

## Financial sustainability of master trust pension schemes



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- 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.

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- 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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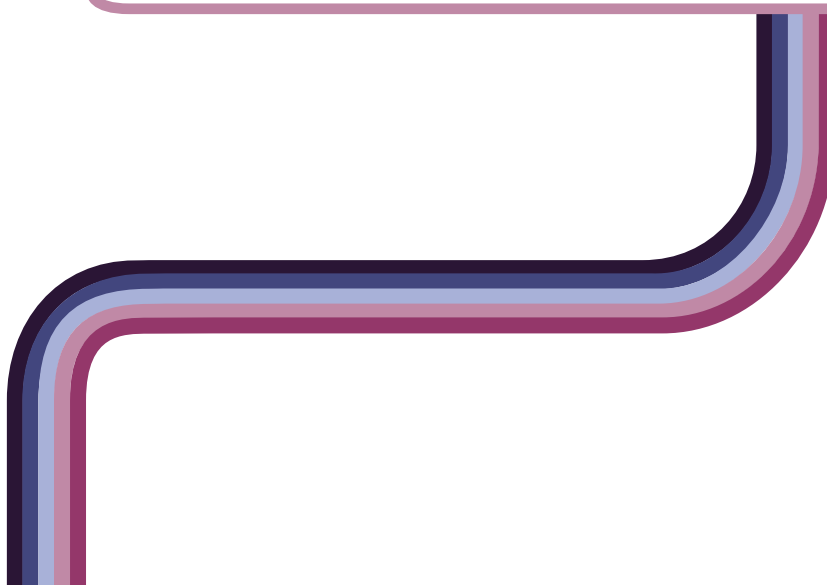
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# Executive Summary

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Automatic enrolment has led to a rapid increase in pension savers, with more than 10 million enrolled since its introduction in 2012. Master trusts have been created to meet this increased need for pension provision. Setting up a master trust is a capital-intensive venture, requiring professional advisors, systems for processing contributions, fund management, administration and marketing. In order to achieve financial sustainability, master trusts must ensure that they are able to cover both initial start-up costs, and loan repayments in cases where start-up capital has been borrowed, as well as ongoing costs associated with running the scheme. While a scheme's chosen charging structure impacts individual members, it also affects the financial sustainability of the scheme more broadly, so careful consideration must be given to ensure that this is appropriate for expenditure needs.

## **The greatest challenge to the financial sustainability of master trusts is the need to cover initial start-up and running costs until levels of membership and assets have grown sufficiently**

There are significant costs associated with setting up a new pension scheme, as well as ongoing running costs, which can be more challenging to cover in the early years of the scheme while pot sizes are small. In order to meet costs during the period before the scheme income is sufficient, the master trusts will rely on financial support from other sources. If initial capital is provided as a loan, then servicing of that loan through regular payments is required as set out in the terms of the loan and is a cost to the scheme. These repayment cashflows also need to be met from future charges, alongside the ongoing costs of the scheme. Master trusts set up by an existing pension provider may benefit from existing administration and IT systems, while master trusts set up from scratch generally face higher initial start-up costs. As a result of concerns about the business models of some of the master trusts and the resulting impact on the schemes' financial sustainability, the Government introduced an authorisation regime.

**Master trusts’ annual expenditure has been growing year on year, with cumulative expenditure around £1 billion by 2019 and costs expected to continue to grow**

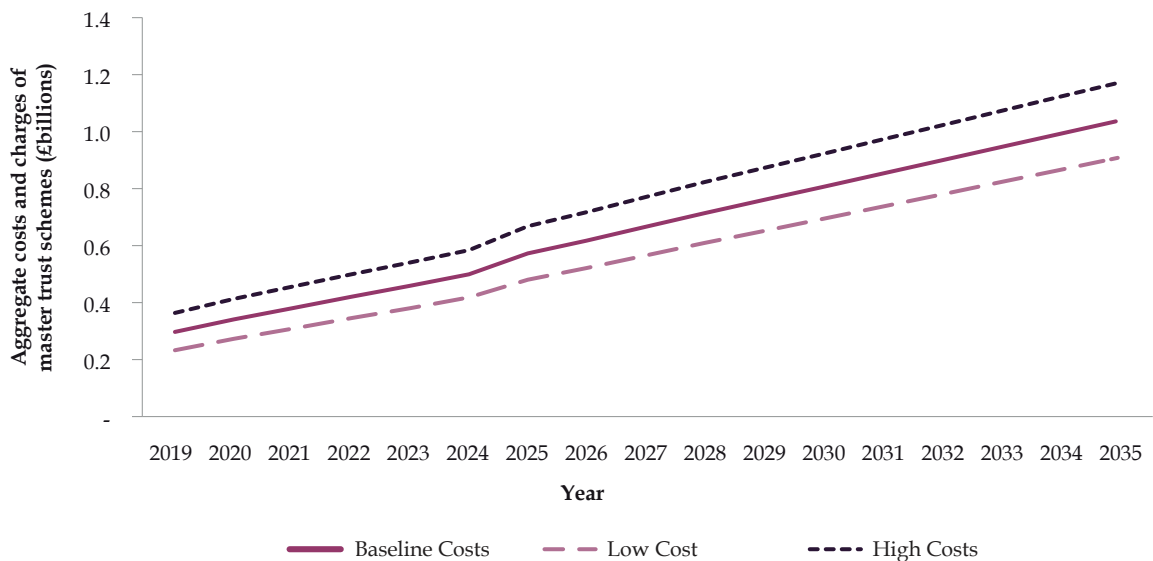
**Chart Ex.1**  
**Cumulative investment into the four largest master trusts may be at around £1bn by 2019**

Annual costs of setting up and running the largest 4 master trust pension schemes (£millions)



**Chart Ex.2**  
**Costs of master trust schemes are increasing in earnings terms**

Projection of costs of master trust schemes (£billions in 2020 earnings terms) under high, baseline and low cost scenarios





The master trust industry is unlikely to achieve breakeven on costs until around 2025. Thereafter, the industry may generate annual profits which will accelerate as the funds under management grow. However, in reality there may be some reduction in the profits as providers seek to achieve a competitive advantage by reducing their charges, while still having a large enough pool of assets under management to achieve a profit from the charges.

### **There are a number of known future challenges which are likely to impact master trust costs moving forward**

- **Pensions dashboards:** Data cleansing exercises necessary for the implementation of pensions dashboards are likely to present additional costs for master trusts, both on an immediate and ongoing basis. While the cost of dashboards to the master trust industry is difficult to accurately predict, the Department for Work and Pensions' estimates in the Pensions Bill 2020 Impact Assessment suggest large schemes would face implementation costs of around £200,000 each. For medium size schemes, implementation costs are calculated to be around £75,000 each, along with having to share the cost of £100,000 per administrator. Over the longer-term, this may be offset by lower costs in other administrative areas as a result of higher quality data.
- **Deferred members:** Small pots belonging to deferred members are likely to become an increasingly important issue as job mobility continues to grow. While active pots are more continuously administered as new contributions are regularly received and allocated, deferred pots present their own administration issues as a result of inefficiencies in administering multiple pots for the same person or maintaining contact with an individual without having a current employer to provide contact information. Schemes with a greater proportion of pots belonging to deferred members may experience costs that are particularly high relative to their assets under management, as these pots tend to be small and do not grow with ongoing contributions. Without policy change, the number of deferred pots in master trust schemes could grow from 8 million to 27 million by 2035.
- **COVID-19:** While the full impact of COVID-19 on pensions is not yet certain, reductions in overall contribution levels as a result of increased unemployment and volatility in the stock market are likely to impact master trusts' income from charges, at least in the short-term.

# Introduction

This report is informed by desk research, PPI modelling, and interviews with industry representatives.

## Background and approach

The success of automatic enrolment has been to bring 10 million new people saving into a pension. With such a large number of new pension savers, new pension schemes have launched to meet the demand. The majority of automatically enrolled savers are in master trusts pension schemes, many of which have launched since 2012, changing the landscape of pension provision in the UK. The regulatory regime has reacted by setting out an authorisation procedure which master trusts must undergo in order to be permitted to operate.

Setting up a master trust is a capital-intensive venture, requiring professional advisors, systems for processing contributions, fund management, administration and marketing. Some master trusts may be able to benefit from infrastructures available through an existing parent company, other master trusts that start from scratch face significant up-front costs for such required items.

Other challenges include the issue of deferred members. The number of deferred members have grown at twice the rate of active members resulting in engagement issues between the member and provider (no longer able to communicate via the employer, email and postal addresses change) and with no further contributions, a lack of assets under management (AUM) growth for the provider.

It is estimated that approximately £1bn has been invested collectively by the largest automatic enrolment providers in setting up and running their platforms. Even after 7 years and increases to contribution rates, the charges generated from the AUM may not be enough to cover the ongoing costs and pay off the outstanding debt on the start-up costs. Financial sustainability remains a challenge in the automatic enrolment industry, especially in light of further investment being required for known challenges such as improving infrastructure and member portals responding to the current pandemic, data quality, member engagement, pensions dashboards and transfer initiatives but also for unknown future challenges such as possible future regulatory change.

## Roadmap of the report

This report examines the ways in which the costs faced, and income received, by automatic enrolment pension providers can affect their financial sustainability. Like all PPI reports, this report does not offer policy recommendations.

**Chapter One** examines the automatic enrolment market including the growth in master trusts and the process under which they are authorised to conduct business.

**Chapter Two** describes the expenditure involved in provision of a pension scheme and examines the levels of transparency and existence of cross-subsidies within different charging structures.

**Chapter Three** describes the income to pension scheme providers, including charges and the role of the scheme funder. It considers the relationship of charges to costs and examines the existence of cross-subsidies within different charging structures.

**Chapter Four** uses PPI modelling to examine the effects of different charging structures on a number of hypothetical schemes and show how charging structures and combinations of charging structures can affect provider outcomes.

**Chapter Five** examines other challenges affecting the master trust industry as a whole, including small pots and the impact of COVID-19.

# Chapter One: Automatic enrolment and the introduction of master trusts

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This chapter examines the automatic enrolment market including the growth in master trusts and the process under which they are authorised to conduct business.

## **Automatic enrolment has led to a rapid increase in pension savers, with more than 10 million enrolled since its introduction in 2012**

Prior to automatic enrolment, around 40% of employees were saving in a pension scheme. In order to increase pension savings the Government, with cross party support, introduced automatic enrolment in 2012. Employers were compelled to make pension provision for their employees and to enrol them into an appropriate pension scheme unless the employee actively asked to be withdrawn.

