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SMALL POTS: WHAT THEY ARE AND WHY THEY MATTER

Small pots: what they are and why they matter

This document is intended to support the DWP Small Pots Working Group which has been established with the remit to provide interim recommendations on the priority option or combination of options to deal with small deferred member pots to inform subsequent work. It summarises research recently conducted by the Pensions Policy Institute (PPI), and published in the report: "Policy options for tackling the growing number of deferred members with small pots" sponsored by NOW: Pensions. This Briefing sets out the potential problems associated with small deferred member pots, how policy solutions to these could be approached and the trade-offs that need to be considered.

What is a “deferred member”?

A “deferred member” is an individual who has pension savings managed by a pension provider or employer, to which they and their employer are no longer contributing. These pension savings are considered to be a “deferred pension pot”, with “pot” referring to the amount of money held in the pension savings account at any given time. A member may defer because they have moved jobs, and therefore no longer have access to the pension scheme used by their employer. Others may stop contributing to their pension without moving jobs because of issues of affordability, or because they intended to opt out of saving through automatic enrolment but missed the one-month opt-out window.

Some members may stop contributing because they fall below the earnings threshold for contributions during a particular period (for example, those in casual work or on zero-hour contracts). These people may resume contributions once their earnings exceed the threshold and should not therefore, be considered to be “deferred” members.

Why do small deferred member pots matter?

A small pot held by an "active" member, who is still contributing to their pot, is of less concern to policy-makers because, as a result of ongoing contributions, these pots are likely to grow to a size where they will be more likely to provide a long-term financial benefit to the member and the provider.

However, small pots held by deferred members can represent an ongoing financial risk to the member as these pots may be:

- Eroded by charges and potentially reduced to £0.
- Too small to contribute in any meaningful way to retirement income.
- 'Lost' over time, due to members forgetting they own the pot and providers l losing track of members' latest addresses.
- Could act as a disincentive to later life planning, rather than put towards retirement income products.

For providers, managing a large number of small deferred pots:

- Could threaten financial sustainability, as providers may not receive a sufficient amount in charges to cover administration costs.

How small is a small pot?

There is no precise value which can be used to judge whether a pot is "small". The values of small pots will vary over time and differ between people based on their circumstances and other factors such as scheme charging structure. A small pot is, rather, shorthand for a pot which, by the nature of its size and the circumstances of its management, is unlikely to provide a significant financial benefit to its owner. Small pots also pose financial difficulties to providers, who may face a choice between charging the member less than the provider pays in management costs, or charging the member an amount which covers costs, but depletes the pot by more than the pot gains in investment returns.

Financial difficulties for members

Small deferred member pots will be eroded over time by charges which include a flat-fee. Charging structures which include a flat-fee alongside a percentage Annual Management Charge (AMC are a common charging approach within master trust schemes, which contain a large proportion of those automatically enrolled into pension schemes.

A £100 pot, deferred at age 22, with an annual flat-fee charge of £20 and an AMC of 0.25% would be eroded to zero before the member reaches State Pension age (age 68. A pot of £500, deferred at age 22 would be worth around £100 by age 68 under this charge structure. [1]

Financial difficulties for providers

While an AMC only approach would not erode small pots, these pots would be financially unsustainable for providers who do not charge a flat-fee. If an AMC at the highest permissible rate was charged (0.75% [2], the costs associated with running a scheme, with no additional flat-fee, would require an average pot size of around £2,300 for the provider to breakeven (to be spending less or the same amount on administering the pot as the member pays in fees).[3] When this is reduced to nearer the industry average AMC of 0.5% or equivalent, the required average pot size to breakeven grows to just under £4,000. Small pots, which make it difficult for providers to breakeven, will need to be cross-subsidised by members with larger pots. These cross-subsidies reduce the return for those with larger pots.

1. Baker et. al. (PPI) (2020) Policy options for tackling the growing number of deferred members with small pots

2. PPI modelling assumes investment costs of 0.15%

3. Based on PPI analysis of master trust accounts

Why are there so many small deferred member pots?

Prior to automatic enrolment, deferred pots made up a much smaller proportion of workplace pension pots than they do today. While even prior to automatic enrolment, small deferred pots were not ideal for members and providers, they were likely to form a smaller proportion of an individual's pension portfolio and providers will have found it easier to subsidise management costs (either from profits or through charges on other members.

The introduction of automatic enrolment has led to a rapid increase in the number of small deferred pots. This increase is a function of the way the automatic enrolment policy works, as employers are responsible for choosing a qualifying pension scheme in which to enrol their employees.

Many people who have been automatically enrolled have accrued deferred pots as a result of moving jobs, and being automatically enrolled into a new scheme, effectively leaving their old pot behind.

