

PREMIER PENSIONS MANAGEMENT LTD

LEGISLATION UPDATE : 6/04

Issues relating to Defined Contribution Schemes

With the growth of Defined Contribution Scheme in the UK as a method of providing pension benefits to employees, there are some particular challenges which can often be overlooked but can lead to difficulties in terms of members' benefits. This note outlines some of these.

1. Default Investment Strategy (Lifestyle option)

The vast majority of UK occupational defined contribution Schemes offer the ability for members to have a default option. A default option will typically consist of a "Lifestyle" strategy which enables members to make use of a background switching programme which effectively reduces their investments in equity markets and builds up investments in gilts/bonds and cash in a phased period up until retirement. Whilst periods vary, with ten years and five years being the most popular prior to normal retirement date, the switching matrix moves assets on a member by member basis having regard to the matrix working off the number of years until retirement. A similar principle applies to future contributions.

Booklets often give an overview of the intricacies of such a switching programme but there can be differences in terms of the administration systems and the administration policies involved in implementing this. For example, some administrators operate a lifestyle programme on an annual basis, therefore, depending on the birthday of the member, the switching programme could actually start up to one year earlier than the booklet/explanatory information would describe. Also, a member in this situation could be invested in the asset classes needed at retirement one year earlier than the actual retirement date itself.

Comment

Whilst booklets and communication to members typically describe the overall process, it is important that the details of the administration switching procedures are clarified with the Scheme Trustees. Where the actual switching process varies significantly from that detailed in booklets, it is sensible to communicate this to members in order to avoid subsequent challenges and potentially disappointed members. Moreover, any variation can be to the detriment of members (depending upon the relative movement of markets/asset classes) which can put the Trustees in a difficult position and has seen claims for investment loss as well as use of the IDR procedure.

Action: Trustees should review:

- i) Administration Procedures
- ii) Trust Deed & Rules
- iii) Booklets

to make sure the procedure is clear and then communicate it to members.

2. Unallocated Accounts

Typically, when a member leaves an occupational scheme within 2 years, they receive a return of their own contributions less a charge for tax etc. The employer portion would become detached from the leaving member and placed into an unallocated account. Whilst technically the contributions belong to the Trustees it could also be argued that the contributions could be returnable to the employer (notwithstanding that the contributions themselves could not be returned as they would be held in Trust). Often, decisions as to how such monies are utilised have developed over time but who legally has the power to decide how these monies could be used are often overlooked. Further, the governing Trust Deed and Rules are also non-specific.

Comment

It is important that proper procedures and clarification as to who has the power to decide how these monies are utilised is put in place. This is especially the case where the Company itself has high turnover leading to significant sums invested in such accounts. In addition, have the Trustees/Employers specified where these contributions should have been invested? Often such issues are overlooked with a result that the monies are held in inappropriate investments. These monies will typically remain in the options selected by the relevant member.

Action: Request the Trustees to ask the administrators the current value of the unallocated accounts. Depending on the scale, agree what to do with the assets.

Agree a procedure to reallocate the assets in the future.

3. Administration reconciliation

How consistent is investment information contained on member records held by your scheme administrator compared with the actual investment manager?

We are aware of a recent situation for a client where some changes had been decided in relation to one of the investment options offered (due to continuing poor performance). The new options were offered to members with the intention of effecting an efficient transfer from the old options to the new options. Whilst full communication took place between the Trustees and administrators (who were involved in setting the timescales for processing etc), problems were subsequently encountered in dealing with the investment rearrangements. These delays were caused by differences between the actual assets held with the investment manager and the total member assets shown on the Administrators records. These differences were not actually disclosed to the Trustees by the Administrators until the eleventh hour, which nearly jeopardised the switching timetable confirmed to members.

Comment

Administration reports concentrate on turnaround times and other key performance indicators but how much information is disclosed in terms of investment allocations? We anticipate this will be an area of greater scrutiny in the future.

Action: Trustees to ask for confirmation from the record keepers that the allocations they hold, match the assets held by the Investment Manager(s). Also, where an unallocated account is held, the amount held and where these monies are invested should be provided to the Trustees

4. Investment Switches

The typical UK member would not look to actively switch investments using the options available within their own specific scheme. How often is it that the impact of switching is confirmed to members in terms of how often switches can be made and the underlying charges which should be applied? In our experience such issues are often not specified which can result in difficulties when members learn after the event of charges which have been levied.

Similar issues apply to charges for ongoing investment fees and admin charges – although often these are paid by the employer.

Comment

Such detail should be contained in communication materials issued to members to avoid difficulties and misunderstandings taking place.

Action: Update the investment literature

5. Procedures at Retirement

With the number of Defined Contribution schemes increasing and the employees covered in these maturing, the number of employees who are retiring from such arrangements are increasing in the UK. Unlike Final Salary arrangements where there is absolute clarity in terms of benefits which could be provided, the procedures involved in securing a pension and paying tax-free cash in relation to a specific member is often not as clear as it could be. From a member's perspective, they need to know answers to the following type of questions:

- What pension will I receive when I retire?
- What flexibility do I have in terms of the level of pension increases, spouses' pension and other ancillary options and will this affect my own pension? (Note Pensions Act changes)
- How long would a pension be guaranteed for?
- Is my pension provided from the Scheme or is it secured with an insurance company in the open market?
- If it is secured in the open market who pays for the cost of reviewing that market and advising of the best pension that could be obtained?
- Is the pension purchased in my own name or in the name of the Trustees?
- How long will it be before I receive my first pension instalment and when will my tax-free cash be paid?
- Can this process be simplified or shortened?

Comment

If Trustees review the market, have the Financial Services Authority procedures been fulfilled.

The processes involved in securing benefits for members at retirement are often skated over in terms of the communication given to members. Even with absolute efficiency, it can take six to eight weeks after retirement for the first pension instalment to be made and the member needs to appreciate that this is unavoidable due to the design of the defined contribution scheme.

In addition, if charges are deducted from a member's account, this needs to be verified beforehand to avoid the member feeling negative about the Company at retirement.

Action: Trustees need to agree a policy on retirement and communicate it to members.

Review the Trust Deed & Rules and administrative procedures.

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*This update includes general information and cannot be relied upon for individual schemes issues.
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