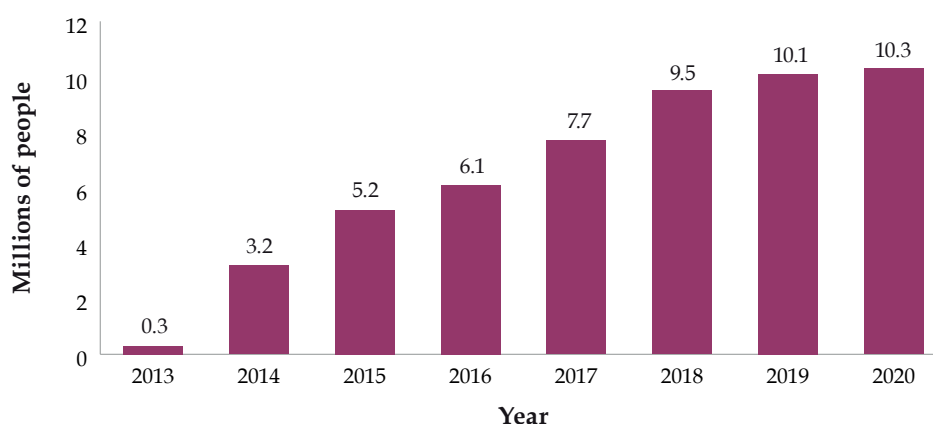
Since the introduction of automatic enrolment in 2012 pension saving in the UK has grown rapidly (Chart 1). With fewer people opting-out of automatic enrolment pension schemes than expected,<sup>1</sup> the number of pension scheme savers exceeded the Government's expectations.

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1 NAO (2015)

Chart 1<sup>2</sup>**Automatic enrolment has brought millions of people into pension saving since 2012**

Number of automatically enrolled pension scheme members (millions at 31 March of year)



Employers who did not operate their own pension scheme became required to enrol their employees into a pension scheme which was suitable for the purpose, so they needed a pension that was easy to implement. This meant that there was the prospect of millions of employees saving in a pension scheme for the first time and many employers, who had no experience in providing a pension scheme for their employees. This created a gap in the market for pension providers that the employers could go to as a simple and cost effective pension solution for their employees.

**Master trusts have been created to meet this increased need for pension provision**

The new boom in pension saving created a large market for pension provision. This gap was filled by the growth of master trusts which offer the same pension scheme to many employers and hope to take advantage of economies of scale to keep their costs down. A master trust as set out in legislation<sup>3</sup> is a private sector occupational pension scheme which is intended to be used by multiple unconnected employers to provide Defined Contribution benefits. Master trusts are controlled by a board of trustees who have a fiduciary duty to operate in the interest of the members of the scheme.

The Government set up the National Employment Savings Trust (NEST) as a master trust pension scheme that would be available to all employers should they wish to use it. This

means that NEST could not refuse to serve any employer, whereas other providers can choose to decline employers if they don't meet the size or employee profile requirements of the provider, however, some private sector providers also adopt the policy of accepting all employers.

**Master trusts set up by an existing pension provider may benefit from existing administration and IT systems, while master trusts set up from scratch generally face higher initial start-up costs**

If the master trust has the backing of an existing pensions provider, then they may have access to an administration system and an IT platform that can be used for the new business, reducing the start-up costs. They may also have a source of initial funding without having to attract external investment. They may also be able to market on the brand recognition of a trusted financial provider. Each of which could reduce the initial start-up costs.

Other pension providers started to emerge as master trusts in the early days of automatic enrolment. This included existing pension providers offering a master trust and new providers starting from scratch. Not all the new master trust pension schemes were well financed, leading to concerns about whether they would be able to provide a robust and sustainable pension scheme, this led to the Government implementing a process which all master trusts have to undergo in order to be authorised to operate.

2 TPR (2020)

3 Pension Schemes Act 2017

## As a result of concerns about some master trusts' financial sustainability, the Government introduced an authorisation regime

The rapid growth in the number of pension schemes entering the industry as master trusts and concerns over the viability of the business models of some of the master trusts and the resulting impact on the schemes' financial sustainability, led to the Government implementing an authorisation procedure for master trusts to act as pension providers. Authorisation may be able to increase the stability of master trust providers, this could benefit individuals, the staff of the master trust and improve trust in the pension system.

The authorisation process is performed by The Pensions Regulator and involves demonstrating that the master trust has appropriate people and strategies in place to demonstrate that the scheme meets the authorisation criteria. The authorisation criteria include:<sup>4</sup>

- **Fit and proper** individuals of honesty, integrity and have knowledge appropriate to their role.
- **Systems and processes** (including IT) in place to ensure the scheme can run efficiently and has robust systems and processes to effectively govern the scheme in accordance with all the relevant requirements.
- **Continuity strategy** that sets out to how members will be protected if there is a triggering event and how a master trust may be closed down or how the triggering event will be resolved.
- **Scheme funder** which must be a body corporate or partnership and only carry out activities relating directly to the master trust. It must be able to financially support the master trust.
- **Financial sustainability** the master trust needs to have enough financial support to ensure it can set up and operate on a day-to-day basis and to cover the costs subsequent to a triggering event without increasing the cost to members.

In particular, The Pensions Regulator wishes to ensure that certain key roles in the master trust are filled appropriately. These include the:

- **trustees**, who are responsible for the running of the pension scheme in accordance with the trust deed and rules and in the best interests of the members,
- **the scheme funder**, which is liable to provide funds to meet its running costs if charges are not sufficient or is entitled to receive profits where the charges exceed the running costs, and
- **the scheme strategist**, who makes decisions about the business activities of the master trust, they are responsible for the business plan and the continuity strategy.

Of the 90 master trusts operating before the introduction of the authorisation procedure 38 applied to The Pensions Regulator for authorised status, of which 37 were granted and 1 withdrew its application.<sup>5</sup> The unauthorised master trusts had to shut down and transfer their assets. After the initial round of authorisations, a further master trust has been authorised bringing the current number of authorised master trusts in the UK to 38.

Following authorisation, the schemes are subject to ongoing supervision where they must demonstrate that they continue to meet the requirements of the authorisation procedure.

## The greatest challenge to the financial sustainability of master trusts is the need to cover initial start-up and running costs until levels of membership and assets have grown sufficiently

Running a master trust is an expensive proposition; the scheme faces costs relating to the ongoing administration of accounts, IT systems, legal and compliance, Investment management, marketing, data cleansing, regulatory fees, etc. Many of these costs are initial start-up costs, or unrelated to the size of the pool of assets.

The costs are recouped by charging the members a management charge on the assets/contributions, however in the beginning of a master trust's life there may be very low levels of assets or membership. This may mean that a cash injection is required from the scheme funder.

The key problem to overcome when starting a master trust is that the scheme faces the costs involved in setting up and running the master trust immediately, but income is slow to arise to cover these costs. The income from the scheme arises from charges made on the pension savings. The charges received by the master trust are initially low for two reasons; it takes time to build up a membership base, and savings start at zero in the pot and gradually build up. Charges that are based on either the number of savers or the amount of savings (or both) are likely to start at a low level.

In order to meet costs during the period before the scheme income is sufficient, the master trusts will rely on financial support from other sources. This may be by borrowing with a repayment schedule, and/or from a scheme funder who is liable to pay the balance of costs, in the early years of operating, only making a profit after the assets have grown to such an extent as to exceed the costs of running the scheme.

<sup>4</sup> Adapted from TPR (2018)

<sup>5</sup> TPR (2019)

## Chapter Two: Ongoing costs to master trust schemes

As discussed in Chapter One, operating a pension scheme for automatic enrolment requires expenditure, this includes both initial outlay and operating costs. This Chapter examines the expenditure facing a pension scheme; how that changes through the lifetime of the scheme and what has been the aggregate cost to the master trust schemes since the introduction of automatic enrolment. Then Chapter Three examines the income to the schemes and we can compare the outgo to the income that the schemes receive in charges.

### **There are significant costs associated with setting up a new pension scheme**

It can be very expensive to launch a new master trust pension scheme that is authorised by The Pensions Regulator. To run a pension scheme successfully, and to gain authorisation from The Pensions Regulator, the scheme must have the practical elements of the scheme already in place. These include the design of the pension scheme, legal agreements with service providers, IT infrastructure, call centres to answer queries from employers as well as from members and robust administration software to process contributions and monitor pension funds. These can be very expensive but must be in place before any members join the pension scheme.

Securing the financing to meet these costs can itself be expensive, requiring a marketing budget to appeal to potential investors, legal services and a fully developed business plan. The costs of undergoing and meeting the authorisation criteria may be a barrier to entry to new master trust schemes if they are unable to recoup those costs reasonably quickly.

Master trusts set up by a parent company which is an existing pension provider may have an advantage, if, for example, the parent company already has infrastructure in place, has an existing and proven IT system which can be modified to fit the needs of the master trust. For example, insurance companies with group personal pension business will have a lot of the required infrastructure and expertise. The result may be that it is easier and less expensive for such an existing pension provider to enter the market with master trust schemes than a new master trust starting from scratch.

### **Once a pension scheme has been set up, there are ongoing costs associated with running the scheme**

In addition to the initial costs associated with setting up and launching the pension scheme, are the ongoing costs associated with the secure and robust running of the scheme. These are likely to be primarily the administration of pensions, the maintenance and improvement of the systems and the marketing of the scheme.

### Schemes with a greater proportion of pots belonging to deferred members may experience costs that are particularly high relative to their assets under management

Active pots are more continuously administered because new contributions are regularly received and allocated, this may mean that active pots are more expensive to administer. However, deferred pots present their own administration issues, as a result of inefficiencies in administering multiple pots for the same person or maintaining contact with an individual without having a current employer to provide contact information.

For example, consider an individual who has a pension pot with "A2Z master trust" as a result of their employment. The individual then leaves their employer and is no longer making any pension contributions, the pension becomes an inactive pot. They then start work with a new employer in the same industry who also uses "A2Z master trust" as their pension provider. They could then be in a situation where they have an active and deferred pension with the same provider, both being administered

separately increasing the cost for the provider. Being able to identify multiple pots owned by the same individual can increase efficiency but imposes a cost on the master trust.

