PENSIONS POLICY INSTITUTE

PPI

Policy options for tackling the growing number of deferred members with small pots

Executive Summary

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The PPI is an educational, independent research organisation with a charitable objective to inform the policy debate on pensions and retirement income provision. The PPI's aim is to improve information and understanding about pensions and retirement provision through research and analysis, discussion and publication. It does not lobby for any particular issue or reform solution but works to make the pensions and retirement policy debate better informed.

The PPI is funded by donations, grants and benefits-in-kind from a range of organisations, as well as being commissioned for research projects.

Pensions affect everyone. But too few people understand them and what is needed for the provision of an adequate retirement income. The PPI wants to change that. We believe that better information and understanding will lead to a better policy framework and a better provision of retirement income for all. The PPI aims to be an authoritative voice on policy on pensions and the provision of retirement income in the UK.

The PPI has specific objectives to:

- Provide relevant and accessible information on the extent and nature of retirement provision
- Contribute fact-based analysis and commentary to the policy-making process
- Extend and encourage research and debate on policy on pensions and retirement provision
- Be a helpful sounding board for providers, policy makers and opinion formers
- Inform the public debate on policy on pensions and retirement provision.

We believe that the PPI is unique in the study of pensions and retirement provision, as it is:

- Independent, with no political bias or vested interest
- Led by experts focused on pensions and retirement provision
- Considering the whole pension framework: state, private, and the interaction between them
- Pursuing both academically rigorous analysis and practical policy commentary
- Taking a long-term perspective on policy outcomes on pensions and retirement income
- Encouraging dialogue and debate with multiple constituencies

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A Pensions Policy Institute report

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Executive Summary

This report explores the potential outcomes on the number of deferred pension pots, charges for members and costs for providers of a range of policy options. This summary covers the main points of the report and acts as the conclusion.

To effectively reduce the number of small, deferred pots, large scale policies will need to be introduced alongside more streamlined, uniform systems for payroll and pot transfers

The number of deferred pension pots in the UK Defined Contribution (DC) master trust market is likely to rise from 8m in 2020 to around 27m in 2035. Member charges often erode small, deferred member pots over time and small pots can be uneconomic for providers to manage. Extra management costs may eventually be passed on to members through increased charges. Financial instability in master trust schemes, arising from too many small pots, could, in extreme circumstances result in trustees triggering an event to wind up the scheme.

Policies aimed at consolidating pots are likely to provide a better long-term solution than tackling charging structures

Altering charging structures is unlikely to resolve the problems associated with small, deferred member pots, as charges either erode member pots or prevent schemes from breaking even on pot management, and deferred pots will not generally grow large enough to overcome these issues (unless they are re-joined by the member or transferred to consolidate with other pots).

If DC pension pots are to remain financially sustainable for both members and providers, a more strategic policy-based approach, exploring options for pot consolidation is required. With all policies, there are trade-offs to consider. All policies have potential benefits and drawbacks, and the relative merits will be viewed differently by different stakeholders. Consideration by policymakers will need to involve all of the potential trade-offs associated with each model and how policy levers may mitigate potential negative outcomes.

As all policies have potential benefits and drawbacks, a combination of policies may be helpful going forward

All of the policies explored in this report reduce the number of deferred pots, the charges that members pay, and the costs paid by providers, to some degree. However, the policies cannot be judged solely on their economic impact. All policies involve trade-offs and some present potential market difficulties such as giving particular schemes a competitive advantage or encouraging "cherry picking" of members who appear most profitable. Some policy models, such as the lifetime provider model, would involve significant restructuring of the regulatory framework governing pension schemes.

A policy model which combines aspects of several of these, including the use of dashboards, could help reduce small pots without giving undue advantage or disadvantage to any particular scheme or member. It is worth industry and policymakers reflecting on a model which highlights the potential benefits attached to the models discussed in this report but contains functionality which reduces the potential for disadvantages.

In order to successfully deliver a policy to reduce the number of small pots, a degree of consensus among consumer and employer representatives, industry, Government and regulators (all affected parties) will be necessary, and therefore all these groups should be included in the decision-making process.