As people are likely to change jobs several times during their working lives (people could have somewhere between 6 and 12 jobs in their lifetimes on average)[4] they could accrue several small pots through changing jobs.

Sometimes people are automatically enrolled by their new employer into a pension scheme where they already have a deferred pot – in these cases, some providers, for example NEST, automatically reunite the member with their former pot. However, this is not the case for all schemes.

Some small pots are also generated when people who intend to opt out miss the one-month window and cease saving at a later date. In these cases, they cannot have their contributions returned and will leave a pot containing only a few months' worth of contributions. These are often referred to as "micro-pots".

4. https://www.recruitment-international.co.uk/blog/2017/11/millennials-likely-to-have-12-jobs-in-their-working-lives-research-finds

What type of scheme holds the majority of small deferred member pots?

Prior to automatic enrolment, many employees with higher incomes were already saving into a workplace pension through either a Defined Benefit scheme or a contract-based scheme with a third-party insurer. The majority of those automatically enrolled joined a master trust scheme. Those joining a master trust scheme are more likely to be in the automatic enrolment target group of low earners and more likely to change jobs frequently.[5] As a result, the master trust universe holds the majority of small, deferred member pots, which are not generally consolidated within or between schemes. This Briefing focusses mainly on data from master trust schemes and issues concerning these schemes and their members, though most of the concerns and policies could also affect and benefit members of personal pension schemes and single employer trusts.

5. Silcock et. al (PPI) (2019) The DC Future Book: in association with Columbia Threadneedle Investments

What is the scale of the problem?

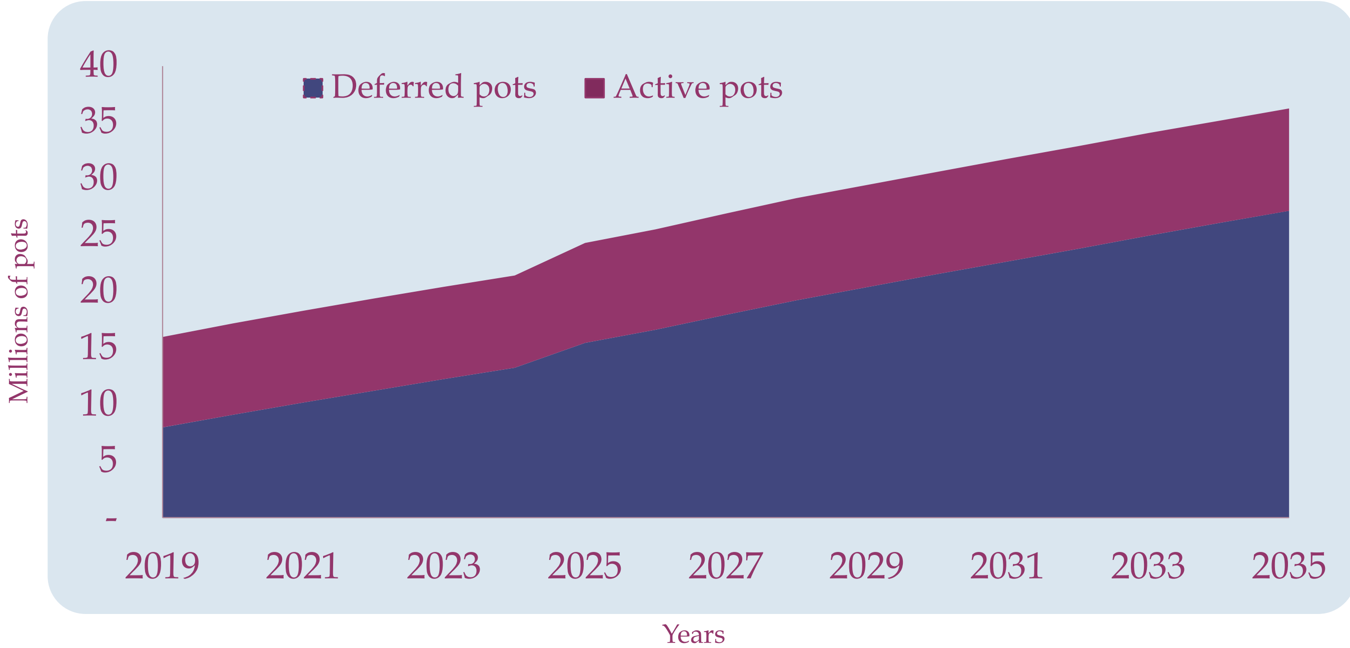
Given the increasing flexibility of the labour market, and the automatic enrolment policy, the proportion of deferred pots will increase as people change jobs (and generally switch providers)[6] throughout their working lives. The number of small pots accrued would also increase as a result of the Government's ambition to reduce the minimum age of eligibility for automatic enrolment from age 22 to age 18 during the mid-2020s as this would bring more people into saving who are particularly likely to move jobs and work part-time or casually.[7] There are currently 8 million deferred pension pots and 8 million active pots in master trust schemes, which could increase to around 27 million deferred pension pots [8] and 9 million active pots by 2035 without intervention (Chart 1).