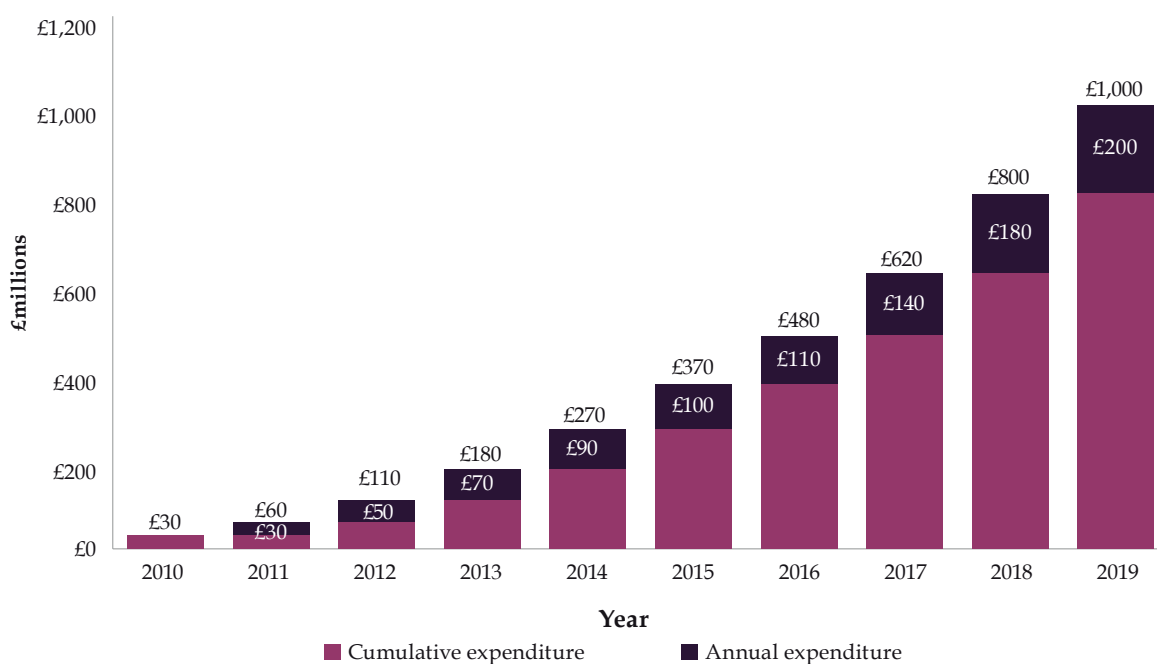
Active pots are likely to be larger on average than inactive pots:

- As a proportion of the size of the pot, inactive pots may then be more expensive to administer.
- Schemes with large numbers of deferred pension pots may therefore have high costs relative to the size of the money they are managing.
- Large schemes with more inactive pots may face higher relative costs than smaller schemes with a larger proportion of active pots.
- As schemes mature they are likely to have more and more deferred pots, for example data from large master trusts suggest that the number of deferred pots is around the same as the number of active pots, and is growing.

### Master trusts' annual expenditure has been growing year on year, with cumulative expenditure around £1 billion by 2019

Chart 2<sup>6</sup>  
Cumulative investment into the four largest master trusts may be at around £1bn by 2019

Annual costs of setting up and running the largest 4 master trust pension schemes (£millions)



6 Calculations on the finances of the 4 largest master trust schemes from NOW: Pensions



Costs incurred to date are around £1billion (Chart 2), this includes money that has been spent on setting up the IT infrastructure, ongoing expenditure on the running and maintenance of the scheme, marketing the scheme to employers, paying a levy to The Pensions Regulator and the financing of debt. The results in this report rely on publicly available data and discussion with industry on the reasonableness of assumptions made. This results in the figures in this report being illustrative approximations.

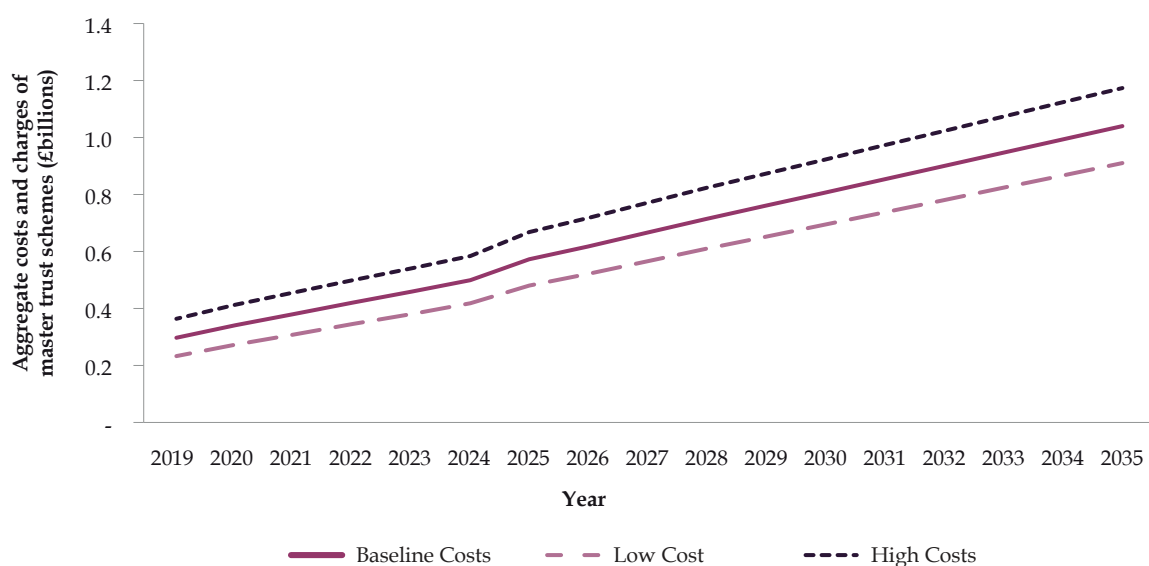
### Costs associated with running a master trust will continue to grow

PPI modelling suggests that projected annual costs of master trust schemes are likely to increase in earnings terms (Chart 3). Sensitivity scenarios for higher and lower costs are also shown which assume ongoing administration costs of around 25% higher or 25% lower than in the baseline scenario.

Chart 3<sup>7</sup>

#### Costs of master trust schemes are increasing in earnings terms

Projection of costs of master trust schemes (£billions in 2020 earnings terms) under high, baseline and low cost scenarios



There is a slight kink in the cost in 2025, this is as a result of the assumed introduction of the automatic enrolment Review recommendation to lower the minimum age for automatic enrolment from 22 to 18.<sup>8</sup> This increases the costs because there are suddenly a cohort of new members, each with a newly active pot, increasing the number of pots to be administered.

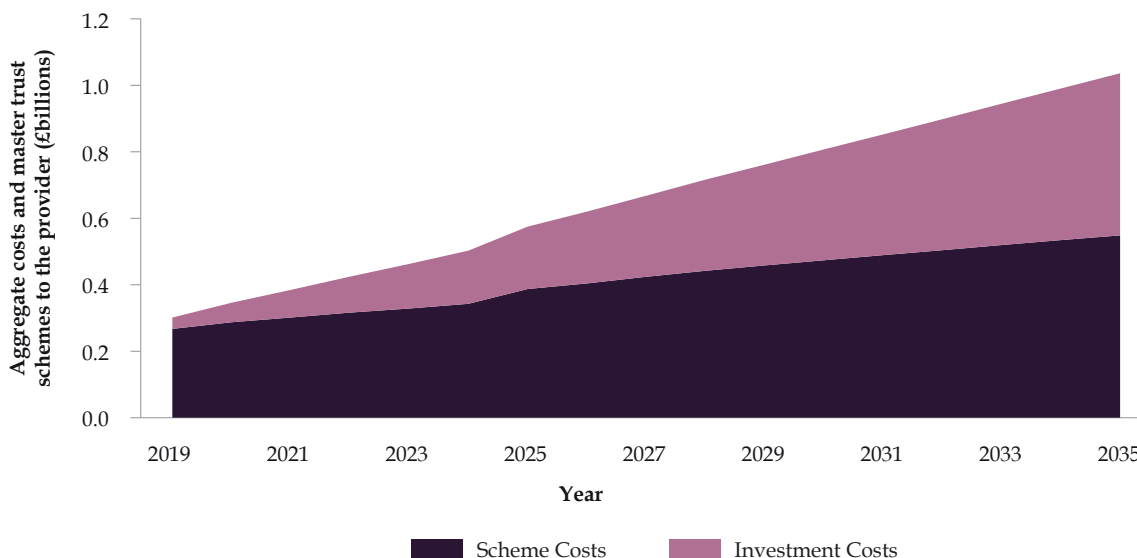
However, much of the growth is due to the costs of investment management, which are linked to the size of funds. As the fund's build up through contributions and asset returns, the investment management's charge increases proportionally with it. The cost of servicing the pots may be more closely linked to the number of pots and the growth in earnings reflecting the salaries paid to administration staff (Chart 4).

7 PPI modelling

8 DWP (2017)

**Chart 4<sup>9</sup>**  
**Split of costs**

Projection of costs of master trust schemes split by investment charges and scheme costs (£billions in 2020 earnings terms)



In the modelling it was assumed that fund management costs remain at the same percentage of assets under management, despite the fact that automatic enrolment assets are increasing quite rapidly. It might otherwise be assumed that economies of scale may be achieved from having larger sums invested, reducing the investment management charge. In this case we are assuming that the savings are spent on more active management and a greater focus on investment opportunities that benefit the environment but cost a little more to manage.

These are the expected future costs, they are simply due to the general running of the scheme in the world as it is, however, new costs could develop in the future. The master trust industry is still in its relative infancy, regulation is still developing, as the introduction of the authorisation process in 2015 exemplifies, further changes to regulation could introduce costs, and could lead to changes in the master trust landscape.

**Some schemes may face higher costs in the short-term as they ready their data for the introduction of pension dashboards, although data cleansing exercises could reduce administrative costs over the longer-term**

The pensions dashboard is intended to help people with their retirement planning by having their pensions information securely online. This will require providers to have data formatted to the specific requirements of the dashboard, or dashboards and an IT infrastructure to connect securely to pass the data through. There are therefore two distinct and separate sources of cost arising from the dashboard, the IT cost and the data cost.

Data received on each individual originates with the data provided by the employer at the time they were an active member. The data on the master trust’s admin system can only be as good as data provided by the employer. Different employers will have different HR and payroll management systems and may therefore produce data with inconsistencies, making comparisons difficult. Master trusts may also take a more active role in analysing

the contributions they are sent, to ensure that employers are providing the correct contributions on behalf of the members.

Clean data is a requirement for the proposed pensions dashboard, which will enable an individual to find their pension information from different providers all in one place. It will require that master trusts provide clean data to the dashboard provider.

Data cleansing can be an expensive exercise as it can be very labour intensive, but the result of having undertaken the exercise may be to reduce costs in other aspects of the administration.

### **Consolidation of multiple pots belonging to a single member could help to make master trust running costs more efficient**

The ongoing costs of the scheme are closely linked to the number of pension pots that the scheme is operating. If the scheme has a large number of pots, in particular inactive pots, which have less revenue growth potential, the scheme may wish to take some action to mitigate the admin cost of the pots. It may be the case that some of the pots belong to the same individual, matching the records

and in some cases consolidating the deferred pots could reduce inefficiencies and costs of administration. Some schemes already try to match existing inactive pots with active pots when savers return to the scheme whether with a different employer, or by returning to the same employer. This helps minimise the cost of administration and can also reduce the charge to the member if their scheme has a flat-fee charge on each pot.

Members can also have multiple pots across pension scheme providers. Consolidating pots across providers requires an industry initiative to match and exchange pots. There is such an initiative called Member Exchange that may address this form of cross provider duplication.<sup>10</sup>

As in the case of preparing for the pensions dashboards, clean and reliable data is essential in performing a consolidation exercise. Preparing data for the dashboard may be an opportunity for the master trust to consider whether they have any pension pots that can be consolidated. It may be difficult to identify where multiple pots are owned by the same individual. This makes it difficult to consolidate pots appropriately. Care must also be taken to ensure that the pots are not consolidated with incorrectly matched individuals.