This report considers the potential impact on small pots of the following policy options:

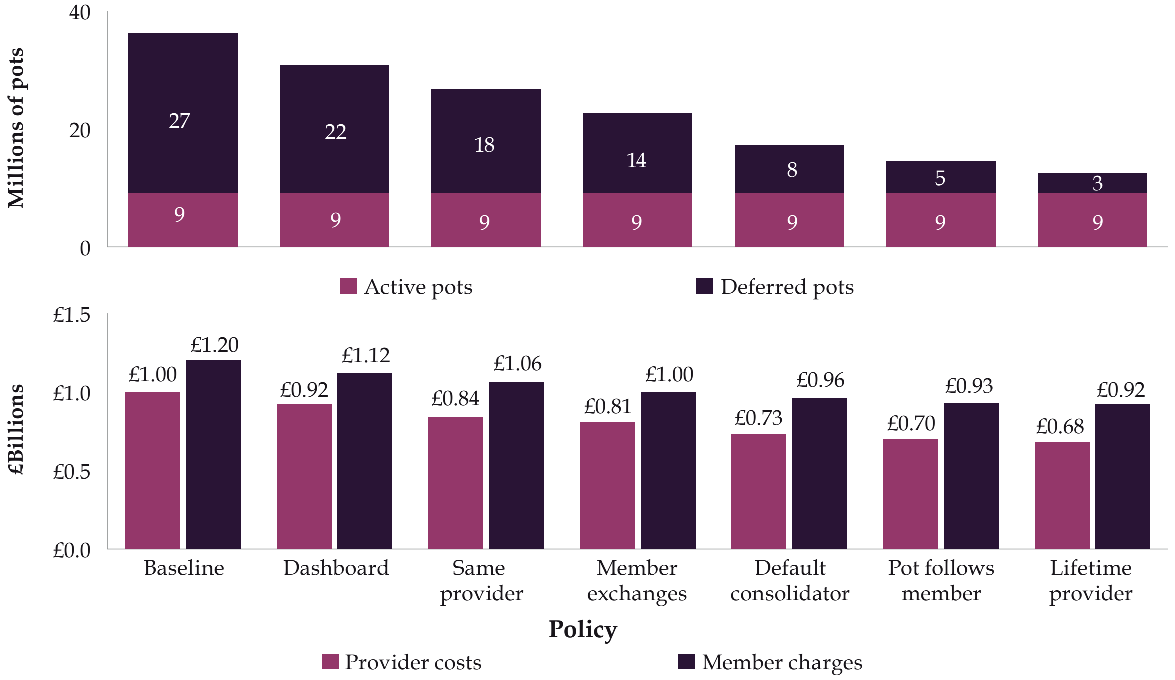
- **Dashboards:** platforms that allow members to view all pots with different providers in one place and could facilitate more consolidation (though this is not the sole intention of dashboards, which are designed to enable informed pension decision-making).
- **Same provider consolidation:** returning members are re-enrolled into their deferred pot.
- **Pot follows member:** pots move with members to new employer's schemes.
- **Member exchange:** a form of pot follows member, which allows for the reassignment between schemes of all existing pots into the current active scheme.
- **Lifetime provider:** members remain with the same provider throughout their working life.
- **Default consolidator:** pots deferred for a year, transfer to a consolidator provider, with members being given an opportunity to opt out.

Consolidator models reduce the number of deferred member pots, member charges and provider costs to varying degrees

All the policy models explored reduce the number of deferred member pots, the amount members pay in charges and the cost to providers of administering pots, with the lifetime provider and pot follows member models resulting in the most significant impact by 2035 (Chart Ex.1).

Chart Ex.1[1]
Consolidator models reduce the number of deferred member pots to varying degrees

Number of active and deferred pots, aggregate member charges and aggregate provider costs in master trust universe by 2035 under different policy models



The key benefits members and providers derive from small pot consolidation is that member charges become more affordable as pot sizes grow, and provider costs are reduced as they are administering fewer pots, avoiding duplication of administrative tasks and resources. Larger pots, of around £4,000 and above, are easier to charge in a way which does not erode pot size, while also allowing providers to breakeven.

Policymakers will need to consider the trade-offs for employers, members and providers involved in each policy

The main trade-offs policymakers will need to consider when choosing between the different policies are outlined below. While the lifetime provider and pot follows member policies reduce the number of deferred pots, member charges and provider costs most significantly, these have potential market drawbacks attached such as significant systemic change (lifetime provider) or placing an increased burden on provider and employer administration (pot follows member). Therefore, other policies with less significant drawbacks or a combination of policies are worth considering (Table Ex.1):

1 PPI modelling

Table Ex.1: policy option trade-offs[2]

