We are seeing the emergence of a new pensions divide

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Automatic enrolment into workplace pensions has led to increased attention on the vehicles into which employees will be expected to save for retirement. While the demise of 'defined benefit' pensions at the expense of 'defined contribution' seems irreversible, ***Craig Berry*** *of the TUC argues that we need to recognise that a new divide is unexpectedly opening up and that the growing concentration of employees in low-contribution schemes is a particularly worrying trend.*

The process of automatic enrolment got underway at the end of last year. By 2017, millions of employees will have been enrolled into a workplace pension for the first time by their employer. By and large they will end up in 'defined contribution' (DC) schemes, whereby the individual savers are fully responsible for the risk of investment losses. Essentially they will get lower retirement outcomes if their pension pot doesn't perform well in the capital markets.

This contrasts with 'defined benefit' (DB) schemes, which are of course increasingly rare, whereby the final outcomes are determined in advance (usually related to an employee's salary), and employers are liable if the pension fund does not perform well enough to pay out the accrued benefits as expected.

The idea of a pensions divide originally related to the difference between these two approaches. DB pensions are much more secure, but not necessarily less generous – if contributions are high and investment performance good, DC pensions can deliver. In recent years, these conditions have too often not been met. As more and more people are enrolled into DC pensions, however, it is right to distinguish between different types of DC provision. To coin a phrase, there is more than one way individualise a pension risk. In certain regards, the divide within DC provision is greater than the divide between DB and DC.

On the one hand, trust-based DC schemes ape DB provision, in that they are governed by a board of trustees, whose sole duty is to protect scheme members' interests. On the other hand, contract-based DC schemes – which in the world of workplace pensions are usually, and oxymoronically, termed 'group personal pensions' – have no formal governance arrangements at scheme level. Members have a contract that the provider must respect, but given the complexity and long-term nature of pensions saving, and the fact that it is their employer that actually negotiates the contract, the effect of this in practice is limited. Although trust-based governance is not a panacea for workplace pensions, the absence of trustees means that, when it comes to decisions on issues such as investment and charges, the members' perspective is not adequately voiced.

Individual savers will of course have little appreciation of this vital difference. The issue is further complicated by the fact that the two products are overseen by different regulators – the former by the Pensions Regulator (TPR; which governs trustee conduct) and the latter by the Financial Services Authority (FSA; which governs contract-based product providers such as insurance companies). TPR is currently consulting on how it regulates DC trustees; this is likely to see the regulatory framework for trust-based schemes significantly enhanced, yet as a result reinforce the governance gap between the two approaches.

Data published last week by the Office for National Statistics underlined another aspect of the divide. No matter how they are governed or regulated, the most important determinant of outcomes from DC pension will be the contributions put into schemes: the governance gap is compounded by the problem of low contributions into contract-based DC schemes. *Employee* contributions into trust-based and contract-based schemes are roughly equivalent. 53 per cent of trust-based scheme members pay less than 4 per cent of their salary into their pension pot, compared to 62 per cent of contract-based scheme members. The figures for contributions below 2 per cent are 25 and 30 per cent, respectively.

It is *employer* contributions where the damage is being done. And on this issue, the divide between the two approaches is actually worsening – an extremely alarming trend on the eve of the introduction of auto-enrolment. For trust-based schemes, in 2011, 47 per cent of members had employer contributions of 8 per cent or under. This fell to 42 per cent in 2012. For contract-based schemes, 69 per cent now have employer contributions of 8 per cent or under, a fall of only two percentage points from 2011. And within this, there is now a higher concentration of workers in schemes with very low contributions. In 2011, 27 per cent of contract-based scheme members had employer contributions below 4 per cent – this proportion had actually *increased* by 2012 to 29 per cent.

Of course, contribution rates are not determined by the type of DC scheme selected by employer for their staff. Neither contract-based providers nor their regulators are therefore at fault in any direct sense. Instead, what this trend seems to indicates is a 'race to the bottom' whereby employers discharge their duty to provide a workplace pension scheme with as little cost as possible, in terms of both contribution levels and scheme management. There is already evidence that contract-based provision is increasingly more popular than trust-based provision.

The new data refers to contribution rates in place before auto-enrolment got underway. But if such trends are evident among those employers voluntarily providing a workplace pension, then it is unlikely the new compulsory regime will lead to significant improvements in the short term. Indeed, under auto-enrolment employers will only be required to contribute 3 per cent of an employee's salary (and even this is calculated on a restricted band of earnings). Certainly, we should expect the governance gap to deepen, as employers choose contract-based solutions to minimise their responsibility for scheme management.

Given this, it will almost certainly be necessary for statutory minimum contributions to rise – perhaps earlier than 2017, when the government has said it will review auto-enrolment. There is also a need for a concerted effort to improve DC governance, with the government cutting through regulatory discrepancies to set higher standards for the management and oversight of contract-based schemes, as well as supporting TPR's efforts regarding trust-based schemes. Governance issues were frustratingly absent from DWP's recent 'reinvigorating workplace pensions' strategy document.

We have long known about the vast inequality in pension arrangements, within a single employer, between company directors and ordinary employees – another issue which cuts across the DB/DC divide. The growing concentration of employees in low-contribution, contract-based DC schemes appears to represent a disturbing evolution of this divide.

Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our comments policy before posting.

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