# Chapter Three: Charges on master trust schemes

The master trust scheme requires income to cover the costs outlined in Chapter Two. Income is received by making charges on the pension funds in its care. This Chapter examines the mechanisms under which master trust schemes receive income and the potential growth in charge income in the future.

## There are five basic forms of charging structures within master trust default strategies:

- A single annual management charge (AMC) paid annually as a proportion of an individual's funds under management. It is paid every year until retirement, irrespective of whether contributions are still being made.
- A single fund AMC plus a flat-fee charge. This is an AMC with an additional flat-rate levy, irrespective of whether contributions are still being made.
- A single fund AMC plus a percentage contribution charge levied during the periods when contributions are made.
- A variable fund AMC. This is an AMC that varies according to the total amount of funds under management, with a higher percentage levied against smaller pots, reducing as they grow.

- A single fund AMC with a flat-fee charge and a floor on the fund amount below which no charges are taken (de minimis).

The choice of what charging structure a master trust implements may be based on the profile of their business, or as part of a strategy on how to handle cross-subsidies. A scheme that has a policy to accept all employers may prefer a different charging structure to one which has criteria for whom they accept as their members.

For the avoidance of confusion, this report will use the following initialisations to refer to the different elements of the overall charge:

- Proportion of Fund Charge (PFC) to mean a charge (or the part of a charge) which is levied as a percentage of the fund under management,

- **Proportion of Contribution Charge (PCC)** to mean a charge (or the part of a charge) which is levied as a percentage of the contributions made to the scheme,
- **Flat-Fee Charge (FFC)** to mean a charge (or the part of a charge) which is levied as a flat monetary amount irrespective of the amount of fund or contributions.

Automatic enrolment schemes can change their charging structure, perhaps at a particular point in the life of their business when one charging structure is more appropriate than another. In the early stages of the master trust's existence the funds held on behalf of members are very low, they have not built up enough for a pure PFC to provide a sufficient income to pay the costs of the scheme. However, as the scheme assets increase, the PFC while staying at the same rate, becomes a much larger sum of money, which could at some point allow the scheme to rely solely on a PFC, and if the fund continues to grow, to eventually reduce the charge rate.

### **Pension schemes that are used for automatic enrolment are subject to a charge cap**

The master trust recoups costs and provides a return on investment for the scheme funder by levying charges on the fund assets, and/or contributions into the pension scheme. However, they are subject to restrictions on the amount of charges that may be applied to members. A full description of the current charge cap is set out in Appendix One.

In 2015, the Government introduced a system of capping on the charges that apply to pension schemes being offered to employees as automatic enrolment schemes. This was to ensure that members, who had not made an active choice to be entered into an automatic enrolment scheme, were not burdened by high charges. The requirements specify the maximum charge that can be applied to a pension fund under different charging structures.<sup>11</sup> The capped charging structures allow for charges in the form of proportion of fund charges, flat-fee charges and for

proportion of contribution charges, with an intention that the restrictions under each structure are equivalent. However, the various caps are not equal in most circumstances, the equivalence depends on the amount of money in, and the contribution to, the pot.<sup>12</sup> For example a combination charge.

For shorthand the charge cap is often expressed in terms of the cap that applies to the pure PFC variant, (0.75% of the fund a year), however, this may be less relevant as more schemes adopt combination charges. While the commonly used shorthand expresses only the cap on PFC schemes, the other charging variants are also capped.

### **While the charge cap does not apply to members who make an active choice about investment strategy, because 99% of master trust members are in the default strategy, it protects them from high charges that could erode the value of their pension pots**

Members who make an active choice to opt for a strategy other than the default are not covered by the cap; however, currently 99% of members in automatic enrolment master trusts remain with the default strategy.<sup>13</sup>

Capping the charges is intended to protect the scheme members from high charges that erode the value of their pensions. It puts a limit on the income that the provider can obtain from the members, however, competitive pressures may be more at play than strictly the charge cap. Master trusts generally charge somewhat below the level of the charge cap. There has been a move to combination charges. Individuals who are enrolled into a master trust now are very likely to be in a scheme with a combination charge, because 99% of employers who use master trust schemes are using one with a combination charge.<sup>14</sup> Combination charges may enable providers to more quickly cover the costs of providing a pension scheme where funds have not built up to such an extent that a pure PFC would be adequate to recoup the costs.

11 See Appendix One for charging cap description

12 PPI (2019a)

13 PPI (2019b)

14 Industry analysis by NOW: Pensions

### PFC charging structures involve cross-subsidisation from members with larger pots to those with smaller pots

Flat-rate PFC based charges take more money from larger pots in the scheme, but the cost of administrating larger pots is not significantly more than to administer smaller pots. There is a mismatch between the charges on the fund and the cost of managing it, this means that the smaller pots are cross-subsidised by the larger funds. The smaller pots are being charged less than the cost of administration, because the larger pots are able to cover the cost.

### These cross-subsidies help smaller pots to grow, which for active members can mean that they effectively cross-subsidise their early years of lower relative charges as their pot size increases

The argument, from the individuals’ point of view, as to how desirable this is, could be made on both sides. Cross-subsidies mean that one party is losing out relative to another party, and the losing party may argue that it is not fair that

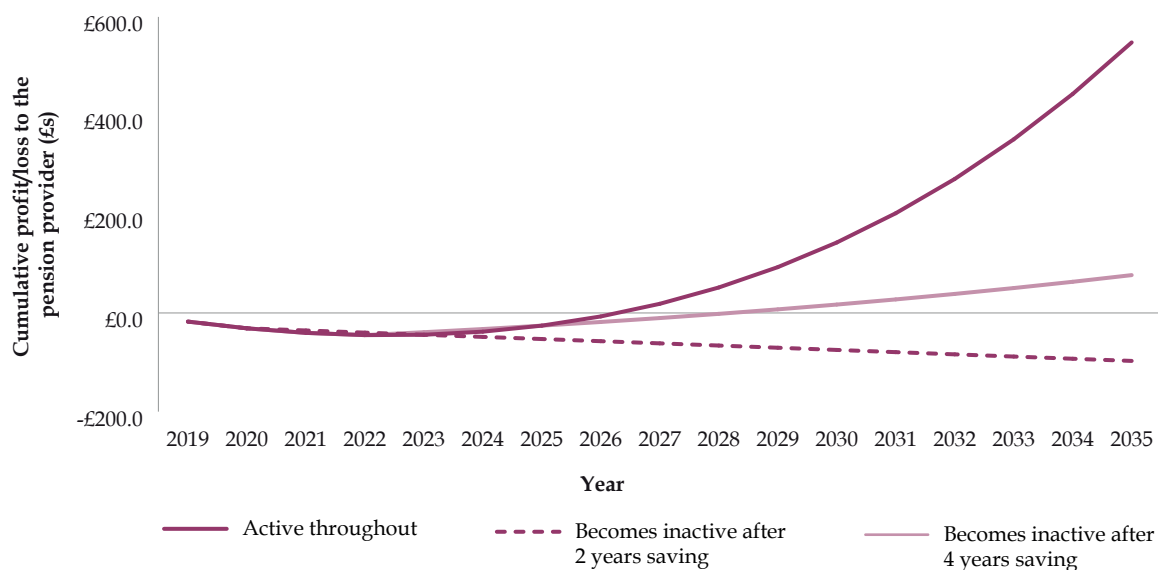
they are covering their own costs and someone else’s. On the other hand, if the smaller pots are each charged the full cost of administration this could significantly hamper the build-up of new pots, and small inactive pots could deplete to nothing. Hampering the build-up of new pots could lead to individuals losing faith in the pension scheme and choosing to cease membership.

The cross-subsidy may also be seen as a public good, an aim of the policy of automatic enrolment was to bring people into pension saving who had fallen through the cracks, this includes people on low wages, those who move jobs (creating deferred pension pots) who are the type of people who may receive the benefit of the cross-subsidy.

As a pot increases and the PFC are larger in monetary terms, this may be considered as the individual cross-subsidising their past self. However, when members become inactive their pots do not grow to the extent that they can achieve a cross-subsidy of their past self (Chart 5) in order to successfully cross subsidise their own past, the member must have longevity in the scheme to actually build up a large pot.

Chart 5<sup>15</sup>  
Long-standing active members can self subsidise their early years of loss

Cumulative surplus/loss of a median earner saving at automatic enrolment minimum rates with an annual charge of 0.45% of fund (crossing the horizontal zero is when the individual’s cumulative charges exceed cumulative costs) (2020 earnings terms)



### **Charging structures based on a flat-fee or a combination of a proportional and flat-fee may reduce the risk of large potholders transferring out of the scheme**

The cross-subsidy could put the scheme at risk of specialist providers who advertise to members who have accumulated large funds, approaching such members with the promise of a lower management charge if they transfer their pot. By targeting existing large funds, the specialist provider can take advantage of charge income from the larger fund without having the period of losses while the fund builds up.

The specialist provider can offer a lower fee because they only take the larger funds and therefore do not have smaller funds to subsidise. The impact on a master trust scheme of a successful predatory approach like this to the larger pots of a provider would be to reduce the average pot size of the scheme, and thereby reduce the PFC income. Without having larger funds to subsidise the smaller funds, the provider would be put in a difficult financial situation, possibly requiring them to increase the charge level, or turn to the scheme funder to cover the costs.

If the master trust were to use a charging structure that reduces the cross-subsidy, they would be less susceptible to facing losses of members from a predatory provider, because having smaller pots that cover their own costs mean that losing larger schemes would not put the same financial strain on the provider in administering the remaining pots. Also, if the larger pots are not cross-subsidising the smaller ones, then they will not be being charged high fees that another provider could seek to undercut and they would not be such an attractive prospect to the predatory provider.

A charging structure that might reduce the cross-subsidies is a combination of the proportional fund charge and a flat-fee charge. This could take the form of a monetary charge, irrespective of the size of the pot that is intended to more closely match the costs that arise in administering the pot. The cost of administration of pots is not likely to be proportional to the size of the pot, so the flat-fee may more closely match the cost, with a variable element of the charge to cover the investment management costs which are levied by the investment manager as a PFC.

The problem with an FFC is that it is unattractive to members with smaller pots and may lead to the smaller pots being depleted rapidly, especially over the course of a long working life. However, there may be some approaches to pot consolidation that could mitigate the impact by trying to ensure that small inactive pots are

combined with other pots belonging to the same member, either within the provider or as part of a cross provider effort. These are considered more deeply in a PPI report “Deferred Pensioners, Defusing the pensions time bomb”<sup>16</sup>

### **As well as covering ongoing running costs, master trusts must ensure that charges levied on members can cover the repayment of initial investment capital**

In order to meet the initial costs of the scheme the master trust must obtain capital. If initial capital is provided as a loan, then servicing of that loan through regular repayment is required as set out in the terms of the loan and is a cost to the scheme. These repayment cashflows also need to be met from future charges alongside the ongoing costs of the scheme.

