PENSIONS POLICY INSTITUTE

PPI response to the Department for Work and Pensions' consultation on the Future of the defined contribution pension market: the case for greater consolidation

Response from the Pensions Policy Institute, July 2021

1. This is the Pensions Policy Institute's (PPI) response to the DWP's call for evidence on the Future of the defined contribution pension market: the case for greater consolidation

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 of the areas of focus of the consultation discussion paper. Rather, the response takes the form of two research reports concerning master trust pension schemes, one focussing on the problem of small pots resulting from deferred pensions, the other on the financial sustainability of master trust schemes. The reports were sponsored by NOW: Pensions and informed by a roundtable discussion with leading industry thinkers and scheme representatives, chaired by Chris Curry, PPI Director.

4. This covering letter sets out the main conclusions of the reports. Please read the reports for the underlying analysis.

5. We would be happy to discuss any of the contents further if that would help the consultation.

Main conclusions of the deferred pensions report

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

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

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

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

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

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

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

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

11. 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.

The deferred pensions report considers the potential impact on small pots of the following policy options:

- Dashboards: platforms that allow members to view all pots with different providers in one place and could facilitate more consolidation (though this is not the sole intention of dashboards, which are designed to enable informed pension decision-making).

* Same provider consolidation: returning members are re-enrolled into their deferred pot.
* Pot follows member: pots move with members to new employer's schemes.
* Member exchange: a form of pot follows member, which allows for the reassignment between schemes of all existing pots into the current active scheme.
* Lifetime provider: members remain with the same provider throughout their working life.
* Default consolidator: pots deferred for a year, transfer to a consolidator provider, with members being given an opportunity to opt out.

Main conclusions of the financial sustainability report

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

12. 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.

13. 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.

14. 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

15. 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.

16. 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.

17. 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.

Enclosures

The deferred pensions report is available here:
https://www.pensionspolicyinstitute.org.uk/sponsor-research/research-reports/2020/2020-07-23-policy-options-for-tackling-the-growing-number-of-deferred-members-with-small-pots/

The financial sustainability report is available here:
https://www.pensionspolicyinstitute.org.uk/sponsor-research/research-reports/2020/2020-08-27-financial-sustainability-of-master-trust-pension-schemes/