PENSIONS POLICY INSTITUTE
PPI

Addressing the challenge of deferred small pots: a call for evidence

Response from the Pensions Policy Institute, March 2023

1. This is the Pensions Policy Institute's (PPI) response to the DWP's call for evidence on the challenge of deferred small pots.

2. The PPI promotes the study of pensions and other provision for retirement and old age. The PPI is unique as it is independent (no political bias or vested interest), focused and expert in the field, and takes a long-term perspective across all elements of the pensions system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

3. This submission does not address all consultation paper questions. Rather, the response takes the form of the findings of PPI research reports; Policy options for tackling the growing number of deferred members with small pots (2020)[1] and How have other countries dealt with small, deferred member pension pots? (2021)[2]. In addition, a copy of the PPI briefing note Small Pots: What they are and why they matter (2020) which formed the PPI's evidence to the small pots working group is attached. This covering letter sets out the main conclusions of these research reports as they relate to deferred small pots and consolidation. Please read the reports for the underlying analysis.

4. We would be happy to discuss the contents further if that would help the consultation.

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[1] Baker, M. et al (2020), Policy options for tackling the growing number of deferred members with small pots, PPI, London
[2] Silcock, D. (2021), How have other countries dealt with small, deferred member pension pots?, PPI, London

1. Relevant conclusions from the PPI report "Policy options for tackling the growing number of deferred members with small pots"

1.1 The two automated consolidation options discussed in the call for evidence, namely the default consolidator and pot-follows-member models were compared in this PPI report and the benefits and potential drawbacks of both were outlined. The following conclusions were derived from this analysis.

1.2 Member charges often erode small, deferred member pots over time and small pots can be uneconomic for providers to manage. Extra management costs may eventually be passed on to members through increased charges. Financial instability in master trust schemes, arising from too many small pots, could, in extreme circumstances result in trustees triggering an event to wind up the scheme. The number of deferred pension pots in the UK Defined Contribution (DC) master trust market is likely to rise from 8 million in 2020 to around 27 million in 2035. To effectively reduce the number of small, deferred pots, large scale policies will need to be introduced alongside more streamlined, uniform systems for payroll and pot transfers.

1.3 Increases in cost efficiency will result in greater reductions in costs for providers. Investment and administrative costs vary between providers based on many factors. While both models have the potential to reduce the aggregate level of provider costs, by reducing the number of pots which need to be administered, those who already pay lower than average costs will experience greater savings from each policy, and those who pay more will experience less. Under an assumption that provider admin costs are +/- 25%, of the baseline assumption (£19pa for an active pot and £13pa for a deferred pot), greater cost efficiency could result in annual master trust provider costs of around £640m per year under pot follows member and around £630m under the lifetime provider policy. With a starting level of higher than average costs, master trust provider cost savings could be less significant, with a total annual provider cost of around £840m per year under pot follows member and around £800m under the lifetime provider policy. As part of moves towards streamlining transfers and managing contributions, industry may want to explore ways of improving cost efficiency, particularly for providers who outsource their management to third parties.

1.4 Both models reduce the number of deferred pots, the charges that members pay, and the costs paid by providers, to some degree. However, they cannot be judged solely on their economic impact. Both models involve trade-offs and some present potential market difficulties such as giving particular schemes a competitive advantage or encouraging "cherry picking" of members who appear most profitable. The default consolidation model would also involve significant restructuring of the regulatory framework governing pension schemes.

1.5 An approach that combines aspects of several interventions, including the use of dashboards and increased member engagement, could help reduce small pots without giving undue advantage or disadvantage to any particular scheme or member. It is worth industry and policymakers reflecting on an approach that highlights the potential benefits attached to both models but contains functionality which reduces the potential for disadvantages. In order to successfully deliver a policy to reduce the number of small pots, a degree of consensus among consumer and employer representatives, industry, Government and regulators (all affected parties) will be necessary, and therefore all these groups should be included in the decision-making process.

1.6 Policy makers will need to consider the trade-offs for employers, members and providers involved in each policy. While the default consolidation and pot-follows-member models reduce the number of deferred pots, member charges and provider costs, they also have potential market drawbacks attached such as significant systemic change (default consolidation) or placing an increased burden on provider and employer administration (pot follows member).

2. Relevant conclusions from the PPI report "How have other countries dealt with small, deferred member pension pots?"

2.1 The PPI conducted three in-depth case studies on Australia, Ireland and the USA, and eight country profiles on Belgium, Chile, Denmark, Israel, Mexico, New Zealand, Norway and Sweden in order to understand what these countries could teach the UK about dealing with small, deferred member pots. The following conclusions are derived from these studies.

