather than redoubling their efforts. Although it is a legal requirement for companies with over five employees to provide access to a stakeholder scheme, in practice where there is no employer support this will remain an empty shell, as we have seen. This is an important and difficult issue for both government and private sector providers."

The problem is particularly acute where the company's workforce has a low-to-average earnings profile, as this represents uneconomic business for advisers and providers. The report explains that advisers identify such companies as "no-go zones", partly because of lack of profits but also because they are afraid that they may be accused of mis-selling to employees who would be better off boosting their state pensions by claiming the pension credit through the government's complex means-testing system.

Harrison says, "We examined the products and costs in the SME market and found that where a life office decides a company is uneconomic, either it will not deal directly with the employer or, if it does, it imposes an above average annual management charge (AMC), which is paid for by the individual member."

Harrison explains that this problem is compounded in two important ways. First, given the homogenous products and services offered by life offices in the SME sector, advisers select providers according to the rates of sales commission they pay. The providers that by their own admission pay "crippling" rates of commission in a bid to win market share, offer with profits, managed unit-linked and tracker funds as the scheme default option. The quality of the default option is critical because between 80% and 90% of members accept this option and stay in the fund until retirement. The report examined the range of funds used for the default option and identified a worrying lack of consistency, particularly in the approach to asset allocation, which, as an earlier study by the Pensions Institute demonstrated, largely determines the outcome.

Second, there is a shocking absence of formal annuity services for members of these schemes, most of whom accept the pension provider's annuity, which could offer a retirement income 30% lower than the best available rates. Once the annuity is purchased it is impossible for individuals to seek a better deal, even if they would qualify for an enhanced rate due to a life-shortening health condition.

"As a result of these factors many of the employees that do join the company scheme face a triple whammy: high charges, an inconsistent approach to asset allocation, and unnecessarily poor annuity rates," Harrison says.

Christine Farnish, chief executive of the National Association of Pension Funds (NAPF), welcomed the report: "This much-needed report lifts the lid on the real reasons why the UK faces a serious savings crisis. It gives an illuminating insight into the challenges we face here."

The style and methodology of the report is highly unusual. An important feature 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 corporate line," Harrison explains.

"As such the findings and recommendations of this report are at times uncomfortable and controversial but we hope they will shed light on what hitherto have 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. We hope policymakers will consider our findings in conjunction with the interim report from the Pension Commission, which will be published on 12 October."

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The Pensions Institute, 'Delivering DC? Barriers to participation in the company-sponsored pensions market', by Debbie Harrison, Alistair Byrne, and David Blake, is

published on 1 October 2004, price £150 (first copy free to corporate members). For order forms go to <http://www.pensions-institute.org>, or email pensions@city.ac.uk

About the Pensions Institute

The Pensions Institute at Cass Business School was founded by Professor David Blake in 1996. As the first and only UK academic research centre focused entirely on pensions, the Institute brings together a broad range of disciplines including economics, finance, insurance, and actuarial science through to accounting, corporate governance, law and regulation.

The objectives of the Pensions Institute 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.

The 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 (e.g., corporate, public and international sectors).
- ***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 Maastricht Treaty anti-age discrimination legislation 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.

About the Authors

David Blake

Dr David Blake is Director of the Pensions Institute and Professor of Pension

Economics at Cass Business School, City of London. He is author of *Financial Market Analysis* published by Wiley in 2000, *Modelling Pension Fund Investment Behaviour* and *Issues in Pension Funding* both published by Routledge in 1992, and *Pension Schemes and Pension Funds in the United Kingdom* published by Oxford University Press in 2003. Dr Blake established the Pensions Institute in June 1996.

Debbie Harrison

Debbie Harrison is a Senior Visiting Fellow of the Pensions Institute, a financial journalist, author, and consultant. She is a regular contributor to the *Financial Times* and the author of the first undergraduate textbook on financial planning, *Personal Financial Planning: Theory and Practice* (2004, Pearson Education). Her institutional reports focus on UK and European pensions, asset management, and the design of social welfare systems. These include *Investment Strategies for Pension Funds in Europe* (2000, Informa Publishing), and *Competitive Multi-Manager Strategies* (1999, FT Business).

Alistair Byrne

Alistair Byrne is a lecturer in finance at the University of Strathclyde in Glasgow and a Fellow of the Pensions Institute. His research and consulting interests lie mainly in the application of behavioural economics to pension scheme design. Prior to joining academia in 2003 he spent ten years at AEGON Asset Management UK, latterly as Head of Equity Research. He has published research in a number of academic and practitioner journals including the *Financial Analysts Journal*, the *Journal of Asset Management* and the *Professional Investor*.