Being able to demonstrate a good return on capital will also be required in order to attract further investment which the business needs in order to fund expansion of the business, marketing the business, or to pay for arising one-off expenses. One such one-off expense might be ensuring that the business is fully able to provide cleaned appropriate data in the format required for the pensions dashboard when it is released.

For example, NEST operates a combination charging structure where contributions are charged a PCC at a rate of 1.8% and funds under management are charged a PFC at 0.3%. The contribution charge is intended to be used to pay off the loan received from the Government to start up the business, when that loan is repaid it is possible that NEST will drop the contribution charge.

Two of the other larger master trusts also have a combination charge, both of which have a PFC and an FFC. One of which also has rebate on the PFC as the fund value increases, this would have the effect of reducing the cross-subsidy between larger and smaller pension schemes.

### **Cross subsidising employer charges**

Master trust schemes may also have employer charges, these are charges payable by the employer to cover the costs of setting up a new employer on the system, and/or monthly charge on the scheme for the service provision. These charges may be negotiable, in which case they might lead to cross subsidies occurring between the members of the scheme and the employer. The extent to which an employer chooses one scheme over another because of the charge to themselves, rather than the charges to the employees as members may also lead to a form of cross subsidy of employees to employers.

# Chapter Four: Projection of the costs and income of the master trusts

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**This chapter uses PPI modelling to examine the effects of different charging structures on a number of hypothetical schemes and shows how charging structures and combinations of charging structures can affect provider outcomes.**

## **The master trust industry is unlikely to achieve breakeven on costs until around 2025**

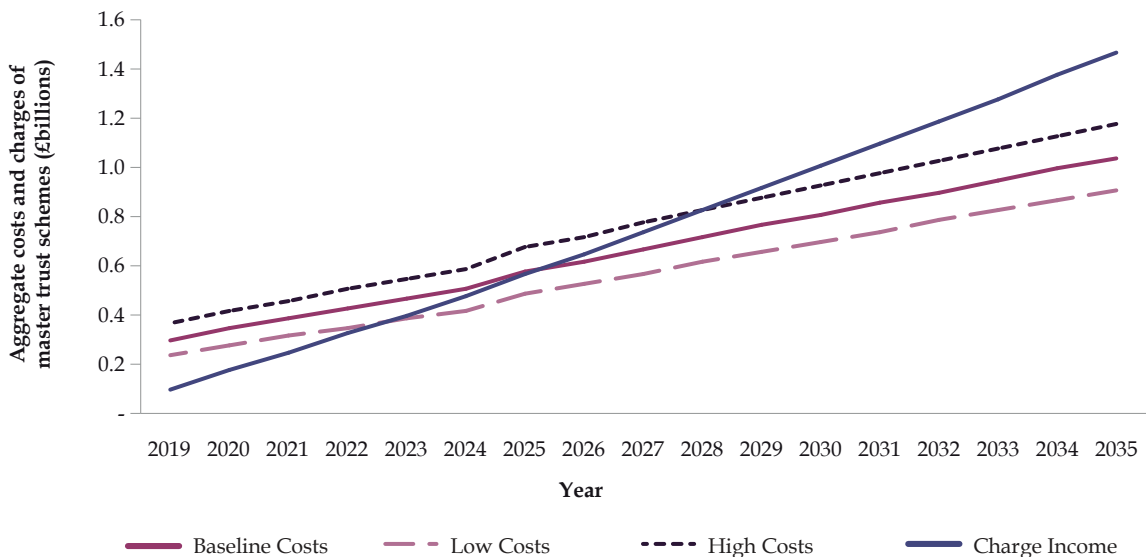
Following on from the costs projection in Chapter Two, PPI modelling of charge income suggests that the master trust industry is currently operating at a loss year on year and is unlikely to achieve breakeven until around 2025

under the baseline costs scenario. Thereafter the industry may generate annual profits which will accelerate as the funds under management grow (Chart 6). However, in reality there may be some reduction in the profits as providers seek to achieve a competitive advantage by reducing their charges, while still having a large enough pool of assets under management (AUM) to achieve a profit from the charges.



Chart 6<sup>17</sup>**The master trust industry may be operating at a loss until the mid 2020s**

Charges v cost of scheme under 0.45% proportion of fund charge



Low charges on schemes with large AUM may serve as a barrier to entry for new providers in the future. Lower charges increases the time until a new scheme achieves profitability. If the prevalent rates of charges fall, then new providers would have to balance offering competitive rates and having been able to service the cost of their start-up expenses and achieve profitability over a reasonable time horizon.

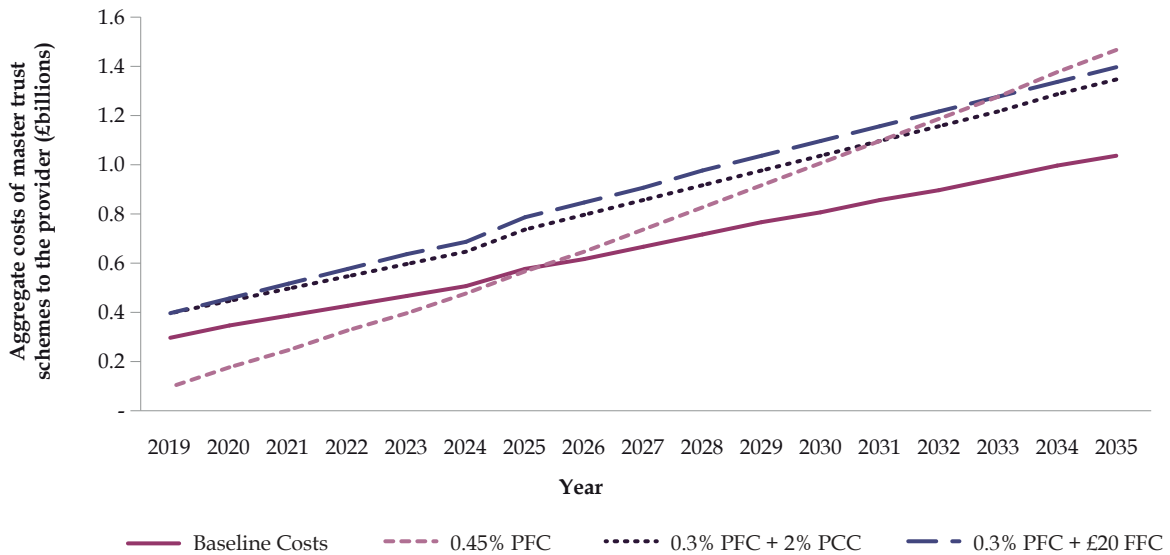
The costs to the industry are currently higher than the charge income under the assumption of an average charge income of 0.45% of the fund value. Changing that assumption, to reflect a trend to combination charges (Chart 7), shows that charges could exceed costs under either the combination charges of:

- 0.3% proportion of fund charge (PFC) and flat-fee charge (FFC) of around £20, or
- 0.3% PFC and a contribution charge of 2%.

Chart 7<sup>18</sup>

**Moving to combination charges could lead to income exceeding costs**

Aggregate costs compared to charges under scenario charging structures assumed for the entire industry



**Different charging structures can affect sustainability for individual schemes**

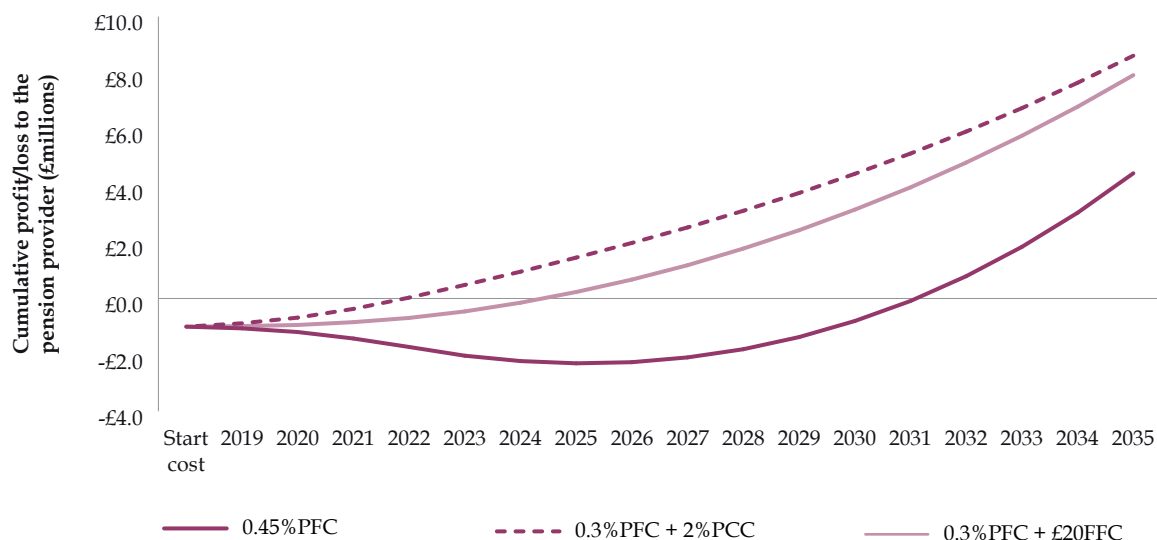
At the provider level, the choice of an appropriate charging structure might be based on the profile of the scheme itself, a large fund can sustain a PFC, however a scheme starting out may wish to use a combination charge of a lower PFC, and either an FFC or a proportion of contribution charge (PCC).

As a simple example, to understand the interactions of costs and charges, consider a new provider with £1million in start-up costs. The scheme grows from 5,000 new active

members in 2019, their first year of operation, to having around 60,000 members by 2035, at which point a quarter of them are active. Their active members earn on average at the median level and make contributions at 8% of salary, leading to an average contribution of around £2,000 a year per member. The outcomes for payback and subsequent profitability may be different depending on the approach the scheme takes to charging (Chart 8).

Chart 8<sup>19</sup>**Combination charges may allow a scheme to break even sooner**

Cumulative surplus/loss for a new scheme under different charging structures (crossing the horizontal zero is when the scheme breaks even) (2020 earnings terms)



The combination charge approaches can pay back the investment more quickly, taking just over three years for the PFC and PCC combination charge to generate enough profits to pay back the initial £1million investment.

The fastest repayment is under the combination PFC and PCC, in this example. In the early stages of the pension fund, each new year's worth of contributions are a significant proportion of the fund. For example, in the first year, the entire fund is from contributions received in that year, such that a 2% PCC is closely equivalent to a 2% PFC. This enables the PCC approach to pay off the initial expense relatively quickly, however in later years, as the funds have grown, the PFC element becomes dominant. This is the approach used by NEST to pay off the government loan that was used to set up NEST.