6. Some providers operate a scheme whereby returning members are automatically re-enrolled into their existing pot.
7. DWP (2017) Automatic enrolment review 2017: Maintaining the momentum
8. This estimate assumes no linking of pots where the member has returned to the same scheme.

Chart 1[9]

Without policy change the number of deferred pots could grow from 8m to 27m by 2035

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



9. PPI modelling

What can be done about small deferred member pots?

There are a variety of policy levers available for tackling small pots, such as requiring employers or pension providers to transfer or consolidate pots together. Altering charging structures could protect members from pot erosion and incentivise pension schemes to consolidate small pots, but is unlikely to resolve the problem as there may be barriers to consolidation across different pension schemes.

If pots are to remain financially sustainable for both members and providers, a more strategic policy-based approach, exploring options for pot consolidation, where small pots are grouped together into a single pot, is required. Though keeping charges reasonable, proportionate and transparent will always have an important impact on member outcomes. There are a number of methods for constructing a policy for consolidating both current and future pots.

What needs to be considered in developing policies for consolidating pots?

Policies designed to consolidate member pots will affect several key stakeholders:
Members: while overall, pot consolidation is likely to improve member outcomes, the design of the policy could include potential pitfalls. For example, a policy which includes the potential for members to save with a scheme that has higher charges, than several smaller charges could result in member disadvantage. Policies which encourage uncompetitive practices could also result in member disadvantage over the long-term.

Employers: policies which require employers to change the way they administer and pay pension contributions could result in employers spending resources on updating processes, and could potentially add complications into the automatic enrolment process going forward, which would have cost and resource implications for payroll providers and human resources.

Pension providers: policies which require pension providers to administer a higher number of transfers would add to the costs of administering schemes (often paid to third party administrators) and could result in higher charges for members. Policies which encourage schemes to compete for members could result in some schemes retaining the most profitable members while other schemes, who cannot afford to create bespoke offerings and marketing campaigns, may hold the majority of less profitable members, who will yield less income from charges and create difficulties for administering the scheme.

How might consolidation policies work?

Pot consolidation policies can be structured in many different ways, though there are three main policy foundations for pot consolidation:

1. **Pot follows member:** as members change jobs and are enrolled into new schemes, their previous pot is consolidated into their new pot
2. **Lifetime scheme:** members contribute into one pot throughout working life, despite their employers choice of scheme
3. **Consolidation of pots within schemes:** members with more than one pot in a scheme have these automatically consolidated

Each of the above foundation policies involves both potential benefits and potential drawbacks for members, employers and pension providers. These potential benefits and potential drawbacks are “policy trade-offs” which must be considered when designing and implementing policy.

What are the potential policy trade-offs?

Each of the above foundations can be structured in many different ways, and safeguards can be built in to tackle some of the main policy trade-offs. Policies which are currently under discussion include:

1. **Pot follows member:** the 'pot follows member' policy involves pots moving with a member as they change employers. A member-exchange policy, where schemes "trade" pots periodically, transferring deferred pots into a member's active scheme can also be used to simplify a pot follows member policy. While these policies would provide fairly comprehensive member coverage, and are not likely to increase the administrative burden on employers, there is the potential for members to be transferred into schemes with higher charging, and for a greater administrative burden on providers.
2. **Lifetime scheme:** a 'lifetime scheme' can be structured through several different ways, for example, through members staying with the first scheme they join, having a provider selected for them when they first start saving or for all pots to be sent to a pre-chosen scheme when deferred for a particular amount of time. These models allow for very comprehensive coverage, though they increase the administrative burden on employers, could end up with some schemes, who are chosen to be consolidators, gaining an unfair competitive advantage, could incentivise "cherry picking" of more profitable-seeming employees and employers and may require significant systemic change.
3. **Consolidation of pots within schemes:** 'within scheme consolidation' could be structured through individual schemes consolidating pots for any member who joins with an existing pot in that scheme. This policy model is fairly simple and would not significantly increase the administrative burden on employers or pension providers, however, it would provide less comprehensive coverage than the other two policy models. It could form part of a combination of solutions.

Which polices are under consideration?

PPI's report "Policy options for tackling the growing number of deferred members with small pots" explored the impact of several potential policies:

- 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.
- Same provider consolidation: returning members are re-enrolled into their deferred pot.

