

UNISON Defined Contribution Benchmark – what represents a “reasonable” defined contribution scheme?



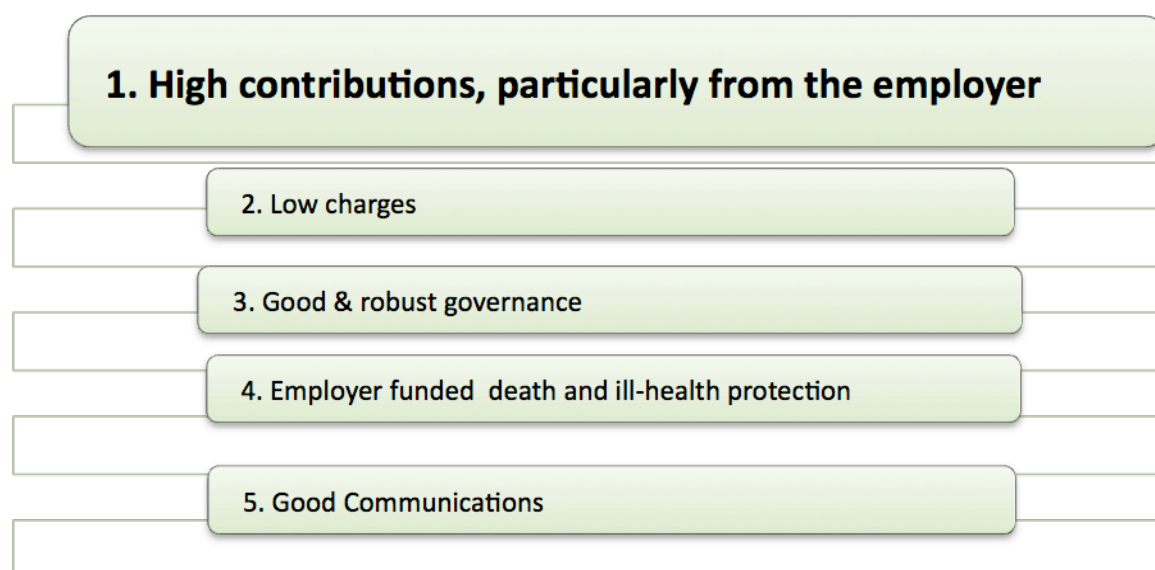
What is a Defined Contribution (DC) pension scheme?

- This is a scheme where you build up a pot of money which is then converted into a pension on retirement. The size of your pot depends upon the amount contributed, the performance of your fund and the charges to be taken from it. Your ultimate pension entitlement will also depend on the rates available on retirement for converting your fund into an annual pension (known as the annuity rate).

What is UNISON's policy on DC pension schemes?

- UNISON does not generally support such schemes as there's plenty of evidence to show that these schemes typically pay out much less on retirement than good quality defined benefit pension schemes, such as those currently offered to Local Government and NHS employees. UNISON very much continues to favour and campaign for good quality defined benefit pension provision but we recognise that many employees will have little option other than to join a defined contribution pension scheme or otherwise miss out on an employer sponsored scheme altogether. Furthermore, it's likely this trend will grow further and hence it's vital our members understand what pension provision is made available to them and its relative adequacy. The same goes for representatives of members in pension scheme negotiations.
- UNISON has produced a briefing paper on what we perceive to be the relative inadequacies of defined contribution pension provision which is available on our website, www.unison.co.uk/pensions.

UNISON's 5 point plan for a "reasonable" DC scheme



1. HIGH CONTRIBUTIONS, PARTICULARLY FROM THE EMPLOYER

1.1 It's without a shadow of a doubt that the total contribution levels to defined contribution pension schemes are inadequate.

The following table shows the average contribution rates for private sector occupational pension schemes for both defined contribution and defined benefit schemes as provided by the Association of Consulting Actuaries 2009 "Pension Trend Survey":

| | Employer | Employee |
|----------------------|----------|----------|
| Defined Contribution | 6.7% | 4.3% |
| Defined Benefit | 23.2% | 6.3% |

In general the age profile of defined contribution pension schemes is younger and so contribution levels may increase in the future as members become older and become more engaged in providing for their retirement.

