Are smaller DC pensions facing a cost of governance crisis?

Dale Critchley explores the challenges for trustees managing the money of savers in DC schemes

The financial futures of over 23 million private sector workers rely on the trustees of defined contribution (DC) pension schemes according to figures from The Pension Regulator[1]. They look after over £113.5 billion set aside for later life and invest the contributions of over 10.6 million people each month.

While most members are looked after by the trustee boards of larger schemes there are over 27,700 DC pension schemes according to The Pension Regulator data. Only 1,370 boards of trustees look after more than 12 members, and the boards of 36 schemes (master trusts) look after £78.8 billion of savings for over 20.6 million members.

There's a huge responsibility on trustees, not just within the boards of large master trusts, but within all occupational pension schemes, to manage their scheme in a way which gives their members the best chance of achieving their goals.

The biggest cost within large pension schemes is administration, but in smaller schemes the cost of good governance can easily outstrip that, and the cost of governance can only be expected to rise. Current levels of inflation are likely to be reflected in the cost of professional services, and in the cost of trustee time next year. Alongside this, the scope of the work that needs to be done by trustees continues to increase, as the expectations of government and members grow.

Expectations of government

The increased regulatory workload of trustees is reflected in the growth in the size of the Chair's Statement. What began life as window into the workings of the trustee board has become an increasingly difficult read.

Disclosure of costs and charges has been followed by disclosure of net fund performance. Policies and progress in managing environmental, social and governance risks are supplemented by a separate report aligned to the tax force for climate related change disclosures (for large scheme's currently, but all schemes are included on Treasury's roadmap).

Soon we will see additional disclosure of the asset mix within default arrangements, with a requirement to explain the trustees' rationale in the statement of investment principles. The aim is to nudge trustees to consider wider asset classes including infrastructure, private equity and private debt, a potential win/win of higher returns for members and more investment in UK economic growth.

Within the next two years we expect to see further change impacting on governance costs. A review of the Chair's Statement itself, to perhaps carve out compliance related reporting. The results of the discussion paper on helping members make decumulation decisions may result in a need to offer more structured support on investments and member communications. We will

see the final version of The Pension Regulator's Code of Practice, which may well require more documentation of governance processes and audits of effectiveness. Finally, we will see the requirements for a revised value for members assessment.

All of these will need to be funded. There will be one off and ongoing legal costs to ensure compliance, as well as professional advice to potentially build revised investment solutions and ensure the trustees are delivering effective communications, as well as operating an effective system of governance.

Expectations of members

There was a time when members simply expected their DC pension to deliver a pot of money when they stopped work, which they could convert into an income outside of the scheme, but expectations are changing, and the current cost-of-living challenges, alongside pension freedoms has perhaps accelerated the change.

Pension savings represent the largest component of wealth for a large proportion of the UK population[2]. As expenditure takes up a greater proportion of net income each month the UK savings index is expected to fall to zero next year[3] and some pension scheme members will be looking to rely on savings or debt to make ends meet. For a proportion of those over 55, their pension fund represents a savings buffer they might need to rely on before they retire.

HMRC statistics[4] show a 23 per cent increase in the number of taxable withdrawals in the second quarter of 2022 compared to the same period in 2021. The number of individuals making withdrawals increased by nearly 100,000 to 508,000. What this doesn't show is the number of members accessing tax free cash only, a number which is likely to rise as cost-of-living headwinds strengthen.

Many occupational pension schemes are ill equipped to meet member expectations around retirement flexibility. Clunky paper-based administration, and rules that don't allow non statutory payments or transfers are more suited to cliff edge retirement than the phased approach to retirement favoured by many. Schemes can be modernised, but this will come at additional cost.

Most single employer trust-based schemes don't allow members to designate to drawdown within the scheme. This can result in a need to transfer to access tax free cash or provide an unintended nudge to cash in the whole pot, potentially reducing a member's annual allowance and their ability to rebuild their savings. Those who are still saving in the scheme might be forced to carry out a convoluted in-out hokey cokey to arrange a transfer while maintaining their contributions, in schemes with rules designed to stop them doing just that.

Trustees should also recognise that they may well have financially vulnerable members, looking to make decisions that they didn't plan for. The need for advice has never been greater.

Changing the scheme rules, administration, and governance to allow drawdown would be a huge step forward for members, enabling them to benefit from the economy and oversight of their workplace scheme, but it's beyond the means of many trustee boards. Due diligence on a trusted adviser or partner drawdown provider should be a more achievable aim, however.

How can trustees avoid a cost of governance crisis?

When we're looking at spiralling household budgets our first inclination is to cut back, to do less, to save money, but that shouldn't be an option for trustees. If, as individuals, we choose to cut back on our heating it's we who feel the chill. If trustees choose to cut back on their governance, and on keeping their scheme up to date, it's their members who are left out in the cold.

The DWP made it clear that schemes that don't offer good value compared to alternatives should wind up and seek a transfer to a scheme that offers better value. Members shouldn't suffer poorer outcomes due to a lack of funding for the scheme's upkeep.

The value for members assessment was meant to address the issue of small schemes who lack the financial backing to deliver good outcomes but there's little evidence that small schemes have taken decisive action, and there may be larger schemes that are equally unable to cope with upcoming cost of governance challenges.

Automatic enrolment has amplified the role that DC trustee boards play in delivering the later-life income of UK workers and they need to be supported to deliver the very best outcomes. It's the trustees who carry much of the liability for poor outcomes, and who deserve to be supported. If that's not happening, they should think about their own position, as well as that of their members, and look at the options to consolidate into schemes that have the resources deliver the modern DC pensions that people need.

Written by Aviva policy manager for workplace benefits, Dale Critchley

[1] https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-scheme-return-data-2021-2022

[2] ONS : Income, spending and wealth: how do you compare compare?https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/articles/incomespendingandwealthhowdoyoucompare/latest

[3] Office for Budget responsibility, Economic and fiscal outlook, November 2022 https://obr.uk/docs/dlm_uploads/CCS0822661240-002_SECURE_OBR_EFO_November_2022_WEB_ACCESSIBLE.pdf (page 19)

[4] National statistics: Private pension statistics commentary: September 2022https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary-september-2022