In this hypothetical provider, under the combination charge with a proportion of fund charge and flat-fee charge, each fund is charged enough through the FFC to cover the average ongoing cost within this hypothetical provider. The PFC cover the repayment of the initial expenses and the investment costs which,

are levied as a proportion of fund. This is an approach that aims to reduce cross-subsidies and to target the charges in a way that reflects the costs of the scheme.

The PFC approach takes longer to payback the initial expenses. The scheme must wait until the funds are large enough for a 0.45% fee to be of significant value. However thereafter, as the fund size continues to increase, the proportion of fund approach should generate higher returns than the two combination approaches. When the fund is large enough, the pure PFC may produce income which is larger than the other two approaches, which can be seen from the steeper and faster increasing slope upward of the PFC line (Chart 8).

The choice of charging structure may also reflect the relative maturity or profile of membership of the scheme. Consider the same hypothetical scheme as above, with £1million in start-up costs, the scheme grows from 5,000 new active members in their first year of operation to having around 60,000 pots by 2035. However, in this case we run scenarios where the proportion of active to deferred pots vary. The three scenarios are, set out in Table 1.

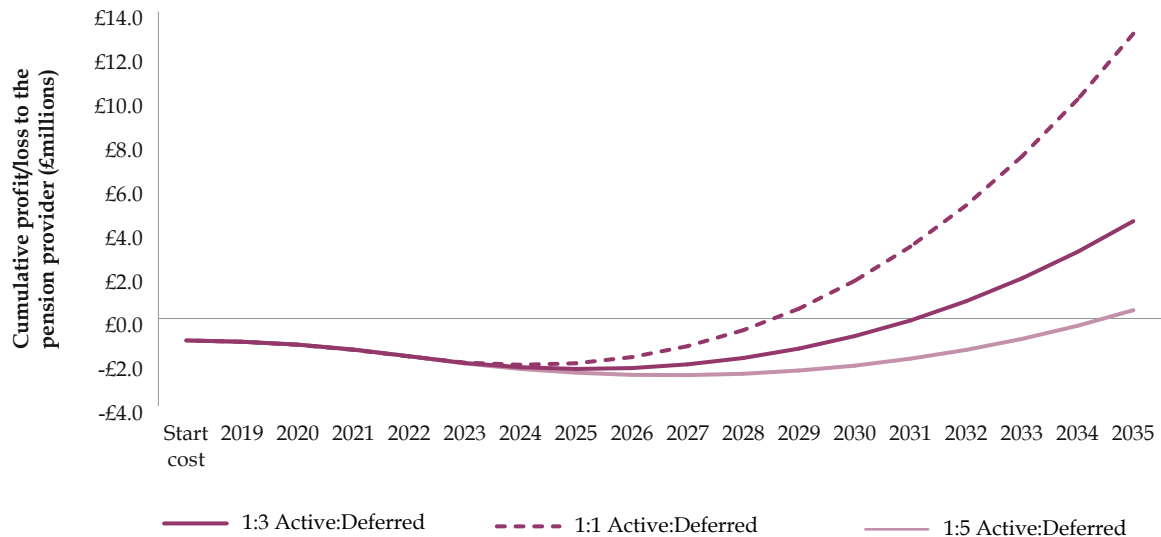
Table 1: Distribution of actives and deferreds in the three scenarios

Scenario	Number of actives in 2035	Number of deferreds in 2035
Baseline (1:3)	15,000	45,000
Low deferred (1:1)	30,000	30,000
High deferred (1:5)	10,000	50,000

Under the pure PFC the more deferred pots there are, the longer it takes to pay off the initial expense (Chart 9).

**Chart 9<sup>20</sup>**  
**Deferred members increase the time to breakeven for a proportion of fund charge scheme**

Cumulative surplus/loss for a new scheme with different proportions of deferred members by 2035 under a PFC of 0.45% only (crossing the horizontal zero is when the scheme breaks even) (2020 earnings terms)



The payback period under a pure PFC depends on the size of the assets under management (AUM). Active members are making contributions to their pension pot, which builds up the AUM. Deferred pots do not receive any new contributions, they are only growing through investment return. Eventually, in the high ratio of deferred pots scenario, the initial expense is paid back, but not until 2035, compared to the low deferred ratio scenario where the initial expense is paid back by 2029 and by 2035 the cumulative profits are at £13 million in 2020 earnings terms.

Chart 9 and the subsequent charts in this chapter predict a surplus by projecting forward the revenue from charges which grows faster than the growth of costs. In practice this surplus may fund any of:

- a return to the Scheme Funder,
- improvements to systems, scheme infrastructure and member services, or
- a reduction in the charges levied on members.

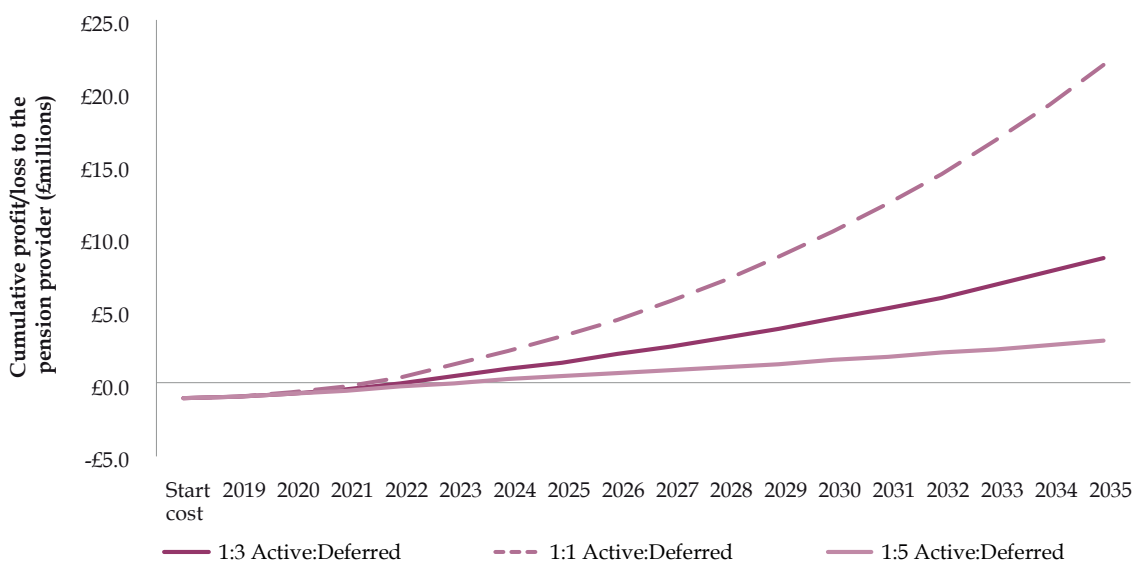
In a competitive marketplace with plentiful providers the division between these three will likely be driven by market forces.

With fewer active members, there are fewer, and therefore lower total, contributions. This means that the combination charge which uses

a proportion of contribution charge will provide lower income when there are more deferreds (Chart 10). A scheme which relies on a PCC is therefore susceptible to lower than anticipated income if they have more deferred members than expected.

**Chart 10<sup>21</sup>**  
**A contribution charge scheme is susceptible to an increase in deferred members**

Cumulative surplus/loss for a new scheme with different proportions of deferred members by 2035 under a combination PFC of 0.3% and PCC of 2% a year (crossing the horizontal zero is when the scheme breaks even) (2020 earnings terms)



However, in the fewer deferreds scenario, the total contributions are higher, so the contribution charge income is significant, leading to much higher profits.

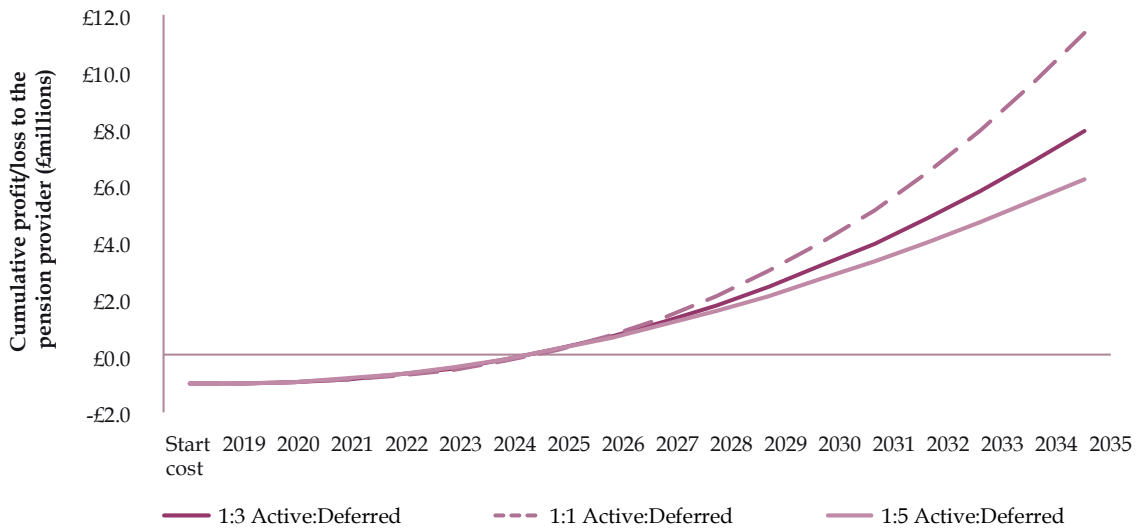
The flat-fee combination charge has a little less variability in the outcomes as a result of the proportion of pots that are deferred. This is

because each pot pays the same flat-fee whether deferred or not and the differences start to be more evident when the AUM are of significant size such that the proportion of fund charge becomes the dominant element of the total charge income. At that point the lower fund values of deferred schemes makes a difference between the outcomes (Chart 11).

Chart 11<sup>22</sup>

**A flat-fee scheme may be less seriously affected by an increase in deferred members**

Cumulative surplus/loss for a new scheme with different proportions of deferred members by 2035 under a combination PFC of 0.3% and FFC of £20 a year (crossing the horizontal zero is when the scheme breaks even) (2020 earnings terms)



Choosing an appropriate charging structure may help a pension provider avoid losses in the situation that they are faced with having lots of deferred pots, however the impact of deferred pots is a larger issue for the industry and is discussed in Chapter Five.

# Chapter Five: Challenges affecting the master trust industry

This Chapter considers the costs to the master trust industry of implementing and maintaining the pensions dashboard, the deferred cases and how they form a large and important piece of the solution for master trusts, and raises the possible impact that unforeseen external factors such as the 2020 COVID-19 outbreak might have on pension saving.

## Data cleansing exercises necessary for the implementation of pensions dashboards are likely to present additional costs for master trusts, both on an immediate and ongoing basis

There will always be a need for investment in the master trust to improve the pension scheme, or as a result of regulatory or legislative requirements. There are currently a set of known future costs, that are very likely; the costs associated with preparing the scheme to be ready and compliant for the pensions dashboard. The pensions dashboard is an initiative that aims to enable people to have information about all of their pension savings in one place.