2.2 Without unique identification numbers for members, centralised transfer and consolidation systems are less effective. Without a unique identifier, a lot of resources are required to ensure that the correct pots are being put together. While the UK has some numbers which could potentially be developed to become national identity numbers, at this point, the lack of such a number is an impediment to the easy transference and consolidation of pension pots.

2.3 Systems of transfer and consolidation are easier for employers to comply with when there is a large central platform, or several connected platforms. Several countries use a clearing house and/or central data platform to manage the flow of contributions (Australia, Chile, Mexico, New Zealand, Sweden, USA; Ireland has one in development). The benefits of a central platform are that they reduce the administrative burden on employers, while also reducing the potential impact of employer error on the member, however, the set-up costs and time it takes to set up a central platform are significant. Regardless of approach, pension providers are likely to have to make some adjustments in order to use a central platform. Sharing the costs of adapting technology and the ongoing running costs between pension providers and Government will reduce the costs borne by members.

2.4 Unified data standards help to ensure a less costly and speedier transfer system. Many countries with a current national transfer and consolidation system, especially those with a lifetime provider model, (Australia, Chile, Mexico, New Zealand) require pension providers to submit data in a standardised format. Data standards allow a central system to easily collect data on individuals and pension schemes and to ensure that individual contributions are sent to the correct account. Data standards should also result in faster transfers and make regulatory enforcement and assessment of tax compliance easier.

2.5 Default consolidators are a useful adjunct to a pot follows member or lifetime provider system, in order to pick up smaller pots which may not be covered. While default consolidator vehicles have not been used as a sole policy in any of the countries investigated in this report (because countries tended to opt for more industry based models), Australia uses a default consolidator model for very small pots. Introducing a default consolidator alongside a pot follows member or lifetime provider model, is an effective way of ensuring that small pots which are not picked up by the larger system, are not unduly eroded by charges.

2.6 Pot follows member significantly reduces the number of small, deferred pots, however, pension providers will need to cover the transfer costs. Under a pot follows member model (Israel, Norway, USA) individuals generally save with their employer's chosen scheme (though in some models, e.g., Norway, members can choose to opt out of pot follows member into a lifetime provider model). However, as most employers who are automatically enrolling new members in the UK are using master trust schemes, a pot follows member model is unlikely to result in loss of members to these schemes. In a pot follows member scheme, pension providers will need to cover the extra costs of transferring pensions as people change jobs. However, the introduction of a central data platform, unique identity numbers and a national pension reporting data standard would lead to a significant reduction in transfer costs under this policy model.

2.7 Dashboards complement existing policies, increase the availability of information to members, and reduce the likelihood of lost pots. Australia, Denmark, Israel and Sweden all operate member dashboards in conjunction with other policies, though impact varies between countries based on the wider policy context. Evidence shows that dashboards are generally associated with higher levels of consolidation, particularly when accompanied by a communications campaign. Dashboards can also be united with comparative data on member charges and scheme returns (Australia) to support informed decision making. Comprehensive dashboards are good complements to existing policies, increasing the availability of information to members and reduce the likelihood of lost pots.

2.8 Lifetime providers are an effective way of consolidating pots and reducing transfer costs and administrative fees borne by members, but also require significant infrastructure adjustments and may result in loss of business for some schemes which provide a competitive service to members. Australia currently operates a lifetime provider-voluntary model and is moving to a lifetime provider-automatic model, Ireland is looking to introduce both an automatic and carousel lifetime provider model, and Chile, Mexico and New Zealand are all running lifetime provider-automatic models. The lifetime provider model is highly effective at reducing the number of pots and saving both provider and member costs, but requires significant investment in the development of both centralised and internal provider infrastructure and it will be important to consider how to ease the potential cost and resource investment of schemes. The lifetime provider model could result in a loss of business to some schemes who offer a competitive, low cost service, if others advertise and attract customers away from the schemes which their employer might have chosen. Loss of business to these schemes could harm existing members. The model could be designed with the inclusion of master trust schemes in mind. For example, authorised master trust schemes could be used as defaults, on a carousel basis, for those who do not make an active choice of pension provider.

2.9 Refunding small pots directly to members is likely to reduce future retirement incomes and predominantly impacts women, ethnic minorities and lower earners. Australia and the USA both operate small pot refund systems. However, Australia's system only refunds pots of less than AUS$200 (2020), (£111) or pots held by members who are aged 65 years or older. These pots are less likely to be consolidated with larger pots over time and therefore members holding these pots are less likely to lose out on pension savings if they receive a refund. On moving jobs, around 30% of US employees choose to take all of their 401(k) savings as a lump sum. In 2015, around US$92.4bn (£70.6bn) was lost due to full lump sum withdrawals and the US model sees significant funds, particularly those belonging to women, ethnic minorities and lower earners, leaving the pension saving system and ultimately reduces future retirement incomes.

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