How new regulation is boosting trust in workplace pensions

As workplace pensions increasingly move from defined benefits to defined contributions, workers must know they can trust their scheme

Finance > Pensions

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Workplace pensions is a market in flux. For more than two decades, employers have been replacing final salary or defined benefit (DB) pensions with defined contributions (DC) arrangements.

The reason is simple. Employers are no longer prepared to shoulder the risk of DB scheme liabilities and have passed the investment risk on to the often-unsuspecting employee member.

In 2012, the government launched the auto enrolment (AE) project to drive up the numbers of employees saving into pensions, reducing pensioner poverty and the burden they might place on the state. On face value, it's been a resounding success. Since October 2012, more than 10.5 million individuals have been enrolled in workplace pensions who previously were ineligible or had simply opted out. However, the amounts saved into workplace pensions are small – and falling over time, according to data from The Pensions Regulator (TPR).

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So after almost a decade, the government is increasing the pressure on employers to not simply offer pensions, but to improve those offerings to employees. New requirements in the Pension Schemes Act 2021 for DC schemes include beefing up enforcement, increasing disclosure and reporting requirements and directing schemes to prepare for the pensions dashboard project, which is currently in progress but has suffered numerous delays.

Better protected

Helen Ball, a partner at specialist pensions law firm Sackers, says AE was the catalyst for improving protection of the average DC scheme member. Previously, there was little law specifically governing DC; once AE was implemented, a code of practice was produced, quickly followed by regulations.

"It definitely has improved and tightened up decision-making," says Ball. "A simple example is that many DC schemes would not have reviewed their investment strategy often, or even at all. There is now a legal requirement to review the default investment strategy every three years."

TPR's insistence on greater board diversity for DC trustee boards and the lengths it went to authorise master trusts in 2017 have also driven up standards, says Ball. However, she asks whether that really targets the schemes that concern the regulator the most: non-compliant schemes that are often smaller in size. TPR has also acknowledged that small schemes are not necessarily bad schemes.

While the average member is now better protected, that doesn't improve their understanding of the quality of their scheme. It also doesn't prepare them for the retirement they might expect.

An uncertain future

According to consultancy group Aon's *DC Pension and Financial Wellbeing Employee Research 2021*, employees are concerned about saving for the future. A quarter believe they will never be able to retire and at least half think they will have to work past the age of 68. Almost nine in every 10 (87%) expect a shortfall in their retirement income.

Some say they're prepared to save more in the future or economise in retirement, but 11% accept that they do not know how they will address this.

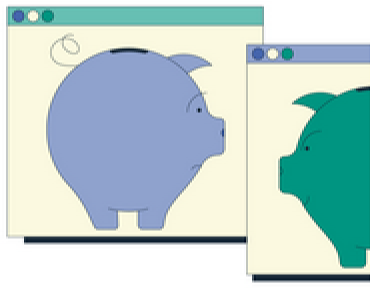
Despite these fears, almost three quarters (71%) have no idea how much they need to save before they can retire, with the number higher among women (76%).

Perhaps of greatest concern should be that 63% of those with the least time to save – respondents above the age of 55 – have not set a goal for retirement.

Almost two thirds of employees (63%) feel they aren't saving enough to meet their long-term needs, while a third say they can probably afford to save more. Fewer than a third say they can't afford to save more for the future and a quarter (25%) say that other financial goals are more important now. However, more than a third (34%) say there's nothing stopping them from saving more now.

"People haven't got the tools to understand that because they haven't had any financial education," adds Ball. "That's really why schemes are being compelled to demonstrate value for members."

Putting the member first



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The Aon data shows that one in seven employers are looking to save money in the way they run their DC plans. There has certainly been a move away from running small schemes. TPR data shows that while the vast majority of schemes are micro schemes with fewer than 12 members, the number of small schemes has been falling year on year.

While there may have been good reasons for running a standalone DC scheme in the past, the need to demonstrate value for money to members is forcing schemes to look for an alternative. Even some large schemes of more than £1bn in assets have realised that someone else may be able to do a better job of managing the pension than they will in the future.

The regulator is keen to have a simpler market to oversee with fewer moving parts, though this does not mandate consolidation with a third-party specialist such as an insurer or master trust. Employers who choose the path of consolidation have a responsibility to consider the best value, says Alistair McQueen, head of retirement and saving at the insurer, Aviva.

"We must always remember that when we – employers, trustees, or regulators – talk of consolidation, we are in fact talking about other people's money," says McQueen.

"The value an individual has in their current pension arrangement can only be judged by that individual themselves."