The cost of dashboards to the master trust industry is difficult to accurately predict. The Department for Work and Pensions (DWP)

provided cost estimates to the Pensions Bill 2020 Impact Assessment.<sup>23</sup> According to the DWP calculations, large schemes would face implementation costs of around £200,000 each; and medium size schemes face implementation costs of £75,000 each, along with medium sized schemes also having to share with administrators the costs of £100,000 per administrator.

Assuming that 7 of the current 38 master trusts are classified as large (more than 100 members), and that the remaining 31 are medium sized; with, on average, each administrator serving two master trusts, the implementation cost to the master trust industry as a whole may be around £5.3 million. By 2025 there are projected<sup>24</sup> to be around 24 million pots in master trusts, this works out to be around £0.22 a pot.

<sup>23</sup> DWP (2019) Pension Dashboards Impact Assessment (Annex H to Impact Assessment of Pensions Bill 2020)

<sup>24</sup> PPI modelling

Ongoing costs are also set out in the Impact Assessment, at around £100,000 a scheme each year. This would suggest ongoing costs to the master trust industry of around £3.8 million a year, or around £0.16 a pot.

The DWP uses a wide range for sensitivity for some of their assumptions. Using the largest sensitivity in the document, a range of +/- 90%, would lead to implementation costs of between £0.5 million to £10 million, and ongoing costs in the range of £0.4 million to £7.2 million a year.

**Small pots belonging to deferred members present a challenge for master trusts’ cost efficiency, an issue that is likely to grow in importance alongside increased job mobility**

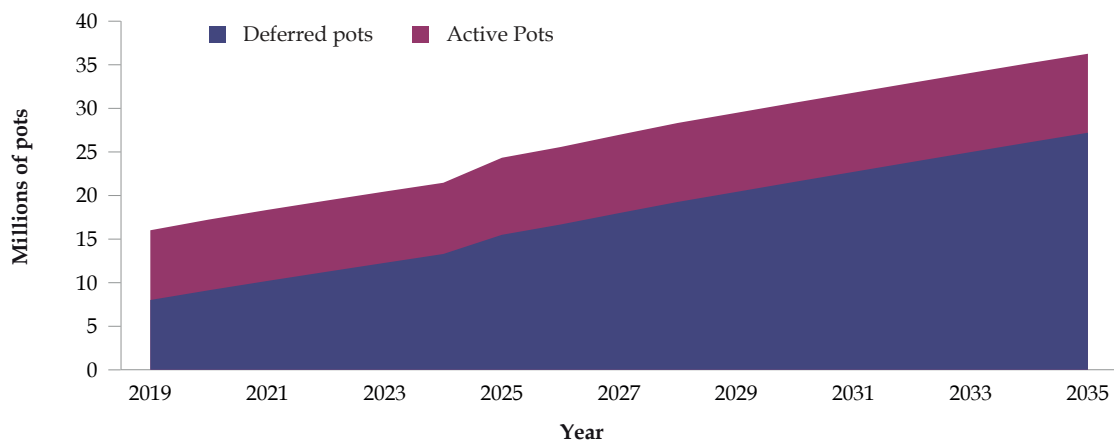
Small deferred pots are costly and inefficient to the provider. Under the automatic enrolment

system small pots are likely to arise for most employees. Automatic enrolment requires employers to enrol their qualifying<sup>25</sup> employees in a pension scheme. Employees save into their employer’s nominated pension scheme until they move employment. When people move employment, the pot with their previous employer becomes inactive.

Job mobility research suggests that people might have on average 11 jobs during their working life,<sup>26</sup> this would mean they may have 11 different incidences of saving into a pension scheme. They may well have more than one pension with the same provider, especially in the case that a provider specialises in a particular sector, and therefore multiple employers use the same provider. But even the provider may not routinely consolidate pensions belonging to the same person.

**Chart 12<sup>27</sup>**  
**Without policy change the number of deferred pots could increase from 8m to 27m by 2035**

Projected number of pots among master trust schemes by year, by deferred and active pots, without policy change



Each individual may be expected to have a few pension pots whether all with different providers, some consolidated within a provider and perhaps some unconsolidated within a provider (Chart 12). From the individual’s point of view, charges could deplete the value of the scheme, especially a scheme they were enrolled into during a short-term job early in their career. For the provider, there is inefficiency in paying staff to administer multiple pots that

belong to the same person, there is also the risk of poor customer satisfaction if their pot has been depleted due to charges applying over many years.

In a master trust that uses a proportion of fund charge, smaller pots are subsidised by larger pots. Inactive pots tend to be smaller than active pots. The increase in the ratio of inactive pots to active pots increases the extent to which active

25 Qualifying criteria includes meeting the earnings trigger amount (currently £10,000) and being over the minimum age (currently age 22)

26 DWP (2010)

27 PPI modelling



pots may need to support the inactive pots. For example, where there is an equal number of active and deferred pots, if the average inactive pot is £500, then, in order to subsidise

the inactive pot, the average active pot has to be around £10,400. As the ratio of inactive pots increases, so does the size of the active pots to support them (Table 2).

Table 2: Size of active pot required to cross subsidise growth in number of inactive pots

Year	Number of inactive pots to each active pot	Size of average active pot required to support inactive pots
2019	1	£10,400
2023	1.5	£12,300
2027	2	£14,200
2031	2.5	£16,100
2035	3	£18,000

The increase in the number of inactive pots, along with potential policy options for mitigation are explored in more detail in the PPI's report "Deferred Pensioners: Defusing the pensions time bomb".<sup>28</sup> That report sets out options to consolidate deferred pots but there would also be cost implications of the potential options. A full analysis of the costs of the options set out in the paper is outside the scope of this report. However, there would likely be short-term costs arising from the consolidation of deferred pots. For example, in the case of automatically transferring to a new employer's scheme, there would be costs associated with making updates to the IT system, an increased administrative burden, and there is a cost associated with making the transfer to another master trust. In the short-term, there may be a net cost associated with the measure, but in the medium to long-term, the reduction in the number of deferred pots would create a net cost saving in the industry as there are fewer inactive pots to manage.

**While the full impact of COVID-19 on pensions is not yet certain, reductions in overall contribution levels as a result of increased unemployment and volatility in the stock market are likely to impact master trusts' income from charges, at least in the short-term**

The outbreak of COVID-19 has had a disruption on the working and employment situation for many people. Some employees have been

furloughed, others are able to work from home. For employees that are working from home, their employee and employer contributions to pension schemes operate exactly as they would if the employee were at work. For employees on furlough, the pension contributions can be claimed through the Coronavirus Job Retention Scheme,<sup>29</sup> however, the support for pension contributions is due to be withdrawn on 31 July 2020, following that, employers will have to make the pension contributions themselves. Industry indicates that, so far, the contributions have continued into master trust schemes.

Further impact of COVID-19 is unclear. The response to COVID-19 has caused significant changes to the working patterns and shopping habits of people. It is unknown what impact this could have on future working patterns, as people are accustomed to working from home, or are perhaps used to having meetings over video chat rather than in person, this could have a lasting benefit for companies if working from home continues. Other industries may be permanently negatively affected. For example, changes to shopping habits may accelerate physical store closures. This could affect unemployment levels and economic outcomes.

28 PPI (2020)

29 <https://www.gov.uk/guidance/claim-for-wage-costs-through-the-coronavirus-job-retention-scheme>

Estimates of the economic impact have informed a set of COVID-19 scenarios. The COVID-19 scenarios considered are:

- Membership of the scheme is affected by a short-term increase in unemployment and employees opting-out or ceasing to make contributions to the scheme. Which combined, result in a fall in active participation in 2021 of 12% compared to the baseline, but trending back to baseline levels by 2024.
- In addition to the membership impact, there is a fall in the value of equities resulting in the funds under management losing 5% of their value in 2020.

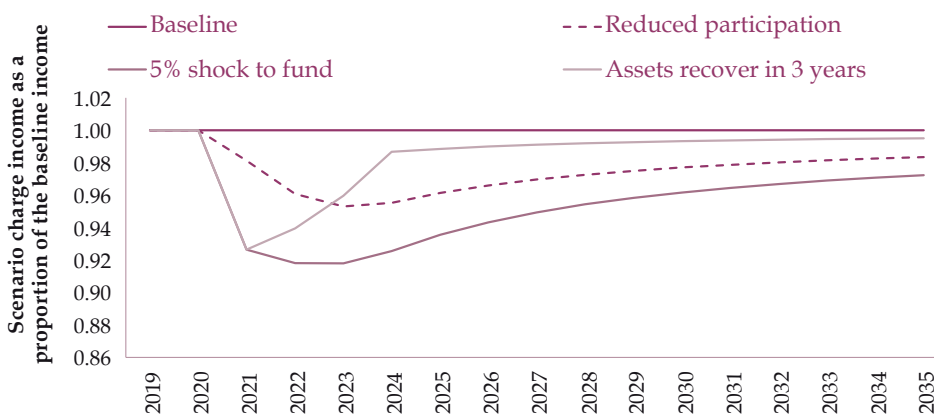
- In addition to the membership impact, there is a fall in the value of equities resulting in the funds under management losing 5% of their value in 2020, however, over the following three years assets recover and return to the projected values under the baseline scenario.

These scenarios are cumulative, each subsequent scenario also contains the elements of the previous scenario.

The impact of these scenarios on charge income has been modelled (Chart 13).

**Chart 13<sup>30</sup>**  
**COVID-19 could affect short term income from charges**

Proportional impact on charge income of COVID-19 under scenarios where opt outs, asset values are affected



All scenarios see a shock and then some eventual recovery. However, the recovery is not complete in any of the modelled scenarios. For example, by 2035 the impact of the three years of reduced participation is that fund charges are 2% lower than they would otherwise have been.

In the shock to fund scenario, the one year of negative returns compounded with the reduced participation, reduces the charge income by 8% in 2023. The assets that are in the fund in 2020 are assumed to continue to be worth 5% less than under the baseline run, however, as more contributions are made, building up the fund so that the proportional impact of the 2020 assets is lessened over time. By 2035 the charges from the fund remain 3% lower than under the baseline run.

The third scenario models a market correction of the shock to the fund, on top of the reduced participation. The asset returns in the three years after the initial shock are higher than they were under the baseline run, as the market recovers and corrects for the shock. This also means that any contributions made during the correction period receive higher returns than assumed under the baseline run. This enables the fund to perform better than the reduced participation only scenario.