1.2 How much is an adequate contribution?

Although contribution levels do not solely determine levels of retirement income, since there are other driving factors such as investment returns and mortality trends, these figures indicate that there is a clear gap in the amount of money allocated to defined contribution pension schemes both from employees and employers compared with defined benefit schemes.

Most defined benefit pension schemes are contracted-out of the State Second Pension (S2P) whereas most defined contribution schemes are contracted-in. If an employee is contracted-in then they will receive S2P on top of their occupational pension – but note that S2P is only paid from State Pension Age, which will eventually rise to 68 for anyone whom is born after the 5 April 1978. But even after ignoring this difference, the contributions to most defined contribution schemes are inadequate.

To see the extent of this the table below shows estimates of the contribution levels which would need to be paid (by the employee and employer combined) for each year of service (as a % of salary) to target typical final salary benefits in a defined contribution scheme. The table below shows total level contribution rates for employees between the ages of 25 and 55 on entry with benefits of 1/60th accrual over their working lifetimes and retiring at age 65 (i.e. as is currently the case in the Local Government Pension Scheme and 2008 Section of the NHS Pension Scheme).

| Starting Age | Contribution (% of salary) |
|--------------|----------------------------|
| 25 | 20.6 |
| 30 | 22.7 |
| 35 | 24.9 |
| 40 | 27.2 |
| 45 | 29.7 |
| 50 | 32.3 |
| 55 | 35.0 |

1.3 Current contribution rates are nowhere near sufficient

Although pension needs vary substantially between individuals **the above contribution rates suggest that current levels of employer and employee contributions are not sufficient to provide adequate pensions such as a half or two-thirds of an employee’s final salary and as such defined contribution scheme members may find that they will have to work for longer to be able to retire with an acceptable standard of living.** Contributions paid to defined contribution pension schemes will need to increase significantly if they are to provide reasonable retirement incomes and be seen as a valuable alternative to defined benefit schemes amongst the workforce. This sizeable difference in employer contribution rates paid towards defined contribution and defined benefit pension schemes again raises equality issues amongst the workforce.

1.4 The contribution level standard of the NAPF Pensions Quality Mark needs to increase

Defined contribution pension schemes that satisfy three basic criteria set down by the National Association of Pension Funds (NAPF) can apply for a Pensions Quality Mark (PQM) that in the NAPF’s view would constitute the sponsoring employer as providing a “good quality DC pension scheme”.

One of these standards concerns contribution levels. To qualify for a PQM there must be minimum contribution levels of at least 10%, with a minimum employer contribution of 6%. For the PQM Plus, overall contribution rates must be at least 15% with an employer minimum contribution rate of 10% or more.

It's very unlikely that these levels of employee and employer contribution levels will generate pensions on retirement of at least half of pre-retirement salary and hence we would call for the NAPF to upwardly revise these limits and send out a stronger message to employers and the industry that more needs to be invested in defined contribution schemes to provide employees on retirement with a reasonable standard of living. This is the time to be realistic and not accepting of a race to the bottom!



Decent contributions are in UNISON's view the key to the success of defined contribution schemes. However, there are other important issues that need addressing, which are as follows:

2. LOW CHARGES

2.1 Pension fund charges at face value seem relatively small and insignificant but this is not the case. In December 2008 one of the most senior figures in the fund management industry, David Pitt-Watson admitted in a submission to the Royal Society for the Encouragement of the Arts, Manufactures and Commerce (RSA) that up to 40 per cent of private-sector pension pots are swallowed up in fees.

2.2 The RSA called for a sharp reduction in annual fees from the 1.5% it said was typically payable in Britain to the 0.5% charged in Sweden and the Netherlands.

2.3 Mr Pitt-Watson is quoted in the report saying: "A pension lasts 50 years. So an average pound invested in the pension is there for 25 years; 1.5% is paid in fees on the balance of the fund every year; 25 times 1.5% is 37.5%, or approximately 40%." He told The Times: "Just do the maths and it comes to about 40%".

2.4 Currently, there's no charge restriction on personal pensions but stakeholder pension providers can levy an Annual Management Charge of no more than 1.5% of the fund value for the first 10 years of the policy and 1% thereafter.