Policy	Trade-offs	
	Potential positives	**Potential negatives**
Dashboards	• Encourages engagement	• Potential for lower levels of consolidation
Same provider consolidation	• Simplicity • Reduces administrative burden on providers and employers	• Less comprehensive coverage • Potential for "cherry picking"
Pot follows member	• More comprehensive coverage • Reduces administrative burden on employers	• Increased pot erosion resulting from transfers to schemes with higher fees • Increased administrative burden for providers • Potential for "cherry picking"
Member exchange	• A simpler version of pot follows member	• Less comprehensive coverage than pot follows member • Delay in transfers leading to pot erosion • Potential for "cherry picking"
Lifetime provider	• Policy simplicity • Ease of administration • Most comprehensive coverage	• Unfair competitive advantage • Significant systemic change • Increased administrative burden for employers • Potential for "cherry picking" • Delay, leading to small pot generation
Default consolidator	• More comprehensive coverage • Provides for those who change jobs frequently or move in and out of work • Low administrative burden on employers	• Unfair competitive advantage • Delay in transfers leading to pot erosion • Potential for "cherry picking"

There are several policy options for dealing with potential negative outcomes associated with the above policy options:

Dashboards will complement other consolidation policies

The potential for lower levels of consolidation, associated with dashboards, which require active engagement from members, could be tackled by ensuring that dashboards are used to complement one or more additional policy approaches to reducing the number of small, deferred member pots, such as the others discussed in this report.

Regulation on charging could support pot follows member

While it will be particularly difficult to avoid pots being transferred to higher charging schemes from time to time in a pot follows members approach, there is scope for legislative protection. The requirements of master trust authorisation and Chairs Statements on value for money are intended to ensure member protection against unduly high charges. Charges may in fact become more homogenous over time as a result of the current consultation on the charge cap.[3]

2 Policies not modelled are not included in the table
3 DWP (2020)

A carousel approach to scheme allocation could help reduce competition issues with the default consolidator and lifetime provider models

The potential for an unfair competitive advantage associated with the default consolidator and lifetime provider models could be addressed by allocating new members to a scheme from a pre-approved list (based on an authorisation process), ensuring that no one scheme is given undue advantage. Existing members who are already saving could remain with their current provider, so as not to result in too much transferring at policy inception.

The lifetime provider model would require changes to the regulatory landscape

The potential, associated with the lifetime provider policy, for an increased administrative burden on employers who must pay contributions into several different schemes would require the development of a new regulatory framework in order to ensure that lifetime providers can fulfil the role that single providers nominated by an employer fulfil today of:

- Monitoring automatic enrolment compliance on behalf of the Regulator,
- Ensuring that contributions are paid regularly,
- Ensuring that late payments are chased down, and
- Sampling contribution calculations for correctness.

The scale, timeframe and costs of these developments are likely to be high. This policy would also require the development of systems that assist payroll providers to cope with multiple pension schemes being used by one employer. These systems would most likely need to include the development of online tools for facilitating easier pension contributions, that are made available to companies who operate payroll in-house.

Limiting policies to certain schemes could prevent members from being transferred out of schemes which offer special benefits

Some form of scheme opt out, or limiting policy coverage to certain schemes (such as master trusts) may be required in order to ensure that employees are not transferred out of schemes in which the benefits outweigh the potential drawbacks of being a deferred member.

Policymakers will need to consider how to address the danger of encouraging "cherry picking" of members

Most consolidator models carry the danger of encouraging "cherry picking" by schemes. While automatic enrolment itself resulted in some schemes "cherry picking" employers who appeared to offer the most profitable set of members,[4] consolidator schemes could result in schemes vying for the pots of individual members, whose income and contributions appear to offer the most in long-term profit. There would need to be serious attention paid by policymakers to the potential for cherry picking in order to ensure that members with lower incomes are not disadvantaged through mainly saving in schemes which many of the most "profitable" members have left.

4 www.accountingweb.co.uk/community/industry-insights/insurers-cherry-picking-employers-staging-auto-enrolment-shock; www.ftadviser.com/2015/08/24/pensions/personal-pensions/providers-not-open-for-sme-auto-enrolment-business-BgA91TYsqDkkbuQ32hnzEI/article.html

Increases in cost efficiency will result in greater reductions in costs for providers

Investment and administrative costs vary between providers based on many factors. While all of the policies explored in this report have the potential to reduce the aggregate level of provider costs, by reducing the number of pots which need to be administered, those who already pay lower than average costs will experience greater savings from each policy, and those who pay more will experience less. Under an assumption that provider admin costs are +/- 25%, of the baseline assumption (£19pa for an active pot and £13pa for a deferred pot), greater cost efficiency could result in annual master trust provider costs of around £640m per year under pot follows member and around £630m under the lifetime provider policy. With a starting level of higher than average costs, master trust provider cost savings could be less significant, with a total annual provider cost of around £840m per year under pot follows member and around £800m under the lifetime provider policy.

As part of moves towards streamlining transfers and managing contributions, industry may want to explore ways of improving cost efficiency, particularly for providers who outsource their management to third parties.

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