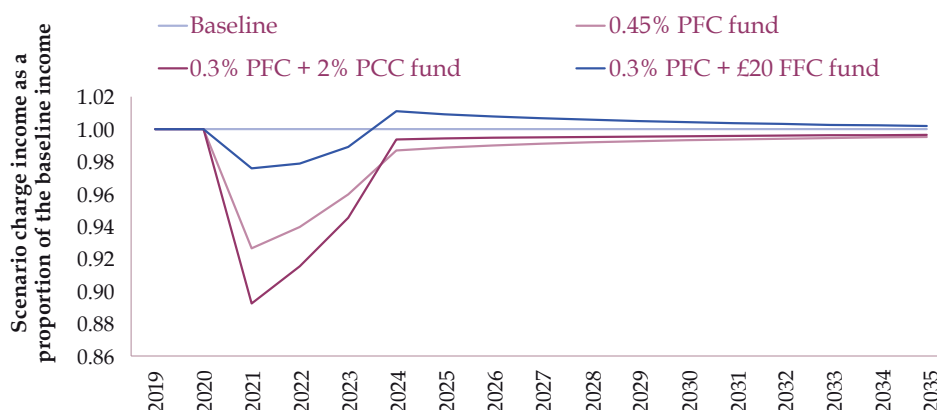
**The impact on COVID-19 may depend on charging structures**

The charge income received in the wake of COVID 19 may depend on the type of charging structure that the scheme has in place (Chart 14).

30 PPI modelling

Chart 14<sup>31</sup>**Charging structure could affect how schemes fair under COVID-19**

Proportional impact on charge income of COVID-19 for schemes with different charging structures where opt outs, asset values are affected



The analysis for Chart 14 assumes the third cumulative COVID-19 scenario where unemployment increases in the short-term, the assets fall in value, but there is a recovery over the three following years.

A scheme with a pure proportion of fund charge (PFC) sees a shock to the assets under management (AUM), leading to an initial fall in the charge income, however, as the market recovers the assets rise and the charge income starts to recover also.

The scheme with a proportion of contribution charge (PCC) see a bigger impact initially, because it is more immediately affected by the increase in unemployment. Higher unemployment leads fewer active members. Schemes with the PCC see a reduction in asset values and also a reduction in contribution charge income.

The scheme with a flat-fee charge (FFC), has fewer active members joining, so fewer pots to charge. However, the existing pots that would be active in the non-COVID scenario become deferred, so they still exist in some form and are subject to the flat-fee. As such they are not as badly affected as the schemes with the PCC. They also have a smaller portion of their income coming from proportion of fund charges than the pure PFC scheme. As a result the scheme with a combination charge consisting of proportion of fund and flat-fee charges does better in this scenario than the other schemes.

The costs associated with COVID-19 are just one of the costs that may loom on the horizon for master trust pension schemes. Other potential shocks, including the implementation of the dashboard, may also increase the costs, or reduce

the charge income, for master trusts. They must then be able to raise money from financial backers, while being able to demonstrate that they are a worthwhile investment to make.

### The future of master trust provision contains challenges and opportunities for master trusts

Achieving charging structures and a charging cap that deliver financial stability and ensure that all members achieve a good outcome. Both outcomes are mutually beneficial, strong master trusts are more able to provide good outcomes for members and members who do well out of saving will be more likely to continue saving and to achieve larger pots. This may necessitate further consolidation of master trust schemes.

The issue of deferred members looms large. To solve the issue of the proliferation of deferred member pots, especially small pots, will require finding ways to re-unite members with their money, and possibly consolidate pots, within and across providers.

Implementation of the 2017 Automatic Enrolment Review will bring more people into pension savings as the minimum age is reduced from 22 to 18, and savings based on contributions based on salary without a lower band will accelerate the build-up of assets under management. This may enable master trusts to break even sooner.

The impact and duration of effect that COVID-19 and Brexit might have is currently unknown, but could affect both employment and investment markets.

31 PPI modelling

## Appendix One: the Charge Cap

Under the 2015 charge cap requirements, only three types of charging structure may be used in the default arrangements of qualifying schemes. These are subject to different charge limits:

- a single percentage charge – capped at 0.75 per cent of funds under management
- a combination of a contribution charge plus a percentage of funds under management charge – permissible combinations are shown in the table below:

Contribution percentage charge rate	Percentage of funds under management rate
1% or lower	0.6%
Higher than 1% but no higher than 2%	0.5%
Higher than 2% but no higher than 2.5%	0.4%

- a combination of a flat-fee plus a percentage of funds under management charge – permissible combinations are below:

Flat-fee charge (£ per year)	Percentage of funds under management rate
£10 or less	0.6%
More than £10 but no more than £20	0.5%
More than £20 but no more than £25	0.4%

These charge limits apply at member level – that means that each relevant member must not be subject to a charge in excess of the limits above.

# Appendix Two: Technical Appendix

The modelling for this report involves the projection of Defined Contribution (DC) pension saving of the master trust industry considering both an individual's outcomes and the outcomes of the industry in aggregate. There have been a number of simplifying assumptions around the pensions industry which are outlined below, and the baseline scenario assumptions are used except where stated explicitly in the report. The application of the policy interventions is outlined below.

## Key reported metrics

### Annual costs

This is the annual cost to the provider to administer the pension scheme. It includes all costs associated with the running of the scheme including administrative expenses, investment fees (generally paid to an investment manager) and other costs associated with the business such as servicing debt. It is presented in current (2020) earnings terms.

### Annual charges

This is the annual charge paid by the member to the provider. It is presented in current (2020) earnings terms.

### Assumptions: Pension scheme membership

#### Starting conditions

The number and size of pots in 2019 is based upon the trustee and other financial reports of major master trusts in the UK. Where reported figures are not available for particular providers, industry averages have been assumed. These figures are aligned with The Pension Regulator's own published data on the master trust market.<sup>32</sup> This identifies the number of active pots, the number of deferred pots and the funds under management. The publications sourced are shown in the table below:

Appendix Table 1: Publications used for PPI modelling

Master trust provider	Publications sourced
NEST	NEST Scheme Annual Report and Accounts 2016/17, 2017/18, 2018/19 NEST Corporate Annual Report and Accounts 2016/17, 2017/18, 2018/19
The People's Pension	The People's Pension Scheme Annual report and financial statements 2017/18, 2018/19 B&CE Holdings Limited Annual report and financial statements 2016/17, 2018/19
NOW: Pensions	Now: Pensions Trust Annual Report and Financial Statements 2016/17, 2017/18, 2018/19
Smart Pension	Smart Pension Limited Financial Statements 2018/19
Legal and General	Legal & General WorkSave Mastertrust (RAS and Non-RAS) Annual report 2018/19

32 TPR (2019)

### Projection

The number of active pots is assumed to grow in line with the working age population. This is assumed to be from age 22 to State Pension age (Spa) initially, and from age 18 to SpA from 2025, assuming that the recommendations of the automatic enrolment review are enacted. This implicitly assumes that opt-out rates continue to remain steady and that the portion of workplace pensions serviced by master trusts is steady.

- Working age population projections are taken from the ONS.<sup>33</sup>
- Steady opt-out rates is based upon experience observed by DWP.<sup>34</sup>

The number of deferred pots is assumed to increase to three times the number of active pots by 2035. This reflects the size of the provider market and job churn amongst the workforce.

### Assumptions: Cost base

The cost of administering schemes each year is based upon the total costs incurred by providers and reported in their accounts

(Appendix table 1), alongside confidential interviews with the providers and regulator including validation of these assumptions. The assumptions used were:

- Investment related expense of 0.15% of assets under management (AUM).
- Additional administrative costs of £19.80 per active pot per year and £13.00 per deferred pot. These costs are assumed to increase in line with projected earnings (taken from OBR determinants<sup>35</sup>).

### Assumptions: Charging structures

For simplicity, a uniform charging structure has been applied. This consists of a proportion of fund charge and an additional fixed charge. This structure reflects the current state of the market (most large master trusts charge a combination of a fixed fee and proportion of fund charge), with the notable exception of NEST which charges a contribution based fee instead of a fixed fee. The charge is therefore representative of the market and is not intended to reflect any particular provider.

### Market assumptions

Growth in workforce	It is assumed that the workforce grows in line with growth of population between age 18 and SpA. <ul style="list-style-type: none"> <li>• This assumes that employment levels remain constant.</li> <li>• We will use ONS population projections to calculate population growth.</li> </ul>
Growth in automatically enrolled workforce	<ul style="list-style-type: none"> <li>• It is assumed that, over time, all the workforce that are in pension schemes are active members of automatic enrolment schemes - except public sector and opt-outs.</li> <li>• It is further assumed that private sector workforce stays at same proportion of workforce. And that opt-outs are at the same level as current.</li> </ul>
Earnings growth	In line with OBR projections, trending to 3.8% in the long-term.
Number of active members of automatic enrolment schemes	It is assumed that the total number of actives in aggregate is the same as the overall auto enrolled workforce (less public sector and opt-outs, as above).
Number of deferred members of automatic enrolment schemes	In 2019 the total number of deferreds appears to be roughly equal to total actives. It is assumed that this will grow in future as people have deferred pots with different providers from different periods of employment. It will also be assumed that the number of deferred pots increases from the same number as actives in 2019 to three times the number of actives by 2035.
Contribution levels	OPSS 2018 suggested that the contribution rate was 5% in 2018 (which was the minimum contribution rate, but applied to whole salary). 2019 figures have not yet been released, but we might assume that the pattern stays the same, in which case we would use 8% total contribution.

33 ONS (2019)  
 34 DWP (2020)  
 35 OBR (2020)

## Scheme assumptions

<b>Average scheme management charge</b>	<b>0.45% of assets</b>
Alternative charging structure for hypothetical scheme (proportion of fund plus contribution charge)	0.30% of assets + 2% of contributions
Alternative charging structure for hypothetical scheme (proportion of fund plus flat-fee charge)	0.30% of assets + £20 a year
Actives	50% of the number of pots in 2019
Average active pot size	£1,300 in 2019
Cost of administration of an active pot	£19.60 per year
Deferred	50% of the number of pots in 2019 75% of the number of pots in 2035
Average pot size	£500 in 2019
Cost of administration of a deferred pot	£13 a year

## Investment fund

<b>Asset Class</b>	<b>Asset proportion</b>	<b>Asset return</b>
Equity	50%	7%
Bond	30%	4%
Cash	5%	4%
Other	5%	7%

## Income and expenditure assumptions

Admin cost growth	It is assumed that admin costs are largely per-pot management, growth is in line with number of pots and per pot cost growth in line with assumed earnings growth.
Asset charge level	We assume that the investment management asset charge is an AMC of, on average 15 basis points overall. This is in addition to the cost of administering the pot.

## Impact of COVID-19 scenario (not baseline)

Shock of investment return due to COVID-19	Initial reduction in AUM, subsequent recovery. Investment assumptions are based on OBR long-term forecasts.
Shock to employment levels due to COVID-19	OBR suggest that 2020 unemployment rates will increase from around 4% to 10% during the year, before falling back to around 7.5% what will happen in the middle to long term.
Shock to participation due to COVID-19	COVID-19 scenario with higher opt-out/cessation at 15%.

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