2.5 The Government wishes to introduce a "low cost" defined contribution occupational pension scheme from 2012, called National Employment Savings Trust (NEST), aimed

at the millions of workers without access to a workplace pension scheme meeting certain minimum standards.

2.6 The Annual Management Charge for NEST will be 0.3% per annum but contributions will also be subject to a 2% charge on the value of the contribution to help repay the costs of establishing NEST.

2.7 On the basis of the above evidence UNISON believes that an average total charge, including all administrative and fund management charges, should not exceed 1% of the value of the fund per annum if the scheme is to be considered relatively low charging.

3. DEATH & ILL-HEALTH PROTECTION

3.1 In typical defined contribution arrangements these protections usually take the form of separate insurance contracts between the employer and insurance company.

3.2 We would certainly expect a reasonable defined contribution scheme to provide survivors protection (and particularly a death-in-service lump sum payment) as well as protection in the event of ill-health, perhaps through a suitable Permanent Health Insurance policy or Income Protection Policy.

3.3 For members in defined benefit schemes that are being closed and replaced with defined contribution provision, we would expect the level of protection to be broadly equivalent to that applicable in the defined benefit scheme.

3.4 The cost of insuring these benefits should be met by the employer in addition to the contributions outlined in the earlier table.

4. GOOD & ROBUST GOVERNANCE

4.1 As defined contribution schemes in effect place all the risk on individual scheme members, UNISON would expect to see this risk mitigated to an extent by good and robust governance arrangements. In particular the establishment of a Governance Group tasked with monitoring fund performance, overall fund structures, take-up rates, effectiveness of communication and reviewing the efficiency of the administrative service.

4.2 UNISON would expect a reasonable defined contribution scheme to at least satisfy the governance standard of the NAPF Quality Mark, see <http://www.pensionqualitymark.org.uk/thestandards.php> for further details.

5. GOOD COMMUNICATIONS

5.1 A good defined contribution scheme and sponsoring employer should ensure that members receive clear, easy to understand information about the choice of funds

available with the employer preferably arranging and financing the cost of independent advice with a financial adviser for members.

5.2 UNISON also calls on employers to look to use The Pensions Advisory Service's free Workplace & Communities Service which works through qualified advisers entering workforces to present to staff on how best they can plan for their retirement.

5.3 We would also like to see on an ongoing basis regular information being provided to members about general fund performance and issues raised by the Governance Group, rather than simply an annual update triggered by the provision of an annual benefit statement.

5.4 We'd like to see all pre-retirement literature refer to the Open Market Option (i.e. the ability to shop around to try to find a better annuity rate), the Financial Services Authority's Comparative Tables on annuities, and The Pensions Advisory Service's Online Annuity Planner.

The Purpose of our Benchmark

The above Benchmarks are prerequisites of what we would expect to see from a defined contribution pension scheme for it to be considered anywhere near comparable to the typical final salary pension benefits offered to many of our members in the public and in many cases, the private sector. This is an approximate guide of what we should be campaigning for in relation to any defined contribution schemes that do not currently meet the standards outlined above.

You should also note that if you are in a defined contribution scheme that does not satisfy the above standards, this does not mean you should leave it!! Any employer sponsored pension arrangement is good in the sense that you are obtaining an employer contribution that you would not otherwise get plus you qualify for income tax relief on your pension contributions and in many cases have life cover protection.

Activists and member representatives should use this Benchmark paper in negotiations where the employer wishes to implement a defined contribution pension scheme or indeed as a source for looking to improve the terms of current pension provision.

Are you confident that your defined contribution pension scheme will provide you with adequate pension benefits in retirement? If not, take action and campaign for improvements. Dignity and financial security in retirement should be a basic expectation, not a myth.

What can you do?

- Benchmark any defined contribution pension scheme you are currently offered or are offered in the future against this paper
- If it falls short, campaign for improvements

- Make your activists/representatives aware if your pension scheme looks to be inadequate for the purposes of protecting you and your dependants in retirement
- Spread the word that defined contribution pension schemes are only as good as the amount of money invested in them
- Don't forget that pensions are in effect deferred pay and are not an ancillary benefit of your terms and conditions of employment. They are a substantial part of your overall employment package

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