The Aon research shows that few have an informed opinion of their scheme, but McQueen is confident that most employers are conscious of their duty of care to their employees' financial futures.

"Any good employer will act in the best interest of their employees. The fastest growing section of this market is master trust, but the employer and trustees must decide whether that is the right thing to do."

Bigger, better, stronger

For employers selecting a business to run their workplace scheme, it's vital to consider whether the chosen company is committed to the long term. "There will be further consolidation within the master trust market," says Andrew Cheseldine, a professional trustee and chair of the trustee board at master trust Smart Pension.

While there are almost 40 to choose from, at least 10 of these are hybrids with specific functions or markets, while others have yet to achieve critical mass.

"A number of master trusts are looking to grow or leave the market because they're not cost effective at their current size," he says.

Since their authorisation, master trusts are financially stronger. Like insurance companies – which have their own master trusts – they are required to keep reserves.

"While there may be some disadvantages, such as not having the same tailored service when moving to a master trust, by and large, members will be in a stronger scheme and may gain some comfort from it having a brand they are familiar with," says Robin Dargie, senior consultant at Quantum Advisory.

This doesn't mean schemes will become any cheaper to run, says Cheseldine. While there is a charge cap set at 75 basis points (0.75%), an average master trust will already be offering 50 (0.5%). However, it may drive down fees for standalone DC schemes.

"Employers will see a benefit because quite often they're subsidising DC. The members will see an improvement in security, because they'll be part of a much bigger, better-regulated scheme," he adds.

Small pots

AE has caused another problem that won't be resolved by consolidation of smaller DC schemes.

Many individuals have small pots from being enrolled for short term or previous jobs.

These pots are often unclaimed by employees, because they have lost track or were unaware they ever existed. The value of these pots is undermined by ongoing charges and consumers would be better off if they were put to work in a single pension vehicle.

There are currently 3 million such pots worth less than £100 and 9 million under £2,000, says Cheseldine, who is on a working party looking for a way to consolidate them.

"At the current rate, there will be 20 million small pots in existence by 2025," says Cheseldine. "While this is quite a separate issue from driving up standards through consolidation, it doesn't mean that we shouldn't think about it, as both matters could have a considerable impact on incomes in retirement."

A brave new DC world

The pension business isn't known as a hotbed of innovation. Revolution, when it comes, tends to happen at a glacial pace. Collective defined contribution (CDC) is no different.

The Pension Scheme Act 2021 finally provides legislation to allow the formation of CDC schemes. Like DB schemes, employers pay a fixed rate of contributions into the scheme and members are paid pensions. However, the difference is that increases on those pensions will vary according to affordability. This way, an employer can share the risk of providing such a benefit with the members.

The attraction for employers is fixed costs, so their pension budgets won't vary.

Members may expect a pension payment on average 70% higher than they might achieve from buying an annuity with a DC pot, and 40% higher than provided under a typical DB scheme, according to research by consultants WillisTowersWatson.

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Volatility – the curse of DC investments, particularly for those close to retirement – is smoothed out so that pension levels are relatively stable. CDC may also mean there's less chance of members outliving their assets, as is the danger with an income drawdown solution.

Trade unions are rather more positive about the potential for CDC than traditional DC. In fact, the Royal Mail and Communications Workers Union have been lobbying hard for a change in legislation so a CDC scheme for up to 140,000 members might be created.

Aviva's McQueen can see why Royal Mail finds CDC an attractive alternative. As a large employer, it has a highly unionised workforce, while it currently has a DB pension arrangement. Such factors make CDCs attractive to such a unique, established employer.

"We will watch with interest to see how it takes advantage of it," McQueen adds.

CDC has its critics, too. Former pensions minister Baroness Ros Altmann of Tottenham is "very nervous" about the introduction of CDC. One of her concerns is the potential impact of the ability to transfer out of the scheme on the scheme itself.

"There is no provision for risk margin here," says Altmann. "If you transfer out, the expectation seems to be that you get the full current value. While you are perfectly entitled under the current legal system to do this, I think there should be a haircut to the transfer value."

Altmann sees the potential unfairness, which could lead to different generations selecting against each other and maximising their cut. This could undermine the point of a collective vehicle.

"The risk to the individuals in the CDC scheme could be that it delivers no pension at all," she adds.

Capital Cranfield's Cheseldine also struggles with balancing fairness for all members with the ability to transfer out of the scheme. But despite his reservations, he thinks CDC could be a useful tool in post-retirement benefits.

"It's a good start and using an organisation like Royal Mail will help to test the model, because it is such a big organisation," says Cheseldine.

"However, the problem will come when people start trying to sell it to much smaller organisations with less stable workforces."

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