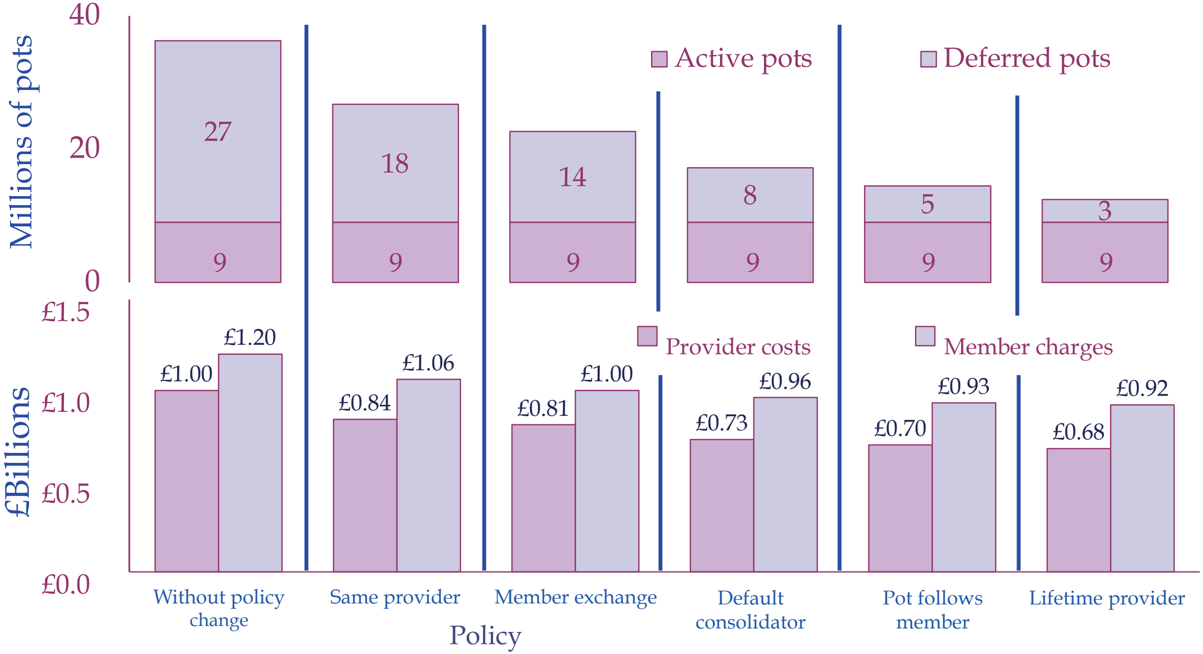
How might the above policies affect members and providers?

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. These results assume that policies apply to all pots regardless of size. If policies did not apply to all pots, then the results would be less significant. (Chart 2)

Chart 2 [10]

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



10. PPI modelling

What happens now?

There is a recognition within industry and Government that the issue of small deferred pots would benefit from being tackled. This is the genesis of the Department for Work and Pensions (DWP) Small Pots Working Group, which has been created, with the aim of developing consensus on the priority option or combination of options to address the challenge to help inform subsequent work by industry, delivery partners and Government. It will be crucial that any policy approach involves a consensus from all key stakeholders and political parties, as an effective approach could involve significant systemic change and the potential for increased costs being levied on providers and employers. (DWP)- Small Pots Working Group will need to weigh up the potential benefits and drawbacks of policy approaches in order to determine a way forward as an interim step, and work closely with interested parties in order to fully understand their views and concerns.

Questions for discussion

- How much of a potential risk/financial problem do small pots pose to members/providers? Are there available ways of quantifying these risks?
- How practical are the proposed solutions?/How much appetite is there within industry and Government?/Are there any other options beyond these?
- What are the barriers to implementing solutions?/How may these be overcome?

Glossary:

Active member: an individual who has pension savings managed by a pension provider or employer, to which they and their employer are contributing.

Annual Management Charge (AMC: an annual charge, generally a percentage of pot size, levied on members by pension providers to cover administration and investment costs.

Automatic enrolment: under automatic enrolment, eligible employees (earning £10,000pa or above and aged between 22 and State Pension age) are enrolled into a qualifying workplace pension scheme upon entering a new job and, with their employer, will contribute a minimum of 8% of band earnings (including tax relief. Employees have one calendar month in which to "opt out", and receive back any contributions that they have made, with employer contributions returning to the employer.

Deferred member: an individual who has pension savings managed by a pension provider or employer, to which they and their employer are no longer contributing.

Flat-fee: a flat charge (not a percentage levied on members by pension providers to cover administration costs.

Pension pot: the amount of money held in a pension savings account at any given time.

Policy trade-offs: the potential benefits and drawbacks to stakeholders which must be considered and weighed during policy design.

Pot consolidation: when small pots are grouped together into a single pot.

Small pension pot: a pot which, by the nature of its size and the circumstances of its management, is unlikely to provide a financial benefit to its owner.